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TAX REFORM ACT OF 1986, PART IV

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

FEBRUARY 5 AND 6, 1986

(Deficit Reduction and Capital Formation)

(Part 4 of 5 Parts)

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COMMITTEE ON FINANCE

BOB PACKWOOD, Oregon, *Chairman*

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TAX REFORM ACT OF 1986, PART IV

WEDNESDAY, FEBRUARY 5, 1986

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

The committee met, pursuant to notice, at 9:30 a.m. in room SD-215, Dirksen Senate Office Building, Hon. Packwood (chairman) presiding.

Present: Senators Packwood, Danforth, Chafee, Heinz, Wallop, Durenberger, Grassley, Long, Bentsen, Baucus, Bradley, and Mitchell.

[The press release announcing the hearing follows:]

[Press Release]

COMMITTEE ON FINANCE SETS HEARINGS ON TAX REFORM

Five days of hearings on H.R. 3838, the Tax Reform Act of 1986, have been scheduled for the first two weeks of the second session of the 99th Congress, Chairman Bob Packwood (R-Oregon) announced today.

Senator Packwood said the hearings are set for January 29 and 30, and February 4, 5 and 6.

The principal purpose of the hearings is to examine the economic effects of H.R. 3838, on international competitiveness and capital formation. Senator Packwood said the Committee would invite several prominent economists to testify on this topic.

The hearings also will cover certain new subjects included in H.R. 3838, but not proposed by the Reagan Administration last year. Public witnesses will be scheduled to testify on these matters, Senator Packwood said. Senator Packwood chaired 28 hearings addressing tax reform issues between May 9 and October 10, 1985, receiving testimony from over 300 witnesses. He indicated these 1986 hearings would not cover subjects addressed at the 1985 hearings. Public witnesses will be strictly limited.

All of the hearings will begin at 9:30 a.m. in Room SD-215 of the Dirksen Senate office Building in Washington, with Senator Packwood presiding.

The CHAIRMAN. The committee will come to order. Dr. Heller was due to be with us today, and he is at the moment stuck in Cleveland. Whether or not he is going to make it here, we don't know. He thinks he will be here by 10 o'clock; I wouldn't swear to it, but we will start, in any event, with Dr. Meyer and Dr. Galper, and if Dr. Heller joins us, we will put him on at the end.

So, unless you gentlemen have any objection, we will start in the order on which you are on the witness list. Dr. Meyer, your entire statement will be in the record; and if you could abbreviate your comments to 10 minutes so we could ask questions, we would appreciate it.

STATEMENT OF LAURENCE H. MEYER, PH.D., PRESIDENT, LAURENCE H. MEYER AND ASSOCIATIONS; AND PROFESSOR OF ECONOMICS, WASHINGTON UNIVERSITY, ST. LOUIS, MO

Dr. MEYER. Thank you. Mr. Chairman and other members of the committee, thank you very much for giving me this opportunity to share my views on tax reform with you this morning. From the very outset of the discussion of fundamental tax reform, proponents have argued that revenue neutral tax reform that lowered marginal tax rates and broadened the tax base would promote increased saving and capital formation. Throughout this discussion, there has been a failure to recognize that any benefits for investment from reductions in marginal personal or corporate tax rates would be more than offset by the elimination or curtailment of specific investment incentives, such as the investment tax credit and accelerated depreciation. Thus, proponents of tax reform have both oversold the economic benefits of lower margin tax rates and have failed to appreciate the significant costs associated with the elimination of proinvestment incentives in the current tax law.

The high deficit fiscal policy over the last several years has already offset most of the stimulus associated with the investment incentives in the 1981 Tax Act. If we eliminate those investment incentives, along with others introduced earlier, without also lowering the deficit, capital formation will be substantially slowed. Therefore, the debate on tax reform must also take into account prospective action or inaction on the deficit, suggesting that Gramm-Rudman and tax reform need to be studied together, not in isolation.

The results reported in the study prepared by Laurence Meyer and Associates for this committee do just that: Compare the effects of tax reform with and without the implementation of Gramm-Rudman. These results are based on simulations of the Washington University macroeconometric model, a 400 equation model, designed specifically to allow evaluation of the impact of alternative tax structures on real GNP growth, capital formation, and other important macro variables.

Let me summarize for you the findings of the study. First, tax reform along the lines of H.R. 3838 with unchanged monetary policy would slow the rate of economic expansion over the period from 1986 to 1991 by an average of slightly under one-half percentage point a year. In this nonaccommodated case, tax reform would slow the rate of increase in the business capital stock by almost a full percentage point a year and would leave the business capital stock 4½-percent lower in 1991 than it would have been in the absence of tax reform.

If monetary policy were to become more accommodative, the restrictive impact of tax reform on aggregate demand would be offset so the rate of expansion in real GNP would be unchanged, but the business capital stock would grow on average a half percentage point lower and would be 3 percent lower in 1991. These two cases of accommodated and nonaccommodated tax reform provide a plausible range of the effects of tax reform. Output growth would likely slow from zero to a half a percentage point a year. The growth in the business capital stock would slow from one-half to 1 percentage point a year. And the business capital stock would be lower by 1991 by between 3 and 4½ percent.

Now, to Gramm-Rudman. If Gramm-Rudman is also implemented and fully accommodated by a more stimulative monetary policy, then output growth would be unchanged; and the lower interest rates associated with fully accommodated deficit reduction would substantially, though not completely, offset the curtailment of investment incentives now proposed as part of tax reform. Thus, Gramm-Rudman and tax reform are complementary in that fully accommodated deficit reduction allows the economy to absorb the curtailment of investment incentives with a relatively small net effect on capital formation. On the other hand, implementation of tax reform along with Gramm-Rudman will more than completely neutralize the otherwise stimulative impact that deficit reduction would have on capital formation, neutralizing perhaps the single most important benefit promised by deficit reduction.

If tax reform and Gramm-Rudman are both implemented, but monetary policy fails to provide the offsetting stimulus, the likelihood of a recession in 1987 is sharply increased, and a slow average rate of expansion and weak capital formation are likely for several years. Under these circumstances, simultaneous passage of Gramm-Rudman and tax reform would compound the downside risks of each and dramatically increase the likelihood of a serious and prolonged slowdown.

The effect of tax reform and Gramm-Rudman on capital formation results from their effect on the cost of capital to firms. In our model, that cost of capital is measured by what we call rental prices that reflect the cost of owning, operating, and maintaining a piece of capital, allowing for the price of the capital good, the rate of economic depreciation, real financing costs, relevant corporate and personal tax rates, and other elements of the tax structure such as the treatment of depreciation, interest expense, and capital gains. Since the rental price of investment reflects the true economic cost of investment, an increase in the rental price discourages capital formation. The rental price impacts of tax reform and Gramm-Rudman are detailed on page 18 of my statement.

I want to highlight this morning the percentage increase in the rental prices for the business capital stock in 1988, which we assume to be the first year of full implementation. We assume it is phased in in 1987, rather than in 1986 as H.R. 3838 is now written. I want to emphasize the percentage increases in the rental rate in 1988 in the case of nonaccommodated tax reform because that gives us the best measure of the direct impact of tax reform alone on the cost of capital. Note the dramatic rise in the rental price for equipment: 18.3 percent increase in that rental price in 1988 with H.R. 3838. The increase in the rental price for structures is also large, but not quite as great, 9.2 percent. The sharper impact on equipment reflects the effect of rescinding the investment tax credit which can be taken on equipment but not on most structures.

While Treasury II also increased the rental price of equipment, its effect was about half as large as that of H.R. 3838, due primarily to the fact that Treasury II included full indexation of depreciation. Treasury II would actually have lowered the rental price for structures, again due to full indexation of depreciation. This suggests that the full indexing of depreciation would provide the opportunity to substantially reduce the very large increases in the cost of capital associated with H.R. 3838. Indexation would also improve the neutrality of the Tax Code with respect to inflation and would permit the combination of tax reform and Gramm-Rudman to strengthen capital formation instead of slightly weakening it.

While not in my paper prepared for this committee, I have subsequently estimated the impact of introducing indexation into H.R. 3838. Indexation would reduce the increase in the cost of capital from 18.3 percent for equipment to 12.2 percent; and it would reduce the increase for structures from 9.2 percent to 3.6 percent.

Let me summarize the conclusions of my analysis and my recommendations to this committee. Tax reform and deficit reduction must be studied together, not in isolation. They are longrun complements, but each has serious near-term downside risks, risks that would be compounded by implementing them simultaneously. It should also be understood that simultaneous implementation of tax reform and Gramm-Rudman would more than neutralize the otherwise beneficial longrun effects of deficit reduction on capital formation.

A second point. Tax reform is progressively being whittled down to tax revision. The gains in simplicity and economic neutrality are more modest than initially hoped for. Tax reform is still desirable, but it is not so pressing a problem as reducing the deficit. This committee should keep in mind the pressing nature of its commitment to deficit reduction in its deliberations on tax reform. In particular, tax increases such as oil import fees and value-added taxes should not be considered as ways of obtaining revenue to pay for tax reform. If such an approach were to be taken, then the reform of personal and corporate income taxes, instead of being revenue neutral, would be a tax reduction, a tax cut when we need additional revenues, if Gramm-Rudman is to be implemented. If you were to take this approach it would forcefully indicate the absence of resolve to implement Gramm-Rudman.

Finally, even with Gramm-Rudman, tax reform along the lines of H.R. 3838 would slow capital formation. A major reason for this is the failure to index depreciation. The most important change this committee can make in H.R. 3838, therefore, is to fully index depreciation. This would substantially reduce the impact on the cost of capital of tax reform and allow the combined effect of tax reform and Gramm-Rudman to be at least neutral with respect to capital formation.

Thank you very much.

The Chairman. Dr. Meyer, thank you very much.

Dr. Galper.

[The prepared written statement of Dr. Meyer follows:]

TAX REFORM, DEFICIT REDUCTION, AND CAPITAL FORMATION

Laurence H. Meyer

Testimony before the Senate Finance Committee

February 5, 1986

SUMMARY

1. Tax reform along the line of the the House Ways and Means Committee bill (.H.R.3838) with unchanged monetary policy would slow the rate of economic expansion over the period from 1986 through 1991 by an average of 1/2 percentage point per year. In this "nonaccommodated" case, tax reform slow the rate of increase in the business capital stock by almost a full percentage point per year, and leave the business capital stock 4 1/2 percent lower by 1991 than it would have been in the absence of tax reform.

2. If monetary policy were to become more stimulative to offset or "accommodate" the restrictive impact of tax reform on aggregate demand, the rate of expansion would be unchanged. However, the business capital stock would still grow on average 0.7 percentage points more slowly over the period and would be 3% lower by 1991 than in the absence of tax reform.

The accommodated and nonaccommodated cases provide a plausible range for the economic effects of tax reform: output growth is likely to slow from 0 to 1/2 percentage points per year, the growth in the business capital stock should slow from 0.7 to 1 percentage point per year, and the business capital stock should be 3 - 4 1/2 percent lower by 1991.

3. If Gramm-Rudman is implemented and fully accommodated by a more stimulative monetary policy, leaving output growth unchanged, the lower interest rates associated with this fully accommodated deficit reduction would partially offset the curtailment of investment incentives now proposed as part of tax

reform. As a result, the business capital stock would grow on average only 0.4 percentage point more slowly and would be only 2% lower by 1991. Thus Gramm-Rudman and tax reform are complementary, in that fully accommodated deficit reduction allows the economy to absorb the curtailment of preferential treatment of investment with a relatively small net effect on capital formation. From an alternative perspective, on the other hand, implementation of tax reform along with Gramm-Rudman will completely negate the otherwise stimulative effect of deficit reduction on capital formation, neutralizing perhaps the single most important contribution anticipated from Gramm-Rudman.

4. If tax reform and Gramm-Rudman are both implemented, but monetary policy fails to provide any offsetting stimulus, the likelihood of a recession in 1987 is sharply increased and a slow average rate of expansion and weak capital formation are likely for several years. Under these circumstances, simultaneous passage of tax reform and Gramm-Rudman compounds the downside risks of each and dramatically increases the likelihood of a serious and prolonged economic slowdown.

5. There is one important modification of H.R.3838 that I urge the committee to consider: full indexation of depreciation allowances. Indexation of depreciation allowances would both improve the neutrality of the tax code with respect to inflation and provide the opportunity to substantially reduce the very large increases in the cost of capital associated with tax reform, also permitting the combination of tax reform and deficit reduction to strengthen rather than slightly impair capital formation.

This testimony is based on a study prepared by Laurence H. Meyer & Associates. Dr. Meyer is President of Laurence H. Meyer & Associates, Ltd and also Professor of Economics and Research Associate at the Center for the Study of American Business at Washington University in St. Louis.

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TAX REFORM, DEFICIT REDUCTION, AND CAPITAL FORMATION

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February 5, 1986

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From the very outset of the discussion of fundamental tax reform, proponents have argued that revenue neutral tax reform that lowered marginal tax rates and broadened the tax base would promote increased saving and capital formation. The pro-capital formation orientation of tax reform was stressed by both Senator Bradley and Congressman Gephardt in support of their "Fair Tax Act", by Congressman Kemp and Senator Kasten in support of their "Fair and Simple Tax", and then by the Treasury in their supporting material for their initial tax reform recommendations and the President's subsequent tax reform proposai (Treasury I and II). Throughout the discussion of tax reform, their has been an unwillingness on the part of the framers of the proposals to recognize that any benefits for investment from reductions of marginal personal and corporate tax rates would be more than offset by the elimination or curtailment of specific investment incentives such as the investment tax credit and accelerated depreciation. Thus proponents of tax reform have both oversold the economic benefits of the general incentive effects of lower marginal tax rates and failed to appreciate the significant costs associated with the elimination of pro-investment incentives in the current tax law.

This testimony is based on a study prepared by Laurence H. Meyer & Associates, Ltd. Dr. Meyer is President of Laurence H. Meyer & Associates and also Professor of Economics and Research Associate at the Center for the Study of American Business at Washington University in St. Louis.

The high deficit fiscal policy over the last several years has already offset most of the incentive effects of the investment incentives in the 1981 tax act. The business tax cuts lowered the cost of acquiring capital, but the increase in real interest rates associated with the high-deficit fiscal policy raised the cost. If we eliminate those investment incentives, along with investment incentives introduced in the 1960's, without also lowering the deficit, capital formation will be substantially slowed. Therefore, the debate on tax reform must also take into account prospective action or inaction on the deficit, suggesting that Gramm-Rudman and tax reform need to be studied together, not in isolation.

The simulation results reported below will do just that: compare the effects of tax reform with and without implementation of Gramm-Rudman. Gramm-Rudman would contribute to lower interest rates and, if accompanied by appropriately more stimulative monetary policy, would encourage investment. Successful implementation of Gramm-Rudman would therefore permit implementation of tax reform along the lines of H.R.3838 without seriously impeding capital formation. Furthermore, restoring indexation of depreciation, an important ingredient in both Treasury I and II, but a provision stricken from H.R.3838, would both improve the neutrality of the tax code with respect to inflation and further purge the combined policy of deficit reduction and tax reform of any negative impact on capital formation. Such a result permits both removal of the distortions associated with current investment incentives, while maintaining the rate of capital formation.

However, both Gramm-Rudman and tax reform carry serious downside risks. If monetary policy is not perfectly coordinated with deficit reduction or if Gramm-Rudman is implemented in an environment of slow growth or recession, Gramm-Rudman could be accompanied by rising unemployment and falling investment. To implement tax reform at the same time with its own potential for slowing the expansion and weakening investment in the near term would be to risk a severe and prolonged economic decline. Congress should therefore exercise caution in implementing tax reform until the initial adjustment to Gramm-Rudman has been successfully accomplished.

ECONOMIC EFFECTS OF TAX REFORM

It is useful to classify the economic effects of tax reform into the following four categories (1) aggregate demand effect via revenue-nonneutrality, (2) efficiency effect via introducing or eliminating tax-induced distortions to economic decisions, (3) general incentive effect associated with lower marginal personal and corporate tax rates, and (4) specific incentive effects associated with preferential treatment for specific industries or activities.

1) **Demand effects via revenue non-neutrality:** A cut in tax revenue would be stimulative, an increase would be restrictive. Given that tax reform is designed to be revenue neutral, this effect can be ignored. The results reported below assume that nonaccommodated tax reform is almost revenue neutral during the five years covered by the simulation.

2) **Efficiency effects via reduced tax-induced distortions to economic efficiency:** Taxes do more than raise revenue. They affect economic decisions by altering the rates of return to work, saving, investment, etc. Economic theory predicts that tax-induced distortions generally reduce economic efficiency and reduce national output because they interfere with the market allocation of scarce resources to

their most productive uses. Tax induced distortions which favor capital intensive industries over those less capital intensive or which favor equipment relative to structures, along with those that provide favored tax treatment to specific industries, all distort economic decisions, reduce the efficiency of resource allocation, and impose a cost in the form of lower national output relative to a world free of such distortions. The size of this cost is difficult to quantify, but that does not mean it is not significant and that reducing this cost is not a worthy goal for tax reform. Tax reform legislation which moves to make depreciation for tax purposes closer to economic depreciation, which reduces the preferential tax treatment of specific industries and specific inputs, therefore, improves economic efficiency.

It should be noted, however, that an important non-neutrality in the current tax system involves the impact of inflation on real tax liabilities. For example, because depreciation allowed for tax purposes is computed on the basis of original rather than replacement cost, inflation reduces the present value of the depreciation deduction to the firm, raises the cost of capital, and discourages investment. Treasury I included a wide-ranging effort to make the tax system inflation-neutral. Treasury II made some effort, but not as far ranging as that in Treasury I. HR 3838, on the other hand, has scrapped virtually any attempt to move toward a tax structure that is inflation neutral. Thus, while HR 3838 would move toward more equal taxation of different industries, and treat equipment and structures more equally, it would leave the inflation distortion in the current tax code unaddressed.

This is especially important because a significant difference between HR 3838 and Treasury II is the substantially larger increase in the cost of capital for both equipment and producers structures in HR 3838 that primarily reflects the effective absence of indexation of depreciation in that bill. The most important change I can recommend to this committee is to restore indexation of depreciation and restore the lost revenue in a way that does not raise the cost of capital to firms.

(3) **General incentives associated with lower marginal tax rates:** Proponents of tax reform generally argue that lower marginal tax rates stimulate work, saving, and investment. However, economic theory is not so definitive, and the accumulated body of empirical evidence provides painfully little support for the general incentive effects of lower marginal tax rates. Lower marginal personal tax rates raise the after-tax real wage rate and the after-tax real rate of return to saving. Economic theory is ambiguous about the net effect of such changes on work and saving, due to the well-known interaction of income and substitution effects.

Supply-side insistence that these changes stimulate work and saving derives from exclusive consideration of the substitution effects: workers will substitute work for leisure when the reward to work and the opportunity cost of leisure increase, while households will save more if the reward to saving increases. However, there are offsetting effects in each case. Workers find that they have higher income with unchanged hours of work and may decide to buy an increased amount of leisure with their higher income; households find that with higher after tax real returns they can accumulate the same desired wealth position in the future with smaller saving each period and hence may reduce saving.

Theory being agnostic on the net effects, the issue must be settled by observing how individuals have responded in the past to changes in their after-tax wage and interest rates. While empirical work in economics always produces a mixture of results, to the dismay of both economists and noneconomists, the evidence on the response to tax rate changes overwhelmingly suggests that the effects are small, even negligible. In the model used below to simulate the effects of tax reform, careful attempts were made to determine the impact of tax rate changes on saving and work decisions. The fact that such a response is negligible or absent in the model used below to simulate the effect of tax reform is not a reflection of ideological commitment to such a finding, but rather reflects our respect for the data. We found no effect on the saving decision and only a minor effect on the work decision. We conclude that the general incentive effects of reduced personal income taxation have been dramatically oversold.

Lower marginal tax rates for corporations should spur investment. There are offsetting effects here to, in that lower tax rates also reduce the value of deductions for interest, but, on balance, both economic theory and empirical evidence suggests that lower corporate income tax rates encourage investment.

(4) **Incentive effects associated with preferential tax treatment:** Preferential tax treatment of certain industries and activities induces more resources to flow in the direction of the favored industry or activity. Preferential tax treatment for rehabilitation of historical buildings for example increases the amount of such rehabilitation. Similarly, tax credits for R&D stimulate R&D, while tax preferences that favor investment will stimulate investment. This should come as no surprise, because such tax preferences have been at the heart of tax policy in the postwar period. It is a legitimate question as to whether tax policy should take as an objective altering the allocation of resources relative to what the market would otherwise produce. In addition, even if we decide we want more of a

certain kind of activity, there are other ways of achieving that objective, short of filling the tax code with a myriad of special preference provisions. Nevertheless, it should be understood that removing such preferential treatment without offsetting action will reduce the flow of resources to the favored activity. Hence tax reform, by eliminating or curtailing incentives to invest, is likely to seriously undermine capital formation. This negative effect of investment will only be partially offset by the benefits of lower marginal corporate income tax rates, and would be compounded by the increase in capital gains tax rates.

Incentives for capital formation were introduced in an effort to stimulate economic growth. One reason there was such widespread support for expanded economic incentives in the 1981 Act was the widely held view that the tax structure discriminated against saving and capital formation. In particular, the nonindexation of the tax structure, particularly the use of original rather than replacement cost in the calculation of depreciation for tax purposes, resulted in inflation discouraging capital formation. As an offset to this distortion, depreciation was accelerated for tax purposes. Now that inflation has been reduced so substantially, it might be argued that the case for the increased investment incentives is no longer strong. On the other hand, the high deficit fiscal policy over the past four years has driven up real interest rates, offsetting substantially the investment incentives in the 1981 tax act. We could move back to reduced specific incentives for capital formation if we lowered the deficit without the prospect of reduced capital formation. Thus Gramm-Rudman is an important complement to tax reform, permitting increased efficiency without lower capital formation.

ECONOMIC GROWTH AND CAPITAL FORMATION: TWO CAVEATS

I do not want to overstate the value of tax incentives in promoting capital formation and economic growth. Let me therefore note two important limitations that need to be understood. First, increased investment incentives, as they stimulate investment, also raise interest rates. In the long run, the induced rise in interest rates substantially dampens and may even fully offset the effect of tax incentives on investment. In fact, in the long run, tax incentives only stimulate capital formation if the induced rise in interest rates stimulates saving. Given the empirical evidence that saving is not very sensitive to interest rates, investment incentives have only a temporary stimulative effect on investment, an effect which may nevertheless persist for a decade or more.

Second, even if investment incentives permanently lower the cost of capital to firms, this results only in a once and for all increase in the desired capital stock, not a permanently higher rate of increase in the capital stock. A faster rate of capital formation and economic growth will be observed during the transition to the higher desired capital stock. Once the adjustment is complete, however, the rate of capital formation and economic growth will be the same as it was prior to the introduction of the tax reform.

Despite the fact that investment incentives do not permanently raise the rate of capital formation, the do have near-term affects raising both the rate of capital formation and the rate of economic expansion. Hence, curtailing those preferences will slow the economy and reduce the rate of capital accumulation for a decade or more.

SIMULATION RESULTS USING THE WASHINGTON UNIVERSITY MACROECONOMETRIC MODEL

To study the macroeconomic effects of tax reform, simulations were run with the Washington University Macroeconometric Model. This model has previously been used to study FAIR and FAST, Treasury I and II, and Gramm-Rudman. A series of simulations are run with differing assumptions about fiscal and monetary policy. The key issues are: (1) Is Gramm-Rudman implemented along with tax reform? (2) Is tax reform accompanied by an easing of monetary policy to offset the otherwise restrictive impact of tax reform on aggregate demand? (3) Is Gramm-Rudman accompanied by an easing of monetary policy to offset its otherwise restrictive impact on aggregate demand?

Implementing H.R.3838 in the Simulations

It is assumed that tax reform is not implemented until 1987, with the tax rate reduction provisions not introduced until the third quarter of 1987, and the remaining provisions introduced at the beginning of the year. This schedule seemed more plausible to us that the implementation dates in HR 3838. The relevant features of HR 3838 for the simulations reported below are:

(1) **The decline in the average personal tax rate**: The average personal tax rate is reduced 5.5%%, effective third quarter 1987. This yields an increase in disposable income and an increase in consumption expenditures.

(2) **The decline in average marginal personal tax rates:** The average marginal personal tax rate is reduced by 11%, effective third quarter of 1987. This raises the after-tax interest rate to households, discouraging expenditures on consumer durables and home purchases, but has a minimal effect on overall consumer expenditures and hence saving. The decline in the marginal personal tax rate also raises the real after-tax wage rate and has a small positive effect on labor force participation.

(3) **The increase in the maximum tax rate on capital gains:** The dividend exclusion is reduced to 50% in 1987 and to 42% thereafter. This increases that maximum tax rate on capital gains, increases the equity yield firms must pay to finance investment, raising the cost of capital and discouraging investment.

(5) **The decline in the marginal corporate tax rate:** The marginal corporate income tax rate is reduced from 46% to 36%, effective, third quarter 1987. This tends to lower the cost of acquiring capital to firms and stimulate investment.

(6) **Rescinding the investment tax credit:** The ITC is eliminated, effective first quarter 1987. The ITC applies to equipment only. However, some of what is classified as structures in the NIPA is classified as equipment for tax purposes. Therefore elimination of the ITC has a big impact raising the cost of acquiring equipment, but it also has a small effect raising the cost of acquiring structures. Hence, rescinding the ITC discourages investment in both equipment and structures, but also discourages equipment relative to structures.

(6) **Replacing ACRS with IDS:** A new set of rules for depreciation of capital assets, called the Incentive Depreciation System (IDS) would replaces the current

Accelerated Cost Recovery System (ACRS), effective in the first quarter of 1987. IDS is less generous for both equipment and structures, but is dramatically less generous for structures. This raises the cost of acquiring capital and discourages investment. The depreciation schedule for overall business equipment changes from: (a) 150% declining balance with a switchover to straight line, a half year convention, and a recovery period of 4.6 years, to (b) 200% declining balance with a switchover to straight line, a half year convention, and a recovery period of 9.2 years. The depreciation schedule for overall nonresidential structures changes from (a) 150% declining balance with a switchover to straight line, a half-year convention, and a recovery period of 18 years, to (b) straight line, a half year convention, and a recovery period of 30 years. The depreciation schedule for overall residential structures changes from (a) 175% declining balance with switchover to straight line and a recovery period of 30 years to (b) straight line and a recovery period of 30 years. There is an indexation provision, but it allows only very partial indexation for the excess of inflation over 5% per year. For the simulations reported below, this is the same as zero indexation since inflation remains below 3 1/2%.

(7) **The 10% exclusion of dividends:** This is implemented by reducing the average corporate tax rate. It reduces taxable profits, raises dividends, and increases equity values.

The simulations make no allowance for efficiency gains. They do, however, provide an estimate of the net effects of (1) the incentive effects of lower marginal and personal tax rates and (2) the disincentives effects of repealing or curtailing tax preferences for investment.

The simulations also fail to take full account of the way in which the provisions of H.R.3838, like Treasury I and II, substantially discourage the purchase of real assets to generate tax losses, and subsequent resale of such assets once the tax losses are exhausted to another party who then benefits from the same rapid depreciation and resells, etc. Such "churning" of real assets, principally multi-family housing and commercial structures, is a principal tax shelter under existing tax laws. It is one of the great assets of tax reform that, by slowing the front-loading of depreciation, such churning is discouraged, because this is one of the most obvious examples of decisions motivated by tax rather than by economic or market considerations. It should be understood, however, that by eliminating such churning of real assets, tax reform discourages the flow of funds into the previously favored activity. Hence, the impact on multi-family residential construction and nonresidential structures in the simulations reported below may be somewhat underestimated.

The Methodology Underlying the Simulation Results

The basic procedure is to begin with a base simulation which includes neither tax reform nor Gramm-Rudman. Then tax reform reform and Gramm-Rudman are added, with and without monetary accommodation, in a series of policy simulations. Each policy simulation is then compared to the base case to determine the impact of the specific policy change implemented on the economy.

An accommodated policy change means that monetary policy is assumed to be altered to offset the impact of the fiscal policy change on the path of real GNP. Unaccommodated policy changes will involve both changes in the level and the composition of GNP. Accommodated policy changes will involve only changes in the composition of GNP. Accommodated policy is a more optimistic assumption. However, it presumes a perfect coordination of monetary and fiscal policies which is possible via repeated computer simulations, but difficult in practice. Accommodated and unaccommodated case provide a useful range of results, from the most optimistic to the most pessimistic.

Summary of the Simulations and Findings

The **base simulation** assumes that neither tax reform nor Gramm-Rudman is implemented. In this simulation, the economy grows at 3.2 percent per year and inflation remains between 3% and 3 1/2% per year. Interest rates decline gradually, as does the unemployment rate. The federal budget deficit widens continuously. Money supply growth is initially over 7%, then declines to a 5% rate. The baseline simulation does not represent a forecast. It is an analytical construct that serves only as a basis for comparison of the results generated by the implementation of tax reform and Gramm-Rudman. We have constructed this baseline to be roughly consistent with the CBO budget assumptions in the absence of Gramm-Rudman and the average forecasts of long-term economic performance recorded in a recent survey of economists reported in Blue Chip Economic Indicators.

Table 1 compares the performance of several economic variables in the policy simulation with their pattern in the base simulation. The variables included are: (1) the percentage difference between real GNP in 1991 in the policy simulation compared to the base simulation; (2) the difference in the average growth rate of real GNP over the period 1986 through 1991 in each policy simulation compared to the base simulation; (3) the difference in the average rates of growth in the stock of business capital (and equipment and structures separately) and residential housing stocks (single family and multi-family units separately); and (4) the difference in the business capital stock (and equipment and structures stocks separately) in 1991; (5) the difference in the average rate of growth in residential construction over the period 1986 through 1991; (6) the difference in the average AAA corporate bond rate over the period 1987 though 1991; and (7) the difference in the average unemployment rate over the period 1987 though 1991.

Policy simulation #1 assumes that non-accommodated tax reform (specifically H..R.3838) is implemented without Gramm-Rudman. It provides a measure of the direct effects of tax reform without any change in monetary policy (money growth is maintained at the same rate as in the base simulation) and without any other policy change implemented simultaneously. H.R.3838 sets in motion two conflicting forces. On the one hand, the reduction in personal tax rates raises personal disposable income and spurs consumption spending. On the corporate side, however, the reduction in the corporate tax rate is swamped by the effects of rescinding the investment tax credit and switching to a less generous depreciation schedules. The effect is to substantially raise the marginal rate of taxation on new business investment spending, to slow investment, and retard GNP growth. Real GNP is 2.2% lower in 1991 compared to the base case, the growth rate in real GNP is 1/2 percentage point lower over the period 1986 through 1991 compared to the base case, the stock of business capital is 4.4% lower in 1991 (with the stock of equipment 7.3% lower and the stock of structures 1.7% lower).

Policy simulation #2 provides a more optimistic assessment of the impact of tax reform when we assume a more stimulative monetary policy maintains output growth similar to that in the base year; nevertheless, tax reform alters the

Table 1
Economic Effects of Tax Reform
Percent Difference from Baseline Simulation
(unless otherwise noted)

	No Gramm-Rudman		Full Gramm-Rudman	
	without Fed Accomodation (Policy 1)	with Fed Accomodation (Policy 2)	without Fed Accomodation (Policy 4)	with Fed Accomodation (Policy 3)
Real GNP in 1991	-2.2	0.0	-5.8	0.0
Average Growth in Real GNP 1987-1991 (percentage points)	-0.5	0.0	-1.2	0.0
Average Growth in Bus. Capital Stock 1987-1991 (percentage points)	-0.9	-0.7	-1.3	-0.4
Equipment	-1.6	-1.2	-2.1	-0.9
Structures	-0.4	-0.2	-0.6	0.0
Real Business Capital Stocks in 1991:	-4.4	-3.2	-6.1	-2.0
Equipment	-7.3	-5.5	-9.6	-4.0
Structures	-1.7	-0.9	-2.8	-0.1
Average Growth in Residential Inv. 1987-1991 (percentage points)	0.0	1.4	-0.7	2.9
AAA Corporate Bond Rate, average 1987-1991 (percentage points)	-0.2	-0.4	-0.8	-1.5
Civilian Unemployment rate, average 1987-1991 (percentage points)	0.6	0.0	1.9	0.2

composition of output, with less investment and residential construction, relative to the base case. In this simulation, the rate of monetary growth is raised relative to the base case, lowering interest rates enough to provide an offset to the restrictive effect of tax reform on GNP. There remain some important compositional effects of tax reform. Business fixed investment over the period is still slower, but the decline in the business capital stock is not as steep as in the case of nonaccommodated tax reform. Real GNP is unchanged in 1991 from what it would have been in the absence of tax reform, but the stock of business capital is still 3.2% lower in 1991, again with most of the decline in the stock of equipment.

Policy simulation #3 provides the most optimistic overall assessment of tax reform, combined accommodated tax reform with accommodated Gramm-Rudman. The net result is a substantial decline in nominal and real interest rates and a still smaller effect on capital formation. Equipment spending is still depressed, but the stock of structures is unchanged at the end of the period from what it would have been in the absence of tax reform and Gramm-Rudman. As in the previous simulation, real GNP is unchanged in 1991 compared to the base case. but the stock of business capital is 2% lower. The stock of equipment is 4% lower, while the stock of structures is unchanged from what it would have been in the absence of both fully accommodated tax reform and Gramm-Rudman.

Policy simulation #4 provides the most pessimistic assessment of tax reform, combining nonaccommodated tax reform and nonaccommodated Gramm-Rudman. Output declines substantially relative to the base case and despite lower interest rates, capital spending is sharply lower than the base case. This simulation reflects the compounding of the downside risks associated with each of tax reform and Gramm-Rudman. Real GNP is 5.8% lower in 1991 in this case, the growth rate in real GNP is full percentage point lower on average over the 1986 through 1991 period, and the business capital stock is 6.1% lower in 1991 than in the absence of both tax reform and Gramm-Rudman.

Policy simulation #3 suggests that tax reform and Gramm-Rudman are nicely complementary in the long-run. Gramm-Rudman allows tax reform with its increased burden on corporate income and rolled back investment incentives to be implemented without seriously undermining capital formation in the long run.

Policy simulation #4 suggests, however, that there is a serious danger of a severe and prolonged downturn in attempting to implement both tax reform and deficit reduction simultaneously.

<u>Rental Price Effects of Tax Reform</u>

The effect of tax reform and Gramm-Rudman on capital formation results from their effect on the cost of capital to firms, measured by rental prices that reflect the cost of owning, operating and maintaining a piece of capital, allowing for the price of the capital good, the rate of depreciation in real value (economic depreciation), the associated real financing costs, the relevant personal and corporate tax rates, and related tax considerations including the rules governing depreciation allowances for tax purposes (tax depreciation), investment tax credits, and the treatment of both interest expense and capital gains income. Since the rental price of investment reflects the true economic cost of investment in capital, an increase in the rental price discourages capital formation.

Table 2 reports the impact on the rental price of various capital goods associated with tax reform with and without monetary accommodation and simultaneous implementation of Gramm-Rudman. The percentage change in the various rental prices is shown both for 1988, the first full year of implementation of tax reform and in 1991, the last year of the simulation. First, consider the nonaccommodated tax reform case, as this provides the most direct measure of the impact of tax reform alone on capital costs.

Table 2
Effects of Economic Policy Shifts on
the Rental Price of Investment
Percent Change from Baseline Simulation

	Business Capital				Residential Structures			
	equipment		structures		single-family		multi-family	
	1988	1991	1988	1991	1988	1991	1988	1991
Policy #1 Tax Reform without accomodation by the Fed; No Gramm-Rudman...........	18.3	17.0	9.2	5.6	2.1	0.0	6.5	2.9
Policy #2 Tax Reform with accomodation by the Fed; No Gramm-Rudman...........	17.3	13.4	7.8	2.1	1.1	-5.4	4.7	-1.9
Policy #3 Tax Reform with accomodation by the Fed; Full Gramm-Rudman	12.2	7.2	-0.7	-8.5	-8.4	-17.2	-5.6	-16.2
Policy #4 Tax Reform without accomodation by the Fed; Full Gramm-Rudman...........	17.3	13.9	6.4	-4.9	0.0	-10.8	3.7	-8.6

Note the dramatic rise in the rental price of equipment, 18.3% in 1988 and 17.3% in 1991. The increase in the rental price is lower in 1991 because the decline in aggregate demand associated with the initial increase in the rental price lowers interest rates, partially offsetting the initial increase in the rental price. The rental price for structures also increases sharply, by 9.2% in 1988 and 5.6% in 1991. The sharper impact on equipment reflects the effect of rescinding the investment tax credit which can be taken on equipment but not on most structures. While Treasury II also increased the rental price of equipment, its effect was about half as large as H.R.3838, due primarily to the indexation of depreciation in Treasury II. Treasury II would also have slightly *lowered* the rental price for structures initially, again a reflection of the indexation of depreciation in that tax reform package.

H.R.3838, on the other hand, impacts more modestly on residential structures than was the case of Treasury II, due to the inclusion of the exemption of state and local property taxes in H.R.3838 and its repeal in Treasury II. As a result, the rental prices for single family homes initially increases quite modestly for H.R.3838; the larger increase for multi-family homes reflects the assumption that these are owned by businesses and therefore affected by the less generous tax treatment of depreciation in H.R.3838.

Table 2 also details the way in which accommodation lowers the increase in rental prices for equipment and structures and how the simultaneous implementation of Gramm-Rudman further reduces the effect on rental prices. In the case where both tax reform and Gramm-Rudman are fully accommodated by monetary policy, the rental price of equipment still rises by 12.2% initially, but the rental price of both nonresidential and residential structures actually decline.

CONCLUSIONS AND RECOMMENDATIONS

Tax reform and deficit reduction must be studied together, not in isolation. They are long-term complements, but each has serious near-term downside risks, risks that would be compounded by attempting to implement both simultaneously.

Tax "reform" is progressively being whittled down to more moderate tax "revision". The gains in simplicity and economic neutrality are all more modest than initially hoped. Tax reform is still desirable, but it is not so pressing a problem as dealing with the deficit.

The deficit still needs to be dealt with. The passage of Gramm-Rudman is a statement of serious intent only, but, until Congress and the Administration agree on a tax increase, it lacks credibility. I urge Congress to allocate its scare time first to assuring a smooth implementation of deficit reduction. Once the economy has adjusted to the initial phase of deficit reduction, tax reform should be reconsidered and implemented. In the environment of lower deficits and more accommodative monetary policy, the curtailment of investment incentives will be easier to implement and will not seriously slow capital formation from what it would have been in the absence of both tax reform and deficit reduction. It should be understood, however, that adding tax reform along the lines of H.R.3838 to Gramm-Rudman will offset, perhaps more than completely, the potential stimulus to capital formation associated with deficit reduction.

There is one major change I would urge that Congress make in the treatment of depreciation. Full indexation of depreciation, as incorporated in Treasury I and II, should be part of tax reform. Reintroducing indexation would provide an opportunity for reducing the dramatic increase in the cost of capital associated with H.R.3838. By reducing the impact of tax reform on capital formation, such a modification would also allow the combined effect of Gramm-Rudman and tax reform to strengthen rather than slightly impair capital formation.

STATEMENT OF HARVEY GALPER, PH.D., SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Dr. GALPER. Thank you, Mr. Chairman and members of this committee. It is a pleasure to be here to present my views on H.R. 3838, the Tax Reform Act of 1985. As requested, my testimony will focus on the economic effect of this legislation, with special emphasis on capital formation and international competitiveness.

There are three main points which I wish to make today. First, on balance, H.R. 3838 is sound legislation and good tax policy. A general broadening of the tax base and reduction in rates constitutes a desirable roadmap for future tax changes. The end result would be a fairer tax system and a more efficiently operating economy. Although there are reasons to have reservations about particular elements of the plan, again, on balance, it deserves your support.

Second, the goals of increasing the Nation's rate of capital formation and improving the international competitiveness of U.S. industry are legitimate and important. These goals should be addressed by appropriate policy measures; but in my view, structural revisions of the U.S. tax system are not the most effective instrument for achieving these goals. What is needed is an increase in the abysmally low rate of national savings in the country today.

My third point carries the certain risk of repeating a message that you are no doubt sick to death of hearing; but I will say it, anyway. The most important actions that can be taken to deal with both domestic capital formation and international competitiveness is to reduce the size of the annual Federal budget deficit and to adopt a complementary easing of monetary policy. But deficit reductions cannot be accomplished through expenditure cuts alone. Tax increases are needed as well. It is necessary, therefore, to deal in a coordinated fashion with both of the main deficiencies of the current tax system. It does not raise enough revenue, and it is needlessly inefficient and inequitable.

The remainder of my statement will elaborate on these points, but let me begin with just a brief overview of some of these savings and investment flows that I was referring to a moment ago. The components of saving and investment are shown in table 1 at the end of my testimony. The point to be emphasized here is that private savings has been fairly stable over a long period of 35 years. The reduction in our national saving rate is virtually solely attributable to the Federal Government deficit, particularly in recent years, where over 60 percent of private saving has been absorbed by the Government deficit, thereby leaving us with a very low rate of overall savings. On the investment side, domestic investment has not been the source of the problem. The problem is that we have had negative net foreign investment.

In other words, in recent years the Nation has been on a consumption binge. The simple and distressing fact is that when all components of saving are considered, we as a Nation have been saving at about half our normal rate--3.5 to 4 percent of the net national product. The higher levels of domestic investment have been sustained by drawing upon the saving of the rest of the world; and this in turn gives rise to the trade deficit, an appreciated dollar, high priced U.S. goods in foreign markets, cheap foreign goods in the United States, and general difficulties for U.S. firms competing in global markets. In short, a decline in international competitiveness.

In an increasingly interrelated global economy, international competition and domestic capital formation are inextricably linked. The only way to successfully reduce the trade deficit, that is to increase international competitiveness, and to increase domestic investment is to increase at the same time the national saving rate. And the only sure way to do this is to reduce the deficit.

Tax cuts to increase private savings will not work; and the experience with tax cuts since 1981 should provide ample evidence of this. Since 1981, marginal tax rates have been cut dramatically. Real pretax rates of return on financial assets have been high. Individual retirement accounts have been greatly liberalized. And yet, the private saving rate declined. So, what we need to do to increase national savings, in a word, is to reduce the deficit. Now is there a role for tax policy in all of this? I think there is a role, but it is more of a supportive role.

There are two important elements of what tax policy should do. It should first support the free enterprise system so that saving, investment, and labor supply decisions to the maximum degree are based on market signals of profitability rather than Government-designed tax incentives. And second, it should have a tax base as comprehensive as possible so that marginal tax rates can be as low as possible and intrude on economic decision making as little as possible.

From this point of view, I would say that H.R. 3838, the House bill, is a decided improvement and a very good start on a broad-based lower rate system. And yet, there have been many criticisms of H.R. 3838, particularly with respect to capital formation, economic growth, and international competitiveness. Are these criticisms valid?

Much of the criticism stems from the substantial increase in corporate revenues projected over the period 1986 to 1990. In table 2 of my testimony, I point out the sources of these increases in corporate tax revenues. I think it is important to look at what these sources are quite carefully because if you compare the depreciation and investment tax credit changes on the one hand with the rate cuts on the other, you find that about 75 percent of the revenue gain from tightening depreciation rules and eliminating the investment tax credit is offset by the corporate rate cut and changes in dividend taxation. The net effect of these major provisions is a five-year revenue loss of only $29 billion or only a relatively small amount of the total increase in corporate tax revenues. The net revenue gain from these provisions amount to only 20 percent of the total increase in corporate revenues, and these are the provisions that should have the main effect on U.S. industry.

The other sources of increased revenue are primarily directed to changing the tax rules for selected industries that now enjoy rather large tax benefits. What are some of the specific criticisms of H.R. 3838 and what would be the response to them?

The first is that H.R. 3838 could cause a recession. My response here is that, in the short run, the net output effect of a shift of income from corporations to households is likely to be small and, as has already been indicated, can be readily offset by monetary policy. The second criticism is much more important. It is that H.R. 3838 will cause substantial declines in long-term capital formation because it will increase the cost of capital or the effective tax rate on new investment. There are several responses here. The first crucial point is that current law taxes income from different kinds of investment at widely differing rates. For example, equipment that is eligible for the 10 percent investment credit has an effective corporate tax rate under current law that is actually negative at moderate rates of inflation due to the combination of ACRS and the investment credit.

Any tax reform that equalizes rates of tax will work to the advantage of some kinds of assets and to the disadvantage of others. If we remove negative tax rates, if we remove these subsidies, obviously we would expect the cost of capital for these particular assets to increase. The question is: What is happening to the overall cost of capital? What is happening there is a matter of some difference of opinion, although my own view is that the House bill probably does increase effective tax rates on capital income to some degree when both corporate and individual taxes are taken into account. But even here, we can overstate this effect. For example, there is no reason to take current law as the starting point. If we adopted the changes in H.R. 3838, this would not increase corporate tax rates relative to historic standards.

Second, as noted above, to the extent that the overall increase in corporate taxation is accompanied by greater uniformity in the tax treatment of various assets in industry, the efficiency or quality of investment improves. This in itself will tend to offset any potential loss of aggregate investment induced by higher capital costs.

Third, even the tendency toward a higher overall cost of capital can be offset by policies to reduce the deficit and lower interest rates. For example, in the period from 1979 to 1984, 93 percent of the growth in business equipment spending was concentrated in two assets: business automobiles and computers that received no net tax reduction under the 1981-82 act.

Let me stop here and I will just conclude very briefly by saying that the problem with both capital formation and international competitiveness is not the structure of our tax system, but merely insufficient savings. The solution is to both restructure our tax system and to provide a sufficient level of savings in this country.

Thank you, Mr. Chairman.

The CHAIRMAN. Dr. Galper, thank you. We will go in the order of first-come, first-served, and I have Senators Bentsen, Packwood, Grassley, Mitchell, Baucus, Long, Danforth, and Wallop. I am going to put myself at the end of the list; so Senator Grassley, you will go after Senator Bentsen. Senator Bentsen.

[The prepared written statement of Dr. Galper follows:]

Statement

of

Harvey Galper*

Before the
Committee on Finance
United States Senate

on

H.R. 3838
The Tax Reform Act of 1985

February 5, 1985

*Mr. Galper is a Senior Fellow at the Brookings Institution. The views expressed in this statement do not necessarily reflect those of Brookings staff members or the officers and trustees of the Brookings Institution.

Mr. Chairman and Members of this committee:

It is a pleasure to be here to present my views on H.R.3838, the Tax Reform Act of 1985. As requested, my testimony will focus on the economic effects of this legislation with special emphasis on capital formation and international competitiveness.

There are three main points which I wish to make today. First, on balance, H.R.3838 is sound legislation and good tax policy. A general broadening of the tax base and reduction in rates constitutes a desirable road map for future tax changes. The end result will be a fairer tax system and a more efficiently operating economy. Although there are reasons to have reservations about particular elements of the plan, on balance, it deserves your support.

Second, the goals of increasing the nation's rate of capital formation and of improving the international competitiveness of U.S. industry are legitimate and important. These goals should be addressed by appropriate public policy measures. In my view, however, structural revisions of the U.S. tax system are not the most effective instruments for achieving these goals. What is needed is an increase in the abysmally low rate of national saving.

My third point carries the certain risk of repeating a message that you are no doubt sick to death of hearing, but I'll say it anyway. The most important actions that can be taken to deal with both domestic capital formation and international competitiveness is to reduce the size of the $190 to $200 billion annual federal budget deficits and to adopt a complementary easing of monetary policy. But deficit reductions cannot be accomplished through expenditure cuts alone; tax increases are needed as well. A major deficiency of H.R.3838, in my view, is that it does not raise sufficient revenues to meet our needs as a nation. Deficit reduction to increase the national saving rate is the most effective means of dealing with capital formation and international competitiveness.

I would, therefore, urge this committee to take the opportunity for tax restructuring that is now before you and use it for raising revenues as well. It is necessary to deal in a coordinated fashion with both of the main deficiencies of the current tax system: it does not raise enough revenue and it is needlessly inefficient and inequitable.

All of us recognize that the constraints on raising additional revenues at the present time are severe, if not overwhelming. But there is simply no escaping the fact that if the federal government continues to run large budget deficits at the same time as households and corporations continue to generate low rates of private saving, the long-run prospects for economic growth and productivity will be greatly diminished. In a word, if the underlying fiscal structure is seriously out of balance, no amount of accelerated depreciation or investment tax credits will compensate. The solution is not to put our tax system out of order to offset a fiscal system that is also out of control. The solution is to restore order to both houses.

The remainder of my statement will elaborate on these points, but let me begin with a broad overview of our current economic situation that emphasizes the interrelatedness of federal budget deficits, international competitiveness and capital formation.

Saving and Investment Flows

Any discussion of saving and investment must begin with the observation that the nation adds to its productive stock of capital in each year by net investment--that is, investment net of the annual depreciation or wearing out of existing assets. It is, of course, an accounting identity that net national saving must equal net national investment in each year.

But the sources of saving and investment are quite different. Saving can come from private sources--household saving and business retained earnings--and government sources--federal and state and local surpluses (deficits are negative saving). Investment can also take two forms: domestic investment that U.S. firms make in this country or foreign investment, investment that we as a nation make outside the country. Foreign investment can also be negative in which case foreign countries on balance invest more in the United States than U.S. citizens and firms invest abroad. In such a case, foreign-owned investments bring some benefits to this country, but most of the returns accrue to the advantage of the foreign owners.

A further point to note is that net foreign investment equals the current account balance in our dealings with the rest of the world: that is, U.S. exports of goods and services to the rest of the world minus imports of goods and services from abroad. The intuition behind this equality is that to the extent that we export more than we import, we are financing the consumption of citizens of other countries by investing in those countries. In that case, net foreign investment is positive, and our domestic saving is invested abroad. In contrast, when imports exceed exports, net foreign investment is negative, other countries finance our imports by investing in the United States, and their saving flows here.

The identity that the components of saving equal the components of investment is shown in table 1, where data are presented for the last 35 years as shares of net national product (GNP minus depreciation). Four things stand out in this table.

(1) Net private saving--household and business saving combined--has been relatively stable at 8.5 to 9.5 percent of NNP for long periods of time, rarely varying by more than 1 percent of NNP.

(2) The main factor influencing net national saving is government saving, strongly negative in recent years because of the federal budget deficit.

(3) Net domestic investment has also been fairly stable at about 7.5 percent of NNP for long periods of time, although falling more recently.

(4) The main source of variation in net national investment in recent years has been net foreign investment, which was strongly negative, particularly in 1985 as the current account deficit reached $111 billion.

In recent years, in other words, the nation has been on a consumption binge. The simple and distressing fact is that when all components of saving are considered, we as a nation have been saving at about half our normal rate, less than 3.5 to 4 percent of NNP. The higher levels of domestic investment--6.5 percent of NNP--have been sustained by drawing upon the saving of the rest of the world. And this, in turn, gives rise to the trade deficit, an appreciated dollar, high-priced U.S. goods in foreign markets, cheap foreign goods in the United States, and general difficulties for U.S. firms competing in global markets--in short, a decline in international competitiveness.

Table 1 thus highlights three concerns with current policy.

- First, to maintain current domestic investment in the face of low national saving, the nation must rely on the continued willingness of other countries to invest in the United States. If they become reluctant to do so, domestic investment cannot be sustained.
- Second, the nation's problem has not been insufficient domestic investment as much as insufficient saving, and the primary cause here has been the government deficit.
- Third, the inevitable consequence of any country that wishes to invest more domestically than it is willing to save domestically is

a trade and current account deficit in the balance of payments -- and a loss of international markets.

These results are purely a matter of accounting and arithmetic. As long as we go on investing 7 percent of our NNP in plant, equipment, inventories, and housing, and saving only 3 to 4 percent of our NNP, we will be running a current account deficit of 3 to 4 percent of NNP. This arithmetic will hold for any other country in the world, as well. If Japan saves as a nation <u>more</u> than it invests, it will have to run a trade and current account surplus in its dealings with the rest of the world. If the United States saves <u>less</u> than it invests, it will have to run a trade deficit.

In an increasingly interrelated global economy, international competition and domestic capital formation are inextricably linked. The only way to successfully reduce the trade deficit (that is, to increase international competitiveness) <u>and</u> to increase domestic investment is to increase at the same time the national saving rate. To attempt to increase domestic investment without increasing domestic saving will attract more <u>foreign</u> saving and make the trade balance and international competitiveness worse. To attempt to cut the trade deficit without increasing domestic saving will diminish the foreign investment coming into the country and reduce domestic capital formation.

In light of these saving and investment linkages, it is necessary at this point to dispel one notion about what tax policy cannot do. There may be some who would agree with the view that the country suffers less from insufficient investment than from insufficient domestic saving to finance this investment, but who would then claim that the way to stimulate more private saving is to provide tax incentives for such saving, by cutting taxes on capital income in order to increase the after-tax return of those doing the saving. This point of view may appear to have some connection to the two problems of international competitiveness and capital formation, but it is also wide of the mark.

First, if we do not at the same time raise taxes in other ways to offset the lower taxes on capital income, we are merely increasing the federal deficit and thereby reducing, not increasing, national saving. Second, analysis of the policies we have been pursuing since 1981 should teach us that private saving is just not very responsive to increases in real after-tax returns.[1] It would hardly have been possible to plan a better experiment to test the responsiveness of private saving. Since 1981, marginal tax rates have been cut drastically, particularly for those in the highest income levels. Real pretax rates of return on financial assets have been maintained at very

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1. For a discussion of this issue, see Barry P. Bosworth, "Statement Before the Joint Economic Committee, U.S. Congress," September 17, 1985 and "The U.S. Economy in the 1980s," mimeo.

high levels, and individual retirement accounts have been greatly liberalized. This latter source alone caused the inflow of funds to IRAs to increase from less than $5 billion in 1981 to over $32 billion in 1983. And yet, the private saving rate declined, even when the effects of the business cycle are removed.

Part of the reason may be that saving responds to changes in real after-tax returns only with long lags. Part of the reason may be that the saving incentive from the liberalization of IRAs was poorly designed in that individuals could take advantage of the tax break without doing any net saving, either by switching funds into an IRA from other sources or by borrowing to invest in IRAS, thereby realizing both an interest deduction and the IRA deduction. But whatever the reason, private saving has simply not responded.[2]

But is there no role at all for tax policy, aside from raising more revenue? Let me turn to this subject next.

What Can Tax Policy Do?

Although tax policy cannot cure all the ills traceable to fiscal irresponsibility, good tax policy is essential for establishing a sound climate for long-term business planning and investment. Such a policy

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2. As one who has supported a progressive, expenditure-based tax as a desirable model for tax reform, I favor such an approach on the grounds of equity and efficiency, but not as a means to increase total saving. See Aaron and Galper, Assessing Tax Reform, especially chapter 4.

should be designed to:

- provide an equitable distribution of tax burdens levied according to a valid measure of ability to pay.
- support the free enterprise system, so that saving, investment and labor supply decisions to the maximum degree are based on market signals of profitability rather than government-designed tax incentives.
- provide a stable and certain environment for long-term business planning, so that today's decisions are not undone by tomorrow's change in tax rules.
- be as comprehensive as possible, so that tax rates can be as low as possible.
- be reasonably comprehensible and administrable, so that both the taxpayer and the tax collector understand the system.

A few implications of these criteria should be pointed out here. One implication is that as long as there is uncertainty as to how tax revenues may be raised in the future, the current system will disrupt some business planning. It is, therefore, necessary to deal decisively with the revenue question in this context as well. Another implication is that the interaction of the current system with inflation, which renders some tax burdens arbitrary and unpredictable, is also not conducive to long-term business decision-making. A third is that statutory distinctions across assets and industries with respect to depreciation and cost recovery rules can reduce economic efficiency. A fourth is that base-broadening should be the key operating rule in tax reform. A fifth is that appropriate income management rules for all assets are a far better solution than a complex, and indeed, incomprehensible minimum tax.

If tax restructuring is guided by these principles, there is quite enough good work to be done.

Evaluation of H.R.3838

On balance, under these criteria, a fairly high grade should be given to the House bill. On the fairness principle alone, the bill is to be commended in reducing the tax burden on our lowest income families and in removing 6 million taxpayers from the tax roles. In terms of the other criteria the evaluation is mixed, but still positive. First, the need to increase revenues has not been addressed. Also, since the treatment of capital income remains unindexed, inflation and the tax system can interact in complex and unpredictable ways. At least with respect to the depreciation rules, the more complete indexing that the President initially proposed is far preferable to the token provisions in the House bill that would index depreciation deductions to the extent of one-half of inflation in excess of 5 percent.

However, strongly on the plus side is the application of more uniform depreciation and income measurement rules across assets and the removal of tax preferences from a range of activities as diverse as tax-exempt bonds, financial institutions, tax shelters, defense contracting, and assets with long construction times. Also, to be applauded generally is the search for ways of broadening the tax base in order to lower tax rates. In some respects, base broadening fell far short of what could have been accomplished. Surely, some part of the deduction for state and local taxes can be eliminated and we do not need to continue to provide incentives to take labor compensation in the form of in-kind fringes rather than as cash. Also, many activities such as second homes continue to receive unjustified and inefficient subsidies. Nonetheless, considerable progress has been made in reducing or eliminating unnecessary tax preferences.

The minimum tax, in my view, is a flawed vehicle for tax reform due to its excruciating complexity, and perhaps greater progress could have been made as well toward integrating corporate and individual taxes. The 10 percent dividend deduction, phased in over ten years, is a limited beginning indeed.

But many of my negative assessments reflect the fact that more could have been done. Compared to current law, and especially in view of the constraint of revenue neutrality, the bill, if enacted, would be a decided improvement.

The Council of Economic Advisors and the Treasury have also indicated that the bill is an improvement over current law and that the economic effects are, on balance, positive. These effects would include: (1) a more efficient allocation of resources due to the reduction of tax preferences across industries, assets and activities;

(2) increases in labor supply induced by lower marginal tax rates; and (3) improvements in tax compliance induced by lower tax rates.

Nonetheless, many in the business community are highly critical of H.R.3838 as devastating to capital formation, economic growth, and international competitiveness. What are the bases for these views and are they valid?

Are the Criticisms of H.R.3838 Correct?

The criticisms of H.R.3838 are based on several independent kinds of analysis, but they all stem from the substantial increase in corporate revenues projected over the period 1986-1990. These estimates are shown in table 2.

The increase in corporate taxes amounts to $139 billion between 1986 and 1990, or roughly $28 billion per year. But about 75 percent of the revenue gain from tightening depreciation rules and eliminating the investment tax credit (line 3) is offset by the corporate rate cut and changes in dividend taxation (line 6). The net effect of these major provisions is a 5-year revenue increase of only $29 billion, or less than $6 billion per year (line 7). It is these major provisions that should have the primary effect on investment in the nation's industrial corporations. The net revenue loss from these provisions amount to only about 20 percent of the total increase in corporate receipts.[3]

In contrast, the major corporate tax increases result from changes in the tax rules for selected industries--financial institutions, insurance, energy, and production under long-term contracts. These sectoral impacts should not be dismissed as minor or inconsequential. But the questions to be addressed here are different than whether the cost of capital has been increased in a fundamental way for major U.S. industrial firms.

The issues, rather, are the following: (1) Do the new rules generally result in a more uniform and even-handed taxation of income across sectors of the economy? (2) Do these rules provide adequate opportunity for the effected sectors and industries to adjust? If the answers to these questions are "yes," then the changes will result in a more efficient and productive economy. On the other hand, if the adjustments are felt to be too abrupt, then the alternative is to ease the period of transition, but not to lose the ultimate benefits of a more neutral tax system.

With this background in mind some of the more specific criticisms of H.R.3838 may be addressed.

Criticism #1: The enactment of H.R.3838 will throw the economy into a recession.

Response: This frightening criticism, fortunately, is easily

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3. There are also a few other small revenue losers, such as the research and experimentation credit and the simplified LIFO provisions for small business.

dismissed. At one level, it is hard to see how a switch of income from corporations to individuals -- with no resulting net increase in tax revenues -- could have a serious adverse affect on total spending in the economy in the short-run. At the very least there are two offsetting effects: a short-run increase in consumer spending from higher disposable income and a decline in corporate investment outlays from both reduced corporate cash-flow and lower long-term profitability of investment. The net effect is likely to be small in any case and will probably be dominated by the short-run increase in consumption, much as was indicated by the simulations of the macroeconomic models presented to you last week. Furthermore, any tendency to declines in output could be offset by an easing of monetary policy. (The issue of the composition of GNP, particularly the possible decline in investment over the longer term, will be discussed below.)

Nonetheless, some business interests have presented simulations from many of these same macroeconomic models, but based on their own sets of assumptions, as evidence that enactment of the House bill will precipitate a recession. One lesson here, of course, is not new. These models can spin out any result you want depending upon the assumptions that are made. If an overly restrictive monetary policy is assumed, along with a slow or slight response of consumer spending to disposable income and a quick and powerful investment response, a recession can be predicted. But does the economy really operate this way; and more important, is it reasonable to expect the monetary authorities to sit around doing nothing while the economy goes downhill?

At most, these models tell us that there may be short-term transitional problems and that during the transition period, it would be wise to moderate monetary policy in order to keep the economy humming. More substantive in my view is the criticism of H.R.3838 in terms of the potential long-term performance of the economy. This deserves a more careful response.

Criticism #2: H.R.3838 will cause substantial declines in long-term capital formation because it will increase the cost of capital or the effective tax rate on new investment:

Response: The first crucial point in evaluating this criticism is the recognition that current law taxes income from different kinds of investment at widely varying rates. For example, for equipment that is eligible for the 10 percent investment tax credit, the effective corporate tax rate under current law is actually negative at moderate rates of inflation due to the combination of ACRS and the investment credit. (See table 3 which is taken from The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity, May 1985, page 159.) This means that the tax system actually subsidizes investment in equipment, rendering the after-tax return to the firm higher than the before-tax return. In contrast, the effective tax rate on other components of corporate investment, factories and inventories, has been very high, on the order of 46 percent at the corporate level.[4]

Any tax reform bill that equalizes rates of tax will work to the advantage of some kinds of assets and to the disadvantage of others. But only by reducing these disparities in taxation will capital flow into its most productive use as investment decisions become more motivated by underlying economic profitability than by tax considerations. If the only test of desirable tax policy is to maintain negative tax rates on corporate investment in new equipment to the detriment of factories and material inputs, then we are doomed to continue tax-induced economic distortions with its associated loss of economic efficiency and growth.-

Opinions may differ on how best to reduce variations in effective tax rates, but few dispute the desirability of doing so. Virtually all tax reform plans put forth by the Administration and members of the Congress have had this objective in mind. H.R.3838 is no exception. The evidence suggests that, in this regard, the House bill has been successful.[5]

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4. Other research using different methodologies have yielded somewhat different absolute results, but all studies confirm the existence of wide disparities in the tax treatment of different assets. See, for example, Congressional Research Service, "Effective Tax Rates in the Ways and Means Committee Tax Proposals: Updated Tables, December 2, 1985; Yolanda K. Henderson, "Investment Incentives under the Ways and Means Tax Bill," Tax Notes, December 9, 1985, pp. 1059-62.

5. See, for example, Henderson, "Investment Incentives..."

The difficult task is how to achieve both a more neutral tax system and one that does not increase substantially the overall taxation of capital income. In this regard, there are differences of opinion as well, but the weight of evidence is that some increase in the overall taxation of capital income would occur under under H.R.3838. Reasons for the difference in views on this subject relate to differing analytical assumptions, including the means of financing new investment, taxes paid at the household level as well as the corporate level, interest rates, and expected future rates of inflation. An example of a study finding an increase in the overall taxation of capital income under H.R. 3838 is that of Yolanda Henderson; and example of the opposite view is the study by the Congressional Research Service.[6] My own view is that the House bill probably does increase effective tax rates on capital income to some extent when both corporate and individual taxes are taken into account.

However, there are several reasons why the reactions of those opposed to H.R. 3838 have been greatly overstated.

- First, there is no reason to take current law as the starting point in determining the appropriate level of capital income taxation. The Economic Recovery Tax Act of 1981 even as modified by TEFRA in 1982 was excessively generous in its depreciation allowances. If

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6. See Henderson, "Investment Incentives..." and Congressional Research Service, "Effective Tax Rates..."

the House bill were enacted, federal corporate tax liabilities as a share of corporate economic income would rise from its post-war low of 18 percent in 1985 to around 35 percent by the end of the decade, at or below the level that prevailed through most of the 1960s and 1970s.

- Second, when corporate effective tax rates are calculated by industry, much of the aggregate tax increase is found to be concentrated in industries currently enjoying very low effective tax rates such as communication, public utilities, and rubber and plastic products. Other industries such as non-electrical machinery manufacturing, trade, apparel, and instruments and electronics actually have lower effective tax rates under H.R. 3838 than under current law.[7] It is simply not true that all industries are adversely affected.
- Third, as noted above, to the extent that the overall increase in corporate taxation is accompanied by greater uniformity in the tax treatment of various assets and industries, the efficiency or quality of investment improves. This, in itself, will offset any potential loss in aggregate investment induced by higher capital costs.

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7. These calculations are based on the same methodology used by the Congressional Budget Office in its publication, Revising the Corporate Income Tax, May 1985. The real discount rate has been assumed to be 5 percent and the expected rate of inflation 5 percent.

- Fourth, even the tendency toward a higher overall cost of capital can be offset by policies to reduce the deficit and to lower real interest rates. A reduction of real interest rates of 1 to 2 percentage points would fully offset the higher cost of capital under H.R.3838. This is consistent with the analysis of other observers who have found that the effects of taxes on investment can easily be swamped by other factors such as changes in the prices of capital goods and in the cost of borrowed funds. For example, in the period 1979-1984, 93 percent of the growth in business equipment spending was concentrated in two assets--business automobiles and computers--that received no net tax reduction under the 1981-82 tax acts.[8]
- Fifth, although this may be small comfort, international competitiveness is improved by reductions in domestic investment if national saving is not increased. As discussed earlier, this is because a reduced inflow of capital from abroad lessons pressure on the dollar and thereby helps U.S. firms competing in international markets. Again, the point is illustrated that international competitiveness and domestic capital formation are conflicting goals as long as we do not increase the national saving rate.

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8. See, Barry P. Bosworth, "Taxes and the Investment Recovery," Brookings Papers on Economic Activity, 1:1985.

In summary, the higher tax rates on capital income under H.R.3838 is a cause for some concern, but it has been greatly overemphasized. This concern should be balanced against a more uniform treatment of all assets and the recognition that our primary need is to increase national saving by reducing the deficit. In fact, if the additional corporate taxes raised under H.R. 3838 were used for deficit reduction rather than to cut individual taxes (other than at the very bottom), the result would be both welcome and constructive. In that event, the increase in national saving, and the associated decline in interest rates permitted by an easing of monetary policy, could leave us with the best of all worlds--more neutral capital income taxation and higher overall levels of saving and investment.

<u>Criticism #3: H.R.3838 will hurt the international competitiveness of U.S. industry because it provides a less effective cost recovery system than our competitors and will increase the cost of U.S. goods in foreign markets.</u>

<u>Response</u>: This criticism may be addressed at several levels. Most important is a restatement of the fact that the primary cause of high-priced U.S. goods in foreign markets has little to do with tax provisions but very much to do with the appreciated dollar. As long as foreign investors are attracted by high interest and investment opportunities in the United States, foreign demand for the dollar will keep its value high to the detriment of U.S. exporting and import-competing firms.

If the federal budget deficit is not reduced and interest rates are not allowed to fall, investment incentives will not improve the trade deficit or international competitiveness in any meaningful way. Tax incentives may help particular industries most able to take advantage of them, but only to the detriment of other industries. Electrical machinery manufacturing may use the investment credit intensively to reduce its costs and to increase its exports. But as long as the aggregate imbalance between national saving and national investment is unchanged, other industries will only be able to export less or import-competing industries will be able to sell less in domestic markets. In a regime of fluctuating exchange rates, the dollar will simply appreciate until a balance is again restored between national saving and the sum of domestic and foreign investment.

A second response to the international competitiveness argument is that tax provisions by their very nature can reduce prices of U.S. goods in foreign markets only by very small amounts. For U.S. nonfinancial corporations as a whole federal corporate tax liabilities in 1985 as a percentage of gross output amounted to less than 3 percent ($62 billion of taxes compared to output of $2,283 billion). Even if federal corporate taxes were eliminated in their entirety, the reduction were fully passed through to final product prices, and exchange rates did not adjust at all, the resulting 3 percent improvement in the competitiveness of U.S. industry in foreign and domestic markets must be considered to be minimal. This potential change in prices is particularly small when compared to foreign exchange rates which can change this much in a few days.

Certainly, particular industries could experience larger changes than the sector-wide average, but the options under consideration really do not encompass tax changes on the order of eliminating or doubling the corporate tax. Preliminary calculations of maximum possible changes in the price of value added by industry resulting from H.R. 3838 reveal percentage changes of less than 2 percent for 24 out of 28 two-digit industries. If the prices of all intermediate goods and services purchased by these industries increased by the average percentage, then the total price effect would be less than 2 percent as well, again quite a small impact.

Third, the cost recovery comparisons across countries, such as the calculations performed by Arthur Andersen and Company, are deficient in several respects as indicators of international competitiveness.[9] For one thing, these calculations fail to account for other factors such as tax rates at the corporate level or indeed the entire structure of taxation applying to corporate income. On the first of these points, a corporate tax rate as low as 36 percent would put the United States at the bottom of the range of statutory rates paid by Canada, France, Germany, Japan, and the United Kingdom. It is as reasonable to expect

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9. Many of these points are addressed in detail in a letter of September 17, 1985 from Secretary Baker to the chairman of this committee.

these countries to be as concerned about the lower U.S. corporate rate as we might be about their depreciation rules.

With respect to the entire structure of taxing corporate income, Japan provides a very useful example. If only corporate taxes are considered, Japan is at a distinct disadvantage relative to the United States. Corporate tax rates are much higher in Japan, and depreciation allowances are much less generous. Tax preferences at the household level along with preferred financing terms compensate for the stiffer corporate taxes.[10]

Even more fundamentally, there has been no systematic evidence that differences in corporate taxation or even overall capital income taxation effect economic performance in any systematic way. Indeed, one of the most ambitious studies comparing capital income taxation in the United Kingdom, Sweden, Germany, and the United States showed almost a perfect inverse relationship between taxation of capital income and the rate of growth of output or corporate investment.[11] Not much should be concluded from this result either, except to note that while structural tax changes of the kind currently under consideration

10. The offsets at the individual level are so important for Japan that in some presentations of the Arthur Andersen data a footnote is added to explain why the corporate results for Japan are misleading. For a discussion of tax rates on capital income in Japan, see John B. Shoven, "A Comparison of the Taxation of Capital Income in the United States and Japan," September 1985.

11. See Mervin A. King and Don Fullerton, The Taxation of Income from Capital, 1984.

may play some marginal role, economic growth and capital formation apparently spring from deeper wells.

In summary, domestic capital formation and international competitiveness require a tax policy that is directed toward an efficient domestic economy with sufficient domestic saving. The first goal requires a broad-based, low-rate tax system that is uniform across assets and industries. The second requires enough revenues to pay for the public services needed at the federal level. H.R.3838 is an excellent start toward the first goal. A commitment to further broaden the tax base and to add a point or two to each individual and corporate tax rate can achieve the second goal as well.

Table 1. Saving and Investment as a Share of National Product, United States, 1951-85

percent

Item	Percent of Net National Product				
	1951-60	1961-70	1971-80	1981-85	1985
Net Saving[a]					
Private Saving[b]	8.4	9.2	9.7	8.6	8.8
Government Saving	-0.7	-1.0	-2.0	-4.7	-5.4
Net National Saving-Investment	7.7	8.1	7.7	3.9	3.4
Net Foreign Investment	0.3	0.6	0.0	-1.3	-3.1
Net Domestic Investment	7.4	7.6	7.4	5.2	6.5

Source: U.S. Department of Commerce

a. Net saving and investment equal the gross flow minus capital consumption allowances (the depreciation of existing capital). Net National Product equals GNP minus capital consumption allowances. Pension funds of State and Local governments are allocated to private saving.

b. Business and Household Saving

TABLE 2

CORPORATE TAX CHANGES
(in millions of dollars)

	1986	1987	1988	1989	1990	1986-90
Major Revenue Gains						
1. Depreciation Changes	-304	-477	2,093	6,432	12,082	19,826
2. Repeal Investment Tax Credit	9,171	17,728	21,583	22,815	26,506	97,803
3. SUBTOTAL	8,867	17,251	23,676	29,247	38,588	117,629
Major Revenue Losses						
4. Rate Cuts	-5,186	-15,691	-21,181	-22,382	-23,352	-87,797
5. Net Dividend Changes	139	188	-51	-454	-917	-1,095
6. SUBTOTAL	-5,047	-15,503	-21,232	-22,836	-24,269	-88,892
7. SUBTOTAL: Net Major Changes	3,820	1,748	2,444	6,411	14,319	28,737
Other Revenue Losses						
8. Extend R&E Credit	-449	-902	-1,116	-804	-446	-3,717
9. Simplified LIFO	0	-201	-384	-514	-637	-1,736
10. All Other	-179	-500	-593	-532	-527	-2,331
11. SUBTOTAL	-628	-1,603	-2,093	-1,850	-1,610	-7,784
Other Revenue Gains						
12. Minimum Taxes	1,171	1,551	909	920	1,247	5,798
13. Foreign Tax Provisions	979	1,647	2,222	2,899	3,376	11,123
14. Financial Institutions	944	1,476	1,389	1,484	1,803	7,096
15. Accounting Changes	6,147	12,065	15,783	14,799	12,925	61,719
16. Insurance Changes	979	1,891	2,193	2,547	2,855	10,465
17. Meals, Travel, Entertainment	668	1,070	1,117	1,246	1,346	5,447
18. ESOP Provisions	1,062	2,117	1,371	686	522	5,758
19. Energy & Minerals	494	689	628	706	762	3,279
20. Other	-62	292	1,072	2,186	3,656	7,144
21. SUBTOTAL	12,382	22,798	26,684	27,473	28,492	117,829
22. TOTAL CORPORATE CHANGES	15,574	22,943	27,035	32,034	41,201	138,782

Source: House Ways and Means Committee Report on H.R. 3838

Table 3

Effective Corporate Income Tax Rates on Equity Financed Investments
Returns to Capital Distributed Equally Between Dividends and Capital Gains 1/

	All 2/ Capital	Equipment and Structures	Equipment	Structures	Inventories 3/
Pre-1981 law 4/					
at 10% inflation	48	48	31	53	46
ACRS 5/					
With investment tax credit					
at 10% inflation	41	40	20	45	46
at 5% inflation	35	31	-4	39	46
Without investment tax credit					
at 5% inflation	41	39	41	39	46

Source: The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity, May 1985, pp. 158-9.

1. Assumes a 4 percent real return after corporate tax. Assumes two-thirds of capital gains deferred indefinitely, and the remaining third taxed at the given statutory rate less the applicable exclusion. The effective tax rate at the entity level may be lower than reported here on leveraged investments, depending on the degree of debt finance and the relation between the interest rate on debt and the rate of return on the investment.

2. All capital includes equipment, structures and inventories.

3. Assumes LIFO accounting with no reduction in inventories and inventory prices rising with inflation.

4. Assumes 46 percent corporate statutory tax rate and 32.7 percent personal tax rate and 60 percent capital gains exclusion. Assumes sum of years digits depreciation over 9 years and 10 percent investment credit for equipment and 150 percent declining balance over a 34.4-year life for structures.

5. Assumes 46 percent corporate tax rate and 32.7 percent personal tax rate with 60 percent capital gains exclusion. Assumes 5-year depreciation schedule with half-basis adjustment for equipment and 18-year schedule for structures.

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

Dr. Meyer, I have looked at your testimony and heard your comments about indexing. But the business people who have testified before us in general have not given much weight to indexing. I think one of the reasons is that indexing is a benefit down the road some place; most corporate heads figure they will be retired by that time, that they won't really see the benefits under their administration.

Then, they make another point with some foundation, that when you reach that point down the road and you begin to see a substantial loss of revenue to the Treasury, the Treasury and the Congress will change its mind and take it away. Now, I understand the economic theory of indexing, and I appreciate that; but the motivations for the guy who is managing the business are such that I doubt it is going to turn him on. How would you answer that one?

Dr. MEYER. Let me answer that; and I have three points to make about it. It is a very interesting point.

Senator BENTSEN. I will give you two points because I want to ask another question.

Dr. MEYER. First of all, it is down the road. Investment is a forward-looking decision; you are locking in a piece of capital for a long period of time. You had better believe that firms, in making such decisions, are going to take full account of the kind of depreciation they are going to be getting down the road. Now, there is a second problem of whether or not Congress would be willing to withstand the revenue loss. That is a more difficult problem. One of the advantages in the short term is that very limited losses early on may become very large down the road.

Senator BENTSEN. That is right.

Dr. MEYER. But your point is certainly well taken. As a point of economic legislation, indexation is outstanding, excellent, and has much to commend itself.

Senator BENTSEN. Beautiful, yes.

Dr. MEYER. But your point is well taken.

Senator BENTSEN. We are talking about the real world. I will commend to you a speech I made at the Harvard Business School 6 years ago, predicting what was going to happen on this.

Dr. MEYER. But we are talking about the commitment of Congress here——

Senator BENTSEN. All right. Dr. Galper, one for you. You talked about the increase in savings. I couldn't agree with you more. There is incredible frustration for those of us on this committee. This country of ours has a great propensity for consumption and spending, and we put the incentives in there for saving, we think, and we don't see much reaction. And you talk about getting the budget deficit down; and about getting inflation down, which has been happening. But I don't see much correlation there on the savings.

How do you motivate people to save? I have not heard this, and I didn't really hear it in your testimony. Tell me how you do that.

Dr. GALPER. The burden of my testimony is that tax incentives will not be successful in doing that.

Senator BENTSEN. I am not arguing with you on that.

Dr. GALPER. The only way we can deal with that effectively, in my view, is to reduce the deficit. The deficit is a form of dissaving by the Federal Government that offsets the private saving that we do as households and firms.

Senator BENTSEN. I am not arguing that with you. I am just asking about human behavior, how people are reacting in this country; and I don't see how we turn that around. It is frustrating.

Dr. GALPER. I think we just have to turn it around by dealing with the deficit. That is the only answer I can give you on that.

Senator BENTSEN. I want to congratulate the chairman. He has searched very diligently for someone that would say something nice about this bill. [Laughter.]

Senator BENTSEN. And these have been some pretty guarded comments about it, but congratulations.

The CHAIRMAN. Senator Grassley?

Senator GRASSLEY. Would you give us your reaction to the oil import fee suggestion that has been floating around Capitol Hill to raise money, which could be used to maintain the individual marginal tax rates at a lower level and still provide revenue for capital formation, and the extent to which that affects our international competitiveness? I assume that the argument, on the one hand, would be that capital formation is going to help our international competitiveness; but then whether there is any offsetting aspects of the oil import fee that would still leave a positive impact—I mean a positive impact of the tradeoff of increased capital formation in a Senate bill over House bill 3838?

Dr. GALPER. To whom is that directed, Senator?

Senator GRASSLEY. To both of you.

Dr. GALPER. OK. Let me respond to that first. I am going to sound a bit like a broken record here, but I would be in favor of many forms of a tax increase that were devoted to reducing the deficit: rather than to reducing taxes eleswhere. So, if in fact you asked me the question of would this be important in promoting capital formation if we could raise additional revenues, that would reduce the deficit and allow an easing of interest rates, I would look much more favorably upon that. If you say how much is this going to affect capital formation and international competitiveness if the revenues raised by an import fee are used to reduce taxes elsewhere, I will say pretty damned little.

Dr. MEYER. I think that we need to reserve the oil import fee and any other alternative revenue sources to what ought to be the number one priority of this committee, this Congress, and this nation, and that is deficit reduction. While I am concerned about the impacts of H.R. 3838 on capital formation, I would much rather see tax reform effort collapse and make a real serious attempt at reducing the deficit. We are going to need alternative revenue sources to do that. We ought to preserve every one of them.

Senator GRASSLEY. A second question, a little bit different: Concentrate on the lack of a differential between the corporate tax and the corporate capital gains tax. If there is anything negative in that, what it is; and assuming there is something negative, the extent to which you think it ought to be changed?

Dr. GALPER. Well, in a general way I would argue that I would like to see all forms of income taxed uniformly and that I find little basis for the distinction between capital gains taxes versus other taxes. One possible offset——

Senator GRASSLEY. So, you really don't see anything negative then in 3838 in that respect?

Dr. GALPER. Moving towards more uniformity——

Senator GRASSLEY. On the corporate side?

Dr. GALPER. Yes.

Senator GRASSLEY. But would you say what you just said for the individual?

Dr. GALPER. Yes; with one important proviso, and that is, as was mentioned with respect to depreciation, I would much prefer capital gains also to be indexed. If we were taxing real capital gains and not just nominal or the inflationary element of capital gains, then I would like to see that form of income taxed in the same way as any other income.

Senator GRASSLEY. Dr. Meyer.

Dr. MEYER. I think that is the key. Uniform taxation of capital gains is desirable only if capital gains is indexed. In the earliest Treasury proposal, it was; in the current one, it isn't. So, that differential in the treatment of capital gains was introduced only in H.R. 3838; I am not sure how detrimental it is. Certainly, the increase in the maximum rate for capital gains for persons in H.R. 3838 is also damaging to capital formation. That I would certainly think is. The sharper increase to the corporations of the capital gains tax rate is probably also detrimental, but I am not sure it is as powerful a force.

Senator GRASSLEY. Do you see any problems for corporations in the sense that there isn't a differential between the capital gains tax and the corporate tax rate for them, but for partnership and sole proprietorships there still is a differential between——

Dr. MEYER. Obviously, it can affect the relative gains from different forms of organization, something that perhaps we don't want the Tax Code to be doing.

Senator GRASSLEY. But does your study of that lead you to believe that that would have a influence on a trend away from the corporate structure?

Dr. MEYER. No; Our study doesn't bear on that.

Senator GRASSLEY. And you don't have any gut reaction?

Dr. MEYER. I suppose, on balance, it would but probably not a very powerful force.

Senator GRASSLEY. Yes.

Dr. GALPER. On that point generally, the reduction in marginal tax rates across the board is very important in this respect because it reduces the tension between the treatment of different forms of income. The differential treatment becomes much more important when we have very high marginal tax rates, where some income gets deferred and some income is fully taxed, whether it is in capital gains form that the preference appears or some other form. I think that is an important point to keep in mind when we look at the benefits of a general lower-rate system. It reduces the tensions between various forms of income.

The CHAIRMAN. Senator Mitchell.

Senator MITCHELL. Mr. Chairman, back when I was a Federal judge, at the conclusion of the prosecution's case, I always instructed the juries that since they had heard only one side of the case, they should not make up their minds and should permit the other side to be heard.

Dr. Meyer is the seventh consecutive witness before this committee to testify in opposition to the House bill, and Dr. Galper the first to support it. So, I assume we are at that point in these proceedings, and I would hope that we are now going to have several witnesses who hold Dr. Galper's view. If I may disagree mildly with my good friend from Texas, I think there are plenty of economists who will testify; and I know the chairman is alwavs interested in a balanced presentation before this committee--a fair representation of both points of view. I would hope that my colleagues on this jury will keep an open mind until we hear the other side, having heard one side portrayed here for weeks.

The CHAIRMAN. We should get Dr, Heller here soon, who will also basically be on the side of the bill.

Senator MITCHELL. Yes. So, I welcome you, Dr. Galper.

Dr. GALPER. Yes.

Senator MITCHELL. I tell you that, based on what we have heard so far, you are swimming upstream. I would like to ask a question. I will make a little statement first and then ask a question, which leads into your testimony.

The whole issue here has been phrased in the context of international competitiveness. Others might phrase it as a desire for some sectors of our economy to continue to avoid tax liability. Now, according to the Department of Commerce, business fixed investment as a percentage of the gross national product was lower last year than it was in 1981. I think that bears repeating. After we enacted huge investment subsidies in 1981, that sharply reduced business taxes to encourage investment; investment has gone down. Now, many economists believe the reason for that is that business is not particularly responsive to investment incentives, that demand impacts are much more important in business decisions to invest; and to the extent that tax incentives do influence investment decisions, the result is a less than optimum utilization of resources that distorts market influences.

The view is shared by many, including Michael Evans, the president of Evans Consulting Co., who found that investment in industrial plant and equipment—the primary target of the 1981 bill—has actually fallen. My question to you is this: If investment did not respond to the generous incentives created in 1981, can this committee properly conclude that the 1981 bill actually worsened the competitive position of U.S. industry because the revenue cost of the investment incentives increased the budget deficit, which has ultimately made U.S. goods less competitive in international trade?

Dr. GALPER. Yes, I agree with much of what you are saying, Senator. The main source, as I indicate in my statement, of our loss of international competitiveness is the trade deficit, which is related to the budget deficit. Appreciation of the dollar swamps what could possibly be done on the tax side to reduce the prices of U.S. goods in foreign markets. The effect has really been to increase the prices of U.S. goods in foreign markets, strictly as a result of the appreciation of the dollar.

If we eliminated all corporate taxes on nonfinancial corporations, we would reduce prices at most by 3 percent. Now, that is swamped by what happens to the appreciation of the dollar and changes in exchange rates on a daily basis and on a weekly basis. And indeed, it is true that when you look at what the effect of investment incentives has been, these investment incentives can be easily swamped by other changes, just in terms of business fixed investment. I quote in my testimony a study from Barry Bosworth at the Brookings Institution, which indicated that over the period 1979 to 1984, looking at the sources of the major increase of business fixed investment, in equipment particularly, 93 percent of it was concentrated on automobiles and on computers which received no tax benefits, no net tax benefits from the the 1981-82 tax acts. This is because what was driving investment there was totally unrelated to the tax benefits. It was related to the relative reduction of the prices of those assets, on the one hand; it also related to the fact that people were engaging in leasing rather than buying automobiles as individual households. And so, when businesses purchased the automobiles to lease to households, it showed up as business purchases of equipment.

So, I would agree that we have overstated what can be accomplished with these tax incentives and what, in fact, we should be paying attention to is a more neutral, even-handed treatment across all assets and across all industries.

Senator MITCHELL. Thank you very much, Dr. Galper. Thank you, Mr. Chairman.

Dr. MEYER. Mr. Chairman, could I correct perhaps a misperception that Senator Mitchell and perhaps some others share about the position of Dr. Galper and myself?

I think we have overwhelming agreement actually on the economic analysis. We have some shades of differences of opinion. We both believe in the priority of deficit reduction relative to tax reform. We both agree that there needs to be a tax increase to deal with the deficit. I think we both believe that capital formation will be impaired on net by this. I place a little bit more emphasis on the impact on capital formation, and Dr. Galper a little bit more on potential efficiency gains and neutrality; but we are not sharply different over the economic analysis of this bill.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman. Dr. Galper, as I understand it, you do think that all things being equal, as you all often say, that higher savings rates in the United States are desirable, that is it would increase our competitive position and it would strengthen the American economy. Is that right?

Dr. GALPER. Yes.

Senator BAUCUS. I agree with you also that there are many factors which affect savings rates in this country, but I am wondering if you think that our Tax Code in any way, despite the other factors that affecting the savings rate, does the Tax Code in any way affect American savings rates?

Dr. GALPER. That is, as you know, one of the most——

Senator BAUCUS. Everything else being equal. I understand the trade deficit, the value of the dollar exchange rate, et cetera. There are a lot of factors there, and they are very important factors.

Dr. GALPER. Yes.

Senator BAUCUS. I am trying to focus in on the degree to which, if at all in your judgment, the Tax Code affects American savings rates.

Dr. GALPER. If you look at private savings, that is one of the most hotly debated issues in economics today. How responsive is private savings to changes in after-tax returns induced by changes in the tax system? My own view is that saving is not particularly responsive to this at all, and I use the evidence since 1981 to support this.

Since 1981, we have had big reductions in marginal tax rates, particularly at the top by those who do most of the saving. We have had very high before-tax rates of return on real assets. We have had individual retirement accounts, all of which promote——

Senator BAUCUS. I understand that.

Dr. GALPER. But we haven't had any increase in private savings.

Senator BAUCUS. I understand that. We don't have a lot of time here. I am wondering how easily or how well anyone can determine the degree to which the IRA's or the all-savings program or whatever actually influence people's decisions to save or not to save. One can argue that there are lots of other factors that are more important in determining that willingness or unwillingness of a person to save. One can also argue that, were it not for those provisions, personal savings rates would decline even further, or at least would have declined. I mean, how confident are you at all that you can measure the ones who are willing to save? And I ask that, too, because as you know other countries have a little different view of this.

Most European countries, for example, do not allow the consumer interest deduction. Now, that arguably is an incentive to save, and not to borrow. In some other countries, namely Japan, they do grant the incentives to save; they exempt certain interest income--in fact, a lot of income from taxation. Are you saying that those policies in those countries are wrong in that they do not affect the propensity to save? Does it affect the propensity to save in those countries; whereas the Americans just act differently and don't look at the Tax Code? I am just trying to focus in on the reasons.

Dr. GALPER. I understand. It is difficult to tease out exactly what savings does and does not respond to. I guess I would cite the 1981 evidence or the post-1981 evidence for the reason that it was hard to develop a better controlled experiment as to whether private savings does respond to tax incentives and what we have had since 1981.

Senator BAUCUS. So, what you are saying is you really don't know?

Dr. GALPER. No, what I am saying is that the evidence seems to suggest that savings does not respond to these types of tax changes; and one reason why and the logic behind it is that it is possible to take advantage of, let's say, the IRA provision—and we have had massive inflows of funds into these things—without doing an additional incentive.

Senator BAUCUS. What else can we do in the code to help increase personal savings?

Dr. GALPER. I don't think we can do very much to change private savings, that is household, by means of tax benefits. What we can do is deal with overall savings by increasing——

Senator BAUCUS. Is there any analysis where we had a fairly strict limit on the consumer interest that could be deducted?

Dr. GALPER. I would prefer that as a policy.

Senator BAUCUS. Have you run any analysis on that? I was just wondering.

Dr. GALPER. I have done nothing which would indicate what the saving effect would be of that.

Senator BAUCUS. Maybe we have looked only at—perhaps we should look at some sticks in the code, that is, some disincentives to borrow by imposing some kind of limitations on consumer interest.

Dr. GALPER. I would advocate that on the hopeful grounds that it could do something about it, but also on other grounds as well.

Senator BAUCUS. Then, I hear you are saying that, yes, the Tax Code does affect savings.

Dr. GALPER. No, I am saying that, if anything, that would move in the right direction; but I wouldn't expect very much from it.

Senator BAUCUS. We are talking about a question of degree here, then? You agree with the theory, as I hear you, that, yes, one can with the Tax Code affect the personal savings rates; but what you are also saying, as I hear you, the degree to which that influences savings is debatable.

Dr. GALPER. Let me just say that the evidence as I read it suggests that tax incentives do not affect savings—private savings—very much at all. We can argue about whether we are talking about a little bit or next to nothing, but it is small stuff.

Senator BAUCUS. Thank you.

The CHAIRMAN. I put myself at the bottom although I was here earlier, but let me ask one question, following up Senator Baucus. We hear lots of arguments about the Japanese savings rate and the immense savings incentives that they have to put away tax-free savings. You are saying those incentives really are not the reason that they save and they would do the same without the incentives?

Dr. GALPER. What I am saying is there are cultural reasons why savings differ across countries, and I think those greatly swamp whatever can be done on the tax laws.

The CHAIRMAN. Senator Wallop?

Senator WALLOP. Thank you, Mr. Chairman. Dr. Galper, in your summary, which was provided for the committee, in the first provision there, you say: On balance, H.R. 3838 is sound legislation and good tax policy. A general broadening of the tax base and reduction in rates is desirable and will result in a fairer tax system and a more efficiently operating economy.

Wherein lies this base broadening, especially on the individual side?

Dr. GALPER. Well, there is some base broadening on the individual side. There has been some removal of tax shelter preferences which are base broadening on the individual side. There is some cutback in categories of itemized deductions on the individual side. If you asked me if I would like more base broadening on the individual side, I would say yes. And that is why I used the words "this is a desirable roadmap in the direction that we should go." I would prefer that we did more with including certain categories of fringe benefits as base broadeners on the individual side. I would prefer that we looked more at the State and local deductions; take another look at that to see if there is some revenue that can be gained there. I understand that is very controversial. I would prefer that we could do more with, again, reducing the interest deduction for nonbusiness purposes. So, I would like to see more base broadening.

All I am saying is that I think this is the direction that we should be going.

Senator WALLOP. But in point of fact, there really is virtually no base broadening in the individual side, and the reduction is paid for primarily with the transfer of obligations to the business sector. Isn't that correct?

Dr. GALPER. Not exclusively.

Senator WALLOP. Not exclusively; primarily is what I am saying.

Dr. GALPER. I think if you look at the combination of base broadening on the individual side and base broadening on the business side. That goes a long way toward reducing the rates for individuals. That is right.

Senator WALLOP. Then you go on to say that it is important to increase the Nation's rate of capital formation and to improve the international competitiveness of U.S. industry. Virtually, everyone that has come in here has said that this bill increases the cost of capital and decreases U.S. competitiveness and, by shifting the burden from the service industries to the capital intensive industries, you have simply said that those which are service industries have a lower rate of taxation, and they are the ones which primarily input. So, I don't understand where we are going to get this climate of which you speak that is necessary for us; and in your statement, you say: "Although tax policy cannot cure all the ills traceable to fiscal responsibility, good tax policy is essential for establishing climate for long-term business planning and investment."

And along comes this thing where one, we have nobody in the country who knows when the effective dates are; two, we have recapture of tax that was legitimately taken by people; three, we have increased the cost of capital, particularly new capital. And it strikes me that this goes exactly counter to what you suggest is good tax policy.

Dr. GALPER. The point that I am making here is that when I say I want to set a sound climate for business investment, that means certainty with respect to future tax rules; and I agree with you about that point; but also it means even-handed, uniform treatment across assets and across industries so that we don't provide tax incentives for some type of activity as opposed to another. That is what I mean by a stable climate for long-term business investment and planning. With respect to the international competitiveness, it is not the Tax Code that is the source of this problem. It is appreciation of the dollar because we are not raising sufficient revenues to pay for our Government expenditures.

Senator WALLOP. You think the cost of capital has no effect on international competitiveness?

Dr. GALPER. I think it is a very, very small effect. At most, I think this would increase effective tax rates on capital incomes in an aggregate sense by maybe 5 or 6 percent; and if you look at, as I indicated earlier, how much the price of goods in U.S. markets would be affected if we changed the cost of capital by 5 or 6 percent, we are talking about less than 1½ percent. That is not the source of our lack of competition abroad.

Senator WALLOP. But I think that one of your statements makes the comment that over the life, a business investment would be reduced by 4 percent. Four percent is not much over 5 years, but it is a reduction. That doesn't seem to me to be in any respect the right direction to travel.

Dr. GALPER. As I said, the direction I would like to see us traveling is the direction of reducing the deficit. I would prefer to have as low tax rates as we can, but I also think we have to reduce the deficit first.

The CHAIRMAN. Senator Bradley?

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

Let me just point out that today, once again, that today's testimony reemphasizes what some of the earlier testimony showed, namely that taxes are only one element of the cost of capital. And when you look at the international competitiveness question, the fluctuation in the value of the dollar far offsets that. Can you give us any dimension regarding that earlier testimony, in which a panel that was viewed as being against tax reform said that if you had only a 4- to 5-percent decline in the value of the dollar, that that would totally offset all of the so-called disincentives for capital formation that are embodied in the House bill? Does that sound about right to you?

Dr. GALPER. Yes.

Senator BRADLEY. Did you say "yes"?

Dr. GALPER. Yes.

Senator BRADLEY. Yes?

Dr. GALPER. Yes.

Senator BRADLEY. One of the things I think would be helpful for the committee, Dr. Galper, would be to have you address why efficiency is just as if not more important than the absolute level of capital stock? And why lower tax rates across-the-board promote that efficiency?

Dr. GALPER. I think that efficiency is often lost sight of in tax policy because we think we can direct investment by means of special tax incentives to some areas that we happen to feel are more productive than others. I am a strong believer in the market economy, and I believe that signals from the market will determine best where investment should go. And when business men and women respond to market incentives, they will make investment decisions that will be, in the long run, best interest of the Nation. When we have investment incentives of particular types of assets which now give rise to negative tax rates, that means that the after-tax return is greater than the before-tax return on those assets, which means that when we invest in those assets, we are sacrificing a lot of return that we can be getting if we invest it someplace else, were it not for the tax inducement to invest in these subsidized taxes.

When we treat all industries and all assets alike and more uniformly, we get rid of that loss of output, loss of productivity resulting from investing in those types of activities which have these low rates of return. So, I think that uniformity and neutrality across assets is equivalent to, from that point of view, increasing our capital stock.

Senator BRADLEY. Although this will not please you, I think it is necessary to put the following in the record. One of our earlier witnesses, Paul Craig Roberts, who is perceived as someone who is arguing against the tax-reform proposal, alluded at the end of his testimony to a study he had done on relative costs of capital. We have got the study, and the study concluded taxation at the corporate level is actually higher in Japan than in the United States. United States depreciation rules are also generally more favorable, and in Japan they don't have a general investment tax credit. An important conclusion to be drawn from this is that the cost of capital is affected by the overall tax system, not only by corporate taxes. Now, Dr. Meyer, in your opening testimony, you said that those people who had made various reform proposals had not—what did you say?—"An unwillingness on the part of framers of the proposals to recognize that any benefits for investment from reductions in marginal personal tax rates incorporates and would be more than offset by the specific investment incentives."

Let me respond and simply say that at least I know that we gave that consideration and believed ultimately that more weight should be given to the quality of investment and to the efficiency of resource allocation. For example, how does it help international competitiveness if we have a boom in building office buildings?

Dr. MEYER. I was referring specifically to the tax bill that you were a sponsor of, and the language in that bill indicating that it would be progrowth, procapital formation. I agree there are efficiency effects as well, but I am sort of seeking a truth-in-packaging law here and applying it to Congress and to everybody. If it is going to be detrimental to capital formation but we are going to make it up with efficiency gains, let's say it. Let's not package this thing as something that is procapital formation and progrowth when, in fact, it isn't. That is my point.

Senator BRADLEY. But could you answer the question? Why, how would it help international competitiveness to set investment incentives that produce a building boom in offices?

Dr. MEYER. You need structures; you need equipment. You don't want buildings? Where are you going to put the equipment? I don't understand. I don't understand the sense of the question. If you raise the cost of acquiring capital, businesses will acquire less capital. If they acquire less capital, then we will obviously have less capital formation. I don't understand what you are trying to get at.

The CHAIRMAN. Let me rephrase the question and butt in again, if I may, because I think I know what he's driving at. You go overseas to Japan; you go overseas to China; and you see that they have very definite priorities. And certainly, housing is not one of their priorities nor are large office buildings that are air-conditioned. Their priorities are much higher on capital investment and agriculture. We have a very high priority on downtown office buildings.

And I think all he is asking about is how does the downtown office building improve our international competitiveness?

Dr. MEYER. First of all, H.R. 3838, just as an example, would end up raising the cost of business plant and equipment relative to residential structures. You would get more housing and less business equipment. As between office buildings and other forms of capital, if you think that you are in a better position to make those judgments than the business community, that is fine.

I think the Tax Code should be neutral with respect to the various forms. I don't think the investment tax credit is a good idea; it subsidizes equipment relative to structures. I think we should eliminate that from the Tax Code, but this goes way beyond that. The problem with H.R. 3838 is what it does to depreciation——

Senator BRADLEY. Are you for economic depreciation then, if you are for neutrality?

Dr. MEYER. For economic depreciation, including full indexation.

Senator BRADLEY. So you would support that?

Dr. MEYER. With the limitation--with full indexation.

The CHAIRMAN. Senator Durenberger.

Senator DURENBERGER. Mr. Chairman and gentlemen. I have been operating on the theory that the economics that have been driving this country since I have been in active politics is expectations. In the late 1970's, when I got in here, we all expected inflation to be high; so, inflation was high because we borrowed today and paid back in cheaper dollars, and all that sort of thing.

One of the things that has happened since then, of course, is that the President has brought us some new sense of optimism about the future, and he has told us that inflation doesn't have to be high if we would cut taxes. So, we cut taxes and inflation went down. And as I have sat here on this committee, both in the majority and in the minority, I have also adopted the tax policy theory—I call it the Pavlov policy.

I mean, we push something in here and there is a reaction out there. And we pull something back here, and there is a reaction out there. But it is sort of all the same thing. There is no guiding philosophy any more. There is no long-range vision. There is no——

I mean, we are doing a tax bill here with principles of 35 percent, 33 percent, $2,000, and revenue neutrality. Those are not tax principles. They have nothing to do with tax principles. How do you bring a country together on that kind of a theme?

You know, I listened to your debate on savings, and I agree with you. Tax policy isn't going to change it. You can get more people to save if you give them a penny for doing it; but it is a cultural problem in this country.

The President is still telling us we can have, have, have; and you don't have to pay for it. You know. All you have to do is balance the Federal budget, and somehow that solves all your problems. You don't have to do without. You don't have to do without the interest deduction. You don't have to do without this, that, and the other thing.

I have been raised to believe I can have a $500 home worth $1 million. All I have to have is a $500 downpayment. I run it up to the point where I have priced my kids out of the housing market;

but I don't want to give it up because I believed that there was something good about that. So, it strikes me that we can fool around here all we want, playing the savings game; we still have a cultural problem in this country because all the signals all around us are still that somehow we can have a man on the Moon, we can have somebody in Tokyo in 2 hours, we can have free health care. You know, we can have all these things somehow without paying for them.

And not only not paying for them; you can get a reduction in your tax rates because Government is just ripping off all that money anyway; so, cut the rate and maybe they will shape it up. I am trying to describe for you a cultural problem that I think exists, since both of you fellows are experts.

Then, add to that this dimension: The President talked last night about welfare reform and independence. You make a lot of people independent with jobs, but you make them independent today in America with $3.35 jobs. And when they go to those $3.35 jobs, they may have a $2,000 exclusion from income tax, but they ain't got no exclusion from the payroll tax; and the payroll tax hits them on the first dollar, the second dollar, and it keeps climbing up.

And on top of the Social Security, payroll tax, the States have to come along with an unemployment compensation tax, and then they come along with workers' compensation tax. And people are downwardly mobile. My kids are designed to go down. They aren't going to be able to make what I made; at least, it seems to me that is where the signals are.

And into that, we are trying to do this kind of a tax bill. Are we out of our minds? [Laughter.]

Senator DURENBERGER. I am sharing a frustration. It gets worse every day as I sit here.

Dr. GALPER. What should our priorities be? That is the question. I think there is some priority that should be attached to reforming the system. I agree with you that 35 percent and $2,000 is not a tax policy. I would also say, however, that an objective of trying to lower tax rates on a broad base does make desirable tax policy sense; but what makes even more sense is paying for what we wish to buy both as a Nation with our Federal Government and as individuals with our own household budgets.

So, I think we have to put our fiscal house in order, and I think we should also try and put our tax structure in order. And the order in which you want to put those two things in order may be a matter of judgment, but I think they are both important jobs to be done.

Senator DURENBERGER. Dr. Meyer.

Dr. MEYER. 35 percent as a maximum rate sounds great. $2,000 for an exemption sounds great. Where is the money going to come from? I think it is impractical; it is unworkable. We have to have a sense of priorities. Deficit reduction is No. 1. We can't further compromise the income and corporate tax base with further reductions in marginal rates at this time. If this committee spends all its time trying to get those rates down, I think tax reform is going to collapse.

You have got to pay some attention to shifting back some of the burden in H.R. 3838 from corporations. We have got to reduce the impacts on the cost of capital. That is the primary impact. We have got to separate deficit reduction from the tax reform.

The CHAIRMAN. Senator Bentsen.

Senator BENTSEN. Thank you very much, Mr. Chairman. A comment was made about the cost of capital in Japan. My friend from New Jersey is absolutely right. There is one study showing that Japan's capital cost is higher. But there are also studies showing that their capital cost is lower. And it depends upon what you put into the formula.

Whatever it may be, we have a situation in this country where, since 1977, according to the figures that came out yesterday, we have had only a 4.2-percent increase of productivity in the nonfarm sector. Last year the increase was zero. And yet, the Japanese have approached double-digit increases since 1977, and Europe has approached 5 percent.

When you get that kind of disparity, we ought to try, it seems to me, everything we can to try to increase productivity. Now, I certainly agree with you that some of the factors influencing productivity figures get swamped by currency fluctuations or other factors; but almost all of the witnesses we have had have stated that, if we follow the House bill or administration bill, we would hurt productivity in this country. They have argued over how much, but almost all of them think they would.

I don't see why we should go in that direction, whether it is a little or a lot; and with the full understanding that it can be distorted by these other things.

I listened to the question about tax incentives for commercial buildings, which have caused buildings to be built for tax reasons, not economic reasons. I am the guy that led the fight in 1984 to try to reduce those incentives. I said they were much too generous. I lost that one. And now we have all kinds of buildings being built in Houston and other cities. With a 21-percent vacancy rate in downtown Houston, they are building a new 50-story building—for tax reasons. That is the reason.

So, this system has to: Evolve, and we have to correct misplaced incentives; but again, shouldn't we still try to do things to encourage productivity with the tax system, however marginal it might be? When you talk about a totally level playing field between all corporations, don't we have to take into consideration the diversified manufacturing base for this country? Can we improve our standard of living merely with a service economy? I wish you would respond to that.

Dr. MEYER. As you know, I am in agreement with you. I don't think this is an appropriate time to move substantially to raise the cost of capital or to do something that would be damaging to capital formation. Let me just note, though, about structures as opposed to equipment for one thing—why some of these things are happening.

A lot of tax shelters really encourage commercial structures because of tax shelters. You can buy these buildings, and because the depreciation is so accelerated, you write them off, sell them to somebody else after you have generated tax losses——

Senator BENTSEN. I understand that. I want to put a stop to some of that.

Dr. MEYER. That is right. We want to put a stop to that. We don't want to discourage people from buying buildings and holding them to use in production. We want to discourage them from buying them for tax losses. And by slowing depreciation up and indexing it, we would do precisely that. That is the combination. Slow the acceleration of depreciation and index depreciation; and it will accomplish precisely that.

Dr. GALPER. Let me make one comment. I am not advocating as a desirable policy we should increase the cost of capital. I am not saying that at all. What I am saying is there are offsets to this that we do have to consider as part of this legislation. One offset is the uniformity across assets which itself can be a source of productivity as we make our investments in those forms of capital formation that yield the highest returns, rather than where the tax benefits are the greatest. That in itself can be a source of increase in productivity.

The second point that I want to make—and this is again repeating what we said before—is that if we are able to deal more effectively with the deficit, we could lower interest rates and thereby stimulate investment more generally from that route, rather than trying to continually use tax gimmicks as a device.

Senator BENTSEN. I don't quarrel with that.

The CHAIRMAN. Senator Long.

Senator LONG. Let me ask you about some of the so-called tax subidies that we do have in the law. How do you feel about the favorable tax treatment that we give to private housing in an attempt to make it attractive for people to own their own homes? Do you think we ought to repeal that?

Dr. GALPER. As an economist, I think that there are lots of problems with that form of tax preference. It gives rise to bigger benefits to those in higher marginal tax rates than to those in lower marginal tax rates. It overly subsidizes, in my view, residential investment as opposed to business, plant, and equipment investment. If I had my choice, I would try and reduce the effect of that type of subsidy; and to the extent that we had it, I would try and make it more even-handed across income classes.

Senator LONG. Now, I don't know of anything we couldn't improve on; if you were God Almighty, you could improve on anything, you would think. But if you are looking at whether to have a housing subsidy or not to have one, since we started such a policy we have made tremendous headway in terms of helping to see to it that people own homes rather than rent them. Do you think that is a desirable objective or not?

Dr. GALPER. I think it is desirable to have home ownership, but I don't think we have to encourage second homes or mansions or extravagant residences. I think there is a difference between trying to encourage people to own their own homes and to have that subsidy be greater and greater, the more that they want to expand their residences.

Senator LONG. You get down to a point where you might be right, and then again, you might not. If you tell somebody you want to help them to own a home, and if you get down to as much detail as you started to suggest, the first thing you know, you are going to say that each home must have a broom closet; and if it is a two-family home, they have to have two commodes; and one thing and another. By the time you get through, people will say that if they have to put up with all that, just forget about it.

The point I am making is that we have made a lot of progress toward individual home ownership by making it more attractive to own your own home. For many years, our laws were more favorable to individual home ownership than they were to renting. That tended to make homeowners out of a great number of people. If you had your choice about doing none of it or doing some of it, would you do none or do some of it?

Dr. GALPER. I don't think that is a fair choice, I guess I would say.

Senator LONG. Not a fair choice? Here is the line right here. Now which side would you rather be on—this side or that side, if you had your choice?

Dr. GALPER. I would try hard not to answer that question. [Laughter.]

What I would like to do is have less of it and have what we have distributed more equitably.

Senator LONG. You would like to straddle the line, in other words?

I think that is important in this case because we can do a better job with that subsidy if we want to continue to provide that subsidy; and I don't see any reason why we shouldn't try and do that.

Senator LONG. I appreciate your thoughtful reaction to the question. I think I can find somebody else who can help me better. [Laughter.]

Dr. Meyer, do you want to comment?

Dr. MEYER. The world is full of tradeoffs; and in the tax issue, it is a tradeoff between all these preferential treatments that are there for a reason: To encourage people to take advantage of that particular activity. So, in the case of home ownership, we want to encourage home ownership and we subsidize it. Now, if we really want to go base broadening and lower marginal tax rates, we have to give up this kind of an approach to tax policy and putting in a lot of special preferences. My own feeling would be that we have come to feel very strongly about subsidizing and promoting home ownership, and I would probably want to leave in the mortgage deduction for first homes, exclude it for second homes; and I would want to be more aggressive on some of the other tax preferences, rooting them out.

You know, you can't lower marginal tax rates unless you are going to eliminate most of the tax preferences.

Senator LONG. There are a lot of ways to lower marginal tax rates. You can enact some other tax; or do what Reagan does: Just run up the deficit. There are all kinds of things. [Laughter.]

Dr. MEYER. That is right. The world is full of tradeoffs, and you have got two of them right there. That is right.

Senator LONG. Thank you very much.

The CHAIRMAN. Senator Bradley?

Senator BRADLEY. Thank you very much, Mr. Chairman. Dr. Galper, in your testimony you say: "The cost recovery comparisons across countries, such as calculations performed by Arthur Andersen, are deficient in several respects as indicators of international competitiveness." Could you elaborate on that point?

Dr. GALPER. Yes; what these studies tend to show is what are the present values of depreciation deductions across countries and how do they compare? And so, they just take this one dimension of the tax structure and say in which countries is cost recovery greatest? And there are several problems with this, most of which is that there is much more to the environment within which business decisions are being made than how quickly we are depreciating assets.

It doesn't take into account rates; it doesn't take into account financing, and the like. There was a time when the United Kingdom had the most favorable cost recovery system because they allowed rapid depreciation, but that didn't promote particular growth in investment. And Japan, as you say, looks like it is very low on this list because its cost recovery system is not particularly generous; and in fact, some of those tables also have footnotes for Japan saying, well, there are other factors in this case.

We can't just look at cost-recovery rules alone here; and yet that is what the table presents. So, there are other elements of this whole system which determine both the saving and investment mix; and taking this one element and saying this is what drives investment is misleading.

Senator BRADLEY. I don't know if Dr. Heller is going to get here, so I would like to read a quote from his testimony and get your reaction to it, Dr. Galper. He refers to a study by Mervin King, National Bureau of Economic Research, that says:

> Of the four countries studied, West Germany, the country with the highest overall effective tax on income from capital also has the highest rate of growth of nonfinancial corporate capital. Sweden was second, and the United States third in both categories. The lowest overall effective tax on income from capital was found in the United Kingdom, side by side with the lowest capital growth rate.

Now, how do you explain this, if taxes are the determining factor of investment and also of international competitiveness?

Dr. GALPER. I certainly wouldn't want to say that we want high taxes to promote growth, but I would say that it is a much more complicated process than those who simplistically look at the tax rates on capital income would say. We do have to look at the entire context within which business decisions are being made. We have to look at the vitality of the economy in a much more general sense.

I am not troubled, therefore, by some of the increases in the cost of capital that are imposed by H.R. 3838. I don't advocate them as a good thing. But I am not troubled by them because I think the saving-investment decisions are motivated by other things besides the specific tax elements.

Senator BRADLEY. Now, Dr. Meyer has asserted that we have depreciation or ITC's or whatever to increase the overall level of investment in those particular areas. Now, you had some figures in your testimony about what has happened since 1981. Could you repeat those figures? You were talking basically about the Bosworth study.

Dr. GALPER. Yes; there are two elements which I think are worth referring to—one on the saving side and one on the investment side. On the saving side since 1981, despite massive subsidies and incentives for private savings, private saving has actually declined. We have had big cuts in marginal tax rates. We have had high pretax returns in real terms on assets. We have had IRA incentives——

Senator BRADLEY. And savings have declined.

Dr. GALPER. On the savings side. On the investment side, if you look at where the investment has increased since 1979, it has not been in those areas which have had these big tax cuts. It has been in areas where there has not been much of any tax change. In the equipment area, which was indicated in the study by Barry Bosworth, it has been primarily computers and business automobile investment that has accounted for 93 percent of the investment growth over the period of 1979 to 1984; and yet, those are two areas where there has not been any net change in tax benefits from the 1981-82 tax acts.

Senator BRADLEY. How do you explain that, Dr. Meyer? I see you are champing at the bit over there with the opportunity to respond, so go ahead.

Dr. MEYER. Thank you for asking.

Senator BRADLEY. How do you explain that?

Dr. MEYER. Oh, I think it is a very important point. Taxes—investment tax credit, accelerated depreciation—are not the only influence on investment. What we have done is, on the one hand, we gave more investment incentives; on the other hand, we run huge deficits which raise real interest rates and offset them. We didn't improve the climate for investment one bit.

Senator BRADLEY. So, you then have to accept that, if we gave less investment incentives to the Tax Code and interest rates and other elements of the economy improve, that overall economic growth could very well be higher?

Dr. MEYER. What I show in the study is if you do Gramm-Rudman, lower the deficit, and do tax reform, you will only slightly impair capital formation. You wouldn't have better, but——

Senator BRADLEY. No, no; I am talking about economic growth.

Dr. MEYER. Economic growth?

Senator BRADLEY. Would be improved?

Dr. MEYER. Economic growth would be basically unchanged.

Senator BRADLEY. Unchanged?

Dr. MEYER. Basically unchanged.

Senator BRADLEY. If interest rates dropped?

Dr. MEYER. If interest rates are sufficiently lower with Gramm-Rudman and accommodated by monetary policy, you could withstand tax reform without slowing the rate of economic growth over the 5-year period.

Senator BRADLEY. But it wouldn't increase at all?

Dr. GALPER. No efficiencv gains, though.

The CHAIRMAN. Senator Durenberger, any other questions?

Senator DURENBERGER. Yes. Gentlemen, on the issue of the consumption incentives or the savings disincentives, one way to move that situation closer to neutral is to reduce the tax deductions for consumptions in the income tax, which would probably enable us to lower the rate.

Another is to tax only income which is devoted to consumption. That would make it difficult, I would imagine, to lower the rate. The third is a specific tax on the transfer of ownership of goods and services in some way, which might have a variety of uses—pay off the debt, increase spending, or it could go into lowering the income tax rate of the payroll tax rate.

What would you suggest to a committee that might be interested in reducing the benefits of consumption in the Tax Code generally in this country? What is the better course that we follow: knowing that those are three of the main courses open to us?

Dr. MEYER. Could I answer that first? I think that it would be a substantial waste of this committee's time to be worrying about the various kinds of tax structure changes that could be made to increase the saving rate.

I don't think that any change that is being contemplated in tax reform would have a substantial impact on the saving rate. I think you are barking up the wrong tree.

Senator DURENBERGER. But we can raise money if we eliminate the deductions that are available for consumption?

Dr. MEYER. You can——

Senator DURENBERGER. I am not advocating that as a saving incentive.

Dr. MEYER. That is right.

Senator DURENBERGER. But at least we reduce the revenue lost through consumption.

Dr. GALPER. As a base-broadening device, for example, with the income tax you could reduce categories of deductions which are for particular types of consumption.

Senator DURENBERGER. My question is: What should we do? What, in your opinion, should we do, given the nature of the economy and the existing deficit and whatever else you are here to testify on?

Dr. GALPER. Well, I would search for further ways, first, of broadening the base as a way of raising additional revenues. That is where I would look first because I think this is consistent with both tax reform and with the need for additional revenues. So, I would look at various forms of untaxed income or of benefits that are given to categories of consumption under the current tax system. That is where I would go first.

Second, I would look for other sources of revenue, if we can't do that; and other things being equal, I guess I would prefer moving to perhaps some consumption-based sources of revenue, if we have done all that we think we can do under base broadening under the income tax.

Senator DURENBERGER. Dr. Meyer, do you oppose going to a broad-based general consumption tax?

Dr. MEYER. I oppose it as a part of tax reform. I think that we should maintain the same amount of income from the income tax system. I believe the income tax system is the best and most equitable way of raising revenue. If, when we are done with that tax reform, we find we still need revenue—which we will—and if we haven't broadened the tax base enough to make it easy to add to the tax rate in that system—which I don't think we will do—then I think we will need to look to a value-added tax in order to raise money to close the deficit.

But I think we should not use it as part of tax reform because it would compromise the implementation of deficit reduction.

Senator DURENBERGER. There has been great concern over the highly leveraged nature of corporate America in recent years. Some have suggested we place limits on the amount of debt that corporations can deduct as means of slowing this move away from equity financing. Do you think we should consider placing such limits on corporate debt?

Dr. GALPER. I would have to think about that. My first reaction to that would be negative. I think we should do more about equalizing the tax treatment between debt and equity, but I don't think the solution is to put limits on debt. The solution is to see how we can provide a tax system which doesn't penalize equity relative to debt.

There are two dimensions of that. One, again, is to the extent that we lower marginal tax rates, that also moves in the direction of equalizing the treatment of debt and equity; and that is another benefit of that type of approach. The other is the extent to which we can integrate more corporate taxes with individual taxes; then we won't have this additional penalty to equity financing. So, I would be in favor of those types of structural tax changes, but I don't think I would be in favor of limits on the amount of debt.

Dr. MEYER. My concern would be that, as H.R. 3838 stands now, it has already shifted too much of the tax burden onto corporations. We need to find ways to index depreciation and make up the revenue loss without further taxing corporations.

The CHAIRMAN. Any other questions?

Senator BRADLEY. Mr. Chairman, I just want to follow up on what Senator Durenberger said, with just one point.

You said that tax reform with lower rates would reduce the amount of leverage financing. Now, why would it reduce the amount of leverage financing?

Dr. GALPER. Because part of the benefit of leverage financing is the benefit of the interest deduction, particularly in an inflationary environment.

Senator BRADLEY. So, because the interest rate has dropped, the value of the deduction would be less, and therefore, there would be less leverage financing?

Dr. GALPER. Because tax rates have dropped, yes, that is correct.

Senator BRADLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Gentlemen: thank you very, very much. We appreciate it. Has Dr. Heller arrived yet?

[No response.]

The CHAIRMAN. While we are waiting, I wonder if we might take Senator Curtis, who has some comments to make. Carl, if you wouldn't mind coming now while we are waiting for Dr. Heller, it would help us.

Senator Curtis has served for—what?—38 years in the Congress all together?

Senator CURTIS. It was 40. I was 20 on this committee.

The CHAIRMAN. Twenty on this committee, and a ranking member for a good many years. We are delighted to have you back before us.

Senator CURTIS. I will try to refrain from asking myself questions, although I spent 20 years doing that. [Laughter.]

STATEMENT OF HON. CARL T. CURTIS, FORMER U.S. SENATOR, ON BEHALF OF THE NATIONAL ASSOCIATION OF ROYALTY OWNERS

Senator CURTIS. Mr. Chairman, I deeply appreciate the opportunity to be here. I know the tremendous load that you have and the number of witnesses who want to be heard; and I shall be very brief.

The oil royalty owners are here to emphatically oppose the repeal of the depletion allowance as it relates to royalty income. Royalty income is not ordinary income. It is not like the income from merchandising, agriculture, professional fees, or wages. Those types of income constitute reoccurring income, which can be produced year after year. If an individual owns a certain number of barrels of oil in the ground and sells it, he has sold a capital asset. It is gone. It cannot be reproduced.

The royalty owner is in the same position as if a farmer sold 5 acres of his farm. The money received for the 5 acres sold is not ordinary income. It is the return on the sale of a capital asset, and it is taxed at capital gain rates. Because royalty owner income is the result of selling an irreplaceable capital asset, the depletion allowance was made a part of our income tax many years ago.

The depletion allowance has been reduced to 15 percent. We urge this committee to either retain present law for the depletion allowance or grant capital gains treatment to royalty income. Royalty owners, by and large, are not individuals of wealth. The Bankers Association in Oklahoma advises us that the average royalty payment in that State is $200 a month. Royalty owners are farmers, mostly, retired persons, or widows or other descendents, or transferees of farmers. To pick out this group and tax as ordinary income their income from a sale of a capital asset is not only unsound national policy, but it is cruel and unjust.

Retaining the depletion allowance merely for stripper wells, as the House has done, is not a fair answer and will be unjust between taxpayers and geographical areas. With all the earnestness at my command, I beg each of you on behalf of the 2.5 million royalty owners—oil royalty owners—and the 1.5 million gas royalty owners in all 50 States to resist such an unjust act. The depletion allowance should be retained or capital gains treatment be afforded these people as it is for coal or iron royalty income and timber income. A lease bonus payment, in reality is an advanced royalty payment and should also be given percentage depletion and capital gains treatment.

Mr. Chairman, I thank you very much.

The CHAIRMAN. Senator Curtis, thank you very much.

The CHAIRMAN. Are there questions of Senator Curtis?

Senator LONG. I would like to ask the Senator about this matter. Senator, is it not correct that, if I have 100 acres of land, whether I sell one acre or whether I sell a half acre or whether I sell the whole 100 acres, that is a capital gains transaction?

Senator CURTIS. That is correct.

Senator LONG. Now, if I have an oil well and I sell a fractional interest, be it 1 percent, one-half of 1 percent, or 100 percent, that is also a capital gain because you are selling part of the real estate. Is that not correct?

Senator CURTIS. That is correct.

Senator LONG. Now, unfortunately, if I am selling, let's say, 100 barrels, that is not treated as a capital gain.

Senator CURTIS. But it is capital gains. It is an asset that is there that cannot be reproduced, unlike all other types of ordinary income. This is part of your property that is gone.

Senator LONG. Now, do you understand why it is that a royalty owner objects to being denied the right to sell oil by the barrel at capital gains rates, compared to the capital gains treatment he could get if he sold a fractional part?

Senator CURTIS. No; I think he is thoroughly justified in asking for capital gains treatment.

Senator LONG. Let me just make sure I understand this. I do own some royalties, so I do understand this. If you sell some oil in the ground, it has to be a fractional interest—1 percent, let's say, or 100 percent—and it has to be appraised by someone who knows something about geology. That appraisal invariably is far below the amount that that will actually yield. So, to use a colloquial term, the seller just leaves a lot of money on the table because he never gets paid for all that he is selling.

Now, the reason for that is that that geologist is usually hired by those making the loan or those who are on the buying end. If he doesn't have a conservative estimate of how much oil there is down there, or if there turns out to be less than he estimates, they will never hire him again. So, in order to be available to represent the bank and the lender, he has to make the appraisal very conservative. The result is that in selling the fractional interest of an oil or gas reserve, invariably the seller takes one terrible beating because invariably the estimate is far below the amount that he is actually selling.

Senator CURTIS. I agree with you. If there is an estimate and he has to give the best chances on the side of the purchaser, which is to the disadvantage of the owner, and while it is a different transaction.

The same thing is true if the oil is pumped out and he sells so many barrels. It is a sale of his capital assets.

Senator LONG. Thank you, Senator.

The CHAIRMAN. Any other questions?

Senator BENTSEN. Thank you very much, Mr. Chairman. I am delighted to see my friend, Carl Curtis, before this committee; and I don't know anyone who was a more distinguished Republic Senator when he served here, but one who never hestitated to cross to this side to work with us when he thought it was important to the country.

It is very nice to have you back.

Senator CURTIS. Thank you, sir.

Senator BENTSEN. Senator, I find it rather difficult to understand why depletion for oil should be treated in a discriminatory manner as compared to coal or iron ore, copper. As I look at this tax law that has been proposed, they bring the depletion allowance down to 5 percent for most minerals. But they say for oil it goes to zero.

Now, I know that oil is not politically popular, and a lot of folks have a lot of fun bashing oil, so to speak; but a lot of the old image is gone, as far as realities. We have got more bankruptcies than we have ever seen in that business. Where we had 4,500 rigs several years ago, we are down to 1,500. A lot of people seem to have forgotten 1973 and what happened when we became too dependent on foreign oil. I hope there will be some reconsideration of this; and I, for one, am going to be working to see that that depletable resource gets at least the consideration of the other major minerals in this country. I know the bill reduces depletion on sand, gravel, and clay down to zero; but those are minerals in great supply—plentiful supply—so perhaps from a national defense standpoint, there is some difference there.

But can you tell me some justification for saying that oil falls to zero, while coal, iron ore, copper, other metals receive something better?

Senator CURTIS. I very advisedly used the term in here that I thought it was an unjust and cruel thing to do. From the national standpoint, it is bad. We need oil; we need the encouragement of it. We do not want wells to be shut down and capped or purposely made stripper wells for a tax advantage. There is every reason in the world why we should be adding encouragement to oil production in this country.

In addition to that, you get oil from land. The people who live on land are farmers. We have a farm crisis, according to everybody's statements. And now, when these farmers or their children, who might be living in another city, sell interest in that land—so many barrels of oil—they shouldn't be penalized and say that is ordinary income.

That is like your income from your wheat or your corn that you can produce some more next year.

Senator BENTSEN. Thank you very much.

The CHAIRMAN. Any other questions?

Senator CURTIS. Again, I thank the committee, and I thank the chairman.

Senator BRADLEY. Mr. Chairman, let me just thank Senator Curtis for his testimony and his clear advocacy of this issue. And I appreciate his coming before the committee, too. I am honored by it.

Senator CURTIS. Thank you.

The CHAIRMAN. It is good to have you back with us.

Senator CURTIS. Thank you.

The CHAIRMAN. Dr. Heller, I am glad you got here.

Dr. HELLER. Yes, so am I. Thanks. [Laughter.]

The CHAIRMAN. We took the other two economists and turned them loose. So, you are our last witness, and why don't you go right ahead? This is a very, very distinguished economist in this country who has appeared before this committee numerous times.

Senator LONG. Thank you, Senator.

STATEMENT OF WALTER W. HELLER, PH.D., REGENTS' PROFESSOR OF ECONOMICS, UNIVERSITY OF MINNESOTA, MINNEAPOLIS, MN

Dr. HELLER. You turned them loose, and now you are going to turn me loose. I understand you announced that I was somewhere in a fog. [Laughter.]

The CHAIRMAN. Hopefully, we were speaking geographically and not economically.

Dr. HELLER. Yes; I understood someone murmured: So, what is new? [Laughter.]

Well, I hope I do a little better than that.

Let me just quote one paragraph that gives you an idea of where I am coming from on the House package as a whole, and then I will zero in on the economic impacts. On the overall judgment of the House bill, the purist in me continues to say that this is a far cry from all-out tax reform; but the realist in me says that, in striking a better balance between poor and rich, in curbing many tax abuses, in broadening the tax base enough to lower tax rates significantly, and in reducing business tax disparities, it is a distinct move in the right direction.

So, what Rusty has wrought, let not the Senate tear asunder. Now, I try to make 10 points in my testimony, and I will try to give them about 1 minute apiece in line with your injunction to hold to 10 minutes in this statement.

These 10 points are largely aimed at putting the economic impacts of H.R. 3838 in broad perspective. Now, the first four points are on the overall impact on corporate tax burdens. First, the percentage of total receipts provided by the corporate income tax has dropped from 28 percent in 1956 to 11 percent this year; and the House bill would raise this to 13.6 percent. That is roughly the average level in 1975 to 1980. Second, combing out the impact of erosion of the income tax base and the growth of other tax revenues, the second point is that the slice of corporate profits that is taken by the Federal income tax has skidded from 44 percent in the early 1950's to 33 percent in 1970, to 23 percent in 1980, and 13 percent in the recession year, 1982. That is essentially the average corporate tax rate, subject to some increase because of the recovery. And under the House bill, the corporate tax bite will remain far below the levels of earlier years.

Third, when the added corporate tax burden of $138 billion in the next 5 years is put under the microscope, it bears out President Reagan's assertion that the great bulk of that increase in the House bill and in his own plan is the result of jacking up the tax on those who have been escaping their fair share of the business tax burden, not by hitting those who are already pulling their weight. And I accept the President's judgment on this, as I do on all matters when he is right. And the House report on the bill bears him out, in spades. Over 5 years, the bill would add $98 billion to corporate burdens by repealing the investment tax credit; that was an old favorite of mine years ago; and another $20 billion by tightening depreciation. But it would also lighten burdens by $94 billion, mostly by lower rates. In other words, a net of only $24 billions or 27 percent of the total corporate tax increase in the

House bill represents an added levy on typical corporate operations.

As for the remaining 83 percent, you may quarrel with the particular targets of those increases, but the nature of the tax increase is crystal clear; namely, it jacks up burdens on tax-favored companies by curbing tax preferences and narrowing loopholes, just as the President indicated.

Now, fourth, the House bill makes the corporate tax more even-handed in its impact by taxing income from depreciable and nondepreciable assets similarly and by narrowing the tax gap between equity financed and debt-financed investments. Tax rates across different types of investment, different types of asset, are made considerably more equal than under present law; and that is a plus, a distinct plus. So, although the bill would moderately increase the overall tax rate on capital income, it would at the same time level the economic playing field substantially, and that, as I say, is an asset.

Now, let me turn to the impact of the House bill on the rates of savings, investment, and growth, all of which have hit their post-war lows in the 1980's. Real growth has averaged under 2 percent so far in the 1980's, compared with over 4 percent in the 1960's and over 3 percent in the 1970's. Net national saving has plunged to its lowest level in 50 years, as has net private investment by Americans. And so, the committee's deep concern over the investment and savings aspects of tax reform is certainly well grounded. My statement makes six points on this subject.

First, tax reform can't hold a candle to deficit reduction as a means of promoting savings and investment. The deficit is the major force that is leeching savings away from the private sector, and thereby boosting interest rates and curbing capital formation and stunting economic growth and keeping the dollar overvalued and thereby undermining our competitive position in the world.

Congress and the President can do far more to boost U.S. capital formation by making tax reform a significant revenue raiser and thereby sucking less private saving and investment into that black hole of the deficit than by enlarging tax breaks for investment. I realize that is a tough political issue, but as far as the economics of it is concerned, there are lots of things we don't know but that is one thing we do. Many of the provisions of ERTA like IRA's were designed to boost savings and investment, but they failed because the dissaving that they involved by enlarging the deficit swamped the savings that they generated. I mean, that IRA thing is costing us $13 billion a year and not generating much net additional savings. And I think there is a case where tax incentives went wrong, even though it is a great thing for Americans who want to squirrel away some funds for retirement. But as far as the tax side is concerned, what we gained in the tax-preference swings was dwarfed by what we lost in the deficit roundabouts.

Second, we should bear in mind that interest rates far outweigh changes in tax incentives in determining the user cost of capital. And one clear implication of this is that the FED can readily overcome any negative effects that tax reform might have on capital formation.

Third, we shouldn't forget that business investment is only one of several sources of economic growth and competitiveness. Investments in human brain power through education and skill training and investments in research and development and investments in physical infrastructure have been shown by the studies by Ed Denison, who is the world's authority on growth, to outweigh private investment in plant and equipment as a source of economic growth.

So, sensible supply-side economics, as against what Herb Stein calls "punk supply-sidism", says that we have to invest—invest, not spend—more, not less, public funds in these other sources of growth. For that purpose, we need to strengthen, not weaken, our revenue base.

What does that light tell me, Mr. Chairman?

The CHAIRMAN. That you have only got about a minute and a half left.

Dr. HELLER. A minute and a half left? Well, thank heaven, I only have five more points. [Laughter.]

Dr. HELLER. Fourth, I am not about to say that higher taxes on capital income spur more investment than lower taxes; but you know we ought to give due weight to the efficiency gains under the House bill that derive from the more even-handed treatment of different types of investments and the incentive effects of lower marginal rates.

And the econometric models don't do that. They don't give enough weight to the efficiency gains and to the incentive gains from lower marginal rates. I don't think they give enough weight to the fact that, if you can rechannel investments according to market advantage rather than tax advantage, that strengthens growth and strengthens the capital stock.

Fifth is a point that is painful to us economists to admit, and that is that we really don't know as much as many of us pretend to know about the specific impacts of particular tax provisions. You can get authorities on both sides, for example, on the research and development credit, all of whom you respect. Your own Congressional Budget Office, and Ed Mansfield, a great authority on the subject at the University of Pennsylvania, say the R&D credit is bad, and yet DRI and Bob Lawrence at Brookings say it is good. And I must admit that we economists don't come up with a solid front on that kind of thing.

Sixth, perhaps an obvious point is that if the committee untaxes capital income, it is going to have to tax labor income more heavily. There are just no two ways about it. We have been doing that ever since the war. We have been boosting taxes on labor income and reducing taxes on capital income; and if we put in too many special benefits for capital income, we are just going to slam labor income.

So, overall, I conclude that tax reform is important and ought to be pursued, indeed, the need is urgent; but under the banner of tax reform, let's not assign jobs to the income tax that it can't do nearly as well as other instruments.

The CHAIRMAN. Thank you, Dr. Heller.

[The prepared written statement of Dr. Heller follows:]

ECONOMIC EFFECTS OF H.R. 3838, THE TAX REFORM ACT OF 1985
STATEMENT BEFORE THE COMMITTEE ON FINANCE, U.S. SENATE

by
Walter W. Heller
Regents' Professor of Economics, University of Minnesota
Washington, D.C., February 5, 1986, 9:30 a.m.

Mr. Chairman and Members of the Committee:

To conserve your time and enable me to focus my testimony directly on the impacts of tax reform that appear to be of prime interest to the Committee, I'm appending to this statement my overall appraisal of H.R. 3838 published as a Board of Contributors article in the Wall Street Journal of January 22.

To give you an idea of "where I'm coming from" on the House package as a whole, I will quote only my concluding paragraph:

> On the overall judgment of the House tax bill, the purist in me continues to say that this is a far cry from all-out tax reform. But the realist in me says that in striking a better balance between poor and rich, in curbing many tax abuses, in broadening the tax base enough to lower tax rates significantly and in reducing business-tax disparities, it is a distinct move in the right direction. What Rosty hath wrought, let not the Senate tear asunder.

Much of the testimony you heard in the first two days of your hearings last week took the position that H.R. 3838 hits corporations too hard and will seriously damage private investment. To lighten that load and yet maintain revenue neutrality, revenues would have to be found elsewhere within the bounds of the income tax through measures like curbing deductions of state and local taxes or outside the bounds through an oil import fee or other excise taxes or even a sales tax. The Treasury Department tells us that the Senate would have to add nearly $100 billion of revenues over five years to bring H.R. 3838 into line with the President's demands, roughly half of it to bolster business tax breaks and the other half to boost the personal exemption to $2000 and cut the top individual rate to 35%.

I'm going to argue that H.R. 3838 would not overburden corporations, that its adverse impact on investment is overstated, and that cutting the Federal deficit is a far more effective way to boost private savings, invigorate private investment, and beef up our international competitiveness than tilting the tax code toward business and wealthy investors.

Further, I will argue that the greatest economic contribution that tax reform can make over the long run is (a) to weed out the tax provisions that pull resources out of their most efficient uses and divert them into less efficient, less productive channels and (b) in that process, to broaden the tax base and use the proceeds either to cut marginal tax rates or to cut the deficit.

I will argue that if this be heresy, it's good orthodox heresy -- or to put it in less jesting terms, it may be political heresy, but it is economic orthodoxy.

The Corporate Tax Increase in Perspective

There are few absolutes in taxation. No one can say, for sure, that the corporate tax burdens under H.R. 3838 are too heavy or too light.

Too much of that judgment depends on value preferences, on unsettled questions of tax incidence, and on less-than-certain analyses of economic effects.

What may help, however, is a little historical perspective, some disentangling of the components of the corporate tax increase, and a reading on whether the House bill makes the corporate tax more even-handed.

H.R. 3838 would restore the corporate income tax as a source of Federal revenues to its relative status of the late 1970's:

- From a lofty 28% of total Federal receipts in 1956, the corporate tax skidded to 8% in 1982 as a result of the erosion of the corporate tax base and the growth in other revenues, compounded by the recession of the early 1980's.
- Recovery is boosting the corporate share to 11% of receipts in 1986.
- The House bill would raise this to 13.6% by 1990, about what it averaged in the 1975-80 period.

To comb out the impact of growing payroll and other tax revenues on these percentages, one should examine the trend of the effective rates of tax on corporate profits over the years. From an average rate of 44% in 1951-52, the effective rate dropped to 40.8% in 1960, 33.5% in 1970, 23% in 1980, and 13% in 1982. The increases under H.R. 3838 would not bring the burdens on corporations within shouting distance of those earlier average effective rates.

Although there is much viewing with alarm on the nearly $140 billion of added tax liabilities of corporations under H.R. 3838, much less attention is drawn to the distribution of those burdens. President Reagan is right on the mark when he stresses that the great bulk of the increased taxes on corporations under his plan -- and much the same is true for H.R. 3838 -- results from imposing heavier burdens on those who have been escaping their fair share of the business tax burden, not by heaping heavier burdens on those who are already paying their fair share. I accept the President's judgment on this as I do in all matters -- when he's right.

The figures in the House Report on H.R. 3838 bear him out: for the five fiscal years 1986 through 1990, the depreciation changes in the House bill would cost corporations $20 billion, while repeal of the investment tax credit would cost $98 billion, for a total of $118 billion.

- Offsetting these tax increases for corporations in general would be tax cuts of $88 billion in the form of lower corporate rates and another $7 billion through the dividend deduction and the extension of the R&D credit, for a total of $94 billion.
- In other words, only $24 billion or 17% of the total corporate tax increase represents an added burden on typical corporate operations.
- As for the remaining 83%, one may quarrel with the particular selection of targets in the House bill, but the nature of the tax increase is crystal clear: it consists of jacking up burdens on tax-favored companies by curbing tax preferences and narrowing loopholes, just as Mr. Reagan indicated.

Buttressing the foregoing numbers showing that H.R. 3838 would make the corporate income tax more even-handed in its impact are the findings of the study by Yolanda Henderson of the American Enterprise Institute (Tax Notes, December 9, 1985). Using techniques that she and Don Fullerton, (now Deputy Assistant Secretary of the Treasury for Tax Policy) have developed, she concludes that "tax rates across different types of investment would be made more equal than under current law" and that by taxing income from depreciable and non-depreciable assets similarly, the bill "would 'level the playing field' as much as the Administration's plan." She finds that under both plans, the standard deviation of capital costs would drop from 1.71 percentage points under present law to 0.93 under H.R. 3838.

True, the Henderson study calculates that the overall marginal effective tax rate on capital income (including all taxes, both corporate and individual and state-local income and property taxes) would rise to 30.6% under the House bill (as against 29.4% under the Reagan proposal) from 26.3% under current law.

Another way of looking at the distribution of that increase is its impact on equity-financed versus debt-financed investments. The net effect of the House package would be to impose little or no added tax on the former while boosting the tax on the latter (mainly because the cut in the corporate rate from 46% to 36% erodes the value of interest rate deductions). So it would narrow the gap between debt and equity financing, a distinct plus in terms of economic effects. (The plus would be much bigger if the tax code were amended to index interest payments for inflation, that is, to screen out that part of interest paid to compensate lenders for the loss of purchasing power of their money.)

Impact of Tax Reform on Savings, Investment and Growth

That brings us directly into the difficult and uncertain sphere of impacts of tax reform on savings, investment, and growth. And again, in gauging and judging the investment impacts of H.R. 3838 and its alternatives, we have to guard against losing our bearings, our sense of perspective.

Our goal is clear enough: high levels of saving, investment, productivity and economic growth. The Committee's concern over these objectives is right on target, especially in light of the poor performance on all four fronts in the 1980's:

- In spite of generous savings incentives in the 1981 tax law, personal savings fell and, in 1985, net domestic savings flows (individual plus business savings minus replacement investment), at about 8% of GNP, ran a little below their long-run level. Over half of all private saving had to be used to finance the budget deficit, amounting to about 4 3/4% of GNP, thus bringing the national saving rate to its lowest level since the 1930's.
- Net private domestic investment ran at about 5 3/4% of GNP, much of it financed by inflows of foreign savings. With combined public and private financing needs adding up to 10½% of GNP, domestic savings fell $100 billion short of those financing needs, the largest savings gap in the modern history of this country. Net investment by Americans is at its lowest ebb since

the 1930's.

- The record on productivity is equally discouraging. The spurt induced by the 1983-84 recovery evaporated in 1985, and there is as yet no indication of the turn-up in trend productivity growth that we had anticipated for the mid-1980's.
- The real growth rate, after running at a 4.2% annual rate in the 60's and managing to average 3.1% in the 70's, has slipped to less than 2% thus far in the 80's. Even if we assume no recession in the next four years and 3% annual growth, the decade would weigh in at just 2.4% annual growth.

Small wonder that this Committee is deeply concerned with boosting investment and growth. And your concerns have surely been heightened by the testimony you have heard on the negative impacts of H.R. 3838 on investment. But there is another side to the story.

First and foremost, important as tax reform is in promoting fairness and economic efficiency, it cannot hold a candle to deficit reduction as a means of promoting savings and investment. The numbers just cited show that the deficit is the major force that is leeching savings away from the private sector. In that process, it is boosting interest rates, curbing capital formation, stunting economic growth, keeping the dollar overvalued, undermining our international competitive position, piling up huge debts to foreigners, and shrinking the legacy we pass on to our children.

Anything done in the name of tax reform that would thwart deficit cutting should be avoided like the plague. Anything that can be done in the course of reform to facilitate deficit-cutting should be welcomed with open arms. If providing or safeguarding tax incentives for saving and investment enlarges the deficit, it will be self-defeating. Thus, if meeting the President's demand for adding $40 to $50 billion of tax incentives for business in the next five years (in addition to $40 to $50 billion of tax breaks to individuals through higher exemptions and a lower top rate) end up using revenues that could have narrowed the deficit gap, the net impact on private saving and investment will be negative. What we gain in the tax-preference swings will be dwarfed by what we lose in the deficit roundabouts.

Tax breaks for IRA's are a good case in point. Attractive as they are to taxpayers to build up savings for retirement, they are a bad bargain for the economy:

- Though the inflows into IRA's are very large, surveys show that for the most part, taxpayers simply switch funds from other sources, or even from borrowing, into their IRA's, rather than curbing consumption. A dog that gets the bone, not by sitting up, but simply by barking comes to mind.
- IRA's will cost the Federal Treasury some $13 billion of revenue this year with a corresponding increase in the Federal deficit, or dissaving. The result: a net reduction of saving and one reason why ERTA has failed to boost saving.

The lesson is pretty clear: Congress and the President could do far more to boost U.S. capital formation by making tax reform a significant revenue raiser and thereby sucking less private savings and investment into the black hole of the deficit than by enlarging tax breaks for investment.

Second, still focusing on forces other than tax incentives that determine levels of capital formation, we have to recognize that changes in interest rates far outweigh changes in tax incentives in determining the user cost of capital. High interest rates simply swamped the investment incentives of ERTA as modified by TEFRA. The boost that tax cuts gave to cash flow worked for a while, but that has largely worn off.

A New York Federal Reserve Bank staff study (Quarterly Review, Federal Reserve Bank of New York, Winter, 1984-35) concluded that the 1981-82 tax cuts significantly reduced the user cost of capital, "but judged in terms of the FMP (Federal Reserve-MIT-Pennsylvania) model, these tax changes appear to have contributed only about one-fifth of the 1983-84 growth in capital spending." Much the greater part of that growth came, first, from personal tax cuts that stimulated actual and expected sales and, second, from the sharp drop in nominal interest rates in 1982.

The Federal Reserve study suggests another factor to be mindful of in determining the role of investment tax incentives in the scheme of things. Time and again, it has been the pressure of rising consumer demand that has spurred capital formation. It is important to strike the right balance between tax impacts on consumption and investment.

Once we consider these other forces that may stimulate or inhibit investment, the sobering findings of the comparative international study by Mervyn King and Don Fullerton for the National Bureau of Economic Research should not surprise us:

- Of the four countries studied, West Germany, the country with the highest overall effective tax on income from capital, also had the highest rate of growth in non-financial corporate capital.
- Sweden was second and the United States third in both categories.
- The lowest overall effective tax on income from capital was found in the United Kingdom side-by-side with the lowest capital growth rate.

That brings up a third consideration bearing on the sources and forces that determine whether an economy will grow at a good clip and be competitive, namely, the level of investment in what broadly falls under the heading of infrastructure. To facilitate private investment calls for public investment in highways and streets, water and sewer systems, and basic public services. To be productive and competitive calls for a highly skilled labor force. It also calls for strong technological advances and the research and development expenditures that produce them. The common thread? These are all areas requiring bigger outlays by some level of government to strengthen and expand both production and productivity in our economy. In other words, good old classical supply-side precepts called for increased tax revenues to achieve our growth and competitive goals.

Fourth, having tried to put tax incentives into their proper economic perspective, let me now turn directly to the allegation that, all other things being equal, H.R. 3838 will seriously impair investment, growth, and competitiveness. I'm not about to argue that a bill that boosts the overall tax rate on capital income from 26.3% to 30.6% will spur investment.

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But I will argue that the bill, by significantly reducing the tax disparities that now distort resource flows, will increase efficiency in the use of capital. That, in turn, means higher output from any given stock of capital.

With all due respect, even awe, for the large econometric models and their products, I don't believe they are geared to give due weight to the efficiency gains, the higher output we'll get from a given capital input as a result of reducing tax disparities among different assets. Redirecting resources from lower-efficiency channels into which they are drawn by tax advantage (as in the case of many types of equipment where tax breaks now convert negative pre-tax returns into after-tax profits) into more productive uses determined by market advantage is a distinct plus (an analysis by Dale Jorgenson of Harvard University concluded that the tax neutralization effected by Treasury I would have generated large enough efficiency gains to raise GNP by about 3%, though most observers believe this overstates the gains.) The efficiency gains don't come quickly, but they could well dominate in the longer run. And in the short run, the obvious remedy for any negative effects on investment levels is an adjustment of Federal Reserve policy to offset those effects. Even if the model builders and other witnesses who cry the blues about short-run adverse effects on private capital formation are partly right, that should not deny us the long-term improvements in efficiency.

Fifth, it is not just that the nay-sayers on the investment impacts of H.R. 3838 give insufficient weight to the gains in efficiency and even-handedness in the distribution of corporate tax burdens. It is: how can they be so sure of their conclusions? Economists can say a number of things for sure, within tolerable limits, on the first three categories above. But when it comes to judging the effects of particular tax provisions on private capital formation, I would subscribe to the statement of Barry Bosworth of Brookings, who concludes, after exhaustive studies of the impact of taxes on saving and investment, that "the tax system has become so complex, with myriad special provisions for different types of saving and investment, that economists can no longer tell you whether a specific provision actually promotes or discourages capital tax formation. . . . . There is such an enormous interaction between the tax system and the method of financing an investment project that the final outcome is very uncertain."

A case in point is the appraisal of the economic impact of the research and development credit that would be renewed by H.R. 3838. Four highly respected authorities divide two and two on the subject. Analyses by the CBO and Professor Edwin Mansfield of the University of Pennsylvania sharply criticize the credit in its present form. In contrast, DRI and Robert Lawrence of Brookings conclude that the credit has been very effective and should be continued. That's the kind of unanimity that endears economists to the public and economic policy makers! As implied above, there are many places where economists, even though they represent quite different schools of thought, can provide reasonably reliable and agreed conclusions. The impacts of specific tax measures on levels of investment are not one of them.

Joseph Pechman, in a report on a Brookings Research Conference on why economic analyses of the Treasury's original tax reform proposal differed so much, clearly set forth the disagreements and uncertainities that exist concerning the impacts of tax reform on the user cost of capital, interest rates, international capital flows and the like. I earnestly commend this study to the Committee's attention since it bears so directly on the vital decisions that will be made here on the income tax provisions that affect saving and investment. (The study referred to is "The Treasury Tax Reform Plan: Pro- or Anti-Growth?" published in the Brookings Review, Spring 1985.)

Sixth, the Committee should keep in mind that if it treats capital income more tenderly, revenue neutrality will perforce cause it to treat labor income less tenderly. This would continue a trend that characterizes the post war period in which effective tax rates on capital income have dropped, while taxes on labor income have been increasing A corrclary is that the provision of lower taxes for investment income means cutting taxes for higher income groups at the inescapable cost of increasing taxes on lower income groups. Policy makers should be at least as concerned with the disincentive effects of higher taxes on work effort as they are with the incentive effects of tax breaks for capital income.

Conclusion

There seems little doubt that the tax revisions in H.R. 3838, while falling fall short of perfection, would improve the allocation of resources over the long run and thereby improve the efficiency of the use of capital and, in this respect, raise the level of output of the economy. But the magnitude of this effect is in dispute. And that does not resolve the separate question of whether the overall level of taxation of investment income should be raised or lowered and what impact this would have on total investment. My view of these matters is at variance with the more negative assesments of the economic impact of H.R. 3838 that you have heard to date. But on the specific investment impacts of that bill's provisions, our economic tools of analysis are not refined enough to be very surefooted.

Let me conclude by saying that I am a strong advocate of tax reform that will not eat up revenues that ought to go into deficit reduction, but would instead increase efficiency and broaden the tax base, lower tax rates and give us a fairer springboard for using the income tax, if need be, for raising new revenues. Such a reform is vital from a purely economic point of view. And that is quite apart from the most compelling cause for action, namely, the need to remove the poor from the income tax rolls and provide the tax relief to the near-poor that the 1981 tax Act denied them. None of what I have said weakens the case for tax reform. The need is urgent. But under the banner of tax reform let's not assign jobs to the income tax that it can't do nearly as well as other instruments and policy measures.

WEDNESDAY, JANUARY 22, 1986

A Guarded Yes for Tax Reform

By WALTER W. HELLER

If, as some predict, the House tax package comes out of the Senate much as it went in, should Mr. Reagan sign it?

First, is it root-and-branch tax reform? No. Note that it is increasingly being called tax revision, overhaul, structuring and revamping, but seldom reform.

Second, is it simplification? No. It's complication. So many fine lines are drawn between small and big business, between taxable and nontaxable municipals, and around pinpoint reliefs of various kinds that lawyers and accountants everywhere have been brought back from the brink of despair.

Third, does it, as the Treasury I plan would have, truly replace tax advantage with market advantage as the guide to resource flows? No. It curbs some of the worst distortions, or tax expenditures, but not enough to say that the income-tax code is no longer an industrial policy in disguise, and a capricious one at that.

Fourth, does it help close the deficit gap by gaining more revenue than it loses? No, if anything it is "revenue neutral" on the minus side.

Then I am against it, yes? No. It does substantially more good than harm.

Democratic Chairman Dan Rostenkowski's House Ways and Means Committee produced a second-best bill that, while hardly simple and sweeping, is a distinct improvement over present law. And those of us who are battle-scarred veterans of lost tax-reform wars need to remember that one should not let the best be the enemy of the good.

Major Blow for Tax Justice

First and foremost, the House bill would right some of the wrongs that were done to the poor by the 1981 Tax Act. If one believes that reduction of poverty and inequality is a worthy objective, the bill strikes a *major* blow for tax justice.

At the lower end of the income scale, the bill takes three tax-liberating steps by boosting the refundable earned-income credit for low-income parents by nearly $4 billion a year in fiscal 1990, raising the standard deduction by $7.5 billion, a benefit aimed at lower-income and lower-middle-income earners who seldom itemize; and by providing an additional $39 billion of tax relief through the near-doubling of the personal exemption. For a married couple with two children, the combined exemption and standard deduction would jump from $7,400 to $12,800. More than six million of the working poor would be removed from the rolls. The burden of income and payroll taxes on a family of four right at the poverty line (an income of $10,609 last year), which rose from 1.9% of income in 1979 to 10.4% currently, would drop to 3.3% by next year.

Second, the House bill also makes some progress on the equal treatment of equals dimension of tax fairness. Granted, it treats a great many tax preferences gingerly. But the bill still has considerable bite. It scales back the tax shelters of the oil-and-gas, umber, hard-minerals, real-estate and banking industries, sharply limits tax-free contributions to 401(k) employee retirement plans, ends the preferential "completed-contract" method of accounting on military contracts, taxes unemployment compensation fully, and so on.

Further, the House bill mops up behind its rather untidy loophole-closing efforts by imposing truly tough minimum taxes on both individuals and corporations. It would cut sharply the list of 29,800 individual tax returns with incomes of more than $250,000 that paid little or no tax in 1983. A better approach would have been to use the scalpel and cut out the specific tax breaks that now give these escape artists a free ride. But again, the minimum tax cleaver is not a bad second best.

Fourth, the bill would strengthen the income tax as a potential source of future deficit reductions. In recent years, the war cry has been that one should not tap the eroded base of the income tax for added revenues, but rather serve both equity and revenue needs by ending a broad range of "tax expenditures." To the extent that tax revision broadens the base of the tax—as the House bill does—it provides a fairer launching pad for needed future tax increases. Under the House bill it would be possible by 1990 to raise $55 billion a year by a two-percentage-point increase in income-tax rates across the board.

Fifth, by imposing these tough minimum taxes, by cutting various credits and deductions, and by bringing a lot of excluded income back into the tax base, the House bill is able to cut tax rates sharply. This will contribute not just to fairness but to improved economic incentives.

The most serious charge against the bill is that it will have something between a damaging and devastating impact on business investment.

There's no denying that under the bill's provisions, taxes on capital income would rise. A study by Yolanda Henderson of the American Enterprise Institute shows that the overall tax rate (including all taxes) would be 30.6% as against 29.4% under the Reagan proposal and 26.3% under current law. And I am not about to argue that higher taxes on capital income will spur more investment than lower taxes.

But I will argue that the bill, by significantly reducing the tax disparities that now distort resource flows, will increase efficiency in the use of capital. That, in turn, means higher output for any given stock of capital. The Henderson study shows that the standard deviation of capital costs would drop from 1.71 percentage points under present law to 0.93 point, thus creating a considerably more even economic playing field.

Further, the net effect of the House package would be to impose little or no added tax on equity-financed investments while boosting the tax on debt-financed investment (mainly because the cut in the corporate rate from 46% to 36% erodes the value of interest-rate deductions). Narrowing the tax gap between debt and equity financing is another plus.

In more concrete terms, one finds that the bill, much like the Reagan plan, would ease taxes for most firms in the food-processing, computer, health-services and similar industries while hitting heavy industry and finance harder. In October, Martin Feldstein described the Reagan plan to cut taxes for about one-fifth of the large firms as a clever move to split the business community. I prefer to believe that Mr. Reagan was driven by a sense of economic fairness, not political cynicism.

I accept the president's judgment that in large part the heavier taxes on corporations would result from higher levies on those who have been escaping their fair share of the business tax burden rather than from piling new burdens on those already pulling their weight.

Another tack taken by critics of the bill's investment impact runs something like this: "Look at the 1983-85 investment boom touched off by the tax incentives of the 1981 act—do you want to snuff that out?" There are three responses.

First, the boom has already petered out, and besides, it wasn't as much of one as it was made out to be. It started from a depressed base resulting from the only two consecutive years of decline in plant and equipment investment in the postwar period. Real investment spending had receded to its 1978 level and only returned to its previous peak in late 1983.

Second, there is serious doubt about the effectiveness of the 1981 tax breaks for investment. It is true that, in the kind of unanimity that endears economists to the public, various studies of the investment impact of the 1981-82 tax cuts have come down on all sides of the question. Those attributing the investment boom mainly to tax cuts are clearly in the minority.

Board of Contributors

Those of us who are battle-scarred veterans of lost tax reform wars should not let the best be the enemy of the good.

The CHAIRMAN. Senator Long.

Senator LONG. Doctor, you said in your statement that deficit reduction is extremely important. I agree with you, but I have had difficulty understanding why, if we are going to raise $172 billion to make tax reform revenue neutral, we don't take some of that money and put that into deficit reduction. The President's position is that he will veto the bill, if we do anything with the money we raise other than use it to cut rates.

I may be compelled to go along with that, but to me, I think it is ridiculous. The interest rates are sky high. Don't we have some of the highest interest rates in the world and the highest interest rates in our history?

Dr. HELLER. Well, in real terms——

Senator LONG. I mean for normal times. I ~~am~~ not talking about the Arab oil boycott. I am talking about normal times.

Dr. HELLER. In real terms, the relationship of our nominal interest rates and the expected rate of inflation is such that we still have terribly high real interest rates—no two ways about it. And they are near record levels.

And as I say in my statement and emphasize again and again, the most important single thing you can do to bring those interest rates down would be to use some of the proceeds of tightening the tax base to reduce the deficit because it is the deficit that is, as I say, the black hole into which our private savings are going. You know, pure supply and demand relationships tell you that if there is a smaller supply of savings available for private investment, that is going to drive up the price, and in the process, dry up investment.

Senator LONG. I saw David Stockman on television recently. He says, now that he has been in free enterprise and is not speaking for the President, that if you know of some loophole that ought to be closed, you ought to take that money and use it for deficit reduction. Do you agree with that?

Dr. HELLER. I do. You know, I am not saying that we shouldn't make some adjustments, but the idea of, as you say, raising $172 billion or whatever it is by the provisions that tighten up the income tax and use all of that for easing tax rates, in the light of that huge deficit does not make good economic sense.

Senator LONG. It seems to me that if the President wanted to ask for tax reform and some rate cuts, he might justify it as a sweetener on a bill that would reduce the deficit; but I find difficulty in cleansing my mind of the conviction that if we are going to raise a lot of revenue, we ought to put some of it into reducing the deficit—maybe half or something like that. I noted that one of the other economists is nodding the same as you are.

We want to cut the deficit, if we are going to do all that.

These enormous deficits will have to be inflationary sooner or later, won't they? If not immediately, they will have to be inflationary eventually?

Dr. HELLER. Eventually, there is no way that we are going to avoid, if we keep up at this rate, monitizing that deficit or debt; and it will be a source of inflation and especially, if we keep on this way, the interest on the debt is going to eat us up.

Senator LONG. I tried to inquire some time back as to what countries do when they keep running up so much debt that there is no hope of paying it off. And the study by, I believe, the Library of Congress informed me they do one of two things. Either they default or they inflate. It seems that between the two choices, it is easier to just print more money and tell people: Look, you want to be paid? Fine. How would you like to be paid? In millions or billions? I mean, we have to print both kinds.

We will print one bill that is 6 inches long and we will call that the million dollar bill. We will print one that is 12 inches long, and we will call that the billion dollar bill. There is no point in printing trillion dollar bills; we don't owe that much right now, but just add more zeroes on the end and we can pay the debt.

Now, that is the sort of thing you are asking for when you double the national debt, as we have under this administration, and then proceed to double it again. Can that fail eventually to bring fear and uncertainty in the investment market out there to cause them to demand more interest?

Dr. HELLER. I think that is what is going to happen. Let me say, by the way, that I think that we have had a Gramm-Rudman stock market, that is, that the prospect of cutting back those deficits has been the healthiest tonic to the stock market. I don't happen to like Gramm-Rudman as it stands because it doesn't have the tax increase in the mix, but I heard Rudman the other night at a meeting here in Washington say that his basic hope in Gramm-Rudman is that, what I call a deficit disarmament agreement, would include a tax increase.

Senator LONG. Seeing the way things are going right now, the political reaction is that if Gramm-Rudman goes into effect, even the early cut—not to mention this thing in October—leads me to believe that when October comes, the Congress, facing that election, is going to say, well, this is such an immense problem that we ought to put this off until February. And then in February, they will say we ought to put it off until next December; and they eventually will just call the whole thing off because it is drastic medicine, and not many people are going to be happy about voting for it when they see what the details are.

What is going to be the reaction in the business community, if Congress in effect defaults on Gramm-Rudman?

Dr. HELLER. I think there would be tremendous disappointment in the business community. They would much rather accept a package with a tax increase that would really cut the deficit and a lot of polls have shown that. And they show that the American people are now for that.

And if you did that, that would support the stock market; but if you finesse it or don't abide by it or simply throw it in the ashcan, I will bet you the market would go like that. Down.

Senator LONG. Down?

Dr. HELLER. Down.

Senator LONG. Thank you, sir.

Senator CHAFEE. Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman. Dr. Heller, you have said that you think that there should be a tax increase as part of overall deficit reduction.

Dr. HELLER. I think it is a vital part from an economic point of view.

Senator BRADLEY. And therefore, the question is: Whose taxes should we raise?

Dr. HELLER. Well, I am somewhat flexible about that, but I have some ideas. One would be to have an energy tax that, if you taxed energy across the board to avoid any unfairnesses, that would give you—that is a $400 billion base—you could get a lot of money out of a 5-percent energy tax, say $20 billions. Alcohol and tobacco. That doesn't offer you an awful lot of revenue, but you ought to double them. Then, I myself feel that part of a deal—and in this, I am a little bit like Martin Feldstein, whom I believe you are going to hear tomorrow—that you ought to have a deal where you cut back the indexing on entitlements and cut back the indexing on taxes. That raises just a whale of a lot of revenue, as you know, from the CBO rack-up.

So, those are some of the things I would do. Oh, something else I would do; I would tax half of Social Security benefits to everybody, not just to those with incomes above $38,000. We ought to pay—there is no reason why with decent exemptions and so forth in the tax law that we don't tax the Social Security benefits, and I don't think they ought to be put in the Social Security kitty. I think they should be made available for general purposes.

Senator BRADLEY. You said you would like to close loopholes also to reduce the deficit.

Dr. HELLER. Excuse me. I should have said as a point of departure, I would like to use some of this base broadening and loophole-closing revenue for deficit reduction; and I was going beyond that.

Senator BRADLEY. You wouldn't want to close the loopholes, though, if it left the distribution of tax burden significantly different, would you? You wouldn't want to have closed the loopholes that would affect the middle income person and keep the loopholes that protected the upper income person?

Dr. HELLER. No, that is not my style.

Senator BRADLEY. So, you have a distribution question?

Dr. HELLER. There is no question that in the 1980's the distribution of income in this country has, for the first time in the postwar period, been shifted upward instead of downward.

Senator BRADLEY. What would you say to an approach that essentially does some tax reform, cuts the rates, and eliminates some loopholes, but does not eliminate some of the major so-called capital formation loopholes that are disproportionally used by upper income individuals? And to make up that revenue, in order to be revenue neutral, you impose a new tax?

Dr. HELLER. You know, that is just tailor made to shift burdens from the upper income groups to the lower income groups. A brandnew tax, like a value-added tax—there is almost no good way to shield the lower income groups under a value-added tax; and if you just put on a bunch of consumption taxes, obviously you are hitting the lower income groups heavier than the upper income groups.

And that is what I meant when I said that if you are going to tax capital income more lightly, you have got to tax labor income more heavily. And if you are going to tax the upper income groups more lightly, it follows you are going to hit the lower income groups more heavily. We have been doing that for the past 5 years, and I think we ought to quit.

Senator BRADLEY. We have heard a steady drumbeat here over the last couple of days that the House bill will destroy U.S. international competitiveness, that it will destroy capital formation; and you seem to say, look, there are other points that you have to consider. And I think the committee would benefit from your elaborating on those points.

Dr. HELLER. Yes.

Senator BRADLEY. For example, decline of the dollar, and the viewpoint that it offsets totally the adverse effects on capital formation. And that is a statement which has been made by someone who is opposed to the bill. The committee has focused on taxes as the sole determinant of investment, and I think that you have not only said that are other elements of determining investment, but that there are also other kinds of investment, all of which are important for economic growth. I think on both of those levels the committee would benefit from your thoughts.

Dr. HELLER. Well, I don't really have to add much to what you just said, but that is exactly right. What one does in dealing with tax reform is sort of act as if tax reform is the most important thing in the world in impacting investment and competitiveness and so forth. And the simple truth is it ain't. There are a lot of things that are much more important. In the long run to have a skilled labor force and to have high-technology industries with technological advances and so forth is at least as important, maybe more so; and of course, one of the troubles there is that takes additional Government money, not less Government money.

And then physical infrastructure, private investment is not going to thrive if you don't have everything from roads to streets to water systems and sewer systems and so forth; and we act as if every penny spent through the Government is a subtraction from economic growth. And that is just not so, as a lot of it is an addition.

You know, over the years, what has been the real secret of our American growth and essentially outstripping the rest of the world? Why are we still the richest country in the world, both in terms of wealth and in terms of annual flow of goods and services? Well, I suppose universal public education and higher education in this country can take—and I am speaking a little bit as an advocate—a lot of the credit for that. So, you have got to invest in human brain power; and investment in human brain power is expensive, but it is investment. It is not spending.

Senator CHAFEE. Dr. Heller, you mentioned one of the things that has made the country strong and given us such a high standard of living, and that is the high technology. One of the concerns that the high-technology people have shown is the decrease in the differential between the capital gains tax and the ordinary income tax, particularly in the House bill.

In other words, instead of having the difference between a maximum rate of 50 and 20, the differential now is the difference between 38 and 22.

Dr. HELLER. Yes.

Senator CHAFEE. What do you think of that?

Dr. HELLER. Well, I like the original Treasury I plan frankly. I would prefer to have seen us index capital gains for inflation, take the inflation content out of them, and then tax them right along at the lower rates with other income. And I am not tremendously impressed with the supposed negative effects of that change in the House bill. It isn't the way I would prefer to do it, but observing the economic scene and my own reactions when I am investing money and so forth, and perhaps I shouldn't argue ad hominum, but I don't see that that differential is going to discourage a lot of investment. But let me assure you, it is not an area where you can assert the economic impact with any great precision. Anybody who tells you that you can is just dead wrong.

Senator CHAFEE. But they had a point, and I am rather sympathetic to the argument.

Dr. HELLER. Yes.

Senator CHAFEE. They cite the changes that were made in 1978 when we decreased the top capital gains rate from 49 percent down to 28 percent and then to 20 percent in 1981. They point to the rise in venture capital that presumably flowed into these high-technology ventures, that have now made this country able to export, and to a considerable degree created thousands of jobs, and so forth.

Dr. HELLER. You know, you are right. There was a good spurt in venture capital investment, and I am not to say that if we have lower taxes on venture capital investment instead of higher taxes that that isn't going to make it more attractive. Of course, higher income makes it more attractive than lower income; but the interesting thing is, you know, the big spurt in venture capital investment has passed. The venture capitalists are having a hard time raising money, and I don't think it has a thing to do with H.R. 3838. This has been true for a couple of years. I happen to be a venture capital investor myself, and I have two things to say about that.

One is, I have watched that market very closely. In my modest way, I have put some money into it; and I find that it is a much shrunken market, that it is much tougher go. Second, when you hit some little difference in capital gains tax, it isn't going to make much difference.

If you invest for 50 cents a share and it goes up to $20 a share, I don't think that the matter of capital gains is going to be a big——

Senator CHAFEE. The argument is that if you can put your money into bonds and be taxed at 35 percent, why are you going to roll the dice and end up being taxed at 22 percent?

Dr. HELLER. Well, for the same reason that you invest in a lottery. I mean, there are an awful lot of risktakers and that is just the way they are built. You know the odds, but if you hit, the rewards are very, very lush. I am not saying that is the whole story, but I think you have to look at it in part that way; and I don't think the capital gains tax differential is going to stifle that very much although it will have some adverse effect; I have no doubt on that point.

Senator CHAFEE. You said that IRA's haven't increased savings; and one of the panelists before, as I understand it, said no tax incentives will increase savings. How do you think we can increase savings?

Dr. HELLER. The way to increase savings is to cut the Federal deficit. Just look at the numbers. I was just looking at some that Gerald Corrigan, president of the New York Federal Reserve Bank, used the other day in relation to 1985. Net savings in the country last year were 8 percent of gross national product. That is business and individual savings minus replacement investment; that was 8 percent of GNP. We had to use 4¾ percent of GNP to finance the deficit. So, what was left for private investment was the remaining 3¼ percent.

Now, what we did was import a bunch of capital; but we don't want to do that the rest of our lives. We are already reducing the legacy for our children. We are doing that by slower growth, and we are doing that by the debts we are building up abroad. So, what happened was that our national saving rate dropped to the lowest level in 50 years. The thing to do is to get that deficit down so that the drain away from private investment is reduced. That is the No. 1 priority.

Now, the other thing is, in that process, to reduce interest rates, and that inevitably has got to occur——

Senator CHAFEE. Will that follow if you bring down the deficit? It will bring down the interest rates.

Dr. HELLER. Oh, sure. There are no two ways about it. Again, on a pure supply and demand principle, if you withdraw, let's say, $40 billion a year of demand for funds by the Federal Government, the savings aren't going to drop by that much. They may drop $5 billion or something. You are going to have $35 billion more available to the private market. That is bound to drive down interest rates unless the Federal Reserve keeps them up; and if they do, you just go skewer the Federal Reserve.

Senator CHAFEE. All right. Thank you. Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you. I am sorry I wasn't able to be here for Larry Meyers and Harvey Galper's testimony; but the Banking Committee has been running hearings as well on tax reform. And in addition, my colleague from Pennsylvania, Senator Spector, has been holding hearings on the outbreak of avian influenza in Pennsylvania.

Dr. Heller, I have had a chance to review your testimony, though; and I have a couple of questions I want to ask you about savings and investment. Let's separate tax reform from any efforts to reduce the budget deficit.

I don't disagree with you. I think we do see the budget deficit as doing a lot for this country. It will lower the cost of capital, and it will stimulate capital formation; but in the context of the kind of tax reform that you favor, something moving past the House bill, where essentially lower rates are given individuals, in the case of the House-passed bill, a substantial amount of that is financed by an increased tax burden on corporations and an alleviation of it on individuals.

Some base broadening, but largely through the former. Do you contend that the House reform bill would increase savings?

Dr. HELLER. No.

Senator HEINZ. Would it decrease savings?

Dr. HELLER. One thing I tried to emphasize in my testimony is that economists should be humble.

Senator HEINZ. We all, both economists and noneconomists, have much to be humble about.

Dr. HELLER. Yes; have much to be humble about. Of course, Golda Maier used to say: Don't be so humble; you are not that great. And I think that we might bear that in mind, too, when we are throwing around so much humility; but we have to recognize that it is extraordinarly difficult to predict the precise impacts on savings and investment——

Senator HEINZ. I am not asking for an econometric analysis. I am just asking for you to reply with your kind of basic good sense and analytical skills. I am just trying to get a sense from you whether you think that H.R. 3838 is going to decrease savings. And then, I am going to ask you some questions on the investment side.

Dr. HELLER. Yes.

Senator HEINZ. Savings and investment have a relationship, but in terms of job creation it is not one for one, depending on what happens to the savings pool.

Dr. HELLER. Yes.

Senator CHAFEE. Could I just interrupt one moment? I notice that Dr. Galper is back there. Dr. Galper, why don't you come and sit up here? We might get a couple of shots at you, too. How about Dr. Meyers? Is he still here or did he go? He must have gone. I know you have both testified, but I don't think Senator Heinz was here. I know I wasn't here. Go ahead, Dr. Heller, please.

Dr. HELLER. OK. I guess what I am saying is that, on the savings side, I don't see a decisive impact either pro or con.

Senator HEINZ. Now, let me go one step further on that, if I may.

Dr. HELLER. All right.

Senator HEINZ. Because I worry that there will be a substantial reduction in savings, that while certainly in that $140 billion transfer of tax burden to corporations, some of it could be legitimately transferred because we are just closing very economically questionable, inefficient corporate tax breaks—loopholes.

Dr. HELLER. All right.

Senator HEINZ. I suspect there is another portion of that, probably the majority of it, that comes out of what would be corporate savings, corporate-retained earnings. It will be given to consumers, and one of the things we have learned about the Reagan tax cuts is people don't save them. They spend them; and in most cases, they seem to spend even more than they got. So, why—if my observations are accurate—wouldn't it be accurate to say, in fact, that H.R. 3838 will reduce savings?

Dr. HELLER. I guess what I am saying is that the impact of the House bill on savings just pales into insignificance compared with what you do to the deficit.

Senator HEINZ. We understand that. That is not my issue.

Dr. HELLER. You are probably right that there would be a net reduction of savings with the shift of tax burdens from individuals to corporations; but I don't think it is of a very large order of magnitude. And by the way, I want to come back for just a moment to this question—I covered it in my testimony—of what kind of a tax increase we are putting on corporations. You know, 17 percent of it, as the House report shows, is in a sense on normal corporate operations; 83 percent comes from what President Reagan called essentially putting burdens on those who are pulling less than their full weight.

So, the great bulk of the increase is not, you know, on the ordinary every-day operations of corporations. Now, I am very conscious of this evening of the playing field somewhat. I have served on the boards of banks and an insurance company, on one hand, and a health care company and a food processing company, on the other. And you know the disparity between the taxes on the first two and the second two is enormous. The food processing company and the health care company are paying taxes up there in the 40 percent-plus range. And I hate to tell you what the bank and insurance company are paying.

Senator HEINZ. Mr. Chairman, may I ask a favor of my colleagues? I have a follow-up question, a brief one, but I have to go and testify and be at the Rules Committee at 12. Could I proceed for about 1 or 2 additional minutes, even though I know I am not entitled to it?

Senator CHAFEE. Well, you go ahead. Special dispensation. [Laughter.]

Senator BRADLEY. Is it possible that one member could object?

Senator HEINZ. Yes, it is, Senator Bradley. I am at your mercy. [Laughter.]

Senator CHAFEE. Go ahead, John.

Senator HEINZ. There is no doubt that other changes in the Tax Code could lead on the investment side to what economists would call a more efficient application of investment.

Dr. HELLER. Right.

Senator HEINZ. I believe we could create the same number, and in certain cases perhaps more, jobs with less capital investment. I am not necessarily persuaded that that doesn't have some high prices that we pay. I suspect that there overall is a correlation—and there certainly are exceptions, but there is a correlation—between value added, as we would normally apply the term, and capital intensiveness of industry. Is that correct—that typically high value-added industries use above-average amounts of capital?

Dr. HELLER. I would guess—do we have an answer to that, Harvey?

Dr. GALPER. I don't know of any a priori grounds one would expect that to be true.

Senator HEINZ. Well, how about some statistical grounds?

Dr. GALPER. Value added could be both labor and capital, and high labor intensive activities could also add a lot of value added. So, I don't know; I just——

Senator HEINZ. I just happened to run into a high labor intensive operation, with just a few exceptions, such as computer programming.

Dr. GALPER. You see, I know what the statistical answer is, but I don't know what the a priori——

Senator HEINZ. Maybe it is something we ought to find out because here is my concern.

Dr. GALPER. OK.

Senator HEINZ. And this will conclude my question. If in fact there is a correlation between relative capital intensiveness and relative value added, if you can direct me to that hypothesis——

Dr. GALPER. OK.

Senator HEINZ. Would it then be true that in shifting to lower value-added industries, less capital intensiveness industries, as we would have to to maintain the same elements of job creation, that we would experience a drop because of the reduction in net aggregate and value added in our economy of our standard of living?

Dr. HELLER. Well, if we grant you your questionable premise, then that follows, although you can't keep that in a tight little box. You have to look at the total operations in the economy. Perhaps you get an increase in other aspects of economic activity that would offset that. So, you see, I guess that is a point that doesn't worry me too much. If the statistics were to bear you out in spades, you would have to give more weight to that. I guess that is about what I have to say about that.

Dr. GALPER. I don't think it is an argument for taxing some components of value added. From an overall efficiency point of view and productivity point of view, I don't think there is an argument for taxing some components of value added more heavily than other components of value added. I think the basic efficiency argument is a neutral system.

Dr. HELLER. Yes.

Dr. GALPER. In that way, the output of the economy is maximized.

Dr. HELLER. And that is why I would go back—which of course politically is impossible—I would go back to Treasury I. I still feel that the closer you can get to having resources guided by market advantage rather than tax advantage, the better off the economy is. There are transition problems. You are right. As a matter of fact, there is a Frenchman—I have forgotten whether it was Bastiat—who had a whole theory of taxation on the principle that any old tax is a good tax because the economy is adjusted to it. And it is true that the readjustment process is costly. I am not about to deny that; but what you are aiming at is, in the long run, a highly efficient economy that is going to be competitive in the world. And one of the ways to do that is stop dragging resources out of their best uses that the market would allocate them to by diverting them into less efficient reasons——

You know, it is incredible under the present law what happens to equipment. You take equipment investments that are real losers, and you convert them into gainers.

Senator HEINZ. Dr. Heller, forgive me, but you are going to get me in trouble with my colleagues. I didn't mean for my question or for your reply to be quite so long.

Dr. HELLER. You didn't mean to trigger such a prolific response.

Senator CHAFEE. You are now in Senator Bradley's time; and if he wants Dr. Heller to continue on this line, that is his choice.

Senator BRADLEY. All right. I would just like to make one point and see if they wouldn't agree with me, in Senator Heinz' attempt to relate capital intensiveness with value added. If you look at the present income tax system, the capital intensive industries in many cases are the ones that are not paying as much tax as those that are less capital intensive. It would be surprising to me if you would then argue from that that the high technology firms that are paying 40 percent or the food firm that you serve on the board has a high tax rate, is not a value added—that it doesn't add value. Wouldn't you agree?

Dr. HELLER. A good point. I agree with that.

Senator BRADLEY. It is the end of the day, but let me just try one more time on the record to make the case that you just made and just underline it because we are continually confronted with: Don't you think that what we really need for competitiveness is this little tax incentive? Or: We can't get rid of that tax incentive because all we will get is a lower tax rate, and that is not enough to offset it. The efficiency argument, the value of the market allocation of resources, and how that flows through to individual business decisionmakers and how that improves the overall economy and therefore promotes the public interest is not, I believe, a case that has been made as loud and clear in these hearings as it should have been made.

So, I am asking you. Assume you are in Economics 201, not 101, and make the case?

Dr. HELLER. I try to make it in my prepared statement; but basically, it is clear that if you change the tax laws in such a way, that resources flow into their most productive uses, and the tax law is unquestionably pulling them out of those most productive uses—and I mention the equipment thing in particular—where it is simply true that all kinds of economic losers, losers in the marketplace, are converted into gainers—profitable gainers—by tax subsidies.

Now, that obviously has to be an inefficient use of our capital. And if we could reestablish—and you know, who is arguing for a market-oriented economy—us liberals, you know—that is the strange sort of thing, but it isn't so strange when you——

Senator BRADLEY. It always returns to its true origin.

Dr. HELLER. Well, when you recognize that economists of a different a stripe as Milton Friedman and myself could agree on this kind of thing—that is, the establishment of—really letting market incentives determine the flow of resources—that that is a more efficient way to go; not in all cases, but as a general rule. And then, look at all of the distortions and what they cost by lowering the real output, lowering the real rate of return, there is no question in my mind that a full-fledged tax reform could give us more efficient, which means more productive, economy.

And I really think it is terribly important to note that, with all the tax cuts and everything, here we are running at the lowest growth rate that we have had in the post-war period—we had that 4¼ percent growth rate in the 1970's, 3⅒ percent annual growth rate in the 1970's, and in the 1980's we are running below 2 percent—and even if we average 3 percent the rest of the decade, we would only come out with 2.4 percent growth. Our productivity performance is lousy. It is really very poor, and our savings and investment by Americans is back to the levels of the 1930's.

Now, there has got to be something wrong somewhere, and I think part of it is the structure of the tax system, though a much greater part is those huge deficits.

Senator BRADLEY. And the best of both worlds would be to reduce the deficit and reform the income tax system?

Dr. HELLER. Absolutely. And if in the process of removing tax preferences, tax loopholes, tax favoritism, for particular industries, you are able to make some revenues available for deficit reduction—I say that in the statement—that is exactly the best of both worlds.

Senator BRADLEY. But wouldn't you also agree to raise taxes on the present system would only enhance the underlying inequity of the system?

Dr. HELLER. That is what we have been arguing for some time, that we have made the corporate and individual income taxes kind of pariahs for additional revenue raising by riddling the base, making Swiss cheese out of the base. And you fill up those holes, which you wouldn't want to do with Swiss cheese, but fill up those holes in the tax, you have a far better springboard for raising revenues in a fair way. If we put the House bill into effect—and as I said, it is far, far from perfection—it will do some of that. It does get the playing field more even and removes some of the tax preferences.

You know, by 1990 under that bill, you could raise $55 billion a year by a 2 percentage point across-the-board increase. And I am not advocating that; I just think it is one thing we ought to recognize, and we really would overcome at least part of that argument, that we shouldn't use the income tax for additional revenues because it is so pock-marked with special provisions.

Dr. GALPER. Might I say that I also believe in a springboard that is made up of solid cheese? I support that. [Laughter.]

Senator BRADLEY. Let me thank you and just tell you how sorry I am that the entire committee was not here and how sorry I am that the CNN didn't cover today's hearing either. So, we had a double loss today in terms of this side of the story.

Dr. HELLER. Yes. I followed as closely as I could the first 2 days of hearings, and you sure heard one side of the story. You are going to hear tomorrow from Charlie Schultze; you will want to listen closely to him; and you will hear from Marty Feldstein, whom I think the world of as an economist; but you are going to hear more of anti-House-bill story from him. And I believe the other side, which is the right side, of course, is not getting enough attention.

Senator BRADLEY. Thank you.

Senator CHAFEE. Dr. Heller, as I gather from what you have been saying here in answer to Senator Bradley's question, if we don't do anything about the deficit, all this monkeying around that we are doing with trying to encourage savings, trying to encourage greater capital investment, and so forth, really doesn't amount to a lot.

Dr. HELLER. It will be swamped. If we don't do the deficit reduction job, the things that we can do by taxation—and there are things—I am not arguing that it is a useless enterprise, it is not—but they are chicken feed compared with getting the deficit down and stopping that drain on private savings and investment.

Senator CHAFEE. You would agree with that, Dr. Galper?

Dr. GALPER. Absolutely.

Senator CHAFEE. You give the example of Great Britain. You quoted from somebody who compared four countries?

Dr. HELLER. Yes. Incidentally, one of the authors was Don Fullerton, the new Assistant Secretary of the Treasury in charge of tax policy.

Senator CHAFEE. Does that mean the lower the rates, the less the investment. I mean, it is very hard to explain Great Britain's situation. How do you explain it?

Dr. HELLER. Well, it is one of those things that in effect underscores the fact that we don't know as much as we would like to know about the impact of taxation on investment because here is Germany, with the toughest taxes on capital income and the highest rate of capital growth—and here, as you point out, the U.K. has the lowest taxes on capital and the lowest rates of capital growth. Now, what that means is that there are a lot of other factors in the picture, but it really is remarkable. Sweden is second on both, and the United States is third on both out of the four. And that correlation runs entirely counter to the kind of testimony you have been hearing in the first 2 days because what you are hearing essentially is: Cut the taxes on capital income and you will get a lot more capital growth.

And these correlations say, looking across countries—cross-section studies—there is no support for that.

Senator CHAFEE. I will say this, in all fairness to the prior witnesses. Every single one of them said that, on a scale of 1 to 10, deficit reduction was ten and doing something about the tax reform was 3 or 4 or something like that. In other words, they agreed with you on the importance of deficit reduction.

Dr. HELLER. Senator, I appreciate your pointing that out because it isn't that economists can't agree on anything and it isn't that we don't know certain things for sure. It is just that this whole area of tax impacts on investment and saving is a very dicey area, and we don't know as much as we sometimes profess that we know.

Senator CHAFEE. Let me ask you a question. You were starting to say something about equipment and how some distortions in investment have come about as a result of the Tax Code. I wasn't sure what distortions you were talking about.

Dr. HELLER. What I was talking about was the 1981 Act which put in just enormously favorable provisions on depreciation coupled with the earliest investment tax credit. What it meant was—and I have seen this, by the way, in the corporate boardroom—where you have a project to purchase or build some equipment, and it really doesn't look very profitable until you plug in the tax subsidy; and that makes it advantageous—I mean, after all, if a company is going to make maximum profits for its stockholders, it has got to take into account what the net returns are going to be after taxes. And here you have projects that, before taxes, would never pass muster; and after taxes, because of the big subsidy—the fact that the Government actually gives you money, gives you back more than you put into the equipment—it becomes a profitable venture.

And that has just got to be wrong because it means the test of the marketplace is simply being perverted by taxation.

Senator CHAFEE. Dr. Galper, we are getting tremendous pressure here for eliminating the proposed cap or a minimum cap on industrial development bonds. We have heard that these bonds are the solution to everything, all the problems of the Nation. We have heard these bonds will help the inner cities, and the infrastructure you were referring to. We have been told that we must have them or the country is going to grind to a halt. Now, what do you say to that, Dr. Galper?

Dr. GALPER. That is one of the beauties of our tax system: anyone can claim if we just got this one special preference, all of our problems would be solved. I would just like to return to the message that we have been hearings namely: What is the market test here? To the extent that these tax exempt bonds are being used to finance private facilities, I think that is again a perversion of allowing the sources to go to their best and most productive use because it means that some private activities are able to get benefits unavailable to other private activities and therefore, because of the tax incentives, because of the tax benefit—in this case, tax-exempt bonds—are able to undertake activities which otherwise would not be profitable. So, I would say we have areas where tax exemption is being used to subsidize private market activities that aren't bearing the market test properly; then we should get rid of them.

And it is not just a matter of putting a cap on them. It should be—in my view, those preferences should be eliminated entirely.

Senator CHAFEE. Well, a hospital won't be built. It won't get the equipment. The Federal Government is pressing down on the Medicare reimbursement and hitting the hospitals. You are hitting them two ways; and they say this is an outrage.

Dr. GALPER. OK. As I said initially, of course, I was talking about private sector use of IDB's, which goes on to a high degree with the small issues, the pollution control, the private stadiums, or whatever. If you are talking about areas where there is a tension between what is done in the private sector and what is done in the public sector with respect to hospitals, I think the problem is a little bit different. Then, the question is: What is the best way of providing appropriate public support for what we think should be publicly supported activities, namely health care? Now, I am still not particularly a friend of tax exempt financing from that point of view, either, because I think too much of the benefit for tax exempt financing goes to high income taxpayers and not enough to the ultimate people who are borrowing the funds.

But I would say if we are concerned about whether we are delivering medical care properly, then that should be looked at not in that context and not necessarily in terms of the context strictly of tax exempt bonds or other tax breaks.

Dr. HELLER. I might add, if I may, Senator, that with a tremendous amount of unused capacity in hospitals today, one has to ask whether that was partly generated by excessively generous tax exemptions. You know, all over the country now, there are just a whale of a lot of unused beds; and that is causing, as you know, some very severe pains in the both profit and nonprofit hospitals.

Dr. GALPER. And that is another problem with the way these particular tax incentives have been provided. For bonds for construction of new facilities, that is quite different than for operation or for other types of cost savings that could reduce the cost of medical care.

Senator CHAFEE. What about this argument? We had a former mayor of a major city in the Nation come before this committee. He is very knowledgeable about that city. He pointed out that they were able to restore the inner core of that city that was decayed. It consisted of tatoo parlors and peep shows. Now, it has soaring, magnificent buildings; with 25 percent of those employed in the buildings being those who previously were unemployed. They now have major new sources of tax revenue to the city as a result of what took place. All this was accomplished with what were called tax increment bonds. Now, what do we say? Should we get rid of those bonds? You will prevent this urban development from happening in the future because the Federal Government is no longer spending money in UDAG's and EDA's to the extent we did in the past.

Dr. GALPER. Maybe there is where we out our finger on the problem, Senator; and that is, if we think that there is need to rebuild and redevelop our cities, what is the most efficient way of doing it? And just as we were talking about investment in human capital and investment in education, there are other types of investment that the Government should be making. We shouldn't be cutting back all forms of spending indiscriminately; and in my view, however, tax benefits of this kind are decidedly second best instruments for accomplishing the purpose. And in large part, it is because much of the benefit goes to higher income investors in those bonds, rather than to the ultimate project itself. So, I would say we should reconsider our spending priorities on these grounds, as well as whether these tax incentives are appropriate.

Senator CHAFEE. What do you say, Dr. Heller?

Dr. HELLER. I would go along with that.

Senator CHAFEE. Do you find a bias toward equity financing or debt financing in the existing code and in the House bill?

Dr. HELLER. Well, the bias——

Senator CHAFEE. One way or the other?

Dr. HELLER. Yes. I understand, I think, what you are getting at. The bias in the existing code, of course, is very sharply toward debt financing; and I think that is a bummer in the present code. The fact that you can borrow, and I am not talking now about consumer finance where we, after all, are stimulating consumption by the deductibility of installment debt interest and all that. And I think that is a good place to pick up some more funds. But you know, looking at it from a business investment standpoint, we are giving just tremendous breaks to debt financing by the deductibility of interest.

Now, what the House bill does, according to this study by Yolanda Henderson at the American Enterprise Institute, which is a study that is based on techniques that she and Don Fullerton of the Treasury developed, she shows that while the overall marginal tax on capital income—and when she says overall, she means corporate and individual, State and local, the works—would rise from 26 percent to 30 percent. Under the President's plan, it would have been 29 percent. In that process, the tax on debt financing is increased relative to the tax on equity financing. In equity-financed investment, the tax remains practically the same as it is under present law; but debt-financed investment, because of the lower tax rates and therefore the lesser break that you get for deducting interest, that is increased.

So, we are narrowing the gap between debt and equity financing according to her study, and that strikes me as sound. We are narrowing that gap, and I call that a good thing.

Dr. GALPER. I call that a good thing, too.

Senator CHAFEE. I wasn't sure that there was such a tilt now in favor of debt financing because of all this venture capital. I thought the lower capital gains rates would encourage investors to put in equity.

Dr. GALPER. Well, there is an offset, but the bias results essentially from the fact that equity financing is taxed both at the corporate level and then, again, at the household level. To the extent that the household level tax is reduced by capital gains treatment, that can offset to some degree, and in some instances a considerable degree, the additional tax that is paid at the corporate level. So, when we are talking about the bias toward debt finance, we are really combining both household and corporate level taxes to look at the total tax burdens on a piece of investment, depending on the form of financing of that investment.

Now, I think most economists would argue that it is not a good idea to have the tax system influence the form of financing. We can be overly leveraged. We can engage in financing decisions which are primarly tax motivated again, rather than being motivated by a particular form of financing that would make the most economic sense, from the point of view of the project.

So, if we can do something to reduce those disparities, partly by reducing tax rates which then reduces the benefit to debt financing, probably perhaps by looking at ways of coordinating or integrating the taxation of corporate income at the corporate level and at the household level, I think those are all desirable measures to take.

Now, the dividend is a small step in that direction. As you know, in H.R. 3838, in connection with this 10 percent dividend deduction that corporations would be allowed, I think it is probably too small a step, and I would like to see more movement in that direction. I think it shows the way to go; and I think a benefit is that it would try to deal with this bias toward debt financing that exists in the current Tax Code.

Dr. HELLER. I agree with that. You know, that is something that those of us who consider ourselves tax specialists—and that used to be my main concentration in economics—struggled with—this integration of corporate and individual income taxes—for as long as I can remember. Of course, the total integration would be by treating corporations as partnerships, but nobody wants to face that because then they have to pay taxes on income that may not be distributed. And so, we have to use second best; and second best is the dividend credit of the kind that is in H.R. 3838, though it is a very, very minor beginning. And I wouldn't want to see it erode a lot of revenue, but if it were balanced with revenues from other sources, it would be an improvement in the taxation of capital.

Senator CHAFEE. Let me ask you this, and this is the last question. The important thing really is to get the deficit under control. Now, let's assume that we have learned to do that. If that were so, would you go for the House bill or would you prefer to stay with the tranquility or at least the experience that comes with the existing Code? What would you take, Dr. Galper?

Dr. GALPER. I think the House bill is an improvement over current law. So, if we were going to look for additional sources of revenue and deal with the deficit more generally, I would take the House bill plus further deficit reduction as preferable to current law, plus deficit reduction.

Senator CHAFEE. What do you say, Dr. Heller?

Dr. HELLER. I would, too, but I would plug in very heavily the improvement it makes in the distribution of tax burdens by the exemption provisions and the credit—the earned income credit—and the zero bracket amount or standard deduction. I mean, we have just got to remove those 6 million people who are in official poverty status from the tax rolls. And I wouldn't want that to get lost, in any way, shape, or manner.

Senator CHAFEE. That is the House bill?

Dr. HELLER. That is the House bill. Oh, yes, I am arguing for the House bill. And that is one of the reasons I come out for it. The minimum tax, which is not a great instrument—as I say, it sort of cleans up behind the rather untidy loophole closing efforts—and yet, the American people are quite right when they complain that 40 of our biggest corporations didn't pay any taxes in 1984. Also, 29,800 people with incomes over $250,000 a year paid little or no tax. What I am saying is there are fairness elements and protection of the lower income groups elements that buttress the case for the House bill; and then, the mouse bill itself, I think, by reducing disparities of taxation among the different types of corporations on different types of investment and different types of assets, it does make some advance on that score, on the score of efficiency.

So, I forgive them for not doing more, and I would go for the House tax bill, presumably improved by the Senate, side by side with deficit reduction. I think it is well worth doing on its own merits.

Senator CHAFEE. Presumably improved how?

Dr. HELLER. How would I improve the House bill?

Senator CHAFEE. Yes. How would you improve the House bill?

Dr. HELLER. Do you have another hour?

Senator CHAFEE. No.

Dr. HELLER. Among other things, I would do something about the interest deduction. I really think that we are much too generous on that score, and we bias the whole investment picture.

Senator CHAFEE. Wait. The interest deduction for corporations?

Dr. HELLER. Yes. Right, for corporations. I would treat that essentially the way the President proposed. That is pretty sensible. Indexing the interest payments for inflation so that you don't allow a deduction for that part of interest which is nothing but essentially a restoration to the lender of his loss of capital through inflation. I would surely make a change like that.

Senator CHAFEE. All right.

Dr. HELLER. And then, just to wind up, there are lots of provisions that were in Treasury I, tough as it was, that I feel would meet the principle of having the marketplace allocate resources; and so, I would change those in that direction. I am not saying I expect that to happen in the Senate, but you are asking me what are my druthers; and that is what they are.

Senator CHAFEE. How about you, Dr. Galper?

Dr. GALPER. Yes; I would agree with that. What we are both talking about is further ways of broadening the base so that, even with lower rates, we could move in the direction of generating additional revenues that could be used for deficit reduction. I think it would be good to combine, as I said in my statement, tax reform as a way of broadening the base and lowering rates and raising additional revenues as a contribution to reducing the deficit. And the best way I think of raising additional revenues—the first best way—is looking at various base broadeners, such things as not only the form of change in the interest deduction that Dr. Heller was talking about, but also interest deduction at the individual level, some degree of taxation of fringe benefits, if it is possible to do that, some degree of capping the mortgage interest deduction, certainly for second homes. All of these things are very politically popular, you understand.

Some of these things would be perhaps limiting in part the deduction for State and local taxes. I would look for those measures as a way of raising additional revenues to contribute to the deficit and still be consistent with the principle of a broad-based lower rate tax system.

Senator CHAFEE. Finally, Dr. Heller, you mentioned something about taxing Social Security benefits. Do you mean you would tax them all or just half?

Dr. HELLER. I would tax half.

Senator CHAFEE. Half?

Dr. HELLER. Half. What I meant was I would tax all recipients and let the lower income recipients be protected by——

Senator CHAFEE. By the rates?

Dr. HELLER. Yes; and exemptions.

Senator CHAFEE. All right. Fine. Thank you both very much for coming. It has been excellent, and we appreciate it.

[Whereupon, at 12:24 p.m., the hearing was adjourned.]

THURSDAY, FEBRUARY 6, 1986

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

The committee met, pursuant to notice, at 9:30 a.m. in room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Packwood, Roth, Chafee, Heinz, Durenberger, Symms, Grassley, Long, Bentsen, and Bradley.

The CHAIRMAN. The hearing will come to order, please.

Today we have as distinguished a panel as we are likely to have before this committee, and none of them is new to this committee. I think I have seen every face here several times, some of them more than several times.

I think Charlie Schultze has been here for—what—the last 30 years, off and on?

Dr. SCHULTZE. I am not that old.

The CHAIRMAN. All right. We have Dr. Martin Feldstein, Dr. Charles Schultze, Dr. Norman Ture, and Dr. Alan Auerbach.

Unless you have any objection, gentlemen, we will take you in the order that you are on the panel list. Your statements will appear in the record in full; and if you could hold yourselves to 10 minutes so we can question you, we would appreciate it.

Dr. Feldstein?

STATEMENT OF MARTIN FELDSTEIN, PH.D., PRESIDENT, NATIONAL BUREAU OF ECONOMIC RESEARCH; GEORGE F. BAKER, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY, CAMBRIDGE, MA

Dr. FELDSTEIN. Thank you very much, Senator. I am certainly pleased to be with you again, although I am less pleased than I usually am when I come to this committee because I wish you were doing something else this morning.

I wish you were focusing on the deficit rather than on——

The CHAIRMAN. You are not the first one to say that, I might add.

Dr. FELDSTEIN. I realize that as well. Let me summarize the statement that I have prepared.

I begin by commenting on the bill that has been sent over here from the House, which I think is just a very bad bill; and I don't think that the proposals that the President has made for changing it make it a better bill.

I think, as many of the witnesses who have already come before this committee have said, it would hurt our economic performance; it would reduce incentives to invest; it would make the allocation of our capital stock worse.

It is certainly not tax reform. Whatever the original ideas of going after the traditional targets of tax reform were, they have all been dropped, some for good substantive cause and some because they are just politically too difficult to go after.

It is not simplification. It doesn't do much for the vast majority of taxpayers, but for those in upper income brackets, it actually makes things a lot worse because they will have to worry about a minimum tax as well as the regular tax.

And finally, I think it is just the wrong way to deal with the very real problem of taking low-income taxpayers off the tax rolls.

An indiscriminate, across-the-board increase in the personal exemption is extremely costly. Treasury estimates $48 billion a year by 1990.

So, in short, I think that the tax plan that has come over from the House, as well as what the President has submitted, would really serve the Nation very badly.

And if there is to be a major overhaul, I hope that it will take a different direction.

I have tried to indicate in the statement six things that I think ought to be borne in mind by this committee as you move in that direction.

First is to reiterate something I said here last June when I testified and that is that the change in the personal exemption, if it is to be made, should be targeted much more. By capping the exemption for brackets about the 15-percent bracket, you can save a tremendous amount of revenue.

Increasing the personal exemption to $2,000 for the bottom bracket, $1,200 for the next bracket, and leaving it alone in the 35 percent bracket would cut the cost in half and essentially make it unnecessary to increase the taxes on investment and savings in a way that both the President's bill and the House bill would do.

I think that is probably the singlemost important change to be made within the framework of the administration and House bills.

Second represents something where my own thinking has changed over time, and that is how to treat the State and local taxes.

I began with the view that the only way you could get significant tax reform was to eliminate the deduction for State and local taxes; and I am now convinced there is just no money in it, that I made a mistake, and I think it is a mistake that was shared by the Treasury staff, by the Joint Committee staff, in presuming that if you eliminate the deduction for State and local taxes or for some kinds of State and local taxes, or cap the deduction for State and local taxes, the States and localities will just sit by and do nothing about it.

That is just very unlikely. I think that, in fact, what they would do would be to change the nature of the taxes that they collect. And you don't need much of a shift from the current structure of State and local taxes, about two-thirds of which fall on individuals—either with sales taxes or property taxes or income taxes—to taxes on businesses or fees collected from businesses for the U.S. Treasury to lose money in the shuffle because, while personal taxes of those kinds are technically deductible, only about half of them ever do get deducted, and they get deducted against an average tax rate of about 27 percent.

Taxes paid by businesses are fully deducted. Every business takes that deduction, and they take it at 46 percent under current law and perhaps somewhere in the 35 to 40 percent under whatever law you might propose.

The Treasury could lose more because of the increased deductions taken by businesses than it gains by eliminating the deduction or capping the deduction on the personal side.

The CHAIRMAN. Let me be sure I understand what you are saying. The States will shift the taxes to businesses which are fully deductible, and therefore we will lose money?

Dr. FELDSTEIN. Exactly. They will shift a little bit of them; and all you need is for them to shift about one-sixth of their total current tax collections to businesses, and it is gone. You have not made any money.

And I can't be sure how much is going to be shifted. The statistical evidence suggests that States are sensitive to this issue, that those States where the cost of levying the tax on individuals is higher on those individuals, use more taxes on business in States where the other is true.

I think you cannot count on that as a revenue source, and it would be a mistake to do so.

Third, I think it is very important to maintain the incentives to invest; and both the administration's bill and particularly the House bill are going in just the wrong direction.

They would end up diverting a larger share of our scarce capital into things like shopping centers and office buildings and vacation homes, larger homes for high-income individuals, sending that capital abroad, and the like.

I think it is a mistake to think that we are in a situation now where what we need is an increase in the corporate income tax.

After all, between TEFRA and DEFRA, Congress took back virtually everything in the way of tax cuts that was given to corporations in ERDA in 1981.

OMB estimates last year were that, of the $55 billion of 1988 tax reductions for corporations, in ERDA all that is left is $4 billion.

I don't think in that setting we really are in a position where we want to raise taxes on corporations by $25 billion in order to have a reduction of personal taxes.

My own preference is to retain the investment tax credit. I think it is still a very cost-effective way of encouraging investment.

It puts cash immediately into the hands of investors and, because it happens quickly, because it happens up front, their discounting of future tax benefits doesn't reduce its value.

I think it is more cost effective than other ways of encouraging investment; but if, in the end, the ITC is going to be dropped or reduced, then I would say that the administration's proposal to index depreciation is really a very valuable one.

It provides a way of increasing incentives for investment and also of providing a kind of insurance that, if we do drift back into higher rates of inflation, that is not going to erode the value of depreciation.

I talk briefly in the prepared statement about what I think is the right direction for tax reform, something that I hope you will come back to in the future, but really doesn't get addressed now; and that is the problem of the very unequal treatment of debt and equity.

And finally, I remind you that the purpose of the tax system, after all, is to raise revenues and that we don't have enough revenue, and that the committee would serve the Nation better if tax reform and revenue increasing could be considered together.

I think that there are ample opportunities for raising revenue without hurting investment incentives.

The prospects for an increase in the tax on gasoline combined with an oil import fee would be not only very productive of revenue but could be balanced in a way to achieve a kind of geographic neutrality so that the States that are hurt more by higher imported oil prices will be balanced by the change in the gasoline tax.

I also think that a temporary modification of the indexing rules for individuals is a very powerful way of gradually increasing revenue without actually having to increase anybody's tax rates.

By putting a 3-percent threshold in the bracket indexing, you would over time raise substantial amounts of additional revenue. By 1991, a 3-percent threshold, a 3-percent deduction, in the bracket indexing would produce $55 billion a year.

And when I think about that combination of roughly $25 billion a year from capping, from targeting the personal exemption, perhaps $20 or $25 billion a year from energy taxes, and the potential revenue gain from a minor modification in the indexing, I think that there is plenty of scope for both achieving some of the desirable tax reforms—bringing down the top rates and taking the poor off the rolls and also contributing to deficit reduction without having to go to a value-added tax at the present time.

Thank you.

The CHAIRMAN. Thank you. Dr. Schultze.

[The prepared written statement of Dr. Feldstein follows:]

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February 6, 1986
9:30 a.m.

REWRITING THE TAX BILL

Testimony before the

Senate Finance Committee

Martin Feldstein

Professor of Economics

Harvard University

February 6, 1986
Washington, D.C.

REWRITING THE TAX BILL

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Testimony before the Senate Finance Committee

February 6, 1986

Thank you, Mr. Chairman. I am very pleased to appear before this committee as you begin the process of writing new tax legislation.

I strongly believe that the tax bill that passed the House of Representatives is very bad tax policy. Even with the modifications proposed by the President, it would take our tax law in the wrong direction. I reach this conclusion for four basic reasons:

It would hurt our nation's economic performance. The immediate effect of its sharp reduction in the incentive to invest would likely be to push the economy into recession. Over the longer term, the reduced level of investment in plant and equipment would slow the growth of real incomes and reduce the competitiveness of American industry in world markets.

It is not tax reform. The original goal of a fundamental tax reform to broaden the personal tax base and reduce tax rates has been abandoned. All of the major provisions of the tax code that have been the target of tax reformers for so long - the deduction for interest on home mortgages and consumer loans, the exclusion of employer-paid health insurance premiums and other fringe benefits, and the deduction of state and local tax payments -- have now been judged to be either politically untouchable or socially desirable. What remains is not tax reform but a major tax reshuffle that would raise corporate taxes by about 30 percent and use the money to finance cuts in personal tax bills.

It is not tax simplification. For most taxpayers, there are no changes in the tax reporting requirements. But many upper income taxpayers would have to prepare two sets of tax returns -- one return for the regular income tax and another for the greatly expanded minimum tax.

It is the wrong way to cut taxes for low income families. An across-the-board increase in the personal exemption is an extremely costly and inefficient way of achieving the desirable goal of reducing the tax burden on low income families. The President's proposal would be even more costly than the House-passed plan, raising the cost of the personal exemption by $48 billion a year by 1990.

In short, the tax plan that has evolved from the original conception to the final House bill and Presidential recommendations would serve our nation very badly. Let me turn now to six basic suggestions that I want to recommend to this Committee as you develop an alternative plan.

Target the change in the personal exemption. Taking the poor off the tax rolls is a desirable goal. It can be done at a small fraction of the $40-plus billion dollar annual cost of the Administration's plan by targetting the increased exemption.

In my testimony to this committee last June, I suggested that the personal exemption should be raised to $2000 only for families in the proposed 15 percent bracket with a more modest increase to $1200 in the 25 percent bracket. Targeting the exemption in this way would cut the revenue cost in half -- saving more than

$20 billion a year. Even more could be saved and the tax reduction targetted more effectively to families by increasing the exemption only for dependent children. Yet another good way to target help to low income families would be to leave the personal exemption unchanged but to increase the exisiting earned income credit for employees with children.

Preserve the deduction for state and local taxes. Although tax experts have offered many arguments both for and against repealing the current deduction for state and local taxes, the most persuasive argument for eliminating the deduction has been that doing so would raise more than $30 billion a year in additional federal revenue that could be used to reduce personal tax rates.

Unfortunately, that argument is wrong. If the current deduction were eliminated, state and local governments would be pressured by their constituents to rely more heavily on taxes and fees paid by businesses and less on income, property and sales taxes paid by individuals. The federal Treasury could lose more because of the resulting increase in deductions by businesses than it gains by eliminating the personal deductions for state and local taxes.

Each dollar of increased state and local tax on business would reduce federal tax receipts by 46 cents. In contrast, only about half of the personal tax payments are deducted at all and the average marginal tax rate for those deductions is only 27 percent, implying a net cost to the federal government of 13 cents per dollar of state and local tax collected from individuals. If eliminating the deductibility of personal taxes induced state and local governments to raise the share of their total revenue paid by busineses from the current one-third to one-half, the Treasury would gain no additional revenue by eliminating deductibility. If it rose to more than half, the Treasury would lose revenue. Even if the corporate rate is cut to 38 percent, eliminating deductibility would cause a fall in Federal revenue if states and localities increased the business share of their revenue to more than 55 percent.

Eliminating only the sales tax deduction would also produce much less revenue than traditional calculations suggest and might easily lose revenue. States and localities that now use sales taxes would be under substantial political pressure to shift to income taxes or property taxes that local residents could deduct on their federal income tax. Since a larger share of those taxes would be paid by individuals who itemize and who are in relatively high tax brackets, the Treasury might end up losing more revenue from these increased deductions than it gains by eliminating the deduction for sales taxes.

Maintain the incentive to invest. The Administration's proposal and, even more, the bill passed by the House, would substantially reduce the incentive to invest in productive plant and equipment. They would divert a larger share of our nation's scarce capital into shopping centers, office buildings, vacation homes and larger houses for upper income taxpayers. This reshuffle of investment incentives would hurt the economy in both the near term and the more distant future.

Those who are eager to raise taxes on corporations to finance a cut in personal taxes should bear in mind that the combination of TEFRA (the 1982 Tax Equity and Fiscal Responsibility Act) and DEFRA (the 1984 Deficit Reduction Act) rescinded virtually all of the business tax cut enacted in 1981. According to the OMB analysis presented in the fiscal year 1986 budget, the net effect of all of the tax legislation enacted from 1981 through 1984 will be to reduce 1988

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corporate taxes by only $4 billion. By contrast, 1988 personal taxes will be lowered by $191 billion. This hardly seems to call for raising corporate taxes by $25 billion a year in order to reduce personal taxes by another $25 billion.

Those who argue that eliminating the investment tax credit and slowing depreciation for equipment would create a more level playing field between industrial equipment and industrial structures do not appear to realize that those tax changes would create a wider gap between the high effective tax rates on these industrial investments and the low effective tax rates on owner-occupied housing, on commercial and residential real estate, and on corporate investments in advertising and other things that can be written-off immediately.

In the past year, there have been several economic studies of the likely effect of alternative tax reform plans on the efficiency with which the nation's capital stock is allocated among different uses. Although these studies differ in many details, two basic conclusion seems to emerge: First, the maximum potential long-term gain from the improved capital allocation that might result from any feasible plan is small -- perhaps only one-tenth of one-percent of GNP a year. Second, the Administration's plan and the Ways and Means plan might well be counterproductive, causing a reallocation of capital in a way that reduces the long-term level of GNP. I would add a third conclusion of my own: the effect of redistributing the capital stock is likely to be less important than the adverse impact of the proposed tax changes on the return to saving and therefore on the overall rate of capital accumulation and growth.

Both direct experience and analytic studies indicate that the investment tax credit is a particularly powerful incentive. The ITC is more cost-effective than other tax changes as a way of stimulating investment because it immediately reduces the out-of-pocket cost of investing in new equipment and because the high hurdle rates of return that firms use to discount future aftertax cash flows substantially reduce the present value of other types of tax changes. Eliminating the ITC and using the resulting revenue to cut the corporate tax rate or increase depreciation allowances would have the net effect of depressing investment. I believe that the ITC should be retained.

But if the ITC is to be eliminated, depreciation rules should be modified to maintain as much as possible of the current incentive to invest. For that purpose, the Administrations's proposal to index depreciation is relatively cost-effective and deserves to be enacted. But even with this indexing, the Administration's proposed depreciation lives should be shortened in order to maintain current incentives.

Strengthen the minimum tax on corporations. A tax system in which many large and profitable corporations do not pay tax or do not appear to pay tax is politically unacceptable and may weaken general tax compliance. A strengthened minimum tax that assures that all profitable businesses pay some tax each year should be part of the tax system.

Rethink corporate tax reform, focusing on the unequal treatment of debt and equity. The most serious problem with the current corporate tax system is probably its very unequal treatment of debt and equity capital. Current tax rules lead to very different tax rates simply because companies have different debt-equity ratios. These tax rules also raise the cost of capital and thereby reduce the international competitiveness of American businesses. By encouraging the substitution of debt for equity, the current law increases the riskiness of the nation's financial system. None of the current tax proposals begins to deal seriously with these issues. The Congress should now reject the proposals to destroy investment incentives and should return in a future year to redesign the corporate tax system in a way that treats debt and equity more neutrally.

Raise revenue. Some revenue will be needed to finance the desirable changes in the personal income tax: reducing the tax burden on low income families and lowering the high marginal tax rates. Even more revenue will be needed to achieve the important budget goals of a $144 billion deficit in FY 1987 and lower deficits in future years. Although these deficit reductions cannot be responsibly achieved without substantial spending cuts, the public now recognizes by a two-to-one margin that taxes will also have to be raised if the deficit is to be brought under control. With the Gramm-Rudman requirments and with the public understanding of the need for increased revenue, the Congress has no excuse for letting deficits continue to pile up.

The decline of more than 20 cents a gallon in the price of crude oil provides the most logical candidate for a revenue increase. A 15 to 20 cent increase in the gasoline tax would raise $15 billion a year. Supplementing this with a modest $3 a barrel tax on imported oil would yield at least an additional $5 billion while helping to offset the adverse effect that the combination of the oil price drop and the hike in the gasoline tax hike would otherwise have on U.S. oil producers, oil service firms, and banks with loans to these companies.

I would also favor modifying the tax bracket indexing by adjusting tax brackets only for the excess of inflation over 3 percent. Like the extension of the 16 cent cigarette tax, a 3 percent floor on indexing would not be a tax increase but only the elimination of a prospective tax reduction. Nor would it alter the principle that high rates of inflation should not be allowed to push taxpayers into higher and higher tax brackets. And yet by 1991 the 3 percent floor would produce about $55 billion a year in additonal revenue, at least 85 percent of which would come from reductions in consumption. A parallel 3-percent floor on the indexing of various benefit programs including Social Security could produce an additional $55 billion a year by 1991.

Although there are many appealing things about a value added tax, there are also many serious problems. Since the combination of an energy tax that recaptures only part of the recent decline in the price of oil and a modest 3 percent floor on future indexed tax reductions could together raise $75 billion a year by 1991 while targetting the increase in the personal exemption could yield another $25 billion, I believe it is premature to think about a value added tax.

STATEMENT OF CHARLES L. SCHULTZE, PH.D., SENIOR FELLOW, THE BROOKINGS INSTITUTIONS; AND PROFESSOR OF ECONOMICS, UNIVERSITY OF MARYLAND, WASHINGTON, DC

Dr. SCHULTZE. Mr. Chairman and members of the committee, the first four pages of my statement are a summary, and I will go through that with you and put the rest in the record.

Over the next 3 to 5 years, the volume of investment in the United States—and I understand your committee is importantly concerned with investment—the volume of investment in the United States will principally be determined not by tax-related changes in investment incentives but by the availability of national savings.

That availability, in turn, is going to depend on what is done about the budget deficit and what happens to the value of the dollar.

If the Federal Government continues to absorb 4 to 5 percent of GNP to finance its own borrowing, in a country whose net saving is only 8 to 9 percent of GNP, then the structure of the economy will be increasingly tilted away from investment, no matter what you do with particular incentive-oriented provisions of the Tax Code.

Second, I think it will be difficult for your committee and for the Congress as a whole to determine the economic effects of tax policy and to discuss the components of a major tax bill without first having arrived at some broad understanding of what ought to be the role of taxation in dealing with the budget deficit.

It is widely accepted by most of those who are familiar with the current budgetary situation that, on both political and substantive grounds, spending cuts cannot be found sufficiently large to do the job alone.

Under these circumstances, it is impossible to talk about the desirability or undesirability of this or that particular tax measure that raises additional revenue without knowing whether those revenues are to go toward lowering the budget deficit or toward lowering other existing taxes.

Some comprehensive notion of where the Nation should be heading with respect to the overall budget seems to me is a prerequisite to making specific decisions about the details of the tax law.

Third, in this context, H.R. 3838 that is in front of you does offer one advantage as a framework for tax policy decisions. It puts the Nation's tax system in a better position to absorb what, in my judgment at least, will ultimately have to happen; namely, a tax increase designed to cut the budget deficit down to reasonable size.

The deficit problem is so serious that one shouldn't be too picky about any politically acceptable means of raising revenues to help deal with it; but I believe that a value-added tax or a sales tax or something like that is both politically unlikely and substantively a less preferable way to get the job done.

Various other specialized taxes might be used to pick up some extra revenue, but to get the $50 billion or more in additional annual tax revenues that are ultimately going to be required, some increase in income taxes will probably have to occur.

Adding 2 percentage points to the tax rates now set forth in H.R. 3838 would pick up sums of this magnitude and would be fairer and would have less economically harmful effects than would an increase in tax rates under the current system, with its narrower base and higher marginal rates.

Under the economic circumstances we will face over the foreseeable future, $1 of additional national savings made available by reducing the budget deficit will go almost dollar for dollar into additional investment or reduced accumulation of foreign debt and will far more than offset any disincentive effects that the higher taxes will bring with them. And they will bring some, like all taxes do.

Fourth, you have been particularly concerned, I understand, about the disincentive effects of H.R. 3838 on domestic investment.

I believe that the magnitude of such effects has been much overstated in some of the recent discussions. Critics cite the $139 billion in added corporate taxes imposed by H.R. 3838 over the next 5 years, and the $41 billion annual increase in corporate tax revenues by 1990.

But $114 billion of those added revenues over the next 5 years and $27 billion of the 1990 annual increase are yielded by provisions that reduce loopholes, tax shelters, and special privileges.

The combined yield of changes in capital recovery provisions and the corporate tax rate is a much smaller number.

Nevertheless, some negative effects on investment are contained in H.R. 3838. It would make economic sense, although I have to admit it would be very difficult policitically, to reconsider some of the loophole-closing and revenue-raising provisions of the original November 1984 Treasury proposal and the smaller list of such provisions contained in the President's proposal but dropped by the House Ways and Means Committee.

For a total revenue cost of $10 to $15 billion a year, it would be possible, I think, to improve significantly the overall investment incentives in H.R. 3838 by liberalizing its capital recovery provisions while as much as possible preserving neutrality among assets and industries.

Placing stricter limits than does H.R. 3838 on the deductibility of personal interest in excess of investment income is one candidate for a revenue-raising measure.

Another would be to allow deductibility for State and local taxes only on amounts in excess of some percentage of income, and there are others.

Finally, with respect to the total effects of H.R. 3838 on long-term economic growth, I think there are four pluses and one minus, at least in the major parts of the bill.

On the plus side, H.R. 3838 reduces tax loopholes, tax shelters, and privileges and thus helps to channel private energies and resources into more economically efficient directions.

With respect to investment, H.R. 3838 reduces somewhat the economic inefficiencies generated by the provisions of the current law, which impose significantly different tax rates on different industries, different assets, and different sources of financing.

It significantly lowers marginal tax rates on individuals and thus provides greater incentives for earning additional personal income and for taking risks.

By lowering the corporate tax rate, it provides greater incentives for business investment in R&D and other intangible assets.

On the minus side, H.R. 3838 increases the effective tax rate on investment and decreases corporate cash flow and so will work to reduce aggregate investment in physical assets.

Mr. Chairman, I think it is impossible, given the state of current economic knowledge, to be very positive about how these offsetting effects will balance out, in terms of effects on the long-run level and in terms of GNP.

The balance of supply-side effects are not likely to be large. They could be tipped, I think clearly in a positive direction, by the suggestions I made above to shift some revenues from the personal taxes into improved cost of recovery.

Finally, Mr. Chairman, let me end where I began. All of these final considerations about the supply side effects of changes in the tax structure in H.R. 3838 or other parts of the discussion pale in significance when faced with what a continuation of the large budget deficits will do to the cost of capital, to investment incentives, to investment itself, and economic growth.

And it seems to me that dealing with that is the first priority. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Dr. Ture.

[The prepared written statement of Dr. Schultze follows:]

Statement

of

Charles L. Schultze*
Brookings Institution

before the

Committee on Finance

U. S. Senate

February 6, 1986

Mr. Chairman and Members of the Committee:

You have asked me to give my assessment of the potential economic impact of tax reform legislation. I will take as my starting point HR3838.

Let me begin by summarizing my conclusions.

1. Over the next three to five years the volume of investment in the United States will principally be determined not by tax related changes in investment incentives but by the availability of national saving. That availability in turn, will depend on what is done about the budget deficit and what happens to the value of the dollar. If the federal government continues to absorb 4 to 5 percent of GNP to finance its own borrowing, in a country whose net saving is only 8 to 9 percent of GNP, then the structure of the economy will increasingly be tilted

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*The author is a Senior Fellow at the Brookings Institution. The views set forth here are solely those of the author and do not necessarily represent the opinions of the trustees, officers, or other staff members of the Brookings Institution.

away from investment no matter what you do with particular incentive-oriented provisions of the tax code.

2. I think it will be difficult for your Committee, and for the Congress as a whole, to determine the economic effects of tax policy, and to discuss the components of a major tax bill, without first having arrived at some broad understanding of what ought to be the role of taxation in dealing with the budget deficit. It is widely accepted by most of those who are familiar with the current budgetary situation, that on both political and substantive grounds spending cuts cannot be ???found sufficiently large to do the job alone. Under these circumstances it is impossible to talk about the desirability or undesirability of this or that particular tax measure that raises additional revenue without knowing whether those revenues are to go towards lowering the budget deficit or towards lowering other existing taxes. Some comprehensive notion of where the nation should be heading with respect to the overall budget is, it seems to me, a prerequisite to making specific decisions about the details of the tax law.

3. In this context HR3838 does offer one advantage as a framework for tax policy decisions. It puts the nation's tax system in a better position to absorb what will ultimately have to happen -- namely a tax increase designed to cut the budget deficit down to a reasonable size. The deficit problem is so serious that one should not be too picky about any politically acceptable means of raising the revenues to help deal with it. But I believe that a value-added or sales tax is a politically unlikely and substantively less preferable way to get the job done. Various other specialized taxes might be used to pick up

some extra revenues. But to get the $50 billion or more in additional annual tax revenues that are required, some increase in income taxes will probably have to occur. Adding two percentage points to the tax rates now set forth in HR3838 would be fairer and have less economically harmful effects than would an increase in tax rates under the current system, with its narrow base and higher marginal rates. Under the economic circumstances we will face over the foreseeable future one dollar of additional national saving, made available by reducing the budget deficit will go, almost dollar for dollar, into additional investment or reduced accumulation of foreign debt, and will far more than offset any disincentive effects that the higher taxes will bring with them.

4. You have been particularly concerned about the disincentive effects of HR3838 on domestic investment. I believe that the magnitude of such effects has been much overstated in some of the recent discussions. Critics cite the $139 billion in added corporate taxes over the next five years, and the $41 billion annual increase in corporate tax revenues by 1990. But $114 billion of those added revenues over the next five years, and $27 billion of the 1990 annual increase are yielded by provisions that reduce loopholes, tax shelters and special privileges. The combined revenue yield of changes in capital recovery provisions and the corporate tax rate is a much smaller number. Nevertheless, some negative incentive effects on investment are contained in HR3838. It would make economic sense -- although it would, I admit, be very difficult politically -- to reconsider some of the loophole closing and revenue raising provisions

of the original November 1984 Treasury proposals and the smaller list of such provisions contained in the President's proposals but dropped by the House Ways and Means Committee. For a total revenue cost of $10-$15 billion a year it would be possible, I think, to improve significantly overall investment incentives in HR3838 by liberalizing its capital recovery provisions, while as much as possible preserving neutrality among assets and industries. Placing stricter limits than does HR3838 on the deductibility of personal interest in excess of investment income is one candidate for a revenue-raising measure. Another would be to allow deductibility for state and local taxes only on amounts in excess of some percentage of income.

5. With respect to the total effects of HR3838 on long-term economic growth there are four pluses and one minus. On the plus side: HR3838 reduces tax loopholes, tax shelters, and privileges and thus helps to channel private energies and resources into more economically efficient directions; with respect to investment it reduces somewhat the economic inefficiencies generated by the provisions of the current law which impose significantly different tax rates on different industries, different assets and different sources of financing; it significantly lowers marginal tax rates on individuals and thus provides greater incentives for earning additional personal income and for taking risks; and by lowering the corporate tax rate it provides greater incentives for business investment in R&D and other intangible assets. On the minus side HR3838 increases the effective tax rate on investment, and decreases corporate cash flow and so will work to reduce aggregate investment in physical assets.

It is impossible, given the state of our current knowledge to be very positive about how these offsetting forces will balance out in terms of effects on the long-run level and growth of GNP. The balance of supply side effects are not likely to be large. They could be tipped clearly in a positive direction by the suggestions I made above to shift some revenues from the personal tax into improved cost recovery.

Taxes, Deficits, and Investment Prospects

As I stated at the outset, the effects of HR3838 on investment incentives will be totally swamped by the effects of the federal budget deficit under the conditions that the United States will be facing the in the period ahead. To set the stage I have to say a few words about the role of the Federal Reserve Board in determining the path of GNP over the years immediately ahead.

For some time now the Federal Reserve has been following, and subject to a few caveats, will surely continue to follow a flexible monetary policy that promotes, encourages, and produces a continued moderate expansion of GNP along a noninflationary path. It has been, and again with a few caveats, is likely to continue to be broadly successful in this objective. To a first approximation, therefore, the Federal Reserve will determine the path of GNP over the next few years. Several consequences flow from this fact. In the first place, neither HR3838 nor any other tax reform bill, can change by very much the overall level of demand and spending in the economy. That will continue to be fixed by the Federal Reserve. Any potential effect of the tax reform bill on the overall state of demand will simply be one among many other factors that the Federal Reserve will take into account in setting the monetary control levers. Those who claim that the bill will cause a recession in the period ahead not only sharply exaggerate the possible demand effects of a revenue neutral tax bill but more importantly do not take monetary policy sufficiently into account.

A second and more important consequence of the fact that the path of GNP will be fixed on a noninflationary path by monetary policy is what it implies for the future course of business investment. The federal government is now borrowing an amount equal to about 5 percent of GNP. In the absence of specific actions to change it, that borrowing, while falling somewhat, perhaps to 3-1/2 or 4 percent of GNP, will remain extremely high by historical standards. Within a framework where the total level of GNP is more or less determined by Federal Reserve policy, the 3-1/2 to 4 percent of GNP that goes to federal borrowing will not even temporarily be financed by a huge infusion of newly created bank credit. It can only come from some combination of two sources. It can come out of the 8 to 9 percent of GNP that is saved by the private sector. And, at the cost of running a balance of payment deficit, it can some from an inflow of foreign savings. In the last year or so, foreign borrowing has directly and indirectly -- mainly the latter - financed about 60 percent of the federal budget deficit. But that pattern cannot indefinitely be sustained. Foreigners will not continue year after year to add huge amounts of dollar denominated assets to their portfolios. The flow of foreign saving into the United States will shrink, possibly disappear completely, and conceivably become an outflow. Then we will have to finance a budget deficit of 3-1/2 to 4 percent of GNP principally or even solely out the limited 8 to 9 percent of GNP that is available from domestic savings. The Federal Reserve will have to permit, encourage, and engineer a large rise in interest rates so as to squeeze out demand for domestic investment in housing and plant and equipment to make room for federal borrowing.

Under these circumstances therefore it is the size of the federal deficit that will determine the availability of savings to finance domestic investment. Changes in effective tax rates on income from investment, such as contained in HR3838, will have little influence in determining the overall size of investment. The provisions of HR3838 would influence, to a modest extent, the allocation of the limited domestic savings left over after financing the budget deficit between housing and business investment, with a little more going to housing and a little less to business investment. But these effects pale alongside what will ultimately be the very large negative effects of the federal budget deficit on investment once the inflow of foreign savings dries up.

<u>The Potential Role of HR3838 in Dealing with the Budget Deficit</u>

Under the circumstances we are likely to face in the next three to five years, every reduction in the budget deficit will show up almost dollar for dollar in higher investment in the United States. And to the extent it does not show up there, it will show up in the form of a lower trade deficit and a correspondingly lower accumulation of foreign debt, a development which, like increased domestic investment, will boost American living standards in the future. In turn, I believe that any objective examination of the budget will show that it is impossible to reduce the deficit sharply below $100 billion a year by 1989 or 1990 -- as called for under the Gramm-Rudman deficit targets -- without a substantial tax increase. Quite apart from its mechanical formula to generate an equiproportional reduction in spending, the Gramm-Rudman bill pretty well identifies the broad areas of civilian spending that are likely to be off limits when it comes to spending cuts; social security, veterans compensation and pensions, unemployment insurance and so forth. It is simply going to be impossible to get, out of the defense budget plus that limited area of civilian spending, the $80 to $100 billion dollars in annual savings that will be needed by 1989 to meet the Gramm-Rudman targets. A sizeable tax increase will also be required.

In my judgement neither a straight value-added tax, nor a value-added tax dressed up to look like something else should be high on the list of ways to raise taxes. In the first place, from the standpoint of anyone who wants to limit the growth in government, a hidden tax like the value-added tax carries a major risk with it. I think it quite likely that the government sectors of the major countries of Europe would never have approached or exceeded 50 percent of GNP, as they now do, without having adopted many years ago the hidden value-added tax, which is so easy to inch up bit by bit. It is, I suspect, no coincidence that the two major industrial countries whose government sectors, by a wide margin absorb the lowest share of GNP, are the two without a value-added tax, namely Japan and the United States.

There is another reason to put a value-added tax low on the list of revenue-raising priorities at the present time. During that period the United States will be facing a temporary increase in inflation, as the value of the dollar declines and the prices of imports and import-competing goods rise. So long as that increase does not get reflected in wages, the rise in inflation will be temporary. But if wages rise, in a futile attempt to avoid the impact of the falling dollar, then a longer lasting impetus to inflation will occur. In the year or years when it is first imposed the value-added tax will also temporarily add to the inflation rate. Again, wage earners would have to swallow that rise without an extra wage increase, if longer term inflationary effects are to be avoided. The sum of the two price raising events -- a falling dollar and the initial effect of a value-added tax -- might well be too much for the system to take, so that a longer term inflationary force would be generated.

And so, to generate the additional revenues needed to reduce the budget deficit, and thus to prevent a fall in domestic investment, personal income taxes will have to be raised. While HR3838 does have its weak points, it also has some substantial pluses, which I discuss later. The relevant point here is that HR3838 broadens the personal income tax base and lowers marginal tax rates. Raising additional revenues on that broader base and with the lower marginal tax rates would be superior, both from the standpoint of fairness and in terms of minimizing the economic costs of a tax increase, than would be the raising of equal amounts of revenue from the current tax system. A 2 percentage point increase in the schedule of rates under HR3838 would increase annual revenues by some $50 billion in 1989 and still leave marginal rates well below their current levels.

As part of an overall negotiated solution between the Senate, the House, and the President, incorporating such a tax increase into a tax revision bill along the broad lines of HR3838 would in my judgement make good sense. But even if some other revenue raising solution to the deficit problem turns out to be the favored one, it would clearly be desirable to have at the least the broad outlines of a budgetary compromise in mind <u>before</u> one began to play put and take with the tax reform bill. Both politically and substantively the actions you take on any particular revenue proposal have to be considered in the context of how it fits into an overall package. I do not see, for example, how you can make a political and economic evaluation of various proposals that have been put forward to raise additional revenues without knowing whether those revenues are to be used to reduce taxes somewhere else in the system or to lower the budget deficit.

<u>Supply-side Effects of HR3838: 1. Investment</u>

As I said earlier the availability of national saving, particularly as determined by the level of the budget deficit, will be the principal determinant of business investment in the United States over the next three to five years. But if some solution to the political impasse over how to reduce the deficit is found, and if the deficit is lowered substantially in the near future, then the effects of HR3838 on investment incentives will become more relevant.

On balance the provisions of HR3838 would reduce both business incentives to invest in durable capital assets and lower the internal cash flow available for investment. But the magnitude of these effects has been overstated in much of the discussion.

Critics of HR3838 are fond of pointing out that it would raise corporate taxes some $41 billion a year by fiscal 1990 and by a total of $139 billion over the next five years. But the total increase in corporate tax revenues that it would generate is not a good measure of how the bill would affect investment. Table 1 breaks down the increase in corporate tax revenues under HR3838 into three parts: the increase due to the limitation or removal of various tax loopholes shelters, and other preferential treatment; the revenue increase due to the abolition of the investment tax credit and the tightening up of depreciation rules; and the reduction in revenues from the lower corporate rate, the partial dividend deduction and retention of the R&D credit.

More than half of the total increase in corporate tax revenues comes from the reduction of special privileges and tax shelters -- yielding $27 billion in 1990 and $114 billion over the five years 1986-1990. These changes will tend to make the tax system more evenhanded and reduce distortion. In that respect the changes are likely to improve rather than to retard economic growth.

The remaining revenue changes, netting to an increase of $14 billion in 1990 and $25 billion over five years, are the ones to consider in terms of their impact on business investment and economic

Components of the Increase as Corporate Revenues
Under HR3838: Selected Years

(billions of dollars)

	FY 1988	FY 1990	Sum; 1986-1990
Loophole closing, etc.	+26	+27	+114
Other changes, net:	+1	+14	+25
• ITC and depreciation	(+24)	(+39)	(+118)
• Rate reductions	(-22)	(-25)	(-93)
Total	+27	+41	+139

Source: Ways and Means Committee Report

growth. The reduced speed of capital recovery because of the abolition of the ITC and the tightening of depreciation rules more than offsets both in dollar amounts and in terms of economic effect, the reduction in corporate tax rates. Some business investment will indeed be discouraged. But the magnitudes involved are much less than is often implied by those who point to the full five-year $139 billion increase in corporate taxes.

Among economic specialists in the field of taxation, a lot of effort has recently gone into attempts to get a comprehensive measure of the marginal effective rates which are imposed by the tax system on the income earned from various kinds of investments. If you imagine investors as demanding a certain after-tax rate of return before they are willing to make additional investments, then, in order for an investment project to be undertaken, it has to yield enough income before taxes both to pay the taxes on that income and to satisfy investors' demand for a satisfactory after-tax return. The effective tax rate is thus a measure of the tax wedge between the required after-tax return and the before-tax yield of the investment. The higher that tax wedge, the higher the yield that must be generated by any potential investment before it will be undertaken. And so, the higher the tax wedge, the fewer the otherwise profitable investments that can get over the hurdle. Or a say it another way, as you raise the effective tax rate you raise the cost of capital to those who want to make investments. Because the tax code treats the income from equity investment differently from debt-financed investment, estimates of effective tax rates differ depending on what assumption is used about financing sources.

Calculating the effective tax rates imposed by the complex U.S. tax code and their effect on the cost of capital requires a host of assumptions about the behavior of investors, about the debt-equity mix of the investment financing and about the investment process generally. Moreover, I do not think anyone has yet fully thought through the complications that are involved when we take into account, as we now must, the fact that the relevant capital market from which we draw financing is no longer just the United States but the world. In addition, once we calculate the change in effective tax rates and the cost of capital implied by HR3838 or any other tax bill, we still have to make some additional key assumptions to estimate by how much investment is likely to be changed for a given change in the cost of capital. The point of going through all of this is to suggest that no one ought to be very confident about his estimate of exactly how much any given tax change will affect investment.

I have seen several recent estimates of the consequences of HR3838 for effective tax rates and the cost of capital to business investors. Various authors give different answers depending how they handle the various assumptions involved. I think a fair assessment would be that HR3838 would impose an increase in the overall cost of capital to American business of something in the neighborhood of 6 percent, assuming that the investment is financed two-thirds by equity and one-third by debt.

Estimates of how much a 6 percent change in the cost of capital would, in turn, affect the stock of capital in the United States also vary substantially from one author to another, especially with respect to the matter of timing -- how long it would take for the changes to be made. According to a recent survey of such estimates by my colleague Barry Bosworth at Brookings, a reasonable middle-of-the-road estimate is that a 6 percent rise in the cost of capital might lower the business capital stock five years from now by about 3 percent below what it otherwise would have been.[1] This reduction in the stock of capital might then lower the productive capacity of the U.S. economy five years from now by something in the neighborhood of 1 percent.

I cite these estimates not because they are all that believable, but to give you some idea both of the many assumptions that have to be chained together to arrive at numerical results, and to suggest that we

1. Barry Bosworth, Tax Incentives and Economic Growth, Brookings (1984), pp. 108-109.

are not dealing, in any event, with very large effects. Moreover, as I emphasized earlier, these effects will be swamped by other developments in the period ahead.

While HR3838 increases the effective tax rate on business investment as a whole, it substantially reduces the difference in tax rates among different kinds of assets and different industries. When the tax law imposes tax burdens that differ among industries and assets it sets up incentives for private investors, acting in a perfectly rational way, to allocate investment in a distorted pattern that reduces the economic efficiency of the economy as a whole. Investments that yield high returns from a national economic standpoint are turned down for tax reasons in favor of lower yielding, less efficient investments which are favored by the tax code. The result is lower national output and productivity. HR3838 substantially reduces these distortions. According to a recent estimate by Yolanda Henderson of the American Enterprise Institute and Amherst College, the variation of effective tax rates across different assets is cut in half by HR3838.[2] Again, the precise estimate of how much distortions are redeuced depends on a host of assumptions, but the direction is clear, and the change introduced by HR3838 is significant.

HR3838 would make an additional improvement in economic efficiency through its effect on the financing of investment. The bill reduces the advantage of debt financing relative to equity financing for

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2. Tax Notes, December 9, 1985, pp. 1059-1062.

investment in the corporate sector. Taking into account changes in both the personal and corporate taxes, virtually all of the increase in effective tax rates that HR3838 imposes on income from corporate investment arises from increases in the cost of debt finance. This bill should thus reduce the bias toward debt finance currently incorporated in the law, and in this way improve the long-run efficiency and stability of the corporate sector. (I have to repeat, however, that all these estimates make a number of strong assumptions about the behavior of investors that may not be fully appropriate in a world of international capital mobility.)

Thus, HR3838 increases the average effective tax rate on income from business investment, but it reduces the distortions generated under the current law by differences on taxation among industries, assets and sources of finance. While I find it difficult to assess the net balance of these effects, HR3838 would clearly be a better bill if its overall increase in the tax rate on investment income were softened by a liberalization of its capital recovery provisions, maintaining as much as possible equal treatment among assets of various kinds. As I stated in the introduction, I think consideration should be given to reviving some of the revenue yielding reforms incorporated in the original Treasury proposal of November 1984 but lost on the way through the White House and the Ways and Means Committee. Additional revenues of $10-$15 billion a year from those sources, applied to reducing the taxation of income from investment would significantly improve the bill.

2. Some Other Supply-side Effects of HR3838

In dealing with the supply-side effects of HR3838 I have so far concentrated on the bill's effect on investment incentives. And while the effects are smaller than often claimed, they are nevertheless negative. But there are some positive supply-side effects of the bill. Let me at least list some of the important ones.

1. Reduced marginal tax rates on individuals. Lower marginal tax rates do provide, on balance, greater incentives for individuals to supply more labor. Recent economic research, while conflicting in many aspects, does suggest that the effects of lower taxes on the labor supply of males is likely to be quite small, but that there may be more significant effects on the working decisions of married women. The opportunity to earn increased take-home pay from additional work does induce increases in labor force participation by married women. Overall there would be some positive effects on the total labor supply from HR3838, although the magnitude would in all probability not be very great.

2. HR3838 reduces the gap between the top bracket rate on income and the capital gains rate, from a current differential of 28 percentage points to a differential of 16 percentage points. Two percentage points of the reduction in the differential comes from an increase in the capital gains rate, but most of it arises from the cut in the top bracket rate of the individual income tax. One of the major economic distortions that the tax code induces is the large incentive it provides to design economic activities so that they yield capital gains rather than ordinary income. In the process human energies and

economic activities are diverted toward wasteful ends. The substantial reduction of the differential provided by HR3838 should, on balance, yield positive results, despite the two point rise in the capital gains rate itself.

As I stated in the introduction to this testimony, I do not believe that economic research can yet provide generally accepted and comprehensive quantitative measures of the sum of supply-side effects of a complex tax bill. In a bill like HR3838 which incorporates measures that work in opposite directions with respect to such effects, no one should be entirely confident that he or she can know what the balance of effects will be. On the other hand, what I think can be said with certainty is that the long-term supply-side damages to the American economy from failure to reduce the budget deficit sharply over the next several years will swamp any impact, positive or negative, of the structural provisions of HR3838. Paradoxically at this juncture in our history the most important contribution to improving the supply of goods and services in the United States would be quick passage of a tax increase that along with spending cuts would produce a sharp and credible drop in the budget deficit.

STATEMENT OF NORMAN B. TURE, PH.D., PRESIDENT, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION, WASHINGTON, D.C.

Dr. TURE. Thank you, Mr. Chairman. I am pleased to have the opportunity to offer my views on the economic effects of H.R. 3838.

In my view, by far the most important objective of constructive tax reform must be to renew and foster the dynamic growth impetus of the American economy.

This requires reducing tax barriers to effective performance of U.S. businesses at home and in the world marketplace.

Because efficient performance and sturdy growth of the industrial sectors of the economy are critically important in achieving economic progress, improvements in the tax environment for one group of taxpayers should not be secured at the expense of creating a more hostile tax environment for industrial businesses.

Both H.R. 3838 and the President's May 1985 reform proposals would raise serious impediments to enlarging economic opportunities at home and strengthening the participation by American business in expanding world trade.

The tax reform effort to date, in my judgment, has been misfocused.

It has started from preconceived notions about what should be the top statutory tax rates for individual and corporate taxpayers and then turned to the adjustments in the tax base required to assure no change in static estimated total tax revenues.

The correct focus should be to specify a tax base that is as nearly right as possible in terms of some relevant operational criteria and then determine by how much statutory rates can and should be cut in the light of long-term budgetary requirements and projected economic growth.

Because of the mistaken focus, proposed base adjustments have been dictated by revenue requirements, not by useful dictates of economic neutrality or efficiency.

Most of the base-broadening measures would be economically punitive. This would be particularly true in the case of the single biggest revenue raiser in H.R. 3838, the repeal of the investment tax credit.

Together with the proposal for replacement of the accelerated cost recovery system by the mislabeled incentive depreciation system, this reform would raise taxes on the returns to depreciable capital by the staggering sum of $145 plus billion over the fiscal years 1986 to 1990.

These base broadeners must be expected to depress the growth of the overall amount of the economy's production facilities and to shift capital additions from the industrial to the nonindustrial sectors of the economy.

They would shift economic activity from capital intensive to labor intensive production, slowing the overall growth in the capital-labor ratio and the advance in labor productivity, real wage rates, and employment opportunities.

Because a very substantial fraction of both our export- and import-competing production is highly capital intensive, the increases in capital costs and the subsequent increases in labor costs that the proposed changes in capital cost recovery provisions entail would have a seriously adverse effect on the ability of U.S. businesses to compete profitably in world trade.

The existing ACRS-ITC capital recovery system has served the economy very well indeed since its inception in 1981. It has gone a long way in moderating the income tax bias against investment and depreciable capital.

It has provided a high degree of uniformity in effective tax rates with respect to a wide range of machinery and equipment.

I urge the committee to retain the ITC and to leave ACRS intact or, at the least, to provide an alternative system affording capital recovery deductions, the present value of which are at least equal to those under ACRS-ITC.

Most of the other revenue-raising base broadeners would also increase the tax burden on saving and capital formation. Close to $260 billion of the $427.6 billion of gross revenue additions proposed in H.R. 3838 would be derived from increasing taxes on saving and the return to capital.

Some proponents of this approach have argued that the adverse effects of this huge increase in tax burdens on saving and capital formation would be more than offset by the proposed rate reductions and the allegedly more efficient use of capital resources resulting from the claimed more nearly neutral capital recovery system in either the President's proposal or H.R. 3838.

The statutory rate reductions taken by themselves are eminently desirable. The proposed rate reductions, however, would fall far short of moderating the capital cost increases that would result from the proposed increases in taxes on savings and capital income.

And the proposed new capital recovery systems would result in significantly greater distortions of the market valuations of different kinds of assets, hence a greater misallocation of capital than results under present law.

I will offer for the record, if I may, two IRET economic reports that address this matter.

The adverse effects of the corporation income tax on the economy also urge that the last thing tax reform should do is to increase corporate tax liabilities by base broadening or otherwise.

The $87 billion in revenue reductions that H.R. 3838 would afford by cutting the statutory rates of the corporate income tax would be swamped by the $226.5 billion of gross revenue increases from the economically punitive broadening of the corporate income tax base.

We should keep in mind that nearly all of this $140 billion in net additional corporate liabilities really are additional taxes borne by individuals as corporate employees, shareholders, and/or customers.

What H.R. 3838 boils down to, therefore, is a huge shifting around of a given amount of tax burdens among individuals. H.R. 3838 is a massive redistribution program with enormously adverse economic effects.

If I have the time, I would like to offer a few specific recommendations with respect to H.R. 3838.

One, do not increase the standard deduction. The standard deduction is a deduction for expenses the taxpayer does not have.

It is a redundant zero rate bracket, duplicating that created by the personal exemption. The proposed increase is costly over the 5-year period. It would lose $32.5 billion.

Second, change the personal exemption into a tax credit of, say, $400. This would be an increase, in effect, in the increase in the personal exemption for 15 percent bracket taxpayers, both over present law and over the proposed $2,000 exemption under H.R. 3838.

It would be an increase over present law but not over the proposed $2,000 exemption for both 25 percent and 35 percent bracket taxpayers.

It would reduce the revenue loss of H.R. 3838 by—and I cannot be confident of this estimate, and I urge the staff to either verify or amend it—but I think by about $25 billion per year or by about $125 billion over the 5-year projection period.

Third, reject the proposed caps on IRA's, 401(k)'s, 403(b)'s and so forth. The caps would be antisaving, discriminatory, and blatantly redistributionist.

Fourth, reject the alternative minimum tax proposal. At the least, delete from the preference list depreciation, mining exploration, and development costs, completed contracts, intangible drilling costs, and charitable contributions of appreciated property.

Fifth, allow a cash-out on a discounted basis or an extended carry-back of unused investment tax credits.

A cash-out or an extended carry-back is not, however, to be seen in my judgment as a substitute for keeping ITC and an efficient and effective capital recovery system.

Sixth, reject the proposed changes regarding royalty payments with respect to intangibles transfered to a related corporation or to a possession corporation operating in Puerto Rico, or at the very least, provide explicit quantitative guidelines for determining the amount of the payment, the frequency and extent of the adjustments, and other rules that will constrain and limit the judgment of the Internal Revenue Service.

Such guidelines, I think, are absolutely critical if those provisions are to be operational.

Seventh, reject the foreign tax provision changes in H.R. 3838. I think it is certainly time to rethink and reorient our entire approach to the taxing of foreign source income.

The foreign tax proposals in H.R. 3838, I think, would be discriminatory. They would result in differential rates of tax, in effect, on different kinds of income generated abroad.

They would be the equivalent of imposing a system of selective excises on differing kinds of operations in foreign markets.

To summarize, the Committee on Finance should set as its principal goal moderating, if not eliminating, those features of the present tax system that create barriers to the Nation's economic progress.

It should seek to reduce the tax bias against saving and capital formation, against productive effort, against the implementation of technological advances, against innovation in products and production processes, against new enterprises, and against effective participation in the international marketplace.

Substantial statutory rate reductions are important components of the tax program to this end but these rate cuts should not be purchased at the cost of additional tax burdens on saving and capital income.

Rather than imposing huge additional levies on the industrial sectors of the economy, tax reform should look to a new revenue source to provide the revenue lost by any rate reductions and other revenue-losing tax changes that are to be adopted.

The value-added tax, preferably of a subtraction form, proposed in the so-called business transfer tax, has much to commend it for this purpose.

In any event, tax reform should shun the economically punitive base broadeners of the sort proposed in H.R. 3838.

Thank you.

The CHAIRMAN. Thank you, Dr. Ture.

Dr. Auerbach.

[The prepared written statement of Dr. Ture follows:]

TAX REFORM, PRIVATE CAPITAL FORMATION, AND INTERNATIONAL COMPETITIVENESS

Testimony Presented

to

The Committee on Finance,

United States Senate

by

Norman B. Ture*

President of IRET

(Institute for Research on the Economics of Taxation)

February 6, 1986

*The views presented in this statement are my own and not necessarily those of IRET or its contributors.

Tax Reform, Private Capital Formation, and International Competitiveness

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(Institute for Research on the Economics of Taxation)
February 6, 1986

The Committee on Finance is to be commended for conducting these hearings before undertaking the difficult task of basic revision of the Federal tax system. Changing the tax structure involves great potential for either significant benefit or damage to the American economy. The task should be undertaken with great care and deliberation; there is no need to rush at it and every reason to proceed slowly, rigorously examining the likely effects on the economy of each proposed change as well as the economic consequences of the package taken as a whole.* It is to be hoped that these hearings will be useful to this end.

May I respectfully suggest that the first question the Committee should raise is whether there is in fact an urgent need for tax reform legislation this year and if so, to what objectives should it be addressed. There are, of course, always opportunities for improvements in taxation, but if there are to

*Permit me to remind the Committee that no such rigorous assessment was provided either in connection with the Treasury's tax reform program of November 1984, the President's proposals of May 1985, or the House Bill 3838.

be numerous, drastic changes in the tax laws aimed at a basic restructuring of the tax system, the Committee will want to be quite sure that the improvements will warrant the very substantial adjustment and other costs these changes will entail.

In my view, by far the most important objective of constructive tax reform must be to renew and foster the dynamic growth impetus of the American economy by reducing existing tax barriers to effective performance of U.S. businesses at home and in the world market place. Doing so, I believe, requires minimizing tax deterrents to those economic activities on which advancing productivity, real wage rates, employment, and real output throughout the economy depend. Because efficient performance and sturdy growth of the industrial sectors of the economy are critically important in achieving economic progress, constructive tax reform efforts should be at pains to assure that improvements in the tax environment for one group of taxpayers are not secured at the expense of creating a more hostile tax environment for industrial businesses. Tax reform should not seek to subsidize the growth of the Nation's industrial base, but it certainly should not inhibit that growth.

Constructive tax reform should also seek to make the tax system fairer and simpler -- less costly -- to comply with, to administer, and to enforce. The problem that one tax reform effort after another has confronted in this respect is lack of consensus and reliable, operational guides for determining what

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fairness requires and for fashioning a fairer tax system that is not also far more complex and burdensome for taxpayers and tax administration alike.

I believe that neither H.R. 3838 nor the President's May 1985 reform proposals, of which H.R. 3838 is a close copy, would afford a tax system that would serve the tax policy objectives of economic growth and efficiency, fairness, and simplicity as well as present law. Both reform proposals, I believe, would be serious steps backwards. Both represent sharp reversals of the course of constructive tax reform initiated by the Economic Recovery Tax Act of 1981. Both would raise serious impediments to achieving the goals of enlarging economic opportunities at home and strengthening the participation by American business in expanding world trade. If this Committee's efforts are to be successful in bringing forth the design for truly constructive tax reform, the approach in H.R. 3838 and in the President's proposals must be rejected. This means, of course, that this Committee will have to take on the tax reform job ab initio.

The entire tax reform effort to date has been misfocused. It very clearly has started from preconceived notions about what should be the top statutory tax rates for individual and corporate income taxpayers and then turned to the adjustments in the tax base required to assure no change in (static estimated) total tax revenues. The correct focus, I submit, is precisely the reverse. The objective of tax reform should be achieve a tax base that is as nearly "right" as possible, in terms of some relevant operational criteria, and then determine by how such statutory rates can and should be cut in the light of long-term budgetary requirements and projected economic growth.

Because of the mistaken focus, proposed adjustments of the income tax base have been dictated by revenue requirements, not be any useful dictates of tax fairness, simplification, or economic neutrality or efficiency. It is a mistake to believe that simplification for individual taxpayers is achieved, on the one hand, by eliminating certain itemized deductions, income averaging, or the second-earner deduction, or, on the other hand, by taking hundreds of thousands of individual taxpayers off the tax rolls by greatly increasing the personal exemption and the standard deduction. It is equally mistaken to believe that such base changes serve to make the system fairer. For corporate taxpayers, no simplification is to be found in either the President's proposals or the House bill; on the contrary, an already horrendously complex and burdensome tax system would be made even more so.

Many, if not all, of the base broadening measures would be economically punitive. This is particularly true in the case of the single biggest revenue-raising base broadener in H.R. 3838, the repeal of the investment tax credit. Together with the proposed replacement of the accelerated cost recovery system by the mislabeled "incentive depreciation system," this "reform" would raise taxes on the returns to depreciable capital by the staggering sum of $145.3 billion over fiscal years 1986-1990.

These base broadeners must be expected to depress the growth in the overall amount of the economy's production facilities and to shift capital additions from the industrial to nonindustrial sectors of the economy. They would shift the focus of economic activity from capital-intensive to labor-intensive production, slowing the overall growth in the capital: labor ratio, hence in the advance in labor productivity, real wage rates, and employment opportunities. When one recognizes that a very substantial fraction of both our export and import-competing production is highly capital intensive, one must also recognize that the increases in capital costs that the proposed changes in capital cost recovery provisions entail would have a seriously adverse effect on the ability of U.S. business to compete profitably in world trade.

These capital-punishing base broadeners warrant subtitling H.R. 3838 the "Deindustrialization Act of 1985-86." At a time when we should be focusing on renewing and reinforcing the economy's growth impulses and strengthening the competitive position of American business in international markets, H.R. 3838 would load additional tax burdens on the industrial sectors and basic industries of the economy upon which the nation's long-term economic progress critically depends.*

The misfocus of the tax "reforms" embodied in H.R. 3838 is the result of the specific constraints imposed on the current tax reform efforts at their outset. One of these constraints is the requirement to reduce the top statutory rate for individuals from 50 percent to 35 percent. No equivalent reduction in rates at the bottom of the present rate schedule is deemed feasible or effective in matching tax reductions for low-income individuals with those of upper-bracket persons. The effort to achieve evenhandedness in personal tax reductions was deemed to require increases in the personal exemption to a level, stipulated by the President, of at least $2,000, as well as in the standard deduction. To avoid opening an untoward gap between the top individual and top corporate rates, a reduction in the latter to a level close to the proposed top individual rate was deemed to be essential. Taken together, these rate cuts and the exemption and standard deduction increases would result in a staggering revenue loss, estimated in static terms, at $402.1 billion over the fiscal years 1986-1990.

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*Much of the enormous diversity of economic activity which has so greatly enriched American economic life has been made possible by the strong advances in productivity in manufacturing and other industrial sectors. These productivity gains, in turn, have depended heavily on increases in the quantity and quality of the capital with which labor services have been combined in these sectors. Raising the cost of depreciable capital used in these sectors will slow economic advance throughout the economy.

The second constraint of no net change in total tax revenues over the 5-fiscal year projection period dictated finding revenue gainers in equally staggering amounts. The third constraint imposed by the President -- that no new revenue source is to be introduced -- meant that this enormous gross revenue addition had to come from broadening the income tax base. As already indicated, over $145 billion of the gross revenue gain proposed in H.R. 3838 is to come from repeal of the Investment Tax Credit (ITC) and replacement of the Accelerated Cost Recovery System (ACRS) by the antediluvian Incentive Depreciation System (IDS). Other capital income provisions in the bill would add another $5.5 billion to the tax load on the returns to capital. A new alternative minimum tax, virtually all of the burdens of which would rest on capital, would add another $24.9 billion to the gross revenue gainers. At a time when public policymakers are searching for ways to reduce the trade deficit, H.R. 3838 would slap an additional $11.5 billion of tax on the capital income of U.S. businesses derived from their foreign operations. Another $66.8 billion of additional levies on capital income would be obtained from the so-called accounting provisions of H.R. 3838; more than $46 billion of this amount would be obtained from the proposed requirements to stretch out deductions and accelerate inclusion of revenues on multi-period production activities, disregarding the uncertainties of income measurement in these cases. More than $8 billion would be raised in additional taxes on financial institutions adn from restrictions on the tax-exempt status of certain state and local obligations. An additional

$23.7 billion of taxes would be imposed on individuals' savings through punitive changes in pension, deferred compensation, and similar fringe benefit provisions. In total, close to $260 billion of the gross revenue additions proposed in H.R. 3838 are to be derived from increasing taxes on saving and the return to capital.

The adverse effects of these enormous tax increases (and the increases in marginal tax rates they imply) on the costs of saving and of capital would certainly depress the growth path of the nation's total stock of production facilities. This depressing effect would be substantially greater for some types of capital and capital users than for others. To repeat an earlier observation; it would be particularly severe for a broad range of industrial enterprises, for capital-intensive businesses, and therefore for export and import-competing production.

Some proponents of the President's tax reform proposals and H.R. 3838 have argued that whatever adverse effects this huge increase in tax burdens on saving and the returns to capital might have would be more than offset by the proposed rate reductions and the more efficient use of capital resources resulting from the allegedly more nearly neutral capital recovery system that either the President's Capital Cost Recovery System (CCRS) or the IDS in H.R. 3838 would provide. There is, indeed, much to be said on behalf of statutory rate reductions and their benefits in terms of moderating the income tax disincentives for personal effort, saving, and capital formation. The proposed rate reductions, however, would fall far short of moderating the capital cost increases that would result from the proposed increases in taxes on saving and capital income. And contrary to the assertions that either of the proposed new capital recovery systems would improve the allocation of capital, both would result in significantly greater distortions of the market valuation of different kinds of capital in differing uses, hence in greater misallocation of capital than results under present law. May I submit for the record two IRET analyses addressed to this subject, the first entitled **Pluses and Minuses (Mostly) in the President's Capital Cost Recovery System** (Economic Report No. 29, July 8, 1985) and the second called **The Incentive Depreciation System Threatens Capital Formation** (Economic Report No. 37, February 2, 1986). These analyses show that both the President's and H.R. 3838's proposed revisions of the capital recovery system would not only tilt the playing field against capital formation but also riddle it with potholes.

Much has been made, mistakenly and regrettably, of the alleged virtue of these base broadeners in insuring that all corporate taxpayers would be required to bear their "fair share" of the total tax burden, that no corporations will be able any longer to "zero out." These calls for corporations to bear their "fair" share of the total tax burden are utterly at odds with reality. There simply is no meaningful or operational standard of fairness that can be applied to corporations as taxpayers. The demand that corporations pay their "fair share" of the tax load really is a demand for increasing the amount of taxes levied on corporations which comes down to increasing taxes on corporations' customers, employees, and shareholders.

Corporations do not pay taxes; they only collect them. Only real, living people ultimately pay all taxes; they pay the taxes levied on corporations either as owners of corporations, as corporate employees, as customers, or as all three. No one knows how corporate income tax liabilities are distributed among real people in one or another of these roles.

Even if we knew how corporate income tax liabilities are distributed among individuals as customers, employees, and/or shareholders, it would be only by the rarest chance that we would deem that distribution to be fair, to conform with any criteria of fairness that we would find acceptable. Once we recognize what both common sense and rigorous economic analysis tell us, that corporations don't pay taxes -- only real people do, and we don't know how much of the corporate tax load is paid by whom it is overwhelmingly clear that there is no way to determine the "fair share" of the income tax burden that all corporations or any one corporation should bear. There simply is no basis for determining how much of the tax load, all of which is ultimately borne by individuals as savers, workers, or consumers, should be collected by corporations.

The adverse effects of the corporation income tax on the economy also urges minimizing reliance on this revenue source, if we can't get rid of it entirely. The last thing tax reform should seek to do is to increase corporate tax liabilities. Doing so, by base broadening is no less bad tax policy than doing so by raising rates. The $87 billion in revenue reductions that H.R. 3838 would afford by cutting the statutory rates in the corporate income tax would be swamped by the the $226.5 billion of gross revenue increases from the economically punitive broadening of the corporation income tax base.

We should keep in mind that all of this nearly $140 billion in net additional corporate tax liabilities really are additional taxes borne by individuals as corporate employees, shareholders, and/or customers. Individuals may not be conscious of this additional burden, because its imposition on corporations tends to hide it from those who ultimately bear it. It is there to be borne by them, nonetheless.

What H.R. 3838 boils down to, therefore, is a huge shifting around of a given amount of tax burdens among individuals. If the revenue estimates are anywhere near correct, there is no lightening of the tax load for individuals taken altogether, although some will assume more of the load, some less than they now bear. Whatever the claims for H.R. 3838 or the tax reform approach it embodies, in truth it is a massive redistribution programs with enormously adverse economic effects.

To recapitulate, the rate cuts-personal exemption increase, static-revenue-neutrality, and no-new-revenue-source constraints imposed on tax reform by the President and observed in H.R. 3838 lead inexorably to severely punitive tax base adjustments that would have seriously adverse effects on the U.S. economy. Over the long run, H.R. 3838 would result in a significant erosion of the nation's industrial base, further deterioration of the competitive position of U.S. business in the international economy, and overall, a less productive and less efficient economy. If all of these constraints must be observed, virtually any tax reform program will closely resemble H.R. 3838, and if so, it would be far better to scrub the tax reform effort all together.

In all likelihood, the revenue neutrality constraint must be retained. This constraint would be far more meaningful if it were not based on so-called static revenue estimates that assume that no one reacts to the changes in costs and rewards that tax changes necessarily involve. The one certain thing one can say about these estimates is that they are certainly wrong. Revenue estimates that take account of changes in the composition of economic activity in response to tax changes and what those behavioral changes in turn imply for tax revenues would be far more meaningful and useful. At the least, it seems to me, this Committee should not perceive the revenue neutrality constraint as calling for balancing of revenue gainers and losers down to the last billion dollars; indeed, even a $10 billion discrepancy is probably statistically insignificant.

The individual-and-corporate-rate-reductions constraint may also be inescapable, but I would strongly urge that the proposed increases in the personal exemption and standard deduction are far less urgent, if indeed thay are desirable at all. Together, these increases account for over $180 billion of the 5-year revenue loss that must be made up if revenue neutrality is to be assured. These tax changes have little merit in economic terms, and I have difficulty in understanding how taking people out of the tax system makes the system fairer or simpler. At the very least, the Committee might consider phasing these tax changes in over an extended period, for example over the 5-year projection period. This would be a far better way of limiting the revenue loss than by confining the full exemption increase to individuals who use the standard deduction, i.e., those whose deductible expenses fall short of the free-ride tax abatement that the standard deduction affords.

Whether or not the Committee accepts these constraints of revenue neutrality and the mandated rate cuts and personal exemption and standard deduction increases, it certainly should not further tie its hands by rejecting alternative revenue sources. It it does so, it will at most play variations on the H.R. 3838 theme, and it will pass up the opportunity to convert the present counterproductive and damaging tax reform program into a program that will result in a tax system imposing fewer and less severe obstacles to economic progress.

One such alternative revenue source would be a value added tax. On several occasions in the last few decades, serious consideration has been given to substituting a value added tax for some part of the individual and corporate income taxes. The advantages of doing so in terms of easing tax deterrents to economic growth and reducing the anti-saving bias of the income tax have long urged this substitution as a major feature of a constructive tax reform program. Added urgency comes today from the need to finance individual and corporate rate cuts without having to resort to base broadeners that cannot be justified on the grounds of fairness, simplification, or growth but that, on the contrary, are seriously out of keeping with these announced objectives of tax reform. There is, therefore, much to be said in favor of the substitution on this score alone.

In addition, the reliance on a VAT in lieu of base broadeners to finance income tax rate reductions would constructively address the serious problem of the trade deficit confronting the United States. The enlarging trade imbalances of the last few years have been exerting unwholesome pressure in the political forum for protectionist measures that would prove costly to consumers and business alike, constrict rather than expand trade, and impair the U.S. economy's efficiency and productivity.

The inclusion of a value added tax, with its border tax adjustments, as part of an overall revenue neutral tax reform program would not only provide the means of financing constructive income tax rate reductions, it would also afford a powerful means for eliminating the existing tax bias against U.S. businesses in both the domestic and international market places. No tax change, in and of itself, is the entire answer to the problem of restoring American competitiveness in the world economy, but the proposed substitution would surely make an important contribution in this respect.

This contribution would be obtained not merely from the VAT's border tax adjustments that are not available under the income tax but also from the far more favorable treatment of all kinds of business capital under a VAT than under the income tax. The border tax adjustments would allow our exports to go abroad unburdened by the VAT, while requiring imports into the U.S. to bear the VAT to the same degree as domestic production. The expensing of capital outlays under the VAT would provide neutral tax treatment of the uses of our production capability and income for consumption or for capital formation and of the use of capital or labor inputs in the production process throughout the private sector of the economy. Moreover, this treatment affords tax neutrality with respect to differing kinds of capital.

For example, a business would expense its purchases of materials for work in process and for additions to inventory just as it would expense its purchases of machinery and equipment, all of its outlays and costs incurred for research and development, and any other purchases it would make from other firms. Contrast the obvious benefits of this approach with the punitive changes in the capital recovery system and the repeal of the investment tax credit in both the Administration's tax reform package and H.R. 3838.

If relied on to finance much, if not all, of the revenue cost from individual and corporate rate reductions, the VAT would obviate the need to repeal the ITC and to substitute the IDS or CCRS for the present ACRS. The arguments advanced for repeal of ITC and ACRS are, I believe, spurious; the real reason is the tax revenue to be gained from repeal. These revenue gains would cost the economy dearly.

The existing ACRS-ITC system has, I believe, served the economy very well indeed since its inception in 1981. It has gone a long way in moderating the income tax bias against saving and investment, particularly in depreciable capital. It has provided a high degree of uniformity in effective tax rates with respect to a wide range of machinery and equipment. While this capital recovery system is not perfect, neither is it badly broken. It certainly does not call for the damaging repairs that both the President's plan and H.R. 3838 propose. I urge the

Committee to retain the ITC and to leave ACRS intact or at the most to provide an alternative system affording capital recovery deductions the present value of which are at least equal to those under ACRS-ITC.

Whether the ITC is retained or repealed, the Committee should seriously consider finding some way to give tax effect to the ITC carryovers accumulated to date. To a substantial extent, these unused ITCs are in the hands of basic industrial concerns and manufacturing companies that are extensively exposed to extremely vigorous competitive pressures from foreign producers in both foreign and our own domestic markets. Many of these companies are currently suffering severe limitations on their financial capacity to undertake innovations in both product lines and production processes that would materially enhance their competitive position, as well as expanding their production and employment. Moreover, if the alternative minimum tax (AMT) proposed in H.R. 3838 is adopted, many of these companies that would be subject to the AMT would effectively lose these unused ITCs. The AMT is bad tax policy, but if it is to become law, it surely should not be permitted, in effect, to apply retroactivity to annul ITCs accrued but unused in the past. At the least, all companies with ITC carryovers should be allowed to offset their AMT liability by their ITCs. For the reasons already indicated, much more important and constructive treatment would be to permit unused ITCs either to be carried back for some substantial period, perhaps 15 years or so, or to be cashed out in the next taxable year or so.

I regret that I can't supply an estimate of the revenue consequences of either an extended carryback or prompt cash out of unused ITCs. I have been informed that either approach would be approximately revenue neutral over the fiscal years 1986-1990. Indeed, if this sort of provision would result in the employment and output gains and improvements in the world trade position of affected businesses that I've suggested, it would very likely prove to be a revenue gainer.

As I've already suggested, I believe that the AMT in H.R. 3838 is very bad tax policy. As a revenue raiser, it would take its bite primarily out of capital and capital income. It would thereby contribute to increasing the cost of capital, with the adverse effects on capital formation and international competitiveness discussed earlier in this testimony. On the basis of what is good tax policy for the nation's economic well being, the alternative minimum tax should be summarily rejected.

The Committee on Ways and Means, however, argues for an AMT on equity grounds, not on the basis of economic considerations. To quote the Committee's report, "The Committee believes the minimum tax should serve one overrriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits." (Committee on Ways and Means, U.S. House of Representatives, Tax Reform Act of 1985, Report to Accompany H.R.

3838. 99th Congress, 1st Session, Rept. 99-426, December 7, 1985, pp. 305-306.)

As applied to corporations, this obiter dictum is without substance. To repeat, corporations don't pay taxes, and no equity goal is served by insisting, via an AMT, that all corporations pay tax or that no corporation can avoid tax payment. For real, live human beings, a different issue is posed by AMT proposals. As the Ways and Means Committee itself acknowledges, many if not all of the items treated as preferences serve worthwhile purposes. Insofar as this is the case, it is difficult to understand in what way the taxpayer's response to these tax incentives should be considered excessive. If, notwithstanding, it is believed that one or more of these so-called preferences are too much of a good thing, good tax policy calls for their reevaluation, one by one, not the cop out of an AMT. In any event, before signing off on an AMT, one must hope this Committee will carefully consider whether whatever gains in fairness an AMT might provide would be worth the substantial economic costs it would entail.

It is certainly to be hoped that this Committee will carefully evaluate the changes in the foreign tax provisions proposed in H.R. 3838. These proposed changes are based on erroneous assumptions about the effects of the present provisions on U.S. business decisions about the location of production facilities and enterprises. They would set up artificial distinctions with respect to various foreign income sources and types and subject these differing income flows to differential tax treatment. The net result would be to increase the tax liability on so-called passive income generated in foreign jurisdictions, in the process greatly complicating both compliance and administration. Even more important, these provisions would increase the tax burden on American businesses in foreign markets, in time reducing the presence and competitive effectiveness of these businesses. At a time when strengthening the competitive position of U.S. businesses in the world marketplace is deemed to be an increasingly important policy objective, the foreign tax provisions in H.R. 3838 are anomalous, to say the least. Their $11.5 billion revenue gain would come at a very high price, indeed, in terms of basic economic policy considerations.

To summarize, if the Committee on Finance intends to go forward with the tax reform process, it should set as its principal goal moderating if not eliminating those features of the present tax system that create barriers to the nation's economic progress. It should seek to reduce the tax bias against saving and capital formation, against productive effort, against the implementation of technological advances, against innovation in products and production processes, against new enterprises and against effective participation in the international marketplace. Substantial statutory rate reductions are important components of tax revisions to this end, but these rate cuts should not be purchased at the cost of additional tax burdens on saving and capital income. Rather than imposing huge additional levies on the industrial sectors of the economy, tax reform should look to a new revenue source to provide the revenue lost by any rate reductions and other revenue-losing tax changes that are to be adopted. The Value Added Tax, preferably of the subtraction form proposed in the so-called Business Transfer Tax, has much to commend it for this purpose. In any event, tax reform should shun the economically punitive base broadeners of the sort proposed in H.R. 3838.

This Committee has the opportunity to take the tax reform effort onto new ground in the field of tax policy. We must hope the Committee will seize that opportunity and avoid the deindustrializing, anti-competitive reform program in the House bill.

STATEMENT OF ALAN AUERBACH, PH.D., PROFESSOR OF ECONOMICS, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA

Dr. AUERBACH. Thank you, Mr. Chairman and members.

I appreciate this opportunity to offer my views on the economic effects of this particular tax reform bill.

There are obviously many benefits to be derived from this sort of tax reform. Reduced marginal rates and a broader tax base should bring with them a reduction in socially unproductive tax avoidance; in addition, there are many provisions in the present bill that rationalize the tax treatment of specific industries and activities.

But these benefits are evident, as they have been throughout the tax reform process; one must also consider whether the costs of tax reform make the package undesirable.

There are many who worry that the shift toward higher corporate taxes would reduce domestic fixed investment and at the same time hinder the ability of capital intensive domestic corporations to compete.

Although I do not believe that this tax bill taxes capital rationally in all respects, I think we must maintain a realistic view of what structural tax policy is capable of achieving.

A change in the tax treatment of investment as envisaged by the pending bill may very well induce a decline in business fixed investment; but it will not cause a depression in capital goods industries, nor will it worsen our overall competitive position internationally.

The enormous trade imbalance of 1984 and the even larger one experienced last year indicate quite clearly that we have a very serious problem; but the problem is not related to the structure of taxation, either here or abroad; and it cannot be solved by a change in corporate tax collections.

Let me begin by discussing the impact of the proposed tax reform on business investment.

A rise in corporate tax collections alone, while it certainly may make certain people unhappy, is not necessarily bad either for investment or for the economy as a whole.

Business investors understand that the relevant consideration when a project is being evaluated is the additional tax burden associated with the income from that project.

This marginal tax burden depends not only on the corporate tax itself but also on the level of deductions for interest and depreciation and the tax credits available.

It is customary to express this additional tax burden as a percentage of the income from the investment itself. We call that the effective tax rate, which tells us what the real burden of taxation is on any particular investment.

In determining whether an investment is worth undertaking, companies also consider the financial costs, the primary determinant of which is the interest rate; combining financial and tax costs gives the overall cost of capital which is the return an investment must provide to satisfy both the Internal Revenue Service and the company's own shareholders and creditors.

The higher the cost of capital, the fewer the investment projects that will be able to meet this standard for adoption; this is the way that the effective tax rate and various tax provisions affect the amount of investment that occurs.

The current proposal would alter the effective tax rates on most new investment projects, reducing the top corporate rate from 46 percent to 36 percent by itself would lower the effective tax rates, but broadening the tax base would raise them again.

Scrapping the accelerated cost recovery system would essentially undo the tax rate reduction for fixed investment, and the additional removal of the tax credit would lead to an increase in effective tax rates on affected investments, primarily machinery and equipment.

The net effect should be to raise the tax burden and, through it, the cost of capital for investments currently receiving the investment tax credit.

It is very, very difficult to predict the exact impact of these changes because so many other tax provisions indirectly affecting investment would also be changed.

My own rough calculations suggest that in the short run fixed nonresidential investment could decline by as much as 5 percent or about six-tenths of 1 percent of GNP.

However, a substantial fraction of the output loss, both in the short and the long run, may be recouped through an improved allocation of capital in the corporate sector, resulting from the shift in the tax burden among assets.

I do think, however, that any reduction in capital formation would be unfortunate; and because of this, I consider the House bill to be a step backward from the Treasury II proposal, which would have provided corporate tax revenues through a recapture tax on previous depreciation allowances, rather than a tax increase on new investments.

That recapture provision was strongly condemned, but in my view, without justification. Any reduction in the corporate tax rate will bring with it windfall gains for owners of existing capital assets since the income from these assets will be taxed at a lower rate than was anticipated when they were purchased.

Such windfalls would be very large if the provisions of the House bill were immediately adopted. Limiting them would provide more tax revenue which could then be used to provide better incentives for new investment.

One, but not the only way of achieving this, would involve a gradual rather than an immediate switch to the new corporate tax rules, with the additional revenue being raised used to lower the eventual top corporate rate below the proposed rate of 36 percent.

I think approaches such as this, but not only this particular approach, should be seriously considered instead of increasing the tax burden on new investment.

While I oppose deliberately increasing the tax burden on new investment, it is worth pointing out that this reduction in investment that might occur in the short run under the House plan is no bigger than typical year-to-year investment fluctuations that we have experienced in recent years.

This doesn't illustrate to me the unimportance of tax incentives, for I think they matter a lot; but it merely reminds us that there are other factors that affect investment, too.

Between 1980 and 1982, the real after-tax interest rate facing corporations rose by about 3 percentage points. There is no recent change in the tax treatment of investment including the one currently being considered by this committee that exerted an impact of a similar magnitude.

Let me turn now to the effects that this bill might have on international competitiveness.

As I said before, while I believe that there is severe international competitive pressure, I believe just as strongly that it is not due to the way we tax capital income in this country and that it would be an egregious mistake to attempt to use the corporate income tax as a vehicle for correcting trade problems.

Now, there are many delusions in this country about the effect of taxes on foreign competition. First, there is a widely held belief that U.S. corporations face a much higher cost of capital than their foreign counterparts, particularly those in Japan.

Yet the evidence in support of this belief is, in my view, at best weak. That the cost of capital is lower in Japan has never been convincingly demonstrated, and this should not be used as an argument to support particular policy actions.

A second fallacy is that, to whatever extent the cost of capital may be higher in the United States, it is due to the high corporate tax burden here; in this case, the evidence is a bit clearer because it suggests that Japan and not the United States experiences a higher tax burden at the corporate level on its investments.

So, the cost of capital is not necessarily higher in the United States; and even if it is, the cause probably lies beyond the corporate tax.

Nevertheless, many feel that lowering the cost of capital through corporate tax reductions would grant U.S. firms a much needed competitive advantage. And many even feel that it must be done for many U.S. firms to survive, but basic economic logic suggests otherwise.

The problem with international competitiveness is evident from the large trade deficit, but simple national income accounting tells us that the trade deficit must equal private domestic saving less the credit demands of the private and Government sectors.

If private and public uses of funds exceed the saving of the private sector in this country, as they have in recent years, additional funds must come from abroad; and for these funds to be available for foreign purchases of U.S. assets, the United States must provide them by running a trade deficit.

This result, although it is unfortunate, is an identity, which means it is no more subject to debate than the sum of two numbers.

If we wish to reduce the trade deficit then, it is necessary to increase private domestic savings, reduce the Government budget deficit, or reduce private domestic investment, though, obviously, we should not view these three methods as being equivalent.

You are obviously aware of the importance of reducing the Federal budget deficit and have recently taken action toward this end.

Reducing Government credit demands would put less pressure on interest rates, leading to slower capital flows from abroad and less pressure on the dollar exchange rate.

An increase in tax collections would contribute to reducing the deficit, but this tax bill does not contemplate increasing tax revenues. So, we turn to the other ways of providing funds.

Now, while increasing private domestic savings would help ease the trade deficit, this has proved to be a very difficult task in the past.

The net private savings rate has been quite stable over many decades and has actually declined in recent years.

Although the effectiveness of provisions such as the individual retirement account is unclear, I think the House bill's curtailing of these plans is misdirected. The revenue cost of the plans could be reduced much more effectively, I think, by the use of threshold levels rather than caps.

Evidence on IRA contributions suggests that a large fraction of them are made by individuals contributing the maximum amount; and for them, there really is no tax incentive to increase their savings.

And hence, the IRA's for them are very costly to the Government and to other taxpayers.

Now, the final way to reduce the trade imbalance would be, of course, to reduce domestic investment although I don't think there should be very much support for this approach.

On the other hand, tax policy encouraging domestic investment will, at the same time, encourage capital inflows; the negative side of this will be an increase in the trade deficit.

Thus, attempts to make the tax treatment of investment more favorable would actually encourage more inflows and increase the trade deficit; so it is hard to see how they could avoid worsening the competitive position facing domestic producers.

Not every industry would become less competitive abroad. In particular, very capital-intensive industries might gain more through a lower cost of capital than they would lose through tougher competitive pressure on the exchange rate.

But overall, I believe the House bill would actually strengthen the competitive position of U.S. producers by discouraging investment, though I must stress that there are better ways to achieve this objective.

The final part of my comments, which I won't have time to get to, discusses the corporate minimum tax; I question the advisability of strengthening this provision in the new tax bill.

[The prepared written statement of Dr. Auerbach follows:]

The Economic Effects of Tax Reform on Capital Formation and International Competitiveness: The Impact of H.R. 3838

Testimony before the Committee on Finance, U.S. Senate

by

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February 6, 1985

Mr. Chairman and Members of the Committee:

I appreciate this opportunity to offer my views on the economic effects of the tax reform bill recently passed by the House and now under consideration by your committee. Over the past year, many tax reform plans have been considered. The present bill, though different in many respects from its predecessors, shares with them a basic approach to tax reform. This approach is characterized by a broadening of both individual and corporate tax bases, a reduction in marginal tax rates, and a shift in the overall tax burden from individuals to corporations with little change in total tax revenue.

There are obviously many benefits to be derived from this sort of tax reform. Reduced marginal rates and a broader tax base should bring with them a reduction in socially unproductive tax avoidance. In addition, there are many provisions of the present bill that rationalize the tax treatment of specific industries and activities. But these benefits are evident, as they have been throughout the tax reform process. One must also consider whether the costs of tax reform make the package undesirable. Many worry that the shift toward higher corporate taxes would reduce domestic fixed investment and, at the same time, hinder the ability of capital-intensive domestic corporations to compete with foreign-based rivals.

Although I do not believe that this bill taxes capital income rationally in all respects, I do believe we must maintain a realistic view of what structural tax policy is capable of achieving. A change in the tax treatment of investment as envisaged by the pending bill may induce a decline in business fixed investment. But it will not cause a depression in capital goods industries; nor will it worsen our overall competitive position internationally. The enormous trade imbalance of 1984, and the even larger one experienced last year, indicate clearly that we have a serious problem. But the problem is not related to the structure of taxation either here or abroad. It cannot be solved by a change in corporate tax collections.

The Cost of Capital and Investment

Let me begin by discussing the impact of the proposed tax reform on business investment. A rise in corporate tax collections alone, while it may make certain people unhappy, is not necessarily bad either for investment or for the economy as a whole. Business investors understand that the relevant consideration when a project is being evaluated is the additional tax burden associated with the income from that project. This marginal tax burden depends not only on the corporate tax rate itself, but also on the level of deductions for interest and depreciation and the tax credits available. It is customary to express this additional tax burden as percentage of the income from the investment itself. This "effective tax rate" tells us what the real burden of taxation is on any particular investment. Under current law, many investments face effective corporate tax rates well below the official corporate tax rate of 46 percent, because of the many tax incentives available to offset taxable income.

In determining whether an investment is worth undertaking, companies also consider the financial cost, the primary determinant of which is the interest rate. Combining financial and tax costs gives an overall cost of capital, which is the return an investment must provide to satisfy both the Internal Revenue Service and the company's own shareholders and creditors. The higher the cost of capital, the fewer the investment projects that will be able to meet this standard for adoption. It is through the cost of capital, then, that tax policy affects investment. By altering the effective tax rate an investment faces, tax policy influences the cost of capital and hence the number of profitable investment projects available.

The current proposal would alter the effective tax rates on most new investment projects. Reducing the top corporate rate from 46 percent to 36 percent would lower effective rates, but broadening the tax base would raise effective rates: scrapping the Accelerated Cost Recovery System would essentially undo the tax rate reduction, and the additional removal of the investment tax credit would lead to an increase in effective tax rates on affected investments, primarily equipment. The net effect should be to raise the tax burden, and through it the cost of capital, for investments currently receiving the investment tax credit. (Though previous plans would also have shifted the tax burden toward equipment investment, the overall tax increase included in the current proposal is somewhat larger than would have occurred under the Bradley-Gephardt Fair Tax or the May 1985 Treasury II plan.)

It is very difficult to predict the exact impact that these changes would have on the level of investment in the short and long runs, because so many other tax provisions indirectly affecting investment would also be changed. My calculations suggest that short-run nonresidential investment would decline immediately by about five percent, or six-tenths of a percent GNP, and that the fixed capital stock of the corporate sector could be about 4 percent lower in the long run. However, a substantial fraction of the output lost through this reduction in the capital stock may be recouped through an improved allocation of capital in the corporate sector resulting from the shift in the tax burden among assets. My estimates for 1984 suggested that approximately 3.25 percent of the fixed corporate capital stock was being wasted through misallocation caused by the tax system. The provisions of the House bill should reduce this cost substantially.

I think any reduction in capital formation would be unfortunate. Over the long run, the rate of capital accumulation has been found to influence the rate of economic growth. Lower investment will reduce our growth rate. Because of this, I consider the House bill to be a step backward from the Treasury II proposal, which would have provided corporate tax revenues through a recapture tax on previous depreciation allowances rather than a tax increase on new investment.

That recapture provision was strongly condemned, in my view without justification. Any reduction in the corporate tax rate will bring with it windfall gains for owners of existing corporate capital assets, since the income from these assets will be taxed at a rate lower than was anticipated when they were purchased. Such windfalls would be large if the provisions of the House bill were immediately adopted. Limiting them would provide more tax revenue, which could then be used to provide better incentives for new investment. One way of achieving this end would involve a gradual, rather than immediate, switch to the new corporate tax rules, with the eventual top corporate rate being set below the proposed rate of 36 percent. Approaches such as this should be seriously considered instead of increasing the tax burden on new investment.

While I oppose deliberately increasing the tax burden on new investment, it is worth pointing out that the reduction in investment activity that would result from the House plan is no bigger than the typical year-to-year fluctuations in investment that we have experienced in recent years as the result of macroeconomic events. Nonresidential fixed investment as a percentage of GNP dropped from 12.0 percent in 1981 to 11.3 percent in 1982, the first full year after the introduction of the Accelerated Cost Recovery System. It fell further to 10.7 percent in 1983, and was back up to 11.6 percent in 1984. To me, this does not illustrate the unimportance of tax incentives, for I think they do matter a lot. It merely reminds us that there are many other factors that affect investment. Certainly an important factor contributing to the investment decline of the early 1980s was the rise in real interest rates that occurred at this time. Remember that the cost of capital for investment includes not only taxes but also financial expenses. Between 1980 and 1982, the real, after-tax interest rate facing corporations rose by about 3 percentage points. No recent change in the tax treatment of investment, including the one presently being considered by this Committee, exerted an impact of this magnitude.

The Effects on International Competitiveness

While I believe very strongly that U.S. corporations are under severe competitive pressure from abroad, I believe just as strongly that this is not due to the way we tax capital income in this country. It would be an egregious mistake to attempt to use the corporate income tax as a vehicle for correcting trade problems.

There are many delusions in this country about the effect of taxes on foreign competition. First, there is a widely held belief that U.S. corporations face a much higher cost of capital than their foreign counterparts, particularly those in Japan. Since the cost of capital is a major determinant of investment, this would be an important fact, if it were true. Yet, the evidence in support of this belief is, at best, weak. My research comparing a representative sample of companies in Japan and the United States is inconclusive. By one measure, the cost of capital in Japan is somewhat lower. By another, it appears to be higher. Although more research should be done on this question, evidence that the cost of capital is lower in Japan has never been convincingly demonstrated and this should not be used as an argument to support particular policy actions.

A second fallacy is that, to whatever extent the cost of capital may be higher in the U.S., it is due to the high corporate tax burden here. In this case, the evidence is a bit clearer and suggests that it is Japan, and not the U.S., that imposes a higher tax burden on its corporate investment. Thus, the cost of capital is not necessarily higher in the U.S. than Japan. If it is, the cause probably lies beyond the corporate tax.

Yet even if neither the cost of capital nor its tax component is presently higher in the U.S., some argue that lowering the cost of capital through corporate tax reductions would grant U.S. firms a much-needed competitive advantage. Many even feel that this must be done for U.S. firms to survive. Basic economic logic suggests otherwise.

The problem of international competition is evident from the large trade deficit currently being experienced. But simple national income accounting tells us that the trade deficit must equal private domestic saving less the credit demands of the private and government sectors. If private and public uses of funds exceed the saving of the private sector in this country, additional funds must come from abroad. For these funds to be available for foreign purchases of U.S. assets, the U.S. must provide them by running a trade deficit. This result, unfortunate though it may be, is an identity, which means that it is no more subject to debate than the sum of two numbers.

If we wish to reduce the trade deficit, then it is necessary to increase private domestic saving, reduce the government budget deficit, or reduce private domestic investment, though we should not view these three methods as being equivalent. An increase in saving would represent an increase in the rate of national wealth accumulation, while a reduction in investment, of course, would not. You are obviously aware of the importance of reducing the federal budget deficit, for this reason among others. You have recently taken action toward this end. Reducing government credit demands should put less pressure on interest rates, leading to smaller capital flows from abroad and less pressure on the dollar exchange rate. An increase in tax collections would contribute to reducing the deficit, but the tax bill under discussion does not contemplate increasing tax revenues.

While increasing private domestic saving would help ease the trade deficit, this has proved a difficult task in the past. The net private saving rate has been quite stable over many decades, and has actually declined in recent years. Although the effectiveness of provisions such as the Individual Retirement Account at increasing saving is unclear, the House bill's curtailing of this and other pension-related savings plans is misdirected.

The revenue cost of these plans could be reduced much more effectively by instituting threshold levels rather than overall limitations on contributions. Evidence on IRA contributions suggests that a large fraction of them are made by individuals contributing the maximum amount. Individuals in this situation face no tax incentive at all to increase their savings. For them, the IRA tax deduction is a costly gift from the government and, indirectly, other taxpayers.

The final way to reduce the trade imbalance is to reduce domestic investment, though I suspect there is little support for adopting this approach. Perhaps a less perverse way of putting the problem is that, were it not for capital inflows from abroad, private investment in the U.S. would be in a depression. The negative side of these capital inflows is, unfortunately, the trade deficit. Tax policy aimed at encouraging domestic investment will encourage capital inflows at the same time. The view is certainly held abroad, if not in the U.S., that the currently favorable U.S. tax treatment of investment is part of the reason for the large capital inflows of recent years. As attempts to make this treatment more favorable would encourage more inflows, it is hard to see how they could avoid worsening the trade deficit, presumably through exchange rate appreciation.

Not every industry would become less competitive abroad in this case. In addition to the less favorable terms of trade, domestic producers would face a lower cost of capital if tax incentives were introduced. Very capital intensive industries could well become more competitive as a result, but the aggregate effect on the ability of U.S. producers to compete abroad would be reduced. For this reason, I believe that the House tax bill would actually strengthen the overall competitive position of U.S. producers. Once again, though, I must stress that there are better ways to achieve this objective.

In summary, it is unclear that the U.S. has higher cost of capital than its keenest trading rival, Japan. If it does, the gap exists in spite of, rather than because of, differential corporate tax treatment. Strengthening investment tax incentives, while lowering the U.S,. cost of capital, would exacerbate the competitive position of domestic corporations. Corporate taxes are thus neither the source of nor the solution to the problem of international competitiveness.

The Corporate Minimum Tax

Before concluding my testimony, I would like to touch on one additional part of the House tax bill: the proposed strengthening of the corporate minimum tax. Under the provisions of the bill, corporations would face an alternative minimum tax of 25 percent on a base broadened by the removal of several tax incentives, including accelerated depreciation. Corporations having a lower tax burden under the regular corporate tax would pay the minimum tax instead. Thus, it ensures that no corporation's tax bill will fall below 25 percent of its minimum tax base.

Except as a cosmetic device, the logic of this mechanism escapes me. It limits the extent to which corporations can take advantage of the tax incentives for investment provided by other tax provisions, representing a complete change in philosophy from the 1981 Economic Recovery Tax Act, which liberalized leasing to facilitate the use of such incentives by business. Either investors should receive the incentives or they should not. There is little reason to ration them according to the current level of taxable income. Especially if the investment tax credit is repealed and accelerated depreciation reduced, I see little reason for the increased complexity of the corporate minimum tax.

In recent years, a large fraction of the corporations in key industries such as automobiles, steel and airlines have suffered tax losses, primarily because of economic reverses rather than an excessive response to tax incentives. I doubt whether many of these companies with tax losses would be caught by the minimum tax, either, but if they were, what purpose would be served? I believe that a more appropriate legislative response would be a reform of the provisions restricting the use of tax losses.

Conclusions

The tax bill under consideration would not encourage business fixed investment, though it would improve the allocation of this investment among alternative uses. The overall incentive to invest would compare unfavorably to current law and to other tax reform plans considered in recent months, but could be improved somewhat without changing the plan's fundamental approach.

There is little empirical support for the view that U.S. corporations suffer from a higher cost of capital because of the tax treatment of investment, and even less reason to believe that encouraging domestic investment will reduce the trade deficit.

The CHAIRMAN. Senator Bentsen?

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

Dr. Feldstein, one of the arguments used by proponents of Treasury I, II, and the House bill is that tax reform would level the playing field amongst corporations. I would like to get your comments on that.

Dr. FELDSTEIN. I think what these several bills would do would be to level part of the playing field, but distort the rest in a way that, on balance, would be harmful.

Let me explain what I mean. What these bills would do, as you know, would be to increase the effective tax rate on equipment relative to industrial structures.

So, the balance of the way capital is allocated between equipment and structures within manufacturing industry would probably be somewhat improved.

On the other hand, what these bills would do would be to increase very substantially the effective tax rate on industrial capital relative to a whole range of other kinds of uses of capital—owner-occupied housing, nonindustrial structures, hotels, office buildings, and the like, investments abroad, corporate expenditures that are immediately expensed like advertising, which are a kind of investment for a corporation.

So, on balance, I think this would end up with a less level playing field, a less neutral allocation of capital, a less productive allocation of capital.

Senator BENTSEN. Thank you. Dr. Schultze?

Dr. SCHULTZE. I am sorry; excuse me.

Senator BENTSEN. Back in the late 1970's, you were the chairman of the President's Council of Economic Advisors and played a very major role in the economic reports to the President.

In January 1979, for example, you said, and I quote: "One of the most discouraging developments in 1978 was the slow growth of productivity."

You then went on to say: "Only by devoting a significant share of current production to replace, modernize, and expand the capital stock can we hope to maintain adequate growth and productivity."

And: "Most other industrial countries devote a larger share of output to investment than the United States, and their growth rates in productivity have also been higher."

Back in 1978, nonfarm productivity grew around 1 percent. Last year it didn't grow at all.

You also went on to say: "Tax policy is one instrument that can encourage investment, by lowering the rental cost of capital or raise its return."

Now, using that kind of rationale, you helped draft the Revenue Act of 1978, which made the investment tax credit permanent. Are you satisfied productivity is increasing enough to warrant repealing it?

Dr. SCHULTZE. No, sir, not at all. It seems to me, I still stand by what I said, that the key to this, of course, is that you can change investment incentives all you want; and if you don't have a national savings to finance it, it won't do you a bit of good.

All you will do is drive up interest rates. The key problem—the key problem—by an order of magnitude, compared to anything else, in terms of limiting investment in the United States over the foreseeable future is the fact that the Federal Government now, unlike periods in the past, including 1978, is absorbing 4 to 5 percent of our GNP to finance its own budget deficit.

So, at the present time, it seems to me the key question with respect to investment is going to be what you do with the budget deficit. What you do with H.R. 3838 will be important, but quite frankly, it will play a marginal role compared to that.

Back in 1978, without suggesting that we had no deficit problems, they were pale and insignificant beside what is happening now.

So, it is the availability of national savings which is going to be the key.

Second, I would have much preferred to see the original Treasury plan come up here, which, with respect both to leveling the playing field and to getting the incentives for investment right relative to other incentives, seem to me to do a very good job to insulate the system against the ravages of inflation.

To deal with the whole problem of getting those incentives right and getting a level playing field. Now, you are dealing with H.R. 3838, which isn't that good; but the basic proposition is still correct.

Senator BENTSEN. Dr. Ture, do you want to comment on that?

Dr. TURE. Yes. I think Dr. Schultze was making an erroneous distinction between incentives for saving and incentives for investment.

Just consider the investment tax credit. It certainly is an incentive for investment; but it also is a very powerful instrument for increasing corporate saving.

Reduce or eliminate the investment tax credit, and you will, almost to a dead certainty, reduce corporate saving, dollar for dollar.

The CHAIRMAN. Senator Chafee?

Senator CHAFEE. We are always talking about personal savings here. Dr. Ture, you talked about not tightening up on the 401(k), plans or IRA's, because they forced a savings. However, we have had testimony before us here that that just isn't so. I think Dr. Feldstein touched on this and indicated that you don't get any increase in net savings, rather you just encourage a transferral from other savings accounts.

Indeed, the net savings of the country, since we inaugurated the IRA's in the 1981 tax bill, have declined.

Dr. TURE. Senator, that charge about saving incentives for individuals is a very old one. It goes back to the contests over how liberal or illiberal, as the case may be, private pension plan provisions should be.

But I think that charge has to stand against some rudimentary notions of common sense. These tax provisions reduce, at the margin and on the average, the cost to individuals of saving some part of their income.

So assume that individuals are nonresponsive to that reduction in the cost of saving, I think, says either that they are stupid or uninformed and not just temporarily but forever.

And I think that is a proposition about individuals and their behavior upon which tax policy should not be based.

Senator CHAFEE. People wouldn't argue about the reasons. They would just point to the result.

Dr. TURE. I don't know on what basis they arrive at that conclusion.

Senator CHAFEE. Dr. Auerbach?

Dr. AUERBACH. There is a study done for 1983 by the Statistics of Income Branch of the Internal Revenue Service which found that the majority of IRA's established—and it did relate very much to income levels—were contributions at the limit, either $2,000 or $4,000 or $2,250, depending on the situation of the family.

It was this that I alluded to in my testimony, that for people who are contributing the maximum amount, the incentive to engage in additional saving is nonexistent because any additional saving they wish to do is taxed fully.

And yet, capping provisions such as 401(k)'s and 403(b)'s simply introduces the same kind of problem in other areas; if one desired to limit the revenue cost of these provisions and at the same time provide a marginal saving incentive, then the appropriate way to do it would be to impose a floor rather than a ceiling on these contributions so as to make it necesary for people actually to engage in a substantial amount of saving or at least some saving, rather than transfer of assets, before they would qualify for such an incentive.

Senator CHAFEE. How would you construct a floor?

Dr. AUERBACH. A percentage of gross income, for example, all contributions or a large percentage of contributions over a certain percentage of adjusted gross income would qualify for the deduction.

It would make the provision a lot less expensive, and it would allow——

Senator CHAFEE. Would it be unlimited?

Dr. AUERBACH. Well, it wouldn't have to be unlimited. It could go up to a much higher limit. For example, you could have a floor at 5 to 10 percent of the adjusted gross income with a ceiling at some level determined by the revenue cost of the provision.

But whatever that ceiling would be, it would certainly be more effective in encouraging saving than the current provision.

Senator CHAFEE. Yesterday we heard testimony that nothing we could do in the Tax Code would increase the savings rate.

What do you say to that?

Dr. AUERBACH. Well, we haven't really tried.

Senator CHAFEE. Well, I think we have. Dr. Schultze?

Dr. SCHULTZE. No. I would say that statement isn't correct, but it is about 80 or 90 percent correct; that it is very, very hard to move the national saving rate by changes in tax incentives, which doesn't mean it has no effect. It has very small effects.

The second proposition: Putting in something like IRA's provides some additional incentive to save, but most of the incentive is to (a) simply switch the saving you would do, anyway, into a favored form.

So, I think the answer is that the statement you got yesterday is 90-percent correct, even if not 100-percent correct.

Senator CHAFEE. Dr. Feldstein.

Dr. FELDSTEIN. I think you have to distinguish, when you think about the IRA's, between what happens in the first few years after they are liberalized and what will happen in the long run, because for the first few years people do have resources in hand that they can simply transfer into IRA accounts to take advantage of the new tax break.

But the vast majority of American families have very few years' worth of IRA contributions on hand. So, if they come to like IRA contributions or 401(k) savings, they are not simply going to be able to finance it for more than a couple of years by moving money that they have previously saved.

I think if we stick with the 401(k) plans and we stick with the IRA provisions, we are going to see increasing savings.

Now, you can say: Why haven't we seen it already? And I think there are two answers to that.

First is what I have just already said. It takes a while because people, in the beginning, are simply moving old money over.

But the second thing is that I think we may have seen more of an increase in personal saving than most people realize.

What we know is that the personal savings rate, as reported by the national income accounts, was flat from 1982 to 1984 and actually went down last year.

What most people don't realize is that included in that number that is called personal savings is corporate pension contributions.

The money that General Motors puts into its pension fund on behalf of its employees is called personal savings, even though people don't have anything to do with that decision; it is a corporate-to-corporate deposit.

The importance of that is that corporations have cut back their pension contributions dramatically in the last couple of years because of the higher interest rates and the big increase in the value of their pension assets that resulted from the rise in the stock market.

So, what has really happened over the last—I know this between 1982 and 1984, and I haven't analyzed or seen an analysis of the figures for 1985—is that corporate pension contributions went down dramatically. People saving went up, and the combination of the two that the national income accountants call personal savings has been a wash, unchanged.

So, I think that when we actually go back and understand what has happened, we will have seen an increase in personal, true people, saving over these last few years.

Senator CHAFEE. Thank you.

The CHAIRMAN. Senator Bradley.

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

We have had several days of hearings in the last 2 weeks. Last year we had 25 days of hearings on the issue generically of tax reform.

Although this hearing is focused solely on a specific bill, since we are on the Finance Committee and write tax legislation this hearing also should focus on the issue of tax reform.

We tend to treat tax policy as if it were the little engine that said it could, and that all we need do to enhance international competitiveness is change a little tax policy.

All we need do to improve the cost of capital is change tax policy. In virtually every area of our economy, we decide that the decision factor is tax policy.

Now, if you were counseling the committee on international competitiveness or cost of capital, what would you put as a priority: Reduction of the deficit, lower interest rates, efficiency of the economy generally, or specific tax incentives for investment in specific kinds of assets?

If you were going to prioritize those four, what would you make one, two, three, and four?

Let's start with Dr. Feldstein and just go right down.

Dr. FELDSTEIN. I think that the reduction in the budget deficit—Let me say first that I don't think these are alternatives.

You have posed it as if they are alternatives, but I think you can both improve the character of the tax system and reduce budget deficits at the same time.

Senator BRADLEY. Try not to make this a nice round answer. Make it an answer with angles, so that the committee is given some choices.

Dr. FELDSTEIN. If you are allowed only one thing, you reduce the deficit; and you do it in a way that doesn't make the other things worse.

Your lower interest rates would follow from that. So, if lower interest rates meant something that happens on Constitution Avenue, I would be opposed to doing that, but if it is something that happens because of reduced budget deficits, I would be in favor of it.

But I don't think you should understate the importance that the changes in the tax rules have, not on aggregate investment, which as Charlie Schultze said, depends on aggregate savings but on the composition of it. How much of it goes into shopping centers and how much of it goes into productivity, increasing investments.

And similarly, while the trade balance isn't going to be affected in the aggregate, the composition of it is.

Senator BRADLEY. Keep in mind the choices are deficit, interest rates, a more efficiently functioning economy, and specific tax incentives for specific investments and specific assets.

Dr. Schultze.

Dr. SCHULTZE. My priorities would be deficit reduction, No. one; deficit reduction, No. two; deficit reduction, No. three; and deficit reduction, No. four. [Laughter.]

Dr. SCHULTZE. I start with deficit reduction the same way Marty does. My next proposition would be that that goes together with interest rates; so I find those hard to tear apart.

The only point I would add is, if you are going to cut the budget deficit substantially, the Federal Reserve has to be on the stick to make sure that the interest rates follow.

I would put changes in the tax structure down very low. I believe that, since that is what you are dealing with, they are important, and you ought to try and get them right.

But the general proposition would be that, in terms of the rate of saving in this economy, the rate of investment in this economy, the efficiency with which this economy works, taxes are important; but very often, their importance is exaggerated.

Senator BRADLEY. Yesterday, we had strong testimony in support of the House bill 3838 from Walter Heller and from Harvey Galper.

One of the rationales that they offered was that, lowering tax rates and eliminating the special incentives, you get overall efficiency gains. And, in many cases, such efficiency gains offset the loss of specific targetted incentives. Do you agree with that?

Dr. SCHULTZE. I do. I guess you would have to say I give the bill weak support; but I support it.

I think you could make it better. I think, on balance, that the disincentives for investment—aggregate disincentives for investment—which are in the bill are probably offset, maybe a little more than offset, maybe a little less, by the good points in the bill with respect to lower marginal tax rates, with respect to reducing tax shelters, with respect to evening the playing field to some extent.

I think you could make it better by shifting some income back to making cost recovery somewhat better in the bill. It wouldn't take a lot.

Then, I would be strongly in support. Right now, I am kind of weakly in support. My main argument for the bill would be that I think you are going to have to raise income taxes, anyway; and I would rather raise marginal tax rates at the 38 percent than tax rates at 50 percent, if I have got to add on to them.

Dr. AUERBACH. I think, again, I would also put reduction of the deficit and, with that, a reduction in interest rates because I think that would come with it.

First, because that is the only one of the alternatives which provides the opportunity for an improvement of the international competitive position and an improvement in investment because, by reducing the credit demands of the Government sector, you will increase funds available for investment and decrease the need to get funds from abroad to finance investment and therefore hurt the trade deficit.

And also because of the very magnitude of the credit demand of the Government. As I said, the rise in interest rates in recent years swamps any tax provision that has been passed in the 1980's or has been considered in the 1980's.

So, just the quantitative impact of that provision, or that change, is surely the most important; but I think for the long run obviously attention should be paid to improving the general efficiency of the tax system.

So, I would put that right after.

Dr. TURE. Senator, let me preface my answer—and I will be as explicit as can be—by saying I think your preface to the question was splendid.

You called attention—our attention and that of your colleagues—to the fact that tax policy does not rule the roost. It is one influence.

I would say the same thing is true about every other element of public policy. No one of those things is going to determine whether or not we are efficient or trade effective or any other thing.

At the margin, however, certainly tax policy is highly consequential; and therefore, I would rank tax reform of the sort that I would endorse—certainly nothing of the sort that is involved in 3838—

along with improved efficiency because I think they go hand in glove as the singlemost important things that can be done to improve both domestic and foreign trade.

I think reducing deficits if, and only if, by way of spending reductions probably also would contribute to a more efficiently operating economy, and therefore would be prodomestic and trade growth.

The last of yours is interest rates. I do not believe that real interest rates are readily amenable to control or adjustment by public policy initiatives, and I do not find either in theory or in evidence a close relationship between changes in interest rates and changes in our trade situation.

The CHAIRMAN. Senator Roth.

Senator ROTH. Thank you, Mr. Chairman.

It is my understanding that at least two of you here feel that the legislation is antigrowth. Those of you that feel that is the case: Do you think that adequate revenues are available in the income tax to make the necessary reforms? Or do you feel that we are going to have to seek another source of revenue?

And if you think that we need another source of revenue, would you consider an oil import fee an adequate source of new revenue? What kind of impact would that have on the economy? Or would we be better off going in the direction of a BTT?

Dr. Feldstein.

Dr. FELDSTEIN. I think you can get the revenue that you need within the income tax. I think that, to lose almost $50 billion a year by the end of the decade by doubling the personal exemption, is giving away money that the Government doesn't have.

If you targetted that in the way that I described last June and again in my testimony this morning, if you targeted that on the lower tax bracket taxpayers, you can save $25 billion a year.

That is enough to avoid the increase in the corporate income tax in the President's proposal. So, just by that alone, you could eliminate these antigrowth features of increasing the corporate income tax, eliminating the ITC, and the like.

Second, I think that rather than putting a whole new tax on the books at this point, a change in the indexing of personal tax brackets—a 3-percent floor—for a temporary period would produce a substantial increase in revenue in a relatively painless way.

It would be a reduction in the annual tax cuts that people are going to automatically get, rather than an actual tax increase. By 1991, it would be worth $55 billion a year if we have CPI money. That is three rather than the full CPI as the basis for our indexing.

I would add to that an energy tax primarily on the gasoline side, although I would include a tax on imported oil as well.

And I think from all of those pieces, you can get enough revenue both to avoid the adverse effects in all of the bills that have been presented on investment productivity and also get substantial additional revenue to put into a package to shrink budget deficits.

Senator ROTH. Dr. Schultze.

Dr. SCHULTZE. Senator, let's see. I will try to answer your questions in order.

I think you can get from the current revenue system all you need for purposes of tax reform. If you need additional revenues to straighten out some parts of H.R. 3838, there are ways of picking up additional base broadening or other measures that will give it to you.

Marty Feldstein has suggested one way of doing it with respect to exemptions. I have suggested a couple; but in any event, with respect to tax reform, it seems to me that you do not need to, and it would be wrong to go outside the income tax system and levy another kind of tax and use it as part of this tax reform proposal to lower rates of the income tax.

Second, you may have to go beyond the income tax to get the additional revenues which I think are necessary to close the budget deficit. In my judgment, you don't have to. My first preference would not be that, but you may.

The next point: An oil import fee is one way of doing this. I think an oil import fee would be about lowest——

Well, I will start by saying I will take anything. [Laughter.]

Dr. SCHULTZE. But that is lowest on my list. The reason is that for every $25 to $30 billion that consumers pay, the Government collects about $8.

You put on an oil import fee of, say, $5 a barrel, and consumers will pay an additional $25 to $30 billion for their oil and their derived products. The Government will get $8 billion of it, plus whatever additional they get out of the windfall tax.

And I think that is a very bad bargain. If you are going to do energy, then it seems to me an across-the-board energy tax or a gasoline tax is much better than an oil import fee, but only for reducing the deficit—not to mix into this bill.

Dr. AUERBACH. I just want to make one point. I think that the argument for an oil import fee is weaker now than it was a couple of years ago because one of the arguments for instituting it was that it would help weaken the position of the people from whom we were buying oil and that that might hasten the decline of OPEC and help bring down the underlying cost of energy.

Well, they have done it by themselves; and we don't need to help them any more. I think because of that, there is less of an argument that we would be able to further depress the price of imported foreign oil by instituting an oil import fee.

Dr. TURE. Senator, my answer to your first question, that is can we get the needed revenues out of the income tax changes, depends on how much revenue this committee and Congress as a whole deems we need.

If you are going to accept the revenue losers that are in H.R. 3838 or in the President's proposal, I have the gravest doubt in the world that you can get the required revenue or revenue neutrality out of income tax changes without having extraordinarily deleterious effects on the economy.

I would repeat what I offered in my testimony. In H.R. 3838, there are $427.6 billion of revenue raisers, gross; $260 billion of that represents additional levies on the returns to saving and capital.

Now, I don't know where you are going to find the remainder if you are going to stay with the rate cuts, the personal exemption increases, standard deduction increases, and the other big revenue losers in the bill.

I would strongly urge that you don't try.

You raised a question about the oil import fee. I think any selective excise is bad news and would absolutely resist justification in terms of principles of taxation.

This particular selective excise is particularly bad news. For one thing, it would raise production costs for every single business in this country—no exceptions. It would also raise costs for every household—no exceptions. It would also raise costs for every household—no exceptions.

I cannot see how the economy would be well served, no matter what else that would happen as a result of that, by doing that.

Worse than that, it would raise those costs on a selective basis, depending upon how energy intensive a particular economic activity is. I think that is very, very bad news, too.

It would have an adverse effect on our competitive trade situation, both in terms of import competition and in terms of trade exports in the world market.

It would add burdens that our Third World friends do not need, particularly for example Mexico.

Let me say something positive on behalf of some sort of a value-added tax—your BTT for example. For years past, some of us have been urging at least the gradual substitution of a value-added tax of some form for some part or all of the income tax.

If this is not the appropriate occasion for initiating that effort, I don't know what is.

Senator ROTH. Thank you, gentlemen.

The CHAIRMAN. Senator Durenberger.

Senator DURENBERGER. Gentlemen, Bill Bradley said we make tax policy around here, and he has been on this committee as long as I have. And other than the rate reduction in 1981, I don't really recall making any tax policy. [Laughter.]

Senator DURENBERGER. And I look at H.R. 3838—all 7½ pounds of it—and I don't find much tax policy in that. When I got to Treasury II, or at least the President's version of it—its principles—I can't find tax principles underlying a tax policy.

I find political principles—35 percent, 33 percent, $2,000, revenue neutrality—and I don't consider those tax principles.

Let me take an off-the-wall kind of question here to see if I can get some sense of tax principle that relates to consumption, savings, and that sort of thing.

Most of you responded to an earlier question about what would I do if, et cetera, et cetera, and you said reduce the deficit, reduce the deficit.

Now, I define that as the $200 billion a year add-on that we have gotten used to doing with the national debt, the national government's debt.

It strikes me that, in reality, you could look at it as a trillion dollar a year add-on for the last 2½ years to the total debt in this country, public and private.

It seems to me that the total public and private debt, as I read some of the reports, and I am not expert, it is up over $8 trillion today.

And in the last couple of years, at least, it has been growing somewhere in the neighborhood of $1 trillion a year.

Now, suppose if that is approximately true—and we can discuss whether that is appropriate to discuss as deficit—but suppose we go back to some of your lowest priorities, which is to change the tax structure, and we do this?

We eliminate the interest deduction against taxable income for everything except invested income, and let's say, $250,000 worth of shelter for every American family.

Now, please let me rush to say that is not my proposal. I am just suggesting that as a way to try to get at a principle here, a tax principle.

Suppose we did that in this country? Other than what might happen to the housing industry or allegedly to the automobile industry and so forth, would that introduce a tax principle or tax policy that would have an impact on deficits or a deficit mentality, or living outside our means in a general way or in an economic sense in this country?

Dr. FELDSTEIN. Let me understand that this is on the personal side only we are talking about now?

Senator DURENBERGER. Yes.

Dr. FELDSTEIN. Nothing to do with the corporate side. Just going to eliminate all non-investment interest deductions or investment interest only to the extent of investment income, plus some kind of a cap.

Senator DURENBERGER. A cap, yes.

Dr. FELDSTEIN. That would be a good thing. It would raise a little bit of revenue; not a lot. And it would encourage net saving by discouraging dissaving, discouraging borrowing; it would be a principle. It would not solve all the problems of the world, but it would be a positive piece.

We started in that direction, and it pealed off very quickly. The President made similar remarks at one point a few years ago about how everything was going to be up for discussion, including even the mortgage interest deduction. That self-destructed in about 48 hours.

Senator DURENBERGER. I may, too, for asking the question. [Laughter.]

Dr. FELDSTEIN. It would be a good thing, but it seems to me that like a lot of the other aspects of traditional tax reform it has gotten swept away. And all we have, as you have correctly said, political principles rather than economic principles left in these bills.

Senator DURENBERGER. Dr. Schultze.

Dr. SCHULTZE. I would associate myself with that answer. I think it would be a good idea. I would hate to vote for it, and have to run for office, but I think it would be a good idea.

I remember that sometime back in 1980 in his campaign Jimmy Carter made the mistake of mentioning mortgage interest even, and I think he took it back in 3 days.

As far as I can see, there is absolutely nothing sacrosanct if you phase it in right about semi-unlimited mortgage interest deductions.

Senator DURENBERGER. But it would have an impact on consumption and, thus, on saving.

Dr. SCHULTZE. Yes. It is a good idea. Again, I come back to the same answer I gave Senator Bradley which is don't expect too much from it. That what you can do with that will be in the right direction, but it is not going to revolutionize saving in the United States.

Senator DURENBERGER. Sure. Dr. Auerbach.

Dr. AUERBACH. I think I would just concur with what the two previous speakers have said.

Senator DURENBERGER. Norm?

Dr. TURE. I am delighted to disagree. I can't think of any principle of taxation, I don't care what body or theory you address, that would support treating any interest cost as part of taxable income. It does not add to consumption; it doesn't add to the net worth of the individual. I think it would be very bad news, indeed. I would strongly urge against it.

The CHAIRMAN. Let me ask this question: A year ago, the first hearings we had in this committee were with four economists. We asked them to specifically testify what would happen if we were to reduce the deficit from roughly $200 billion to $150 billion. Charlie, you were one of those. Marty was one. Alan Greenspan was one. I can't remember who the fourth was.

Now this was a year ago, and we were talking about reducing the deficit from $200 to $150 billion, roughly and what would happen on the interest rates. Alan Greenspan was euphoric. He thought 3 to 4 percent. You were more cautious, Marty. You thought maybe 2 to 3. Charlie was in the range of 1 to 2. And I can't remember what the other said.

Dr. SCHULTZE. Paul Craig Roberts was your other.

The CHAIRMAN. Now that was a year ago. We are actually talking about doing this year under Gramm-Rudman roughly what we were talking about doing 1 year ago. If we hit the $144 billion target, whether we hit it with spending cuts or some spending cuts and tax increases, will the interest rates fall?

Dr. FELDSTEIN. Interest rates have fallen. They have fallen in small part, I think, because inflation expectations have dampened, but I think they have come down in large part because you have made progress in dealing with the budget deficit.

We don't project 5 percent of GNP in the future. The CBO doesn't project 5 percent of GNP in the future. So progress is being made.

I think that if you failed to deliver on something approximating Gramm-Rudman targets for 1987, the financial markets are going to be disappointed and interest rates are going to back up. I think they believe that at least the near-term Gramm-Rudman targets are going to be met.

The CHAIRMAN. What if we do deliver?

Dr. FELDSTEIN. You will get some reduction, some further reductions, in real medium- and long-term rates.

The CHAIRMAN. Let me add the second part to the question because Pete Domenici is right on this. Indeed, we are cutting about $25 billion in budget authority in future years with just the $11.7 billion cut in outlays this year.

Dr. FELDSTEIN. Right.

The CHAIRMAN. So that if we really do do it—whether it is in a May-June compromise with Congress and the President or a September sequester—where we hit the 144 and we do it with outlays, the budget authority we reduce in the future years is enormous. So that those who loan money long term can think, my goodness, not only are they going to hit 144, they are going to hit 108; they can practically do that with no change in the budget, if we adopt it in outlays.

Can we expect, what, a half a percent, a percent, a percent and a half further reduction?

Dr. FELDSTEIN. Long-term rates are now about—long-term Treasury rates are now about 9½ percent. Expected inflation runs around 5 percent in the surveys of financial officers and chief investment officers. So you are talking about a 4½-percent real long-term rate. Historically, that number has been about 1½ percent to 2 percent. So there is still a big gap in there. And I think the principal thing that is causing that gap is these projected budget deficits and the feeling that while you make some progress in the near term, the long term is not at all assured.

So I think a large part of that can be whittled away over the next few years if you keep making that kind of visible progress in bringing down budget deficits.

The CHAIRMAN. I want to put words in your mouth.

Dr. FELDSTEIN. You want to put numbers in my mouth.

The CHAIRMAN. Yes.

Dr. FELDSTEIN. I wouldn't be at all surprised if we saw another full percentage point decline in long-term rates over the coming year, if the financial markets are convinced that you really are on that track.

The CHAIRMAN. Charlie?

Dr. SCHULTZE. Basically, I associated myself with Marty. As long as we are not talking tax structure, I usually do.

In the first place, you have already gotten some of the advantage because the markets are betting, not 100 percent, but they are betting maybe 60 percent you will make it. So the problem is if you don't make it, you see interest rates go up.

I don't quite know what the range is, but my guess is you are looking at a reduction, if you do it credibly, of maybe—credibly—of maybe one-half percent or a little more. And if you don't, you are looking at an increase of more nearly 1 percent. That will give you some idea anyway.

The CHAIRMAN. Norm?

Dr. TURE. I think deficit reduction will have a modest effect, if any, on real rates. So far as nominal rates are concerned, if the deficit reduction comes along by way of tax increases, depending on the nature of the tax increases, you might wind up with higher nominal rates rather than lower ones.

If the deficit reduction comes about by way of spending cuts, I think you might get some modest additional reduction in nominal rates. It would come about because of some increase in efficiency throughout the economy, but more because I think people would be less fearful and would require less of a discount for risk than they do now.

The CHAIRMAN. Can I put a number in your mouth? Assuming we do it basically by spending cuts—ironically, if we are only $35 to $40 billion off, and we do it either all spending cuts or one-third, one-third, one-third—the amount of taxes you are talking is relatively de minimis.

Dr. TURE. I think if you got a half point off of the intermediate term nominal rate, you would be lucky.

The CHAIRMAN. All right.

Dr. TURE. And I think your real concern in trying to bring the deficit down should not be focused on what it will do to the level of interest rates, which have moved substantially independently of the level of the deficit.

The CHAIRMAN. Dr. Auerbach?

Dr. AUERBACH. Well, I can't give you an exact estimate of the interest rate change, but I would point out that the decline in the dollar exchange rate is undoubtedly in part attributable to the decline that has already occurred. So we should expect that if no unpleasant surprises occur in the deficit picture in the coming months that the trade imbalance should start to improve on its own. And that is where a lot of the reduction in the budget deficit should go.

The CHAIRMAN. Let me finish up here. Each of you testified in response to this question the deficit reduction will lead to a reduction in interest rates. Now I am trying to find out how much if we get the deficit reduction, and I am looking for figures or guesses or estimates.

Let me let Dr. Auerbach finish here.

Dr. AUERBACH. I am afraid I just wouldn't hazard a guess.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Briefly, from each of you I would like to hear what we should do about this bill. Is it beyond redemption or can something be done to fix it?

Now as I understood Dr. Schultze, you said, iffy-iffy. I am taking you as probably the strongest proponent, you being iffy-iffy. What would you do? Would you concentrate on the cost recovery?

Dr. SCHULTZE. Yes. Let me say when I say "iffy" I support the bill. I think it could be—it could be much stronger if you could find about $10 to $15 billion a year in revenues and ease up on the cost recovery. Yes.

Senator CHAFEE. But how would you find $15 billion in revenues? Would you look at new sources of revenues?

Dr. SCHULTZE. No, no, no, no. Go back to Treasury 1.

Senator CHAFEE. I see.

Dr. SCHULTZE. And look for some of the things that I think were quite good in Treasury 1. I would have to go back home to get a full list of them. And consider them in terms of closing loopholes, reducing preferences and using the revenues therefrom basically to ease up on the depreciation schedules. In fact, to liberalize the depreciation schedules.

Senator CHAFEE. Now do you think we have to do something about the ITC if we did that on the depreciation schedules?

Dr. SCHULTZE. I do not. Then I would go along with H.R. 3838 and abolish the ITC if simultaneously you move up the depreciation schedule.

Senator CHAFEE. Would you be attracted by some of the suggestions that Dr. Feldstein had on dealing with the personal exemption or perhaps the indexing? Those things had appeal to me.

Dr. SCHULTZE. Well, the indexing I would want to think about; the exemptions also. I would put those further down on my list. Particularly with respect to the indexing it might very well be an alternative way to deal with the budget deficit problem. And I wouldn't want to use up the revenues otherwise. It may be an attractive way.

Senator CHAFEE. All right.

Dr. SCHULTZE. Are you talking about indexing on investment or indexing on the bracket rates?

Senator CHAFEE. On the bracket rates. Yes, that was what I was talking about.

All right. Dr. Feldstein, what would you do?

Dr. FELDSTEIN. My first choice would be to drop it all.

Senator CHAFEE. You would junk the whole thing.

Dr. FELDSTEIN. That would be my first choice. If you are not going to do that, then the question is what do you do.

Senator CHAFEE. Can you minister to it?

Dr. FELDSTEIN. Yes. And that is what the second half of the statement tried to talk about.

Senator CHAFEE. All right.

Dr. FELDSTEIN. With targeting the personal exemption. By targeting the personal exemption, you save $25 billion a year by the end of the decade. That is what the President's proposal called for in terms of increased taxes on corporations. So those two could be netted out, and you would not have to lose the investment incentives that are in the President's proposal.

Senator CHAFEE. What are the investment incentives that are of importance? Are the depreciation schedules more important than the ITC or less important?

Dr. FELDSTEIN. In a sense you can only say which is more cost effective. You can't say which is more important in the abstract. You can say which gives more investment incentive per dollar of revenue that the Treasury loses.

And I would say that the ITC is more cost effective. It produces more bang for the buck because the money is in hand right away; there is no uncertainty associated with it. And because companies tend to discount future tax benefits at a much higher rate than the Government's cost of capital.

So giving them the ITC is more cost effective. The case for going to an indexed depreciation instead of the ITC is simply that it postpones the time of the revenue loss to the Treasury.

I would, if I could, keep the ITC. If you can't keep the ITC, then you can make it up by a combination of more generous depreciation rules and indexing of depreciation.

Senator CHAFEE. All right. Dr. Auerbach, can you give this thing mouth-to-mouth resuscitation in some way?

Dr. AUERBACH. Yes, I think you can. I think, as I mentioned in my testimony, one way of reducing the—or providing more revenue which could then be used for providing further incentives is to delay the corporate rate cut, and to use that money directly to provide additional incentives either through more generous depreciation allowances or——

Senator CHAFEE. More generous than in existing law?

Dr. AUERBACH. No, no, than in the bill, than in the bill.

Senator CHAFEE. But that is a loser for the corporations, isn't it? If you keep the rates up——

Dr. AUERBACH. No, no, no, I said delay and have a phase in, for example. We are at 46 percent now, instead of going down to 36 percent immediately, go down gradually to a rate lower than 36 percent so that for forward looking investment decisions, the future lower rate, if they can somehow be made credible, will provide additional incentives. Moreover, there will probably be some revenue left over to slightly enhance the depreciation allowances.

I would favor some package like that. And if that doesn't provide enough revenue, then I guess resort would have to be made to the individual side.

Senator CHAFEE. And, Dr. Ture, you find this an anathema.

Dr. TURE. I think if you are stuck with the constraints which the President put on the tax reform effort way back that you have got a monster on your hands, and the best thing to do would be to put the poor beast out of its misery as soon as you can.

Those constraints are—you have to have huge reductions in tax rates; you have to have a huge increase in the personal exemption and in the standard deduction. That is one. Two, you have to have revenue neutrality measured on a static basis. That is two. And, three, you can't have any alternative revenue source.

Well, that means you have got 3838 with variations. Thirty-eight thirty-eight, I think, is very, very bad news.

If you feel that you cannot get away from those constraints and have to have all three of them, put it on the shelf.

Senator CHAFEE. Well, I don't feel we are bound by those.

My time is up.

The Chairman. Senator Bradley.

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

You each have been asked about an oil import fee. Whether you are for it or against it, do you think if we put one in that we should exempt Mexico?

Dr. Feldstein?

Dr. FELDSTEIN. Exclude?

Senator BRADLEY. Exclude Mexico from the oil import fee.

Dr. FELDSTEIN. If you capped the amount from Mexico. I mean otherwise Mexico simply becomes the shipping channel through which all of the world's oil comes into the United States. But I think there is good reason to want to do a little bit of specifically pro-Mexican foreign aid through that route.

Senator BRADLEY. So give Mexico a free 700,000 barrels?

Dr. FELDSTEIN. Some number.

Senator BRADLEY. Dr. Schultze.

Dr. FELDSTEIN. But I agree that that would not be my choice.

Senator BRADLEY. I know, I know.

Dr. Schultze?

Dr. SCHULTZE. I am not sure you can clean up an oil import fee, but I would agree with Marty except I would want to think through what then all of the probable complications would be and the room for cheating and everything else. If you have——

Senator BRADLEY. Right.

Dr. SCHULTZE. But, basically, if you can get by with it, yeah, do it.

Senator BRADLEY. Dr. Auerbach.

Dr. AUERBACH. Well, I think since the only workable way of doing it would be to cap the exemption—and surely all of that amount would be used up—that it is an exact dollar figure you are talking about. It would probably make just as much sense to provide it directly rather than trying to do it through an exemption which would then provide all kinds of problems of enforcement.

Senator BRADLEY. Yes.

Dr. TURE.

Dr. TURE. You really know how to put hard questions. That one is about as hard as one can come up with because the premise is that you have got to do it. If you have to do it, I really think that the kind of patchwork to do to take care of this problem or that problem is going to be not even second best. We are going to be in the 50th best world.

Senator BRADLEY. Well, my only question is weather you would feel the same way about Canada or Venezuela?

Dr. TURE. I think that is exactly the problem.

Senator BRADLEY. Would you feel the same way about Canada or Venezuela?

Dr. FELDSTEIN. I would not.

Senator BRADLEY. You would not.

Dr. Schultze?

Dr. SCHULTZE. No, I would not.

Senator BRADLEY. Dr. Auerbach?

Dr. AUERBACH. I don't know.

Senator BRADLEY. All right.

Dr. TURE. I would.

Senator BRADLEY. My point is that if you exempt anyone, say example Mexico, you would have significantly less revenue, wouldn't you?

Dr. FELDSTEIN. Depends on how much you exempted.

Senator BRADLEY. Seven hundred thousand barrels.

Dr. SCHULTZE. Current level, yes.

Senator BRADLEY. At the current level you would have about a quarter less in revenue.

So let me ask you: I noticed that in the testimony that Dr. Feldstein and Dr. Auerbach disagreed on whether strengthening the minimum tax is a good idea. Dr. Auerbach said that it is only a cosmetic device that just adds to complexity. And Dr. Feldstein seemed to advocate strengthening it. Maybe the two of you could explain your differences.

Dr. AUERBACH. I am not sure I can explain our differences. I can explain my position, which is that for one thing, the need for a minimum tax would be less under H.R. 3838 because many of the incentives which get thrown into the minimum tax base would be reduced, such as depreciation.

But, second, I don't see the purpose in taking large fractions of the automobile industry, the airlines, the steel industry and saying, well, you know, you are now going to be subject to a separate tax because even though you are not taxable from the point of view of the ordinary tax, you just made it into the minimum tax base so every investment you undertake is going to be subject to tax.

I realize that there are problems in terms of perceived fairness of the corporate tax. But I think you are attacking the wrong villain in this case. I think if you really think that corporate taxes are too low, then you should raise corporate taxes. I am not advocating that.

But if you have decided that you have got about the right corporate tax system, then I just don't see the point of punishing firms which have had bad luck.

Senator BRADLEY. Dr. Feldstein.

Dr. FELDSTEIN. I think the problem, as Alan said, then is a perception problem that the public looks and sees that some large companies, profitable, growing companies, are not paying any tax and they say, wait a minute, why should I be paying tax if they are not paying tax. And so I think it is easier to change their tax liability than to educate the public to the correct and sophisticated argument that Alan makes. I would not have a 25-percent minimum tax. I would not seek to raise substantial revenue from doing it. But I would want to be able to say that any company that is profitable in a normal accounting sense is also making some contribution to paying tax.

Senator BRADLEY. Even if that meant eliminating completed contracts?

Dr. FELDSTEIN. You would be presumably limiting the use of it rather than completely eliminating it in order to get some revenue from a company that now zeros out the cost of completed contracts.

Senator BRADLEY. Thank you.

The CHAIRMAN. Senator Durenberger.

Senator DURENBERGER. Gentlemen, let me try to follow up on this oil import fee from a slightly different angle.

I have been trying to figure out where the chairman of this committee is on the tax bill, if we have one, and there seems to be one area that I know he is real interested in and that is an oil import fee. That is because he was interested last year and the year before and the year before that; for a long time.

Now I come from a consuming State, and I buy the Feldstein theory which is, you know, why tax home heating oil in places that get 30 °, 40 ° below zero in order to finance tax free income for this long list of corporations, et cetera, et cetera, et cetera.

And I could quit at that point. And I told the Chairman I am 96 percent against oil import fees and so forth for this purpose.

Then I got to thinking about this. I got to thinking about if those Arab OPEC countries really are more clever than we sometimes give them credit for being and that, in fact, they are very cleverly driving the world price of oil down to the point where it bankrupts not only the Western producers generally but the U.S. producers specifically; takes down at the same time a fairly substantial part of the American banking system, which supports that industry, and all of a sudden we see the price of oil going right back up.

So if I am concerned about the price of home heating oil in northern Minnesota, it seems to me I have got to be a little bit more sensitive to what I hear from Dave Boren and some of the rest of these folks about what might be going on out there.

Now, again, I don't buy this theory anymore than I bought the $250,000——

Dr. FELDSTEIN. Can I offer you some further reason to——

Senator DURENBERGER. Now where would an import fee be in this scenario? And is there a better way, if my theory is correct, to handle the problem?

Dr. FELDSTEIN. I think there is reason to give weight to your theory. I think that the typical economic response to your theory would be this: Look, if there is that risk that after a while the American sources will dry up and then the price will go up, the usual economist response is, well, you don't have to worry about that; the oil industry will take that into account and will keep the capacity on the shelf so we will be ready to move when the time comes.

But there is one thing wrong with that argument, and that is called the windfall profit tax. Congress has demonstrated to the oil industry in this country that when the price of oil gets very high, they are not allowed to collect the profit. They get taxed away.

And so the oil industry is not going to keep itself ready just in case the price of oil goes back up. So I think we really do run this risk that you talk about because when the price goes down, we step aside and say, well, tough luck, fellows, that is the way the market works. And when the price goes up we say, oh, we have to protect the American consumer and collect some revenue; we can't let you make these windfall——

Senator DURENBERGER. The reality is it has gone down, and we don't know where it is going to end. And are you yet at a point where you would recommend that we use, apart from this tax bill, that we use an import fee or a tax of some kind to stop it?

Dr. FELDSTEIN. I don't have to face that hard question. And you do need revenue. You do have a budget deficit out there. Along with a gasoline tax, I would do $3 a barrel on imports as part of an overall package. Then folks in New England who will complain about the $3 a barrel, seven cents a gallon increase in the price of home heating oil will realize that there is a lot of discomfort going on in Colorado and Wyoming where—or even in Arizona and Texas—where they drive long distances.

Senator DURENBERGER. Charlie.

Dr. SCHULTZE. I would make two or three points with respect to that argument.

First, if this is a conspiracy, some of the conspirators are going to kill themselves in the process because they can't stand it. So I don't think it is a conspiracy.

Senator DURENBERGER. Are you sure about that about the Arab conspirators, if there is such a——

Dr. SCHULTZE. No, I am not sure of anything in this world, but a point nine eight or a point nine nine—I am much surer than almost anything I told you today. [Laughter.]

Which is maybe 0.95.

Very quickly, it seems to me that what your constituents will gain in future years from having the additional American production which will be on stream in future years for a 5—the difference of a $5 oil import fee multiplied by the probability of that happening is so slight that I wouldn't saddle the American people with $25 billion extra of which the Government will only get about eight or nine in order for that very, very small potential improvement in your constituents.

Second, if this is a long-term future increase in the price of oil, why pull the oil out of the ground in the United States now? If it is a future peak up in OPEC—again, if it goes through one more cycle, up and then down, the way to handle that is with a strategic petroleum reserve; not a $5 import fee.

So I would say if I do the risk analysis of what your constituents might gain or might lose, it is a very bad price to pay.

Dr. AUERBACH. I certainly don't think it is a conspiracy; nor do I think we know how oil prices are going to go; nor do I think we really have to worry about what will happen if we let the prices go down.

Senator DURENBERGER. You don't think we have to worry about that?

Dr. AUERBACH. No.

Senator DURENBERGER. It goes down to $10 a barrel?

Dr. AUERBACH. No, I don't because I think we have seen in the last 5 years how fast non-OPEC oil production has increased in response to the high price of oil. I think we will see it again if the price goes up.

Senator DURENBERGER. All right.

Dr. TURE. I would not certainly hinge policy here on this possibility that a conspiracy exists. I think the proposal for an oil import fee is equivalent to "raise foot, shoot same."

When OPEC was really hiking the world price of oil vigorously not all that many years ago, a methaphor that was sort of commonplace even in this Chamber was this is the equivalent of an enemy air force coming across our borders and bombing out some substantial fraction of our production capability. The war is over; we have been rebuilding that production capability.

An oil import fee is saying to the National Guard, go and take out some of those new plants and machinery and equipment. It seems to me this is as counterproductive a proposal as has arisen in recent time.

The CHAIRMAN. Senator Grassley.

Senator GRASSLEY. Dr. Feldstein, on page 3 of your testimony about if we do away with—the cost to Treasury revenue because State and local governments might increase their tax on business. All right.

The first point: Am I right? I don't think that was recognized in Treasury II. I didn't see that argument for that possibility. Is that because it comes in—the increase is going to come in the years beyond the 5 years that are projected?

Dr. FELDSTEIN. No. I think they just got it wrong. I mean, basically, as you know in an awful lot of revenue estimation it is assumed that the behavior of everybody else doesn't change just because the tax law changes. We know in reality the behavior of other people do change. In particular, in this case, it is the behavior of the State and local governments.

Senator GRASSLEY. Well, could I ask you, though, is because of the competition between the States for businesses, wouldn't that keep the tax from rising very much?

Dr. FELDSTEIN. Well, it does, it does already. Right now, about a third of all the State and local revenue comes from businesses in the form of either taxes or fees. But what happens when the Federal Government changes the rule under these kinds of proposals to eliminate some of the deductibility for individuals? A lot of pressure begins to be felt by Governors all over every State. The Governors get together; they say, what are you doing about it? Well, we are thinking about raises our tax on business. Well, so are we.

If they each push it up, then the competition across the States won't be there. So I think it is a force which would increase somewhat the share of taxes collected from business.

And you don't need a very big increase in that share to wipe out the revenue gain to the Treasury. One-sixth, an extra one-sixth of total revenue collected by State and local governments shifting from individuals to businesses would wipe out all the revenue gain under current tax rate.

Senator GRASSLEY. All right.

So then I would ask the other three panelists do they agree or disagree with Dr. Feldstein.

Dr. SCHULTZE. First—well, not first—first, second and third—I think you could get around a lot of the problems that Dr. Feldstein talks about if you allowed or disallowed the deductibility of State and local taxes up to a certain percentage of income, but then allowed them from then on out.

So if State and local governments cut back their, say, income taxes, the first stage of that wouldn't be helping the taxpayer at all because that part of it the taxpayer would be able to deduct. Hence, you would have to have a very big change in State and local tax structure in order to begin to get the effect that Dr. Feldstein was talking about. I don't think that would happen.

So I think, I think, I think, you would guard against most of what Dr. Feldstein is talking about by a limited disallowance of deductibility rather than the full amount. I think that would work in that direction.

Dr. FELDSTEIN. I don't think so. I mean the numbers that were cited in the papers the other day about Senator Long's proposal for 3 or 4 percent of AGI cap would still leave an awful lot of people rushing to their State legislatures and Governors and saying, "hey, what about me; why don't you put some kind of cap in the maximum amount of taxes that the State will collect from me." Thus, forcing the Governor to look elsewhere, and the State legislatures to look elsewhere, for that revenue.

So I think that you cannot count on that as producing revenue in the magnitudes that the joint committee staff or the Treasury estimates by their normal means.

We can't be sure of just how much you are going to get, but it is not real money, and you must not count it as such.

Dr. SCHULTZE. You ought to discount some of the revenues, but actually you ought to discount a lot of the other revenues in all parts of the bill because there will be taxpayer reactions which will reduce it. That is, in most of these cases you do have the same kind of problem, whether it is State and local governments, taxpayers taking other actions.

Dr. FELDSTEIN. They do try, in some of those—some of the tax shelter elimination, they try to take that into account at the staff level.

Dr. SCHULTZE. I understand that.

Dr. FELDSTEIN. Here, they don't at all, as the Senator pointed out.

Dr. SCHULTZE. My only point is you ought to discount the revenues that you will get, but I do not think you can suggest that that discount factor is terribly large particularly if you do what I suggest.

Dr. AUERBACH. I don't have anything to add to what has been said.

Dr. TURE. I think a proposal to disallow deductibility of State and local taxes was wrong in principle and certainly wrong in terms of policy. The policy that the Reagan administration initiated back in 1981 was to try to privatize as much Government activity as possible and to try to shift down to those State and local government levels as much Federal Government activity as was feasible.

Disallowing the deductibility of State and local taxes, whether or not it will produce the kind of revenue effects that Martin suggest, I think is going to make it much, much more difficult to get states and localties to assume responsibilities that are now at the Federal level.

Senator Durenberger and I once had a little discussion about that.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

I would like to pursue a line of questioning that I started yesterday with some of our witnesses who were slightly more optimistic about the economic effects of H.R. 3838 and the President's bill than you are.

One of the questions that I posed was what would happen if we passed either the President's bill or H.R. 3838 and it caused us to shift not just to industries that had to be more efficient in the use of capital because there was less of it, but that if such a shift also carried with it movement into industries that inherently, on average, they used less capital—service businesses usually do—because they carry with it less in the way of value added components. I asked the question to what extent there was a correlation between the capital intensiveness of industry and the value added component.

There was agreement, by the way, that if, in fact, we moved toward lower value-added industries that this would reduce our overall standard of living in the economy. And I don't imagine there is disagreement here, unless someone waves their hand and says that is wrong. I don't see anyone doing that.

Dr. FELDSTEIN. I'm not sure what it means.

Senator HEINZ. You agree?

Dr. FELDSTEIN. I'm not sure what it means.

Senator HEINZ. All right.

Let me give you a for instance. If we should pass a tax bill that hypothetically moves us into industries which create less in the way of value added, will that have the effect of lowering our standard of living overall on average?

Dr. FELDSTEIN. I think the truth in what you are saying is this: That our standard of living as a nation depends on our value added as a nation.

Senator HEINZ. Right.

Dr. FELDSTEIN. Now how we divvy that up, what the industrial composition of that is, doesn't really matter.

Dr. TURE. Let us see if we can't be much more precise about it. What you are, in effect, saying, Senator, is if we move resources from those industries and activities in which the level of productivity of those resources and the rate of gain in that productivity is relatively high to those industries in which it is relatively low, will the standard of living suffer.

It, obviously, will. And I think that is the great long-term hazard in a bill like 3838. It will reshift the focus of activity.

Senator HEINZ. Charlie, I see you waving your hand frantically.

Mr. SCHULTZE. I just want to make a quick point. That you can't talk about it in terms of value added. The highest value added per worker—if you are talking about value added per worker; it has got to be per something—in the country is oil refining. I do not think we would improve national living standards or growth or anything else—you have passed a law and forced all investment to go into oil refining.

So I don't think you can talk about it in value added. I think the real question is the extent to which——

Senator HEINZ. Suppose the oil refining is done overseas rather than the United States and those people who earn, I don't know, $20 an hour are replaced with hod carriers at $10 an hour. Does that have an impact?

Dr. SCHULTZE. No. If it turns out, for example, that either because of market shifts or technology that the market gives incentives and affords profits for moving into silicon valley-type activities, which are a lot less capital intensive than others, and you are getting a very rapid rate of technological change, that will improve your living standard.

If the country decides that it wants for its own particular welfare—consumers want to spend a lot of time in hotels, then you are going to reduce national living standards if you put something in the way of people expanding hotels.

Senator HEINZ. Let us see if you and Norman are basically agreeing on what he said, though.

If the effect of a tax reform bill is to move into industrial sectors that have less growth in productivity, then it seems to me that you do have a drop in the standard of living. You don't disagree with him on that, do you?

Dr. FELDSTEIN. He said move resources including both capital and labor?

Dr. SCHULTZE. Yes. By definition, you are setting the question up.

Senator HEINZ. And does this bill do that?

Dr. FELDSTEIN. No.

Dr. TURE. Yes. I think there is the issue.

Senator HEINZ. Dr. Auerbach is shaking his head. Is that yes or no?

Dr. AUERBACH. No, no.
Senator HEINZ. The bill doesn't do that?
Dr. SCHULTZE. I don't agree that it does that.
Senator HEINZ. So it is an even split. Two versus two. Thank you.
Dr. FELDSTEIN. Counting isn't the right way to get an answer. You want to explain why.
Dr. SCHULTZE. Weighted by age, maybe. [Laughter.]
The CHAIRMAN. Aged by weight, Charlie.
Let me continue my pursuit of whether or not the interest rates are going to come down. I tried to quantify it last time and got some quantification and some not.
Now I want to know if it makes any difference whether we narrow the deficit by spending cuts or tax increases as far as whether or not we can hope to reduce the interest rate.
Let's start with Dr. Ture this time.
Dr. TURE. Well, as I indicated before, Mr. Chairman, I think trying to reduce the deficit by way of raising taxes is not only counter productive in terms of the shape of the economy, but the effect on the level of nominal interest rates is uncertain at best, modest probably, and probably would raise them rather than lower them.
The CHAIRMAN. Dr. Auerbach?
Dr. AUERBACH. I think giving away the spending cuts would come first. There would be a bigger decline in interest rates coming from the spending cuts rather than tax——
Senator HEINZ. I'm sorry, I couldn't hear you.
Dr. AUERBACH. I think a bigger decline in interest rates would be produced by spending cuts.
The CHAIRMAN. Charlie?
Dr. SCHULTZE. I think it depends on the credibility of the actions you take, whether they are going to last, because I believe that the magnitude of the spending cuts you have to take, where I know you would have to take them, to get it only through spending cuts would be such, and the pain would be such, people wouldn't believe it would last, and, therefore, marginally.
I think the effect on credibility would be somewhat greater if you bit the bullet on a tax increase.
Dr. FELDSTEIN. I think Charlie has said the right thing. The issue is credibility. So if you change the indexing provisions in the benefits program, that would be a much more credible change than a few billion dollars knocked off—same number of billions of dollars—knocked off individual spending programs which could easily be racheted up.
If you followed the President's lead of eliminating spending programs, that is more credible per dollar saved than just cutting them down a little bit where they could bounce back up in the future.
The CHAIRMAN. Now let me go to another subject now. I will start with Dr. Ture now. This is the State and local tax deduction. You commented that you thought the way the President was going is wrong philosophically.
Let's talk philosophically for the moment. When we adopted the Internal Revenue Code, it allowed deductions for all taxes. We have since prohibited the deduction of death taxes, inheritance

taxes, gasoline taxes, cigarette taxes, liquor taxes, driver's licenses taxes, and automobiles. In fact, the only four left that you can now deduct are real and personal property and sales and income.

So in terms of philosophy, why is what the President is recommending a sudden revolutionary break with the past?

Dr. TURE. I suspect that is correct. I am not sure whether that is philosophy. It certainly is a break in terms of what—the basic principles established in the Internal Revenue Code when we adopted an income tax in the first place.

Even those who are the most ardent advocates of an income tax with all its deficiencies would still argue is if you correctly define income for income tax purposes, you do not include as part of the tax base the taxes that you are required to pay to another jurisdiction because it is not really part of your income.

The CHAIRMAN. Thirty-seven States do not allow any deduction of the Federal tax against State taxes.

Dr. TURE. I would very strongly urge that if the President could ever put together a real New Federalism Program, one of the things he would urge on the States and localities would be to provide some mutual deductibility.

The CHAIRMAN. All I want to find out for the moment is whether what the President is suggesting is a revolutionary break with the past. To me it seems to be an evolutionary elimination of the deduction of one form or another of State taxes.

Dr. TURE. But in principle I think it is a break.

Dr. AUERBACH. I don't think it really ought to be considered to be a philosophical issue. I think it is just a question of tax policy.

Dr. SCHULTZE. I agree.

Dr. FELDSTEIN. I agree also.

The CHAIRMAN. All right. The last question. Marty, why, if in the past we have succeeded in eliminating the deduction of all of these other taxes, which in the aggregate, I think, mount up to more than all of the sales taxes that the States levy, why if the States have not shifted those taxes to business, if we were to prohibit the deduction of the sales tax, they would somehow try to shift that to business.

Dr. FELDSTEIN. I am not sure that they haven't. I haven't actually looked in any detail at the historic evidence on that. I do know that the share of taxes paid by businesses, share of State and local taxes paid by businesses, has been increasing quite rapidly.

Looking at the evidence across States, which I have done with some care, does indicate that States where a larger proportion of individuals itemize and those individuals have higher marginal tax rates, tend to rely more on personal taxes and less on business taxes than States where individuals cannot benefit from the tax deductibility as much.

So I think the evidence does suggest that States would shift in the direction that I indicated.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. First of all, I want to say that the testimony on the oil import fee, I think, has been excellent. I think it is excellent because I agree with it. [Laughter.]

Senator CHAFEE. The points you have made about its being an inefficient way to raise money and a bad bill are fine. It is some of the best work you have done, all of you. [Laughter.]

Now it seems to me that one of the things we are looking for in this House bill is ways to improve the efficiency of investment. In other words, we want people to spend their money or invest their money, where it is most efficient. We hope they are not planning every investment based solely on after-tax effects, even when pretax effects would cause a different result. We don't want the after-tax effects to be as dramatic as they are currently.

Don't you think that there is a good possibility of that happening with the reduced rates? Witness after witness comes before us—not economists, but the others—plugging their particular concern. They always tell about the effect of the repeal of this or that tax incentive.

Nobody seems to pay any attention to the fact that the rates are going down, and presumably that is going to make a more efficient flow of capital in the country.

You think not, Dr. Feldstein?

Dr. FELDSTEIN. I think there are pluses and minuses in this. And I think the danger is what you are doing is you are increasing very substantially the effective tax rate on capital that goes into plant and equipment relative to other ways of using that capital, relative to shopping centers and hotels and office buildings; relative to sending that capital abroad, relative to companies using that capital for advertising programs rather than real productivity increases.

Senator CHAFEE. You have mentioned shopping centers several times. Actually, the depreciation on real property has been extended considerably in the House bill. I just don't see why if somebody has got a million dollars to invest it is going to flow toward a shopping center.

Dr. FELDSTEIN. The answer to that is that these tax proposals, both 3838 and the President's proposal, would substantially increase the effective tax rate on equipment relative to the effective tax rate on all kinds of structures.

The elimination of the ITC is the main reason that happened. Even when you take into account the lower tax rates, which affect both, you see.

Senator CHAFEE. That is right. But the depreciation schedule for——

Dr. FELDSTEIN. I just tell you what the arithmetic shows. You actually crank through the arithmetic and you get—and this is clear in the Treasury's documents. It is clear in every analysis I have seen. You get a very big increase in the effective tax rate on equipment and you get something between a wash and a small reduction in the effective tax rates on structures.

Senator CHAFEE. Dr. Schultze.

Dr. SCHULTZE. To some extent, what Marty thinks is bad, I think is good. I think the market——

Dr. FELDSTEIN. Needs another shopping center?

Dr. SCHULTZE. Yes. I don't know. Every Saturday I am very glad I can go to the shopping center instead of having to come all the way downtown. Who am I to say that shopping centers are bad?

My proposition is that if you look at the tax rates on different kinds of assets, this bill evens them out. It increases them on equipment.

I don't have a particular bias for or against equipment versus structures.

Second, this bill does a lot of other good things with respect to evening out the treatment of—among different assets, among different types of financing. For example, it narrows, it narrows, but doesn't eliminate, the advantage which debt finance now gets relative to equity finance. And that is good.

It narrows by about 18-percentage points the difference between the tax rate on capital gains and the tax rate on income mainly from pushing the tax rate on income down.

Senator CHAFEE. That is the point I am trying to make.

Dr. FELDSTEIN. If I——

Senator CHAFEE. I am not for shopping centers. They destroy property, real property, and reduce fields and things I like.

Dr. FELDSTEIN. If I believe what Charlie said about this equalizing of tax rates, I would be in favor of these proposals as well. But I don't think that is what happens.

As I said earlier, it equalizes the effective tax rates between equipment and industrial property. And to that extent, it improves the allocation of capital within corporations; however, the gap between the effective tax rate on industrial uses--plant and equipment—and the effective tax rate on my increasing my home or my vacation home gets widened by this.

The difference between the effective tax rate on investment in productivity increasing plant and equipment and the effective tax rate on corporate investment in advertising campaigns, which qet expensed immediately, gets widened.

Senator CHAFEE. My time is up. I think Senator Heinz is next.

Senator BRADLEY. No, I don't think he is.

Senator CHAFEE. Senator Bradley.

Senator BRADLEY. Thank you.

Senator HEINZ. Well, without objection. Can one person object to recognizing Senator Bradley?

Senator CHAFEE. Now wait a minute.

Senator BRADLEY. Not today. [Laughter.]

Following up on what you said, that the H.R. 3838 bias is toward shopping centers and away from equipment, would you break down "equipment" for us? You say it is primarily the ITC. I mean, you get an ITC for the office furniture that you put in this office building. So one of the facts that you are conveying is that companies will have to oay more for the furniture that they put in this building, and that is not an insignificant part of the total. And there are a couple of other kind of startling things that jump out at you, I would guess, if you disaggregated the category, "equipment". So that when you say equipment versus shopping centers, that implies that the quality of our investment is really going to be hurt. Is that really so, once you disaggregate the category?

Dr. FELDSTEIN. I think the basic thing that probably—and most of us would agree about here and that you would agree about—is that what you like to have is equal effective tax rates on different kinds of investments. And what these proposals in H.R. 3838, in particular, do is to equalize some and increase the disparity in others. And I think that is really what the essence is. Do you really want to increase the bias in favor of second homes, which this does, in favor of capital investments abroad, which this does, in favor of the shopping centers, in favor of advertising? I don't think you do.

And so if you were telling me that we were leveling the playing field by reducing the effective tax rates on industrial structures so that that got closer to the current treatment of equipment, and therefore also closer to these other things, I would say fine.

Senator BRADLEY. What would you recommend in order to make this more neutral, if that is our goal? Would you recommend expensing for R&D and for advertising?

Dr. FELDSTEIN. No. You do that now.

Senator BRADLEY. What would you recommend?

Dr. FELDSTEIN. I would recommend more generous depreciation allowances on investment structures.

Senator BRADLEY. How much? Dr. Schultze says you ought to spend $10 billion more a year on——

Dr. FELDSTEIN. No. Not more than H.R. 3838. I would recommend more generous than our existing law——

Senator BRADLEY. More generous?

Dr. FELDSTEIN [continuing]. In order to equalize, if you could. It goes back to Senator Durenberger's suicidal proposal that you might think about limiting the deductibility of mortgage interest payments. We are not going to do that, it appears. If we are not going to do that, then we are going to have to start with the presumption that the tax law is going to have a very low effective tax rate on homes, and apparently on second homes, judging from the reaction that these legislative discussions have had in the last 6 months.

Senator BRADLEY. Dr. Auerbach.

Dr. AUERBACH. Yes. I think it is clear that housing is a favored investment. It is favored under the current law. And with the continuation of the interest deduction, it is going to be favored under the new one.

I am not sure it is appropriate when we talk about the allocation of capital to be making a main comparison between business capital and housing, because I think evidence of how difficult it is to get rid of mortgage deductions suggests that there is something beside efficient allocation of capital that draws people thinking about investments in housing.

So for better or for worse, I think we might say that the allocation of capital between housing and business uses is not equal right now. But we really aren't going to do anything about that. And I think if one focuses on the business allocation of capital, the bill would improve the allocation, although it would also increase the burden on some assets.

Senator BRADLEY. Let me just, if I could, cut that off because the buzzer is about to sound. And let me just have your opinion. The President's budget envisions economic growth at 4 percent. Do you believe that we will have economic growth at 4 percent this year? Yes or no. In the next budget.

Dr. FELDSTEIN. This year, 1986, we could well. If you are asking me if we are going to have it between now and the end of 1987, I think very unlikely.

Senator BRADLEY. Dr. Schultze.

Dr. SCHULTZE. My answer is no, but it is not a massive difference.

Senator BRADLEY. Dr. Auerbach.

Dr. AUERBACH. No comment.

Senator HEINZ. No comment?

Dr. AUERBACH. I just don't know.

Senator BRADLEY. Dr. Ture.

Dr. TURE. A good possibility that we will have 4 percent. I think that the really frail part of that assumption is that you get 4 percent year in, year out throughout the projection period.

Senator BRADLEY. Thank you.

Senator CHAFEE. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

First, I just want to commend Dr. Auerbach. Doctor, in addition to being from Pennsylvania, you are the first economist I have ever met who doesn't have an opinion on every subject under the sun. And I commend you for it. It adds great weight to your testimony, particularly if you agree with Senator Chafee and me on the oil import fee.

I do have, first, what I hope will be a brief question and response on the oil import fee. In 1973 and in 1979 when OPEC socked it to us with some hefty increases, we took it in fairly short order, along with the rest of the world, on the chin, economically. We went into the recession of 1974, 1975, in 1979 we went into the recession of 1980, 1981, and in Pennsylvania it is still going on.

Don't we have just as much to gain from the drop in oil prices as it was socked to us with the increase in oil prices? Yes or no. And if you want to emphasize yes, say yes, yes, yes. Dr. Feldstein?

Dr. FELDSTEIN. All taxes are bad. If we didn't need revenue we wouldn't be talking about being hit on the chin this way.

Senator HEINZ. No. I am just asking a different question. I am not asking whether you like the oil import fee. I am just saying, won't we get some real benefits from this drop in oil prices that are really going to be good for the economy?

Dr. FELDSTEIN. Absolutely.

Senator HEINZ. As good as they were bad when people jacked the prices up. I am not saying dollar for dollar. I am just saying in principle.

Dr. FELDSTEIN. Qualitatively, yes.

Senator HEINZ. Qualitatively.

Dr. Schultze.

Dr. SCHULTZE. Yes, yes, yes.

Senator HEINZ. Yes, yes, yes.

Dr. SCHULTZE. Absolutely.

Senator HEINZ. Dr. Auerbach.

Dr. AUERBACH. Yes.

Senator HEINZ. Did you say absolutely yes?

Dr. AUERBACH. Yes.

Dr. TURE. Emphatically yes.

Senator HEINZ. Pardon.

Dr. TURE. Emphatically yes.

Senator HEINZ. Emphatically yes.

Well, Senator Chafee, you have pretty well sealed off the oil import fee. I think they have just nailed the coffin shut.

Dr. FELDSTEIN. No, no. You must not interpret at least my remarks that way. If you didn't need the revenue, you wouldn't want to——

Senator HEINZ. As you yourself points out, there are other ways to get it.

Dr. FELDSTEIN. Yes. And I wouldn't put this one high on my list unless you needed it for political reasons, as part of a package for political reasons.

Senator HEINZ. I don't need that for political reasons. [Laughter.]

Dr. FELDSTEIN. Yes, I can believe that.

Senator HEINZ. Let's talk about that later on somebody else's time later, maybe yours and mine.

Dr. FELDSTEIN. All right.

Senator HEINZ. Now, Dr. Schultze, I remember with you very well, you had the difficult job of being chairman of the Council of Economic Advisers during President Carter's tenure, and I seem to remember you coming up to the Senate Banking Committee saying, you know, back in 1979 and 1980, when you correctly devined that we were going to have some problems; saying that we needed more incentive for capital investment, particularly in plant and equipment. At that time, our laws provided for an accelerated depreciation range and a 10-percent investment tax credit.

To what extent did ERDA increase the incentives for more investment over what we had then, the 10-percent investment tax accelerated depreciation range?

Dr. SCHULTZE. First, it did increase what I will call the overall incentive for investment. Second, because of the way the depreciation law was set up, the changes in depreciation substantially distorted choices among investment. But it did increase investment incentives.

Senator HEINZ. All right. Let's kind of simplify this and talk equipment and industrial property as opposed to structures.

To what extent, roughly, did it give us? A 5-percent improvement in the ability to recover the cost of capital for those? A 20-percent? A 100-percent? The perception is, generally speaking, that gave some huge mega improvement.

Dr. SCHULTZE. No. My impression—I am trying to remember. My colleague at Brookings, Jerry Bosworth, just went through not too long ago and calculated the change in what economists call the cost of capital that goes with the change in tax incentives for investment. And it is my recollection that he calculated the combination of the 1981 and 1982 laws was worth about a 5-percent—not percentage point—a 5-percent reduction in the cost of capital, which is a modest improvement, and had not very much to do with the course of investment in the last couple of years. But it was a modest improvement.

Senator HEINZ. I don't know what a 5-percent reduction in the cost of capital means to a——

Dr. SCHULTZE. One percentage point. The equivalent of a 1 percent change in the interest rate, round numbers.

Senator HEINZ. I understand that. And I will conclude here just right away.

The information I have seen is that moving from the 10 percent ITC and ADR to ERDA in the present tax law was for industrial property and equipment about a 20-percent improvement in the speed with which that capital was recovered.

Dr. SCHULTZE. The only thing I can tell you, Senator, is, in my limited knowledge—and I think Professor Auerbach can speak to it better than I can—but that 20 percent substantially overstates the relevant measure of the improvement in investment incentives——

Dr. FELDSTEIN. Senator, you said ERDA, and you said before ERDA plus TEFRA.

Dr. SCHULTZE. ERDA plus TEFRA, yes.

Dr. FELDSTEIN. Half of it got taken back in TEFRA.

Senator HEINZ. Half of it got taken back in TEFRA.

Dr. SCHULTZE. So it would have been 7.5 percent instead of 5.

Senator HEINZ. All right. Thank you.

Dr. FELDSTEIN. No. More than half was taken back.

Senator HEINZ. My time has expired. You can see where my questions are leading though.

Senator CHAFEE. Gentlemen, I have one last question for you. Some very thoughtful people on this committee have pointed out the great concern that they have over the effect of the declining oil prices on the strength of certain banks in certain regions of the country. They point to the disastrous effects that declining prices will have, not only locally and regionally but nationally. That is the principal argument that they present for an oil import fee which would result in the price of oil going up for the domestic producers.

What do you say about that? We are concerned about these claims. We do not want a banking crisis in this country. Do you consider a banking crisis to be that real? The argument is that a great deal of collateral of the loans is oil in the ground, thus if the value of the collateral goes down by 30, 40 percent, there is a real problem. What would you say, Dr. Ture?

Dr. TURE. Certainly for those institutions it is a real problem, but I don't know that public policy ought to bail them out of a change in market circumstances any more than if by some miracle you folks were able to reduce interest rates. That certainly is likely to invade bank profitability, at least in the short run. I would think that it would be conceivable that anybody in this committee would say if we had the opportunity to reduce interest rates, we should not do it because we are mindful of the bank situation. I just cannot believe that that is really an important consideration for you to entertain.

Senator CHAFEE. Dr. Auerbach.

Dr. AUERBACH. Yes, I agree. I just have a general feeling, or a predisposition against intervening in that way to preserve certain banks because of a particular change in market circumstances. Because I think it would provide the wrong signal for the current lending decisions at all banks.

Senator CHAFEE. In all fairness, the argument is that it is going to affect not just certain banks, but the Nation. In other words, it has more long-range effect than a few banks in a certain section of the country. We have seen that modest failures have a ripple effect throughout the country, and I think it is something we ought to at least consider.

Dr. AUERBACH. But we have many other industries, for example, the steel industry, that have been suffering terribly. I am not sure that we should single out the domestic oil industry for special protection because of what is happening to the price of oil.

Senator CHAFEE. Dr. Schultze.

Dr. SCHULTZE. First, there will be a problem with some financial institutions. Second, as in all of these cases, I am sure it is being overstated, particularly by the people who represent those areas. That is perfectly natural.

Third, I am morally certain, even though I am not an expert in what Texas and Oklahoma banks look like, that the existing towers' abilities, competence of the major financial regulatory institutions in the Federal Reserve can take care of incipient problems without having a major financial crisis in the United States. And, therefore, it seems to me will be absolutely unwise policy to forego the advantages of lower oil prices in the interest of doing something that much better should be done by the specific financial regulatory authorities in bailing out what banks have to be bailed out, than do it by giving up the advantages this country is going to get from lower oil prices.

Senator CHAFEE. Dr. Feldstein.

Dr. FELDSTEIN. I basically agree with what Charlie Schultze said.

Senator CHAFEE. Well I basically agree with what you all said on this subject. You have given us a lot of excellent ammunition. I have no further questions. Senator Bradley.

Senator BRADLEY. Mr. Chairman, just a few questions. I think that your last statement holds significance beyond just the question of the oil import fee, because it implies that if there is a problem in the debt situation of an energy sector, farm sector for Third World debt, that what you do is look at the financial sector, and try not to increase the subsidy to the hard-pressed sector. Is that not correct?

Dr. SCHULTZE. Yes, sir.

Senator BRADLEY. Everybody is nodding their head, let the record reflect.

[Whereupon, Messrs. Feldstein, Schultze, Auerbach, and Ture nodded in the affirmative.]

Dr. SCHULTZE. Yes, let the record.

Senator BRADLEY. For the record Dr. Auerbach, I would like for you to expand a little bit on one of your statements. You previously said that it would be an aggregious mistake to attempt to use the corporate income tax as a vehicle for correcting trade problems.

Dr. AUERBACH. Correct.

Senator BRADLEY. If you could explain that clearly, I think that would be very helpful.

Dr. AUERBACH. Well I will try.

The point is that whatever we believe about the competitive position of companies in the United States relative to companies in Japan, encouraging investment through investment incentives is bound to harm the overall competitive position because it is going to encourage investors from abroad to invest in the United States. That is fine. At the same time, that is going to strengthen the dollar exchange rate. That is going to make it more difficult for the export sector as a whole to compete.

Now there may be some companies that will gain more than they will lose, but the arithmetic of national income accounting, which is just an identify—it is not something over which anybody has any control—suggests that if these capital inflows go up, there is more investment from abroad, there is more domestic investment, there has got to be a give somewhere. And there is no reason to believe that anything on the budget side is going to happen in response to this. And there is no evidence historically to think that private savings will provide more funds. The inevitable result is that there will be an increase in the trade deficit that will result.

I also say in my testimony that I don't think that that means we should discourage investment. I just think it means that one cannot use incentives for investment as a vehicle for reducing the trade deficit. It just cannot work that way.

Senator BRADLEY. And now a last question to Dr. Schultze. In your testimony you correctly pointed out that if we really want to increase savings and investment what we should do is cut the budget deficit that is eating half of our whole savings, actually more than half of the whole savings. And then you advocated increasing revenue, raising taxes, and raising them through an income tax basically. And you made that argument, I presume, on fairness grounds or progressivity grounds.

Dr. SCHULTZE. That is one reason. The second reason is, as I look at the major alternatives I find problems with them. The big alternative is the value-added tax.

Senator BRADLEY. If you had your way, then, wouldn't it also stand to reason that the natural first step would be to make the tax system fairer so that the people who are now paying no tax would indeed be paying their share of any increased tax?

Dr. SCHULTZE. That is, in effect, the reason why, after having gone through all the plusses and minuses on H.R. 3838, I come out saying, on balance, it makes a better base on which to do, and I think you have to do, namely, raise taxes because the new base, particularly with respect to the personal tax, is fairer, has lower marginal rates, and therefore it can stand an increase in rates better than the current system.

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

Senator CHAFEE. Senator Heinz.

Senator HEINZ. Mr. Chairman, one brief question for you, Dr. Feldstein. Martin, you indicated, I gather, that one of the—and you were supported by other members here—that it was very important in deficit reduction to achieve certainty. And one of the ideas that I know you have favored is to deindex partially or totally for a brief period the indexed programs, the largest of which is Social Security. Indeed, if you don't delay, postpone, cut the Social Security COLA you are not talking about a lot of money. Social Security is trust funded. It is running a profit of between $10 to $15 billion. And although most people simply find it an incredible statement, within the next 20 years it will be running annual surpluses of as much as $50 to $100 billion, depending on your assumptions about inflation and so forth, because of the 1983 reforms and the need to build up a substantial balance in the trust fund to pay for the retirement of the baby boom generation in the year 2015 and thereabouts.

Now many of us feel that any so-called savings in social security outlays does two things. It masts the structural deficit by creating a phony increase in—well creating a phony decrease in immediate Federal borrowing requirement, which ultimately is not going to be realized because one of two things will happen. Either we are eventually going to spend that money in the trust fund, that surplus, or—and this seems to me much more likely—some brilliant politician is going to come along in a few years and say, my goodness, there is too much money in the Social Security Trust Fund. Let's just cut the social security tax rate. Or some other slightly less brilliant one will come along and say, let's increase benefits. And what you will have is, all the rest of the Federal budget, just—we will have paid for having the rest of the Federal budget out of Social Security benefits, thinking that that was a real savings. And we will be very embarrassed to find out later that in fact it was very transient, because some brilliant politician comes along, as everybody knows, and has done one of the several things I just mentioned.

What do you think of that argument? And how does it affect the credibility issue that you were talking about?

Dr. FELDSTEIN. First, the savings that you get in the near term are very real.

Senator HEINZ. There is no doubt about that. The question is, how long do they last?

Dr. FELDSTEIN. And what happens to them later and what the alternatives are? If in fact you do modify the indexing for, say, 5 years, and you permanently ratchet down the level of benefits, then you do not need as large a trust fund in the future. And then at some point, depending upon a lot of other things that are going on, it might be possible to reduce the social security taxes in the future.

Senator HEINZ. Then——

Dr. FELDSTEIN. Otherwise, we know those taxes are going to have to keep rising in the future.

Senator HEINZ. Then haven't we just postponed the day of reckoning, indeed maybe made it worse in terms of the rest of the Federal budget, which is not trustfunded?

Dr. FELDSTEIN. If by the kind of steps that we are both talking about now, if you had a 3-percent threshold on Social Security and on income taxes, and you made a few other much smaller changes, you were at a balanced budget as you went into the 1990's, you then have the option of what you wanted to do later on. Hopefully, that smart politician wouldn't start up another round of large budget deficits. There would be nothing forcing that to happen.

Senator HEINZ. The smart politicians have always started large budget deficits. Thank you, Mr. Chairman.

Senator CHAFEE. Well, gentlemen, we want to thank each of you very much for taking the trouble to come down here. I think all of you have appeared here many times before and we will probably be calling you back again in the future. We want to thank each of you. Thank you.

[Whereupon, at 11:59 a.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

20-28

STATEMENT

BY

SENATOR BARRY GOLDWATER
SENATOR ALAN CRANSTON
SENATOR DENNIS DE CONCINI
SENATOR PETE WILSON

BEFORE THE

SENATE FINANCE COMMITTEE
ON
TAX REFORM
FEBRUARY 19, 1986

On June 5, 1985 in a statement submitted to the Senate Finance Committee, Senator Goldwater requested the Committee's assistance in preserving the tax-exempt status of the Mead-Phoenix Transmission Line Project relative to the Technical Corrections Act of 1985 (S. 814 and H.R. 1800). Since that time, the House has passed a comprehensive tax reform bill, H.R. 3838, which includes technical corrections to the 1984 Tax Reform Act, and this Committee has begun deliberations on its own tax reform legislation. We submit this statement to request the Committee's assistance in protecting the Mead-Phoenix Project from provisions in any tax reform legislation that would undermine the ability to issue tax-exempt bonds when needed for the Project.

The Mead-Phoenix Project is a joint participation project of public bodies in Arizona and California, and the Western Area Power Administration of the United States Department of Energy (WAPA). The Arizona public body is the Salt River Project Agricultural Improvement and Power District in Phoenix, Arizona. The participants in California are the Southern California Public Power Authority (SCPPA), acting for the cities of Los

Angeles, Anaheim, Azusa, Banning, Burbank, Colton, Glendale, Pasadena, Riverside and Vernon; and the M-S-R Public Power Agency, acting for the Cities of Santa Clara and Redding and the Modesto Irrigatin District.

The Mead-Phoenix Project will be a system of high-voltage direct current transmission line facilities located in Arizona, Nevada, and California connecting Phoenix, Arizona with Southern Nevada and Southern California. The Project, which is estimated to be in service in the early 1990's, will enable the participants to make economical energy purchases and transfers through increased transmission capability.

In 1982, the participants began the development phase of the Mead-Phoenix Project with SCPPA issuing tax-exempt obligations to finance Project development and related costs. To date, SCPPA has issued $14.1 million in tax-exempt notes for the Project. Under the 1982 agreement, tax-exempt obligations for development costs issued by SCPPA and planned tax-exempt construction bonds to be issued by SCPPA, would be repaid by the Project participants, including WAPA, under project development agreements and transmission service contracts, respectively. Although WAPA is not an exempt entity under the federal tax code, its proportionate participation and ownership in the Mead-Phoenix Project of 20 percent conform with those federal tax law provisions which provide that no more than 25% of facilities financed with tax-exempt obligations can be used by non-exempt entities.

As was pointed out by Senator Goldwater in his previous statement, Congress in 1984 specifically protected the tax-exempt financing of the Mead-Phoenix Project from the "federal guarantees" restriction in the 1984 Tax Reform

Act by including a grandfather clause for the Project in that Act [see Section 632 (d)]. In addition Congress made the new "consumer loan bond" provision in the Act inapplicable to projects such as the Mead-Phoenix Project, by inclusion of a general transitional rule. The "consumer loan bond" provision in effect limits to 5% the proportionate participation of non-exempt entities in projects financed by tax-exempt obligations (if such participants are treated as having been "loaned" the proceeds). In 1985, however, identical technical correction bills (S. 814 and H.R. 1800), designed to make "technical corrections" to the 1984 Tax Reform Act, were introduced and proposed to change the transitional rule to the "consumer loan bond" provision so that it would make that provision applicable to previously protected projects such as the Mead-Phoenix Project. It was this proposal in the technical correction bills that prompted Senator Goldwater's statement to the Committee on June 5, 1985.

The House consolidated its technical corrections bill as a seperate title (Title XV) to H.R. 3838, its comprehensive 1985 Tax Reform bill, and adopted therein the change to the "consumer loan bond" transitional rule. However, consistent with previously expressed Congressional intent to preserve the ability to issue tax-exempt obligations for the Mead-Phoenix Project, the House specifically maintained the Projects exemption from the consumer loan bond provision [see Section 1573(d)] notwithstanding the change to the transitional rule.

However, H.R. 3838 contains several limitations on tax-exempt obligations which could adversely affect the Mead-Phoenix Project by virtue of WAPA's 20 percent participation. H.R. 3838 provides that governmental bonds issued after December 31, 1985 would no longer be tax-exempt if an amount exceeding the lesser of 1) 5 percent or $5 million were used to make a "loan" to a non-exempt entity or 2) 10 percent or $10 million were "used in a trade or bussiness" by a non-exempt entity. In addition the House bill includes a provision which would place a cap on the portion of tax-exempt bond proceeds which could be considered a "loan" to or "use" by non-exempt entities.

H.R. 3838 does contain a grandfather clause [see Section 703(p)(8)] for the Mead-Phoenix Project which in general protects the Project from the 5% and 10% tests. This grandfather clause is cross referenced to the grandfather clause provided for the Project to protect it from the "federal guarantee" provision [Section 632 (d)] of the 1984 Tax Reform Act. Unfortunately the grandfather clause relative to the 5% and 10% tests as currently drafted is neither technically correct nor sufficiently broad to protect the contemplated financing for the Mead-Phoenix Project.

First, there is an erroneous reference to Section 632(c) rather than Section 632(d). Staff to the House Ways and Means Committee has stated that the cross reference problem is an inadvertent mistake and will be corrected.

Second, the grandfather clause does not protect the Mead-Phoenix Project from a need which would otherwise exist to obtain an allocation of "private activity cap" with respect to the portion of the Project's obligations which would be attributable to WAPA. Staff to the House Ways and Means Committee has stated that the applicability of the "private activity cap" is also an inadvertent mistake and will be corrected.

Third, the grandfather clause would expire on December 31, 1987 [see Section 703 (p)(10)]. There can be no assurance, however, that the financing of the construction costs for Mead-Phoenix and related facilitils can be completed by the sunset date of December 31, 1987 particularly in light of the additional requirement in H.R. 3838 that all proceeds of a tax-exempt issue be spent within three years. As noted above, the current schedule for completion of Mead-Phoenix and related facilities calls for them to be in operation in the early 1990's.

Under H.R. 3838, obligations issued to finance Mead-Phoenix and related facilities after the December 31, 1987 sunset date would not be tax-exempt. As discussed in the previous statement to the Committee, absence of tax-exemption could well cause abandonment of the Mead-Phoenix Project.

We believe that Congress clearly expressed its intent in the 1984 Tax Reform Act to protect the ability to finance with tax-exempt bonds the Mead-Phoenix Project throughout its completion. Fairness also mandates that this intent of Congress be carried out in light of the considerable work that has been undertaken since 1982 and the significant amount of funds which have been expended towards completion of the Project.

Accordingly we want to work with the Finance Committee to ensure that tax reform does not jeopardize the financial feasibility of this valuable project.

STATEMENT

BY

SENATOR PAUL LAXALT
SENATOR ALAN CRANSTON
SENATOR PETE WILSON
SENATOR CHIC HECHT

BEFORE THE

SENATE FINANCE COMMITTEE
ON
TAX REFORM
FEBRUARY 19, 1986

On June 5, 1985, in testimony submitted to the Senate Finance Committee, Senator Laxalt requested the Committee's assistance in preserving the tax-exempt status of the White Pine Power Project relative to the Technical Corrections Act of 1985 (S. 814 and H.R. 1800). Since that time, the House has passed a comprehensive tax reform bill, H.R. 3838, which includes technical corrections to the 1984 Tax Reform Act, and this Committee has begun deliberations on its own tax reform legislation. We submit this statement to request the Committee's assistance in protecting the White Pine Power Project from provisions in any tax reform legislation that would undermine the ability to issue tax-exempt bonds when needed for the Project.

The White Pine Power Project (the "Project") is a 1500 mw-coal fired electric generating plant which the Nevada legislature in 1979 authorized White Pine County to sponsor and finance on behalf of the joint participants in the Project: three Nevada publicy owned utilities, five Nevada privately owned utilities, and six California municipalities.

The Project is a notable example of a partnership approach for effectively dealing with the complexities of siting a major power facility to meet future energy needs of several geographic regions. The Project will also provide significant employment in and significant payments in lieu of taxes to White Pine County, a severely economically depressed area in Eastern Nevada. The Project is in accord with stated federal goals of achieving energy self-sufficiency and improving the balance of trade by reducing the need to purchase oil or energy from foreign sources. In addition to providing jobs, both on-site and at equipment and material suppliers, the Project would also generate considerable federal revenue from federal land lease royalties from coal mining and from income taxes from both primary and secondary employment.

The Project has been under development since 1978 and since that time the necessary land-use, water and air quality permits have all been obtained, the development phase of the Project is nearing completion, and the participants are preparing to carry out plans for the long-term financing for construction.

Since 1979, White Pine County (the "County") has issued tax-exempt notes in the aggregate amount of approximately $20 million to finance development and related costs of the Project on behalf of the participants. Under the financing arrangement, tax-exempt obligations for development costs issued by the County and planned tax-exempt construction bonds to be issued by the County, would be repaid by the Project participants, including the Nevada privately-owned utilities, under project development agreements and power sales contracts, respectively. Although the Nevada privately owned utilities are not tax-exempt entities under the federal tax code, their proportionate participation and ownership in the Project will not exceed 25 percent to conform with those federal tax law provisions which provide that no more than 25 percent of facilities financed with tax-exempt obligations can be used by non-exempt entities.

As was pointed out by Senator Laxalt in his previous statement, Congress in the 1984 Tax Reform Act provided a transitional rule [see Section 631(c)(3)] to the new "consumer loan bond" provision in the 1984 Act which made that provision inapplicable to projects such as the White Pine Power Project. Without the transitional rule, the "consumer loan bond" provision would cause the loss of the tax-exempt status of bonds issued for the Project after July 18, 1984 because 5 percent or more of the bond proceeds could be deemed to be a "loan" to the non-exempt entities, ie. the Nevada privately-owned utilities. In 1985, however, identical technical correction bills (S. 814 and H.R. 1800), designed to make "technical corrections" to the 1984 Tax Reform Act, were introduced and proposed to change the transitional rule to the "consumer loan bond" provision so that it would make that provision applicable to previously protected projects such as the White Pine Power Project. It was this proposal in the technical correction bills that prompted Senator Laxalt's statement to the Committee on June 5, 1985.

The House consolidated its technical corrections bill as a seperate title (Title XV) to H.R. 3838, its comprehensive 1985 Tax Reform bill, and adopted therein the change to the "consumer loan bond" transitional rule. The House specifically maintained the White Pine Power Project's exemption from the consumer loan bond provision [see Section 1569(c)(4)] notwithstanding the retroactive change to the transitional rule, but provided that exemption only for bonds issued before and during 1984. The almost $3 million tax-exempt development notes issued for the Project in 1985 and any future tax-exempt obligations to be issued would thereby become taxable once this technical correction provision is enacted into law.

H.R. 3838 contains several other limitations on tax-exempt obligations which could adversely affect the White Pine Power Project by virtue of the 25 percent participation of the Nevada privately-owned utilities.

H.R. 3838 provides that governmental bonds issued after December 31, 1985 would no longer be tax-exempt if an amount exceeding the lesser of 1) 5 percent or $5 million were used to make a "loan" to a non-exempt entity or 2) 10 percent or $10 million were "used in a trade or bussiness" by a non-exempt entity. The Project would be unable to satisfy either the 5% test or 10% test because of the participation of the Nevada privately-owned utilities.

From the perspective of the public entities involved, a significant factor in the financial feasibility of a project such as the White Pine Power Project is the availability of tax-exempt financing throughout its completion. To now impose new financing conditions by changing the tax law relative to the issuance of tax-exempt bonds could result in the White Pine Power Project not going forward.

We believe such a result would be highly unreasonable since the Project has been under development and significant funds have been expended for the last eight years with diligent compliance with and in good faith reliance upon all federal, state, and local laws and regulations governing siting, licensing and financing.

We believe that on the basis of equity, fairness, consistency with federal policy, and the overall benefits to be derived, the tax-exempt status of the White Pine Power Project should be preserved to allow its completion. The continuation of this project is of the utmost importance to the citizens of Southern California and Nevada.

Accordingly we request that the Finance Committee ensure that tax reform does not jeopardize the financial feasibility of the Project and we would like to work with the Committee to this end.

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