TAX INCENTIVES FOR INCREASING SAVINGS AND INVESTMENTS

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

MARCH 27 AND 28, 1990
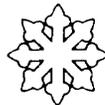
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COMMITTEE ON FINANCE

LLOYD BENTSEN, Texas, *Chairman*

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TAX INCENTIVES FOR INCREASING SAVINGS AND INVESTMENTS

TUESDAY, MARCH 27, 1990

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

The hearing was convened, pursuant to notice, at 11:12 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Also present: Senators Pryor, Packwood, and Roth.

[The press release announcing the hearing follows:]

[Press Release No. H-21, Mar. 20, 1990]

SENATOR BENTSEN ANNOUNCES HEARINGS ON SAVINGS AND INVESTMENT INCENTIVES; IRAs, CAPITAL GAINS AMONG PROPOSALS TO BE EXPLORED

WASHINGTON, DC—Senator Lloyd Bentsen (D., Texas), Chairman, announced Tuesday that the Finance Committee will hold hearings later this month on tax incentives for increasing savings and investment.

The hearings will be on Tuesday, March 27 at 11 a.m. and Wednesday, March 28, 1990 at 10 a.m. in Room SD-215 of the Dirksen Senate Office Building.

The March 27 hearing will examine savings trends in the United States and proposals to improve the low rate of personal savings.

The hearing on March 28 will focus on investment trends in the United States and the President's proposal to lower the tax rate on capital gains income.

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

The CHAIRMAN. The hearing will get under way.

We have a number of members who are not here, but we have a lot of old friends over there at the Joint Session reminiscing about Ike. So, with a conflict over where we would want to be, we think we'd better get under way.

I'll tell you one memory of Ike. I can recall being over there visiting with him in about 1950, I suppose it was, having lunch with him in Versailles. I was trying to talk him into running for President as a Democrat. Obviously, I only batted 500 percent on that one. But he was really quite an interesting and able man.

The other day I got a note from my granddaughter, 8 years old. She said, "I love you, Granddad," but she didn't mail it to me, she faxed it to me. [Laughter.]

Quite a machine, the fax, and I suppose part of the wave of the future; but I can't help but remember that it was invented in this country by Xerox, and now it is manufactured overseas by Xerox in Japan with a joint contract.

(1)

That's the same sort of problem that we have with the color TV in your living room, or the VCR that's beside it, or the microwave oven back in your kitchen, all of them invented in this country but almost all of them now manufactured overseas.

One of the the reasons, I think, is because interest rates are so high in this country, and it puts us at an enormous competitive disadvantage. If you have equal management and equal labor, but the cost of capital is so much lower in other countries, if it is 10 percent here and it is 8.5 in Germany and 6.25 in Japan, and that goes into the cost of building a new plant and its productivity, they have an enormous advantage over us.

So that is why it is important that we get savings rates up in this country. That is why it is important that we get this deficit down, because that is the greatest savings of all.

The Federal Government ought to be encouraging people to save. I have a proposal that has proven it will work. I want to bring back the Individual Retirement Account, the IRA, bring it out of retirement and expand it, to help encourage Americans to save to make two of the biggest investment of their lives, buying that first home or helping their kids have a college education.

The American people understand the IRA. They understand how it works, and it is a proven winner at increasing savings.

The President has proposed a new savings incentive called "The Family Savings Account," which gives taxpayers a break when they take the money out instead of a deduction at the very beginning.

The goals of my IRA proposal and the President's Family Savings Account are the same, to get national savings rates up. Tax incentives can help increase savings.

But I am going to make sure that if we enact incentives, they also promote new savings, and that we don't increase the Federal budget deficit in the short term or the long term.

Studies show that the deductible IRA is effective at increasing savings. It gives people an immediate deduction, one they would see every April 15th; but no one knows for sure that so-called "back-end IRA's" will work. I doubt that, for a working American family which is trying to make ends meet on a day-to-day basis, a promised tax break, and perhaps as late as the 21st century, is going to be enough incentive for a significant increase in savings.

The Family Savings Account is politically attractive, because it is sure cheaper right now than restoring the IRA. The Family Savings Account, because it is complete and permanent tax avoidance, costs big bucks down the road. With the IRA, though, everybody still pays their fair share.

Last year Secretary Brady, when he was talking about the difference in the two proposals, said, "The difference is, which generation pays it?"

Now, in the President's Budget, one out of every seven dollars goes to pay interest on the Federal debt. That is the personal income taxes of every American located west of the Mississippi. The Federal Government's debt held by the public is now well over $2 trillion, and growing. It is a big hole that has tripled over the last decade. Our budget, and its deficit, has been getting bigger and

bigger every year, and we have to enact proposals that won't trap our children and grandchildren into that hole.

We may have given up on the fax machine and the VCR to foreign manufacturers, but if we continue to spend beyond our means, before long we may be measuring the Federal budget deficit in yen. Increased savings will help us avoid that.

The IRA is a savings plan that should have never been retired, and I personally happen to think that that's the way we ought to go; but, obviously, we will also consider the President's proposal.

I defer to my friend Senator Packwood for any comment he might have.

OPENING STATEMENT OF BOB PACKWOOD, A U.S. SENATOR FROM OREGON

Senator PACKWOOD. MR. Chairman, thank you.

The longer I am on this committee and the longer I look at economic incentives we undertake—I am not sure if we ever know if they work or not—the more questionable I become about much of our economic knowledge.

Example: President Reagan is running for re-election in 1980. Inflation is running at 13 or 14 percent, interest rates are running 17–20 percent, and the budget deficit is $50–$60 billion. The Republican campaign in 1980 is, "The horrendous Carter deficit has caused these interest rates and inflation rates; elect us, and we'll reduce them. We get elected, the deficits go to $200 billion, but the interest rates come down." I don't understand why; economists told us that if the deficit went up, the interest rates would also go up.

A second example: The average personal savings rate is the most frequently quoted rate although a better measure of the total savings rate is the combination of personal savings rates with business savings rates. The average personal savings rate in the fifties and sixties was approximately 7 percent, and around 9 percent in the early seventies. That's the highest our personal savings rates have been since the end of World War II. I don't know what it may have been prior to that time.

And then in 1974 we passed ERISA, the Employment Retirement Income Security Act, and for the first time set up a limited IRA. It was the first of the IRA's. But during the late seventies the savings rate went down even though we had enacted IRA's.

In 1981, we expanded IRA's so that everybody could have one. The savings rate continued to decline until it finally bottomed out at its lowest point in 1986.

The 1986 Tax Reform Act didn't get rid of IRA's. As a matter of fact, most people can still buy them. The 1986 Act limited the use of tax deductible IRA's by high-income taxpayers. After the 1986 Act, the savings rate started up again. I don't understand why.

I find it interesting that the savings rate decreased during the time IRA's were created and continued to decrease after IRA's were expanded. But, when we limited the IRA's in 1986, the personal savings rate went up. Maybe there is a correlation, and maybe there isn't. But I am less sanguine about this subject and I know less about it than I thought I did.

I was on the Banking Committee for years when Senator Proxmire was chairman, and every January he would have an economist come. I think the fellow was from the University of Wisconsin, but I wouldn't swear to that; my recollection isn't clear. But he came every year for the 8 years I was on the committee.

Each January he would tell us what was going to happen in the ensuing year.

One January I read his testimony from the year before in which he had said that A-B-C would happen. During that year, it utterly had not happened at all. I mean, he wasn't even close.

So when he finished his testimony that year, I said, "Doctor, could I ask you a question?"

"Yes, of course, Senator."

"Last year you said A-B-C was going to happen."

"hat is correct."

"It has not happened."

"No."

"In fact, it utterly has not happened. Is that correct?"

"That is correct."

"Can you explain that?"

"Oh, yes," he said, "unforeseen intervening circumstances." [Laughter.]

"Well," I said, "any possibility in the coming year of unforeseen intervening circumstances?"

He said "No, Senator. We have got a pretty good handle on it now. You know what is going to happen," I asked?

He said, "Well, maybe."

So, if I take all of your testimony with just a grain of salt, it is just experience. I guess the old adage is right, "judgment comes from experience, and great judgment comes from bad experience."

I have voted for some things I absolutely knew would lead to a specific result that I wanted, but the expected result didn't happen.

So I may support these IRA's, but perhaps not with the full-throated enthusiasm of those on my right and left, and without necessarily the guarantee in my mind that, if we pass these, we know for sure the savings rate is going to go up because of them.

The CHAIRMAN. Senator Roth? For the rebuttal, I hope. [Laughter.]

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

Senator ROTH. Mr. Chairman, I congratulate you for holding these hearings today.

I think that how Americans save money is less important than the fact that they should save money.

I believe it is the responsibility of Congress to make the job of savings as attractive as possible for the American family.

I believe the issue of savings in this country has reached a crisis proportion. Young people have a hard time scraping together a down payment for that new house; families are finding it more and more difficult to save for their children's college education; and older Americans worry about their security as retirement approaches.

Now, what about the economic arguments for encouraging savings? The Japanese investment in this country has raised the dander of many Americans; yet, it is the ability of the Japanese to invest that is based on the ability of the Japanese people to save.

I think you and I agree, Mr. Chairman, that Americans must become a nation of savers if the United States is to meet the economic challenges ahead.

The ultimate goal of including any IRA legislation in a tax bill is to increase personal savings and to provide for retirement for the family.

I think there will be some very interesting statistics brought out during these hearings to show how much older Americans are becoming, and how much more important it is that they have savings to cushion the effects of living longer.

But increased savings is necessary for economic growth and competitiveness, as well as personal security. I think both of these goals are critical as we move into the new century.

In closing, let me say, Mr. Chairman, I hope that we can reach some kind of consensus as to approach. I am encouraged by the fact that you have come out with your proposal, that the Administration now is supporting a savings plan. It seems to me that the time is ripe for constructive action to promote personal savings.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator.

Mr. Secretary, we are pleased to have you, Secretary Gideon; and Secretary Jones, we are very pleased to have you.

STATEMENT OF HON. KENNETH W. GIDEON, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. GIDEON. Mr. Chairman and Members of the Committee:

I am pleased today to have this opportunity to discuss the role of tax incentives for personal saving, and in particular the Administration's Family Savings Account proposal. Sidney Jones, the Assistant Secretary of the Treasury for Economic Policy, is with me here today to discuss the effects of FSAs on personal savings.

In addition to FSAs, the President's budget contains two other proposals designed to address the nation's low rate of savings: the capital gains proposal, and the proposal to expand IRA's to include savings for a first home purchase.

All three proposals are included in the Administration's "Savings and Economic Growth Act" which has been introduced in the Senate by Senators Packwood, Dole, and Roth as S. 2071.

A number of legislative proposals have been made recently to modify current-law IRA's. The Administration's Savings and Economic Growth Act would permit penalty-free IRA withdrawals for first-time home purchases.

Also, under several expanded IRA proposals, an individual who contributes to an IRA may deduct the amount of that contribution that is deductible under current law plus 50 percent of the amount that is not deductible under current law, subject to the maximum-contribution limits that are in current law.

These proposals typically permit penalty-free withdrawals from IRA's for first-time home purchases and certain educational expenses.

However, IRA expansion proposals do not change the fundamental character of IRA's as vehicle dedicated to retirement savings, nor do they increase current-law limits for contributions by nonworking spouses.

The President's Family Savings Account is designed to provide an incentive for savings generally, not merely retirement savings.

Under the proposal, individuals may make nondeductible contributions to an FSA of up to $2500 per taxpayer. Unlike IRA's, there are no special limits on contributions by a nonworking spouse.

In order to target the savings incentive contributions that are allowed, only single persons with adjusted gross income below $60,000, those filing as heads of households and surviving spouses with adjusted gross income below $100,000, and married couples' joint returns with AGI below $120,000 are eligible.

These contributions will be allowed in addition to contributions by or for these individuals to other tax-favored retirement savings vehicles.

Although contributions to an FSA are nondeductible, earnings in the account accumulate tax-free. Furthermore, earnings can be withdrawn tax-free provided they are earnings on contributions held in the account for 7 years or more.

Withdrawals on earnings of contributions held in the account less than 7 years are included in gross income; and, in addition, withdrawals on earnings held in the account for less than 3 years are subject to a 10-percent early-withdrawal tax.

Besides the timing of the tax benefit, which is discussed in greater detail later in my statement, the principal differences between FSA and current-law deductible IRA's lie in the greater availability and flexibility of FSAs as a savings vehicle.

While it is appropriate to have a dedicated retirement savings vehicle such as an IRA, the need to increase the nation's personal savings rate calls for a vehicle that is available for more general types of savings, and that takes into account the differing savings needs of individuals.

For example, a young or middle-age couple may be unwilling to set aside savings in an IRA that cannot be withdrawn without adverse tax consequences until their retirement. Likewise, an older couple may be willing to save, even when they have reached the age when the mandatory-distribution rules discourage contributions to an IRA.

FSAs address these shortcomings in the current system by encouraging individuals to save without imposing the restrictions that are needed in a vehicle that is dedicated to retirement savings.

Because contributions need be held in the FSA for only 7 years to receive full tax benefits, individuals have far greater flexibility in structuring their savings through an FSA than through an IRA.

This increased flexibility is most apparent in the penalty provisions applicable to early withdrawals. While distributions from an IRA are generally subject to the penalty at any time before retire-

ment, death, or disability, distributions from an FSA are subject to penalty only within 3 years from the date of contribution.

In addition, the 10-percent penalty on IRA distributions applies to the entire amount of the distribution, except to tl.e extent the distribution consists of nondeductible contributions; while, at the same time, the 10-percent penalty on the FSA distribution applies only to the amount of earnings distributed.

This difference, both in the timing and severity of the penalties, means that savings in an FSA is a far less risky proposition for those whose savings goals are not limited to retirement needs.

Finally, the FSA encourages individuals to save who fall outside the current limits applicable to IRA's—the nonworking spouse, who is limited to a $250 contribution to an IRA, generally would have the opportunity to make the full $2,500 contribution to an FSA.

Contributions to an FSA are also permitted regardless of whether an individual is an active participant in an employer-sponsored retirement plan, in contrast to an IRA, where deductions are phased out for such individuals with AGIs above $25,000 for individuals and $40,000 for married taxpayers.

The AGI limits that do apply under an FSA are significantly higher than those imposed for current-law IRA's and take into account the special circumstances of heads of households, that are ignored under the current IRA regime.

After careful study of the various alternatives, the Administration has concluded that the FSA proposal would serve a broader range of savings needs than an expansion of the IRA program.

FSAs offer a more flexible vehicle for encouraging savings of all kinds by taxpayers in more diverse personal circumstances.

Expanded IRA proposals do not change the fundamental character of IRA's as vehicles dedicated to retirement savings, even when they permit more liberal withdrawals than under current law.

The Administration agrees that IRA's should not be diverted from their intended purpose of encouraging retirement savings, and for this reason designed FSAs as a savings incentive separate and apart from an IRA regime.

The FSA provides an affordable and effective savings incentive which can be accommodated within the budgetary constraints imposed under the Gramm-Rudman-Hollings Law.

The Treasury estimates that the revenue costs of the FSA proposal is $4.7 billion in the 1990-95 budget period; the Joint Committee estimate, of about $5 billion over 5 years, is quite similar.

IRA expansion proposals are significantly more expensive, often for significantly lower benefit levels. Over the long term, the FSA proposal is likely to be no more expensive, proportionate to the tax benefits conferred, than expanded IRA proposals when considered on a present-value basis. This is because of the essential revenue equivalency of current contribution deductions for savings incentives like IRA's and the earnings exemption of savings incentives like FSAs.

The static revenue cost of the proposal is due mainly to the switching of taxable assets into FSAs. Revenue is lost on the cumulative interest build-up that would otherwise be taxed. As more taxable assets are switched into FSAs, the revenue costs associated

with the proposal will increase due to the compounding of interest on new contributions, as well as interest compounding on existing balances.

We do take issue, however, with one statement that has been made in the Congressional Budget Office's report on the budget, that if a 10-percent taxable interest and dividend income were switched to FSAs, long-run revenue costs would reach $8 billion a year; and if 25 percent of taxable interest and dividend income were switched to FSAs, long-run revenue costs would reach $20 billion a year.

Such long-run estimates are based on numerous assumptions that may not be valid. The experience with IRA's does not support the CBO assumptions. To reach a revenue loss of $20 billion per year would require switching of $1 trillion of taxable assets into FSAs. However, since 1975 when IRA's first became available, only about $200 billion have been contributed to IRA's, and not all of those contributions resulted from switching of taxable assets.

Further, IRA's were more broadly available over much of this period than FSAs would be under the President's proposal. Thus, the $200 billion in cumulative IRA contributions since 1975 represent only about one-fifth as much asset-switching as the CBO assumed in its assumption.

We have provided a distribution table, attached as Figure 1 to my testimony, Mr. Chairman.

We are also aware of some concerns that have been raised regarding the effects of the SSA proposal on the tax-exempt bond market. However, our analysis suggests that FSAs will have at most a small impact on the tax-exempt bond market, for the following reasons:

First, some portions of FSA contributions should be new savings and, to that extent, will not compete at all with other investment vehicles.

Second, in 1988, holdings of tax-exempt bonds by individuals were only 55 percent of the total holdings of tax-exempt bonds; although, this year it has been growing.

Our analysis shows that only a third of individuals' holdings are by individuals that are eligible for the FSA program. Many of these individuals will not participate in FSAs or will not participate fully.

Assuming reasonable participation rates by those eligible who hold tax-exempt bonds, and taking into account the growing share of individuals' holdings, we estimate that only about 5 percent of the tax-exempt bond market would potentially be affected by the FSA program.

Third, past experience with IRA's, All-Saver Certificates, 401Ks, and other forms of tax-favored savings, indicates that municipal bonds have been able to compete effectively with savings incentives that are similar to the FSA.

Consequently, we conclude that the FSA program is unlikely to cause a material decrease in the purchase of tax-exempt bonds by individuals or to decrease the interest-rate spread between taxable and tax-exempt bonds.

Based on these factors, we strongly urge the Congress to enact the Family Savings Account proposal, as well as the other provisions of the Savings and Economic Growth Act.

Mr. Chairman, that concludes my formal statement. I would be happy to answer questions, either now or after Dr. Jones speaks.

The CHAIRMAN. Secretary Jones, did you anticipate and desire to testify?

Dr. JONES. I would like to make just two brief comments.

The CHAIRMAN. That will be fine.

Dr. JONES. And submit my testimony for the record.

The CHAIRMAN. Certainly.

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

STATEMENT OF HON. SIDNEY L. JONES, ASSISTANT SECRETARY FOR ECONOMIC POLICY, U.S. DEPARTMENT OF THE TREASURY

Dr. JONES. Senator Packwood's skepticism about simple relationships and economics is justified as you can see in Exhibit 1 at the back of my testimony. However, one of the few things of which we can be fairly certain is that countries that save and invest more tend to have higher economic growth rates. This has been demonstrated over a very extended period of time.

The second thing of which we can be rather certain, as shown in Exhibit 2 at the very end of the testimony, is that the U.S. gross saving rate has been very stable throughout the entire century with the exception of the Great Depression and the Second World War.

During the post-war period, that gross saving rate has averaged 16.5 percent of the Gross National Product. It has, however, eroded during the 1980's to approximately 14.1 percent of the Gross National Product.

The CHAIRMAN. What is the gross saving rate?

Dr. JONES. The "gross saving rate" is the rate before you take depreciation out; the "net saving rate" is the rate with depreciation taken out, and the base of the "net national product" rather than the "gross national product."

The difference between the 16.4 percent average saving rate throughout the post-wartime period and the 14.1 percent during the 1980's, for an economy of our size, is about $120 billion per year in lost savings. That is a dead-weight loss to what could be going into capital equipment, to technology, and to human-resource development.

In looking at the issue of savings and investment, I would like to emphasize that the number one issue is the Federal budget deficit. And looking at the erosion of the national saving rate during this period, it is not the result of personal savings nor is it the result of business saving; it is more than explained by the significant increase in the Federal budget deficit. So, in all that we do, by far the most important thing is to reduce the Federal budget deficit.

Finally, let me comment very briefly on the economic effects of the President's new proposal for the Family Savings Account.

In my testimony I cite a variety of advantages of this new account; but to me it has three particular advantages:

First of all, it is intended to change behavior. We often refer to the Japanese as having a high saving rate What is ignored is that historically they had a very low saving rate. In the inter-war period their saving rate was far below other countries. They changed that saving rate by adopting a different system of savings accounts after the Second World War.

Similarly, Canada has been able to change their saving rate in the 1970's, and it has now diverged from the U.S. system.

The British, last week, announced a new account. The acronym is TESSA; it is called a Tax Exempt Special Saving Account."

All of these savings accounts, incidentally, have much higher provisions for the amounts that can be included on a tax-enhanced basis than do our proposals.

The second advantage, and the most important advantage, to me, is that the FSA is simple and understandable. Most of our governmental programs cannot be understood without training in accounting or law and, as a result, the people tend to ignore them.

Finally, the advantages of the FSA include that there is not a long lock-in period. The 7-year timeframe gives the family flexibility in the use of their savings for a variety of purposes.

What the effect of the FSA accounts will be on savings is extremely difficult to estimate. We do have the record, however, of the IRA accounts, and for those accounts, in 1982, $28 billion went into IRA accounts; in 1983, $32 billion; in 1984, $35 billion; in 1986, $37.8 billion; in 1987 that figure declined to $14 billion or about 40 percent of the previous figures.

But it is difficult to determine whether the IRA contributions were incremental or not. The Council of Economic Advisors has done some careful estimates and has come to the conclusion that the new or incremental savings resulting from the Family Savings Account during the period 1990–94 would total about $40 billion; or, crudely, $5–10 billion of new incremental saving per year.

The CHAIRMAN. What years were those, Doctor?

Dr. JONES. 1990 to 1994, the 5-year period.

My own estimates, which are based on public opinion polls and then adjustments to reflect what people actually do, come to similar conclusions; that the amount of new saving, or incremental saving, probably varies somewhere between $5 to $10 billion per year.

If one uses a standard economic assumption that the new savings would flow directly into investment, and that it, in turn, would produce incremental Gross National Product at a fairly standard relationship, then it is our estimate and the estimate of the Council of Economic Advisors that during this introductory period the incremental economic growth resulting from that new saving would approximately equal the cost of the $4.7 or $5 billion per year estimates of revenue loss from the switching of accounts.

Therefore, initially, at least, we believe that the family savings account would not increase the Federal budget deficit, and that, as the effects of saving and investment resulted, the feedback effects would actually increase revenues and would reduce the Federal budget deficit.

Therefore, we feel that the Family Savings Account will change behavior, will encourage saving, and will actually, eventually, lead to increased revenues.

Thank you very much..

The CHAIRMAN. Thank you, Dr. Jones.

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

The CHAIRMAN. Mr. Gideon, I really don't follow the reasoning of your statement on the tax-exempt bonds. As I look at the situation, with what you would be able to earn under the Family Savings Account, tax-free, by investing in securities, normally taxable securities, that traditionally pay more than municipal bonds, and the Family Savings Account is set up where it is just the equivalent of buying municipal bonds, I don't understand why there wouldn't be a very substantial shift into the FSAs of money that would normally go into municipal bonds.

And we will have a witness later who will testify that that is going to injure their market substantially. Why wouldn't they go into the FSA, where they would have no taxes to pay and have a security that is paying higher than a municipal bond?

Mr. GIDEON. I think that in the eligible investor situation, many of them may prefer the FSA. But I don't think that is a reason to deny them that choice.

On the other hand, our view of impact, however, is that first of all individuals are only about half the market, and of those individuals who constitute half the market, most of them are well above the——

The CHAIRMAN. Mr. Gideon, since the 1986 law, you have had a substantial shift to individuals buying municipals. That is where it has moved. And you have had mutual funds now set up with municipals, to make it easier for people of more modest income to be able to buy them. So I think your data is out of date.

Mr. GIDEON. We don't think that our data is out of date, Mr. Chairman, and we really don't believe that there will be that much of an effect.

I would have to observe, however, that expansion of IRA deductions, since that, too, would be a better deal for people who have the same money to spend than investing in a tax-exempt municipal, and could be expected to have fairly similar effects on their market.

The CHAIRMAN. Oh, I don't think I follow that, and I don't agree with it. I think, over the long run, the people buying FSA end up with a better return. And I don't agree, either, with your costs when you get to present value. I think the cost is almost $2 for $1 for the FSA over the IRA, when we are talking about making available a 50-percent deduction for IRA contributions.

As I mentioned earlier, I can't help but remember what the Secretary of the Treasury said: "It is just question of which generation pays it."

It looks to me like you are talking about some of the instant-gratification; or, as I recall Mr. Darman said "now-nowism." That's what you are doing here in pushing the cost off into the future.

Mr. GIDEON. If I could respond to that, Mr. Chairman——

The CHAIRMAN. Please do.

Mr. GIDEON [continuing]. The Secretary was referring to IRA vehicles last year, in which withdrawals would be restricted for some time into the future. The withdrawal behavior under an SSA proposal would be quite different.

The CHAIRMAN. But my IRA allowed an earlier withdrawal when you are going out to buy a home, or when you were talking about helping your kids on their college education.

Mr. GIDEON. But there are two problems, it seems to me, with that approach, Mr. Chairman.

First of all, it requires that Congress anticipate the categories of need for the family. We think the family is better able to anticipate its own need. The only restriction in an FSA is that the savings be maintained for an appropriate period of time, and I think that is a very important difference in this area.

The CHAIRMAN. Let me get to another point, as the President's chief tax advisor.

One of the things I have learned over the years here is to try to avoid the cliff approach to tax proposals. I note on the President's proposal, if an individual is making $60,000, he gets a $2500 Family Savings Account. If he gets $60,001, he gets nothing. The same thing is true for a couple, as far as the cliff approach to it.

As a tax lawyer and as someone advising the President, is that any way to run a railroad?

Mr. GIDEON. Well, the existing IRA phase-outs have proven to be reasonably complex. In view of the fact that nondeductible IRA's would remain available to those above the limit—in other words, we are not taking anything away—we felt that that wouldn't be an inappropriate way to run the eligibility limits.

The CHAIRMAN. I see my time has expired.

Senator Roth?

Senator ROTH. Thank you, Mr. Chairman.

One of your proposals would phase out or terminate the Family Savings Plan to the single person who has income in excess of $60,000, or for a couple, $120,000. I wonder why the Administration has taken that approach.

For example, let me ask you this question: Isn't one of the purposes of your proposal to save for retirement, even though it is in 7-year segments?

Mr. GIDEON. Certainly, retirement savings could be one of the reasons to use an FSA; but the FSA presents greater flexibility to save for any of the myriad needs that a family might have, Senator Roth.

Senator ROTH. Yes, but you could construct an IRA to do the same, couldn't you?

Mr. GIDEON. Well, at some point, if you allow kind of an unlimited number of deductions, it seems to me that it will cease to be an IRA—that is, it will cease to be a retirement account. We think there is a good and sufficient purpose for IRA accounts, and they ought to have retirement restrictions. We are simply proposing an additional savings alternative.

Senator ROTH. Well, it does seem to me that there is a critical need to promote savings for retirement, in particular, and your proposal seems to do that less than, say, the existing IRA's. Would you agree with that?

Mr. GIDEON. Well, it is not targeted or limited to retirement savings as is the existing IRA; but we think the need to increase savings in this country extends to all savings, not merely retirement savings.

Senator ROTH. Let me go back to the point I was raising earlier, where you terminate the right to save for those who have income in excess of $60,000, if an individual. Why did you use that approach rather than making such savings subject to the minimum tax? Would that be another way of handling the problem?

Mr. GIDEON. There certainly could be alternatives to that approach, Senator. We were concerned, however, that we target this to the group that needed it the most.

One of the problems as you go above this group is whether a limited incentive of this sort will simply promote asset-switching. In the class that is eligible for the FSA, the potential for asset-switching is limited, because we know from statistical surveys that they don't have that much in the way of liquid assets that they could switch.

When they get through the potentially switchable assets, one of two things is going to happen: Either they are going to save more, which is the effect we hope will occur and think will occur, and that is going to be net new savings, the effect we want; or they will cease to use the account, and at that point we won't have a revenue loss.

Senator ROTH. Going back to the idea that we are trying to promote savings for retirement, one of my concerns with your proposal, in the sense that it is no longer available if you make more than $60,000, is that a young man or a young woman might decide to go that route for retirement, to put aside the $2500 as permitted under your proposal for each year and build their whole savings program on that basis.

But then you do have the problem that, somewhere down the road, if that young person is successful, they aren't going to be able to continue that program; they will no longer be eligible for it. And I wonder if that makes sense.

Mr. GIDEON. Well, they would not be able to continue to make new contributions to an FSA. In other words, what they had in an FSA would continue in the FSA and would not be disqualified.

Senator ROTH. But what I am saying is, somebody in their twenties—and this is certainly what we are trying to promote, is that people plan more for their retirement because they are living longer. What we are saying to these people is, "Yes, you can save under this program; but somewhere down the way, if you are successful, you will no longer be able to take advantage of it." So their whole program that they laid down as a responsible young man or young woman is no longer available to them. It seems to me that is bad policy.

Mr. GIDEON. Well, there are other retirement alternatives available, typically for people in that situation.

Senator ROTH. My time is up, Mr. Chairman.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. Mr. Secretary, why did we grow well in the fifties and sixties when the total savings rate, counting personal and business, was still much below Japan or much below even the

European countries coming out of the war? It can't be attributed particularly to exports; they were not that big a portion of the GNP in the fifties and sixties, and yet we grew well and productivity went well on a modest savings base. Why is that?

Dr. JONES. The growth rate in the fifties and sixties was 4 percent, and in the seventies and eighties it has been 2.7 percent. The difference is in the productivity rate. So, you really have to go back behind the productivity rate.

Senator PACKWOOD. Why? Was the productivity rate fall in any way related to the savings rate?

Dr. JONES. I think it was, because the low saving rate then leads you to a lower investment rate. And as we have had over this last post-war period, we have had our country ranked near the bottom of the list as regards to plant and equipment investment.

Senator PACKWOOD. But we were near the bottom in the fifties and sixties on savings, also.

Dr. JONES. Well, we had accumulated, as we came into that post-war period, intact plants and equipment; we did not suffer the destruction, and it was fairly new plant and equipment.

Second, we had the extensive technology of the Second World War. We were investing about 3 percent of our Gross National Product into technology. That has eroded during the subsequent period.

Finally, the human resource development, or the effectiveness of our schools and our training and some of the other aspects. I think there is general agreement that there has been erosion there.

Productivity has fallen from about 2.6 percent a year in the fifties and sixties down to 1.2 percent in the seventies and eighties, and that can be partially explained by the aging of the plant and equipment, by the erosion of the technology, and by the lack of commitment to human resource development.

Now, other reasons could be the proliferation of government regulations; many economists believe that the age and sex composition of the labor force changed rather dramatically, as women surged into the labor force and as the baby boom children entered the labor force.

But the truth of the matter is, we can explain only about one-half of that productivity erosion. I happen to think it is tied to those investment aspects.

Senator PACKWOOD. All right.

Now, let's assume the personal savings rate gets back to an average of 8 percent. Assuming the business savings rate didn't fall off, would that be adequate to recapture the fifties and sixties?

Dr. JONES. No. The personal savings rate during the post-war period has been 7.2—you are correct. But it fell to 5.4 percent during the 1980's. It straggled back up to that average in 1989. Business saving stayed somewhat stable.

Senator PACKWOOD. Right. But if we get personal savings back to let us say 8 percent, would that be adequate to recapture the fifties and sixties?

What I am asking is: Is our historical savings average no longer enough?

Dr. JONES. I am not sure I could answer that in absolute terms, but I could be fairly definitive in saying: simply having personal

savings and business savings at the historical norms would not be enough, because we would still have the massive dis-saving at the Federal budget level, and that really is the crucial issue in getting the national saving rate back up into the 16-percent zone.

So, it will be helpful as the baby boom matures, at least chronologically, that they will, hopefully, begin to save somewhat more, and we may be seeing that at the moment in the rate going back up to 5.5 percent.

Senator PACKWOOD. Tell me why—I hate to appear dumb—as we drive the deficit downward, the saving rate will axiomatically go up.

Dr. JONES. Well, the calculation of the national savings rate is the three categories: personal savings, business saving, and the government effects.

Now, the State and local governments are in small surplus at the moment, contributing about 0.1 percent to the national savings. But the Federal budget is in deficit, averaging during the eighties 3.9 percent of the Gross National Product; so that 3.9 percent deficit has basically swamped the stability of the other categories and has resulted in that 2.3 percent reduction in the overall rate.

Senator PACKWOOD. In other words, you subtract the government deficit from the other savings, and therefore that becomes your rate?

Dr. JONES. Yes, sir, to get the national savings rate. Yes, sir.

Senator PACKWOOD. So, if we got the deficit down by $100 billion, we would raise the savings rate about 2 percent?

Dr. JONES. Yes.

Senator PACKWOOD. So we should be cautious about adopting anything that will widen the deficit.

Dr. JONES. Yes, sir.

Senator PACKWOOD. Thank you.

The CHAIRMAN. Dr. Jones, I am concerned about the testimony that you give, as I understand it, that the increased growth that we get from these savings with the FSA will more than offset any revenue loss that we might have from that.

And I understand that Professor Boskin will be testifying in the same tenor insofar as capital gains. That carries me back to 1981 when, I can recall, the argument then was, if we cut the tax rate very substantially, the increased growth was going to take care of that. And now we have these enormous deficits that in part are brought about by that kind of a massive cut. I think that is a rather dangerous assumption. It concerns me very much, frankly.

I have no further comments.

The CHAIRMAN. Senator Roth?

Senator ROTH. I have a further question along that line.

Isn't it true that the revenue of this country is roughly 19 percent of Gross National Product?

Dr. JONES. Yes, sir.

Senator ROTH. So that there has been no decline, percentagewise, of revenue from the 1981 tax cuts?

Dr. JONES. The historical average of revenues from 1950 to 1979 was 18 percent; at the present time it is over 19 percent. So the revenues are currently higher than they were historically.

Senator ROTH. Isn't it also true that spending has increased? It has gone up—what?—roughly 23-24 percent of Gross National Product, so that the reason for the deficit is not the lack of revenue but the fact that spending has increased.

Dr. JONES. During that same 30-year period, the outlays averaged 19.2 percent. You are correct, they rose to 24 percent during the early eighties, and at the moment they are about 22 percent. So, the spending has risen considerably above its historical average. The revenues are slightly above their historical average.

Senator ROTH. Isn't it also true that, as a result of the tax cut of 1981, this country has undergone the longest growth period in the peacetime history of the country, that unemployment has declined, interest rates have gone down, so that the results of the 1981 tax legislation did result in unparalleled growth, in contrast to the late seventies?

Dr. JONES. We are in our 89th month of economic expansion. The unemployment rate and the inflation rates track the indications that you have made.

I personally feel that the tax actions had a positive effect. Economists would have difficulty disaggregating, say in their direct correlations, but I think it did contribute to the economic growth.

Senator ROTH. There is no question that we were in very tough times in the late seventies, and in the eighties we had a strong economy.

Dr. JONES. Yes, sir.

Senator ROTH. Thank you, Mr. Chairman.

The CHAIRMAN. I might add, if I had the ability to write $200 billion worth of hot checks every year, I could have an economy that seemed to be moving, too.

Thank you very much, gentlemen.

We will now have a panel that will consist of Dr. Kotlikoff, who is a Professor of Economics at Boston University, and Dr. Jonathan Skinner, at the University of Virginia.

Gentlemen, if you will, take the witness stand.

Dr. Kotlikoff, if you would proceed, please.

STATEMENT OF LAURENCE J. KOTLIKOFF, PH.D., PROFESSOR OF ECONOMICS, BOSTON UNIVERSITY, AND RESEARCH ASSOCIATE, NATIONAL BUREAU OF ECONOMIC RESEARCH, BOSTON, MA

Dr. KOTLIKOFF. Thank you.

Mr. Chairman and Members of the Senate Finance Committee, I am honored to speak with you today about the crisis in U.S. saving.

In 1989 the U.S. rate of saving out of net national product, our net national saving rate, was a mere 3.6 percent. This figure is just 40 percent of the 8.9 percent average net national saving rate observed between 1950 and 1979.

Unfortunately, last year's remarkably poor saving performance was not outlier compared with the rest of the 1980's. Between 1980 and 1984 the U.S. saving rate averaged only 5 percent; and since 1985, it has averaged only 3.6 percent.

Now, these figures are based on the National Income and Product Account data, and economists understand that there are some

problems with those numbers, particularly with the measurement of consumption of durables by both the private sector and the government.

There is a table in the back of the testimony that indicates that, if you make the corrections to these numbers you see, the absolute net national saving rate is higher. but you also see a very large drop in the saving rate in the 1980's. So, whether or not you make the corrections, there is a big problem.

We have heard mention this morning of the personal and the private saving rate. I do not think these are very reliable saving measures, for reasons I can discuss with you later if you are interested; but I offer as an alternative measure of household saving the following, which I call the net nongovernment saving rate:

If you take net national product and you subtract out government consumption, then you have got the national output that is left over after the government has consumed. And if you ask what fraction of that is not consumed by the private sector, that is the definition of this nongovernment saving rate.

Now, that nongovernment saving rate averaged 11.4 percent over the period 1950 through 1979. In contrast, from 1980 through 1989, the nongovernment saving rate averaged only 5.5 percent. So, household saving behavior, this household saving rate, this nongovernment saving rate, has dropped by 50 percent.

Now, why do we care about the rate of U.S. saving? Well, there are several important reasons. One is keeping up with the Jones—in this case the Western Europeans and the Japanese.

While the data differences make exact comparisons difficult, if one makes certain corrections to try to get as close as possible to the same kind of comparison, one sees that the U.S. is saving at roughly half the rate of the Western Europeans, and perhaps about a third of the rate of the Japanese.

Now, based on these current saving patterns, total wealth owned by Americans will increase by about 10 percent over the next decade, while that of the Japanese will increase by about 20 to 25 percent.

If current saving patterns persist, Americans will over time become the poor cousins of the Japanese and the Western Europeans. We will not only have less wealth per person but less national product per person, because net national product includes income earned on U.S. assets, American-owned assets.

The second reason to be concerned about the low U.S. saving rate has to do with the fact that, as we acquire less of the world's wealth, that means our control of the world's wealth is diminishing, including wealth that is invested in the U.S., and we are seeing the significant current-account deficits in this decade.

The reason, as the Japanese are correctly telling us, that we are running these current-account deficits is because we are saving at such a low rate, and therefore we are not accumulating enough wealth to invest in the U.S. by ourselves, and therefore foreigners are doing the investing for us.

Now, we should be very happy that foreigners are investing in the U.S. We should not respond to our low saving rate by keeping out their investment in the U.S., but what we should do is really address our saving rate problem.

The third reason to be concerned about the U.S. saving behavior has to do with the baby boom generation. It appears that the baby boomers are not putting aside enough for their retirement. They may be looking at their parents and their grandparents, their welfare position vis-a-vis themselves and thinking that, when they become elderly, Social Security is going to be as generous to them as it was to their parents and grandparents.

But we know, because of the 1983 Social Security amendments, that the baby boomers have already lost about 15 to 20 percent of their future retirement benefits, and we see Medicare and private employers cutting back on old-age health coverage. So I think the baby boomers should be concerned, and the response of the baby boom generation appears to be saving less.

So, now we have to face the prospect of a very politically powerful baby boom generation arriving in their old age with very low relative incomes, and this raises the specter of another huge intergenerational transfer through Social Security in about 30 years.

That raises the concern that I know members of this committee share, that the Federal Government put aside enough resources today to help finance the baby boomers future Social Security benefits.

While the testimony outlines different explanations of the low U.S. saving rate, I don't believe it has to do with increased government consumption in the eighties. I don't think the Federal deficits can really explain the low U.S. saving rate that we have observed. I don't think the demographics or changes in income inequality will do it, either.

To a large extent, there is a big puzzle that economists are studying, but we really do not have the answer; there is no smoking pistol. It may be that the changes are things that are a little more subtle to discern, such as a decline in savings for bequests, because older people are much more annuitized with respect to their resources than was the case 10 or 15 years ago, because of private pensions and Social Security.

The CHAIRMAN. Doctor, if you would, summarize. Your time has expired.

Dr. KOTLIKOFF. All right.

I did have some comments about the IRA's and the FSA proposals. Basically, I have the view that these are not effective ways to stimulate national saving. They were tried. I think the evidence does not support the view that they did increase saving; I think, if anything, the evidence is quite the opposite, that there was a big decline in national saving precisely at the time these things were expanded.

I think we should not continue what I believe is a failed and a flawed policy; rather, I think we should engage in three other alternative options, which I will just briefly mention:

One proposal would be to have the U.S. Government—this is a proposal which would not cost very much money at all—have the U.S. Government send out annual statements to each citizen indicating precisely what the citizen had contributed to Social Security, precisely what the citizen can expect to get back from Social Security, and precisely how much that citizen should be saving on his own account to finance his own retirement. So, some advice from

the government to the private citizens, I think, could be very helpful.

A second idea would be to switch towards a value-added tax. I think that is a very important policy option which the government has not yet attempted, and most economists agree that moving toward a consumption-oriented tax structure would improve our national saving.

The third proposal here is to target our generational fiscal policy by looking at the national saving rate. If our national saving rate is low, that is a time when our fiscal policy in terms of its generational stance should be tighter.

If you want to think about the deficit as a measure of the generational stance of fiscal policy, you can; but I think there are better present-value measures that we could come up with that would indicate how we are treating different generations.

The CHAIRMAN. Thank you, Doctor. I want to give them time to ask questions of you.

Dr. KOTLIKOFF. Certainly.

The CHAIRMAN. Dr. Skinner, if you would, proceed, please.

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

STATEMENT OF JONATHAN S. SKINNER, PH.D., ASSOCIATE PROFESSOR, UNIVERSITY OF VIRGINIA, AND RESEARCH ASSOCIATE, NATIONAL BUREAU OF ECONOMIC RESEARCH, CHARLOTTESVILLE, VA

Dr. SKINNER. My name is Jonathan Skinner. I am Associate Professor of Economics at the University of Virginia, and Research Associate at the National Bureau of Economic Research. My research focuses on the effectiveness of savings incentives such as IRA's.

The United States saves only 3.6 percent of GNP, well below its domestic investment. This is disturbing for at least two reasons:

First, as long as we rely on foreign capital to finance U.S. investment, we will be stuck with multi-billion dollar trade deficits for years to come; and, second, consuming rather than saving income today means a lower standard of living in the future.

Most of that low savings rate can be blamed on the government deficit, but household saving has lagged as well. I am therefore pleased to comment on the Family Savings Account, designed to encourage national savings.

I will make two general points in this testimony:

First, the evidence from IRA's suggests that tax incentives can be effective in stimulating household saving; and, second, the Family Savings Account may look like an IRA, but it is not. It no longer offers the powerful instant gratification of the up-front tax deduction, and it allows assets to be cashed out after 7 years, making it easier and more tempting to shuffle old saving into the Family Saving Account.

So, the first question is: Did IRA's increase personal saving?

The pioneering study by Stephen Venti of Dartmouth College and David Wise of Harvard University found that less than one in $10 of IRA saving were shuffled from previous accounts; the rest was new personal saving.

Daniel Feenberg of the National Bureau of Economic Research and I set out to disprove the Venti and Wise results. In our study using IRS data, we expected to find widespread shuffling. To our surprise, we found the opposite: IRA contributors tended to increase their taxable saving. Rather than disprove the Venti and Wise study, we confirmed it.

Now, some researchers have argued that IRA's are still shuffled saving, because families that bought IRA's would have saved more in taxable assets had IRA's not been offered. But the critics gloomy picture of investors stashing taxable assets into IRA's just is not so.

There is other evidence supporting the views that IRA's are new saving. Advertising has been effective in encouraging IRA enrollments, and when advertising dropped off after 1986, so also did contributions, even among those who were still eligible to contribute.

Another piece of evidence is that taxpayers owing money to the IRS on April 14th are much more likely to contribute to an IRA. A taxpayer would prefer to open an IRA account rather than write a check to the dreaded IRS. So, the up-front deduction provides the instant gratification necessary to get taxpayers into the saving habit.

Finally, once hooked, IRA savers stay hooked. Eighty-five percent of contributors in 1982 re-enrolled in 1983. IRA's are effective at getting taxpayers to "just say yes" to new saving.

In the second part of my testimony I want to outline four reasons why the Family Savings Account may look like an IRA, but it does not quack like an IRA.

First, the tax benefit of the Family Savings Account is provided in the future rather than immediately. The immediate deduction of the IRA was a major factor in attracting new contributors. Investors want the tax break now, not when they retire.

Second, the Family Savings Account doesn't lose revenue now, but it does in the future. By contrast, IRA deposits will enhance future tax revenue by at least $70 billion once the deposits are cashed out.

I would favor taking the bitter medicine today, given the pressure of Gramm-Rudman-Hollings, to ensure that the revenue lost from a front-ended savings incentive will be financed by some other tax.

Third, evidence that IRA's are new saving cannot necessarily be used to conclude that Family Savings Accounts are new saving. Family Savings Accounts are far more liquid than IRA's. Assets can be cashed out after 7 years, making it easier to shuffle. A $5,000 deposit in a Family Savings Account, financed by a 7-year ballooning home equity loan, could achieve the proverbial and illusive "free lunch," with the tab picked up by the U.S. Treasury.

Fourth, front-ended savings incentives such as the IRA psychologically lock in saving by imposing a tax on withdrawals. Cashing out an IRA at any age triggers an unpleasant tax liability on both the interest and principal. I believe this, in fact, assures that the money is taken out only when it is necessary to do so. There is no lock-in effect with the Family Savings Account.

A final point: The effectiveness of tax incentives in promoting national saving depends crucially on how the incentives are financed. A saving incentive program financed by debt—or, just like

debt, a deferred tax break such as Family Savings Accounts—can harm rather than help long-term saving. A concerted effort to both reduce the government deficit and stimulate personal saving is a key ingredient to continued economic growth.

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

The CHAIRMAN. Dr. Skinner, you have testified as to your concern about the possible shifting of savings rather than new savings that are brought about. In comparing the IRA and the Family Savings Account, what is the profile of the type of investor that would be investing in one or the other?

Dr. SKINNER. I don't have evidence on who would actually invest in a Family Savings Account; but my guess is that it would tend to appeal to fairly sophisticated investors, the Money and Forbes magazine readers who are doing a fair amount of investing and understand the benefits.

Because it offers this deferred benefit rather than instant gratification, my guess is that it will not pick up the kind of people who just want the tax break right now. So, you may be excluding some fairly sizable portion of people who you do want to begin to save for their retirement.

The CHAIRMAN. One of the things that I am concerned about is, with more and more of these budgetary constraints, we have a tendency to concentrate on the short term, what happens to the budget, rather than the long term. Could you give me a feel about what would be the long-term budgetary effect of each of these proposals?

Dr. SKINNER. One way to characterize the Family Savings Account is that it would be similar to a deficit financed IRA, in the sense that the tax break comes when the investor takes the money out of the Family Savings Account. It is promised to you today but paid off in the future. So, today the government doesn't have to incur the cost of the tax break. But the government is promising that it will provide this tax break say 10, 15, 20 years from now, which sounds to me much like government debt; that is, the government promises in the future to pay for today's benefits.

The CHAIRMAN. Thank you, Doctor.

Senator Packwood?

Senator PACKWOOD. Dr. Kotlikoff, you are a research associate with the National Bureau of Economic Research?

Dr. KOTLIKOFF. Yes.

Senator PACKWOOD. And you are, Dr. Skinner?

Dr. SKINNER. Yes.

Senator PACKWOOD. And you did a study with Daniel Feenberg, who appears to be an associate, also?

Dr. SKINNER. Yes.

Senator PACKWOOD. What is the National Bureau of Economic Research? Can anybody be an associate?

Dr. KOTLIKOFF. It is an association of academic economists that do research. It is really a pure research but policy-oriented research institute. It doesn't take policy positions. It is financed primarily by the academic economists getting grants from the Federal Government to do their research, and there are some foundations that provide some financing for the research.

Senator PACKWOOD. So it is kind of a clearinghouse for getting money, and the associates don't necessarily have to agree with each other?

Dr. KOTLIKOFF. As you have heard, we do not agree with each other. On the issue of whether the IRA's or the FSAs would lead to more national saving, we disagree.

Senator PACKWOOD. It is kind of a big tent in which all opinions can be covered.

Dr. KOTLIKOFF. Exactly.

Senator PACKWOOD. Like the Republican Party. [Laughter.]

I have no other questions, Mr. Chairman. Thank you.

The CHAIRMAN. I don't believe I will comment. [Laughter.]

Senator Roth?

Senator ROTH. Dr. Skinner, I don't know whether it was your study or another, but one study was based on analyzing the actual income tax returns on a large enough basis that you felt you had an ample sample to demonstrate that there was new saving. Is that correct?

Dr. SKINNER. Yes. We used IRS public-use data that followed taxpayers over 4 or 5 years.

Senator ROTH. And your conclusion was that this did significantly represent new savings?

Dr. SKINNER. We concluded that the critics' view of widespread shuffling was not correct.

Senator ROTH. One of the arguments given for the Administration's Family Savings Plan is that it would be more appealing to the young, that there isn't the desire to make the commitment, a long-term commitment—"Age 65 seems a long ways off, and why worry about that when there are more immediate problems, such as buying a house or sending your children to school, or whatever?"

Would you agree that the Family Savings Plan does have an advantage in that regard? That it would be more appealing to the young?

Dr. SKINNER. Yes, I think it would be more appealing to the young, because it would provide this vehicle for saving for education for their children or housing. But the question is: Would they have saved that money, anyway? And, second: Does this provide, inadvertently, a vehicle for people who aren't saving for a house or education but are saving for their European vacation to shuffle money into this type of saving? That is my concern.

Senator ROTH. From the standpoint of the national economy, do we necessarily care why they save? I mean, from the point of view of investment, productivity, and growth of the economy, do we care as to why they save?

Dr. SKINNER. No, we don't care. But in encouraging people to save in this way we are giving up revenue, and we are not getting their savings for very long; we are only getting them for 7 years.

One reason why I favor the Individual Retirement Account is because for many taxpayers it really does lock up their savings for 20 years, perhaps, and that is going to be in there contributing to national productivity for a long time.

Senator ROTH. Thank you, Mr. Chairman.

Senator PRYOR. Senator Roth, Senator Bentsen has had to go over to the Senate, I believe, and he has asked me to fill in for him. I am the relief pitcher today. So, if there are no further questions by you, I wonder if Senator Packwood is going to return?

[Pause.]

Senator PRYOR. I have been informed there are no further questions from Senator Packwood.

We will excuse this panel. We want to thank both of you this morning for attending and sharing your thoughts, and we appreciate very much your being present.

Our next witness is Hon. Mary O. Boyle, the commissioner of Cuyahoga County, testifying on behalf of the National Association of Counties; from Cleveland, OH.

Senator ROTH. Mr. Chairman?

Senator PRYOR. Yes, Senator Roth.

Senator ROTH. While the next witness is coming forward, I have some testimony from Merrill Lynch that I would ask be included in the record.

Senator PRYOR. It will be placed in the record at this point, Senator Roth.

Senator ROTH. Thank you.

Senator PRYOR. Thank you.

[The information appears in the appendix.]

Senator PRYOR. Ms. Boyle will be testifying on behalf of the National Association of Counties, and I believe that you are from Cleveland, OH. Is that correct?

Ms. BOYLE. That is correct, Mr. Chairman. Thank you for the opportunity to be with you today.

Senator PRYOR. Well, thank you very much.

I don't know what limitation the Chairman had imposed on testimony, but we will place the full body of your text in the record. I wonder if you might be able to summarize your statement.

STATEMENT OF HON. MARY O. BOYLE, COMMISSIONER, CUYAHOGA COUNTY, TESTIFYING ON BEHALF OF THE NATIONAL ASSOCIATION OF COUNTIES, ACCOMPANIED BY SUSAN WHITE, LEGISLATIVE REPRESENTATIVE OF THE NATIONAL ASSOCIATION OF COUNTY OFFICIALS

Ms. BOYLE. Mr. Chairman, I have prepared a brief version of the material that we submitted to the Committee for the record.

Senator PRYOR. Very good.

Ms. BOYLE. I have with me, on my left, Susan White, who is the Legislative Representative of the National Association of Counties (NACo), whom I am representing today. Susan is staff for the Tax and Finance Steering Committee of NACo.

Senator PRYOR. We appreciate both of you being here today. Thank you. You may proceed.

Ms. BOYLE. Thank you, Senator.

I am here on behalf of NACo to discuss two priority concerns: How to stimulate savings and investment by and for all Americans, and how to finance the rebuilding of America so that we will be in a position to foster economic growth, create jobs, and support

American business in its struggle to compete in the international markets.

It is imperative that these two concerns be linked. The need to address both issues is clearly evident.

Low U.S. savings have contributed to higher interest rates, lower investment, reduced productivity growth, and higher trade deficits.

We commend the Chairman, Senator Bentsen, for his proposals to address these issues, and we hope that a compromise will be worked out between Congress and the Administration which takes into account our views regarding public capital investment.

We support the concepts that have been under discussion this morning, Mr. Chairman, regarding encouraging Americans to save and invest long term, and we are here today to talk about the need to encourage investment in the infrastructure of this country as well.

The National Council on Public Works Improvement created by Congress to assess the state of America's infrastructure found in its report, "Fragile Foundations," that "America's infrastructure is barely adequate to fulfill current requirements and insufficient to meet the demands of future economic growth and development."

During NACo's legislative conference here in Washington last week, we discussed the need for increased savings and investment, as well as the need for investment in America's infrastructure. Our deliberations resulted in a resolution calling for a joint effort which would tie savings and investment to the financing of public infrastructure.

To accomplish this, NACo supports, as an option, the establishment of a deductible IRA vehicle tied to investment in tax-exempt bonds for public capital facilities, as well as the elimination of the disincentives to invest in bonds, authorized under the 1986 Tax Reform Act.

As you know, tax-exempt bonds are the major tool used by counties, States, cities, towns, and schools to pay for essential public projects. Historically, our ability to sell debt with interest exempt from Federal income tax has been key to borrowing money at low cost for all taxpayers to build and repair schools, bridges, roads, airports, ports, and other facilities critical to the productivity of our country.

However, the 1986 Tax Reform Act has had major consequences for the tax-exempt bond market. The most onerous provisions which have affected the demand for tax-exempt bonds are:

The elimination of the bank deduction for interest costs incurred to purchase and carry tax-exempt debt for all but the smallest governmental issues;

Inclusion of tax-exempt interest earned on all bonds, including the regular government bonds, in the corporate alternative minimum tax adjusted current earnings preference, and third,

Inclusion of tax-exempt interest earned on private activity bonds.

Data clearly show that these tax law changes have affected corporate demand for State and local debt. An attached pie chart illustrates how banks have left the market. What is not yet reflected in the pie charts is the recent departure of property and casualty insurers from this market. Individuals are now the most significant purchasers of tax-exempt bonds.

Recent enactments alone will not destroy the market for bonds, however, but their cumulative effect is to erode that market through increased uncertainty and volatility.

The challenges for the tax-exempt bond market continue. The Administration's proposed Family Savings Account (FSA) has a laudable goal, which NACo supports, to stimulate savings and investment by middle-class Americans. However, the capital formation it seeks to stimulate will only benefit private investment and in fact is expected to appeal to the same group of individuals who are currently the major investors in tax-exempt bonds.

These accounts would permit investors to earn interest at taxable rates and have that interest exempt from Federal income taxes if they are held for 7 years. Local governments would be forced to pay higher borrowing costs just to compete—an ultimate cost shift to all taxpayers.

Those eligible for the FSA would be individuals who have adjusted gross incomes less than $60,000 and joint filers less than $120,000.

Treasury data suggests that a significant amount of tax-exempt bonds are owned by this same group of middle-income investors. In a Treasury Department study, 27 percent of the tax-exempt interest reported was listed on returns with an adjusted gross income of under $50,000, and 55 percent was reported on returns having less than $100,000.

The same holds true for tax-exempt mutual funds which permit investments by individuals in small denominations. A survey of this growth investment vehicle, which has grown from $4 billion to $93 billion in the decade 1979-89 revealed that 42 percent of the bonds were held by households with incomes less than $50,000 and 77 percent with incomes less than $ 100,000.

These numbers illustrate quite dramatically why NACo and other State and local public-interest groups are concerned that the FSA may endanger the market for tax-exempt financing; and that, in return, will endanger an already fragile and shifting public infrastructure. In fact, the Government Finance Officers Association raised these issues on behalf of nine public interest groups before the House Ways and Means Committee earlier this month.

NACo strongly urges Congress and the Administration to consider the potential impact of this proposal on the tax-exempt bond market, and we further urge you to bridge the issues of stimulating savings and investment, and investing in the country's infrastructure.

Once again, I thank you, Mr. Chairman, for the opportunity to testify on behalf of NACo, to be able to present our views to this committee, and we look forward to working with you and the members of the committee.

I will be happy to answer questions.

Senator PRYOR. Thank you, Commissioner Boyle.

Let us assume for a moment that I am an investor and I have some extra dollars to invest, and I am looking around for the best and safest investment with a good return, and ultimately, for the fewest dollars going to Uncle Sam. What would I look for when I look at putting money in a Family Savings Account, and between

-that and a tax-exempt bond to help finance the infrastructure? What, as an investor, would I be looking at?

Ms. BOYLE. Well, if I am an investor who is not necessarily making a decision based on saving for retirement—which was an issue discussed at some length this morning in this hearing—I am an investor who would probably evaluate the Family Savings Account and a tax-exempt bond as two potential options that are shorter-term investment than, for instance, saving for retirement.

As the current proposal was presented by the Administration, the Family Savings Account will win, because it is a better deal than investing in a tax-exempt bond, because of its tax benefits and its return, its guaranteed return at the higher rate.

Therefore, I would be inclined to go with the Family Savings Account proposal, all other things being equal, Mr. Chairman.

Senator PRYOR. And your concern is that people will move existing funds from the investment in infrastructure to the Family Savings Account?

Ms. BOYLE. Yes. Mr. Chairman, going back to my role as a public official who is attempting to deal with major infrastructure problems, my concern is that that would result in there being fewer investors who would be interested in buying my government paper, therefore potentially driving up the cost of that government paper and making it much more difficult for me to carry on my job as a public official.

I don't believe that is anybody's intention, and I think we heard in the Treasury presentation today that they are concerned about it and are implying that they don't believe there would be any consequence.

My concern, however, is that the current purchasers of tax-exempt debt have significantly changed in the last 4 years, and they are continuing to change, from everything we can see, and this would be a very difficult time to provide any disincentive to the individual investor out of the tax-exempt market.

Senator PRYOR. I wonder if you might discuss the concepts of (1) an IRA being front-loaded, and (2) the back-ended IRA. Would you discuss that for a moment?

Ms. BOYLE. Well, Mr. Chairman, with all due respect, I fear I am not exactly the expert witness that could provide the best kind of information on that.

We came today to basically say our concern is, when you make decisions about expanding the use of IRA's, that you also take into consideration whether there is a way that that same vehicle or some vehicle like that could also encourage investment in capital infrastructure.

Senator PRYOR. Commissioner Boyle, you have brought up a very interesting point of view this morning, and I want to thank you for it. I know I speak for the entire committee. Your entire statement will be placed in the record.

We thank both of you for coming, and I wonder if Ms. White has any further comments before we call the next panel.

Any further comments?

Ms. WHITE. I think the Commissioner has covered our position.

Senator PRYOR. Thank you. We appreciate very much your contribution this morning.

Ms. BOYLE. Thank you, Senator.

Senator PRYOR. Thank you so much.

We will call our final panel this morning: Mr. David Silver, president, Investment Company Institute, from Washington, DC. Mr. Silver, we welcome you.

Mr. William North, I believe today you will be representing the National Association of Realtors. Am I correct, Mr. North? That is the group you will be speaking for?

Mr. NORTH. Yes, senator.

Senator PRYOR. Mr. Silver, we appreciate your comments. You now have the floor.

[The prepared statement of Ms. Boyle appears in the appendix.]

STATEMENT OF DAVID SILVER, PRESIDENT, INVESTMENT COMPANY INSTITUTE, WASHINGTON, DC

Mr. SILVER. I am David Silver, president of the Investment Company Institute, the national association of the mutual fund industry. The Institute's membership includes over 3,000 mutual funds with over 30 million shareholders.

Mutual funds have traditionally served as vehicles through which investors channel their savings into the nation's economy, through a diversified, professionally managed pool of investments.

In January of this year, total industry assets reached $1 trillion, of which $112 billion were Individual Retirement Accounts.

Although I speak as a representative of an industry with an obvious economic interest, I do not think it is controversial to state that mutual funds provide an efficient means to recycle savings and investment dollars into a broad spectrum of securities issued by a wide variety of companies and municipalities. For that reason, our members have accumulated a vast amount of experience in selling IRA's, processing millions of IRA investments, and in other operational aspects of the IRA program.

Others at this and earlier hearings have documented the importance of increased personal savings for our nation's economy.

We in the mutual fund industry welcome the opportunity to share our experience with IRA's as the Congress considers various proposals to expand personal savings in the most effective and least costly manner.

Our own impression of the public response to the universal IRA, as confirmed by most recent economic studies, demonstrates that the personal savings rate can be increased through a simple, universal, tax-favored savings program that is consistently available year after year.

Prior to the Tax Reform Act of 1986, IRA contributions grew from about $5 billion in 1981 to about $38 billion in 1986. At the time the 1986 Act was passed, IRA contributions accounted for 30 percent of all personal saving.

Similarly, at the end of 1981 the total pool of IRA assets consisted of $26 billion; while, by the end of 1986, the pool had grown to $277 billion, a tenfold increase.

As expanded in 1981 to provide universal coverage to wage earners in every income bracket, the IRA was a unique, simple, effective savings vehicle.

The universal IRA was easily understood and was established with a minimum of paperwork and red tape. It was a flexible program, enabling IRA participants to exercise their own freedom-of-investment choice in a variety of financial institutions that offered a broad selection of investment products. That is shown on Table A, Mr. Chairman, of our full statement.

The relative simplicity and universal coverage of the new IRA rules encouraged financial institutions to engage in large-scale and highly-successfully marketing campaigns. Their efforts touched a responsive chord among working Americans, releasing a pent-up demand for a universal retirement-savings vehicle.

In 1987, however, IRA contributions declined by 63 percent. Part of the sharp decline in IRA contributions is attributable to the limits on deductible contributions imposed by the 1986 Act. However, the confusion among taxpayers over the eligibility for deductible versus nondeductible IRA contributions and the significant recordkeeping requirements imposed on taxpayers who make nondeductible IRA contributions also contributed to this decrease.

Congress is currently considering a number of tax-favored savings programs which propose either a front-end deduction or a back-end tax exemption.

Although we have no experience with the proposed back-end programs, our experience with the universal IRA has taught us some important lessons. Savings incentives work best if the rules are simple and permanent, and if they do not require burdensome recordkeeping. Frequent changes create uncertainty and reduce contributions.

If investors are uncertain of the conditions under which contributions to a tax-favored arrangement may be made, they often opt to make no contribution. Why save for the long haul, unless there is a sense that the program is likely to have a degree of permanence?

Similarly, if financial institutions find the terms of a tax-favored savings program too complex to describe in a simple, effective marketing campaign, they may abandon the effort and not make the costly long-term marketing and administrative commitments necessary.

We applaud Chairman Bentsen, and you, Senator Pryor, and other members of this committee in recognizing the importance of individually-oriented savings incentives as a way to address a most serious economic problem, our nation's low savings rate. We look forward to assisting the committee in designing an effective, universal, and permanent savings incentive.

I would be most happy to respond to any questions.

Thank you.

Senator Pryor. Thank you, Mr. Silver.

Before we ask questions, we will call on Mr. North.

Mr. North?

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

STATEMENT OF WILLIAM NORTH, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF REALTORS, CHICAGO, IL

Mr. North. Thank you, Senator Pryor.

My name is Bill North. I am the Executive Vice President of the National Association of Realtors. The National Association represents virtually every facet of the real estate industry, including real estate brokers and salespersons, developers, appraisers, syndicators, and property managers.

On behalf of the more than 800,000 members of our association, I want to thank you for holding these hearings and for inviting the National Association to testify on proposals to restore tax incentives for savings and investment in the United States.

The National Association of Realtors is concerned about the extremely low rate of savings and investment in this country. It is our belief that only through bold leadership and initiative at the national level can the savings rate in the United States be improved.

We believe that one major component of any plan to enhance savings and investment in the United States must be the adoption of tax incentives to foster a general climate of savings and investment and to tailor incentives in particular areas of national interest.

We further believe that one of the most important national interests which should be served by our savings policy is affordable housing for all Americans.

Senator Pryor, the decade of the 1980's saw a steady decline in the nation's home-ownership rate, reversing a 40-year trend of rising home ownership among our citizens.

During the last decade, all age groups of the population experienced declining home-ownerships; but most disturbing was the fact that the largest decrease in home-ownership rates was experienced by those Americans under 25 years of age and by those in the prime home-buying ages of 25 to 34.

The combined home-ownership rate of these two age groups declined by roughly 15 percent during the decade of the eighties.

Studies conducted by the National Association and by other industry groups have confirmed that the decline in home ownership is caused by three primary factors:

First, higher home prices, which requires significantly larger down payments;

Second, a slower rate of growth for a family median income, which makes it more difficult to accumulate the down payment; and

Third, higher rental payments, which leave less and less of the tenants' income left over for their own home purchase.

Because of these obstacles to home ownership, the National Association of Realtors strongly endorses and recommends adoption of Chairman Bentsen's proposal, introduced last year, to expand the use of Individual Retirement Accounts by allowing up to $1,000 in deductions for those unable to deduct contributions under present law, and to allow penalty-free access to IRA's for the first-time home purchases.

During the decade of the Nineties, we believe that access to mortgage financing for prospective homeowners will be seriously restricted, in part due to the tougher capital requirements that have been imposed on lending institutions under the recently enacted FIRREA legislation.

These restrictions make it imperative that home seekers be provided greater access to the largest remaining existing source of capital available in the country—namely, pension plans, pension funds, deferred-compensation plans, and IRA's.

For this reason, we applaud the Chairman's proposal to permit access to IRA accounts on a penalty-free basis for first-time home purchases. We would, however, respectfully ask that the proposal be modified to permit withdrawals by spouses, parents, and grandparents, to assist their relatives in purchasing a home for the first time.

Our studies, together with other research data, have consistently shown that the IRA balances of prospective homeowners are small when contrasted with those of their parents or grandparents, whose assistance may be necessary to help them purchase their first home.

While we do not assert that the adoption of the Chairman's proposal with our suggested modification is a panacea for curing the nation's housing affordability problems, we do believe that these measures would constitute a positive first step upon which we can build. We have also determined that the cost of this modification would be relatively small in budgetary terms.

We are, of course, pleased that the Administration has offered a proposal to permit limited withdrawals of $10,000 from an IRA for first-time home purchases if certain criteria are met; however, we greatly prefer the Chairman's proposal, on balance.

I would be pleased to respond to any further questions concerning our testimony, and the extended testimony is available to the committee.

Senator PRYOR. Mr. North, we will put your entire statement in the record. We appreciate both of you being succinct in your comments, and your contribution is very much appreciated.

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

Senator PRYOR. Mr. North, I have got three sons, 24 to 30. They are gainfully employed. We don't know how in the world any of these young men is ever going to buy a home. Is there any encouragement out there without some sort of an inducement in savings or a deduction for something like an IRA? Do you see anything out there on the horizon?

Mr. NORTH. We think it will take initiatives like the extension of the IRA and other initiatives to tap into pensions and profit-sharing plans to achieve that objective.

This is why we press so strongly for the amendment to Senator Bentsen's proposal, to allow parents, grandparents, and spouses to participate. It takes the resources of the whole family these days to enable someone to start paying on their own mortgage rather than paying on somebody else's.

Senator PRYOR. The President has the proposal of the first-time home-buyer proposal; that is, to give that individual some advantage in a first-time home purchase situation.

Senator Bentsen made, in addition to that, his own proposal. Now, has the Association taken a position between these two approaches?

Mr. NORTH. Yes, we are emphatically in favor of Senator Bentsen's approach.

We are concerned about the $10,000 limit. We think that unreasonably and unnecessarily discriminates against citizens of the country in high-cost areas. We are also not convinced that the 110 percent of median income limitation would alleviate this problem.

So there is no question in our minds that the approach taken by Senator Bentsen—again, modified so that the whole family can participate and assist—is the correct approach.

Senator PRYOR. Mr. North, Mr. Silver just stated that one of the salvations of any savings proposal that we ultimately propound from this committee to the Senate floor, to the House, and hopefully to the President's desk, would be one of simplification, clarity, and certainty.

Would the IRA proposals—the withdrawal proposals—present any new complexities for the taxpayer that would be insurmountable or discouraging?

Mr. NORTH. I think this is one of the reasons, also, that we favor Senator Bentsen's proposal over the Administration's. In our best judgment, this authorization of the use of IRA proceeds for the payment of the down payment in a first-time purchase could be accomplished without going through any regulations, without involving ourselves in any complex issues of what is median income in any given area. It could be implemented immediately and effectively and very simply.

Senator PRYOR. I noticed this morning in the Washington Post that the Japanese are giving us some recommendations on how to get our economy back on a safe and sound footing.

One thing they recommended is that we remove the deduction for interest on home ownership. I know you don't have any comments on this, do you? [Laughter.]

Mr. NORTH. I am glad you know that I don't have any comments on it. [Laughter.]

Senator PRYOR. I thought it was somewhat timely. Because of your appearance this morning, I had to just throw that in. But I know this, that of all of the issues out there, this is one that I see less likely to be passed into law. That would be sort of the last vanguard. That is the last hope for home ownership as I can see in this country.

Mr. NORTH. Well, I think our response to that is this: According to our readings and the readings of everyone we know who deals in this area, home ownership continues to be the number-one priority, the number-one aspiration of this country, as well as our most critical need.

To the extent that we have a national policy, a national policy that supports our people, we think that the orientation of our tax laws and the orientation of our incentive systems for savings must take into consideration the importance of home ownership. People do want to own their own home. They want to pay interest on their mortgage, not interest on somebody else's mortgage, and we think they ought to be given that opportunity.

Senator PRYOR. Mr. Silver, hopefully you were here in the hearing room a moment ago when Commissioner Boyle, who preceded you, talked about the concern that the counties and the local governments have that funds may be lured from the traditional tax-exempt bond for the infrastructure into an IRA account.

Would you have a comment on this? Do you have any studies that might back this up, or refute her findings in this area?

Mr. SILVER. No. I would say that, as the organization which sponsored the creation of tax-exempt mutual funds which changed the nature of that market. I can confirm that the Commissioner is right: there is now approximately $100 billion in tax-exempt mutual funds from smaller investors.

I would generally agree with the analysis that, if a savings plan is structured so that it is in the same range of liquidity as competing investments, they will both simply sell on a yield basis and be competitive with each other.

The longer the required holding term of the savings plan, the less liquid it is, and therefore the less of a threat that you force competition between a tax vehicle and other savings.

Senator PRYOR. Mr. Silver, thank you.

Mr. North, do you have any further comments, or do either of you? Because we are about to conclude our hearing.

Mr. NORTH. No. I just would like to express once more our appreciation for the invitation to attend.

Senator PRYOR. Let me apologize for not being here this morning. I will tell you the reason why, and perhaps you will understand. This morning there was a joint meeting of the Congress, the House and the Senate, to commemorate the 100th birthday of General Eisenhower, President Eisenhower.

I had the rare opportunity to help preside over that hearing, with Speaker Foley. One of the reasons I was late, in addition to having speakers today such as Walter Cronkite, John Eisenhower, Clark Clifford, and Arnold Palmer, I stood in line for 35 minutes waiting for Arnold Palmer's autograph. [Laughter.]

That is why I was somewhat detained today.

We thank both of you. Once again, your full statements will be placed in the record.

We will now conclude our hearing.

Thank you very much for coming.

Mr. SILVER. Thank you, Senator.

[Whereupon, at 1:00 p.m., the hearing was concluded.]

TAX INCENTIVES FOR INCREASING SAVINGS AND INVESTMENTS

WEDNESDAY, MARCH 28, 1990

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

The hearing was convened, pursuant to notice, at 10:02 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Also present: Senators Bradley, Rockefeller, Packwood, Heinz, and Durenberger.

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

The CHAIRMAN. This hearing will come to order.

Yesterday we analyzed America's savings problems, trying to see what we can do to restore a level of savings that will help us get the cost of capital down in this country. If we do not do that, we cannot continue to be the world's dominant economic power. I have worked for many years to try to encourage investment capital in this country—entrepreneurship, long-term investment. Healthy American businesses create jobs and they are the cornerstone of a strong economy, so we ought to take seriously any tax proposal that may increase business development and entrepreneurial activity.

But any such proposal, however attractive on the surface, cannot be considered by itself. We have to look carefully at what it would do to our Federal budget deficit which is becoming increasingly more difficult to take care of. During my tenure in the Senate, I have been a long time supporter of a capital gains rate differential. The 1986 Tax Reform Act eliminated the capital gains rate differential, and last year, despite my support for this provision, I voted to delay consideration of it.

The reasoning behind my decision to delay its consideration is because I found this provision to be much more attractive when the top income tax rate was 70 percent. At such a high income tax rate, you had much more of a differential than you have now, when the average is 28 percent. And now, in addition to that, we are talking about a capital gains rate of perhaps 20 percent.

People disagree about how much red ink the President's budget proposal would generate after the first couple of years. And considering that question, estimates from the Joint Tax Committee and the Department of Treasury were about $29 billion apart last year.

Now that gap is closing: they are only $24 billion apart now. Such differences give you some idea of the problems we have on this Committee as we look at a budget resolution, and we have to deal with CBO numbers and OMB numbers which are quite different. While one of them is talking about gaining approximately $12 billion over 5 years, the other is talking about losing $11 billion.

Four years ago Treasury estimated that a capital gains increase would raise $21.8 billion. Can we have it both ways? In this Committee we are faced with using those estimates and trying to see what we can do to meet the targets of Gramm-Rudman. We want to know how the supporters of the President's proposal plan to pay for it. Would it contribute to a bipartisan, comprehensive solution to our savings and investment problems? That is what I would like to find out; and that is one of the reasons we will have witnesses of opposing points of view to try to evaluate them.

I now defer to my colleague, Senator Packwood, for any comment he would like to make.

OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON

Senator PACKWOOD. Mr. Chairman, thank you very much. I do wish to make a comment.

The last trip I was home in Oregon I made a special effort following up basically on mail that I had received to talk with people who were writing about wanting capital gains treatment, because the letters did not seem to be coming from people who were making $100,000 or $200,000. And you know the figure that is cited so often by the opponents of capital gains, 83 percent of the benefits go to those who make over $100,000 a year.

I would read these letters and I would think there is something wrong. I can tell from the letter this person does not make $100,000 a year; doesn't make $50,000 a year would be in my guess. And then I discovered what the flaw was in the argument. The people who make the argument about the 83 percent are counting the capital gain as if it were recurring income.

So let me give you an example of some people that are treated as making over $100,000 a year. John Phelps, from Dallas, Oregon. He's a log truck driver. He owns his own truck. He grosses about $80,000 a year; he nets about $35,000–$40,000 a year because log trucking is an expensive avocation. He repairs his truck, he has heavy gasoline bills, and tires are expensive. He's been doing this for 22 years. He works six and a half days a week. He wants to retire and sell his truck. The truck is worth about $65,000. The difference in capital gains for him, savings, if there is a capital gains tax, is about $5,000.

This man would be counted in that year as making over $100,000 because he has an $40,000 net and he would sell his log truck for $65,000. He would save $5,000. And to this man, that is a tremendous amount of money.

Take a look at Gene Whittaker in Hillsboro, OR, another letter I got. He owns a paint and glass store. He does some minor work on the commercial buildings, puts in windshields on trucks. He bought the business 17 years ago; paid about $55,000 for it, counting the

building and the property. He has never taken out of the business more than $35,000-40,000 a year. He works six or 7 days a week. He has four employees. He would like to retire. He thinks he can sell the business now for about $175,000. So he will be one of those that is over the $100,000 bracket. This man is not rich.

I found example, after example, after example of this. In fact, now this is what I have concluded. Instead of 83 percent of the benefits going to those who make over $100,000 a better way to phrase it is this: 65 percent of all capital gains are realized by those who make under $100,000, if you do not count in income the sale of the asset; 47 percent of all capital gains are realized by those who make under $50,000, if you do not count the sale of the asset.

So as to this argument as to whether the rich benefit or do not benefit, I find it a fallacious argument. But let's go even further. Let's assume that all of the benefits came from people that made over $100,000. I had the Joint Committee send me a letter the other day and I asked them how much money we could raise if we had a tax rate of 100 percent in this country—100 percent, all of it. If you make over $100,000 the Government takes it all.

I got a letter back from them telling me how much we would make in 1991, 1992, 1993, 1994 and 1995. And it went up each year. We would collect $124 billion the first year—and I cannot remember, $167 billion the second year, and more until we are up into the $300 billion and $400 billion bracket 5 years out. I called up and said, "How can this be?" Well there was a little asterisk they needed to add. And they sent the letter back and the asterisk is in it. It did not assume any change in behavior.

Well, of course. If you are willing to work all your life and give 100 percent of the money to the Government we will collect a lot. And yet, if you had that 100 percent tax—and I bounced this off of Ron Pearlman, and they cannot do the projections and I understand why—if you were to lower that 100 percent tax on incomes over $100,000 to 75 percent or 50 percent, some people might work more. They thought, gee, I get to keep half of it, I get to keep a quarter of it, I'll work and make a little more and the Government would collect money if we lowered the tax from 100 percent, the Government would collect more money.

And yet you know what the argument is that could be made, this only benefits people who make over $100,000 a year. And my answer would be, "So what." If we can make money by lowering the tax rates, why should we care from whom the money comes. If by lowering the tax rate from 100 to 75 percent or by lowering the capital gains tax rate from 28 to 20 percent we can actually gain money for the Government that we can spend on poverty programs or food stamps or the environment or drug education or prenatal care for poor women, why should we care if the money came from people who make over $50,000 or over $100,000 or over $200,000.

So let's put aside the argument as to who benefits. The Government, and therefore everybody we spend it on, benefits if it raises money.

So that brings us to the second question. If we cut the capital gains tax, does it raise or does it lower money. I know the theory of the Laffer curve has been laughed at for years, but his theory is right. There is an optimum level of taxation at which you will real-

ize more money. At a zero rate of taxation you do not get very much. At 100 percent rate of taxation you do not get very much. And some place between zero and 100 is a correct rate that will raise the optimum amount of money.

I think that is what this debate on capital gains ought to be about. Can we lower the level of taxation and increase the revenues? Treasury says yes; Joint Tax Committee says no. And so as we go through these hearings, I am going to be very interested in quizzing witnesses from the different agencies as to what has been their historical record on predictions involving tax cuts before, and especially capital gains tax cuts before.

I will conclude by saying one thing about timber—because it is a parochial interest for me; it is the biggest employer I have in the State. President Bush's capital gains proposal last year did not include timber and without that I was not going to support it. It does include timber this year. It is also interesting the Sierra Club, the Audubon Society, the National Resources Defense Council and the Wilderness Society have endorsed a capital gains differential for timber because they realize it is critical for reforestation. And on private lands, without it, we will not adequately reforest and with it we will. It is interesting because these groups do not go outside their field very often. So I am delighted to have their support. They have not gone any further than timber. They have not speculated on corporate versus noncorporate. They have not speculated on collectibles versus noncollectibles. But as far as timber is concerned, they say it is necessary for the preservation of the environment.

Mr. Chairman, I am delighted to have these hearings. I look forward very much to the witnesses we are going to quiz.

The CHAIRMAN. Thank you, Senator.

Senator Durenberger?

OPENING STATEMENT OF HON. DAVE DURENBERGER, A U.S. SENATOR FROM MINNESOTA

Senator DURENBERGER. Mr. Chairman, I thank you very much.

I was unable to attend yesterday's hearing on savings incentives because I was escorting the Trans-Antarctica members to the White House. But I do understand that in your opening statement yesterday you mentioned how times and technology have changed to the point that your granddaughter is now sending you personal messages via the fax machine. And you noted that while facsimile transmission was invented in the United States, fax machines are no longer made in the United States. And the same, unfortunately, holds true of television, microwave ovens and VCRs to name just a few.

The decline of our manufacturing competitiveness did not occur overnight. But as the Chairman indicated yesterday, a relatively high cost of capital has made it difficult for many of our companies to take the long-term view and invest for the future. That is why I support the idea of restoring a tax incentive for long-term investment.

Mr. Chairman, I believe that the debate over capital gains should not take on the overtones of a partisan fight between the President and the Congress. I think the decision on capital gains ought to be

viewed in much the same perspective that we viewed the 1986 Tax Act and the 1988 trade bill. An important question to be asked is how a capital gains differential will affect America's competitiveness in a global market.

In that vein, I would preliminarily note that nearly all of our major trading partners, including West Germany, Japan, Canada, Taiwan, South Korea, most of the EC countries either exempt long-term gains from taxation or oppose a tax far lower than the U.S. tax. Although it would not be fair to attribute our short-term trade problems to how we tax long-term gains, I believe the issue is very important to the overall long-term health of our economy.

In 1987 I introduced legislation that would have provided a sliding scale long-term capital gains differential with a minimum 4-year holding period. I introduced the bill because I believed then and still believe that a real long-term capital gains differential will help to encourage a shift in investment strategy away from short-term to long-term. I believe the capital gains proposal now under consideration will go a long way toward achieving that goal, for it would provide a very strong incentive for investors to hold investments for the long-term rather than churning their assets.

The ranking member of this Committee has said, and I think I quoted him correctly here, that it does not make any difference from whom the money comes. I must differ with him on that point. I think it does make a big difference. I think it is important to point out that the current tax code makes almost no distinction between the entrepreneur who risks his or her capital on an unproved new frontier technology and the arbitrage speculator who gets in the middle of the latest corporate takeover.

In fact, our current system penalizes the long-term investor and entrepreneur because it does not factor in the impact of inflation on assets held for a substantial period of time. By allowing a sliding scale exclusion for truly long-term gains, this proposal diminishes the impact of inflation on asset values and reduces the possibility that investors will be taxed on phantom gains.

Furthermore, establishing a differential for a long-term gain will help to alleviate the current bias in the tax code which favors debt instead of equity. It encourages companies to saddle themselves with far more debt than we think prudent. Although a capital gains differential will not completely eliminate this bias, it will reduce the cost of capital for American companies, while increasing the after-tax rate of return on equity.

Mr. Chairman, much of the focus of our debate will surely focus on the revenue effects of cutting the capital gains tax. While Treasury estimates a six-year revenue gain of $12.5 billion, the Joint Tax Committee estimates an $11.4 billion revenue loss. I assume the debate between Ken Gideon and Ron Pearlman today will be interesting.

I would note, however, that neither estimate assumes how much additional revenue will be generated as a result of increased growth in the overall economy. That, as the ranking member has indicated, we all should anticipate will occur if we cut the capital gains rate.

So, Mr. Chairman, we should not approach the issue of capital gains by narrowly focusing solely on how many more capital gains

realizations will occur if we lower the tax rate. Instead, we should be considering whether or not a long-term capital gains rate differential will stimulate new investment, growth in our economy, long-term corporate investment, and increased global competitiveness.

I believe the answer to those questions is yes. And I hope this hearing will convince all the members of the Committee of the importance of adopting the President's proposal.

The CHAIRMAN. Our first witness will be Senator Graham from Florida. He has had a long-term interest in the reduction of capital gains tax rate.

Senator Graham, we are pleased to have you.

STATEMENT OF THE HON. BOB GRAHAM, A U.S. SENATOR FROM FLORIDA

Senator GRAHAM. Thank you, Mr. Chairman and Members of the Committee. I appreciate this opportunity to testify on behalf of S. 1938, which was introduced in November of last year by Senator Nunn, Senator Cranston and myself. I have a full statement, which I would like to file for the record and would present excerpts of that statement.

The CHAIRMAN. Without objection, that will be done.

Senator GRAHAM. Mr. Chairman, the purpose of S.1938 is to encourage long-term investment. For sometime we have been concerned with the time frame in which economic decisions are made and evaluated in this country. There is strong evidence that our country's investors, entrepreneurs and corporate management have substantially overemphasized financial return on the short-ranged basis to the detriment of a long-range investment strategy.

This short-range emphasis has resulted in a lack of research and development on increase in plant and equipment deterioration and created an environment in which many American industries are failing to invest in order to be competitive in the global economy of this and into the 21st century.

Mr. Chairman, as policymakers, we have a responsibility for the creation of an economic environment that encourages corporate management and investors to turn their focus away from quarter-by-quarter analysis for measuring success or failure. Unfortunately, Congress itself has not been immuned from the lure of short-term planning.

I would suggest, and do in further detail in my statement, that proposals that were made last year relative to the capital gains tax and the IRA fell into the trap we're seeing in cities that substitute short-term gain to the detriment of a long-term investment strategy.

We should be encouraging our corporate management, entrepreneurs and investors to emphasize the long-term. We should be encouraging these people to invest their money for long-term growth in the American economy which will provide jobs and economic opportunity. One step to long-range thinking is to lengthen the holding periods for investment purposes which is what S.1938 does.

Low-cost capital is another element that could remove some of the pressures for the instant gratification syndrome. From a public

policy point of view, we recognize that this cannot be achieved until we have the political will to balance our Federal budget.

However, we can assist in the achievement of low-cost capital and expand the horizon of the time frame for economic decisions by rewarding investors whose investments meet the criteria of being long-term.

Mr. Chairman, I look forward to working with your Committee to incorporate the provisions of S.1938 into a legislative program that enhances America's competitive future. Our bill has the essential characteristic of linking the amount of tax reduction to the length of the holding period. Essentially, after a one-year holding period the tax rate will be reduced by 5 percent; and a similar 5 percent each year thereafter up until a 10-year holding period, at which time the tax rate would be reduced by 50 percent over the base rate.

We believe that by linking the amount of the tax benefit to the length of the holding period, we will create a positive incentive for a different frame of reference in terms of evaluating investment decisions.

We have another provision which is drawn heavily from recommendations of Senator Bumpers that would give special attention to venture capital and entrepreneurial activities similar to the recommendations that were made by Senator Durenberger.

Mr. Chairman, our proposal and in fact no single proposal—can alone accomplish the objective of altering entrepreneurial behavior, but it can be a significant part in a comprehensive strategy to change America's short-term investment focus. I have a longstanding interest in adjusting capital gains as one means of lengthening the time frame for economic decisions. This bill is a step on the road to an economic objective which our nation much reach.

I look forward to working with your Committee to achieve this direction. Thank you, Mr. Chairman.

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

The CHAIRMAN. Senator, I think that statement is helpful. I have one concern, however. Philosophically, I can see the advantages in a graduated tax over a period of time. I also like the objective of trying to encourage long-term investment, but it does seem to me that such a proposal substantially adds to the complexity of the tax system when you have something for a conventional capital investment and you have something quite different for a venture capital investment.

And again, I must stress that we would like to encourage both of those. But one of our main objectives in the 1986 Tax Reform Act was to simplify the tax system, and now it looks like we are headed in the other direction.

I defer to any comment or question you may have, Senator Packwood.

Senator PACKWOOD. I have only one question, Senator. In your bill you included both individual and corporate capital gains, but you did not touch on corporate in your testimony. Do you still want corporate capital gains?

Senator GRAHAM. Yes. And we provide that the corporate rate would be one-half of the rate for individuals—that is, where indi-

viduals would have a 5 percent per year reduction in the tax rate, corporations would have 2.5 percent.

Senator PACKWOOD. Thank you.

The CHAIRMAN. Senator Durenberger?

Senator DURENBERGER. No questions, Mr. Chairman.

The CHAIRMAN. Senator Bradley?

Senator BRADLEY. No questions, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator.

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

The CHAIRMAN. Our next witness will be Hon. Michael Boskin, who is the President's Chairman of the Council of Economic Advisors. We are very pleased to have you.

STATEMENT OF HON. MICHAEL J. BOSKIN, PH.D., CHAIRMAN, PRESIDENT'S COUNCIL OF ECONOMIC ADVISORS

Dr. BOSKIN. I am very pleased to be here again, Senator. Mr. Chairman, Senator Packwood, and other distinguished Members of the Committee, I do have a statement I have provided. I would like for it to be placed into the record. Which I will summarize in my introductory remarks.

The CHAIRMAN. It will be taken in its entirety.

Dr. BOSKIN. Thank you.

I appreciate the opportunity to present the Administration's views on the capital gains tax provisions of the Savings and Economic Growth Act of 1990. The key component of that Act, as you know, is the restoration of the capital gains tax differential which existed prior to the Tax Reform Act of 1986. This proposal is an important part of a package of Administration initiatives designed to remove impediments to savings and investment, to encourage innovation and entrepreneurship, and to enhance economic growth.

The American economy is the largest most productive economy in the world. We are in the eighty-eighth month of the longest peace-time expansion in our history. We cannot, however, take continued economic growth merely for granted and we must not become complacent, especially at a time when our citizens are demanding that resources be devoted to providing nontraditional types of goods and services, such as a healthier environment, at considerable costs to the economy. We must redouble our efforts to enhance economic growth.

The Administration's foremost priority is to sustain the highest possible rate of economic growth. That goal, sir, is not just an abstraction, it is how we create rising living standards for the bulk of the population, how we develop the resources to uplift those most in need, how we provide economic and social mobility to our citizens, how we leave a better legacy to our children, and how we maintain America's leadership in the world.

The faster economic growth is going to require movement on several fronts, but it will make more social and private goals attainable. Increasing the rate of growth of living standards will require higher rates of savings and investment. Longstanding Government policies, as several of you—especially you, Mr. Chairman—mentioned such as the budget deficit, as well as tax policies, impede national savings and investment.

Partly because of these policies Americans save and invest a smaller fraction of gross national product than their counterparts in other industrialized countries. According to the World Bank the United States' investment rate ranks last among the 22 Western industrialized economies.

A major reason for the relatively low rate of investment in the United States is the high cost of capital. Some studies estimate the cost of capital in the United States is almost twice that in Germany or Japan. Taxes, a large component of the cost of capital, produce a bias against equity finance in the United States. Taxes on capital gains increase capital costs for equity finance while reducing the returns to investors.

Lowering the capital gains tax rate will lower the cost of capital. As a result of the Tax Reform Act of 1986, the overwhelming bulk of which was quite favorable, the United States unfortunately now taxes capital gains at the same rate as other income for the first time since 1921. The United States is burdened with a higher capital gains tax rate than almost every one of our major competitors. Most of them tax capital gains at a lower rate than ordinary income. Many of them do not tax capital gains at all—for example, West Germany, Italy, and most of the newly industrialized economies of the Pacific Rim.

Most of these nations also have numerous other tax provisions—such as partial or complete integration of personal and corporate income taxes—that reduce the overall taxation of capital income. The high cost of capital is a particularly onerous problem for new ventures and small businesses that have only limited access to traditional sources of finance.

Much of the return to entrepreneurs who bring new products to market, particularly through new business formation, comes through increasing the value of the business. Reducing the tax rate on capital gains will reward those who bring successful ideas to market and will help improve the climate to invest in new technologies and products, thereby creating jobs.

During the current record breaking expansion, as throughout U.S. history, most new jobs have been created by small and medium size firms. Lowering the capital gains tax rate will encourage entrepreneurs to start new businesses, to develop new products for new markets here and abroad. Lower capital gains tax rates will encourage risk taking, raise investment, improve competitiveness and spur economic growth.

These important issues, notwithstanding, as your remarks, Mr. Chairman, and those of the other Senators have indicated, much discussion has been focused on the more narrow question—how will the President's proposal or any other proposal affect Federal revenues?

Congress and the Administration are naturally concerned about the revenue consequences of any proposal, particularly during this period of necessary budget stringency and our joint responsibility under the Gramm-Rudman-Hollings law. While the economic benefits of capital gains tax reduction are likely to outweigh any reasonable estimate of its cost, let me briefly state some issues with respect to the revenue impact of the capital gains tax reduction before turning to its broader impact on economic performance.

Assistant Secretary of the Treasury, Gideon, is scheduled to testify later and he will amplify, I am sure, on these remarks.

A capital gains tax rate reduction affects revenues in five ways. Therefore, one has to estimate each of these five to get an estimate of the total impact of the capital gains tax rate reduction on Federal revenues.

First, the lower capital gains tax rate will induce greater realization of capital gains, as investors sell after they become unlocked from the higher capital gains rate. Many of these gains would escape taxation completely or at least defer it substantially. It is well documented that lowering the capital gains tax rate will reduce this lock-in effect, freeing investors to find more productive investments, increasing realizations of capital gains and raising revenue due to higher voluntary tax payments.

The second effect reduces revenue, as the tax rates on capital gains that would have been realized anyway are lower.

Third, over time there will be some restructuring of return to investments from ordinary income into capital gains. And with the reduced tax rate, that will reduce revenue.

Fourth, the President's proposal raises revenue through provisions to recapture depreciation allowances on investments sold for capital gain and to include capital gains as a preference item for alternative minimum tax purposes.

The CHAIRMAN. Dr. Boskin, I want to apologize to you, but I have been called to the floor. I have an amendment over there that warrants my attention and I am asking Senator Bradley to preside in my absence.

Dr. BOSKIN. Fine, Senator.

Fifth, and most important, the capital gains rate reduction will spur growth, increase incomes and GNP, leading to additional revenues.

While opinions can differ on each of these five factors, our best estimate of the bottom line is that the Administration's proposal to reduce capital gains tax rates is likely to raise Federal revenues in both the short run and over the longer horizon. The Office of Tax Analysis of the Treasury estimates that the President's proposal will gain $12.5 billion over the next 5 years. The Joint Committee on Taxation estimates that the President's proposal will lose $11.4 billion.

Neither of these estimates captures the favorable effects of economic growth on Federal receipts which would offset JCT's estimated losses or enhance OTA's estimated gains.

It is my own view, by the way, that OTA's revenue estimates are more representative of the extensive research on the effect of changes in capital gains tax rates on realizations.

Let me turn now for a few moments to discuss the impact of capital gains tax rate reductions on economic performance. The United States is faced with challenges to increase saving and investment, raise technical innovation and productivity growth, and improve our international competitiveness. The President's proposal on capital gains is one part—a central, important part—of a program to lower the barriers to meeting these goals.

Reducing the tax rate on capital gains will foster more rapid economic growth. To estimate the likely size of this effect, the CEA

has done a standard computation of the impact of lower capital gains tax rates on the economy. The computation traces through the effect of lower tax rates on the cost of capital, capital formation and the resulting increase in productivity and GNP.

This computation may well be conservative since it is ignores some important effects of capital gains, such as the reallocation of capital to higher productivity uses as the result of the reduced lock-in, increased entrepreneurial activity and so on.

Despite its limitations, it provides a rough, useful estimate of the magnitude of the likely effect and is comparable to other estimates. Over the past 2 years there have been a variety of estimates to the effect of reducing capital gains tax rates on national output and other costs of capital.

Put on a basis consistent with the Administration's proposal, a survey of these suggested that GNP will ultimately rise by between two-tenths of a percent and 1.2 percent per year.

The Council of Economic Adviser's estimate is at the effect lies roughly in the middle of this range, with GNP ultimately rising by about six-tenths of a percent as the result of adopting the Administration's proposal, which would amount to about $60 billion per year in the year 2000. This would be a rise equivalent to current Federal spending on education, training, employment and social services combined and roughly four times private sector spending on basic research.

Over the next 5 years, cumulatively, we estimate the President's proposal would increase GNP by roughly speaking $60 billion, over the next 10, cumulatively, by about $280 billion.

As I stressed in my opening remarks, increases in GNP represent new jobs, better opportunities and better standards of living for Americans. It also means higher Federal revenues. The estimated revenue dividend from the growth induced by the capital gains proposal would be roughly $12 billion over the next 5 years and probably over $50 billion over the next 10 years.

Let me make two final remarks. A variety of judgments must be made in making these sorts of estimates. One has to estimate how much capital costs will decline, how much that decline will stimulate investment, the time span and the speed over which that new investment will take place and the effect of that higher capital formation on economic growth. We have tried to make reasonable assumptions about each of those and, indeed, many of those assumptions are quite conservative relative to the literature. But reasonable people can disagree about various aspects of them. I would be happy to go into detail if anyone is interested.

Let me then conclude by saying that we are faced with a challenge of meeting international competition, of raising productivity growth, improving living standards and meeting our domestic and international obligations. In each case, more rapid economic growth is the foundation for meeting that challenge. Restoring the capital gains differential is a pro-growth policy that will reduce the tax bias against equity finance, decrease the costs of capital in the increasingly competitive market place, increase investment and accelerate economic growth.

Senator Bradley, that concludes my opening remarks. Thank you very much for the opportunity.

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

Senator BRADLEY. Thank you very much, Dr. Boskin.

Senator Packwood?

Senator PACKWOOD. I have just one question. I know you have to leave. Our next witness is Dr. Jane Gravelle with Congressional Research Service and she is quite critical of your analysis of the different capital gains studies, and these are the 12 studies that I refer to that you and Treasury are perpetually citing. Have you read her analysis and do you have any question or criticism of it?

Dr. BOSKIN. Well, yes. I know she is going after me. So it is a little awkward to say this before her. We received the paper yesterday.

Senator PACKWOOD. Okay.

Dr. BOSKIN. We had seen a preliminary version and we believe that there are some serious problems with her analysis, as she believes there are problems with ours. In terms of the critique she makes of the Treasury estimates and of the broad range of studies of the responsiveness of capital gains realization tax rates, she seems to downplay very substantially a large fraction of that evidence. She relies heavily on the time series studies, analysis of behavior through time, and discounts those on microeconomic or cross-section data, a trend that is the opposite of recent and econometric research.

She is, in my opinion, somewhat selective in her analysis of those studies and I think if one analyzes the full range of studies as Treasury has done and as I did in my letter to you and to Senator Bentsen, I believe that Treasury is more representative of the entire sample.

With respect to her criticism of our estimates on the cost of capital and on economic growth she seems to have several criticisms. One is that our cost of capital effect is too large. Analyzing that, it seems to me that she has assumed implausibly low tax rates on capital gains realizations of around 18 percent. I guess if you add in State and local taxes, that would mean almost everybody that is realizing those gains is in the 15 percent bracket. We think those are way too low.

She says quite incorrectly and I do not know the source of this— that we do not incorporate the loss of capital gains taxes due the effect of deferral and to step-up basis of death. Indeed our analysis does do that. It discounts the tax rate by a factor of 75 percent to account for deferral and step-up basis of death.

Our calculation is a standard user cost of capital calculation. She has a very, very high real rate of return and hence a given reduction on a much higher base would be a smaller percentage—a base that would require pre-tax rates of return of 16 percent or something like that. If you have a lot of such investments in mind, I would like to know about them after I leave Government and have an opportunity to rearrange my portfolio.

She also assumes more investment is debt-financed, looking at recent flow-of-funds data. We have used the historical average. And she also is very concerned about our assumptions about the source of funds and the supply of funds that would be made available— the supply of saving, if there is an increased demand for investments, say, in the corporate sector. I am not quite sure of why she

has that view. I believe she is thinking primarily that the U.S. economy is quite closed. The last 10 years has taught us the American economy is quite open to the flow of capital from around the world, which would assume that we face a very elastic supply of saving to the American economy.

So for all of those reasons, I think that her estimates are probably way too low. She also in her model assumes investors are myopic and she assumes that providing incentives for investors actually reduces the capital stock.

Senator BRADLEY. Other than that you agree with it, right? [Laughter.]

Dr. BOSKIN. Other than that, I have a high regard for Jane. I have known her for a long time. I was a little surprised at this. We have tried to reconcile the cost of capital estimates.

Senator PACKWOOD. I am sorry you did not have time to analyze her report. [Laughter.]

Dr. BOSKIN. We were up late last night so this is only a preliminary assessment. [Laughter.]

In trying to go from her estimates to ours—from her very small effect of the cost of capital—by using more reasonable estimates of tax rates on realized gains of the required rate of return to attract investment and things of that sort, we were able to fully reconcile the difference between her estimate of about a 0.9 reduction and ours of around a 3.5 percent reduction.

I also am of the opinion that the basic structure of her model, which is not forward looking, but rather myopic, tends to understate the likely impact on long-run economic growth.

All that said, let me just repeat what I said at the beginning. There are many assumptions that have to be made. We have tried to be sort of in the middle of the set of assumptions. We have a somewhat conservative set of assumptions we have made, we believe. She is making more conservative assumptions yet. Yet other people would estimate a much larger effect than we would.

Senator PACKWOOD. Thank you, Mr. Chairman.

Senator BRADLEY. Thank you.

Senator Durenberger?

Senator DURENBERGER. No questions, Mr. Chairman.

Senator BRADLEY. No questions?

Senator DURENBERGER. No, sir.

Senator BRADLEY. Dr. Boskin, I would like to, if I could, deal with the question of how much the capital gains reduction will actually do for the economy or cost of capital and try to compare that to other types of actions that might produce similar or more positive impacts. Last fall, I think it was, I think in your testimony before the Joint Economic Committee you said that the 30 percent capital gains exclusion would be the equivalent of about a 10 to 15 basis point reduction in the interest rates.

I was curious. Your analysis that you made to make that statement was what?

Dr. BOSKIN. Well we have an analysis and the proper number would be about 20 basis points, in my opinion. There was a long series of questions and Senator Sarbanes kept saying it is 5 basis points and I said I thought it would be several times that. So I had not done a precise calculation. I was doing that off the cuff, in my

head. We have now done a precise calculation and it looks like roughly 20 basis points.

Senator BRADLEY. So that you think that——

Dr. BOSKIN. But I don't think you can fully——

Senator BRADLEY [continuing]. In terms of interest rates, it would be the equivalent of a reduction of two-tenths of a percent. Right? On 20 basis points.

Dr. BOSKIN. On the cost of capital——

Senator BRADLEY. Right.

Dr. BOSKIN [continuing]. For those firms that are able to borrow in traditional capital markets. But we believe that this will be a source of funds to firms that have difficulty with traditional borrowing: new start-up firms.

Senator BRADLEY. No, but just focusing on the economic impact, because that is really what the Committee is trying to think through. One of the claims is that, you know, we reduce the capital gains rate and there is boom, and there will be growth, and there will be greater savings. These are claims that should be looked at, and they should be looked at in their own merit, but also looked at in terms of what other things might happen that could yield the equivalent amount.

That is why your statement this morning that the reduction in capital gains—the exclusion of 30 percent—is roughly the equivalent of two-tenths of 1 percent interest rate drop, is I think a very important thing for the Committee to keep in mind and that we have to be realistic about what this actually means for the economy.

Dr. BOSKIN. I would agree with that fully, Senator, except I tried to indicate in my remarks that I thought that for an important sector of our economy, you cannot really capture the important stimulative effect by just looking at the cost of capital or the reduction of interest rates. New start-up firms have a very difficult time getting access to debt finance or the kind of venture capital that tends to get spoken of. Only one in five initial public offerings, for example, even had any venture capital. It comes from informal capital.

I believe the effect there would be quite a bit larger, but that is a modest, although very important sector of our economy.

Senator BRADLEY. Do you have an analysis of that?

Dr. BOSKIN. We have prepared some very preliminary analysis of the type I have just indicated. But we do not have the—we have not yet been able to quantify the impact on GNP.

Senator BRADLEY. Now earlier this year we had Alan Greenspan here. I asked him a question that, if we took the Social Security trust fund off budget and then we faced up to what the deficit was and balanced the budget, and then used the trust fund to cut and retire the outstanding debt in the amount of the trust fund, what would interest rates be. He said that interest rates would be 3 percent, which is 300 basis points, roughly, lower than where they are now.

Do you basically agree with his analysis?

Dr. BOSKIN. Well qualitatively I believe if we did what you just suggested, which would involve a tremendous change of trillions of dollars in reduction in national debt in the Government's net

saving over a span of time—and which, by the way, in general, as you know we have a proposal to do something similar to that, that we have presented with our budget—then the impact on interest rates would be substantial. I have not done an analysis that would suggest they would fall 300 basis points, but I am sure they would fall substantially.

Certainly that large an effect, if the Fed accommodated it—which this big change in fiscal policy, running a large cumulative surplus, which of course they ought to do—it would be foolish of them not to—would certainly lead to a large reduction in interest rates.

Senator BRADLEY. It just makes the point, I think, and you have confirmed the point, in terms of value to the economy, reduction of the budget deficit has an infinitely more powerful effect on everything than, you know, tacking on some exclusionary capital gains however merited it might be, in a narrow sense, as you have made the point.

Dr. BOSKIN. Well let me just reiterate our strong——

Senator BRADLEY. You would certainly agree with that.

Dr. BOSKIN [continuing]. Commitment to deficit reduction and let me just reiterate that while capital gains is important, deficit reduction is also tremendously important.

Senator BRADLEY. Okay.

I would like just to get two other points. Last year CEA said household savings was $206 billion in the country. How much additional savings would you expect from this capital gains reduction? How much more than $206 billion?

Dr. BOSKIN. Well we would expect some additional saving. We would also expect the United States to be a more attractive place to invest and some saving to come from the rest of the world as well as from our household sector. I do not have the precise number before me. I will get it for you.

Senator BRADLEY. Okay. I would very much like to have that number if I could.

[The information appears in the appendix.]

Senator BRADLEY. Then there is the problem, of course, on revenue estimates which, you know, gets extremely complex. But do you have any explanation? In 1985 Treasury projected that there would be a revenue increase from raising the rate from 20 to 28 percent. And now there is a projection there will be a revenue increase for moving the opposite way. Which Treasury was right?

Dr. BOSKIN. Well I will let you ask the Treasury about the earlier study. But my own opinion is that there would be a gain in revenue from the President's proposal.

Let me also emphasize that while, because of Gramm-Rudman, there is tremendous emphasis on these differences, they do amount to a very small fraction of total Federal revenue—one- or two-tenths of a percent.

Senator BRADLEY. I think somebody that works on your staff now, Larry Lindsey, did a study at Harvard——

Dr. BOSKIN. He is not on my staff, but he is in the White House, yes.

Senator BRADLEY [continuing]. In which he said that basically the claim for revenue increases was not merited, was false; and he laid

the study out which was, I thought a rather startling document. He did it in Tax Notes. I guess you saw the article.

Dr. Boskin. No, I am not familiar with this particular article.

Senator Bradley. You have not seen the article? Okay. Well I will save the questions then for Treasury on the various studies.

Dr. Boskin. I am aware of an article that he co-authored with Jane Gravelle, Senator Packwood, in Tax Notes mentioned before, where both of them seemed to agree that there would be an extremely strong efficiency gain from reducing the capital gains tax rate, a substantial increase in the productivity of investment and so on.

Senator Bradley. But not a revenue increase? In fact, the opposite.

Dr. Boskin. I do not recall. This was, I think, from last year and I just do not recall the discussion of that.

Senator Bradley. That aspect of the article you do not recall?

Dr. Boskin. No. All I remember—No, no, no. There certainly would be a large short run revenue gain from the unlocking, from the higher productivity, and it actually ought to persist if we earn higher productive investments.

Senator Bradley. Okay.

Well, I thank you very much for your testimony, Dr. Boskin. We always welcome you to the Committee and think you are an excellent economist.

Dr. Boskin. Thank you, Senator Bradley.

Senator Packwood. No questions.

Senator Bradley.

Senator Durenberger?

Senator Durenberger. No questions.

Dr. Boskin. Thank you very much.

Senator Bradley. All right.

Our next witness is Jane Gravelle, Senior Specialist of Economic Policy, Congressional Research Service, who has had the benefit of listing to Dr. Boskin. Welcome to the Committee, Dr. Gravelle.

STATEMENT JANE G. GRAVELLE, PH.D., SENIOR SPECIALIST IN ECONOMIC POLICY, CONGRESSIONAL RESEARCH SERVICE

Dr. Gravelle. Thank you. I would like to thank you for the invitation to appear before you today to discuss my study entitled "Can a Capital Gains Tax Cut Pay for Itself." I am going to summarize my statement which I have provided to the Committee. I have also provided copies of the study itself.

There are two possible avenues through which a capital gains tax cut might be argued to pay for itself. The first is through a large and sustained increase in realizations. The second is through an increase in economic growth and the revenue base.

Both the Joint Committee on Taxation and the Administration estimate a substantial realizations response. The Joint Committee has estimated a loss of $11.4 billion over the next 5 years; the Administration has estimated a gain of $12.5 billion. The Administration has also argued, however, that using the smaller realizations response estimated by the Joint Committee the remaining shortfall in revenues will be made up by economic growth.

The economic growth effect appears substantially overstated for a number of reasons. First, there appears to be an error in measuring the cost of capital, which has magnified the estimate by a factor of six to seven times. I estimate that the effect on the cost of capital will be .5 percent, as contrasted with the 3.6 percent estimated by the Council.

Secondly, there is a failure to take into account the savings response. Mike just mentioned an international economy. I do not think introducing the open economy would help his argument very much since the capital gains tax is on the wrong side of the market, but we can talk about that later if you would like.

The third problem is the failure to explicitly account for the very slow adjustment process in the capital stock. It typically takes 30, 40 or 50 years for the capital stock to adjust in most models. And during that interim period, when the capital stock is growing, any deficits that occur will soak up any induced savings. If the induced savings is smaller than the increased deficit then we will find that the capital stock will contract rather than expand. My dynamic study of these effects, even with a very generous savings elasticity, indicates that that is exactly what will happen—the capital stock will contract and the initial revenue loss predicted by the Joint Committee would be slightly magnified.

The first route, therefore—induced realizations—is the avenue through which a capital gains tax cut might conceivably pay for itself. Let me, just in case I do run out of time, try to summarize my analysis. My analysis suggests that the Joint Committee's estimates of the revenue effects appear to be more reasonable predictions of the revenue consequences than those of the Administration and may themselves substantially understate the revenue loss associated with cutting the capital gains tax.

Before discussing the statistical evidence, I would like to make two general observations. First, we all recognize that there are uncertainties associated with all of the statistical studies and to some extent the public policy question is how to use highly imperfect information to decide how to accommodate a tax provision in the budgetary process.

If we use elasticities that are too high, we will have increases in deficits that retard economic growth. If we use elasticities that are too low, we achieve somewhat more deficit reduction than otherwise planned. If the latter error is considered less damaging than the former, then we will wish to be extremely conservative in choosing our elasticities. I think conservatism is the position that the Administration has taken.

Secondly, the only significant source of a sustained permanent increase in realizations is selling assets which would otherwise have been held until death. Thus, to believe that there is a large, permanent sustained increase in realizations we must believe that individuals who are otherwise not planning to sell assets at all and thus to escape the tax entirely will now be induced to sell in large numbers.

The Administration has argued in testimony presented earlier to this Committee that statistical studies have shown their realizations response to be quite conservative. They presented a table of 12 studies showing that their long run elasticity is smaller than 9

of the studies. The Administration's tabulation contains, in my view, a number of problems which I have corrected in my testimony on page 6. When these elasticities are corrected, the Administration's estimates rank relatively high. Or to put it another way, if the Administration were to choose their elasticity from the corrected list of elasticities which would have the same rank as in the original list, they would choose an elasticity only 60 percent as high. And that is an elasticity which would produce a revenue loss larger than that of the Joint Committee.

One also has to consider very carefully to what extent these empirical studies are valid. There are—I hope not to get into too much economic jargon here, but there are two basic kinds of studies—microdata studies, which look at individuals; and aggregate time series studies, which look at aggregate changes over time. These studies yield very different results as shown on my bar graph on page 8.

The twin towers on the right are the cross-section studies—microdata studies; then the middle ones are the panel studies; the ones on the left are the time series studies. The microdata studies are the only ones that have yielded very large responses and they have also yielded very disperse responses. The time series studies have produced less disperse and lower elasticity estimates.

I tried to explain in my study and in my paper what I consider and many others consider to be two disabling flaws in the microdata studies. One, the inability to separate the temporary from the permanent response; and the second, the inability to account for individual specific differences in these studies.

For those reasons I do not believe that these studies are valid for estimating the effect of the capital gains tax cut. The Joint Committee has taken the position that these microdata studies are not very reliable and that is a judgment with which I concur.

The time series estimates, I suspect, offer our best shot at trying to estimate the aggregate realization response. They have some problems as well. However, to the extent that I was able to identify what I believe the major problems are, those problems are such as to cause these elasticities to be overstated. These involve not being able to deal with the short versus the long run response; not being able to deal with changes in realizations when the stock market moves rapidly; and many institutional changes over the years, such as LBO's, and so forth, which have induced realizations, which occurred at the same time that the tax rate was reduced.

It is for those reasons that I believe that the Joint Committee's estimates of the revenue effect are more reasonable predictions of these effects and that they, themselves, may well be understated.

In the final analysis, there is always going to be some uncertainty associated with these estimates. We can only use these studies to try to guide our thinking about the behavioral response. I hope my comments have been helpful to you in considering this issue.

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

Senator BRADLEY. Thank you very much, Dr. Gravelle.

Senator Packwood?

Senator PACKWOOD. Doctor, these studies you talk about are those 12 studies that Treasury has, are they not?

Dr. GRAVELLE. There are 12 studies from the literature, Senator.

Senator PACKWOOD. Yes, well in the literature. But Treasury cites them all, and eight of them, as they interpret the studies, would cause revenue to be raised by this capital gains cut, four would cause it to be lost.

Dr. GRAVELLE. It is nine and three, I think.

Senator PACKWOOD. Okay, nine and three. That is even better.

Dr. GRAVELLE. According to their list.

Senator PACKWOOD. And actually of the nine, if you rank them, the 1985 Treasury II study, which is the one they rely upon for the behavior is the lowest of the nine. I mean there are eight others that say it would raise more money than Treasury does.

Dr. GRAVELLE. Let's see, the Treasury—which Treasury study are you referring to?

Senator PACKWOOD. Well I think it is Treasury II, not to be confused with any of the studies they were putting out during Tax Reform. The highest one is Gillingham-Greenless and Zeischang.

Dr. GRAVELLE. That is right.

Senator PACKWOOD. That is 1989.

Dr. GRAVELLE. Right.

Senator PACKWOOD. The Treasury 1985 II is the eighth on the list, ranked in order of how much revenues they will produce.

Dr. GRAVELLE. On their original list?

Senator PACKWOOD. Yes.

Dr. GRAVELLE. Yes, that is right.

Senator PACKWOOD. Then you have four studies——

Dr. GRAVELLE. That is a time series study.

Senator PACKWOOD. Yes, theirs is. But all of these are not time series studies.

Dr. GRAVELLE. No. The ones at the top are mostly the microdata studies.

Senator PACKWOOD. Yes. Then you have four studies that indicate they will lose revenue. And the one that indicates it will lose the most is Professor Auerbach who is testifying later today.

Dr. GRAVELLE. Right.

Senator PACKWOOD. Those are the studies you are talking about?

Dr. GRAVELLE. That is right.

Senator PACKWOOD. All right.

Dr. GRAVELLE. The ones on page 6.

Senator PACKWOOD. All right. Now what I want to know is this: I want to phrase this right. Do you not agree with those studies or do you not agree with the Treasury's assumptions? And, have you changed the assumptions, so that when you criticize the studies, it isn't really the studies?

Dr. GRAVELLE. Well I have done—are you referring to my corrections in the list?

Senator PACKWOOD. Yes.

Dr. GRAVELLE. Is that what you are asking about?

Senator PACKWOOD. Yes. Have you changed the assumptions upon which the studies were based?

Dr. GRAVELLE. No. No. The reason that I made the changes—there are really three reasons. One is that many of these studies are run in functional forms so that the elasticity, which is the percentage change in realizations divided by the percentage change in

taxes, the elasticity rises as the tax rate rises. So it is very important if you are doing a comparison to make sure that all of your studies, as much as possible, are evaluated at the same tax rate. So that is one set of changes that I made, to try to evaluate them all at the same tax rate.

Senator PACKWOOD. But I want to make sure because I have asked the authors of two of the studies and they would say that you have changed their assumptions in the studies. You are saying you have not changed their assumptions?

Dr. GRAVELLE. Not at all.

Senator PACKWOOD. You have taken exactly the assumptions they have and come to a different conclusion?

Dr. GRAVELLE. I have not redone the studies. I have corrected the studies for the correct tax rate—that is to put them all in a consistent tax rate. I have looked at the studies and put down what I feel is the representation of the studies from the authors. And then there was one, I think where a mistake was made. I will be happy to amplify any particular study if you would like.

Senator PACKWOOD. Well let me ask you, are you working from the baseline capital gains realizations from the CBO assumptions of what they say the realizations would be or are you using a different assumption?

Dr. GRAVELLE. My numbers have nothing to do with that issue. They are just looking at the elasticity estimates themselves.

Senator PACKWOOD. All right. Then I will save that question for Ron Pearlman. I think I have no other questions, Mr. Chairman.

Senator BRADLEY. Thank you very much, Senator Packwood.

Dr. Gravelle, do you have any response to Dr. Boskin's comments? Were you able to note all those?

Dr. GRAVELLE. Well, I——

Senator BRADLEY. There were so many.

Dr. GRAVELLE. Well I would like——

Senator BRADLEY. What one or two would you like the Committee to focus on?

Dr. GRAVELLE. I would like to talk about his statements about the cost of capital. Because that is the first step you take and if that step has got a problem, then all your other steps are off too. The cost of capital estimate that is 3.6 percent is just completely inconsistent with the magnitude of the revenue effect. I used the cost of capital formula and came out with a 0.9 percent effect for the corporate sector and then I cross checked that by looking at the revenue estimates themselves. That is, I took a portion of the revenue associated with the corporate sector, divided by corporate profits as a cross check and that came out about the same level.

The magnitudes of these kinds of—I mean you can put a lot of numbers in a cost of capital estimate and change it. But with this kind of tax change, that is a capital gains, there is very easy cross check to do, which is just to look at the loss itself. And that is what I did, just to check that my number was reasonable. And based on the revenue loss, the percentage change in user cost is about .5 percent. It is a small effect.

Senator BRADLEY. I think that is an interest point that you make. That is, all these models make predictions based upon historical data, right?

Dr. GRAVELLE. Yes, that is correct.

Senator BRADLEY. And then they say, okay, here is the 1986 Act that went into effect, it removed the exclusion for capital gains and, therefore, we predict that this will raise or lose revenue. And you are saying, okay, well this is all fine, you know, economists in a room, you always find 100 economists, 100 different opinions, and everybody has a different idea. But you are saying there is a chance for a reality check here.

Dr. GRAVELLE. Yes, that is correct.

Senator BRADLEY. Did the removal of the exclusion produce revenue or lose revenue? And how did that compare to the various studies predictions?

Dr. GRAVELLE. Well you can only use the time series studies to try to predict anything like that, because that is what is built into them. You cannot look at any one. I mean that is why you use statistical analysis. You cannot look at any one particular year. But I think a point, and a point you are probably going to hear from the Joint Committee, is that were you to take these realizations elasticities and try to go back and predict, you would be on very slippery footing with some of the cross section studies.

I mean the large elasticities there would have exhausted all of the accrued assets. You would run out of them.

Senator BRADLEY. The various studies made predictions that if you remove the exclusion how much more revenue will be produced. And, you know, dimensions—Felstein, $37 billion; Lindsay, $83 billion; Treasury, $55 billion; actual, $133 billion. I mean that is a fairly startling difference here.

Dr. GRAVELLE. Yes. Yes.

Senator BRADLEY. Wouldn't it be interesting to get this data for 1988?

Dr. GRAVELLE. Well I think it would be very interesting to take some of these studies and go back and see how well they predict. I think that is useful.

Senator BRADLEY. To me that basically is, does this have any relevance at all to what we are talking about.

Dr. GRAVELLE. That is right. Well I do think we need to look back at the basic information we have to try to check what our models do. Our models impose consistency on us and that is why we use them. But there is no substitute for thinking.

Senator BRADLEY. Well we might ask you to do that—have formatted all of the models and their predictions versus the realities.

Senator Heinz?

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

Ms. Gravelle, the Treasury Department back in 1984 recommended repealing the capital gains tax differential and would have coupled that with indexing for capital assets. The reasons given for that proposal were, and I quote, "The current preferential tax rate for capital gains has often been justified as an allowance for the overstatement of capital gains caused by inflation. The preferential rate actually serves this purpose only sporadically. The effects of inflation accumulate over time, yet the preferential tax rate does not vary with the holding period of an asset or with the actual rates of inflation during such period. As a result, the preferential

rate undertaxes real income at low rates of inflation and overtaxes capital gains at higher rates of inflation.

Moreover, the preferential rate does not prevent taxation of inflation caused nominal gains in circumstances where the taxpayer has in fact suffered an economic inflation adjusted loss."

Now in sum and substance, the President's capital gain proposal is a preferential rate. It does not include, for the most part, indexing. If one had a choice of doing one or the other, which would be the better tax and economic policy?

Dr. GRAVELLE. Well I think that depends on what your objective is.

Senator HEINZ. Let's say the objective is for the Government to be economically neutral with respect to whether or not people hold their investments for a longer or shorter time.

Dr. GRAVELLE. Well if you really want to be economically neutral you would probably choose indexing, I would think, over——

Senator HEINZ. Isn't that an important goal of the Tax Code, or at least the 1986 Tax Reform Act, economic neutrality.

Dr. GRAVELLE. Certainly, neutrality is an issue, and indexing would also do more for unlocking.

Senator HEINZ. I beg your pardon?

Dr. GRAVELLE. For unlocking of gains relative to an exclusion. But it would not encourage the holding on of assets for a long period of time. So it really depends on——

Senator HEINZ. It wouldn't encourage it, but wouldn't it do less to discourage the holding of assets for a longer period of time?

Dr. GRAVELLE. Well let me just digress for a minute and say——

Senator HEINZ. No, no.

Dr. GRAVELLE. Okay.

Senator HEINZ. You made a statement which needs to be clarified right now. You said it will not encourage people to hold longer and that nothing may ever encourage people to hold an asset longer than——

Dr. GRAVELLE. But compared to an exclusion——

Senator HEINZ [continuing]. But would you agree that taxing the inflation gains discourages longer holding periods; particularly since the longer you hold a capital asset the more inflation-generated gain you are likely to have, wouldn't you say the current tax regime and the President's proposal, as it stands now, does nothing to address what is a disincentive to hold for longer periods?

Dr. GRAVELLE. It is a highly imperfect substitute for indexing.

Senator HEINZ. Yes. But what about the encouragement, discouragement question?

Dr. GRAVELLE. The indexing should do more to unlock investments relative to that exclusion.

Senator HEINZ. I don't know what that means. What do you mean by unlock investments?

Dr. GRAVELLE. Well let me try to say this again. If you were to use indexing rather than a flat exclusion you would have a larger exclusion ratio the shorter the period of time the asset is held.

Senator HEINZ. Yes. But explain the context of unlocking to us.

Dr. GRAVELLE. In other words, if you were going to do an exclusion then an asset held for maybe a year you might exclude 90 per-

— cent of it, an asset held for 2 years, you might exclude 80 percent. You would have a sliding scale——

Senator HEINZ. As in the Finance Committee bill last year.

Dr. GRAVELLE. [continuing]. That would be the opposite of what the President has proposed.

Senator HEINZ. Yes.

Dr. GRAVELLE. So it really depends on how important the unlocking versus trying to get sort of a longer time horizon is. I mean there are a lot of other issues between those proposals as well, but——

Senator HEINZ. But if you had to choose between one or the other, you would choose indexing I gather?

Dr. GRAVELLE. I don't know. I cannot recommend anything.

Senator HEINZ. I am not asking you to recommend anything. I am asking you to make a choice. If someone puts a gun to your head and says you have to choose one or the other, which is better for the country, which one would you choose?

Dr. GRAVELLE. Senator, if I answer that question, the Congressional Research Service may have a gun to my head. I am really not permitted to make recommendations.

Senator HEINZ. We wouldn't want that to happen.

Dr. GRAVELLE. No, please not.

Senator HEINZ. You mean you are not allowed to express opinions either for or against anything?

Dr. GRAVELLE. I can state the advantages and disadvantages of those two proposals. That is all I can do.

Senator HEINZ. Okay. All right.

Thank you, Mr. Chairman.

Senator BRADLEY. Thank you, Senator Heinz.

Senator Rockefeller?

Senator ROCKEFELLER. Dr. Gravelle, this may have been asked before I came in. But there was the tax cut back in 1981. The theory of it was to increase savings on the part of Americans as people and in terms of corporations it was to encourage corporations to reinvest, and there were no strings, of course, put upon it. Because that assumption was made, it did not work out that way and there were a variety of bad results, at least in the judgment of this Senator, that came from that; and I think we have been paying quite a price since then.

The same Administration came back—and I think that Senator Heinz referred to this—and rejected capital gains differential in Tax Reform and Treasury at that time found that a large rate reduction had in fact had a negligible effect on growth anyway. So now we have the Administration coming back.

I appreciate your CRS position, but I can ask you some questions to which you can give neutral responses. Do you think—would you characterize our present situation in the Tax Code in this country as relates to individuals as being progressive, regressive or somewhere in between?

Dr. GRAVELLE. Well the income tax is progressive. The Social Security——

Senator ROCKEFELLER. The changes that we've made to it?

Dr. GRAVELLE. The changes that we have made since the 1980's, I think those have pretty clearly reduced the progressivity of the tax system.

Senator ROCKEFELLER. Have been what?

Dr. GRAVELLE. Reduced the progressivity of the tax system.

Senator ROCKEFELLER. Of income taxes?

Dr. GRAVELLE. Of income taxes, yes; and also the tax system in general because we have had more reliance on Social Security taxes relative to income taxes, and particularly corporate income taxes.

Senator ROCKEFELLER. In terms of capital gains in which common wisdom indicates that that would be a better result for those who have wealth as opposed to those who do not, it would not be unfair to say that that would increase regressivity?

Dr. GRAVELLE. I would say reduce progressivity.

Senator ROCKEFELLER. Reduce progressivity?

Dr. GRAVELLE. Yes. I think it is pretty clear that the capital gains tax benefits are largely concentrated among high income people. There are certainly people, such as those that Senator Packwood mentioned, that have occasional gains, but I think the evidence is pretty clear that the wealthy people are the people who mostly have capital gains income. And so giving them or reducing their taxes would make the tax system less progressive.

Senator ROCKEFELLER. Thank you, Mr. Chairman.

Senator BRADLEY. Thank you, Dr. Gravelle. Let me just ask one other quick question. In terms of relative impacts on the economy, you had Dr. Boskin saying that if you do the exclusion on capital gains it will cut the interest rates from 8 percent to 7.8 percent. Then you had Alan Greenspan saying that if you were able to balance the budget and take the trust fund and reduce the debt, it would cut interest rates from 8 percent to 5 percent or even down to 3 percent.

It seems to me that that is an aspect that we do not consider in the Finance Committee because we deal with taxes. And yet from 1950 to 1980 the real interest rate in America was thirty-five one-hundredths of a point. From 1980 to 1989 the real interest rate has been 4.5 percent. So that if you were doing something to get the interest rates down, relative to some little change in the Tax Code, which do you feel as an economist would have the most positive impact on the economy?

Dr. GRAVELLE. Well it is not even whether things are positive; it is whether they are certain. I mean I think that reducing the deficit is something we can be fairly sure would increase savings. I think that tax subsidies are uncertain. That is what the literature says. And certainly if they are financed by deficits they run the risk of actually deterring investment.

Senator BRADLEY. Thank you very much, Doctor Gravelle.

Senator PACKWOOD. Could I ask a follow up?

Senator BRADLEY. Sure.

Senator PACKWOOD. Did you ask her the question, if we got the deficit down would the interest rates go down? I didn't quite understand what you asked her.

Senator BRADLEY. I was asking her what is the relative impact on the economy of a change in the Tax Code versus interest rates

coming down. And she asserted interest rates coming down would have a much more positive impact. The means to interest rates coming down would be reduced in the budget deficit.

Senator PACKWOOD. And you agree?

Dr. GRAVELLE. Yes.

Senator PACKWOOD. Then why did the interest rates go down when the deficit went up to $225 billion?

Dr. GRAVELLE. Well there are lots of influences on the interest rate—that is the economists' regular out, but it is true.

Senator PACKWOOD. Unforeseen circumstances.

Dr. GRAVELLE. Unforeseen circumstances. [Laughter.]

But nevertheless, we do know that if we reduce the deficit we are pretty clearly increasing our national savings rate. That is a pretty direct route.

Senator PACKWOOD. One last specific question. Did the 1986 Tax Reform Act make the personal income tax code more or less progressive?

Dr. GRAVELLE. Well that is where I disagree with some of my colleagues. I do not think it had a big effect in general, but I do think that it might not have done as much to increase progressivity as a lot of people argue, simply because of a lot of the tax increases, such as the accounting rules and the restrictions on tax shelters and so forth that were very short lived revenue gains. I do not think it was really very important in the aggregate though as far as the effect. Certainly nothing compared to what happened in the 1981 tax cuts which had a big effect.

Senator PACKWOOD. Thank you, Mr. Chairman.

Senator BRADLEY. Thank you very much, Dr. Gravelle.

Our next panel consists of Hon. Kenneth W. Gideon, Assistant Secretary for Tax Policy, U.S. Department of the Treasury, Mr. Ronald A. Pearlman, Chief of Staff, Joint Committee on Taxation.

It is my understanding that there is a million purse offered for a one-on-one game for Michael Jordan and Magic Johnson and this is the Finance Committee equivalent of this confrontation. [Laughter.]

Although people who see the former one-on-one will understand it much more clearly than those who will listen to this, I am sure. We welcome you to the Committee and we look forward to your testimony. Shall we flip a coin to see who goes first?

Mr. Gideon?

Mr. GIDEON. I am pleased to begin.

STATEMENT OF HON. KENNETH W. GIDEON, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. GIDEON. Mr. Chairman and Members of the Committee, I appreciate this opportunity to discuss with you today the proposed capital gains-tax rate reduction for individuals that is contained in the Administration's——

Senator PACKWOOD. Could I interrupt for a moment? Mr. Pearlman, do you have a written statement?

Mr. PEARLMAN. Senator Packwood, I will be working from the methodology pamphlet we issued yesterday and an outline which you should have in front of you.

Senator PACKWOOD. I just got it 5 seconds ago. Thank you.

Mr. GIDEON. Let me begin again, if I might.

I appreciate this opportunity to discuss with you today the proposed capital gains rate reduction for individuals contained in the Administration's 1991 budget. Over this year and last, arguments for capital gains tax cuts have been stated in great detail and I am not going to attempt here this morning to catalog the entire group.

Dr. Boskin, in his testimony, has already addressed the crucial issue of economic growth. Judgments about how best to configure a tax system so as to promote economic growth are, of course, not made by the United States alone. They are made by our major trading partners as well. The difference between their judgments and those reflected in our current tax law on this issue is striking. We alone, among the other G-7 countries—Canada, France, Germany, Italy, Japan, and the United Kingdom—provide no relief from ordinary rates on capital gains. Chart 1 attached to my testimony provides a country-by-country comparison.

Most of these nations have also integrated their corporate income tax systems to eliminate or reduce multiple layers of tax on corporate income. The focus of their tax policy on capital formation is clear. These differences are all the more striking when one considers how quickly these countries responded to our rate reductions in 1986. Since 1986 all have enacted rate reduction measures.

These developments raise the question as to whether the United States will volunteer to become the control case in an international tax policy experiment during the next decade. While our major trading partners vigorously pursue tax policies intended to lower the cost of capital and make their businesses as competitive as possible, opponents of a capital gains tax cut would have this country take the opposite course.

Our competitors are also industrialized democracies. We know from the reports of their political debates that they too are concerned about distributional issues. Yet they have chosen a very different path with respect to capital income taxation. Their policies demonstrate a recognition that capital is the seed corn of economic growth that benefits their entire populations. It is important that we understand that, if they are right and if we fail to alter our own course, our distributional disputes will be about a shrinking portion of the world's wealth.

We must also come to grips with the fact that the new birth of freedom and free markets which offer so much promise for a better future may limit this Committee's freedom of action. The time has passed when the United States may design its tax system without regard to the impact of that system on the ability of Americans to compete in the global market. The stakes here are not just profits, but jobs. We are apt to discover over the next 10 years that a tax system which imposes a higher burden on capital than our trade competitors' systems may prove as great a competitive handicap as inefficient technology.

Let me now turn to the question of the revenue estimates. The differences between the Joint Committee on Taxation staff and the Treasury Office of Tax Analysis staff are set forth in Chart 2 to my testimony. On March 6, I delivered to this Committee a detailed description of our revenue estimating methodology and assumptions.

I called on the Joint Committee staff to make public the same information on their methodology as promptly as possible. A lengthy pamphlet has emerged shortly before this hearing. Given its length and the brief period of time that we have had to review it, my responses today must be preliminary.

The most striking thing about the pamphlet is what is not in it. In Table 5 in the Appendix to my March 6 testimony the equations and parameters necessary to replicate OTA's estimates of the year-by-year revenue impact of the President's capital gains tax proposal were presented. Unfortunately, the same detailed specification of methodology used by the JCT is not contained in the Joint Committee pamphlet.

Instead, Appendix A to the Joint Committee pamphlet offers us two equations from the literature without telling us that they were the equations utilized by the Joint Committee, only that their equation is much like one of the equations presented. We would still like to have a complete set of data comparable to what we provided on March 6.

Second, the pamphlet confirms the critical factual assertions made in my March 6 testimony about the primary reasons for the differences in estimates. The CBO baseline figures are substantially higher than the Administration figures. In addition, the JCT effective elasticity is lower than that used by Treasury, and we remain convinced that their effective elasticity is lower than the elasticity used last year.

The Joint Committee has stated that its current long run elasticity for all assets is 0.66 as opposed to the 0.71 reported in Mr. Pearlman's testimony last year. But importantly, they note that they have changed their equations. So that even if they had used exactly the same elasticity measured at a 20 percent tax rate, their overall results could be expected to differ.

It is worth emphasizing in this context——

Senator BRADLEY. Mr. Gideon, could I interrupt you just a minute.

Mr. GIDEON. Sure.

Senator BRADLEY. Everyone knows, but let's just put it on the record what we are trying to resolve here with your testimony and Mr. Pearlman's testimony The Treasury Department says that a cut in the capital gains will raise roughly $7 billion over a 5-year period; and the Joint Tax Committee says a cut in the capital gains will lose about $22 billion over the same period.

Mr. GIDEON. I do not believe they say it will lose $22 billion, Senator Bradley.

Senator BRADLEY. I am sorry.

Mr. PEARLMAN. Senator, why don't you look at page 11 of the Joint Committee pamphlet and it does have the numbers. Excuse me, page 3. And it does have the numbers in there—the comparison in there—Table 1 of the explanation.

Senator BRADLEY. Yes. There is a $24 billion difference. Treasury says it will raise $12 billion and Joint Tax says it will lose $12 billion. That is what this testimony is about.

Mr. GIDEON. That is right.

Senator BRADLEY. Why does Treasury assert that it will raise $12 billion and why does Joint Tax say that it will be reduced by $12 billion.

Mr. GIDEON. If I could——

Senator BRADLEY. I am sorry to interrupt.

Mr. GIDEON. Could I complete my statement?

Senator BRADLEY. Yes.

Mr. GIDEON. Thank you.

Second, the pamphlet confirms the critical factual assertions made in my March 6 testimony about the primary reasons for the difference in estimates. The CBO baseline figures are higher than the Administration figures. In addition, the Joint Committee effective elasticity is lower than that used by Treasury and is, as I stated earlier, 0.66 this year as opposed to the 0.71 reported last year.

Now it is worth emphasizing in this context that differences that might appear to be trivial have very large consequences. Keep in mind that in this pamphlet the Joint Committee attributes virtually the entire $24 billion gap to which you just referred to differences of 0.14 with respect to long-term elasticity, and 0.1 with respect to short-term elasticity.

To test this proposition, OTA ran its model substituting the JCT's elasticities for the OTA elasticities.

Senator BRADLEY. Would you define elasticity so, you know, it is very clear what you are speaking about?

Mr. GIDEON. Sure. It is the measure of responsiveness. In other words, it is a fractional value that is utilized to predict how much more response you will get, that is in terms of more asset sales, for a given cut in the rate of capital gains.

Given OTA's best guess about the pattern of JCT elasticities over the budget period, we found that substituting their elasticities for ours accounts for about 63 percent of the total difference between lines 1 and 2 as shown on Chart 2. This suggests that other factors, including the baseline and tax rate assumptions account for a significant part of the difference.

Nonetheless, the choice of elasticities remains a critical issue. The JCT defense of its elasticities indicates that the JCT has been quite selective in its use of the statistical evidence. For example, in its review of the econometric studies the Joint Committee rejects the results of cross-sectional data sets. These studies, of course, tend to produce higher elasticities than those generated by the time series equation.

Jane Gravelle's recent report contains a similar approach to analyzing the results of the economic literature. Like the Joint Committee, Dr. Gravelle gives short shrift to studies based on cross-sectional data which reach conclusions inconsistent with her views. She notes that many of the econometric studies present a range of estimates and she faults the Treasury for presenting only the midpoints of the ranges.

It is inherently difficult, however, to summarize in a single number the results of complicated statistical studies. Although the Treasury approach may have been mechanical, it has one important advantage. It limits the effects of any biases that the analysts might have. By contrast, Dr. Gravelle presents her preferred elas-

ticities for each study. Most of her preferred values tend to be at the low end of the range of estimates.

To cite an example of the judgmental nature of her corrections, the 0.58 figure cited for the type of——

The CHAIRMAN. Mr. Secretary, we have a problem here. I have just been advised that there is a Republican objection to Committees continuing while the Senate is in session. And it appears as though I have no choice in this situation.

Senator PACKWOOD. Could we recess the Committee for a moment and have an informal session?

The CHAIRMAN. Well I think in fairness, before we close it down, Mr. Pearlman from the Joint Committee on Taxation ought to have a chance to speak up from his point of view. Could we do that?

Senator PACKWOOD. I would be happy to take 10 or 15 minutes and try to ferret out this problem.

The CHAIRMAN. So would I——

Senator PACKWOOD. All right.

The CHAIRMAN. So in fairness, how long has the Secretary been speaking?

Senator PACKWOOD. Five or 10 minutes.

The CHAIRMAN. Ten minutes. Why don't you summarize, Mr. Secretary, and then we will give equal time to Mr. Pearlman in an informal session here—a recessed session.

Senator PACKWOOD. So moved, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. GIDEON. Okay. Let me simply go to the bottom line. From what we have read of the Joint Committee pamphlet we do not see a reason to reassess our judgment about elasticities. We continue to believe that the revenue maximizing rate is an appropriate way to look at these problems and we are puzzled, frankly, by their reported revenue maximizing rate.

This can best be resolved, we believe, by full disclosure of their model and methods; and then we can analyze what the differences specifically may be.

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

The CHAIRMAN. Thank you.

Mr. Pearlman?

STATEMENT OF RONALD A. PEARLMAN, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION, ACCOMPANIED BY THOMAS A. BARTHOLD, JOINT TAX STAFF ECONOMIST, ALSO ACCOMPANIED BY ROSEMARY D. MARCUSS, ASSISTANT DIRECTOR FOR TAX ANALYSIS, CONGRESSIONAL BUDGET OFFICE

Mr. PEARLMAN. Thank you, Mr. Chairman. I am pleased to attend an informal session of the Committee. I think I can do this in less than 10 minutes.

The CHAIRMAN. Let me be sure I have qualified this. For the record, the Committee is now in recess.

Senator PACKWOOD. Could we ask just this one question? Even though we are in recess, would you mind instructing the reporter to continue to take notes. [Laughter.]

The CHAIRMAN. Well said. The reporter will continue to take notes.

Mr. PEARLMAN. Mr. Chairman, let me see if I can do this very quickly. I basically want to make three points. I want to talk a bit about our conclusion about long run behavioral response. I want to talk a minute about revenue maximizing rates. And then I want to make a brief statement about distribution.

Let me begin by saying as Secretary Gideon has pointed out, we have released a detailed explanation of our revenue estimating methodology. We think any suggestion that has been made that inadequate information has been provided for the Treasury Department or anyone else to do revenue estimates to simulate what we have done is pure theatrics. It is just absolutely inaccurate to say that we have not put our equation forward. If you read pages 54 and 55 of the pamphlet you will see that we make very clear what equation we have used and what adjustments we have made.

I should also point out that there is a longstanding, informal relationship between the revenue estimating staffs of the Treasury Department and the Joint Committee. The Treasury Department knows our phone number. If they have any questions about our revenue estimate or our methodology, Secretary Gideon knows, and hopefully his staff knows, that all they have to do is pick up the telephone.

Please turn to page 2 of the outline. If you want to follow the outline, I am going to refer to it and then I am going to make a few references to the pamphlet.

Secretary Gideon is correct that our conclusion is that the vast majority of the difference between the two estimates is attributable to our differing views about the long run behavioral response to a capital gains rate reduction. The shorthand econometric way of referring to that difference is elasticity.

Now he continues to raise questions about the baseline differences. We have quantified the baseline differences. That is, there is clearly a difference between the CBO and OMB base lines. At pages 17 through 19 of the pamphlet we go into considerable detail as to what the effect of those baseline differences are. We have calculated those differences as being $2 billion over the 5-year period. That is, the effect on the revenue estimate of the CBO, OMB baseline differences is $2 billion over the period, and in the out years, that is in 1994 and 1995, it is about $.5 billion or a half billion a year.

Now you can reach your own conclusion about whether that is significant or not. We stand by our statement that it is a relatively minor aspect of the difference between the two estimates. If you have further questions about the CBO baseline realizations a representative of CBO is here and I am sure she will be happy to respond to your questions.

Our conclusion is very simple. In the short run, in the case of the proposal before us, the Administration's proposal, we say in the first two fiscal years, there is a sharp behavioral response to the rate reduction and that response is reflected in our revenue estimate. The elasticity derived from the equation that is used during those 2 years is 1.1.

There is also a behavioral response in the long run and no one should think that the Joint Committee estimate does not assume a long-run behavioral response. That is just absolutely not correct. There is a long-run behavioral response. Indeed, we project some $557 billion of additional realizations over the 1990 to 1995 period, as a result of the lower rate. But—and this is the key point—every time you reduce a rate you also have a static revenue loss. That is, if you compare existing activity—not new activity, but existing activity—under today's regime and a lower rate regime, there is going to be less revenue coming into the Federal Government. There is no difference of agreement between the Treasury and us on that point.

Our judgment is, and we believe it is supported by history, our judgment is that in the long run, that is after fiscal year 1991, what we refer to as the static revenue loss, that is the change in revenues from existing activity due to the change of the tax rate from current law to a lower rate, will not be made up by the additional realizations. So that on net, that rate reduction will produce net revenue losses in the out years.

When you analyze behavioral response, you have to look at the static loss as well as the induced realizations. You cannot just say intuitively, well of course people will sell more assets. Everyone agrees people will sell more assets. You also have to look at what happens to assets that would have been sold anyway and the effect on the revenue simply by a rate reduction—the so-called static consequence. Our belief is, in the long run, the static loss will not be offset by the so-called induced realizations or the additional realizations that will result from the lower rate.

Now why do we conclude that? And why do we think we are correct? Because we have looked at 35 years of aggregate economic data. The methodology or the data approach is called the time series approach. That is just a shorthand way of saying you go back and look at what the facts actually were. So what do we look at? We look at real GNP. We look at inflation. We look at the tax rates that were actually in effect over that 35 year period. We look at stock market fluctuations. We look at Federal Reserve data on household ownership of corporate equity, because this is an individual rate reduction. Those are the principal features of the so-called time series analysis.

And what we find is, that both GNP and the stock market activity—let me say it differently—that realizations, capital gains realizations—pretty well track both GNP and stock market activity. Obviously, when there is a rate difference there is a blip in the pattern, as there was in 1986, as there was in 1978, and indeed as there was in 1981. But generally, over the 35 year period realizations follow that track. And that is what our equation uses.

Now why do we think that is better? Why do we think the time series equation is better than what Treasury uses? Actually, it is a matter of inadequate data. The Treasury relies heavily on cross-sectional analysis which is a year-by-year analysis. We do not think you can make predictions about the future using analyses of taxpayer behavior from a single year. The Treasury uses so-called panel studies. If we had a 35 year panel study, that is taking a taxpayer, a particular taxpayer, and following that taxpayer's behav-

ior through the tax system for 35 years, we would be delighted to use that information. That would clearly be preferable information. However, we do not have that kind of information.

The only information that is out there that will permit you to look to a long period of economic history is the so-called time series analysis and the proof is in the pudding. Our equation will replicate with a high degree of accuracy the actual capital gains realizations over the 35 year period. We do not believe the Treasury elasticity will. We do not believe the Treasury's elasticity applied to time series analysis—that is go back and look at the actual aggregate economic data and plug in the Treasury's elasticity—will replicate the actual capital gains realizations over the 35 year period.

So I say to you, the challenge in my judgment is can the estimator demonstrate that the equation he is using indeed will reasonably project history. And if he can, is there any reason to think that it isn't going to reasonably project the future. Our judgment is, we can demonstrate it will reasonably project history and we are confident that it will reasonably project the future.

Why are we so confident? We used it in 1986. We used the same methodology in 1986 and the estimates are coming true. We projected revenue increases for calendar year 1986, fiscal year 1987. We had them. We projected substantial revenue losses for calendar year 1987 and fiscal year 1988. We are seeing them. We projected a crossover year in 1989—just sort of no effect. We are starting to see substantial revenue increases from the repeal of the capital gains preference in 1990 and 1991. Both the CBO and the OMB baselines show that. They show increased gains realizations in those years. So we believe that we can demonstrate historically that the equation we are using is a reliable equation.

Now Treasury says we changed our methodology from last year. Let me just declare it again. We did not. We have included in the pamphlet an estimate that we provided Congressman Russo last year, in September, which we incidently have released with his approval. We would not do that without his approval. It was an estimate of a proposal that essentially is the same as the President's proposal, except that it did not have staggered holding periods. It was done using exactly the same methodology and the numbers are there. You can look at the numbers and you can make a judgment about whether we did something this year to cause problems for the Administration proposal by examining the Russo estimate.

There is another thing that I think is very worthwhile looking at. There are a couple of Tables—pages 22 and 23 have Tables 6 and 7. Tables 6 and 7 take actual Treasury information—it is nothing we made up—it is Treasury information and what Table 6 tells you is if you take the President's proposal under the Treasury's own numbers, the static revenue loss—I mentioned before the static revenue loss—is not adequate in the out years to offset the induced realizations. Bottom line, it loses money.

You may say well that is not what Senator Bradley mentioned a moment ago, that the President's proposal raises money in the out years. In fact, it raises money in every year. How does it do that? Because they put in a depreciation recapture provision. Because they put in an alternative minimum tax provision and because

they played around a little bit with effective dates and holding periods.

But the simple fact is that if you look at Treasury's actual numbers, induced realizations are not enough to offset the static revenue loss. Now, why do I refer to that? There is a big magnitude of difference. We think the difference is much larger than Treasury. Treasury would say that it is a fairly small revenue loss and we think it is much larger. The point I make by referring to this is, don't let the Administration come before this Committee and tell you the Joint Committee is out in left field, that the Joint Committee's elasticity is crazy, that there is no way that a change in a preferential rate is going to lose money in the future. Treasury's own numbers show it.

Table 7, is another variation of this. The Treasury itself has estimated the Administration's proposal with a prospective effective date. It shows revenue losses. They are not our numbers; they are the Treasury Department's numbers. Again, the reason it shows revenue losses, at least in part, is because static losses are not offset by induced realizations.

I am not going to dwell on the literature debate. You know, we can take the literature and we can put it in our form; and they can put the literature in their form and Dr. Gravelle restated the literature in her form. My own judgment is that our elasticity fits very comfortably within the range of elasticities by unaffiliated researchers, independent researchers that have used the time series analysis. You can agree or disagree with that and I do not think any further discussion is worthwhile.

On the revenue maximizing rate, let me simply say to you again, notwithstanding what the Treasury Department has said to you this morning, our revenue maximizing rate, as calculated under our model, is 28.5 percent. And you might say to us: Doesn't that sound crazy? Why is it you are going to reduce capital gains? How can you maximize? Won't it be higher than today's maximum rate?

Well let me explain quickly. It is a half percent higher for two reasons. There is a bubble. Don't forget the bubble. Some people are paying at higher than 28 percent on a marginal basis. And secondly, some people will sell the same capital assets even if the rate goes up a little bit. Switched around, there will be a static revenue pick up before realizations start going down if the rate goes up. Now not very much.

If the rate goes up above 28.5 percent we would say you would start losing money. But not up to 28.5 percent. Well you could say to us: Well why shouldn't it be 25 percent or 23 percent? It doesn't sound right. We know there is a behavioral response to a capital gains rate reduction, why isn't your revenue maximizing rates going to be less than 28 percent? Let me say it to you again, intuition is what drives you here and what you have to be very careful of. That is what I have found I have had to be careful of. The natural intuition is, of course people will sell more assets if the rate goes down. That is a given. We all agree with that. The question is: Will the increased realizations be enough to offset the static revenue loss?

So all we are telling you when we tell you our rate is 28.5 percent is the answer to that question, in our judgment, is no. Now we

have got a very interesting series of Tables on pages 42 to 44 of the pamphlet that show you those numbers on a percentage point basis—that is going down from 28 to 27 to 26—and you can look and see what happens to the static loss and to the induced realizations.

On distribution, just one point. We view the subject of whether distribution is relevant to the debate as to be a policy issue to be resolved by the Members. We will simply make two professional statements to you. There is no question that in a year in which revenues increase for example, we would say in 1990 or 1991—that clearly some taxpayer is going to be paying more tax. There is no question about it.

It is also clear, however, that in every year of any rate reduction, whether it is capital gains or any other rate, some taxpayers are going to benefit from that rate reduction. Our best professional judgment is that a distributional analysis should be presented showing the benefit. Whether you agree with that, whether you disagree with that, that is not our judgment; that is your judgment to make and we are happy to leave that judgment to you.

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

The CHAIRMAN. Thank you very much, Mr. Pearlman. Mr. Pearlman, when Secretary Gideon spoke on March 6, he took some time to point out the type of people that had come up with these assumptions and these projections in the Treasury Department, and I am sure to buttress a point that there was not a partisan finding in this.

Mr. Pearlman, what was your last position in the Federal Government before you held this one?

Mr. PEARLMAN. When I was in the Federal Government previously I was a predecessor to Secretary Gideon; I occupied the position of Assistant Secretary for Tax Policy at the Treasury Department.

The CHAIRMAN. Under whose Administration?

Mr. PEARLMAN. Under the Reagan Administration.

The CHAIRMAN. That is a Republican Administration? [Laughter.]

Mr. PEARLMAN. It was when I was there.

The CHAIRMAN. All right. [Laughter.]

Thank you very much.

Senator Packwood?

Senator PACKWOOD. Mr. Gideon, I am looking at a Treasury report called "Report to the Congress on the Capital Gains Tax Reduction of 1978." Treasury put it out in 1985. Was that when you were there, Ron, or not?

Mr. GIDEON. Yes.

Mr. PEARLMAN. It was. It was put out when I was there.

Senator PACKWOOD. And Treasury estimated that in 1979, 1980, 1981, 1982 and 1983, from the 1978 capital gains tax cut we realized increased revenues over those 5 years of between $1–$2.3 billion. That is what the report says.

Mr. GIDEON. Yes, I think that is what the report says.

Senator PACKWOOD. Ron, are you shaking your head that the report does not say that?

Mr. PEARLMAN. Let me not disagree. I would rather put it in the form of clarification. What the report did, what the 1985 report did, was show what the revenue effects would be under different sets of data—one being the time series data, which happens to be the method that was being used by the Treasury Department and is used by the Joint Committee now, and that did not show revenue increases over the 5-year period. It showed revenue losses after the first year or two. And one under the cross-section analysis, which is what the Treasury Department apparently now uses. And that did show revenue increases.

So there were essentially two messages out of the 1985 report.

Senator PACKWOOD. Okay. So you are saying that the time series showed—now wait a minute. Where is it? The time series indicated revenue increases between 0.9 and 1.1?

Mr. PEARLMAN. That is correct. I think that is right. I am rusty on the numbers, but I think that is correct.

Senator PACKWOOD. All right, in the first year. All right.

Now at the time we did the 1978 capital gains tax cut the Joint Tax Committee estimated over those 5 years a $6.2 billion loss. Here I am reading from the revenue effect of the tax provisions of the acts, the Conference Report, the Joint Tax Committee estimates.

Mr. PEARLMAN. All right. I assume that is right. I am not familiar with it.

Senator PACKWOOD. Why were they wrong?

Mr. PEARLMAN. Well, first thing I cannot—I don't know. I mean, obviously, I wasn't here and I do not know the answer to that question. I am not even sure I could find that out. I mean the only thing I can say to you, again, the best thing I think I can say to you is that the thing I am familiar with, because I was heavily involved when I was at the Treasury Department and it has become an issue since I have been here, is that I am familiar with the estimate that the Joint Committee did of capital gains in 1986. And I can tell you we are right on target with the estimate that was done in 1986 with the facts we know today. Now I cannot explain 1978.

Senator PACKWOOD. All I am saying is you could just as well be right or wrong.

Mr. PEARLMAN. Let me say this, Senator Packwood. I do not think anyone, certainly not I—and you know, I mean I know I don't have to tell this Committee—these estimates are not done by the lawyers of these two offices. These estimates are done by trained—thank God they are not—they are done by trained econometricians in both offices. No one ever presents to the Congress, and we never presented to the Administration, any representations about the infallibility of these estimates. You make the best professional judgment you can make.

Senator PACKWOOD. That is fair enough. And you could be wrong.

Mr. PEARLMAN. Of course, we could be wrong. Absolutely.

Senator PACKWOOD. Now I want to ask a couple of other questions on the baseline because this is where you were dramatically different. Your induced effects are about the same. You have some minor differences on the other factors, but the other factors balance out. You are off $25 billion on the base line.

Mr. PEARLMAN. Well I don't mean to interrupt your question.

Senator PACKWOOD. That's all right.

Mr. PEARLMAN. But in the absolute when you look at the baseline numbers for any particular year—I mean now we are literally talking about the baseline numbers.

Senator PACKWOOD. All right.

Mr. PEARLMAN. When you look at the baseline numbers, look at page 17 of the pamphlet. In the absolute it would appear that there are big differences—$40 billion between CBO and OMB in 1990 and it goes down to a much smaller difference in 1995. But that is very misleading, Senator, because there are not those kind of differences showing up in the estimate.

Let me put it to you this way, that if we start from a higher baseline, if CBO's baseline is $254 billion in 1990, rather than $214 billion, then the induced realizations we predict from that baseline are also higher.

Senator PACKWOOD. I understand that.

Mr. PEARLMAN. Okay. So our calculation is that over the 5 year period the difference in the estimate is $2 billion. In fact, I can give you a number that I did not give you in my comments before. The difference in the 1990 estimate is $900 million—to give you a feel for the base. So it is really not the baselines. It is the induced realizations in our judgment that causes the difference.

Senator PACKWOOD. But the reason your induced realizations are the same is that you are working from the higher baseline. If you were working from their baseline, your induced realizations would be much lower.

Mr. PEARLMAN. That is true. But let me say, I do not think our induced realizations are the same. I do not think Treasury and we would agree with the level of induced realizations from any—at least from this particular proposal.

Senator PACKWOOD. Well maybe I am using the wrong term. Are induced realizations the effect of taxpayer behavior?

Mr. PEARLMAN. I'm sorry?

Senator PACKWOOD. I am looking at what you called "Details of Joint Committee on Taxation, Revenue Estimate of the Bush Capital Gains."

Mr. PEARLMAN. Yes.

Senator PACKWOOD. Your number 2 is "Effective Taxpayer Behavior."

Mr. PEARLMAN. Yes, that is the induced realizations. Right.

Senator PACKWOOD. And your figure for the 5 years is $78.4 billion.

Mr. PEARLMAN. I'm sorry. I understand what you are saying. The answer is yes. Excuse me. Your answer is yes. That the reason our induced realizations come out the same is because we are working from different baselines. Yes.

Senator PACKWOOD. Okay. I want to ask him some further questions. I will wait my turn on how they got to there.

The CHAIRMAN. Senator Bradley?

Senator BRADLEY. Thank you, Mr. Chairman.

If I could follow on, Ron, in the pamphlet on Table 6, this deals with the induced realizations. Basically over a 5-year period you see a revenue loss of $21 billion. That is the one I was referring to

earlier when I had the mirror of $12 billion. But you see a $21.8 billion loss, and the Treasury sees a $6.9 billion increase.

Mr. PEARLMAN. That is correct.

Senator BRADLEY. What I notice, however, is that the trend in the Treasury begins to shift in 1994 and 1995. Now if you were going to project that out further to 1996, 1997, would you anticipate that the Treasury loss would be greater in those out years?

Mr. PEARLMAN. I am going to dodge your question by not anticipating what the Treasury loss would be. Let me instead make a statement about our estimate. We have said this in the pamphlet. While we do not do actual estimates beyond 1995 because we are constrained by the CBO baseline—that is, we do not have baseline assumptions beyond 1995—we believe that capital gains losses will continue and will grow at least with inflation.

Now whether that is true of the Treasury trend line, I cannot answer you. It is true—that is our best qualitative judgment about our own estimate.

Senator BRADLEY. Mr. Gideon, what is the Treasury's judgment about the out years 1996, 1997?

Mr. GIDEON. Looking at that line alone, it would become somewhat more negative. However, it is important——

Senator BRADLEY. It would lose more money?

Mr. GIDEON. It would lose a little more money. But it is important to note that the overall proposal we project to be positive in the out years. The reason has to do with the depreciation recapture provisions and the AMT features of the proposal. They are part of the proposal as well.

Senator BRADLEY. Now if you compare Table 6 and Table 7 you see that the Revenue effect of the proposal made applicable only to newly acquired assets—revenue loss—you're not that far apart, you're about $1 billion apart—minus $2.6 billion, minus $1.0 billion. But the overall revenue loss is much bigger—minus $21 billion. So would you conclude from that that the amount of new assets here is really rather small; it is basically selling a lot of old assets is what is going on.

Mr. PEARLMAN. There is no question. Again, I will only refer to the Joint Committee estimate. There is no question that the difference between our projected loss for a prospective proposal and our projected loss resulting from any proposal, not only the Administration's proposal, but any proposal that effects existing assets, is as a result of the tax consequence of the sale of that big pool of existing assets. Yes.

Senator BRADLEY. Then how does that produce, you know, new investment and growth if it is simply selling old assets?

Mr. PEARLMAN. Well I'll try to give—I'll make the argument to you. The reason I put it that way is because I——

Senator BRADLEY. Well let Mr. Gideon make the argument.

Mr. PEARLMAN. All right. That's fine.

Mr. GIDEON. I'll be happy to make the argument. If you release old assets so that they can be more economically invested, we believe you would get more growth from that. In other words, what you are doing is you are allowing taxpayers a greater freedom to reconfigure the economy in a way that will produce more efficient asset investments.

Senator BRADLEY. So if they sell the old assets and interest rates go up in Japan, they can buy yen bonds?

Mr. GIDEON. Well that might be what they do, but we would hope that they would reinvest in the United States. And if we provided a favorable capital environment, that is what they would do.

Senator BRADLEY. Let me, if I could, go to a couple of the other Tables just to take a look at what you have presented to us, Ron. Because I think they are interesting.

On Table 14 where you deal with the question of how frequently people take capital gains, as I read that Table you have people who take capital gains each of the last 5 years, have an annual capital gain every year of about $100,000, and people who take capital gains only once every 5 years, have an annual capital gain of $2,000; is that correct.

Mr. BARTHOLD. Senator, my name is Thomas Barthold; I am a staff economist with the Joint Committee on Taxation.

What you have done is you have divided the number of taxpayers in column one by the dollar value and the number of taxpayers on the far right column by the dollar value. That seems to be great division.

Senator BRADLEY. You mean correct?

Mr. BARTHOLD. Correct; yes, sir.

Senator BRADLEY. Okay. So it is $100,000 for people who take the gain every year and $2,000 for people who take the gain one out of every 5 years.

Well I have a couple more questions. Let me just confirm one more point if the Chairman would allow me to.

The CHAIRMAN. Yes, of course.

Senator BRADLEY. This has to do with—This again gets to the question of where the bulk of the benefit goes. And again, no value judgment, just presenting the facts as I see them in terms of Table 17. Table 17 shows that about 45 percent of the taxpayers had only one gain. And it shows that these taxpayers took about 20 percent of the capital gains. Again, kind of equating that one every 5 years. And then it shows that 55 percent of the people who claimed capital gains had multiple gains, but they got 80 percent of the capital gains. So would you say there is a rough correlation there between the guy that takes the capital gain once every 5 years, gets a very small capital gain, and as a percent of total capital gains, it is small versus the person who takes the capital gain every year and takes a very large capital gain and gets a very big percent of all the capital gains in the system?

Mr. BARTHOLD. Senator, in the data we were presenting, both in Tables 14 and 15 and in Table 17, we were trying to look at two sides of the question that you are asking. Tables 14 and 15 look at a panel of the same identical taxpayers, tracked from 1979 to 1983, where we were able to look at their total realizations; and Table 17 is data from one specific year where we had very detailed transaction data from 1985.

The question that you asked was basically, what does the data say about taxpayers who realize just one gain as opposed to multiple gains; and that is what those tables try and address.

Senator BRADLEY. So that your degree of confidence then is really actually greater with Table 15?

Mr. BARTHOLD. I personally think we need to look at both.

Senator BRADLEY. Okay. All right.

Mr. BARTHOLD. We need to look both at specific transactions and the aggregate through time.

The CHAIRMAN. Well, along those same lines on the matter of distributional effect, I heard my distinguished colleague talk about some of the people of lesser income, and justifiably so, as to their realization of the capital gain. And in fairness, I think we ought to touch on those of higher income too, as to how such a proposal would relate to them.

The Joint Tax Committee, in responding to a request in November of last year, stated that the average benefit of the capital gains cut in 1990 to each of the 100 top income individuals is $3 million under the House-passed bill, and $5 million under the President's proposal. Then when they get to the 1,000 top income people in the country they report the average benefit for the top 1,000 individuals would be $1 million under the House-passed bill and $2 million under the Administration's proposal. Or to state it another way, those numbers would indicate that 1,000 of the highest income people in the country would receive a tax benefit greater than the total Federal income tax payments of the citizens of six individual States. Now that is how it affects matters on the other end of the income scale.

I think that you were pointing out, Mr. Pearlman, is that Treasury is assuming that the permanent effect of a capital gains reduction is to lower revenues once you get rid of the alternative minimum tax and the depreciation recapture. Is that a correct statement?

Mr. PEARLMAN. That is the point that I was trying to make. That is correct.

The CHAIRMAN. Thank you.

Senator Packwood?

Senator PACKWOOD. I want to go back once more to that 1985 study, Ron.

Mr. PEARLMAN. Okay.

Senator PACKWOOD. I have now reread that paragraph. The Treasury's estimate of between $1 billion and a $2.3 billion gain over the 5 years depends upon whether you assume the time series or not.

Mr. PEARLMAN. That is correct.

Senator PACKWOOD. But there is a gain in any event. It is just whether it is smaller or somewhat bigger?

Mr. PEARLMAN. I think that is right.

Senator PACKWOOD. Now I would appreciate if you would do this for me. Tell me—research it in the past—where did the Joint Tax Committee go wrong on its estimates? What factors did they presume when they were estimating 1978 that turned out not to be correct, I guess?

Mr. PEARLMAN. Certainly I will be happy to dig up the estimator who was here in 1978 and try to figure that out. I have no independent ability to do that.

Senator PACKWOOD. Well, but the irony is, if you happen to be off in terms of the magnitude on the same estimate now, it about accounts for the difference.

Mr. PEARLMAN. Well let me just suggest to you again, I take some comfort from the fact that we did an estimate 3 years ago that looks like it is right on target. I mean that should tell us something.

Senator PACKWOOD. I want to ask you——

Mr. PEARLMAN. In addition, let me say again, Senator, because I think it is very important, that we are happy to use our equation and try to replicate the real historical realizations, and show you that the equation we are using today—elasticity is just a shorthand way of saying it—the equation we are using today, when you plug in the realizations for a particular year—excuse me, you plug in the various macroeconomic items for a particular year, inflation, GNP and so forth, and we will hit the realizations pretty accurately over a 35 year period.

Senator PACKWOOD. Do me a favor, will you, will you take a look at the last chart in Secretary Gideon's testimony. It is called Figure 1. It has bar graphs.

Mr. PEARLMAN. Sure.

Senator PACKWOOD. I want to go over it with you. I want to see if I read it right and if you and I read it the same way. It is "Capital Gains Realization and Stock Prices, Year-to-Year Changes, 1977 to 1989."

All right. Now in 1977 the capital gains realizations look like they were up about—I'll take a guess—15 percent and the Standard & Poor's down maybe 2 or 3 percent, if you read it rough. The next year capital gains realization is up maybe 10 or 11 percent; stock market down maybe 1 or 2 percent. Then the next year, although this is 1979—this is the first year now after the cut—realizations are up tremendously, as you might expect; and the market up 10 percent. The following year, as you might expect, realizations are way down because everybody went out in 1979 not knowing what we might do with capital gains and—am I reading this correct?

Mr. PEARLMAN. Do you mind if my economist friend responds to you?

Senator PACKWOOD. No.

The CHAIRMAN. Would you all mind if the Chairman interrupts for just a minute? We have a vote coming at 12:15 and frankly I want to get over there to make a tabling motion. I really want to apologize to the rest of these witnesses. We will try to figure out what we can do. I know that we will certainly accept your statements and we will have questions propounded to you. Whether we can do more than that, I will just have to check on the procedures in the meantime. So I apologize to the rest of you. We will not be able to go on with the confirmation hearing that we anticipated earlier.

Senator PACKWOOD. Thank you, Mr. Chairman.

I just want to know if I am reading the chart right.

Mr. BARTHOLD. Senator Packwood, I think the chart, as you suggested, looks at year-to-year percentage changes in gain realizations and year-to-year percentage changes in the Standard & Poor's 500 index. There is a comparable picture in the Joint Committee pamphlet on page 27.

Senator PACKWOOD. I saw that but it didn't——

Mr. BARTHOLD. It looks at different aggregate levels.

Senator PACKWOOD. It did not look comparable to me. You have tremendous fluctuation there. If I look at the bar graph, it seems to me—forgetting the tax years, whether we have changed the capital gains—there are as many aberrations as there are similarities. And to project 1989 realizations the way you have, doesn't look right based on the historical data.

Mr. BARTHOLD. Well I think the confusion, Senator, is that we are looking at changes in levels. What the Figure 1 in the Treasury testimony, I think, is entirely consistent with Figure 3 in the Joint Committee print, because the Joint Committee print includes the total number of realizations and the total value of the stock market index. And while admittedly there are changes year-to-year in realizations and changes in the index, they still both remain positive. That is really what the figure shows.

Senator PACKWOOD. So what——

Mr. BARTHOLD. So for example while the Standard & Poor's index fell with the market crash in 1987 it was still actually a fairly high positive number by historic standards. The 1987 crash took us down approximately to the 1985 level.

Senator PACKWOOD. I want to read then, just so I understand, and I think I do now, your page 18 where you have the support for the baseline increase in realizations in 1989. You say, "CBO estimates that about two-thirds of the increase in realizations in fact occurred in 1989, although it will not be possible to confirm this until this year's tax filing season is complete."

Are you basing that on the assumption that realizations will track the stock market? Because we do not have any tax returns to go on yet.

Mr. PEARLMAN. Well we really could ask CBO to answer that themselves since we have a representative here.

Do you want to do that, Rosemary?

Senator PACKWOOD. You are using CBO's figures?

Mr. PEARLMAN. We are.

Senator PACKWOOD. All right.

Mr. PEARLMAN. But I mean rather than ask—why don't we ask Dr. Marcuss, since she is here to respond to your question since it is really a question about the CBO baseline?

Senator PACKWOOD. Okay.

Dr. MARCUSS. By that we mean that based on data that we now have available for 1989, which includes personal income tax payments. The data we have is both stock market data, real GNP data, and tax collection data, but only aggregate data through March of 1990. So it is not the full final payments on 1989.

Senator PACKWOOD. It is just an unusually high increase based upon historical averages. I realize what you have said in your pamphlet, Ron; but it is an unusual increase. It is a 36 percent increase in 1 year which we have equaled in some years before, but usually because they were capital gains change years and people were conducting themselves one way or another depending upon whether we were going up or down.

It is just an unusual blip is all. And if the blip was more average—15 or 16 percent—then Treasury and Joint Committee would be almost exact on their baseline.

Dr. MARCUSS. It is a large number. It is in part, however, the product of a very rapidly rising base. Realizations themselves have risen very rapidly over the last 12 years. So those dollar magnitudes look very large in the long run, but as percents they are not stand out numbers.

Senator PACKWOOD. Well, yes, but the percentage based upon the dollar increase is a 36 percent increase, which is a high percentage.

Dr. MARCUSS. It is a high percentage, yes.

Senator PACKWOOD. Thank you, Mr. Chairman.

Senator BRADLEY. Thank you, Senator Packwood.

I am going to exercise the prerogative of the new Chairman at the moment and thank this panel for testifying. And then looking at the next panel I see two people from Washington, which means they could get up here, if we were going to have another hearing, a little easier. I see one from Philadelphia. What I would like to do is have Dr. Auerbach, if he could, to come to the table and answer a few questions before the buzzer goes. We will not have much time. I think that will be probably the fairest way to proceed.

I apologize to everyone on the third panel because it appears there is no way we are going to be able to get to you.

Let me thank Joint Committee and the Treasury for their presentations.

Dr. Auerbach, since I really do not know when the buzzer is going to go off, let me, if I could, to ask you to get to what I see as the core of your testimony. Maybe you do not think it is the core, but I find it the most interesting.

In your testimony you say, and I quote, "Essentially the cut in capital gains benefits would be considerably smaller than portrayed and it would very likely result in a loss of tax revenue and it would have other costs that the Administration has ignored in its analysis. Moreover, compared to available alternatives, the partial exclusion of long-term gains is distinctly an inferior way of achieving each of its apparent objectives."

Now those sentences naturally make me want to read further and hear further. So could you for the benefit of the Committee summarize not so much what the revenue loss is—we have just had the experts—but what you think are the other costs that the Administration has ignored and why you think a cut in capital gains is an inferior way of achieving the objectives of the President's plan.

Dr. AUERBACH. I think probably the most important cost that is ignored is the fact that the revenue estimates, both of the Administration and the Joint Committee, start in 1990. If they started in 1988 they would have big negative numbers for each of the last couple of years, ever since we started talking seriously about a capital gains tax cut.

The point is that the timing of gains is not just prospective after the tax cut occurs; it goes back in time as well. We could have a very, very big increase in capital gains realizations every time we cut the tax and we could make it bigger if we announced it in advance so the people would make sure they didn't realize any capital gains, except in years when the tax was very low.

That might make some people think that capital gains were very responsive to the tax rate, but it would really mean that the fre-

quency of changing capital gains tax rates was losing the Treasury a lot of money.

Neither the Joint Committee or the Administration revenue estimates take account of that. I am sure that the people in both Agencies are aware of this problem; but it is translated into the revenue estimates in the way that they are presented.

Senator BRADLEY. So basically you say they do not anticipate people selling in anticipation of a rate increase?

Dr. AUERBACH. Well let me put it another way. One of the reasons why the short-run revenue estimate is positive, even for the Joint Committee, and is larger, more positive for the Administration than in the long run is because people are bunching their sales of assets. And that bunching doesn't just come from the future, it comes from the past as well.

A reason why the gains are there to be realized is that people have been holding off in anticipation of a tax cut. It would be crazy not to do that. The point is that lowering the tax rate now would result in a true revenue loss as well as encouraging people in the future, the next time the rate goes up, to believe that it is going to come down again.

Senator BRADLEY. I see. So is there any way you can quantify that? In other words you are saying basically that all these moves up and down of the rate freezes people from taking action that they otherwise would that would produce revenue for the Government?

Dr. AUERBACH. Yes. Well, to quantify it in the opposite way, in 1986 realizations doubled when people knew the tax rate was coming up. So do the opposite experiment for yourself and suppose people saw the tax rate coming down; what would happen to realizations? You could be pretty sure they would go down a lot.

The point is that everybody is happy to include the 1986 results as a revenue increase as a result of the increase in taxes in 1987. If they are going to behave in a symmetric fashion, they should include the revenue losses from, say, 1989 when talking about the effects of the tax cut in 1990. That is a real cost and it is not incorporated in anybody's revenue estimates that I have seen.

Senator BRADLEY. And how do you get at the number?

Dr. AUERBACH. Well you could use models of the kind that I have estimated.

Senator BRADLEY. So basically it is in your testimony?

Dr. AUERBACH. It is not in my testimony, but it could be divined from the various works that I have published.

Senator BRADLEY. What about, therefore, why is this an inferior way of achieving the same objectives?

Dr. AUERBACH. Well it depends on what your objectives are. As has already been discussed——

Senator BRADLEY. Well this is growth, investment——

Dr. AUERBACH. Well as I indicated, you would have to increase personal savings or private savings by about one-quarter in order to generate the kind of income growth that Dr. Boskin testified was likely to happen. As far as I can tell, you would have to——

Senator BRADLEY. Using the increase—do you mean personal savings?

Dr. AUERBACH. By about $60 billion a year for the next 5 years. You would have to increase private savings by about $60 billion each year for the next 5 years in order to generate the $61 billion increase in output that he forecast.

My guess is that taking the most optimistic assumptions that one could make reasonably or unreasonably, the income growth over the next 5 years coming from the proposal would be at most $4 billion. That is not revenue growth; that is income growth. The revenue growth, presumably, would be scaled down accordingly.

Senator BRADLEY. You mean the national income?

Dr. AUERBACH. Yes. Yes.

Senator BRADLEY. You say it would produce a $4 billion increase and he says it is $61 billion increase?

Dr. AUERBACH. That is right.

Senator BRADLEY. And to what do you attribute the difference?

Dr. AUERBACH. Well I'm afraid he went first so I cannot ask him and I really do not know. But I took the most optimistic assumption I could think of, which was his own estimated elasticity of savings with respect to the real rate of interest.

One thing I do agree with him on or come closer to agreeing with him on is the effect in terms of the interest rate. He said 20 basis points. My own guess would be about 10 or 8 basis points. Either way, if you take even a 20 basis point increase in the real interest rate, I just don't see how you can generate the kind of increased capital formation that would be necessary in order to generate the kind of output predictions here.

Senator BRADLEY. So basically, this again is a little bit of a discussion between two respected economists in terms of what the equivalent reduction of the interest rate is, but it is an argument between two respected economists, one of whom says a reduction of an 8 percent interest rate to a 7.92 interest rate; and the other says a reduction from an 8 percent interest rate to a 7.8 percent interest rate; right?

Dr. AUERBACH. Well as I said, I am more comfortable with that difference than I am with the forecast growth of GNP.

Senator BRADLEY. So the inferior way is therefore what is better——

Dr. AUERBACH. Right.

Senator BRADLEY. If the cut in capital gains is not going to carry the whole economy on its back to the higher amount, what is a better way to get the economy moving?

Dr. AUERBACH. If you are interested in inflation you do the opposite of what the Administration is doing. That is, you have a sliding scale that goes up and not down over time. That was already discussed by Dr. Gravelle.

If you are interested in investment incentives you provide incentives at the firm level, not at the level of the individual saver. Providing a cut for capital gains for individuals does not guarantee that there will be any more capital made available for investment in the United States. Households have to save more in order for that to happen. And even if they save more, there is nothing that guarantees that those resources are going to be devoted to investment in the United States.

Senator BRADLEY. You mean it could be consumption?

Dr. AUERBACH. No. No. If I save through a multinational firm in the United States that chooses to invest the money abroad, I would still get capital gains treatment; whereas foreigners are not going to benefit at all from the capital gains preference that is being given.

And as far as the lock-in effect goes, I think that is very poorly understood.

Senator BRADLEY. Which effect?

Dr. AUERBACH. The lock-in effect that was discussed by Secretary Gideon.

The fact that I decide to realize my assets does absolutely nothing to the allocation of capital in the economy. If I sell you shares of stock that I own, that stock does not disappear. The point is, it is a change in the pattern of ownership; the lock-in effect that people often talk about as being one of the costs of capital gains taxation is a misallocation of the assets among individuals in the economy. It doesn't have anything to do with where the resources are invested. It is very poorly understood.

Finally, to the extent that venture capital or risky investments are what people are thinking of, you are using a cannon to swat to a fly. It is a very, very small part of the capital gains picture; even if one wishes to encourage venture capital, to reduce the capital gains tax on all assets, including all assets that are already in place, is something that I just find very hard to understand.

Senator BRADLEY. What about the personal savings figure—$206 billion.

Dr. AUERBACH. Right. Right.

Senator BRADLEY. Dr. Buskin said he would get back to me. What do you think he will be telling me?

Dr. AUERBACH. Well, if you——

Senator BRADLEY. How much more will it increase the personal savings?

Dr. AUERBACH. Well it has to increase by $60 billion or else he is going to have to come up with something else to give you the extra amount of money to get $61 billion.

Senator BRADLEY. So you think he will say $61 billion and you will say $4 billion?

Dr. AUERBACH. He ought to say, to be consistent in the calculation, about $60 billion a year in new savings. I wish him good luck.

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

Senator BRADLEY. Let me thank you very much. I apologize. Triple—five buzzers. I have to run for a vote. Let me also apologize to the other witnesses on this panel and to the other panel. The Chairman has wanted me to say that he offers his apology and we hope that you will have a chance to come back to the Committee another time. We welcome and look forward to your testimony. I know some of you have come a long way; and some of you have even come from Texas, and that is very important to the Chairman and therefore it is important to me.

Thank you very much.

Dr. AUERBACH. Thank you, Senator.

[The prepared statements of witnesses who did not testify: Messrs. Aaron, Cohen, Glickman, Bloomfield, Sellery, and Kertzman, appear in the appendix.]

Senator BRADLEY. The Committee is adjourned.

[Whereupon, the hearing was recessed at 12:25 p.m., pending notification of the chairman.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

PREPARED STATEMENT OF HENRY AARON [1]

PROPOSALS TO EXCLUDE A PART OF CAPITAL GAINS FROM TAXABLE INCOME

Mr. Chairman: Thank you for inviting me to testify on the administration's proposal to exclude a part of capital gains from taxable income. In the course of my testimony I shall try to make four major points:

• The proposed exclusion of a part of capital gains from taxable income is an inferior device for achieving each of the objectives that the administration lists as justification for its proposal.

—To promote long-run investment, the most effective instrument is to reduce interest rates, an objective that can be achieved only by an honest program of deficit reduction.

—To reduce lock-in, the most effective instrument would be to tax unrealized gains of decedents as ordinary income. Furthermore, constructive realization is the only change in tax treatment of capital gains that will permanently increase revenues under all plausible assumptions regarding taxpayer behavior. With generous exemptions, it would raise $10 billion over the next five years, according to the Congressional Budget Office.

—To deal with the distortions of inflation, in the calculation not just of capital gains but of other forms of capital income, it is time to begin gradually to adjust capital transactions for inflation.

• A properly calculated estimate of the revenue effects of the capital gains exclusion would show a large revenue loss, possibly more than 40 billion over the period 1990-1995

• The capital gains exclusion is about the most regressive tax proposal advanced with a straight face in my memory. Fifty-five percent of the benefits would accrue to households with annual incomes of over $200,000 (66 percent according to the Joint Committee on Taxation), according to the administration's own estimates. Moreover these benefits are large, averaging about $20,000 a year per return.

• In significant measure, these gains come at the expense of other taxpayers who do not realize capital gains, in flat contradiction to claims made by administration spokespersons.

The president has once again called for a reduction in tax rates on capital gains held more than one year. The case for a reduced rate on capital gains rests on three propositions. The first is that nominal gains overstate real gains because of inflation. The problem is indisputably real, but the solution of excluding part of realized gains from tax is clearly dominated by indexing. An exclusion is a seriously flawed substitute. But if it is used, an exclusion designed to offset inflation should rise, not fall, with the length of the holding period, as Roger Brinner showed fifteen years ago.[2]

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[1] Henry Aaron is Senior Fellow at the Brookings Institution and Professor of Economics at the University of Maryland. The views expressed in this statement do not necessarily reflect those of staff members, officers, or trustees of the Brookings Institution or the University of Maryland.

[2] Roger E. Brinner, "Inflation and the Definition of Taxable Personal Income," in Inflation and the Income Tax, Henry J. Aaron, editor, Brookings, 1978, pp 121-145. An attachment to this testimony reproduces Brinner's proof.

The second argument advanced for a reduced rate on long-term capital gains is that incentives to undertake risky investments will be increased if rates are reduced, partly because reduced lock-in will augment the supply of capital available for such investments and partly because increased rewards to entrepreneurs will spur demand. The third is that revenues will rise permanently because realizations grow.

Tax concessions on capital gains are a remarkably inefficient method of encouraging current real investment. Most capital gains are earned on financial assets. The investment behavior that matters for the growth of the nation is real investment—in plant and equipment, in research and development, and in training and education of workers. The volume of trade in financial assets is many times larger than the volume of new investment. At any one time the great bulk of financial assets that might be sold for capital gains represent claims against real investments already in place. Certainly tax relief on gains accrued before enactment of an exclusion can have no effect whatsoever on investment behavior, unless perhaps it suggests to investors that Congress might in the future shower them with similar tax gifts that they had no reason to expect when they made their investment decisions.

If the objective of the capital gains exclusion is to encourage risky investments, that goal could be accomplished far more effectively and at drastically reduced cost by providing some relief for active entrepreneurs in future start-up companies. One does nothing to spur entrepreneurs to take risks by sparing capital gains taxes on me or millions of other investors like me who take no active part in the management of the assets we own.

A further problem with this line of reasoning is that connection' between changes in tax rules that encourage individuals to hold certificates of ownership in something for three years and more far-sighted decisions by corporate managers Is very weak indeed. In theory, managers might be more willing to undertake investments with longer term payoffs, in the belief that shareholders would have an increased incentive to be more patient. But this is thin gruel. To the extent that short investment horizons are a problem, the most promising remedy is deficit reduction and associated drops in interest rates. Moreover, stock prices depend sensitively on the whims of pension fund managers and other institutional investors who will be unaffected by these changes because the portfolios they manage are not taxable in the first place.

The particular set of arguments advanced by the Treasury Department seem to me to be particularly weak and illogical. They claim, for example, that the graduated reduction over three years in the proportion of capital gains subject to tax is desirable because "investors should be encouraged to extend their horizons and search for investments with longer-term growth potential." But later they divine that too long a horizon is a bad thing, because they point out (correctly) that capital gains taxes create a "lock-in" effect. The Treasury, like the Three Bears it would seem, knows that some holding periods are too short, some are too long, and some are just right. The correct point is that the tax system should not try to distort the signals the market gives regarding economic decisions. That goal can be approached most nearly by taxing real gains, purged of the artificial value caused by inflation. Even this approach leaves some tax inducement to extend holding periods because a decision not to sell is rewarded by deferral of taxation.

The capital gains proposal has elicited a good deal of heated rhetoric on how far revenues would rise or fall and on who would benefit from the exclusion and how much. The abundance of heat and shortage of light arise because we simply do not have sufficient information to make good estimates of either revenue effects or benefits. Not surprisingly, the two issues are related.

The capital gains exclusion would produce four distinct effects.

Effect 1—The exclusion would provide tax relief for filing units who would have sold assets whether or not the law was changed;

Effect 2—The exclusion would cause the acceleration of same sales that would have occurred later in the life of the current owner;

Effect 3—The exclusion would induce some sales of assets that would otherwise have been held until death.

Effect 4—The exclusion would cause some tax units to change transactions to convert ordinary income into capital gains.

The Treasury groups together the second and third effects in its revenue estimates; the Joint Committee on Taxation groups the second, third, and fourth in its

revenue estimates.[3] The failure to distinguish these effects is regrettable, as their relative size is central to the calculation of both the revenue effects of the capital gains exclusion and the distribution of benefits and costs of the exclusion. The reason for withholding this detail, I suspect, is that we have so little data on which to estimate the size of each effect that reporting the detail would make embarrassingly clear the full dimensions of the creative process at work in preparing these revenue estimates.

The Treasury and the JCT disagree about the magnitudes of each of these effects. My own view is that, as far as they go, the JCT's estimates, if anything, give an overly optimistic impression of the long-run effects of the administration's proposal on government's revenues. I do not think that the Treasury estimates should be given much credence, as they systematically overstate what is found in the economics literature about the responsiveness of capital gains realizations to taxes.[4] But neither set of estimates reveals how much of the added revenue in the period 1990-1995 comes at the expense of reduced revenues later on.

This issue is important not only for interpreting the effects of the exclusion on revenues, but also for judging the size and distribution of the benefits from the capital gains exclusion. To illustrate this point, I shall focus on the four types of effects that the exclusion will have on behavior that I just noted.

Effect 1—Relief For Sales That Would Have Occurred Anyway

The Treasury and JCT disagree about the volume of capital gains realizations under current law (see table 1). The gap between the JCT and Treasury estimates reflects differences in judgments that fall well within the range of reasonable uncertainty about the likely realizations of capital gains. Should the stock market rise sharply, actual realizations under current law could well be larger than those assumed by the JCT. Should the stock market drop significantly, actual realizations could easily be smaller than those assumed by the administration.

The key point, which is not in dispute, is that households that would sell appreciated assets under current law stand to gain a lot if rates are cut. A second key point that is not in dispute is that *this particular component of the gain from cutting effective rates of tax on capital gains involves no increase in economic efficiency, no increase in economic growth, no expansion of entrepreneurial investment.* It is a pure windfall, a transfer from taxpayers who do not realize capital gains to those who do.

I think few members of Congress would rise to defend a transfer of as much as $20 billion a year from the mass of American taxpayers to those who realize capital gains, particularly since gains accrue almost entirely to the rich. If this effect were the only result of the capital gains exclusion, I doubt that it would be proposed. But there is a good deal more to the exclusion of part of capital gains from tax.

Effect 2—Accelerated Sales

The size of effect 2 (and 3) is far harder to estimate. This uncertainty affects not only the revenue estimates, but also the distribution of benefits and costs. Everyone agrees that the capital gains exclusion will increase realizations of gains. Some assets that would have been sold in the future will be sold sooner because of the reduced rate of tax on capital gains (effect 2). In general, the acceleration of sales will reduce nominal revenues flowing to the Treasury.

Suppose that two assets purchased in 1985 each with an accrued gain of $1 million are sold in 1990 because of the introduction of a 30 percent exclusion. In the absence of the exclusion, one asset would have been sold in 1991 and one in 2005. It is reasonable to assume that the gain accumulated in 1990 would continue to brow at about the rate of discount.[5] Assuming a marginal tax rate of 28 percent, the Treasury in 1990 would collect $196,000 on the gain from each asset [28 percent of 70 percent of $1 million] with the exclusion. If the exclusion were not enacted, the Treasury would collect taxes on gains realized in 1991 and 2005, each with a present value (in 1990 dollars) of $280,000. In this example, the introduction of the exclusion means that the Treasury, in effect, is borrowing against the future, accepting a reduced current payment instead of full payment later on. The Treasury loses $84,000 (in 1990 dollars) on all assets with $1 million in gains whose sales are accelerated.

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[3] Both sources present estimates of the revenue effects of other provisions in the administration proposal—the depreciation recapture, the application of the minimum tax to excluded gains, and the effective date. I shall ignore these issues in my testimony.

[4] For a reserved but devastating critique of the Treasury estimates, see Jane 6. Gravelle, "Can a Capital Gains Tax Cut Pay for Itself?" Congressional Research Service, March 1990.

[5] The gain on some assets would grow faster than the rate of discount and on some assets it would grow slower. The assumption I am using is meant to be a reasonable middle-range assumption.

Given the annual budget accounting framework, both transactions reduce the 1990 deficit. But both sacrifice future revenue of greater present value. It is worth noting that even if the exclusion causes some investors who would have sold assets within less than three years to increase holding periods to qualify for exclusion of part of the gain, revenues will be reduced by a similar amount in present value.

This problem is not unique to estimating the revenue effects of this particular proposal. It is an issue whenever the timing of tax collections is affected by a change in the law. The revenue estimating framework that is accepted by both the JCT and the Treasury ignores these timing issues. For many proposals timing does not matter much and can be ignored safely. For proposals designed explicitly to accelerate tax collections, this issue is critical; to ignore it in revenue estimates guarantees that the results will be highly misleading.

Effect 3—Sale of Assets that Would Otherwise be Held Until Death

The introduction of an exclusion will also cause realization of some gains that would otherwise have been held until death and thereby would have escaped capital gains tax altogether. To the extent that this occurs, tax revenues rise unambiguously.

Unfortunately, no one has any information on how much of the added revenue the Treasury would collect in 1990 or, for that matter, in any of the years 1990 through 1995 would come from acceleration of sales that would otherwise have occurred later and how much from sales of assets that would otherwise have been held until death.

How much of the induced sales comes from effect 3 and how much from effect 2 is absolutely crucial to estimating the long run revenue effects of the capital gains exclusion. The truth of the matter is that no one has much of an idea about this crucial question. Neither the Treasury nor the JCT make clear what they are assuming. One thing is clear, however—*unless all of the induced sales are assumed to come from assets that would otherwise have been held until death, the estimates of both the JCT and the Treasury overstate the long-run revenue effects of the capital gains exclusion.*

While reliable estimates are simply not attainable, it is possible to make some rough calculations based on crude assumptions. I want to stress that these assumptions are quite arbitrary, but I think that they are reasonable. They are consistent with the revenue estimates reported by both the JCT and the Treasury.

Some crude calculations by various analysts suggest that roughly two-thirds of capital gains are held until the death of the taxpayer and hence escape tax altogether. If one assumes that two-thirds of the revenue from induced sales in the JCT and Treasury estimates come from sales of assets that would otherwise have been held until death and one third represents acceleration of sales that otherwise would have occurred later in the taxpayers life, then the true revenue gain from induced sales should be reduced about 40 percent below the amounts shown in each report.[6] If this adjustment were made, the Treasury would have estimated a revenue loss of the capital gains proposal of $21.5 billion, instead of a revenue gain of $12.5 billion. The JCT would have estimated a revenue loss of $42.6 billion instead of a loss of $11.4 billion. These estimates are much nearer to the true revenue effects of the capital gains exclusion than are estimates of either the Treasury or the JCT.

I want to repeat that I have no way of knowing what fraction of any induced sales will consist of accelerated sales and what fraction will consist of assets that would otherwise be held until death. That fraction clearly has a major influence on the long-run revenue effect of the exclusion. If all sales consisted of accelerated sales, each dollar of revenue from induced sales would reduce revenues by $1.25. Instead of reporting that induced sales increase revenue, they should be reported as losing revenue. Applying this assumption to the estimates of the JCT and the Treasury would result in estimated revenue losses of $113.9 billion and $85.8 billion, respectively. I do not think that this estimate is reasonable, as some part of the induced revenues will surely come from assets that would otherwise have been held until death. But only if all of the sales consist of assets that would otherwise be held until death do the revenue estimates presented by she JCT and the Treasury give an accurate picture of the long-run revenue effects of the exclusion.

I realize that revenues from any source are welcome to hard pressed legislators struggling to meet this year's deficit reduction targets. But you should keep in mind that in some significant measure, the revenue gains claimed from induced sales are

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[6] If the average exclusion that would result from the administration's plan is 25 percent, the revenue loss is 25 percent of revenue that is accelerated. This implies that the revenue gain is $0.58 per dollar of revenue collected. $[(-0.25 \times .339 . .) + .666 . . .) = 58333 . . .]$.

just as phony as they would be if you told taxpayers that they can spare themselves $10 of taxes that would be due in a few years by paying $7 today. You would simply be trading a smaller deficit today for a larger one tomorrow. If you provide such an opportunity to a small group of taxpayers, the rest of the population is going to have to cover the cost of this largesse.

Effect 4—Conversion of Income

Some people will be induced by the option of excluding up to 30 percent of capital gains to take income in the form of capital gains rather than in some other form that would be fully-taxable. A corporation may award stock options rather than pay bonuses, for example. The Treasury projects a modest, but rising, revenue loss from this source that reaches $2 billion annually in 1995.[7] While the Treasury loses revenue from this source, the net gain to those whose taxes are reduced is less than the amount of tax they save, since they are driven to adopt business arrangements available under current law, but rejected presumably because they are inferior apart from tax advantage that partial exclusion would confer. I shall return presently to the question of how large the benefits are.

The benefits and costs arising from the exclusion of part of long term capital gains thus consist of three components.

Effect 1

The first component arises from the static revenue loss. This component provides a benefit worth between $85 billion and $100 billion to recipients of capital gains, depending on whether you use the JCT or the Treasury estimates. It is a pure transfer to units that realize capital gains from those who do not.

Effects 2 and 3

The second component is the revenue from induced sales. The size of these welfare effects depends on whether the added revenues come from accelerated sales or from sales of assets that would otherwise be held until the owner's death. The following calculations give an idea of the range of uncertainty.

If all of the revenues in this category came from sale of assets that would otherwise have been held until the taxpayer dies, the exclusion would raise revenues permanently. This revenue increase would provide a corresponding benefit to those taxpayers who do *not* realize capital gains because they would be asked to bear a permanently reduced share of tax burdens.

Those paying the additional taxes would also enjoy gains. If one assumes that some of those who would be induced to realize gains by an exclusion were on the margin of selling anyway, some would be just on the margin of selling even after the introduction of the gain, and the rest would be distributed evenly between these two possibilities, then the welfare gain for those induced to sell would be approximately $13.1 to $14.1 billion depending on whether one uses the JCT or Treasury estimates of induced sales.[8]

On the other hand, if all of the revenues come from the acceleration of sales, the present value of taxes collected is reduced by about 25 percent, a revenue loss to taxpayers other than those realizing capital gains of $19.6 billion to $21.1 billion depending on whether one uses the JCT or the Treasury estimates. The corresponding welfare gain to those who pay the added taxes (given the same approach as indicated in note 8) would be $9.8 billion to $10.5 billion.

These results are shown in the bottom half of table 1. I want to emphasize as strongly as I can that these estimates are my crude attempts to deal with the fact that a lack of the necessary data makes it impossible to calculate correctly either the revenue effects or the welfare effects from excluding a part of capital gains. But three important conclusions stand out.

• *First, if one assumes that any significant portion of the induced revenue from introduction of the capital gains exclusion comes from the earlier sale of assets that owners would sell later under current law, the proposal is a very big revenue loser.*

• *Second, unless one assumes that all of the induced revenue comes from sales of assets that would otherwise have been held by the owners until death, the capital gains exclusion inflicts sizable losses on taxpayers other than those who realize capital gains.*

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[7] The JCT does not report a separate estimate for this behavioral response.

[8] These calculations assume an average marginal rate on realized gains of 25 percent and an average exclusion of 25 percent. The exclusion reduces the effective rate to 18.75 percent, a saving of 6.25 percent. The welfare gain ranges from 0 percent to 6.25 percent of the gain and averages 3.125 percent of the gain.

• *Third, the capital gains exclusion confers sizable gains on the fraction of taxpayers who realize capital gains; the gains for the tiny fraction of taxpayers with adjusted gross incomes of more than $200,000 per year average more than $20,000 per return.*

Demonstration That The Proportion of Capital Gains That Should be Included If the Object is to Offset Inflation Rises with the Holding Period

Assume that an asset appreciates at the instantaneous rate of $\underline{n}$, that the instantaneous rate of inflation is $\underline{p}$, and that the real rate of growth is g ($g = n - p$). At the end of $\underline{t}$ periods, an asset that cost $X to purchase will have a value of Xe^{nt} (were $\underline{e}$ is the exponential growth factor). The nominal gain is $Xe^{nt} - X$.

Of this gain, however, $(Xe^{pt} - X)$ is inflation gain and should not be taxed. Hence, the gain that is properly subject to tax is $[(Xe^{nt} - X) - (Xe^{pt} - X)]$. The question of whether the proportion of capital gains excluded to adjust for inflation should rise or fall is therefore equivalent to asking whether $(Xe^{nt} - Xe^{pt})/(Xe^{nt} - X)$ rises or falls as t increases. The X term cancels.

So the question of whether the fraction of the gain included in tax should rise or fall with the holding period becomes: does the term $(e^{nt} - e^{pt})/(e^{nt} - 1)$ rise or fall as t increases, where t is the holding period? If one divides both the top and the bottom by e^{nt}, this term becomes $(1 - e^{-gt})/(1 - e^{-nt})$. As t becomes larger, the numerator and denominator both approach 1, indicating that as t becomes large, the proportion of the capital gain that should be included in the tax base approaches 100 percent.

Table 1.—REVENUE EFFECTS OF CAPITAL GAINS EXCLUSION

	JCT	Treasury
Revenue effect, 1990-1995:		
Static effect	−100.2	−74.7
Induced realizations	+78.4	+79.6
less adjustment (see text)	−31.4 (−105.7 [1] to 0 [2])	−33.8 (−98.0 [1] to 0 [2])
Other	+10.6	+7.3
Total	−42.6 (−113.9 to −11.2)	−21.5 (−85.8 to 12.1)
Welfare effects, 1990-1995:		
General population:		
Static effect	−100.2	−74.7
Induced realizations	?	?

Table 1.—REVENUE EFFECTS OF CAPITAL GAINS EXCLUSION—Continued

	JCT	Treasury
less adjustment	(+78.4 to −19.6)	(+79.6 to −21.1)
Total	?	?
Capital gains recipients:		
Static effect	+100.2	+74.7
Induced realization	?	?
less adjustment	(+13.1 to 9.8)	(+14.1 to 10.5)
Total	?	?

[1] Assuming all induced sales are accelerated.
[2] Assuming all induced sales are of assets that would have been held until death.

Table 2.—HOLDING PERIODS FOR REALIZED CAPITAL GAINS, 1985

Holding Period	Percent of Gain [1]
Less than 1 year	11.9
1 year to 2 years	9.0
2 years to 3 years	7.5
3 years to 4 years	6.4
4 years to 5 years	6.8
5 years to 6 years	5.0
6 years to 7 years	5.0
7 years to 8 years	3.7
8 years to 9 years	3.9
9 years to 10 years	3.2
Over 10 years	37.7
Missing	(26.7)

[1] Excluding assets for which holding period is missing.

Source: Dan Holik, Susan Hostetter and John Labate "1985 Sales of Capital Assets," paper presented to the American Statistical Association, August 6–9, 1989.

PREPARED STATEMENT OF ALAN J. AUERBACK

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to appear here today to present my views on the President's proposed reduction in the tax rate on long-term capital gains. I appear on my own behalf; the views expressed in this testimony are based solely on my own professional analysis and interpretation of the evidence.

When fully phased in, by 1992, the President's plan would reduce the tax rate on long-term capital gains by providing a 30 percent exclusion for assets held for at least three years, and smaller exclusions for assets held for between one and three years. The full 30 percent exclusion would be provided during 1990 for assets held for at least one year, and in 1991 for assets held for at least two years. The Administration argues that the proposed change will promote savings and investment, encourage innovation and entrepreneurial activity, and reduce the "lock-in effect", by which a looming capital gains tax discourages investors from selling assets.

All of these potential benefits are made more attractive by the promise that they will come at no cost to the Treasury. The Administration forecasts an increase in revenue in each of the fiscal years for which it offers projections, with a total gain of $12.5 billion from fiscal year 1990 through fiscal year 1995. More recently, it has bolstered this claim by arguing that still more revenue will be generated by the economic growth the capital gains tax cut will produce. One is left with the impression that enactment of the capital gains proposal will produce important economic benefits and cannot fail to raise revenue at the same time.

I am sure this is the impression that the Administration intends to create. It is difficult to oppose a plan that provides major benefits at no cost. However, there are serious flaws in this characterization of the President's plan. Its benefits would be considerably smaller than portrayed, it would very likely result in the loss in tax revenue, and it would have other costs that the Administration has ignored in its analysis. Moreover, compared to available alternatives, the partial exclusion of long-term gains is a distinctly inferior way of achieving each of its apparent objectives. One cannot and should not ignore the existence of these alternatives when evaluating the President's proposal.

Revenue and the Lock-In Effect

For a capital gains tax reduction to increase revenue, it must increase realizations by a greater proportion than the tax rate declines, to recoup the "static" revenue loss due to the rate reduction itself. There are four types of investor response that increase realizations:

1. a lower lock-in effect: the reduced tax on realizations encourages investors to turn over portfolios more frequently, and hold fewer gains until they escape taxation at death;

2. increased capital formation: a reduced cost of capital encourages greater capital accumulation, thereby producing additional capital gain income;

3. tax avoidance and income sheltering: the differential tax rate promotes the shifting of income from other, fully taxed sources; and

4. timing of sales: the lower tax rate encourages investors to realize gains that would otherwise have been realized in other years in which the tax rate is or is expected to be higher.

All of these responses are likely to occur to some extent, but their implications are quite different and hence their relative magnitudes important. The first two cause tax revenues to rise permanently as the result

of reduced economic distortions. It is these that the Administration has
emphasized in its initial revenue estimates and subsequent statements. Tax
avoidance causes capital gains tax revenue to rise but other revenue to fall
by even more. The Administration's revenue projections include estimates of
the revenue lost from such shifts. The timing of sales causes current revenue
to rise, but revenue in other years to fall by even more. The
Administration's forecasts minimize the importance of such behavior, but
recent evidence suggests that it is a mistake to do so.

Anyone who has studied the year-to-year fluctuations in capital gains
realizations must be convinced of their extreme sensitivity to taxation. For
example, the increase in capital gains tax rates in 1987 led to a huge
increase in realized capital gains at the end of 1986 as taxpayers hurried to
sell assets before the increase took effect. Realizations of long-terms gains
rose from $166.4 billion in 1985 to $318.0 billion in 1986 and then fell to
roughly $138.0 billion in 1987 (an exact figure for 1987 doesn't exist because
taxpayers no longer have to report long-term and short-term gains separately).

Those who prepared the Administration's revenue estimates would probably
interpret the drop between 1986 and 1987 as evidence that a permanent change
in capital gains taxes would have a large permanent effect on realizations.
Actually, the recent pattern of realizations proves only that changes in
capital gains tax rates evoke changes in realizations. There is little doubt
that a reduction in capital gains taxes would, briefly, increase the level of
realized gains, as investors alter the timing of their realizations to take
advantage of the lower rate. But once the rate has been at its new lower
level for a longer period, revenue from the timing of gains will vanish.

My own evaluation of the empirical evidence[1] suggests that a reduction in
capital gains tax rates now would lead to a permanent increase in the level of
realizations. However, this increase would be far less than would be required
to raise capital gains tax revenue in the long run. While there is a range of
uncertainty about how large the taxpayer response would be, most empirical
studies that have concluded otherwise should be discounted because they do not
adequately distinguish between changes in the level and the timing of gains
realizations.

Because of my own analysis of the situation, I find the alternative
revenue estimates produced by the Joint Committee on Taxation to be much more
plausible than those of the Administration. The JCT forecasts revenue losses
of between $3.1 billion and $4.3 billion for each year from 1992 to 1995,
after an initial revenue gain in fiscal years 1990 and 1991. One may presume
that such revenue losses will grow in the period after 1995.

Indeed, even the short-run revenue increase that both the Administration
and the Joint Committee predict is "tainted". A system of taxation under
which the capital gains tax rate frequently rises and falls invites investors
to time the realization of gains to occur in low-tax years. The President's
continuing pledge to lower the capital gains tax rate has undoubtedly led some
investors to delay their realizations during the past couple of years. Much
or all of the short-run revenue increase that would result from passing the
capital gains tax reduction would, in a very real sense, represent the delayed
collection of taxes on these deferred gains, albeit at a lower rate of tax.
Thus, the current revenue from these gains would be less than the past revenue
loss induced by the expectation that the rate reduction would occur.

Put another way, if fiscal years before 1990 were included in the revenue
estimates for the President's capital gains tax proposals, there would be
negative entries for past years that might well eliminate even the short-run
revenue gain that appears in both Administration and Joint Committee
forecasts.

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[1]See Alan J. Auerbach, "Capital Gains Taxation and Tax Reform," National
Tax Journal 42, September 1989, pp. 391-401.

I have little doubt that a reduction in capital gains tax rates would lessen the lock-in effect and increase realizations somewhat, if not enough to prevent a revenue loss. The reduced lock-in effect is a very weak argument for reducing capital gains taxes, however, because the distortion itself is not particularly significant and because there are better ways of alleviating it.

There appears to be some confusion over the distortions associated with the lock-in effect. The lock-in effect does not alter the social allocation of capital or the availability of capital to new enterprises. Its only distortion is to the portfolio choice of investors. One investor's decision to sell an asset does not make the asset disappear, nor does it make capital available to other enterprises; it simply transfers the ownership of the asset. While a greater ability to rebalance portfolios would improve the allocation of risks among investors, I would not rank inadequate portfolio rebalancing among the major causes of our nation's current economic problems.

The lock-in effect arises because of the favorable treatment already accorded capital gain income: investors are not taxed on gains until these gains are realized, and benefit by deferring the tax on accrued gains. The Administration's "solution" to this problem is reduce the lock-in effect by reducing the tax itself. Following this approach, one could eliminate the lock-in effect only by eliminating the capital gains tax entirely. But reducing the lock-in effect does not require a tax reduction, only a reduction in the tax benefit of deferral.

Eliminating the tax benefit of deferral would require that the capital gains tax rate rise with an asset's holding period and that the current rule granting forgiveness of capital gains tax liability at death be changed. It is ironic that in calling for a tax rate that declines with respect to holding period, the President's plan actually counteracts its own stated objective of reducing the lock-in effect.

Some have suggested that the sliding scale of tax rates is needed to compensate for the effects of inflation, but this argument is simply incorrect. The portion of gain attributable to inflation declines over time. The needed correction would occur automatically under an inflation-indexed capital gains tax. In lieu of indexing, a sliding scale exclusion that roughly compensated for the effects of inflation would decline, not increase with the length of holding period.

The Cost of Capital and Economic Growth

In recent weeks, the Administration has argued that the growth in income resulting from a capital gains tax cut will provide an additional increase in revenue over the next five years, beyond that supposedly coming from the reduced lock-in effect. According to one Administration source, "[a] conservative estimate is that the President's proposal would lower the cost of capital for businesses by 3.6%[2] The source continues: "Over the next 5 years, the lower cost of capital arising from the President's proposal can be reasonably expected to increase GNP by a total of $61 billion. This would yield roughly $12 billion in extra revenue over the 5 years."

Although I cannot easily verify that such a GNP gain would lead to the stated revenue increase, I will not challenge this part of the claim. However, the predicted decline in the cost of capital and increase in GNP strike me as neither conservative nor reasonable. Even wildly optimistic estimates are much lower.

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[2] Letter to The Honorable Bill Archer from Michael J. Boskin, Chairman of the Council of Economic Advisors and Robert R. Glauber, Under Secretary of the Treasury, March 6, 1990.

Let me deal first with the estimated cost of capital decline of roughly 3.6%. As I discuss in Appendix A of my testimony, this is an implausibly high figure. Even an estimate half this large could not be characterized as conservative. One can attribute this small impact on the cost of capital to several factors that attenuate the strength of the tax reduction. First, many capital gains already escape tax at death; their tax rate cannot be lowered. Second, a significant share of all equity is held by investors not subject to the individual income tax or the proposed capital gains tax reduction. Third, only a portion of the returns to debt and equity go to shareholders in the form of capital gains.

This small tax rate reduction does seem disappointingly small relative to the large tax cut being proposed, but it must be remembered that most of the reduction in taxes that will be granted over the next several years will be associated with assets already in place and therefore will have no effect at all on the cost of capital.

The next question is how much of an increase in GNP this potential reduction in the cost of capital would generate. In addressing this question, it is important to remember that the proposed reduction in capital gains taxes is a tax reduction for investors who supply capital to businesses, not for the businesses themselves. Whereas an incentive provided directly to business would encourage investment, regardless of the source of funds, the capital gains tax cut will spur investment and growth only if U.S. households are willing to provide more capital while at the same time sharing some of the tax reduction with business through a lower cost of capital. If there is no increase in saving, there will be no increase in investment.

Further, there is nothing to ensure that an increase in U.S. private saving will increase domestic investment. If I buy the shares of a U.S. company that then invests the funds in another country, my capital gains on these shares will receive the same tax cut as will gains associated with domestic investment. The tax cut will increase domestic growth only to the extent that U.S. households save more and the additional funds are invested in the United States.

Even if a significant fraction of new household saving is channelled into domestic projects, it is very unlikely that much new saving will occur. Indeed, as I discuss in more detail in Appendix B of this testimony, the tax cut may very well decrease private saving and national saving. Even under the most optimistic assumptions that the tax cut produces no revenue loss (before account is taken of growth) and private saving is very responsive to the after-tax rate of return, the increase in GNP (not tax revenue) over the next five years would be about $4 billion, not $61 billion. Thus, from a revenue perspective, added growth cannot bail out the Treasury, even in the unlikely event that such growth occurs at all. It is more likely that the increase in the deficit caused by the tax cut will reduce national saving and GNP growth.

Encouraging Risk-Taking and New Ventures

The Administration supports its capital gains tax proposal by arguing that the plan will provide a special boost to venture capital enterprises, operations that are typically associated with the generation of capital gains. However, even those who believe that a reduction in the capital gains tax would spur venture capital formation must concede that venture capital represents a minute fraction of the assets that would typically qualify for long-term capital gains tax treatment.

Moreover, funds for venture capital did not dry up with the rise of capital gains tax rates in 1987. One recent study[3] found a substantial increase in venture capital funds supplied by individuals between 1986 and 1987. The same study also found "that 88 percent of the funding for independent venture funds arises from investors who are not affected by the personal income tax" (such as corporate, foreign, and tax-exempt investors).

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[3] James M. Poterba, "Venture Capital and Capital Gains Taxation," NBER Working Paper #2832, January 1989.

It is not obvious that the tax system should provide additional encouragement of risky ventures, which already benefit from the favorable treatment of capital gains relative to ordinary income. However, it is not necessary to argue this point to recognize that a blanket reduction in capital gains taxes is the wrong tool to use to spur the formation of venture capital enterprises. It would make much more sense to design a tax measure that concentrated on such activities.

For example, a much cheaper and more direct approach would be to reduce the rate of capital gains tax on the entrepreneurs who are actively engaged in their formation and success, the "active" participants whose rewards to ideas and labor appear in the form of stock appreciation and hence are largely taxed as capital gains. A provision of this sort would distinguish between passive and active investors in the same way that this is currently done to determine the applicable rules for the deductibility of investment losses.

Conclusion

Ever since the Tax Reform Act's repeal of the 60 percent exclusion for long-term capital gains, there has been strong support for a return to a reduced rate of tax on such gains. Before Congress acts to repeal the 1986 provision, it should recall why the change was made in the first place.

There were at least two major arguments in favor of removing the capital gains tax preference. First, doing so helped discourage the conversion of ordinary into capital gain income to avoid taxes, a major occupation of the tax shelter "industry". Second, the increased tax on capital gains helped offset the reductions in the overall progressivity of the tax system brought about by the Act's flattening of the marginal rate schedule. Since the ordinary marginal tax rate on those individuals with the most capital gains was reduced by the Act to only 28%, it became possible to remove the capital gains tax preference without having extremely high tax rates on realized capital gains.

The passage of time has not affected this analysis. If a capital gains tax cut provided a "free lunch," its distributional consequences would not matter very much; no one would lose. In reality, however, there would be losers, the taxpayers who would have to supply the lost tax revenue. These taxpayers would in all likelihood be far less able to bear the required new taxes than those receiving the capital gains tax cut. Roughly two-thirds of these tax benefits would accrue to individuals with incomes above $200,000, according the Joint Committee.

Beyond this transfer of the tax burden, the proposed capital gains tax reduction would have very insignificant effects on the cost of capital and economic growth, and is an inferior way to reduce the lock-in effect, correct for inflation, or spur venture capital enterprises.

Appendix A: Estimating the Effect of a Capital Gains Tax Reduction on the Cost of Capital

The average marginal capital gains tax rate under current law has been estimated by the CBO to be approximately 25%[4] Using my own estimates that slightly more than half of all taxable capital gains are never realized and that just under a quarter of the remaining gains are realized each year[5], and using a nominal discount rate of 8 percent, I find an effective capital gains tax rate of 9%. The President's proposal would reduce the effective tax rate by at most 30% of this, because of recapture provisions and since gains must be held for three years to obtain the full exclusion. Thus, the reduction in the effective tax rate on nominal taxable capital gains is at most 3%. If as much as half of all nominal gains are due to inflation, the reduction in the effective tax rate on real gains would equal about 6%.

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[4] Congressional Budget Office, How Capital Gains Tax Rates Affect Revenues: The Historical Evidence (CBO, March 1988), Table 4.

[5] Alan J. Auerbach, "Capital Gains Taxation and Tax Reform," op. cit.

However, only about half of corporate equity is held by households[6].
Thus, the reduction in the average tax burden on all capital gains is about
3%. Further, capital gains represent only a portion of the return generated
by businesses. If one makes the extreme assumption that 2/3 of all returns to
equity are subject to the capital gains tax, the reduction in the tax rate on
all returns to equity is 2%. Since this reduction only applies to the
roughly 60% of the aggregate corporate capital structure that is accounted for
by equity, the overall reduction in the effective tax rate on business income
is just over 1%.

If one further assumes that the increased demand for capital by business
does not bid up the after-tax return required by suppliers of capital at all,
this tax cut leads to a reduction in the cost of capital by a percentage equal
to the change in the tax rate divided by one minus the tax rate. For a high
overall investor tax rate of .2 on nominal returns and, with the maintained
assumption that real income is half of nominal income, a corresponding tax
rate of .4 on real returns, the implied reduction in the cost of capital is
roughly 2%.

Thus, a combination of extreme assumptions aimed at maximizing the
effect on the cost of capital leads to an figure that is roughly half as big
as the Administration's "conservative" estimate. Less extreme assumptions
would make this estimate much smaller.

Appendix B: Estimating the Effect of a Capital Gains Tax Reduction on Output

Suppose a capital gains tax cut raises exactly enough revenue to pay for
itself on a permanent basis, a quite optimistic assumption; then one can view
the reduction in capital gains taxes as if it were an uncompensated reduction
in the wedge between before-tax and after-tax returns to saving.

An uncompensated increase in the after-tax return to saving need not
increase saving at all. The "substitution" effect that encourages more saving
must outweigh the "income" effect encouraging more consumption, and there is
scant evidence suggesting this to be the case.

Even if one assumed an optimistically high positive elasticity of private
saving with respect to the after-tax rate of return of .4, however, the
projected increase in saving would be quite small, and the short-run increase
in GNP minuscule.

The reduction in the effective tax rate on real capital gains derived in
Appendix A is about 6 percentage points, and it applies only to capital gain
income, a small fraction of all returns to private saving. For example, in
1989, according to the Economic Report of the President, personal income from
interest, dividends and rent was $778 billion. Adding one quarter of
proprietors' income (treating the rest as labor income) yields a total of
$866 billion. By comparison, the 1985-87 average of realized capital gains
was $208 billion. Doubling this figure to take account of gains never
realized still makes capital gains only about one-third of all personal
capital income, making the effective reduction in the tax rate on saving about
2 percentage points.

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[6] This figure is taken from Table 4 of Alan J. Auerbach, "Tax Policy and
Corporate Borrowing," presented to the conference "Are the Distinctions
between Equity and Debt Disappearing?" sponsored by the Federal Reserve Bank
of Boston, October 1989.

Even if none of the benefit of this tax reduction were eroded by a decline in the before-tax rate of return, the real after-tax rate of return would rise by only 3.33%, given the initial tax rate on saving of 40% used above. At a savings elasticity of .4, this would increase private saving, currently about $250 billion per year, by 1.33%, or $3.33 billion per year. Over the next five years, $16.67 billion of new capital put in place at the rate of $3.33 billion per year would increase nominal capital income by a total of $4 billion, assuming an 8% rate of return.

Thus, even under very optimistic assumptions about the responsiveness of saving to the after-tax rate of return, the increase in private saving would increase output during the next five years by about $4 billion, rather than the $61 billion claimed by the Administration. However, even if one maintains this saving elasticity assumption, there are other factors that decrease this output effect further. First, the government is likely to lose revenue as a result of the tax cut. Assuming that it borrows to meet this extra deficit, its additional borrowing (based on the Joint Committee on Taxation's revenue estimates) will roughly offset the possible $3.3 billion per year of extra private saving, eliminating any growth in national saving and output. Thus, the best one can possibly expect is that output and national saving will not decline.

Furthermore, the elimination of the lock-in effect may in itself reduce personal saving, as those investors whose wealth is tied up in appreciated assets will suffer a smaller penalty from selling these assets for the purposes of consumption. The potential importance of this factor is hard to gauge, but it would simply increase in magnitude the decline in national saving that the capital gains tax cut is likely to produce.

SUBMITTED BY SENATOR LLOYD BENTSEN

[JOINT COMMITTEE PRINT]

PRESENT LAW, PROPOSALS, AND ISSUES RELATING TO INDIVIDUAL RETIREMENT ARRANGEMENTS AND OTHER SAVINGS INCENTIVES

SCHEDULED FOR A HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON MARCH 27, 1990

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

MARCH 26, 1990

CONTENTS

ERRATA FOR JCS-11-90

On page 8 (B. Administration Proposal), in the section under the heading, *"Contribution limits,"* make the following changes:

In the first sentence of the first paragraph, change the parenthetical to read: "(a married couple would be permitted to make $5,000 in annual contributions if both spouses together earn at least $5,000)."

Change the second sentence of the second paragraph to read: "Contributions would be permitted for single taxpayers with AGI of $60,000 or less, for heads of households or surviving spouses with AGI of $100,000 or less, and for married taxpayers filing joint returns with AGI of $120,000 or less."

O

INTRODUCTION

The Senate Committee on Finance has scheduled a hearing on March 27, 1990, on legislative proposals and issues relating to individual retirement arrangements (IRAs) and other savings incentives.

This pamphlet,[1] prepared by the Staff of the Joint Committee on Taxation, provides a brief description of the present-law rules regarding IRAs and other savings incentives (Part I), legislative background of the present-law rules (Part II), a description of proposals including the Senate Finance Committee proposal (S. 1750), the Administration proposal (S. 2071, Senators Packwood, Roth, and Dole), S. 1771 (Senators Packwood, Roth, and others), and S. 1069 (Senator Baucus) (Part III), and a discussion of the issues relating to IRAs and other savings incentives (Part IV).

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Present Law, Proposals, and Issues Relating to Individual Retirement Arrangements and Other Savings Incentives* (JCS-11-90), March 26, 1990

I. PRESENT LAW

A. Individual Retirement Arrangements

In general

Under certain circumstances, an individual is allowed a deduction for contributions (within limits) to an individual retirement account or an individual retirement annuity (an IRA) (Code sec. 219). An individual is generally not taxed on amounts held in an IRA, including earnings on contributions, until the amounts are withdrawn from the IRA. Thus, under present law, tax deferral is provided during the period from the time an IRA contribution is made until an amount is withdrawn from the IRA. Contributions cannot be made to an IRA after the individual attains age 70½.

Deduction limits

Under present law, the maximum deductible contribution that can be made to an IRA is generally the lesser of $2,000 or 100 percent of an individual's compensation (earned income in the case of self-employed individuals). A single taxpayer is permitted to make the maximum deductible IRA contribution for a year if the individual is not an active participant in an employer-sponsored retirement plan for the year or the individual has adjusted gross income (AGI) of less than $25,000. A married taxpayer filing a joint return is permitted to make the maximum deductible IRA contribution for a year if neither spouse is an active participant in an employer-sponsored plan or the couple has combined AGI of less than $40,000.

If a single taxpayer or either spouse (in the case of a married taxpayer) is an active participant in an employer-sponsored retirement plan, the IRA maximum deduction is phased out over certain AGI levels. For single taxpayers, the maximum IRA deduction is phased out between $25,000 and $35,000 of AGI. For married taxpayers, the maximum deduction is phased out between $40,000 and $50,000 of AGI.

In the case of a married taxpayer filing a separate return, the deduction is phased out between $0 and $10,000 of AGI. A couple is not considered married for purposes of the IRA deduction rules if they file separate returns and live apart from one another at all times during the taxable year.

An individual is an active participant in an employer-sponsored retirement plan for the taxable year if the individual is an active participant for the plan year ending with or within the individual's taxable year. An employer-sponsored retirement plan means (1) a qualified pension, profit-sharing, or stock bonus plan (sec. 401(a)); (2) a qualified annuity plan (sec. 403(a)); (3) a simplified employee pension plan (sec. 408(k)); (4) a plan established for its employees by

(2)

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the U.S., by a State or political subdivision, or by any agency or instrumentality of the U.S., or a State or political subdivision (other than an unfunded deferred compensation plan of a State or local government (sec. 457)); (5) a plan described in section 501(c)(18); and (6) a tax-sheltered annuity (sec. 403(b)).

Nondeductible IRA contributions

Individuals may make nondeductible IRA contributions to the extent deductible contributions are not allowed because of the AGI phaseout and active participant rules. Thus, an individual may make nondeductible contributions up to the excess of (1) the lesser of $2,000 or 100 percent of compensation over (2) the IRA deduction limit with respect to the individual. In addition, an individual may elect to make nondeductible contributions in lieu of deductible contributions. Individuals making nondeductible contributions are required to report the amount of such contributions on their tax return. As is the case with earnings on deductible IRA contributions, earnings on nondeductible contributions accumulate on a tax-deferred basis.

Taxation of withdrawals

Amounts withdrawn from IRAs (other than nondeductible contributions) are includible in income when withdrawn. If an individual withdraws an amount from an IRA during a taxable year and the individual has previously made both deductible and nondeductible IRA contributions, then the amount includible in income for the taxable year is the portion of the amount withdrawn that bears the same ratio to the amount withdrawn as the income on all IRAs of the individual bears to the value of all such IRAs.

To discourage the use of amounts contributed to an IRA for non-retirement purposes, withdrawals from an IRA prior to age 59½, death, or disability are generally subject to an additional 10-percent income tax (sec. 72(t)). The 10-percent additional income tax is intended to recapture the tax benefit of deferral. The 10-percent additional income tax does not apply to withdrawals that are part of a series of substantially equal periodic payments made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of the taxpayer and the taxpayer's beneficiaries.

B. Other Savings Incentives

Educational savings bonds

Under present law, interest income earned on a qualified U.S. Series EE savings bond issued after December 31, 1989, is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year (sec. 135).

The exclusion from gross income of interest on U.S. Series EE savings bonds is available only to taxpayers who are issued such bonds after having attained age 24. During the year the bond is redeemed, the taxpayer to whom such bond was issued must pay "qualified higher education expenses," meaning tuition and required fees for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at an eligible

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educational institution. A taxpayer cannot qualify for the interest exclusion by paying for the education expenses of another person (such as a grandchild or other relative) who is not a dependent of the taxpayer.

The exclusion is phased out for certain upper-income taxpayers. A taxpayer's AGI for the year the bond is redeemed (not the year the bond was issued) determines whether or not the phaseout applies. For taxpayers filing a joint return, the phaseout range is for AGI between $60,000 and $90,000. For single taxpayers and heads of households, the phaseout range is for AGI between $40,000 and $55,000. The phaseout rate for the exclusion is applied ratably over the income phaseout range.

Generally, all Series EE savings bonds can be purchased through payroll savings plans, at most commercial banks, at many savings and loan associations, and at other qualified financial institutions. Such bonds can be purchased in various denominations, ranging from $50 to $10,000. The purchase price is one-half the denomination (or face value) of the bond. In any one year, a person may purchase Series EE savings bonds with denominations (or face value) totalling up to $30,000. The interest rate on Series EE savings bonds varies, depending on how long the bonds are held. The interest rate on such bonds held for more than 5 years is based on the market rate for Treasury outstanding obligations with 5 years to maturity. Bonds held for less than 5 years earn interest on a fixed, graduated scale. Interest earned on Series EE savings bonds is paid when the bonds are redeemed [2]

Other provisions

A number of other types of tax-favored savings arrangements are permitted under present law, a discussion of which is beyond the scope of this pamphlet. These arrangements include employer-sponsored retirement plans, retirement plans for self-employed individuals, life insurance contracts, and tax-exempt bonds.

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[2] See Congressional Research Service, *Saving for College with Education Savings Bonds*, March 22, 1989, pp. 3-6.

II. LEGISLATIVE BACKGROUND

A. Individual Retirement Arrangements

Employee Retirement Income Security Act of 1974

The individual retirement savings provisions of the Internal Revenue Code were originally enacted in the Employee Retirement Income Security Act of 1974 (ERISA) to provide a tax-favored retirement savings arrangement to individuals who were not covered under a tax-qualified retirement plan maintained by an employer. Individuals who were active participants in employer-sponsored retirement plans were not permitted to make deductible contributions to an IRA. As enacted in ERISA, the limit on the deduction for IRA contributions was generally the lesser of (1) 15 percent of the individual's compensation (earned income in the case of a self-employed individual) for the year, or (2) $1,500.

Economic Recovery Tax Act of 1981

The Economic Recovery Tax Act of 1981 (ERTA) increased the deduction limit for contributions to IRAs and removed the restrictions on IRA contributions by active participants in employer-sponsored plans. Under ERTA, the deduction limit for IRAs was generally the lesser of (1) $2,000, or (2) 100 percent of the individual's compensation (earned income in the case of a self-employed individual). Any individual was entitled to make a deductible contribution to an IRA even if the individual was an active participant in an employer's plan.

The ERTA changes were motivated by Congressional concern that a large number of workers, including many who were covered by employer-sponsored retirement plans, faced the prospect of retirement without the resources needed to provide adequate retirement income levels. The Congress concluded that retirement savings by individuals during their working years can make an important contribution towards providing retirement income security.

Tax Reform Act of 1986

The Tax Reform Act of 1986 (the 1986 Act), added the present-law restrictions on deductible IRA contributions by active participants in employer-sponsored retirement plans. These restrictions are similar to those originally included in ERISA. In addition, the 1986 Act added the present-law rules permitting individuals to make nondeductible contributions to an IRA.

B. Other Savings Incentives

The exclusion from income for interest on education savings bonds was added to the Internal Revenue Code by the Technical and Miscellaneous Revenue Act of 1988.

III. DESCRIPTION OF PROPOSALS

A. S. 1750 (Senate Finance Committee) [3]

In general

The deductibility of an individual's contributions to an IRA would be expanded under the bill. Generally, the bill would permit a deduction of one-half of the otherwise nondeductible portion of the contribution made by an individual. The bill also would allow withdrawals from an IRA without imposition of the 10-percent additional income tax to the extent the amount withdrawn is used for either the purchase of a first home or for certain education expenses.

Expansion of present-law deduction rules

Under the bill, an individual who contributes to an IRA would be able to deduct the amount of the contribution that is deductible under present law, plus 50 percent of the contribution that is not deductible. This additional 50-percent deduction would be allowed only with respect to contributions that would otherwise have been deductible but for the active participant rule. The present-law maximum dollar limitation ($2,000) and other limitations relating to deductibility (e.g., the 100 percent of compensation limit) would continue to apply.

For example, assume that a single taxpayer who is an active participant has an AGI of $100,000. The taxpayer contributes $2,000 to an IRA. Under present law, none of the $2,000 contribution is deductible because of the taxpayer's AGI level and active participation in an employer-sponsored retirement plan. Under the bill, the taxpayer would be permitted to deduct $1,000 (50 percent of the nondeductible contribution).

The bill also would disallow the deduction for interest on loans the proceeds of which are used to make an IRA contribution.

Withdrawals by first-time homebuyers

Under the bill, the 10-percent additional income tax on certain IRA withdrawals would be waived for withdrawals by first-time homebuyers that are used within 60 days to acquire, construct, or reconstruct the taxpayer's principal residence. A first-time homebuyer would be an individual who has not had an ownership interest in a principal residence during the 2-year period ending on the date of acquisition of the principal residence to which the with-

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[3] The provisions described were included in the 1989 budget reconciliation provisions, as approved by the Senate Finance Committee (included in S. 1750 as reported by the Senate Budget Committee), but were deleted by Senate floor amendment. The provisions are similar to those contained in S. 1682, the Savings and Investment Incentive Act of 1989, introduced by Senator Bentsen and others on September 27, 1989.

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drawal relates. The date of acquisition would be the date the individual enters into a contract to purchase a principal residence or begins construction or reconstruction of such a residence. The bill would require that the spouse of the taxpayer also meet this requirement as of the date the contract is entered into or construction commences. Principal residence would be defined as under the provisions relating to the rollover of gain on the sale of a principal residence (sec. 1034).

Under the bill, any amount withdrawn from an IRA for the purchase of a principal residence would be required to be used within 60 days of the date of withdrawal. The 10-percent additional income tax on early withdrawals would be imposed with respect to any amount not so used. However, if the 60-day rule could not be satisfied due to a delay in the acquisition of the residence, the taxpayer would be able to recontribute all or part of the amount withdrawn to the IRA prior to the end of the 60-day period without adverse tax consequences. Any amount recontributed would generally be treated as a rollover contribution (sec. 408(d)) without regard to the limitations on the frequency of IRA to IRA rollovers.

Withdrawals for education expenses

Under the bill, withdrawals used by a taxpayer during the year for qualified higher education expenses would not be subject to the 10-percent additional income tax on early withdrawals. Qualified higher education expenses would be defined as tuition, fees, books, supplies, and equipment required for courses at an eligible educational institution, as defined under the provisions relating to education savings bonds (sec. 135). Amounts withdrawn would be available for use for the education of the taxpayer, or the taxpayer's spouse, dependents, or grandchildren.

The amount that could be withdrawn for education expenses for a taxable year without imposition of the 10-percent additional tax would be reduced by any amount that is excludable from the taxable income of the taxpayer under the provisions relating to education savings bonds (sec. 135).

Effective date

Under S. 1750, the expansion of the present-law IRA deduction provisions would be effective for taxable years beginning after December 31, 1990. The provisions relating to the exceptions to the 10-percent additional income tax would apply to distributions on or after January 1, 1990. The deduction disallowance for certain interest expenses would be effective for indebtedness incurred after the date of enactment in years ending after such date.

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B. Administration Proposal (S. 2071, Senators Packwood, Roth, and Dole) [4]

Family savings accounts

Under the Administration proposal and S. 2071, an individual would be permitted to make nondeductible contributions to a family savings account (FSA). If these contributions remain in the account for 7 years or more, amounts withdrawn (including both the contributions and earnings thereon) would be excluded from gross income. The bill would also allow certain withdrawals from an IRA without imposition of the 10-percent additional income tax to the extent the amount withdrawn is used for the purchase of a first home.

Contribution limits

The maximum annual contribution to an FSA under the proposal would be limited to the lesser of $2,500 or 100 percent of the individual's compensation (a married couple would be permitted to make $5,000 in annual contributions if both spouses together earn at least $2,500). Individuals who may be claimed as a dependent on another taxpayer's return could not contribute to an FSA.

Only individuals meeting certain AGI limitations would be able to make a contribution to an FSA. Contributions would be permitted for single taxpayers with AGI of less than $60,000, for heads of households with AGI of less than $100,000, and for married taxpayers filing joint returns with AGI of less than $120,000. Amounts contributed to an FSA would not affect the amount that could otherwise be contributed to tax-favored retirement plans (e.g., employer-sponsored retirement plans or IRAs) or to other tax-favored forms of saving (e.g., education savings bonds).

Taxation of withdrawals

Special rules would apply with respect to withdrawals of earnings allocable to contributions not held in the account for 7 years. To the extent a withdrawal consists of earnings allocable to contributions held less than 3 years, such earnings would be includible in gross income. The individual also would be subject to an additional 10-percent tax on the amount includible in income. To the extent a withdrawal consists of earnings allocable to amounts held at least 3 years but less than 7 years, such earnings would be includible in gross income, but no additional tax would apply. In no event are withdrawals of contributions includible in gross income.

Withdrawals from an FSA would be treated as made first from the earliest contribution (and earnings thereon) remaining in the account at the time of withdrawal. Earnings would be allocated to contributions in accordance with Treasury regulations.

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[4] S. 2071, the Savings and Economic Growth Act of 1990, was introduced by Senators Packwood, Roth, and Dole on February 6, 1990. The bill contains the proposed Family Savings Account and IRA withdrawal provisions described in the President's Budget Proposal for Fiscal Year 1991.

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Withdrawals by first-time homebuyers

The Administration proposal and S. 2071 would allow certain individuals to withdraw up to $10,000 from an IRA for the purchase of a first home without imposition of the present-law 10-percent additional income tax on early withdrawals. This provision would apply to individuals who did not own a home in the last 3 years and who are purchasing or constructing a principal residence that costs no more than 110 percent of the median home price in the area where the residence is located. No withdrawal would generally be permitted from an account that had received a rollover amount from a qualified plan.

Effective date

The Administration proposal and S. 2071 would apply to taxable years beginning after December 31, 1989.

C. S. 1771 (Senators Packwood, Roth, and others) [5]

In general

Under the bill, a taxpayer would be permitted to make nondeductible contributions to an individual retirement plus account (IRA-Plus account). Amounts withdrawn from the IRA-Plus account generally would not be included in taxable income. Special rules would apply with respect to withdrawals for first home purchases, education, and medical expenses.

Nondeductible contributions

Under S. 1771, a taxpayer would be permitted to contribute annually to an IRA-Plus account the lesser of $2,000 or the individual's compensation (earned income in the case of a self-employed individual). Starting in years after 1994, the maximum dollar contribution would increase to $3,000. The maximum permitted contribution would be reduced by any deductible or nondeductible contributions made to a present-law IRA. A nonworking spouse would be able to contribute to an IRA-Plus account provided the combined compensation of both spouses is sufficient. All contributions would be nondeductible and, unlike the present-law IRA rules, could continue to be made after an individual has attained the age of 70½.

Present-law IRAs could be rolled over into an IRA-Plus account prior to the earlier of January 1, 1992, or the date on which the taxpayer attains age 55. IRA contributions previously deducted would be included in income ratably over a 4-year period. Earnings on deductible contributions would not be taxed upon rollover; subsequent withdrawals of rolled over amounts (and earnings thereon) would be taxed as described below.

Taxation of withdrawals

Except in the case of a qualified distribution, amounts withdrawn from an IRA-Plus account would be subject to the general rules regarding taxation of IRA distributions. Thus, a withdrawal

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[5] S. 1771 was introduced by Senators Packwood, Roth, and others on October 19, 1989.

would be includible in income to the extent it constitutes earnings, and would also be subject to the 10-percent additional income tax.

Qualified distributions would not be includible in income and would not be subject to the 10-percent additional tax. A qualified distribution would include (1) a distribution made after an individual attains age 59½, (2) a distribution made due to the death or disability of the taxpayer, or (3) a qualified special purpose distribution. A distribution would not be a qualified distribution (and therefore would be subject to tax in accordance with the general rules) if it is made less than 5 years after the individual established an IRA-Plus account. In the case of a rollover from a present-law IRA, the 5 years would be measured from the date of the rollover.

A qualified special purpose distribution would include a distribution used to purchase a first home or for the payment of certain education or medical expenses. Qualified special purpose distributions would be limited to 25 percent of the IRA-Plus account. The 5-year holding period would also apply to qualified special purpose distributions.

A taxpayer would qualify as a first-time homebuyer if the taxpayer (and his or her spouse, if any), has no present ownership interest in a principal residence during the 3-year period ending on the date of the purchase. Principal residence would be defined as under the provisions relating to the rollover of gain on the sale of a principal residence (sec. 1034). Under the bill, the basis of the house would be reduced by the amount of the withdrawal that was excluded from income by reason of the provision.

In order to qualify as a withdrawal to purchase a first home, the bill would require that amounts withdrawn be used to acquire, construct, or reconstruct the principal residence of the first-time homebuyer. Eligible expenses would also include usual or reasonable costs of settlement, financing, or closing. Amounts withdrawn would generally be required to be applied to the purchase of a home within 60 days of the withdrawal. Amounts not so used could generally be recontributed to an IRA-Plus account without adverse tax consequences.

Withdrawals from the IRA-Plus account would also be permitted in order to pay or reimburse medical expenses to the extent such expenses would be allowable as a deduction as amounts paid for medical care (sec. 213), without regard to whether the taxpayer itemizes deductions.

Finally, withdrawals would be permitted in order to pay for certain qualified higher education expenses including tuition, fees, books, supplies, and equipment required for enrollment or attendance of the taxpayer, or the taxpayer's spouse, dependent children, or grandchildren at an eligible institution. Eligible institutions would include colleges or certain vocational education facilities (as described under the rules relating to education savings bonds). The amount that could be withdrawn for education expenses for a taxable year under the provision would be reduced by any amount that is excludable from the taxable income of the taxpayer under the provisions relating to education savings bonds (sec. 135).

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Effective date

The bill would apply to taxable years beginning after December 31, 1989.

D. S. 1069 (Senator Baucus) [6]

Increase in nondeductible contributions; IRA withdrawals

The bill would increase the maximum nondeductible IRA contribution to $4,000. The present-law 100-percent compensation limit would still apply. In addition, the bill would add exceptions to the present-law 10-percent additional tax on early withdrawals from an IRA for certain education expenses, first-time home purchases, and long-term care expenses.

Education expenses eligible for the exception would be qualified tuition and related expenses of the taxpayer or the taxpayer's spouse and dependents. Qualified tuition and related expenses would include tuition and fees required for enrollment at an educational institution, books, supplies, and equipment required for courses of instruction, and reasonable living expenses incurred while away from home. Expenses of retraining for purposes of obtaining or enhancing future employment would also be eligible for the exception.

The exception for first-time homebuyers would apply to amounts used to acquire or construct a principal residence (within the meaning of sec. 1034), if the taxpayer did not have a present ownership interest in a principal residence at any time prior to the acquisition or construction of the home.

An exception from the early withdrawal tax would also be available with respect to amounts withdrawn by the taxpayer for custodial or health care provided to the taxpayer or his or her spouse. The exception would apply to care provided in a nursing home or to any goods or services provided outside the nursing home in connection with the provision of the custodial or health care to the individual.

Effective date

S. 1069 would be effective for taxable years beginning after December 31, 1989.

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[6] S. 1069 was introduced by Senator Baucus on May 18, 1989.

IV. ISSUES RELATING TO INDIVIDUAL RETIREMENT ACCOUNTS AND OTHER SAVINGS INCENTIVES

A. The Role of Saving in the National Economy

Saving, investment, and economic growth

Investment fosters economic growth by increasing the total amount of capital available for production. From a consumption perspective, a larger pool of capital enables greater production of goods and services for consumers. From an income perspective, a larger pool of capital enables workers to be more productive. Increases in productivity generally lead to growth in wages and salaries (i.e., higher earnings and more employment).

It is important to distinguish gross investment from net investment. Gross investment includes investment which is undertaken to replace depreciated or worn out capital. Net investment measures increases to the capital stock. Even if there is no growth in net investment, investment to replace depreciated capital still enhances economic growth to the extent that the replacement capital embodies improved (and more efficient) equipment and technologies.

In simple terms, national saving provides the source of funds for national investment. A basic accounting identity of the national income and product accounts [7] provides that national investment must equal the sum of private saving, public saving, net imports (total imports less total exports), and net transfer payments to foreigners (e.g., donations to international relief efforts). Many analysts have ignored the foreign sector, primarily because in the past it was small relative to the U.S. economy, and interpreted this

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[7] The national income and product accounts measure the flow of goods and services (product) and income in the economy. The gross national product (GNP) of the economy is the total annual value of goods and services produced by the economy and may be measured in several ways. One way is to measure GNP by expenditure on final product in the economy. By this measure,

(1) $GNP = C + I + G + (X\text{-}M)$.

Equation (1) is an accounting identity which states that gross national product equals the sum of consumption expenditures (C), investment expenditures on plant, equipment, inventory, and residential construction (I), governmental purchases of goods and services (G), and net exports (exports less imports, or X-M).

An alternative is to measure GNP by the manner in which income created in the economy is disposed of. By this measure,

(2) $GNP = C + S + T + R$.

Equation (2) is another accounting identity which states that gross national product equals the sum of consumption expenditures, saving by consumers and businesses (S), net tax payments to the government (T), (net tax payments are total tax receipts less transfer, interest, and subsidy payments made by all levels of government), and net transfer payments to foreigners by private citizens, such as donations to international relief efforts (R).

Because both measures of GNP are simple accounting identities, the right hand side of equation (1) must equal the right hand side of equation (2). From this observation can be derived an additional national income accounting identity.

(3) $I = S + (T\text{-}G) - (X\text{-}M) + R$

This is the basis for the statement in the text that national investment equals private saving (S), plus public saving (T-G), net imports (M-X), and net transfer payments to foreigners (R).

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basic relationship as saying that national investment must equal national saving, where national saving is the sum of private saving and public saving.

National saving and foreign trade and investment [8]

National investment need not equal national saving if there is an international balance of payments surplus or deficit. Economists argue that dollars which Americans spend overseas, either through the purchase of imported products or through transfers overseas return to the United States in two ways. First, foreigners could buy American products. That is, the United States could export some of its national output. Second, foreigners could make investments in the United States. This latter event would directly increase national investment. However, a trade deficit need not cause foreign investment in the United States. Some economists argue that when demand for investment funds in the United States outstrips the supply of national saving, interest rates rise in response. Increases in interest rates attract foreign capital to investment in the United States. However, to take advantage of this opportunity, foreign investors first must convert their currencies to dollars. This increases demand for the dollar, thereby increasing the dollar's exchange rate relative to the foreign currency. A stronger dollar makes imported goods relatively cheaper and our exports relatively more expensive. As a consequence, net exports fall and an increased trade deficit could result.

Some observers are concerned that low national saving encourages and may even require foreign investment in the United States. Profits generated by this investment could flow abroad rather than to future generations of Americans. Proponents of foreign direct investment counter that by providing current American workers with physical capital, foreign investment increases the productivity and ultimately the wages of current and future Americans.

Sources of national saving

National saving is generally divided into private saving and public saving. Private saving is comprised of household or personal saving and business saving. Households save by not spending all of their disposable income (i.e., after-tax income). Businesses save by retaining some of their earnings. Public saving reflects the extent to which the Federal, State, and local governments run budget surpluses or deficits. Table 1 presents data on the components of national saving in the United States. As the table demonstrates, business saving typically has been about twice as large as personal saving. In recent years, public dissaving (i.e., government deficits) has been almost as large as (and between 1985 and 1987 larger than) personal saving.

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[8] For a more detailed discussion of foreign trade and domestic saving and investment, see Joint Committee on Taxation, *Background and Issues Relating to the Taxation of Foreign Investment in the United States* (JCS-1-90), January 23, 1990.

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Table 1.—Gross Saving, Selected Years, 1929-1989

[Billions of dollars]

Year	Gross private saving			Public saving			Total national saving
	Per-sonal	Busi-ness	Total	Federal	State and local	Total	
1929............	2.6	12.3	14.9	1.2	−0.2	1.0	15.9
1939............	1.8	9.3	11.1	−2.2	0.0	−2.2	8.9
1949............	7.4	32.5	39.9	−2.6	−0.7	−3.4	36.5
1954............	16.4	42.3	58.8	−6.0	−1.1	−7.1	51.6
1959............	21.8	60.3	82.1	−1.1	−0.4	−1.6	80.5
1964............	31.5	79.3	110.8	−3.3	1.0	−2.3	108.5
1969............	42.2	106.7	148.9	8.4	1.5	9.9	158.8
1974............	96.7	157.6	254.3	−11.6	7.2	−4.3	247.9
1975............	104.6	198.9	303.6	−69.4	4.5	−64.9	238.7
1976............	95.8	225.6	321.4	−53.5	15.2	−38.4	283.0
1977............	90.7	263.8	354.5	−46.0	26.9	−19.1	335.4
1978............	110.2	298.9	409.0	−29.3	28.9	−0.4	408.6
1979............	118.1	327.7	445.8	−16.1	27.6	11.5	458.4
1980............	136.9	341.5	478.4	−61.3	26.8	−34.5	445.0
1981............	159.4	391.1	550.5	−63.8	34.1	−29.7	522.0
1982............	153.9	403.2	557.1	−145.9	35.1	−110.8	446.4
1983............	130.6	461.6	592.2	−176.0	47.5	−128.6	463.6
1984............	164.1	509.5	673.5	−169.6	64.6	−105.0	568.5
1985............	125.4	539.9	665.3	−196.9	65.1	−131.8	533.5
1986............	124.9	544.6	669.5	−206.9	62.8	−144.1	525.3
1987............	101.8	562.0	663.8	−161.4	51.3	−110.1	553.8
1988............	144.7	593.8	738.6	−145.8	49.7	−96.1	642.4
1989 [1].........	206.3	599.3	805.6	−149.9	45.0	−104.9	700.7

[1] Estimate.

Source: Department of Commerce, Bureau of Economic Analysis.

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Trends in national saving

Because saving provides the funds necessary for investment, recent trends in national saving have concerned some observers. Table 2 presents saving by component as a percentage of gross national product (GNP). National saving since 1982 has comprised a smaller percentage of GNP than at any time in the preceding 2 decades. Both private and public saving as a percentage of GNP have fallen from their levels of the mid- to late-1970s. Some analysts suggest that because households save out of their disposable income (i.e., after-tax income), it is more appropriate to examine personal saving relative to disposable income than to examine personal saving relative to GNP. Table 3 presents personal saving as a percentage of disposable income. Generally, the same trends observed in Table 2 are evident in Table 3.

Table 2.—Gross Saving as a Percentage of Gross National Product, Selected Years, 1929–1989

Year	Gross private saving			Public saving		Total national savings
	Personal	Business	Total	Federal Government	State and local government	
1929	2.5	11.8	14.3	1.2	−0.2	15.3
1939	2.0	10.2	12.2	−2.4	0.0	9.7
1949	2.8	12.5	15.3	−1.0	−0.3	14.0
1954	4.4	11.4	15.8	−1.6	−0.3	13.9
1959	4.4	12.2	16.6	−0.2	−0.1	16.2
1964	4.8	12.2	17.1	−0.5	0.2	16.7
1969	4.4	11.1	15.4	0.9	0.2	16.5
1974	6.6	10.7	17.3	−0.8	0.5	16.8
1975	6.5	12.4	19.0	−4.3	0.3	14.9
1976	5.4	12.7	18.0	−3.0	0.9	15.9
1977	4.6	13.3	17.8	−2.3	1.4	16.9
1978	4.9	13.3	18.2	−1.3	1.3	18.2
1979	4.7	13.1	17.8	−0.6	1.1	18.3
1980	5.0	12.5	17.5	−2.2	1.0	16.3
1981	5.2	12.8	18.0	−2.1	1.1	17.1
1982	4.9	12.7	17.6	−4.6	1.1	14.6
1983	3.8	13.6	17.4	−5.2	1.4	13.6
1984	4.4	13.5	17.6	−4.5	1.7	15.1
1985	3.1	13.4	16.6	−4.9	1.6	13.3
1986	3.0	12.7	15.8	−4.9	1.5	12.4
1987	2.3	12.4	14.7	−3.6	1.1	12.2
1988	3.0	12.2	15.1	−3.0	1.0	13.2
1989 [1]	3.9	11.5	15.4	−2.9	0.9	13.4

[1] Estimate.

Source: Department of Commerce, Bureau of Economic Analysis.

Table 3.—Personal Saving as a Percentage of Disposable Personal Income, Selected Years, 1929-1989

Year	Personal saving as a percentage of disposable personal income
1929	3.2
1939	2.6
1944	25.1
1949	3.9
1954	6.3
1959	6.3
1964	7.0
1969	6.4
1974	9.3
1975	9.2
1976	7.6
1977	6.6
1978	7.1
1979	6.8
1980	7.1
1981	7.5
1982	6.8
1983	5.4
1984	6.1
1985	4.4
1986	4.1
1987	3.2
1988	4.2
1989 [1]	5.5

[1] Estimate.

Source: Department of Commerce, Bureau of Economic Analysis.

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Is the U.S. savings rate too low?

In general

Advocates of a higher national saving rate note that the United States' national saving rate is low when compared to that of other nations. This comparison is shown in Table 4 for total national saving and in Table 5 for household or personal saving. Generally, saving rates of all nations have declined from the rates of the late 1960s. In percentage terms, the decline in the national saving rate of the United States between 1966 and 1985 is greater than the decline of the saving rates of Japan and Germany, but less than the decline of the saving rates of France and Italy. Table 5 shows that between 1972 and 1988 household saving rates generally have declined.

Table 4.—Gross Saving As Percentage of GDP Selected Countries, Selected Years, 1966–1985

Country	1966	1969	1972	1975	1978	1981	1982	1983	1984	1985
United States	20.2	20.0	19.4	18.1	21.0	19.8	16.8	15.8	17.4	16.5
Japan	32.1	36.7	38.3	32.3	32.3	31.1	30.5	29.8	30.6	31.4
Germany	26.8	27.6	26.4	20.9	22.6	20.2	20.3	21.1	21.5	22.2
France	25.8	25.0	26.0	23.0	22.6	19.7	18.6	18.1	18.5	18.0
United Kingdom	19.6	21.6	19.5	15.5	19.5	17.3	17.6	17.5	18.5	19.2
Italy	22.8	24.4	22.0	20.1	22.4	19.0	18.4	17.9	18.1	17.7
Canada	23.9	23.0	21.3	21.1	20.1	22.4	19.0	19.2	19.4	18.6
Belgium	23.6	24.4	25.5	21.8	20.5	13.4	14.1	15.0	15.5	15.9
Greece	20.3	21.9	28.3	23.3	26.3	24.7	17.7	16.3	16.6	12.2
Netherlands	26.3	26.9	26.9	23.1	21.0	20.5	21.1	21.5	23.4	24.1
Sweden	25.2	23.8	23.4	23.8	17.6	15.7	14.2	16.4	18.0	17.8
Switzerland	30.2	31.1	32.6	27.8	27.0	28.4	28.1	27.9	28.9	30.0
Australia	25.1	26.4	27.4	24.6	21.8	22.6	20.2	18.4	21.5	20.1

Source: Organization for Economic Co-Operation and Development, *OECD Economic Outlook,* 40, December 1986.

Table 5.—Net Household Saving As A Percentage of Disposable Household Income, Selected Years, 1972-1988

Country	1972	1975	1978	1981	1982	1983	1984	1985	1986	1987	1988
United States.........	7.5	9.4	7.3	7.7	7.0	5.5	6.3	4.5	4.2	3.3	4.4
Japan......................	18.2	22.8	20.8	18.3	16.5	16.3	16.0	16.0	16.4	15.1	15.2
Germany	14.4	15.1	12.0	13.5	12.7	10.8	11.4	11.4	12.2	12.3	12.6
France [1]..................	18.9	20.2	20.4	18.0	17.3	15.9	14.5	14.0	13.2	11.5	12.3
Italy [1]......................	31.2	30.3	29.3	26.7	25.9	26.1	25.5	24.7	23.7	22.2	22.8
United Kingdom [1]	9.6	12.1	11.5	12.9	11.9	10.4	10.6	9.8	7.5	5.6	4.1
Canada...................	8.7	12.7	12.6	15.4	18.2	14.8	15.0	13.8	11.3	9.7	8.7
Belgium	17.4	17.1	16.6	16.3	13.9	15.2	13.8	11.6	12.8	11.8	12.4
Greece....................	20.3	19.0	20.4	21.6	19.7	18.8	20.6	21.4	18.0	17.5	19.7
Netherlands...........	7.6	3.9	2.5	2.3	4.7	2.0	1.9	2.0	3.5	2.2	2.0
Sweden...................	2.3	4.7	4.5	3.8	0.5	1.2	0.9	1.1	−1.0	−3.6	−3.6
Switzerland............	10.0	7.6	4.6	4.6	6.2	5.8	5.8	5.7	7.0	8.4	9.0
Australia.	11.8	14.2	11.0	9.1	7.7	7.6	8.4	6.9	6.6	7.8	8.9

[1] The figures for France, Italy, and the United Kingdom are gross saving rates. All other figures are rates of gross household saving less household borrowing.

Source: Organization for Economic Co-Operation and Development, *OECD Economic Outlook,* 45, June 1989.

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Advocates of a higher national saving rate argue that higher saving will increase growth and international competitiveness. They contend that without greater saving the United States will be unable to maintain one of the world's highest standards of living. Others argue that the United States has long been a relatively low-saving nation, and yet has enjoyed substantial economic growth. They note that many of the nations with higher saving rates were nations which needed to rebuild after the destruction of war on their own territory. They also contend that as nations' standards of living rise, it is natural to expect them to become more consumption oriented and reap some of the fruits of their past investment.

Personal saving

Some advocates of a higher national saving rate are concerned about personal or household saving rates in the United States as compared to those of other countries. Aside from the effect personal saving has on investment, they are concerned that Americans are not properly preparing themselves for their retirement years. Given increased lifespans, low personal saving today could result in higher public sector spending in the future to support retirees. Others counter that the low household saving rate would not be as worrisome from an investment perspective were it not for the large governmental budget deficits which have nearly entirely consumed personal saving for the past 6 years. They also point to studies which argue that current low personal saving rates may be a result of demographic factors and that as the "baby boomers" age, personal saving will rebound.[9] They note that international comparisons may be misleading since the American baby boom was more pronounced than that of other countries.

B. Issues in Public Policy Towards National Saving

In general

Some observers have advocated that the Federal Government initiate policies to increase national saving. Advocates can be found for policies to increase personal saving, policies to increase business saving, and policies to increase public saving. Those who advocate policies to increase private rather than public saving argue that savings will be put to their most efficient use if left in the hands of the private market rather than being directed by the government. Advocates of increasing public saving contend that incentives for private saving are inefficient to the extent that they reduce Federal revenues or require Federal expenditures which at least partially offset increases in private saving. They argue that much of the blame for reduced national saving in the 1980s can be attributed to Federal Government deficits. They argue that the most direct way to increase national saving is to reduce the Federal budget deficit. Others counter that such a view ignores the fact that if the Federal Government raises revenues or reduces expenditures, household disposable income and business profits are likely to decline which will have the effect of reducing private saving.

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[9] See, Alan Auerbach and Laurence Kotlikoff, "Demographics, Fiscal Policy, and U.S. Saving in the 1980s," National Bureau of Economic Research Working Paper No. 3150, October, 1989.

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Some economists have argued that public policy is unlikely to affect national saving regardless of whether it is directed towards private saving or public saving.[10] In this view, individuals would discern that a reduction in the Federal deficit would reduce the need for tax revenue in the future to service the remaining debt. Consequently, they would reduce saving because less income would be required in the future to pay the taxes necessary to service the debt. Other economists counter that the experience of the 1980s, when public and private saving both declined, would appear to refute this view.

Tax policy and national saving

The bills and proposals described in Part III (above) each provide tax preferences in an attempt to increase personal saving. The proposals all increase the expected after-tax return on savings, thereby making saving relatively more attractive than current consumption. As a result of such incentives, taxpayers may choose to save more. However, if taxpayers save with certain goals or target amounts in mind, increasing the net return to saving means the goal could be met with a smaller investment of principal. For example, a taxpayer in the 28-percent marginal bracket may set aside $1,300 today to help defray tuition expenses of his child 15 years from now. If the taxpayer's investment earns 8 percent annually and those earnings are taxed annually at a 28-percent tax rate, 15 years from now his or her investment will be worth $3,000. If the taxpayer could defer the tax owed on the earnings for 15 years, an investment of only $1,025 today would be worth $3,000 15 years from now (assuming the same 8 percent return and 28-percent tax rate).

Substantial disagreement exists among economists as to whether taxpayers will respond to increases in net return on savings by increasing or reducing their saving. Some studies have argued that theoretically one should expect substantial increases in saving from increases in the net return.[11] Other studies have argued that, theoretically, large behavioral responses to changes in the after-tax rate of return need not occur.[12] Empirical investigation of the responsiveness of personal saving to after-tax returns provides no conclusive results. Some find personal saving responds strongly to increase in the net return,[13] while others find little or a negative response.[14]

If taxpayers respond to increases in their net return by increasing saving, the Tax Reform Act of 1986 (the 1986 Act), by lowering marginal tax rates for many taxpayers, may be expected to increase saving. For example, if prior to 1987, a 50-percent marginal

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[10] See Robert J. Barro, "Are Government Bonds Net Wealth?" *Journal of Political Economy*, Vol. 82, November/December, 1974, pp. 1075–1117.

[11] See, Lawrence H. Summers, "Capital Taxation and Accumulation in a Life Cycle Growth Model," *American Economic Review*, 71, (September 1981).

[12] See, David A. Starrett, "Effects of Taxes on Saving," in Henry J. Aaron, Harvey Galper, and Joseph A. Pechman (eds.), *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax*, (Washington: Brookings Institution), 1988.

[13] See M. Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Economy*, April 1978, 86.

[14] See G. von Furstenberg, "Saving," in H. Aaron and J. Pechman (eds.), *How Taxes Affect Economic Behavior*, Brookings Institution, 1981.

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tax bracket taxpayer could earn a 10 percent return, his or her net
after-tax return would be 5 percent. If the same taxpayer were in
the 28-percent marginal tax bracket after 1986, his or her net after-
tax return would be 7.2 percent. The 1986 Act may also have en-
couraged saving by limiting interest deductibility. On the other
hand, by limiting the availability of deductible IRAs and increasing
the rate of tax on income from realized capital gains, the 1986 Act
may have discouraged saving.

Effectiveness of tax-favored saving arrangements

Tax-favored saving arrangements such as IRAs or FSAs do not
necessarily promote new saving. The higher net return and the in-
creased awareness of the need to save for retirement, college ex-
penses, or other goals which could arise from the private market
advertising for savings accounts could induce taxpayers to save
more.[15] On the other hand, some taxpayers might merely transfer
existing savings accounts into a tax-favored account.

Some observers believe that IRAs have been responsible for new
saving, i.e., saving which would not otherwise have occurred.[16] An-
alysts have compared the saving rate of Canada, which has savings
incentives similar to the IRA, to that of the United States and have
argued that an IRA is effective in increasing national saving.[17]
Some analysts have criticized the methodology of studies which
claim IRAs create new saving and argue that the reported results
of the effect of IRAs on saving are implausibly large.[18] Others
argue that IRAs have for the most part been financed by taxpayers
either shifting funds from their existing holdings of securities into
IRAs, or by placing in IRAs funds which they would have saved in
any event.[19] In addition, it would be possible to finance the ac-
count with borrowed funds, in which case no net saving would
occur. If a home equity loan were used, the interest on the bor-
rowed funds would be deductible as well. Such an outcome may
create pure arbitrage profits for the taxpayer. The interest expense
is deductible against current income, while the interest income is
sheltered from tax.

Certain of the proposals described in Part III would limit the
ability of higher-income taxpayers to utilize fully all of the saving
incentives provided by the proposals. Experience with IRAs prior to
the 1986 Act indicated that although many lower-income individ-
uals contributed to IRAs, higher-income taxpayers made up the
greatest percentage of participants. Taxpayers with AGI of $50,000
or more were more than twice as likely to contribute to an IRA
than were taxpayers with AGI below $50,000. Higher-income tax-
payers made larger contributions as well. Taxpayers with adjusted

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[15] See, for example, Feenberg, Daniel, and Jonathan Skinner, "Sources of IRA Saving," in
Lawrence Summers (ed), *Tax Policy and the Economy*, vol. 3, (Cambridge: Massachusetts Insti-
tute of Technology Press), 1989.

[16] See, Venti, Steven F. and David A. Wise, "The Evidence on IRAs," *Tax Notes*, vol. 38, Janu-
ary 25, 1988, pp. 411–16.

[17] See, Carroll, Chris, and Lawrence H. Summers, "Why Have Private Saving Rates in the
U.S and Canada Diverged?" *Journal of Monetary Economics*, 20, September 1987.

[18] See Gravelle, Jane G., "Capital Gains Taxes, IRA's, and Savings," CRS Report for Congress
89-543, September 26, 1989.

[19] See, Galper, Harvey and Charles Bryce, "Individual Retirement Accounts: Facts and
Issues," *Tax Notes*, vol. 31, June 2, 1986, pp. 917–21.

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gross incomes of $50,000 or more constituted approximately 29 per-
cent of all IRA contributors in 1985, but accounted for more than
35 percent of IRA contributions. In 1987, taxpayers with adjusted
gross incomes of $50,000 or more constituted approximately 15 per-
cent of all IRA contributors, but accounted for more than 19 per-
cent of IRA contributions. (See Tables 6 and 7.)

Table 6.—IRA Participation By Income Class, 1985

Adjusted gross income class	Returns reporting IRA Contributions		
	Number in millions	Percent of eligible returns [1]	Contributions (billions of dollars)
All classes	16.2	17.8	38.2
Under $10,000	.6	2.3	1.1
$10,000 to $30,000	5.1	13.6	9.7
$30,000 to $50,000	5.7	32.9	13.5
$50,000 to $75,000	3.0	56.5	8.7
$75,000 to $100,000	.9	74.1	2.7
Over $100,000	.8	76.1	2.6

[1] Eligible taxpayers include self-employed persons as well as wage and salary
employees. However, taxpayers whose income consists solely of interest income, for
example, were ineligible to contribute to IRAs.

Source: Internal Revenue Service, *1985 Statistics of Income.*

Table 7.—IRA Participation By Income Class, 1987

Adjusted gross income class	Returns reporting IRA Contributions		
	Number in millions	Percent of returns [1]	Contributions (billions of dollars)
All classes	9.8	9.2	14.1
Under $10,000	.5	1.4	.7
$10,000 to $30,000	3.7	9.0	5.4
$30,000 to $50,000	4.1	20.9	5.3
$50,000 to $75,000	.8	10.0	1.4
$75,000 to $100,000	.3	14.9	.6
Over $100,000	.4	19.0	.7

Source: Internal Revenue Service, *1987 Statistics of Income.*

With marginal tax rates reduced for many taxpayers as a result of the 1986 Act, the effectiveness of a tax preference for saving could be lower today than prior to 1987. For example, if prior to 1987, a taxpayer in the 50-percent marginal tax bracket received a 10-percent return on his or her investment, excluding such income from tax would increase his or her net return to 10 percent from an after-tax return of 5 percent. After the 1986 Act, such a taxpayer would be in the 28-percent marginal tax bracket and the exemption would increase his or her net return to 10 percent from an after-tax return of 7.2 percent. Thus, the exemption provided a greater increase in net return prior to 1987.

C. Issues in the Design of Tax-Based Savings Incentives

Deferral vs. exemption

The proposals described above for tax-based savings incentives would either defer taxes on contributions (and earnings thereon) to a preferred saving account or provide an exclusion from income for such amounts.

Exempting income from taxation is always more valuable to the taxpayer than deferring taxation on the same income. For example, if $1,000 could be invested for a period of 10 years to earn 8 percent annually and those earnings were taxed annually to a taxpayer at a 28-percent marginal tax rate, the accumulated interest, net of taxes, would be $750.71 after 10 years. If the earnings were not taxed annually, but rather the tax was deferred for 10 years and assessed on the accumulated interest at the end of the 10-year period at a 28-percent marginal tax rate, the value of the taxpayer's net earnings would be $834.43. If those earnings were exempt from taxation, this investment would have accumulated $1,158.93 in interest by the end of the 10-year period. In this example, deferral increases the taxpayer's return by 11.2 percent over the 10-year period compared to annual taxation. Exemption is 38.9 percent more beneficial than deferral over the same period. The longer the period of deferral, the greater the benefit of deferral becomes, and the longer the period of deferral, the closer the benefit of deferral gets to the benefit of exemption.

The benefit of tax exemption generally is greater to a higher-income taxpayer than a lower-income taxpayer, because the tax liability saved per dollar of tax-exempt income is greater for taxpayers in higher tax brackets. The benefit of deferral depends not only on the taxpayer's current tax rate, but also on his or her future tax rate. The benefit of deferral is increased for a taxpayer who currently is in a high marginal tax bracket, but who can defer the tax liability until a lower marginal rate applies. The benefit of deferral is decreased if the taxpayer currently is in a low marginal tax bracket and defers the tax liability to a year when a higher marginal tax rate applies. In this circumstance, because of the taxpayer's low initial tax rate, the taxes deferred may actually be worth less (in present value terms) than the taxes owed at the later date when the taxpayer is in a higher tax bracket.

Economics of initial deductibility and deferral of income compared to exclusion from income

Under present law, IRAs provide tax deferral. In the case of deductible IRAs, no tax is assessed on either the amount contributed to an IRA or the earnings on such amount until the taxpayer sub-

sequently withdraws the funds from the IRA.[20] The Administration's FSAs and the Packwood-Roth IRA-Plus are examples of exclusion of income from tax. Any income earned under these proposals would be exempt from tax upon withdrawal.

Some analysts have suggested that these seemingly different approaches in the design of tax-preferred savings accounts are functionally equivalent, both to the taxpayer and to the Federal Government. The funds available to a taxpayer after a period of years under the 2 approaches depends, if the invested funds otherwise earn the same rate of return, on the taxpayer's current and future tax rates. The value of the stream to the Federal Government depends upon the Federal Government's discount rate.[21]

Example

Assume the taxpayer has $1,000 of income which he contemplates saving. Assume the taxpayer can earn an annual return of 10 percent on the investment. Denote the marginal income tax rate the taxpayer faces today by t_0 and the marginal income tax rate the taxpayer will face 10 years from now by t_{10}.

Suppose the taxpayer contributes the $1,000 to a tax-favored savings account which qualifies for a tax deduction for the current contribution and which taxes subsequent withdrawals (much like a present-law, tax-deductible IRA). At the end of 10 years, the taxpayer withdraws the principal and accumulated earnings and includes the withdrawal in income. The after-tax value of the withdrawal will be $2,593.74 $(1-t_{10})$.[22]

Alternatively, assume that the contribution to the tax-favored account is not deductible against current year taxes, but that any income earned is exempt from tax (much like the Administration's FSA proposal). In this case, the taxpayer must pay tax on the $1,000 of income, leaving $1,000 $(1-t_0)$ to deposit in the tax-favored account. Assume that this amount will earn 10 percent per year. At the end of 10 years, the taxpayer withdraws the funds. Upon withdrawal, the taxpayer has $2,593.74 $(1-t_0)$.

The table below summarizes the example for both types of accounts in terms of funds available after 10 years to the taxpayer and the pattern of tax receipts to the Federal Government.

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[20] A nondeductible IRA allows a taxpayer to defer tax on earnings on nondeductible contributions until the taxpayer withdraws the funds from the IRA.

[21] Analysts disagree about what discount rate the Federal Government should apply when computing the present value of funds receivable in different years.

[22] $2,593.74 is the future value of $1,000 compounded annually at 10 percent.

Table 8.—Funds Available to Taxpayer and Pattern of Tax Receipts Under Deductible IRA and FSA

Funds Available to Taxpayer After 10 Years

Deductible IRA .... $2,593.74$(1-t_{10})$

FSA .... $2,593.74$(1-t_0)$

Pattern of Income Tax Payments Under Deductible IRA and FSA

	Tax payments in		
	Current year	Years 1–9	Year 10
Deductible IRA	0	0	$2,593.74$t_{10}$
FSA	$1,000$t_0$	0	0

As the table indicates, the funds available to the taxpayer after 10 years under the 2 options depends upon the taxpayer's current and future tax rates. The present value of the stream of tax payments to the Federal Government depends upon the Federal Government's discount rate.

Present and future tax rates equal

When the taxpayer's tax rate today is equal to the taxpayer's tax rate in the future ($t_0 = t_{10}$), there is no difference in the amount of the funds available after withdrawal. Some have argued that in this case the present value of the tax revenues collected is identical and that only the timing of the tax collection is different. This is true if the Federal Government's discount rate is equal to the rate which the taxpayer can earn on an investment (10 percent in this example). The present value of $2,593.74 receivable in 10 years discounted at 10 percent is $1,000. However, if the Federal Government's discount rate is less than the rate which the taxpayer can earn on an investment (say, 8 percent), then the present value of the tax receipts receivable under the deductible IRA exceeds that of the receipts receivable under the FSA. On the other hand, if the Federal Government's discount rate is greater than the rate which the taxpayer can earn on an investment (say, 12 percent), then the present value of the tax receipts receivable under the FSA exceeds that of the receipts receivable under the deductible IRA.

Present tax rate greater than future tax rate

When the taxpayer's tax rate today is greater than the taxpayer's tax rate in the future ($t_0 > t_{10}$), the taxpayer will have more

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funds available after withdrawal with the deductible IRA than with the FSA, all else equal. If the taxpayer's current tax rate exceeds his or her future tax rate, more revenue is lost per dollar of up-front deduction than is recouped with the tax per dollar of withdrawal. Discounting at 10 percent, the present value of the taxes foregone are greater under the deductible IRA than under the FSA. However, if the Federal Government's discount rate is less than the rate which the taxpayer can earn on an investment, the opposite may be the case.

Future tax rate greater than present tax rate

If the taxpayer's tax rate today is less than the taxpayer's tax rate in the future ($t_0 < t_{10}$), the taxpayer will have more funds available upon withdrawal under an FSA, than with a deductible IRA, all else equal. If the taxpayer's current tax rate is less than his or her future tax rate, less revenue is lost per dollar of deduction than is recouped with the tax per dollar of withdrawal. Discounting at 10 percent, the present value of the taxes foregone are greater under the FSA than under the deductible IRA. However, if the Federal Government's discount rate is greater than the rate which the taxpayer can earn on an investment, the opposite may be the case.

Taxpayer perceptions

A taxpayer who believes that his or her tax rate in the future will be less than the current tax rate should find the deductible IRA more attractive. Many taxpayers do not have a higher marginal tax rate upon retirement. This is often because social security comprises a portion of many taxpayers' retirement income, and only a portion of social security is subject to tax. On the other hand, such an analysis is based upon the constancy of the structure of tax rates over the taxpayer's life. If taxpayers believe that tax rates will be higher in the future, they might well find the FSA more attractive. If taxpayers believe that tax rates will be lower in the future, they might well find the IRA more attractive.

Some taxpayers may prefer the deductible IRA because of the difficulty in predicting future tax rates and liability. Some taxpayers may prefer to reduce current tax liability and increase current cash flow. Some taxpayers may prefer the FSA because it provides the certainty that their earnings are exempt from tax.

Whether the stream of tax receipts to the Federal Government is equivalent under either type of tax-favored saving account depends upon whether the tax rate the taxpayer will face upon withdrawal is the same as the tax rate he or she faces at the time of contribution, and on whether the appropriate discount rate for the Federal Government is greater than, equal to, or less than the rate of return which taxpayers can earn on their investments.

Taxpayers who save more than IRA contribution limit

The preceding discussion implicitly has assumed that the amount the taxpayer intends to save is less than the applicable account contribution limit. For example, if the taxpayer has only $1,000 of taxable income available for saving, under the FSA he or she must pay tax out of that $1,000 before contributing to the FSA. Conse-

quently, he or she makes a net FSA contribution of less than $1,000. With a deductible IRA, he or she can contribute the full $1,000.

If a taxpayer plans to save annually more than the contribution limit, the FSA effectively increases the amount of saving which can benefit from the tax preferences accorded an FSA or IRA.[23] To illustrate, assume a taxpayer has $3,000 of taxable income which can be saved. Assume that both the IRA and the FSA have a contribution limit of $2,000. In addition, assume the taxpayer's marginal tax rate is 28 percent and that his or her tax rate will be 28 percent 10 years from now. Assume investments earn 10 percent annual interest.

Under an IRA with a $2,000 contribution limit, the taxpayer could contribute $2,000 to the IRA and deduct the $2,000 from taxable income leaving only $1,000 of the $3,000 in earnings subject to current year tax. This would create a $280 tax liability. After paying tax, the taxpayer would have $720 which he or she could invest in nontax-favored investments. However, earnings on such investments would be taxable annually. After 10 years, the $2,000 contributed to the IRA would be worth $5,187.49 before tax, and $3,734.99 after tax upon withdrawal. The $720 invested in nontax-favored investments would be worth $1,443.05 after tax.[24] This is a total of $5,178.04 from the 2 investments.

Under an FSA with a $2,000 contribution limit, the taxpayer could contribute $2,000 to the FSA. However, because such contributions are not deductible against current income, the taxpayer's $3,000 of earnings incur an $840 income tax liability (28 percent of $3,000). After paying tax and contributing $2,000 to the FSA, the taxpayer would have $160 which he or she could invest in nontax-favored investments. Earnings on such investments would be taxable annually. After 10 years, the taxpayer would have $5,187.49 available for tax-free withdrawal from the FSA, and $320.68 available after-tax from the $160 invested in nontax-favored investments. This is a total of $5,508.17 from the 2 investments, which is 6 percent greater than under a deductible IRA which has the same contribution limit.

The earlier example comparing an IRA to an FSA assumed that the taxpayer would have to pay tax on the FSA contribution out of money available to contribute, leaving less money to contribute. However, this example demonstrates that the taxpayer would be wiser to make the full contribution to the FSA and pay the tax liability out of other funds set aside for saving. To be equivalent to a $2,000 FSA, an IRA would have to have a deductible contribution limit of $2,777.78. Because different taxpayers have different marginal tax rates, equivalence between these tax-favored saving alternatives would require different contribution limits for different taxpayers.[25]

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[23] More generally, this analysis applies to any taxpayer who is willing to pay the tax liability due on income contributed to an FSA out of other income, rather than the FSA contribution.

[24] It is assumed that the monies invested in nontax-favored investments also earn 10 percent interest annually, but after tax have a net return of 7.2 percent annually. $1,443.05 is the value of $720.00 compounded annually at 7.2 percent for 10 years.

[25] More generally, for a taxpayer facing a marginal tax rate of t, the equivalent contribution limit for a deductible IRA is C/(1-t) where C is the contribution limit for a tax-favored account which exempts future income.

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The potential for tax arbitrage and the design of savings incentives

In general

Savings incentives providing either deferral or exemption of income from tax have the effect of raising the net return to taxpayers by reducing their tax liability. Some analysts have observed that increasing the return on some, but not all, assets, creates profitable opportunities for arbitrage.[26] To the extent taxpayers engage in tax arbitrage by utilizing the saving incentive, personal saving does not increase, the Federal Government loses revenue, and, in combination, national saving declines. Tax arbitrage, therefore can offset potential gains in national saving which might otherwise result from the proposed saving incentive. Tax arbitrage can occur if a taxpayer can borrow to make a tax-favored investment or can shift funds from existing or planned saving into the tax-favored vehicle. Saving incentives can be designed to reduce this possibility.

Borrowing

When interest on borrowed funds is deductible, it may be profitable for a taxpayer to borrow to contribute to a tax-favored savings account, even if the interest rate on the loan incurred exceeds the rate of return on investments in the account. For example, if investments in the tax-favored account earn 10 percent per year and the taxpayer's marginal tax rate is 28 percent, it would be to the taxpayer's advantage to borrow to fund the account even if the annual interest rate on the loan is as high as 13.8 percent. Critics of tax-favored savings accounts note that when such arbitrage occurs not only is there no new saving undertaken by the taxpayer, as borrowing offsets saving, but the loss of the revenue to the Federal Government causes national saving to decline.

Critics of tax-favored accounts note that this type of tax arbitrage could be limited by providing symmetrical treatment of saving and borrowing. They observe that either an increase in saving or a decrease in borrowing will increase the personal saving rate. Accordingly, it is inefficient and creates arbitrage opportunities to limit tax benefits to contributions to specified accounts such as an IRA or FSA while permitting taxpayers to deduct interest expense against other income.

Proponents of tax-favored savings accounts note that the spreads in interest rates for borrowing as opposed to lending which result from financial intermediation reduce the potential profitability, and thereby the likelihood, of such tax arbitrage. Proponents also observe that the opportunities for tax arbitrage would be further reduced by prohibiting borrowed funds to be used to make deposits to tax-favored accounts, or similar measures targeted at abusive transactions. Proponents of tax-favored savings accounts argue that limiting tax preferences to contributions to designated accounts simplifies the incentive both for the taxpayer and for IRS administration. Symmetric treatment of saving and borrowing would add substantial complexity for taxpayers. For example, taxpayers who

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[26] Galper, Harvey and Eugene Steuerle, "Tax Incentives for Saving," *The Brookings Review,* Winter 1983.

do not itemize their deductions currently do not need to retain records of their indebtedness for tax purposes.

Shifting of existing savings

Some analysts argue that the creation of tax-favored saving accounts creates an opportunity for a second type of tax arbitrage. They observe that it can be advantageous for taxpayers to transfer funds from existing savings into the tax-favored accounts. Such behavior would not increase private saving and would reduce national saving by the amount of tax revenue foregone to the Federal Government.

Proponents of tax-favored saving accounts counter that to the extent that the tax-favored accounts impose a holding period requirement such account shifting is limited. In addition, shifting which does occur may commit existing funds to saving for a longer period of time and thereby constitute new saving. Proponents also observe that for many taxpayers the ability to shift funds is limited by the small amount of financial assets which most households hold, and that any such shifting possibilities would be quickly exhausted for many taxpayers.

Shifting of planned savings

Tax-favored saving accounts also may create opportunities for a third type of tax arbitrage. Currently, taxpayers save billions of dollars per year (see Table 1). Some taxpayers may contribute to a tax-favored account funds which they would have saved in any event. Doing so increases the taxpayer's return on saving, but does not necessarily increase the taxpayer's aggregate saving. Moreover, when the revenue loss to the Federal Government is taken into account, aggregate saving could decline. Proponents of tax preferences for saving observe that increasing the net return to saving, even for those taxpayers who already save, may induce increases in planned saving.

Many analysts have argued that the potential for tax arbitrage can be reduced and the efficiency of saving incentives increased if the tax benefits provided are only available at the margin. By this the analysts mean that tax benefits should not be provided for saving which would have occurred in the absence of the tax benefit. For example, if a taxpayer saved $1,000 annually before enactment of a saving incentive and subsequently saved $1,000, the post-enactment saving of $1,000 should not receive a tax benefit. Tax benefits only should be granted to saving in excess of $1,000. If, subsequent, to enactment, the taxpayer saved $1,100, the increase of $100 would represent the "marginal" increase in saving. These analysts observe that present-law IRAs and the proposed FSAs have limited ability to reward marginal increases in saving because each imposes an annual contribution limit.

Proponents of present-law IRAs and FSAs counter that many families annually save substantially less than either the $2,000 IRA contribution limit of present law or the $5,000 contribution limit of the proposed FSA. Consequently, the proposed tax benefits reward increases in saving at the margin for these taxpayers. Proponents further contend that it is difficult to design and administer a proposal which would reward only those increases in saving

which were at the margin. Identifying marginal increases in saving requires a measure of that saving which theoretically would have occurred without the tax preference. Such a measure is not available. Conceivably, a tax incentive could be designed which rewarded increases in a taxpayer's net worth, as increases in net worth reflect increased saving or reduced borrowing. However, such a calculation would require substantial information to be supplied by the taxpayer, such as the total value of all assets and indebtedness. Taxpayers currently are not required to provide such information. This requirement could impose great demands for recordkeeping on individual taxpayers and prove difficult for the IRS to administer and enforce.

Taxpayers' saving goals and the design of saving incentives

Taxpayers save for a variety of reasons. Some save to provide retirement income for themselves or to leave a bequest to their spouse or children. Others save to finance their children's education, to make the down payment on a home, or take a vacation. Some saving provides a precautionary reserve of funds for use in emergencies. The different goals which motivate saving can be expected to affect the choice among saving instruments. For example, saving to provide precautionary reserves implies that the funds may be needed immediately and consequently liquid assets such as a savings account at a bank or a money market fund would provide the appropriate savings instrument. Retirement savings may not be needed for 20 years or more so that the taxpayer might find the greater returns associated with less liquid assets more attractive.

This discussion suggests that tax preferences for saving for particular goals may be made more efficient if they do not bias taxpayers in their selection of saving instruments. For example, a tax preference for retirement saving which required taxpayers to use only bank saving accounts might inefficiently induce taxpayers into holding too much of their saving in liquid assets and reduce funds available for less liquid investments. On the other hand, restriction of saving to particular instruments may promote other goals. For example, to the extent deposit insurance protects bank saving accounts, the surety of the retirement income would be guaranteed.

If one goal of tax incentives for saving is to promote saving towards a particular goal (e.g., retirement income, education, or home purchase), it might be difficult to restrict utilization of the tax preference solely to those taxpayers who intend to meet that goal. For example, the deductible IRA can provide substantial benefit to a taxpayer whose saving goal is something other than creating retirement income. This is because of the benefit of tax deferral which the IRA provides. For a taxpayer with a 28-percent marginal tax rate, $1,000 of income would leave $720 available after tax to be saved. If this amount is invested to earn 8 percent annually and the earnings are taxed annually at a 28-percent marginal tax rate, at the end of 10 years the taxpayer will have $1,260.51. If, however, the taxpayer can deduct the $1,000 and accumulate 8 percent annual interest tax-free, at the end of 10 years he or she will have $2,158.92. After including the distribution in income, subject to the additional 10-percent tax on early withdrawals, the taxpayer would

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net $1,338.53 (slightly over 6 percent more than if the account had not been used). Some would argue that a goal of any saving incentive should be to increase the national saving rate. They would not find use of an IRA for nonretirement purposes troubling, because saving for non-retirement purposes also contributes to the national saving rate. On the other hand, to the extent that such saving is merely transferred from a nontax-favored instrument to the IRA, no gain in national saving has occurred.

Opponents of tax preferences for saving for education, housing, or retirement have argued that many taxpayers currently save towards these goals. They argue that a tax preference in such circumstances is not rewarding behavior which taxpayers would not have otherwise undertaken. This reduces the efficiency of the tax preference in generating new saving. Proponents of such tax preferences note that currently many taxpayers are saving insufficient amounts for education or home purchase and that, as a consequence, such potential inefficiencies are likely to be small.

Some proponents of tax preferences for retirement savings have observed that when many taxpayers reach retirement age their only assets are their home, their car, and their pension. They own few financial assets. Proponents of IRAs argue that an investment vehicle, like an IRA, which induces taxpayers to hold more financial assets upon retirement increases national saving. On the other hand, this same observation would suggest that liberalizing the rules for IRAs to permit penalty-free nonretirement uses of IRA funds (e.g., home purchase) might not increase national saving. Liberalizing withdrawals increases the likelihood that the taxpayer holds few financial assets upon retirement. In addition, the observation that many taxpayers own their home upon retirement suggests that those taxpayers save to buy homes and providing a tax preference for an activity they already undertake can have a large efficiency cost. Proponents of liberalized withdrawals note that the data on current retirees may not be relevant because the real (inflation adjusted) price of housing is greater today for first-time home buyers than it has been in the past.

Provisions of present law providing saving incentives

Present law contains various tax incentives for savings. Given the existence of these tax-favored savings vehicles, some argue that additional savings incentives are not justified. For example, the interest on qualified bonds issued by State and local governments is exempt from Federal income taxation. The interest on U.S. Series EE savings bonds currently is taxed on a deferred basis. In addition, if the taxpayer uses the interest from qualifying Series EE savings bonds to pay qualifying post-secondary education expenses, the interest is exempt from tax. Many taxpayers can contribute to tax-favored defined contribution or other qualified pension plans to save for retirement. Under certain circumstances, benefits accrued under a qualified pension plan may be borrowed or withdrawn to pay education expenses, purchase homes, or other nonretirement savings goals.

Interest earned on a life insurance contract accrues annually (inside buildup). The interest income which has accrued to the policy is subject to taxation on a tax-deferred basis. Consequently,

the policy could be redeemed to meet a saving goal. Alternatively, a loan against the cash surrender value of a life insurance contract can be used as a method of tax-favored saving, generally without current income taxation of the inside buildup. Present law offers deductible or nondeductible IRAs to all taxpayers. Finally, parents can shift assets to children and receive the benefit of the children's lower marginal tax rates if the children are over 14 years old.

Others argue that the existing tax incentives are insufficient to encourage systematic, long-term saving. They note that surveys indicate most families that save for their children's college education are saving at levels insufficient to finance college education for their children. They further observe that homeownership rates are falling and argue that it requires a greater saving rate today to accumulate the funds necessary to make a down payment than in prior years. They argue that the national saving rate is too low and further inducements to save are warranted.

Enactment of additional saving incentives would be expected to alter taxpayers' choices among various taxable and tax-preferred instruments. For example, some have suggested that the Administration's proposed FSA would reduce demand for qualifying tax-exempt State and local bonds, thereby increasing issuers' interest costs. This would occur because tax-exempt bonds trade with yields below those of taxable securities. The FSA would permit taxpayers to earn taxable yields on a tax-exempt basis. The purchase of otherwise taxable instruments to be held in an FSA would be preferable to the purchase of tax-exempt bonds. More generally, the FSA or an expanded IRA could be expected to increase the demand for otherwise taxable instruments at the expense of instruments which are tax-referred under current law. On the other hand, to the extent that existing tax-preferred instruments are held only by taxpayers who would be ineligible for the FSA (e.g., taxpayers whose adjusted gross income exceeds $120,000) the demand for existing tax-favored instruments would be unaffected. The annual contribution limitation of the FSA proposal also would limit the effect on the demand for other tax-preferred instruments. Moreover, to the extent that savings incentives generate increases in saving, the demand for all instruments would increase. If this were to occur, the issuers of instruments which are tax-preferred under current law conceivably could benefit as the cost of capital declined.

Equity considerations

Some believe it is inappropriate to permit any taxpayer an exemption, full or partial, for interest on savings. They argue that such provisions more often benefit higher-income taxpayers than lower-income taxpayers, and that it is inappropriate to extend tax incentives to save to higher-income taxpayers because they already possess the means to save without added inducement. They observe that higher-income taxpayers save a higher proportion of their income than do lower-income taxpayers. Others argue that the declining national savings rate justifies savings incentives which are broadly applicable.

To address equity concerns, the benefits of saving incentives for higher-income taxpayers could be restricted in a number of ways. The amount of the annual contribution could be limited. For exam-

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ple, under present law the deductibility of IRA contributions is phased out for married taxpayers with AGI between $40,000 and $50,000. However, higher-income taxpayers may make nondeductible IRA contributions for which the benefit of tax deferral remains. The Administration's FSA proposal would phase out benefits for married taxpayers with adjusted gross income in excess of $120,000.

Credits for annual contributions, rather than deductions for contributions, could be utilized as a way to address perceived inequity of saving incentives. In general, a credit provides the same dollar reduction in tax to all taxpayers regardless of their tax rate. Depending upon size, a credit could be more or less generous than a deduction. However, deductions and nonrefundable credits provide no benefit to individuals who have no income tax liability.

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PROPOSALS AND ISSUES RELATING TO TAXATION OF CAPITAL GAINS AND LOSSES

Scheduled for a Hearing

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON MARCH 28, 1990

Prepared by the Staff

OF THE

JOINT COMMITTEE ON TAXATION

MARCH 23, 1990

CONTENTS

INTRODUCTION

The Senate Committee on Finance has scheduled a hearing on March 28, 1990, on the tax treatment of capital gains and losses and the President's fiscal year 1991 budget proposal to reduce the tax rate on certain capital gains.

This pamphlet,[1] prepared in connection with the hearing, provides a description of the present-law tax treatment of capital gains and losses (Part I), legislative background (Part II), the President's budget proposal (Part III), other capital gains proposals (Part IV), as well as a brief analysis of issues related to the taxation of capital gains and losses generally and specific issues related to the President's proposal (Part V). A 1989 staff pamphlet provided a description and analysis of the President's fiscal year 1990 budget proposal to reduce the capital gains tax rate.[2]

Prior Joint Committee on Taxation staff pamphlets [3] also provide a discussion of prior law tax treatment of capital gains and losses and related issues.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Proposals and Issues Relating to the Taxation of Capital Gains and Losses* (JCS-10-90), March 23, 1990.

[2] Joint Committee on Taxation, *Tax Treatment of Capital Gains and Losses* (JCS-7-89), March 11, 1989.

[3] *See* Joint Committee on Taxation, *Tax Reform Proposals: Taxation of Capital Income* (JCS-35-85), August 8, 1985, pp. 24-44; and Joint Committee on Taxation, *Taxation of Capital Gains and Losses* (JCS-52-83), November 1, 1983.

I. PRESENT LAW

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On disposition of a capital asset, long-term capital gain is currently taxed at the same rate as ordinary income. Long-term capital loss is deductible against capital gain, but not against ordinary income except to a limited extent. For depreciable property used in a trade or business and not held for sale to customers, and for certain other noncapital assets, net gain can be treated as capital gain, while net loss is an ordinary loss.

A complex set of statutory provisions attempts to limit the ability of taxpayers to recharacterize ordinary income assets as assets eligible for capital gain treatment, and also requires recharacterization of capital gain as ordinary income to the extent of certain prior deductions from ordinary income. In addition, certain judicial interpretations of the statutory provisions require gain or loss to be characterized as ordinary, rather than capital, in certain circumstances.

As a result of the changes made by the Tax Reform Act of 1986, taxing capital gains at the same rate as ordinary income, many of these rules now affect only the determination of the deductibility of capital losses.

The Tax Reform Act of 1986 provided that the maximum rate for capital gains would not exceed the maximum ordinary income rates specified in the Act. (See Code sections 1(j) and 1201.) The various rules relating to the recharacterization of gains as capital rather than ordinary were retained in the Code to facilitate the reinstatement of a capital gains rate differential if there is a future tax rate increase.

A. Statutory Provisions

Capital gains

Long-term capital gain is defined as gain from the sale or exchange of a capital asset held for more than one year. Net long-term capital gain is the excess of long-term capital gains over long-term capital losses.

Capital losses

Capital losses of noncorporate taxpayers are generally deductible in full against capital gains.[5] In addition, such losses may be de-

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[4] H. Rept. 99-841, p. II-106, Conference Report on H.R. 3838.

[5] However, section 165 generally denies individuals a deduction for losses not incurred in a trade or business unless such losses are incurred in a transaction entered into for profit or qualify as deductible casualty losses. *See also* section 267 (disallowance of deduction for certain losses from sale or exchange of property between related persons) and section 1092 (limitation on current deductibility of losses in the case of straddles).

ducted against a maximum of $3,000 of ordinary income in each year. Capital losses in excess of these limitations may be carried over to future years indefinitely, but may not be carried back to prior years.

Capital assets

A "capital asset" generally means any property held by the taxpayer except certain specified classes. Capital assets generally do not include (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, or (5) certain U.S. publications.

Certain depreciable property, nondepreciable business property, and special assets (sec. 1231)

A special rule (sec. 1231) applies to gains and losses on the sale, exchange, or involuntary conversion of certain noncapital assets. Net gains from such assets (in excess of depreciation recapture) are treated as long-term capital gains but net losses are treated as ordinary losses. However, net gain from such property is recharacterized as ordinary income to the extent net losses from such property in the previous 5 years were treated as ordinary losses. The assets eligible for this treatment include depreciable property or land held for more than one year and used in a trade or business (if not includible in inventory and not held primarily for sale to customers in the ordinary course of business). Also included are certain special assets including interests in timber, coal, domestic iron ore, certain livestock and certain unharvested crops.

Patents

Under certain circumstances, the creator of a patented invention may transfer his or her rights to the patent and treat amounts received as proceeds from the sale of a capital asset, whether or not the proceeds are contingent on the use or productivity of the patent (sec. 1235).

Regulated futures contracts

Under present law, unlike most assets (with respect to which no gain or loss is realized until a disposition), regulated futures contracts, foreign currency contracts, nonequity options and dealer equity options are "marked-to-market" as gain or loss accrues (sec. 1256). Forty percent of the gain or loss is short-term gain or loss and 60 percent of the gain or loss is long-term gain or loss. Prior to the Tax Reform Act of 1986, this resulted in a maximum tax rate of 32 percent. Individuals who have a net loss regarding such contracts may elect to carry it back three years against prior net gain regarding such contracts.

Losses on small business stock

An individual may deduct as an ordinary loss up to $50,000 ($100,000 in the case of a joint return) on the loss from the disposition of small business corporation stock (section 1244 stock) originally issued to the individual (or to a partnership having the indi-

vidual as a partner), without regard to the $3,000 limit generally applicable to losses. A small business corporation is a corporation engaged in the active conduct of a trade or business whose equity capital does not exceed $1,000,000.

Certain foreign corporate stock

Special rules recharacterize as ordinary income a portion of gain on the sale or exchange of certain foreign corporate stock, to compensate for the deferral of U.S. tax on corporate earnings and profits accumulated abroad (sec. 1248).

Collapsible property

The distinction between capital gains and ordinary income has led to numerous taxpayer attempts to realize the value of an anticipated future ordinary income stream through the sale of a "capital" asset, such as stock in a corporation, or an interest in a partnership, that holds the income-producing asset.

Present law contains statutory rules intended to prevent such use of partnerships and corporations to convert what otherwise would be ordinary income into capital gains from the disposition of stock or a partnership interest. These provisions (secs. 341 and 751) known as the "collapsible" corporation and "collapsible" partnership provisions, are among the most complex provisions of the Internal Revenue Code and have been criticized by some for apparent inconsistencies in application and for limited effectiveness in some circumstances.

Similarly, certain partnership rules relating to basis allocations (secs. 732(c) and 755) attempt to prevent conversion of ordinary income to capital gain by preventing allocations of basis from capital assets to ordinary income assets in certain partnership transactions. These rules have also been criticized by some as having limited effectiveness in certain situations.

Recapture provisions

Depreciation recapture rules recharacterize as ordinary income a portion of gain upon dispositions of depreciable property. These rules vary with respect to the type of depreciable property. Under ACRS, for personal property, previously allowed depreciation (up to the amount of realized gain) is generally recaptured as ordinary income. In the case of real property using the straight-line method of depreciation (the only method generally permitted for real property placed in service under present-law ACRS), there is no depreciation recapture upon disposition if the asset is held more than one year. For real property to which the present-law ACRS does not apply, generally, the excess of depreciation deductions over the straight-line method is recaptured as ordinary income. Special rules apply to certain non-residential property and to certain low-income housing.

Similar recapture rules apply to dispositions of oil, gas, geothermal or other mineral property. These rules require ordinary income recapture (up to the amount of realized gain) of previously deducted intangible drilling and development costs, mining expenses, and depletion.

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The recapture rules require the recognition of ordinary income in some situations that are otherwise tax-free or tax-deferred. For example, although recognition of gain on an installment sale is otherwise deferred, recaptured ordinary income with respect to depreciated real or personal property is recognized in the year of the sale.

Recapture is imputed to a partner who sells a partnership interest if recapture would have been imposed upon the disposition by the partnership of the recapture property. Except in the case of certain previously deducted depletion, intangible drilling and development and mining exploration costs, there is no comparable imputation to a shareholder of an S corporation who sells his or her stock.

Realization events

In general, property appreciation is not taxed until the property is disposed of in a taxable transaction. There are certain exceptions to this rule. For example, regulated futures contracts and certain other items must be "marked to market" as gain or loss accrues even though there has been no disposition of the asset.

Nonrecognition events

Under various nonrecognition provisions, realized gains and losses in certain transactions are deferred for tax purposes. Examples of such nonrecognition transactions include certain corporate reorganizations, certain like-kind exchanges or property, involuntary conversions followed by an acquisition of replacement property, and the sale of a principal residence within two years of the acquisition of a new principal residence. Generally, nonrecognition treatment defers gain or loss for tax purposes by providing a carryover basis from the old holder to the new holder or a substitution of basis from the old property to the new property.

Certain exemptions

Present law effectively forgives income tax on accrued appreciation on the occurrence of certain events. For example:

Basis step-up at death.—At death, income tax on unrealized capital gains on an individual taxpayer's assets is forgiven, due to the step-up in basis such assets receive.[6]

Sale of principal residence.—$125,000 of gain on the sale of a principal residence by a taxpayer age 55 or over is exempt from tax if, during the 5-year period ending with the date of the sale, the property was owned and used as the taxpayer's principal residence for at least an aggregate of 3 years.

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[6] Such appreciation might give rise to Federal estate and gift tax. In many instances, however, opportunities for deferral and the rate structure under the Federal estate and gift tax may result in significantly less tax than would be imposed under the income tax. The value of stock or other assets held at death would be included in the decedent's gross estate and, if not passing to a surviving spouse or to charity, the decedent's taxable estate as well.

The extent to which such inclusion gives rise to Federal estate and gift tax depends on the value of the decedent's taxable transfers. The Federal estate and gift tax depends on the value of the decedent's taxable transfers. The Federal estate and gift tax rates begin at 18 percent on the first $10,000 of taxable transfers and reach 55 percent (50 percent for descendents dying after 1992) on taxable transfers over $3 million. A unified credit in effect exempts the first $600,000 from estate and gift tax. The graduated rates and unified credit are phased out for estates in excess of $10 million.

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B. Statutory Interpretations

The statutory provisions described above have led to numerous disputes about the characterization of gain or loss as capital or ordinary. Literally hundreds of cases have been litigated involving capital gains issues; and the varying results of the cases can encourage taxpayers to take aggressive positions on tax returns. The issues that have been litigated and the principles asserted in particular cases include the following.

Property held primarily for sale to customers

Inventory and property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business are excluded from the definition of a capital asset. The object of this exclusion is to preclude capital gains treatment for receipts obtained in the routine conduct of the taxpayer's enterprises.

A host of cases have been litigated over whether gain realized by a taxpayer was attributable to the sale of property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. The majority of these cases has involved real estate sales, and the sale of equipment held for rental (or for rental and then sale). In both instances, the litigation generally revolves around the question of the "primary" purpose for which the property was held. *Cf. Malat v. Riddell*, 383 U.S. 569 (1966). The resolution of this question, in turn, has generated an intricate web of subordinate rules and exceptions relating to (1) the existence of business (ordinary income) and investment (capital gain) purposes and (2) the acquisition of property for one purpose and its disposition for another purpose. Factual issues include the extent to which the taxpayer advertised the property, the frequency of sales, and whether unusual circumstances led to the sale. *See, e.g., The Municipal Bond Corporation v. Commissioner*, 341 F.2d 683 (8th Cir. 1965), *on remand*, 46 T.C. 219 (1966). In many situations, the taxpayer may have a considerable degree of flexibility in adopting those advertising or sales practices that are the most likely to support the desired result.

Sale or exchange treatment

Many cases have involved the issue whether a transfer is a sale or exchange, thus qualifying for capital gains treatment, or a transfer more properly characterized as a lease or other transfer producing ordinary income. This issue arises, for example, where the transferor has the right to receive contingent payments based on future sales or profits, or retains certain elements of control over the property. *See, e.g., Nassau Suffolk Lumber & Supply Corp. v. Commissioner*, 53 T.C. 280 (1969) (Acq. 1970-2 C.B. xx). Statutory provisions have been enacted to deal with certain types of transfers (*e.g.*, sec. 1235, providing capital gain treatment for certain transfers of patents for future periodic or contingent payments; sec.1253, providing ordinary income treatment when certain rights to control the use of specified intangibles are retained). However, where these provisions do not apply, the issue remains.

Another issue that arises is whether there is a difference in sale or exchange characterization between the termination or expira-

tion of certain instruments or contract rights and the assignment of such rights to a third party prior to expiration.[7] There is some authority that in certain situations if an instrument or right is held to maturity or expiration, the expiration is not a sale or exchange and the resulting gain or loss is ordinary; but if the instrument or right is sold prior to expiration, gain or loss on the sale is capital. *See, e.g., International Flavors and Fragrances v. Commissioner*, T.C. Memo 1977-58, 36 T.C.M. 260 (1977). Various statutory provisions attempt to specify the outcome in the case of particular instruments or rights (*e.g.*, sec. 988, generally requiring ordinary rather than capital treatment for certain foreign currency related transactions; sec. 1271 and related provisions, dealing with certain debt instruments).

Holding period

Numerous cases have involved the issue whether the taxpayer satisfied the required holding period for capital gains treatment. Taxpayers may utilize various arrangements in attempts to shift ownership of assets prior to the expiration of the required holding period while still appearing to meet the holding period requirement. For example, taxpayers may attempt to transfer short-term assets in a tax-free transaction to another entity controlled by the taxpayer that has been held for the required period of time, and then dispose of that entity under circumstances where the various collapsibility or recapture rules may be vulnerable or inadequate.

Taxpayers may also attempt to enter transactions that effectively shift the risk of gain or loss to another taxpayer prior to expiration of the holding period, but that do not in form provide for a sale until after the holding period expires.

Allocation of gain to capital assets

Numerous cases have involved the proper allocation of purchase price among assets. When a taxpayer sells a combination of assets some of which are eligible for capital gains treatment and some of which are not, it is necessary to allocate the purchase price and the taxpayer's resulting gain among the assets. *Williams V. McGowan*, 152 F. 2d 570 (2d Cir. 1945). Under the prior law differential between capital gains and ordinary income, the seller of property had an incentive to allocate more of his gain to capital assets. As one example, under the prior law differential for capital gains, on the sale of a building and land under circumstances where there would be recapture of accelerated depreciation on the building, the seller had an incentive to allocate more of the gain to the land, thus reducing the potential recapture. Because the building is depreciable and the land is not, the buyer has an incentive on the contrary to allocate more of the price to the building. In some cases, this tension between the parties might limit the degree to which the government would be whipsawed by parties taking inconsistent positions. In general, if the parties did specify an allocation in their contract with appropriate regard to value, they are bound by it for tax purposes; and if they have adverse tax interests the courts and

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[7] *See also* discussion of "Other capital asset definitional issues," *infra.*

the Internal Revenue Service will generally accept the allocation. *See, e.g., Ullman v. Commissioner,* 264 F. 2d 305 (2d Cir. 1959); *Commissioner v. Danielson,* 378 F. 2d 771 (3d Cir.), *cert. denied,* 389 U.S. 858 (1967). However, it is not clear whether taxpayers will always specify an allocation in a contract or take consistent positions.

Another example of the same issue arises on the sale of a business, where the seller would have an incentive to allocate more of the price to goodwill or other assets eligible for capital gains treatment, while the buyer would prefer to allocate more of the price to depreciable assets. Under prior law, many intangible assets depreciable by the buyer were eligible for capital gains treatment by the seller, thus eliminating any tension between the parties.

The Tax Reform Act of 1986 added section 1060 to the Code. This section generally applies to sales of trade or business assets. It specifies a residual method of allocating price to nondepreciable goodwill and going concern value, generally adopting the method specified in Treasury Regulations dealing with certain sales of corporate stock that are treated as sales of the underlying assets (Prop. and Temp. Reg. sec. 1.338(b)–2T). It also authorizes the Internal Revenue Service to require the parties to report their respective allocations of purchase price, thus assisting the Internal Revenue Service in identifying inconsistent positions for audit. Some commentators have observed that the section does not strictly require consistent allocations and it is unclear to what extent the government would still be exposed to whipsaw due to inconsistent positions taken by the parties during periods of a capital gains rate differential.

Corn Products doctrine

In *Corn Products Refining Co. v. Commissioner,* 350 U.S. 46 (1955), the Supreme Court addressed a taxpayer claim that gain on the disposition of corn futures was capital gain. The taxpayer was a manufacturer of products made from grain corn and had acquired the corn futures to assure the needed supply of corn at a fixed price. The Supreme Court held that the disposition of the futures produced ordinary income, even though the futures were not literally inventory or other property specifically excluded by statute from the definition of a capital asset. The Court held that gain on this type of hedging transaction was ordinary income, and stated that Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss. Numerous subsequent lower court decisions interpreted the *Corn Products* decision to mean that property otherwise within the definition of a capital asset may have such an important and integral relationship to the ordinary conduct of the taxpayer's business that it loses its identity as a capital asset. In 1975, the Internal Revenue Service stated that if a taxpayer acquired and held property with a "predominant" business (as opposed to investment) purpose, gain or loss on disposition would be ordinary; conversely, a "predominant" investment purpose would cause gain or loss to be capital. (Rev. Rul. 75-13, 1975-1 C.B. 67.) Later, following several

Tax Court decisions,[8] the Internal Revenue Service took the position that even a "predominant" business motive cannot preclude capital gain or loss treatment, as long as there was a "substantial" investment motive for acquiring or holding the property. (Rev. Rul. 78-94, 1978-1 C.B. 58). Of course, it is to the taxpayer's advantage to have gains characterized as capital, and losses as ordinary.

In *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988), the Supreme Court rejected a taxpayer claim for ordinary loss treatment on the sale of stock of a bank that had been 65 percent owned by the taxpayer's holding company. The Supreme Court stated that *Corn Products* is properly interpreted as standing for the narrow proposition that hedging transactions that are an integral part of a business' inventory-purchase system fall within the inventory exclusion of the Code. There is considerable uncertainty about the scope of the *Arkansas Best* decision and its impact on lower court decisions and Internal Revenue Service positions interpreting *Corn Products*.

Arrowsmith doctrine

In *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), the Supreme Court held that amounts paid by former corporate shareholders (as the transferees of corporate assets received in a prior year corporate liquidation) to satisfy liabilities of the liquidated corporation were capital, rather than ordinary losses. The Court related the payments to the earlier receipt (at capital gains rates) of corporate assets in the liquidation. Pursuant to *Arrowsmith*, the characterization of a transaction in one year may depend upon its relationship to another transaction in a prior year.

Other capital asset definitional issues

A number of cases have addressed the question of the extent to which a taxpayer may obtain capital rather than ordinary treatment by assigning various contract rights that, if held to maturity, would have produced ordinary income. In certain circumstances, this ability has been limited by a court's conclusion that the asset assigned is not a capital asset but rather a substitute for ordinary income. *See, e.g., Commissioner v. Ferrer*, 304 F. 2d 125 (2d Cir. 1962); *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958). On the other hand, in many situations the assignment of all rights to a lease or to a business interest that would produce ordinary income in the future can be treated as capital gain.

Tax benefit rule

The Internal Revenue Service has occasionally asserted the "tax benefit rule" in attempts to recharacterize as ordinary income a portion of the gain from the disposition of property otherwise entitled to capital gain treatment. The amount to be recharacterized reflects the extent to which the basis of such property was reduced by deductions taken from ordinary income, to which no specific

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[*] *W. W. Windle Co. v. Commissioner*, 65 T.C. 694 (1976), *aff'd on other grounds*, 550 F.2d 43 (1st Cir. 1977), *cert. denied*, 431 U.S. 966 (1977); *Bell Fibre Products Corp. v. Commissioner*, 36 T.C.M. (CCH) 182 (1977). *Compare Union Pacific Railroad Co., Inc. v. United States*, 524 F.2d 1343 (Ct.Cl. 1975), *cert. denied*, 429 U.S. 827 (1976).

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statutory recapture provision applies on disposition of the property. For example, in *First National Bank of Lawrence County v. Commissioner,* 16 T.C. 147 (1951), the Internal Revenue Service successfully asserted that net proceeds received on the retirement of certain bonds that had previously been written off by a bank against ordinary income as worthless were taxable as ordinary income rather than as capital gain.

The scope of the tax benefit rule is uncertain [9] and the Internal Revenue Service does not contend that all items deducted from ordinary income are automatically subject to recapture on the sale of property otherwise eligible for capital gains treatment. For example, the Internal Revenue Service has ruled under section 174 that deductions previously taken for research and experimental expenditures under that section are not recaptured on disposition of the developed property.[10]

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[9] *See Hillsboro National Bank v. Commissioner,* 460 U.S. 370 (1983), for Supreme Court discussion of the rule.

[10] Rev. Rul. 85-186, 1985-2 C.B. 84. Prior to the issuance of this ruling, the Internal Revenue Service had taken a different position and indicated in a revenue ruling and in a technical advice memorandum that it might assert tax benefit rule recapture of research and experimental deductions taken under section 174 of the Code on the disposition of patents or technology otherwise eligible for capital gains treatment under the special rules applicable to patents or under other provisions (Rev. Rul. 72-528, 1972-2 C.B. 481; TAM 8409009 (1983)).

II. LEGISLATIVE BACKGROUND

Reduced tax rate for capital gains

Noncorporate capital gains were taxable at reduced rates from 1921 through 1987.

The Revenue Act of 1921 provided for a maximum 12.5 percent tax on gain on property held for profit or investment for more than 2 years (excluding inventory or property held for personal use). Because of the relatively low tax rates on ordinary income during the 1920's and 1930's, this provision benefited only higher bracket taxpayers.

The system of capital gains taxation in effect prior to the Tax Reform Act of 1986 dated largely from the Revenue Act of 1942. The 1942 Act provided for a 50-percent exclusion for noncorporate capital gains or losses on property held for more than 6 months. The Act also included alternative maximum rates on capital gains taxes for noncorporate and corporate taxpayers. The basic structure of the 1942 Act was retained under the Internal Revenue Code of 1954.

The Revenue Act of 1978 increased the exclusion for noncorporate long-term capital gains from 50 to 60 percent. Together with concurrent changes in the noncorporate minimum tax, this had the effect of reducing the highest effective rate on noncorporate capital gains from approximately 49 percent [1] to 28 percent. The reduction in the maximum individual rate from 70 to 50 percent under the Economic Recovery Act of 1981 (ERTA) reduced the maximum effective capital gains rate from 28 percent to 20 percent.

The Tax Reform Act of 1986 repealed the provisions granting reduced rates for capital gains, fully effective beginning in 1988.

The Internal Revenue Code of 1954 as originally enacted provided for an alternative tax rate of 25 percent on corporate capital gains. The Tax Reform Act of 1969 raised this rate to 30 percent. The Revenue Act of 1978 reduced the rate to 28 percent. Finally, the Tax Reform Act of 1986 repealed the alternative rate.

Holding period

Under the Revenue Act of 1921, the alternative maximum rate for capital gains applied to property held for more than 2 years. Since that time, Congress has, on several occasions, adjusted the holding period required for reduced capital gains taxation.

The Revenue Act of 1934 provided for exclusion of varying percentages of capital gains and losses depending upon the period for which an asset was held. Under that Act, 20 percent of capital gains was excludible if an asset was held for 1 to 2 years, 40 per-

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[1] The 49-percent rate resulted in certain cases where the taxpayer was subject to the individual "add-on" minimum tax and the maximum tax "earned income" limitation.

cent if an asset was held for 2 to 5 years, and 60 percent if the asset was held for between 5 and 10 years. Where an asset had been held for more than 10 years, 70 percent of capital gains was excluded.

The Revenue Act of 1938 provided for two classes of long-term capital gains. For assets held for 18 months to 2 years, a 33-percent exclusion was allowed. Where assets were held for more than 2 years, a 50-percent exclusion was provided. No exclusion was allowed for assets held for 18 months or less. The 1938 Act also provided alternative ceiling rates applicable to the same holding periods as the capital gains exclusions.

In the Revenue Act of 1942, Congress eliminated the intermediate holding period for capital gains purposes. The 1942 Act provided for two categories of capital assets: assets held for more than 6 months (long-term capital assets), for which a 50-percent exclusion was allowed; and assets held for 6 months or less (short-term capital assets) for which no exclusion was provided. The alternative tax rates on individual and corporate net capital gains (i.e., the excess of net long-term capital gains over short-term capital losses) were based upon the same 6-month holding period.

A 6-month holding period for long-term capital gains treatment remained in effect from 1942 through 1976. The Tax Reform Act of 1976 increased the holding period to 9 months for 1977 and one year for 1978 and all subsequent years. The Deficit Reduction Act of 1984 reduced the holding period to 6 months for property acquired after June 22, 1984 and before 1988.

Treatment of gain and loss on depreciable assets and land used in trade or business

Depreciable property used in a trade or business was excluded from the definition of a capital asset by the Revenue Act of 1938, principally because of the limitation on deductibility of losses imposed by the Revenue Act of 1934. This step was motivated in part by the desire to remove possible tax deterrents to the replacement of antiquated or obsolete assets such as equipment, where depreciation would be fully deductible against ordinary income if the asset were retained, but loss would be subject to the capital loss limitations if the asset were sold.

The availability of capital gain treatment for gains from sales of depreciable assets stems from the implementation of excess profits taxes during World War II. Many depreciable assets, including manufacturing plants and transportation equipment, had appreciated substantially in value when they became subject to condemnation or requisition for military use. Congress determined that it was unfair to tax the entire appreciation at the high rates applicable to wartime profits. Accordingly, in the Revenue Act of 1942, gains from wartime involuntary conversions were taxed as capital gains. The provision was extended to voluntary dispositions of assets since it was not practical to distinguish condemnations and involuntary dispositions from sales forced upon taxpayers by the implicit threat of condemnation or wartime shortages and restrictions.

The Revenue Act of 1938 did not exclude land used in a trade or business from the capital asset definition. Since basis would have

to be allocated between land and other property for purposes of depreciation in any event, the differing treatment of land used in a trade or business and depreciable property used in a trade or business was not viewed as creating serious allocation difficulties.

However, in the Revenue Act of 1942, Congress excluded land used in a trade or business from the definition of a capital asset and extended to such property the same special capital gain/ordinary loss treatment afforded to depreciable trade or business property.

In 1962, Congress required that depreciation on section 1245 property (generally, personal property) be recaptured as ordinary income on the disposition of the property. In 1964, Congress required that a portion of the accelerated depreciation on section 1250 property (generally, real property) be recaptured as ordinary income. Subsequent amendments have required that the entire amount of accelerated depreciation on section 1250 property be recaptured as ordinary income. However, any depreciation taken to the extent allowable under the straight-line method is generally not recaptured as ordinary income, but rather creates capital gain.

Noncorporate capital losses

In the early years of the income tax, losses from investments not connected with a trade or business were not deductible even against gains from similar transactions. This rule was changed in 1916 to allow deductions for transactions entered into for profit (but only to the extent of gains from similar transactions). The rule was further adjusted by the Revenue Act of 1918.

The Revenue Act of 1921 provided that net capital losses were deductible in full against capital gains or ordinary income. Because capital gains at this time were taxable at a maximum 12.5-percent rate, but capital losses could be used to offset income taxable at higher rates, this rule resulted in substantial revenue loss. Accordingly, the rule was amended by the Revenue Act of 1924 to limit the tax benefit from capital losses to 12.5 percent of the amount of such losses. The 1924 Act also repealed the previously existing carryforward for excess capital losses.

Under the Revenue Act of 1934, the percentage exclusion for net capital gains was made dependent upon the length of time for which the property was held. In conjunction with this change, the Act allowed equivalent percentages of capital losses to be deducted against capital gains and, in the event of any excess, against $2,000 of ordinary income. The $2,000 limit on the amount of ordinary income against which capital losses could be deducted was motivated by the fact that some very wealthy investors had been able to eliminate all their income tax liability by deducting losses incurred in the stock market crash against ordinary income.

Under the Revenue Act of 1942, capital losses could offset up to $1,000 of ordinary income with a carryforward of unused losses. The Tax Reform Act of 1976 increased this amount to $3,000. Between 1970 and 1986, only one-half of the net long-term loss could be carried forward.

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business corporation as an ordinary loss. These limitations were doubled in 1978.

In 1958, individuals were allowed to deduct up to $25,000 ($50,000 on a joint return) of loss from the disposition of stock in a small

III. PRESIDENT'S BUDGET PROPOSAL

Description of Proposal

The President's fiscal year 1991 budget proposal [12] would allow individuals an exclusion of a percentage of the gain realized upon the disposition of qualified capital assets. Assets held 3 years or more would qualify for a 30-percent exclusion; assets held at least 2 years but less than 3 years would qualify for a 20-percent exclusion; and assets held at least one year but less than 2 years would qualify for a 10-percent exclusion. For a taxpayer in the 28-percent tax bracket, this would result in a regular tax rate of 19.6 percent for assets held 3 years or more, 22.4 percent for assets held between 2 and 3 years and 25.2 percent for assets held between one and 2 years.

Qualified capital assets generally would be capital assets as defined under present law, except that collectibles would be excluded. In addition, all depreciation would be recaptured in full as ordinary income.

The capital gains exclusion would be a preference for purposes of the alternative minimum tax. The amount treated as investment income for purposes of the investment interest limitation would be reduced by the capital gains exclusion attributable to investment assets.

The provision would apply to dispositions (and installment payments received) after the date of enactment. For the portion of 1990 to which the proposal applies, a 30-percent exclusion would apply for all assets held one year or more. For 1991, the exclusion would be 20 percent for assets held between one and 2 years and 30 percent for assets held at least 2 years. After 1991, the staggered exclusion described above would apply.

Revenue Effects

Table 1 provides the Joint Committee on Taxation staff's estimate of the net budgetary effects of the Administration's capital gains proposal for fiscal years 1990 through 1995.[13]

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[12] The proposal was introduced by Senators Packwood, Dole and Roth as S. 2071. A companion bill, H. R. 3772, was introduced in the House of Representatives by Mr. Archer. The effective date of these bills is March 15, 1990.

[13] The Treasury Department's estimate of the revenue effects for the same period is a revenue gain of $0.5 billion in fiscal 1990, a revenue gain of $4.9 billion in fiscal 1991, a revenue gain of $2.8 billion in fiscal 1992, a revenue gain of $1.2 billion in fiscal 1993, a revenue gain of $1.7 billion in fiscal 1994, and a revenue gain of $1.4 billion in fiscal 1995, for a six-year total gain of $12.5 billion.

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Table 1.—Revenue Estimates of the Administration's Capital Gains Proposal, Fiscal Years 1990–1995

[Fiscal year; billions of dollars]

	1990	1991	1992	1993	1994	1995	1990–95
Revenue Effect.........	0.7	3.2	−4.3	−3.6	−4.3	−3.1	−11.4

Source: Joint Committee on Taxation.

IV. OTHER LEGISLATIVE PROPOSALS

1. S. 1771 (Senator Packwood and others)

S. 1771, introduced by Senator Packwood and others on October 19, 1989, would allow individuals an exclusion of a percentage of the gain realized upon the disposition of qualified capital assets. Assets held 7 years or more would qualify for a 35-percent exclusion; assets held more than one year but less than 7 years would be allowed an exclusion equal to 5 percent for each full year the asset was held. This gain would not be taken into account under the phase-out of the 15-percent rate and personal exemptions.

In addition, corporations would pay tax at a lower rate on the gain realized upon the disposition of qualified capital assets. Assets held more than 15 years would be taxed at a 29-percent rate. Assets held more than 3 years but less than 15 years would be taxed at a rate equal to one percentage point below the regular tax rate of 34 percent for each three full years the asset was held.

Qualified capital assets generally would be capital assets as defined under present law, except that collectibles would be excluded. In addition, all depreciation would be recaptured in full as ordinary income.

The capital gains exclusion would be a preference for purposes of the alternative minimum tax. The amount treated as investment income for purposes of the investment interest limitation would be reduced by the capital gains exclusion attributable to investment assets.

An individual could elect to index the basis of certain assets held more than two years for inflation occurring after 1990 for purposes of determining gain upon a taxable sale, rather than to exclude a portion of the capital gains for that year. Under the bill, the assets generally eligible for indexing would be common stock, tangible personal property and real property, provided such assets are either capital assets or assets used in a trade or business and were held for more than two years.

The bill contains numerous exceptions and other provisions dealing with an array of issues. These issues include the denial of indexing for debt instruments,[14] the differentiation of common stock eligible for indexing from preferred stock (considered more like non-indexable debt); possible abuses such as incorporation of non-indexed assets to obtain indexing with respect to stock; depreciation recapture, problems regarding the appropriate treatment of in-

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[14] The legislative history of prior Congressional proposals to index for inflation have disallowed indexing for debt instruments. Indexing debt was viewed as producing complex adjustments that would not produce additional revenues where both the borrower and the lender have the same marginal tax rate. The legislative history (apparently still addressing the situation in which a borrower and a lender have the same marginal rate) suggested that to the extent inflation is anticipated correctly and interest rates are free to rise, interest rates would tend to rise to a rate that would compensate for inflation on an after-tax basis.

terests in different types of flow-through entities (such as regulated investment companies, real estate investment trusts, partnerships and subchapter S corporations); and concerns related to application of the short sale provisions of existing law.[15]

The bill would apply to sales and exchanges after October 1, 1989.

2. S. 1938 (Senator Graham and others)

S. 1938, introduced by Senator Graham and others on November 20, 1989, would allow individuals an exclusion of a percentage of the gain realized upon the disposition of qualified capital assets. Assets held 10 years or more would qualify for a 50-percent exclusion; assets held more than one year but less than 10 years would be allowed an exclusion equal to 5 percent for each full year the asset was held. For assets held before October 14, 1989, the exclusion would be one-half of these amounts (but, for this purpose, in no event shall an asset be treated as acquired before October 19, 1983). Qualified venture capital stock would be allowed an exclusion of 40 percent for stock held between 4 and 6 years and 50 percent for stock held more than 6 years.

In addition, corporations would pay tax at a lower rate on the gain realized upon the disposition of qualified capital assets. Assets held more than 10 years would be taxed at a 25.5-percent rate. Assets held more than 2 years but less than 10 years would be taxed at a rate equal to .85 percent below the regular tax rate of 34 percent for each full year the asset was held. Qualified venture capital stock would be taxed at a rate of 20.4 percent if held between 4 and 6 years and 17 percent if held more than 6 years.

Qualified capital assets generally would be capital assets as defined under present law, except that collectibles would be excluded. In addition, all depreciation would be recaptured in full as ordinary income.

Qualified venture capital stock means stock in a qualified venture capital corporation issued after October 18, 1989, originally issued to the taxpayer. A qualified venture capital corporation means a corporation with a paid-in capital of less than $20 million (on the date of issuance) engaged in the active conduct of a trade or business. Personal service corporations are excluded.

The capital gains deduction is not allowed for purposes of the minimum tax to the extent it exceeds one-half of the deduction allowed with respect to qualified venture capital stock net capital gain. The amount treated as investment income for purposes of the investment interest limitation would be reduced by the capital gains exclusion attributable to investment assets.

The bill would apply to sales and exchanges after October 18, 1989.

3. S. 348 (Senator Bumpers and others)

S. 348, introduced by Senator Bumpers and others on February 7, 1989, would provide a capital gains exclusion for certain small busi-

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[15] A similar proposal for indexing passed the Senate in 1982 (as a floor amendment to the Tax Equity and Fiscal Responsibility Act of 1982), but was not enacted. Likewise, a similar proposal passed the House of Representatives in 1978 but was not enacted.

ness stock. Specifically, taxpayers other than corporations would be able to deduct from gross income 25 percent of net capital gain from the disposition of "qualified small business stock" that was held for at least 4 years at the time of the disposition. A maximum tax rate of 21 percent would apply. In addition, the deduction would be treated as a preference for purposes of the alternative minimum tax.

"Qualified small business stock" means stock which is (1) issued by a "qualified small business" more than 6 months after the date of enactment, (2) first acquired by the taxpayer (directly or through an underwriter), and (3) not issued in redemption of (or otherwise exchanged for) stock that was issued prior to the effective date.

A "qualified small business" means a corporation that: (1) has paid-up capital of $100 million or less immediately after the issuance; (2) was engaged in an active trade or business for at least 5 years prior to the issuance (or, if shorter, its period of existence); (3) is engaged in an active trade or business immediately after the issuance; and (4) is not a personal service corporation.

4. Other bills introduced in the Senate

Other bills introduced in the Senate relating to capital gains include S. 171, introduced by Senator Kasten and others, to provide a variable capital gains tax differential for certain capital gains and to index the basis of capital assets; S. 182, introduced by Senator Heinz, to provide for indexing of certain assets; S. 411, introduced by Senator Boschwitz and others, to restore a capital gains tax differential; S. 551, introduced by Senator Cranston and Senator Boschwitz, to restore a capital gains differential; S. 645, introduced by Senator Boschwitz, to provide for the indexing of certain assets and to increase the holding period for capital assets from one year to three years; S. 664, introduced by Senator Armstrong and others, to provide for the indexing of certain assets; S. 869, introduced by Senator DeConcini, to restore the deduction for capital gains of individuals and to ensure that the tax-rate on long-term capital gains of individuals does not exceed 21 percent; S. 1238, introduced by Senator Fowler, to restore the capital gains treatment for timber; S. 1286, introduced by Senator Kasten, to provide a maximum long-term capital gains rate of 15 percent and indexing of certain capital assets; S. 1311, introduced by Senator Armstrong and others, to provide a maximum rate of 15 percent on capital gains before 1991, to provide indexing of the bases of certain capital assets after 1990, and to provide a 20-percent maximum rate on capital gains from qualified small business stock held for 4 years or more; and S. 1541, introduced by Senator Kerry, to restore a capital gains tax differential for small and high-risk business stock held for 5 years or more (with lower rates on gains from such stock held for 10 years or more).

5. H. R. 3299 and H.R. 3628 as passed by the House

The Omnibus Budget Reconciliation Act of 1989 (H.R. 3299)[16] as passed by the House of Representatives on October 5, 1989, would

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[16] For a description of the provisions, see H. Rept. 101-247, September 20, 1989, pp. 1474-1480.

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have allowed individuals a temporary exclusion of 30 percent of the gain realized upon the disposition of qualified capital assets held more than one year. The capital gains provision in H.R. 3299 were deleted in conference. The identical provisions also passed the House as H.R. 3628 on November 9, 1989.

Qualified capital assets generally would have been capital assets as defined under present law, except that collectibles would be excluded. In addition, all depreciation would have been recaptured in full as ordinary income.

The capital gains exclusion would have been a preference for purposes of the alternative minimum tax. The amount treated as investment income for purposes of the investment interest limitation would have been reduced by the capital gains exclusion attributable to investment assets.

The exclusion would have applied to sales and exchanges on or after September 14, 1989 and before January 1, 1992.

In addition, the bill provided that gains from the sale or exchange of qualified capital assets on or after September 14, 1989, were not taken into account in computing the additional 5-percent tax imposed by reason of the phaseout of the 15-percent bracket and personal exemptions.

Finally, the bill provided for indexing the basis of certain assets acquired after 1991 for inflation.

V. ANALYSIS OF ISSUES

A. Issues Relating to a Reduced Tax on Capital Gains

1. Arguments for reduced tax on capital gains

Lock-in.—Many argue that higher tax rates discourage sales of assets. For individual taxpayers, this lock-in effect is exacerbated by the rules which allow a step-up in basis at death and defer or exempt certain gains on sales of homes. The legislative history suggests that this lock-in effect was an important consideration in Congress' decision to lower capital gains taxes in 1978. As an example of what is meant by the lock-in effect, suppose a taxpayer paid $500 for a stock which now is worth $1,000, and that the stock's value will grow by an additional 10 percent over the next year with no prospect of further gain thereafter. Assuming a 28-percent tax rate, if the taxpayer sells the stock one year or more from now, he or she will receive $932 after payment of $168 tax on the gain of $600. With a tax rate on gain of 28 percent, if the taxpayer sold this stock today, he or she would have, after tax of $140 on the gain of $500, $860 available to reinvest. The taxpayer would not find it profitable to switch to an alternative investment unless that alternative investment would earn a total pre-tax return in excess of 11.6 percent. Preferential tax rates impose a smaller tax on redirecting monies from older investments to projects with better prospects, in that way contributing to a more efficient allocation of capital.

A preferential tax rate on capital gains would both lower the tax imposed when removing monies from old investments and increase the after-tax return to redirecting those monies to new investments. Some have suggested that the lock-in effect could be reduced without lowering taxes on old investments. For example, eliminating the step-up in basis upon death would reduce lock-in. Alternatively, preferential tax rates only for gains on newly acquired assets would increase the after-tax return to new investments, thereby making reallocation of investment funds more attractive than currently is the case. On the other hand, taxpayers would not necessarily redirect their funds to new investments when their monies in older investments are unlocked. Taxpayers might instead choose to consume the proceeds.[17]

Some have argued that the lock-in effect should not be as strong for capital gains accurred on assets held by corporations as on assets held by individual taxpayers, because corporations do not re-

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[17] One recent study argues that second mortgages permit taxpayers to "realize" accrued capital gains on their personal residences without paying tax. The study presents data which indicate that taxpayers use their accrued gains to finance increased consumption more often than re-investment. Such behavior would reduce personal saving and investment. *See* Joyce M. Manchester and James M. Poterba, "Second Mortgages and Household Saving," *Regional Science and Urban Economics*, vol. 19, May 1989.

ceive the benefit of step-up in basis. They also observe that most corporate assets do not represent portfolio investments, but rather are held in furtherance of the corporation's business activity. Therefore, there is likely to be less discretion in timing of realization of corporate assets. Proponents of a preferential tax rate on corporate capital gains counter that lock-in occurs because of the ability to defer realization and that consequently corporations can be subject to substantial lock-in effects.

Incentives for equity investments.—A second argument for preferential capital gains tax rates is that they encourage investors to buy corporate stock, and especially to provide venture capital for new companies, stimulating investment in productive business activities. This argument was important in the 1978 debate over capital gains taxes, and there has been a large growth in the availability of venture capital since 1978. Proponents argue that the preference provides an incentive for investment and capital formation, with particular mention of venture capital and high technology projects.

Others argue that the capital gains preference may be an inefficient mechanism to promote the desired capital formation. They argue that a preferential capital gains tax rate is not targeted toward any particular type of equity investment although promotion of high technology venture capital is apparently a goal. Furthermore, a broad capital gains preference affords capital gains treatment to non-equity investments such as gains on municipal bonds and certain other financial instruments.

--To the extent that potential sources of venture capital or other equity investment, or secondary purchasers of corporate stock, are tax-exempt or partially tax-exempt (for example, pension funds and certain insurance companies and foreign investors), a tax preference could have a small incentive effect on investment. Since 1978, tax-exempt entities (pension funds and non-profit institutions) have constituted the fastest growing source of new venture capital funds.[18] On the other hand, proponents argue that capital gains treatment for venture capitalists who are taxable has importance. They argue that this is particularly acute for the entrepreneur who often contributes more in time and effort than in capital.

Opponents of a capital gains preference argue that creating a preference for capital gains could encourage the growth of debt and the reduction of equity throughout the economy. When debt is used -in a share repurchase program or leveraged buyout transaction the taxpayers who hold the original equity securities must realize any gain that they might have. A lower tax rate on gains could make holders of equity more likely to tender their shares in a leveraged buyout transaction or share repurchase program.[19]

Competitiveness.—Related to the argument that preferential capital gains tax rates encourage investment is the argument that a lower capital gains tax rate will improve the international competitive position of the United States. Proponents of a reduction in cap-

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[18] *See* James M. Poterba, "Venture Capital and Capital Gains Taxation," in Lawrence H. Summers (ed.), *Tax Policy and the Economy*, (Cambridge: MIT Press), 1989.

[19] Jane Gravelle, "Tax Aspects of Leveraged Buyouts," CRS Report to Congress, 89-142 RCO, March 2, 1989.

ital gain tax rates observe that many of our major trading partners have lower marginal tax rates on the realization of capital gains than does the United States. For example, prior to this year, all gains on stocks, bonds, and unit trusts were exempt from tax in Japan. The recent Japanese tax reform imposes a tax at the taxpayer's discretion of either one percent of the gross proceeds or 20 percent of the gain, a rate still below the maximum U.S. rate. In West Germany, all long-term gains are exempt from tax.

Others point out that the issue of the effect of capital gains taxes on international competitiveness is really one of the cost of capital of domestic firms compared to that of their competitors. Corporate income taxes, individual income taxes on interest and dividends, net wealth taxes,[20] as well as taxes on capital gains, all may affect the cost of capital. Opponents of a capital gains preference argue that the fact that marginal tax rates on capital gains are higher in the United States than in other countries does not imply automatically that American firms are at a competitive disadvantage. Moreover, because of the ability to defer gains, to receive step-up at death, and because of substantial holding of corporate equity by tax-exempt institutions, the effective tax rate on gains, which helps determine the cost of capital, may be substantially below the statutory rate. For example, one recent study calculated that prior to 1987 the effective marginal tax rate on capital gains, including State taxes, was less than 6 percent.[21]

On the other hand, proponents of a capital gains tax reduction contend that any reduction in a tax on capital may reduce the cost of capital.

Bunching.—Because capital gain is generally not taxed until a disposition, taxpayers can face large jumps in taxable income when the gain is realized. With graduated tax rates, such bunching could lead to a higher tax burden than if the gain were taxed as it accrued. If the benefit of deferral is not enough to compensate for the extra tax in some of those cases, then the additional benefit of a preferential tax rate helps to achieve parity (although its availability is not limited to such cases).

Some analysts have argued that the flattened marginal tax rate schedule of present law diminishes the amount of bunching and so, presumably, reduces the need for a preferential tax rate as a remedy for it. These analysts have stated that the most significant bunching problems under present law would now befall those taxpayers in the 15-percent marginal tax bracket whose gains could push them into the 28-percent bracket. However, they point out that relatively few taxpayers who realize gains are in these circumstances.

Inflation.—Another argument for preferential tax treatment of capital gain is that part of the gain represents the effects of inflation and does not constitute real income. This argument was also

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[20] While the United States does not impose on annual tax on an individual's net wealth, several of our trading partners do, for example, West Germany, the Netherlands, Spain, and Switzerland. *See* OECD, *Taxation of Net Wealth, Capital Transfers and Capital Gains of Individuals,* Paris, 1988.

[21] Don Fullerton, "The Indexation of Interest, Depreciation, and Capital Gains and Tax Reform in the United States," *Journal of Public Economics,* 32, February 1987, pp. 25–51.

important in 1978. Proponents observe that the preference may provide to taxpayers some rough compensation for inflation.

Others claim that a preferential tax rate is a very crude adjustment for inflation. For example, since 1978 the price level approximately has doubled. Thus, an asset purchased in 1978 for $1,000 and sold today for $2,000 would have a purely inflationary gain. Even with a preferential rate, this gain would be taxed. On the other hand, for an individual who purchased an asset in 1986 for $1,000 and sold it today for $2,000, a reduction in the tax rate from 28 percent to 19.6 percent would more than offset the effects of inflation over the past three years A preferential rate also does not account for the impact of inflation on debt-financed assets, where inflation reduces the cost of repaying the debt.

Double taxation of corporate earnings.—Theorists have suggested that capital gains treatment on a disposition of corporate stock might be viewed as ameliorating the double taxation of corporate earnings. The first step of double taxation occurs at the corporate level; the second step occurs at the shareholder level as dividends are paid or as shares which have presumably increased in value by retained earnings are sold. However, other theorists have argued that preferential capital gains treatment is a very inexact means of accomplishing any such benefit. Among other things, the capital gains holding period requirement is unrelated to earnings. Also, any relief that a capital gains preference provides from the burden of double taxation applies only to retained corporate earnings. Distributed earnings would be still generally subject to double taxation.

2. Arguments against reduced tax on capital gains

Measurement of income.—Opponents of reduced tax on capital gains argue that appreciating assets already enjoy a tax benefit from the deferral of tax on accrued appreciation until the asset is sold, which benefit reduces in whole or in part any bunching or inflationary effects.[22] In addition, if capital assets are debt-financed, inflation will reduce the real cost of borrowing to the extent interest rates do not rise to compensate for the reduced value of principal repayments and interest is deductible. Thus, debt financing may further tend to offset any adverse impact of inflation. Some opponents of the preference have contended that a direct basis adjustment by indexing for inflation would be more accurate and would reduce uncertainty regarding the eventual effective rate of tax on investments that might impair capital formation.[23]

On the other hand, proponents of a preference for capital gains contend that the benefit of deferral is insufficient to make up for more than very modest inflation. Moreover, they argue that indexing may be viewed as too complex to implement.

Neutrality.—To the extent that preferential rates may encourage investments in stock, opponents have argued that the preference tilts investment decisions toward assets that offer a return in the

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[22] *See* Roger Brinner, "Inflation, Deferral and the Neutral Taxation of Capital Gains," *National Tax Journal*, vol. 46, December 1973.

[23] A more detailed discussion of issues relating to indexation of capital gains is below (D. "Indexing").

form of asset appreciation rather than current income such as dividends or interest. Furthermore, because the individual capital gains preference is accomplished by a deduction (or exclusion) from income, it provides a greater benefit to high-income than to middle- or low-income taxpayers. On the other hand, it is argued that neutrality is not an appropriate goal because risky investments that produce a high proportion of their income in the form of capital gains may provide a social benefit not adequately recognized by investors in the marketplace.

Reduction of "conversion" opportunities.—Opponents of the preferential capital gains rate contend that it not only provides a reduced tax rate on gains from the preferred assets but also encourages taxpayers to enter transactions designed to convert other, ordinary, income to capital gains.

Conversion can also occur through debt-financing the cost of assets eligible for capital gains rates. For example, if a taxpayer borrows $100 at 10 percent annual interest to acquire a capital asset that is sold for $110 a year later, and repays the borrowing with sales proceeds, the taxpayer has an interest deduction of $10 that can reduce ordinary income [24] and a capital gain of $10 subject to preferential rates. The taxpayer thus has a net after-tax positive cash flow even though on a pre-tax basis the transaction was not profitable.

On the other hand, it is argued that such "conversion" opportunities are simply an additional tax incentive for types of investments the capital gains preference is intended to encourage. In addition, it is argued that the passive loss limitations of present law limit taxpayers' ability to "convert" ordinary income to capital gains.

Simplification and consistent treatment of taxpayers.—Opponents of the preferential capital gains rate point out that the application of different tax rates to different sources of income inevitably creates disputes over which assets are entitled to the preferential rate and encourages taxpayers to mischaracterize their income as derived from the preferred source. Litigation involving holding period, sale or exchange treatment, asset allocation, and many other issues has been extensive in the past. A significant body of law, based both in the tax code and in judicial rules, has developed in response to conflicting taxpayer and Internal Revenue Service positions in particular cases. Its principles are complicated in concept and application, typically requiring careful scrutiny of the facts in each case and leaving opportunities for taxpayers to take aggressive tax return positions. It has been argued that the results derived in particular cases lack even rough consistency, notwithstanding the substantial resources consumed in this process by taxpayers and the Internal Revenue Service. Elimination of the preferential rates on capital gains has obviated the incentive for many such disputes. It has also obviated the need for such complex provisions as the collapsible corporation and collapsible partnership rules, which have been criticized for apparent inconsistencies in ap-

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[24] Even if an interest deduction is subject to present law investment interest limitations, it can be offset against investment income that is ordinary income.

plication, and certain aspects of the varying recapture provisions for different types of assets.

On the other hand, it is argued that so long as a limitation on deductions of capital or investment loss is retained, some areas of uncertainty and dispute continue to exist (for example, whether property was held primarily for sale to customers in the ordinary course of business, and the application of the *Corn Products* and related doctrines). Since (as discussed further below) limitations on the deductibility of capital or investment losses may be desirable to limit the selective realization of losses without realization of gains, the amount of simplification and consistency that has occurred as a result of eliminating the preference for long term capital gains has been limited somewhat.

B. Issues Specific to the Administration's Proposal

1. Holding period

Some argue that taxpayers do not plan their investments with sufficiently long time horizons. They argue that because some taxpayers realize their gains after holding the investment for short periods, managers of enterprises plan their enterprise's investment with a view to the short run, forsaking profitable long-term investments. Others argue that there is no evidence that managers ignore potentially profitable long-term investments at the expense of short-term investments and that there is no evidence of a causal link between stockholder holding period and management behavior.

Establishing a holding period requirement of 36 months to qualify for preferential capital gain treatment would create incentives for some of those taxpayers who would otherwise realize their gains in less than 36 months to defer some of those gains until they had been held for at least 36 months.[25] The holding period requirement would not be expected to have any effect on the timing of the realization of gains which taxpayers would have realized after 36 months in the absence of the holding period requirement.

Two studies, which specifically examined the effect of the holding period requirement of prior law, concluded that the holding period requirement did affect individual taxpayers' decisions as to when to realize gains.[26] If the tax rate varies by holding period, the taxpayer's decision to realize a gain now or later involves a comparison of the current after-tax yield from realization to the expected future after-tax yield from realization. While a tax rate which is lower the longer an asset has been held would increase

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[25] Under the proposal, it may be necessary to develop rules to prevent a taxpayer from first contributing assets with a short holding period to an entity, such as a partnership or S corporation, in which the taxpayer's equity interest has a longer holding period, and then selling the equity interest, in order to obtain the benefits of the longer holding period.

[26] *See* J. Eric Fredland, John A. Gray, and Emil M. Sunley, Jr., "The Six Month Holding Period for Capital Gains: An Empirical Analysis of Its Effect on the Timing of Gains," *National Tax Journal*, vol. 21, December 1968, and Steven Kaplan, "The Holding Period Distinction of the Capital Gains Tax," National Bureau of Economic Research Worʻing Paper Number 762, September 1981.

An earlier study, *see* Lawrence H. Seltzer, *The Nature and Tax Treatment of Capital Gains and Losses* (National Bureau of Economic Research) 1951, had concluded that the five graduated holding periods which were part of the Code from 1934 to 1937 reduced the turnover of capital assets.

the after-tax yield to waiting, the taxpayer is uncertain as to whether his pre-tax gain will be larger or smaller if he waits. The taxpayer must decide whether the gain in tax reduction offsets the uncertainty about the size of the gain. Under prior law, the reward to waiting was more substantial than that offered by the Administration's current proposal. For example, if a taxpayer had accrued $100 in gain, under prior law if it was classified as short term, the net would be $50 (assuming the 50-percent marginal tax rate). If the gain was classified as long-term, the net would be $80 (assuming the 60-percent exclusion of prior law). Under the Administration's proposal, the net return on a $100 gain to a taxpayer in the 28-percent tax bracket would be $72 if the asset had been held less than one year, $74.80 if the asset had been held between 12 and 24 months, $77.60 if the asset had been held between 24 and 36 months, and $80.40 if the asset had been held 36 months or longer.

Lengthening the holding period should, by itself, increase taxpayers' average holding periods for all assets in their portfolios. However, taxpayers' average holding periods probably are affected by more than the holding period requirement. If a reduction in the tax rate on capital gains induces taxpayers to realize gains in their portfolios more frequently and to realize gains which they otherwise would have held, unrealized, until death, then taxpayers' average holding periods for all assets in their portfolios may decline. Consequently, while the Administration's proposal may cause fewer taxpayers to realize gains within 36 months, it may also cause the average holding period to fall.

2. Capital losses

Deductibility against ordinary income.—The present limits on the deductibility of capital losses against ordinary income are intended to address problems that arise from the high degree of taxpayer discretion over when to sell certain types of assets. If capital losses were fully deductible against ordinary income, as was the case between 1921 and 1934, a taxpayer owning many assets could selectively sell only those assets with losses and thereby wipe out the tax on ordinary income even if those losses were offset by unrealized capital gains in the taxpayer's portfolio. This concern would support retention of a limitation on the deduction of capital or investment losses, even if capital or investment gains were not subject to preferential tax treatment and even though tax distinctions between investment and non-investment assets tend to generate disputes over the proper characterization of particular assets. Some have suggested a marked-to-market system (parallel to present-law treatment of regulated futures contracts) for both gains and losses, at least in the case of publicly traded stock and securities or other readily valued assets. Others contend that limitation of such a system to these types of assets would retain possibilities for taxpayer manipulation.

Limits on the deductibility of capital losses may be unfair to taxpayers who have losses in excess of unrealized gains, since they may never get to deduct legitimate losses. Or, even if, over a period of years, the taxpayer can deduct his full loss, the present value of the deduction is reduced by deferral of the loss deduction. The reduction in the value of the loss deduction creates an asymmetric

treatment of gains and losses. This relative penalty on loss deduction may discourage taxpayers from undertaking risky investments. However, the ability of the taxpayer to defer realization of his gains at his discretion creates incentives to undertake such investments.

The present system—allowing the deduction of losses against up to $3,000 of ordinary income—is a compromise between the desire to be fair to taxpayers with net losses and the need to protect the tax base from selective realization of losses. In effect, small investors, who are presumed not to have large portfolios with unrealized gains, are allowed to deduct capital losses against ordinary income, and large investors, for whom $3,000 is not significant, are not. Arguably, however, large investors may have larger portfolios and lower transactional costs, making it easier selectively to realize accrued gains to offset losses and reduce the adverse impact of the $3,000 limit.

Reduction of long-term capital loss carryovers.—The prior law rule requiring that long-term losses be reduced by 50 percent when deducted against ordinary income (up to the $3,000 limit) was also a compromise between the need to protect the tax base and equity to investors with net capital losses. If long-term losses were fully deductible against ordinary income, as was the case before 1969, taxpayers with both long-term gains and losses could realize the gains and losses in alternate years, paying tax on only 40 percent of the gains and fully deducting the losses. Under prior law, a taxpayer who took care to realize losses before they became long-term could, of course, achieve this result despite the 50-percent reduction. To compensate for the loss limitation, Congress retained a 50-percent cutback, instead of increasing it to 60 percent, when the capital gains exclusion percentage was increased from 50 to 60 percent in 1978.

The Administration's proposal does not reduce long-term losses deducted against ordinary income. The proposal treats all long-term loss carryovers as losses from the sale or exchange of property held between one and two years.

3. Treatment of taxpayer with both gains and losses from the sale of capital assets

In general.—Under the law prior to the Tax Reform Act of 1986, the amount of gain that was entitled to the 60-percent capital gains exclusion was the excess of net long-term capital gain over net short-term capital loss for the year. Thus, in determining the amount eligible for the exclusion, the amount of gain from the sale or exchange of capital assets held more than six months was reduced, first, by the amount of losses from the sale or exchange of capital assets held more than six months and then was further reduced by the excess of short-term capital losses for the year over short-term capital gains for the year.

If a capital gains structure is adopted with multiple holding periods providing a larger exclusion for longer-held gains, rules must be adopted to provide the manner in which a taxpayer's capital losses for any taxable year offset capital gains for that year. Rules also must be adopted to prescribe the treatment of the carryover of long-term capital losses.

Administration proposal.—The Administration proposal would, in effect, treat all long-term capital losses as losses arising from the sale of assets held between one and two years, notwithstanding the actual holding period of the asset sold. This would result in long-term capital losses first offsetting capital gains with a holding period of between one and two years, with any excess next offsetting capital gains with a holding period of between two and three years, and with any further excess then offsetting capital gains from assets held more than three years.

Assume, for example, a taxpayer has a $100 gain from the sale of a capital asset held between one and two years, a $50 gain from the sale of a capital asset held more than three years and a $100 loss from the sale of an asset held more than three years. Under the Administration proposal (when fully effective in 1992), the $100 loss from the asset held more than three years would offset the $100 gain from the asset held between one and two years. The taxpayer would then be entitled to exclude $15 of gain (30 percent of the $50 gain attributable to the asset held more than three years), resulting in $35 of net gain being subject to tax.

Principles set forth in S. 1771 and S. 1938.—Under these bills, gains and losses within each category of gains and losses are first netted against each other. Next, the net loss from any category is then netted against the net gain from other categories in a prescribed order. Under these bills, the carryover of any long-term capital loss is treated as loss from the sale or exchange of an asset with a holding period of between one and two years. This carryover rule is intended to simplify the calculation of the loss carryovers.

Assume the facts in the example set forth above under the discussion of the Administration proposal. Under the principles set forth in each of these bills (but using the holding periods and exclusion amounts set forth in the Administration proposal), $50 of the loss from the asset held more than three years would first offset the $50 of gain from the asset held more than three years. The remaining $50 loss would then offset the gain from the asset held between one and two years. The taxpayer would then be entitled to exclude $5 of gain (10 percent of the $50 gain attributable to the asset held between one and two years), resulting in $45 of net gain being subject to tax.

Principles used under prior law when multiple holding periods were in effect.—When multiple holding periods for long-term capital gains were in effect before World War II, netting of gains and losses between categories of gains and losses (either short-term and long-term) did not occur. The applicable portion of the net gain from each category of long-term gain was excluded from income and the allowable loss from any category of asset with a net long-term loss was reduced by the applicable portion of the loss. Under this system, any capital loss carryover (after proper reduction in the current year) would be carried over in full.

Again assume the facts in the prior example. Applying these principles to the holding periods and exclusion amounts set forth in the Administration proposal, 10 percent of the $100 gain (i.e., $10) from the asset held between one and two years would be excluded from income. In addition, the $50 gain and $100 loss from the sale of capital assets held more than three years would be netted, re-

sulting in a net loss of $50. However, the taxpayer would be allowed to deduct only 70 percent of the $50 net loss (i.e., $35) from the assets held more than three years. The net amount of capital gain included in taxable income would thus be $55 ($90 gain reduced by $35 allowable loss).

4. Definition of qualified assets

The Administration proposal generally would apply to all assets which were eligible for the long-term capital gain exclusion of prior law. The proposal, however, would deny the proposed exclusions to collectibles. The proposal, however, Proponents of the proposal argue that denying the exclusion to collectibles targets the proposal towards those assets which are most directly responsible for future growth, such as investments in plant and equipment. On the other hand, economic neutrality argues for not artificially biasing taxpayer's choices of the form of their investments.

A preference which applies to corporate stock but not to collectibles, or some other class of assets, may make tax administration and compliance more difficult. Taxpayers may attempt to obtain the capital gains preference for sales of collectibles by contributing these assets to a C corporation and selling the stock of that entity. Certain disadvantages to holding such property in corporate form, such as the imposition of a corporate-level tax if the collectibles themselves are later sold or distributed by the corporation, would tend to discourage such activity.[27]

C. Distributional Effects of a Reduction in Capital Gains Taxes

Table 2 below presents the Joint Committee on Taxation staff's estimate of the distributional effect of the Administration's proposal. The second column in the table below estimates the number of returns in each income class which will benefit from the proposed capital gains rate reduction. The third column reports the aggregate tax reduction which accrues to each income class. The fourth column calculates the average dollar tax reduction per return. The last column calculates the percentage of the aggregate tax change which accrues to each income class.

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[27] The Administration proposal, S. 1771, and S. 1938 each would deny long-term capital gains treatment to the sale of S corporation stock or a partnership interest to the extent the gain is attributable to the gain from collectibles held by the S corporation or partnership.

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Table 2.—Distributional Effect of the Administration's Capital Gains Proposal

[1990 income levels]

Income class [1]	Number of returns with tax change (Thousands)	Aggregate tax change (Millions of dollars)	Average tax reduction [2] (Dollars)	Percent distribution of aggregate tax change
Less than $10,000	59	−$4	$68	([3])
$10,000 to $20,000	623	−56	88	0.4
$20,000 to $30,000	1,360	−136	100	.9
$30,000 to $40,000	1,811	−297	164	1.9
$40,000 to $50,000	1,502	−415	276	2.6
$50,000 to $75,000	2,423	−1,004	414	6.3
$75,000 to $100,000	984	−785	798	4.9
$100,000 to $200,000	1,299	−2,709	2,085	17.0
$200,000 and above..........	681	−10,522	15,454	66.1
Total....................	**10,756**	**−15,928**	**1,481**	**100.0**

[1] The income concept used to place tax returns into income classes equals adjusted gross income plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) inside buildup on life insurance, (4) worker's compensation, (5) nontaxable social security benefits, (6) deductible contributions to individual retirement accounts, (7) the minimum tax preferences, and (8) net losses in excess of minimum tax preferences from passive business activities.

[2] The tax reduction reported here assumes no change in taxpayer behavior. Thus, this measure understates the tax benefit received by certain taxpayers.

[3] Negligible.

NOTE.—Details may not add to totals due to rounding.

SOURCE: Committee on Taxation.

The table above calculates the benefit from the proposed rate reduction which taxpayers would receive if they realized the same amount of gains that they would have realized in the absence of a rate reduction. In other words, this calculation measures only the benefit the taxpayer receives if he or she does not alter behavior. This is a conservative estimate of the actual benefit, because it does not assume a behavioral response. If taxpayers respond by realizing additional gains they will obtain even more benefit from the change, since taxpayers change their behavior only if the change makes them even better off. Thus, this calculation understates the benefit received by higher income taxpayers.

In other words, Table 2 reports the distribution of the tax burden rather than the distribution of taxes paid. If a reduction in capital gains tax rates leads to greater realizations and tax revenue paid by high-income taxpayers, the distribution of taxes paid will have shifted more onto high-income taxpayers. However, an increase in the distribution of taxes paid does not imply that the tax burden on high-income taxpayers has increased, because, as noted above,

any additional tax paid in response to a capital gains rate cut results only from changed behavior.[28]

D. Indexing

Proponents of indexing contend that indexing would accomplish the goals of capital gains taxation while producing a more accurate measurement of economic income with greater neutrality.

Opponents contend that indexing is complex, should not be significant if efforts to control inflation are successful, and would erode revenues if such efforts are not successful.

1. Issues related to partial indexing

The 1989 House-passed reconciliation bill (H.R. 3299) and S. 1771 would provide indexing of basis but would not generally index costs of financing property.

Where some but not all assets are indexed, several issues arise. To the extent that the basis of certain assets is indexed but debt-financing of those assets is not, the adjustment for inflation may be overstated. An overadjustment in favor of the taxpayer who finances assets can occur even if it is assumed that interest rates correctly anticipate inflation and rise in the marketplace to reflect the effect of inflation on borrower and lender. For example, suppose a taxpayer acquires an asset for $100 (fully financed) and sells it one year later for $115. Inflation over the year is 5 percent. The lender and the taxpayer are each in a 28-percent tax bracket. The lender, seeking a 10 percent pre-tax rate of interest and anticipating 5-percent inflation, charges 15 percent interest for the year. On a pre-tax basis, the taxpayer receives $115 in return of basis and gain on the sale, but pays the lender $115 in interest and principal, producing no net cash flow.

If there is no indexing and no capital gains preference, the after-tax result is the same as the pre-tax economic result—the taxpayer receives $15 of income taxable at 28 percent and pays $15 of offsetting, deductible interest, producing no after-tax net cash flow. If both the basis of the asset and the interest on the financing are indexed (assuming an accurate indexing factor has been identified and applied) the taxpayer again has $10 of gain and $10 of offsetting deductible interest, producing no after-tax net cash flow. However, if the basis of the asset is indexed for inflation but the financing is not indexed, then the taxpayer has $10 of gain (taxed at 28 percent) but a $15 deduction, producing an after-tax positive net cash flow of $1.40, assuming the deduction can be used in full to offset other income in the 28-percent bracket.[29]

If some but not all assets are indexed, additional consideration would have to be given to provisions designed to accomplish the desired results in certain special situations. For example, if stock but

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[28] For further discussion on the appropriate methodology for assessing distributional effects, see Jane G. Gravelle and Lawrence B. Lindsey, "Capital Gains," *Tax Notes*, 38, January 25, 1988, pp. 397 405.

[29] Indexing the basis of assets without indexing debt-financing of such assets also overcompensates the borrower if interest rates do not rise enough to compensate for inflation on an after-tax basis. Thus, if the stated interest payment in the example is only $10 (rather than $15), interest is not indexed, and there is no capital gains preference, the taxpayer will have a pre-tax positive net cash flow of $5 and an after-tax positive net cash flow of $3.60.

not debt is indexed, (or if debt is indexed in a different manner than stock—for example, by interest adjustments rather than basis adjustments) the question arises whether some types of assets, such as preferred stock or convertible debt, should be classified as stock or as debt for this purpose.

If some assets are not indexed or are only indexed at the option of the holder, it would be necessary to provide for the appropriate treatment of various types of flow-through entities that may hold indexed assets but whose stock or interests may or may not be indexed. Conversely, if an interest in an entity is eligible for indexing but the entity may hold substantial non-indexable assets, consideration could be given to provisions designed to prevent taxpayers from indirectly obtaining indexing for nonqualified assets.

The question also arises whether indexing of an otherwise capital asset is appropriate in situations such as the disposition of stock in a controlled foreign corporation or foreign investment company, where present law requires ordinary income treatment to account for prior income deferral.

In the case of depreciable assets, rules are necessary to prevent the churning of assets in order for the buyer to obtain a higher basis for depreciation than the seller's basis, where the seller's gain is not taxed as a result of indexing. H.R. 3299 provided that indexing did not apply to the extent of depreciation recapture.

Finally, if capital gains treatment is reinstated for some types of assets (as would the case under H.R. 3299) then, depending upon the rate of inflation, taxpayers may continue to have an incentive to engage in transactions designed to convert ordinary income to capital gains income. Because of this possibility, the complex provisions of present law dealing with situations in which capital gains treatment is available (for example, the collapsible partnership rules) presumably could not be eliminated.

2. Other indexing considerations

"Lock-in".—It is possible that indexing might not relieve "lock-in" problems, because a taxpayer whose after-tax economic gain is protected against future inflation may decide to continue to hold an asset to obtain the benefits of tax deferral, or the benefits of tax exemption if the asset is held until death. Others contend that indexing alleviates "lock-in" by removing the burden of taxing nominal gains arising from inflation.

Complexity.—Indexing would involve a significant amount of recordkeeping. Records of the cost of property and of improvements are generally maintained under present law. However, records of the dates such costs are incurred may not be retained under present law, since the acquisition date is generally not relevant to the determination of tax liability.

Indexing would substantially increase the volume of calculations necessary to calculate taxable gain for many common transactions. For example, consider an individual who sells stock which was purchased 10 years before the sale and who has reinvested the quarterly dividends in additional stock during this entire period. Under present law, if all the stock is sold at once, the individual can add the original cost and the dollar amounts of each of the 40 reinvested dividend payments in order to obtain the stock's basis, which is

subtracted from the sales proceeds in order to determine taxable gain. Under indexing, each of the 41 components of basis (the original purchase plus the 40 dividend payments) would be multiplied separately by indexing factors based on the full number of years that had elapsed since the dividend was reinvested in order to compute the inflation-adjusted value of that component and determine the basis of stock.

The interaction of indexing rules with other Code provisions would raise further issues. For example, the basis of a partnership interest or S corporation stock in the hands of a partner or shareholder is affected by numerous transactions, including distributions, that could complicate accurate indexing of such interests. Another example is the appropriate interaction with the short sale provisions of the Code. Theoretically, it can be argued that any inflation adjustment for a short sale should require the short seller to report a capital gain to the extent of inflation. If such a requirement were not imposed, it may not be appropriate to allow a shareholder who sells short "against the box" (i.e., while he or she owns shares of stock for which the short sale is made) to receive an inflation adjustment for the stock owned during the period of the short sale.

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PREPARED STATEMENT OF MARK A. BLOOMFIELD

INTRODUCTION

My name is Mark A. Bloomfield. I am president of the American Council for Capital Formation (ACCF). The ACCF represents a broad cross section of the American business community, including the manufacturing and investment sectors, Fortune 500 companies and smaller firms, individuals, and associations. Our board of directors includes cabinet members of prior Republican and Democratic administrations, former members of Congress, prominent business leaders and public finance experts. We appreciate this opportunity to present testimony on strategies for increasing U.S. investment and on the role that a capital gains tax rate reduction could play toward that end.

There is a growing national consensus among economists, policymakers, and editorial writers that one of our most serious challenges is to raise U.S. investment levels. While differences exist on appropriate public policy remedies to deal with low levels of investment, there is little disagreement that higher investment rates are essential to U.S. economic competitiveness.

U.S. INVESTMENT PATTERNS

International Comparison of Saving and Investment and Productivity

Investment spending in the United States compares unfavorably with that of other nations. From 1973 to 1987, saving and investment as a percent of gross domestic product were lower for the United States than for any of our major competitors with the exception of the United Kingdom (see Table 1).

Japan's lead in saving and investment is highlighted by a comparison over the 1985-1987 period. Japan is investing an increasing share of its GNP—32.2 percent in 1987—while the United States is moving in the opposite direction—down to 16.6 percent in 1987 from 17.2 percent in 1985 (see Chart 1). *Even more disturbing is the fact that Japan, whose GNP is roughly half that of the United States, is investing more in absolute dollar amounts than is the United States.* In 1987, Japan's total fixed investment equaled $767 billion, while the comparable figure for the United States was only $749 billion.

According to a new analysis by Congress's Office of Technology Assessment, "Making Things Better: Competing in Manufacturing," released earlier this month, part of Japan's economic success is due to its great investment in advanced equipment in its leading industries. From 1976 through 1987, Japanese investment in machinery and equipment consistently ranged from 14.9 to 20.9 percent of GNP; in the United States, it ranged from 7.5 to 9.0 percent of GNP. Japanese capital investment in the late 1980s was especially high, posting double-digit increases in both 1988 and 1989. In manufacturing, the rate of increase was even greater—over 25 percent for both years. An important reason for these whopping investment increases was a shift in production to higher value added goods. Capital investment in U.S. manufacturing, by contrast, rose only 9 percent from 1988 to 1989 (less in real terms).

Given Japan's high level of investment, it is not surprising that the country's manufacturing productivity growth has outstripped ours over the last 15 years, growing by *5.7%* compared to *2.5%* in the United States. In fact, U.S. productivity growth ranks ninth out of twelve countries, a fact suggesting that reducing our trade imbalance may be extremely difficult.

The importance of investment in physical capital to manufacturing productivity growth is described in a study by Harvard Professor Lawrence Summers; Massachusetts Institute of Technology Professor Paul R. Krugman; and Dr. George N. Hatsopoulos, chairman of the board and president of Thermo Electron Corporation, and chairman of the Federal Reserve Bank of Boston. They compared the rates of growth of manufacturing productivity with the rates of increase in the quantity of physical capital per worker for five major industrial countries for the period 1970-1985 (see Chart 2). They note that the relation is strikingly close and also is essentially proportional, as indicated by the closeness of the scatter of points to a 45-degree line. The United States is last in both productivity growth and capital accumulation.

The higher growth rate of the Japanese capital-labor ratio is, of course, the result of higher capital spending per employee. *On average, Japan has been investing 50 percent more per manufacturing employee than the United States. Recently the disparity has increased to 100 percent.* Why do the Japanese spend more on capital than we do? A good part of the answer is that their cost of capital is much lower than ours, the authors conclude.

Investment Growth Before and After Tax Reform

Some recent reports have attempted to make the case that the Tax Reform Act of 1986 (TRA) has had no discernible impact on U.S. investment spending. *In fact, investment spending since the passage of the 1986 tax reform act has not been as buoyant as in the early part of the expansion that began in the fourth quarter of 1982 (see Table 2).* Nonresidential fixed investment, which includes both structures and producers' durable equipment (PDE) has grown at a rate of only 3.5 percent since the beginning of 1986, compared to 9.4 percent in the 1982–1985 period. Similarly, since 1986 PDE has grown at only 6.7 percent, compared to 13.3 percent in the pre-tax reform period. Since 1986, PDE less computers (both mainframe and desktop) has grown at only 3.0 percent, while in the early and mid-1980s the rate was 7.4 percent.

The relatively slow growth of investment in the post-tax reform period is even more surprising in view of the currently high level of capacity utilization in manufacturing, mining, and utilities. Capacity utilization averaged only 78.0 percent from the fourth quarter of 1982 (the beginning of the current business expansion) through the fourth quarter of 1985 (see Table 2). In the post-1986 period, utilization has averaged 81.8 percent. High levels of capacity utilization usually are associated with strong growth in business investment because firms seek to increase capacity during periods of strong demand.

LBO Activity and Capital Gains Rate Increases

In recent years, leveraged buyouts have siphoned off large amounts of capital that might have been more productively employed elsewhere. A new study by Hayne E. Leland, professor of finance at the University of California at Berkeley, demonstrates that the capital gains provisions in the TRA *increased* the attractiveness of LBOs and debt finance. Dr. Leland notes that at first glance one might think the 1986 changes would have *reduced* the incentive, since corporate rates were cut from 46 percent to 34 percent—thereby cutting the tax savings from interest deductions. But the TRA also changed the taxation of debt and equity returns at the personal level. Prior to the tax code change, individuals paid a maximum of 20 percent tax on capital gains, but as much as 50 percent on interest and dividends, which were treated as ordinary income. Thus, individuals tended to prefer equity over debt because capital gains on equity were taxed at a lower rate than interest and dividends. While a firm saved taxes by issuing debt at the corporate level, it had to pay higher interest to offset the tax disadvantage of interest income to bond holders.

Using methodology based on the pioneering research of Nobel laureate Franco Modigliani and University of Chicago Professor Merton Miller, Dr. Leland finds that prior to the 1986 Tax Reform Act each extra dollar of leverage (that is, debt replacing equity) led to a $0.22 increase in the value of the firm. In the post-1986 tax environment, each extra dollar of leverage leads to a $0.34 increase in value, which is more than 50 percent greater, despite the drop in the corporate tax rate. *In short, the tax revision of 1986 created a more powerful impetus toward increased leverage.*

The potential costs of a highly leveraged economy are real. A deeply indebted economy is subject to collapse in any substantial downturn. Bankruptcies and job losses could seriously weaken the U.S. economy.

ENCOURAGING U.S. INVESTMENT THROUGH LOWER CAPITAL COSTS

The Cost of Capital Concept

The cost of capital is the pretax return of a new investment needed to cover the purchase price of the asset, the market rate of interest, inflation, taxes, and the return required by the investor. Another frequently used measure is the user cost of capital—often called the "hurdle rate" because it measures the return an investment must yield before a firm would be willing to undertake the capital expenditure. For example, for a typical manufacturing firm to be willing to purchase a new piece of equipment given current tax law and economic conditions, the asset would have to yield an annual return of approximately 25 percent. This yield would cover all costs, including the purchase price of the equipment, real (economic) depreciation, financing costs, and taxes. The only difference between the user cost (or "hurdle rate") and the pretax return measure is that the former includes economic depreciation (about 15 percent per year for equipment, for example). Economic depreciation, which measures the actual useful life of an asset, does not vary with the tax code.

Capital costs are an important factor in determining which investments firms will make. High capital costs mean that only those projects with the greatest expected return will be undertaken because only they will yield a return large enough to sat-

isfy investors, resulting in less overall investment and an aversion toward higher-risk projects.

International Capital Costs Comparison

Earlier international comparisons based on the traditional pretax return concept show that U.S. capital costs are approximately twice those of Japan, 60 percent higher than the United Kingdom's, and 30 percent higher than those of West Germany. Experts conclude that the currently high U.S. capital costs are due to three primary factors: (1) high interest rates; (2) the lack of indexing of depreciation allowances for inflation; and (3) Federal tax code changes since 1982.

New research by Stanford University Professor John B. Shoven indicates that the U.S. cost of capital is higher than previously estimated. Professor Shoven's study is a step forward in capital cost analysis because he incorporates a measure of the risk premium actually demanded by investors in the traditional pretax return measure, whereas previous studies used the unrealistic assumption that the risk premium could be measured by the real interest rate on safe, short-term government bonds. Using his more realistic measure of the pretax return required by investors, *Dr. Shoven concludes that the U.S. cost of capital is approximately two and one-half times higher than that of Japan and that the U.S. tax system discriminates against risky investments.*

Dr. Shoven shows that for a typical piece of equipment financed with equity and with an assumed five-year life, the cost of capital was 10.4 percent in the United States in 1988 compared to 4.1 percent in Japan—a difference of 153 percent. U.S. structures financed with equity face capital costs 147 percent higher than Japanese structures. Debt-financed investments in the United States also incur substantially higher capital costs than in Japan.

The new Office of Technology Assessment study, "Making Things Better: Competing in Manufacturing," makes a similar point regarding Japan's capital cost advantage over the U.S. The study notes that there is some disagreement over just how large (or small) the differences are, but most recent studies estimate significantly higher capital costs in the United States than in Japan. On the high side, the estimates range up to 13 percentage points difference, while the difference at the low end is on the order of 1 or 2 percentage points. Even relatively modest differences of a few percentage points in capital costs can be a significant disadvantage in making investments that take many years to pay off, the study concludes.

Taxes and the Cost of Capital

Taxes are a very important element in the cost of capital. For example, Dr. Shoven's analysis shows that for an equity-financed plant, one-third of the cost of capital is due to the income and capital gains tax, one-third to interest rates, and one-third to the required risk premium. Taxes are approximately 15 percent of the cost of capital for equity-financed equipment, with the remainder divided equally between interest rates and the risk premium.

The problem facing U.S. industry can be illustrated by a specific example relating to the speed with which a corporation recovers the capital it invests in new equipment. A new study by Arthur Andersen & Co. shows that under the strongly pro-investment tax regime put in place in 1981, a steel company that installed a modern and competitive continuous casting process would through existing tax credits and deductions, recover its invested capital in less than five years. But tax legislation enacted since 1981 changed all that, primarily by repealing the investment tax credit and lengthening depreciation lives. Under current law, that steel company, if subject only to the regular corporate tax, would recover only 77 percent of its capital within five years. And if, as most major steel companies are, it is subject to the alternative minimum corporate tax, the company would recover only 30 percent of its investment in five years (see Chart 3).

The study by Arthur Andersen & Co. also shows that for equipment that is technologically innovative or crucial to U.S. economic strength, including equipment used to make computer chips, robots for the manufacturing process, engine blocks and crankshafts for automobiles and trucks, telephone switching equipment, and equipment used in the continuous casting process for steel, we lag badly behind our major competitors. In fact, compared to five of our major competitors, we rank last or next to last in terms of the present value of cost recovery allowances of capital cost recovery (see Table 3) and in the bottom tier in terms of speed of capital cost recovery (see Table 4).

From a competitive standpoint, U.S. tax policy since 1981 has hindered, rather than helped as our firms attempt to hold their U.S. market share and also expand sales abroad. The United States ranks near the bottom internationally both in terms

of speed of capital cost recovery and with respect to the present value of the recovery allowance.

Options for Reducing U.S. Capital Costs

There are several generally agreed upon ways to reduce U.S. capital costs:

Federal Deficit Reduction.—Most public policy experts conclude that deficit reduction, particularly if financed by spending cuts rather than tax increases, would tend to reduce interest rates and thereby lower U.S. capital costs.

Direct Investment Incentives.—Measures such as more rapid depreciation or an investment tax credit (ITC) could have a major effect on the cost of capital. For example, a 5 percent investment tax credit (ITC) could reduce the pretax return required on investments in equipment by an investor by around 25 to 30 percent, according to estimates based on the Washington University macroeconomic model. Significantly, the new Office of Technology Assessment study, "Competing in Manufacturing," calls for a carefully targeted ITC, designed to promote improvements in manufacturing techniques.

Lower Capital Gains Taxes.—Several independent estimates predict that capital gains tax reductions would reduce U.S. capital costs. The cost of retained earnings is a major factor in most firm's capital costs. Research by Don Fullerton and Mervyn King shows that 93 percent of equity is raised by retained earnings compared to only 7 percent from new shares. Investors' willingness to let firms retain earnings depends primarily on two factors: (1) their view of the firm's earning potential and (2) tax rates on appreciated stock (capital gains). Lower capital gains taxes mean that firms can undertake investments with lower yields (hurdle rates) without making investors any less willing to let firms retain earnings. In other words, the cost of capital to the firms declines.

A capital gains tax cut has the further advantage, according to the Council of Economic Advisers and the Treasury Department, of raising revenue rather than costing money. *Since a capital gains tax cut is the only legislative proposal actively under consideration, it is the one on which I focus for the remainder of my testimony.*

THE CASE FOR CAPITAL GAINS RATE REDUCTIONS

Impact of Changes in Tax Policy on U.S. Capital Costs

Changes in tax law subsequent to the passage of the 1981 Economic Recovery Tax Act (ERTA) and especially the Tax Reform Act of 1986 have increased both the pretax return required by investors and the hurdle rate a firm's projects must meet. According to the Congressional Research Service, using the pretax return measure, capital costs of investment in equipment, for example, have risen almost 90 percent since 1982 (see Chart 4) using the hurdle rate concept, capital costs for equipment have risen by 23 percent (see Chart 5).

Research by Dr. Yolanda Henderson, an economist with the Federal Reserve Bank of Boston, also leads her to conclude that the Tax Reform Act of 1986 increased the U.S. cost of capital by 15 percent. *Dr. Henderson further concludes that the required pretax return would have risen only half as much as it did if the capital gains tax rate had not been raised in 1986.* Higher capital gains taxes mean that for any given after-tax rate of return required by investors, the pretax return must be larger; thus, the cost of capital firms face is higher.

Research by CEA Chairman Michael Boskin, Stanford Professor John Shoven and others confirms the fact that capital gains tax reductions would tend to reduce U.S. capital costs. Support for some type of capital gains tax reduction is an important first step in reducing high U.S. capital costs.

International Comparison of Capital Gains Rates

The U.S. taxation of capital gains should also be analyzed in the context of the treatment afforded capital gains (both individual and corporate) by our international competitors. They recognize the contribution a capital gains tax differential can make to new risk capital, entrepreneurship, and new job creation. U.S. capital gains taxes are among the highest in the world (see Table 5). Germany, Japan, and South Korea, among others, either exempt long-term capital gains on portfolio stock from tax or tax gains only lightly. As Dr. Shoven's research makes clear, the favorable treatment of capital gains in Germany and Japan is an important element in their lower capital costs.

Not only do virtually all industrialized countries tax individual capital gains more lightly than does the U.S., they also accord more favorable treatment to corporate capital gains.

Capital Gains and the U.S. Saving Rate

Testimony before this committee yesterday focused on the problem of our low national saving rate. Reducing the budget deficit will curtail government dissaving, but steps to increase private saving are also needed. A discussion of the taxation of capital gains should be looked at in the context of our current tax laws, which tend to encourage consumption and discourage saving. Consumption today costs less in terms of foregone future income because income is taxed before it can be saved. Furthermore, any income that flows from the investment of those savings is also taxed again. If income that is saved—and the further income it generates—were exempt from tax, the cost of current consumption compared to what could be consumed in the future would rise and the incentive to save would be strengthened.

The Tax Reform Act of 1986 substantially increased the bias against saving by imposing one of the largest capital gains tax rate increases since the advent of the capital gains tax differential in 1922. This change took place in an increasingly competitive world where most nations tax capital gains more lightly than we did even before the capital gains tax rate increase in the 1986 act. There is a large body of economic research, including that of CEA Chairman Michael Boskin, Harvard Professor Lawrence Summers and Stanford Professor John Shoven, showing that savers do respond positively to higher after-tax rates of return. The capital gains tax increase of the 1986 act reduced after-tax rates of return to investors and therefore made saving, in the form of equities, considerably less attractive.

Entrepreneurial Effort

Restoring a capital gains tax differential will have a particularly powerful impact on the entrepreneurial sector of the U.S. economy, making possible new technological breakthroughs, new startup companies, and new jobs. Venture capital requires a number of participants: entrepreneurs, informal investors, venture capital funds, and finally, healthy public markets. All of these participants are sensitive to after-tax rates of return. The key to successful venture investment is the ability to attract and motivate the entrepreneur. By taxing the entrepreneur's potential gain at a higher rate, either the pool of qualified entrepreneurs will be reduced or the investors will have to accept a lower rate of return. In either case, the implications for the U.S. economy are clearly negative.

Furthermore, fledgling companies depend heavily on equity financing from family, friends, and other informal sources. Professors William E. Wetzel and John Freear of the University of New Hampshire surveyed 284 new companies and found that private individuals were the major source of funds for those raising $500,000 or less at a time. The individuals providing startup capital for these new companies do pay capital gains taxes and are sensitive to an increased tax rate on gains.

It is true that a portion of the organized venture capital pool comes from tax-exempt entities, but the informal pool is equally important. Data collected by the National Venture Capital Association documents the fact that private taxable investors, including corporate venture capital funds, provide on an informal basis as much funding as does the organized venture capital industry. Most importantly, it is the taxable investors who, more often than not, provide the seed corn for the new firms, with tax-exempt pension funds and formal venture capital pools entering the funding process at a later stage. The willingness of tax-exempt entities to participate in the venture capital process is also dependent, to a very large extent, on a vibrant stock market, which is directly affected by the level of capital gains taxes.

The Tax Reform Act of 1986 discouraged entrepreneurial endeavors. An analysis prepared by Dr. Gregory J. Ballentine of KPMG Peat Marwick concludes that the 1986 act fails to recognize that many capital gains investments are inherently risky and that realized capital gains often include purely inflationary gains that are not income. In fact, the combined effect of taxing inflationary gains and limiting the deductibility of capital losses leads to severe over taxation and produces a "surtax" on many investments that will earn capital gains.

For example, assuming a 4 percent real return and 5 percent inflation, a taxpayer in the 28 percent marginal tax bracket pays a 29 percent higher tax on an asset yielding capital gains held for five years than on one that earns ordinary income, such as dividends, and which is taxed currently. Even worse, under the same assumptions, a taxpayer in the 28 percent bracket who realizes a gain on a "high risk" capital asset faces a tax rate on an asset held five years that is 50 percent higher than the rate on ordinary income. Higher taxes on risky capital assets result from the fact that, while capital gains are subject to full taxation, losses are allowed only limited deductibility. These factors clearly discourage investment.

Criteria for a Capital Gains Rate Cut

Lower capital gains taxes for individuals and corporations are an important step in reducing U.S. capital costs and promoting investment. A permanent capital gains tax differential should meet three criteria: First, it should make economic sense by lowering the excessively high cost of U.S. capital, reducing the bias against high-risk capital, and ameliorating the taxation of inflationary gains. Second, it should be fair to all income groups and sectors of the U.S. economy. And third, it should be a revenue-raiser in the short term and not a revenue loser in the long term.

The beneficial economic effect of capital gains rate cuts on capital costs is described earlier and will not be repeated here.

Fairness

There is much controversy about the "fairness" of capital gains cuts. There are two aspects to the fairness issue. What is most often discussed is the predicted distribution of taxes paid by different income classes. What, in fact, is more important is the beneficial impact to the U.S. economy and the fairness of opportunities created or lost for the less fortunate in our society.

First, a threshold question is whether saving should be taxed at all. Many Americans believe that saving should be exempt from taxes.

Second, as Treasury assistant secretary Kenneth W. Gideon stated before this committee, enactment of the Bush proposal *increases* the taxes paid by the wealthy. The OTA calculations demonstrate that once the dynamic responses of taxpayers are taken into account, the amount of taxes paid by high-income taxpayers will increase. Taxpayers with incomes of $200,000 or more will pay almost one billion dollars in additional capital gains taxes. The share of taxes paid by lower- and middle-income taxpayers will decline since their taxes do cot increase so significantly.

Third, many capital gains are realized by taxpayers on a one-shot basis, perhaps by individuals selling a family business or retirees cashing in their assets. Evidence that this one-shot phenomenon is significant is found in the recent Joint Tax Committee study. The JCT panel study, which covered the period 1979-1983, found that 44 percent of taxpayers reporting gains realized a gain in only one year of the five (see Chart 6) Only 16 percent of taxpayers who realized gains during the five-year period did so in each year.

Fourth, as economist Lawrence B. Lindsey observed recently, it is the politics of envy to refuse to enact a capital gains tax cut which (according to the JCT) would make the private sector better off by $100 billion over the next five years while costing the government only $11 billion over the same period. Lindsey concludes that only envy could keep in place our current capital gains tax rates since the tax costs the economy $9 for every $1 it produces.

Revenue Effects

The Treasury Department's Office of Tax Analysis (OTA) estimates that the President's capital gains proposal, if enacted, would increase revenues by $12.5 billion over the budget period and provide modest increases in revenue thereafter. The staff of the Joint Committee on Taxation (JCT) estimates that the proposal would lose $11.4 billion over the same period and continue to lose money thereafter. This represents a difference of $23.9 billion over the budget period.

According to the recent Treasury testimony, there are two major causes for the difference between the OTA and the JCT revenue estimates: (1) the OTA assumes a smaller year-to-year change in capital gains realizations, absent any tax code revisions (the baseline forecast); and (2) the OTA assumes greater taxpayer responsiveness to capital gains tax rate changes (elasticity).

The OTA estimates that baseline capital gains realizations would increase gradually along with growth in the economy. In contrast, the JCT's baseline (which is provided to it by the CBO) is assumed to jump by over 50 percent from 1988 (the last year for which data are available) to 1990. The OTA believes that the extraordinary increase in capital gains realizations projected by the CBO for this two-year period is highly improbable. Its effect is to raise the baseline level of realizations quite dramatically throughout the budget window, thereby significantly enlarging the JCT's estimates of the static revenue losses.

The OTA's assumption about capital gains elasticities is based on a review of twelve government and academic studies that have examined the question. Three of these were published by the OTA in 1989. As CEA Chairman Boskin observes in his recent letter to key members of the congressional tax writing committees on this subject, because the twelve studies use different methods and different data, they arrive at different estimates. While the Treasury and the JCT estimates arc both within the range of effects implied by these studies, the Treasury estimate is much

closer to the middle of the range: Only two of these twelve studies estimated taxpay-er responsiveness as low as the JCT analysis. While Treasury is closer to the aver-age elasticity estimate, nine of the studies found an even greater response of asset sales to capital gains tax rates than did Treasury.

Furthermore, neither the OTA nor the JCT includes in its estimates macroeco-nomic, or "feedback," effects of lower capital gains taxes on economic growth and tax revenues. While this accords with the standard practice of both staffs, it does not mean that such positive effects will not occur, merely that they are not estimat-ed.

As CEA Chairman Boskin and Treasury Under Secretary Robert Glauber have ob-served, although the impact of a capital gains tax cut on growth is difficult to meas-ure precisely (and this is one reason that neither Treasury nor the JCT currently includes such formal estimates in its revenue projections) reasonable estimates yield revenue dividends which more than offset any static estimate of revenue loss. In their view, a conservative estimate is that the President's proposal would lower the cost of capital for business by 3.6 percent. The lower cost of capital will increase investment and, therefore, productivity and economic growth. Over the next five years, the lower cost of capital arising from the President's proposal can be reason-ably expected to increase GNP by a total of $61 billion, according to the CEA, which would yield roughly $12 billion in added revenue. Even using the extremely pessi-mistic JCT estimates and making lower-bound assumptions, the capital gains tax cut would increase revenue over the next five years, once economic growth is consid-ered. As Martin Feldstein noted in congressional testimony, extra growth of only four hundredths of one percent (0.04 percent) would offset even the JCT's estimate of revenue loss from the President's proposal.

Finally, Chairman Boskin and Under Secretary Glauber conclude that this is a conservative estimate of the likely beneficial effects of GNP, because a capital gains tax cut encourages the entrepreneurial, highly productive investments that contrib-ute most strongly to growth. In addition, a capital gains tax cut will help "unlock" investors, allowing them to move to more productive investments. Estimates based only on the reduced cost of capital do not include these important effects on the mix of investment in the economy.

CONCLUSIONS

The question raised by President Bush's proposal to cut capital gains taxes is simple but of great importance: Are policymakers prepared to take the first impor-tant step in reversing recent tax policy, which has impaired this nation's future international competitiveness by sharply increasing the capital costs of investing in productive equipment? Make no mistake about it, a high and sustained rate of in-vestment in modern, state-of-the-art equipment is essential to U.S. competitiveness; it is the only way our high-wage economy can restore the productivity growth that allows us to compete with low-wage industrial nations around the world. As the new study by the Office of Technology Assessment makes clear, Japan's high level of in-vestment in advanced equipment is a major factor contributing to its competitive-ness in world markets.

The debate about the appropriate taxation of capital gains has been with us almost since the inception of the Federal income tax. From 1922 until 1986, a cap-ital gains tax differential existed as part of U.S. tax policy for very sound economic policy reasons that are recognized by almost all of our economic competitors.

A capital gains tax cut will be productive for the U.S. economy and fair for U.S. taxpayers. Although there is considerable controversy about the revenue conse-quences of the President's capital gains initiative, a very strong and credible case can be made that this initiative, with its important consequences for the cost of cap-ital, will not reduce revenues and, in fact, is a revenue raiser.

Attachment.

Table 1: Saving and Investment as a Percent of Gross Domestic Product, 1973–1987

	United States	Canada	Japan	France	West Germany	United Kingdom
SAVING						
Net Saving[a]	5.0	9.2	18.6	9.0	10.5	5.9
Personal Saving[b]	5.7	7.5	12.9	8.3	8.1	4.7[c]
Gross Saving (net saving plus consumption of fixed capital)[d]	17.7	20.7	31.9	21.2	22.4	17.7
INVESTMENT						
Gross Non-Residential Fixed Capital Formation	13.5	15.7	23.7	14.6	14.6	13.8
Gross Fixed Capital Formation	18.2	21.7	30.0	21.0	20.7	17.5

Source: Derived from National Accounts, Vol. II, 1973–1985 and 1975–1987, Organisation for Economic Co-operation and Development (OECD), 1987 and 1989 eds. Prepared by the American Council for Capital Formation Center for Policy Research, December 1989.

[a] The main components of the OECD definition of net saving are personal saving, business saving (undistributed corporate profits), and government saving (or dissaving). The OECD definition of net saving differs from that used in the National Income and Product Accounts published by the Department of Commerce primarily because of the treatment of government capital formation.
[b] Personal saving is comprised of household saving and private unincorporated enterprise.
[c] This percentage is for the years 1973–1986.
[d] The main components of the OECD definition of consumption of fixed capital are the capital consumption allowances (depreciation charges) for both the private and the government sector.

Chart 1: Fixed Investment in the United States and Japan as a Percent of GNP

17.2%   30.1%   16.7%   30.5%   16.6%   32.2%

1985   1986   1987

☐ United States   ■ Japan

Note: Fixed investment is defined as additions of new and imported durable goods.

Chart 2

Manufacturing Productivity as a Function
of the Capital-Labor Ratio
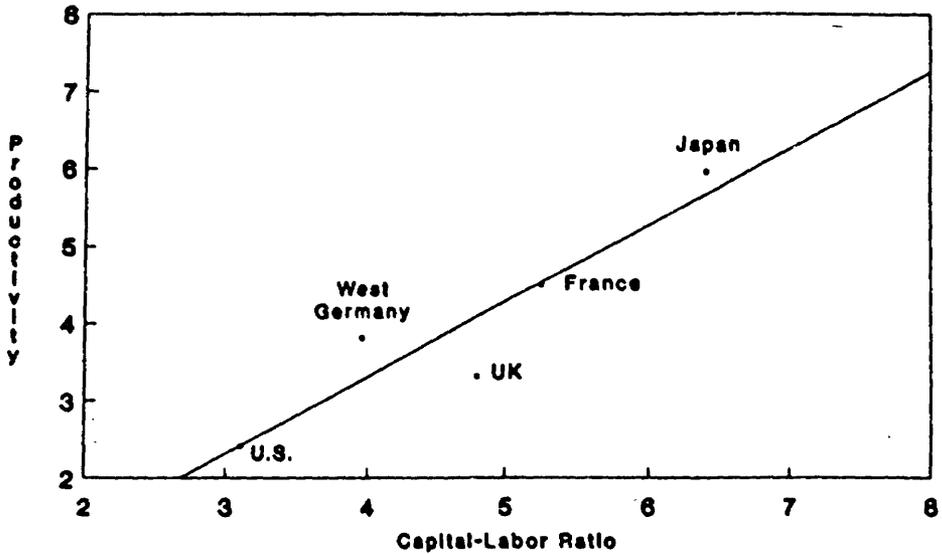
Chart 3

Nominal Capital Costs Recovered After Five Years for Equipment Used to Make Selected Manufactured Products in the US

Nominal Recovery After 5 Years

140
120
100
80
60
40
20
0

Computer Chips | Switching Equipment | Factory Robots | Crankshafts | Continuous Casting | Engine Blocks

■ 1985 Law 1/   ▨ Current Law—Regular Tax 2/   ☐ Current Law—Alternative Minimum Tax 3/
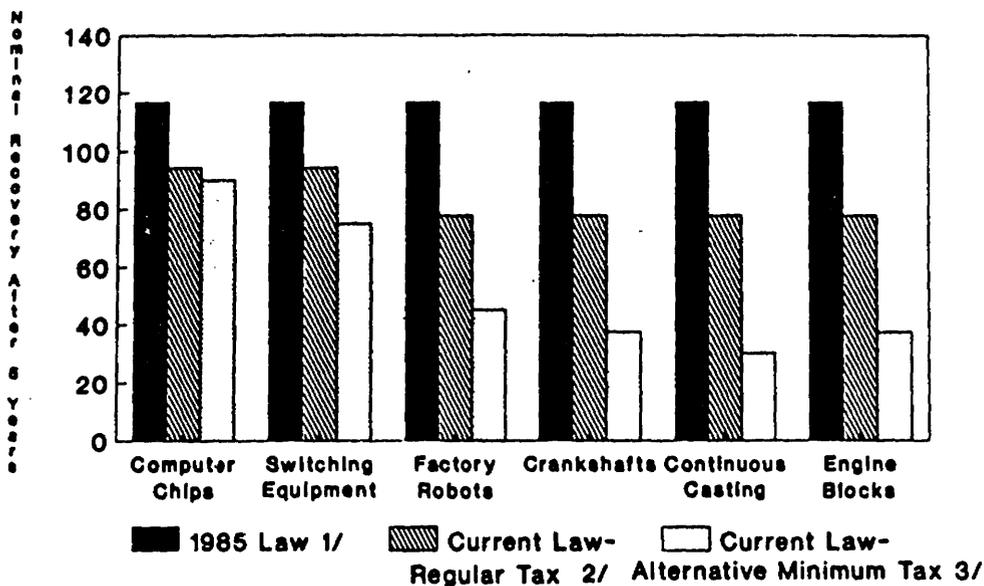
Source: Arthur Andersen & Co.

Note: Nominal capital costs recovered after five years measure the speed at which a firm is able to recover its capital expenditures. Under 1985 law in the U.S., the combination of depreciation and the investment tax credit resulted in a nominal recovery of 116.5 percent of capital expenditures after five years.

1/ 1985 law refers to the federal tax code provisions for capital cost recovery on December 31, 1985, or the Economic Recovery Tax Act of 1981 as modified by TEFRA (1982) and DRA (1984).

2/ Current law-regular tax refers to the capital cost recovery provisions of the Tax Reform Act of 1986. The calculations assume the investing firm incurs the regular marginal corporate tax rate of 34 percent.

3/ Current law-alternative minimum tax refers to the capital cost recovery provisions of the Tax Reform Act of 1986 for firms incurring the alternative minimum tax adjusted current earnings rule. The calculations assume the firm stays on the minimum tax.

TABLE 2: Growth in Investment and Capacity Utilization Levels During
Recent Business Cycles (constant 1982 dollars)

Expansion Phase of Business Cycle a/ (Trough to Peak)	Capacity Utilization b/ (Average)	Nonresidential Fixed Investment	Producers' Durable Equipment (Annualized Growth Rate)	Producers' Durable Equipment Less Computers
1970(4)-1973(4)	83.2%	7.9%	11.3%	11.0%
1975(1)-1980(1)	81.2%	6.9%	7.4%	6.8%
1980(3)-1981(3)	80.4%	8.7%	5.4%	4.3%
1982(4)-1989(4) c/	80.1%	5.4%	8.9%	4.2%
Pre Tax Reform Pattern:				
1982(4)-1985(4)	78.0%	9.4%	13.3%	7.4%
Post Tax Reform Pattern:				
1986(1)-1989(4)	81.8%	3.5%	6.7%	3.0%

Sources: Federal Reserve Board and U.S. Department of Commerce data. Prepared by the American Council for Capital Formation Center for Policy Research, March 1990.

a/ The business cycle turning points are determined by the National Bureau of Economic Research.

b/ Manufacturing, mining, and utilities.

c/ The peak in the business expansion that began in November 1982 has not yet occurred.

TABLE 3: International Comparison of the Present Value of Cost Recovery Allowances for Equipment Used to Make Selected Manufacturing Products

	Computer Chips		Switching Equipment		Factory Robots		Crankshafts		Continuous Casting Equipment		Engine Blocks	
	P.V.	U.S. Rank	P.V.	U.S. Rank	P.V.	U.S. Rank	P.V.	U.S. Rank	P.V.	U.S. Rank	P.V.	U.S. Rank
U.S.: 1985 Law 1/	91.90	(2)	91.76	(2)	91.76	(2)	91.76	(2)	91.76	(2)	91.76	(2)
U.S.: Current Law, Regular Tax 2/	76.55	(5)	78.34	(5)	68.44	(6)	68.44	(6)	68.44	(6)	68.44	(6)
U.S.: Alternative Minimum Tax 3/	65.22	(6)	66.56	(6)	54.14	(6)	38.46	(6)	42.94	(6)	38.46	(6)
Canada	77.28		76.51		75.39		75.26		75.20		75.26	
Japan	87.85		86.29		83.50		84.16		83.75		84.16	
Singapore	91.48		91.48		91.48		91.48		91.48		91.48	
South Korea	99.58		93.20		93.20		95.64		98.21		95.64	
West Germany	83.49		82.30		81.65		82.90		81.12		82.90	

Note: The present value computations for the U.S. and Japan use discount rates which incorporate estimates of the real return required by investors calculated by Stanford Professor Dr. John B. Shoven in "Consumption Taxes vs. Income Taxes for Deficit Reduction and Tax Restructuring," October 1989. Using the required return calculated by Dr. Shoven plus a current measure of inflation in each country yields a discount rate of 4.10 percent for Japan and 13.10 percent for the U.S. Discount rates for the remaining countries are based on long-term government bond rates tabulated by the International Monetary Fund.

1/ 1985 law refers to the federal tax code provisions for capital cost recovery on December 31, 1985, or the Economic Recovery Tax Act of 1981 or modified by TEFRA (1982) and DRA (1984).

2/ Current law, regular tax, refers to the capital cost recovery provisions of the Tax Reform Act of 1986. The calculations assume the investing firm incurs the regular marginal corporate tax rate of 34 percent.

3/ Current law, alternative minimum tax, refers to the capital cost recovery provisions of the Tax Reform Act of 1986 for firms incurring the alternative minimum tax adjusted current earnings rule. The calculations assume the firm stays on the minimum tax.

Source: Arthur Andersen & Co.

TABLE 4: International Comparison of Nominal Costs Recovered as a Percent of Cost after Five Years for Equipment Used to Make Selected Manufacturing Products.

	Computer Chips		Switching Equipment		Factory Robots		Crankshafts		Continuous Casting Equipment		Engine Blocks	
	X	U.S. Rank	X	U.S. Rank	X	U.S. Rank	X	U.S. Rank	X	U.S. Rank	X	U.S. Rank
U.S.: 1985 Law 1/	116.54	(2)	116.54	(1)	116.54	(1)	116.54	(1)	116.54	(1)	116.54	(1)
U.S.: Current Law, Regular Tax 2/	94.24	(3)	94.24	(3)	77.69	(5)	77.69	(5)	77.69	(5)	77.39	(5)
U.S.: Alternative Minimum Tax 3/	90.00	(3)	75.00	(5)	45.00	(6)	37.49	(6)	30.10	(6)	37.49	(6)
Canada: 1990	79.59		79.59		79.59		79.59		79.59		79.59	
Japan	87.07		64.35		60.83		64.35		64.35		64.35	
Singapore	100.00		100.00		100.00		100.00		100.00		100.00	
South Korea	124.99		106.92		106.92		108.83		112.60		108.83	
West Germany	81.39		81.39		81.39		87.34		81.39		87.34	

1/ 1985 law refers to the federal tax code provisions for capital cost recovery on December 31, 1985, or the Economic Recovery Tax Act of 1981 or modified by TEFRA (1982) and DRA (1984).

2/ Current law, regular tax, refers to the capital cost recovery provisions of the Tax Reform Act of 1986. The calculations assume the investing firm incurs the regular marginal corporate tax rate of 34 percent.

3/ Current law, alternative minimum tax, refers to the capital cost recovery provisions of the Tax Reform Act of 1986 for firms incurring the alternative minimum tax adjusted current earnings rule. The calculations assume the firm stays on the minimum tax.

Source: Arthur Andersen & Co.

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Chart 4: Impact of U.S. Tax Code Revisions on the Cost of Capital for Equipment Used in Manufacturing (Pretax Return Basis)
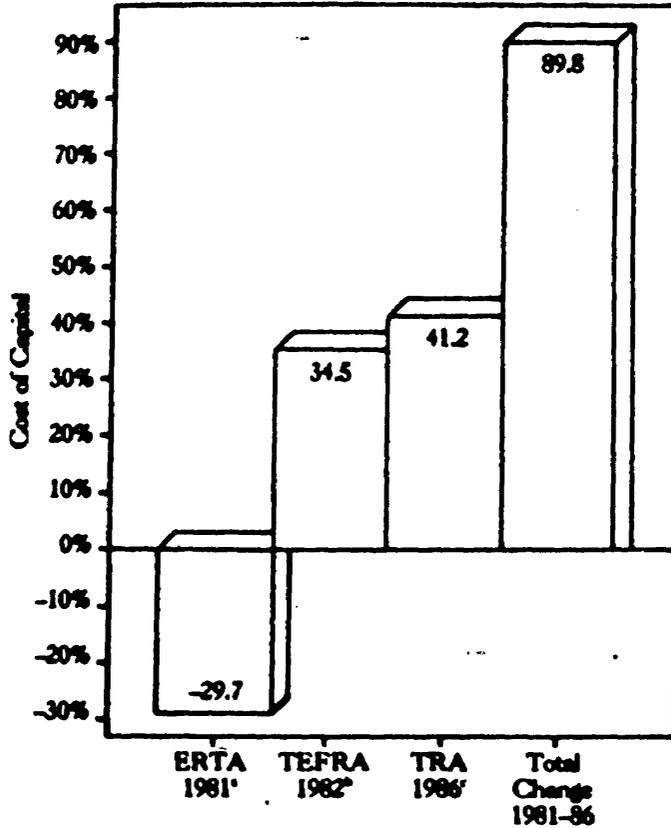
Note: The capital cost used here is the pretax return required by an investor, which is net of economic depreciation.

ᵃThe Economic Recovery Tax Act of 1981 (ERTA) reduced rates compared to prior law.

ᵇThe Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) reduced ERTA's investment incentives.

ᶜThe Tax Reform Act of 1986 (TRA) further reduced the investment incentives available under TEFRA and raised effective tax rates to a level higher than that prevailing in 1980.

Chart 5: Impact of U.S. Tax Code Revisions on the Cost of Capital for Equipment Used in Manufacturing (User Cost Basis)

TABLE 5: INTERNATIONAL COMPARISON OF
CAPITAL GAINS TAX RATES

	INDIVIDUALS			CORPORATIONS		
Industrialized Group	Maximum Marginal Short-Term Capital Gains Tax Rate	Maximum Marginal Long-Term Capital Gains Tax Rate	Holding Period for Long-Term Gains Treatment	Maximum Marginal Long-Term Capital Gains Tax Rate	Holding Period for Long-Term Gains Treatment	Capital Loss Deductions Against Ordinary Income
United States	33%	33%	More than 1 year	34% b/,c/	More than 1 year	No
Australia	49.25%	49.25%	More than 1 year	39% b/,d/ (indexing)	None	No
Belgium	Exempt	Exempt	None	21.5% e/	5 years	
Canada	19.33%	19.33%	None	29%/25% f/	None	No
France	16%	16%	None	15%/25% g/	2 years	No
West Germany	56%	Exempt	6 months	36% b/	None	Yes
Italy	Exempt	Exempt	None	36% b/	None	
Japan	1%/20% a/	1%/20% a/	None	37.5% b/,h/	None	Yes
Netherlands	Exempt	Exempt	None	40% b/,i/	None	Yes
Sweden	42%	16.8%	2 years	21% j/	2 years	No
United Kingdom	40%	40%	None	35% b/ (indexing)	None	No
Pacific Basin Group						
Hong Kong	Exempt	Exempt	None	Exempt	None	
Singapore	Exempt	Exempt	None	Exempt	None	
South Korea	Exempt	Exempt	None	30% b/,k/	None	Yes
Taiwan	Exempt	Exempt	More than 1 year	25% b/,l/	None	

Sources: Spicer & Oppenheim and Securities Industry Association, International Tax Comparisons; Price Waterhouse, Corporate Taxes: A Worldwide Summary, 1989 edition; Tax Analysts, Tax Notes International, various issues (1989 and 1990); and Commerce Clearing House, various publications.

Note: The data for individuals reflect tax rates only on securities, while the data for corporations apply to tax rates on all capital assets. State, provincial, municipal, and local taxes are not reflected in these rates.

a/ Taxpayer has a choice of a 1% withholding tax on gross sales proceeds or a maximum tax on net capital gains of 20%.
b/ Gains are taxed at ordinary rates.
c/ The holding period is more than one year for assets acquired after December 31, 1987.
d/ Indexing applies to assets acquired after September 19, 1985; assets acquired before that date are exempt from tax.
e/ This preferential rate applies to buildings, equipment, share of corporate stock, and other portfolio investments. Pending government tax reform would eliminate the preferential long-term rate for corporations. Indexing is applied to assets acquired before 1950.
f/ In general, the gains of publicly held firms are taxed at an effective rate of 29% (25% if the income is from Canadian manufacturing or processing).
g/ Long-term gains from the sale of fixed assets are taxable at a rate of 15%. Long-term gains on building sites are taxed at a 25% rate.
h/ There is generally an additional 20% tax on gains from the sale or transfer of land held less than ten years.
i/ This rate declines from 40% to 35% after the first Fls 250,000 of taxable income.
j/ There is generally no special treatment for the sale of real property, machinery, equipment, patents, or leaseholds.
k/ There is an additional tax of 32% to 53% on the sale of land or buildings.
l/ Corporate income tax for capital-intensive and high-technology companies may not exceed 20% of taxable income. Land is not considered a capital asset, and the sale of securities by non-security industry firms is exempt from tax.

Chart 6

Percent of Returns with Single and Multiple Capital Gains Realizations over the 1979-1983 Period
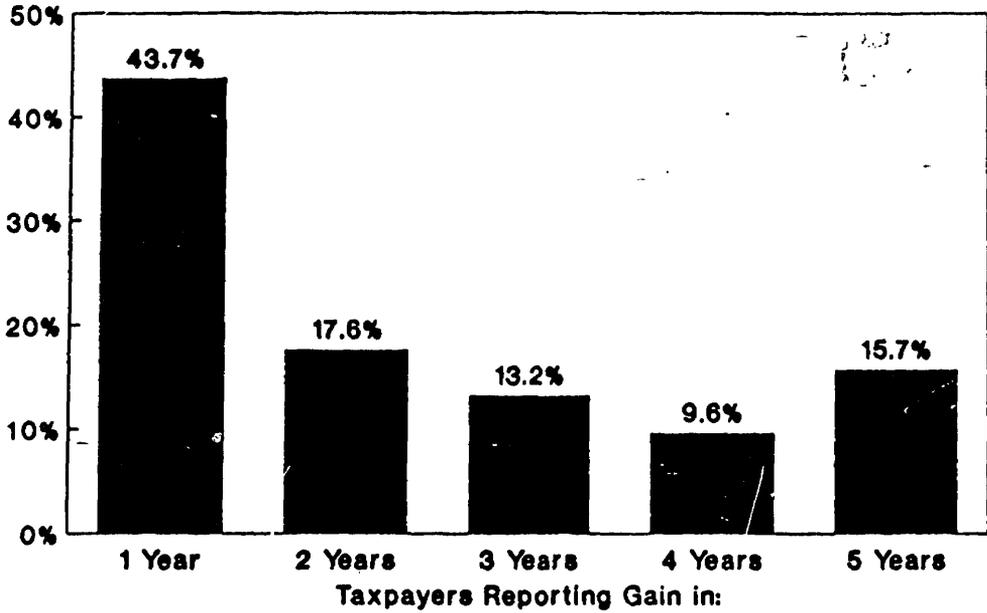
PREPARED STATEMENT OF MICHAEL J. BOSKIN

INTRODUCTION

Chairman Bentsen, Senator Packwood, and other distinguished members of the committee, thank you for the opportunity to present the Administration's views on the capital gains tax provisions of the Savings and Economic Growth Act of 1990.

A key component of the Savings and Economic Growth Act of 1990 is the restoration of a capital gains tax differential, which existed prior to the Tax Reform Act of 1986. This proposal is an important part of a package of Administration initiatives designed to remove impediments to saving and investment, to encourage innovation and entrepreneurship, and to enhance economic growth.

Benefits of Higher Economic Growth

The American economy is the largest, most productive economy in the world and we are in the 88th month of the longest peacetime expansion in our history. We cannot, however, take continued economic growth for granted. We must not become complacent. The Administration's foremost priority is to sustain the highest possible rate of economic growth. That goal is not just an abstraction. Economic growth is how we create rising standards of living for the bulk of the population. How we develop the resources to uplift those most in need. How we provide economic and social mobility to our citizens. How we leave a better legacy to our children. And how we maintain America's leadership in the world. Faster economic growth requires movement on many fronts, but it makes many more social and private goals attainable.

Saving and Investment: Keys to Increased Growth

Increasing the rate of growth of living standards will require higher rates of saving and investment. Yet longstanding government policies impede national saving and investment. Partly because of these government policies, Americans save and invest a smaller fraction of gross national product (GNP) than their counterparts in other industrialized economies. According to the World Bank, the U.S. investment rate ranks last among the 22 Western industrialized economies.

A major reason for the relatively low rate of investment in the United States is the high cost of capital. Some studies estimate that the cost of capital in the United States is almost twice that of Japan or Germany. Taxes--a large component of the cost of capital--produce a strong bias against equity finance in the United States. Taxes on capital gains increase capital costs for equity finance, while reducing the return to investors. Lowering the capital gains tax rate will lower the cost of capital.

As a result of the Tax Reform Act of 1986, the United States now taxes capital gains at the same rate as other income for the first time since 1921. The United States is burdened with a higher capital gains tax than almost all our major competitors. Most tax capital gains at a lower rate than other income. West Germany, Italy, and most of the newly industrialized economies of the Pacific Rim do not tax long-term capital gains at all. Most of these nations have numerous other tax provisions--such as partial or complete integration of personal and corporate income taxes--that reduce overall taxation of capital income.

The high cost of capital is a particularly onerous problem for new ventures and small businesses, which have only limited access to traditional sources of finance. Much of the return to entrepreneurs and their backers who bring new products to market- -particularly through new business formation--comes through increasing the value of the business. Reducing the tax rate on capital gains will reward those who bring successful ideas to market and will help improve the climate to invest in new technologies and products, thereby creating jobs. During the current record-breaking economic expansion, as throughout U.S. history, most jobs have been created by small and medium-sized firms. Lowering the capital gains tax rate will encourage entrepreneurs to start new businesses to develop new products for new markets here and abroad. Lower capital gains tax rates will encourage risk-taking, raise investment, improve competitiveness, and spur economic growth.

REVENUE ESTIMATES OF THE PRESIDENT'S PROPOSAL TO REDUCE CAPITAL GAINS TAX RATES

These important issues notwithstanding, much discussion has been limited to the more narrow question: how will the President's proposal affect Federal revenues? Congress and the Administration are naturally concerned about the revenue consequences of any proposal, particularly during this period of necessary budgetary stringency and our joint responsibility under the Gramm-Rudman-Hollings law. While the economic benefits of capital gains tax reduction are likely to outweigh any reasonable estimate of its cost, I shall begin with a brief discussion of the revenue impact of the capital gains tax rate reduction before turning to its broader impact on economic performance.

A capital gains tax cut affects revenues in five ways. First, a lower capital gains tax rate will induce greater realizations of capital gains. In the presence of a tax due when capital gains are realized, investors will avoid selling appreciated assets and remain "locked-in" to their old investment decisions. Many of these gains would escape taxation completely by the owners holding them until death. It is well-documented that lowering the capital gains tax rate will reduce the "lock-in effect," freeing investors to find more productive investments, increasing realizations of capital gains, and raising revenue due to higher, voluntary tax payments.

Second, the tax rates on those capital gains that would have been realized anyway will be lower, which works to reduce revenue. Third, over time taxpayers will also structure their investments to convert ordinary income into capital gains, reducing the tax rate on this income and therefore revenue.

Fourth, the President's proposal also raises revenue through provisions to recapture depreciation allowances on investments sold for a capital gain and to include capital gains as a preference item for alternative minimum tax purposes. Fifth, and most important, the capital gains rate reduction will spur growth and increase incomes and GNP, leading to additional revenues.

The bottom line is that the Administration's proposal to reduce capital gains tax rates is likely to raise Federal revenues in both the short run and over a longer horizon. The Office of Tax Analysis of the Treasury estimates that the President's proposal will gain $12.5 billion over the next five years. The Joint Committee on Taxation estimates that the President's proposal will lose $11.4 billion over the next five years. As I indicated in my earlier letters to Chairman Bentsen and Senator Packwood, neither of these estimates captured the

favorable effects of economic growth on Federal receipts, which
would offset JCT's estimated losses and enhance OTA's estimated
gains. As I also noted in those letters, OTA's revenue estimates
are more representative of the extensive research on the effect
of changes in capital gains tax rates on realizations.

IMPACT OF CAPITAL GAINS TAX RATE REDUCTIONS ON ECONOMIC PERFORMANCE

I would like to turn now to the impact of capital gains tax
rate reductions on economic performance. As I said at the
beginning, the focus of the debate simply should not be on
revenue alone. Even the $12.5 billion increase in revenue over
the next 5 years estimated by the Treasury or the unlikely $11.4
billion loss estimated by JCT amount to a change of less than
two-tenths of 1 percent in overall Federal revenues. The capital
gains proposal would have little direct impact on Federal
revenues and should be viewed instead as part of a sound strategy
to enhance economic growth.

The United States is faced with challenges to increase
saving and investment, raise technical innovation and
productivity growth, and improve international competitiveness.
The President's proposal on capital gains is one part--a central,
important part--of a program to lower the barriers to meeting
these goals.

Capital Gains Rate Reduction and GNP

Reducing the tax rate on capital gains will foster more
rapid economic growth. To estimate the likely size of this
effect, the CEA has done a standard computation of the impact of
lower capital gains tax rates on the economy. The computation
traces through the effect of lower tax rates on the cost of
capital, capital formation, and the resulting increase in
productivity and GNP. This computation may well be conservative,
since, as I will discuss in a moment, it omits important dynamic
effects of lower capital gains tax rates, such as higher quality
of capital, increased entrepreneurship, and a larger flow of
funds to finance new business formation. Despite the limitations
of this computation, it provides a useful rough estimate of the
magnitude of the likely effect and is comparable to other
estimates.

Over the past two years, there have been a variety of
estimates of the effect of reducing capital gains tax rates on
national output. Put on a basis consistent with the
Administration's proposal, a survey of these suggests that GNP
will ultimately rise by between 0.2 percent and 1.2 percent per
year. The Council of Economic Advisers believes that the effect
lies roughly in the middle of this range, with GNP ultimately
rising by about 0.6 percent as the result of adopting the
Administration's proposal, or about $60 billion per year in the
year 2000. This would be a rise equivalent to current Federal
spending on education, training, employment, and social services
combined and roughly 4 times private-sector spending on basic
research.

Over the next five years, CEA estimates that the President's
proposal would raise GNP by roughly $60 billion; over the next
ten years, by roughly $280 billion. As I stressed in my opening
remarks, increases in GNP represent new jobs, better
opportunities, and better standards of living for Americans.
Higher GNP also means higher Federal revenues: the estimated
revenue dividend from the growth induced by the capital gains
proposal would be about $12 billion over the next five years and
over $50 billion over the next ten years.

There are a variety of judgments that must be made in making these estimates:

o A lower cost of capital will stimulate additional investment, but it is difficult to forecast the speed with which firms will adjust their capital spending towards the new, higher level. To the extent that the timing differs from that embodied in the estimate, the increase in GNP could be over- or under-estimated.

o For simplicity, our estimate ignores the important role of a higher investment rate on technological progress. Increased investment produces not only _more_ capital, but also _better_ capital as firms install new, improved production processes. Increasing the _quality_ of the capital stock will increase GNP by more than estimated here.

o Our estimate also assumes that capital formation's contribution to economic growth is roughly 35 percent. Many economists believe that the contribution of capital is much larger, which would lead to a greater increase in GNP.

o Our estimate assumes that a 1 percent decrease in the cost of capital increases the desired amount of capital by 7/10ths of 1 percent.   Many economists believe that the response is more likely to be one-for-one. (If one uses the conventional response of a 1 percent increase in desired capital and if the contribution of capital is 50 percent rather than 35 percent, the capital gains cut would increase GNP by twice the amount estimated above.)

o One of the most important reasons to reduce capital gains taxation is to encourage entrepreneurship, a critical element in economic growth. The capital gains proposal would expand the supply of funds to entrepreneurs and lower their cost of capital. In addition, there may be an increase in the supply of entrepreneurial talent. Neither of these effects is taken into account in the CEA GNP estimate, further reasons why the GNP increase from the capitals gains proposal may be larger than estimated by CEA.

CAPITAL GAINS RATE REDUCTION AND ECONOMIC PERFORMANCE: WHAT ARE THE LINKS?

The links between adopting the Administration's capital gains tax proposal and increased economic growth are straightforward.

Increasing the Quality of Investments

The first step is reducing the lock-in effect. This will lead investors to more productive investments, raising the productivity of the capital stock. High capital gains tax rates lock investors and the economy into past investments purely for tax reasons. The importance of shifting portfolios goes beyond mere shuffling of paper assets. The signals provided by market values are the most efficient way to identify socially beneficial investments. When investors are locked-in, we run the risk of missing more productive investment opportunities.

Reducing the Bias Against Saving and Investment

Restoring the capital gains differential would reduce the overall bias against saving and investment. Saving and

investment are taxed twice: once when the income is earned and
again when the returns are received. In addition, the tax system
currently favors corporate debt over equity. Debt-financed
corporate investments are taxed only at the personal level, while
equity returns are taxed twice--first in the corporation income
tax and again when individuals receive returns.

Lowering the Cost of Capital

A lower tax rate on capital gains will reduce the bias
against saving and investment, in part by lowering the cost of
capital. The Council of Economic Advisers estimates that the
President's proposal will ultimately reduce the cost of capital
by approximately 3.6 percent.

The "cost of capital" does not reflect only the cost of
funds to finance investment. It is the pre-tax rate of return
that an investment must yield in order to be profitable. In
order to attract investment funds, a business must cover
operating expenses, depreciation, taxes, etc. and still meet the
market test of offering a competitive after-tax return. Thus,
the cost of capital reflect the direct cost of funds, tax rules,
and other factors such as the rates of depreciation and economic
obsolescence.

Unlike the cost of funds--for example, interest rates--one
cannot directly examine data on the cost of capital. There are
standard techniques for using data on depreciation, tax rates,
interest costs, and so forth to compute the cost of capital. Our
estimate of the cost of capital uses these techniques.

Not surprisingly, like the estimated effect on overall
output, our estimate of the effects on the cost of capital falls
well within the range of estimates that have been produced to
investigate the stimulative effects of a capital gains tax
reduction. There are inevitable differences in cost of capital
calculations that stem from judgments needed to implement the
standard techniques. For example, the cost of capital will
differ between an investment financed by new equity, retained
earnings, and debt issue. Differences in the assumed mix of
financing will, thus, affect the overall cost of capital.

The Cost of Capital for New Firms

Our estimate is intended to give a ballpark notion of the
overall effect on the cost of capital. Of course, not all firms
are the same. In particular, the cost of capital differs for new
and established firms.

Established corporations rely largely on debt or internal
finance--retained earnings--for new investment. For these firms,
the capital gains tax is the major personal income tax on equity
returns. (Of course, these firms are faced with the corporation
income tax as well.) In contrast, very young firms have more
difficulty arranging debt finance and often only at higher rates,
so lowering the equity cost of capital is even more critical for
these firms. For an all-equity, no-dividend firm, we estimate
the the capital gains proposal would reduce the cost of capital
by 4.2 percent, compared to 3.6 percent for the average firm.

Some have mistakenly argued that capital gains taxes do not
materially affect new firms because much venture capital comes
from nontaxable sources. For example, in 1988, 46 percent of the
funds provided to venture capital firms came from pensions, and
67 percent from nontaxable entities.

Very young, startup ventures do not normally receive venture
capital finance and rely on capital gains for both returns to

entrepreneurs and deferred compensation of employees.
Preliminary research indicates that 90 percent of firms that
receive "informal" investment financing have fewer than 20
employees. Alternatively, in 1986, only 1 in 5 firms that
reached the state of an initial public stock offering had
received financing from venture capital firms.

In sum, informal capital is important to the formation of
new businesses. Reducing the capital gains tax rate is likely to
have a major effect on the cost of capital for these firms.

Raising the Rate of Capital Formation and Economic Growth

With a lower cost of capital, individuals and businesses
will increase their investment in productive capital. Our
estimate, based on the assumptions discussed above, is that the
level of business capital will ultimately rise by about 2.5
percent. Many economists believe that capital is more responsive
to reductions in the cost of capital, and therefore believe that
capital rises even more. Changes in the cost of capital are an
incomplete measure of the effect on capital formation. Some
firms may not have access to capital markets, even at the going
rates. For those that rely more heavily on internal instead of
external finance, the stimulus is even larger.

The final step in the link between a lower capital gains tax
rate and economic growth is the most straightforward. The
increased capital formation leading to a larger capital stock
will increase the level of GNP by raising productivity, resulting
in increased employment, higher incomes, and greater Federal
revenues. As noted above, we expect that the capital gains rate
reduction would be responsible for raising GNP by roughly $60
billion per year by the year 2000.

CONCLUSION

America is faced with the challenge of meeting international
competition, increasing productivity growth, raising living
standards, and meeting our domestic and international
obligations. In each case, more rapid economic growth is the
foundation for meeting the challenge. Restoring the capital
gains tax differential is a pro-growth policy that will reduce
the tax bias against equity finance, decrease the cost of capital
for American firms in the increasingly competitive global
marketplace, increase investment, spur entrepreneurial activity,
and accelerate economic growth.

This concludes my prepared remarks. I would be pleased to
answer any questions.

BILL BRADLEY
NEW JERSEY

United States Senate
WASHINGTON, DC 20510

April 6, 1990

Dr. Michael J. Boskin
Director
Council of Economic Advisors
Executive Office Building
Washington, D.C.   20500

Dear Mike:

At the Finance Committee hearing on March 28, 1990, you testified that adopting the President's capital gains proposal would increase GNP by about $60 billion a year in the year 2000. You estimated that over the next 5 years, it would increase GNP by about $60 billion and over the next 10 years by about $280 billion. You also said that you'd expect some additional saving over and above the 1989 amount of $206 billion and that you'd provide me with the precise number.

In subsequent testimony, Professor Alan Auerbach testified that "you would have to increase personal savings or private savings by about one-quarter in order to generate the kind of income growth that Dr. Boskin testified was likely to happen...My guess is that taking the very most optimistic assumptions that one could make...the income growth over the next 5 years from the proposal would be at most $4 billion."

When I asked Professor Auerbach what he attributed the disparity between your $60 billion projection and his $4 billion, he was unable to answer but said he assumed it must be your "estimated elasticity of savings with respect to the real rate of interest."

Given the importance of this question to Congress' deliberations, I would appreciate hearing from you as soon as possible on the following:

(a) how much do you expect personal savings to increase as a result of the President's proposal;

(b) what is the explanation for your answer, including all relevant assumptions; and

(c) is there any other explanation for your projected increase in GNP?

I look forward to hearing from you at your earliest convenience.

Sincerely,

Bill Bradley

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

April 20, 1990

Bill

Dear Senator Bradley:

I want to again thank you and the other members of the
Senate Finance Committee for having the opportunity to present
the Administration's views on the capital gains provisions in the
Savings and Economic Growth Act of 1990.

At the hearing and in your letter of April 6, you requested
information on the Council of Economic Advisers' calculation of
the capital accumulation likely to follow from the President's
proposal on capital gains. As I discussed, it is likely that the
cumulative impact of higher annual rates of capital formation
would be to raise the level of private capital by roughly 1.7
percent by the year 2000. As a result, the level of GNP would
ultimately rise by roughly 0.6 percent. Not all of the funds to
finance the additional capital formation must come from personal
saving. Retained earnings of businesses or net inflows of
foreign saving could contribute as well. The precise
decomposition of the overall increase into its components is
difficult to predict, and would depend upon the future path of
deficit reduction, exchange rate movements, international
interest rate differentials, economic growth, and a myriad of
other factors.

In your letter, you indicated that Professor Alan Auerbach
testified that "you would have to increase personal savings or
private savings by about one-quarter in order to generate the
kind of income growth that Dr. Boskin testified was likely to
happen." This statement is simply wrong. To see just how
seriously inaccurate this assertion is, let me trace through the
implications of a 25 percent increase in private saving and
compare the results to the much more reasonable CEA estimate. In
1989, private saving in the United States was $805.4 billion.
Assuming normal growth, a 25 percent increase in private saving
would amount to roughly $220 billion in 1991 and the additional
saving would reach nearly $400 billion annually after 10 years.
This additional saving would raise capital formation each year,
with a cumulative effect of raising the level of the private
capital stock by close to $1.5 trillion after 5 years and by over
$3 trillion by the year 2000. This implies that the private
capital stock would rise by over 22 percent, over 10 times larger
than the CEA estimate.

Using a conservative estimate of the "elasticity" of output
(GNP) growth with respect to capital stock growth of 0.35 (many
economists believe that this elasticity is larger), the Auerbach
25 percent assertion implies that annual GNP would rise by
roughly $130 billion in 1991, by roughly $350 billion after 5
years, and by approximately $800 billion by the year 2000.

Adding up these annual increases, GNP would be cumulatively
higher by roughly $1 trillion over the first 5 years, and by over
$4 trillion over 10 years. These calculations imply an increase
in GNP of over 7 percent in the year 2000, again more than 10
times larger than the estimated effect on GNP of reducing capital
gains tax rates that I reported in my testimony. Perhaps
Professor Auerbach either misspoke, was misinterpreted, or
misunderstood our estimate.

I also want to pass along further information concerning the
article you mentioned authored by Larry Lindsey in which you
indicated he stated that the capital gains tax reduction would
result in a loss of Federal revenue. While this statement
sounded strange to me, I deferred because I did not have the
article immediately available for reference. I have since had
the opportunity to both examine the article and discuss its
contents with Larry. Two points are relevant. First, Larry (who
is on leave from Harvard University to serve as Special Assistant
to the President for Policy Development and a leading expert on
capital gains taxation) co-authored the paper ("Capital Gains,"
Tax Notes, January 25, 1988, copy enclosed) with Jane Gravelle of
the Congressional Research Service. The article clearly states
that the two authors disagree on the revenue impact of a capital
gains tax rate reduction. In his other writing, Larry has
clearly articulated his research finding that a capital gains tax
rate cut from current levels would raise revenues and enhance
economic efficiency. Second, the only mention of revenue costs
in the article itself refers to static effects alone and, thus,
provides an incomplete picture of the overall impact.

Finally, let me reiterate the Administration's strong
support for deficit reduction, the most direct way to raise the
national saving rate. Deficit reduction, while vital, is only
cne component of a comprehensive program to foster higher
sustained growth of living standards in the United States. We
must also decrease impediments to private saving, investment, and
entrepreneurship in our tax rules, regulatory programs, and legal
system. The President's proposal on capital gains is an integral
part of our effort to lower the cost of capital, improve
international competitiveness, and increase economic growth.

Sincerely,
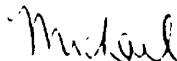
Michael J. Boskin

Enclosure

The Honorable Bill Bradley
United States Senate
Washington, D.C. 20510

PREPARED STATEMENT OF MARY O. BOYLE

GOOD MORNING, MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE. THE NATIONAL ASSOCIATION OF COUNTIES, (NACo), APPRECIATES THE OPPORTUNITY TO TESTIFY BEFORE YOU TODAY.

I AM HERE, ON BEHALF OF NACo, TO DISCUSS TWO PRIORITY CONCERNS: HOW TO STIMULATE SAVINGS AND INVESTMENT BY AND FOR ALL AMERICANS, AND HOW TO FINANCE THE REBUILDING OF AMERICA SO THAT WE WILL BE IN A POSITION TO FOSTER ECONOMIC GROWTH, CREATE JOBS AND SUPPORT AMERICAN BUSINESS IN ITS STRUGGLE TO COMPETE IN INTERNATIONAL MARKETS.

IT IS IMPERATIVE THAT THESE TWO IMPORTANT CONCERNS BE LINKED. THE NEED TO ADDRESS BOTH ISSUES IS CLEARLY EVIDENT.

LOW U.S. SAVINGS HAVE CONTRIBUTED TO HIGHER INTEREST RATES, LOWER INVESTMENT, REDUCED PRODUCTIVITY GROWTH AND HIGHER TRADE DEFICITS. NACo COMMENDS YOU MR. CHAIRMAN FOR YOUR PROPOSALS TO ADDRESS THIS ISSUE AND WE HOPE THAT A COMPROMISE WILL BE WORKED OUT BETWEEN CONGRESS AND THE ADMINISTRATION WHICH TAKES INTO ACCOUNT OUR VIEWS REGARDING PUBLIC CAPITAL INVESTMENT.

WHILE THE LACK OF SAVINGS AND INVESTMENT IS CONTRIBUTING TO THIS COUNTRY'S SLIPPING COMPETITIVE EDGE, IT HAS ALSO BEEN WIDELY ACKNOWLEDGED THAT THE NATION'S INFRASTRUCTURE IS IN DIRE NEED OF REPAIR.

THE NATIONAL COUNCIL ON PUBLIC WORKS IMPROVEMENT, CREATED BY CONGRESS TO ASSESS THE STATE OF AMERICA'S INFRASTRUCTURE FOUND IN ITS REPORT, FRAGILE FOUNDATIONS: A REPORT ON AMERICA'S PUBLIC WORKS, THAT "AMERICA'S INFRASTRUCTURE IS BARELY ADEQUATE TO FULFILL CURRENT REQUIREMENTS, AND INSUFFICIENT TO MEET THE DEMANDS OF FUTURE ECONOMIC GROWTH AND DEVELOPMENT."

DURING NACo'S LEGISLATIVE CONFERENCE HERE IN WASHINGTON LAST WEEK, WE DISCUSSED THE NEED FOR INCREASED SAVINGS AND INVESTMENT AS WELL AS THE NEED FOR INVESTMENT IN AMERICA'S INFRASTRUCTURE. OUR DELIBERATIONS RESULTED IN A RESOLUTION CALLING FOR A JOINT EFFORT WHICH WOULD TIE SAVINGS AND INVESTMENT TO THE FINANCING OF PUBLIC INFRASTRUCTURE.

TO ACCOMPLISH THIS NACo SUPPORTS THE ESTABLISHMENT OF A DEDUCTIBLE INDIVIDUAL RETIREMENT ACCOUNT VEHICLE TIED TO INVESTMENT IN TAX-EXEMPT BONDS FOR PUBLIC CAPITAL FACILITIES, AS WELL AS THE ELIMINATION OF THE DISINCENTIVES TO INVEST IN BONDS, AUTHORIZED UNDER THE '86 TAX ACT.

AS YOU KNOW, TAX-EXEMPT BONDS ARE THE MAJOR TOOL USED BY COUNTIES, STATES, CITIES, TOWNS AND SCHOOL DISTRICTS TO PAY FOR ESSENTIAL PUBLIC PROJECTS. HISTORICALLY, OUR ABILITY TO SELL DEBT WITH INTEREST EXEMPT FROM FEDERAL INCOME TAXES HAS BEEN KEY TO BORROWING MONEY AT LOW COSTS TO ALL TAXPAYERS TO BUILD AND REPAIR SCHOOLS, BRIDGES, ROADS, AIRPORTS, PORTS AND OTHER FACILITIES SO CRITICAL TO THE PRODUCTIVITY OF OUR COUNTRY.

HOWEVER, THE '86 REFORM ACT HAS HAD MAJOR CONSEQUENCES FOR THE TAX-EXEMPT BOND MARKET. THE MOST ONEROUS PROVISIONS WHICH HAVE AFFECTED THE DEMAND FOR TAX-EXEMPT BONDS ARE:

O THE ELIMINATION OF THE BANK DEDUCTION FOR INTEREST COSTS INCURRED TO PURCHASE AND CARRY TAX-EXEMPT DEBT FOR ALL BUT THE SMALLEST GOVERNMENTAL ISSUES;

O INCLUSION OF TAX-EXEMPT INTEREST EARNED ON ALL BONDS-- INCLUDING PLAIN VANILLA GOVERNMENTAL BONDS--IN THE CORPORATE ALTERNATIVE MINIMUM TAX ADJUSTED CURRENT EARNINGS PREFERENCE, AND;

O INCLUSION OF TAX-EXEMPT INTEREST EARNED ON PRIVATE-
ACTIVITY BONDS IN THE INDIVIDUAL AND CORPORATE ALTERNATIVE
MINIMUM TAX AS A SEPARATE PREFERENCE ITEM.

DATA CLEARLY SHOW THAT THESE TAX LAW CHANGES HAVE AFFECTED
CORPORATE DEMAND FOR STATE AND LOCAL DEBT. AN ATTACHED PIE CHART
ILLUSTRATES HOW BANKS HAVE LEFT THE MARKET. WHAT IS NOT YET
REFLECTED IS THE RECENT DEPARTURE OF PROPERTY AND CASUALTY
INSURERS. INDIVIDUALS ARE NOW THE MOST SIGNIFICANT PURCHASERS OF
TAX-EXEMPT BONDS.

RECENT ENACTMENTS ALONE WILL NOT DESTROY THE MARKET FOR
BONDS HOWEVER, THEIR CUMULATIVE EFFECT IS TO ERODE THAT MARKET
THROUGH INCREASED UNCERTAINTY AND VOLATILITY.

THE CHALLENGES FOR THE TAX-EXEMPT BOND MARKET CONTINUE.
THE ADMINISTRATION'S PROPOSED FAMILY SAVINGS ACCOUNT (FSA), HAS A
LAUDABLE GOAL WHICH NACo SUPPORTS TO STIMULATE SAVINGS AND
INVESTMENT BY MIDDLE CLASS AMERICANS. HOWEVER, THE CAPITAL
FORMATION IT SEEKS TO STIMULATE WILL ONLY BENEFIT PRIVATE
INVESTMENT AND IN FACT IS EXPECTED TO APPEAL TO THE SAME GROUP OF
INDIVIDUALS WHO ARE CURRENTLY THE MAJOR INVESTORS IN TAX-EXEMPT
BONDS.

THESE ACCOUNTS WOULD PERMIT INVESTORS TO EARN INTEREST AT
TAXABLE RATES AND HAVE THAT INTEREST EXEMPT FROM FEDERAL INCOME
TAXES IF THEY ARE HELD FOR SEVEN YEARS. LOCAL GOVERNMENTS WOULD
BE FORCED TO PAY HIGHER BORROWING COSTS JUST TO COMPETE--AN
ULTIMATE COST SHIFT TO ALL TAXPAYERS.

THOSE ELIGIBLE FOR THE FSA WOULD BE INDIVIDUALS WHO HAVE
ADJUSTED GROSS INCOMES LESS THAN $60,000 AND JOINT FILERS WITH
ADJUSTED GROSS INCOMES LESS THAN $120,000. TREASURY DATA
SUGGESTS THAT A SIGNIFICANT AMOUNT OF TAX-EXEMPT BONDS ARE OWNED
BY THIS SAME GROUP OF MIDDLE-INCOME INVESTORS. IN A TREASURY
DEPARTMENT STUDY, 27 PERCENT OF THE TAX-EXEMPT INTEREST REPORTED
WAS LISTED ON RETURNS WITH AN ADJUSTED GROSS INCOME OF UNDER
$50,000 AND 55 PERCENT WAS REPORTED ON RETURNS HAVING LESS THAN
$100,000.

THE SAME HOLDS TRUE FOR TAX-EXEMPT MUTUAL FUNDS WHICH
PERMIT INVESTMENTS BY INDIVIDUALS IN SMALL DENOMINATIONS. A
SURVEY OF THIS GROWTH INVESTMENT VEHICLE WHICH HAS GROWN FROM $4
BILLION TO $93 BILLION IN A DECADE REVEALED, THAT 42 PERCENT OF
THE BONDS WERE HELD BY HOUSEHOLDS WITH INCOMES LESS THAN $50,000
AND 77 PERCENT WITH INCOMES LESS THAN $100,000.

THESE NUMBERS ILLUSTRATE QUITE DRAMATICALLY WHY NACo AND
OTHER STATE AND LOCAL PUBLIC INTEREST GROUPS ARE CONCERNED THAT
THE FSA MAY ENDANGER THE MARKET FOR TAX-EXEMPT FINANCING, WHICH
WILL, IN RETURN, ENDANGER AN ALREADY FRAGILE PUBLIC
INFRASTRUCTURE. IN FACT, THE GOVERNMENT FINANCE OFFICERS
ASSOCIATION RAISED THESE ISSUES ON BEHALF OF NINE PUBLIC INTEREST
GROUPS BEFORE THE HOUSE WAYS & MEANS COMMITTEE EARLIER THIS
MONTH.

NACo STRONGLY URGES CONGRESS AND THE ADMINISTRATION TO
CONSIDER THE POTENTIAL IMPACT OF THIS PROPOSAL ON THE TAX-EXEMPT
BOND MARKET. WE FURTHER URGE YOU TO BRIDGE THE ISSUES OF
STIMULATING SAVINGS AND INVESTMENT IN THE COUNTRY'S
INFRASTRUCTURE THROUGH;

O TARGETING NEW INVESTMENT INTO SOCIALLY AND ECONOMICALLY
DESIRABLE PUBLIC PROJECTS NEEDED TO REBUILD AMERICA, AND;

O RESTORING THE INCENTIVES THAT WERE ELIMINATED FOR BANKS
AND OTHER CORPORATIONS IN 1986, THEREBY BROADENING THE MARKET FOR
TAX-EXEMPT DEBT.

IN SUMMARY, IT IS OUR HOPE THAT WE CAN TURN THE CHALLENGES THAT LIE AHEAD INTO OPPORTUNITIES, NOT ONLY FOR MIDDLE CLASS AMERICANS TO BE ABLE TO INVEST AND SAVE BUT FOR ALL OF US TO REAP THE BENEFITS FROM A PUBLIC INFRASTRUCTURE THAT IS SAFE AND HELPS TO ENSURE THE ECONOMIC WELL-BEING OF AMERICA.

ONCE AGAIN, THANK YOU, MR. CHAIRMAN, ON BEHALF OF NACo FOR THIS OPPORTUNITY TO PRESENT OUR VIEWS. WE LOOK FORWARD TO WORKING WITH YOU AND I WILL BE GLAD TO ANSWER ANY QUESTIONS AT THIS TIME.

TAXATION AND FINANCE STEERING COMMITTEE
RESOLUTION IN SUPPORT OF SAVINGS AND INVESTMENTS
IN TAX-EXEMPT BONDS

WHEREAS, savings and investment are critical to the over all health of the nation's economy; and

WHEREAS, investment in public infrastructure and projects, not only promotes and ensures that basic public services are provided, but aids productivity and allows the United States to compete in an international economy; and

WHEREAS, it has been well documented that the United State's public infrastructure is in need of major repairs and improvements; and

WHEREAS, the most critical tool used by states and local government for financing public capital projects and improving and repairing this country's infrastructure is the issuance of tax-exempt debt; and

WHEREAS, incentives for investing in tax-exempt bonds have declined in the past several years due to several tax law changes, such as the inclusion of tax-exempt interest in the alternative minimum tax and the loss of the deduction for banks who carry tax-exempt securities; and

WHEREAS, the Administration has proposed a savings initiative,the Family Savings Account, which may endanger the market for tax-exempt bonds as it offers a tax-free investment at higher interest rates targeted to the very household sector that invests in tax-exempt bonds:

THEREFORE BE IT RESOLVED, that the National Association of Counties, supports the Administration's goal of providing incentives for savings and investment and further urges Congress and the Administration to target such savings and investments into socially and economically desirable public capital projects needed to rebuild America, such as a deductible Individual Retirement Account vehicle tied to investment in public capital facilities. We further urge Congress and the Administration to abolish the current obstacles to investments in tax-exempt bonds,including the AMT and to restore the bank deduction for interest costs incurred for carrying tax-exempt debt.

Adopted by the Taxation and Finance Steering Committee
(unanimous)
March 17, 1990

Adopted by the NACo Board of Directors
March 18, 1990

Trends in Holdings of Municipal Securities
4th Quarter, 1983

7.20%

18 50%

39 50%

34.80%
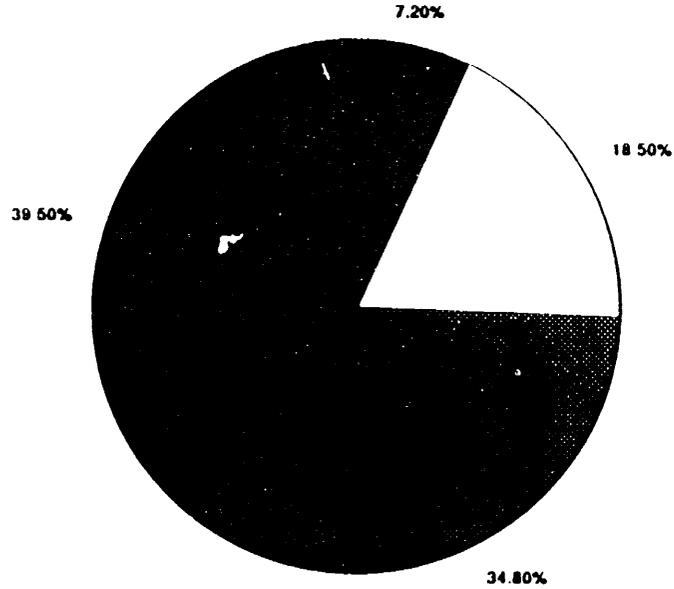
☐ Miscellaneous   ☐ P&C Insurance   ☐ Commercial Banks   ■ Individuals
                      Companies

Trends in Holdings of Municipal Securities
2nd Quarter, 1989

4.90%

20.30%

55.90%

18.90%
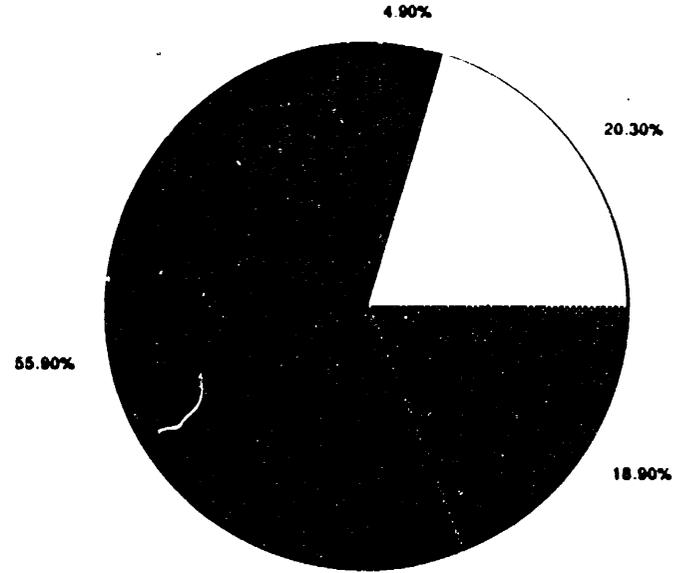
■ Miscellaneous   ☐ P&C Insurance   ☐ Commercial Banks   ■ Individuals
                      Companies

SOURCE: Federal Reserve Flow of Funds

PREPARED STATEMENT OF N. JEROLD COHEN AND DAVID G. GLICKMAN

INTRODUCTION

This testimony has been prepared by N. Jerold Cohen, a partner in the law firm of Sutherland, Asbill & Brennan, who practices tax law in Atlanta, Georgia, and David G. Glickman, a shareholder in the law firm of Johnson & Gibbs, a Profession— al Corporation, who practices tax law in Dallas, Texas and Washington, D.C. The purpose of this testimony is to set forth our views with respect to the tax policy implications of reintroducing into the law a preferential rate of tax for capital gains. The views set forth herein are solely ours.

As a preface, several points should be noted. We are tax lawyers, not economists. Thus, we express no views as to the macroeconomic effect of such reintroduction, or its revenue impact. Furthermore, we are not tax purists—we believe that the tax system may at times be used to deliver a subsidy, in addition to being used to raise needed revenues (although this clearly should be its principal purpose, and history demonstrates that we are better served when the system is used for this purpose). If those in authority determine that a subsidy is appropriate, the tax system should be available to deliver the subsidy provided that the following conditions are met: (1) the tax expenditure is subject to the budgetary process in a manner similar to direct expenditures; (2) the expenditure is subject to sunset so that it can be reviewed on a regular basis; and (3) the tax system is determined to be the most efficient manner to deliver the subsidy.

Based upon our experience as tax practitioners, as former government employees, as teachers and lecturers on the subject of tax policy, and anecdotal information obtained from other practitioners, we conclude that from a tax policy standpoint a preferential rate for capital gains *should not* be reintroduced into the law. Thus, if such reintroduction is deemed appropriate, in our view such a decision must be based on reasons other than sound tax policy.

THE INTRODUCTION OF A PREFERENTIAL RATE FOR CAPITAL GAINS VIOLATES ALL GOALS OF SOUND TAX POLICY

As stated, if there are reasons for reintroducing a preferential rate for capital gains, they have nothing to do with sound tax policy. In fact, such a step would seem to violate every precept of a rational tax system. Sound tax policy involves consideration of the effect of a tax proposal on the efficiency of business transactions, on fairness in the tax system (generally referred to as horizontal and vertical equity) and on simplicity (both from the standpoint of the taxpayer and the Internal Revenue Service). None of these concerns are furthered by a preferential rate for a particular type of income.

A capital gains tax preference promotes certain types of activities and the structuring of transactions in particular ways in order to obtain the preference. It may be that this behavior is the desired goal, but the efficiency of achieving this goal through the tax system should be examined. Unless a particular tax provision is carefully targeted, its benefits not only encourage the desired behavior, but also spill over to attract a number of transactions never thought to be within its reach and to distort other transactions in a manner never intended. There is no question but that a broad based capital gains rate preference would have exactly these results.

The rate preference also is questionable from the viewpoint of horizontal equity (i. e. similarly situated taxpayer, should be treated similarly). It is difficult to convince the wage earner who has an income of $50,000 that he should be taxed at a much higher rate than the trader who earns $50,000 speculating in the market. Recent studies also indicate that even within the upper income tax group the benefits of a capital gains tax are skewed to those having multiple capital transactions.[1]

Similarly, a question exists as to the effect that a capital gains preference has on vertical equity. Although the question historically has been raised as to the percentage of tax various income groups should pay, from the inception of the Internal Revenue Code we have had a progressive system. Assuming that such a system remains intact, the distributional effect of the reintroduction of a capital gains preference should be examined in light of studies indicating that the distribution of the benefits of such a proposal are targeted to high income taxpayers.[2]

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[1] Analysis by Staff Joint Committee on Taxation in Response to Request by Representative Byron Dorgan (January 18, 1990).

[2] See, e.g., Joint Committee on Taxation Staff Estimate of Administration Proposal for Reduction in Taxes on Capital Gains of Individuals (February 14, 1990).

Finally, and perhaps most importantly, the reintroduction of a capital gains preference would add substantially to the complexity of the Internal Revenue Code of 1986, as amended (the "Code") and to the difficulties of administration of its provisions by the Internal Revenue Service. Historically, such complexity has been recognized as one of the "Achilles' heels" of the preference. For example, over thirty years ago it was noted in Congressional hearings that the preferential treatment for capital gains was singly responsible for the largest amount of complexity in the tax system.[3]

Almost all of the practitioners that we have consulted agree that the Tax Reform Act of 1986 eliminated a substantial. measure of transactional complexity when it eliminated the capital gains tax preference.[4] The capital gains tax preference was the "potting soil" for the complex structuring of legitimate transactions as well as for tax shelter transactions. Tax shelters primarily relied upon deferral of tax or conversion of income from ordinary to capital. While the lower rates, the at-risk rules and the passive loss rules all converged to eliminate most abusive transactions, we have enough faith in the tax practitioner to believe that the reintroduction of capital gains will reignite the gaming" of the system.

However, it is in the area of legitimate transactions that we are most concerned. Tax planning is enormously simplified when transactions can be planned without concern for a rate break. Issues concerning the definition of a capital asset, whether there has been a sale or exchange, and the length of holding periods are no longer the focus of transactional analysis.

Of course, in 1986 most of the complex network of statutory provisions resulting from a capital gains regime was retained in the Code, with the stated purpose thereof to make a reintroduction of the preference easier to achieve (such provisions were also required by the continuation of the limitation on capital losses). However, one may now frequently ignore these provisions. With the elimination of capital gains there is the hope that other complex, litigation productive provisions may be eliminated, such as the collapsible corporation provision and the accumulated earnings tax provision. Thus, it seems clear to us that the Tax Reform Act of 1986 struck a blow for reduction of complexity in the tax system and the reintroduction of a preferential rate for capital gains is a step in the wrong direction from a tax policy prospective.

A PREFERENTIAL RATE FOR CAPITAL GAINS MAY OFFSET INFLATIONARY COMPONENTS OF CAPITAL GAINS

Historically, various tax policy reasons have been given for the reintroduction of the preference for capital gains. For example, when the tax rate was much more steeply graduated, it was argued that "bunching" of capital gains in the year of disposition in the highest bracket was unfair since a portion of the taxable gain was arguably earned each year the property was held. This problem seems to have been solved in 1986 with the lessening of the number of brackets, the reduction of rates and the reduction of income levels for which the maximum marginal rates came into effect (even the need for income averaging was deemed eliminated).

Furthermore, it has been argued that without a capital gains preference, a "lock-in" of investment will take place since taxpayers can avoid forever paying tax on taxable gain by simply holding the property until death. If this is deemed to be a problem (and many believe it is), the most disingenuous way to attack it is by giving a preference on capital gains. Rather, the problem should be attacked directly by either adopting an accrual concept for taxable gain or applying a tax on gain for lifetime gifts and at death. Realistically speaking, the adoption of either of these two approaches is unlikely, but using a capital gains preference to solve the problem is certainly an unsuitable substitute.

Finally, and perhaps most importantly, it has been argued that a preferential rate for capital gains is necessary to remove the inflationary components of capital gains from taxation. Taxing such illusory gain is certainly a great concern. Applying a reduced tax rate to certain gains, however, strikes us as a rough and inexact solution to this problem.

First, as noted previously, gain is often actually earned over a period of years. In such case it can be argued that not taxing such gain annually is a benefit to taxpayers equal to an interest-free loan by the government. This issue was addressed in

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[3] S. Surrey, Definitional Problems in Capital Gains Taxation, reprinted in 2 Tax Revision Compendium, Comm. on Ways and Means, 1203 (Comm. print 1959)

[4] See, e.g., Draft Report of Capital Gains Task Force, Section of Taxation, American Bar Association (1989) (seven members voting).

1986 when in certain circumstances interest was charged on a deferred payment of tax on installment sales. If this analogy is correct, a question is raised as to the extent of the detriment of taxing illusory gain when adjusted for the tax benefit of deferral of payment of tax.

In any event, if the purpose of introducing a preferential rate for capital gains is to serve as some crude proxy for indexing the basis of capital assets, why not simply adopt indexing. Indexing the basis of each asset for inflationary price increases constitutes far better tax policy than utilizing a preferential rate for this purpose.

Although indexing is one option presently being considered, it carries its own "complexity baggage."[5] For example, will additional problems be created by indexing capital assets and not debt relating thereto? It seems to us that a legitimate question exists as to whether the problems that would be created by indexing are justified by the problem deemed to exist. We do not feel comfortable recommending the inclusion of indexing into the law without a great deal more study.

Finally, if a capital gains preference is reintroduced, what form is the most palatable? Proposals have been made to adopt a provision that would increase the capital gains preference the longer the property is held. Obviously, with respect to the illusory gain, and perhaps fairness, this might be a desirable approach. However, from both the taxpayer's and the government's standpoint, the complexity problem could be severe both from a transactional and statutory viewpoint. For example, what do you do when several assets with different holding periods are disposed of in the same year? Do you use a "basket" approach based on holding periods? Do capital loss carryforwards consist of a series of losses with different holding periods? What approach is taken with respect to passthrough entities such as mutual funds? Thus, any such approach should be reviewed closely to make certain that such fine tuning" is required. Perhaps, a bright and clear line would be better.

SOUND TAX POLICY REQUIRES THE ELIMINATION OF THE DISTINCTION BETWEEN ORDINARY AND CAPITAL LOSSES

Some of the same considerations that cause those of us who labor in our tax system to be concerned with the possible reintroduction of the capital gains preference also apply to the retention of the distinction between ordinary and capital losses. The taxation of what is thought of as capital gains at ordinary income rates with a restriction on the deduction of capital losses is patently unfair even to those of us who are used to dealing with inequities under the Code.

Presumably, Congress did not take this step in 1986 because of what is known as the cherry-picking problem"—the ability of a taxpayer having a substantial portfolio of marketable securities to selectively realize losses and thereby eliminate taxable income.

While this concern may make some sense when one is dealing with marketable securities, it seems less plausible in the case of assets for which there is no ready market. It is difficult to imagine tax planning based upon the selective sale of closely held stocks or even real estate investments. To the extent a taxpayer is wealthy enough to have a large portfolio of such assets and relatively easy access to purchasers, perhaps some tax planning would take place with non-marketable assets. The benefit to the system of the elimination of the capital loss distinction, however, would warrant taking a risk that there will be an occasional situation where non-marketable assets may be so used.

Marketable securities present a different problem. Even that problem could be overcome, however, by adoption of a mark to market concept similar to that recently adopted to confront the tax straddle problem.[6] If a taxpayer wished to obtain an unlimited deduction of a loss on a marketable security, the taxpayer could elect to mark all of his or her marketable securities to market, thereby preventing a situation where a taxpayer is "cherry-picking" the losses and continuing to defer gains.

Such a solution would not be simple. To avoid the isolation of appreciated marketable securities, attribution of holdings might be necessary. However, such additional complexity would be a small price to pay for the elimination of the complexity produced by requiring all capital losses to be subject to special treatment.

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[5] For a brief discussion of the problems inherent with indexation, see, E. Cohen, The Pending Proposal to Index Capital Gains, Tax Notes 103 (October 2, 1989).

[6] See, paper by Martin D. Ginsburg, *Income Tax Complexity: Capital Gain and Loss Issues,* Presented at Invitational Conference on Reduction of Income Tax Complexity (January 11-12, 1990).

SIMPLIFICATION OF THE TAX SYSTEM DUE TO THE ELIMINATION OF THE PREFERENTIAL RATE FOR CAPITAL GAINS IN 1986

One of the most significant accomplishments of the Tax Reform Act of 1986 was the simplification of the tax system caused by the elimination of the preference for capital gains coupled with the lowering of tax rates. At some point, a lower rate causes taxpayers to no longer want to "game" the tax system because it is not in their economic interest to pursue avoiding taxes. Any type of incentive to prefer one type of investment over another will once again reintroduce gaming. Furthermore, if additional revenue were needed to pay for the reintroduction of the capital gains preference, it certainly will be argued that such revenue properly should come from an increase in marginal rates. We believe that such a result—increasing marginal rates to reduce rates on gains from the sale of capital assets—is a backward result. Thus, to keep the backbone of the simplification accomplished by the Tax Reform Act of 1986 in place, tax rates should be kept low and preferential rates should not be granted to any particular class of assets.

CONCLUSION

Based on the above, we submit that Congress should move very cautiously before reversing the action taken in 1986. In addition, we believe that problems dealing with the illusory gain result from inflation should be studied to determine the extent of the problems and the complexities involved in trying to solve them. Finally, action should be taken with respect to the treatment of capital losses to promote tax equity and simplicity.

PREPARED STATEMENT OF KENNETH W. GIDEON

[March 27, 1990]

Mr. Chairman and Members of the Committee: I am pleased to have this opportunity to discuss the role of tax incentives for personal saving, and in particular the Administration's Family Savings Account ("FSA") proposal. Sidney Jones, Assistant Secretary for Economic Policy in the Treasury, is here with me today to discuss the effects of FSAs on personal saving.

In addition to FSAs, the President's budget contains two other proposals designed to address the nation's low rate of savings: the capital gains proposal and the proposal to expand IRAs to include savings for a first home. The capital gains proposal provides for a permanent partial exclusion from tax of gains on long-term investments in productive assets. The IRA proposal will allow millions of American families an opportunity to save for their first home.

All three proposals are included in the Administration's "Savings and Economic Growth Act" which has been introduced in both houses of Congress—in the Senate by Senator Packwood, Republican Leader Dole and Senator Roth as S. 2071 and in the House by Representative Archer as H.R. 3972. These proposals together represent a balanced, prudent package of savings stimulants which are consistent with our overall national economic goals. Increased savings would lower the cost of capital for our nation's business, enhance the ability of American companies to compete in a global market and lower the cost of most goods and services we consume.

TAXATION OF INVESTMENT INCOME AND SAVINGS

General Description of Current Law.—Investment income earned by an individual generally is included in gross income. In addition, new funds added to an individual's savings generally are not deductible from gross income. Such increases in individual savings include deposits to savings and other investment accounts, as well as additional purchases of stocks, bonds, and other investment media.

The tax treatment of retirement savings represents the main exception to these two general rules. In the case of retirement savings, income earned in tax-qualified retirement savings vehicles generally is excluded from gross income, while new contributions to such vehicles generally are deductible from gross income (or excluded from an employee's gross income if the contribution is made by his employer), usually within statutory limits. Well-known examples of tax-qualified retirement savings vehicles include IRAs, section 401(k) plans, qualified pension plans, and section 403(b) annuities.

Retirement savings are clearly an important part of overall national savings but savings for this special purpose are subject to national retirement income policies which can be restrictive and discourage savers with long-term, but less than lifetime

savings goals. For example, the tax-favored retirement savings vehicles contain certain provisions which, in one way or the other, penalize the withdrawal of savings before retirement age.

Current Law IRAs.—The IRA is the present law tax-qualified retirement savings vehicle that most closely parallels the President's proposed Family Savings Account. Currently, the maximum annual deductible contribution that can be made to an IRA is generally the lesser of $2,000 or the individual's compensation for the year, except in the case of a nonworking spouse for whom the maximum annual deductible contribution is $250. The maximum annual deductible contribution is available to single taxpayers with no more than $25,000 in adjusted gross income ("AGI"), to married taxpayers with no more than $40,000 in AGI, and to other taxpayers who are not active participants in employer-sponsored retirement plans regardless of the amount of their AGI. For taxpayers who are active participants in employer-sponsored retirement plans, the maximum annual deductible contribution is phased out for single taxpayers with AGI between $25,000 and $35,000, and for married taxpayers with AGI between $40,000 and $50,000.

Taxpayers who are not entitled to the maximum annual deductible contribution may make nondeductible contributions to an IRA. As is the case with earnings on deductible IRA contributions, earnings on nondeductible contributions accumulate on a tax-deferred basis.

With the exception of nondeductible contributions, amounts withdrawn from an IRA are included in gross income at the time withdrawn. Withdrawals before age 59-1/2, death, or disability generally are subject to an additional 10-percent penalty tax. IRA withdrawals must begin by age 70-1/2.

Proposals to Expand Current Law IRAs.—A number of legislative proposals have been made recently to modify current law IRAs. The Administration's Savings and Economic Growth Act would permit penalty-free IRA withdrawals for first-time home purchases. Also, under several expanded IRA proposals, an individual who contributes to an IRA may deduct the amount of the contribution that is deductible under current law, plus 50 percent of the amount of the contribution that is not deductible under current law, subject to the current law maximum contribution limits. These proposals typically permit penalty-free withdrawals from IRAs for first time home purchases and certain higher education expenses. However, IRA expansion proposals do not change the fundamental character of IRAs as vehicles dedicated to retirement savings nor do they increase the current law limits for contributions by nonworking spouses.

FAMILY SAVINGS ACCOUNT PROPOSAL

Description of Proposal.—The President's Family Savings Account proposal is designed to provide an incentive for savings generally, not merely retirement savings. Under the proposal, individuals may make nondeductible contributions to an FSA of up to $2500 per taxpayer. Unlike IRAs, there are no special limitations on contributions by a nonworking spouse. In order to target the saving incentive, contributions are allowed only for single people with AGIs below $60,000, for those filing as heads of households and surviving spouses with AGIs below $100,000, and for married couples filing joint returns with AGIs below $120,000. These contributions will be allowed in addition to contributions by or for these individuals to tax-favored retirement savings vehicles.

Although contributions to an FSA are nondeductible, earnings in the account accumulate tax-free. Furthermore, earnings can be withdrawn tax-free, provided they are earnings on contributions held in the account for at least 7 years. Withdrawals of earnings on contributions held in the account for less than 7 years are included in gross income. In addition, withdrawals of earnings on contributions held in the account for less than 3 years are subject to a 10-percent early withdrawal tax.

Comparison to Current Law IRAs.—Besides the timing of the tax benefit which is discussed in greater detail below, the principal differences between FSAs and current law deductible IRAs lie in the greater availability and flexibility of FSAs as a savings vehicle. While it is appropriate to have a dedicated retirement savings vehicle such as an IRA, the need to increase the nation's personal savings rate calls for a vehicle that is available for more general types of savings and that takes into account the different savings needs of individuals. For example, a young or middle-aged couple may be unwilling to set aside their savings in an IRA that cannot be withdrawn without adverse tax consequences until their retirement. Likewise, an older couple may be willing to save even though they have reached an age when the mandatory distribution rules discourage contributions to an IRA. FSAs address these shortcomings in the current system by encouraging individuals to save with-

out imposing the restrictions that are needed in a vehicle dedicated to retirement savings.

Because contributions need be held in an FSA for only 7 years to receive full tax benefits, individuals have far greater flexibility in structuring their savings through an FSA than through an IRA. This increased flexibility is most apparent in the penalty provisions applicable to early withdrawals. While distributions from an IRA are generally subject to penalty at any time before retirement, death, or disability, distributions from an FSA are subject to penalty only within 3 years from the date of contribution. In addition, the 10-percent penalty on IRA distributions applies to the entire amount of the distribution (except to the extent the distribution consists of nondeductible contributions), while the same 10-percent penalty on FSA distributions applies only to the amount of earnings distributed. This difference in both the timing and the severity of penalties means that saving in an FSA is a far less risky proposition for those whose savings goals are not limited to retirement needs.

Finally, the FSA encourages individuals to save who fall outside the current limits applicable to IRAs. The nonworking spouse, who is limited to a $250 contribution to an IRA, generally will have the opportunity to make the full $2,500 contribution to an FSA. Contributions to an FSA are also permitted regardless of whether an individual is an active participant in an employer-sponsored retirement plan, in contrast to an IRA where deductions for contributions are phased out for such individuals with AGIs above $25,000 in the case of single taxpayers and above $40,000 in the case of married taxpayers. The AGI limits that do apply under the FSA proposal are significantly higher than those imposed under current law deductible IRAs and take into account the special circumstances of heads of households that are ignored under the current IRA regime.

Comparison to Expanded IRA Proposals. After careful study of the various alternatives, the Administration has concluded that the FSA proposal would serve a broader range of savings needs than an expansion of the IRA program.

FSAs offer a more flexible vehicle for encouraging savings of all kinds by taxpayers in more diverse personal circumstances. Expanded IRA proposals do not change the fundamental character of IRAs as vehicles dedicated to retirement savings even when they permit more liberal withdrawals than current law. The Administration agrees that IRAs should not be diverted from their intended purpose of encouraging retirement savings, and for this reason designed FSAs as a savings incentive separate and apart from the IRA regime. This approach continues IRAs as dedicated retirement savings vehicles, while at the same time permitting taxpayers to save without regard to their reasons for doing so and without imposing on them constraints that are really only appropriate in a retirement savings environment.

The FSA provides on affordable and effective savings incentive which can be accommodated within the budgetary constraints imposed under the Gramm-Rudman-Hollings law. The Treasury estimates the revenue cost of the FSA proposal at $4.7 billion in the 1990-95 budget period; the Joint Committee estimate of $5.0 billion over five years is quite similar. IRA expansion proposals are significantly more expensive often for significantly lower benefit levels. Over the long-term, the FSA proposal is likely to be no more expensive (proportionate to the tax benefits conferred) than expanded IRA proposals, when considered on a present value basis. This is because of the essential revenue equivalence of current contribution deduction savings incentives like IRAs and earnings exemption savings incentives like FSAs.

REVENUE COST OF THE FSA

The annual revenue loss estimates for the FSA proposal are as follows:

FISCAL YEAR

[Billions of dollars]

1990	1991	1992	1993	1994	1995	1990-95
(1)	−0.2	−0.6	−1.0	−1.3	−1.6	−4.7

1 Loss of less than $50 million
Note: Assumes an effective date of 1/1/90

The static revenue cost of the proposal is mainly due to the switching of taxable assets into FSAs. Revenue is lost on the cumulative interest build-up that would otherwise be taxed. As more taxable assets are switched into FSAs, the revenue cost

associated with the proposal will increase due to the compounding of interest on new contributions as well as interest compounding on existing balances.

The proposal allows withdrawals earnings from FSAs after three years without penalty and after seven years without penalty or income tax payment. To the extent that individuals use FSAs as a substitute for other relatively liquid forms of saving, we expect some individuals to begin withdrawing funds after the three-year penalty period. This withdrawal behavior mitigates the revenue cost of compounding interest on FSA balances.

Long Range Revenue Effects

The above revenue estimates were produced using the Administration's economic forecast, which is available only through 1995. To produce estimates for years beyond 1995 would require an extrapolation of the official forecast. Such an extrapolation would be highly problematic given the uncertainties surrounding long-run macroeconomic forecasts. Further, because saving behavior depends on demographic as well as macroeconomic factors, forecasts of demographic changes and of taxpayers' saving responses to these changes would also be required. Very small changes in the economic or demographic forecasts, or in estimates of taxpayers' behavioral responses, could lead to very large differences in long-run estimates of the revenue cost of FSAs. Therefore, such long-run estimates would not provide a reliable guide for decision-making.

Although we do not have a quantitative estimate of the long-run revenue cost of the FSA proposal, we can make some qualitative observations. The proposal is expected to continue to lose revenue beyond the budget period. The level of revenue loss will depend, as noted above, on changing demographics, economic conditions, and taxpayer behavior, all of which will affect the level of contributions to FSAs as well as the source of those contributions. The long-run revenue loss will also depend on the average length of time taxpayers hold FSAs. The source of FSA contributions and the average holding period for FSAs are important because most of the revenue loss from FSAs is the income tax lost on earnings on investments that, in the absence of FSAs, would have been placed in taxable accounts. Because the investment earnings grow at a compound rate, this revenue loss increases with the average holding period for FSAs.

The Congressional Budget Office's report, An Analysis of the President's Budgetary Proposals for Fiscal Year 1991, states that at 1991 income levels: (1) if 10 percent of taxable interest and dividend income were switched into FSAs, long-run revenue costs would reach $8 billion per year; and (2) if 25 percent of taxable interest and dividend income were switched into FSAs, long-run revenue costs would reach $20 billion per year. As noted above, such long-run estimates are based on numerous assumptions that may not be valid. Experience with IRAs does not support the CBO assumptions. To reach a revenue loss of $20 billion per year would require switching $1 trillion of taxable assets into FSAs. However, since 1975, when IRAs first became available, only about $200 billion has been contributed to IRAs, and not all of those contributions resulted from switching taxable assets. Further, IRAs were more broadly available over much of this period than FSAs would be under the President's proposal. Thus, the $200 billion in cumulative IRA contributions since 1975 represent only about one fifth as much asset switching as assumed by CBO.

DISTRIBUTIONAL IMPLICATIONS OF THE FSA

A distribution table for the FSA proposal is presented in Figure 1.

EFFECTS OF THE FSA ON THE MUNICIPAL BOND MARKET

We are aware of concerns that have been raised regarding the effect of the FSA proposal on the tax-exempt bond market. However, our analysis suggests that FSAs will have at most a small impact on the tax-exempt bond market for the following reasons. First, some portion of FSA contributions should be new savings, and to that extent will not compete at all with other investment vehicles.

Second, in 1988 holdings of tax-exempt bonds by individuals were only 55 percent of the total holdings of tax-exempt bonds, although this share has been growing. Our analysis shows that only a third of individuals' holdings are by individuals that are eligible for the FSA program. Many of these individuals will not participate in FSAs, or will not participate fully. Applying reasonable participation rates to those eligible individuals who hold tax-exempt bonds, and taking into account the growing share of individuals' holdings, we estimate that only about 5 percent of the tax-exempt bond market would be potentially affected by FSAs.

Third, past experience with IRAs, All Savers Certificates, 401(k)s, and other forms of tax-favored savings indicates that municipal bonds have been able to compete ef-

fectively with savings incentives similar to the FSA. Consequently, we conclude that the FSA program is unlikely to cause a material decrease in purchases of tax-exempt bonds by individuals or to decrease the interest rate spread between taxable and tax-exempt bonds.

INSURANCE PRODUCTS

Although the explanatory material accompanying the President's FSA proposal as transmitted to Congress on February 1 indicated that FSA deposits may not be invested in insurance contracts, the Administration is prepared to consider variation of the FSA proposal that would involve annuities. If a vehicle similar to individual retirement annuities were included in the proposal, we do not believe that there would be a material effect on the revenue estimate or other analysis presented above.

CONCLUSION

Based on the foregoing, we strongly urge the Congress to enact the Family Savings Account proposal as well as the other provisions of the Savings and Economic Growth Act.

Mr. Chairman, that concludes my formal statement. I would be happy at this time to answer questions from you or any other members of the Committee.

SCHEDULE A

	Family Savings Account	Current Law IRA
Tax Treatment of Contributions	nondeductible	some deductible some nondeductible
Tax Treatment of Inside Build-Up	tax-free	tax-free
Tax Treatment of Distributions	tax-free	fully taxable except for non-deductible part
Maximum Annual Contribution	$2,500	$2,000
Maximum Annual Contribution for Nonworking Spouse	$2,500	$250
AGI Limits for Full Tax Benefit		
Married	$120,000	$40,000*
Head of Household	$100,000	$25,000*
Surviving Spouse	$100,000	$25,000*
Single	$60,000	$25,000*
Penalty-Free Withdrawal of Account Balance	after 3 years	not until age 59-1/2, death or disability
Amounts Subject to Penalty	earnings only	earnings plus contributions
Fully Tax-Favored Withdrawal of Account Balance	after 7 years	not until age 59-1/2, death or disability
Type of Savings Permitted	any type	retirement

*--Except in the case of individuals who are not active participants in an employer-sponsored retirement plan for whom there is no limit.

Note--The President's budget would amend current law IRAs to permit penalty-free withdrawals for first-time home purchases.

Distribution of Tax Reduction: President's FSA Proposal
1990 Levels

Percent of Total Change in Tax Liability

Adjusted Gross Income Class ($ 000)
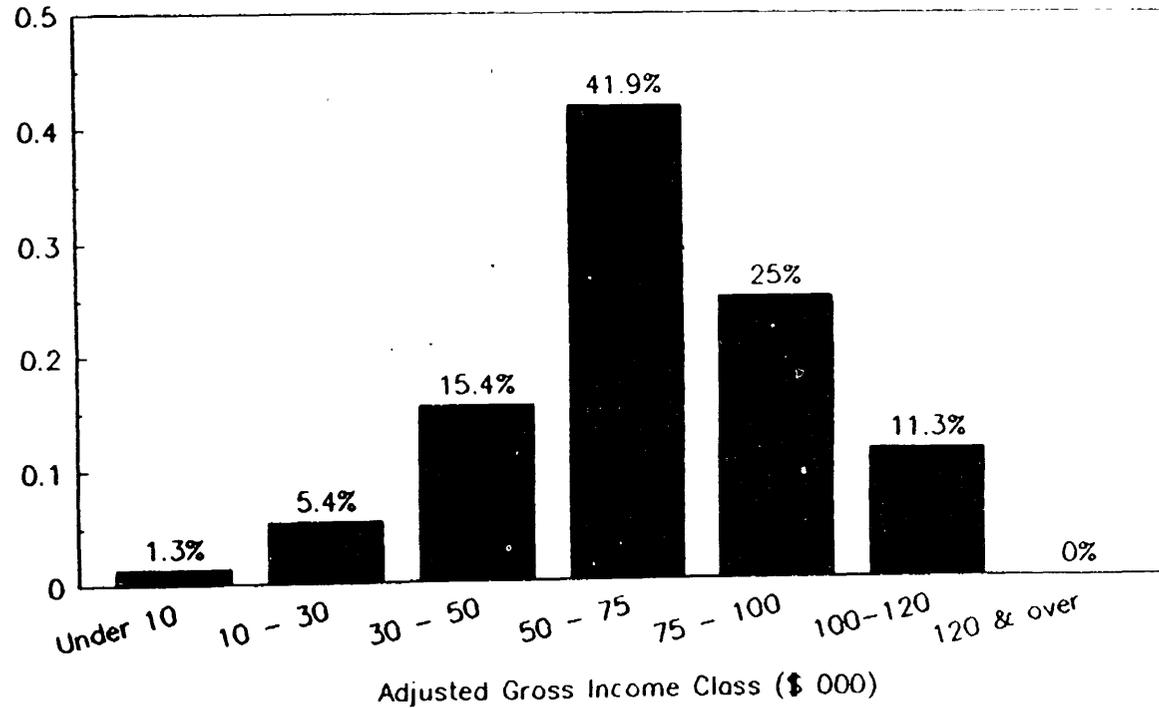
U.S. Department of the Treasury
Office of Tax Analysis

March 22, 1990

PREPARED STATEMENT OF KENNETH W. GIDEON

[March 28, 1990]

Mr. Chairman and Members of the Committee: I appreciate this opportunity to discuss with you today the proposed capital gains rate reduction for individuals contained in the Administration's 1991 budget. Over this year and last, the arguments for a capital gains tax cut have been stated in great detail, and I will not attempt to review the entire catalogue this morning. For those who wish more detail, I would refer to my March 6 testimony before this Committee[1] and to the General Explanations of the President's Budget Proposals Affecting Receipts which we published in January 1990.

Dr. Boskin in his testimony has already addressed the crucial issue of economic growth. Judgments about how best to configure a tax system to promote economic growth are, of course, not made by the United States alone. They are made by our major trading partners as well. The difference between their judgments and those reflected in our current tax law on this issue is striking. We alone among the other G-7 countries—Canada, France, Germany, Italy, Japan, and the United Kingdom—provide no relief from ordinary rates on capital gains. Chart 1 attached to my testimony provides a country-by-country comparison. Most of these nations have also integrated their corporate income tax systems to eliminate or reduce multiple layers of taxation on corporate income. The focus in their tax policy on capital formation is clear. These differences are all the more striking when one considers how quickly these countries responded to our rate reductions in 1986. Since 1986, all have enacted rate reduction measures. See Chart 1.

These developments raise the question whether the United States will volunteer to become the control case in an international tax policy experiment during the next decade. While our major trading partners vigorously pursue tax policies intended to lower the cost of capital and make their businesses as competitive as possible, opponents of a capital gains tax cut would have this country take the opposite course.

Our competitors are also industrialized democracies. We know from the reports of their political debates that they too are concerned about distributional issues. Yet they have chosen a very different path with respect to capital income taxation. Their policies demonstrate a recognition that capital is the seed corn of economic growth benefiting their entire populations. It is important that we understand that if they are right—and if we fail to alter our own course—our distributional disputes will be about a shrinking portion of the world's wealth.

We must also come to grips with the fact that the new birth of freedom and free markets, which offers so much promise for a better future, may limit this Committee's freedom of action. The time has passed when the United States may design its tax system without regard to the impact of that system on the ability of Americans to compete in the global market. The stakes here are not just profits, but jobs. We are apt to discover over the next 10 years that a tax system which imposes a higher burden on capital than our trade competitors' systems may prove as great a competitive handicap as inefficient technology.

REVENUE ESTIMATES

Let me now turn to the question of the revenue estimates. The differences between the Joint Committee on Taxation staff ("JCT") and Treasury Office of Tax Analysis staff ("OTA") estimates are set forth in Chart 2.

On March 6, I delivered to this Committee a detailed description of our revenue estimating methodology and assumptions. I called on the Joint Committee staff to make public the same information on their methodology "as promptly as possible." A lengthy pamphlet has emerged, shortly before this hearing. (Joint Committee on Taxation, *Explanation of Methodology Used to Estimate Proposals Affecting the Taxation of Income from Capital Gains*, JCS 12-90, March 27, 1989.)) Given its length and the brief period we have had to review it, my responses today must be preliminary.

The most striking thing about the pamphlet is what is not in it. In Table 5 and the Appendix to my March 6 testimony, the equations and parameters necessary to replicate OTA's estimates of the year-by-year revenue impact of the President's capital gains tax proposal were presented. Unfortunately, the same detailed specification of the methodology used by the JCT is not provided in the JCT pamphlet. We

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[1] The portion of my March 6 statement dealing with the capital gains issue has been made available as an Appendix for the convenience of the Committee.

presented the actual equations used, the average tax rates with a 10 percent, 20 percent, and 30 percent exclusion, the elasticities used each year, and the parameters for the portfolio effects used each year. These items are absent from the JCT pamphlet. Instead, Appendix A to the JCT pamphlet offers us two equations from the literature without telling us that they were the equations used by the JCT—only that their equation is "much like" one of the equations presented. We would still like to have a complete set of data comparable to what we provided in my March 6 testimony.

Second, the pamphlet confirms the critical factual assertions made in my March 6 testimony about the primary reasons for the difference in estimates. The CBO baseline figures are substantially higher than Administration figures. In addition the JCT effective elasticity is lower than that used by Treasury, and we remain convinced that their effective elasticity is lower than the elasticity used last year. The Joint Committee has stated that its current long-run elasticity for all assets is 0.66, as opposed to the 0.71 reported in Mr. Pearlman's testimony last year; but more importantly, they note that they have changed their equations, so that even if they had used exactly the same elasticity (at a 20 percent tax rate), their overall results would be expected to differ. Indeed the JCT appears to admit that the application of their last year's methodology would result in a smaller revenue loss for the current proposal.[2] It is worth emphasizing that in this context what appear to be trivial differences may have large revenue consequences. Keep in mind that the Joint Committee in this pamphlet attributes virtually the entire $23.9 billion difference between the estimates to the .14 difference (.66 JCT, .80 OTA) in long-term elasticities and the .10 difference (1.1 JCT, 1.2 OTA) in short-run elasticities.

ELASTICITY

The Joint Committee pamphlet asserts that the difference in elasticities accounts for virtually the entire difference in the estimates. To test this proposition, OTA ran its model substituting the JCT elasticities for the OTA elasticities reported on March 6. Given OTA's best guess about the pattern of JCT elasticities over the budget period, we found that substituting their elasticities for the OTA elasticities lowers the revenues for a straight 30 percent exclusion from a $6.5 billion gain [3] to a $11.3 billion loss—a difference of $17.8 billion. This accounts for about 63 percent of the total difference between the $21.8 billion loss estimated by the JCT and the $6.5 billion gain estimated by OTA for lines I and II of the estimates as shown in Chart 2. This suggests that other factors, including baseline and tax rate assumptions, account for a significant part of the difference. An alternative way to have examined this issue would have been to estimate the effect of the 30 percent exclusion using the JCT model with the OTA elasticities. However, given the data published thus far, we are unable to determine what the results of running our elasticities in the JCT model would be.

Nonetheless, the choice of elasticities remains a critical issue. The JCT defense of its choice of elasticities indicates that the JCT has been quite selective in its use of statistical evidence. For example, in its review of econometric studies, the JCT rejects the results obtained from cross-sectional data sets. These studies tend to produce higher elasticities than those generated by time-series equations.

Jane Gravelle's recent report contains a similar approach to analyzing the results in the econometric literature. ("Can a Capital Gains Tax Cut Pay for Itself?," CRS, March 23, 1990.) Like the JCT, Gravelle gives short shrift to the studies based on cross-sectional data, which reach conclusions inconsistent with her views. She notes that many of the econometric studies present a range of estimates, and faults the Treasury for presenting only the midpoints in the ranges. It is inherently difficult, however, to summarize in a single number the results of complicated statistical

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[2] Footnote 51 of the JCT pamphlet states "There is no question that *if* the elasticity specification used both last year and this year to estimate proposals involving a 30-percent exclusion had been applied to last year's Administration proposal (which provided a 45-percent exclusion), it would have resulted in a lower elasticity." While the precise meaning of this sentence is unclear, it seems to confirm that this year's JCT methodology may be characterized by a lower effective elasticity than last year's.

[3] This amount is the sum of lines I and II in Chart 2 and in Table 7 of my March 6 testimony. In order to make lines I and II of Chart 2 comparable to lines I and II in the Joint Committee estimate, it was necessary to estimate a 30% exclusion proposal (rather than the actual 3-tier Administration proposal) because the JCT does not account for the 20% and 10% exclusion in the static and induced lines of its table. Accordingly, footnote 2 to Table 2 of my March 6 testimony provides estimates for a 30% exclusion consistent with the JCT approach and treats the tiered effects as does the JCT. Footnote 2 was presented to facilitate a comparison of the OTA and JCT estimates.

studies. Although the Treasury approach may be mechanical, it has an important advantage: it limits the effects of any biases that the analyst might have.[4] By contrast, Gravelle presents her "preferred" elasticities for each study. Most of her preferred values tend to be at the low end of the range of estimates. To cite an example of the judgmental nature of her "corrections," the 0.58 figure cited for the paper by Darby et al. ignores the fact that when the authors use their results for simulating the effects of a capital gains tax reduction, they find that revenues increase.

We also disagree with Gravelle's characterization of our own elasticity as 0.98. This elasticity does not take into account portfolio effects, whereas OTA's actual revenue estimates, in effect, use a lower elasticity that includes portfolio effects. We believe that this lower figure, the 0.8 elasticity that we reported in our March 6 testimony, is a more accurate way to describe our methodology.

In contrast to JCT and Gravelle, the Treasury's evaluation of the econometric evidence takes seriously the results of both cross-sectional and time-series studies. The cross-sectional methodology is a standard procedure widely used in econometrics to analyze a variety of phenomena. To discount the results of such studies seems inappropriate, especially since there are a number of economists who would argue, contrary to the JCT, that it is more difficult to make valid inferences from time-series than from cross-sectional data.

There are several problems with time-series analyses. First, aggregate data tend to trend up or down together over time. Therefore, it is difficult to discern the independent effect of any particular variable. Second, in a time-series analysis one must characterize the entire tax system by a single tax rate number. Therefore, much information on variations across taxpayers is lost. Finally, because time-series equations are based on relatively few observations, the results tend to be very sensitive to the inclusion of new data. For example, in an equation based on a time-series from 1956 to 1986, Auerbach found an elasticity of about zero. When he reestimated the equation with one more year of data, the elasticity increased to 0.49 (evaluated at a 20 percent tax rate). (See Alan Auerbach, "Capital Gains Taxation and Tax Reform," National Tax Journal, September, 1989.)

In contrast, cross-sectional data allow investigators to take advantage of the great variation in the tax environments of various households. In addition, cross-sectional data contain rich descriptions of households' economic and demographic situations, allowing the investigator to control for such variables in order to isolate the independent effect of taxes.

In any case, when properly interpreted, several of the time-series studies suggest higher elasticities than used in the Treasury estimates. For example, while JCT suggests that the "preferred" results in the paper by Jones have long-term elasticities of 0.18 and 0.25, the author explicitly states that his own preferred long-term elasticity is 0.9, which is about the same elasticity used by OTA (0.8 after portfolio effects). (Jonathan D. Jones, "An Analysis of Aggregate Time Series Capital Gain Equations," p. 20) OTA continues to believe that the choice of elasticity should be made based on the entire economic literature.

Ultimately, the decision with respect to the choice of elasticities is judgmental. Nevertheless, it remains a fundamental point of difference between us.[5]

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[4] In her reproduction of the Treasury table, Gravelle omits the Treasury footnote which clearly noted the midpoint methodology. The footnote reads: "The elasticity is the midpoint of the reported long-run elasticities for those studies reporting a range of elasticities for different models. The elasticities are not directly comparable in many cases. For example, the elasticities are computed at varying tax rates in the studies. In some studies the elasticities are the result of dynamic behavioral simultations, while in others the elasticity is computed at the average tax rate. In some cases the elasticities are derived from equations reported in the studies at a 25.4% tax rate after tax reform. These factors account for some of the differences in elasticities. Elasticities evaluated at current law tax rates would be higher for many of these studies."

[5] The JCT pamphlet contends that in the long run, the sole source of increased realizations is capital gains from assets that would otherwise have been held until death. In footnote 23 JCT asserts that without this category of realizations, the capital gains elasticity would be zero; that is that there would be no response at all. But this ignores the fact that with a lower capital gains rate, assets may be turned over several times in a lifetime in an effort to move investments to their best economic use, resulting in a long-run increase in realizations. The faster turnover could still leave taxpayers holding investments for reasonably long holding periods. One model, for example, suggests a capital gains elasticity of about 0.4 for such turnovers with no change in the amount of assets held until death. (See Martin Bailey, "Capital Gains and Income Taxation" in A.C. Harberger and M. Bailey (eds.), The Taxation of Income from Capital, Brookings, 1969.)

We will continue to review the JCT pamphlet. However, our preliminary conclusion is that we find no basis in the arguments presented there for changing the elasticities utilized in our estimates. We respect the right of the JCT staff to hold a different professional opinion—but the difference is just that. Nothing in this pamphlet establishes that it is more, and indeed until the JCT comes forward with the full specifications for its model, it is not possible to evaluate fully its other contentions.

ALTERNATIVE MINIMUM TAX ("AMT")

While we agree with the JCT that the static and realization lines of the estimates are easily the most important in understanding the difference between the two estimates, we do believe that the difference in the AMT preference line is significant, particularly for the long run. Differences in the estimated revenues from the AMT account for nearly $2 billion of the difference between the JCT and OTA revenue estimates. The JCT shows a revenue pickup of only $0.1 to $0.2 billion per year, implying that hardly any new taxpayers would be subject to the AMT at all. But elsewhere the JCT has argued that there would be increased capital gains realizations of at least $82 billion each year, and that most of this would be by high-income taxpayers. Under pre-1986 law, the capital gains preference was the primary reason why most taxpayers who were subject to the AMT paid the AMT. It is unlikely that the revenue impact could be as small as the JCT estimates imply.

BASE LINE

The Joint Committee chose not to present a table equivalent to Table 4 in my March 6 testimony. (See Appendix.) However, the equivalent data can be pieced together from data reported in the pamphlet.[6] Chart 3 attached to my testimony compares the CBO baseline and the Administration baseline through the estimating period.

To attain the $254 billion 1990 baseline realization figure projected by CBO, there would have to be an increase in realizations from 1988 to 1990 of about 54 percent. We are also told that two-thirds of this increase will occur between 1988 and 1989. We do not find such an increase with no change in law any more plausible today than we did three weeks ago. While we do agree that capital gain realizations bear a general long-run relationship to GNP and to stock prices, Figure 1 shows that the year-to-year relation of realizations to stock prices is weak at best.

DISTRIBUTION

My remarks here can be quite brief. We and the JCT do not have a large disagreement on the facts. The differences in percentages cited on page 51 of the JCT pamphlet are probably accounted for by the fact that the JCT uses "expanded income" as a classifier rather than permanent income. Their classifier results in a larger percentage of capital gains being attributed to people in the upper income classes.

We do have a significant disagreement on presentation. We believe that it is inappropriate to ignore the full estimate of taxes paid in presenting distributions of tax burden. The JCT believes it is appropriate to reflect distributions based solely on the static line. The justification offered for the latter presentation is tradition and the fact that the newly induced gains are "voluntary." But all capital gains are voluntary in this sense. The JCT counts capital gains taxes paid under current law but ignores the additional capital gains taxes that would be paid under the Administration's proposal in assessing distributional consequences. In any event, the facts remain—our table reflects the entire shift in taxes paid due to the proposal. The Joint Committee's does not.

REVENUE MAXIMIZING RATE

We have not had an opportunity to evaluate fully the portion of the JCT pamphlet dealing with the revenue maximizing rate. My March 6 testimony stated that in order to duplicate the JCT's elasticities in our model, we would have had to use a revenue maximizing rate of approximately 35 percent. That statement remains true.

The JCT asserts that the maximizing rate in their model is 28.5 percent—or in their phrase "a rate approximately equal to (or slightly higher than) the rates im-

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[6] The CBO baseline for 1990–1995 is reported in Table 3 of the pamphlet. Page 18 of the pamphlet states that two-thirds of the CBO increase in realizations from 1988 to 1990 occurred in 1989. Stated another way, this statement means that CBO projected a 36 percent increase in capital gains realizations in 1989 over 1988.

posed under current law" (p. 42) and documents this claim by presenting a table (Table 10 of their pamphlet) which indicates that the proposal would show a slight gain (in all years but the first two) if the tax rate on capital gains were 28.5 percent, but a loss in all years if the rate were as high as 30 percent. (Table 10, p. 42)

Because the pamphlet does not provide the complete specifications for the JCT model, we cannot independently confirm the JCT revenue-maximizing rate. However, we have difficulty reconciling this statement with two other recent JCT estimates. In *Reducing the Deficit: Spending and Revenue Options* (page 347), which was released by the CBO in February 1990, the JCT estimated the revenue effect of creating a permanent 33 percent individual tax bracket with a capital gains rate cap of 28 percent. The estimate is given below:

[Dollars in billions]

1991	1992	1993	1994	1995	1991–1995
3.8	7.6	8.7	10.1	11.7	41.9

On March 13, 1990, BNA's Daily Tax Report set forth a copy of the revenue table prepared for Chairman Rostenkowski's package to eliminate the budget deficit. As we understand it, Mr. Rostenkowski's package would eliminate the "bubble" and would not place a 28 percent maximum tax rate on individual capital gains. Thus, the tax rate on capital gains would reach 33 percent for that portion of the population most responsive to a rate cut. The JCT estimates for bubble elimination without a 28 percent rate cap on capital gains are given below:

[Dollars in billions]

1991	1992	1993	1994	1995	1991–1995
4.2	8.2	9.3	10.6	12.0	44.3

Note that in the second estimate, when capital gains are subject to a 33 percent marginal tax rate, revenues exceed those when the maximum tax rate is 28 percent. Hence, a comparison of the two sets of estimates strongly suggests that the JCT would estimate that the revenue maximizing rate must be well above 28 percent and could be higher than 33 percent.

We continue to believe that the revenue maximizing rate is a useful way for non-economists to evaluate the implications of the elasticity assumptions made in these estimates. We also continue to believe that the history of prior tax changes supports OTA's estimate of a revenue maximizing rate of about 23 percent. We simply do not believe that a significantly higher rate comports with our experience since 1978.

COMPLEXITY

Because the Internal Revenue Code currently limits deductions for capital losses and requires taxpayers to compute the basis of capital assets, taxpayers will face no significant increase in complexity or recordkeeping from a reduced rate for capital gains. Most who have capital gains would willingly accept such incidental burdens as may occur. Prior enforcement experience suggests that the Internal Revenue Service will be able to administer the law since it involves no new classifications of assets not already required by the limitation on capital losses.

CONCLUSION

We continue to call on the JCT to disclose to us the equations and specifications for its model. We remain convinced that our estimate is the more probable.

As Dr. Boskin noted earlier, however, the issue presented is principally one of economic growth. We must begin to configure our tax policy to assure that America is not hampered in the global market place by its tax system. A capital gains tax cut is an important first step.

Thank you, Mr. Chairman. I will be pleased to answer questions at this time.

Chart 1

A Comparison of the Tax Systems of the G-7 Countries

	Top Corporate Rate (Federal)		Top Personal Rate (Federal)		Capital Gains (portfolio)	Integration System	Recent Changes in Integration Systems
	1986	1990	1986	1990			
U.S.	46	34	50	28/33	28/33	None	
Italy	46	36	62	50	0	Imputation	
France	45	39/42	58	50	16[1]	Imputation/Split Rate	1989, reduction of tax on undistributed profits from 42 to 39%.
U.K.	35	35	60	40	40[2]	Imputation	
Canada	46	28	34	29	22[3]	Shareholder Credit	
Germany	56/36	50/36	56	53	0	Split Rate/Imputation	1990, reduction of undistributed rate from 56 to 50%.
Japan	43.3/33.3	37.5	70	60	20[4]	Shareholder Credit	1990, elimination of split rate.

[1] An annual exclusion of the gain from the sale of approximately $50,000 of securities is allowed.

[2] Indexed for inflation; each taxpayer has annual exemption of 5,000 British pounds.

[3] Each taxpayer has a lifetime exemption of 100,000 Canadian dollars; the rate of 22% reflects the exemption of 25% of gains.

[4] The 20% rate includes only the national tax. If stocks are held more than one year, the taxpayer may opt for a final tax on the sales proceeds in lieu of capital gains; the rate is 1%, but may be reduced to 0.5% or increased to 20 percent in special circumstances.

CHART 2

TREASURY AND JOINT COMMITTEE ON TAXATION (JCT) REVENUE EFFECTS OF THE ADMINISTRATION'S CAPITAL GAINS PROPOSAL

Item			Fiscal Year ($ Billions)						
			1990	1991	1992	1993	1994	1995	1990-95
I. Static effect of 30% exclusion:	1/	Treasury	-2.1	-14.3	-15.6	-16.6	-17.5	-18.4	-84.5
		JCT	-2.6	-17.7	-18.7	-19.9	-20.4	-20.9	-100.2
		Difference	0.5	3.4	3.1	3.3	2.9	2.5	15.7
II. Effect of induced realizations:	2/	Treasury	2.8	19.3	18.4	17.0	16.6	17.0	91.1
		JCT	3.0	18.9	14.4	14.9	13.4	13.8	78.4
		Difference	-0.2	0.4	4.0	2.1	3.2	3.2	12.7
III. Effect of full depreciation recapture:		Treasury	-0.0	-0.3	0.5	1.1	1.6	1.7	4.6
		JCT	0.3	1.8	1.9	2.1	2.1	2.2	10.3
		Difference	-0.3	-2.1	-1.4	-1.0	-0.5	-0.5	-5.7
IV. Effect of phase-in of the 3-year holding period:		Treasury	--	-0.1	-1.0	-1.0	0.2	0.2	-1.7
		JCT	--	-0.3	-2.0	-0.9	0.4	1.6	-1.2
		Difference	--	0.2	1.0	-0.1	-0.2	-1.4	-0.5
IV. Effect of treating excluded portions of gains as a preference item for AMT purposes:		Treasury	--	-0.2	0.5	0.6	0.8	0.8	2.5
		JCT	--	0.1	0.1	0.2	0.2	0.2	0.8
		Difference	--	-0.3	0.4	0.4	0.6	0.6	1.7
V. Effective date of proposal:	3/	Treasury	-0.2	0.4	--	---	--	--	0.2
		JCT	0.1	0.6	--	--	--	--	0.7
		Difference	-0.3	-0.2	0.0	0.0	0.0	0.0	-0.5
VI. Total revenue effect of proposal:		Treasury	0.5	4.9	2.8	1.2	1.7	1.4	12.5
		JCT	0.7	3.2	-4.3	-3.6	-4.3	-3.1	-11.4
		Difference	-0.2	1.7	7.1	4.8	6.0	4.5	23.9

Note Details may not add to total due to rounding
1/ This line reflects an estimate of the proposed exclusion assuming no change in taxpayer behavior
2/ This line reflects an estimate of the increase in budget receipts attributable to taxpayer decisions to realize more capital gains as a result of the lower tax rate
3/ Lines I-IV, above, reflect a January 1, 1990, effective date, line V represents an adjustment to these lines to reflect an assumed effective date of March 15, 1990

CHART 3
BASELINE HISTORICAL TOTAL CAPITAL GAINS
WITH CBO AND TREASURY PROJECTIONS
1978 – 1995

Year	Baseline Capital Gains Realizations		Year to Year Change in Capital Gains Realizations	
	($ billions)		(percent)	
Historical				
1978	51		13.3	
1979	73		43.1	
1980	74		1.4	
1981	81		9.5	
1982	90		11.1	
1983	123		36.7	
1984	140		13.8	
1985	171		22.1	
1986	326		90.6	
1987	144		-55.8	
1988	165		14.6	
Projected:				
	CBO	OTA	CBO	OTA
1989	225	185	36.4	12.1
1990	254	214	12.9	15.7
1991	268	236	5.5	10.3
1992	287	256	7.1	8.5
1993	295	270	2.8	5.5
1994	301	286	2.0	5.9
1995	315	300	4.7	4.9

Department of the Treasury   March 26, 1990
Office of Tax Analysis

FIGURE 1.
CAPITAL GAINS REALIZATIONS AND STOCK PRICES
YEAR TO YEAR CHANGES: 1977–1989

Year to Year Percent Changes
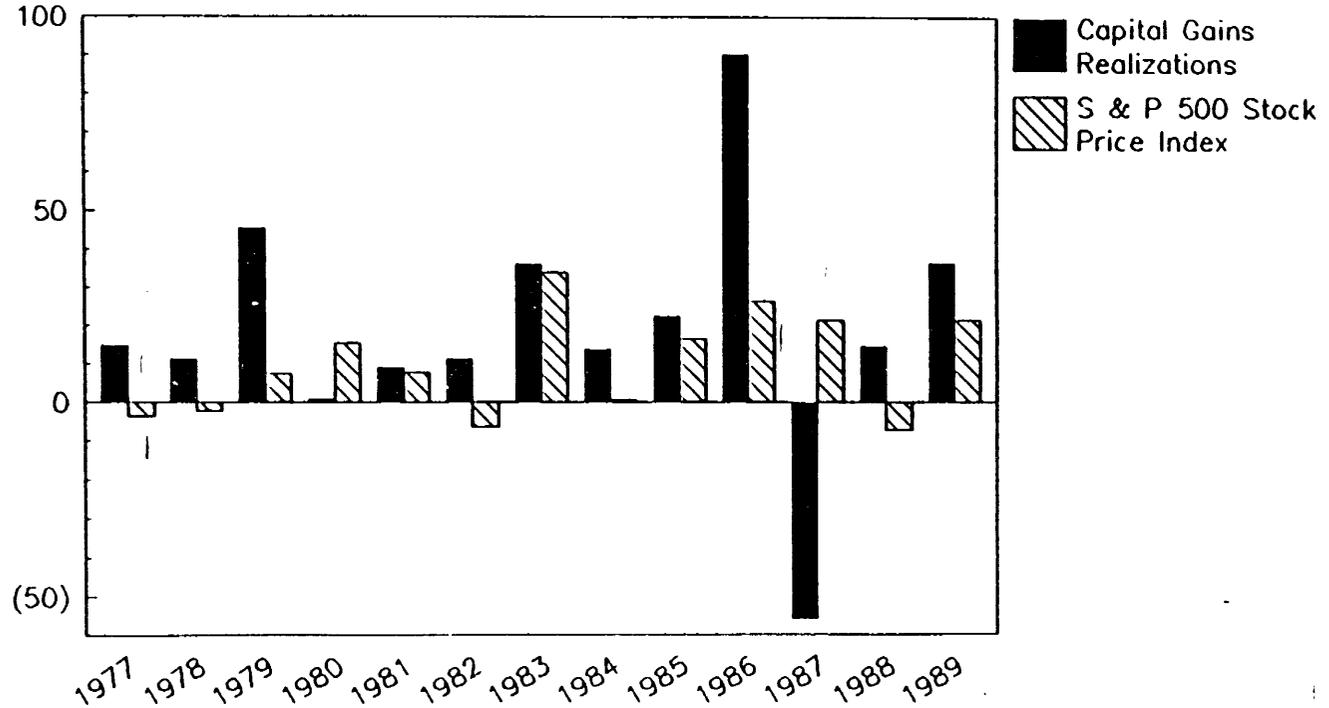
1989 capital gains are JCT baseline realizations
assuming no change in tax rates.

APPENDIX.—EXCERPTS RELATING TO CAPITAL GAINS FROM STATEMENT OF KENNETH W. GIDEON ASSISTANT SECRETARY (TAX POLICY) DEPARTMENT OF THE TREASURY, MARCH 6, 1990

Mr. Chairman and Members of the Committee: I appreciate this opportunity to discuss with you today the revenue proposals contained in the Bush Administration's budget for fiscal year 1991. These proposals are designed to advance the Administration's goals of enhancing economic growth and improving our nation's ability to compete in an integrated world economy.

My oral remarks today will focus on Part I of my written testimony which sets forth the procedures followed by Treasury's Office of Tax Analysis (OTA) in estimating the budget impact of the Administration's capital gains proposal. Part II of my written testimony contains a more detailed explanation of the capital gains proposal, the Family Savings Account, and first-time homebuyer proposals proposed by the President and introduced in the Senate as S. 2071 by Senators Packwood, Dole and Roth, as well as other significant revenue proposals in the budget.

PART I.—OFFICE OF TAX ANALYSIS ESTIMATES OF THE REVENUE EFFECTS OF THE PROPOSED REDUCTION IN CAPITAL GAINS TAX RATES FOR INDIVIDUALS

As is now well known, OTA estimates that the President's capital gains proposal, if enacted, would raise revenues $12.5 billion over the budget period and provide modest increases in revenue thereafter. The staff of the Joint Committee on Taxation (ACT) estimates that the proposal will lose $11.4 billion over the same period and continue to lose money thereafter. Like others, I am both concerned and surprised by the $23.9 billion gap between the OTA and JCT estimates. Indeed, the disparity in these estimates contrasts sharply with the closeness of the estimates made by both staffs with respect to most of the Administration's other revenue proposals.

Under the circumstances, I believe it is essential for this Committee to understand the procedures used by the Office of Tax Analysis to produce its estimates of the proposal. Accordingly, I am providing in my testimony today a detailed presentation of the assumptions, data, and methodology used to produce the OTA estimates. I am sure that the JCT will wish to provide similar detail with respect to its estimates (including the CBO data on which its estimates are based). I call on the JCT and CBO to do so as promptly as possible. This Committee, indeed, the Congress and the American people are entitled to detailed disclosure of the assumptions and methodology of the estimators when the estimates vary so significantly on an issue of major importance. Because we do not now have the level of detail with respect to the JCT estimates which we have disclosed today with respect to the OTA estimates, our analysis of the factors giving rise to the difference is not complete.

Summary of Critical Differences in OTA and JCT Revenue Estimates

Based on our current information, we have identified two major differences.

• OTA's estimates imply that tax revenues from sales of capital assets would be maximized if taxed at a 23 percent rate (*i.e.*, the "revenue maximizing rate"). It appears to OTA that JCT's analysis implies that such revenues would be maximized at a rate around 35 percent—significantly above the current maximum average rate of 28 percent on *ordinary* income. OTA analysts find it implausible that tax revenues from sales of capital assets would increase if taxed at rates *higher* than rates applicable to ordinary income. Stated more technically, the JCT's elasticity is lower than that used by OTA and appears to be lower than the elasticity JCT used last year, which is at a very low end of the range of existing estimates. We think it is simply too low.

• The JCT estimate apparently assumes a very large increase (perhaps more than 50 percent from 1988—the last year for which we have data—to 1990) in the level of capital gains that would be recognized if there were no change in law. An increase of this magnitude does not accord with historical experience and is, in our judgment, highly improbable.

These differences take on significance because we should remember that the estimators—both OTA and JCT—have been wrong on this issue before. Both substantially *underestimated* the capital gains revenues which accrued after the 1978 rate cut.

Absence of Macroeconomic Effects from Both Estimates

Neither the OTA nor JCT have included macroeconomic or "feedback" effects. While this accords with the standard practice of both staffs, it does not mean that such positive effects will not occur, merely that they are not estimated.

Secretary Brady, CEA Chairman Boskin, and probably many members of this Committee share the realistic expectation that positive economic effects will occur if the cost of capital is reduced through a capital gains rate cut. As Professor Martin Feldstein recently noted in testimony before the House Budget Committee even a "microscopically small 4 one-hundredths of one percent" increase in the annual growth rate of GNP would produce additional tax revenues of approximately $5 billion per year.[1] Expressed as a decimal, that's only 0.0004.

Such growth would benefit all Americans—not just sellers of capital assets. Indeed, the need to provide a fiscal climate conducive to creating new jobs is what this debate ought to be about rather than an arcane dispute over revenue estimates.

In addition to the macroeconomic effect of having a lower cost of capital, a lower capital gains tax would also permit the existing stock of capital to move to more efficient uses. Neither OTA nor JCT took these potential efficiency gains into account in making the estimates.

Effects of the Proposal on Revenues

The academic studies on the effect on Federal tax revenues of changes in capital gains tax rates agree that capital gains tax rates do have substantial effects on capital gains realizations, although there is wide variation in conclusions about the magnitude of the effect. Indeed, there is no disagreement between OTA and JCT that this effect exists. It is reflected on line II of both estimates. (Tables 2 and 3.) There is disagreement on its magnitude.

OTA's revenue estimate was made after a careful review of the major empirical studies by experts in government and the academic community. Compared to the results in most of the studies, OTA's estimate of induced realizations is conservative. Table 1 provides detail on these studies. I would point out that the long-run elasticity used by OTA in its present estimates is at least as conservative as every study conducted by the U.S. Department of Treasury. Treasury economists including Gerald Auten, Robert Gillingham, John Greenlees, and William Randolph have all found much higher elasticities. By any reasonable standard, OTA has endeavored to err on the side of caution when estimating these behavioral effects.

Before analyzing the OTA estimate in detail, let me make one point about its source. The revenue estimates reported in the budget were produced by the nonpolitical, professional, career, civil-service staff of Treasury's Office of Tax Analysis, which provides all Treasury revenue estimates for other legislative and budget proposals. The OTA staff makes use of the best data and analysis available within the time frame allowed for revenue estimates and updates its data and methods as new information becomes available.

Both the OTA and JCT estimating staffs vigorously defend their independence and professionalism. It is worth stressing, therefore, that the difference in revenue estimates is a professional difference of opinion. Accordingly, the estimates should be evaluated on their merits—not their political appeal.

Explanation of Table 2: Revenue Effects of the President's Capital Gains Proposal

Table 2 shows the revenue effect of significant elements of the President's capital gains proposal as estimated by OTA. In addition, it shows the effect of taxpayers' behavioral responses incorporated in the estimate. The comparable table published by the JCT is attached as Table 3.

1. *Effect of Tax Rate Reduction on the Level of Current Law Realizations.* The first row of Table 2 shows the revenue loss that OTA estimates would result from reducing tax rates as provided in the President's proposal based on the level of capital gains that would have been realized at current law rates, that is, without any behavioral response to the new law. This "static" revenue loss results from applying the proposal to all individually held assets. It is estimated to reduce revenues by $14.1 billion in 1991. The static loss generally grows gradually thereafter with growth in the overall economy.

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[1] Speaking of the JCT estimate, Professor Feldstein stated that: "If . . . the improved incentives for saving, investment and entrepreneurship were to increase the annual growth rate of GNP between now and 1995 by even a microscopically small 4 one-hundredths of one percent— for example, from the CBO's estimate of an average 2.44 percent real GNP growth per year to 2.48 percent—the additional tax revenue would be about $5 billion a year and would turn their estimated revenue loss into a revenue gain. In short, the potential economic advantages of the capital gains reduction are substantial and the potential revenue loss is doubtful at best. The difficulty of estimating the effects of the capital gains exclusion is far too great to put any confidence in the $3 billion staff estimate. But even if that is accepted at face value, the slightest improvement in real economic performance would be more than enough to turn that revenue loss into a revenue gain."

The basis for these calculations is shown in Table 4. OTA estimates that $214 billion of net capital gains would be realized in 1990 and that this amount would grow to $300 billion by 1995 with no change in the law.

2. *Effect of Taxpayer Behavior.* The second row of Table 2 shows the net additional revenue collected as a result of changes in taxpayer behavior. Lower tax rates on capital gains will induce taxpayer's to realize more capital gains than they otherwise would have. These induced gains are composed of taxable realizations that would otherwise have been tax-exempt because they would have been traded in a like-kind exchange, held until death, or donated to charities, as well as capital gains realizations accelerated from future years and gains arising from portfolio shifting to capital gains assets from consumer durables or other investments.

The additional revenue from increased realizations of capital gains is partially offset by the estimated effects of conversion of ordinary income into capital gains. Taxpayers have found various ways to convert ordinary taxable income into capital gains. Many conversion techniques utilized before 1986 have been eliminated or sharply restricted by the provisions of the 1986 Act, but a capital gains tax rate differential is likely to encourage taxpayers to shift to sources of income which qualify for lower tax rates. In order to make the estimate as accurate as possible, OTA estimated this effect as well.

As indicated by a comparison of rows I and IIa in Table 2, OTA estimates that revenues from induced realizations more than offset the static revenue loss on baseline gains. This conclusion is based on the responsiveness of taxpayers to changes in the capital gains tax rate, which has heretofore been the central aspect of the debate over capital gains and revenue.

The measure of taxpayer responsiveness is generally characterized as the "elasticity" of realizations with respect to the capital gains tax rate, defined as the percentage increase in capital gains realizations divided by the percentage decrease in the overall capital gains tax rate. (Henceforth, for brevity I will refer to this measure simply as the "elasticity.")

OTA's assumption about capital gains elasticities is based on a review of government and academic studies examining the question, all of which are publicly available. Even a cursory review of these studies, listed in Table 1 to this testimony, reveals that while there is a great deal of variation in estimated elasticities, there is a strong consensus that tax rates have significant effects on capital gains realizations. This result accords with intuition and simple common sense. Stated more plainly, lower rates induce more realizations and higher rates cause taxpayers to defer capital asset sales. The decision to realize a capital gain is generally highly discretionary. Hence, the decision is quite sensitive to the individual's tax environment. It is important to note that even small differences in elasticities can have large consequences for revenue estimates.

I would point out in this connection, that we have far better information with which to predict the effects of changes in capital gains rates than we did in 1978, when Congress last legislated a cut in the capital gains rate. We have considerable data from the 1978 tax cut, as well as data from the further reduction in capital gains rates resulting from the reduction in the top marginal income tax rate from 70 percent to 50 percent in 1981, which had the effect of lowering the top rate on long-term capital gains from 28 percent to 20 percent. The data resulting from the behavioral response to these tax changes provide a rich base from which to estimate the effects of further capital gains rate changes.

As Table 1 indicates, the elasticity estimates used by Treasury are smaller than the elasticities found in nearly all of the studies. OTA assumes an elasticity of 1.2 in the short-run, declining to about 0.8 in the long-run. An implication of this elasticity is that the average marginal tax rate that would maximize revenues from the capital gains tax is about 23 percent. In other words, a rate either higher or lower than 23 percent would produce less revenue than a 23 percent rate.

While the implied revenue maximizing rate is a useful way to convey the concept of elasticity in a form which is more comprehensible to noneconomists, the revenue maximizing rate is not ideal from the standpoint of economic efficiency and growth. It is instead the upper limit at which tax should be imposed. While a higher tax rate always imposes efficiency losses on the economy by comparison to a lower rate, imposing tax at a rate above the revenue-maximizing rate would cause revenue loss as well.

OTA's estimates for this year do reflect a change in elasticity from the elasticity which we used last year. Last year OTA utilized a long-run elasticity of 0.9 rather than the 0.8 used this year. OTA changed its elasticity in its normal process of updating its model and in an effort to be cautious. The direction of the change would,

absent changes in the JCT's elasticities, have narrowed the gap between the estimates considerably.

For purposes of easy reference, Table 5 sets forth OTA's elasticity assumptions for this year and last year. In the OTA model, the value of the elasticity depends on the value of the marginal tax rate—the higher the marginal tax rate, the higher the elasticity. Hence, to allow comparability across years, all elasticities are evaluated at a 20 percent marginal tax rate. That is, each elasticity is calculated as if the marginal tax rate were 20 percent. Table 5 also shows the marginal and average tax rates assumed each year.

3. *Depreciation Recapture as Ordinary Income.* The effect of the recapture is to limit the exclusion for depreciable assets to the increase in value over the original cost basis of the depreciable asset. OTA estimates that depreciation recapture would generate $4.6 billion over the 5 year budget period.

4. *Effect of the Alternative Minimum Tax.* Under our proposal, the excluded portion of long-term capital gains will be subject to the alternative minimum tax. This provision has a significant revenue effect. OTA estimates that it adds $2.5 billion to revenues over the 5 year period.

The revenue estimate of the proposal is significantly affected by the recapture and alternative minimum tax provisions. Indeed, these provisions account for the fact that the proposal generates a net revenue gain in 1993 and later years. The importance of depreciation recapture is due to the fact that depreciable assets account for approximately 40 percent of all net capital gains.

Revenue Effects After the Budget Window

I also wish to point out that OTA has provided revenue estimates only through FY 1995. This is because the estimate is based on the baseline macroeconomic forecast for the United States economy provided by the "Troika," a committee whose members represent the Office of Management and Budget, the Council of Economic Advisers and Treasury. The Troika baseline forecast extends only through 1995. Any extrapolation of the baseline beyond 1995 either would require a purely mechanical approach (*e.g.*, an assumption that economic trends would continue unchanged in the future) or would involve an independent forecast of such trends. Either approach would be arbitrary and could well result in the use of economic assumptions inconsistent with those underlying the Troika 5 year forecast. In addition, any baseline assumptions made by the OTA staff would likely create a debate about out-year macroeconomic growth which OTA has traditionally avoided. Because of these concerns, we and the JCT, have concluded that point estimates for periods beyond the budget window generally will not be provided.

We believe it is appropriate, however, to state OTA's views as to the revenue trend expected in periods after the budget period. OTA projects that, if enacted, the President's proposal would raise revenue modestly in all years following the 1991–1995 budget period.

Distributional Effects of the Capital Gains Proposal

The purpose of the Administration proposal is to increase the incentives for saving and investment and increase the efficiency of capital transactions. Fulfillment of these goals will benefit all Americans. A review of Table 6 also shows that enactment of the proposal would not reduce the tax burden of the wealthy. Indeed, they would pay more.

The conventional approach to measuring tax burdens is based on the amounts of taxes paid by income class. The distributional effect of a tax change is determined from the distribution of taxes paid before and after the enactment of the proposal. The change in taxes paid is an indicator of the change in tax burden.

For some types of tax proposals that cause only small behavioral responses, it is sufficient to show the amount of tax change on the original amount of income reported before the tax change. However, as discussed above, all analysts agree that capital gains realizations are very responsive to changes in tax rates. Therefore, in analyzing the distributional effects of capital gains tax changes, the behavioral responses of taxpayers should be taken into account to obtain a reasonable estimate of changes in tax payments.

OTA's analysis of the distributional effects of the fully phased-in Administration proposal on capital gains taking into account the behavioral responses of taxpayers is shown in Table 6. (The calculations are done assuming the proposal is fully phased in at 1990 levels.) The table demonstrates that once the dynamic responses of taxpayers are taken into account, the amount of taxes paid by high-income taxpayers will increase. Taxpayers with incomes of $200,000 or more will pay almost a billion dollars in additional capital gains taxes. The share of taxes paid by lower

and midd'e-income taxpayers will decline since their taxes do not increase so significantly.

For purposes of comparison, Table 6 also shows how taxes paid would change without taking behavioral changes into account. The distribution of changes in capital gains taxes under the "no behavioral change" assumption appears to show that high-income taxpayers would receive large tax reductions. Dynamic distribution analysis, however, clearly indicates that these high-income taxpayers would pay more in taxes.

Thus, dynamic analysis shows that a capital gains tax cut provides a "win-win" situation: while high-income taxpayers would pay more in taxes, they would be better off because the lower capital gains tax rates will allow them to make investment decisions with less concern about the tax impact. They will have chosen to pay the additional taxes voluntarily. Taxpayers with lower incomes will not pay more unless they also benefit from the rate cut. Overall, the result is to collect relatively more taxes from those with higher incomes.

It should also be pointed out that in Table 6, taxpayers are classified according to their average income over a period of years, which is referred to as "permanent income." A single year measure of income that includes capital gains fails to classify many taxpayers in the correct income class. In particular, the use of single year income including gains classifies many middle-income taxpayers with large one-time gains from the sale of a small business, a farm or a personal residence as "high-income." As a result, the share of capital gains attributed to high-income taxpayers is overstated. This approach counts the gains of one-time realizers and others whose income is temporarily high as being high-income taxpayers. An alternative approach is to classify taxpayers by income other than capital gains. A preferred approach is to classify taxpayers by their permanent income. While ideally one would want to compute the average income over the taxpayers' lifetimes, available data allow us to do so only over 5 years. By averaging a taxpayer's income over 5 years, the effects of temporary income spikes are substantially reduced and overcorrection is also avoided. This is the methodology used in Table 6.

JCT's distributional table is based solely on the static portion of its estimate. In other words, in presenting its distribution tables, JCT ignores the dynamic part of its own estimate. The JCT table is therefore a distribution of the benefits of a rate cut to those who would have sold capital assets in any event, but ignores distribution of the additional tax paid by those who will be induced to sell at lower rates. Table 6 provides a more complete and accurate picture than the JCT table.

Comparison of OTA and JCT Estimates

Table 7 summarizes the principal differences between the Treasury estimate of the revenue impact and the Joint Committee on Taxation (JCT) staff estimate. Table 7 demonstrates that the total difference over the 5 year budget period is $23.9 billion. The two main sources of differences are in the estimates of the static revenue loss (Line I) and the assumed responsiveness of taxpayers (Line II).

The static revenue loss is obtained by multiplying the change in the average tax rate on capital gains times the volume of realizations that would have occurred with no change in the law. The level of realizations that would have occurred with no change in the law is referred to as the "baseline" level of realizations. Differences in static revenue loss estimates can result from differences in baseline capital gains and/or differences in the tax rates used. The table shows that over the 5 year period, the discrepancy in the static revenue loss estimates is $15.7 billion. We are not able to separate the part of the JCT estimate due to the average tax rate and the portion due to CBO's estimates of capital gains realizations.

As mentioned earlier and documented in Table 4, OTA estimates that baseline capital gains would increase gradually along with growth in the economy. We understand that the JCT's baseline, which is provided to it by the CBO, is assumed to jump by over 50 percent from 1988 (the last year for which data are available) to 1990. OTA believes that the extraordinary increase in capital gains realizations projected by CBO for this 2 year period is highly improbable. Its effect is to raise the baseline level of realizations quite significantly throughout the budget window, thereby significantly enlarging JCT's estimates of the static revenue losses.

Another major difference between the OTA and JCT estimates is that the JCT estimate appears to assume a lower level of responsiveness (elasticity) by taxpayers. OTA revenue estimators tell me that the only way they could replicate their long-term results in their model would be to assume that the revenue maximizing rate is around 35 percent. Recall that the comparable rate for OTA is approximately 23 percent. The implication of the JCT revenue maximizing tax rate is that the capital gains tax rate could be raised to a level significantly higher than the current tax

rates on ordinary income such as dividends and interest, and total capital gains revenue would continue to increase. As noted above, OTA is aware of no study which suggests that revenues would increase if the capital gains tax rate were significantly higher than the rate of tax on ordinary income, yet that is the apparent implication of the long-run elasticities utilized by the JCT in making its estimates. Indeed, virtually every study in Table 1 that allows computation of a revenue maximizing rate implies that the maximizing rate is below the rate imposed on ordinary income. This is hardly surprising since, just as we anticipate a portfolio effect for a rate differential in favor of capital assets, one would also expect taxpayers to attempt to shift out of capital assets if the rates imposed on them were higher than ordinary rates. The considered professional judgment of Treasury analysts is that the JCT elasticity is simply too low.

Although OTA anticipated that the JCT staff would find that the proposal will lose revenue over the budget period, OTA and I were frankly, surprised at how large their predicted loss was. Based on JCT's analysis of last year's proposal, we had supposed that the JCT would show a significantly lower loss over the budget period 1990-1995, rather than the $11.4 billion loss recently reported. In part, this is no doubt due to CBO's revision of baseline capital gains realizations. However, this also seems clear that the JCT also reduced its elasticity assumption as well. While both Treasury and JCT analysts regularly update and improve their models as new information becomes available, this particular revision apparently caused the JCT to increase the loss it estimated for the President's proposal, and increased rather than narrowed the gap between the two estimates.

The revenue estimators of OTA are professionals who have labored to produce their best judgment of the revenue effects of the President's proposal. I am not an economist—and I share much of the perplexity of members of this Committee with respect to how to evaluate this important disparity. A few of my personal thoughts may be of some utility to the Committee.

First, "elasticity" is a term that speaks mainly to economists. OTA estimators tell me that we can infer a revenue maximizing tax rate from these elasticities. Specifically, OTA's estimate implies that revenue would be maximized if the rate were set at 23 percent, and the JCT's estimate appears to imply that we would maximize revenue if the rate were around 35 percent. Based on our historical experience with capital gains since 1978 I find it more likely that we will raise revenue through a rate cut than through a rate increase above ordinary rates.

Second, I do not find it plausible that a 50 percent jump in capital gains realizations will occur in a 2 year period without a change in tax law. Yet that is apparently what CBO has projected and hence what the JCT is required to include in its base line estimates.

Finally, lowering the capital gains rate will lower the cost of capital and should promote economic growth. Even trivial increases in GNP, as noted above, will generate revenues more than sufficient to offset even the JCT estimates. The prospect of increased economic growth emphasizes the fact that this debate should not be about technical estimating problems. It is about making this country more competitive.

Since the estimators have been unable to resolve their differences, however, Congress and the American people clearly should have all the data, assumptions, and methodology underlying the estimates placed on the record for full public scrutiny. We have done that today and we look forward to disclosure of the same material with respect to the JCT estimates and CBO projections on which it is based at the earliest possible time.

Thank you, Mr. Chairman. I will be pleased to answer questions at this time.

PART II.—DETAILED DISCUSSION OF THE ADMINISTRATION'S REVENUE PROPOSALS CAPITAL GAINS TAX RATE REDUCTION FOR INDIVIDUALS

Description of the Proposal

In general, the Administration proposes that the capital gains tax rate for individuals be reduced on long-term investments by enacting a sliding scale exclusion for long-term capital gains. The proposal provides for a 10, 20, or 30 percent exclusion for long-term capital gains on assets held by individual taxpayers for 1, 2 or 3 years, respectively. The three year holding period requirement will be phased in over three years.

Holding Periods. Individuals will be allowed to exclude a percentage of the capital gain realized upon the disposition of qualified capital assets. The amount of the exclusion will depend on the holding period of the assets. Assets held 3 years or more will qualify for an exclusion of 30 percent. Assets held at least 2 years but less than

3 years will qualify for a 20 percent exclusion. Assets held at least 1 year but less than 2 years will qualify for a 10 percent exclusion.

As a result of the exclusion, the tax rate applicable to capital gains on qualified assets held for at least 3 years will be 19.6 percent for a taxpayer in the 28 percent tax bracket. Similarly, investments held by such a taxpayer between 2 and 3 years will be taxed at a 22.4 percent rate, and assets held between 1 and 2 years will be taxed at a 25.2 percent rate. Individuals in the 15 percent tax bracket will pay proportionally lower rates of tax (13.5 percent, 12.5 percent, and 10.5 percent, respectively).

Qualified Assets. Qualified assets will generally be defined as any assets qualifying as capital assets under current law and satisfying the holding period requirements, except for collectibles. Collectibles are assets such as works of art, antiques, precious metals, gems, vintage alcoholic beverages, and stamps and coins. Assets eligible for the exclusion will include, for example, corporate stock, manufacturing and farm equipment, a home, an apartment building, a stand of timber, or a family farm.

Phase-in Rules and Effective Dates. The proposal will be effective generally for dispositions of qualified assets after the date of enactment. For the balance of 1990, the full 30 percent exclusion will apply to assets held at least 1 year. For dispositions of assets in 1991, assets will be required to have been held for 2 years or more to be eligible for the 30 percent exclusion, and at least 1 year but less than 2 years to be eligible for the 20 percent exclusion. For dispositions of assets in 1992 and thereafter, assets will be required to have been held at least 3 years to be eligible for the 30 percent exclusion, at least 2 years but less than 3 years for the 20 percent exclusion and at least 1 year but less than 2 years for the 10 percent exclusion.

Additional Provisions. The excluded portion of capital gains will be added back in when calculating income under the alternative minimum tax. Installment sale payments received after the effective date will be eligible for the exclusion without regard to the date the sale actually took place. For purposes of the investment interest limitation, only the net capital gain after subtracting the excluded amount will be included in investment income.

Depreciation deductions taken with respect to all depreciable property will be recaptured in full as ordinary income. This provision prevents taxpayers from benefiting from the exclusion provision for depreciation deductions that have already been claimed in prior years. To the extent that depreciable assets have increased in value above their unadjusted basis, taxpayers will be able to benefit from the exclusion.

Reasons for the Proposal

Restoring a capital gains tax rate differential is essential to promote savings, entrepreneurial activity, and risky investment in new products, processes, and industries that will help keep America competitive and economically strong. At the same time, investors should be encouraged to extend their horizons and search for investments with longer term growth potential. The future competitiveness of this country requires a sustained flow of capital to innovative, technologically advanced activities that may generate minimal short-term earnings but promise strong future profitability. A preferential tax rate limited to longer term commitments of capital will encourage business investment patterns that favor innovations and long-term growth over short-term profitability. The resulting increase in national output will benefit all Americans by providing jobs and raising living standards.

In addition to the improvements in productivity and economic growth, a lower rate on long-term capital gains will also improve the fairness of the individual income tax by providing a rough adjustment for the taxation of inflationary gains that do not represent any increase in real income. In addition, it provides relief from the double taxation of investments in corporate stock.

Incentives for Longer Range Investment. A capital gains preference has long been recognized as an important incentive for capital investment. The first tax rate differential for capital gains in this country was introduced by the Revenue Act of 1921. For the next 65 years there was always some tax rate differential for long-term capital gains. The preferential treatment for capital gains has taken various forms including an exclusion of a fixed portion of the nominal gains, an exclusion that depended on the length of time a taxpayer held an asset, and a special maximum tax rate for capital gains. But at no time after 1921 and before 1987 were long-term capital gains ever taxed at the same rates as ordinary income.

By eliminating the capital gains exclusion and lowering tax rates on ordinary income, the 1986 Act increased the incentives for short-term trading of capital assets. This occurred because the tax rate on long-term capital gains was increased while the tax rate on short-term capital gains was reduced. By providing for a slid-

ing scale exclusion that provides full benefits only for investments held at least 3 years after a phase-in period, the proposal will reduce the incentive for short-term trading.

The Cost of Capital and International Competitiveness. The capital gains tax is an important component of the cost of capital, which measures the pre-tax rate of return required to induce businesses to undertake new investment. Evidence suggests that the cost of capital in the United States is higher than that in many other industrial nations. While not solely responsible for the higher cost of capital, high capital gains tax rates hurt the ability of U.S. firms to obtain the capital needed to remain competitive. By reducing the cost of capital, a reduction in the capital gains tax rate will stimulate productive investment and create new jobs and growth.

Our major trading partners already recognize the economic importance of low tax rates on capital gains. Virtually all other major industrial nations provide lower tax rates on capital gains (or do not tax capital gains at all). Canada, France, Germany, Japan, the Netherlands, and the United Kingdom (among others), all treat capital gains preferentially.

According to a recent study by a Boston Federal Reserve Bank economist, the increase in the capital gains tax rate under the Tax Reform Act of 1986 increased the cost of capital to corporations by 8 percent.[2] This increase in the cost of capital tends to discourage capital formation and to misallocate resources away from productive business investments. This study concluded that in the long run, corporate capital would decline by as much as 5½ percent because of the capital gains tax induced increase in the cost of capital. This adverse effect of the higher cost of equity capital has a disproportionately large effect on new corporations. Another undesirable side effect of the increase in the capital gains tax was to increase the advantage of debt over equity finance.

The Lock-In Effect. Under a tax system in which capital gains are not taxed until realized by the taxpayer, a substantial tax on capital gains tends to lock taxpayers into their existing investments. Many taxpayers who would otherwise prefer to sell their assets to acquire new and better investments may instead continue to hold onto the assets, rather than pay the current high capital gains tax on their accrued gains.

This lock-in effect of capital gains taxation has at least three adverse effects. First, it produces a misallocation of the nation's capital stock and entrepreneurial talent, because it alters the investment decisions that would be made in a genuinely free market. For example, the lock-in effect reduces the ability of entrepreneurs to withdraw from an enterprise and use the funds to start new ventures. Productivity in the economy suffers because entrepreneurs are less likely to move to where they can be most productive, and because economic resources may be used in a less productive fashion rather than transferred to other, more efficient, enterprises. These effects can be especially critical for smaller firms, which may not have good access to capital markets and where ownership and operation frequently go together.

Second, the lock-in effect produces distortions in the investment portfolios of individual taxpayers. For example, some individual investors may be induced to assume more risk than they desire because they are reluctant to sell appreciated investments to diversify their portfolios.

Third, the lock-in effect reduces government receipts. To the extent that taxpayers defer sales of existing investments, or hold onto investments until death, taxes that might otherwise have been paid are deferred or avoided altogether. Therefore, individual investors, the government, and other taxpayers lose from the lock-in effect. The investor is discouraged from pursuing more attractive investments and the government loses revenue.

Substantial evidence from more than a dozen studies demonstrates that high capital gains tax rates in previous years produced significant lock-in effects. The importance of the lock-in effect may also be demonstrated by the fact that realized capital gains were 16 percent lower under the high tax rates in 1987 than under the lower rates in 1985, even though stock prices had risen by approximately 50 percent over this period. The high tax rates on capital gains under current law imply that the lock-in effect is greater than at any prior time.

Penalty on High Risk Investments. Full taxation of capital gains, in combination with limited deductibility of capital losses, discourages risk taking. It therefore impedes investment in emerging high-technology and other high-growth firms. While many investors are willing to take risks in anticipation of an adequate return, fewer

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[2] Yolanda Henderson, "Capital Gains Taxation and the Cost of Capital for Mature and Emerging Corporations," Unpublished Paper, October 1989.

are willing to contribute "venture capital" if a significant fraction of the increased reward will be used merely to satisfy higher tax liabilities. A tax system that imposes a high tax rate on gains from the investment reduces the attractiveness of risky investments, and may result in many worthwhile projects not being undertaken.

In particular, it is inherently more risky to start new firms and invest in new products and processes than to make incremental investments in existing firms and products. It is therefore the most dynamic and innovative firms and entrepreneurs that are the most disadvantaged by the current high capital gain tax rates that penalize risk taking. Such firms have traditionally been contributors to America's edge in international competition and have provided an important source of new jobs.

Double Tax on Corporate Stock Investments. Under the U.S. income tax system, income earned on investments in corporate stock is generally subjected to two layers of tax. Income on corporate investments is taxed first at the corporate level at a rate of 34 percent. Corporate income is taxed a second time at the individual level in the form of taxes on capital gains and dividends at rates ranging from 15 to 33 percent. The combination of corporate and individual income taxes thus can produce effective tax rates that are substantially greater than individual income tax rates alone. To the extent the return to the investor is obtained through appreciation in the value of the stock (rather than through dividend income), a reduction in capital gains tax rates provides a form of relief from this double taxation of corporate income. While a lower capital gains tax rate reduces the cost of capital for both corporate and noncorporate business, the greater liquidity of shares in publicly-traded companies suggests that the overall effect would be to reduce the bias towards noncorporate business that results from our dual-level tax system.

Inflationary Gains. Although inflation has been kept low under policies of the last 8 years, even low rates of inflation mean that individuals who sell capital assets at a nominal profit are paying tax on a fictional element of profit that represents only inflation. High rates of inflation, such as those that existed in the mid and late 1970's exacerbate the problem. Current law taxation of nominal capital gains at the full rates applicable to ordinary income has the inequitable result of producing unintended high tax rates on real (inflation-adjusted) capital gains that exceed the tax rates on ordinary income. This taxation of inflationary capital gains has particularly been a problem for lower and middle-income taxpayers with capital gains. However, adjusting directly for inflation through indexation would greatly complicate income tax returns and raise a number of difficult technical problems with respect to pass-through entities. The Administration proposal for a sliding scale exclusion provides a rough adjustment for the effects of inflation without creating the complexities and additional recordkeeping that a precise inflation adjustment would require.

Tax Shelters. Some claim that a lower rate for capital gains will threaten tax reform and result in a new proliferation of tax shelters. Prior to tax reform, 60 percent of long-term capital gains on assets held at least 6 months were excluded. Under the new Administration proposal, the maximum exclusion rate is 30 percent. Because of the smaller exclusion rate, depreciation recapture, and the alternative minimum tax, there is little danger of a resurgence of tax shelters. In addition, other rule changes under tax reform, such as the limits on the deduction of passive losses, also protect the tax system against tax shelter abuses.

Complexity. Some suggest that adopting a preferential rate for capital gains will complicate the business and investment tax system. However, the distinction between capital and ordinary income was kept in the Internal Revenue Code for the purpose of limiting capital losses and in anticipation of a return of a preferential rate. The IRS has also retained tax forms for almost all reporting requirements with respect to capital gains, such as Schedule D (Capital Gains and Losses) and Form 4797 (Sales of Business Property).

Holding Periods. In developing the proposal, the Administration sought to balance its concern about locking taxpayers into their investments against its desire to discourage short-term investment strategy. Accordingly, the proposal ties increases in the capital gain exclusion rate to the period an asset is held in order to give taxpayers an incentive to hold their assets longer. Taxpayers will be entitled to a maximum 30 percent exclusion if they hold their assets for at least 3 years. Any lock-in effect is modified, however, because taxpayers will still be entitled to an exclusion (albeit smaller) for shorter holding periods down to 1 year.

Effects of the Proposal on Revenues

Treasury's Office of Tax Analysis estimates that the proposal will raise $4.9 billion in FY 1991 and $12.5 billion from FY 1990 through FY 1995. The Joint Committee on Taxation estimates that the proposal will raise $3.2 billion in FY 1991 but lose $11.4 billion from FY 1990 through FY 1995.

Table 1
SURVEY OF CAPITAL GAINS REALIZATIONS ELASTICITIES

Studies	Data Type	Capital Gains Type	Realization Elasticity [1]
Gillingham, Greenlees, and Zieschang (1989)	Pooled Cross-Section Time Series, 1977-85	All Capital Assets	3.80
Feldstein, Slemrod, and Yitzhaki (1980)	Cross-Section, High-Income Sample, 1973	Corporate Stocks	3.75
U.S. Treasury (1985)	Panel Data, 1971 to 1975	All Capital Assets Corporate Stocks	1.68 2.07
Auten, Burman, and Randolph (1989)	Panel Data, High-Income Sample, 1979 to 1983	All Capital Assets	1.65
Lindsey (1987)	Pooled Cross-Section and Time Series, 1965-1982	All Capital Assets	1.37
Jones (1989)	Time-Series 1948-1987	All Capital Assets	1.18
Darby, Gillingham, and Greenlees (1988)	Time Series, 1954 to 1985, All Taxpayers	All Capital Assets	1.07
Auten and Clotfelter (1982)	Panel Data, Middle-Income Sample, 1967 to 1973	All Capital Assets	0.91
Congressional Budget Office (1988)	Time Series, 1954 to 1985	All Capital Assets	0.89
Office of Tax Analysis (1990) [2]		Short-run Long-run	1.2 0.8
U.S. Treasury (1985)	Time Series, 1954-1985	All Capital Assets	-0.80
Joint Committee on Taxation (1989) [3]		Short-run Long-run	1.2 0.7
Minarik (1981)	Cross-Section High-Income Sample, 1973	Corporate Stocks	0.62
Auerbach (1988)	Time Series, 1954 to 1986	All Capital Assets	0.57

Sources: Council of Economic Advisors and Auten, Burman and Randolph (1989).
1/ The elasticity is the midpoint of the reported long-run elasticities for those studies
   reporting a range of elasticities for different models. The elasticities are not directly
   comparable in many cases. For example, the elasticities are computed at varying
   tax rates in the studies. In some studies the elasticities are the result of dynamic
   behavioral simulations, while in others the elasticity is computed at the average tax
   rate. In some cases the elasticities are derived from equations reported in the studies at
   a 25.4% tax rate after tax reform. These factors account for some of the differences in elasticities.
   Elasticities evaluated at current law tax rates would be higher for many of these studies.
2/ Based on an average tax rate of 20 percent, after portfolio effects.
3/ Based on announced values for last year's administration proposal, after portfolio effects.
   The JCT elasticities may be lower this year.

TABLE 2

REVENUE EFFECTS OF THE PRESIDENT'S CAPITAL GAINS PROPOSAL

Fiscal Year ($ Billions)

Item 1/		1990	1991	1992	1993	1994	1995	1990-95
I. Loss on Existing Gains Under Plan	2/	-2.1	-14.1	-14.4	-13 9	-14 7	-15.5	-74.7
II. Effect of Taxpayer Behavior	2/	2.8	19.0	16 2	13.3	14 0	14.3	79.6
a. Induced Realization Effect		2.8	19 1	16.7	14 2	15 5	16.3	84.6
b. Conversion of Ordinary Income		0.0	-0.1	-0.5	-0.9	-1 5	-2 0	-5.0
III. Depreciation Recapture		-0.0	-0 3	0.5	1.1	1 6	1.7	4 6
IV. AMT Expansion		-0.0	-0.2	0.5	0.6	0.8	0 8	2.5
V. Effective Date Effect		-0.2	0.4	0.0	0.0	0 0	0 0	0.2
VI. Total Effect of Proposal		0.5	4.9	2.8	1.2	1.7	1.4	12.5

Department of the Treasury
Office of Tax Analysis

February, 28, 1990

1/ Lines I through IV assume January 1, 1990 effective date Line V shows the effect of an effective date of March 15, 1990
All estimates ignore effects on economy Details may not add to totals due to rounding

2/ Estimates for a flat 30% exclusion are

IA	Loss on Existing Gains Under 30% Exclusion		-2 7	14 3	15 6	16 6	17 5	18 4	84 5
IIA	Effect of Taxpayer Behavior Under 30% Exclusion		2 8	19 3	18 4	17 0	16 6	17 0	91 1
	Induced Realization Effect		2 8	19 4	19 0	18 1	18 3	19 3	96 9
	Conversion of Ordinary Income		0 0	0 1	0 6	1 1	1 7	2 3	5 8
	Net Effect of Phase in (I+II+IA-IIA)		0 0	0 1	1 0	1 0	0 2	0 2	1 7

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TABLE   3

- Table 1 -

ESTIMATED REVENUE EFFECTS OF THE ADMINISTRATION'S CAPITAL GAINS PROPOSAL

Fiscal Years 1990-1995

[Billions of Dollars]

Item[1]	1990	1991	1992	1993	1994	1995	1990-95
I. Static effect of the 30% exclusion[2]...................	-2.6	-17.7	-18.7	-19.8	-20.4	-20.9	-100.2
II. Effect of induced realizations[3]......................	3.0	18.9	14.4	14.9	13.4	13.8	78.4
III. Effect of full depreciation recapture.................	0.3	1.8	1.9	2.1	2.1	2.2	10.3
IV. Effect of phase-in of the 3-year holding period......	--	-0.3	-2.0	-0.9	0.4	1.6	-1.2
V. Effect of treating excluded portion of gain as a preference item for AMT purposes...................	--	0.1	0.1	0.2	0.2	0.2	0.8
VI. Effective date of the proposal[4]......................	0.1	0.6	--	--	--	--	0.7
TOTAL, Revenue Effect of the Proposal................	0.7	3.2	-4.3	-3.6	-4.3	-3.1	-11.4

Joint Committee on Taxation
February 13, 1990

NOTE: Details may not add to totals due to rounding.

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[1] All estimates in this table are done incrementally; that is, assuming provisions described on preceeding lines of the table have been enacted.
[2] This line reflects an estimate of the proposed exclusion assuming no change in taxpayer behavior.
[3] This line reflects an estimate of the increase in budget receipts attributable to taxpayer decisions to realize more capital gains as a result of the lower tax rate.
[4] Lines I-V, above, reflect a January 1, 1990, effective date. line VI represents an adjustment to these lines to reflect an assumed effective date of March 15, 1990.

Table 4

Total Capital Gains Realized
Under Current Law and an Across the Board rate Cut   1/
(S Billions)

Tax Year		Realizations Under Current Law	Realizations Under Rate Cut 1/	Change in Realizations Under Rate Cut 1/
1978		51	--	--
1979		73	--	--
1980		74	--	--
1981		81	--	--
1982		90	--	--
1983		123	--	--
1984		140	--	--
1985		171	--	--
1986		326	--	--
1987	P	144	--	--
1988	P	165	--	--
1989	E	185	--	--
1990	E	214	288	74
1991	E	236	308	72
1992	E	256	315	59
1993	E	270	338	68
1994	E	286	358	72
1995	E	300	373	73

Department of the Treasury   February 28, 1990
Office of Tax Analysis

1/ Estimates are for the full plan and assume an effective date of 1/1/90.

'P', Data are preliminary.
'E', Estimate.

Table 5

Summary of Treasury Revenue Estimating Assumptions

		1989	1990
Short Run Elasticity	1/	1.2	1 2
Long Run Elasticity, After "Portfolio Effects"	1/	0.9	0 8
Long Run Elasticity, Before "Portfolio Effects"	1/	1.0	0.9
Revenue Maximizing Tax Rate		0.20	0.23
Marginal Tax Rate	2/	0.257	0 257
Average Tax Rate	2/	0.229	0.229

1/ All elasticities are evaluated at a marginal tax rate of 20 percent. A lower marginal tax rate would lead to a lower elasticity while a higher marginal tax rate would lead to a higher elasticity.

2/ These are computed by taking a weighted average of tax rates on OTA's Individual Model, weighted by dollars of realized capital gains.

Table 6

Distribution of Taxes on Capital Gains Under Current Law
and the Fully Phased-in Administration Proposal

Fully Phased-in Proposal at Calendar Year 1990 Levels

Permanent Adjusted Gross Income /2	Tax on Capital Gains		Change in Taxes	
	Current Law	Rate Cut 1/	Static	Dynamic
	(in $ billions)			
Less than $10,000	0.3	0.3	0.0	0.1
$10,000 to $20,000	0.7	0.7	-0.1	0.1
$20,000 to $30,000	0.8	0.8	-0.1	0.0
$30,000 to $50,000	3.0	3.0	-0.5	0.0
$50,000 to $100,000	7.9	8.2	-1.1	0.3
$100,000 to $200,000	9.7	10.0	-1.4	0.3
$200,000 or more	26.8	27.7	-3.8	0.9
Total	49.0	50.7	-7.1	1.7

Department of the Treasury   March 5, 1990
Office of Tax Analysis

1/ This table is not directly comparable to revenue estimate tables because it shows the fully phased-in Administration proposal at estimated 1990 levels of realizations. The fully phased-in proposal provides 10, 20 and 30 percent exclusions for assets held one, two and three or more years, respectively.

/2 The income classifier for this table is estimated permanent Adjusted Gross Income for 1990 (including capital ga   imputed from a 5-year panel of individual income tax returns.

TABLE 7

TREASURY AND JOINT COMMITTEE ON TAXATION (JCT) REVENUE EFFECTS OF THE ADMINISTRATION'S CAPITAL GAINS PROPOSAL

Item			1990	1991	1992	1993	1994	1995	1990-95
I. Static effect of 30% exclusion:	1/	Treasury	-2.1	-14.3	-15.6	-16.6	1/.5	-18.4	-84.5
		JCT	-2.6	-17.7	-18.7	-19.9	-20.4	-20.9	-100.2
		Difference	0.5	3.4	3.1	3.3	2.9	2.5	15.7
II. Effect of induced realizations:	2/	Treasury	2.8	19.3	18.4	17.0	16.6	17.0	91.1
		JCT	3.0	18.9	14.4	14.9	13.4	13.8	78.4
		Difference	-0.2	0.4	4.0	2.1	3.2	3.2	12.7
III. Effect of full depreciation recapture:		Treasury	-0.0	-0.3	0.5	1.1	1 6	1.7	.:
		JCT	0.3	1.8	1.9	2.1	2 1	2 2	10 3
		Difference	-0.3	-2.1	-1.4	-1.0	-0.5	-0.5	-5.7
IV. Effect of phase-in of the 3-year holding period:		Treasury	--	-0.1	-1.0	-1.0	0.2	0.2	-1.7
		JCT	--	-0.3	-2.0	-0.9	0.4	1.6	-1 2
		Difference	--	0.2	1.0	-0.1	-0.2	-1.4	-0.5
IV. Effect of treating excluded portions of gains as a preference item for AMT purposes:		Treasury	--	-0.2	0.5	0.6	0.8	0.8	2.5
		JCT	--	0.1	0.1	0.2	0.2	0.2	0.8
		Difference	--	-0.3	0.4	0.4	0.6	0.6	1.7
V. Effective date of proposal:	3/	Treasury	-0.2	0.4	--	--	--	--	0.2
		JCT	0.1	0.6	--	--	--	--	0.7
		Difference	-0.3	-0.2	0.0	0.0	0.0	0.0	-0.5
VI. Total revenue effect of proposal:		Treasury	0.5	4.9	2.8	1.2	1 7	1.4	1?.5
		JCT	0.7	3.2	-4.3	-3.6	-4 3	-3.1	-11.4
		Difference	-0 2	1.7	7.1	4.8	6 0	4.5	23.9

Department of the Treasury   February 28, 1990
Office of Tax Analysis

Note Details may not add to total due to rounding
1/   This line reflects an estimate of the proposed exclusion assuming no change in taxpayer behavior
2/   This line reflects an estimate of the increase in budget receipts attributable to taxpayer decisions to
     realize more capital gains as a result of the lower tax rate
3/   Lines I-IV, above, reflect a January 1, 1990, effective date; line V represents an adjustment to these
     lines to reflect an assumed effective date of March 15, 1990

APPENDIX

REVENUE ESTIMATES FOR THE ADMINISTRATION'S CAPITAL GAINS PROPOSAL

This appendix provides a concise description of OTA's methodology for estimating the revenue effects of the Administration's capital gains proposals.

I. General Conventions

The primary model used in the analysis is the OTA Asset Portfolio Model. The distribution of the sales price, basis, holding period and gains for the assets sold by taxpayers are benchmarked to the 1981 and 1985 Sales of Capital Assets studies. Depreciable and non-depreciable assets are modelled separately. Tax rate parameters used in this model are based on simulations using OTA's 1985 Individual Tax Model. The assumed level of baseline realizations and other parameters are shown in Table 5 and at the end of this appendix.

The revenue estimating methodology accounts for (1) induced realizations due to lower tax rates, (2) deferral of realizations due to lower future tax rates, and (3) "portfolio effects" or conversions from ordinary income to capital gains due to differential tax treatment of capital gains and ordinary income.

In simulating the Administration's proposal, induced realizations are modelled by comparing the tax rate in period t to the current law tax rate. The tax rate in period t is also compared to the proposed tax rate in period t+1 in order to estimate potential deferrals under the phase-in and the subsequent periods. Portfolio effects are estimated by examining the wedge in period t between the proposed capital gains tax rate and the current law tax rates on ordinary income.

The effects of other features of the proposal, such as the extension of the AMT to excluded gains, are directly estimated from OTA's Individual Tax Model.

II. Induced Realizations

Consistent with much of the literature, capital gains realizations are modelled in semi-log functional form with respect to the tax rate:

(1) $I_{v,t} = (e^{-\epsilon(MTRp-MTRa)}-1) * GAINS_{v,t}$

where $I_{v,t}$ is the level of induced realizations of assets of vintage v in period t, and $GAINS_{v,t}$ is the baseline level of realizations of assets of vintage v in period t. This functional form was used to estimate revenues for both this year's and last year's proposals. ϵ is a parameter related to the elasticity which ranges for all assets from 5.8 in the first year to 4.5 after 3 years. At a 20% tax rate, these values correspond to elasticities ranging from 1.2 in the first year to 0.9 (0.8 after portfolio effects) in the fourth year. For purposes of modelling depreciation recapture, the value of ϵ is taken to be 4.2 in the second year, 2.94 in the third, and 2 in the fourth year. MTR_p is the proposed marginal tax rate, and MTR_a is the actual marginal tax rate.

III. Deferrals

Under the proposal tax rates decline with the length of the holding period for holding periods up to three years. Lower future tax rates result in postponed realizations and dampen the effects of lower tax rates in the current year, but result in increased future realizations.

$D_{v,t}$, the deferral of gains from the sale of assets of vintage v in period t that are held less than 3 years (and thus are not provided the maximum 30% exclusion under the proposal) are given by:

(2) $D_{v,t} = (e^{-\phi(MTR_f - MTR_c)} - 1) * (GAINS_{v,t} + I_{v,t} + D_{v-1,t-1}*(1+g))$

where MTR_f is the lowest marginal tax rate over the current and following five years, MTR_c is the marginal tax rate in period t (actual or proposed), and g is the growth rate of baseline realizations. ϕ is a parameter related to the elasticity of deferrals with respect to the tax rate and is set equal to 0.75 of the parameter ϵ.

IV. Portfolio Effects: Conversion of Ordinary Income

Lower tax rates on capital gains induce realizations partially by encouraging investors to hold more capital-gains-producing assets and fewer ordinary-income-producing-assets. These portfolio effects are estimated from the equation:

(3) $P_{v,t} = (e^{-n(MTR_p - MTR_a)} - 1) * GAINS_{v,t}$

where $P_{v,t}$ is the level of ordinary income lost as a result of asset conversion and where n is a parameter ranging from 0 in the first year to 0.5 in the fifth year.

V. Key Parameters Used in the Revenue Estimates

The parameters noted below are used in OTA's revenue estimates. Several steps are followed in obtaining these estimates: First, tax liability under current law is computed by multiplying baseline gains by the average tax rate (0.229). Second, tax liability under the proposed law is computed by multiplying total gains (including the effects of induced realizations and deferrals) by the average tax rate under the proposal after recognition of the induced realizations (0.165 for a 30% exclusion, 0.186 for a 20% exclusion, and 0.208 for a 10% exclusion. These average rates reflect the fact that some taxpayers move into different tax brackets as a result of induced realizations). Third, the portfolio effects are determined by multiplying the amount of ordinary income lost by the average tax rate on converted income (0.24). Finally, the total revenue effect of the proposal is calculated by subtracting the tax liability under current law and the portfolio effects from the tax liability under the proposal.

Calendar Year

	1990	1991	1992	1993	1994	1995
Current Law Tax Rates:						
Marginal Tax Rate	0.257	0.257	0.257	0.257	0.257	0.257
Average Tax Rate	0.229	0.229	0.229	0.229	0.229	0.229
Average Tax Rate with 30% Exclusion	0.165	0.165	0.165	0.165	0.165	0.165
Average Tax Rate with 20% Exclusion	0.186	0.186	0.186	0.186	0.186	0.186
Average Tax Rate with 10% Exclusion	0.208	0.208	0.208	0.208	0.208	0.208
Average Tax Rate for Portfolio Effects	0.240	0.240	0.240	0.240	0.240	0.240
Elasticity-Related Coefficients:						
Induced Realizations (ϵ)	5.8	5.2	4.7	4.5	4.5	4.5
Portfolio Shifting (n)	0.0	0.125	0.250	0.375	0.500	0.500
Long-Term Baseline Realizations: ($ Billions)	204	225	239	253	267	278

PREPARED STATEMENT OF SENATOR BOB GRAHAM

Mr. Chairman, thank you for the opportunity to testify before your
committee on investment strategies and S. 1938, a bill I
introduced last November with Senators Nunn and Cranston to
encourage long term investment.

For some time, we have been concerned with the time frame in which
economic decisions are made in this country. There is strong
evidence that our country's investors, entrepreneurs and corporate
management have substantially overemphasized financial return on
the short range basis to the detriment of long range investment.
This short range emphasis has resulted in a lack of research and
development, an increase in plant and equipment deterioration, and
created an environment in which many American industries are
failing to invest in order to be competitive in the global economy
into the twenty-first century.

Mr. Chairman, as policymakers, we have a responsibility for the
creation of an economic environment that encourages corporate
management and investors to turn their focus away from a quarter-
by-quarter analysis for measuring success or failure.
Unfortunately, Congress has not itself been immune from the lure
of short-term planning.

Two examples that came before Congress last session were the
capital gains bill passed by the House of Representatives and the
IRA proposal included in Senator Packwood's capital gains bill.
Both of the measures are similar in responding to the call for
immediate revenue gain. The House passed bill encouraged the
churning of assets to generate additional revenue over a 24-month
period by reducing the tax rate on capital gains and then
returning the rate to its existing status with indexing for the
future. The IRA proposal traded a small amount of current revenue
for a substantial reduction of future taxes from our most affluent
taxpayers.

These are not the policy proposals we should be making because
they take us in the opposite direction and orientate us to a fire
sale mentality. Instead we should be looking long range. We
should be encouraging our corporate management, entrepreneurs and
investors to emphasize the long term. We should be encouraging
these people to invest their money for long term growth in the
American economy which will provide jobs and economic
opportunities. One step to long range thinking is to lengthen
holding periods for investment purposes, which is what S. 1938
does.

Low cost capital is another element that could remove some of the
pressures of the instant gratification syndrome. From a public
policy point of view, we recognize that this cannot be achieved
until we have the political will to balance our federal budget.
However, we can assist in the achievement of low cost capital and
expand the horizon of the time frame for economic decisions by
rewarding investors whose investments meet the criteria of being
long term.

Mr. Chairman, I look forward to working with your committee to
incorporate the provisions in S. 1938 into a legislative program
that enhances America's competitive future. Our bill has the
following characteristics:
It applies to all capital assets except collectibles. It applies
a tax rate cut but does not index. It is directed to both
individuals and corporations and the excluded gain is to be
treated as a tax preference for alternative minimum tax purposes.

Specifically, individuals who acquire capital assets after the date of enactment, will be able to exclude five percent of the gain on the sale of said capital assets after a one year holding period. For each additional year holding period thereafter, the individual could exclude an additional five percent of the taxable gain up to a total exclusion of fifty percent, which occurs after a ten year holding period.

Individuals who acquired capital assets prior to date of enactment of this legislation and all corporate capital assets (previously owned and acquired after the date of enactment of this legislation) will be able to exclude five percent of the gain on the sale of said capital assets after a two year holding period. For each additional year of holding period thereafter, the taxpayer could exclude an additional 2.5 percent of the taxable gain up to a total exclusion of twenty-five percent, which occurs after a ten year holding period.

For capital assets acquired more than six years prior to the date of enactment of this bill, the taxpayer will be credited with six years of holding period as of the enactment date of this legislation and will be eligible for a fifteen percent exclusion. For each additional year of holding period thereafter an additional 2.5 percent exclusion is allowable until a maximum exclusion of twenty-five percent is reached.

Additionally, the bill provides for a special new tax incentive for venture/seed capital investment, whose principal architect is our colleague, Senator Bumpers, that has the following characteristics:

    I.   Applies to direct investment in new corporations with capitalization of less than twenty million dollars.

    II.   Applies to individuals and corporations.

    III.   After a four year holding period a forty percent exclusion of the gain is applicable; after a six year holding period a maximum fifty percent exclusion of the gain is applicable.

    IV.   Fifty percent of the excluded gain would be used as a tax preference for the alternative minimum tax.

Mr. Chairman, this proposal cannot alone accomplish the objective of altering entrepreneurial behavior, but it can be a significant part in a comprehensive strategy to change America's short-term investment focus. I have a long-standing interest in adjusting capital gains as a way to lengthen the time frame for economic decisions. I believe this bill is the first step on the road to an economic objective we must reach. I look forward to working with your committee in this direction.

EFFECTS OF THE PROPOSED CAPITAL GAINS TAX CUT ON THE DEFICIT

Mr. Chairman and Members of the Committee, I would like to thank you for the invitation to appear before you today to discuss the results of my research on revenue implications of the proposal to allow up to a thirty percent exclusion of capital gains from the income tax. My remarks are based on a recent study of this issue contained in Congressional Research Service report entitled "Can a Capital Gains Tax Cut Pay for Itself?," released on March 23, 1990.

There are two possible avenues through which a capital gains tax cut might be armed to pay for itself. The first is through a large and sustained increase in capital gains realizations induced by the tax cut. The second is through an increase in economic growth which will increase the revenue base. The Joint Committee on Taxation has estimated that while a substantial realizations response will occur, a capital gains tax cut will result in a revenue loss of $11.4 billion over the period 1990–1995. The Administration has claimed that the realizations response will be so large that there will actually be a gain in revenue of $12.5 billion. The Administration has also argued, however, that even if the smaller realizations response estimated by the Joint Committee on Taxation is employed, the remaining shortfall in revenues will be made up by economic growth.

I would like to address the latter argument first since it is relatively straightforward. A letter written on March 6, by Michael Boskin, the Chairman of the Council of Economic Advisors, stated that the capital gains tax cut was conservatively estimated to reduce the cost of capital by 3.6 percent. Without providing specific details as to how this number was in turn translated into output and revenues, the letter further concluded that the increased output arising from the expansion of capital would yield an additional $12 billion in revenue over the period 1990–1995, enough to make up the revenue shortfall estimated by the Joint Committee on Taxation.

This economic effect appears substantially overstated for a number of reasons: an original error in measuring the cost of capital, failure to take into account the savings response, and failure to explicitly account for the relatively slow adjustment process.

First, a 3.6 percent reduction in the cost of capital is a major overstatement, apparently arising largely from the failure to take into account the large fraction of capital gains that are never taxed because of the step up in basis at death. My calculations indicate that, holding net after-tax returns constant, the effect of the capital gains exclusion is to reduce the net cost of capital for the corporate sector by 0.9 percent. Moreover, this estimate is consistent with a direct calculation from the revenue loss estimate; themselves: assuming that about a third of capital gains are associated with corporate stock, the revenue loss divided by pre-tax corporate profits plus net interest is one percent. To calculate the effect for all of the economy, dividing the total static revenue loss by an estimate of capital income in the economy would yield a reduction in the cost of capital of 0.8 percent. Thus, the estimate of the effect on the cost of capital by the Council is, by my calculations, four times too large. This inconsistency between the price effect estimated by the Council and the price effect implied by the revenue cost is in part responsible for their finding of such a large induced growth effect.

Secondly, the percentage change in the cost of capital should be measured with respect to the total cost of capital, inclusive of depreciation, or what is technically referred to as the user cost of capital, as this is the price which drives investment decisions. By this calculation, the percentage change in the cost of capital should be only 0.55 percent, suggesting that the Council has overstated the effect by a magnitude of six to seven times.

Thirdly, even this estimate is too large because it is assumes that the after-tax return will not rise. Technically, it is assuming an infinitely elastic savings response that is that individuals will supply any amount of capital without requiring an increase in. the savings rate. Even the most generous estimates of this savings elasticity have set it no higher than 0.6 and some estimates suggest that the savings response is negative—i.e., that. savings will decline. This savings effect would mitigate, eliminate, or actually reverse any effects on capital and output.

Finally, any estimates must take account of the fact that the capital stock adjusts very slowly. Net investment in any year is typically only about two to three percent of the capital stock. Thus, any increase in investment in the first few years would lead to extremely small increases in capital stock and output.

If we really wish to address the question of whether a capital gains tax cut can pay for itself, we need to take into account this slow adjustment process. Moreover, we must also recognize that any deficits which occur in the interim will soak up

savings; if these deficits are larger than induced savings, the capital stock will contract rather than expand. I used a simple model to trace these effects and found that once these dynamic aspects are taken into account, the capital gains tax cut, assuming the pattern of realizations roughly follows that estimated by the Joint Committee on Taxation, would contract the capital stock and magnify any revenue loss, even with a very generous savings elasticity.

The first route, therefore, induced realizations, is the avenue through which a capital gains tax cut might conceivably pay for itself. Let me first state the basic conclusions from my study regarding this effect. Both the Joint Committee on Taxation and the Administration assume a substantial realizations response; the Joint Committee on Taxation's estimate is somewhat smaller than that of the Administration's. My analysis suggests that the Joint Committee's estimates of the revenue effects appear to be more reasonable predictions of the likely revenue consequences than those of the Administration and may, themselves, substantially understate the revenue loss associated with cutting capital gains taxes.

Before discussing the statistical evidence, I would like to make two general observations. First, there are uncertainties associated with all of the statistical estimates of realizations response. (These responses are characterized in the form of elasticities, which are percentage changes in realizations divided by percentage changes in tax rates.) Therefore, to some extent, the public policy question is how to use highly imperfect information to decide how to accommodate a tax provision in the budgetary process. If we use elasticities that are too high, we will have increases in deficits that reduce national savings and retard economic growth. If we use elasticities that are too low, we achieve somewhat more deficit reduction than otherwise planned. If the latter error is considered less damaging than the former, then we will wish to be extremely conservative in choosing our elasticities. Indeed, the Administration's stress on using conservative elasticities suggests that is the view they hold.

Secondly, it is important to point out that the only significant source of a sustained permanent increase in realizations is selling assets which would otherwise have been held until death. Merely increasing the turnover rates of assets which would already have been sold would only induce a temporary increase, since additional sales would increase the basis for future sales: these gains will not be taxed twice. Thus to believe that there is a large permanent effect, we must believe that individuals who were otherwise not planning to sell assets and thus contemplating escaping the tax entirely would now be induced to do so in large numbers. Such a response is possible because much of gain does escape tax, but history suggests that realizations as a percent of unrealized accruals has be en relatively stable over time.

The Administration has argued, in testimony presented earlier to this Committee, that statistical studies have shown that their realizations response is quite conservative. They presented a table of twelve studies showing that their long-run elasticity is smaller than nine of the studies, while the elasticity used by the Joint Committee is smaller than ten of the studies. The Administration's tabulation contains, however, a number of problems in representing or reporting the results of these studies, thus, overstating these elasticities from the literature. When these elasticities are corrected, the Administration's estimates are relatively high, ranking below only five of the studies. This different characterization of the Administration's elasticity is shown in the table which tabulates the studies both with the original listing and with the new listing. Or to put it another way, if the Administration were to choose an elasticity with the same rank in the corrected list of the original studies as they did in the studies actually presented, they would choose an elasticity only sixty percent as large, which would produce revenue losses larger than those projected by the Joint Committee.

Moreover, one has to consider carefully to what extent these empirical studies are valid. There are two basic types of studies: micro data studies (both cross section and panel) which try to estimate the realizations response by looking at individual observations, and aggregate time series studies which look at realizations and tax rates over time.

SURVEY TABLE FROM TESTIMONY OF KENNETH W. GIDEON, MARCH 6, 1990

Original Listing		New Listing	
Gillingham, Greenlees, and Zieschang (1989) C	3.80	Gillingham, Greenlees and Zieschang (1989) C	3.80
Feldstein, Slemrod, and Yitzhaki (1980) C	3.75	Feldstein, Slemrod, and Yitzhaki (1980) C	3.75
U.S. Treasury (1985) P	1.68	Auten, Burman and Randolph (1989) P	1.65
Auten, Burman and Randolph (1989) P	1.65	U.S. Treasury (1985) P	1.29

SURVEY TABLE FROM TESTIMONY OF KENNETH W. GIDEON, MARCH 6, 1990—Continued

Original Listing		New Listing	
Lindsey (1987)..	1.37	Lindsey (1987)..	1.18
Jones (1989) T..	1.18	Office of Tax Analysis..................................	0.98
Darby, Gillingham, and Greenlees (1988) T..............	1.07	Jones (1989) T..	0.139
Auten and Clotfelter (1982) P........................	0.91	U. S. Treasury (1985) T................................	0.130
Congressional Budget Office (1988) T....................	0.89	*Joint Committee on Taxation*.....................	*0.76*
Office of Tax Analysis................................	*0.80*	Congressional Budget Office (1988) T....................	0.76
U.S. Treasury (1985) T..................................	0.80	Darby, Gillingham, and Greenlees (1988) T..............	0.58
Joint Committee on Taxation.....................	0.70	Minarik (1981) C...	0.62
Minarik (1981) C...	0.62	Auten and Clotfelter (1982) P 0.55........................	
Auerbach (1988) T..	0.57	Auerbach (1989) T 0.54.......................................	

C = Cross Section; P = Panel; T = Time Series.
Source: U.S. Library of Congress, Congressional Research Service, *Can a Capital Gains Tax Cut Pay for Itself?* Report No. 90-161 RCO, by Jane G. Gravelle, March 23, 1990, 23 p. The data in the table are from tables 2 and 3, pp. 6-7.

These types of studies have yielded considerably different results as shown in the bar graph, which reports the original studies listed in the table and three additional time series studies discussed in my paper. As this graph indicates, only the micro-data studies have yielded the large responses which lead to a revenue gain; more-over, the variation is these studies has been quite pronounced. Time series studies have produced less disperse, and lower, elasticity estimates.

Without resorting to economic jargon, let me try to explain what I consider, and what many others consider, to be two disabling flaws in these micro-data studies. First, individuals may be responding to a temporary change in their tax rate. If one expects one's tax rate to be temporarily low, then responses may be large as individuals seek to take account of the window of opportunity. If we needed any evidence of the power of this response, it can be found in the surge of realizations in 1986 as individuals sought to sell before the tax rates went up. But we are not seeking to measure the potentially large response to a temporary tax reduction, but rather the smaller response to a permanent one. None of the micro-data studies have satisfactorily dealt with this problem.

Secondly, these micro-data studies only work well if we assume that individuals are basically identical. But individuals with similar economic incomes have different tax rates even though they face the same tax law. For the high income individuals who primarily realize capital gains, these differences in tax rates arise primarily from different investment tastes, suggesting that indeed these individuals are not identical. These taste differences may affect both their tax rate and their realizations, which is another way of saying that we cannot establish causality in these studies and thus, that the inferences we draw are not valid.

The Joint Committee on Taxation does not consider these types of studies reliable. This is a judgment with which I concur.

The remaining category of studies, the aggregate time series studies, all yield elasticities which are below those needed for the capital gains tax cut to pay for itself. There are many difficulties with these studies as well, particularly since they involve a relatively small number of observations. Nevertheless, most of the major problems I can identify with the time series studies would reduce the measured elasticities. First, most models of capital gains realizations would predict a larger short run response than a long run response, and the time series studies may be reflecting these larger short run effects.

Secondly, these studies do not usually include a variable which picks up the change in accrued unrealized gains, which can be quite important since much of the increase in realizations was associated with both a drop in the tax rate and a rise in the stock market. To explain this point simply, if an individual has a stock with a basis of $50 and a sales price of $100, and the price of the asset doubles, realizations will triple because basis is fixed. It is very difficult to measure this variable, but when the Congressional Budget Office attempted to do so, the realizations elasticity dropped considerably and became no longer statistically significant. (This latter point means, technically, that we cannot reject the hypothesis that the tax rate has no effect on realizations).

Thirdly, there were a number of institutional changes in the last ten to fifteen years which might have caused realizations to rise independent of the drop in tax rates. These include the growth of mutual stock funds which may have higher turn-over rates than individuals do, the drop in brokerage fees, the increased reporting

requirements for capital gains which may have increased compliance, and the surge in leveraged buyouts which probably led to realizations that might not otherwise have occurred.

The Administration's estimate is above all of the time series estimates and even the Joint Committee's estimate is a little high. In light of these issues there may well be reason to believe that the Joint Committee may have under-estimated the revenue loss associated with the capital gains reduction.

In the final analysis, there is always some uncertainty associated with statistical studies. We can only use these studies to guide our thinking about the behavioral response. I hope that my comments have been helpful to you in considering this issue.

Attachments.
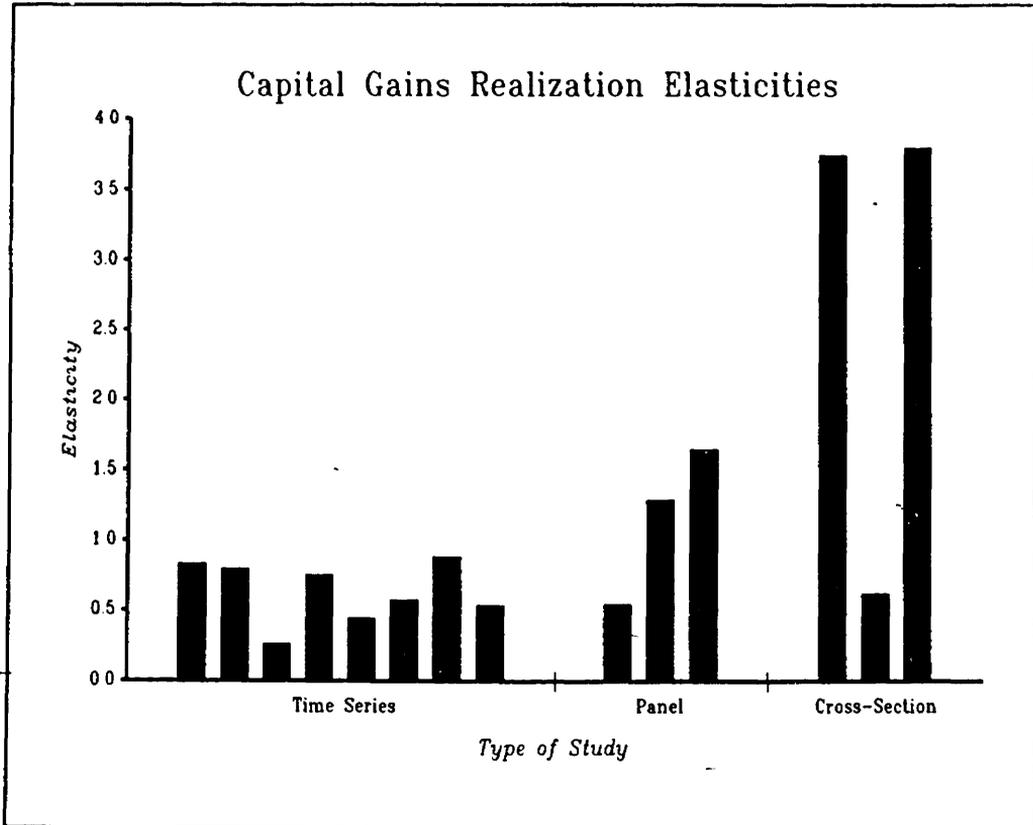
Capital Gains Realization Elasticities

Source: U.S. Library of Congress, Congressional Research Service, *Can a Capital Gains Tax Cut Pay for Itself?*, Report No. 90-161 RCO, by Jane G. Gravelle, March 23, 1990, 23 p. The data in the chart are taken from table 2, p. 6.

CAN A CAPITAL GAINS TAX PAY FOR ITSELF?

INTRODUCTION

The Administration proposes to restore a tax benefit for capital gains by allowing thirty percent of these gains to be excluded from income.[1] For the budget period FY 1990 to FY 1995, the Joint Committee on Taxation estimates that the proposal will lose $11.4 billion while the Administration's Office of Tax Analysis (OTA) estimates that it will gain $12.5 billion. While there are differences in the projected magnitudes of capital gains realizations under current law, the difference in sign of these estimates derives from differences in the estimated increase in realizations induced by the tax cut.

Both estimates include a substantial behavioral response. The Joint Committee on Taxation (JCT) estimates that the static revenue loss from the proposal (assuming no change in behavior) would be $100.2 billion over the five year period, but taxes on new realizations will be $78.4 billion. Another $10.6 billion in increased taxes will accrue from miscellaneous features of the change, primarily the recapture of depreciation. By 1995, the proposal is estimated to lose $3.1 billion: a loss of $20.9 billion offset by $13.8 billion in taxes due on increased realizations, with another $4 billion arising from miscellaneous features. The total loss in 1995 is $3.1 billion.

The OTA estimates show the static loss at $74.7 billion, offset by $84.6 billion in taxes on induced realizations. There is a further loss of $5 billion due to the switching from ordinary income to capital gains assets. Another $7.3 billion would be gained from miscellaneous features, again primarily recapture of depreciation. For 1995, the proposal is estimated to lose $15.5 billion, offset by $16.3 billion due to induced realizations. There would be a loss of $2 billion due to shifting of ordinary income into capital gains, and a gain of $2.5 billion due to miscellaneous provisions. The total gain is $1.4 billion.

The Administration argues that its higher estimates of tax induced realizations are more consistent with economic studies than the JCT's, but are nevertheless extremely conservative. In a recent development, the Administration has also argued that even if the more conservative JCT

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[1] When fully phased in, the exclusion applies to assets held for three years; assets held for two years receive a twenty percent exclusion and assets held for one year receive a ten percent exclusion. The proposal does not apply to collectibles or to the amount of depreciation claimed which will otherwise reduce the basis and thus appear to be a capital gain.

estimates are used as a starting point, increased revenues from the economic stimulus will produce offsetting revenues which will cause the proposal to pay for itself over the first five years and more than pay for itself over the first ten years. We review both of these arguments in the following sections.

THE REALIZATIONS RESPONSE

As the figures cited above indicate, both estimates assume a substantial response of taxpayers in the level of capital gains realizations. Although the Administration has assumed a more pronounced response, they have also claimed that their responses are quite conservative. Assistant Treasury Secretary Kenneth W. Gideon states in his testimony of March 6, 1990 before the Senate Finance Committee:

> "OTA's revenue estimates were made after a careful review of the major empirical studies by experts in the government and the academic community. Compared to the results in most of the studies, OTA's estimate of induced realizations is conservative. Table 1 provides detail on these studies... By any reasonable standard, OTA has endeavored to err on the side of caution when estimating these behavioral results."

A similar view is expressed in a letter dated March 6 written to several Members of Congress Michael Boskin, Chairman of the Council of Economic Advisors, who also refers to these studies:

> "...I strongly believe that the Treasury estimates are superior to the JCT, and that they probably understate the increase in revenue resulting from a cut in the capital gains tax."

Boskin stresses that the Treasury estimates are smaller than the estimates in nine of the existing twelve studies.

Two witnesses at a hearing on February 27, 1990 by the House Budget Committee had a different perspective. Henry Aaron of the Brookings Institution stated:

> "My own view is that the Administration's proposal should be treated as the upper limit of any possible revenue gain, but that the JCT estimate is nowhere near the bottom end of the range of plausible estimates of the revenue loss."

Similarly, Alan Auerbach of the University of Pennsylvania stated at the same hearing:

" ...I find the alternative revenue estimates produced by the Joint Committee on Taxation to be much more plausible than those of the Administration."

The Administration has appealed to the econometric literature on this issue to support their case that a capital gains tax cut will pay for itself and clearly this is not a unanimous view. The following sections are a review of this issue. We first suggest that the numerical results cited by the Administration do not allow a proper comparison of the OTA elasticity with those estimated in the literature and are not entirely representative of the empirical findings in a number of studies.[2] Secondly, our assessment of this literature suggests that we should be quite cautious in relying on these studies. In particular, there are very serious problems with the micro-data studies. Micro-data studies examine the characteristics of different taxpayers rather than the relationship between overall capital gains and taxes over time. In light of this assessment, the JCT estimates seem more appropriate and indeed may very well understate the revenue loss associated with the capital gains tax cut, a view also suggested by Aaron.

ADJUSTMENTS IN THE SURVEY OF ELASTICITIES

Both Gideon and Boskin refer to a table surveying the elasticities from the twelve studies included in Gideon's testimony and reproduced below in Table 1. The Administration's tabulation does indeed suggest that the OTA estimate is conservative. In terms of ranking the studies from ʰ ᴴ (1) to low (12) elasticities, the OTA estimate ranks exactly at number ᴸ ᵤ ᵗ the Joint Committee's is between 9 and 10.

The Administration's tabulation contains, however, a number of problems in representing or reporting the results of the empirical studies. Moreover, one can assess the merits of these studies more easily by characterizing the research methods used. Table 2 reclassifies the studies by type and presents the corrected numbers, along with adding the 1982 Auten study and the 1986 Congressional Budget Office (CBO) study. An alternative result reported by the CBO in their 1988 study is included because, for reasons suggested below, it may help to illustrate the importance of accounting for changes in accrued gains.

A number of studies estimate the values for an equation which yields a different elasticity result depending on size of the tax rate. Some of the numerical corrections are to seek out the values which are appropriate for assessing the current proposal. The most appropriate value to use for a given proposed change would be a value which is midway between the old and new tax rates, a value equal to 85 percent of the current marginal tax rate of .257, or approximately 22 percent. This correction tended to lower the elasticities

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[2] The elasticity is the percentage change in realizations divided by the percentage change in tax rates.

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because most of them were derived from an earlier table included in Auten, Burman, and Randolph (1989) which valued the elasticities at higher rate than that appropriate to the proposed thirty percent exclusion. When the OTA reported its own elasticity, however, it was valued at a lower rate than appropriate, 20 percent. These differences in choice of tax rate make the OTA elasticity look relatively low. These tax rate corrections were made in all cases where they were possible; no correction was possible for the micro-data studies because of insufficient data or for the Treasury 1985 time series data which was run in a form which makes it difficult to adjust to current circumstances. (In some cases, especially for the Auten and Clotfelter study of a middle income sample, the elasticity will be understated because it was measured at lower tax rates; on the other hand, two of their three basic equations produced long run elasticities which were lower still and not statistically significant).

The second reason for correcting the elasticities is that a number of them are reported as the midpoint of a range reported in the survey table in the Auten, Burman, and Randolph study. Their purpose in specifying this range was to illustrate the variation in point estimates as a background for a discussion of the causes of variation in the econometric studies. Reporting the midpoint of a range may, however, misrepresent the general findings of studies if there is an extreme value. Moreover, authors may report functional forms which they find questionable to illustrate some point they are making, even though they state clearly that they do not prefer a particular equation. The elasticities reported in Table 2 reflect either the averages of those equations which the authors themselves indicate that they find to be reasonable specifications, a stated preferred equation, or the equation chosen for further use in simulation work.

Finally, in one case (Jones) there appeared to be a simple mistake in reporting the elasticity. The specific details of the corrections are presented in Appendix I.

The OTA elasticity was also altered to include the elasticity before portfolio effects. The OTA estimates that realizations will rise for two reasons: an unlocking of gains which will increase revenues and a shift into capital gains yielding assets from other assets which will lose revenues. For example, realizations may go up because individuals sell assets they otherwise would not have sold (the unlocking effect) or they may go up because individuals will shift assets from ordinary income into capital gains (the portfolio effect). Table 1 reports the total realizations effect, but the revenue estimates treat a small part of that effect as leading to a revenue loss.

Table 1: Survey Table from Testimony of Kenneth W. Gideon, March 6, 1990

Studies	Data Type	Capital Gains Type	Realizations Elasticity
Gilligham, Greenlees, and Zieschang (1989)	Pooled Cross-Section Time Series, 1977-1985	All Capital Assets	3.80
Feldstein, Slemrod, and Yitzhaki (1980)	Cross-Section, High Income Sample, 1973	Corporate Stocks	3.75
U.S. Treasury (1985)	Panel Data, 1971-1975	All Capital Assets Corporate Stocks	1.68 2.07
Auten, Burman and Randolph (1989)	Panel Data, High Income Sample 1979-1983	All Capital Assets	1.65
Lindsey (1987)	Pooled Cross Section Time Series, 1965-1982	All Capital Assets	1.37
Jones (1989)	Time Series 1948-1987	All Capital Assets	1.18
Darby, Gillingham, and Greenlees (1988)	Time Series 1954-1985	All Capital Assets	1.07
Auten and Clotfelter (1982)	Panel Data, Middle Income Sample, 1967-1973	All Capital Assets	0.91
Congressional Budget Office (1988)	Time Series, 1945-1985	All Capital Assets	0.89
Elasticity: Office of Tax Analysis 1990		Short Run Long Run	1.20 0.80
U.S. Treasury (1985)	Time Series (1954-1985)	All Capital Assets	0.80
Elasticity: Joint Committee on Taxation 1989		Short Run Long Run	1.20 0.70
Minarik (1981)	Cross Section High Income Sample, 1973	Corporate Stock	0.62
Auerbach (1988)	Time Series 1954 to 1986	All Capital	0.57

Table 2: Studies Classified by Type, With Corrected Values

	Value Reported in Testimony	Corrected Values
Aggregate Time Series		
Auerbach (1989)	0.57	0.54
Darby, Gillingham and Greenlees(1988)	1.07	0.58
CBO (1988)	0.89	0.76
CBO (1986)	Not Reported	0.27
Jones (1989)	1.18	0.89
Treasury (1985)	0.80	0.80
CBO Alternative (1988)	Not Reported	0.45
Auten (1982)	Not Reported	0.84
Micro-Data		
Panel		
Auten and Clotfelter (1982)	0.91	0.55
Treasury (1985)	1.68	1.29
Auten, Burman and Randolph (1989)	1.65	1.65
Cross Section		
Gillingham, Greenlees, and Zeischang (1989)	3.80	3.80
Feldstein, Slemrod and Yitzhaki (1980)	3.75	3.75
Minarik (1981)	0.62	0.62
Lindsey (1987)	1.37	1.18
Office of Tax Analysis Elasticity*		0.98
Joint Committee on Taxation Elasticity*	0.76	

* Elasticity before portfolio response. The reader should, however, consult the discussion under the heading "Assessment of Studies" which addresses the question of to what extent the empirical studies are producing a number comparable with this elasticity when portfolio effects are taken into account. Appendix I contains details of the calculations.

Table 2 presents an entirely different picture. While the JCT estimates can be considered somewhat conservative with reference to these studies, although not extremely so, the OTA elasticity can no longer be considered conservative. Indeed, if the numbers in Table 1 were used to guide the Administration in their choice of elasticity, that elasticity might be higher than the one they would have chosen given the adjusted numbers in Table 2. Or to put it another way, if the elasticity is chosen to have essentially the same rank in the corrected list of elasticities as in the original numbers, using the same original twelve studies, the elasticity would be below .6, rather than the .98 they are effectively using.

ASSESSMENT OF THE STUDIES

As indicated by the classification of the studies in Table 2, most econometric studies fall into two major classes: aggregate time series and micro-data cross section. The time series studies generally show the elasticity to be below one (the estimate necessary, roughly, to yield no revenue loss), and well below one in many cases. The cross section studies vary widely. Moreover, in both cases there are instances where the tax variable was not statistically significant, which means that we cannot reject the hypothesis that the realizations response is zero.

These differences reflect the basic data sources used to generate the estimates. Aggregate time series data sets use observations of total gains, average marginal tax rates, and other aggregate variables over time while micro-data cross section studies use observations of gains, tax rates, and other variables for a sample of individual taxpayers within a single time period. Panel studies are micro-data studies that add some limited time dimension to the cross section study of gains by tracing individuals over a few years. The Gillingham, Greenlees, and Zeishchang study includes micro data for several years but does not trace the individuals themselves, and thus we have classified it with the two other single year cross section studies by Feldstein, et al., and Minarik. The Lindsey study includes many years, but also disaggregates taxpayers by income class; this hybrid treatment makes the estimated elasticities of this study difficult to classify.

If these studies were measuring the same phenomenon, they should yield similar results. The fact that they are so divergent suggests that they are not. The following discussion is designed, therefore, to explain the major differences between the types of studies and their shortcomings. We conclude that it is probably safer to rely on time series estimates, simply because the problems with cross section studies appear to be crippling. Moreover, there are reasons to believe that the time series estimates may actually be overstated, suggesting a relatively low realizations elasticity.

There are, to be sure, shortcomings in both types of studies. Therefore, to some extent the public policy question is how to use highly imperfect information to decide how to accommodate a tax provision in the budgetary

process. If we use elasticities that are too high we will have increases in deficits that reduce national savings and retard economic growth. If we use elasticities that are too low, we achieve somewhat more deficit reduction than otherwise planned. If the latter error is considered less damaging than the former, then we will wish to be extremely conservative in choosing our elasticities. Indeed, the Administration's stress on using conservative estimates suggests that is the view they hold. By that standard, even the JCT elasticity would probably be seen as too high.

There are a host of both econometric and theoretical problems associated with all of these studies, many of which are detailed in the studies themselves. Many of these problems are common to both types of studies. For example, none of the studies really captures well the basic theory of realizations behavior, in part because that theory itself is not really developed. Individuals may realize gains for consumption purposes which would require an extremely complex over-lapping generations life cycle model. They may wish simply to switch assets either because they have changed expectations or because they wish to re-balance their portfolios. These theories do, however, tend to suggest that the major source -- in some models the only source -- of permanent changes in realizations is the selling of assets otherwise held until death.[3] If individuals are not very willing to sell assets they otherwise intend to hold until death, then a cut in the capital gains tax might yield a temporary response, but not a permanent one. This occurs primarily because the initial increased realizations reduce the basis for future realizations and thus offset the increases arising from higher turnover rates. That is, the same income cannot be taxed twice. Yet, none of the studies really capture these dynamic elements, and with one exception they do not include changes in accrued unrealized gains as an explanatory variable.

Moreover, the studies try to capture the effect on realizations through a single variable, the capital gains tax rate, when the effect depends in part on the array of possibilities for investment and timing of gains. For example, to the extent that realizations reflect a portfolio response as well as an unlocking effect, changes in the capital gains tax which derive from changes in ordinary income have uncertain effects on realizations arising from portfolio shifts. In general, taxpayers are more likely to move into tax favored investments when ordinary tax rates are high. But the effect of changing the ordinary tax rate (as opposed to changing the preference for capital gains income) on realizations through this portfolio effect depends on where capital gains yielding assets rank among tax favored assets (i.e. they are favored relative to fully taxable assets, but disfavored relative to tax exempt bonds and perhaps tax shelters). Moreover, other features of the tax law (such as depreciation)

[3] See for example, Bailey, Martin J. Capital Gains and Income Taxation. In Harberger, Arnold C., and Martin J. Bailey, eds. The Taxation of Income from Capital. Washington, The Brookings Institution, 1969, p. 11-49, and Stiglitz, Joseph E. Some Aspects of the Taxation of Capital Gains. National Bureau of Economic Research. Working Paper No. 1094, March 1983.

and influences such as inflation which can alter relative degrees of tax preference also influence this portfolio effect, as well as the lock in effect itself. This simplified representation of a more complex model, therefore, causes problems for all of the empirical studies.

There are, however, some key differences in the types of studies. These differences are so important that they should affect how much we rely on different estimates and which category of estimates we choose as the most valid. The following discussion is a comparison of the problems with micro-data studies and time series studies. The reader is referred to the studies themselves and to some of the critiques cited below for more detail.

The Micro-data Studies

In many ways, cross section data seem initially more attractive than time series. The sample size is much larger, leaving more scope for the study of many explanatory variables. The initial studies used this data source. There are two important basic criticisms of these micro-data studies: failure to fully account for transitory effects, and failure to account for individual specific effects.[4]

The transitory effects issue is relatively straightforward. An individual's tax rate may vary from one year to the next because of fluctuations in earnings or in measured taxable income. When an individual is in a temporarily low tax rate compared to his permanent rate he has a strong incentive to realize gains at that time, including speeding up realizations he would otherwise have deferred. Indeed, if we needed any proof that individuals respond to temporary tax differences, we need only examine 1986 when realizations rose dramatically because of the expectation that tax rates were going up. Similarly, when tax rates are above average he has a strong incentive to delay realization until his tax rate falls. Thus, even if we observe a strong inverse relationship between realizations and tax rates, this will not tell us what happens when tax rates are permanently lowered. Cross section

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[4] One perhaps less important problem which exists for any cross section study is trying separating out the effects of income and price on behavior. The only source of differential price is the tax rate and in a progressive income tax system the tax rate is determined by the income level. If this relationship were linear we would not be able to separate these different effects, but because there are many income levels associated with a different tax level, it is possible to estimate such a relationship. However, we are still not able to obtain correct estimates unless we know the functional form of the relationships to begin with, as pointed out by Feenberg, who examines this problem in the context of studies on charitable contributions. Feenberg's findings suggest that this bias is probably not very important. See Daniel Feenberg. "Are Tax Price Models Really Identified? The Case of Charitable Giving." National Tax Journal, Vol. 60, December 1987, pp.629-634.

studies cannot deal with this phenomenon at all, and thus must be considered quite suspect (and likely to overstate the elasticity, other things being equal).

Panel studies can try to address this problem, albeit imperfectly. This point was one of the important contributions of Auten and Clotfelter's study. They separated taxes and income into permanent and transitory elements, by treating the permanent values as the averages over the previous three year period and including a transitory element as the difference between the current value and the average value. They found the transitory tax rate to have a much larger and statistically significant effect on gains, while the permanent rate resulted in a much lower, and frequently statistically insignificant effect, suggesting that this issue of transitory tax effects is extremely important. The Treasury (1985) panel study used the same approach, while the Treasury (1989) study by Auten, Burman and Randolph effectively did so by including lagged tax rates. Because they included only one lag, their correction involves an average over two years rather than three.

Even so, the panel data corrections are not entirely satisfactory because two or three years are not enough to establish a permanent rate. Suppose for example, two individuals have a permanent tax rate of .25 percent but one individual's tax rate drops temporarily to .20 percent. The true deviation of his current tax rate (the transitory component) is .05 but the deviation will be measured as .033 and his permanent tax rate will be measured as .233 (the average of .25, .25 and .20) when a three year averaging approach is used. Thus, part of the transitory effect will still be ascribed to a permanent effect. This situation will be worse in the case of only a two year average, where the transitory component will be measured as .025 and the permanent tax rate as .225. Thus, the panel studies done to date must be viewed as only partially dealing with this transitory tax effect. In both of these cases, we would still expect that the realizations response would be overstated. This problem of transitory tax rates is further complicated by the fact that realizations may be affected by expectations of future changes.

The final basic problem with cross section studies is the presence of unmeasured individual specific effects. Cross section studies work well if the individuals being compared only vary due to measurable factors such as marital status and age which are included as explanatory variables. Otherwise it is not possible to tell how a given individual is affected when his tax rate changes. If individuals differ in their preferences, then it may be invalid to use findings from cross section to make inferences about the response to an exogenous change. Indeed, since all individuals face the same tax law, the fact that individuals with similar economic incomes have different tax rates strongly implies that they are different, particularly in their tastes in investment which tend to drive tax differentials for the high income individuals who realize most gains. These different tastes may simultaneously affect both their tax rate and their level of realizations. This is another way of saying that the independent variable, the tax rate, is not truly independent, but rather itself determined by behavior (endogenous).

Some aspects of this problem might be dealt with. For example, there is a technique which can be used in panels to deal with constant effects (such as a taste for risk), called fixed effects. One can study the deviation of current gains from the average gains over the period of the panel as a function of the deviation of other variables from their averages, so that the fixed effects drop out. Unfortunately, as Slemrod and Shobe[5] have pointed out, permanent tax rates are indistinguishable from other fixed effects because they are constant over time. Thus, only the transitory effect, which is meaningless for estimating the effect of a permanent tax change, may be consistently estimated if fixed effects are present.

It is largely for these reasons that considerable doubt as to the validity of cross section studies, even those with panels, has developed. Auerbach, for example, concludes that these studies simply cannot deal with the transitory and individual specific effects.[6] Moreover, those panel studies which span periods of exogenous tax change such as the Auten, Burman, and Randolph study are also affected by some of the issues of dynamic adjustment which complicate time series analysis. That is, individuals may be adjusting to a permanent as well as a temporary change in their tax rates, and it not possible to separate these components. Thus, while recognizing that this study was an extraordinarily sophisticated one in dealing with a number of complex econometric and theoretical problems, the results cannot be viewed as very reliable for estimating the response to a permanent tax change for all of the reasons cited above as the authors themselves suggest in their paper.[7]

Difficulties with Time Series

If micro-data studies seem inherently unreliable, can we then turn to time series studies? These studies all suggest that the elasticity is below one (the value roughly needed for the capital gains tax cut to pay for itself). Time series studies largely avoid some of the major problems of cross section since most of the variation in tax rates across time is clearly exogenous -- a result

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[5] Slemrod, Joel, and William Shobe, "The Tax Elasticity of Capital Gains Realizations; Evidence From a Panel of Taxpayers." February, 1989.

[6] Auerbach, Alan. "Capital Gains Taxation and Tax Reform." National Tax Journal, Vol. 62, September, 1989, pp. 391-401.

[7] This point is made by one of the authors of the study. See Leonard Burman, "Why Capital Gains Tax Cuts (Probably) Don't Pay for Themselves," forthcoming in Tax Notes, April 2, 1990.

of tax law changes rather than taxpayer behavior.[8]   Moreover, like micro-data studies the capital gains tax treatment is represented by a single variable. In aggregate studies, this tax variable is further collapsed into a single economy wide tax rate, which may result in aggregation bias. Time series also suffer from the inherent problems of small sample size. This small sample size limits the number of variables which can be included and causes an incomplete representation of the dynamics of adjustment.   Some of the remaining problems, such as problems with time trends, have been addressed in some of the studies, such as Auerbach's and Jones's, by using differenced data.

Briefly, aggregation bias occurs because a lot of individual tax rates are averaged into one rate.   This can create a problem if the responses of individuals in different income brackets are different and if the tax law changes did not proportionally alter the tax rates across income classes. And by averaging out variations, it may cause the estimated elasticity to be too low. Much has been made of aggregation bias by some critics of time series studies. The 1988 CBO study explored this issue by separately estimating the response for the top one percent and bottom 99 percent, finding that this effect was apparently unimportant. This result may not be surprising given the heavy concentration of capital gains among high income taxpayers. Thus while aggregation bias may be a problem it does not appear to be a significant one.

Finally, it is very difficult to capture many of the variables which influence realizations. This shortcoming, however, appears on the whole more likely to result in the time series estimates being overstated. There are three elements of this argument.

If asset prices are not changing erratically then realizations would tend to be a constant fraction of assets absent changes in other variables, and all values would grow at the steady state rate. For this reason, one of the variables which is usually introduced into a time series equation is asset values, either of corporate stock or some measure of tradeable wealth. However, when price changes of assets deviate from the rate of change in the economy this relationship would not be stable. To consider a simple example, suppose an asset would normally sell for $100 and the basis is $50. But suppose the price of stock now doubles. Asset value will rise to $200 but basis will not change. While the asset price has doubled, realized gains have almost tripled. This point is extremely important because much of the reason

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[8] Endogeneity can be a problem with time series as well as cross section since an average marginal tax rate must be constructed, and that marginal tax rate can be influenced by gains. CBO used some techniques to account for this effect; in any case, this problem appears to be of minor concern. Another problem is called sample selection bias, which occurs because only those actually realizing gains are reflected in the data, but this problem also appears to be a minor one.

for finding a statistically significant relationship between realizations and tax rates is that realizations rose after 1978 in excess of what could be accounted for by other variables such as wealth and income and this rise was accompanied by a reduction in marginal tax rates. This was also a period, however, when the stock market was rising rapidly, and it might be that the rapid rise in realizations was reflecting not a response to tax cuts but rather the natural response to a surge in asset values.

Thus, time series estimates (and cross section, for that matter) should include a variable to reflect the effect of changes in accrued gains rather than changes in assets. But such a variable is difficult to construct because, although we know what changes in asset values are, we cannot observe changes in aggregate basis. Nevertheless, CBO did try to construct an accruals variable in one of their alternatives, which is included in Table 2. The elasticity dropped considerably and the coefficient on the tax term was not statistically significant. This finding is consistent with the discussion above but must be considered with caution because the stock of accruals is measured with error.

Another reason for overstatement of the responsiveness of realizations to tax rates is that there have been some institutional changes not captured in the regressions: the reduction in brokerage fees, the growing popularity of mutual stock funds which tend to have higher turnover rates (owing perhaps to both professional management and lower brokerage fees due to buying and selling in blocks), the growth in leveraged buyouts which may induce some realizations that might not otherwise have occurred, and introduction of reporting requirements for capital gains which may have increased compliance. The last issue was explored by the CBO (1988) study by using a dummy variable for the years of the reporting requirements. The dummy variable was not statistically significant, but the tax rate coefficient did fall, implying an elasticity of .58. While such an equation is not conclusive, it is suggestive.

A final reason that the time series estimates may be overstated involves dynamics. To the extent that increased realizations responses are decreasing holding periods of assets that would have been sold anyway rather than resulting in the realization of gains on assets held until death, the short run response will be considerably larger than the long run response. Moreover, if the response arises from portfolio rebalancing, the sales of the existing stock of assets in the first year or so will be much larger than the increase in turnover rates in the long run, leading to an initial surge of realizations which will then decline. Indeed both the Treasury and the Joint Committee on Taxation incorporate such differentials between short run and long run elasticities. Time series estimates may be primarily capturing a shorter term response which will be larger than the permanent response.[9] This issue of

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[9] While a completely satisfactory model of capital gains realizations has not been developed, Kiefer has explored the time path of adjustment when trading occurs because of continually changing expectations about rates of

dynamics is complicated, however, by asymmetries in the response to tax reductions versus tax increases. Because only a small fraction of assets are sold each year, the short term response to a tax decrease might be more pronounced than the short term response to a tax increase, the latter being limited for any taxpayer to the annual level of gains already realized.

Concluding Notes on the Realizations Response

Although the critique in this section suggests that all of the estimates are unreliable, the flaws of cross section, including panel studies, appear to be more disabling than those in the time series. Certainly, all studies are not of equal validity and one's estimate is best guided not by an average but by an understanding of the weaknesses of different study techniques. Moreover, the omitted variables in time series do appear by and large to suggest that the time series estimates, themselves lower than the cross section estimates, may nevertheless be overstated. On the whole, therefore, the body of evidence does not suggest that elasticities are high enough for a capital gains tax cut to pay for itself through a realizations response; indeed, it suggests that the JCT estimates may well understate the revenue loss.

FEEDBACK FROM ECONOMIC GROWTH

This growth feedback issue raised in Assistant Secretary Gideon's testimony was also raised in another letter to several Members of Congress, also dated March 6, jointly signed by Michael Boskin, Chairman of the Council of Economic Advisors and Robert R. Glauber, Undersecretary for Finance of the Treasury Department. These statements claimed that the revenue loss from the capital gains tax cut would be made up by increased output arising from the stimulus to capital from the capital gains tax cut. This letter states:

> Even using the extremely pessimistic JCT estimates and making lower bound assumptions, the capital gains tax cut would increase revenue over the next five years, once economic growth is considered.

The letter states that a conservative estimate is that the President's proposal would lower the cost of capital for businesses by 3.6 percent. There is apparently some recognition that the capital stock cannot adjust instantaneously. In any case, the conclusion is that over the next five years, the lower cost of capital will lead to an increase in GNP of $61 billion and raise revenue of roughly $12 billion, approximately offsetting the net revenue

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return. These time paths can be quite complex with realizations rising, then falling, and then rising again. See Donald W. Kiefer, Lock-In Effect Within a Simple Model of Corporate Stock Trading.

loss estimated by the JCT. In the next ten years, the lower cost of capital is said to increase GNP by $274 billion, with a revenue increase of $55 billion, which would swamp any loss.

This claim is considerably overstated for several reasons. First, a 3.6 percent reduction in the cost of capital is a major overstatement. Appendix II shows that this estimate is inconsistent with the magnitude of the revenue that would be lost in the absence of a realizations response. For corporations, we estimate that the percentage reduction in the required pre-tax return, holding n)t after tax return to equity constant, is only .9 percent. For aggregate capital, including owner occupied housing, it is about .8 percent. The primary reason for the overstatement in the estimate appears to be a failure to account for the large fraction of capital gains which are never realized due to step up in basis at death. Obviously, overstating the effect on the cost of capital by a magnitude of four would make it much more likely that the revenue gain from growth would appear to offset the cost of the tax cut, as a simple matter of arithmetic. Or, put another way, if the cost of capital measure used in the Council's analysis were reduced to .9 or .8 percent, the feedback would be less than $3 billion even without any of the other corrections discussed subsequently.

Moreover, if one is calculating the investment effects of a change in taxes holding net return constant, the change should be measured relative to the user cost of capital, the sum of the pre-tax return and depreciation rate, since this price drives investment. For the corporate sector, the depreciation rate is approximately seven percent, or almost half the total user cost. Thus, our calculations would suggest that the percentage change in the user cost of capital would be .5 percent. For capital as a whole, with a lower depreciation rate of .03 (owing to more structures and less equipment as compared to the corporate sector), the percentage change would be about .55 percent.

Furthermore, the growth estimate appears to assume an extremely elastic supply of capital. Growth is produced by an expansion of the capital stock. But a given percentage cut in the cost of capital, holding the net rate of return constant will not produce as large an effect on the capital stock if individuals require an increase in rate of return to supply more capital. Even the highest estimates of the supply elasticity of savings are no more than .4 to .6, and some evidence suggests that an increase in the rate of return will cause the savings to fall rather than rise, because the higher return to savings will allow individuals to consume more both today and in the future, even if their consumption in the future rises proportionally more (i.e. the income effects dominate substitution effects). For example, setting the elasticity to .6 would cut the projected increase in the capital stock by half even if one could attain the steady state instantaneously and not be concerned with the financing of deficits.

If we really want to answer the question as to whether a capital gains tax cut can pay for itself through a combination of realization responses and growth feed back effects, it is necessary to take into account the fact that the

capital stock grows very slowly even if the savings rate increases. For example, net savings is typically only about two to three percent of the capital stock. Thus a 3 percent increase in investment in the first year would only increase the capital stock by less than one tenth of a percent. In addition, some of the savings during the adjustment period must be used to finance the deficit, and as the deficit grows, the interest on the debt and the need for borrowing grows. Normally, private savings would not be expected to rise enough to both finance the deficit and increase the private capital stock, since some large fraction of the tax savings is expected to be consumed. Therefore, if one traces the effect of a deficit financed savings incentive, even with a generous assumption of savings elasticity, the deficit simply grows without limit, and the capital stock declines continuously. The question then is whether this analysis can be altered by simultaneously including a realizations response and the feedback effects.

To explore this issue, we calculated an illustrative adjustment path, using the myopic adjustment model in Appendix II, under the assumption that the realizations response offsets all of the revenue loss in the first year, eighty percent in the second year, and seventy percent thereafter, and with one percent initial change in the pre-tax rate of return.[10] Normalizing our results to reflect a $12 billion loss after realizations response but before growth effects, we obtained the following results. Even for an extremely high savings elasticity of .6, these effects would increase the $12 billion cost over the first five years to $12.06 billion. In this case, the growth effects on the deficit are negligible. In the first ten years, however, the loss would rise from $30.23 billion with no feedback effects to $33.79 billion. These deficits would rise continuously. The capital stock would expand by a negligible amount for a brief period (to a maximum of 3/100 of one percent), and eventually fall as the deficit crowds out private investment despite the increase in savings. For a zero savings elasticity, the $12 billion cost would rise to $12.58 billion in the first five years; in the first ten years the cost would rise from $30.23 billion to $36.49 billion. Crowding out of private capital begins almost immediately with the capital stock 4/100 of one percent lower after five years and 12/100 of a percent lower after ten years.

While the assumption of a revenue feedback moderates the results of the normal crowding of private investment by the deficit, it does not reverse them. Thus, if a capital gains tax cut adds to the deficit, it will likely reduce growth and productivity in the economy.

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[10] In this calculation, the effect of depreciation is negligible because the expansion of capital is constrained by savings supply. Incorporating depreciation becomes much more important if savings were very elastic because the expansion of capital is then largely governed by the expansion in the investment demand.

CONCLUSION

The basic question in this study is whether the capital gains tax is likely to pay for itself through realizations and growth. The analysis in this study suggests that such an outcome is highly unlikely. The realizations response does not appear adequate to make up for the static revenue loss. Indeed, it seems quite likely that even the revenue loss predicted by the JCT may be understated. Moreover, even with the losses predicted by the JCT, borrowing to finance these losses will be larger than any induced savings, causing the capital stock to contract rather than expand. Thus, taking into account feedback effects in the economy will merely increase the projected negative effect on the deficit.

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APPENDIX I: CORRECTIONS TO ESTIMATES

The Council of Economic Advisors, in constructing the table, relied in many cases on choosing the midpoint of a range of estimates listed in the Auten, Burman, and Randolph (1989) study. Choosing a midpoint can easily misrepresent the findings if there is one extreme value; a more appropriate procedure would have been to average the results where several elasticities are presented. Moreover, in some cases, the range is not correctly reported, or the authors were simply experimenting with different forms and clearly state preferences that do not include some of the experiments that were performed. In the case of Jones, there appears to be a simple mistake in the reported number. The 1986 CBO regression was apparently overlooked.

Since the elasticity can vary with the tax rate for most functional forms, the elasticities are all corrected where possible to reflect the midpoint of the range between the old and new tax rate; the Auten, Burman, and Randolph study derived elasticities at a somewhat higher rate. When corrections are made, they are adjusted to a tax rate of 85 percent of the Treasury's reported marginal tax rate of 25.7 percent (slightly under 22 percent). Specifics of the corrections follow. In some cases no corrections were made. For a number of the studies there is no way to determine an appropriate elasticity because of lack of information. These include the Treasury (1985) time series studies, and all of the micro-data studies; the only modifications for these studies are those where the reported elasticity in the table did not appear to reflect appropriately the elasticity in the study.

(1) Auerbach's number is taken from his most recent regression, reported in his 1989 study, which he states to be his preferred estimate.

(2) Darby, Gillingham and Greenlees' number is taken from the average of their three modified regressions excluding the regression which uses a quadratic form of the tax variable and which is not statistically significant; including it would lower the estimates. These three regressions include a semi-log form, a log, log form with the price variable being the after tax share, and a log, log form with tax rate variable. The latter yielded the highest elasticity of .67. The original Auten, Burman, and Randolph table includes a higher number from the inclusion of a large elasticity from a modification of the Treasury (1985) regression which the authors clearly find unsatisfactory because the elasticity is sensitive to the level of realizations. Such a regression cannot be easily interpreted for the current period. Note however that since their regression was run using the high income marginal tax rate, the elasticities for the semi-log form and the log form with the price variable being the after tax share, their elasticities should probably be increased to account for using higher overall marginal tax rates.

(3) CBO's 1988 number is the average of their four regressions evaluated at the 22 percent tax rate.

(4) CBO's 1986 number is a single regression evaluated at the 22 percent tax rate.

(5) Jones (1989) ran numerous regressions in a specification search. His preferred estimate, as indicated in the text, is .8'J, consistent with the number reported in the 1989 summary provided by Treasury in releasing the three 1989 studies. His regression was run in log, log form so that the elasticity is constant at every tax rate.

(6) CBO's alternative regression is evaluated at the 22 percent tax rate; it was not, however, statistically significant.

(7) Auten and Clotfelter reported four basic regressions with elasticities of .36, .37, .55, and 1.45. The last regression included losses which the authors did not appear to believe to be reasonable. The first two regressions were not statistically significant. We report the .55 elasticity. One could make a case that this elasticity over-represents the response they found, since lack of statistical significance technically means that you cannot reject the hypothesis of no response. On the other hand the average marginal tax rate in the sample was quite low, suggesting that the elasticity from the equation which is significant is understated.

(8) Treasury's (1985) panel study included five regressions. We report the one chosen for simulation analysis and the only one for which information on statistical significance was reported. The study suggests a variety of problems with the other regressions.

(9) Lindsey's estimate was corrected for the 22 percent tax rate.

(10) The elasticity actually used by the Treasury was changed to reflect response before portfolio effect, a value of .9 rather than .8. It is increased to .98 to reflect the higher marginal tax rate.

(10) The elasticity for the Joint Committee on Taxation was supplied to the author.

The following are references to the studies:

Alan J. Auerbach. Capital Gains Taxation and Tax Reform. National Tax Journal, September 1989, pp. 391-401.

Auten, Gerald E. Capital Gains Taxes and Realizations: Can a Tax Cut Pay for Itself? Policy Studies Journal, Autumn 1980, pp. 53-60.

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APPENDIX II: MODELING THE MACROECONOMIC EFFECTS

A. Initial Cost of Capital Estimates

This appendix provides details on the measurement of the net cost of capital effects of the capital gains tax cut, why they differ from those of the Council of Economic Advisors, and presents a simple model to trace the dynamics of the economy wide response. The latter assumes a closed economy; with an open economy, the effects on the net cost of capital would be smaller for the corporate sector and larger for the noncorporate sector.

The cost of capital, R, is a weighted average of debt and equity costs of the following form:

(1) $R = ((f(i^*(1-u)-p) + (1-f)E)/(1-u)$

where:
  f = share of debt finance
  i = nominal interest rate
  u = corporate tax rate
  E = real return to all stockholders before personal tax
  p = inflation rate

We now define E^* as the after tax rate of return to stockholders:

(2) $E^* = E(1 - st -(1-s)gtx)-pgtx$

where t is the average marginal tax rate on stockholders, s is the share of real income received as dividends, g is the modifier to account for deferral and exclusion of capital gains at death, and x is the fraction of capital gains included in income.

We measure the effect of the capital gains tax cut on the cost of capital by changing x from 1 to .7, and holding E^* constant. The following values were used in the calculation. The debt share, f, was set at .4 based on flow of funds data. The nominal interest rate was set at .08; the inflation rate at .04, the corporate tax rate at .34, the initial real return to equity at .0883, the value of s at .67 and the value of t at .18, the marginal tax rate on capital gains reported by the Treasury after accounting for the holding of approximately thirty percent of equity by tax exempt shareholders (based on flow of funds data). The value of g is set at .21. Two thirds of gains are assumed to never be taxed because they are realized at death, based on a rough midpoint between the 76 percent share reported by Gravelle and

Lindsey and the 50 percent reported by Auerbach.[11] The effective rate was further reduced by taking into account the deferral advantage, assuming corporate stocks are held for seven years on average. This formula does not account for the fact that the exclusion rate is lower for assets held less than three years. The result for this formula was a .9 percent reduction in the cost of capital, equivalent to 8 basis points.

This number was cross checked against a direct cash flow estimate, by assuming that 35 percent of capital gains are on corporate stocks and dividing that share of the gain by the sum of corporate interest payments and corporate profits. That calculation yielded a very similar estimate of 1 percent.

To extrapolate the gain to the entire capital stock, the entire revenue effect before any realizations response was divided by capital income in the economy, assuming it is a quarter of net national product. This same share was used in the dynamic calculation model below. The result was a percentage change of .8 percent.

How did the Council obtain such a large number for the net cost of capital effect? The measure used by the Council was interpolated from an existing study of a different capital gains effect by Yolanda Henderson, Capital Gains Taxation and the Cost of Capital for Mature and Emerging Firms, presented at a Conference of the American Council for Capital Formation, October 13, 1989. Her calculations apparently did not account for the reduction in the capital gains effective tax rate due to the step up in basis when assets are held until death. This error was magnified because she used the new view of dividends which treats dividend taxes as irrelevant, rather than the traditional view employed in equation (2). (If the new view were used in equation (2) the cost of capital effect would be slightly larger at 1.4 percent; we do not employ the new view because of its counter-factual implications). These - overstatements were then again magnified by extrapolating the calculation to the entire capital stock (where the new view of dividends would play no role).

B. The Model of Capital Accumulation

This section presents the simple model of capital accumulation which is used to trace the path of the capital stock, revenues and other variables when the capital gains tax change is introduced assuming a Cobb Douglas production function, a fixed labor supply, and myopic expectations. The basic equations are:

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[11] See Gravelle, Jane G. and Lawrence B. Lindsey. Capital Gains. Tax Notes, January 25, 1988, and Alan Auerbach, Capital Gains and Tax Reform, National Tax Journal, September 1989, pp. 391-401.

(3) $\quad Q_t = AK_t^a L^{(1-a)}$

(4) $\quad K_{(t+1)} - K_t = (s_t(Q_t - dK_t)(1-t) - nK_t - D_t)/(1+n)$

(5) $\quad s_t = b(R_t(1-u))^E$

(6) $\quad R_t = aQ_t/K_t - d$

Equation (3) is the production function relating gross output (Q) at time t to the capital stock (K) as time t. Equation (4) is the equation of change in the capital stock. This change is equal to net savings less normal investment to keep the capital fixed less government borrowing, all divided by $(1+n)$, where n is the growth rate in the economy. Net savings is $s(Q_t - dK_t)(1-t)$, where s is the savings rate out of income after depreciation and taxes, d is the depreciation rate, and t is the aggregate tax rate in the economy. The deficit, D_t is the actual revenue loss plus interest on accumulated debt. Equation (5) is a formula for the savings rate as a function of the after tax rate of return, where R is the marginal product of capital and u is the capital income tax rate. E is the elasticity of savings with respect to the net interest rate. The final equation, (6) is the first order condition from the production function in (3). To calibrate the model, we set a at .32 (equivalent to capital income 25 percent of net national product), n at .025, d at .03, the initial ratio of the capital stock to output at 3.5, the initial capital income tax at .3 and the wage income tax at .2. The reduction in capital income tax rate is that sufficient to cause the net cost of capital to fall by one percent, holding after tax return fixed. The inflation rate for measuring nominal levels of change is .04.

PREPARED STATEMENT OF SIDNEY L. JONES

I. BACKGROUND

Why Saving is Important

Productivity is the key to sustaining economic growth, competing in an increasingly integrated world economy, and adjusting to changing demographic patterns. There has been a close relationship between a nation's rate of saving and its growth of productivity (output per worker). [See Exhibit 1.] Higher saving provides the resources necessary for more productive investment and output growth.

The Historical Record

Total national saving (in broad terms, income minus consumption) as a share of gross national product has been relatively stable throughout most of this century. The exceptions were during the Great Depression and World War II. Since the late 1970s, however, there has been a downward trend in the U.S. saving rate, requiring the inflow of foreign capital to maintain even the current inadequate rate of investment. [See Exhibit 2.] There is a consensus that the United States needs to save more to support a higher rate of investment.

Not only is the recent record of U.S. saving low by our own historical standards, it is disappointing in comparison with foreign countries. According to a recent OECD calculation covering the period 1981 to 1987, the U.S. gross national saving rate ranked 18th among 21 major countries for which data were available. Our net national saving rate ranked 19th among 20 countries for which those data were available. The U.S. personal saving rate also ranked near the bottom of a list of major industrial nations. Some have argued that our low ranking merely reflects different national accounting practices or an overly narrow definition of saving. However, the U.S. saving rate remained low even after adjustment for different patterns of national behavior involving research outlays, education spending, housing and consumer durable goods purchases, public retirement pension programs, and government spending priorities.

II. FAMILY SAVINGS ACCOUNTS

The Savings and Economic Growth Act

The best and most important way to improve our national saving rate is to make significant progress in reducing prospective Federal budget deficits. Progress *has* been made in this regard, but we still have a long way to go. Intensified effort is required, especially if we are to meet the challenges posed by changing economic conditions and national priorities.

President Bush also has proposed the Savings and Economic Growth Act of 1990 as a three-part program to enhance economic growth in the United States. One element of the Act is a 30 percent exclusion for capital gains on assets held for three years, with smaller exclusions for shorter-term gains. This tax reduction will stimulate business saving, by encouraging equity finance and the retention of earnings for new investment. In addition, it will provide an incentive for individuals to save and invest for the longer run. The President's plan also encourages saving toward the purchase of a first home, through its proposal to allow a penalty-free withdrawal of up to $10,000 for that purpose from Individual Retirement Accounts (IRAs).

The third element of the Savings and Economic Growth Act, and my subject today, is the Family Savings Account. The FSA is a new kind of savings plan that would be allowed *in addition to* current-law IRAs, 401(k) plans, and other tax-exempt saving programs. Individuals would be able to contribute an amount up to $2,500 of their total compensation for the year; couples could contribute up to $5,000. Although these contributions would not be tax-deductible, the earnings would be tax-free as they are accrued. Neither the contributions nor the earnings would be taxed when withdrawn, provided they are maintained in the account for at least seven years.

Single taxpayers with adjusted gross incomes of up to $60,000, and joint filers with incomes of less than $120,000, would be eligible to make FSA contributions. A ten percent penalty, in addition to regular tax liability, would be assessed on earnings from contributions held in the account less than three years. If withdrawn after more than three years but less than seven years, the earnings would be taxable but not subject to penalty.

Advantages of FSAs

This FSA proposal combines a number of desirable characteristics:

- FSAs eliminate the double taxation of saving.
    - The neutral tax treatment of consumption and FSA saving counteracts the longstanding policy bias against saving and investment.

- Because existing programs are retained, the FSA expands the total contribution limit on tax-favored saving, creating an additional incentive to save.

- The great majority of Americans will be eligible to participate and benefit from this enhanced return to saving.

- The FSA program avoids the long lock-in period associated with existing retirement saving programs.
    - FSAs could be used as a means of saving, not only for retirement, but also for major expenditures such as housing, education, catastrophic medical care, or other financial difficulties.
    - This should make the FSA particularly attractive to young families and individuals interested in accumulating financial resources to achieve important goals at varying times in their lives.

- FSA contributions can be invested in a wide variety of assets, and contributions can be tailored to a family's circumstances.
    - Current tax-exempt investment options tend to be restricted to certain asset types such as municipal bonds.
    - These current alternatives may also have minimum investment amounts that make them primarily attractive to wealthy taxpayers.

- FSAs are simple and understandable – you don't need a financial adviser to explain how they work.

- The FSA does not produce large near-term Federal revenue losses.
    - The saving contributions are not deductible in calculating taxable incomes.
    - The adjusted gross income limitations eliminate those savers who have the largest accumulations of liquid assets, and who therefore could most easily "switch" existing taxable investments into FSAs.

- Finally, and most important, FSAs will be effective in generating new personal saving.

III. IMPACT ON SAVING

The FSA proposal, like the President's proposed capital gains tax rate cut, is designed to stimulate economic growth. FSAs will lead to new household saving, and will provide long-term benefits. A higher national saving rate will narrow our trade deficit. It also will contribute to a lower cost of capital, a larger U.S. capital stock, and a higher gross national product.

The Council of Economic Advisers (CEA) has made some calculations that indicate the potential value of FSAs. The Council's estimate is that the FSA plan will increase personal saving by about $40 billion over the 1990-1994 period. My own rough estimates, based on public opinion polls concerning participation rates and average contribution amounts, are consistent with the estimates prepared by the CEA.

It should be emphasized that FSA contributions are not tax-deductible, so there is very little revenue loss at the beginning, by contrast with current-law "front-ended" IRAs. In the first year, for example, the revenue loss from a dollar of FSA contribution would only be around two cents – the foregone tax on the earnings accrued during the year. Even that is only a revenue loss if the dollar was "switched" to an FSA from a taxable form of saving. The annual static revenue loss will gradually accumulate as tax-exempt FSA's grow in size. The Treasury projection of static revenue loss – Federal government dissaving – is less than $5 billion over the five-year budget period.

All of these effects of FSAs are difficult to predict, and necessarily involve some educated assumptions. However, the Council of Economic Advisers' estimate is that the FSA program will produce feedback revenue from increased saving and economic growth that roughly offsets its static revenue cost over the first five years. These feedback effects will continue to accelerate, leading to an increase in government revenues as well as personal saving in the longer run.

IV. CONCLUSION

By providing the resources needed to meet important investment goals, we can promote growth of our future standard of living. Enhancement of domestic saving decreases the cost of capital and encourages investment. We can meet the challenge of global competition by allocating more of our national resources to saving and investment priorities – investment in modern plants and equipment, investment in technology, and investment in our people.

Family Savings Accounts will not, by themselves, ensure that our saving rate rises to its optimal level, but they are an important step in the right direction.

GROSS SAVING AND REAL GROWTH

1960 to 1987

Growth of Real GDP per Employee

Gross Saving as a Percent of GDP

Japan
Italy
France
Germany
U.K.
Other OECD
Canada
U.S.
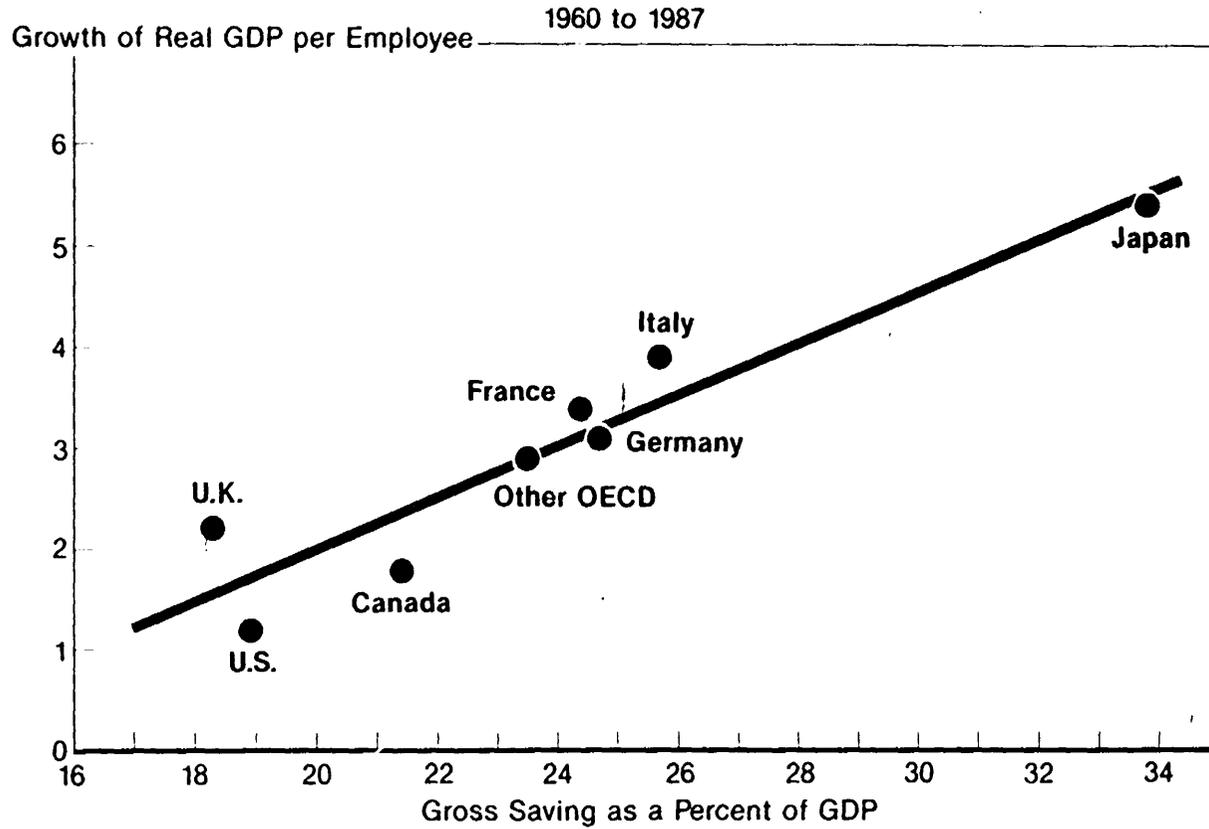
Source:'OECD, Historical Statistics, 1960-1987.

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Exhibit 1

U.S. GROSS SAVING RATIO, 1898-1989

(Saving as Percent of GNP)

Depression of 1930's and World War II

1898-1928 Private Saving 16.7% Average

1950-1979 Total Saving 16.4% Average
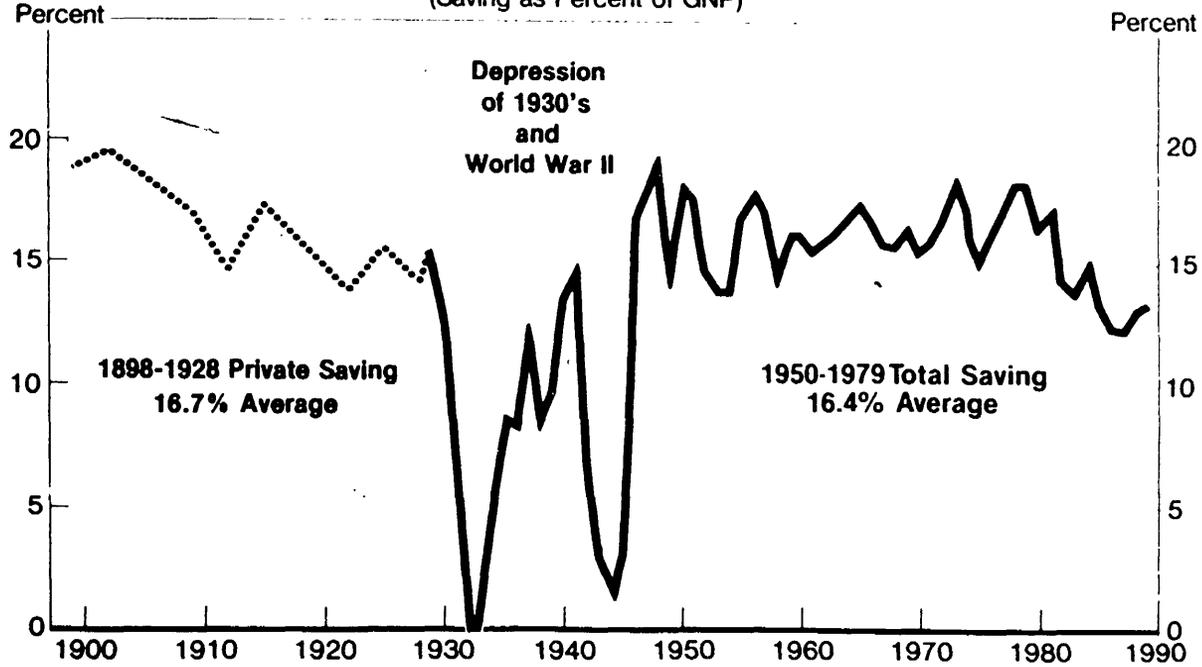
Note: 1898-1928 data from David and Scadding, Journal of Political Economy, April 1974.
Data following 1928 are from U.S. Department of Commerce.

March 22 1990 An57a

Exhibit 2

Prepared Statement of Mitchell E. Kertzman

Mr. Chairman, there are critical issues facing this nation and their importance goes beyond the legislative agendas of a particular association or lobbying group.

Mr. Chairman, you have done a masterful and statesman-like job of focusing on these fundamental issues. In doing so, your first question has been, "What will be in the real long-term interest of our nation?" And that is the question that should be asked.

The American Electronics Association believes that lower capital gains is in our nation's long-term interest, and we have thought so for more than a decade.

But make no mistake about it, Mr. Chairman, the American Electronics Association stands ready to join you in supporting bold and dramatic solutions to address the fundamental problems our country faces.

Single isolated measures will not make this nation more competitive or get this country on a sounder economic footing. America needs a broad, comprehensive proposal designed to increase savings, reduce the deficit, and lower the cost of capital. When Chairman Rostenkoswki released his deficit proposal this month, AEA did not condemn it for neglecting capital gains; we hailed it for its vision and boldness. It is in this spirit of cooperation and openness that I testify before you today.

Mr. Chairman, I hope that the kind of far-sighted proposal I am talking about will include incentives for real capital investment. Not only do we suffer from under investment in this country, we suffer from the wrong kind of investments. Our industry—a capital-intensive industry key to America's future—suffers as a result.

Venture funding that once went to entrepreneurs and start-up companies is now flowing to unproductive, leveraged buy-outs. The truth is we no longer live in an investment climate that is likely to produce an Apple Computer or a Compaq Computer. These companies—which today employ thousands of U.S. workers and produce cutting-edge technology—would be considered too expensive and too risky for today's short-term oriented economy. The alarming slowdown in these entrepreneurial ventures is highlighted in recent articles in the "Wall Street Journal" and "The New York Times," which I would like to submit for the record.

Mr. Chairman, this is what AEA's support for capital gains is all about. We are trying to encourage individuals and others to invest in long-term, high risk entrepreneurial activities. Indeed, that is exactly what happened following the 1978 capital gains cut. Individuals and venture capitalists saw these investments as great opportunities, and, as a result, hundreds of high tech start-ups took off and thousands of new jobs were created.

It is indeed true that other factors—such as changes in pension fund rules—help explain the new era of entrepreneurial activity that took place. But there is also little question that the lower capital gains tax rate played a significant and critical role.

As far as specific capital gains legislation, AEA has not endorsed any particular bill at this time and stands ready to discuss with you any proposal the Committee may want to consider. Our interest in capital gains is the same as our interest in a broader economic proposal. We want to encourage long-term investment in productive and worthwhile endeavors. AEA therefore has advocated a significant capital gains differential and a holding period of between three and five years.

I might add that—for the high tech industry—a proposal with a holding period of longer than 3-5 years makes little sense since that it is the typical product development timeline. We have no problems with a sliding scale approach. Indexing alone, I might add, obviously does not address the issue of encouraging risk investment.

Mr. Chairman, the American Electronics Association has focused its attention this year on the Patience and Cost of Capital. These are two of the single most important factors explaining America's declining competitive position with Japan. They are complicated and multi-faceted issues. While we have proposed several short-term solutions, such as the permanent extension of the R&D tax credit, our own industry has not yet agreed on a set of long-term prescriptions. Indeed, a discussion of possible prescriptions will be the focus of an AEA industry/government conference at the end of April.

Just last week, AEA released a major white paper, "Capital Costs and Job Creation," which describes the impact of high capital costs upon America's technology industries. I would like to submit a copy of this report for the record.

There are two conclusions, however, that I think we can make. One is that lower capital gains taxes do play a part in lowering the cost of capital. In this regard, I would urge the Committee to consider the conclusions of several well respected economists. One of those economists, Dr. George Hatsopoulos, has recently finished

a paper entitled: "Capital Gains Differential: Does it Work?" which I would like to submit for the record.

The other conclusion is that reducing the capital gains tax is only part, perhaps even a small part, of what needs to be done to lower U.S. capital costs. Reducing the deficit, increasing savings, and fostering a new government/industry partnership must all be part of the equation if we are to stop the downward slide in American competitiveness.

That is why AEA is here today urging the Committee not only to consider lower capital gains taxes but also to take a bold, broad-based approach to the budget and to our economic future. I do not know if recent reports are accurate that there is a new momentum for a substantive budget agreement between Congress and the Administration. AEA certainly hopes so, and we strongly encourage such a development.

This is not to say that I am not here asking for something. I am asking that some of our critics turn down their rhetoric—to stop questioning our motives in supporting capital gains—to quit the name calling and start discussing the issue. We are not fatcats. We are entrepreneurs. The American Electronics Association has 3,500 member companies. The members who care most about capital gains are not our multinationals. Instead, they are mostly smaller companies or start-ups, many of which are struggling to stay afloat.

When someone on the Hill calls the people who run these companies "fatcats," it is the same as someone calling them a "bigot" or "un-American." It is hurtful, it is not productive, and it is not true.

Nor is it correct to say that we are fiscally irresponsible by supporting capital gains. Joint Tax has economists predicting the capital gains will lose revenue. The Treasury Department has its office of Tax Analysis with civil service economists who say that lower capital gains will raise revenue. Whose right? I can't say for sure, and I hope our critics will have the courage to say they can't either. We do know that historically lower capital gains has brought in far more revenue than the Joint Tax Committee had predicted at the time. We also know that neither Treasury or Joint Tax fully consider the economic benefits that result from lower capital gains taxes when they make their revenue estimates.

On the issue of fairness. I am a Democrat and I hope the Democratic Party never stops making this issue part of its national agenda. But opposing capital gains on the grounds that the wealthy stand to benefit is no argument. It fails to consider that millions of middle income Americans will also benefit from lower taxes on capital gains. It also fails to answer the question of whether lower taxes on capital gains is good public policy in revitalizing our economy. My point here is that while we may disagree with some on the merits of capital gains, we do so in good faith and with the same concern for our nation's well-being.

I hope that these comments have been useful and that you will view AEA as part of the solution. We want to look long term and craft solutions that make economic sense. We certainly cannot afford to do less. To give one example: The Japanese economy is only 60 percent the size of the U.S. economy. However in constant 1980 dollars, Japan is now spending more on plant and equipment than the United States. In per capita terms, Japan is investing more than twice as much as the U.S. on plant and equipment. In the electronics industry, our market share has been slipping at an alarming rate in seven out of 10 different technology sectors.

Mr. Chairman, we know that reversing this downward trend will only be the result of a long and difficult negotiation process. We also know of no one more skilled and respected than yourself to help lead that process forward. AEA pledges to support your efforts. We salute your leadership.

PREPARED STATEMENT OF LAURENCE J. KOTLIKOFF

Mr. Chairman and Members of the Senate Finance Committee: I am honored to speak with you today about the crisis in U.S. saving. In 1989 the rate of U.S. saving out of net national product—our net national saving rate—was a mere 3.6 percent. This figure is just 40 percent of the 8.9 percent average rate of net national saving observed between 1950 and 1979. Unfortunately, last year's remarkably poor saving performance was no outlier compared with the rest of the 1980s. Between 1980 and 1984 the U.S. saving rate averaged only 5.0 percent; and since 1985 it has averaged only 3.6 percent.

These figures are based on National Income and Product (NIPA) measures and definitions of net national product, household consumption, and government consumption. Economists have long faulted NIPA accounting for treating the acquisi-

tion of consumer and government durables as current consumption. Proper treatment of durables consumption leads to higher national saving rates, but there is still a huge decline in U.S. saving in the 1980s in the corrected saving data (please see Table 1).

WHY PRIVATE AND PERSONAL SAVING RATE MEASURES ARE UNRELIABLE

The net national saving rate—defined as net national product less total private plus government consumption divided by net national product—has a solid conceptual basis in economic theory. This, unfortunately, is not the case for other concepts of saving, such as the NIPA private and personal saving rates. These measures of saving depend on the definition of taxes and transfers, which, from the perspective of economic theory is completely arbitrary. To give an example, consider social security contributions. Economic theory does not tell us whether to label these payments to the government as "taxes" or as "the purchase of claims to future social security benefits. The "tax" terminology suggests social security contributions are not a form of private saving, while the "purchase of claims" terminology suggests they are a form of private saving. Since social security contributions are considerable, how one chooses to label them will make a major difference to one's measure of private and personal saving.

Rather than rely on such economically arbitrary and, therefore, uninformative indices of household saving behavior, I suggest we consider what I shall call the nongovernment saving rate. The nongovernment saving rate takes net national product less government consumption as the appropriate measure of disposable income for the private sector; it is the nation's output left over after the government has consumed. The nongovernment saving rate then asks what fraction of this disposable income is saved (not consumed) by the private sector; i.e., the denominator for the nongovernment saving rate is defined as net national product less government consumption, while the numerator equals this measure of disposable income less private consumption. Table I presents measures of the nongovernment saving rate. Regardless of whether one corrects the basic data for consumer and government durables, it is clear that the nongovernment saving rate fell dramatically in the 1980s. According to the uncorrected data, the nongovernment saving rate averaged 11.4 percent over the period 1950 through 1979. In contrast, from 1980 through 1989 the nongovernment saving rate averaged only 5.5 percent.

WHY DO WE CARE ABOUT THE RATE OF U.S. SAVING?

The low rate of U.S. saving is very troubling for a number of reasons. First, there is the problem of keeping up with the Jones—in this case Western Europe and Japan. While data differences make precise international comparisons of net national saving rates difficult, the available figures (after corrections) suggest the U.S. is saving at roughly half the rate of the Western Europeans and at about a third of the rate of the Japanese. Based on current saving patterns, total wealth owned by Americans will increase by roughly 10 percent over the next decade, while that of the Japanese will increase by 20 to 25 percent. If current saving patterns persist, Americans will, over time, become the poor cousins of the Japanese and Western Europeans. We will not only have less wealth per person, but less net national product (income) per person, since NNP includes income earned on American owned assets.

Second, less wealth accumulation by Americans means less control of the world's wealth by Americans, including wealth that is invested in the U.S. As the Japanese correctly tell us, the reason we are running large current account deficits is because the accumulation of additional wealth by Americans—the saving of Americans—is insufficient to finance investment in the U.S. Since Americans aren't saving enough and investing enough in the U.S. foreigners are doing the investing for us. One answer—the wrong answer—to foreign investment in the U.S. is to restrict such investment. Such a policy would make Americans even poorer over time because the level of U.S. wages, out of which many Americans save, depends on the amount of capital employed in the U.S. relative to the amount of labor employed in the U.S. Restricting foreign investment will lower U.S. capital to labor ratios and lower U.S. real wages.

A third reason for concern about U.S. saving relates to the welfare of the next generation of retirees and their potential demands on the next generation of workers. The fact that income levels and poverty rates of the current elderly are close to those of the rest of the current population does not necessarily mean the same will be true in 30 years. Apparently baby boomers are not setting as much aside (in proportionate terms) for their old age as did their parents. Perhaps they are saving less

because they think social security will be as generous to them as it was to their parents and grandparents. The social security facts, however, suggest the opposite. The future benefits of baby boomers have already been cut by 15 to 20 percent under the 1983 Social Security Amendments. In addition, retiree medical benefits provided by Medicare (as well as private employers) are in the process of being scaled back. These points would not be so troubling if we could expect baby boomers, who are going to live lon. r, to work longer. But the trend toward early retirement continues, albeit at a slowe: rate than in the 1970s.

The prospect of a politically powerful baby boom generation arriving in old age with low incomes relative to the working age population raises the specter of another huge intergenerational transfer through social security. Surely, the saving behavior of the baby boomers should compound our concern that the Federal Government put enough aside today to help finance the baby boomers' social security benefits.

ALTERNATIVE EXPLANATIONS OF LOW U.S. SAVING

What has changed to lead households to switch from saving 11.4 cents of every dollar of national output not consumed by the government to saving only 5.5 cents of every dollar of national output not consumed by the government?

One potential explanation for low U.S. saving in the 1980s that can be dismissed is that increased government consumption is to blame. As Table I indicates the ratio of government consumption to NNP was only slightly higher in the 1980s than in the previous two decades. It is easy to show that had the nongovernment saving rate not declined in the 1980s, the small increase in government consumption relative to NNP would have had only a trivial impact on the rate of national saving.

While the government did not consume much more of NNP in the 1980s than in the previous three decades, many contend that the government, by running large deficits, shifted the burden of paying for government consumption from current to future generations. Such generational policy, the argument goes, should induce a spending spree by current generations in response to their reduced tax bill. This argument ignores, however, other policies of the Reagan administration that redistributed away from current generations toward future generations. One important example is the 1983 Social Security Amendments.

The strongest proponents of "the deficit caused the drop in our saving rate" are Keynesian economists. According to the Keynesian view households base their consumption decisions on current disposable income, and the Reagan income tax cuts raised disposable incomes. This is true, but other Federal, state, and local policies lowered disposable incomes. On balance, disposable income as a share of net national product was only slightly higher in the 1980s than in the previous decades. For all (Federal, state, and local) governments the ratio of taxes plus transfers to NNP averaged .220 between 1980 and 1987. It averaged .226 for the 1970's, .239 for the 1960s, and .224 for the 1950s. In considering these figures it is also worth noting that the very slight decline in the 1980s in the ratio of net taxes to NNP primarily reflects a decline in corporate taxation.

It is hard to argue that saving disincentives are responsible for the decline in saving in the 1980s. Marginal personal tax rates on capital income fell through the last decade, with the top marginal rate declining from 70 percent in 1980 to 33 percent in 1988. Some of the policies used to promote savings, such as the IRs, were, unfortunately, poorly designed to produce new saving and probably reduced rather than increased national saving. Others, such as the move toward a consumption oriented tax base associated with the adoption of the Accelerated Cost Reco\ ery System were not in place for long enough to have had a significant effect cn saving; simulation studies (e.g., Summers, 1981 and Auerbach and Kotlikoff, 1987) indicate that many government policies aimed at stimulating savings can have significant effects that are observed only after decades, rather than a few years.

Most theories of consumption predict that households will increase their spending in response to an increase in wealth. While the 1980s witnessed a significant increase in stock market wealth, if one adds together capital gains and losses for all U.S. assets less liabilities the total capital gain for the 1980s is only $260 billion measured in 1988 dollars. This represents only 1.7 percent of total 1988 U.S. net wealth, and is too small to account for much of the decline in net national saving.

The 1980s witnessed changes in income inequality, demographics, and female labor force participation, but each of these changes should have led to more, not less net national saving. One possible explanation for the recent decline in saving is a reduction in saving for bequests, which may tie in with the decline in the birth rate. At least half and possibly as much as two thirds of U.S. wealth can be traced not to life cycle saving for retirement but rather to private bequests and other intergener-

ational transfers. It is hard to assess whether there has been a decline in the bequest motive for saving, but such a decline would not be surprising given the general deterioration of the family in the U.S.

Much of U.S. bequests in this century may have been in large part involuntary in reflection of the limited availability of old age annuities. But the increased availability of social security and private pension annuities, particularly over the last twenty years, may have reduced bequests and precautionary concerns about eating up one's wealth too fast. The reduction in life span risk may thus have spurred the elderly to consume more, contributing to the reduction in national saving.

Whether a decline in bequest saving explains our critically low saving rate is a question whose answer will require significant additional research. At the moment, however, there is no "smoking gun" explanation for e critically low level of U.S. saving.

PROPOSED SAVING INITIATIVES

The Administration and this committee should be strongly applauded for sounding the alarm about our national saving crisis. Unfortunately, recent policy proposals with respect to saving may do more to lower than to raise national saving. Let me first discuss the proposed Family Savings Accounts (FSA) and the expansion of the deductibility of IRA contributions. I will then turn to the proposed cut in capital gains taxes.

To understand whether a given saving proposal will work in terms of raising net-national saving, we need to ask whether the proposal will lead to less household consumption than would otherwise be the case. The mere fact that households place a portion of their savings in IRAs or similar accounts does not mean they are reducing their consumption. Quite the contrary. As you are aware, IRAs and FSAs permit tax arbitrage whereby individuals reduce their taxes by simply moving money that they may previously have saved or only recently borrowed from a non-tax sheltered account into an IRA or FSA. The tax savings permit such individuals to consume more.

Unfortunately, economic research has failed to focus on the consumption effects of IRAs and similar accounts. Instead, the research has studied the propensity of different segments of society to put money in these accounts. But the placing of money in these accounts tells us nothing about their saving effects. The only clear fact about household consumption and IRs is that household consumption as a share of NNP increased precisely during the period that the use of IRAs expanded. This factoid should give considerable pause to advocates of IRAs and FSAs.

One response to the concern about tax arbitrage is that the proposals limit their use by very high income households. While this is true, middle income and even many lower income households are able, with a little bit of thought, to see how they can save taxes and consume more by "investing" in IRAs and FSAs. Even if we consider households who have no previous saving and cannot borrow from relatives or the banking system to engage in tax arbitrage, there is no guarantee that contribution of funds to IRAs and FSAs will be associated with a reduction in current consumption. First, many of the households who place their saving in these accounts may have intended to save the same amount even in the absence of these tax shelters, and using these accounts will simply lower their tax liabilities, permitting an increase in their consumption. This seems particularly likely for households who would anyway save more than the maximum contribution amounts. Second, for households contributing less than the maximum contribution amounts and for whom these tax shelters truly represent marginal incentives to consume less today and, therefore, more tomorrow, there is also what economists term an "income effect" to consider. The "income effect" here refers to the fact that households need to put less aside today to meet specific future consumption goals if they can earn a higher after-tax return on their saving. While there is a "substitution effect" from the higher after-tax return that may lead households to raise their future consumption goals, the "income effect" could certainly outweigh the substitution effect, leaving even non-tax arbitragers both contributing to these tax shelters and consuming more.

Another reason to suspect that the new proposals will lower, not raise national saving are the proposals' provisions that permit households to withdraw their funds, at no penalty, to purchase their first home or to pay for educational or medical expenses. Unfortunately, these provisions are geared toward helping households increase, not reduce, their current or near term consumption of housing, medical, and educational services. Indeed, the IRA and FSA proposals permit the use of already accumulated IRA funds to finance these types of current consumption.

The proposed cuts in capital gain taxes is another example of a poorly designed saving incentive. While they would provide increased incentives for additional saving, the proposed tax cuts also represent a tax windfall to those with accrued, but not yet realized capital gains on past saving. Under the proposed capital gains tax cuts, most of those with accrued capital gains will be able to realize these gains at a 19.6 percent rate, rather than at a 28 percent rate. True, the tax cut may lead to more short run tax revenue, but it will almost surely mean less future revenue. In present value there is likely to be a significant revenue loss. Since every present value loss to the Treasury is a present value gain to the household sector, the household sector is likely to celebrate this event by consuming more. In short, if the intent of the capital gains tax cut is to raise national saving we need to think again.

OTHER POLICY OPTIONS

What can the Federal Government do to restore our national saving rate to at least the level of the 1970s? One answer is simply to inform the public that this is a national problem which each of us needs to address at an individual level. The government could also help by requiring all employers as well as the Social Security System to send workers annual statements indicating their accrued retirement benefits plus a calculation showing the amount of additional private saving required to reach an adequate level of total saving.

A second step the government could take is to adopt a value added tax. Virtually all economists agree that a consumption-oriented tax structure would produce more saving than our income-oriented tax structure. In addition to improving saving incentives, the redistributive effects of switching to a consumption-oriented tax base will also stimulate saving.

A third step is for the government to use the saving rate to target its fiscal policy. An increasing number of economists as well as members of this committee are questioning whether the reported deficit is a useful indicator of tight or loose fiscal policy. Under the guise of a balanced budget the Federal government ran a very loose fiscal policy in the 1970s when it expanded the Social Security System. Other policies, such as The 1986 Tax Reform Act, while having little or no implications for the reported deficit, are also viewed by many economists as a loosening of fiscal policy. Running a tight fiscal policy involves placing a bigger fiscal burden on current generations. This can be achieved in a number of ways, some of which will affect the reported budget deficit and some of which will not. The tightening of fiscal policy should be gradual, but it should continue until the U.S. saving rate again reaches a level suitable to the world's premier economic power.

Table 8.—NET NATIONAL AND NONGOVERNMENT SAVING RATES CORRECTED AND UNCORRECTED

Period	Corrected measures		G/Y	Uncorrected measures		G/Y
	National saving rate	Nongovernment saving rate		National saving rate	Nongovernment saving rate	
1950–959	.133	.167	.203	.092	.116	.211
1960–969	.130	.166	.215	.089	.116	.226
1970–979	.118	.152	.223	.085	.109	.222
1980–985	.072	.093	.230	.050	.064	.223
1980–989	na	na	na	.043	.055	.225

na: not available.
The corrected net national product measure adjusts the National Income and Product Accounts measure of net national product by (1) adding the imputed rent on consumer durables and government tangible assets, excluding military equipment (expenditure on which is treated as current consumption) and (2) subtracting the depreciation on the stock of consumer durables and government tangible assets (excluding military equipment). Corrected private consumption measure equals private consumption expenditure on goods and services plus the imputed rent on consumer durables. Corrected government consumption equals the National Income Account measure of government consumption less government expenditures on (nonmilitary) equipment and structures, plus the imputed rent on government equipment (nonmilitary) and structures.

PREPARED STATEMENT OF WILLIAM D. NORTH

INTRODUCTION

Good morning, Mr. Chairman and members of the Committee. My name is Bill North. I am the Executive Vice-President of the NATIONAL ASSOCIATION OF REALTORS. The NATIONAL ASSOCIATION OF REALTORS represents virtually

every facet of the real estate industry, including REALTORS, developers, apprais-
ers, syndicators, and property managers. On behalf of the more than 800,000 mem-
bers of our Association, I want to thank you for holding these hearings and for in-
viting the NATIONAL ASSOCIATION OF REALTORS to testify on proposals to re-
store tax incentives for savings and investment in the United States.

SUMMARY OF TESTIMONY

The NATIONAL ASSOCIATION OF REALTORS is concerned about the deplor-
ably low rate of savings and investment in this country. It is our belief that only
through bold leadership at the national level can the savings rate in the United
States be improved. One major component of any plan to enhance savings and in-
vestment in the United States is through the adoption of tax incentives to foster a
general climate of savings and investment and to tailor incentives for savings in
particular areas of national interest. Towards this end, we commend the Chairman
for the proposal that he introduced last year to expand the use of individual retire-
ment accounts (IRAs) and to allow penalty-free withdrawals for first-time home pur-
chases and for college-tuition payments. Only through proposals of this nature can
the savings rate be improved and the housing affordability crisis reversed. We
would respectfully suggest one codification which, we believe, is consistent with the
thrust of your proposal. This modification would allow penalty-free withdrawals
from an IRA by spouses, grandparents, and parents to assist their spouse, child, or
grandchild in amassing a sufficient downpayment to make a first-time home pur-
chase. We believe this would further the Chairman's efforts in improving housing
affordability at a modest cost to the Treasury ($11 million annually).

NEED FOR SAVING INCENTIVES TO IMPROVE HOUSING AFFORDABILITY

The focus of my testimony is on the need for tax incentives for savings that will
improve housing affordability in this country.

Mr. Chairman, the decade of the 1980s saw a steady decline in the nation's home-
ownership rate, reversing a 40 year trend of rising homeownership among our citi-
zens. During the last decade, all segments of the population by age group demon-
strated declining homeownership rates. While the percentage of decline in general
was small—from 65.6% of households in 1980 to 63.8% in 1988—the statistic itself
translates into two million fewer families who are able to realize the American
dream of owning their own home than would have been the case if the 1980 rate of
homeownership had been sustained through the decade. Most disturbing, however,
is the fact that the largest decrease in homeownership rates was exhibited by those
under 25 years old and by those in the prime homebuying ages of 25-to-34 years old.
The combined homeownership rate of these two age groups declined by roughly 15%
during the decade of the '80s. The tables in Exhibit I graphically illustrate this de-
cline by decades, by age group, and by income levels.

The report of the National Housing Task Force, which was released in March
1988, identified several factors that contributed to the precipitous decline in home-
ownership, especially among younger Americans. These factors included a scarcity
of mortgages at affordable rates, rising home prices, particularly in certain regions,
such as the West Coast and the northeastern corridor, and, most importantly, the
inability of prospective homeowners to accumulate sufficient savings to make a
downpayment on a first-time purchase of a home.

Studies conducted by the NATIONAL ASSOCIATION OF REALTORS and vari-
ous industry groups have consistently shown that the single most compelling prob-
lem preventing young people from buying a home for the first time is the inability
to save enough money to make a downpayment on the purchase of a home. This
problem is caused by a combination of circumstances that include higher prices, re-
quiring a larger downpayment, and rental payments that consume an increasingly
larger share of the tenant's income. This result reduces the amount of net savings
that can be applied to a downpayment.

Specifically, it is well documented that the median price of a home has risen sub-
stantially over the last 20 years. In 1970, the median price of an existing single
family home was $23,000; this figure rose dramatically to $89,300 by 1988. This rep-
resents a 288%! The effects were even more pronounced in certain selected regions.
For example, in California, the median price rose a whopping 594% from $44,300 in
1970 to $168,560 in 1988. Although home prices were rising 115% nationally, the
median family incomes were rising by 75%, and, most significantly, the median in-
comes of first-time homebuyers rose by only 52.3%. When price increases of this
magnitude are tied to slower growth in family median income, the problem of

saving a sufficient amount for a downpayment is accentuated, since the amount of a downpayment is tied to a fixed percentage of the purchase price.

In addition, the savings problem for prospective homeowners was exacerbated by an increase in the percentage of a tenant's income that rental payments consumed. For example, during the early 1970s, rental payments represented between 23-and-25% of family income. In the early 1980s, the statistic rose to 40% generally, but soared to a staggering 58.4% for single parent families. Obviously, high rental payments militate against savings for homeownership.

RECOMMENDATIONS

The NATIONAL ASSOCIATION OF REALTORS recommends adoption of the Chairman's proposal introduced last year to expand the use of individual retirement accounts by allowing up to $1,000 in deductions for those unable to deduct contributions under present law and to allow penalty-free access to IRAs for first-time home purchases. During the early part of the '90s, we believe that access to affordable lending for prospective homeowners will be further circumscribed, partly due to the tougher capital requirements that were imposed on lending institutions under the recently enacted FIRREA legislation. These restrictions accentuate the need to allow access to the largest existing available source of capital, namely, pension funds, IRAs, and deferred compensation plans.

For this reason, we applaud the Chairman's proposal to permit access to IRA accounts on a penalty-free basis for first-time home purchases. We would respectfully ask that the proposal be modified to permit withdrawals by spouses, parents, and grandparents, to assist their relatives in purchasing a home for the first time. Our studies, together with other research data, have consistently shown that the IRA account balances of prospective homeowners are small when contrasted with those of their parents or grandparents whose assistance may be necessary to help them purchase their first home. While we do not assert that adoption of the Chairman's proposal with our suggested modification is a panacea for curing the nation's housing affordability epidemic, we do believe that these measures would constitute a positive, first step on which we can build. We have also determined that the cost of this modification would be relatively small in budgetary terms ($11 million annually).

Similar data has also confirmed that investing IRA funds in a home is a very prudent investment. Data that the NATIONAL ASSOCIATION OF REALTORS have compiled reveals that the average annual after-tax rate of return on housing over a recent eight year period was 12.2%. On a policy basis, we would strongly contend that use of an IRA account to acquire a residence is totally consistent with the overall retirement purpose that IRAs were intended to serve.

We are pleased that the administration has offered a proposal to permit limited withdrawals of $10,000 from an IRA for first-time home purchases if certain criteria are met (the home price cannot exceed 110% of the area median home price and a principal residence requirement must be satisfied). However, we prefer the Chairman's proposal for several reasons: first, the Chairman's proposal does not limit the amount that can be withdrawn from an IRA; secondly, the Chairman's proposal does not impose a limitation on the purchase price of homes that can be acquired with IRA funds. We believe that the absence of a restriction on the purchase price will improve the effectiveness of such a proposal in high cost-of-living areas. Thirdly, while the administration's proposal does not allow for withdrawals from IRAs that have received rollover contributions from other deferred compensation plans, such as other IRAs, 401(k) plans, or pension benefits, the Chairman's proposal permits these rollovers. We believe that the ability to make a tax-free rollover to an IRA of qualified pension plan proceeds, deferred compensation benefits, or funds from another IRA, when coupled with the unlimited withdrawal feature, would have a salutary effect on the capital needs of prospective homebuyers. We simply urge that the Chairman's proposal be amended to allow penalty-free withdrawals by spouses, grandparents, and parents.

We thank the Chairman for providing us with this opportunity to present our views and for extending this invitation to testify. We would be delighted to answer any questions that the Chairman or other members of the Committee may have.

EXHIBIT 1

Table 1
U.S. HOMEOWNERSHIP RATE
(Percentages)

Previous Decades		The 1980s	
Year	**%**	**Year**	**%**
1930	47.8	1980	65.6
1940	43.6	1981	65.4
1950	55.0	1982	64.8
1960	64.2	1983	64.6
1970	64.6	1984	64.5
1980	65.6	1985	63.9
		1986	63.8
		1987	64.0
		1988	− 63.8

Source: U.S. Bureau of the Census

Table 2
HOMEOWNERSHIP RATE BY SELECTED HOUSEHOLD CHARACTERISTICS: 1980-1988
(Percentage Distributions)

	1980	1983	1988	Percent Change 1980-1988
All Households	65.6	64.6	63.8	- 2.7
Age				
Under 25	21.3	19.3	15.5	-27.2
25-34	52.3	47.0	45.0	-14.0
35-44	72.3	69.6	67.1	- 7.2
45-64	78.5	78.8	77.8	- 1.0
65 and over	72.3	74.8	75.0	- 3.7
Income				
Under $5000	49.4	43.3	39.5	-20.0
$5000-$9999	56.8	50.3	48.6	-14.4
$10,000-$14,999	59.1	55.8	52.7	-13.9
$15,000-$19,999	66.5	59.7	57.6	-13.4
$20,000-$24,999	73.7	65.7	61.4	-16.7
$25,000-$34,999	82.0	74.1	68.0	-17.0
$35,000-$49,999	88.5	81.6	77.6	-12.3
$50,000 +	91.9	89.1	86.9	- 5.4

Sources:
o   "All Households" data from U.S. Bureau of the Census, Current Housing Reports, Series H-111. Vacancy Rates and Characteristics of Housing in the United States. Nos. 76-5 through 86-5.
o   Age data from American Housing Survey, 1980; U.S. Dept. of Commerce, Current Population Survey, 1983 and 1988.
o   Income data from U.S. Bureau of the Census, Current Population Reports, Series P-60.
o   Tabulations by the Economics and Research Division, NATIONAL ASSOCIATION OF REALTORS®.

Prepared Statement of Ronald A. Pearlman

I. Introduction

A. Reference to Joint Committee staff testimony before Finance Committee (March 14, 1989)

B. Release of JCS-12-90, Explanation of Methodology Used to Estimate Proposals Affecting the Taxation of Income From Capital Gains (March 27, 1990)

C. Terminology

1. "Realizations" – gains from the sale of capital assets

2. "Baseline realizations" – gains from the sale of capital assets under current law

3. "Static revenue effect" – revenue loss from a capital gains rate reduction (or revenue increase from rate increase) disregarding any behavioral response

4. "Induced realizations" – increased gains (or losses) from the sale of capital assets as a result of the behavioral response to a rate change

5. "Elasticity" – the economist's way of mathematically expressing the behavioral response to a tax law change

6. "Time series, cross section and panel studies" – different types of data deemed relevant to projecting the behavioral response to a capital gains rate reduction

7. "Revenue maximizing rate" – the point at which either an increase or a decrease in a tax rate would produce less net revenue

II. Joint Committee staff estimate of Administration's capital gains proposal

A. Summary of estimate – raises revenue in F/Y 1990 and 1991; loses revenue in each year thereafter (Pamphlet, Table 1, p.3; Table 2, p.10)

B. CBO baseline realizations – little effect on estimate .5 billion per year (1994-95); 2.0 billion over 5 years (Pamphlet, pp.17-19)

C. Principal staff conclusions regarding taxpayer behavioral response to proposed capital gains rate reduction:

    1. Sharp short-run behavioral response for two fiscal years (1990 and 1991) following a rate change with a March 15, 1990 effective date (elasticity 1.1)

    2. More modest long-run behavioral response (1992-1995) (elasticity .66)

        a. Joint Committee staff predicts $557 billion of additional realizations (F/Y 1990-1995) as a result of the lower rates in the Administration's proposal

        b. But, the increase is insufficient to offset the long-run static revenue loss

D. Rationale for Staff conclusion regarding long-run behavioral response

    1. Reliance on historical aggregate economic data (real GNP, inflation, stock market fluctuations, tax rates and household ownership of corporate equity)

        a. Realizations generally track nominal GNP (Pamphlet, Table 8, p. 24, Figures 1 and 2, and pp. 25-26) and stock market activity (Pamphlet, Figure 3, p. 27); realizations also are affected by tax law changes

        b. Following short-term responses to the 1978 and 1981 rate changes, realizations again tracked nominal GNP and stock market activity

        c. Preliminary 1988 data suggest the same pattern following the 1986 Act changes (Pamphlet, p. 28)

        d. Use of panel data currently are not as reliable as time series data because long-term panel data are not available; cross section data likewise are unreliable because they account only for one year

    2. The equation developed by the Joint Committee staff using a time series analysis is able to replicate historical capital gains realizations with a high degree of accuracy

        a. Historic data influences the equation to be used (sets the parameters)

        b. The Joint Committee staff equation is essentially the same as an equation commonly used by other economists undertaking time series analyses

c. The equation predicts 98% of the year-to-year
   variability of historic realizations; i.e.,
   it is very accurate

d. The equation produces the elasticity; the
   Staff does not decide on a specific
   behavioral response; the historic data make
   that determination

e. The Joint Committee staff does not believe a
   time series equation similar to that found in
   most existing academic studies but using
   Treasury's elasticity will predict historical
   realizations with the same level of accuracy
   as the Joint Committee staff equation (that
   results in a lower long-run elasticity)

3. Econometric Studies - Review of time series
   studies indicates the Joint Committee staff
   equation is well within the elasticity range
   established by other researchers

III. Responses to Treasury Assertions

A. CBO and OMB baseline differences

1. The CBO F/Y 1990 baseline is based to a large
   extent on economic events that actually have
   occurred, including post-86 Act realizations
   (Pamphlet, p.18)

2. A lower CBO baseline for F/Y 1990 or 1991 would
   mean lower estimated revenue increases in these
   years under the Administration's proposal

3. CBO and OMB baselines are very close in the
   out-years, particularly 1994-95 (Pamphlet, p. 17)

B. Analysis of behavioral response - Elasticity

1. There is more agreement than meets the eye

a. The offices appear to agree that the long-run
   behavioral response is inadequate to offset
   the static revenue loss from a rate reduction

   (1) See Treasury's own analyses (Pamphlet,
       tables 6 & 7, pp. 22-23)

   (2) Treasury prediction of revenue increases
       from the Administration's proposal appear
       to result from the depreciation
       recapture, AMT and effective date
       features

b. The elasticities are relatively close (.66
   (Joint Committee staff) versus .8 (Treasury)

even though they produce substantial
differences on an average of $250 billion
annual baseline realizations

    (1) The Joint Committee staff elasticity
replicates with a high degree of accuracy
historical realizations and is well
within the range of time series
elasticities produced by other
researchers

    (2) The Joint Committee staff does not
believe Treasury's elasticity will
accurately replicate historical
realizations under a time series equation
similar to that found in most existing
academic studies, and we believe it is at
the high-end of the range of elasticities
derived by other time series researchers

c.   The Joint Committee staff did not change its
elasticity from that used last year in
estimating a comparable proposal - Treasury's
assertion to the contrary is incorrect

    (1) The Joint Committee staff 1989 estimate
of a proposal that is very close to the
1990 Administration proposal used the
same elasticities and resulted in
essentially the same revenue effects -
see Russo revenue estimate (September 15,
1989) - permanent 30% exclusion for all
assets except collectibles; no staggered
holding period (Pamphlet, table 9, p. 36)

    (2) The Administration's proposal is
different this year

        (a) Real estate and depreciable property
were excluded in 1989; all assets
except collectibles are included in
1990

        (b) 45% exclusion in 1989; 30% in 1990

    (3) Joint Committee staff estimating equation
changed in the Spring of 1989

        (a) Completely unrelated to, and no
effect on, our evaluation of long-run
behavioral response -- the change was
designed to more precisely estimate
staggered holding period proposals

        (b) This probably is the source of the
confusion

C. The Joint Committee staff elasticity is not too low – the Joint Committee staff does not understate long-run behavioral response – Treasury's assertion to the contrary is incorrect

    1. The Joint Committee staff relies on 30 years of historical economic data; we disagree with analyses that rely on data derived from shorter time periods

    2. Treasury's and CEA's analysis of the literature (econometric studies) presented to the Finance Committee during testimony on March 6, 1990 is misleading

        a. Studies are not comparable – data differ (time series, cross section and panel studies)

        b. Some studies have resulted in predictions of realizations which do not accord with the historical record (Feldstein and others, Auten & Clotfelter and Lindsey, Pamphlet, pp. 32-33)

        c. Studies do not consider the "portfolio effect" (Pamphlet, p. 33)

        d. Accuracy of presentation of selected studies in Treasury table (Pamphlet, pp. 34-35)

D. The revenue maximizing rate derived from the Joint Committee staff elasticity is consistent with the staff's analysis of the long-run taxpayer behavioral response

    1. The Joint Committee staff elasticity produces a revenue maximizing rate of 28.5%; assertion by Treasury that it is 35% is incorrect

    2. Why 28.5% rather than 28%? - 33% bubble; the static revenue increase is greater than induced realizations loss.

    3. Don't rely on intuition – must consider the static revenue loss (or gains) as well as induced realizations (gains realized) (Pamphlet, tables 10, 11 and 12, pp. 42-44)

    4. The reference to "revenue maximizing rate" is confusing, unreliable and misleading

        a. Confusing – just another way of describing long-run taxpayer behavior

        b. Unreliable – ignores important factors that are included in the actual capital gains revenue estimate – portfolio effect,

compliance levels, historical trend toward increased stock market activity

c. **Misleading** - it implies there is a single such rate for every proposal - See Pamphlet, p. 58, illustrating how four different equations for the same proposal produce four different revenue maximizing rates

d. The economic literature focuses on the elasticity, not the revenue maximizing rate

IV. Distribution

A. In any year where revenues resulting from induced realizations exceed the static revenue loss (example, F/Y 1990 or 1991), there is no question that increased capital gains taxes will be paid to the government

B. Also, there is no question that in every year following any rate reduction (including a capital gains rate reduction) the affected taxpayers receive an after-tax benefit

C. While our professional judgment is that the after-tax benefit is the most accurate way to measure the distributional impact of a rate reduction (and, thus, is the basis upon which we have published distributional analyses of capital gains proposals), the Joint Committee staff views the relevance of any distributional analysis as a policy issue properly decided by the Members of Congress

Prepared Statement of William C. Sellery, Jr.

My name is William Sellery. I'm the Executive Director of the Forest Industries Committee on Timber Valuation and Taxation, a nationwide organization of landowners whose supporters are interested in tax laws which will foster and protect the ownership of timberland, and encourage the planting, growing, harvesting, and regeneration of trees.

I am also Tax Advisor to the National Forest Products Association, a Washington-based trade association which represents the interests of wood products manufacturers.

I appreciate the opportunity to present our views on capital gains to the Senate Finance Committee.

The FICTVT is made up of thousands of timberland owners from every state in the union, ranging in size from the largest fully integrated manufacturing companies to the thousands of individual, private, nonindustrial landowners. Our common bonds are the tax laws which have such a dramatic effect on the forest economy. Perhaps no other single activity of the Federal government so directly effects the economic well-being of the overall forest products economy than decisions relating to the Internal Revenue Code.

In that regard, the FICTVT, together with the National Forest Products Association and a multitude of other forest related organizations, strongly support a reinstatment of a significant, permanent capital gains rate differential which would include timber as an eligible asset and corporations as well as individuals as eligible owners.

Mr. Chairman, there is an immense sense of frustration among landowners all over the country as they have seen taxes on the harvest or sale of timber rise to the point where the economics of planting and professionally managing timberland have significantly deteriorated. We hope we can enlist the support of this committee in reestablishing capital gains as a major element of improving that economic climate.

We are greatly encouraged by the recent proposal of the Administration to reinstate capital gains. Although we believe the proposal should be improved by allowing corporations to be eligible owners, we strongly support the President's initiative to start the process of restoring tax equity and fairness to all asset holders, including timber growers. In that regard, we would urge you to include corporations as a capital gains provision is considered by this committee. A fundamental tenet of tax policy is that the form of ownership should not materially impact the marginal rate of taxation applied to a transaction. Different treatment for corporations would be unsound tax policy.

Mr. Chairman, a significant capital gains differential is a proven economically sound method of providing fair taxation Of timber income. Timber growing requires heavy front-end expenditures, long term carrying charges, high risks of weather, disease, insects and fire—all uninsurable. Rates of return are historically low compared to alternative investments, with capital literally locked in the ground during the growing cycle. Timber-growing does not enjoy market liquidity as trees cannot be economically harvested before maturity.

The capital gains provision of the Tax Code proved to be an effective mechanism for increased production and improved forest management. Since its enactment in 1944, capital gains treatment for timber sales resulted in impressive gains in planting and productivity. Today, in spite of increased harvests to meet consumer needs, there is actually more growing stock than in 1944. Capital gains played an important role in establishing that fact.

America's forests are the most productive forest lands in the world because of the huge timber growing investments that have been made to increase productivity. Without the capital gains rate differential, investments in growing long term timber crops are not economically viable.

And for every year there is inadequate reforestation and less effective timber management, that year's planting is lost forever—a tree simply cannot be planted retroactively.

The economic impact of the loss of capital gains is just now starting to be felt, with the long term negative consequences likely to be even greater. The consequences of the decreased flow of capital investment in timber will mean that lands currently owned will be less well managed, pressure will mount to harvest forests prior to economic maturity, planting activity will decrease, and marginal land will go out of production. In some cases, timberland will be cut over and replaced with yearly agricultural crops or real estate developments.

All of these fallouts will result in fewer jobs and hurt many small rural communities. And, of course, a more limited supply will lead to significantly greater pressure to harvest timber from public lands at a time when more public lands are being withdrawn from harvesting for a variety of reasons.

In addition, there are a multitude of benefits provided to society by sound forest management practices—practices enhanced by a climate of fair taxation as owners manage for optimum productivity. These practices serve to significantly enhance the overall environmental quality of our forests and surrounding communities. Our professionally-managed forests provide vital wildlife enhancement, water quality, a hedge for soil erosion, provide for recreational needs and create aesthetic beauty.

In fact, we are now learning more fully the critical role being played by reforestation in the effort to combat the so-called "greenhouse effect," while at the same time, the land is growing trees for the future supply of wood. Landowners are committed to sound environmental stewardship of our forest land. But without the corresponding fair economic environment necessary to grow trees over the long run, it would not be unreasonable to anticipate deterioration in those management practices.

In conclusion, Mr. Chairman, reinstating a significant capital gains differential, and reestablishing its application to timber for both individuals and corporations is essential if timber growers are to meet future raw material demands for the thousands of consumer products dependent on wood and fiber.

PREPARED STATEMENT OF DAVID SILVER

I am David Silver, President of the Investment Company Institute. The Institute is the national association of the American investment company industry. Its membership includes 3,004 open-end investment companies, more commonly known as mutual funds, 192 closed-end investment companies and 13 sponsors of unit investment trusts. Its open-end investment company members have assets of about $950 billion, accounting for approximately 90 percent of total industry assets, and have over 30 million shareholders.

I. THE INSTITUTE'S INTEREST IN TAX-FAVORED SAVINGS PROGRAMS

Mutual funds have traditionally served as vehicles through which investors may channel their investment dollars into the nation's economy through diversified, professionally managed pools of investments. They serve as an important investment medium for both tax-favored savings programs, such as retirement plans and Individual Retirement Accounts (IRAs), and savings outside such programs.

In January of this year, mutual fund assets reached $1 trillion, of which $112 billion were Individual Retirement Accounts. Although I speak as the representative of an industry with an obvious interest, I do not think it a controversial view that mutual funds provide an efficient means to recycle personal savings into a broad spectrum of securities issued by a wide variety of companies. Moreover, our members have accumulated a vast amount of experience in selling IRAs, in processing millions of IRA investments and in other operational aspects of the IRA program. At a time when increased personal saving is important to our economy and particularly important to the national well-being, we stand ready to share our experience with the Congress in developing the best possible program to expand the nation's savings in the most effective, least costly manner.

II. THE INSTITUTE'S CONCERN ABOUT THE LOW RATE OF SAVINGS

We share the increasing concern of many that the rate of personal savings in the U.S. is too low. Increased savings reduce the cost of capital and contribute to the nation's productivity. Higher productivity makes America more competitive in the world economy and is the principal determinant of a rising living standard in America. There is a clear, positive relationship between a nation's savings rate and its productivity growth. On the individual level, those who save are, of course, better able to meet their own long term needs and those of their families.

From a global perspective, the U.S. personal savings rate ranks close to the bottom among industrialized nations. Over the past two decades or so, the U.S. personal savings rate has been in decline. It was about 9 percent of personal income in the early 1970s, around 7 percent in the late 1970s, approximately 6 percent in the early 1980s, and barely above 4 percent in the last 5 years. It reached its low of 3.2 percent of personal income in 1987 before rebounding to 5.5 percent in 1989.

III. EXPERIENCE DEMONSTRATES THAT A SIMPLE, UNIVERSAL AND PERMANENT TAX-FAVORED SAVINGS PROGRAM WILL PROMOTE SAVINGS

Our considerable experience with the universal IRA has demonstrated that the personal savings rate can be increased through a simple, universal tax-favored savings program that is consistently available.

A. The Success of the Universal IRA

The success of the universal IRA is perhaps the best indication that tax-favored arrangements in fact promote personal savings. The IRA is the only tax-favored retirement plan aimed directly at individuals which does not require the intermediation or goodwill of an employer. Prior to the Tax Reform Act of 1986, IRA *contributions* grew from about $5 billion in 1981 to about $38 billion in 1986. At the time the 1986 Act was passed, IRA *contributions* accounted for about 30 percent of all personal saving. Similarly, at the end of 1981, the total pool of IRA *assets* consisted of $26 billion, while by the end of 1986, the pool had grown to $277.1 billion. In five short years, IRA *assets* rose tenfold.

The universal IRA rules had a positive effect on personal savings behavior. As expanded in 1981 to provide universal coverage to wage earners of every income bracket, the IRA was a unique, simple and effective savings vehicle. The universal IRA was easily understood and was established with a minimum of paperwork and red tape. It was a flexible program enabling IRA participants to exercise their own freedom of investment choice through a variety of financial institutions that offered a broad selection of investment products. [Please refer to Tables A and B].

The relative simplicity and universal coverage of the new IRA rules permitted institutions throughout the financial services industry to engage in large scale and highly successful marketing campaigns. Their efforts touched a responsive chord among working Americans, releasing a pent-up demand for a universal retirement savings vehicle. Indeed, the response to the universal IRA was much greater than anticipated.

B. Recent studies confirm that the universal IRA resulted in new savings

For some time, economists have debated the extent to which universal IRA contributions represented new saving or a mere shifting of existing savings to a tax-favored savings vehicle. The most recent studies confirm, however, that, although some shifting of savings from non-tax-favored accounts to IRAs may well have occurred in the years immediately following adoption of the universal IRA, new savings increased with each passing year. This conclusion seems self-evident. For every year after 1982, the household funds available to shift from other sources to the IRA were progressively depleted. Eventually, more and more IRA participants simply chose to spend less and save more to make the next year's IRA contribution.

Thus, in 1988 economists Steven Venti and David Wise concluded in their study of IRAs before the 1986 Tax Reform Act that IRAs "had a substantial positive net effect on personal saving" prior to the 1986 Act. Economists Daniel Feenberg and Jonathan Skinner similarly concluded in 1988 that "there is strong evidence that in fact IRA saving does represent new savings."

These conclusions are valid despite the fact that the personal savings rate declined between 1981 and 1987. In testimony before the House Ways and Means Committee in 1989, economist Lawrence Summers stated that:

> While the officially measured personal savings rate has declined since 1981, this should not be taken as evidence that IRAs do not have a substantial impact on savings decisions . . . Without the enactment of IRAs, the savings rate might well have fallen even further . . . The weight of the available evidence suggests that IRAs generate a significant amount of savings that would not otherwise have taken place.

In addition, there is evidence that the positive impact of the universal IRA on saving affected not only IRA assets but also overall personal saving habits. Economists Venti and Wise found in their study that "persons who contribute to IRAs are more likely than those who do not to have an overall increase in savings and reserve funds."

The evidence of a positive impact on savings produced by a tax-favored program such as the universal IRA is further supported by the experience of other countries with similar tax-favored programs. Perhaps the most compelling evidence is the experience of Canada with the Registered Retirement Savings Plan (RRSP). In 1987 economists Chris Carroll and Lawrence Summers studied the personal savings rates in Canada and the U.S. They concluded that one third of the increase in the person-

al savings rate in Canada between 1981 and 1985 may have resulted from the tax incentives offered by the RRSP.

Comparable results have been demonstrated by the high personal savings rates in France, Japan and the United Kingdom, all of which have implemented a tax-favored savings program.

Of course, tax-favored savings programs like the universal IRA reduce the tax revenue concurrently received by the Federal government. However, we believe that Congress should consider not only the budgetary impact, but also the overall effect a tax-favored savings program will have on the national savings rate. A number of research economists who studied the subject found that the amount of dissaving by the Federal Government in providing tax incentives for personal saving is less than the increased personal saving produced. Moreover, as time goes by and the incremental personal saving stimulated by a tax-favored program increases, so does the overall positive effect on the national savings rate. In addition, when the money is withdrawn, any deferred tax becomes due, and government revenues increase.

IV. IF CONGRESS ADOPTS A TAX-FAVORED SAVINGS PROGRAM, IT SHOULD BE SIMPLE, UNIVERSAL AND PERMANENT

In 1987, IRA contributions declined by 63 percent. Part of the sharp decline in IRA contributions is attributable to the limits on deductible contributions imposed by the 1986 Act. This is not the only explanation. The 1986 Act caused considerable confusion among taxpayers over eligibility for deductible or nondeductible IRA contributions and imposed significant recordkeeping and compliance requirements on taxpayers who elected to make nondeductible IRA contributions.

Congress is currently considering a number of proposed tax-favored savings programs which are variations on two basic models. These models are (1) the deductible savings program (IRA) under which contributions may be deducted when made and earnings grow tax-free, although both contributions and earnings are taxable upon withdrawal; and (2) "back-end" programs under which contributions are not deductible, earnings accumulate tax-free and withdrawals are generally exempt from tax.

Although we have no experience with the proposed "back-end" programs, our experience with the universal IRA has taught us important lessons. Savings incentives work best if the rules are simple and permanent and if they do not require burdensome recordkeeping. Frequent changes create uncertainty and reduce contributions. These considerations are not only important to consumers but also stimulate the financial media to prepare for long term marketing and administrative commitments.

If investors are uncertain of the conditions under which contributions to a tax-favored arrangement may be made, they may simply opt to make no contribution. Why save for the long haul unless there is a sense that the program is likely to have a degree of permanence? Similarly, if financial institutions find the terms of a tax-favored savings program too complex to describe in a simple, effective marketing campaign, they may abandon the effort.

V. CONCLUSION

In conclusion, we applaud the Chairman and Committee for recognizing the importance of savings incentives to address our most serious economic problem—our nation's low savings rate. We look forward to assisting the Committee in designing an effective, universal and permanent savings incentive.

Distribution of Total IRA Assets, Yearend 1989

Self-directed   **Commercial Banks**

$82.0 $98.9

$111.8

Mutual Funds

Thrifts

$26. $49.0

Credit Unions   **Life Insurance Co.**

(billions)

Self-directed   **Commercial Banks**

17.6%   21.3%

24.0%

Mutual Funds

Thrifts

5.6   10.5%

Credit Unions   **Life Insurance Co.**
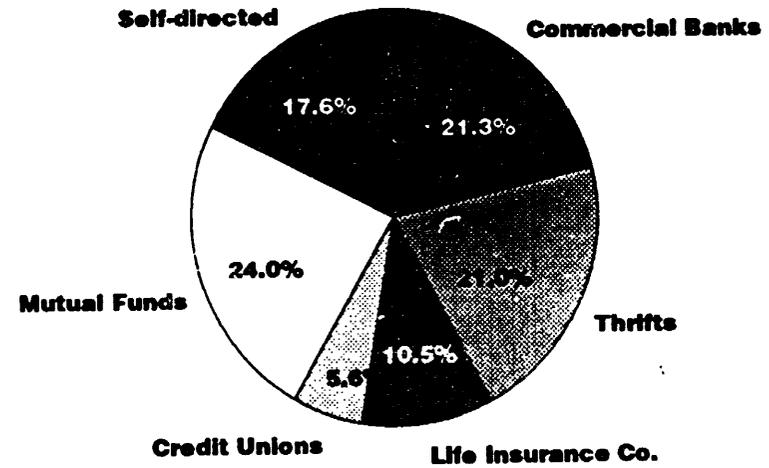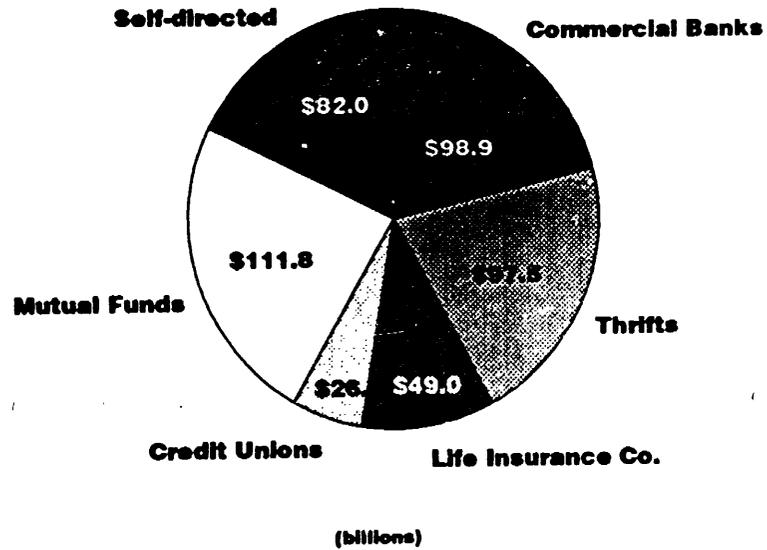
Distribution of Total Mutual Fund IRA Assets

Money Market

$28.6

$52.2 Equity

$34.0

Bond & Income

(billions)

Money Market

23%

47% Equity

30%

Bond & Income
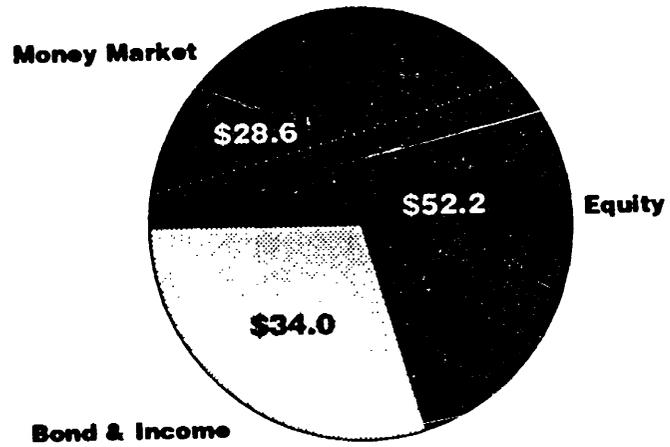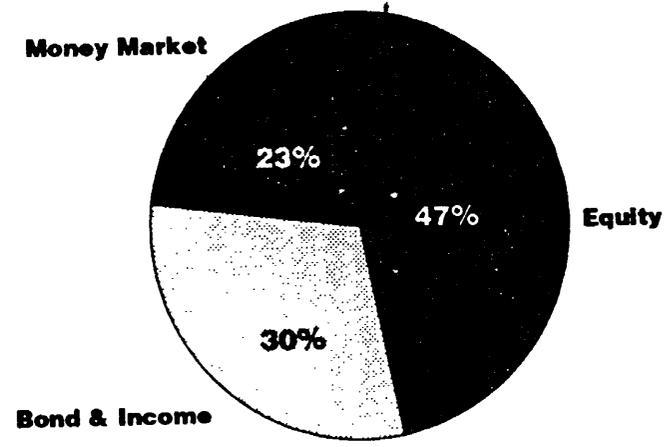
PREPARED STATEMENT OF JONATHAN SKINNER

Good afternoon Mr. Chairman and members of the Committee. My name is Jonathan Skinner, and I am Associate Professor of Economics at the University of Virginia and Research Associate at the National Bureau of Economic Research. My research focuses on why people save, and in particular the effectiveness of saving incentives such as IRAs.

The United States saves only 3 percent of GNP, one-fourth the rate in Japan and one-half that in West Germany. We as a country are not providing enough saving to finance domestic investment. This is disturbing for at least two reasons. First, as long as foreign capital inflows are necessary to finance domestic investment, the trade deficit will continue to be large and looming. Second, consuming rather than saving income today means a lower standard of living in the future.

Most of that low saving rate can be blamed on the United States government deficit. But personal saving rates in the United States were low during the 1980s, and continue to remain far below those in Japan and Canada. I am therefore pleased to comment on an innovative plan, the Family Saving Account, designed to stimulate personal saving.

Under the Family Savings Account, families contribute up to $5000 to a qualified account which exempts interest paid from taxable income. After 7 years, the money can be withdrawn without penalty for any use. In many respects the Family Savings Account resembles the Individual Retirement Account (IRA) because there is no tax impediment to saving; families receive the full rate of return on their investments. By the same token, both the Family Savings Account and the IRA are subject to the same criticism—that such saving incentives do nothing to stimulate household saving. In this view, which I believe to be largely incorrect, taxpayers just take old saving out of existing accounts and shuffle them into the new, untaxed account. Total household saving is unchanged, but the U.S. Treasury loses revenue.

I will make two basic points in this testimony. First, the evidence from Individual Retirement Accounts (IRAs) suggests that the criticism above is misplaced; IRAs are not old, shuffled saving but new saving. And second, while the family Saving Account may look like an IRA, it is not an IRA. Many of the characteristics which make the IRA effective at promoting capital formation are not present in the Family Savings Account. Replacing the IRA's up-front deduction with the Family Savings Account's "backended" deduction will stifle its appeal among those who bought the IRA precisely because it yielded instant gratification. And allowing taxpayers to remove assets after 7 years makes the shuffling of old saving into the Family Savings Account both easier and more tempting.

1. DID IRAS INCREASE SAVING? EVIDENCE FROM INDIVIDUAL TAXPAYER DATA

One way to test whether IRAs are new saving is to compare the saving behavior of IRA purchasers and nonpurchasers in large surveys of *individual.* The pioneering work by Stephen Venti of Dartmouth College and David Wise of Harvard University suggested of every one hundred dollars contributed to an IRA, only 8 dollars were shuffled from previous saving Of the remaining 92 dollars, 57 were withdrawn from consumption and 35 from a reduction in taxes. Their results suggested that IRAs were largely new saving.

In a more recent study with Daniel Feenberg of the National Bureau of Economic Research, I examined nearly 4000 IRS tax returns between 1980 and 1984 to test whether IRAs were new saving. We originally set out to disprove the Venti and Wise study because at the time, we believed that taxpayers took money out of existing taxable assets and shuffled them into IRAs. We therefore expected that IRA contributors would gradually report on their tax returns lower interest and dividend income over time as they shifted taxable assets into IRAs. To our surprise, we found that IRA contributors tended to increase their taxable (as well as nontaxable) saving by more than those who did not purchase IRAs. That is, rather than disprove the Venti and Wise study, we confirmed it.

One objection to our comparison between IRA contributors and noncontributors is that the contributors tend to be wealthier. Hence it is no surprise that they save more, both in IRA and non-IRA sources. To correct for this, we compared families with the same initial wealth, and found that our results still held.[1]

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[1] There was no correlation between IRA purchases and taxable saving among the very wealthy with assets above $50,000, perhaps because of the relative unimportance of IRA wealth.

There are more complicated and sophisticated models of shuffling that are consistent with the numbers that we calculate. For example, one could argue that families who save both in IRA and non-IRA sources *would* have saved more in taxable assets had there been no IRAs. William Gale of UCLA and John Karl Scholz of the University of Wisconsin have recently argued on similar grounds that IRAs are mostly shuffled saving. Nevertheless, the fact remains—and there is no debate about this— the critics' gloomy picture of IRA contributors raiding their taxable assets to hide them in IRAs just isn't so.

My belief that IRAs promote saving is based on more than statistical comparisons of saving between those who contribute to an IRA and those who don't. For example, Dan Feenberg and I found that a taxpayer who owes taxes (above the amount withheld) to the IRS on April 14th is much more likely to contribute to an IRA. We interpret this to mean that a taxpayer in the 40 percent bracket would prefer to open a $2000 IRA account than write an $800 check to the IRS. That is, the up-front deduction provides the instant gratification necessary to get taxpayers into the saving habit.

Another piece of evidence supports the view that IRAs are new saving. Recall the wide distribution of advertisements for IRAs during the mid-1980s. They promised to make you a millionaire by the time you retired if you made an annual contribution of $2000. And in fact our study found that one-third of all enrollees did contribute exactly $2000 to the penny, even if they were eligible to contribute up to $4000. Why? We interpret this to mean that the marketing blitz was effective at conveying both correct information—that IRAs were a good investment, and incorrect information—that the upper limit was only $2000. The sharp drop-off in IRA contributions after 1987 even among those still eligible to contribute lends support to the view that advertising played a key role in the success of IRAs.

A final bit of evidence on the effectiveness of IRAs comes from the finding that once hooked, few IRA contributors drop out. For example, even among contributors with initial taxable assets of less than $2000, 72 percent of contributors in 1982 reenrolled in 1983. Individual Retirement Accounts appear effective at encouraging taxpayers to "just say yes" to the habit of saving systematically for the future.

2. DID IRAS INCREASE SAVING? EVIDENCE FROM AGGREGATE DATA

The evidence from *aggregate* statistics appears to contradict the view that IRAs increase saving. Before IRAs were expanded in 1982, the Commerce Department's personal saving rate was 7 percent of disposable income. By the time that IRAs were largely restricted in 1986, the saving rate had plummeted to 4 percent. Since 1987 when IRAs were largely restricted, saving rates have since jumped back up to near 6 percent. How can this evidence be reconciled with the view that IRAs promote saving?

There are many different ways to define "the" saving rate. The Commerce Department measure of national saving ignores many sources of household wealth accumulation. For example, during 1986 household wealth appreciated in real terms by $220 billion in pension and life insurance funds, $271 billion in stocks, and $97 billion in residential real estate and land, for a total wealth increase of $587 billion. Little of this was included in the Commerce Department measure of saving, which in 1986 was only $125 billion. That is, household wealth accumulation largely excluded from the personal saving measure was nearly five times the conventionally measured personal saving rate. Adopting a broader measure of household saving as the change in real household wealth leads to the conclusion that household saving was quite strong during the mid-1980s. In Figure 1, the measure of saving calculated as the change in real net household wealth (excluding durables and averaged over three years to smooth out year-to-year fluctuations) is shown along with the conventional Commerce Department (NIPA) saving rate. This alternative measure of household saving grew rapidly in 1983 before dropping off after 1987. While the pattern appears to support the view that IRAs were new saving, there are many other more important factors, such as the stock market rebound, for the surge in wealth. My own view is that first, it is risky to conclude anything about IRAs based on a few years of aggregate saving data, and second, the Commerce Department saving rate tells us little about saving and wealth accumulation patterns of American families.

Then what does the Commerce Department measure of saving tell us? It measures how well United States households are providing funds for domestic investment. That is, if the value of my house climbs by $10,000, I may be $10,000 richer, but none of that newfound wealth will find its way to General Motors for new machinery. So the low rate of saving during the 1980s as measured by the Commerce Department is a cause for concern. Even the recent increase in the personal saving

rate, now approaching 6 percent, is no cause for complacency. The national saving rate is still very low, and the rebound may reflect a temporary spending downturn rather than a long-run saving shift. Hence there is still an important role for the government in promoting the household saving rate. But is the Family Savings Account the right way to do it?

3. THE FAMILY SAVINGS ACCOUNT

While the Family Saving Account may look like an IRA, it is not an IRA. In the four points discussed below, I outline disadvantages of the Family Savings Account relative to the benchmark IRA.

(A). The tax benefit of the Family Saving Account is provided in the future rather than immediately.—As noted above, the immediate deduction of the IRA was a major factor in attracting new contributors—investors want the tax break now, not when they retire. Furthermore, the canny investors most likely to take advantage of the Family Saving Account—the *Money* and *Forbes Magazine* readers—are likely to be conscientious savers already. My suspicion is that the up front deduction for IRAs were effective at drawing in precisely those who weren't saving before and getting them in the "IRA habit."

B. The Family Saving Account doesn't lose much revenue now—but it does lose revenue in the future.—By making a potentially large fraction of national saving permanently exempt from taxation, the true revenue cost of the Family Saving Account is being put off into the future. The Family Saving Account is promising a future tax break, which (like any type of government debt) must be paid with future tax revenue. By contrast, the IRA augments future tax revenue. By 1986, there were $350 billion in IRA assets, representing $70 billion in future tax revenue at a conservative 20 percent marginal tax rate.

Ultimately, either the Family Savings Account or the IRA will cost the government revenue. I would favor taking the tax loss today with a front-ended saving incentive rather than putting it off to some future budget. The pressure of Gramm-Rudman-Hollings will at least ensure that the revenue loss from the front-ended IRA will be financed by some other tax. By contrast, the Family Savings Account escapes such fiscal discipline, and will put increased pressure on future deficits.

C. Evidence that IRAs are new saving cannot necessarily be used to conclude that Family Saving Accounts are new saving.—Family Savings Accounts are far more liquid than IRAs. Assets are allowed to be cashed out after 7 years, making it a much more attractive vehicle for shuffling taxable into nontaxable saving. For example, a $5000 (tax deductible) home equity loan with accumulated interest paid after 7 years, coupled with an equal contribution to a (tax exempt) Family Savings Account, could achieve the proverbial and elusive free lunch—with the tab picked up by the U.S. Treasury. By contrast, the IRA locks up saving until retirement, dramatically restricting the potential for shuffling.

D. Front-ended saving incentives such as the IRA psychologically "lock in" saving by imposing a tax on withdrawals.—Theoretically, the timing of the tax payment should make no difference to when the savings account is closed out. But I suspect that human nature causes individuals to avoid spending wealth that carries an unpleasant tax liability (on principal plus interest) due on the next tax return. A backended savings incentive such as the Family Savings Account carry no such liability, making it potentially tempting to spend down wealth before retirement. That is, even if front-ended saving incentives could be cashed out after seven years, my suspicion is that fewer taxpayers would do so because of the consequent tax liability.

In sum, a properly designed saving incentive has the potential to create a more supportive environment to promote national saving. The IRA was very popular with the taxpaying public, and evidence suggests that it was effective at promoting saving. My concern is that, while largely seeking to attain similar goals, the Family Savings Account may not be as effective in promoting long-term saving.

The effectiveness of tax incentives in promoting the national saving rate depends crucially or how the incentives are financed. A saving incentive program, no matter how effective, will probably harm national saving if it is financed by government debt or deferred tax breaks. Hence a concerted effort to reduce the government deficit and stimulate personal saving is a key ingredient to continued economic growth.

Figure 1: Commerce Department (NIPA) Saving and Household Saving

change in household wealth(3 yr. avg.)

annual NIPA personal saving

Percent

Year
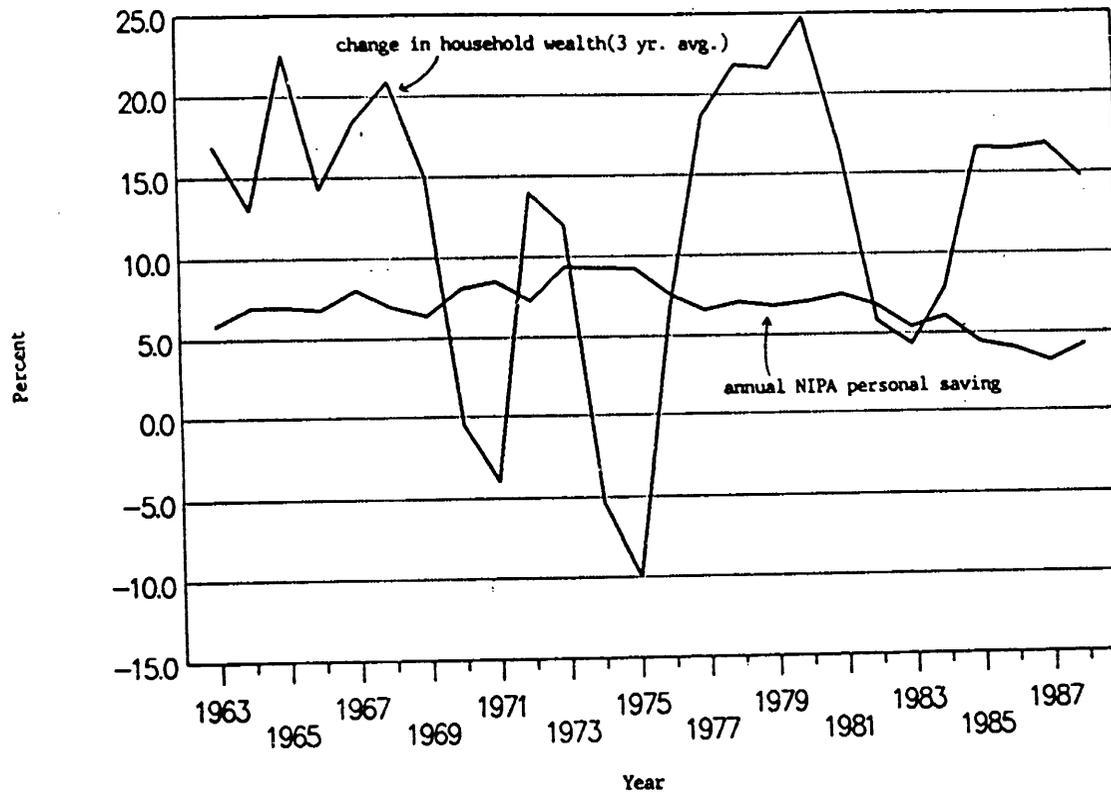
Source: Survey of Current Business(various issues) and Federal Reserve Board Pub. C.9(April 1989).

PREPARED STATEMENT OF SENATOR STEVE SYMMS

CAPITAL GAINS

Mr. Chairman, as you know I am a firm supporter of establishing a separate, lower tax rate for income from the sale and exchange of property. I think it is a matter simply of justice not to tax increases in value that are due mostly to inflation, and which accrue over many years.

It was demonstrated last year that most capital gains income goes to elderly people whose incomes during their working lives are not in the "rich" category, so it is just misleading to say a capital gains rate is a tax cut for the rich.

I would also say we must have a consistency of treatment of taxation of property values. Therefore it is wrong to treat individuals and corporations differently. I will have to oppose a capital gains tax cut that does not accommodate this. I would like to have a more detailed statement also inserted following my remarks.

THE CASE FOR CUTTING THE TAX RATE ON CORPORATE CAPITAL GAINS

Proposals to reduce the individual capital gains tax rate should also include capital assets held by corporations. Restoring a differential would simply reinstate the historical treatment of corporate capital gains; an alternative corporate capital gains tax was part of the Internal Revenue Code from 1942 until its repeal by the Tax Reform Act of 1986 (See Appendix B). Sound tax policy and economic considerations as well as political and revenue consequences argue for inclusion of a corporate capital gains differential with an individual rate cut:

TAX POLICY: Under current law, corporate capital gains are taxed at 34%, compared to 28% (33% in some cases) on gains received by individuals. If individuals receive a 30% exclusion [as the new administration proposal is reported to include (See Appendix A)] and corporate capital gains continue to be taxed at a 34% rate, there will be a 14.4 point spread between corporate and individual capital gains tax rates.

A fundamental tenet of tax policy is that the form of ownership should not materially impact the marginal rate of taxation applied to a transaction. Admittedly, the double taxation of corporate earnings continues to violate this basic principle. Under current law, an individual is taxed at a 28% rate on an asset owned directly, but at 52.5% (a 1.9 times tax multiplier effect) on the same profit realized by a corporation on a capital asset and paid to the taxpayer as a dividend. Under a 30% exclusion for individuals and with no reduced rate on corporate capital gains, an individual will incur 2.6 times more tax on a corporate asset which he owns indirectly as compared with the same asset owned directly (See Appendix C). Differences in tax rates of this magnitude inevitably lead to inequities and excessive "tax planning" to compensate for these distortions.

Failure to reduce corporate capital gains tax rates in conjunction with individual rate cuts will only heighten inequities already inherent in the double taxation of corporate profits described above and accentuate the trend away from the traditional corporate form of organization. IRS data indicate that while total business tax return filings increased by almost 8% in the 1987-89 period, regular corporate returns went up by less than 2%. In sharp contrast, 1120 S coporations, whose profits are taxed at the individual level, increased by 41% and sole proprietors returns went up over 8% (see Appendix D). If this trend continues, the revenue loss due to the shifting of assets from the corporate to the non-corporate sector could become significant.

ECONOMIC POLICY: The U.S. cost of capital is more than twice as high as that of Japan, 60 percent higher than that of the United Kingdom and 30 percent higher than that of West Germany (See Appendix E). Lower individual and corporate capital gains tax rates will help reduce the high cost of capital in the U.S. by reducing the pre-tax return required by the investor.

Another benefit of lower individual and corporate capital gains tax rates is a reduced incentive for the use of debt finance. New research by Dr. Hayne Leland, a University of California finance professor, indicates that the Tax

Reform Act of 1986 actually increased the attractiveness of debt, relative to equity finance. Leland concludes that reducing corporate and individual capital gains rates would encourage equity finance (See Appendix F).

Furthermore, failure to narrow the spread between individual and corporate capital gains rates will exacerbate capital cost differentials in industries in which capital gains are a significant share of earnings compared to those whose earnings are taxed primarily at ordinary rates and whose individual shareholders would be taxed at lower rates if individual capital gains rates alone are reduced (See Appendix G). Capital will be less mobile and economic efficiency will be impeded due to the "lock in" effect if the current 34% corporate capital gains rate is not reduced.

VENTURE CAPITAL: Corporations have traditionally provided a significant amount of funding for the organized venture capital market, averaging 12 percent in recent years. Funding for independent private venture capital firms (including from corporations) is declining, falling from $4.3 billion in 1987 to $2.9 billion in 1988. Corporate capital gains reductions would stimulate corporate support for venture capital, as well as encouraging corporations to fund their own "spin-off" ventures. Corporate interest in venture capital is declining. It seems likely that the 1986 Tax Reform Act, which increased the corporate capital gains rate from 28 to 34%, has contributed to the lessening of corporate interest in start-up enterprises (See Appendix H).

INTERNATIONAL COMPARISONS: The U.S. taxes corporate capital gains at the ordinary income rate of 34%, does not provide for indexation of such gains for inflation, and does not allow capital losses to be used to offset ordinary income. These last two provisions increase the risk, and therefore the cost of capital, for corporate investments expected to yield capital gains. Twelve out of sixteen countries surveyed tax corporate capital gains more favorably than the U.S., either through lower tax rates, allowing losses to offset ordinary income, or indexing gains for inflation. For example, West Germany, the Netherlands, Japan, and Korea permit corporate capital losses to be deducted from ordinary income, and Belgium taxes corporate capital gains at 21.5 percent. In several of the Pacific Basin countries, such as Hong Kong and Singapore, and Malaysia-- emerging industrial countries whose very low wage rates plus efficiency of output offer growing competition to the United States--corporate capital gains are exempt from taxes (See Appendix I).

FAIRNESS: Fairness dictates that corporate capital gains be included in any proposal to lower individual capital gains tax rates. Tax parity will not be achieved unless corporate capital gains rates are reduced to the same level as individual capital gains. To restore equity to the U.S. tax code, corporate capital gains could be taxed at an alternative rate just as they were from 1942 to 1986, or by an exclusion equivalent to the one proposed for individuals.

REVENUE: Much of the confusion over the potential "responsiveness" of corporate capital gains to rate reductions is created by excessive reliance on long-term data comparisons between individual and corporate responses to previous capital gains rate changes. Unfortunately, such comparisons fail to recognize that corporate capital gain rate changes have typically been in the two-

percentage point range, while individual rate changes have been considerably larger. For example, between 1977 and 1982, the nominal individual capital gains tax rate declined from 35% to 20%, a 43% drop. (At the margin, the rates actually declined from 49.13% to 20%, a 59% reduction.) During the same period, the corporate capital gains rate declined two percentage points, 30% to 28%, a reduction which could scarcely be expected to generate a significant upturn in corporate capital gain realizations and tax revenues.

A better illustration of the potential level of corporate responsiveness to changes in capital gains tax rates is documented by recent data on tax returns filed in anticipation of the rate changes under the 1986 Tax Reform Act. With full knowledge that the corporate capital gains tax was about to increase six full percentage points January 1, 1987 (from 28% to 34%), corporations responded with a 94% increase in capital gains realizations in 1986. This increase was identical to the capital gains response by individuals in that year. Clearly, when the incentive is there, the corporate community will respond. (See Appendix J).

Furthermore, new (but unpublished) estimates by the U.S. Treasury Department and by the highly respected revenue estimators at Peat Marwick (KPMG) show that corporate capital gains rate cuts would increase tax revenues during the typical budget reconciliation period. Treasury estimates that reducing the corporate capital gains tax rate from 34% to 23.8% yields $3.2 billion over three years. KPMG's analysis predicts a revenue increase of $1.0 billion over three years if corporate rates are reduced from 34% to 20%. Both estimates are near balance over a full five years.

COMMUNICATIONS

This Statement is submitted by the American Council of Life Insurance to the Committee on Finance for the record of the hearings on the U.S. saving rate held March 27–28, 1990. The American Council of Life Insurance is the major trade association for the life insurance business, representing 616 life insurance companies. Together, these companies hold approximately 92 percent of the assets of all United States life insurance companies and 97 percent of the reserves for insured pension plans.

The backbone of the life insurance business is the provision of long-term financial protection and saving. In so doing, the business accumulates, through permanent insurance and pension products large amounts of personal saving which go directly into private capital formation. Moreover, this saving is particularly well suited to supplying funds for long term investment in plant and equipment, including commercial structures. Tax changes which would discourage this form of personal saving would seriously damage our ability to finance the growth of our economy with domestic saving and would force greater reliance on foreign capital. Thus, any such changes in the name of deficit reduction would be counter productive and should be avoided.

THE IMPACT OF LIFE INSURANCE AND PENSIONS ON SAVINGS AND ECONOMIC GROWTH

U.S. Saving Rate Too Low

It is widely recognized that our rate of net national saving (saving in excess of depreciation) needs to be increased and clearly not discouraged. Net national saving has declined from a rate of more than 7 percent of the Gross National Product (GNP) in the 1960s and 1970s to a rate of less than 3 percent of the GNP in 1989. The desirability of a higher rate of net national saving is undisputed. This is the domestic source for financing the expansion and improvement in the income-producing capital base our economic growth and well being is founded on.

In recent years, the expansion and improvement in that capital base (net domestic investment) has been stronger than our net national saving would allow. We have had to rely on savings from foreign sources. In fact, in 1989, U.S. net national saving needed to be supplemented by an amount equivalent to 1.8 percent of GNP from foreign sources to finance net domestic investment at a rate of 4.6 percent of GNP. Even with the foreign infusion, this 4.6 percent of GNP net domestic investment is below the average rates of net domestic investment of the previous two decades.

Life Insurance and Pension Savings are a Significant Part of National Savings

The personal saving by individuals, including saving done in their behalf by employers through contributions to pension plans, is a major source of our net national saving. Savings through life insurance and insured pensions have, in turn, historically been a significant component of personal savings, and in recent years, have grown relatively more important. As seen in Chart 1, additions to life insurance and insured pension reserves contributed $111 billion of Personal saving in 1989 (additions to uninsured private pension reserves have not been included due to accounting method changes in the Federal Reserve flow of funds data). As can be seen in Chart 2, this source of saving is now one of the three dominant and approximately equal components that make up the bulk of personal saving (the other two are securities and time and savings deposits).

Unique Role of Life Insurance and Pension Reserves in Capital Formation

Life insurance and private pension reserves represent a unique pool of savings. The needs met by life insurance and private pensions are inherently long-term. People save through these vehicles with their eyes on the horizon. Moreover, private pensions and life insurance offer a highly structured, stable and dependable means of saving for those long term needs.

Because of the natural matching of long-term savings to long-term investment, the insurance and pension business has an expertise and a preference relative to other financial intermediaries for investments in plant and equipment, lowering the cost of capital for these investments from what it otherwise would be.

In fact, 66 percent of all financial assets of life insurance companies and private pension funds were invested in corporate bonds, commercial mortgages and corporate equities at the end of 1989. Life insurance and private pension funds together at the end of 1989 held 44 percent of all corporate bonds outstanding in the U.S., as can be seen in Chart 3. Chart 4, which breaks down commercial mortgages by sector, shows that life insurance companies and private pensions held 26 percent of all commercial mortgages at the end of 1989. Finally, Chart 5 shows the life insurance and private pension sector with 20% of the holdings of corporate stock at the end of 1989.

No one disputes that an increased rate of domestic investment in plant and equipment translates directly into an increased competitiveness of the United States in world trade.

Tax Policy Must be Congruent With Savings Goals

It is imperative that tax policy decisions be congruent with the economic and social policy goals that are determined to be the top priorities for our national well-being. As discussed above, savings through life insurance and insured private pensions make up a large, growing component of national savings and have the special characteristic of being ideally suited to long term investments to finance corporate capital spending and commercial construction. Thus, tax changes that adversely impact life insurance and insured private pensions would cause immediate and direct damage to our net national saving, would inhibit our ability to modernize our industrial plant and equipment and would be in direct contradiction with our economic goals.

Chart 1

Growth in Life Insurance & Insured Private Pension Reserves Compared With Private Saving
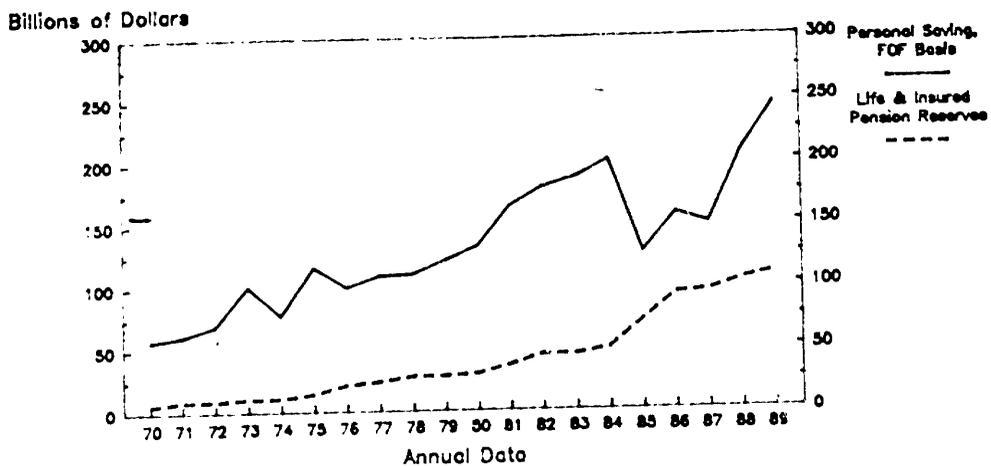
Source: Federal Reserve Board, Flow of Funds

Chart 2

Major Components of Personal Saving
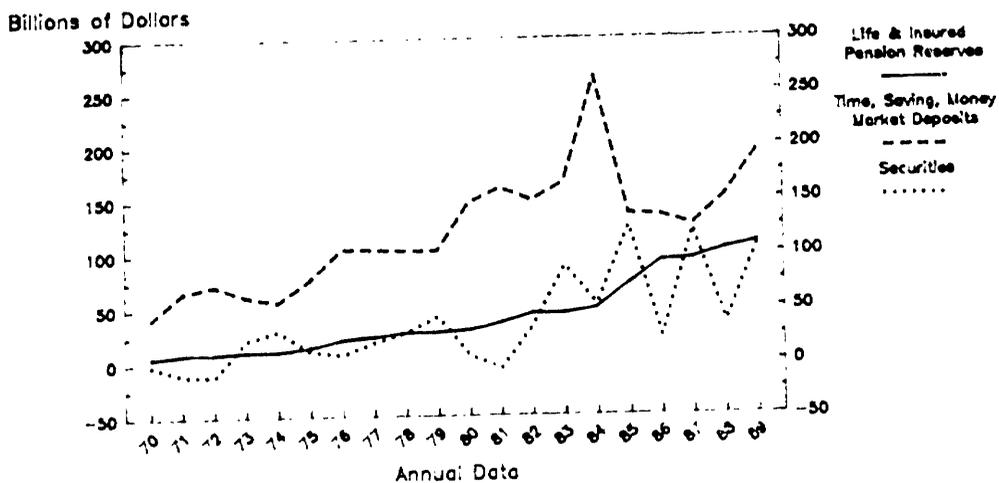
Source: Federal Reserve Board, Flow of Funds

Chart 3
Corporate Bond Holdings by Sector
1989

Life & Pension Co.---44%

Depository Instit.---10%

Other---16%

Foreigners---13%

Mutual Funds---5%

State & Local Retir.---12%
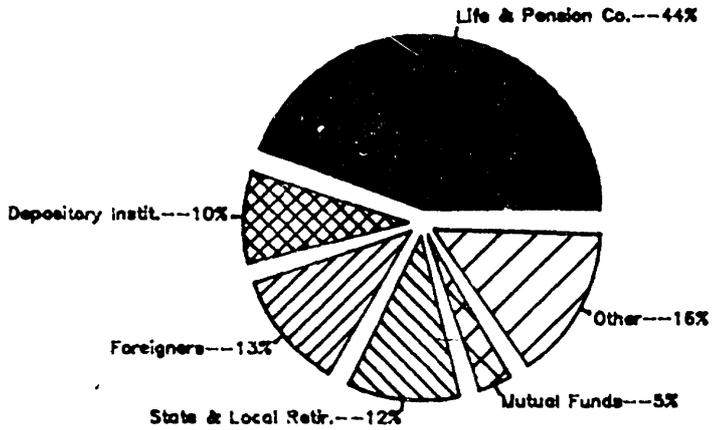
Chart 4
Commercial Mortgage Holdings by Sector
1989

Life & Pension Co.---26%

Commercial Banks---45%

Other---10%

Savings Institutions---19%
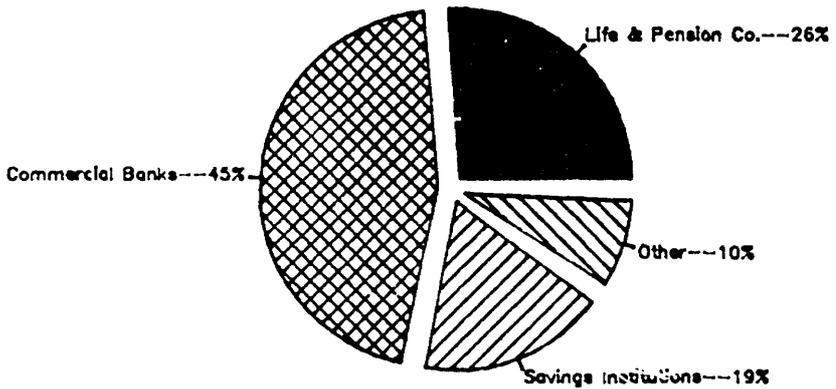
Chart 5
Corporate Stock Holdings by Sector
1989

Household Sector---56%

Life & Pension Co.---20%

Other---5%

Mutual Funds---6%

State & Local Retir.---5%

Foreigners---7%
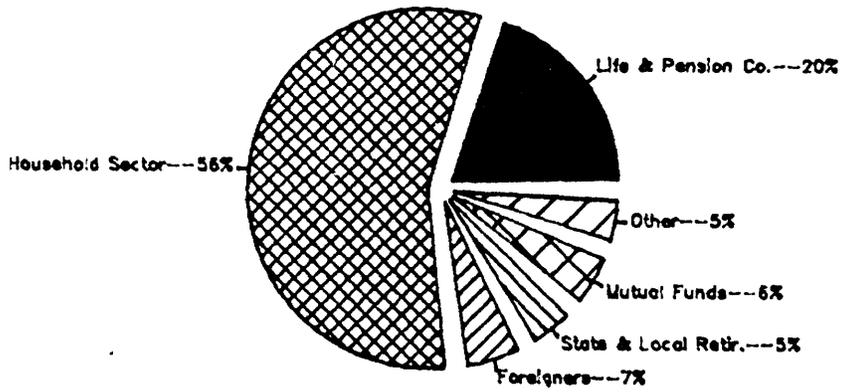
Source: Federal Reserve Board, Flow of Funds

STATEMENT OF THE AMERICAN PUBLIC POWER ASSOCIATION

The American Public Power Association is pleased to submit this statement on the need to encourage investment savings to strengthen the U.S. economy.

APPA is the national service organization representing more than 1,750 municipally and other local publicly owned electric power systems. Collectively they serve one in every seven electric consumers throughout the country. APPA commends this committee for recognizing the importance of investment savings to the national economy. The general managers of our public power systems, who are responsible to their local governments through their governing bodies, have long recognized the importance of capital investment to the health of their utility, the economic well-being of their community and the general productivity of the nation as a whole.

As pointed out in the oral testimony presented by the National Association of Counties (NACo), there is a direct relationship between stimulating investment savings among all Americans and improving the capital public infrastructure across the country. Since the first public power system was established shortly after Thomas Edison began central station electric services at Pearl Street Station in 1882, public power systems have been issuing tax-exempt bonds as a means to stimulate savings while investing in their own community. As such, we believe that tax-exempt bonds are one of the most productive and important forms of investment savings. They serve as the essential linchpin for public capital investment.

TAX-EXEMPT BONDS: THE ESSENTIAL LINCHPIN FOR LOCAL INFRASTRUCTURE PROGRAMS

Public power, like all local government capital intensive infrastructure projects, is heavily dependent on the use of tax-exempt financing in building and operating essential public facilities. Like locally owned solid waste disposal systems, water and wastewater systems, streets, local roads and bridges, these high cost public works require the use of tax-exempt bonds in order to keep project costs feasible.

While the Nation's infrastructure continues to crumble at an alarming rate, local communities must make the tough choice to put off improvements because the community cannot raise the revenues through local taxes, and fees, and because changes in the tax code have rendered tax-exempt bonds ineffective as a result of restrictions placed on the use of the bonds or because certain changes have reduced the market for such bonds.

In fact, in November of 1989 the Rebuild America Coalition released a report calling on Congress to eliminate federal restrictions on the use of tax-exempt financing for infrastructure purposes as one of five legislative goals. The report notes that the United States ranks fifty-fifth in the world in capital investment in infrastructure, spending only 1.1 percent of our gross national product it.

Our lack of investment has affected the Nation's productivity and our ability to compete in the world market. Even more telling is the effect this lack of investment will have on our future. According to this same report, postponing action on our infrastructure investments will cost our children, using a four percent rate of inflation, an additional 60 percent by the year 2000.

TAX REFORM ACT OF 1986

While the 1986 tax law changes have not destroyed the market for tax-exempt debt, the resultant impact of these changes has made it difficult at best to issue tax-exempt bonds and manage a long-term public capital investment program. Correcting this serious problem has been a top priority for local officials across the country as they attempt to address the critical nature of the nation's public infrastructure crisis.

The 1986 tax changes severely upset the market for municipal bonds, essentially eliminated the commercial bank demand for tax-exempt bonds. Bank holding of municipal securities has fallen from $231 billion in 1985 to $153 billion in the fourth quarter of 1988.

Changes in the Alternative Minimum Tax (AMT) also effected the market for municipal securities, leaving the individual investor as the major source of demand for municipal bonds. In addition, changes in private use restrictions have had a particular impact on public power's ability to use tax-exempt financing for long-term power supply plans.

NEW CHALLENGES: THE FAMILY SAVINGS ACCOUNT

More recently, there are new challenges to the market for tax-exempt municipal bonds. The Administration proposes in its FY 1991 budget to stimulate national savings through a new savings plan, the Family Savings Account (FSA). While we support the concept of encouraging investment savings and commend the President for his recognition of this need, we join other governmental organizations in their concern that such a proposal may further reduce the market for tax-exempt bonds and seriously jeopardize the ability of state and local governments to issue this important form of public debt for needy public projects by eliminating the most important buyer of tax-exempt bonds: the individual.

We wholeheartedly urge this committee to seriously consider the ramifications of such a proposal to the municipal bonds market and to develop a sound public policy that would serve to stimulate both investment savings and public capital improvements. With the current infrastructure crisis, the nation can ill-afford further erosion of state and local government's ability to address their infrastructure needs.

The FSA proposal would permit investors to earn interest -- at taxable rates -- and have that interest exempt from federal income taxes if the funds are held for seven years. The savings plan is targeted at middle-income taxpayers -- individuals who have adjusted gross incomes less than $60,000 and joint filers with adjusted gross incomes less than $120,000.

Data provided by the federal governments' 1988 Taxpayer Usage Study and published in the Treasury Department's Statistics Of Income Bulletin (Fall 1989, Column 9, Number 2) suggests that a significant amount of tax-exempt bonds are owned by this same group of middle income investors. For example, 27 percent of the tax-exempt interest reported in the study was listed on returns with an adjusted gross income of under $50,000 and 55 percent was reported on returns having less than $100,000. Generally, investors in long term tax-exempt municipals hold their bonds for an average of 8 to 12 years. Because the FSA would provide more attractive yields and a shorter average term, the family savings account initiative could dramatically dampen the tax-exempt market.

We believe that the tax code should encourage both national savings and infrastructure improvements and not create a Hobson's choice. Adoption of the proposed FSA initiative poses that dilemma.

We join with NACo and other local government organizations in urging you to carefully consider the FSA proposal. If Congress should consider enacting such a program, we urge you to tie this program to public capital investment. This can be done easily by requiring the FSA to be invested in municipal tax-exempt bonds. APPA endorses NACo's recommendations to:

o   target new investment into socially and economically desirable public projects needed to rebuild America, and;

o   restore the incentives that were eliminated for banks and other corporations in 1986, thereby broadening the market for tax-exempt debt used to finance infrastructure.

Thank you for this opportunity to present our views. We look forward to working with you in the months ahead to devise a plan which encourages investment and savings while also permitting us to reinvest in our nation's public infrastructure to ensure the health, safety and economic well-being of America.

Statement of the Coalition for Competitive Capital [1]

INTRODUCTION

A majority of members of Congress have accepted the economic case for cutting tax rates on capital gains, and the passage of legislation (which was blocked on procedural grounds in 1989) is expected by most observers in 1990. To this end, the Administration has fashioned a broader and better capital gains proposal than its 1989 initiative which would extend its rate cut to all individually owned capital assets (except collectibles) and provide for a 30-percent exclusion on assets held three or more years (equating to an effective tax rate of 19.6 for taxpayers in the 28% bracket). The Administration proposal does not at this time include corporations as taxpayers eligible for the capital gains differential.

The Coalition for Competitive Capital strongly believes that proposals to reduce the individual capital gains tax rate should also include capital assets held by corporations. Restoring a differential would simply reinstate the historical treatment of corporate capital gains; an alternative corporate capital gains tax was part of the Internal Revenue Code from 1942 until its repeal by the Tax Reform Act of 1986. Considerations of fairness, tax policy and economic factors as well as political and revenue consequences argue for inclusion of a corporate capital gains differential with an individual rate cut.

TAX POLICY AND CORPORATE CAPITAL GAINS

Under current law, corporate capital gains are taxed at 34%, compared to 28% (33% in some cases) on gains received by individuals. If individuals receive a 30% exclusion and corporate capital gains continue to be taxed at a 34% rate, there will be a 72 percent spread between corporate and individual capital gains tax rates.

A fundamental tenet of tax policy is that the form of ownership should not materially impact the marginal rate of taxation applied to a transaction. Admittedly, the double taxation of corporate earnings continues to violate this basic principle. Under current law, an individual is taxed at a 28% rate on an asset owned directly, but at 52.5% (a 1.9 times tax multiplier effect) on the same profit realized by a corporation on a capital asset and paid to the taxpayer as a dividend (see Table 1). Under a 30% exclusion for individuals and with no reduced rate on corporate capital gains, *an individual will incur 2.6 times more tax on the profits from the sale of a corporate asset which he owns indirectly as compared with the same asset owned directly (see Table 2).* Differences in tax rates of this magnitude are not only highly inequitable, they also inevitably lead to inequities and excessive "tax planning" to compensate for these distortions.

Failure to reduce corporate capital gains tax rates in conjunction with individual rate cuts will only heighten inequities already inherent in the double taxation of corporate profits described above and accentuate the trend away from the traditional corporate form of organization. IRS data indicate that while total business tax return filings increased by almost 8% in the 1987–89 period, regular corporate returns went up by less than 2%. In sharp contrast, 1120 S corporations, whose profits are taxed at the individual level, increased by 41% and sole proprietors returns went up over 8% (see Table 3). If this trend continues, the revenue loss due to the shifting of assets from the corporate to the non-corporate sector could become significant.

INTERNATIONAL COMPARISON OF CAPITAL COSTS

Earlier international comparisons based on the traditional pretax return concept show that U.S. capital costs are approximately twice those of Japan, 60 percent higher than the United Kingdom's, and 30 percent higher than those of West Germany. Experts conclude that the currently high U.S. capital costs are due to three primary factors: (1) high interest rates; (2) the lack of indexing of depreciation allowances for inflation; and (3) Federal tax code changes since 1982.

New research by Stanford University Professor John B. Shoven indicates that the U.S. cost of capital is higher than previously estimated. Professor Shoven's study is a step forward in capital cost analysis because he incorporates a measure of the risk premium actually demanded by investors in the traditional pretax return measure, whereas previous studies used the unrealistic assumption that the risk premium

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[1] The Coalition for Competitive Capital is an informal group of businesses and associations that work for an internationally competitive tax system in the United States. Its address is Suite 200, 1730 Pennsylvania Avenue, N.W., Washington, DC 20006. Its phone number is (202) 393-4760.

could be measured by the real interest rate on safe, short-term government bonds. Using his more realistic measure of the pretax return required by investors, *Dr. Shoven concludes that the U.S. cost of capital is approximately two and one-half times higher than that of Japan and that the U.S. tax system discriminates against risky investments.*

Dr. Shoven shows that for a typical piece of equipment financed with equity and with an assumed five-year life, the cost of capital was 10.4 percent in the United States in 1988 compared to 4.1 percent in Japan—a difference of 153 percent. U.S. structures financed with equity face capital costs 147 percent higher than Japanese structures. Debt-financed investments in the United States also incur substantially higher capital costs than in Japan.

The new Office of Technology Assessment study, "Making Things Better: Competing in Manufacturing," makes a similar point regarding Japan's capital cost advantage over the U.S. The study notes that there is some disagreement over just how large (or small) the differences are, but most recent studies estimate significantly higher capital costs in the United States than in Japan. On the high side, the estimates range up to 13 percentage points difference, while the difference at the low end is on the order of 1 or 2 percentage points. Even relatively modest differences of a few percentage points in capital costs can be a significant disadvantage in making investments that take many years to pay off, the study concludes.

TAXES AND THE COST OF CAPITAL

Taxes are a very important element in the cost of capital. For example, Dr. Shoven's analysis shows that for an equity-financed plant, one-third of the cost of capital is due to the income and capital gains tax, one-third to interest rates, and one-third to the required risk premium. Taxes are approximately 15 percent of the cost of capital for equity-financed equipment, with the remainder divided equally between interest rates and the risk premium.

Several independent estimates predict that capital gains tax reductions would reduce U.S. capital costs. The cost of retaining after-tax earnings, that is, not paying them out as dividends, is a major factor in most firm's capital costs. Research by Don Fullerton and Mervyn King shows that 93 percent of equity is raised by retained earnings compared to only 7 percent from new shares. Investors' willingness to let firms retain earnings depends primarily on two factors: (1) their view of the firm's earning potential and (2) tax rates on appreciated stock (capital gains). Lower capital gains taxes mean that firms can undertake investments with lower yields (hurdle rates) without making investors any less willing to let firms retain earnings. In other words, as capital gains taxes are reduced, the cost of capital to the firm declines.

LBO ACTIVITY AND CAPITAL GAINS

In recent years, leveraged buyouts have siphoned off large amounts of capital that might have been more productively employed elsewhere. A new study by Hayne E. Leland, professor of finance at the University of California at Berkeley, demonstrates that the capital gains provisions in the TRA *increased* the attractiveness of LBOs and debt finance. Dr. Leland notes that at first glance one might think the 1986 changes would have reduced the incentive, since corporate rates were cut from 46 percent to 34 percent—thereby cutting the tax savings from interest deductions. But the TRA also changed the taxation of debt and equity returns at the personal level. Prior to the tax code change, individuals paid a maximum of 20 percent tax on capital gains, but as much as 50 percent on interest and dividends, which were treated as ordinary income. Thus, individuals tended to prefer equity over debt because capital gains on equity were taxed at a lower rate than interest and dividends. While a firm saved taxes by issuing debt at the corporate level, it had to pay higher interest to offset the tax disadvantage of interest income to bond holders.

Using methodology based on the pioneering research of Nobel laureate Franco Modigliani and University of Chicago Professor Merton Miller, Dr. Leland finds that prior to the 1986 Tax Reform Act each extra dollar of leverage (that is, debt replacing equity) led to a $0.22 increase in the value of the firm. In the post-1986 tax environment, each extra dollar of leverage leads to a $0.34 increase in value, which is more than 50 percent greater, despite the drop in the corporate tax rate. *In short, the tax revision of 1986 created a more powerful impetus toward increased leverage.* Leland concludes that reducing corporate and individual capital gains rates would encourage equity finance.

Furthermore, failure to narrow the spread between individual and corporate capital gains rates will exacerbate capital cost differentials in industries in which cap-

ital gains are a significant share of earnings compared to those whose earnings are tax primarily at ordinary rates and whose individual shareholders would be taxed at lower rates if individual capital gains rates alone are reduced (see Table 4). Capital will be less mobile and economic efficiency will be impeded due to the "lock in" effect if the current 34% corporate capital gains rate is not reduced.

VENTURE CAPITAL

Corporations have traditionally provided a significant amount of funding for the organized venture capital market, averaging 14 percent in recent years. Funding for independent private venture capital firms is declining, falling from $4.2 billion in 1987 to $2.4 billion in 1989. Corporate capital gains reductions would stimulate corporate support for venture capital, as well as encouraging corporations to fund their own "spin-off" ventures. Corporate interest in venture capital seems to be declining. It seems likely that the 1986 Tax Reform Act, which increased the corporate capital gains rates from 28% to 34%, has contributed to the lessening of corporate interest in start-up enterprises.

INTERNATIONAL COMPARISONS

The U.S. taxes corporate capital gains at the ordinary income rate of 34%, does not provide for indexation of such gains for inflation, and does not allow capital losses to be used to offset ordinary income. These last two provisions increase the risk, and therefore the cost of capital, for corporate investments expected to yield capital gains. Twelve out of sixteen countries surveyed tax corporate capital gains more favorably than the U.S., either through lower tax rates, allowing losses to offset ordinary income, or indexing gains for inflation. For example, West Germany, the Netherlands, Japan, and Korea permit corporate capital losses to be deducted from ordinary income, and Belgium taxes corporate capital gains at 21.5 percent. In several of the Pacific Basin countries, such as Hong Kong and Singapore, and Malaysia—emerging industries countries whose very low wage rates plus efficiency of output offer growing competition to the United States—corporate capital gains are exempt from taxes (see Table 5).

FAIRNESS

Fairness dictates that corporate capital gains be included in any proposal to lower individual capital gains tax rates. Tax parity will not be achieved unless corporate capital gains rates are reduced to the same level as individual capital gains. To restore equity to the U.S. tax code, corporate capital gains could be taxed at an alternative rate just as they were from 1942 to 1986, or by an exclusion equivalent to the one proposed for individuals.

REVENUE

Much of the confusion over the potential "responsiveness" of corporate capital gains to rate reductions is created by excessive reliance on long-term data comparisons between individual and corporate responses to previous capital gains rate changes. Unfortunately, such comparisons fail to recognize that corporate capital gains rate changes have typically been in the two-percentage point range, while individual rate changes have been considerably larger. For example, between 1977 and 1982, the nominal individual capital gains tax rate decline from 35% to 20%, a 43% drop. (At the margin, the rates actually declined from 49.13% to 20%, a 59% reduction.) During the same period, the corporate capital gains rate declined two percentage points, 30% to 28%, a reduction which could scarcely be expected to generate a significant upturn in corporate capital gain realizations and tax revenues.

A better illustration of the potential level of corporate responsiveness to changes in capital gains tax rates is documented by recent data on tax returns filed in anticipation of the rate changes under the 1986 Tax Reform Act. With full knowledge that the corporate capital gains tax was about to increase six full percentage points January 1, 1987 (from 28% to 34%), corporations responded with a 95% increase in capital gains realizations in 1986 (see Chart A). This increase was identical to the capital gains response by individuals in that year. Clearly, when the incentive is there, the corporate community will respond.

Furthermore, estimates by the U.S. Treasury Department and by the highly respected revenue estimators at Peat Marwick (KPMG) show that corporate capital gains rate cuts would increase tax revenues during the typical budget reconciliation period. Treasury estimates that reducing the corporate capital gains tax rate from 34% to 23.8% yields $3.2 billion over three years. KPMG's analysis predicts a reve-

nue increase of $1.0 billion over three years if corporate rates are reduced from 34% to 20%. Both estimates are nearly revenue neutral over a full five years. Attachment.

Table 1: **Total Tax on Corporate Capital Gain under Current Law and at Lower Rates**

	Current Law	Lower Rates	
		20% Rate	15% Rate
Corporate Profit	$100.00	$100.00	$100.00
Tax	(34.00)	(20.00)	(15.00)
Net Corporate Profit	$ 66.00	$ 80.00	$ 85.00
Tax on Above if Paid as Dividend to Shareholder	$ 18.50	$ 22.40	$ 23.80
Net to Shareholder	$ 47.50	$ 57.60	$ 61.20
TOTAL TAX	$ 52.50	$ 42.40	$ 38.80
Ratio of Total Tax on Corporate Investment to Tax on Direct Individual Investment	1.9x	1.5x	1.4x

While a reduced corporate capital gain tax rate does not solve the bias, it at least reduces it.

Prepared by the Coalition for Competitive Capital, January 1990.

Table 2: **Tax Bias against Corporate Form of Doing Business**

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**Individual Investment
   in Corporation:**[1]

Corporate Profit	$100.00
Tax at 34%	(34.00)
Net Corporate Profit	$ 66.00
Dividend of Above	$ 66.00
Tax at 28%	(18.50)
Net Return to Individual	$ 47.50
Total Tax Burden	$ 52.50

Individual Invests Directly:[2]	Tax	Ratio of Total Tax on Corporate Investment to Tax on Individual's Direct Investment
•Current Law	$28.00	1.9x ($52.50÷$28)
•Bush 15% Capital Gains Tax Proposal	$15.00	3.5x ($52.50÷$15)
•Congressional Capital Gains Tax Proposal at 20%	$20.00	2.6x ($52.50÷$20)

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[1]Assumes a capital asset investment. Under current law, both ordinary income and corporate capital gains are taxed at a maximum rate of 34 percent.

[2]Assumes a capital investment.

Table 3: BUSINESS TAX RETURNS, 1984-1989
(totals and percent change year-to-year)

Individual Income		1984	1985	1986	1987	1988	1989	1987-1989 percent change
Business (Sole	Total	13,776,461	14,136,768	14,625,407	14,808,186	15,237,850	15,997,500	
Proprietorships)	% Change		2.63%	3.46%	1.25%	2.90%	4.99%	8.03%
Corporation Income		3,166,715	3,437,249	3,700,851	3,828,613	4,027,428	4,249,400	
Forms 1120, L and M	Total	2,453,162	2,432,265	2,523,240	2,550,692	2,472,376	2,600,400	
	% Change		-0.85%	3.74%	1.09%	-3.07%	5.18%	1.95%
Form 1120 S	Total	653,640	736,945	811,987	892,376	1,169,736	1,260,200	
	% Change		12.74%	10.18%	9.90%	31.06%	7.73%	41.22%
Partnership, Form 1065	Total	1,675,605	1,755,339	1,831,600	1,824,166	1,825,865	1,890,500	
	% Change		4.76%	4.34%	-0.41%	0.09%	3.54%	3.64%
Totals								
	Total	16,941,176	17,574,017	18,326,258	18,636,799	19,265,278	20,246,900	
	% Change		3.74%	4.28%	1.69%	3.37%	5.10%	8.64%

Note: 1989 numbers are projected.

Source: Internal Revenue Service. Statistics of Income Bulletin. Fall 1987 and Spring 1989. Washington, D.C.

Prepared by the Coalition for Competitive Capital, January 1990.

Table 4: RETURNS OF ACTIVE CORPORATIONS
1985 AND 1986 NET LONG-TERM CAPITAL GAINS
(in thousands of dollars)

Category	1985			1986			Percent Change in Gains
	Long-Term Capital Gains	Business Receipts	Capital Gains as a Percent of Business Receipts	Long-Term Capital Gains	Business Receipts	Capital Gains as a Percent of Business Receipts	
Agriculture, forestry, and Fishing	620,123	65,419,402	0.95%	730,314	71,787,552	1.02%	17.8%
Mining	1,281,360	126,710,610	1.01%	1,366,876	86,873,761	1.57%	6.7%
Construction	1,548,073	374,590,273	0.41%	1,132,342	399,436,063	0.28%	-26.9%
Manufacturing	14,853,783	2,656,345,750	0.56%	24,564,317	2,614,526,752	0.94%	65.4%
Lumber and Wood Products	1,144,085	66,379,858	1.72%	1,062,531	71,936,340	1.48%	-7.1%
Paper and Allied Products	757,845	79,767,320	0.95%	1,111,525	81,247,095	1.37%	46.7%
Transportation and Public Utilities	3,919,855	733,943,970	0.53%	6,694,919	717,929,024	0.93%	70.8%
Wholesale Trade	1,292,313	1,187,581,406	0.11%	2,207,397	1,169,998,313	0.19%	70.8%
Retail Trade	2,632,954	1,216,633,348	0.22%	3,838,817	1,298,421,838	0.30%	45.8%
Finance, Insurance, and Real Estate	25,419,842	501,993,840	5.06%	49,739,250	618,646,549	8.04%	95.7%
Banking	2,405,367	35,564,223	6.76%	4,216,150	38,595,954	10.92%	75.3%
Credit Agencies Other than Banks	1,016,952	26,898,457	3.78%	1,048,268	82,052,420	1.28%	3.1%
Security, Commodity Brokers, and Services	468,754	21,562,819	2.17%	950,241	33,525,833	2.83%	102.7%
Insurance	7,626,177	272,199,436	2.80%	15,262,465	326,224,770	4.71%	100.1%
Insurance Agents, Brokers, and Services	216,244	25,833,298	0.83%	322,210	32,496,387	0.99%	50.4%
Real Estate	3,650,567	57,723,202	6.32%	5,426,538	42,331,043	8.71%	48.6%
Holding and Other Investment Companies, except Bank Holding Companies	10,037,781	62,212,205	16.13%	22,513,378	45,420,144	49.57%	124.3%
Services	2,163,240	497,980,990	0.43%	2,997,412	550,590,929	0.54%	38.6%
TOTAL	53,771,685	7,369,538,953	0.73%	93,297,600	7,535,482,221	1.24%	73.5%

Source: Internal Revenue Service, Statistics of Income. Corporation Income Tax
Returns, 1985 and 1986 editions. Washington, D.C., 1988 and 1989.

Prepared by the Coalition for Competitive Capital, January 1990.

Table 5: International Comparison of Capital Gains Tax Rates

	Individuals			Corporations		
Industrialized Group	Maximum Marginal Short-Term Capital Gains Tax Rate	Maximum Marginal Long-Term Capital Gains Tax Rate	Holding Period for Long-Term Gains Treatment	Maximum Marginal Long-Term Capital Gains Tax Rate	Holding Period for Long-Term Gains Treatment	Capital Loss Deductions Against Ordinary Income
United States	33%	33%	More than 1 year	34% b/,c/	More than 1 year	No
Australia	49.25%	49.25%	More than 1 year	39% b/,d/	None	No
Belgium	Exempt	Exempt	None	21.5% e/	5 years	
Canada	19.33%	19.33%	None	29%/25% f/	None	No
France	16%	16%	None	15%/25% g/	2 years	No
West Germany	56%	Exempt	6 months	36% b/	None	Yes
Italy	Exempt	Exempt	None	36% b/	None	
Japan	1%/20% a/	1%/20% a/	None	37.5% b/,h/	None	Yes
Netherlands	Exempt	Exempt	None	40% b/,i/	None	Yes
Sweden	42%	16.8%	2 years	21% j/	2 years	No
United Kingdom	40%	40%	None	35% b/,a/	None	No
Pacific Basin Group						
Hong Kong	Exempt	Exempt	None	Exempt	None	
Singapore	Exempt	Exempt	None	Exempt	None	
South Korea	Exempt	Exempt	None	30% b/,k/	None	Yes
Taiwan	Exempt	Exempt	More than 1 year	25% b/,l/	None	

Sources: Spicer & Oppenheim and Securities Industry Association, International Tax Comparisons (1989); Price Waterhouse, Corporate Taxes: A Worldwide Summary (1989 edition); Tax Analysts, Tax Notes International, various issues (1989 and 1990); and Commerce Clearing House, Inc., World Tax Series - Germany, various issues.

Note: The data for individuals reflect tax rates only on securities, while the data for corporations apply to tax rates on all capital assets. State, provincial, municipal, and local taxes are not reflected in these rates.

a/ Taxpayers have a choice of a 1 percent withholding tax on gross sales proceeds or a maximum tax on net capital gains of 20 percent.

b/ Gains are taxed at ordinary rates.

c/ The holding period is more than one year for assets acquired after December 31, 1987.

d/ Indexing applies to assets acquired after September 19, 1985; assets acquired before that date are exempt from tax.

e/ This preferential rate applies to buildings, equipment, shares of corporate stock, and other portfolio investments. Pending government tax reform would eliminate the preferential long-term rate for corporations. Indexing is applied to assets acquired before 1950.

f/ In general, the gains of publicly held firms are taxed at an effective rate of 29 percent (25 percent if the income is from Canadian manufacturing or processing).

g/ Long-term gains from the sale of fixed assets are taxable at a 15 percent rate. Long-term gains on building sites are taxed at a 25 percent rate.

h/ There is generally an additional 20 percent tax on gains from the sale or transfer of land held less than ten years.

i/ This rate declines from 40 percent to 35 percent after the first Fls 250,000 of taxable income.

j/ There is generally no special treatment for the sale of real property, machinery, equipment, patents, or leaseholds.

k/ There is an additional tax ranging from 32 percent to 53 percent on the sale of land or buildings.

l/ Corporate income tax for capital-intensive and high-technology companies may not exceed 20 percent of taxable income. Land is not considered a capital asset, and the sale of securities by non-security-industry firms is exempt from tax.

a/ Capital gains are indexed for inflation.

## Tax Law Changes Influence Capital Gains More than S&P 500

Chart 1: Individual Capital Gains Realizations
1977-1978*
(percent change, year to year)

Chart 2: S&P 500 Stock Average
1977-1986
(percent change, year to year)

Chart 3: Corporate Capital Gains Realizations
1977-1986*
(percent change, year to year)

Individual capital gains realizations appear to be affected more by tax rate changes than by the performance of the stock market (charts 1 and 2). In 1979, individual capital gains realizations rose by almost 70 percent in response to a cut in capital gain taxes from a maximum of 35 to 28 percent which took effect in November, 1978. The Standard and Poor average of 500 stocks, in contrast, rose only 12 percent in 1979. Similarly in 1981, the year in which individual capital gains tax rates declined to a maximum of 20 percent, realizations rose by 5 percent even through the S&P average fell by 10 percent. The prospect of paying capital gains taxes of up to 33 percent in 1987 was apparently enough to cause a surge of sales in 1986 after the passage of the Tax Reform Act of 1986. Individual realizations increased by over 100 percent as taxpayers rushed to sell assets before the new, higher tax rates took effect in 1987. S&P stock prices rose by only 15 percent in 1987.

Corporate capital gains realizations also seem to respond more to tax rate changes than to variations in stock prices (chart 3). The capital gains included in chart 3 are those reported by corporations with net income, exclusive of "pass through" investment companies whose gains are taxed at individual capital gains rates. The 1979 tax cut was only 2 percentage points, from 30 to 28 percent, but realizations jumped by 37 percent compared to a 12 percent increase in the S&P 500. Corporate capital gains in 1986 show a strong response to the 1987 rate increase similar to that of individuals. Realizations rose by 95 percent compared to a 15 percent increase in the S&P 500. The data suggest that corporate taxpayers were selling in order to avoid the 34 percent maximum capital gains rate which took effect in 1987. Thus, it seems likely that reductions in corporate, as well as individual capital gains tax rates could yield additional revenue compared to current law.

STATEMENT OF THE FOREST PRODUCTS ASSOCIATION AND THE FOREST INDUSTRIES

The National Forest Products Association and The Forest Industries Committee on Timber Valuation, appreciates the opportunity to present this statement to the Senate Finance Committee for its consideration during deliberations regarding the impact, effectiveness and fairness of the Tax Reform Act of 1986. That Act reduced rates and broadened the tax base. While it did reduce complexity for thousands of low income taxpayers by taking them off the tax rolls it made the tax laws much more complex for most other taxpayers. There is a need to attempt to simplify the tax code and we are pleased to see that the committee is embarking on that course of action.

The Forest Industries Committee on Timber Valuation and Taxation is a long-established national organization of thousands of landowners and Tree Farmers, whose members are geographically dispersed throughout the United States, and range in size from the largest, most fully integrated manufacturing companies, to the smallest individual private Tree Farmer, all of whom are keenly interested in the taxation of timber. The National Forest Products Association is a long-established national trade association which represents the interests and views of all producers of hardwood and softwood forest products, and affiliated regional and product associations.

The two organizations are submitting this statement jointly as a demonstration of the interrelationship and interdependence of timber growers and landowners as the raw material source to the mills and production facilities of the thousands of wood products manufacturers throughout the United States. Our interdependence as "supplier and market" provides a common interest in the equitable taxation of timber. In a like manner, there are a number of other associations and organizations related to timber growing who would also like to be associated with this statement. As Committee members can see from the list, the interest in fair timber taxation is both broad and deep, with a geographic diversity across America.

The 1986 Tax Reform Act repealed the capital gains differential. The consequences of the repeal are the reluctance of taxpayers to continue to invest capital into reforestation and the sense that the government has reneged on a promise that if taxpayers planted trees (which many of them have been doing for almost half a century) that a favorable tax rate would be available on the realized gains.

A timber operation requires heavy front-end expenditures, long-term carrying charges, high risks of weather, disease, insects, and fire -- all uninsurable. Of course, there is the market risk of waiting decades until the trees are ready for harvest. Without a rate differential, timber is unlikely to attract sufficient investment capital to keep up with the increasing demand. Those who would respond by saying that if demand exceeds supply it will drive up prices bringing capital back to the timber industry have not fully considered the uniqueness of timber growing. For every year that there is inadequate reforestation and ineffective timber management means the irretrievable loss of future timber supply. Already in the northwest region of the country there are timber shortages and disturbing signs of it in other areas of the country. Many sawmills have shut down because they cannot obtain logs. More are likely to be closed from the pressure resulting from forestland being taken out of production for a variety of reasons. This means that those lands remaining for timber

production must be managed more intensively. To the extent that
_private-forest landowners do not reforest, or management
practices become less efficient due to misdirected tax policy,
those pressures will continue to escalate the pressure on public
lands.

Unless equitable tax treatment is restored for timber growing, it
will curtail investment and timber growth and jobs will be lost.
Thus, revenues will be reduced. Investment in timber is not a
tax shelter and capital gains has been accorded to create an
equity between investors in timber and those who invest in other
kinds of businesses. The equitable tax treatment of qualifying
timber sales for capital gains reversed the pre-1944 trend of
cutting without any follow through with timber planting and good
timber management. The latest statistics gathered by the U. S.
Forest Service apparently reveal that after a continually steady
growth in planting since 1986 that trend has reversed due to a
number of adverse factors and timber planting decreased in post-
1986 years.

Timber growers responded to the equitable tax treatment that
Congress provided commencing in 1944, and the results have been
spectacular. Thousands of farmers have invested untold funds,
time and effort in growing trees. In 1986, the rug was pulled
out for many timber growers because the equitable tax treatment
they expected to get when they sold their timber was revoked,
forcing them to report gains when they sell their timber at
ordinary rates as economic circumstances forces them to receive a
lifetime's gain on their timber in one year.

The repeal of capital gains by the '86 Act created a serious
inequity for all risk takers and for those who invest in the
productive sector of the economy. There may be disputes over
whether capital gains, in the long run, result in a revenue loss
or a revenue gain. Regardless of whose revenue estimates are
valid, the true measure is how much additional revenue is raised
from a stimulated economy when the risk takers believe they are
taxed fairly ōn the gain, if any, that is realized on such
investments. The repeal of capital gains has created a serious
situation for the forest industry. The long period of time that
trees must be nurtured before they are ready for harvest
exacerbates the inequity.

Despite the increasing demand for forest products (and hence
timber) investors cannot put money in timber operations when the
tax burden is simply too high. Tree farmers who persist will see
their investment financially ruined. They are likely to end up
paying a federal tax that will result in their suffering an
economic loss on the sale of their timber. Capital will simply
no longer flow into timber growing when inflation is taxed as
though it were true profit.

The consequences of the decreased flow of capital investment in
timber means that lands currently owned will be less well
managed, forest research will decline, forests will be harvested
prior to economic maturity, planting activity will decrease and
marginal lands will go out of production, timberlands will be cut
over and converted to agriculture, which would lead to more
agriculture surpluses. All of these fallouts will result in
fewer jobs and hurt many small, rural communities. And, of
course, all this will lead to less timber supply and higher
prices for wood products and significantly greater pressure to
harvest timber from public lands. Currently the trend is for
more public lands to be withdrawn from harvesting by the private
sector.

Capital Gains Aren't Just for the Rich

Before its elimination in 1986, the capital gains rate
differential was a critical component in the economic
considerations of thousand of small, non-industrial private
landowners -- none of whom would consider themselves "rich."
However, the myth persists that capital gains benefits only the
wealthy. Strikingly, a 1981 study of IRS statistics dramatically
shows that over 80% of the individual returns reporting gains
from the sale of standing timber had adjusted gross incomes of
less than $50,000. The frustrations of the "for the rich only"
myth is aptly summed up by the March 16, 1988 letter to the
Washington Post Editor from S. M. Stripling, the 1987 National
Outstanding Tree Farmer from Georgia:

> "Your statement that fifty percent of the capital gains
> go to upper-income people may be true, but that means that
> the other fifty percent goes to those of us in the lower
> brackets. It doesn't take much of a tax increase to put us
> out of business. If we are going to talk fairness, it
> shouldn't matter whether you're rich or poor when it comes
> to how capital gains are taxed"

**Adverse Impact on International Competition and Trade Balance
Deficits**

Factors that in the long-run will result in a reduction of timber
supply means that less timber will be available for export.
Timber and wood products are a major factor in holding down the
nation's balance of trade deficit. Forest products are currently
helping to reduce the trade deficit. One of the adverse factors
threatening the continuation of this contribution to reduction of
the trade deficit is the inequitable taxation of timber in this
country. Most other industrial countries have lower capital
gains rates than this country has and a lot of countries do not
tax appreciation at all. That is, they impose no tax at all on
the sale of capital assets.

Adverse Impact on the Environment

There is growing concern over the release of carbon dioxide into
the atmosphere and the long-range greenhouse impact. Trees
absorb carbon dioxide and experts who are addressing this serious
problem have all indicated the important role that trees play in
controlling the greenhouse effect. They uniformly recommend that
more trees be planted. Recently, when a utility expanded its
plant it learned that 5 million trees would be needed to offset
the carbon dioxide that the new plant would release into the
atmosphere. To its credit, the utility embarked on a program of
planting that many trees around the world. A lot of this
planting is being carried out in countries where the timber has
been largely cut over.

Forests have always had a favorable impact on producing a better
environment apart from absorbing carbon dioxide. They help reduce
erosion, provide large wooded areas suitable for outdoor
activities, such as hiking, fishing, camping and hunting. In
addition, forests are things of beauty. Obviously, the better we
manage our nation's forests the greater is the beneficial impact
on the environment.

President Bush's Proposal for a Capital Gains Rate Reduction

President Bush's budget proposals for fiscal year 1991 calls for
restoration of a capital gains tax differential, to help
stimulate greater saving and investment. These are laudatory

goals which we strongly support. In that regard, we are greatly
encouraged by president Bush's capital gains proposal as much-
needed recognition at the highest level of government of the key
role played by capital gains in achieving those goals. We
believe President Bush should be commended for his initiative to
reestablish a critical component to equitable taxation.
President Bush's initiative is a vital sigh to America that his
Administration is committed to working toward a healthy economic
environment supportive of increased saving and investment.

Additionally, we are pleased to see the U.S. Treasury figures
showing capital gains to be a revenue raiser for the government,
nct only an economic stimulant. Treasury's use of dynamic rather
than static estimates correctly recognizes the affects of
taxpayer response, a critical factor when the realization
decision is entirely within the taxpayer's control. It should
also be noted that the lower rates established in the Tax Reform
Act of 1986 for both individuals and corporations were
significantly beneficial. The continuation of these rates at
their present levels is clearly important to the nation's
economic health.

President Bush's proposal also shifts the business focus from
short run to longer term, reduces the cost of capital, enhances
productivity, and helps increase U.S. competitiveness. The
proposal also reduces the Tax Code's bias toward debt financing
by decreasing the cost of equity capital. The Bush proposal also
insures that ordinary deductions cannot be converted to capital
gains by conforming section 1250 to section 1245 of the Internal
Revenue Code. Finally, the proposal reduces taxation of
inflationary gains by utilizing a tax rate differential rather
than the more complex index adjustment to cost basis.

Restore Capital Gains

President Bush's proposal to restore a capital gains rate
differential is an important initiative to promote long-term
savings and investment. The case for capital gains is
compelling, and the President's proposal is a welcome first step.

However, there is a critically needed modification required
regarding its application to the forms of ownership. Both
corporations and individuals should fairly be allowed capital
gains benefits; the form of ownership should not determine the
tax treatment of the transaction. This modification would
greatly improve the fairness and equity of President Bush's
initiative.

Distinctions Between Forms of Ownership

The Administration's proposal to reduce the capital gains tax
rates contains numerous positive attributes, but the glaring
omission of corporate capital gains is particularly puzzling.
While capital gains of individuals, REITS, RICs, partnerships,
and similar "pass-through" entities are included, equivalent
capital gains by regular corporations are omitted without any
justifying rationale for their exclusion. Equity, as well as
sound tax policy, dictates that similar assets should be taxed
essentially the same, irrespective of the form of underlying
ownership.

A fundamental tenet of tax policy is that the form of ownership
should not materially impact the marginal rate of taxation

applied to a transaction. Admittedly, double taxation of
corporate earnings continues to violate this basic principle.
Such violations lead to inequities and excessive "tax planning"
to compensate for these distortions. By way of example, the Tax
Reform Act of 1986 established a 34% - 28%maximum tax rate
differential between corporations and individuals, representing
the first time in history that the corporate tax rate has
exceeded the individual rate. Not surprisingly, Treasury's 1988
preliminary statistics indicate that while business returns in
total are expected to increase by 5.2% regular corporate returns
will decrease by 2.4% (unprecedented in recent history).
Conversely, individual and pass-through entity business returns
are projected to increase by 6.4%.

Additionally, under current law, an individual is taxed at a 28%
rate on an asset owned directly, but at a 52.5% (a 1.9 times tax
multiplier effect) on the same profit realized by a corporation
and paid to the taxpayer as a dividend. If there is no
comparable reduction in corporate capital gains, an individual
will incur 3.5 times more tax on a corporate asset than on the
same asset owned directly. This illogical and unwarranted
expansion of the existing tax inequity, based solely on the form
of doing business, is insupportable and will unnecessarily
further encourage the restructuring of asset ownership.

Internal Consistency Issues

The proposal's cornerstone, taxpayer responsiveness to lower tax
rates (the "unlocking effect"), fulfills two basic functions.
first, the "unlocking effect" significantly increases tax
revenues in the early years. Secondly, the enhanced liquidity of
the nation's capital stock provides additional stimulus of
increased economic growth over the longer term. These benefits
to the economy are equally appropriate for the corporate sector.
Corporate "unlocking" would stimulate growth, providing
incremental tax revenue over both the short and long term. These
benefits to the economy are equally appropriate for the corporate
sector. Corporate "unlocking" would stimulate economic growth,
providing incremental tax revenue over both the short and long
term.

The basic objectives of the proposal are to stimulate long term
economic growth, create jobs, and enhance our international
competitiveness relative to major industrialized nations. For
those objectives to be achieved, a vitalization of the nation's
basic productive capacity is required. This means that corporate
America should rightly be included in the current proposal.

One of the objectives of the proposal is to encourage a flow of
capital to innovative, technologically advanced and
entrepreneurial-type activities. The omission of corporations
ignores the substantial amounts of venture capital funds that

currently and historically have come from financial and regular corporations taking equity positions in new ventures. Excluding corporations is inconsistent with that objective.

The restoration of a rate differential roughly corrects for taxation of fictitious, inflationary gains without creating the complexities that indexing of basis would entail. Corporations, likewise, are taxed on fictional gains resulting from inflation under our current system. Continuation of the taxation of "phantom" corporate gains is discriminatory.

Corporations may have been excluded because of a presumed lack of corporate-sector responsiveness to reduced capital gains rates. Exclusion based on this assumption may not be correct. Corporations, historically, have never been exposed to changes in capital gains rates of sufficient magnitude to support this conclusion. The minor one-to three-percentage point rate changes which have previously occurred have always been inadequate to support empirical studies on corporate capital gains responsiveness. Assuming a common definition of "capital assets" and comparable rate reductions for both corporations and individuals, corporate capital gain responsiveness could equal or exceed that of individuals.

The nation's publicly-owned and privately-owned forests are one of our great natural assets. Sound policy regarding the tax treatment of timber income is a vital element in the economic consideration of growing trees. We urge the Committee, as it deliberates the impact of the 1986 Tax Reform Act, to actively consider President Bush's capital gains proposal and improve it as fairness and equity dictate, and report it to Congress for passage.

The Case for a Capital Gains Rate Differential

The committee has received testimony and written statements from many different groups that support restoration of a capital gains differential. We agree with those arguments and urge the committee to take favorable action to reverse the repeal of capital gains rates adopted under TRA 1986. We believe our industry has a strong case which incontrovertibly demonstrates that a rate differential is vital in order to attract new investment to insure the replenishment of this important natural resource.

STATEMENT OF GLENN K. MANACHER

The statement below is a proposal for sharp capital gains tax breaks for _primary_ investment only, distinguishing such investment from capital gains realized merely from trading; the latter would be treated (as now) as ordinary income. This statement was originally printed in the hearing record of a Ways and Means Committee hearing at the direction of Cong. Rostenkowski.

I believe this kind of selective tax break has become all the more urgent since 1985. First, there is now a mounting body of evidence, both documented and anecdotal, that real interest rates in the U. S. have raised costs for capital outlays to the point where most American firms can no longer calculate a positive cost of capital for large projects with a profitability horizon beyond four years, whereas the Japanese horizon appears to be eight years or more. Second, the most generous estimate of the "reflux effect" -- money coming in to the treasury as the end-result of a capital-gains tax cut*, is that at very best only 2/3 of the money lost to the treasury ultimately returns. Most estimates are much lower. Third, the appalling extra load of government debt from the S&L crisis, and the possible forthcoming failure of Gramm-Rudman limits all create a climate of greater urgency in assuring that future tax breaks be focused on real, primary investment, the kind that palpably helps to "build America". These, I maintain, are the only breaks with a real chance to yield the positive reflux so dear to conservative economic thinking.

Beyond these considerations, both the political and economic arguments for across-the-board capital gains reduction tend to heavily obscure the issue of the _efficiency_ of such tax breaks. To argue that a tax break is good because some rather small component of it will be used to "build America" neglects the more urgent truth that the deficits created by the remainder may more than negate its positive effects.

Moreover, an additional benefit of such discriminated capital gains taxation would almost certainly be its "shift effect", in particular its ability to lure money away from speculation and into real, productive investment.

The text of the 1985 proposal follows.

* "The Growth Experiment -- How the New Tax Policy is Transforming the U. S. Economy" by Lawrence Lindsay, Basic Books, 1990.

From
Hearings on
Comprehensive Tax Reform
Committee on Ways and Means
U.S. House of Representatives
Part 9, p. 8365-66
July 31, 1985.

STATEMENT OF GLENN K. MANACHER, ASSOCIATE PROFESSOR, DEPARTMENT OF MATHE-MATICS, STATISTICS, AND COMPUTER SCIENCE, COLLEGE OF LIBERAL ARTS AND SCI-ENCES, THE UNIVERSITY OF ILLINOIS AT CHICAGO

My proposal is based on a distinction among: (a) "Primary," productive invest-ment—in capital plant or modernization; (b) "Secondary" investment—in markets whose strength directly affects and supports primary markets, chiefly the stock market; (c) Unproductive investment—investments in hedge markets, art, real estate (with the exception of a personal domecile), land, and all types of foreign in-vestments.

I propose that the tax rates be made to reflect this difference. For instance, whereas under the present codes, the largest long-term rates for all of these are at most 20 percent, the new maximum rates would be, perhaps resp. 15 percent, 28 percent, and 50 percent. Sales of personal homes and certain kinds of personal prop-erty would continue to be shielded.

My proposal begins with the observation that capital in large amounts from exter-nal sources usually requires a major market offering in which stocks, bonds, or de-bentures are sold. This invariably requires the filing of a prospectus with the SEC, at which time the prospectus is subject to careful scrutiny.

Now suppose there were a new, "special," very low tax rate applicable to new of-ferings, provided such offerings were entirely for the purpose of primary invest-ment. Suppose, for the sake of illustration, that this special tax rate were 10 per-cent, and that the "normal" CGT rates were substantially higher.

Of course, few public offerings are purely for primary investment; more typically, some fraction is for land acquisition, debt retirement, etc. The fraction of each offer-ing earmarked for primary investment purposes, as opposed to general purposes, would be carefully spelled out in the prospectus, and the tax rate computed accord-ingly. The computation would be subject to approval by the SEC or some other branch of the Treasury Department; presumably the work involved in this approval would be a very minor component of the overall prospectus review.

Suppose, for instance, that an offering called for 70 percent to be spent on pri-mary investment and 30 percent for general purposes. Then 70 percent of the amount put up by the investor would be taxed at the special 15 percent rate, and the other at the normal CGT rate.

Special gains would be realized by the purchaser (or his heirs) of the newly-offered securities at the time of their sale. Such special gains could be claimed on a one-time-only basis; that is, any subsequent purchaser would realize only normal CGTRs since, in the frame of reference of this scheme, his gains would only be "specula-tive." This scheme would be very easy to policy, since tax returns claiming the spe-cial tax rate would have to be accompanied by a certificate issued at the time of the original offering. It certainly would be no more complex than the procedures used now for any number of tax shelter schemes.

In all cases, the special rate(s) would apply only to the original purchaser and such heirs as might inherit the securities.

The essential idea behind this proposal—the idea that distinguishes it from pro-posals to raise or lower capital gains taxes—is its focus: it is not based on faulty analogies with venture capital. This is important for several reasons. Reducing cap-ital gains taxes in 1979 did increase venture capital investment, enough to generate compensating reflow to the treasury.

However, my analysis convinced me that (a) venture capital investment was on the upswing anyway, (b) venture capital has been only a small component of capital needs, and (c) venture capital is not a good paradigm for our capital reinvestment needs: it is generally provided in search of very large profits in a short time, and tends to be furnished fitfully to those industries which are momentarily in the lime-light.

The focus I mentioned is simply that this plan, for the first time, will grant tax concessions specifically, and pointedly, only for those investments tied tightly and concretely to primary capital investment.

Profits made elsewhere would be taxed normally, and both the treasury and the capital investment climate would benefit. That is why I think my idea is both unique and workable.

STATEMENT OF MERRILL LYNCH

Mr. Chairman, we at Merrill Lynch want to commend you for your
leadership in the effort to restore tax incentives to increase
personal saving. Merrill Lynch manages over $41 billion in IRA
assets and is the largest provider of IRAs in the United
States. In addition, we have a relationship of trust with over
4 million households whose savings are in excess of $271
billion.

We share your concern that the United States is not saving
enough to remain globally competitive as a Nation or financially
secure as individuals. We agree with you that increasing our
Nation's saving rate is one step that should receive broad,
bipartisan agreement and support.

Increasing our personal saving rate is crucial, both for
individuals and for the Nation's future prosperity. Our
personal saving rate is now among the lowest in the
industrialized world, and we must take steps to improve it if we
are to remain a leader in the world economy.

That is why we believe it is so important to enact tax
incentives to encourage people to save, and why we are
encouraged that Congress is moving to adopt incentives to
promote saving.

Recent efforts to enact tax incentives for saving have been hurt
by the belief that they do not work. However, given our
experience with IRAs, we were skeptical about this view and
commissioned a number of studies to determine the effectiveness
of saving incentives.

The collective results provide strong evidence that:

- o   The IRA, from 1982 through 1986 worked; it increased
      National saving, and will provide retirement security
      to a broad cross section of people.

  o   Well-designed saving incentives, like the IRA
      ('82-'86), will stimulate additional personal saving.

  o   Well-designed saving incentives have appeal to
      Americans at all economic levels.

  o   Public policy, through the use of tax incentives, can
      positively affect personal saving behavior.

  o   The saving crisis is real - not imagined.

  o   Regardless of statistical differences, our foreign
      competitors simply save more as individuals, and
      thereby invest more in their Nations' futures than do
      we.

In June 1989, we released the results of a study entitled "Save,
America," conducted by the Institute for Research on the
Economics of Taxation, which concluded that IRAs were a powerful
generator of new saving by middle-income taxpayers before they
were restricted in 1986.

In November 1989, Merrill Lynch published the results of a
Lewin/ICF study on the evidence linking tax incentives and
saving behavior. The study was designed to answer three
questions: (1) what were the past effects of IRAs on personal

saving; (2) what effect did changes in IRA legislation have on saving behavior; and (3) what effect could new IRA tax incentives have on future saving behavior and the U.S. economy?

The results systematically refute a number of myths regarding tax incentives in general, and the IRA specifically.

Myth #1: Tax incentives do not increase personal saving - they merely promote the shifting of funds from other saving vehicles.

Findings: Most contributions to IRAs represent new private saving. The Lewin/ICF analysis found no indication that people shifted funds out of other forms of saving in order to contribute to an IRA, or contributed funds that they would have saved anyway in another form. After controlling for various other factors that might affect saving, IRA contributions were found to be positively related to other saving. This means that, generally, individuals who contributed to IRAs saved more in other forms, not less. They neither shifted nor reduced other saving to contribute to their IRAs.

Lewin/ICF also investigated the effects of IRAs on aggregate household saving by analyzing data relating household acquisition of financial assets (excluding IRAs) to IRA contributions, disposable income, the rate of interest, unemployment, change of GNP, change in stock market values, inflation, and pension plan contributions. Again, it was found that IRA contributions were positively related to non-IRA saving.

Myth #2: IRAs only provide tax incentives for the wealthy.

Findings: The majority of IRA contributors are middle income! In 1978, 75 percent of IRA contributors were persons with family incomes of less than $40,000. In 1982, 55 percent of the persons contributing to IRAs had family incomes lower than $40,000.

Myth #3: Public policy, through the use of tax incentives, cannot affect personal saving behavior.

Findings: When IRAs were curtailed in 1986, annual contributions dropped from nearly $38 billion in 1986 - almost one-third of personal saving - to only $14 billion in 1987. The personal saving rate fell to 3.2 percent in 1987, the lowest since 1947. The personal saving rate has averaged 3.7 percent since 1986, compared to an average of 5.3 percent saving rate when full IRA eligibility existed. About 3.5 percent of the population aged 21 and older contributed to IRAs in 1978. This increased to 17 percent in 1982, after the expansion in eligibility, then fell to 13.8 in 1987, after eligibility was limited. About 44 percent of this decrease in participation was accounted for by persons with family incomes between $30,000 and $50,000.

Other prominent researchers such as Glenn Hubbard (Columbia Business School), Steven Venti and David Wise (Dartmouth and Harvard, respectively), Lawrence Summers and Chris Carroll (Harvard), Jonathan Skinner (University of Virginia) and Daniel Feenberg (National Bureau of Economic Research) have had similar findings.

Based on these insights, Merrill Lynch began to explore with consumers their general saving motivations and habits. We discovered that age 59 1/2 was an eternity to most thirty year olds. Saving for retirement is only one saving concern. Other life-cycle events, such as a home purchase and education, were compelling saving issues.

We also began investigating the value and timing of tax incentives and became convinced that a "back-end" incentive would be a viable proposal.

We found that a "back-end" vehicle - with a tax exemption on amounts withdrawn from the account, as embodied in the IRA-Plus (S.1771) or Family Savings Account (S.2071), - could be a powerful personal saving incentive without further burdening the current budget deficit.

The Lewin/ICF study also modelled a "back-end" tax incentive using the proposed IRA-Plus design (S.1771). Their model projected the macro-economic effects of such a vehicle on both personal saving and capital accumulation.

The study found that the benefits to the economy from an IRA-Plus would be considerable. If an IRA-Plus incentive would lead to a level of total IRA contributions equal to 1986 contribution levels, capital accumulation would increase by an additional $240 billion by the year 2000 over the current-law IRA levels and an additional $760 billion by 2030.

Further, the increased capital accumulation resulting from an IRA-Plus would have a significant positive effect on National income and output. If the IRA-Plus were to increase contribution levels back to 1986 levels, GNP would increase by an additional $19 billion over the current-law IRA levels in the year 2000 and an additional $50 billion by 2030.

In summary, "back-end" tax incentives, such as the IRA-Plus or the Family Savings Account, have the potential to increase both new National saving and GNP. If these tax incentives prompt increases in contributions and saving, as we believe, there would be a substantial rise in capital accumulation and, therefore, increases in National output well into the next century.

Despite these findings, concerns continue to be expressed about tax revenue losses that could result from tax-advantaged saving accounts like a "back-end" IRA-Plus or Family Savings Account. The comments usually assert that the near-term revenue losses would be great due to shifting of funds, and/or that long-term losses would be expected due to lost taxes on earnings produced by new saving.

As I have already noted, the empirical evidence from IRAs does not support an argument for substantial shifting of funds. On the second point, clearly that portion of saving that would be new saving would not result in a long-term revenue loss. This is because earnings on net new saving are earnings that would not otherwise have occurred, and no tax would have been collected in any event. The Government could not lose what it would never have had. Furthermore, the Treasury Department has estimated that a 0.3 percentage point increase in the personal saving rate will generate enough economic growth to produce more government revenue to offset any potential revenue loss.

We also believe there is a general misunderstanding about tax incentives and their effects on National saving and tax revenues. There is no simple, stable or direct relationship between tax revenues and National saving. The economic benefit of a program of tax incentives for saving does not depend solely on the amount of new saving generated or its corresponding tax revenue effects - in the short or long run.

Merrill Lynch commissioned another paper by Lewin/ICF to examine the logic of the relationships among tax incentives, the amount

of new saving generated and different tax incentives for
saving. The study illustrated, using varying percentages of new
saving, the potential effects of tax incentives on tax revenues
and National saving.

The results are compelling and show that even under very
conservative assumptions about how much Family Savings Account
or IRA saving would be transferred from other saving, there
would still be a large initial increase in National saving and
more than a sufficient increase in additional future saving to
fund the government borrowing required by the reduction in tax
revenues. If only one-third of the saving would be new saving,
the increase in private saving would offset the reduction in
public saving.

Lewin/ICF concluded that tax incentives must be evaluated in
terms of their overall economic benefits - increasing National
saving and capital accumulation - and in terms of personal
benefits - increasing personal saving and individual financial
security.

Mr. Chairman, we recognize that some members of the Committee
may question whether a saving vehicle without an up-front tax
deduction will provide enough incentive for new saving. Based
on the evidence, Merrill Lynch believes the answer is a definite
Yes.

The Tax Reform Act of 1986 changed the fundamental tax climate,
enhancing the value and attraction of a "back-end" saving
vehicle and reducing the value of an up-front deduction. Under
the pre-1986 tax law (with its 14 tax brackets and top rate of
50 percent), the value of an up-front deduction was considerably
greater than it is now, and the probability of being in a lower
tax bracket at retirement was also greater.

Today, with only three income tax brackets and taxes on Social
Security earnings, people can no longer be assured of facing
lower tax rates in retirement. Some studies have shown that up
to 60 percent of all taxpayers will face the same or higher
marginal tax rates in retirement as they do while working.

In addition, an overwhelming number of people are convinced that
tax rates will be higher in the future than they are today. In
January of this year, Maritz Marketing Research found that 78
percent of the people they surveyed believe Federal tax
increases are very likely. 59 percent of individuals queried in
a February 1990 Wirthlin Group Omnibus Poll believe they will
face higher taxes in retirement.

In this environment, a "back-end" vehicle, such as the IRA-Plus
or Family Savings Account, is a better deal for the individual.
A back-end account provides greater economic value to the
retiree than its "front-end" predecessor. It also provides tax
relief when most needed, during retirement.

Recent market research confirms the attractiveness of this
approach with consumers. First of all, our own market research
show that consumers prefer the "back-end" approach. In a just
completed Wirthlin Group study of 400 pre-retirees between the
ages of 45 and 64, more than 75 percent said they would save
more if the Government provided them with direct tax
incentives. This was consistent across all households,
regardless of income.

The Wirthlin Group also conducted a poll to identify the saving
account preferences of Americans. 70 percent preferred a
"back-end" account like the Family Savings Account over a
"front-end" account like the conventional IRA. Nearly six out

of ten U.S. adults are interested in a Family Savings Account, as evidenced by their likelihood to consider opening such an account. The Gallup Organization recently conducted a saving survey which showed that 53 percent of individuals polled prefer a "back-end" account.

These results conclusively show that a "back-end" account is a good choice from the consumer's point of view. People are willing to contribute after-tax dollars now in order to secure a steady, dependable stream of tax-free retirement income later.

Finally, let me offer two additional points as to why it is essential to increase our personal saving rate: (1) saving will enable the U.S. to decrease its dependence on foreign capital, and (2) increased saving is vital for individuals to meet the financial challenges of a demographically changing society.

In recent years over half of net domestic investment has been financed by capital from abroad. While this foreign saving has contributed to U.S. economic growth, continued reliance on these inflows is not a viable policy. Over longer periods, for advanced countries, the rate of domestic investment tracks closely the supply of domestic saving. Ultimately, the U.S. must move from a position of current account deficit to surplus and capital outflow, as foreigners receive the returns on their investment in the U.S. If that is to happen without a relative reduction in U.S. living standards, U.S. productive capacity must be increased.

The aging of America adds a new sense of urgency to the need to save. As the population bulge generated by the baby boom and the succeeding birth dearth ages and reaches retirement, consumption expenditures for health care, leisure activities, long-term care, and other requirements will climb sharply, at the same time that the absolute size of the working population will be declining. Currently Americans are not adequately preparing for the costs of the future. In 1985, the median financial assets for all American families headed by persons aged 45-54 was only $600; for ages 55-64, the median was only $5,250.

To provide for the future health care and consumption requirements of a growing elderly population, we must increase our saving now: (1) to enable individuals to accumulate the financial resources to sustain longer lives, and (2) to provide future workers with the additional capital required to increase their productivity.

For America to maintain political and economic leadership, at home and abroad, we must rebuild our personal and National self-reliance by rekindling National saving.

We do face a crisis of insufficient National saving. U.S. saving has been too low for a decade or longer. The cost of this crisis is reflected in stagnant real earnings, unmet needs for more and better public and private capital, and missed opportunities for leadership at home and abroad. These problems will become more severe, especially when the time comes when foreign lenders demand a reversal of the international flow of capital and when the elderly population begins to grow rapidly in the next century.

In short, increasing our saving rate will lower interest rates, cut the cost of capital, reduce our reliance on foreign investment and improve our standard of living. Congress and the President agree: we need to save more.

Statement of the National Venture Capital Association

Mr. Chairman, and members of this distinguished Committee, my name is Robert Pavey. I am a partner in the venture capital firm of Morgenthaler Ventures, located in Cleveland, Ohio. I am appearing before you this morning in my capacity as President-Elect of the National Venture Capital Association (NVCA).

NVCA is an association of 233 professional venture capital organizations located in 33 states. Our association includes virtually all of the largest and most respected firms in the industry. It was organized in 1973 to foster a broader understanding of the importance of venture capital to the vitality of the United States economy.

In 1988 (the last year for which complete numbers are available) the venture capital industry's net new capital investments totaled $3.0 billion. This represents a decline of 27% from the $3.8 billion we invested in 1987.

Mr. Chairman, we appreciate the opportunity to present this statement. We hope that you and the members of this committee will enact a significant reduction in the tax on capital gains this year. We are convinced that no single tax change could do more to spur economic growth, creation of new jobs and improved global competitiveness for the United States.

The historic 1986 Tax Reform Act included many provisions which improved the U.S. economy, among them, lower marginal tax rates for individuals and corporations. But a dark side of that act was its treatment of long-term investors. Though the theme of the overall act was to move toward neutrality in the taxation of various activities, the effect of the 1986 Act on risk capital investment was not neutral but punitive.

Taxes on short-term speculators and corporate raiders were cut almost in half, from 50-28%, while the burden on long-term investors jumped 40%, from 20-28%. People who tie their money up for long periods of time are taxed on artificial gains caused by inflation, and the full value of their losses is not always deductible. This increases the cost of capital for all U.S. companies, and makes it harder for start-up companies to attract the seed funding and growth capital they need to succeed.

We believe it is important to restore positive incentives for long term investment to our tax code as soon as possible.

NVCA's Position on Capital Gains Tax Changes

The National Venture Capital Association supports and urges
enactment of a reduction in the tax on capital gains that is:

- Significant (30-50% reduction)
- Broad based (covering all assets other than collectibles)
- Applies to existing as well as future investments
- Permanent.

By restoring incentives for long-term investment, a lower capital gains
rate on productive assets would spur job creation, economic growth,
and global competitiveness for the United States. It would also:

- Enable more small companies to raise seed funding and growth
   capital from tax-sensitive investors;

- Lower the cost of long-term capital for growing companies of
   all sizes and reduce the tax code's bias toward corporate debt;

- Help cash-strapped young companies recruit key managers
   by enhancing the value of employee stock options; and

- Increase revenue to the Treasury by encouraging investors to
   realize and pay tax on more of their gains.

What is Professional Venture Capital?

Because the term "venture capital" crops up so frequently in the
debate over capital gains policy, I think it would be useful for me to
discuss what we in the professional end of the business mean when we
use the term.

In the first two decades after WWII, a new concept of professional
investment activity developed in the United States which made it
possible for thousands of high risk, young companies to find both the

capital and the high-level business advice they had to have to grow
their businesses.

In those years, a number of individual investors who specialized in
financing and building new companies established investment firms
specifically dedicated to that type of venture. These became the first
professional venture capital firms. By focusing only on venture capital
and pooling the risks and opportunities their portfolio companies
offered, they created more stable returns for their investors. That
stability and the returns achieved attracted more capital, allowing
more venture funds to be created, and gradually a professional venture
capital industry emerged.

Venture Economics of Needham, Massachusetts, estimates there are now 658 professional venture capital firms of various types in the United States.

The involvement of professional venture capitalists in the companies they support differs from regular corporate funding sources in several important ways. Banks avoid businesses which lack collateral or track records to back up a loan, and few banks have the technical expertise to assist in developing a company in an emerging technical field. By comparison, individual investors (informal venture capitalists) can take more risk but they typically invest in only a few young growth companies.

Professional venture capitalists assist young companies by carefully screening both the technical and business merits of proposals, by investing risk capital--with no cash repayment schedule--and by participating actively in the management of their portfolio companies. Our members play a crucial role on the boards of their portfolio companies by contributing the experience they and their firms have developed helping dozens of other companies with similar growth challenges. This on-going management involvement is one of the key distinctives of the venture capital process which separates it from more traditional investment approaches.

The Vital Capital Market For Small Growth Companies Beyond Professional Venture Capital

Because the professional venture capital market is well known and represented by visible organizations like NVCA, it is easy to overlook the fact that it is only a small part of the total capital market for young companies in this country.

The vast majority of new and growing firms either do not meet the stringent requirements of professional venture capital or the public equity markets, or they need less capital than these groups typically invest. The entrepreneurs who found these companies must seek their capital directly and informally from individual investors. This large, informal equity market has been virtually invisible and undocumented because it lacks institutional structure

Recently however, the Small Business Administration has conducted an important study which documents the size and importance of this market.[1]

The study aggregated three regional studies of informal investors into the first accurate national estimate of the informal supply of external equity capital in the United States. **The SBA estimates that informal venture investors provide a total annual capital supply (equity and affiliated debt) of $55.6 billion.**[2]

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[1] Gaston, R.J. & Bell, S. *The Informal Supply of Capital*, Final Report to the Small Business Administration, January 29, 1988.

[2] ibid, pg.170.

The SBA study found that informal investment "appears to be the largest source of external equity capital for small businesses. Nine out of ten investments are devoted to small, mostly start-up stage firms with fewer than 20 employees."[3]

The profile of typical informal investors that emerged shows that these people have a median family income of $90,000 per year, yet one third receive incomes of less than $60,000. Most informal investors are *not* millionaires; their median net worth is $750,000 and 39% have a net worth of less than $500,000. Only one in three informal investors has a net worth of one million dollars or more.[4]

The SBA study found that informal capital "appears to be the single largest source of external corporate equity, almost exceeding all other sources combined. It is over twice as large as private placements and is eight times larger than professional venture capital investments."[5] **They estimate that the total number of firms financed annually by informal investors is 87,300 or 42 times larger than the venture capital industry.**[6]

The SBA study also asked informal investors to specify the form of income they hoped to earn from their investment. Not surprisingly they show a clear preference for capital gains over current income. 46.4% wanted their investment reward either totally or partially in capital gains. Another 35.7% wanted half capital gains and half dividends, while only 18% of the respondents wanted all or mostly

[3] ibid, pg. 3.
[4] ibid, pg. 132.
[5] ibid, pg.169.
[6] ibid, pg. 172.

dividends.[1] We believe that these preferences will change to the detriment of small business as a result of the 1986 abolition of the capital gains preference.

Mr. Chairman, it is clear that the total venture capital investment in this nation's crucial start-up and small growth companies is many times more than the amount invested by professional venture capital firms. **At $3.0 billion, the professional venture capital industry accounts for only 5% of the total risk capital invested each year in America's small growth companies.** We think our part is unusually productive, but it should be clear that this country needs a tax policy that promotes rather than punishes all risk capital investment, not just professional venture capital.

It is true that about half of the capital committed to professional venture capital firms today comes from non-taxed institutions and foreign investors. But nearly all of the informal investments made in our country's vital small growth companies outside the organized venture industry comes from taxpaying investors.

It should be pointed out that institutionally supported venture funds tend to concentrate on funding the growth of young companies rather than exclusively investing in seed capital start-ups. This growth capital is critical to financing rapidly growing industries such as computers, software, telecommunications and biotechnology. The currently unattractive taxation of long-term capital gains is making it more difficult for all of these companies to attract professional management.

There are hundreds of thousands of new companies formed by entrepreneurs every year, addressing smaller or more focused markets, with financing from informal venture capital investors. These companies are critical suppliers to our larger and more mature companies, or they are important regional service providers, and occasionally they grow into an opportunity for professional venture capitalists. These young companies are essential to the American free enterprise system. We should nurture them.

Conclusion

In closing Mr. Chairman, thank you once again for the opportunity to contribute to this committee's deliberations on this vital issue. We hope you will speedily restore a significant capital gains tax differential to our nation's tax code.

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[1] SBA ibid, pg. 109.

STATEMENT OF THE SECURITIES INDUSTRY ASSOCIATION

SIA represents over 600 securities firms headquartered throughout the United States and Canada. Its members include securities organizations of virtually all types which are active in all markets. Collectively, they provide investors with a full spectrum of investment services and account for approximately 90% of the securities business being done in North America. SIA members therefore recognize the impact of tax policy on savings and investment, and appreciate this opportunity to participate in these hearings.

Role of Savings and Investment In the Economy

Savings fuel investment and provide the capital for economic growth, rising standards of living, and international competitiveness. The evidence is overwhelming that countries with high rates of savings and investment are those where productivity, income and standards of living rise most rapidly.[1] National savings of course, is comprised of personal, corporate, and governmental savings. Since the proposals before the committee would boost personal savings, SIA's comments are addressed primarily to incentives for increasing personal savings.

In the 1980s, the personal savings rate in the U.S. slid to the lowest levels in about 40 years. The savings rate was under 5% in the 1985-88 period and a paltry 3.2% in 1987, the lowest rate since 1947. While the U.S. savings rate inched passed the 5% mark in 1989, U.S. savings remain low by historical and international standards. By comparison, in the 1980-1988 period, the Japanese had a personal savings rate averaging 16.4% and the West Germans, 12.2%.

Without the national savings necessary to fund investment, the U.S. has become an "importer" of foreign capital. Foreign investment is approximately the difference between savings of 3% of GNP in the current decade and investment of about 4.8%. The U.S. has, in effect, borrowed the savings of other countries and transferred some asset ownership to those nations.

National savings has been sinking as record debt has been incurred by the government and private sectors. During the 1980s, the U.S. became a net debtor nation, with $532.5 billion in foreign debt accumulated at year-end 1989. Government debt ballooned from $1 billion in 1980 to over $3.5 trillion in 1989. In the same period, the debt of non-financial corporations increased by 2.5 times. In contrast to the debt increase, almost $500 billion of equity capital was removed from the marketplace through mergers, acquisitions and corporate buybacks during the last six years of the decade.

On the demand side, investors have a growing preference for debt securities. Private pension funds, by far the largest institutional investor, began making net sales of equities in 1985. Although the net selling has subsided from the record $27.8 billion of 1987, equity net sales were running at $24.7 billion (9 months annualized) in 1989. These investors shifted their attention to credit market instruments, notably

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[1] "A National Savings President," Martin Feldstein, Wall Street Journal, 11/21/88.

government and corporate bonds, in 1987 and 1988. Individual investors have made average annual net sales of over $100 billion equities in the past five years. Since 1987, the individual investor has preferred more conservative government securities to equity holdings.

Personal savings is the pool from which individuals fund future needs. Traditionally, the "rainy day" for which individuals saved was retirement and old age. Sharp increases in Social Security benefits, Medicare and other pension benefits have eased the worries of many individuals about economic welfare in old age. Some researchers believe the enormous expansion in the wealth of older age groups has led to a permanent decline in the savings rate.

Among the other reasons cited for the decline in personal savings is greater company-provided health and retirement benefits, easier credit availability, and widespread life insurance coverage. So too, the rapid rise in the value of housing since the mid-1970s and the bull market of the 1980s have contributed to a general illusion of wealth. In other words, the very improvement in the standard of living that Americans now enjoy, wrought in part by past savings, may be diminishing the willingness of individuals to save.

International Comparison of Economic Measures

The savings rates of other countries declined in the 1980s, albeit to a lesser extent than the U.S. For example, the U.S. personal savings rate in 1988 was 1.9 times lower than the average rate for the 1970s, 4.4% versus 8.2% (OECD). The Japanese and German savings rate declined by a factor of only 1.4 and 1.1 times, respectively. Nevertheless, of the five major countries to which the U.S. savings rate is compared, four had rates exceeding the U.S. by a minimum of 2 times. (See Table I).

Japan was not always a nation of savers. Before World War II, the Japanese saved less than Americans. Japan's enormous rate of personal savings after the war was the result of a national campaign -- savings incentives were provided and monthly seminars on the importance of workers' savings were conducted in most major corporations and publicized in the media.[2]

In terms of gross fixed capital formation, the U.S. also has lagged behind its major trading partners. A comparison of 1972 to 1987 indicates that the U.S. ratio is well below that of the other countries. France, Germany and the U.K. experienced increases in this ratio in 1988, while the U.S. ratio fell.

The divergence in trends in capital formation may be explained in part by the cost of capital. Lower national savings reduces investment because, by its scarcity, the cost of capital is raised. Several studies comparing the costs of capital internationally conclude that U.S. capital costs are considerably higher than those of its major competitors.

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[2]Overconsumption: The Challenge to U.S. Economic Policy, George N. Hatsopoulos, Paul R. Krugman, and James M. Poterba, Thermo Electron Corporation, 1989.
(1988 data for Canada and Japan not available). In 1989, the U.S. ration dipped to its lowest level since 1975.

Economists Bernheim and Shoven have gauged the U.S. after-tax
cost of capital at twice that of Japan. A recent study by
Federal Reserve economists McCauley and Zimmer concurs that the
U.S. is at a distinct disadvantage compared to Japan and
Germany in terms of cost of capital.[3]

Entering the 1980s, the U.S. had the largest stock market
in the world, comprising 50% of world stock market
capitalization in 1980. While the market value of U.S. stocks
almost doubled in the 1980s, the Japanese market grew at a
stunning pace and became the largest world market in 1987. By
1989 the U.S. share had dwindled to about 31%. The plunge of
the Japanese market in the first quarter of 1990, and the drop
of the yen allowed the U.S. to regain its position as the
world's largest equity market.[4] Nevertheless, that position
is precarious. Based on the Financial Times World Indicies,
the U.S. market accounts for 35% of world capitalization and
the Japanese, 33.5%

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International Comparisons of
the Tax Treatment of Investment Income

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Foreign countries have fostered higher savings and
investment levels through a more favorable tax treatment of
investment income than in the U.S.

While the U.S. has one of the lowest tax rates on wage and
salary income, it also has one of the highest rates on
investment income. Across-the-board, the U.S. falls behind its
major competitors in the tax treatment on the return from
savings -- dividends, interest, and capital gains. Almost all
foreign countries use tax incentives to stimulate savings and
investment.

Dividend Income

Through integration of the corporate and individual tax or
special allowances and exemptions, most major foreign countries
mitigate the double taxation of investment in corporate
equity. Eight of ten major industrialized countries have a
form of integration. France, Germany, Italy, the Netherlands,
Sweden, and the U.K. also have special allowances and
exemptions to encourage equity investment. (See Table II).

Interest Income

Similarly, four of ten major foreign countries generally
apply tax rates lower than the U.S. to interest income. Japan
has the lowest rate, 15%, on the investments reviewed. In
addition, while some countries have rates higher than the U.S.
and some have exempted instruments equivalent to municipal
obligations, other savings incentives are also provided. For
example, interest on 5-year savings accounts of a maximum of
$11,363 is tax exempt in Sweden. (See Table III).

Capital Gains

The U.S. treatment of capital gains is among the harshest
of the major industrialized countries. Canada, France and
Sweden tax long-term capital gains at rates ranging from 16% to

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[3]/Robert N. McCauley and Steven A. Zimmer, "Explaining
   International Difference in the Cost of Capital, Quarterly
   Review, Federal Reserve Bank of New York, Summer 1989.

[4]/Market capitalization measured in U.S. dollars.

under 20%. While Australia and the U.K. have higher statutory
long-term capital gains tax rates than the U.S., substantial
exemptions and indexing of the cost basis result in more
favorable tax treatment of capital gains than in the U.S.
Japan implemented a capital gains tax under its major tax
reform of 1989. Japanese taxpayers can select a 1% withholding
tax on gross proceeds, which is considered equal to a 20% rate
on capital gains because 5% of gross proceeds are considered
"deemed gain." (See Table IV).

    In one of the fastest growing areas of the world, capital
gains are exempt from taxation by most countries. Hong Kong
and four of five Pacific Basin countries do not tax capital
gains.

Improving U.S. Savings

    The federal deficit is the major drain on savings and
deficit reduction is the most potent solution for the dismal
national savings rate.

    Beyond deficit reduction, improving personal savings can
begin to arrest the slide in national savings. The tax code
offers a starting point. Improving the after-tax return on
savings through targeted tax incentives is one way to promote
savings by both individual and corporate investors.

    The trend in the 1980s, however, has been to eliminate
targeted savings and investment tax incentives -- IRAs for many
individuals, the dividend exclusion and the capital gains
exclusion. The Tax Reform Act of 1986 eliminated all targeted
incentives for individual equity investment.

    It is inaccurate to assert that IRAs and capital gains
exclusions failed to increase savings. Many other factors
lowered the savings rate, obscuring the positive effect of tax
incentives. Without targeted incentives before 1986, the
savings rate could have fallen further. Dr. Lawrence H.
Summers estimates that IRA contributions accounted for more
than 1/4 of all personal savings in 1986. Had IRA's not
existed, the same gross amount of personal savings would not
have been forthcoming.

Capital Gains Treatment

    The 1986 tax act contained the largest increase in capital
gains taxes in history; a 65% increase for investors in the top
tax bracket and an even greater increase for some middle income
investors. Prior to 1987, the taxation of inflationary gains,
the double taxation of corporate income, and the capital loss
limitation were mitigated by the capital gains exclusion.
Elimination of the exclusion increased the bias against
long-term equity investment.

    The current return from equity investment, dividends, is
subject to both a corporate and individual tax. A capital gain
on that same investment, to the extent the gain stems from the
reinvestment of corporate income, is also taxed twice. In
addition, the limitation on capital losses is both asymmetrical
and inequitable. Although net capital gains are taxed as
ordinary income, those investors suffering net capital losses
remain limited to only $3,000 in deductions against ordinary
income annually.

    The 1978 and 1981 capital gains tax cuts are a documented
success story. Individuals supplied increased amounts of
capital for equity investment, particularly for those small
companies that create jobs and new technology. Moreover, tax

revenues were raised, not lost. The economic benefits of lower
capital gains taxes would be worthwhile despite any adverse
revenue impact.

Revenue Impact

The debate over the revenue effect of changes in the
capital gains tax rate has produced two opposing sets of
estimates for the president's proposal. Both the Joint
Committee staff and Treasury agree the president's proposal
would raise revenues in 1990 and 1991. In both estimates,
however, the revenue impact on an annual basis is minor in
comparison to the size of annual deficits. A change in capital
gains taxes will not have a significant impact on the deficit,
but will foster trends that encourage economic growth. (See
Table V).

Despite the slash in the capital gains rate from almost 50%
to 28%, capital gains tax revenues collected in 1979 and 1980
exceeded Treasury projections for those years before passage of
the 1978 revenue act.[5/] Moreover, taxes actually paid on
capital gains income continued to increase as the lower
marginal rates of the Economic Recovery Act of 1981 were phased
in. In 1983, a new plateau was reached, with taxes paid on
gains spurting 46% to $18.8 billion from $12.9 billion. By
1985, realizations had increased to about $171.0 billion, and
the tax-take was almost $25 billion.

The Statistics of Income (SOI) series on sales of capital
assets show an almost doubling of asset sales from $67.7
billion in 1985 to $132.8 billion in 1986. So too, estimates
of treasury's capital gains tax revenues leapt to over $46
billion. The spurt in capital gains in 1986 reflects
taxpayers' anticipation of the 1987 increase in rates.
Preliminary SOI data for 1987 indicate that sales of capital
assets remained at about the same level, $133.5 billion.
However, this apparent flat trend is misleading. Individual
gain-taking actually plunged sharply in 1987.

The SOI series reports capital gains in adjusted gross
income; i.e., after the 60% exclusion available in 1986 and
prior years. In 1987, the exclusion was eliminated and a
maximum 28% rate applied to all gains. Hence, 1986's $132.8
billion of capital asset sales represented about 40% of total
realizations of over $330 billion that year, while 1987's sales
of $137.4 billion represent 100%. Treasury's preliminary
estimate of 1987 total gains is $144.0 Billion. In other
words, individuals' response to increased capital gains taxes
was dramatic, precipitating a 60% reduction in realizations.

Assistant Secretary of the Treasury for Tax Policy Kenneth
W. Gideon, in recent testimony, recalled that both Treasury and
the Joint Committee "substantially underestimated the capital
gains revenues which accrued after the 1978 tax cut."
Historical experience has demonstrated that investor reaction
to changes in the capital gains tax rate is significant.

5/ In 1977, the highest taxes on capital gains reached
    49.125%, due to the combined effect of capital gains
    taxes, the minimum tax and the maximum tax.

Who Benefits?

Lower capital gains taxes benefit all Americans. Indirect benefits -- expansion and employment financed by equity investment flow to all economic groups. Direct benefits, through capital gains realizations, belong to a wide strata of Americans. For example, based on the latest NYSE shareownership study in mid-1985, the average stockowner had a median income of about $37,000.

For some individuals, capital gains are the fruition of a lifetime investment or work effort. These individuals are catapulted into an upper income category. For example, the sale of a small business, a taxi medallion, or a house (for those not qualifying for the special exclusion) can make middle-class individuals "rich" for a year in terms of their tax status. It is estimated that nearly one half of all taxpayers report capital gains during their life. A recent study by the joint tax committee found that in the five-year period 1979-83, 44% of taxpayers realized a gain in only one of those five years. On the other end of the spectrum, 16% of taxpayers realized a gain in each year.

IRAs

Individual Retirement Accounts (IRAs) are another example of a targeted tax incentive of the 1980s which was tried, proven successful, and then unfortunately weakened or eliminated. In 1982, with the liberalization of IRA requirements, these accounts were claimed on 12 million returns, bringing about $28.3 billion in savings. By 1986, over 15 million returns showed IRA contributions of over $37 billion. The 1986 tax act curtailed the tax deductibility of IRA investment for many individuals. In 1987, with the limited availability of the IRA tax deduction, only 7.4 million returns claimed IRAs and the amount of funds saved in these accounts receded 62% to only $14.1 billion. (See Table VI).

While individuals responded to the IRA tax incentive, questions have been raised about whether contributions were new savings or the shifting of other assets. A series of studies by Steven F. Venti and David A. Wise for the National Bureau of Economic Research concluded that: 1. IRAs had a substantial positive net effect on personal savings; 2. Two-thirds of the families that contributed to IRAs had annual income of less than $50,000; and 3. The majority of IRA contributions constituted new savings.

IRAs were a powerful educational tool for savings. Through advertising to attract IRA accounts, individuals may focus more on the need to save.6/ For tax year 1984, about one-half of IRA contributions were made in 1985. This "last minute" response suggests that the increased IRA advertising also stepped-up individuals' sensitivity to tax policy.

Research by Chris Carroll and Lawrence Summers compared the divergence of the U.S. and Canadian savings rates. The Canadian and U.S. private savings rate moved in tandem for almost 25 years. In 1972, Canada initiated a retirement savings program, similar to but more generous that the U.S. IRA program, and subsequently liberalized the program in 1976. After 1976, the Canadian savings rate began a climb which pushed it significantly above the U.S. rate.

6/"The Budget Deficit Problem: 1989" by Lawrence H. Summers, Tax Notes, 3/6/89.

Like IRAs, however, withdrawals from a 401(k) plan prior to retirement may be subject to an additional penalty tax. Particularly for younger employees, this may serve as a disincentive to investment. Those employees have other more immediate, though still long-range, savings goals; i.e., the purchase of a home or the education of children.

Special Allowances and Exemptions

Special allowances and exemptions are widely used by many foreign nations to spur individual savings and investment. For example:

Capital Gains: Canada has a lifetime exemption of $84,700 and a larger exemption for the from sale of small business stock. France excludes capital gains on sale proceeds of up to $43,808.

Dividend Income: In the U.S., corporate dividends paid to shareholders are subject to a maximum 56% effective tax rate (combining corporate and personal income taxes). Most major countries use an integrated system as well as exemptions and deductions for dividend income. The Netherlands has an annual exemption of $912/$456, while the U.K. exempts dividends for personal equity plans.

Interest Income: Singapore completely exempts interest on fixed income investment. Several countries offer tax exemption for the interest return on certain investments held for a specific period of time; i.e., five years in Sweden. In the U.K., the interest return on a National Savings Account is tax free.

Conclusion

Member of Congress from both parties and the Administration have introduced a plethera of proposals to stimulate savings and investment. Last year, a majority of both the Senate and House of Representatives supported restoration of a differential for capital gains. The chairman and other members of this panel have suggested various ways to expand Individual Retirement Accounts, and the Administration has proposed a new alternative in its initial Family Savings Plan.

SIA is eager to assist this committee in designing the most effective savings incentives. Because we believe that the need to address the decline in U.S. savings is compelling, we commend the committee for holding these hearings and urge it to enact legislation this year.

Table I

Ratio of Foreign
to U.S. Savings Rate
(Households, 1988)

Country	Foreign/ U.S.
Japan	3.5X
Germany	2.9
France	2.8
Canada	2.0
U.K.	0.9

Source: OECD

TABLE II

Summary of Individual Taxation of Dividend Income

Countries	Integration of Corporation/ Shareholder Taxation	Maximum Marginal Tax Rates on Dividends	Special Allowances Or Exemptions Other Than Integration
United States	No	33%	None
Australia	Yes	16.8%	None
Belgium	Yes	25%	None
Canada	Yes	19.6%	None
France	Yes	35.2%	Annual Exemption (A)
Germany	Yes	31.3%	Annual Exemption (B)
Italy	Yes	21.9%	Special Allowance (C)
Japan	Yes	45%	None
Netherlands	No	72%	Annual Exemption (D)
Sweden	No	42%	Annual Deduction (E)
United Kingdom	Yes	20%	Special Allowance (F)
Hong Kong	NA	NA	All Dividends Tax Exempt
Indonesia	No	35%	None
Malaysia	Yes	15.4%	None
Singapore	Yes	0%	None
South Korea	No	50%	Special Allowances (G)
Taiwan	No	50%	Annual Exemption (H)

Source: International Tax Comparisons, SIA/Spicer & Oppenheim, August 1989.

(A) Annual dividend (or interest) exemption of $2,430/$1,215 (FF 16,000/FF 8,000) for married/single taxpayers.
(B) Annual dividend (or interest) exemption of $617/$309 (DM 1,200/DM 600) for married/single taxpayers.
(C) Special savings stock dividends taxed at 15%.
(D) Annual exemption of $912/$456 (Dfl 2,000/Dfl 1,000) for married/single taxpayers. Special $456 (Dfl 1,000) exemption of dividends for recognized venture capital company.
(E) Annual deduction of $242 (Skr 1,600) per person.
(F) Tax exemption for dividends on personal equity plans.
(G) A 10% maximum tax on certain dividends, including listed stock.
(H) Annual exemption of $14,112 (NT$ 360,000) for dividends (or interest).

TABLE III

Summary of Individual Taxation of Interest Income

Countries	National Government Bonds	Corp. Bonds	Savings Accounts	Other Interest	Special Allowances Or Exemptions
United States	33%	33%	33%	33%	Exemption (A)
Australia	49.25%	49.25%	49.25%	49.25%	None
Belgium	25%	25%	25%	25%	Exemption (B)
Canada	29%	29%	29%	29%	None
France	56.8%	56.8%	56.8%	56.8%	Exemption (C)
Germany	56%	56%	56%	56%	Exemption (D)
Italy	12.5%	30%	30%	50%	Exemption (E)
Japan	15%	15%	15%	15%	Exemption (F)
Netherlands –	72%	72%	72%	72%	Exemption (G)
Sweden	42%	42%	42%	42%	Exemption (H)
United Kingdom	40%	40%	20%	40%	Exemption (I)
Hong Kong	Exempt	Exempt	Exempt	Exempt	NA
Indonesia	35%	35%	15%	35%	None
Malaysia	Exempt	45%	5%	45%	Exemption (J)
Singapore	Exempt	Exempt	Exempt	Exempt	None
South Korea	10%	10%	10%	25%	None
Taiwan	50%	50%	50%	50%	Deduction (K)

Source: International Tax Comparisons, SIA/Spicer & Oppenheim, August 1989.

(A) Interest from state and local obligations is tax emempt.
(B) $1,225 (BFr 50,000) of interest on certain deposits exempt.
(C) Interest on certain savings accounts is tax exempt. Elected withholding at the source results in 27% to 47% rate on savings account. Annual interest (or dividend) exemption of $2,430 (FF 16,000)/$1,215 (FF 8,000) for married/single taxpayers.
(D) Interest on certain long-term government bonds exempt. Annual interest (or dividend) exemption of $617 (DM 1,200)/$309 (DM 600) for married/single taxpayers.
(E) Interest on certain government bonds tax exempt.
(F) For certain individuals, interest is tax exempt.
(G) Annual exemption of $912/$456 (Dfl 2,000/Dfl 1,000) for married/single taxpayers.
(H) Certain savings accounts for a 5-year term are exempt. The maximum balance is $11,363 (SKr 75,000).
(I) Interest on National Savings Certificates is exempt.
(J) Interest on savings accounts of up to $1,867 (M $5,000) is exempt. Interest on fixed deposits held for at least 12 months with the National Bank is tax exempt.
(K) Special deduction of up to $14,112 (NT $360,000) for interest (or dividends) on certain investments.

TABLE IV

Summary of Individual Taxation of Capital Gains
on Portfolio Stock Investment

Countries	Maximum Short-Term Cap. Gain Tax Rate	Maximum Long-Term Cap. Gain Tax Rate	Period to Determine Short- Or Long-Term Gain	Maximum Annual Net Worth Tax Rate
United States	33%	33%	One Year	None
Australia(A)	49.25%	49.25%	One Year	None
Belgium	Exempt	Exempt	Ncne	None
Canada(B)	19.33%	19.33%	None	None
France(C)	16%	16%	None	1.1%
Germany(D)	56%	Exempt	Six Months	.5%
Italy	Exempt	Exempt	None	None
Japan(E)	1%/20%	1%/20%	None	None
Netherlands	Exempt	Exempt	None	.8%
Sweden(F)	42%	16.8%	Two Years	3%
United Kingdom(G)	40%	40%	None	None
Hong Kong	Exempt	Exempt	None	None
Indonesia(I)	35%	35%	One Year	None
Malaysia	Exempt	Exempt	None	None
Singapore	Exempt	Exempt	None	None
South Korea	Exempt	Exempt	None	None
Taiwan(J)	Exempt	Exempt	One Year	None

Source: International Tax Comparisons, SIA/Spicer & Oppenheim, August 1989.

(A) Long-term capital gains on assets acquired before 9/20/85 are tax exempt;
   basis for assets held more than 1 year and acquired after 9/19/85 is indexed
   for inflation.
(B) Lifetime cumulative capital gain exemption of $84,700 (C $100,000); $423,500
   (C $500,000) for gain on sale of shares in small business.
(C) Exemption for capital gains on sale proceeds of up to $43,808 (FF 288,400).
(D) First $515 (DM 1,000)/$1,029 (DM 2,000) of short-term gain is exempt annually.
(E) Choice of 1% withholding tax on gross sales proceeds or a maximum 20% tax on
   net gains.
(F) A 60% exclusion for long-term gain produces lower long-term rate.
(G) First $7,884 (£5,000) of net gain is exempt annually; inflation indexing.
(I) For securities held more than 1 year, gain is taxed at an average effective
   rate which varies depending on several factors, but is generally lower than
   35%.
(J) Capital gain on listed securities generally exempt; otherwise, taxed to a
   maximum rate of 50%; 50% exclusion provided for long-term gain on unlisted
   securities.

Table V

Revenues and Realizations

($ Billions)

	SOI Series		Treasury Series	
	Sales of Capital Assets (net gain less loss)	Total Gains	Taxes Paid On Capital Gain Income	Effective Tax Rates
1977	$20.8	$45.3	$8.1	17.88%
1978	23.2	50.5	9.3	18.50
1979	28.2	73.4	11.7	15.89
1980	30.0	74.6	12.5	16.71
1981	30.8	80.9	12.7	15.61
1982	34.4	90.2	12.9	14.31
1983	49.4	122.0	18.8	15.41
1984	54.5	140.5	21.2	15.41
1985	67.7	171.0	24.5	14.8
1986	132.8	326.0	46.5E	14.6
1987	137.4	144.0P	NA	NA
1988	NA	165.0P	NA	NA

Source: Statistics of Income Bulletin and Office of the Treasury, Office of Tax Analysis.
Note: 1987 SOI reported on a different basis; i.e., no exclusion. Treasury data series varies slightly starting with 1985.
P = Preliminary; E = Estimate; NA = Not Available

Table VI

Individual Retirement Arrangements Adjustments to Income
($ in Billions)

Year	Number of Returns	Amount
1980	2,564,421	$3.4
1981	3,415,053	4.8
1982	12,010,038	28.3
1983	13,613,167	32.1
1984	15,232,856	35.4
1985	16,205,846	38.2
1986	15,535,531	37.8
1987P	7,318,727	14.1

Source: Statistics of Income Bulletins

The U.S. Chamber of Commerce appreciates this opportunity to express its views on President Bush's proposal to lower the tax rate on capital gains income and provide for Family Savings Accounts.

CAPITAL GAINS

At 33 percent, the top capital gains tax rate is the highest that it has been since 1978. The U.S. now taxes long-term capital gains at a higher rate than nearly all of its major Asian and European competitors.

The current level of capital gains taxation discriminates against capital income, discourages venture capital formation, impedes job creation, and hinders the U.S.'s international competitiveness by raising the cost of capital relative to that of its competitors. Lower capital gains tax rates would stimulate economic growth, promote technological innovation, and create new opportunities. If history is any indication, a reduction in the capital gains tax rate will raise revenue by stimulating economic growth, increasing the value of assets, and dramatically increasing capital gains realizations.

Opponents of a rate reduction want us to believe that this debate is about tax breaks for the wealthy. They resort to the politics of envy and use statistics designed to give the appearance that those who realize capital gains are overwhelmingly wealthy. In fact, most capital gains are realized by people who have recurring incomes in the middle- and lower-income ranges.

This debate is not about rich versus poor. It is about America's economic future. It is about encouraging new opportunities, new business, and new technology. It is about creating jobs and expanding the U.S. tax base. The debate is about the U.S.'s competitive position in the world economy.

A recent study conducted by Arthur Andersen & Co. for the Securities Industry Association demonstrates that U.S. capital gains tax rates are among the highest in the industrialized world. As Table I shows, Germany, Italy, the Netherlands, Belgium, Hong Kong, Taiwan, South Korea, and Singapore all completely exempt long-term capital gains on stock investments from taxation. Even France and Sweden tax long-term capital gains at 16 percent and 18 percent, respectively.

The most unfair aspect of the present method of taxing capital gains is that it ignores the fact that much of the gain from the sale of a capital asset is often attributable to inflation. When gains are due in part or entirely to inflation, a capital gains tax serves to confiscate existing wealth generated from past income that has already been taxed at least once. The taxation of inflationary gains is not only economically counterproductive but also unfair. It is completely indefensible for the government to create inflation and then tax the imaginary gain that results from inflation.

This is no minor point. For example, if one bought $1,000 of stock invested in the Standard and Poor's 500 Index in 1970, that stock would have sold for $4,250 in early 1990. This would have been a capital gain of $3,250. At the current 33% tax rate, the taxpayer pays $1,073 in tax. However, inflation since 1970 was 218%. This means that the taxpayers real gain was only $1,070. He was taxed $1,073 on a real gain of $1,070. Not much of an incentive to invest!

Table I.—INTERNATIONAL COMPARISON OF INDIVIDUAL TAXATION OF CAPITAL GAINS ON PORTFOLIO STOCK INVESTMENT IN 1989

Countries	Maximum short-term capital gain tax rate [1]	Maximum long-term capital gain tax rate [1]	Period to qualify for long-term gain treatment	Maximum annual net worth tax rate
United States (A)	33%	33%	One Year	None
Australia (B)	50.25%	50.25%, indexed	One Year	None
Belgium	Exempt	Exempt	None	None
Canada (C)	19.33%	19.33%	None	None
France (D)	16%	16%	None	None
Germany (E)	56%	Exempt	Six Months	0.5%
Italy	Exempt	Exempt	None	None
Japan (F)	1%/20%	1%/20%	None	None
Netherlands	Exempt	Exempt	None	0.8%
Sweden	45%	18%	Two Years	3%
United Kingdom (G)	40%	40%, indexed	None	None

Table I.—INTERNATIONAL COMPARISON OF INDIVIDUAL TAXATION OF CAPITAL GAINS ON PORTFOLIO STOCK INVESTMENT IN 1989—Continued

Countries	Maximum short-term capital gain tax rate [1]	Maximum long-term capital gain tax rate [1]	Period to qualify for long-term gain treatment	Maximum annual net worth tax rate
PACIFIC BASIN				
Hong Kong	Exempt	Exempt	None	None
Indonesia	35%	35%	None	None
Malaysia	Exempt	Exempt	None	None
Singapore	Exempt	Exempt	None	None
South Korea	Exempt	Exempt	None	None
Taiwan	Exempt	Exempt	None	None

[1] State, provincial, and local taxes not included.

(A) The nominal tax rate for long- and short-term capital gains is 28 percent. The marginal rate, however, rises to 33 percent for joint returns between $74,850 and $155,370 and for single returns between $44,900 and $93,130 for calendar year 1989.

(B) Indexing is allowed on long-term gains.

(C) Canadian residents are allowed an annual capital gains exemption of Canadian $30,000 ($25,263 [Based on exchange rates as of February 5, 1990.]) subject to a cumulative exemption of up to Canadian $500,000 ($421,050 [Based on exchange rates of February 5, 1990.]) in 1990.

(D) Gains from proceeds of up to FF272,000 ($48,192 [Based on exchange rates as of February 5, 1990.]) are exempt from taxation in a given taxable year.

(E) The first DM 1,000 ($602 [Based on exchange rates as of February 5, 1990.]) of short-term capital gains is exempt from tax.

(F) Taxpayer has a choice of a 1% withholding tax on gross sales proceeds or a maximum tax on net capital gains of 20%.

(G) Only gains and losses accrued since 1982 will be taxed; gains since 1982 are indexed.

Source: Prepared by Arthur Andersen & Co. for the Securities Industry Association in March 1987; updated by the American Council for Capital Formation Center for Policy Research, March 1989.

The effect on tax revenues of changes in the capital gains tax rate is a major point of contention between proponents and opponents of a rate reduction. Yet the historical evidence and a number of recent academic and government studies indicate that revenues will increase significantly following a rate reduction.

Those who have predicted revenue losses from past capital gains tax cuts have been proven wrong. The Joint Committee on Taxation estimated that the 1978 rate reduction would cost the government more than $2 billion annually. Yet capital gains tax revenue rose following the 1978 cut. The increase was not simply in the year following the rate cut but continued in successive years. Capital gains tax revenue rose from $9.1 billion in 1978 to $11.7 billion in 1979 and $12.5 billion in 1980. The 1981 rate reduction brought about a similar increase in revenue. Revenue rose from $12.7 billion in 1981 to $26.5 billion in 1985. In 1986, when taxpayers saw the capital gains tax increase coming, tax revenue from capital gains exceeded $49 billion (see Table II).

Table II.—REALIZED CAPITAL GAINS AND THE ASSOCIATED REVENUE

Year	Capital gains (Dollars in billions)	Revenues (Dollars in billions)	Top marginal tax rate on capital gains [1]
1968	35.6	5.9	26.9%
1969	31.5	5.3	27.5
1970	20.8	3.2	32.3
1971	28.3	4.4	38.8
1972	35.9	5.7	45.5
1973	35.8	5.4	45.5
1974	30.2	4.3	45.5
1975	30.9	4.5	45.5
1976	39.5	6.6	49.1
1977	45.3	8.1	49.1
1978	50.5	9.1	48.3
1979	73.4	11.7	28.0
1980	74.1	12.5	28.0
1981	80.9	11.7	23.7
1982	90.1	12.9	20.0
1983	122.0	18.5	20.0
1984	138.7	21.5	20.0
1985	171.4	26.5	20.0
1986	326.3	49.7	20.0

Table II.—REALIZED CAPITAL GAINS AND THE ASSOCIATED REVENUE—Continued

Year	Capital gains (Dollars in billions)	Revenues (Dollars in billions)	Top marginal tax rate on capital gains [1]
1987	144.1	32.9	28.0

1968–1982 data are from the Office of Tax Analysis, Department of Treasury, "Report to the Congress on the Capital Gains Tax Reductions of 1978," p 154. 1983–94 data are from the Statistics of Income, with revenue calculated using information from the tables in those volumes The 1985–87 figures are from the Office of Tax analysis, Department of Treasury. The 1987 figures are preliminary.
[1] Rates compiled by Congressional Budget Office based on data from the Office of Tax Analysis, Department of the Treasury.

Dr. Lawrence Lindsey, Associate Director for Domestic Economic Policy at the White House and formerly a professor at Harvard University, has examined the relationship between tax rates and capital gains. His findings confirm the negative effect of high capital gains taxes on Federal revenues and indicate that large revenue gains are likely from a reduction in the capital gains tax rate. Dr. Lindsey based his findings on a review of five of the recent leading academic and government investigations of capital gains taxation. The methodology used in all but one of the studies predicted revenue losses from the 1986 capital gains rate increase. According to Professor Lindsey's analysis, the revenue maximizing capital gains tax rates range from 9 percent to 21 percent. Dr. Lindsey estimates that a reduction in the capital gains rate to 15 percent would increase revenue by nearly $15 billion over three years. Preliminary data from the Internal Revenue Service (IRS) show that following the rate increase in 1987 capital gains realizations dropped significantly, yielding revenue of $32 billion.

In 1988, the Department of the Treasury published an updated version of its 1985 study of the revenue effects of capital gains taxation. The 1985 Treasury study, using statistical evidence available at that time, concluded that the 1978 Act caused a substantial increase in revenue in the first year after the tax cut and in the long run either increased or slightly decreased Federal revenue.[1] Similar conclusions were drawn regarding the 1981 capital gains rate cut. The 1988 update, entitled "The Direct Revenue Effects of Capital Gains Taxation: A Reconsideration of the Time Series Evidence," written by Michael Darby, Robert Gillingham, and John Greenlees, extended the sample used in the 1985 study and corrected several flaws in that earlier study. The update concludes unequivocally that both the 1978 and 1981 capital gains tax changes significantly increased revenue.

Even a 1988 Congressional Budget Office study on the historical effect of a rate change on revenue, often cited by opponents of a rate reduction, found that changes in tax rates on capital gains produced a significant change in behavior on the part of investors. That study concluded that the revenue-maximizing rate was probably below the current top rate of 33 percent. The study made four point estimates of the revenue-maximizing rate. They were all below the present top rate. Equally important, the study did not rule out, based on the data, that 15 percent was the revenue-maximizing rate.

History shows that rate reductions increase revenue. Even if, revenue did not increase, it seems clear that a revenue-neutral tax policy change that encouraged investment and savings, reduced the cost of capital, and increased jobs would be a wise policy change.

Few myths are as enduring as the belief that reductions in the capital gains tax rate redistribute the tax burden to the benefit of the wealthy. Data used by opponents of a rate cut overstate the extent to which the truly wealthy realize gains. This is because such data include the nonrecurring capital gains of those normally in the middle- and lower-income brackets. These people appear temporarily to be quite wealthy. For example, when a middle-class business owner retires and sells a business or when a retired person sells a family home, his income that year may increase several hundred thousand dollars. They are "rich" for one year. The next year, however, they are back among the middle class. Realized capital gains tend to be nonrecurring events. Yet, when combined with a taxpayer's other income, those gains appear to be realized predominantly by wealthy people.

IRS data show that capital gains realizations are actually spread quite evenly throughout ordinary income groups. In 1987, over 70 percent of those reporting a capital gain had ordinary income under $50,000. Another important point is that over 14 million Americans reported a capital gain in 1987, and 26 percent of these

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[1] "Report to Congress on the Capital Gains Tax Reduction of 1978," Office of the Secretary of the Treasury, September 1985.

taxpayers were elderly. One-fourth of the taxpayers with ordinary incomes between $20,000 and $50,000 reported a capital gain at least once during the 5-year period 1979-1983.

In addition to restoring the capital gains differential, Confess should remove the capital loss limitation. The capital loss limitation of $3,000 introduces an asymmetry into the taxation of risky ventures that discourages investment in new firms. In effect, the government is saying: heads I win, tails you lose. If we wish to avoid discouraging people from investing in what are often risky start-up ventures, we should permit a larger deduction from income in the event of a capital loss.

By pursuing the politics of envy, we not only harm middle- and lower-income Americans, we also imperil America's economic position in the world economy. At a time when most of the industrialized world is cutting capital gains taxes, America is moving in the opposite direction. In an increasingly competitive and global economy, America cannot afford to pursue foolhardy economic policies.

In 1989, a bipartisan majority of both houses of Congress supported a capital gains tax cut. Only a procedural device allowed a minority to pr??ent passage of a cut. President Bush has renewed his call for a capital gains tax cut. The Administration's capital gains proposal is based on a sliding scale. The proposal provides for a 10, 20, or 30 percent exclusion for one, two, or three years, respectively. The holding period requirement would be phased in over three years. The proposal applies only to individual capital gains but includes a broad range of capital assets, including stocks, bonds, real estate, and timber. The Department of the Treasury estimates that the Bush Administration's capital gains proposal will raise $4.9 billion in 1991 and a total of $12.5 billion through 1995.

Though the Chamber supports the Administration's proposal, it believes that a number of changes should be made. A simple exclusion approach with one short holding period is preferable to the sliding scale. An exclusion is less complex and does not involve lengthy and unwarranted holding periods. In order for a rate cut to be a significant incentive for investment, the exclusion should yield an effective rate of between 15 percent and 20 percent. The holding period should be no longer than one year.

The proposal should apply to all capital assets but most important should cover corporate as well as individual capital gains. Corporate income is already subject to double and sometimes triple taxation. Failure to provide a capital gains differential for corporations would exacerbate existing distortions and inequities. All of the sound economic arguments that favor a capital gains tax cut apply to corporations as well as individuals.

Traditionally a significant amount of funding for the organized venture capital market has been supplied by corporations. Venture capital support financed by corporations would be stimulated by a corporate capital gains rate reduction, and corporations would be encouraged to fund their own "spin-off" ventures. In addition, lowering capital gains tax rates on corporations as well as individuals would reduce the attractiveness of debt finance and encourage equity finance. Many argue that a corporate capital gains rate reduction would cost the Treasury a great deal of revenue. This analysis is often based on the limited response to the two percent corporate capital gains rate cut from 30 to 28 percent effective in 1979. In 1986, corporations realized 94 percent more capital gains in response to the 1987 six point rate increase in the 1986 Act. The conclusion that should be drawn from this data is that if the incentive is substantial corporations will alter their behavior just as individuals do. Therefore, it is unlikely that a substantial corporate rate reduction would lose revenue. To the contrary, if the rate differential is substantial, a corporate capital gains rate reduction is likely to be self-financing.

FAMILY SHARINGS ACCOUNTS

The Chamber supports the Family Savings Account initiative proposed by the Bush Administration. Under the proposal, families could make annual nondeductible contributions of up to $5,000 ($2,500 for each spouse), or single individuals could contribute up to $2,500. Participation in Family Savings Accounts would be open to taxpayers filing joint returns with yearly adjusted gross incomes up to $120,000 (single taxpayers up to $60,000). Contributions to Family Savings Accounts can be made in addition to IRA contributions, and investments can be made in a wide range of financial instruments.

If the funds are held in the Family Savings Account for seven years, all earnings are tax-free. Funds can be left in the account beyond seven years with all interest accumulating tax-free. Earnings on funds withdrawn between three and seven years are subject to income tax, and any earnings on funds withdrawn prior to three

years are subject to income tax and an additional 10 percent penalty on those earnings.

By reducing the tax bias against savings and increasing the return to savings, the Family Savings Account is bound to result in greater savings. Moreover, the fact that the savings can be used for purposes other than retirement will increase people's willingness to take advantage of the Family Savings Account as a savings mechanism. This program will help American families and will help the economy by increasing the savings rate.

STATEMENT OF THE U.S. LEAGUE OF SAVINGS INSTITUTIONS

The U.S. League of Savings Institutions [1] welcomes this opportunity to present its views on the President's proposals to increase savings and investment provided for in S. 2071, The Savings and Economic Growth Act offered by Senators Packwood, Roth and Dole. Our savings institutions are continually searching for new methods of attracting lower cost savings in order to finance our nation's housing demand. Private savings has always been the lifeblood of our business and, therefore, we applaud the Senate Finance Committee for focusing debate on the importance of savings incentives in revitalizing our nation's capital position.

The 1986 Tax Reform Act (The 1986 Act) reduced marginal tax rates and phased out the deductibility of most forms of consumer interest, thus raising the after-tax yield on savings and increasing the after-tax cost of consumer borrowing. Both of these provisions move in the direction of increasing the personal savings rate.

Savings institutions are mindful, however, that individual families do not base their saving decisions on considerations of yield alone. The consensus of studies of the decline in homeownership, particularly among young households, is that the inability to save for the down payment is a primary hurdle to first-time home purchase. The provision of penalty-free IRA withdrawal for first-time home purchase contained in the President's proposal would provide a tax-advantaged account for down payment accumulation and would almost certainly increase IRA savings by younger households who do not now utilize the account because of its restrictions. Savings by these households, eager to become homeowners a few years from now, are most likely to be new savings to the economy, not merely shifts from other accounts.

The U.S. League of Savings Institutions strongly supports this provision and recommends extending it to 401(k) pension plans. Additionally, inasmuch as the provision only removes the tax *penalty* on early withdrawal from these accounts, leaving the balance fully taxable, the U.S. League would urge the Congress to permit the tax to be paid in equal installments over five years following the withdrawal for first-time home purchase.

The 1986 Act shortened the maximum vesting period for employer-sponsored (defined-benefit) pension plans and limited eligibility for deferral of tax on the principal contributions to an IRA. Today, individuals who are covered by an employer-sponsored pension plan and who have income above certain limits ($35,000 and $50,000 adjusted gross income for single and joint filers, respectively) are not permitted to fully defer IRA principal contributions. This provision implicitly assumes that an individual who is covered by an employer-sponsored pension plan is accumulating funds for his or her retirement. This isn't necessarily the case, however. An individual who changes jobs (voluntarily or involuntarily) before becoming vested in the pension plan does *not* accumulate funds toward retirement. Indeed, a recent U.S. Department of Labor study indicates that the average employee changes jobs 12 times in his or her working life—roughly once every four years. In a dynamic economy, job mobility is the rule rather than the exception. An individual IRA automatically solves all the vesting, funding and portability problems that beset the employer-sponsored, defined-benefit pension programs and provides employees with an important "backup" system other than Social Security.

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[1] The U.S. League of Savings Institutions serves the more than 2,700 member institutions which make up the $1.3 trillion savings association and savings bank businesses. League membership includes all types of institutions—Federal and state-chartered, stock and mutual. The principal officers include: Kenneth D. Seaton, Chairman, Hancock, Michigan; Robert B. O'Brien, Jr., Vice Chairman, Morristown, New Jersey; Frederick L. Webber, President, Washington, D.C.; and J. Denis O'Toole, Executive Vice President for Government Affairs/ operations. League headquarters are at 1709 New York Avenue, N.W., Suite 801, Washington, D.C. 20006. Telephone: (202) 637-8900. The Chicago office is located at 111 East Wacker Drive, Chicago, Illinois 60601. Telephone: (312) 644-3100.

Accordingly, the U.S. League of savings Institutions supports the provisions of S. 1682, The Savings and Investment Incentive Act offered by Senator Bentsen and others.

S. 2071 contains the President's proposal for a Family Savings Account (FSA). Depository institutions have long sought a tax-deferred instrument with which to compete against the tax-deferred inside buildup of insurance company products, and the FSA is potentially such an instrument. The U.S. League supports the FSA concept in principle but has the following modifications to suggest.

First, individual savers' planning horizons do not really extend beyond five years, so the seven-year holding period required for any year's contribution to become eligible for tax exemption of earnings is too long. We believe that a three-year holding period would make the FSA a popular and effective saving incentive. A five-year holding period would coincide with the outer limit of savers' planning horizons and would be preferable to the seven-year holding period.

Second, the provision for a 10% tax penalty on the withdrawal of funds held less than three years will produce little revenue at the cost of an overwhelmingly negative market impact. Since principal flows into the FSA from *after-tax* dollars and earnings withdrawn prior to the completion of the required holding period are subject to ordinary income tax, the 10% tax penalty will be perceived in the market as unnecessarily harsh.

The U.S. League, therefore, recommends that the tax-penalty provision be eliminated.

The U.S. League of Savings Institutions thanks the Committee for focusing attention on this important issue and for allowing us the opportunity to share our views with the Committee on this important issue.

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