CAPITAL GAINS TAX BILLS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-FIFTH CONGRESS

SECOND SESSION

ON

S. 2428

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO ENCOURAGE THE CONTINUED INVESTMENT OF EQUITY CAPITAL IN INDEPENDENT SMALL BUSINESSES

S. 2608

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO PROVIDE A GRADUATED EXCLUSION FROM GROSS INCOME FOR LONG-TERM CAPITAL GAINS AND A GRADUATED NONRECOGNITION OF LONG-TERM CAPITAL LOSSES FOR INDIVIDUALS

S. 3065

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO PROVIDE PRE-1969 TAX TREATMENT FOR CAPITAL GAINS

JUNE 28 AND 29, 1978

Printed for the use of the Committee on Finance

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CAPITAL GAINS TAX BILLS

WEDNESDAY, JUNE 28, 1978

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
GENERALLY OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9 a.m. in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. (chairman of the subcommittee), presiding.

Present: Senators Byrd, Jr., of Virginia, Bentsen, Haskell, Curtis, Hansen, Packwood, Roth, Jr., and Danforth.

[The committee press release announcing these hearings and the bills, S. 2428, S. 2608, S. 3065, follows:]

(For immediate release, May 26, 1978)

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT ANNOUNCES HEARINGS ON CAPITAL GAINS TAX BILLS

Senator Harry F. Byrd, Jr. (I.-Va.), Chairman of the Senate Finance Committee's Subcommittee on Taxation and Debt Management, today announced that hearings will be held on June 28 and 29, 1978, on various bills affecting the taxation of capital gains.

The hearings will be held on Wednesday, June 28 and Thursday, June 29, 1978, beginning each day at 9:30 A.M. in Room 2221 Dirksen Senate Office Bldg.

The following bills, applicable to taxpayers generally, will be the subject of the hearings:

S. 3065, sponsored by Senator Hansen with approximately 61 Senate co-sponsors, a bill reducing the maximum tax rate on net capital gains for corporations and individuals to 25 percent, effective for taxable years beginning after December 31, 1979. Based upon a static economic model without accounting for feedback effect, the bill is estimated to produce an annual revenue loss of $2.4 billion. Proponents of the measure indicate that it will produce a revenue gain.

S. 2608, sponsored by Senator Bentsen and co-sponsored by Senators Ha[illegible], Talmadge, Curtis, and Byrd (Va.), a bill to provide a graduated exclusion [illegible]m gross income for long-term capital gains and a graduated non-recognition of long-term capital losses for individuals. Based upon a static economic model without accounting for feedback effect, the bill is estimated to produce an annual revenue loss of $1 billion.

S. 2428, sponsored by Senator Haskell, a bill providing for the non-recognition of gain from the sale or exchange of an interest in a small business concern where at least 80 percent of the proceeds are reinvested in another small business concern. Based upon a static economic model without accounting for feedback effect, the bill is estimated to produce an annual revenue loss of $600 million.

Requests to Testify.—Persons who desire to testify at the hearings should submit a written request to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, by no later than close of business on Thursday, June 22, 1978.

Legislative Reorganization Act.—Senator Byrd stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their pro-

posed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify must comply with the following rules:

(1) A copy of the statement must be filed by the close of business two days before the day the witness is scheduled to testify.

(2) All witnesses must include with their written statement *a summary of the principal points included in the statement.*

(3) The written statements must be typed on letter-size paper (not legal size) and at least *75 copies* must be submitted by the close of business the day before the witness is scheduled to testify.

(4) *Witnesses are not to read their written statements* to the Committee, but are to confine their ten-minute oral presentations to a summary of the points included in the statement.

(5) Not more than ten minutes will be allowed for oral presentation.

Written Testimony.—Senator Byrd stated that the Subcommittee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length and mailed with five (5) copies by Friday, July 14, 1978, to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510.

95TH CONGRESS
2D SESSION

S. 2428

IN THE SENATE OF THE UNITED STATES

JANUARY 25 (legislative day, JANUARY 24), 1978

Mr. HASKELL introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To amend the Internal Revenue Code of 1954 to encourage the continued investment of equity capital in independent small businesses.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That this Act may cited as the "Small Business and Farms
4 Capital Preservation Act of 1978".
5 SEC. 2. Part III of subchapter O of chapter 1 of the
6 Internal Revenue Code of 1954 (relating to common non-
7 taxable exchanges) is amended by adding at the end thereof
8 the following new section:

II

1 "SEC. 1041. SALE OF CERTAIN SMALL BUSINESS AND
2 FARM INTERESTS.

3 "(a) NONRECOGNITION OF GAIN.—If an individual
4 who has held a qualified small business investment sells any
5 such investment, at the election of the taxpayer, gain from
6 such sale shall be recognized only to the extent that the
7 amount realized on such sale exceeds the amount of any
8 qualified small business investments made by the individual
9 within 12 months of that sale.

10 "(1) LIMITATION.—Subsection (a) shall not apply
11 with respect to any such sale if during such 12-month
12 period the amount of qualified business investments made
13 by the taxpayer is not equal to at least 80 percent of the
14 amount realized on such sale. For purposes of the preced-
15 ing sentence, the taxpayer shall take into account only
16 such investments made during such period as are not
17 taken into account with respect to any other sale.

18 (2) DEFINITION OF QUALIFIED SMALL BUSINESS
19 INVESTMENT.—For purposes of this section, the term
20 'qualified small business investment' means any equity or
21 unsecured investment in any small business concern
22 (within the meaning of section 3 of the Small Business
23 Act), which, in the hands of the taxpayer, is a capital
24 asset (within the meaning of section 1221) and which
25 the taxpayer has held for 12 months or longer.

1 "(3) BASIS ADJUSTMENT.—If any qualified small
2 business investment results in nonrecognition of gain
3 under subsection (a), the basis of the property constitut-
4 ing such investment shall be reduced by the amount of
5 gain which is not recognized.
6 "(4) ASSESSMENT OF DEFICIENCIES.—If the tax-
7 payer has made an election under subsection (a) with
8 respect to a sale, then notwithstanding any other provi-
9 sion of law or rule of law the statutory period for the
10 assessment of any deficiency (including interest and
11 additions to the tax) shall not expire until 3 years from
12 the date the Secretary is notified by the taxpayer (in
13 such manner as the Secretary may by regulations pre-
14 scribe) of the qualified small business investments or the
15 failure to timely make such investments. Such deficiency
16 may be assessed before the expiration of such 3-year
17 period notwithstanding the provisions of section 6212
18 (c) or the provisions of any other law or rule of law
19 which would otherwise prevent such assessment."
20 (b) CLERICAL AMENDMENT.—The table of sections for
21 part III of subchapter O of chapter 1 of the Internal Reve-
22 nue Code of 1954 is amended by adding at the end thereof
23 the following new item.

"SEC. 1041. Sale of certain small business and farm interests."

1 (c) TECHNICAL AMENDMENTS.—

2 (1) Section 1245(b)(4) (relating to like kind
3 exchanges; involuntary conversions, etc.) is amended by
4 striking out "1031 or 1033" and inserting in lieu thereof
5 "1031, 1033, or 1041".

6 (2) Section 1250(d)(4)(A) (relating to like
7 kind exchanges; involuntary conversion, etc.) is amended
8 by striking out "1031 or 1033" and inserting in lieu
9 thereof "1031, 1033, or 1041".

10 (d) EFFECTIVE DATE.—The amendments made by this
11 section shall apply to sales made after December 31, 1977.

95TH CONGRESS
2D SESSION

S. 2608

IN THE SENATE OF THE UNITED STATES

FEBRUARY 28 (legislative day, FEBRUARY 6), 1978

Mr. BENTSEN (for himself and Mr. HANSEN) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to provide a graduated exclusion from gross income for long-term capital gains and a graduated nonrecognition of long-term capital losses for individuals.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION. 1. NONRECOGNITION OF CERTAIN GAINS AND**
4 **LOSSES.**
5 (a) GENERAL RULE.—Section 1202 of the Internal
6 Revenue Code of 1954 (relating to deduction for capital
7 gains) is amended to read as follows:

II

1 "SEC. 1202. NONRECOGNITION OF CERTAIN GAINS AND
2 LOSSES.

3 "(a) LONG-TERM CAPITAL GAINS.—In the case of a
4 taxpayer other than a corporation, a percentage (determined
5 under subsection (c)) of the gain for the taxable year from
6 the sale or exchange of a capital asset held for more than
7 12 months shall be excluded from gross income.

8 "(b) LONG-TERM CAPITAL LOSSES.—In the case of a
9 taxpayer other than a corporation, a percentage (deter-
10 mined under subsection (c)) of the loss for the taxable year
11 from the sale or exchange of a capital asset held for more
12 than 12 months shall not be taken into account for purposes
13 of this title.

14 "(c) DETERMINATION OF PERCENTAGE.—The per-
15 centage referred to in subsections (a) and (b) is 50 per-
16 cent, increased (but not to more than 80 percent) by 2
17 percent for each 12-month period in excess of 12 months
18 the capital asset with respect to which the gain was derived,
19 or the loss was incurred, was held by the taxpayer.

20 "(d) ESTATES AND TRUSTS.—In the case of an estate
21 or trust the provisions of this section shall be applied by
22 excluding the portion of the gains for the taxable year from
23 the sale or exchanges of capital assets, which, under sec-

1 tions 652 and 662 (relating to inclusions of amounts in
2 gross income of beneficiaries of trusts), is includable by
3 the income beneficiary as gains derived from the sale or
4 exchange of capital assets.".
5 (b) CLERICAL AMENDMENT.—The table of sections
6 for part I of subchapter P of chapter 1 of such Code is
7 amended by striking out the item relating to section 1202
8 and inserting in lieu thereof the following:

"Sec. 1202. Nonrecognition of certain gains and losses.".

9 **SEC. 2. REPEAL OF ALTERNATIVE TAX FOR INDIVIDUAL.**

10 Section 1201 of the Internal Revenue Code of 1954
11 (relating to alternative tax) is amended—
12 (1) by striking out subsections (b) and (c);
13 (2) by striking out "subsection (d) gain" in sub-
14 section (a) (1) (A) (i) and (B) and inserting in lieu
15 thereof "subsection (b) gain"; and
16 (3) by redesignating subsection (d) as (b).

17 **SEC. 3. EFFECTIVE DATE; CONFORMING CHANGES.**

18 (a) EFFECTIVE DATE.—The amendments made by this
19 Act shall apply with respect to taxable years beginning after
20 December 31, 1979.
21 (b) CONFORMING CHANGES.—The Secretary of the
22 Treasury shall furnish to the Committee on Ways and Means

1 of the House of Representatives and to the Finance Com-
2 mittee of the Senate a draft of the technical and conforming
3 changes in the Internal Revenue Code of 1954 which may
4 be necessary to reflect throughout such Code the changes in
5 the substantive provisions of law made by this Act.

95TH CONGRESS
2D SESSION

S. 3065

IN THE SENATE OF THE UNITED STATES

MAY 11 (legislative day, APRIL 24), 1978

Mr. HANSEN (for himself, Mr. BENTSEN, Mr. MOYNIHAN, Mr. HARRY F. BYRD, JR., Mr. GRAVEL, Mr. MATSUNAGA, Mr. CURTIS, Mr. DOLE, Mr. PACKWOOD, Mr. ROTH, Mr. LAXALT, Mr. DANFORTH, Mr. ALLEN, Mr. BAKER, Mr. BARTLETT, Mr. BELLMON, Mr. BROOKE, Mr. BUMPERS, Mr. BURDICK, Mr. CANNON, Mr. CHAFEE, Mr. CHURCH, Mr. CRANSTON, Mr. DECONCINI, Mr. DOMENICI, Mr. DURKIN, Mr. EASTLAND, Mr. GARN, Mr. GLENN, Mr. GOLDWATER, Mr. GRIFFIN, Mr. HATCH, Mr. MARK O. HATFIELD, Mr. HAYAKAWA, Mr. HELMS, Mr. HODGES, Mr. INOUYE, Mr. JAVITS, Mr. JOHNSTON, Mr. LEAHY, Mr. LUGAR, Mr. MCCLURE, Mr. MATHIAS, Mr. MELCHER, Mr. NUNN, Mr. PERCY, Mr. SCHMITT, Mr. SCHWEIKER, Mr. SCOTT, Mr. SPARKMAN, Mr. STAFFORD, Mr. STENNIS, Mr. STEVENS, Mr. STONE, Mr. THURMOND, Mr. TOWER, Mr. WALLOP, Mr. WEICKER, Mr. WILLIAMS, and Mr. YOUNG) introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To amend the Internal Revenue Code of 1954 to provide pre-1969 tax treatment for capital gains.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That this Act may be cited as the "Investment Incentive
4 Act of 1978".
5 SECTION 1. Delete subsection (a) (9) of section 57 of
6 the Internal Revenue Code of 1954.

II

1 SEC. 2. (a) Amend section 1201 of the Internal
2 Revenue Code of 1954 to read as follows:
3 "SEC. 1201. ALTERNATIVE TAX.
4 "(a) CORPORATIONS.—If for any taxable year, a cor-
5 poration has a net capital gain, then, in lieu of the tax im-
6 posed by sections 11, 511, 821 (a) or (c), and 831 (a),
7 there is hereby imposed a tax (if such tax is less than the
8 tax imposed by such sections) which shall consist of the sum
9 of—
10 "(1) a tax computed on taxable income reduced by
11 the amount of the net capital gain, at the rates and in
12 the manner as if this subsection had not been enacted,
13 plus
14 "(2) a tax of 25 percent of net capital gain.
15 "(b) OTHER TAXPAYERS.—If for any taxable year a
16 taxpayer other than a corporation has a net capital gain,
17 then, in lieu of the tax imposed by sections 1 and 511, there
18 is hereby imposed a tax (if such tax is less than the tax im-
19 posed by such sections) which shall consist of the sum of—
20 "(1) a tax computed on the taxable income reduced
21 by an amount equal to 50 percent of the net capital gain,
22 at the rate and in the manner as if this subsection has
23 not been enacted, plus
24 "(2) a tax of 25 percent of the net capital gain.".
25 SEC. 2. (a) EFFECTIVE DATE.—The amendments made

1 by this Act shall apply with respect to taxable years begin-
2 ning after December 31, 1979.
3 (b) CONFORMING CHANGES.—The Secretary of the
4 Treasury shall furnish to the Committee on Ways and Means
5 of the House of Representatives and to the Finance Commit-
6 tee of the Senate a draft of the technical and conforming
7 changes in the Internal Revenue Code of 1954 which may
8 be necessary to reflect throughout such Code the changes in
9 the substantive provisions of law made by this Act.

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Senator BYRD. The hour of 9 having arrived, the committee will come to order.

A more significant challenge which confronts the policymakers in Washington is to construct economic and tax policies which provide more jobs for Americans without inflation. The hearings today will focus upon proposals which seek to reduce the capital gains tax, either through direct reductions, or through reductions in certain selected circumstances.

Today, America is not establishing a solid foundation for future economic growth. Among the major non-Communist industrialized nations, we have the lowest ratio of fixed capital investment to gross national product, a ratio of 17 percent for 1977.

Our productive capacity must expand and modernize if we are to be competitive internationally. The value of the dollar is declining and, on Monday in Tokyo, it hit a record low against the yen, declining 25 percent in ten months.

The American public is now beginning to realize that taxes are a major factor affecting the performance of our economy.

The groundswell of support in both the House and Senate for reduction of capital gains rates to their level before the 1969 Tax Act indicates a growing awareness of the impact of tax policy upon economic growth.

Many feel that a great deal of investment funds are now locked in because of high capital gains rates.

In the Senate, S. 3065, sponsored by Senator Hansen of Wyoming, has 61 co-sponsors. Representative Steiger's identical proposal in the House is being actively considered as a crucial element of any tax reduction measures.

Not only does America have the highest tax rate on capital of the major industrialized nations, the indirect tax of inflation further diminishes corporate profits and capital gains in real terms. More dollars go to Washington to finance government spending than into private investment.

Today is the first of 2 days of hearings which will examine several proposals which seek to reverse this trend. A tremendous number of individuals and groups have requested to testify. The subcommittee has attempted to present a balanced cross-section of witnesses, and as many as possible.

The written statement of those persons who have not been listed as witnesses will be made a part of the record and printed along with the statements of those giving oral testimony.

Everyone's statement, regardless of whether it is submitted in person or in writing will be carefully considered.

I might say, in concluding, that this committee has had more requests for the opportunity to testify on the capital gains issue than the committee has had on any other subject to come before it. I received telephone calls from all over the United States, from persons who wanted to be included on the list of witnesses. It just is not possible within the time constraints which we face to include all of the requests. Dozens and dozens of requests were made. The committee did the best it could in trying to balance all elements and we regret that we cannot hear all of the witnesses who wished to testify.

The first witness today will be the Honorable William A. Steiger, Congressman from the State of Wisconsin.

Congressman Steiger, we are pleased to have you with us today. You pioneered this field in the House just as Senator Hansen has in the Senate, and you may proceed, Congressman, as you wish. Let me, before your testimony, ask Senator Packwood, the ranking minority member of the committee, whether he has a statement he would like to make.

Senator PACKWOOD. No, I would rather hear Mr. Steiger.

Senator BYRD. Congressman Steiger, will you proceed?

STATEMENT OF HON. WILLIAM A. STEIGER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WISCONSIN

Representative STEIGER. Mr. Chairman, thank you, sir, very much to all of you on this distinguished committee.

It is particularly timely, this hearing, given the escalation that has taken place recently. I was reminded of what Secretary of the Treasury, Douglas Dillion, said in 1962 when the Kennedy administration recommended lowering the tax rate on capital gains to about 20 percent from the then 25 percent. He said that kind of a change would release the forces of growth within the American economy.

I think the same thing holds true today in our effort to make more sense out of where we are going with our economic system.

What the President did in his press conference the other day in attacking what Senator Hansen and I have tried to do is, I think, unfortunate and what I would like to do this morning is to try and indicate for the committee where I think the President was misled and where he was wrong in some of the statistics he has given to the American people.

I think he has taken some very poor economic advice, and he has not done well in attempting to educate the American people as to how this economic system works, and has used some rhetoric which is simplistic and which I do not believe serves the total effort in this country to try and make sure that we understand how things work.

The proposal that Senator Hansen and I have introduced Mr. Chairman, as you know, is only three sentences long. It simply reduces the rate of taxation for capital gains to 25 percent, the same rate that was in effect prior to 1969.

I will not argue that the proposal known as the Steiger-Jensen-Hansen amendment will stop inflation, produce full employment, balance the budget, eliminate the need for imported oil or reduce the trade deficit. What I do say is that it will greatly improve the economic climate in this country simply by reducing the tax burden on capital stock.

Since 1963, our tax policies have penalized investment and rewarded consumption. To stimulate the economy by encouraging consumption we have lowered income taxes for the lower and middle-income taxpayers, but, at the same time, we have increased the burden on capital by as much as 100 percent.

Recent utterances by the administration, and some of the tax reformers, reveal a very deep confusion over the difference between income and capital. Income, comprised of consumption and savings, is the reward, or incentive, we receive in exchange for labor; capital,

on the other hand, is the resource that provides the tools with which to employ labor.

By taxing capital as income, we reduce the capital stock and our ability to invest, to create jobs, and to improve both the private and the public welfare. Only a mistaken tax policy ignores the economic theory of development.

To make matters worse, our tax code is biased against capital. Income is taxed once, when it it earned, and capital is taxed several times.

We tax the income which is used to obtain capital assets. We tax the nominal, inflated gain on the asset when liquidated, even if it is reinvested, except in housing. We tax the income generated by the original capital asset and the re-invested capital asset.

Clearly, today our tax system discourages the formation of capital and it is little wonder that our economy is suffering from insufficient investment, inflation and slow growth.

I would like to include, if I could, as a part of my remarks a number of things, Mr. Chairman, and I will simply ask unanimous consent that all of the attachments be included in the record.

Senator BYRD. Without objection, all of the statements that the Congressman wishes to make will be included in the record.

Representative STEIGER. Thank you, Mr. Chairman. One of them is by Lawrence Seltzer going back to 1951, I think.

[The material to be furnished follows:]

TAX STRUCTURE AND PRIVATE ENTERPRISE

CAPITAL GAINS AND THE INCOME TAX

(By Lawrence H. Seltzer, *Wayne University*)

The wide variety and still changing tax treatment of capital gains and losses in this and other countries clearly demonstrates that no single policy has been universally accepted. The proper treatment remains a problem everywhere because it involves various unresolved conflicts—in and between concepts of income, equitable considerations, revenue goals, administrative requirements, and the desire to avoid harmful effects upon the markets for capital assets and upon investment incentives.

In sharp contrast to the exclusion of capital gains from taxable income in Great Britain, the United States taxed them in full as ordinary income at the beginning of its present-day series of income tax laws (under the 16th Amendment to the Constitution). After nine years of this practice and four of allowing capital losses in full, Congress responded to strong complaints that this treatment was seriously impeding the sale of assets on which individuals could realize gains and unduly stimulating the sale of those on which they could realize losses. Beginning with the Revenue Act of 1921 (applicable to 1922), a succession of compromise measures was enacted. In each, capital gains continued to be classified as income, but the application of the rate schedule, the allowance for capital losses, the definition of capital assets, and other provisions were successively modified in different ways in an endeavor more adequately to satisfy one or more competing objectives. Since each new set of provisions was an *ad hoc* compromise, differences of opinion have persisted to this day. Current proposals for change run the gamut from complete nonrecognition for income tax purposes of realized capital gains and loss to full inclusion of unrealized as well as realized changes in market values.

The major objections offered to taxing capital gains as ordinary income are: (1) they do not constitute income in a valid economic sense; (2) many of them are illusory, reflecting only changes in price levels of interest rates that leave the real income of the investor unchanged; (3) since the gains an investor realizes in one year characteristically have arisen over a longer period, it is unfair to tax them in full at progressive rates in the year of realization; and (4) substantial taxes on

capital gains have various undesirable practical effects upon the mobility of capital assets, incentives to invest, stability of the securities markets, and stability of government revenues. Let us review these objections, in turn; and, in the process, take note of the opposing contentions.

I. *Are Capital Gains Income?*

Capital gains and losses, it is contended, are not valid elements of true income, as that term is widely used. The traditional concept of income includes only more or less regular and recurring receipts, or, in any event, only those that are more or less expected. An occasional, sporadic gain or loss, especially if unsought and unexpected, does not function like income in guiding conduct or in determining the allocation of economic resources. For this reason, many economists, for their general analytical purposes, though not specifically for those of taxation, confine the concept of income to more or less expected or recurring receipts. Similarly, the accountant usually excludes capital gains and losses from his measure of current income.

Further, it is urged that capital gains do not constitute disposable income for the country as a whole. In many instances they do not represent additions to the total wealth of the country but merely changes in the value of titles to some of this wealth. A reduction in corporate income tax rates, for example, may well raise the market prices of common stocks by several times the amount of the annual tax reduction without adding commensurately, if at all, to the nation's wealth. In other instances, capital gains may reflect real additions to the country's wealth, as when new mines or oil resources are discovered, but these additions cannot be currently consumed. They represent only the capitalized values of expected future incomes. They are capital, not income, it is contended; and taxes on them, therefore, tend to reduce capital accumulation.

Further, to tax capital gains as income, it is argued, puts a double tax on the recipient: first, on the capital value of future incomes; then, on the incomes themselves as they are received. A man who reinvests a capital gain of $50,000 will be subject to income tax on the future incomes he obtains from the gain; and these incomes constitute his real gain. To tax him also on the principal value of the gain itself is to tax him twice. Similarly, there is a double allowance for capital losses when taxable income is reduced by both the capital value of the loss and the subsequent decline in annual income.

The answers offered to the preceding arguments may be summarized as follows:

1. Although different concepts of income may well be valid for other purposes, the proper measure of income for tax purposes is to be found in the actual *ex post* results of economic activity, not in subjective expectations or presumptions. Taxable income should measure the relative ability of individuals to pay taxes, as indicated by the net annual additions to their wealth from economic activity plus their consumption. Capital gains supply an individual with the same additions as any other kind of personal income to his power to buy consumption goods or investments.

To exclude profits of this kind from income tax or to grant them sharply preferential treatment seriously conflicts with the purposes of a graduated income tax. Capital gains constitute a major source of income for many individuals. The figures tabulated from income tax returns show that both the average amount of capital gains per taxpayer and the proportion of taxpayers who report capital gains rise sharply as we ascend the income scale. In some years, capital gains have exceeded dividends as a source of income for taxpayers reporting incomes above $100,000. And the unequal distribution of capital gains among the taxpayers within each income group accentuates the inequity of excluding them from income tax or of giving them unduly preferential rates, it is argued.

Nor do most capital gains differ in underlying economic character from other forms of personal income. They are often deliberately sought as a species of profits. They are rarely wholly "unexpected," but, like ordinary business profits, represent varying mixtures of expected and unexpected elements. In fact, if capital gains did not so commonly constitute a sought reward for exertion and risk, it could be justly contended that they should be taxed more heavily than ordinary income because they would then not serve any function in spurring initiative and exertion or in allocationg economic resources.

In practive, capital gains embody large elements of personal compensation, interest, profits, and rents, and often constitute a thinly veiled disguise for these ordinary kinds of income. A conspicuous example occurs when the retention of

earnings by a corporation over a period of years causes its stock to rise, enabling its stockholders to obtain the equivalent of these reinvested earnings in the form of a capital gain by selling the shares, or to avoid even a capital gain tax on the appreciation from these reinvested earnings by leaving their stock to their heirs.

2. The allegation that double taxation is involved when both a capital gain and the subsequent annual yield derived from it are taxed and the related contention that this practice reduces the country's stock of capital are not relevant for a personal income tax, it is contended. Individuals are free to consume or to reinvest their capital gains. They are in the same position as those who have accumulated savings from other current income. Savers are also subject to income tax both on the saved portion of their income and on the yield subsequently derived from investing these savings. In both cases the current income inclusive of new savings and of capital gains measures the addition to the taxpayer's power to command and direct economic resources into channels of his own choosing. Income taxes are designed, among other purposes, to divert a fraction of this total power to the government. Were taxable income confined to consumed income, a sizable fraction of total personal income would be exempt. Conceivably this exclusion might be desirable under some circumstances—a spendings tax might be favored as a substitute for the income tax—but the case for it would not apply peculiarly to capital gains.

All taxes impinge in some degree upon the ability of taxpayers to save and to accumulate capital. One purpose of the income tax—as of estate and gift taxes—is to reduce inequalities in the distribution of income and wealth, even if this entails some reduction in private capital or in current additions to it. Whether the aggregate capital of the country is lessened by the same amounts, depends in part upon what the government does with the tax proceeds. Public roads, school buildings, and the like are also capital goods.

Finally, it is argued that the difficulty of distinguishing clearly on economic grounds between capital gains and other forms of income creates serious administrative difficulties when the gains receive preferential tax treatment and stimulates efforts on the part of taxpayers and their lawyers to convert ordinary income into this form. The tax preference and the associated tax avoidance adversely affect the morale of the general body of taxpayers, whose co-operation is essential for the American system of a self-assessed income tax.

II. *Illusory Gains and Losses from Changes in Price Levels and Interest Rates*

I turn next to two special sources of capital gains and losses: changes in the general price level and changes in interest rates. It is argued that only by excluding capital gains and losses from taxable income can we avoid the unjust and otherwise harmful effects of taxing as income the spurious capital gains that only reflect a rise in the general price level—a depreciation in the value of the monetary unit. Many homeowners experience this type of illusory gain during and after World War II, when all the money profit they realized from selling a house in one city or neighborhood was commonly needed to help pay for a similar house elsewhere. Allowances for capital losses are held to be similarly inappropriate when they merely reflect a decline in the general price level—a rise in the purchasing power of money.

It is also urged that capital gains and losses resulting from changes in interest rates are similarly unreal. When realized incidentally to a shift of investments, they leave the investor's actual income unchanged. For example, the income from an investor's securities will remain $4,500 a year if he sells $100,000 par value of sixteen-year 4½ per cent bonds he purchsed at par at a $200,000 profit and reinvests the entire proceeds in approximately $120,000 of 3¾ percent similar bonds at par. When interest rates rise, the resulting fall in the market value of his securities, whether or not realized by sale, will similarly leave his interest income unchanged, because their smaller capital value, invested at the higher rates, will produce the same income as before.

In response to these arguments, it is generally conceded that capital gains and losses arising solely from changes in the general price level are fictitious in the sense that they do not measure real changes in the relative economic status of individuals. But it is contended that an upward or downward movement in the price level usually affects different assets in different degree, actually altering the relative economic positions of individuals; and that ordinary incomes are also affected unequally. Hence, it is impossible to isolate illusory capital gains and losses among the many inequities and disruptions of wide movements in the price level. In the event of radical changes in the price level—such as occurred in various European

countries during and after the two World Wars—special countermeasures for capital gains and losses are possible, however. These could take the form, in inflation, of raising the cost basis of capital assets by stipulated percentages, as has been done recently in France and Belgium. Existing provisions protect holders of business assets, in part, by permitting them to postpone recognition of capital gains that are reinvested promptly in similar business property; and a like rule could be adopted for houses or even for all nonbusiness assets. In the event of a drastic fall in prices, on the other hand, it might be necessary to deflate capital values by the use of index numbers or to impose restrictions on the deductibility of capital losses. But the only adequate attack upon the evils of radically changing price levels is through the broad instruments of monetary and fiscal policy, not through adjustments in capital gains taxation.

Capital gains and losses caused solely by changes in interest rates are not illusory in the same sense as those arising from changes in the general price level, it is argued. An investor who realizes a profit of $20,000 by selling his bonds after interest rates have fallen is in a position to command $20,000 more of the world's real goods. Relative to other individuals, he has gained in net worth, even though his interest income may remain unchanged.

Bunched realization of capital gains and losses.—The bunched realization of capital gains and losses has always been a major consideration advanced in favor of giving them special treatment. Under the graduated rate schedule of the income tax, the imposition of the standard income tax rates upon capital gains realized in a single year but emerging over a longer period is held to be inequitable because it usually subjects the gain to a higher effective tax rate than would be applicable ff the gain had been allocated among the years during which it arose. In the same way, long emerging capital losses, if concentrated in taxable income in the year of realization, are given smaller tax reducing value.

In answer to this consideration, it is argued that the sporadic and lumpy character of capital gains and losses is true also, in varying degree, of other kinds of income, notably business profits. Moreover, higher rather than lower taxes on long emerging capital gains are sometimes proposed as an interest charge: the taxpayer has enjoyed the free use of funds otherwise payable in taxes during the period he has postponed realizing his gain. The logical method of achieving equitable tax treatment of fluctuating incomes under a graduating rate schedule is not to exclude them but to adopt some system of averaging.

Practical Effects. Overshadowing the foregoing economic and equitable considerations in statements before Congressional committees and elsewhere has been the emphasis upon various undesirable practical consequences said to flow from treating capital gains and losses as ordinary components of taxable income. A taxpayer cannot usually avoid taxes on ordinary income except by foregoing the income itself. But he can avoid the tax on a possible capital gain by refraining from realizing it, yet nevertheless enjoy many of the advantages of the gain in the form of an increase in his wealth and the increased earning power, dividends, interest, or rent the unrealized gain usually reflects.

Since the investor commonly possesses a wide and often unlimitad range of choice as to whether and when to realize his gains in a legal sense, any substantial tax on them acts as a serious deterrent to sales of property involving capital gains. The effect is to impose a heavy tax on transfers of such capital assets. In consequence, it is argued that society does not get the benefit of highly fluid markets for capital assets and of the easy and continuous redistribution of them among those most anxious to own and use them. Individuals are deterred from making otherwise desirable shifts in the composition of their assets as their needs change. Another conspicuous contention is that price movements in both directions are exaggerated in the markets for common stocks and other equities by the reluctance of owners to sell when prices are rising in the face of an avoidable tax on their gains, and their added disposition to sell when prices are declining in order to benefit from a deductible capital loss. The accentuated fluctuations reduce the attractiveness of equity investments. Further, since venturesome investment depends in considerable degree upon the prospect of exceptional returns, which are often possible only in the form of capital gains, heavy taxes on the latter are held to deter the assumption of unusual risk.

It is argued, moreover, that the net revenues from any substantial taxation of capital gains and reasonably related allowance for capital lossess are negligible over a long period because of the tendency for gains and losses to cancel out and because the realization of losses is encouraged while that of gains is discouraged. Hence it is said that excluding capital gains and losses would improve the stability

of the yield from the personal income tax without seriously reducing its average amount. Under existing treatment the freedom of taxpayers to choose whether and when to realize gains and losses enables them to time their transactions so as to minimize their tax liabilities. Well-advised taxpayers are fairly certain to avail themselves of the tax benefits from realizing their losses when they have offsetting income, and to minimize taxes on their gains by realizing them mainly when they have offsetting losses or by not taking them at all, leaving them to pass untaxed (as far as the income, but not the estate, tax is concerned) to their heirs. A low flat rate on capital gains without allowance for capital losses has been urged as a means of increasing revenues by encouraging larger transfers of assets embodying capital gains. Finally, it is argued that the estate and gift taxes provide rough offsets to the avoidance of income taxes on capital gains.

Opponents of the preceding views argue that the alleged adverse effects upon the capital markets of including capital gains and losses in taxable income are greatly exaggerated. Empirical evidence indicates that realized gains and losses have fluctuated mainly with stock prices rather than with changes in tax treatment. Much of the actual impediment to transfers of capital gains is really due to the possibility of avoiding such taxes completely by holding appreciated assets until death. The effective attack upon these impediments, it is urged, is to remove all possibility of avoiding the tax by making every transfer of property, during life or at death, an occasion for recognizing a capital gain or loss and, possibly, by periodically recognizing accrued but unrealized gains and losses. The gift and estate taxes do not offset the inequity of taxing capital gains at lower rates or exempting them because they are payable also by individuals who do not enjoy capital gains and by those who have paid income taxes on realized gains.

The problem of inducing enough venturesome investment cannot be met equitably or adequately by the preferential tax treatment of capital gains because the greater part of the rewards of risk-taking are often, and perhaps usually, obtained from ordinary profits, dividends, and rent. To the extent that we design the tax system to foster this type of investment, we should do so broadly, covering all the rewards for exceptional effort and risk rather than a single and often spurious form of such rewards.

Even though capital gains and losses may conceivably cancel out in the long run for taxpayers as a whole, they do not do so for particular individuals. The net capital losses of some taxpayers do not justify complete tax exemption or preferential rates for the capital gains of others. Our taxation of capital gains, despite preferential rates, has actually fielded substantial revenues, only a portion of which can be attributed to the restricted deductibility of net capital losses. The irregularity of the revenues is not a solid reason for relinquishing them. Business profits, too, are notoriously unstable as a source of tax revenue. Reduction of the public debt is an excellent use for the surplus revenues of good years; and a revenue source that automatically declines in bad years has the virtue of lessening the adverse effects of federal tax collections upon private spending in period of depressed business.

The conflict of considerations barely summarized above is the "problem" of capital gains and losses. To devise a tax treatment for them that will most nearly satisfy the demands of equity—of giving equal treatment to similarly circumstanced individuals—and at the same time avoid unduly impeding useful transfers of capital assets. The major proposals for meeting this problem fall into two broad groups. One groups seeks the full inclusion of capital gains and losses in taxable income, while minimizing the undesirable effects by averaging them or averaging total income over a number of years, or by including unrealized as well as realized changes in market values of capital assets. The other group would compromise the conflicts of equitable and practical considerations by various *ad hoc* measures of the same general character as those employed in the United States since 1922 but with increased or reduced recognition of capital gains and losses as components of taxable income. Common to both groups is the question whether and to what extent unrealized appreciation and depreciation should be recognized, particularly upon transfers of property by gift or at death.

Finally, from the welter of conflicting considerations that I have rarely sketched, I have omitted an obscure, seldom expressed, but real, influence. That influence is a sentiment. Few persons like to see a baseball game in which there are no runs. no hits, and no errors; or a football game in which no one makes a touchdown. Many Congressmen and other persons have a similar feeling about the tax system and the chances of achieving outstanding financial success. They do not want an airtight tax system. They want to preserve the opportunity for a man to make

a financial homerun, a touchdown, a killing. The preferential tax treatment of capital gains has the virture, in their minds, of offering just such an opportunity.

[Excerpt material taken from Bittker & Stone, Federal Income Estate and Gift Taxation—Fourth Edition, 1974]

Statement of Secretary of the Treasury Dillon, re President Kennedy's 1963 Tax Message

HEARINGS ON H.R. 8363 (PROPOSED REVENUE ACT OF 1963), HOUSE WAYS AND MEANS COMMITTEE, 88TH CONG., 1ST SESS. 47-51 (1963)

One of the most important phases of the tax law in which the President has recommended changes designed to release the forces of growth is the treatment of capital gains and losses.

This part of the tax system has not undergone needed basic revision since 1942. The present provisions are both inequitable in essential respects and detrimental to the mobility of investment funds and liquidity in capital markets. The broad definition of capital gains permits certain types of ordinary income to be taxed at capital gains rates, thus making it more difficult to set an appropriate rate of taxation for true capital gains.

An overhaul of these provisions can make an important contribution to a stronger economy and a fairer tax system. Reduction of tax barriers to the free flow of investment and risk capital will not only add to the strength and buoyancy of the economy but will also produce several hundred million dollars of additional revenue annually. . . .

Percentage inclusion

The President has recommended that the percentage of long-term capital gains included in taxable income of individuals be reduced from the present 50 percent of the gain to 30 percent. In combination with the proposed individual income tax rate [reductions], this will result in capital gains tax rates ranging from 4.2 percent to a maximum of 19.5 percent, compared with an existing range of 10 to 25 percent. It will result in more equal treatment of individuals in various income groups. Unlike the present arrangement, the relative differential between capital gains tax rates and ordinary income tax rates would be the same at all levels of income.

While this would provide a reduction of 22 percent in the caiptal gains tax for those in the highest bracket, the reductions would be substantially greater for all other taxpayers. For instance under present law the 25 percent rate applies whenever ordinary taxable income plus capital gains exceeds $16,000 for a single individual and $32,000 for a married couple. At this same level the effective rate under the President's proposals would be only 12 percent. . . .

Independent outside surveys, our own studies, and letters and comments which are received daily from taxpayers throughout the country indicate clearly that these substantial reductions will increase taxpayers' willingness to realize capital gains and stimulate a larger turnover of capital assets.

Thus the recommended 30 percent inclusion ratio would stimluate a freer flow of investment funds and at the same time provide a more even-handed treatment of taxpayers in all income brackets.

Capital gains of corporations

Corporations should share in the reduction in capital gains tax rates. In line with the reduction of general corporate tax rates, the President has recommended that the present basic structure of capital gains taxation for corporations be retained but that the alternative rate be reduced from the present 25 percent to 22 percent. The 22 percent rate corresponds to the proposed reduced corporate normal tax rate. This will simplify tax accounting for capital gains for almost half a million corporations subject only to the normal tax.

Holding period

The present preferential treatment of assets disposed of within a period of less than a year is difficult to justify either on economic or equity grounds. The 6-month holding period frequently qualifies purely speculative profits. It also makes it less risky to carry out various maneuvers designed to convert ordinary income into capital gains.

A longer holding period makes it possible to provide more liberal treatment for bona fide investment gains without applying unjustified reductions to income from short-term trading in securities. Moreover, the substantial reduction in ordinary income tax rates must be taken into account in considering the proper holding period, as even short-term gains will be taxed at lower rates.

It is for these reasons that the President has recommended that the holding period be lengthened from 6 months to 1 year.

Equal treatment of gains accrued on capital assets at time of transfer by gift or at death

Present law permits the exemption from income tax of capital gains accrued when the appreciated assets are transferred at death. The prospect of eventual tax-free transfer of accrued gains with a stepped-up basis equal to the new market value in the hands of heirs distorts investment choices and frequently results in complete immobility of investments of older persons.

The President has recommended that the proposed reduction in the capital gains tax be accompanied by the taxation at long-term capital gain rates of net gains accrued on capital assets at the time of transfer at death or by gift. This would not apply to assets transferred as charitable gifts or bequests. . . .

The foregoing exceptions and exemptions would limit any impact whatsoever of the proposal to fewer than 3 percent of those who die each year. A number of other provisions set forth relief and transition rules. . . .

Overall effects

Enactment of the President's recommendations for reduction and reform in the capital gains area would substantially reduce the amount of tax paid per dollar of capital gain realized. At the same time, the improved definition of capital gains, the extension of the holding period, and the taxation of capital gains at death will result in a net increase in revenue from this source of $100 million.

In addition, a substantial increase in revenue, estimated at $650 million, will be realized as a consequence of the unlocking effects of the proposals and the greater volume of capital transactions that can be confidently anticipated. The total increase in revenue from the capital gains proposal is, therefore, about $750 million per year.

NOTE

The legislative recommendations set out above encountered stormy weather on Capitol Hill. As enacted by the House of Representatives, the bill (which became the Revenue Act of 1964) did not alter the capital gain rate for corporations, but for individuals the maximum rate was reduced to 21 percent (from 25 percent) for capital assets held for more than two years. The realization-at-death provision recommended by President Kennedy was rejected, along with a last minute alternative proposal for a carryover of basis under which the heirs of a decedent would sometimes be required to use the decedent's basis, rather than the value at date of death. The administration then announced that the proposed rate reduction was unacceptable unless accompanied by either realization at death or a carryover of basis; and the Senate responded by eliminating the rate reduction. A proposal to tax gains at death made by the outgoing Treasury Department of President Johnson was not acted upon by the Congress in the Tax Reform Act of 1969. Congressional leaders indicating that the matter might be considered in connection with a possible revision of the estate and gift tax laws. See also Okner, The Taxation of Decedent's Unrealized Capital Gains, 20 Nat. Tax J. 368 (1967); Somers, The Case for a Capital Gains Tax at Death, 52 A.B.A.J. 346 (1966); Wormser, The Case Against a Capital Gains Tax at Death, 51 A.B.A.J. 851 (1965).

Comptroller General's Report to Hon. Charles A. Vanik, House of Representatives on Investment Tax Credit: Unresolved Issues

DIGEST

GAO's report is a review and an evaluation of previous studies of investment behavior that included the investment tax credit. Its purpose is to discuss the role of the investment tax credit in promoting stability and growth; to identify and evaluate past studies of the tax credit; and to set forth any unresolved issues.

The slow rate of investment spending since the 1974–75 recession regarding the durability of the current economic recovery concerns many policymakers. A

common opinion is that recessions are kindled by a sluggish rate of business investment; when business spending thrives, the economy is generally performing well.

In the current situation there are two areas of concern regarding the level of investment spending: to keep the recovery going in the shortrun and to provide for future productivity gains.

Should business investment be manipulated as part of the Nation's economic stabilization policy? The debate on this question has led to considerable reseach as to what are the determinants of business investment. What influences the firm's investment decision? An understanding of this issue is crucial to the development of an effective policy to help stimulate investment spending and encourage economic growth and stability.

GAO reviewed and assessed past studies of investment behavior that included the investment tax credit and discusses their strengths and weaknesses. CAO collected other suggestive studies and considered the direction that future research should take.

FINDINGS

In reviewing past studies, GAO found that:

About 2 to 4 years is required for a significant response in investment expenditures to tax credit changes. The effectiveness of the tax credit for investment expenditures in the short-term must be considered with substantial caution.

A large portion of the tax credit goes to reward investment that would have been made whether or not there was a tax credit.

The major thrust of the investment tax credit is to provide incentive to long-term economic growth.

These studies also indicate that the investment tax credit:

Encourages investment in new equipment that is more productive than old equipment and which leads to economic growth.

Changes the composition of investment expenditures in favor of machinery and equipment, thereby encouraging economic growth to the extent that machinery and equipment are more productive than investment in other forms of capital. The administration's proposal does extend the investment tax credit to structures.

The investment tax credit may also distort normal market forces.

It may lead to the more intensive use of capital at the expense of labor. The idea behind capital investment is to increase labor productivity, thus supporting economic growth. But it may not be beneficial for employment in the shortrun.

A flat rate (currently 10 percent) applied to all assets with lives of 7 years or more leads to smaller rates of return for assets with longer service lines.

As currently structured, it is not excluded from the depreciable base of an asest so that a writeoff is allowed for an expense not incurred. The asset is depreciated for tax purposes from the original cost, not the price adjusted for the tax credit. The procedure raises the effective rate of the tax credit above the statutory level.

It tends to bypass those businesses which do not require a large capital investment since the credit offsets taxes. The benefits are reduced or eliminated for businesses that lack profits or that are operating at a loss. This tends to place new or marginal businesses at a competitive disadvantage.

Two recent relatively unknown and somewhat tentative studies explored the implications of the method of financing the investment tax credit. These two long-run, full employment models suggest that the method of financing the tax credit may lead to changes in capital costs, in redistribution of wealth, and in consumer behavior. Total investment may actually decline if the Treasury sells bonds to households to finance the credit. If the credit is financed by a reduction in Government expenditures, investment may rise by the full value of the tax incentive to business so that:

The method of financing the investment tax credit may be important in determining the potential effectiveness of the tax credit in stimulating business investment spending.

The potential effectiveness of the credit is critically dependent on the form of the complete fiscal package.

AGENCY COMMENTS

GAO did not request formal agency comments on this report. GAO did, however, receive informal comments from several agencies and considered these comments in preparing the report. Recognized economic experts in the business and academic communities also reviewed the report.

MATTERS FOR CONSIDERATION BY THE CONGRESS

GAO has reservations about the ability of the investment tax credit to promote short-term economic stability. For this reason, GAO believes that the Congress should consider the investment tax credit primarily as a tool to promote capital formation and economic growth. To improve its effectiveness in achieving these longer term goals, the Congress should consider the following possible changes.

Applying the investment tax credit to other types of investment such as structures and workforce training. (While the administration proposes extending the tax credit to structures, the Congress may wish to consider other forms of investment.)

Making the investment tax credit available to those firms that are currently making small profits but are growing rapidly. This would enlargen the base to which the credit is applied and, therefore, aid those industries more likely to invest in machinery and equipment. (The administration's proposal to increase the tax credit limit from 50 to 90 percent goes part of the way, but the Congress may wish to make the credit refundable.)

GAO believes that further research and analysis should be undertaken concerning the effectiveness of the investment tax credit as an economic stabilization device.

Investor Returns and Tax Policy—A Study

By Marilyn V. Brown, C.F.A., For the Ad Hoc Tax Committee of the Financial Analysts Federation

The Financial Analysts Federation, founded in 1947, is a non-profit professional organization devoted to the advancement of investment management. It is composed of 48 Financial Analysts Societies located in the major cities in the United States and Canada. These Societies have an aggregate of 14,500 members who are engaged in security analysis, portfolio management, and executive direction of the investment function. The affiliated Institute of Chartered Financial Anslysts awards the professional designation of "Chartered Financial Analyst" to qualified members upon successful completion of three examinations.

Marilyn V. Brown, a chartered financial analyst, serves as a consultant to the Financial Analysts Federation. In addition, she is President of Marilyn V. Brown, Inc. which provides consulting services on changes affecting the investment process: government legislation and regulation, accounting principles and corporate disclosure.

Foreword

The 14,500 member Financial Analysts Federation (FAF) is the association of investment professionals in the United States and Canada. As managers of investment portfolios and advisors to both individual and institutional investors, the FAF's members play a vital role in the allocation of investment capital in our economy.

The key element in the investment decision making process is the determination of the rate of return expected from that investment. This return is realized in the form of income or capital gains, or a combination of the two and is measured on an annualized basis over the period the investment is to be held.

There has been widespread debate over the various tax proposals intended to stimulate capital formation and numerous econometric studies of the effects on the overall economy and tax revenues. Yet there had been no study of their effect on investors' returns to determine which, if any, of these proposals would encourage investors to make new equity investments—which from the investors' point of view would be most effective in stimulating capital investment.

The FAF, therefore, asked its consultant, Marilyn V. Brown, to conduct a study of how each of the various proposals might affect investor returns. Specifically, the study examines the following tax proposals:

Reducing the corporate tax rate from 48% to 44%,

Reducing the maximum capital gains tax rate from approximately 50% to 25%,

Reducing double taxation of dividends under Congressman Ullman's 10% dividend integration proposal.

The techniques of securities analysis are used to project the possible effects on investors' returns from both dividends and capital gains, holding stock market price relationships constant. The various proposals, singly and in combination, are then compared for their impact on equity investments.

Policy Implications of the Study's Conclusions

Rates of return analysis

In measuring the effects of prospective tax changes on investor returns, the study provides startling insights into the effects of present tax policy on equity investment.

At present tax rates the average equity investment opportunity does not offer sufficient potential return to warrant undertaking the investment risk. As Treasury Secretary Blumenthal said recently, "It no longer pays enough to invest enough."

The study shows that at present tax rates prospective after tax returns for higher tax bracket investors are, on average, lower *on an absolute basis* than those offered by alternative investments such as municipal bonds. For lower tax bracket investors equity investments provide a higher absolute return than investment alternatives, but insufficient returns on a risk adjusted basis. These investors tend to invest largely for dividend return and to be averse to risk.

Reducing the maximum capital gains tax rate from approximately 50% to 25% would be the most effective inducement to equity investment among the tax proposals examined.

While after tax returns from the average investment would remain below those offered by investment alternatives, prospective returns from select equity opportunities, including those carrying higher risk, would likely be increased by a level sufficient to induce higher tax bracket investors to move meaningful amounts of their capital back into the equity markets.

Reducing the corporate tax rate to 44% would improve investor returns marginally.

For the higher tax bracket investor, returns on the average equity investment would remain lower than those from alternative investments. For investors in all tax brackets, dividend returns would remain below those offered by lower risk investments.

Reducing double taxation of dividens would raise investor returns slightly. It would be of greatest benefit to lower tax bracket investors who tend to seek dividend returns. It would provide only modest incentive to higher tax bracket investors.

In the lower tax brackets reducing double taxation of dividends would increase after tax dividend returns more than would a cut in the corporate tax rate. At higher tax bracket levels, it would have approximately the same effect as reducing the corporate tax rate. For all tax brackets, reducing the corporate tax rate would have a greater effect on total after tax returns.

The tables contained in the study provide a simple means for comparing the effects of the specific proposals and possible combinations thereof.

"Windfall" profits

The data on historical and prospective returns from equity investments speak to the question of possible "windfall" profits. Capital gains occur (and can be taxed) only when an investment is made and later sold at a profit. As Table XIV shows, the compound annual capital gain over the 50 year period, 1927–1977, was only 3.4% *pre tax.*

In terms of the future, analysis of prospective returns based on three sets of experience parameters hardly suggest these returns could be considered excessive. If, as a result of changes in tax policy, actual returns do prove to be substantially higher, it will be due to a significant rise in stock market prices caused by an increase in demand for equity capital investment, exactly the result the tax changes were intended to accomplish.

Benefits to public policy

A flow of capital back into equity investment would serve the public policy in many ways. A few are enumerated below:

A revitalized equity market would enable corporations to increase their use of equity capital vs. debt, thereby reducing their reliance on debt capital and their leveraged exposure to economic downturns. Correspondingly, the risk associated with equity capital investment would be reduced.

An improved environment for equity investment should generate a more receptive market for the smaller and technologically innovative companies which historically have provided the wellspring for new competition and technological progress.

Studies show these same companies are also an important source of new jobs.

Conclusion

Treasury Secretary Blumenthal gave a major address on capital formation before the annual conference of the Financial Analysts Federation in Miami on May 8, 1978. In that speech he said, "Investment is lagging for the simple reason that it has become less profitable. The rational investor, before he leaps, looks to expected real returns and to the probability of getting them. This vista of return and risk has been deteriorating."

We believe this study brings additional useful information to the debate on tax policy. We also believe it demonstrates that of the three major choices, a reduction in capital gains tax rate, possible in combination with reduction in the corporate tax rate and partial elimination of double taxation of dividends, is essential to achieving an effective increase in equity capital formation.

July 5, 1978.

THE FINANCIAL ANALYSTS FEDERATION.
AD HOC TAX Committee:
ROBERT D. HEDBERG
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INVESTOR RETURNS AND TAX POLICY

INTRODUCTION

The investment decision making process is a complex one, requiring assessment of a lengthy list of variables. Ultimately, however, the rational investment decision is made on the basis of the prospective return from that investment and the risks to be undertaken in achieving that return.

Return

For the investor in corporate equities, total return may be said to consist of three parts: dividend return, i.e., cash dividend distributions; appreciation return, i.e., an increase in the company's value based on some objective measure such as book value or earnings; and speculation return, a function of the change in the relationship of demand and supply for corporate equities.

Risk

Modern portfolio management theory attempts to determine risk by objective measurement. Rating agencies such as Standard and Poor's and Moody's have applied quality ratings to securities for many years. In general, short term Treasury bills are considered to be essentially risk free. Treasury bonds, municipal bonds and corporate bonds are considered to carry respectively rising degrees of risk. Equity investments, representing ownership participation in corporations are, in general, assigned the highest degree of risk.

Comparison with alternative investment opportunities

In making his investment decision the investor will assess not only the returns and risk associated with one possible investment, but the risks and returns available from alternative investments as well. For the taxable investor, the return measured is that remaining after taxes.

The equity investment decision then is affected by: changes in tax rates, changes in the perceived level of risk and changes in the rates of return and associated risk of other investment opportunities.

In recent years, the rates of return from lower risk non-equity investments have risen almost steadily, while tax burdens on equity returns have been increased. Now there are under consideration several proposals, each of which is intended to reduce the tax burden on equity capital and enhance equity capital formation.

Numerous econometric studies have estimated the macroeconomic effects of these various tax proposals. This study attempts to assess the effects from the viewpoint of the individual investor: how changes in tax policy might affect the rate of return portion of the investment decision making process.

SUMMARY AND CONCLUSIONS

Investor returns and tax policy uses the techniques of securities analysis to isolate and assess the effects of various tax proposals on investment returns to the taxable equity investor. Specifically, it examines and analyses the effects of:

reducing the corporate tax rate from 48% to 44%, reducing the maximum capital gains tax rate from approximately 50% to 25%, and reducing double taxation of dividends under Congressman Ullman's 10% dividend integration proposal. In constructing its analysis the study uses three different data sets: non-financial corporations as a whole, taken as a proxy for average investment returns; the Standard and Poor's Index of 400 of the nations's largest corporations; and a corporate model designed to facilitate specific examination of the corporate tax rate cut.

Financial statement ratios for 1977 were used as a base for projections. These ratios were then extended into the future and altered to incorporate the various tax proposals. Since the 1977 financial ratios used represent the upper end of recent business experience, it is believed that the return projections incorporate an optimistic bias. However, the projections hold constant all elements other than the tax policy proposals. Therefore, they should not be viewed as estimates of experience in a dynamic economy. Rather, they are intended to present orders of magnitude as aids in tax policy decisions. Logically, the three data sets produce different rate of return results, but all point to the same conclusions.

The study concludes that:

1. At present tax rates, prospective after tax appreciation and dividend returns are not competitive with alternative investment opportunities. For higher tax bracket investors, prospective returns from the average equity investment are lower on an absolute basis. For lower tax bracket investors, who are risk averse and invest largely for dividends, returns appear to be uncompetitive on a risk adjusted basis.

2. Reducing the corporate tax rate from 48% to 44% would marginally inprove investor returns. Total returns on average would remain uncompetitive for the higher tax bracket investor.

3. Reducing the maximum capital gains tax rate from approximately 50% to 25% would have a significant effect on after tax investment returns.

While returns from the average investment would remain lower than alternatives for the higher tax bracket investor, prospective returns from above average investment opportunities should become sufficiently attractive to warrant a return of some of their capital into equity markets.

4. Reducing double taxation of dividends would be of greatest benefit to lower tax bracket investors. It would provide only modest incentive to higher tax bracket investors.

5. On average, reducing the corporate tax rate to 44% would have greater impact on investors' returns than reducing double taxation of dividends at the 10% integration level. However, at the lower tax brackets, dividend integration would increase after tax dividend returns more than a cut in the corporate tax rate. At higher tax bracket levels, dividend integration and reducing the corporate tax rate would affect after tax dividend returns about equally. For all tax brackets, reducing the corporate tax rate would increase total after tax returns more than dividend integration.

6. In a high interest rate environment a combination of tax cuts would be necessary to bring equity investment returns in the average corporation up to a level competitive witha lternative investment opportunities such as government, municipal or corporate bonds.

SUMMARY TABLE

The summary table displays the basic findings of the study, illustrating the relative effects of the various tax proposals on investor after tax returns.

The table uses as a base for its projections two corporate models developed from Department of Commerce and Federal Reserve Board data for non-financial corporations in 1977. In Model A, 45% of after tax corporate earnings are paid out in dividends, the dividend payout ratio of nonfinancial corporations in 1977. In Model B, no dividends are paid and all earnings retained and reinvested.

A description of the methodology used in constructing return projections for all three data sets follows.

SUMMARY TABLE.—RELATIVE EFFECTS OF VARIOUS TAX PROPOSALS ON INVESTOR RATES OF RETURN

[In percent]

	Equity Investment									Fixed income investment alternatives		
	48 percent corporate tax rate			46 percent corporate tax rate			44 percent corporate tax rate					
	45 percent dividend payout			45 percent dividend payout			45 percent dividend payout					
	Without dividend interest	With 10 percent dividend interest	No dividend	Without dividend interest	With 10 percent dividend interest	No dividend	Without dividend interest	With 10 percent dividend interest	No dividend	3 mo Treasury bills[1]	Bell System bonds[1]	Municipal bonds[1]
Pretax returns:												
Capital gains return[2]	6.2	6.2	11.3	6.4	6.4	11.7	6.7	6.7	12.2			
Dividend/interest return[3]	5.4	5.4		5.6	5.6		5.9	5.9	6.7	9.0	6.6	
Total return	11.6	11.6	11.3	12.0	12.0	11.7	12.6	12.6	12.2	6.7	9.0	6.6
After tax returns:												
50 percent capital gains/70 percent dividend tax:												
Capital gains return[2]	3.2	3.2	6.0	3.3	3.3	6.2	3.5	3.5	6.4			
Dividend/interest return[3]	1.6	1.8		1.7	1.9		1.8	2.0		2.0	2.7	6.6
Total return	4.8	5.0	6.0	5.0	5.2	6.2	5.3	5.5	6.4	2.0	2.7	6.6
35 percent capital gains/70 percent dividend tax:												
Capital gains return[2]	4.1	4.1	7.6	4.3	4.3	7.9	4.5	4.5	8.3			
Dividend/interest return[3]	1.6	1.8		1.7	1.9		1.8	2.0		2.0	2.7	6.6
Total return	5.7	5.9	7.6	6.0	6.2	7.9	6.3	6.5	8.3	2.0	2.7	6.6
25 percent capital gains/70 percent dividend tax:												
Capital gains return[2]	4.7	4.7	8.7	4.9	4.9	9.0	5.1	5.1	9.2			
Dividend/interest return[3]	1.6	1.8		1.7	1.9		1.8	2.0		2.0	2.7	6.6
Total return	6.3	6.5	8.7	6.6	6.8	9.0	6.9	7.1	9.2	2.0	2.7	6.6
25 percent capital gains/50 percent dividend tax:												
Capital gains return[2]	4.7	4.7	8.7	4.9	4.9	9.0	5.1	5.1	9.2			
Dividend/interest return[3]	2.7	3.0		2.8	3.1		2.9	3.2		3.4	4.5	6.6
Total return	7.4	7.7	8.7	7.7	8.0	9.0	8.0	8.3	9.2	3.4	4.5	6.6
12.5 percent capital gains/25 percent dividend tax:												
Capital gains return[2]	5.5	5.5	10.0	5.7	5.7	10.4	5.9	5.9	10.8			
Dividend/interest return[3]	4.1	4.5		4.2	4.6		4.4	4.8		5.1	6.7	6.6
Total return	9.6	10.0	10.0	9.9	10.3	10.4	10.3	10.7	10.8	5.1	6.7	6.6

[1] Salomon Bros. estimates for bellwether issues, June 21, 1978.
[2] Compound annual rate of return.
[3] Average annual rate of return.

DESCRIPTION OF METHODOLOGY

Criteria established

Several different criteria were established in setting up the analytical procedures for this study.

1. Isolation of the critical variables, i.e., the effects of tax changes on investor returns, from exogeneous factors, such as changes in the economy and stock market prices.
2. Use of real world experience, to the extent possible.
3. Simplification of presentation, to the extent possible.

Methodology used

Three different bases were used to project investor rate of return experience under the various tax proposals: data for non-financial corporations, the Standard and Poor's list of 400 of the nation's largest corporations and a corporate model. The results of these three sets of projections are shown in the section following.

For the non-financial corporations and the Standard and Poor's 400 list, 1977 financial statement data were used as a starting point. The corporate model was constructed on the basis of nonfinancial corporation data and adjusted in order to examine the effects of cutting the corporate tax rate from 48% to 46% or 44%.

For non-financial corporations and the Standard and Poor's 400 list, the projection process started with 1977 pre tax profits as a percentage of equity capital (book value). This pre tax return on equity ratio was then held constant throughout the projection period. It was assumed that the percentage of earnings paid out as dividends remained constant and that retained earnings were reinvested to maintain the base period pre tax return on equity. One set of projections was made at present effective corporate tax rates, another incorporating Treasury Department data on the corporate tax rate cut proposal.

The corporate model began with the non-financial corporations' after tax return on equity capital and assumed that this return was earned after a 48% tax rate. The new, higher pre tax return on equity was then held constant and the corporate tax rate reduced to 46% and 44%.

Although equity investments are generally made with the anticipation that these investments will be held for a considerable period of time, for ease of presentation a three-year time frame was selected. (Annual rates of return would not be measurably affected by a longer holding period.) It was assumed that investment was made at the beginning of year one and sold at the end of year three.

Capital gains were totaled, taxed and then calculated on a compound annual return basis. Dividends were added, taxed and the average return calculated.

Rates of return for non-financial corporations and the S & P 400 list were measured using two standards for purchase and sale price: book value and market value. In projecting market value it was assumed that market value at the end of year three bore the same relationship to book value at the end of the period as beginning market value held to beginning book.

Separate calculations were made incorporating the effects of Congressman Ullman's 10% dividend integration proposal. In making the dividend integration calculations it was assumed that all corporations in the data set would have a tax base large enough to support the full 10% gross up and credit. To that extent the effects of dividend integration are overstated. However, since a 10% integration level is used throughout, and under the proposal the level would be increased to 12% after two years, the effects may be slightly understated.

All of the projected returns were compared with those currently anticipated from three investment alternatives: three month Treasury bills, Bell System bonds, and municipal bonds.

Variables omitted from the methodology

An investor in making his investment decisions will incorporate into his investment decisionmaking process his predictions and assumptions on a very lengthy list of variables. Isolating the specific effects of changes in tax rates and illustrating those effects in a simple to understand format requires eliminating some of those variables. Three very important variables which have been eliminated from the analysis are: the outlook for the economy, the effects of inflation on corporate financial statements, and changes in demand and supply for securities, i.e., stock price fluctuations. Since all are interrelated in terms of their real world impact on investor returns, these variables are discussed briefly.

In selecting results in 1977 as a basis for projections, the analysis uses a year when after tax return on book value was at a record level for the data period 1965–1977. Thus, projections of future return on equity, made on the basis of

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recent period record levels, likely introduce an optimistic bias into the appreciation return assumptions, particularly at this point in an aging economic cycle.

Secondly, using book value to establish purchase and sale price ignores the effects of inflation on corporate financial statements and on the replacement costs of assets recorded and depreciated on the basis of historic costs. Recent analysis suggest that market value, set by demand and supply for equity investment, does incorporate an adjustment for inflation. At the end of 1977, market value for non-financial corporations was below book value. For the S & P 400 list, market was some 20% higher than book value.

As stated earlier, stock market fluctuations, i.e., speculation returns, have been omitted from the analysis. However, as Tables XIII and XIV show, recent experience has been largely negative. Those wishing to incorporate assumptions on stock market prices may do so by adjusting end of year three market values and calculating compound annual rates of appreciation return on their own bases.

Assumptions

It was also necessary to make certain assumptions. Significant among these were the matter of additional outside capital and a constant 45% dividend payout ratio. The use of debt in the corporate capital structure rose steadily until 1974 when the recession vividly demonstrated the hazards of high financial leverage. Since then, debt/equity ratios have declined slightly. Consequently, projecting a stable debt/equity ratio into the future seemed reasonable and in line with the real world environment. Using book value as a basis of purchase and sale eliminated possible complications of additional equity financing. Neither appreciation nor dividend returns would be affected. The market value calculations assume no additional equity financing.

Non-financial corporations were selected because they were felt to present a more typical investor experience than would including financial corporations. The S & P 400 list likewise excludes financial corporations as well as transportation and utility companies.

Because investment is a prospective process, precise projections of investment returns are never possible. True results are known only in retrospect. This analysis was not designed to achieve that impossible precision but rather to provide some useful first order of magnitude parameters as guidance for tax policy decisions.

PROJECTIONS AND ANALYSES

Nonfinancial corporations data base

TABLE I

Description and analysis

Table I uses 1977 data for non-financial corporations as a whole to project investor returns under present effective corporate tax rates.

In Table I-a it is assumed purchase was made at book value at the beginning of year one, equal to actual book value at the end of 1977. Profits were projected by assuming that each year retained earnings were reinvested to produce a pre tax and after tax return on equity equal to that earned in 1977, i.e., 18.9% and 11.3%, respectively. Thus, the $806.2 billion in capital produced pre tax profits of $152.4 in the first year following purchase and after tax profits of $91.1. It was assumed that, as in 1977, 45% of after tax profits were paid out in dividends. Retained earnings were added to equity capital and assumed reinvested to produce an 18.9% pre tax return and an 11.3% after tax return. This same procedure was then continued to the end of year three, at which time the investor sold his investment at the projected book value of $966.0.

The difference between end of year three equity and beginning year one equity of $159.8 billion was then taxed at various capital gains tax rates from 50% to 12.5%, and the compounds annual after tax capital gains or appreciation return calculated. At a 50% capital gains tax rate the compound annual appreciation return was 3.2%, at a 12.5% capital gains tax rate, 5.5%.

Dividends for years one, two and three were added and then taxed at rates ranging from 70% to 25%. After tax dividends were annualized and an average annual dividend return calculated. At a 70% dividend tax rate, annual average dividend return was 1.6%, at a 25% tax rate, 4.1%.

In Table I-b, purchase at market value, end of 1977, equal to beginning of year one, was assumed. In order to project market value at end of year three, a constant relationship between market value and book value end of 1977/beginning of year one and market value end of year three was assumed. Using this constant

relationship appreciation returns remain unchanged from Table I-a. Since market value at the end of 1977 was below book value, dividend returns are increased—at the 70% tax rate level from 1.6% to 2.0%, at a 25% tax rate from 4.1% to 4.9%.

TABLE 1-A.—NONFINANCIAL CORPORATIONS: 1977 EFFECTIVE TAX RATES PURCHASE AND SALE AT BOOK VALUE

[Dollar amounts in billions]

Financial data	1977	Projection— Year 1	Year 2	Year 3
Pretax profits	$141.8	$152.4	$161.8	$171.9
Taxes	$57.0	$61.3	$65.0	$69.1
Aftertax profits	$84.9	$91.1	$96.8	$102.8
Dividends	$38.2	$41.0	$43.6	$46.3
Retained earnings	$46.7	$50.1	$53.2	$56.5
Beginning-year equity	$750.5	$806.2	$856.3	$909.5
Return on equity pretax (percent)	18.9	19.8	18.9	18.9
Return on equity after tax (percent)	11.3	11.3	11.3	11.3
End-of-year equity	$806.2	$856.3	$909.5	$966.0
Taxes as percent of pretax profits	40.2	40.2	40.2	40.2
Dividends as percent of aftertax profits	45.0	45.0	45.0	45.0

Capital gains (appreciation) returns	Capital gains tax rates (percent) 50	35	25	12.5
Increase in equity beginning year 1 to end year 3	$159.8	$159.8	$159.8	$159.8
Increase in equity after tax	$79.9	$103.9	$119.8	$139.8
Yearend 3 equity after tax	$886.1	$910.1	$926.0	$946.0
Divided by beginning year 1 equity	$806.2	$806.2	$806.2	$806.2
Equals total appreciation return after tax	$1.0091	$1.1289	$1.1486	$1.1734
Compound annual aftertax appreciation return (percent)	3.2	4.1	4.7	5.5

Dividend returns	Dividend tax rates (percent) 70	50	25
Total dividends	$130.9	$130.9	$130.9
Dividends after taxes	$39.3	$65.5	$98.1
Divided by 3 equals average annual dividend after tax (percent)	13.1	21.8	32.7
Divided by beginning year 1 equity	$806.2	$806.2	$805.2
Equals average annual dividend return (percent)	1.6	2.7	4.1

Source: 1977 data, Department of Commerce, Federal Reserve Board Flow of Funds Account. Data for years 1 to 3 constructed projecting 1977 financial ratios.

TABLE I-B.—NONFINANCIAL CORPORATIONS: 1977 EFFECTIVE TAX RATES PURCHASE AND SALE AT MARKET VALUE

Capital gains (appreciation) returns	Capital gains tax rates (percent) 50	35	25	12.5
Yearend 3 market value (estimated at 82.9 percent of yearend 3 book value)	800.8	800.8	800.8	800.8
Minus beginning year 1 market value	668.3	668.3	668.3	668.3
Equals increase in market value beginning year 1 to end year 3	132.5	132.5	132.5	132.5
Increase in market value after tax	66.2	86.1	99.4	115.9
Yearend 3 market value after tax	734.5	754.4	767.7	784.2
Divided by beginning year 1 market value	668.3	668.3	668.3	668.3
Equals total appreciation return after tax	1.0991	1.1288	1.1487	1.1734
Compound annual appreciation return after tax (percent)	3.2	4.1	4.7	5.5

Dividend returns	Dividend tax rates (percent) 70	50	25
Total dividends	130.9	130.9	130.9
Dividends after tax	39.3	65.5	98.1
Divided by 3 equals average annual dividends after tax	13.1	21.8	32.7
Divided by beginning year 1 market value	668.3	668.3	668.3
Equals average annual dividend returns	2.0	3.3	4.9

TABLE II

Description and analysis

Table II incorporates in the projections the Administration's proposed reduction in the corporate tax rate. This was done by allocating to non-financial corporations 80% of the estimated reduction in federal tax revenues resulting from reducing the tax rate for all corporations. Treasury Department estimates for 1978, 1979 and 1980 were assigned respectively to years one, two and three. Projection procedures were similar to those in Table I, with the obvious exception, that as the effective tax rate declines, after tax return on equity increases. At the end of year three the equity value at $973.2 is $7.2 higher than in Table I. Pre tax appreciation is similarly higher. On the basis of an assumed constant 45% dividend payout ratio, total dividend payments are also higher by $5.7.

As a result, after tax returns from both appreciation and dividends are modestly higher. At the top tax rate of 50% tax on capital gains and 70% on dividends, the compound annual appreciation return would be increased to 3.3% from 3.2%.

In Table II–a, with purchase and sale at book value, dividend returns to the top tax bracket investor rise from 1.6% to 1.7% as a result of the cut in the corporate tax rate. In Table II–b, with purchase and sale at market value, dividend returns to the top tax bracket investor remain unchanged at 2.0% after the corporate tax rate cut. For the 25% tax bracket investor dividend returns are increased to 5.1% from 4.9%.

TABLE II-A.—NONFINANCIAL CORPORATIONS: INCORPORATING ADMINISTRATION'S PROPOSED REDUCTION IN CORPORATE TAX RATE PURCHASE AND SALE AT BOOK VALUE

[Dollar amounts in billions]

Financial data	1977	Projection— Year 1	Year 2	Year 3
Pretax profits	141.8	152.4	162.0	172.5
Taxes	57.0	60.3	60.4	62.6
Aftertax profits	84.9	92.1	101.6	109.9
Dividend	38.2	41.4	45.7	49.5
Retained earnings	46.7	50.7	55.9	60.4
Beginning year equity	750.5	806.2	856.9	912.8
Return on equity pretax (percent)	18.9	18.9	18.9	18.9
Return on equity after tax (percent)	11.3	11.4	11.9	12.0
End-of-year equity	806.2	856.9	912.8	973.2
Taxes as percent of pretax profits	40.2	39.6	37.3	36.3
Dividends as percent of aftertax profits	45.0	45.0	45.0	45.0

Capital gains (appreciation) returns	Capital gains tax rates (percent) 50	35	25	12.5
Increase in equity beginning year 1 to end year 3	167.0	167.0	167.0	167.0
Increase in equity after tax	83.5	108.5	125.2	146.1
Yearend 3 Equity After Tax	889.7	914.7	931.4	952.3
Divided by beginning year 1 equity	806.2	806.2	806.2	806.2
Equals total appreciation return after tax	1.1036	1.1346	1.1553	1.1812
Compound annual after tax appreciation return (percent)	3.3	4.3	4.9	5.7

Dividend returns	Dividend tax rates (percent) 70	50	25
Total dividends	136.6	136.6	136.6
Dividends after tax	41.9	68.3	102.4
Divided by 3 equals average annual dividend after tax	13.7	22.8	34.1
Divided by beginning year [1] equity	806.2	806.2	806.2
Equals average annual dividend return (percent)	1.7	2.8	4.2

Sources: 1977 data, Department of Commerce, Federal Reserve Board Flow of Funds Accounts, Department of Treasury, "The President's 1978 Tax Program." Data for years 1–3 constructed projecting 1977 financial ratios.

TABLE II-B.—NONFINANCIAL CORPORATIONS: INCORPORATING ADMINISTRATION'S PROPOSED REDUCTION IN CORPORATE TAX RATE PURCHASE AND SALE AT MARKET VALUE

Capital gains (appreciation) returns	Capital gains tax rates (percent) 50	35	25	12.5
Yearend 3 market value (estimated at 82.9 percent yearend book value)	806.8	806.8	806.8	806.8
Minus beginning year 1 market value	668.3	668.3	668.3	668.3
Equals increase in market value beginning year 1 to end year 3	138.5	138.5	138.5	138.5
Increase in market value after tax	69.2	90.0	103.9	121.2
Yearend 3 market value after tax	737.5	758.3	772.2	789.5
Divided by beginning year 1 market value	668.3	668.3	668.3	668.3
Equals total appreciation return after tax	1.1035	1.1347	1.1555	1.1814
Compound annual appreciation return after tax (percent)	3.3	4.3	4.9	5.7

Dividend returns	Dividend tax rates (percent) 70	50	25
Total dividends	136.6	136.6	136.6
Dividends after tax	41.0	68.3	102.4
Divided by 3 equals average annual dividends after tax	13.7	22.8	34.1
Divided by beginning year 1 market value	668.3	668.3	668.3
Equals average annual dividend return	2.0	3.4	5.1

TABLE III

Description and analysis

Table III compares the projected return from investment in non-financial corporations using the 1977 effective tax rate of 40.2% and the Administration's proposed cut in the corporate tax rate. The table also illustrates the effects of incorporating Congressman Ullman's dividend integration proposal at the 10% level. In incorporating the effects of dividend integration, we have assumed that all dividend paying corporations would have a sufficiently large tax base to provide a 10% gross-up and credit. Table III–a uses purchase and sale at book value, Table III–b at market.

The table also contains projected annual rates of return from possible investment alternatives, i.e., three-month Treasury bills, Bell Telephone bonds, and municipal bonds using Salomon Bros. estimates of bellwether issues.

Using the non-financial corporation data base one can compare after tax returns at various levels of taxation to assess the relative effects on investor returns resulting from: the Administration's corporate tax cut proposal, reducing the capital gains tax, lowering the marginal tax rate on dividends, and Congressman Ullman's proposal for reducing double taxation of dividends. These returns can then be compared with those currently projected for alternative investments.

TABLE III-A.—NONFINANCIAL CORPORATIONS: PROJECTED RETURN COMPARISONS, PURCHASE AND SALE AT BOOK VALUE

[In percent]

	Without dividend integration		With 10% dividend integration		Fixed income investment alternatives		
	1977 effective tax rates	Incorporating administration's corporate tax cut	1977 effective tax rates	Incorporating administration's corporate tax cut	3-month Treasury bills[1]	Bell system bonds[1]	Municipal bonds[1]
PRETAX RETURNS							
Capital gains return[2]	6.2	6.5	6.2	6.5			
Dividend/interest return[3]	5.4	5.6	5.4	5.6	6.7	9.0	6.6
Total return	11.6	12.1	11.6	12.1	6.7	9.0	6.6
AFTER TAX RETURNS							
50-percent capital gains/70-percent dividend tax:							
Capital gains return[2]	3.2	3.3	3.2	3.3			
Dividend /interest return[3]	1.6	1.7	1.8	1.9	2.0	2.7	6.6
Total return	4.8	5.0	5.0	5.2	2.0	2.7	6.6
35-percent capital gains/70-percent dividend tax:							
Capital gains return[2]	4.1	4.3	4.1	4.3			
Dividend/interest return[3]	1.6	1.7	1.8	1.9	2.0	2.7	6.6
Total return	5.7	6.0	5.9	6.2	2.0	2.7	6.6
25-percent capital gains/70 percent dividend tax:							
Capital gains return	4.7	4.9	4.7	4.9			
Dividend/interest return[3]	1.6	1.7	1.8	1.9	2.0	2.7	6.6
Total return	6.3	6.6	6.5	6.8	2.0	2.7	6.6
25-percent capital gains/50-percent dividend tax:							
Capital gains return[2]	4.7	4.9	4.7	4.9			
Dividend/interest return[3]	2.7	2.8	3.0	3.1	3.4	4.5	6.6
Total return	7.4	7.7	7.7	8.0	3.4	4.5	6.6
12.5-percent capital gains/25-percent dividend tax:							
Capital gains return[2]	5.5	5.7	5.5	5.7			
Dividend/interest return[3]	4.1	4.2	4.5	4.6	5.1	6.7	6.6
Total return	9.6	9.9	10.0	10.3	5.1	6.7	6.6

[1] Salomon Bros. estimates for bellwether issues, June 21, 1978.
[2] Compound annual rate of return.
[3] Average annual rate of return.

TABLE III-B.—NONFINANCIAL CORPORATIONS: PROJECTED RETURN COMPARISIONS, PURCHASE AND SALE AT MARKET VALUE

[In percent]

	Without dividend integration		With 10 percent dividend integration		Fixed income investment alternatives		
	1977 effective tax rates	Incorporating administration's corporate tax cut	1977 effective tax rates	Incorporating administration's corporate tax cut	3-month Treasury bills[1]	Bell system bonds[1]	Municipal bonds[1]
PRETAX RETURNS							
Capital gains return[2]	6.2	6.5	6.2	6.5			
Dividend/interest return[3]	5.4	5.6	5.4	5.6	6.7	9.0	6.6
Total return	11.6	12.1	11.6	12.1	6.7	9.0	6.6
AFTER TAX RETURNS							
50 percent capital gains/70 percent dividend tax:							
Capital gains return[2]	3.2	3.3	3.2	3.3			
Dividend/interest return[3]	2.0	2.0	2.2	2.2	2.0	2.7	6.6
Total return	5.2	5.3	5.4	5.5	2.0	2.7	6.6
35 percent capital gains/70 percent dividend tax:							
Capital gains return[2]	4.1	4.3	4.1	4.3			
Dividend/interest return[3]	2.0	2.0	2.2	2.2	2.0	2.7	6.6
Total return	6.1	6.3	6.3	6.5	2.0	2.7	6.6
25 percent capital gains/70 percent dividend tax:							
Capital gains return[2]	4.7	4.9	4.7	4.9			
Dividend/interest return[3]	2.0	2.0	2.2	2.2	2.0	2.7	6.6
Total return	6.7	6.9	6.9	7.1	2.0	2.7	6.6
25 percent capital gains/50 percent dividend tax:							
Capital gains return[2]	4.7	4.9	4.7	4.9			
Dividend/interest return[3]	3.3	3.4	3.6	3.7	3.4	4.5	6.6
Total return	8.0	8.3	8.3	8.6	3.4	4.5	6.6
12.5 percent capital gains/25 percent dividend tax:							
Capital gains return[2]	5.5	5.7	5.5	5.7			
Dividend/interest return[3]	4.9	5.1	5.4	5.6	5.1	6.7	6.6
Total return	10.4	10.8	10.9	11.3	5.1	6.7	6.6

[1] Salomon Bros. estimates for bellwether issues June 21 1978.
[2] Average annual rate of return.
[3] Compound annual rate of return.

TABLE IV.—CORPORATE MODELS DATA BASE

Description and analysis

In Table IV two corporate models are constructed to enable isolation and examination of the effects of reducing the corporate tax rate from 48% to 46% or 44%. Table IV projects a 48% corporate rate.

The corporate models use as a starting point the 11.3% after tax return on equity of nonfinancial corporations in 1977. However, for non-financial corporation that return was after a 40.2% effective tax rate. In order to isolate and examine the effects of reducing the corporate tax rate from 48% to 44% in the corporate models, it was assumed that return was achieved after a 48% tax rate. Thus, the assumed pre tax return on equity was increased to 21.7%. (Increasing the pre tax rate of return avoided a possible downward bias in the return projections.)

In Model A it was assumed that 45% of after tax profits were paid out as dividends, as was the case for non-financial corporations in 1977. Retained earnings were assumed to be reinvested to sustain a 21.7% pre tax return on equity. As in the previous tables it was assumed that purchase was made at the beginning of year one and sale at the end of year three. The corporate model uses book value as the purchase and sale price. (The beginning of year one book value was derived from the year one after tax profits base of 100, i.e., 100=11.3% of 885.0).

The capital gain was then taxed at varying rates and the compound annual appreciation rate determined. Dividends were treated as in Tables I and II—added over the three year period, taxed at the various tax rates and the average annual rate of dividend return on beginning of year one equity calculated.

Model B was constructed to simulate a real world situation. Here, as in some corporations, it was assumed that no dividends were paid. Therefore, all after tax profits were reinvested to produce a 21.7% pre tax return on equity value. With all net earnings reinvested, book value increases more rapidly, and, accordingly, the compound annual after tax appreciation return for the period of ownership is higher. Of course, there is no dividend return.

TABLE IV.—CORPORATE MODEL: 48 PERCENT TAX RATE INDEXED TO AFTER-TAX PROFITS YEAR 1

Financial data	Model A: 45 percent dividend payout (projection)			Model B: No dividend (projection)		
	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3
Pretax profits	$192.3	$204.0	$216.7	$192.3	$213.7	$237.9
Taxes	92.3	97.9	104.0	92.3	102.4	114.0
After-tax profits	100.0	106.2	112.7	100.0	111.3	123.9
Dividend	45.0	47.8	50.7			
Retained earnings	55.0	58.4	62.0	100.0	111.3	123.9
Beginning year equity	885.0	940.0	998.4	885.0	985.0	1,096.3
Return on equity pretax (percent)	(21.7)	(21.7)	(21.7)	(21.7)	(21.7)	(21.7)
Return on equity after tax (percent)	(11.3)	(11.3)	(11.3)	(11.3)	(11.3)	(11.3)
End of year equity	940.0	998.4	1,060.4	985.0	1,096.3	1,220.2

Capital gains (appreciation) returns	Capital gains tax rates (percent)				Capital gains tax rates (percent)			
	50	35	25	12.5	50	35	25	12.5
Increase in equity beginning year 1 to end year 3	175.4	175.4	175.4	175.4	335.2	335.2	335.2	335.2
Increase in equity after tax	87.7	114.0	131.5	153.5	167.6	217.9	251.4	293.3
Year end 3 equity after tax	972.7	999.0	1,016.5	1,038.5	1,052.6	1,102.9	1,136.4	1,178.3
Divided by beginning year 1 equity	885.0	885.0	885.0	885.0	885.0	885.0	885.0	885.0
Equals total appreciation return after tax	1.09910	1.12882	1.14859	1.17345	1.18937	1.24621	1.28407	1.33141
Compound annual after-tax appreciation return	3.2	4.1	4.7	5.5	6.0	7.6	8.7	10.0

Dividend returns	Dividend tax rates (percent)		
	70	50	25
Total dividends	143.5	143.5	143.5
Dividends after tax	43.1	71.8	107.6
Divided by 3 equals average annual dividend after tax	14.4	23.9	35.9
Divided by beginning year 1 equity	885.0	885.0	885.0
Equals average annual dividend return	1.6	2.7	4.1

TABLE V

Description and analysis

Table V illustrates the effects on investor returns of reducing the corporate tax rate from 48% to 46%, while holding pre tax return on equity constant at 21.7% and, in Model A, maintaining the dividend payout ratio at 45%. As is shown, reducing the corporate tax rate from 48% to 46% increases after tax profits in year one from the base 100 to 103.8 or by 3.8%. The after tax return in equity is raised from 11.3% to 11.7%.

At the 50% tax rate for capital gains the compound annual appreciation return is increased to 3.3% from 3.2%. At the 70% marginal tax rate on dividends, average dividend return rises from 1.6% to 1.7%.

Model B illustrates the effects if no dividends are paid. Here the compound annual appreciation return after a 50% tax rate would rise from 6.0% to 6.2%.

TABLE V.—CORPORATE MODEL: 46 PERCENT CORPORATE TAX RATE INDEXED TO AFTER-TAX PROFITS YEAR 1 AT 48 PERCENT CORPORATE TAX RATE

Financial data	Model A: 45 percent dividend payout (projection)			Model B: No dividend (projection)		
	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3
Pretax profits	$192.3	$204.4	$217.6	$192.3	$214.6	$239.7
Taxes	88.5	94.0	100.1	88.5	98.9	110.5
After-tax profits	103.8	110.4	117.5	103.8	115.7	129.2
Dividend	46.7	49.7	52.9			
Retained earnings	57.1	60.7	64.6	103.8	115.7	129.2
Beginning year equity	885.0	942.1	1,002.8	885.0	988.8	1,104.5
Return on equity pretax (percent)	(21.7)	(21.7)	(21.7)	(21.7)	(21.7)	(21.7)
Return on equity after tax (percent)	(11.7)	(11.7)	(11.7)	(11.7)	(11.7	(11.7)
End of year equity	942.1	1,002.8	1,067.4	988.8	1,104.5)	1,233.7

Capital gains (appreciation) returns	Capital gains tax rates (percent)				Capital gains tax rates (percent)			
	50	35	25	12.5	50	35	25	12.5
Increase in equity beginning year 1 to end year 3	182.4	182.4	182.4	182.4	348.7	348.7	348.7	348.7
Increase in equity after tax	91.2	118.6	136.8	159.6	174.4	226.7	261.5	305.1
Year end 3 equity after tax	976.2	1,003.6	1,021.8	1,044.6	1,059.4	1,111.7	1,146.5	1,190.1
Divided by beginning year 1 equity	885.0	885.0	885.0	885.0	885.0	885.0	885.0	885.0
Equals total appreciation return after tax	1.10305	1.13401	1.15457	1.18034	1.19706	1.25616	1.29548	1.34475
Compound annual after-tax appreciation return	3.3	4.3	4.9	5.7	6.2	7.9	9.0	10.4

Dividend returns	Dividend tax rates (percent)		
	70	50	25
Total dividends	149.3	149.3	149.3
Dividends after tax	44.8	74.7	112.0
Divided by 3 equals average annual dividend after tax	14.9	24.9	37.3
Divided by beginning year 1 equity	885.0	885.0	885.0
Equals average annual dividend return	1.7	2.8	4.2

TABLE VI

Description and analysis

Table VI illustrates the results of reducing the corporate tax rate to 44% while holding the pre tax return on equity constant at 21.7%.

After tax profits in year one become 107.7, a 7.7% increase over the after tax profit of 100 with a corporate tax rate of 48%. Accordingly, return on equity capital rises to 12.2% in contrast to the 11.3% return at a 48% corporate tax rate. In Model A the compound annual appreciation return after a 50% capital gains tax rate is 3.5%. Average annual dividend return after a 70% marginal tax rate is 1.8%.

In Model B, where all earnings are reinvested, the compound annual appreciation return would be 6.4% after a 50% capital gains tax vs. 6.0% at a 48% corporate tax rate.

TABLE VI.—CORPORATE MODEL: 44 PERCENT CORPORATE TAX RATE INDEXED TO AFTER-TAX PROFITS YEAR 1 AT 48 PERCENT CORPORATE TAX RATE

Financial data	Model A: 45 percent dividend payout (projection)			Model B: No dividend (projection)		
	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3
Pretax profits	$192.3	$204.9	$218.6	$192.3	$215.4	$241.7
Taxes	84.6	89.7	95.7	84.6	94.3	105.8
After-tax profits	107.7	115.2	122.9	197.7	121.1	135.9
Dividend	48.5	51.8	55.3			
Retained earnings	59.2	63.4	67.6	107.7	121.1	135.9
Beginning year equity	885.0	944.2	1,007.6	885.0	992.7	1,113.8
Return on equity pretax (percent)	(21.7)	(21.7)	(21.7)	(21.7)	(21.7)	(21.7)
Return on equity after tax (percent)	(12.2)	(12.2)	(12.2)	(12.2)	(12.2)	(12.2)
End of year equity	944.2	1,007.6	1,075.2	992.7	1,113.8	1,249.7

Capital gains (appreciation) returns	Capital gains tax rates (percent)				Capital gains tax rates (percent)			
	50	35	25	12.5	50	35	25	12.5
Increase in equity beginning year 1 to end year 3	190.2	190.2	190.2	190.2	364.7	364.7	364.7	364.7
Increase in equity after tax	95.1	123.6	142.6	166.4	182.4	237.1	273.5	319.1
Year end 3 equity after tax	980.1	1008.6	1027.6	1051.5	1067.4	1122.1	1158.5	1204.1
Divided by beginning year 1 equity	885.0	885.0	885.0	885.0	885.0	885.0	885.0	885.0
Equals total appreciation return after tax	1.10745	1.13966	1.16113	1.18802	1.20610	1.26791	1.30904	1.36056
Compound annual after-tax appreciation return	3.5	4.5	5.1	5.9	6.4	8.3	9.2	10.8

Dividend returns	Dividend tax rates (percent)		
	70	50	25
Total dividends	155.6	155.6	155.6
Dividends after tax	46.7	77.8	116.7
Divided by 3 equals average annual dividend after tax	15.6	25.9	38.9
Divided by beginning year 1 equity	885.0	885.0	885.0
Equals average annual dividend return	1.8	2.9	4.4

TABLES VII AND VIII

Description and analysis

Tables VII and VIII compare the returns for the corporate models at varying corporate tax rates and individual tax rates for capital gains and dividends. Table VII illustrates the effects without Congressman Ullman's 10% dividend integration proposal. Table VIII includes the approximate effects of 10% dividend integration.

Tables VII and VIII also list estimated returns for three selected investment alternatives—three-month Treasury bills, Bell System corporate bonds, and municipal bonds.

The tables provide an easy system for comparing the effects of various tax proposals on investor returns. By moving down and across the columns it is possible to determine the theoretical effects of a reduction in the corporate tax rate compared to a reduction in the capital gains or dividend tax rates.

As the tables show, at a 48% corporate tax rate total annual returns from our corporate Model A would be 4.8% to the top tax bracket investor. Reducing the corporate tax rate to 44% would increase the total annual return to 5.3%. Reducing the capital gains tax rate maximum to 25% would increase total return for this investor to 6.3%. Dividend integration would increase returns modestly.

For investors paying a 25% dividend tax rate and a 12.5% capital gains tax rate, reducing the corporate tax rate from 48% to 44% would increase his total return in Model A from 9.6% to 10.3%, in Model B from 10.0% to 10.8%. At the 48% corporate tax rate level, dividend integration would raise returns on Model A from 9.6% to 10.0%, and at the 44% corporate tax rate level from 10.3% to 10.7%.

TABLE VII.—CORPORATE MODELS: PROJECTED RETURN COMPARISONS

[In percent]

	Equity investment						Fixed-income investments [1]		
	48 percent corporate tax		46 percent corporate tax		44 percent corporate tax				
	45 percent dividend	No dividend	45 percent dividend	No dividend	45 percent dividend	No dividend	3-mo Treasury bills	Bell system bonds	Municipal bonds
Pre tax:									
Capital gains return [2]	6.2	11.3	6.4	11.7	6.7	12.2			
Dividend/interest return [3]	5.4		5.6		5.9		6.7	9.0	6.6
Total return	11.6	11.3	12.0	11.7	12.6	12.2	6.7	9.0	6.6
After tax:									
50 percent capital gains/70 percent dividend tax:									
Capital gains return [2]	3.2	6.0	3.3	6.2	3.5	6.4			
Dividend/interest return [3]	1.6		1.7		1.8		2.0	2.7	6.6
Total return	4.8	6.0	5.0	6.2	5.3	6.4	2.0	2.7	6.6
35 percent capital gains/70 percent dividend tax:									
Capital gains return [2]	4.1	7.6	4.3	7.9	4.5	8.3			
Dividend/interest return [3]	1.6		1.7		1.8		2.0	2.7	6.6
Total return	5.7	7.6	6.0	7.9	6.3	8.3	2.0	2.7	6.6
35 percent capital gains/70 percent dividend tax:									
Capital gains return [2]	4.7	8.7	4.9	9.0	5.1	9.2			
Dividend/interest return [3]	1.6		1.7		1.8		2.0	2.7	6.6
Total return	6.3	8.7	6.6	9.0	6.9	9.2	2.0	2.7	6.6
25 percent capital gains/50 percent dividend tax:									
Capital gains return [2]	4.7	8.7	4.9	9.0	5.1	9.2			
Dividend/interest return [3]	2.7		2.8		2.9		3.4	4.5	6.6
Total return	7.4	8.7	7.7	9.0	8.0	9.2	3.4	4.5	6.6
12.5 percent capital gains/25 percent dividend tax:									
Capital gains return [2]	5.5	10.0	5.7	10.4	5.9	10.8			
Dividend/interest return [3]	4.1		4.2		4.4		5.1	6.7	6.6
Total return	9.6	10.0	9.9	10.4	10.3	10.8	5.1	6.7	6.6

[1] Salomon Bros. estimates for bellwether issues, June 21, 1978.
[2] Compound annual rate of return.
[3] Average annual rate of return.

TABLE VIII.—CORPORATE MODELS: PROJECTED RETURN COMPARISONS WITH 10 PERCENT DIVIDEND INTEGRATION

[In percent]

	Equity investment						Fixed-income investments [1]		
	48 percent corporate tax		46 percent corporate tax		44 percent corporate tax				
	45 percent dividend	No dividend	45 percent dividend	No dividend	45 percent dividend	No dividend	3-mo Treasury bills	Bell system bonds	Municipal bonds
Pretax returns:									
Capital gains return [2]	6.2	11.3	6.4	11.7	6.7	12.2			
Dividend/interest return [3]	5.4		5.6		5.9		6.7	9.0	6.6
Total return	11.6	11.3	12.0	11.7	12.6	12.2	6.7	9.0	6.6
After tax with 10 percent dividend integration:									
50 percent capital gains/70 percent dividend tax:									
Capital gains return [2]	3.2	6.0	3.3	6.2	3.5	6.4			
Dividend/interest return [3]	1.8		1.9		2.0		2.0	2.7	6.6
Total return	5.0	6.0	5.2	6.2	5.5	6.4	2.0	2.7	6.6
35 percent capital gains/70 percent dividend tax:									
Capital gains return [2]	4.1	7.6	4.3	7.9	4.5	8.3			
Dividend/interest return [3]	1.8		1.9		2.0		2.0	2.7	6.6
Total return	5.9	7.6	6.2	7.9	6.5	8.3	2.0	2.7	6.6
25 percent capital gains/70 percent dividend tax:									
Capital gains return [2]	4.7	8.7	4.9	9.0	5.1	9.2			
Dividend/interest return [3]	1.8		1.9		2.0		2.0	2.7	6.6
Total return	6.5	8.7	6.8	9.0	7.1	9.2	2.0	2.7	6.6
25 percent capital gains/50 percent dividend tax:									
Capital gains return [2]	4.7	8.7	4.9	9.0	5.1	9.2			
Dividend/interest return [3]	3.0		3.1		3.2		3.4	4.5	6.6
Total return	7.7	8.7	8.0	9.0	8.3	9.2	3.4	4.5	6.6
12.5 percent capital gains/25 percent dividend tax:									
Capital gains return [2]	5.5	10.0	5.7	10.4	5.9	10.8			
Dividend/interest return [3]	4.5		4.6		4.8		5.1	6.7	6.6
Total return	10.0	10.0	10.3	10.4	10.7	10.8	5.1	6.7	6.6

[1] Salomon Bros. estimates for bellwether issues, June 21, 1978.
[2] Compound annual rate of return.
[3] Average annual rate of return.

TABLE IX—STANDARD & POOR'S 400 LIST DATA BASE

Description and analysis

Table IX uses as a basis for return projections the 1977 experience parameters for Standard & Poor's list of 400 of the nation's largest corporations. These experience parameters were then converted into an index, using after tax earnings in year one as a base of 100. The procedures followed were similar to those used for the non-financial corporations tables and the corporate model tables. In Table IX-a, purchase was made at equity value beginning of year one, with sale at equity value at end of year three. In Table IX-b, purchase was made a market value. To project market value at end of year three a constant relationship between book value beginning of year one/market value beginning of year one and market value end of year three/book value end of year three was assumed.

Dividend payout was held constant at 44.2% of after tax profits, the same payout ratio as in 1977. It was also assumed that retained earnings were reinvested to produce pre tax and after tax rates of return on equity similar to the experience in 1977. It was further assumed there was no other equity financing and that debt capital increased in line with the internal growth in equity capital.

It is important to note these are not formal economic estimates if projected earnings for the S & P 400. Such projections are beyond the scope of this analysis. Use of the S & P 400 data is intended to provide a third basis for estimating rate of return parameters. However, the projected gains shown here for years one and two do, in fact, reside within the range of S & P 400 estimates for 1978 and 1979 made by stock market analysts.

Table IX-a shows that with purchase and sale at book value the compound annual appreciation return for top tax bracket investors would be 4.3%. Dividend return after a 70% tax rate would be 2.1%, for a combined after tax return of 6.4%. For the investor paying a 12.5% capital gains tax rate the appreciation return would be 7.4%. Dividend returns after tax would be 5.4% at a 25% dividend tax rate.

Table IX-b demonstrates returns based on purchase and sale at market value. Appreciation returns are the same as in Table IX-a. However, because market value is higher than book, dividend returns are reduced, at a 70% dividend tax rate from 2.1% to 1.7%, at the 25% tax rate from 5.4% to 4.4%.

TABLE IX-A.—STANDARD & POOR'S LIST OF 400 CORPORATIONS: 1977 EFFECTIVE TAX RATE INDEXED TO AFTER-TAX PROFITS, YEAR 1, PURCHASE AND SALE AT BOOK VALUE

Financial Data	Year 1	Year 2	Year 3
Pretax profits	194.7	211.0	228.5
Taxes	94.9	102.8	111.3
Aferttax Profits	100.0	108.4	117.4
Dividends	44.2	47.9	52.0
Retained earnings	55.9	60.5	65.5
Beginning year equity	671.5	727.5	788.0
Return on equity pretax (percent)	29.0	29.0	29.0
Return on equity after tax (percent)	14.9	14.9	14.9
End of year equity	727.5	788.0	853.5
Taxes as percent of pretax profits	48.7	48.7	48.7
Dividends as percent of aftertax profits	44.2	44.2	44.2

Capital gains (appreciation) returns	Capital gains tax rates (percent) 50	35	25	12.5
Increase in equity, beginning year 1 to end year 3	182.0	182.0	182.0	182.0
Increase in equity after tax	91.0	118.3	136.5	159.2
Year end 3 equity after tax	762.5	789.8	808.0	830.7
Divided by beginning year 1 equity	671.5	671.5	671.5	671.5
Equals total appreciation return after tax	1.1355	1.1762	1.2033	1.2371
Compound annual after tax appreciation return (percent)	4.3	5.6	6.4	7.4

Dividend returns	Dividend tax rates (percent) 70	50	25
Total dividends	144.1	144.1	144.1
Dividends after tax	43.2	72.0	108.1
Divided by 3 equals average annual dividend after tax	14.4	24.0	26.0
Divided by beginning year equity	671.5	671.5	671.5
Equals average annual dividend return (percent)	2.1	3.6	5.4

Source: Based on preliminary 1977 S. & P. 400 Index data.

TABLE IX-B.—STANDARD & POOR'S LIST OF 400 CORPORATIONS: 1977 EFFECTIVE TAX RATE INDEXED TO AFTER TAX PROFITS, YEAR 1, PURCHASE AND SALE AT MARKET VALUE

Capital gains (appreciation) returns	Capital gains tax rates (percent)			
	50	35	25	12.5
Year end 3 market value (projected at 1.23 times year end 3 book value)	1,049.7	1,049.7	1,049.7	1,049.7
Minus beginning year 1 market value (1.23 times 1977 book)	825.9	825.9	825.9	825.9
Equals increase in market value Beginning year 1 to end year 3	223.8	223.8	223.8	223.8
Increase in market value after tax	111.9	145.5	167.8	195.8
Year end 3 market value after tax	939.4	971.4	993.7	1,021.7
Divided by beginning year 1 market value	825.9	825.9	825.9	825.9
Equals total appreciation return after tax	1.1374	1.1762	1.2032	1.2371
Compound annual after tax appreciation return (percent)	4.3	5.6	6.4	7.4

Dividend returns	Dividend tax rates (percent)		
	70	50	25
Total dividend	144.1	144.1	144.1
Dividends after tax	43.2	72.0	108.1
Divided by 3 equals average annual dividend after tax	14.4	24.0	36.0
Divided by beginning year 1 market value	825.9	825.9	825.9
Equals average annual dividend return (percent)	1.7	2.9	4.4

TABLE X

Description and analysis

Tables X-a and b show projected returns for the S & P 400 list incorporating the effects of the Administration's proposed reduction in the corporate tax rate. The Treasury Department's estimated reductions in corporate income tax revenues resulting from reducing the tax rate for all corporations in 1978, 1979 and 1980 were allocated respectively to years one, two and three.

Projection procedures used were similar to those for Tables IX-a and b, with the obvious exception that, as the effective tax rate declines, the after tax return on equity increases and at the end of year three the equity value is higher than in Table IX.

Table X-a uses book value as the purchase and sale price. Incorporating the effects of the Administration's proposed reduction in the corporate tax rate raises the compound annual rate of appreciation return on book value by less than one half of a percentage point after tax. Assuming a constant 44.2% dividend payout ratio with the corporate tax rate reduced, dividend returns would be increased two to three-tenths of a percentage point after tax.

Table X-b uses market value as the purchase and sale price. Once again, in order to establish market value at the end of the holding period it was assumed that at the end of year three market value bore the same relationship to book value as it did at the beginning of year one. As was shown in earlier projections, using constant assumptions, appreciation return based on market value is the same as that based on book value. However, since market value of the S & P 400 was higher than book value at the end of 1977/beginning of year one, dividend returns are lower, specifically, 1.9% after a 70% tax rate compared to a 2.3% return based on purchase at book value. To the investor paying a 25% tax rate on dividends, annual dividend return is reduced from 5.7% to 4.6%.

TABLE X-A.—STANDARD & POOR'S LIST OF 400 CORPORATIONS: INCORPORATING ADMINISTRATION'S PROPOSED REDUCTION IN CORPORATE TAX RATE INDEXED TO AFTERTAX PROFITS, YEAR 1, TABLE IX, PURCHASE AND SALE AT BOOK VALUE

Financial Data	Year 1	Year 2	Year 3
Pretax profits	194.7	211.0	229.9
Taxes	93.2	95.4	101.4
Aftertax profits	101.5	115.8	128.5
Dividends	44.9	51.1	56.7
Retained earnings	56.6	64.6	71.7
Beginning year equity	671.5	728.1	792.8
Return on equity pretax (percent)	29.0	29.0	29.0
Return on equity after tax (percent)	15.1	15.9	16.2
End-of-year equity	728.1	792.8	864.5
Taxes as a percent of pretax profits	47.9	45.2	44.1
Dividends as a percent of aftertax profits	44.2	44.2	44.2

Capital gains (appreciation) returns	Capital gains tax rates (percent)			
	50	35	25	12.5
Increase in equity, beginning year 1 to end year 3	193.0	193.0	193.0	193.0
Increase in equity after tax	96.5	125.4	144.8	168.9
Year end 3 equity after tax	768.0	796.9	816.3	840.4
Divided by beginning year 1 equity	671.5	671.5	671.5	671.5
Equals total appreciation return after tax	1.1437	1.1867	1.2156	1.2515
Compound annual aftertax appreciation return (percent)	4.6	5.9	6.7	7.8

Dividend returns	Dividend tax rates (percent)		
	70	50	25
Total dividends	152.7	152.7	152.7
Dividends after tax	45.8	76.4	114.5
Divided by 3 equals average annual dividend after tax	15.3	25.4	38.2
Divided by beginning year equity	671.5	671.5	671.5
Equals average annual dividend return (percent)	2.3	3.8	5.7

Source: Based on preliminary 1977 S. & P. 400 Index data.

TABLE X-B.—STANDARD & POOR'S LIST OF 400 CORPORATIONS: INCORPORATING ADMINISTRATIONS PROPOSED REDUCTION IN CORPORATE TAX RATE INDEXED TO AFTER TAX PROFITS, YEAR 1, TABLE IX, PURCHASE AND SALE AT MARKET VALUE

Capital gains (appreciation) returns	Capital gains tax rates (percent)			
	50	35	25	12.5
Year end 3 market value (Projected at 1.23 times year end 3 book value)	1,063.3	1,063.3	1,063.3	1,063.3
Minus beginning year 1 market value (1.23 times 1977 book)	825.9	825.9	825.9	825.9
Equals increase in market value beginning year 1 to end year 3	237.4	237.4	237.4	237.4
Increase in market value after tax	118.7	154.3	178.0	207.7
Year end 3 market value after tax	944.6	980.2	1,004.0	1,033.6
Divided by beginning year 1 market value	825.9	825.9	825.9	825.9
Equals total appreciation return after tax	1.1437	1.1868	1.2156	1.2515
Compound annual after tax appreciation return (percent)	4.6	5.9	6.7	7.8

Dividend returns	Dividend tax rates (percent)		
	70	50	25
Total dividends	152.7	152.7	152.7
Dividends after tax	45.8	76.4	114.5
Divided by 3 equals average annual dividend after tax	15.3	25.4	38.2
Divided by beginning year 1 market value	825.9	825.9	825.9
Equals average annual dividend return	1.9	3.1	4.6

TABLE XI

Description and analysis

Table XI illustrates return comparisons using as a data base the 1977 financial statement ratios of the S&P list of 400 corporations. Table XI-b shows returns based on book value purchase and sale comparing returns at 1977 effective corporate tax rates, incorporating the effects of the Administration's proposed cut in the corporate tax rate and with and without a 10% rate of dividend integration.

Table XI-b uses market value end of 1977 as a basis for establishing purchase price. Since market value was higher than book value, dividend returns are lower. Appreciation returns remain the same, since in establishing sale price at market a constant ratio of market to book was assumed.

Each table compares the projected return with three alternative investment opportunities: three month Treasury bills, Bell System bonds and municipal bonds. In comparing rates of return among the fixed income alternatives and the S & P 400 data base it is important to keep in mind that these fixed income investments are generally perceived to carry lower risk than equity investments.

Both tables show that the greatest impact on after tax rates of return would result from reducing the capital gains tax rate. Both dividend integration and reducing the corporate tax rate would have only modest effect on investor rates of return.

It should be noted that in applying 10% dividend integration it was assumed that all S & P 400 corporations would have a tax base sufficient to support the full 10% gross up and credit. While 1977 data are incomplete, this was not the case in 1976. Presumably, not all 400 corporations would provide a full gross up and credit based on 1977 results. Accordingly, the effects of dividend integration would be overstated.

TABLE XI-A.—STANDARD & POOR'S PROJECTED RETURN COMPARISONS, PURCHASE AND SALE BOOK VALUE

[In percent]

	Without dividend integration		With 10% dividend integration		Fixed income investment alternatives		
	1977 effective tax rates	Incorporating administration's corporate tax cut	1977 effective tax rates	Incorporating administration's corporate tax cut	3-month Treasury bills [1]	Bell system bonds [1]	Municipal bonds [1]
PRETAX RETURNS							
Capital gains return [2]	8.1	8.8	8.3	8.8			
Dividend/interest return [3]	7.2	7.6	7.2	7.6	6.7	9.0	6.6
Total return	15.5	16.4	15.5	16.4	6.7	9.0	6.6
AFTER TAX RETURNS							
50-percent capital gains/70-percent dividend tax:							
Capital gains return [2]	4.3	4.6	4.3	4.6			
Dividend/return [3]	2.1	2.3	2.3	2.5	2.0	2.7	6.6
Total return	6.4	6.9	6.6	7.1	2.0	2.7	6.6
35-percent capital gains/70-percent dividend tax:							
Capital gains return [2]	5.6	5.9	5.6	5.9			
Dividend/interest return [3]	2.1	2.3	2.3	2.5	2.0	2.7	6 6
Total return	7.7	8.2	7.9	8.4	2.0	2.7	6.6
25-percent capital gains/70 percent dividend tax:							
Capital gains return [2]	6.4	6.7	6.4	6.7			
Dividend/interest return [3]	2.1	2.3	2.3	2.5	2.0	2.7	6.6
Total return	8.5	9.0	8.7	9.2	2.0	2.7	6.6
25-percent capital gains/50-percent dividend tax:							
Capital gains return [2]	6.4	6.7	6.4	4.7			
Dividend/interest return [3]	3.6	3.8	4.0	4.2	3.4	4.5	6.6
Total return	10.0	10.5	10.4	10.9	3.4	4.5	6.6
12.5-percent capital gains/25-percent dividend tax:							
Capital gains return [2]	7.4	7.8	7.4	7.8			
Dividend/interest return [3]	5.4	5.7	5.9	6.3	5.1	6.7	6.6
Total return	12.8	13.5	13.3	14.1	5.1	6.7	6.6

[1] Salomon Bro. estimates for bellwether issues, June 21, 1978.
[2] Compound annual rate of return.
[3] Average annual rate of return.

TABLE XI-B.—STANDARD & POOR'S LIST OF 400 CORPORATIONS: PROJECTED RETURN COMPARISONS, PURCHASE AND SALE AT MARKET VALUE

[In percent]

	Without dividend integration		With 10 percent dividend integration		Fixed income investment alternatives		
	1977 effective tax rates	Incorporating administration's corporate tax cut	1977 effective tax rates	Incorporating administration's corporate tax cut	3-month Treasury bills[1]	Bell system bonds[1]	Municipal bonds[1]
PRETAX RETURNS							
Capital gains return[2]	8.3	8.8	8.3	8.8			
Dividend/interest return[3]	5.8	6.2	5.8	6.2	6.7	9.0	6.6
Total return	14.1	15.0	14.1	15.0	6.7	9.0	6.6
AFTER TAX RETURNS							
50 percent capital gains/70-percent dividend tax:							
Capital gains return[2]	4.3	4.6	4.3	4.6			
Divident/interest return[3]	1.7	1.9	1.9	2.1	2.0	2.7	6.6
Total return	6.1	6.5	6.2	6.7	2.0	2.7	6.6
35-percent capital gains/70-percent dividend tax:							
Capital gains return[2]	5.6	5.9	5.6	5.9			
Dividend/interest return[3]	1.7	1.9	1.9	2.1	2.0	2.7	6.6
Total return	7.3	7.8	7.5	8.0	2.0	2.7	6.6
25-percent capital gains/70-percent dividend tax:							
Capital gains return[2]	6.4	6.7	6.4	6.7			
Dividend/interest return[3]	1.7	1.9	1.9	2.1	2.0	2.7	6.6
Total return	8.1	8.6	8.3	8.8	2.0	2.7	6.6
25-percent capital gains/50-percent dividend tax:							
Capital gains return[2]	6.4	7.8	6.4	7.8			
Divident/interest return[3]	2.9	3.1	3.2	3.4	3.4	4.5	6.6
Total return	9.3	10.9	9.6	11.2	3.4	4.5	6.6
12.5-percent capital gains/25-percent dividend tax:							
Capital gains return[2]	7.4	7.8	7.4	7.8			
Dividend/interest return[3]	4.4	4.6	4.8	5.1	51.	6.7	6.6
Total return	11.8	12.4	12.2	12.9	5.1	6.7	6.6

[1] Salomon Bros. estimates for bellwether issues, June 21, 1978.
[2] Compound annual rate of return.
[3] Average annual rate of return.

TABLES XII, XIII, XIV—HISTORICAL DATA

Description and analysis

Tables XII, XIII, and XIV provide data for analysis of historic returns. Table XII contains financial statement data for non-financial corporations for the period 1965–1977. Tables XIII and XIV calculate compound annual appreciation returns (including speculation returns) for nonfinancial corporations and for the Standard & Poor's 500 Stock Index Composite. (The 400 Index was just recently introduced, therefore historical data do not exist.) In Table XIII compound annual appreciation returns are shown for periods ending in 1977 and extending back to 1947. For example, purchases made at market value, 1947 and sold at market value, 1977 would have realized a pre tax compound annual appreciation return of 7.1%. The compound annual appreciation return between 1967 and 1977 was only 0.3%, pre tax.

In Table XIV compound annual appreciation returns for the S & P 500 Index are shown for periods extending back to 1927. The data show that purchase made in 1927 and sold in 1977 would have realized a pre tax compound annual return of 3.4%. For the 1947–1977 period the pre tax compound annual rate of appreciation return was 6.3%. For the most recent ten year period, 1967–1977, the return was negative.

TABLE XII.—NONFINANCIAL CORPORATIONS: BOOK VALUE PROFITS 1965–77, CURRENT DOLLARS

Year	Book value beginning of year [1] (billions)	Profits before tax [2] (billions)	Profits before tax as a percent of book (2)÷(1)	Profits after tax [2] (billions)	Profits after tax as a percent of book (4)÷(1)	Dividends (billions)	Dividend payout ratio (6)÷(4)	Retained earnings (billions)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1965	$337.0	$64.4	19.1	$37.2	11.0	$21.0	56.5	$16.2
1966	359.0	69.5	19.4	40.0	11.1	18.1	45.2	21.9
1967	381.8	65.4	17.1	37.7	9.9	18.9	50.1	18.8
1968	409.2	71.9	17.6	38.3	9.4	20.7	54.0	17.6
1969	430.4	68.4	15.9	35.1	8.2	20.7	59.0	14.4
1970	460.2	55.1	12.0	27.9	6.1	19.9	71.3	8.0
1971	478.8	63.3	13.2	33.3	7.0	20.0	60.0	13.3
1972	503.9	75.9	15.2	42.4	8.4	21.7	51.2	20.7
1973	534.5	92.8	17.4	53.1	9.9	23.9	45.0	29.2
1974	572.2	102.8	18.0	60.2	10.5	26.0	43.2	34.2
1975	621.6	102.3	16.5	61.6	9.9	29.0	47.1	32.6
1976	679.6	130.6	19.2	76.9	11.3	32.4	42.1	44.5
1977	750.5	141.8	18.9	84.9	11.3	38.2	45.0	46.7
1978 p	806.2							

[1] Federal Reserve Board flow of funds accounts, end of prior year book value, 1978 figure an unpublished preliminary estimate.
[2] Department of Commerce.

TABLE XIII.—NONFINANCIAL CORPORATIONS CAPITAL GAINS RETURNS, 1947–77

Year	Book value (billions)	Periods		Compound annual appreciation returns (percent)				
					Capital gains tax rates			
		Beginning	Ending	Pretax	50	35	25	12.5
Purchase and sale at book value:								
1947	$108.142	1947	1977	6.9	4.9	5.6	6.1	6.5
1957	238.502	1957	1977	6.3	4.0	4.8	5.2	5.8
1967	409.204	1967	1977	7.0	4.0	5.0	5.6	6.3
1968	430.432	1968	1977	7.2	4.1	5.1	5.8	6.5
1969	460.170	1969	1977	7.3	4.1	5.1	5.8	6.5
1970	478.752	1970	1977	7.7	4.3	5.4	6.1	6.9
1971	503.715	1971	1977	8.2	4.5	5.6	6.4	7.3
1972	534.506	1972	1977	8.5	4.6	5.9	6.7	7.6
1973	572.186	1973	1977	9.0	4.8	6.1	6.9	7.9
1974	621.573	1974	1977	9.1	4.7	6.1	6.9	8.0
1975	679.567	1975	1977	8.9	4.6	5.9	6.8	7.8
1976	740.494	1976	1977	8.9	4.4	5.8	6.7	7.8
1977	806.225							
Purchase and sale at market value:								
1947	84.922	1947	1977	7.1	5.1	5.8	6.2	6.7
1957	242.470	1957	1977	5.2	3.2	3.9	4.3	4.8
1967	651.771	1967	1977	.3	.1	.2	.2	.2
1968	736.974	1968	1977	(−1.1)				
1969	646.923	1969	1977	.4	.2	.3	.3	.3
1970	649.391	1970	1977	.4	.2	.3	.3	.4
1971	760.466	1971	1977	(−2.2)				
1972	862.427	1972	1977	(−5.2)				
1973	636.969	1973	1977	1.2	.6	.8	.9	1.1
1974	426.349	1974	1977	16.2	8.7	11.0	12.5	14.4
1975	597.007	1975	1977	5.8	2.9	3.8	4.8	5.1
1976	734.118	1976	1977	(−9.8)				
1977	668.296							

Source: Federal Reserve Board Flow of Funds Accounts.

TABLE XIV.—STANDARD & POOR'S 500 STOCK INDEX COMPOSITE CAPITAL GAINS RETURNS 1927–77

Year	Year end price	Periods		Compound annual appreciation return (percent)				
					Capital gains tax rate			
		Beginning	Ending	Pretax	50	35	25	12.5
S. & P. 500 Stock Index:								
1927	$17.66	1927	1977	3.4	2.3	2.7	3.0	3.2
1937	10.55	1937	1977	5.7	4.1	4.7	5.0	5.4
1947	15.30	1947	1977	6.3	4.4	5.1	5.4	5.9
1957	39.99	1957	1977	4.4	2.7	3.2	3.6	4.0
1967	96.47	1967	1977	(−.1)				
1968	103.90	1968	1977	(−1.0)				
1969	92.06	1969	1977	.4	.2	.3	.3	.3
1970	92.15	1970	1977	.5	.2	.3	.3	.4
1971	102.10	1971	1977	(−1.2)				
1972	118.10	1972	1977	(−4.4)				
1973	97.55	1973	1977	(−.6)				
1974	68.56	1974	1977	11.5	6.1	7.8	8.9	10.2
1975	90.19	1975	1977	2.7	1.4	1.8	2.0	2.4
1976	107.46	1976	1977	(−11.5)				
1977	95.10							

INTRODUCTION

This paper is an examination of the provisions of the Federal income tax law affecting capital cost recovery. The primary provisions considered are accelerated depreciation methods, the asset depreciation range (ADR), and the investment tax credit. The paper does not deal with depletion, which is a major aspect of capital cost recovery in the extractive industries. The first section describes these provisions in the context of the income tax. The second examines the history of depreciation and the reasons advanced for changes in each stage of the evolution of this policy. The third section examines the arguments for liberalized capital cost recovery and the reasoning behind these arguments, along with evidence in the literature bearing on these questions. In some cases, particularly in presenting the results of econometric studies, the findings and assumptions are necessarily oversimplified and the reader may wish to examine these studies. A brief evaluation of these arguments, based on the presentation in the body of the paper, may be found in the conclusion to Section III.

A selected bibliography is included.

I. DESCRIPTION OF CURRENT LAW

A. DEPRECIATION

The Federal income tax is conceptually a tax on net income, although in practice taxable income deviates from net income through specified deductions (such as the deduction for charitable contributions.) Thus, provision is made for deducting costs of earning income from gross income. Business costs may be said to fall into two categories—those which are expensed and those which are capitalized. Generally the treatment of business deductions is the same for corporations and individuals.

Expensed items are deducted in one year and are generally limited to items which are useful for that year, such as wages. Items which are capitalized are generally assets of a permanent nature which yield services for more than one year. A capitalized item is one such as land, a building, or a machine. If the item is one which declines in value through use its cost may be deducted over a determinable period of time in the form of depreciation deductions. Thus, depreciation is allowed for buildings and machines, but not for land (although land containing natural resources such as oil may be considered a depletable asset). In practice, some items may be deducted currently which are in the nature of a depreciable cost.

Useful life and rate

There are two aspects of depreciation which must be considered: (1) What is its useful life, that is, what is the period of time over which the cost of an asset

should be deducted? and (2) At what rate should the deductions be taken (that is, should there be greater or smaller deductions in the earlier years?)

In regard to the first question, the Internal Revenue Service prescribes tax useful lives through the Asset Depreciation Range (ADR) system, where industry wide class lives are provided. The taxpayer can depreciate all property in that class at the life provided and may vary by 20 percent in either direction. If he wishes to use a different class life, he must substantiate the deduction as reasonable.

There are several methods of depreciation deductions which are specifically authorized by the Internal Revenue Code. The simplest method is the straight line method. Under this method the taxpayer deducts an equal amount of the cost (less salvage value) [1] in each year of the useful life. For example, if he has an asset worth $5,500, with $500 of salvage value and a useful life of five years, his yearly deduction will be one-fifth of $5,000 or $1,000.

A second method authorized is the declining balance method, where a rate not to exceed twice the straight line rate is applied in each year to the balance of the cost. Salvage value is not considered. In the example described above, the first year deduction under a double declining balance would be $2,200 (40 percent of $5,500). In the next year, the deduction would be $1,320 (40 percent of $3,300). Eventually, under this method deductions would be smaller than they would be under straight line and the taxpayer can switch over and take deductions as if he had used straight line previously.[2]

A third method authorized is the sum of years digits. Under this method a varying fraction is applied to the cost of the asset (less salvage value) each year, with the numerator the remaining useful life of the property and the denominator the sum of the numbers representing the successive years of useful life. In the example described above, the first year fraction would be

$$5/15\left(\frac{5}{1+2+3+4+5}\right)$$

and the first year depreciation would be $1,666 (5/15 times $5,000). The second year depreciation would be $1,333 (4/15 times $5,000).

The law also allows any other consistent method if the deduction at the end of each year during the first two-thirds of useful life does not exceed the amount allowable under double declining balance.

There are limitations on depreciation methods in certain cases. The second owner of an asset is limited to a 150 percent declining balance method (so that the rate applied to the remaining balance is only one and one half times the straight line rate). There are also particular limits on real estate depreciation. New construction, other than residential housing, is limited to a 150 percent declining balance. Used real property other than residential housing is limited to straight line. Used residential housing with a useful life of 20 years or more is limited to 125 percent declining balance.

Recapture

When depreciable property is sold, gain on the sale of the property is generally treated as a capital gain and the lower capital gains tax applies if the property has been held for six months. Often property, particularly buildings, may be sold at a price in excess of its depreciated value or even in excess of the original cost. Since depreciation deductions reduce ordinary income taxed at regular rates, the combination of depreciation on the property and capital gains treatment on the sale of the property can result in the conversion of ordinary income into capital gains and tax savings.

Accordingly, there are provisions to recapture some or all of the depreciation (i.e. treat a portion of the gain as ordinary income) under certain circumstances. The application of these recapture rules is different for personal property (referred to as Section 1245 property) such as trucks and machines and for real property (referred to as Section 1250 property) such as buildings.

In the case of personal property gain on the sale is taxable as ordinary income to the extent of all post 1961 depreciation. That is, the lesser of all post 1961 depreciation or the total gain is treated as ordinary income.

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[1] Salvage value is included in the basis if the declining balance method is used but not if straight line and sum-of-years digits is used. This treatment is shown in the examples. However, if the asset depreciation range is elected, salvage value is included under all methods.

[2] The deductions can never reduce the basis below salvage value.

In the case of real property, depreciation in excess of straight line taken after 1963–1969 is recaptured in full if the property is held for 20 months or less. After 20 months the precentage recapture declines one percent for each month the property is held; thus, there would be no depreciation recapture for property held for more than 10 years. For non-residential real property, any post 1969 excess depreciation is recaptured in full. For residential property, post 1969 depreciation recapture is reduced one percent a month after the property has been held 100 months or less. For certain other property, including certain Federally subsidized housing, the rules for 1963–1969 depreciation continue to apply. If any real property is held for 12 months or less, all depreciation, straight line as well, is recaptured in full.

Special provisions

There are a number of provisions in the tax law which provide special treatment of depreciation including rapid amortization provisions, the additional first year depreciation, treatment of natural resources and expensing of certain items.

1. *Rapid amortization.*—The tax law provides special treatment of depreciation for certain types of property by allowing rapid amortization. Amortization involves, in this context, the use of a straight line method over a shorter period of time than the specified useful life. Amortization provisions which allow a write-off in equal installments over a five year period apply, with various limitations, to the following types of property:

(1) Railroad rolling stock;
(2) Pollution control facilities (for cost attributable first 15 years of useful life);
(3) Rehabilitation expenditures on low income housing;
(4) Employer expenditures on child care and on-the-job-training facilities; and
(5) Coal mine safety equipment.

The law also provides for fifty year amortization of railroad grading and tunnel bores. (Otherwise these items might never be deductible). In the case of any property where the investment credit would apply, it is not available if amortization is taken, except in the case of pollution control facilities, where it is available for cost attributable to portion of useful life over 15 years.

2. *Additional first year allowance.*—The law provides for an additional first year depreciation allowance of 20 percent of the cost of tangible personal property up to $10,000 ($20,000 for a joint return). Although this allowance is available to all taxpayers it is aimed primarily at small businesses. The allowance is based on cost without considering salvage value, but the allowance is subtracted from the basis before determining regular depreciation.

3. *Natural resources.*—Although depletion allowances are another issue, they may be considered the equivalent of depreciation deductions for natural resources. Cost depletion, which allows the deduction of a portion of the cost of the asset based on yearly production, is similar in concept to depreciation. Percentage depletion is an alternative to cost depletion based on a percentage of gross income from production and is unrelated to cost. Percentage depletion is not considered in this study.

4. *Options to expense or defer.*—In certain cases the income tax law allows taxpayers an option in the treatment of items which may be considered capital expenditures. While such treatment may in some cases be considered as incentives or subsidies, optional treatment often applies to expenditures with an indeterminable useful life and thus might never be deductible (or may be only accounted for when the item is sold as is currently the case with land).

Among the items for which optional treatment is allowed are certain research and experimental expenditures, intangible drilling costs (such as labor, supplies and repairs), mining exploration and development expenditures and certain farming expenditures (e.g. expenses of clearing land). In addition, some items such as interest on a construction loan could be considered a capital expenditure but may be expensed because the tax law generally allows the deduction of these items (the building must still be depreciated).

The law also allows certain items to be treated as deferred expenses and thus amortized over a period of years. For example, research and experimental expenditures may be written off over a period of five years or more. Expenses of organizing a corporation, while they may not be written off currently may be deferred in a similar manner. If deferral were not allowed such expenses might never be deductible (as in the case of an on-going corporation).

B. THE INVESTMENT TAX CREDIT

The investment tax credit might be more properly termed the equipment tax credit since it applies generally to machinery and equipment but not to structures.

The provision allows a credit against tax liability for 7 percent of the cost of investment (4 percent in the case of public utilities). The credit does not change the basis for computing depreciation. The allowable credit cannot exceed $25,000 plus one half of taxable income in excess of $25,000. There is a provision for a three year carryback and five year carryforward of unused investment credits.

Certain property is not eligible or not fully eligible for the investment credit. Property with a useful life of less than three years does not qualify. One third of the cost of property with a useful life of three to five years is eligible for the credit, two-thirds of the cost of property with a useful life of five to seven years is eligible and the full cost of property with a useful life of seven years or more is eligible. Items not eligible in general for the credit include buildings and structural components (except for certain storage facilities), property used outside the United States (with certain exceptions such as offshore drilling rigs, telephone cables, etc.), furnishings in lodgings, certain livestock (such as race horses), and property amortized under the special amortization provisions.

C. THE MINIMUM TAX

The U.S. tax law imposes a minimum tax on certain items of preference income. The tax is levied at 10 percent on both corporations and individuals and a taxpayer is allowed to deduct his regular taxes paid plus $30,000 from his preference base before applying the tax. Certain items of accelerated depreciation are considered preference items, including accelerated depreciation and amortization on real property in excess of straight line and amortization in excess of accelerated depreciation in general.

II. History of Depreciation Policy and the Investment Tax Credit

To understand current issues and problems in depreciation policy it is useful to examine how this policy developed. Much of current tax depreciation practice derives from administrative policy rather than legislation and much of the statutory law on tax depreciation was added as a result of prior administrative changes.

This history will concern the major developments in overall depreciation policy which are significant in contributing to current treatment. Developments of specialized provisions or minor treatment will be noted in footnotes.

For purposes of general depreciation policy under the income tax, the history can be divided into five phases: 1913–34, 1934–54, 1954–62, 1962–70 and 1971 to present.

Although the present income tax law dates from 1913, there were earlier forerunners of the income tax. Civil war income taxes were imposed in 1861 and lasted until 1872, but these laws were vague and made no mention of depreciation. Another income tax law in 1894 specifically excluded depreciation as a deduction. This law was subsequently struck down by the courts which found a tax on income unconstitutional.

The precedent for allowing the deduction for depreciation was set in the corporate excise tax of 1909, which allowed "a reasonable allowance for depreciation of property, if any." Regulations indicated that this provision included accounting for obsolescence as well as wear and tear and exhaustion.

A. 1913–34: DEPRECIATION AT THE TAXPAYER'S DISCRETION

The Sixteenth Amendment to the Constitution allowed taxes on income without apportionment among the States and an income tax was subsequently imposed in 1913 upon ratification of the amendment. This law, which taxed individual and corporate net income, allowed "a reasonable allowance for depreciation by use, wear and tear of property, if any." Again obsolescence was included in the regulations. The 1916 Act permitted "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade." Under this law, no consideration was made for obsolescence unless the property was withdrawn from use.

In 1918, the House draft of the Revenue Act of 1918 allowed exhaustion and wear and tear, but did not use the terms depreciation or obsolescence; the Senate version substituted depreciation and in conference the provision was changed to read "a reasonable allowance for the exhaustion, wear and tear of property used

in the trade or business including a reasonable allowance for obsolescence. "This act clearly established at least normal obsolescence as a factor in depreciation.[3]

From the first law in 1913 until 1934. the taxpayer was generally allowed to determine his own useful life for purposes of derpeciation and the then Bureau of Internal Revenue rarely challenged the deduction unless there was clear and convincing evidence that it was unreasonable. The official attitude of the Bureau was summarized in the first Bulletin "F" issued in 1920, following the Revenue Act of 1918: [4]

"It is considered impractical to prescribe fixed definite rates of depreciation which would be allowable for all property of a given class or character * * * The taxpayer should in all cases determine as accurately as possible according to his judgment and experience the rate at which his property depreciates."

At the same time the Bureau indicated that it only approved the straight-line method (or unit of production method generally used in natural resources), as opposed to declining balance and other accelerated methods of depreciation. Undepreciated balances were charged off as an expense in the year of retirement. Normal obsolescence was to be taken into account in determining useful life; extraordinary obsolescence would be reflected only at the time of retirement.

The Bureau issued a second version of Bulletin "F" in 1931 and while it continued to let taxpayers determine their own useful lives, the statement noted:[5]

"Past experience, which is a matter of fact and not of opinion, coupled with informed opinion as to the present condition of the property, and current developments within the industry, and the particular business, furnish a reliable guide for the determination of the useful life of the property."

This edition of Bulletin "F" was accompanied by a separate pamphlet, the "Preliminary Report on Depreciation Studies" which listed probable useful lives of 2,700 industrial assets. The policy of favoring straight-line depreciation was unchanged.

B. 1934–54: THE IRS PRESCRIBES USEFUL LIFE

An era in depreciation policy ended in 1934 by shifting the burden of proof as to the reasonableness of the deduction to the taxpayer. This change was stimulated by a report of a House Ways and Means Committee subcommittee on December 3, 1933 which revealed a substantial increase in depreciation deductions and showed that in 1931 corporate depreciation deductions were larger than corporate taxable income. In view of the revenue needs at a time of depression and what the report considered an alarming increase in depreciation deductions, the report recommended a reduction of 25 percent in depreciation deductions in the following three years. The Secretary of the Treasury proposed that such reduction could be accomplished more equitably by shifting the burden of proof as to the reasonableness of the deduction to the taxpayer. The Ways and Means Committee agreed.

The result was Treasury Decision 4422 which was published in 1934. This decision required the taxpayer to furnish facts regarding his deductions and laid the burden of proof of showing the reasonableness of the deduction on the taxpayer.

Thereafter, taxpayers tended to follow the useful lives prescribed in Bulletin "F." [6] A third and last edition of this document was issued in 1942 providing the average useful life of about 5,000 assets and providing longer lives (and thus lower deductions) for a substantial number of assets.

In 1946 the first change from IRS policy favoring the straight line method occurred when the Service allowed the use of the 150 percent declining balance method.

There was considerable controversy after the 1934 revision concerning depreciation policy between taxpayers and the Internal Revenue Service. In 1953 a new IRS Policy, Revenue Ruling 90, provided: [7]

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[3] The existence of extraordinary obsolescence might also have been said to be recognized since the 1918 act also allowed a 5-year writeoff for certain war-related facilities.

[4] The 1920 edition of Bulletin "F" is reproduced in E. A. Saliers, "Depreciation-Principles and Applications," 2d ed., New York. The Ronald Press, 1922. See p. 494 for this excerpt.

[5] The 1931 Edition of bulletin "F" is reproduced in Saliers, op. cit. 3d ed., 1939. See p. 411 for this excerpt.

[6] There were some departures from the lives through use of special provisions. 5-year amortization was available for certified national defense facilities and was used during World War I and World II and the Korean war (authorization existed from 1940–60). 5-year amortization was also provided for grain storage facilities from 1952–1957.

[7] Revenue Ruling 90, 1953– C.B. 43.

"It shall be the policy of the Service generally not to disturb depreciation deductions and Revenue employees shall propose adjustments in the depreciation deduction only where there is a clear and convincing basis for a change. This policy shall be applied to give effect to its principal purposes of reducing controversies with respect to depreciation."

It is questionable how effective this policy actually was in reducing disputes.

C. 1954–62: ACCELERATED DEPRECIATION METHODS

The 1953 regulations were written into regulations under the Internal Revenue Code of 1954 which re-codfied the tax law. However, the major change in 1954 was the writing into the law of accelerated depreciation methods. The 1954 act sanctioned the use of double declining balance, sum-of-years digits or any other method of depreciation which would not result in larger deductions during the first two-thirds of useful life than under double declining balance.

The reasons for the authorizations of the accelerated methods appeared to involve both questions of more accurate reflections of economic depreciation (particularly depreciation as a result of obsolescence) and questions of stimulating business investment.

The Ways and Means report states: [8]

"In many cases present allowances for depreciation are not in accord with economic reality, particularly when it is considered that adequate depreciation must take account of the factor of obsolescence. The average machine or automotive unit actually depreciates considerably more and contributes more to income in its early years of use than it does in the years immediately preceding its retirement.

"There is evidence that the present system of depreciation acts as a barrier to investment, particularly with respect to risky commitments in fixed assets. Comparatively slow rates of write-off tend to discourage replacement of obsolete equipment and the installation of modern, up-to-date machinery. Under long-run peacetime conditions, in the absence of inflationary pressures existing in the forced-draft economy of the postward period, present tax depreciation methods might depress business capital expenditures below the level needed to keep the economy operating at high levels of output and employment."

The Senate Finance Committee Report indicated similar reasons.

It is also interesting to note that the concept of a depreciation range in useful lives appeared during the 1954 deliberations. The bill as passed by the House provided that the life used by the taxpayer would not be challenged by the IRS unless it differed by more than 10 percent from the useful life determined by the Service. This provision was deleted by the Senate partially because they felt that the new policy in Revenue Ruling 90 (noted above) would be sufficient to reduce taxpayer disputes.

Changeovers to the use of the accelerated methods proceeded somewhat slowly, particularly in the case of small businesses. In 1954, 89 percent of depreciation was under the straight-line method and by 1960, 58 percent of depreciation was still claimed under the straight-line method (although part of this reflected pre-1955 assets).

D. 1962–71: REDUCTION IN LIVES AND THE INVESTMENT TAX CREDIT

Although criticism of depreciation policies was developing in the late 1950's no major changes were made until the introduction of Rev. Proc. 62–61 in 1962.[9] In late 1961 the Treasury Department issued results of a survey of depreciation practices which indicated the need for depreciation revision. The Treasury subsequently issued Revenue Procedure 62–21 which made substantial changes in depreciation policy and useful life. First, the procedure substituted 75 industry-wide class lives for the 5,000 or so Bulletin "F" lives for individual assets. Secondly, it effectively shortened useful lives by 30 percent to 40 percent. Finally it instituted the reserve ratio test, a procedure which required taxpayers to compare their own actual replacement experience with replacement assumed by the guideline lives, and adjust their lives accordingly.

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[8] U.S. Congress, House. Internal Revenue Code of 1954. Report of the Committee on Ways and Means, House report No. 1337. Mar. 9, 1954, p. 22.

[9] However during this period, the additional 1-year depreciation allowance, which primarily benefits small business, was added to the law by the Small Business Tax Revision Act of 1958.

Taxpayers had a three year period of grace in which they could use the new lives without applying the test. In 1965 the test was modified and the moratorium on using it effectively extended since it was felt that the test had defects and that a substantial number of taxpayers could not meet the test.

The Revenue Act of 1962, which also added the investment tax credit, also provided for recapture of depreciation in certain cases. These recapture rules were further tightened in 1964.

The reasons expressed for the 1962 class life system again appeared to be a combination of economic and equity issues. The following excerpts from a statement made by Secretary of the Treasury Dillon illustrate the reasoning behind the new policy; and behind the investment tax credit: [10]

"The new guidelines and procedures for determining depreciation on machinery and equipment used by all American business constitute a fundamental reform in the tax treatment of depreciation that will provide a major stimulus to our continued economic growth.

"Our depreciation practices have not been realistic for a great many years. Based essentially on taxpayers' past replacement practices, they have inadequately reflected the fast-moving pace of economic and technological change."

In discussing the so-called "depreciation gap" due to ever increasing prices for replacement of assets, Secretary Dillon said:

"The fact is that our depreciation reform standing alone goes much of the way towards closing the so-called "depreciation gap." Coupled with the investment tax credit, now pending before the Senate Finance Committee, the reform will close the gap entirely.

"This is not, however, the only reason why enactment of the credit is essential. Depreciation reform, important as it is, will not put American business on a comparable footing with its foreign competitors so far as tax treatment of investment is concerned."

The introduction of the investment tax credit, in 1962, was adopted for the reasons expressed above. The credit adopted then contained a basis adjustment; i.e. it reduced the basis for depreciation by the amount of investment credit taken. This meant that the value of the credit (ignoring the discount rate) was only half (with a 48 percent tax rate), or about 3.5 percent since the amount of the credit would have been taken as depreciation were it not for the credit.

The Revenue Act of 1964 removed the requirement that the basis for depreciation be adjusted to reflect the investment tax credit. The Senate report stated: [11]

"To remove the recordkeeping and accounting problems which have arisen in connection with the basis adjustment provisions and also to provide a greater stimulus with respect to the investment credit, the bill, both as passed by the House and as reported by your committee, repeals the basis adjustment."

Although the investment credit was originally viewed as a permanent part of the tax code, it then entered a period of suspension and restoration. In 1966 the President proposed that the credit (and certain accelerated depreciation on real property) be temporarily suspended.[12] In a statement to the Ways and Means Committee, Secretary of the Treasury Fowler stated: [13]

"The proposal is basically an anti-inflationary measure designed to relieve the pressures, clearly observably in the money markets and capital goods sector, which are producing unusual strains, the highest interest rates in 40 years, and a perceptible trend toward a general condition of economic instability."

The credit was originally to be suspended from October 10, 1966 through December 31, 1967. However, in March of 1967 the President proposed the immediate restoration of the credit, which was subsequently approved March 10, 1967.

The Ways and Means Committee report stated in reference to the reinstatement of the credit and accelerated depreciation on real property: [14]

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[10] Statement by Secretary of the Treasury Dillon, July 11, 1962, on the issuance of the new depreciation guidelines and rules, Reproduced in the 1962 Annual Report of the Secretary of the Treasury on the State of the Finances, pp. 335–336.

[11] U.S. Congress. Senate. Committee on Finance. Revenue Act of 1964. Report No. 830, 88th Cong., 2d sess., Jan. 28, 1974, p. 41.

[12] The act exempted $20,000 of property from the suspension of the credit; and a $50,000 exemption from the suspension on accelerated depreciation as long as the cost of the building did not exceed $50,000.

[13] U.S. Congress. House. Committee on Ways and Means. Hearings on President's proposal on suspension of the investment credit and application of accelerated depreciation, 89th Cong., 2d sess., Sept. 12, 1973, p. 10.

[14] U.S. Congress. House. Committee on Ways and Means. Report on H.R. 6950. 90th Cong., 1st sess., report No. 131.

"The inflationary forces which the suspension of these provisions was designed to moderate have abated. . . . The suspensions have played an important part in reducing the volume of new orders of capital goods to levels that can be sustained without inflationary strain on available capacity. The suspensions have also helped to ease pressures in the money markets and, in particular in the home mortgage market. Restoration of these provisions now will encourage a resumption of balanced, economic growth with high levels of employment and stable prices."

Although the credit was restored in 1967, it was repealed by the Tax Reform Act of 1969. The reason for repeal appeared to be the contribution of the credit to inflation: [15]

"After careful consideration of the sources of the current inflationary pressures, the Congress concluded that the stimulus to investment provided by the credit contributed directly to these pressures. In addition to its effect on inflationary pressures, it concluded that the 1969 level of investment could not be maintained for more than a short period of time, and that it was important for the long-run vitality of the economy to keep the level of investment on a steady growth path."

The choice to repeal rather than suspend the credit was apparently taken because the previous suspension became such a dramatic deterrent to investment as the end of the suspension period approached and because of administrative complexities.

Broadly applicable depreciation policy had been unchanged until 1971 (except for the modification in the reserve ratio test in 1965). However, the Tax Reform Act of 1969 made significant revisions in certain areas of depreciation.

First, the act tightened depreciation policy with respect to real estate by limiting the available methods, tightening recapture rules and adding the minimum tax which applied to real estate depreciation and depreciation on certain leased property. These changes were generally in response to what was felt to be abuses in this area.

The Act also provided five-year amortization for pollution control facilities, coal mine safety equipment, rehabilitation expenditures on low income housing and railroad rolling stock and five year amortization of railroad grading and tunnel bores. The Act also added the minimum tax.

The purpose of the five-year amortization provisions was to provide incentives for and in some cases to reduce the impact of the repeal of the investment tax credit and other provisions on these expenditures. The five-year amortization of railroad grading and tunnel bores was apparently added because of the uncertainty of the useful life of these items and the fact that such deductions might never be taken in absence of a special provision.

E. 1971 TO PRESENT: THE ASSET DEPRECIATION RANGE AND REINSTATEMENT OF THE CREDIT

The year 1971 saw yet another era in depreciation policy. Early in January the Treasury Department announced the introduction of a new depreciation policy. Proposed regulations were written and hearings were held, with the regulations adopted in June. The new system, the Asset Depreciation Range (ADR) system, made two major changes. First, it allowed taxpapers to vary class lives up to 20 percent (in effect, reducing lives by 20 percent). Secondly it repealed the reserve ratio test.

The Treasury indicated two major considerations in providing the new policy: (1) The ADR system was expected to greatly simplify the administration of depreciation and reduce the controversy between taxpayers and the IRS. The reserve ratio test was particularly felt to have a number of defects—it was complex, created numerous administrative problems and was a major source of taxpayer disputes. In addition, it reflected historical experiences of the taxpayer which the Treasury felt to be a questionable guide to future depreciation in an era of technological change. The taxpayer could fail the test if he kept overage equipment on a stand-by or non-productive basis which encouraged premature retirement. The test was felt by the Treasury to be so complex as to be virtually unworkable and a heavy administrative burden on the taxpayers.

[15] U.S. Congress. General explanation of the Tax Reform Act of 1969, H.R. 13270, 91st Cong., prepared by the staff of the Joint Committee on Internal Revenue Taxation, Dec. 3, 1970, p. 188.

Second, the ADR system according to the Treasury was an attempt to recognize the obsolescence factors due to technological change, pollution requirements, foreign competition and the high rate of capital formation since 1962.

In addition to these reasons, the ADR was expected to have a beneficial economic impact by increasing economic growth and thereby reducing unemployment, stimulating investment in modern equipment and thus increasing productivity and dampening inflation, and improving the competitive position of American producers in the World market.

The ADR system was included with minor modifications in the Revenue Act of 1971.[16] This act also restored the investment tax credit, as part of the President's new economic policy. The reasons again appeared to be primarily to stimulate economic growth.

CONCLUSION

The history of depreciation policy clearly reflects that a number of factors have influenced depreciation policy—economic effects, equity, revenue needs administrative complexity, foreign competition and possible abuses. The various arguments in these areas will be considered in the next section. It should also be noted that the much higher tax rates in the later periods gave greater significance to these provisions as compared with earlier periods.

III. ISSUES IN THE TAX TREATMENT OF CAPITAL COST RECOVERY

A. OVERVIEW

The basic issues in capital cost recovery may be examined in the framework of the criteria by which one evaluates a tax system. These generally accepted criteria of a "good" tax system may be summarized as (1) a tax system which is fair and equitable, (2) a tax system which is neutral in its impact on the economy (3) a tax system which contributes to, or at least does not hamper, goals of government policy, such as economic stability and growth, or international trade, and (4) a tax system which is administratively feasible. Obviously a tax provision which meets one criterion may be unable to meet another.

The issues in depreciation policy derive from these criteria. The history of depreciation and investment tax credit policy show a steady trend, at least in the post-World War II period, towards more liberal depreciation policy, allowing faster recovery at an accelerated rate. One view is that such allowances are too liberal in general and are a proper subject of tax reform. Another is that present policy should be retained and perhaps even be further liberalized. Others suggest that while current depreciation policy may be proper in general, certain aspects, particularly those which contribute to tax shelter operations, should be revised, since they may generate inequities and inefficiencies.

The major questions surrounding capital cost recovery policy may be summarized as follows: (1) What is the proper measure of depreciation, that will truly reflect income and what are the equity implications of a measure which does not? (2) Does the tax system contain a bias against savings and investment which justifies liberalized depreciation methods? (3) Does the existence of inflation affect the equity and neutrality of depreciation allowances in measuring income and justify more liberal methods of depreciation? (4) Are revisions in capital cost recovery methods an effective tool of fiscal policy? (5) Can liberalized capital recovery methods be justified as a means of encouraging long term growth? (6) Are liberalized methods justified because other countries provide such liberal methods and are they necessary for U.S. companies to compete in international trade?

In addition to these major questions there are some additional questions: (1) Are certain methods of depreciation justified to reduce administrative complexity? (2) Does the role of liberal depreciation policy in tax shelter operations, which may distort the allocation of resources, require some revision?

B. THE MEASUREMENT OF DEPRECIATION: FAIRNESS AND EQUITY

A major issue in depreciation policy is the question of how accurately tax depreciation provisions actually reflect the decline in the value of the capital.

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[16] The 1971 act also provided for 5-year amortization of childcare and job training facilities, designed to encourage investment in these areas.

This argument is no concerned with the investment tax credit as it is presently constituted since it is in addition to depreciation although the investment credit has some equity implications. The two questions involved here are (1) what sort of rate of decline properly reflects the decline in value and (2) what is the proper estimated useful life of the property?

Rates of decline

The straight line method of depreciation was used in tax accounting until 1954 and is still generally used in financial accounts. When the accelerated methods were introduced the arguments accompanying them indicated in some cases that they were viewed as incentives and in some cases as a reflection of how the value of an asset actually declines. For example, the case of automobiles was cited which decrease much faster in the earlier years. It was also noted that repair and maintenance was likely to be greater in later years. Technological improvements may occur and make a machine obsolete. An older machine may not be as likely to operate full time.

Critics charge that the reference to automobiles whose decline in value is highly influenced by yearly style changes is an inappropriate one. They suggest that in the cases of most assets there is no greater decline in the earlier years. The difficulty is that different types of assets are likely to decline at substantially different rates. A machine made obsolete by new technology, and used in its later years on a part time basis may actually decline at a faster rate in earlier years. However, if a machine stays in full use and produces over its entire life then it is not declining at a faster rate.

In addition, it was argued by Brown [17] that the straight line method itself had built into it an assumption that an asset's usefulness declines at a faster rate in the earlier years, unless the discount rate is 0. This is true because money in the present is more valuable than money in the future due to the discount rate (or interest rate). At a 10 percent rate of return, a dollar earned next year is worth only about 91 cents today (or in other words, 91 cents invested today will yield a dollar in one year). A dollar deducted after one year is worth more than a dollar deducted five years later. Thus, under a straight line method of depreciation the earlier deductions are worth more than the later ones. A depreciation system which actually reflected equal contributions to earnings would have smaller dollar deductions in earlier years than in later ones. Thus, Brown suggests that simply asserting that an asset declines faster in its earlier years is not sufficient to suggest that the straight line method is too slow.

The primary difficulty in assessing rate of decline is simply that it would be almost impossible to demonstrate any general rule. Many observers would suggest that accelerated methods constitute a subsidy. Faster methods are more advantageous to a taxpayer since a savings in tax now is worth more than a savings in the future (due to the interest rate). If the taxpayer is continually replacing his assets he enjoys a continuing tax reduction, and if he is increasing his assets he enjoys a growing tax reduction.

The determination of useful life

The second major question is whether the allowable useful lives appropiately reflect the actual useful lives of assets. If a test such as the reserve ratio test exists, then it may be possible to measure useful lives allowed for tax purposes against actual practices. However, since the reserve ratio test has never actually been in effect there is no way of determining how closely the 1962 guideline lives approximate true lives. There is some evidence however that they were substantially shorter. The Treasury Department [18] surveyed audit depreciation practices piror to the proposal for the 1971 revision. One question asked revenue agents and engineers was whether most, some, or a few taxpayers were receiving more favorable depreciation benefits than they might otherwise be able to justify. 1,573 indicated most, 1,333 indicated some, and only 904 indicated a few. An industry comment generally supported this finding,[19] stating in reference to the reserve ratio test: "As the end of the grace period approached, the Treasury realized few companies would pass the test and set of a 'Brownie points for improvement' system."

Thus, it would follow that if the 1962 guidelines were shorter than actual practice, the 20 percent shorter lives allowed by the ADR system would clearly be

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[17] E. Cary Brown, "The new depreciation policy under the income tax: an economic analysis," National Tax Journal, vol. VIII, March 1955, pp. 81–98.
[18] Department of the Treasury, Asset depreciation range (ADR) system, June 1971, p. 17.
[19] "The great depreciation hoax." Industry Week. May 10, 1971, pp. 28.

substantially shorter. Shorter lives, like the accelerated methods are of benefit to a taxpayer because he can defer taxes.

Equity implications

If asset lives are shorter than actual practice, if accelerated methods are faster than true economic decline, and if an investment credit is allowed, taxpayers who use these methods will benefit over other taxpayers who are unable to avail themselves fully of this liberal tax treatment. While the income impact of the reduction, that is, the incidence,[20] is dependent on the extent to which corporate income taxes and income taxes on unincorporated businesses are shifted to consumers and workers rather than owners, certain types of businesses (and their consumers and workers) would likely benefit. The most obvious beneficiary is more capital intensive industry as opposed to more labor intensive industry.

Second, only those taxpayers who are able to use the accelerated methods will be benefitted. This category would include of course only firms which are making a profit and thus may be of little benefit initially to new and growing enterprises. In practice, it is also likely to mean larger firms will be benefitted relative to smaller ones. For a number of reasons smaller firms have been less likely to adopt accelerated methods, guideline lives and even the investment tax credit.

For example, a survey showed that in 1959, 28.6 percent of assets of businesses with under $1 million in total assets were in accelerated accounts compared to 38.1 percent of assets of businesses with $1 to $25 million total assets and 54.6 percent of assets of businesses with $25 million or more total assets.[21] A survey in 1963 of all manufacturers showed that 78 percent of companies with assets of $100 million or more were using the 1962 guideline lives compared to 69 percent of those with $10 million to $100 million and 47 percent of those with less than $10 million.[22] A survey in 1971 of 626 businesses in Wisconsin, Illinois, Indiana, Michigan, and Minnesota, with 254 replies, showed that 39.4 percent of the firms with assets of under $1 million were using guideline lives compared to 58.7 percent with $1 million and over.[23] The same survey showed that 61.0 percent of firms with assets of under $1 million were using the investment tax credit while 92.3 percent of those with $1 million and over were using the credit. Similar results were found if firms were divided by size of gross sales or number of employees.

A number of factors may explain the failure of smaller firms to take advantage of these provisions. The accounting expenses, particularly the costs of keeping two sets of books, may be too large in relation to the benefits. A smaller business may also be less sure about future investments and reluctant to use accelerated methods when they may have to pay more taxes later. There may be simply a lack of understanding and awareness of the advantages of the provisions. Two additional factors may be noted, however. First, smaller businesses may be less likely to be as capital intensive as larger ones and the expected benefits much smaller in any case. Also they may be more likely to be operating at a loss. Secondly, for very small businesses the existence of the first year allowance may counteract the failure to realize benefits under accelerated depreciation and the investment tax credit.

Third, the use of tax lives shorter than real economic lives will provide a relatively greater benefit for taxpayers whose actual lives deviate most from tax lives. This category of beneficiaries may include firms who more carefully maintain their equipment and are able to keep it in service longer. However, it will also benefit relatively, less efficient firms who use obsolete equipment. In other words, the use of shorter lives may reduce the cost of capital, but may provide no direct incentive to modernize for firms who use out-moded equipment. On the other hand, firms who use obsolete equipment because they lack the cash flow to replace equipment may be better able to do so with more liberal depreciation allowances.

C. TAX NEUTRALITY AND CAPITAL CONSUMPTION ALLOWANCES

The use of liberalized depreciation methods and the investment tax credit have been defended on the grounds that they restore neutrality to a tax system which is biased against capital. A neutral tax or neutral tax system would be defined as

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[20] The question of incidence is discussed in the following section.

[21] Tax Foundation, "Depreciation allowances: Federal tax policy and some economic aspects," 1970, p. 22.

[22] "The great depreciation hoax," op. cit., p. 28.

[23] Archie J. Bakay and Irving K. Christiansen, "The role of accelerated depreciation and the investment credit in stimulating business growth," Akron Business and Economic Review, vol. 4, summer 1973, p. 23.

one which would affect the costs of all goods, services and activities in the same manner. All taxes depart from this criterion in some manner—a tax on wages may affect work more than leisure, a tax on consumption affects consumption more than savings, etc. A non-neutral tax will have an allocational effect on resources, that is, it will divert resources from a non-taxed to a taxed area, relative to the situation without the tax.

There are a number of features of the income tax which may be said to result in a bias against capital formation. The first is that since all savings come out of income, both savings (i.e. including it in the tax base) and the return to savings are taxed. Thus, while all income is reduced by an income tax, initially, the income tax reduces the future flow of benefits from savings more than the benefits from consumption. In other words, the income tax reduces the net rate of return on after tax savings (which may be viewed as future consumption) but does not reduce the enjoyment of current after tax income on consumption. It is argued that consumption would become relatively more attractive than savings, and the relative level of savings would be less than in the absence of a tax. The actual impact, however, would be dependent on how elastic saving is to the rate of return.

The second reason is that the income tax is progressive, taking a larger share of a richer person's income than a poorer person's (the actual effect varies because there are so many modifications in the tax rate). Since the average rate of savings increases as one moves up the income scale, a progressive tax would be expected to produce a heavier burden on savings than a proportional one would.

The third reason is the existence of a separate corporate income tax. This means that at least some corporate income (dividends) are taxed twice. Capital gains taxes on corporate stock might also be viewed as taxes on corporate income. This double taxation means a heavy tax on corporate earnings.

The question of tax neutrality is very difficult to deal with. However, the tax neutrality argument as a basis for liberalizing capital cost recovery allowances can be examined from two standpoints. First, how non-neutral is our tax system? That is, to what degree is our tax system biased against capital? Secondly, is liberalized depreciation a proper response to an alleged bias against capital?

A tax is likely to have non-neutral effects on economic activities. The major ways in which an income tax is likely to affect capital investment are first that it may affect the average level of savings in the economy and thus the supply of capital. Second, by taxing the returns to capital it may affect the demand for capital.

A tax on income may first be expected to affect the allocation between work and leisure. However, there are two effects to be considered—the income effect and the substitution effect. A worker may be encouraged to work less since the return to work is less and leisure becomes relatively more attractive (the substitution effect) or to work harder to restore his original level of income (the income effect). For many workers the choice would not be so available since there are institutional constraints (he may have to work a 40-hour week). There may be other reasons for working hard (prestige). However, studies of work effort among those who have choice (self-employed, professionals, the wealthy) and who also tend to be subject to high rates of income taxes indicate that taxes have very little impact.[24] This would suggest that taxes have little impact on the supply of labor.

Given a certain level of income, a decision will be made as to what portion to save and what portion to consume. Here the effect is the taxation of income from investment as opposed to no additional income taxes if income is used for consumption. Taxes would thus reduce the return to savings. Here also there may be both income and substitution effects. The tax reduces the rate of return to savings. The response may be to substitute consumption for savings (the substitution effect) or the response may be a greater degree of saving to yield the same after tax return (the income effect).

Studies of the elasticity of savings to the rate of interest have provided varying results.[25] Empirically, the observation that savings tend to remain consistent through substantial changes in the interest rate have led many to believe that the savings rate is not particularly responsive to rate of return, or that the income and substitution effects balance. If savings are not responsive to the rate of return, then this feature of the tax system would not involve an anti-capital bias.

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[24] See George Break, "Income taxes and incentives to work," American Economic Review, September 1957 and Thomas Henry Sanders, "Effect of taxation on executives," Cambridge, Mass., Harvard University Press, 1951.

[25] See for example, Colin Wright, "Saving and the rate of interest," in the taxation of income from capital, Arnold C. Harberger and Martin J. Bailey, ed., Washington, The Brookings Institution, 1969, pp. 223–300.

The second major feature of the tax system that has been charged to create a bias against capital is the progressive rates. Even if the relative rates of saving disposable income are not affected by the tax structure, the aggregate rate of saving may be affected by a tax structure with progressive rates because higher income individuals have a relatively higher propensity to save.

Several points may be noted here. First, progression in the tax system may create a necessary "evil" as far as optimal allocation of resources is concerned if a tax system is to be equitable (assuming equity is defined as a tax system based on ability to pay). This same argument can be applied to the necessity of taxing both income saved and income from savings, since reducing this source of revenue might require a less progressive tax structure.

The second point which may be noted is that the income tax is not the only tax. The U.S. tax system—Federal, State and local—is composed of a variety of taxes. Many of these taxes are of a regressive nature (sales, social security). Most studies of the burden of taxation using commonly accepted assumptions of incidence,[26] suggest that the overall tax burden in the United States is roughly proportional for the vast majority of families,[27] even though at very high income levels effective rates are higher. Thus, the anti-capital bias of the U.S. tax system as a whole may not be that significant.

In addition, the savings of the government should also be considered since a portion of the taxes collected by government is saved. One investigator [28] suggested that a proportional tax reduces savings by 3 percent overall if a "bricks and mortar" definition of saving is used and increases savings by 5 percent if the definition of savings includes expenditures on human capital (education, health).

The third feature of the tax system is the imposition of a separate tax on corporate income. The central question again here is the incidence of the corporate tax. Several views of this question may be taken.

The initial case may be taken as that of either perfect competition or monopoly. A profits tax imposed on the corporate sector would lower the rates of return and capital would migrate to the non-taxed (non-corporate) sector. Rate of return would return to equilibrium with a lower rate of return on all capital. Assuming a constant rate of savings, the burden would fall on all capital.

The difficulties are that the assumptions here are not likely to be typical of American industry. The corporate sector has in fact grown substantially in the face of higher rates of corporate tax. While there are many factors at work here, this may suggest that there are substantial barriers to migration of capital from the corporate to the non-corporate sector. Certain industries may find it difficult to operate in non-corporate form. Or a firm could be enjoying very high profits, and reduced rates of after tax profit may be preferable to foregoing market power. In such a case, the corporate income tax may fall on corporate capital rather than all capital.

In addition, all corporations may not be operating to maximize profits. There may be a situation of administered pricing where a price is established by a price leader and profits are not maximized but rather a target profit rate is established. Or a firm may try to maximize sales or market share with a profits constraint. The testimony of businessmen themselves indicate that they may be setting prices while viewing the tax as a cost. Thus, there may be an immediate attempt to pass on a tax in the price of the output (or not to accept labor demands). In such a case the tax may be shifted in all or in part forward to prices and backward to labor. It can also be shifted backward, in part, on wholesalers (by retailers), manufacturers (by wholesalers), raw material suppliers (by manufacturers), etc. Depending on the elasticity of demand for corporate products, the tax then may not necessarily fall on capital.

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[26] The incidence of a tax refers to the question of who actually bears the burden of the tax, i.e. whose income is actually reduced because of the tax. One of the most difficult questions of incidence is that of the corporate income tax, which may be reflected in higher prices, lower returns, lower wages, etc. Depending on which of these reflect the tax, the burden may be progressive or regressive. For example, to the extent that the tax is reflected in prices, the corporate income tax may be regressive; to the extent it is reflected in return to capital, it is progressive. Similar questions of incidence are involved with other taxs such as property taxes on businesses and landlords, the social security tax, etc.

[27] See the recent study by Joseph A. Pechman and Benjamin A. Okner, "Who bear the tax burden?" Washington, Brookings Institution, 1974. Also see Roger A. Herriot and Herman P. Miller. "The taxes we pay," Conference Board Record, May 1971, pp. 31–40, and "Tax burdens and benefits of government expenditures by income class, 1961 and 1965," Tax Foundation, 1966.

[28] Lester C. Thurow, "The impact of taxes on the American economy," New York, Praeger, 1971, p. 28.

There is considerable disagreement as to the incidence of the tax. Theory, while helpful in framing the questions cannot provide conclusive results. Historical examination of net rates of return, although they do indicate a relatively consistent net rate of return in the face of substantially different tax rates, cannot provide conclusive answers since there are numerous other factors which had an influence on rates of return. Econometric studies have produced differing conclusions.[29]

D. THE IMPACT OF INFLATION

A case for liberalized depreciation has commonly been made on the grounds that a depreciation system based on original cost exaggerates income in an inflationary economy. If prices are rising then a depreciation deduction based on original cost will be insufficient to provide for replacement of the asset. The asset will generate greater income, which is taxed, because of rising prices, while depreciation deductions remain the same. Rapid depreciation deductions are said to counter this effect because earlier tax reductions provide an increase in the present value of the depreciation deduction. One analysis has shown that for an asset with a 10-year life with the cost of capital 12 percent, the use of double declining balance depreciation and the use of ADR will be sufficient to offset inflation of 7½ percent,[30] through increases in the present value of tax savings from depreciation. Suggestions have been made that depreciation allowances should be increased each year to reflect inflation.

There is no question that inflation produces distortions in the economy which may be aggravated by an income tax. But it seems difficult to make a case for increasing depreciation deductions in particular because of inflation. Owners of real assets are relatively protected from inflation because of the prices they can charge as compared to owners of fixed financial assets.[31] If one, views an asset as producing a stream of net income over its life (gross income minus the wearing out of the machine) then income produced by a capital asset could actually benefit from inflation because prices are rising while the cost of the machine remains fixed.

This result can be illustrated through an arithmetical example. Consider a $100 machine with a useful life of 10 years depreciated under the straight line method and earning an after tax profit of 10 percent with a tax rate of 50 percent. In the first year after tax income would be $10 ($30 gross price of the product before depreciation and income taxes minus $10 equals $20, times 50 percent equals $10), for a 10 percent return. Assume that in the next year prices increase by 10 percent across the board. The new price will be $33, the after tax profit $11.50 ($33 gross price minus $10 equals $23 times 50 percent equals $11.50). Because of inflation, however, the $11.50 is now worth only $10.45 in year one dollars. Thus, the machine has earned in the second year a higher rate of return—10.45 percent. In the second year, assuming another 10 percent inflation, after tax profit will be $13.15 which is $10.87 in year one dollars for a return of 10.87 percent.

From an accounting standpoint, at the end of 10 years there will not be enough in the capital account to finance a replacement for the machine. This argument is acceptable only if depreciation is viewed as being for the purpose of providing the funds to replace the machine. From an economic standpoint, however, the machine will have earned a higher rate of return than in a world of no inflation.

The preceding illustration was highly simplified.[32] In practice, each manufacturer would have a mix of new and old machines and prices, assuming competition will reflect this cost mix. In addition, different manufacturers will have different average costs for capital equipment. If prices are competitive, the manufacturer of the older machine will realize a relatively larger profit while new producers will suffer. Depreciation allowances liberalized to reflect replacement value will benefit those producers with older machines who are already realizing greater profits, rather than new producers whose cost basis is higher. However, present liberalized methods and the investment tax credit will benefit

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[29] Summaries of the literature on the incidence of the corporate income tax may be found in Richard A. Musgrave and Peggy B. Musgrave, "Public finance in theory and practice," ch. 17, "Incidence of the corporation income tax," New York, McGraw-Hill, 1973, pp. 396–411, and Joseph A. Pechman and Benjamin A. Okner, "Who bears the tax burden?" Washington, Brookings Institution, 1974, pp. 25–37.

[30] James L. Wittenbach, "Using present value analysis to explain inflation off provided by accelerated depreciation." Taxes, vol. 51, October 1973, pp. 610–613.

[31] This view was discussed by William F. Hellmuth, Jr., "Depreciation and changing price levels: fundamental economic issues," in Depreciation and taxes, Tax Institute, Princeton, 1959, pp. 55–69.

[32] Inventory practice may, for example, have some effect.

new producers since the advantages are concentrated in the early years of useful life. But this result is simply because they benefit from purchasing of capital equipment, not to account for the impact of inflation on machine values, and they will benefit whether the producer is replacing assets, adding assets or is a new producer.

Of course, the impact of inflation is unlikely to fall evenly on all sectors. A case could be made for attempting a complete correction under the tax law for all inflation. Such an approach could be very difficult. For example, if corporations were to increase their depreciation deductions, then they should also increase their income due to gains from paying back debt in cheaper dollars. Even if a general approach could be devised, the actual reduction in taxes would be likely to encourage further inflation.

E. LIBERALIZED CAPITAL COST RECOVERY AS AN INCENTIVE: ECONOMIC GROWTH AND STABILITY

Two major arguments for liberal capital cost recovery policy involve the use of such policy to encourage economic growth and its use as a counter-cyclical tool to provide stabilization. The growth argument says that government policy which reduces the cost of capital will encourage a greater level of investment in capital goods which will thereby lead to a greater level of output than in the absence of such policy. The fiscal policy argument suggests that tax provisions which affect the cost of capital can be used as a counter-cyclical stabilizing device. This use is most commonly associated with the investment tax credit. For example, by reducing capital costs in a time of recession, more investment will be encouraged thus increasing output and reducing unemployment. In times of inflation, discouraging investment through tax provisions will reduce the pressure on prices and interest rates, although some argue that investment incentives should be increased in some types of inflation to encourage greater productivity.

These goals of growth and stability appear to be inherently contradictory since the first implies a continuing incentive and the second a varying one. However, it is possible to have a continuing incentive such as liberalized depreciation and a varying one such as the investment tax credit. Both arguments, however, rest on the assumption that these devices will be effective in changing the level of investment, although timing is more important with the latter.

Some evidence exists on the impact of these provisions, including econometric studies and surveys of business behavior, which are discussed in the following pages.

Quantitative analyses of liberalized capital cost recovery

Since the middle of the 1960's there have been a number of efforts to analyze the impact of the investment tax credit and accelerated depreciation through the use of models. The following discussion summarizes the findings of a number of these studies and the criticisms which have been made of them.

One of the best known of these studies is the model developed by Hall and Jorgenson.[33] They examined the impact of the 1954 and the 1962 depreciation revisions and the 1962 investment tax credit. Their model assumes that firms are maximizing profits and measures how much they would be expected to increase investment because of the decreased costs of capital. The model assumes that the elasticity of substitution between labor and capital is 1.[34] Output was held constant.

Their findings showed that gross investment in the 1954–1963 period was increased (deriving from accelerated depreciation methods) for structures 11.4 percent in manufacturing and 9.8 percent for nonfarm nonmanufacturing. For equipment the increases were 7.1 percent and 6.8 percent respectively. They found the 1962 depreciation revisions to be limited to equipment, increasing gross investment (for 1963) in manufacturing by 3.7 percent and in nonfarm nonmanufacturing by 3.7 percent. The most significant impact they found, however, was on equipment through the investment tax credit which for 1963 increased by 10.2 percent for manufacturing and 10.1 percent for nonfarm nonmanufacturing. From these results, they concluded that tax incentives have a substantial impact on investment.

[33] Robert E. Hall and Dale W. Jorgenson, "Tax policy and investment behavior," American Economic Review, June 1967, vol. LVIII, No. 3, pp. 391–414.

[34] The elasticity of substitution is a numerical measure of the relative degree of substitutability of labor and capital. The higher this measure, the greater would be the impact on investment in capital from any given provision which reduces the relative cost of capital.

In later studies,[35] Hall and Jorgenson updated their estimates to cover additional changes. They found the revised investment credit for 1964 (which did not reduce the basis) and the temporary suspension of the credit in 1966 to have a substantial impact on the level of investment. They also found the cut in the corporate tax rate in 1964 to have a slightly negative impact on the level of investment.

The Hall and Jorgenson approach has been criticized on several grounds. One criticism suggests that the elasticity of substitution between labor and capital is in fact substantially less than one. Criticisms along these lines were made by Coen [36] and by Eisner [37] who argued that these assumptions resulted in substantial overstatements of the impact of tax depreciation policy on investment. Eisner suggested that the impact was probably only about one-sixth as much as the Hall-Jorgenson estimates. Another criticism was that interest rates were held constant [38] (interest rates may be expected to rise if there is a greater demand for capital). Hall and Jorgenson,[39] in response, cited a substantial number of studies showing the elasticity of substitution between labor and capital to be around 1. However, there is by no means argument among economists on this question.[40] The assumption of this elasticity will have substantial effects on the results.[41]

Numerous other studies of the effects of tax incentives have been done, some confirming the Hall-Jorgenson results and some finding these tax incentives to be not very effective. While space does not allow a complete discussion of these studies, a few will be noted. Bischoff,[42] using a model which assumed a constant but unspecified elasticity of substitution between capital and labor, found that the effects of these incentives were significant. However, his findings showed that while the stimulus due to the investment tax credit exceeded the revenue loss from the credit, the stimulus from accelerated depreciation was considerably less. Coen [43] found that accelerated depreciation increased expenditures by $2 billion (1954 dollars) from 1954 to mid-1962, while revenue losses were $5.1 billion. For all incentives expenditures were increased by $2.8 billion from mid-1962 through the third quarter of 1966, while revenue losses were $8.6 billion. The incentives would thus not appear to be effective in relation to revenue foregone based on his analysis. Klein and Taubman [44] looked at the effect of a temporary tax credit suspension using the Wharton School model (which allowed the inclusion of feedbacks from the national economy). They found that the suspension of the credit would have reduced investment by $2.3 billion in 1967, with about half the impact due to feedback effects, while a permanent reduction would have reduced investment by $1.6 billion (both 1958 dollars). A study by Aaron, Russek and Singer [45] looked at the effects of the Tax Reform Act of 1969 (which reduced investment incentives) and the Revenue Act of 1971 (which increased incentives using the Federal Reserve Board-MIT model). While their findings were consistent with

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[35] Robert E. Hall and Dale W. Jorgenson, "Tax policy and investment behavior: reply and further results," American Economic Review, June 1969, vol. LIX, pp. 388–400 and "Application of the theory of optimum capital accumulation," in Tax incentives and capital spending, Gary Fromm (ed.), Washington, Brookings Institution, pp. 9–60.

[36] Robert M. Coen, "Tax policy and investment behavior: comment," American Economic Review, June 1969, vol. LIX, pp. 370–379.

[37] Robert Eisner, "Tax policy and investment behavior: comment," ibid., pp. 379–388.

[38] Gerard M. Brannon, "The effects of tax incentives for business investment: a survey of the economic evidence." in The economics of Federal subsidy programs, Joint Economic Committee, 92d Cong., 2d sess., July 15, 1972, p. 251.

[39] Robert E. Hall and Dale W. Jorgenson, "Tax policy and investment behavior: reply and further results," op. cit.

[40] For a brief discussion of studies on the question of the elasticity of substitution between labor and capital, indicating that findings varied from zero to slightly more than 1, see Gerard M. Brannon, "The effects of tax incentives for business investment: a survey of the economic evidence," op. cit., pp. 252–253.

[41] Robert Eisner pointed out that the findings of Coen showed that an estimate of $6.7 billion for 1954 to 1963 (1954 dollars) attributable to investment incentives would be reduced to under $2 billion if an elasticity of 0.2 was used. See "Tax policy and investment behavior: further comment," American Economic Review, September 1970, vol. LX, No. 4, pp. 746–752.

[42] Charles W. Bischoff, "The effect of alternative lag distributions," in Tax incentives and capital spending, op. cit., pp. 61–130.

[43] Robert M. Coen, "The effect of cash flow on the speed of adjustment," ibid., pp. 131–196.

[44] Lawrence W. Klein and Paul Taubman, "Estimating effects within a complete econometric model," ibid., pp. 197–242.

[45] Henry J. Aaron, Frank S. Russek, Jr., and Neil M. Singer, "Tax changes and composition of fixed investment: an aggregative simulation," Review of Economics and Statistics, vol. LIV, November 1972, pp. 343–356.

Hall and Jorgenson in the relative impacts, the magnitudes were considerably less. While Jorgenson [46] using the DRI (Data Resources, Inc.) model forecast an increase in equipment investment of $6–$7.5 billion in 1973 through 1975. Aaron, Russek and Singer forecast an increase of about $1–2 billion. They also found that the increased investment in one component comes at the expense of other components since they assumed that the supply of investible funds was inelastic with respect to the interest rate.

Taubman and Wales [47] criticized earlier studies such as Hall and Jorgenson because they were concerned with a partial equilibrium [48] model in a short run framework. While they conceded this analysis may be useful for measuring the effectiveness of these tax provisions for counter-cyclical purposes, they suggested that a general equilibrium analysis would be more appropriate if the provisions were used to encourage longer term growth. Using such a model, they found that the impact of the tax provisions are substantially smaller than in a partial equilibrium analysis. They note that investment can only increase if the aggregate level of savings increases, either as a response to the interest rate or because of a redistribution of income to those who have a higher propensity to save. As noted earlier, there is some evidence that savings rates are not very responsive to rates of return. They also indicate that the gains from the increase in output due to increased investment after a new equilibrium has been reached is likely to accrue to capitalists rather than workers.

In an examination of the impact of the investment tax credit in the Revenue Act of 1971, Paul Taubman [49] suggests that the investment tax credit had limited usefulness as a counter-cyclical device. He presented results from the Wharton Economic Forecasting Model which showed the annual impact of the credit on investment to be none in the first quarter, $.1 billion in the second and rising gradually to $1 billion in the eighth. Overall impact was $.2 billion in the first year and $.7 billion in the second year. The Data Resources Incorporated (DRI) model found investment to remain unchanged in the first three quarters, but rising to $5.7 billion in the last quarter. The first year effect was none, the second year $2.9 billion. GNP was expected to increase by $.4 billion in the first year and $1.3 billion in the second (Wharton) and by $.1 billion in the first and $.3 billion in the second (DRI). The Wharton model showed a .05 percentage point increase in the Consumer Price Index in both years and a .02 and .07 decline in the unemployment rate for the first two years. The DRI model showed no effect on the Consumer Price Index, no effect on unemployment in the first year and a .1 reduction in unemployment in the second.

Although the two models predicted quite different impacts on investment in the second year, they both show little stabilizing value in the first year and relatively minor impacts on unemployment and inflation in the second. These results, Taubman concludes, indicate that the credit was a failure as a stabilizing device. He also suggests that actual changes in investment observed since then support this conclusion.

The results of these studies show conflicting results but tend to suggest that the Hall-Jorgenson results may be high. The studies do raise some questions about the effectiveness of the tax provisions in stimulating investment.

Tax incentives and investment decisions: Surveys of businesses

The preceding section has looked at some economic analyses of the impact of tax liberalized capital cost recovery. These studies, among other things, assume that businessmen will make investment decisions in a certain way (i.e., that they wish to maximize profits, that they have knowledge to make rational decisions, and that they will respond to such incentives). Another approach to examine the impact is to ask businessmen themselves how these tax provisions affected them. This approach may be particularly useful in examining the usefulness of the

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[46] Dale W. Jorgenson, "Statement in long-term economic implications of current tax and spending proposals," Hearings, Subcommittee on Fiscal Policy, Joint Economic Committee, 92d Cong., 1st sess., May 24, 1974, pp. 176–192.

[47] Paul Taubman and Terence J. Wales, "Impact of investment subsidies in a neoclassical growth model," Review of Economics and Statistics, vol. LI, No. 3, August 1969, pp. 237–297.

[48] A partial equilibrium analysis examines a small sector of the economy. The general equilibrium analysis examines the entire economy.

[49] Paul Taubman, "The investment tax credit, once more," Boston College Industrial and Commercial Law Review, vol. 14, May 1973, pp. 871–890.

incentive as a counter-cyclical device, since such a use requires a relatively rapid response.

A summary article [50] reported the results of several industry surveys. McGraw-Hill's survey in the Spring of 1962 indicated that businesses as a whole would increase their 1962 expenditures by only 1 percent in response to the investment tax credit. Nine out of ten of the companies responding indicated that it would not have an effect. The National Industrial Conference Board survey of the 1000 largest manufacturing corporations, taken in March and April of 1962, suggested that the increase in 1963 expenditures would be small. In more than half the cases the difference was less than 1 percent. In a 1965 article Woodward and Panichi [51] reported that out of 42 firms surveyed, only 4 indicated that the credit exerted a slight influence, 1 a moderate influence, and 31 no influence at all. The National Industrial Conference Board survey of the 1,000 largest manufacturing corporations indicated that there would be only moderate cutbacks from the suspension of the credit—1.3 percent in the first half of the year and 2.8 percent in the second half.

A survey by Castellano [52] of 40 businesses in the Dayton, Ohio area found that out of the 27 responding only 4 indicated that they were strongly influenced by the tax credit, 8 that they were midly influenced and 15 not at all. A survey by Bakay and Christiansen [53] of 626 firms, with 254 replies, in the Wisconsin, Illinois, Indiana, Michigan and Minnesota areas showed that 150 firms reported no difference due to accelerated depreciation, 145 no difference due to the investment credit and 168 no difference due to the guideline lives. There was some influence reported by 63, 60 and 30 of the firms respectively, and no answer for 41, 49, and 56.

In May of 1972, Rinfret Boston Associates [54] added questions about the effect of tax provisons to their regular survey of businesses (which had a 75 percent response rate and accounted for over 50 percent of private capital investment) Of the total, including public utilities, 75.2 percent reported no change in capital spending plans due to the investment tax credit and 90.1 percent reported no change due to ADR. Excluding public utilities, the results were 72.1 percent and 89.9 percent respectively.

The results of these surveys suggest that businessmen themselves are not directly influenced by tax incentives to a substantial degree in their decisionmaking about capital investment.

Qualitative criticisms

These econometric analyses and surveys tend on the whole to suggest that the impact of tax provisions on investment may be limited. However, even if they do have a substantial impact, they can be criticized on other grounds. For example, Robert Eisner [55] criticizes the use of tax provisions to encourage long term growth on both efficiency grounds and on normative grounds. He suggests that in the absence of such provisions consumers are making choices about whether they wish to consume in the present or consume in the future (i.e. invest). Investment stimulated in the present means less consumption. The question then is whether it is a proper role of the government to make these choices for consumers. The acceptance of a goal of induced growth may be a questionable proposition. He also criticizes the use of tax incentives to encourage growth on efficiency grounds. If one assumes that an additional machine will be acquired only if the discounted value of its future production to consumers is equal to its cost, then a subsidy may encourage capital expenditures which would not be freely accepted by consumers. Economic theory suggests that if a firm is maximizing profits it may invest in a marginal unit which will yield discounted income equal to cost. A subsidy

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[50] John W. Cook, "The investment credit: investment incentive and counter-cyclical tool." Taxes. March 1967, pp. 227–233.

[51] F. O. Woodward and Vincent M. Panichi, "Investment influences of the tax credit program," National Tax Journal, vol. 18, September 1965, pp. 272–276.

[52] Joseph F. Castellano, "The effect of the investment tax credit: an emprical study," Akron Business and Economic Review, vol. 3, winter 1972, pp. 31–33.

[53] Archie J. Bakay and Irving K. Christiansen, "The role of accelerated depreciation and the investment credit in stimulating business growth," Akron Business and Economic Review, vol. 4, summer 1973, pp. 22–25.

[54] Statement of Pierre A. Rinfret, "General tax reform," panel discussions before the Ways and Means Committee, pt. 3—Tax treatment of capital recovery, 93d Cong., 1st sess., Feb. 7, 1974, p. 433.

[55] Robert Eisner. "Business investment preferences," George Washington Law Review, vol. 42, no. 3, March 1974, pp. 486–500.

to investment may encourage a firm to invest in a machine which yields discounted income less than cost (disregarding the income attributable to the additional deduction for accelerated depreciation).

The goal of stability, that is of using capital cost recovery provisions for counter-cyclical purposes is a widely accepted role of government policy. If tax provisions can be used effectively in this manner, then they may be justified. The greatest difficulty here, aside from the question of impact, is whether such incentives can be properly timed. If a government response is to be made to a need for investment there are a number of delays encountered. First, the existence of the need must be recognized. The lag in economic data on which to base a decision is one of the most serious problems. Then, government must take legislative action, which could involve a substantial amount of time while policy is debated. After enactment, firms must respond. Since many capital investments require substantial lead time, the reaction of the firm must also take time. It is quite possible, that by the time the firms reacted and the impact of investment was felt, business conditions may have changed so much that it becomes an improper policy. A stabilizing move which has an impact at the wrong time may be worse than no action at all.

F. TAX POLICY AND INTERNATIONAL TRADE

An important argument for liberalized capital cost recovery methods is that such provisions are necessary in order for American firms to compete abroad with firms in countries which have similar liberalized methods of depreciation. For example, a Treasury study [56] reported in 1962 showed that U.S. depreciation policies were more restrictive than other major countries both before and after the 1962 revisions in depreciation and the imposition of the investment tax credit. A study by Rinfret Boston Associates [57] showed the cost recovery provisions in the United States to be more restrictive than in the U.K., West Germany, Japan, Italy, Sweden and Belgium. However these studies did not take account of the corporate tax rates.

A study prepared by Treasury [58] and presented in 1971 did take account of the rates by showing comparative costs of capital. Comparing the United States with several countries they showed capital costs without ADR and the investment tax credit were greater in the U.S. than in other major countries. With the investment tax credit and ADR U.S. capital costs were still higher than those in the U.K. Japan, Italy, West Germany, Sweden and Belgium, and lower than those in Canada, the Netherlands and France. Another difficulty with even a study which takes account of rates is that other countries may ignore other aspects of the country's tax policy which may have a bearing (indirect taxes, regional taxes, etc.). However, it should be noted that indirect taxes, such as the value added tax common in European countries, are rebated on exports.

The argument for liberalized depreciation to compete with other countries' methods may be criticized on several grounds. Eisner and others [59] point out that the argument ignores the basic principle of comparative advantage in international trade. This principle shows that countries will export those goods in which they have a comparative advantage, i.e. which they can produce cheaply relative to other goods.[60] Assuming flexible exchange rates, these rates would adjust to reflect changes in prices, as a nation cannot consistently export more than it imports. The only way in which a country can increase its exports is by increasing its total output and income. Thus an investment incentive would

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[56] Tax Foundation, "Depreciation allowances: Federal tax policy and some economic aspects," New York, 1970, pp. 44–52.

[57] Statement of Pierre Rinfret, "General tax reform," panel discussions before the Committee on Ways and Means, pt. 8, Tax treatment of capital recovery, 93d Cong., 1st sess., Feb. 7, 1973, pp. 427–460.

[58] Statement of Secretary of the Treasury John B. Connally, The Revenue Act of 1971, hearings before the Committee on Finance, U.S. Senate, pt. 1, 92d Cong., 1st sess., p. 8.

[59] See for example, Robert Eisner, "Business investment preferences," George Washington Law Review, vol. 42, March 1974, pp. 497–498 and Paul Taubman, "The investment tax credit, once more," Boston College Industrial and Commercial Law Review, vol. 14, May 1973, p. 878.

[60] Even if it costs a country more to produce everything relative to other countries, it will still trade those commodities that it can produce cheaply relative to other goods and import those which produces less cheaply as it will have more goods if it trades. Similarly, a country which produces everything more cheaply than other countries, will trade those items which are relatively less expensive to produce, as it will also have more goods if it trades.

increase exports only by increasing productivity. However, a government subsidy to one industry might shift the comparative advantage. Thus a provision which reduces capital costs will benefit more capital intensive industries and encourage their exports at the expense of less capital intensive industry.

There may be a case for such provisions if flexible exchange rates do not exist, although again the comparative advantage may shift among industries. However, this argument does not suggest that we necessarily change our capital recovery provisions to match those of other countries. (No one has, for example, suggested that we adopt the income tax rates of other countries in order to compete.) The question may be asked whether it is desirable to adopt provisions which will have an impact throughout our economy for the purpose of encouraging exports. It would seem that a more direct approach, if we do not support flexible exchange rates, is to provide subsidy directed specifically at exports such as the Domestic International Sales Corporation (DISC).[61]

G. ADMINISTRATIVE SIMPLICITY

The arguments for provisions based on administrative simplicity have generally been focused on the question of useful life, as illustrated in the history of depreciation policy. This history illustrates the problem encountered in the 1930's in allowing taxpayers to choose their own lives. With tax rates much higher now a taxpayer in his own self-interest would be expected to choose lives much shorter than actual lives.

The result is that regulations must generally prescribe some sort of guide to useful tax lives. Of course, the shorter the allowable tax lives are in relation to real lives the less the likelihood of taxpayer disputes regarding these lives. In addition, while it may be legally possible to allow shorter lives than the taxpayer's actual lives, it is of questionable legality to require longer lives since the result would be an overstatement of net income. Hence, the argument for shorter lives based on administrative considerations.

Administrative simplicity played a major role in the stated reasons for the Treasury's adoption of the ADR system and abandonment of the reserve ratio test. By choosing average industry tax lives which were probably already shorter than real lives and further allowing the lives to be shortened by 20 percent, along with discarding the reserve ratio test, it would be expected that the vast majority of taxpayers would adopt the guidelines without dispute.

The Treasury indicated two major sets of reasons for adopting ADR in 1971. One reason was the recognition of obsolescence which they felt suggested that depreciation allowances should not be tied to an individual taxpayer's circumstances. The other was stated as:[62]

"The necessity from the standpoint of administration of the internal revenue laws for a comprehensive and improved system for dealing with the allowance for depreciation and the integrally related problem of repair and maintenance expenditures; the long history of controversy over Bulletin F; the fundamental defects of the reserve ratio test; the magnitude of the problem of extensive facts and circumstances disputes with a substantial number of taxpayers; the logic, practical importance and greater equity of relying on industry average lives; the need to move towards neutralizing depreciation as a competitive factor; and the necessity of providing a depreciation accounting system which would produce regular, systematic data for use in establishing industry lives and repair allowances—all these factors dictated the adoption of the ADR system."

The Treasury also noted that if the reserve ratio test were applied, taxpayers who failed it would be expected to assert that their lives were proper on a facts and circumstances basis. They estimated that if even 5 percent of taxpayers did this it would require audits of 150,000 returns. They indicated substantial manpower difficulties in dealing with this.[63]

Some critics have charged that the administrative simplicity argument was simply window dressing for a proposal to provide a subsidy for business. It should be noted that the Treasury does not have the authority to reduce taxes and changes

[61] A DISC's profits are taxed to the shareholder rather than to the DISC itself up to at least 50 percent of earnings. Tax on the remaining 50 percent is deferred as long as reinvested in export activities of the DISC.

[62] Department of the Treasury. Asset depreciation range. June 1971, p. 239.

[63] Ibid., p. 243.

in depreciable lives must be on grounds other than incentive ones. Even so, the Treasury discussion noted the expected stimulus to the economy. It might also be noted that there was substantial debate in 1971 over whether the Treasury had the authority to prescribe ADR and the issue was only resolved when Congress adopted the system as part of the Revenue Act of 1971.

Martin David took such a view of ADR. He noted: [64]

"The action was taken because it did not, in the eyes of the Administration, require legislative approval. Had legislation been required the Treasury need not have offered an elective package to the taxpayer. The administration chose the ADR as a means to short-run stabilization policy, not as an end to improving the administration of the tax law. Had fundamental improvements in tax administration formed the heart of this proposal; had the improvements been backed by by solid documentation there would have been no reluctance to consider a plan that required legislation.

"The truth is that the Treasury conceived of simplification as a useful slogan to sell a program that was generated by strong political pressures from industry and the short-term demands of a sagging economy."

He also suggests that the expectation that litigation over the reserve ratio test would have been overwhelming, as suggested by Treasury, is unlikely since there are substantial costs to the taxpayer in proving depreciation under a "facts and circumstances" test.[65]

It is clear that a system such as ADR has superior administrative simplicity. So would allowing taxpayers to choose their own lives without challenge. The administrative simplicity argument must be put in perspective and the administrative costs compared with possible revenue losses from the proposal. However, if other factors support the adoption of ADR, such as economic incentives, the additional administrative superiority of the system must be considered. If ADR and some other incentive such as an increased investment credit seem equally attractive on other grounds, then a proposal such as ADR may be chosen on administrative grounds.

H. THE TAX SHELTER PROBLEM

The question of tax shelters is a specialized issue in the question of depreciation policy. However, it cannot be denied that accelerated capital cost recovery methods and the expensing of certain items play a major role in the development of tax shelters in real estate, farming, oil and gas and equipment leasing.

Mechanism of the tax shelter

A real estate tax shelter may be taken as an example. Such a shelter would be characterized by a limited partnership as the investment vehicle, usually featuring a highly leveraged investment. The deductions generated are a means of sheltering other income from tax liability. For example, an individual with a high income might invest in an apartment complex, borrowing 90 percent of the funds. During the construction and early period he can deduct taxes, interest on the loan and depreciation before any income is received. These deductions reduce his other income which would have been subject to high rates. In the early years, the tax savings from this deduction may actually exceed his equity investment in the project. Thus, in the case of a limited partnership, he may enjoy a riskless investment.

These provisions figure in tax shelters in other areas as well—the expensing of intangibles in oil and gas drilling, the expensing of farming expenditures in farm shelters and depreciation and investment credit in equipment leasing. The main benefits to the investor are that he may enjoy a relatively riskless investment, that he defers taxes on his regular income and thus enjoys the equivalent of an interest free loan and that there is some possibility of realizing gains reflecting accelerated depreciation when he sells the investment which will be taxed a lower capital gains rate while the depreciation deductions reduced income which would have been taxed at ordinary rates.

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[64] Martin David. Discussion. Tax depreciation reform, the Journal of Finance, vol. XXVII, May 1972, p. 538.

[65] Ibid., p. 540.

The issue of tax shelters

Tax shelters develop because certain provisions, such as accelerated depreciation which may have been put in the law because of fairness, simplicity or as incentives are coupled with the desire of high income individuals to shelter income. Depreciation itself is probably most important in the real estate tax shelter. One reason is that, although accelerated depreciation is limited for real estate, it is still quite likely to substantially exceed true decline in value. For example, Taubman and Rasche[66] suggest that true depreciation in the case of real estate is only about one fourth the rate allowed in the tax law and that a reverse sum of years digits would more appropriately reflect true economic decline.

Tax shelters are likely to reallocate investment capital into particular areas such as real estate. It may be a desirable objective to divert resources, if for example, there is a need for investment in housing. However, to the extent that investments are made in projects whose primary attraction is the tax benefit rather than soundness as an investment, a cost is imposed on society, particularly if these funds are diverted from more productive uses. In addition, the government incures substantial revenue losses.

Methods of dealing with tax shelter operations

Some critics of the use of tax shelters argue that the underlying provisons which lead to these shelters should be revised. For example, they suggest that real property be limited to straight line depreciation. Others, however, propose specific provisions aimed at these operations while retaining the provisions in general use.

There are provisions in current law which are aimed at these problems. These provisions include the recapture rules for treating capital gains as ordinary income and the minimum tax on preference income. Included in the preference income base are accelerated depreciation on real property in excess of straight line and amortization in excess of accelerated depreciation in general These provisions have been charged to be ineffective in some instances. For example, the minimum tax has been charged to be of limited impact because of the low rate and high exemptions. However, it should also be noted that depreciation on real property is much more limited than that on machinery and equipment and that the investment credit is not allowed for structures.

One approach to strengthening the provisions is to revise the minimum tax by increasing the rate and reducing the deductions. The Treasury has proposed a Limitation on Artificial Accounting Losses (LAL). This proposal would disallow as a deduction that portion of loss in the investment which derived from accelerated deductions including accelerated depreciation in excess of straight line on real estate, taxes and interest during the construction period and certain other deductions relating to oil and gas, leased property and farming. Another proposal which has been made is to limit losses to the taxpayer's actual equity investment.

I. REVENUE LOSSES

The provisions involving accelerated capital cost recovery result in substantial revenue losses. Table I sets out estimates of these revenue losses for a number of provisions.

One major item missing from the list of losses shown in Table I is that from accelerated depreciation on machinery and equipment and the existence of tax lives which may have been shorter than real lives before the ADR. In the conceptual analysis of the tax expenditure budget the Treasury stated:[67]

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[66] Paul Taubman and Robert Rasche, "Subsidies, tax law and real estate investment," in U.S. Congress, Joint Economic Committee, "The economics of Federal subsidy programs," pt. 3, Tax subsidies, July 15, 1972, pp. 343–369.

[67] The tax expenditure budget. a conceptual analysis." 1968 Report of the Secretary of the Treasury, Washington, U.S. Government Printing Office, 1969, p. 322.

TABLE 1.—ESTIMATED REVENUE LOSS FOR CAPITAL RECOVERY TAX PROVISIONS[1]

[In millions of dollars; calendar year unless noted]

	1967	1968	1969	1970	1971	1972	1973	Fiscal year 1975
Investment credit	2,300	3,000	2,630	910	1,800	3,800	4,300	4,900
Corporations					1,495	3,050	3,500	4,100
Individuals					305	750	800	800
Depreciation on buildings (other than rental housing) in excess of straight line	500	550	550	500	480	500	530	600
Corporations					320	330	350	400
Individuals					160	170	180	200
Asset depreciation range					700	[2] 860	1,250	1,500
Corporations					600	850	1,240	1,490
Individuals					100	10	10	10
Depreciation on rental housing in excess of straight line	250	250	275	255	500	600	600	600
Corporations					300	350	350	....
Individuals					200	250	250	....
Rail freight car amortization				105	45	[2,3] 80	[3] 40	[3] 10
Housing rehabilitation					25	40	50	65
Corporations					10	15	20	25
Individuals					15	25	30	40
Pollution control amortization			15	15	15	25	35	40
5-yr amortization of child care facilities						5	5	5
Expensing of exploration and development costs[4]	300	330	340	325	325	[2] 650	750	860
Corporations					260	580	650	760
Individuals					65	70	100	100
Expensing of research and development costs	500	550	565	540	545	570	580	650

[1] These estimates are those which have been commonly termed tax expenditures and thus which may be viewed as subsidies. A notable omission is accelerated depreciation on machinery and equipment, for which an estimate is extremely difficult. Also omitted are the items related to farming since they are lumped with capital gains. These estimates are each prepared separately (unless noted), and thus not additive. Only first order effects are considered. Also omitted are some amortization provisions which involve minimal revenue losses.

[2] Changes in the 1972 figures as compared to 1971 which are due wholly or in part to revised data and/or new sources or data and/or improved estimating methods.

[3] This provision is being superseded by the investment tax credit.

[4] Estimates for years before 1972 consider the provision in conjunction with percentage depletion.

Source: Estimates for 1967–72 are from U.S. Congress, House, Committee on Ways and Means, Estimates of Federal Tax Expenditures, prepared by the staffs of the Treasury Department and Joint Committee on Internal Revenue Taxation, June 1, 1973. Estimates for 1973 and fiscal year 1975 are from Tax Analysts and Advocates, Tax Notes, April 15, 1974, and January 21, 1974 respectively.

"Some items were excluded where there is no available indication of the precisee magnitude of the implicit subsidy. This is the case, for example, with depreciation on machinery and equipment where the accelerated tax methods may provide an allowance beyond that appropriate to the measurement of net income but where it is difficult to measure that difference because the true economic deterioration or obsolescence factor cannot be readily determined."

Robert Eisner has proposed a total rough estimate for all accelerated depreciation for 1973 at $11 billion.[68]

CONCLUSION

Translating these arguments for liberalized capital cost recovery methods into a guide for determining tax policy is difficult. Past experience, while not a sure guide to the future, does at least suggest that in the nineteen sixties tax lives were shorter than real lives. The 1971 changes made these lives shorter. Such a departure from the measurement of true economic decline is increased by accelerated methods of depreciation. The investment tax credit, of course, is clearly a departure from true measurement of capital recovery.

[68] Robert Eisner, "Bonanzas for business investment," Challenge, November-December 1973, p. 40.

Thus, these measures can be viewed in large part as tax subsidies to business. It is then proper to examine the arguments for reduction in capital cost through tax policy. The arguments involving inflation and tax neutrality appear to provide a weak argument for liberalized depreciation and investment credits per se. Inflation and a possible anti-capital bias in our tax system are very real questions. These arguments seem to be weak not in the fact of their existence as distorting factors, but in the use of liberalized capital cost recovery as a solution. In the case of inflation, it would seem a more direct remedy to develop government stabilization policies which will help to control inflation, or, if inflation is to be institutionalized, reflect the existence of inflation throughout the tax law.

Similarly with the tax neutrality argument. If we wish to decrease a possible anti-capital bias in our tax system the more direct route would seem to be to reduce those aspects of our tax system which are alleged to be responsible for the bias—reduce the top tax rates, reduce the corporate income tax rates, etc. Policy may suggest, however, that we do none of these, that we are willing to accept this bias as a cost of a tax system which will weigh less heavily on the poor.

The same view may be taken of the argument involving international competition. If tax policy is to be used to encourage exports, a stronger argument may be developed for a provision which directly benefits exports than one which reallocates investment throughout our entire economy.

Administrative simplicity, to the extent that it is an objective, is a good argument for the ADR system. This objective must, of course, be weighed against other costs, and may suggest the use of ADR as an alternative to provisions such as investment credit and the number of depreciation methods allowed which increase complexity.

This analysis suggests that the major reasons for liberalized capital cost recovery methods must be their use for the propose of growth and stability, even though induced growth has itself been challenged as a goal on normative grounds. The difficulty is that the impact, efficiency, cost-effectiveness and distributive results of these provisions in attaining such goals have been brought into question and are largely unresolved.

Representative STEIGER. The view of the White House was not always so disheartening as it is today. President Kennedy, as I indicated at the outset, saw the need to release the forces of growth and recommended cutting back the taxes on capital gains.

I think it might be useful for the committee—and you, Mr. Chairman, have done an excellent job in your opening statement, in laying out some of the problems with which we are faced, to look at what has happened in the 10 years.

In 1968 we were at relatively full employment, inflation was still moderate, the stock market was rising, new companies were being formed and the economy was basically healthy.

The seventies have been fairly dismal, in contrast to that. We have gone through two recessions and double-digit inflation. The stock market has declined and over 5 million individual investors have dropped out of the market.

In 1968, 300 high-technology companies were begun. In 1976, there were none.

Let us look at one particular problem—the ability to raise capital. In 1969, 698 firms with a net worth under $5 million raised $1.4 billion in capital. In 1975, four firms raised $15 million and in 1977, 30 firms raised $118 million. That is million, not billion.

It is plain, frankly, that something is very worng. High-technology industries and venture investors are convinced that the root cause of inadequate capital is the Tax Reform Act of 1969 which increased the tax on capital gains. I agree.

The Act narrowed the gap between ordinary income and capital gains, and it weakened the financial incentive to invest.

An analysis by Oscar Pollack reveals that between 1969 and 1976, investments in tax-free municipal bonds increased by 52.9 percent. Investments in the stock market, a primary source of capital, declined by 5 percent.

Yet, from 1962 to 1969, a period of low taxation on capital, stock market investments increased by 70.7 percent and even Joan Robinson, the English marxist economist, has acknowledged that people do not normally act out of altruistic motives. They need incentives, and if we create disincentives, people will not invest.

In short, capital gains taxes are even more important as a determinant of investment decisions than they are as a producer of revnue, and this point is fundamental and it is one that, to my sorrow, the President's advisers have failed to recognize.

Shrinking capital markets are making it difficult for firms to raise capital. Competition is fierce, but it is not competition to produce goods and services. It is competition to find the little capital that people are willing to make available.

Among the hundreds and hundreds of letters that have come into my office, as I am sure they have into every Member of Congress' office, and particularly to Cliff Hansen's, a retired Michigan businessman has written to say that he planned to start a new business by selling holdings in a mutual fund, but his accountant told him that the tax on the sale would not make the effort worth his while and, instead of creating new jobs, instead of investing in a new business, his money is locked into a mutual fund—and that is not an isolated case.

The Pollack data mentioned above indicates that capital locked into existing investments are flowing to tax-free bonds.

For those who are concerned over whether or not what Cliff Hansen and I are suggesting benefits the wealthy, it seems to me that they have missed the very fundamental point that for those who have substantial wealth, they have a way to deal with it right now, by simply investing in tax-free bonds. That is good for cities and towns and counties and States, but does not do very much at this point to increase the job opportunities for American people searching for employment.

In 1962, most capital gains revenues came from securities, 16 percent from real estate. In 1973, the most recent study, gains from stocks had dropped significantly but real estate had risen 23 percent and real estate is attractive for one reason—inflation.

Bob Strauss, with his trip to Texas, Senator, is the one who has to be charged with the responsibility for moderating inflation but there will be less incentive to invest in real estate if you moderate the rate of inflation and I will let Bob fight that battle, and I will help him, to the extent that we can.

One of the goals is to achieve adequate housing, and yet incongruously the administration is concerned that we might be encouraging capital investment in real estate. I saw that yesterday the cost of lumber had increased 20 percent in the past year. We will certainly not reduce the cost of housing by maintaining a high tax on capital or timber.

Internationally, our economy faces many vigorous competitors and it will be no easy task to maintain our competitive edge in the world

market. We have the highest capital gains tax of any country, the highest percentage of obsolete plants and equipment, the lowest productivity and one of the worst records of inflation. And I think the relationship is clear. The question is, what do we do about it?

The American Academy for the Advancement of Science this very week warned that our investment in research and technology has declined very dangerously. The administration has spent time looking at that very issue.

I think that it is fairly clear—and the AAAS predicts—that it will be 10 years before there is a change in our policy on research and development. Does anyone in this room believe that our competitors will wait 10 years?

I think not.

What is needed for us now is to act, and that is why I think this bill, the Investment Incentive Act is so important.

Some in the administration are not ignoring the problem. Stewart Eisenstaat, in a memo on industrial innovation, has recognized the difficulties that small, high-technology firms encounter in obtaining venture capital, and another very encouraging sign was Secretary Blumenthal's speech in Florida.

He said, and I quote:

> We are not saving enough. Our financial system is providing insufficient equity capital. We are not investing nearly enough in productive plant equipment and technological innovation. Profits are too low, and they are too uncertain.

Both the State and the Commerce Departments are working with the semiconductor industry to prepare them for the challenge of Japanese competition. Crucial to this effort is the increased investment, and that requires encouraging private investors to supply venture capital and to accept the risk that goes with that.

Yet, Treasury and the Executive Office are working against this innovative trade policy by advocating the continued high tax on capital gains.

Mr. Chairman, I assume that bell—I am looking for my sign here, as to whether it says green, yellow or red.

Senator BYRD. The sign is up here, Congressman.

Representative STEIGER. If I can, I will skip most of the rest of it and let you all take a look at it.

Senator BYRD. The full statement will be published in the record.

Let me, if I can, particularly direct your attention to page 7, because you will remember one of the statements that the President made was this would provide $250,000 for those who are millionaires and two bits for those with $15,000 to $20,000 worth of income.

What, of course, the President did not say in his statement was that he attempted to spread among all of those in that tax bracket the return on capital gains. Actually, it is $278 that goes to those who have capital gains in the $15,000 to $20,000 income level.

I suppose, in a sense, what I am suggesting to the committee is that you have to look very carefully at the numbers game. I do not think the numbers game achieves anything in making this economy work. I do not intend to play that game.

But I do believe, Mr. Chairman, that this economy, that this country, and that all the American people will benefit as a result of reducing taxation of capital gains.

I will quit there and be happy to answer any questions, if we have any.

Senator BYRD. Thank you, Congressman Steiger. I have only one question before yielding to Senator Packwood.

What is the status of this legislation in the House of Representatives?

Representative STEIGER. It is pending strongly before the Committee on Ways and Means.

So far as I can tell, despite the rhetoric, the strength continues to grow on the House floor as well as in the committee. Obviously, the problem I have at the moment is that we have to wait until the week of the 16th of July when I think the Ways and Means Committee will get back to work, when I think we will begin work on the Jones package, and then we will have to make some decisions about whether to go to the House floor with the full Steiger-Hansen bill or how this will work.

But I think by the middle of July, Senator, it will be fairly clear that the administration's effort to go with what they call a simple package, no reforms, no capital gains, will not have enough votes in the Ways and Means Committee, and we will report out a bill before the end of July that will have a substantial reduction in capital gains, and we will look forward to sending it to the Senate, having the Finance Committee carefully study it, and then adopt the Hansen amendment to go all the way.

Senator BYRD. Just one additional question for clarification. On page 7 of your statement that you invited attention to a moment ago, you say this: "The Steiger-Jensen-Hansen amendment will reduce taxes for this family by $577.50 simply by removing capital gains from the minimum tax."

I was under the impression that your proposal, as well as Senator Hansen's, not only removed capital gains from the minimum tax but rolled the rate back to what it was prior to 1969.

Representative STEIGER. That is correct. The example that we have given you for the $18,500 two-earner family, which is the national median, is that, as a result of the minimum tax, that is what happens; yes. What the bill proposes to do is to not only remove it from the minimum tax, but just to undo all of the damage that we have done to capital gains and to this economy since 1969 to roll the rate back to 25 percent.

Senator BYRD. Thank you, sir.

Senator Packwood?

Senator PACKWOOD. I have no questions right now.

Senator BYRD. Senator Bentsen?

Senator BENTSEN. Mr. Chairman, I do not have any questions, but I would like to use this opportunity to make a statement, because I feel strongly about this issue.

For 200 years, this country has prospered because we have had a free enterprise system that has encouraged the entrepreneur, the small businessman, to take a risk with the understanding that he was going to be able to keep some of it, if he won. We have not succeeded as a nation by playing it safe.

Today, the risks of starting a new business are as high as ever, but the rewards are even less with our tax system. We just cannot afford a

situation in this country where the risktakers are overtaken by the caretakers. If you do not leave something for the risktakers, there is not going to be anything for the caretakers to care for in this country of ours.

I think the one thing many fail to measure when they talk about equating all kinds of income, they do not measure risk. You cannot force people to put their money into risk situations, if they become convinced they are not going to be able to keep some of it if they win.

Then they invest their money in secure situations. They put it into tax-free municipals, long-term mortgages, and bonds. And new, risk capital companies are just not formed. They will not take that risk unless they feel that they can keep some of it.

I am reminded of what you read about on the sports pages when the fellow hits the daily double. You know, that is the headline. But they do not say anything about those torn-up ticket stubs that are there when you go down and look at the pavement and see the fellows that did not hit.

So again, if we are going to promote economic growth, if we are going to start the new ventures, then I think you are going to have to try to see that you equate that risk, in part, by the tax structure.

Senator BYRD. Thank you, Senator Bentsen.

Senator Hansen?

Senator HANSEN. Thank you, Senator.

Just one question, Mr. Chairman.

The President has said that 80 percent of the benefits from this bill that we have before us would go to taxpayers who make more than $100,000 per year. When the President makes such a patently absurd statement, as I think that is, does he not have to define "make" in a very special way so as to include what some economists call an expanded income class. A person may be earning $20,000 or $25,000 per year, but if he sells a capital asset, its value would combine with his actual earned income to make the total in excess of $100,000. Is that right?

Representative STEIGER. No question about it. And we have asked, you know, Mark McConaghy and the extraordinarily competent staff of the joint committee has been requested, and it is a little hard to do, to analyze that whole set of figures that Treasury is using, because it is not clear or fair. It is, I think, absolutely clear at this point that what they have done is to say, it does not make any difference what you earn as your income. If you sell the asset and go above $100,000 because you bought your home 25 years ago at $20,000 and you now sell it for $85,000, that will immediately force you above the income figure.

So what we have asked the joint committee for is to take out the capital gain and figure out where the income distribution is.

Senator HANSEN. Under the President's definition, then, a wage earner who never earned more than $15,000 or $20,000 any one year throughout his whole lifetime could when he were 70 years old sell his home. If the capital gain on that home, reflecting inflation and all of the other things that have occurred since then, were high enough, that person of modest means would find himself in that select group that the President refers to who earns more than $100,000.

Representative STEIGER. Absolutely right, Senator. No question about that.

Senator BYRD. Senator Roth?

Senator ROTH. I would like to congratulate Congressman Steiger for leading the fight in this very critical area. I think that one of the most important problems that this country faces today, and one that Congress gives too little attention to, is the question of productivity.

We find that we are on a decline instead of moving upward as is necessary if we are going to compete with some of our international partners.

Would you agree with me that one of the most serious problems this country faces today is the fact that the Japanese, the Germans, and the other industrialized countries are outcompeting us, selling products, not only in competition here in the American market, but in Third World countries, and we find ourselves less and less able to compete effectively with them?

Representative STEIGER. Senator Roth, there is no doubt that the present climate, economic climate, in the United States, if it continues as it is right now, we will find not very far down the road that we will be besieged even more than we are today by a kind of high technology, innovative manufacturing, computer, semiconductor, all of the other things that will come from abroad.

One of the reasons that I got into this, having followed Lloyd Bentsen's lead who fought this fight long before any of the rest of us—unfortunately, unsuccessfully—was the kind of testimony that we had before the Ways and Means Committee and that you are going to have today and tomorrow before the Senate Finance Committee, of the venture capital people trying to raise money, not being able to do it and then having to go abroad to raise equity capital so that they can expand and do their business.

And the price that this country will pay for that kind of policy is just frightening as hell, not very far down the road.

So that you are right. We cannot continue this way. We have to make a change and we have to make a change that will allow the United States to maintain its technological capability and its innovative lead, and if we do not do that, then this country is in even more serious trouble as a result of the kinds of things that have happened.

Senator ROTH. Is it not true that one of the principal ways of improving our productivity is by investment in new capital equipment, modernizing our plant, and encouraging technological advances?

Is that not a major part of the answer to improving the productivity of America in comparison with other countries?

Representative STEIGER. Without question. It has to be it always has been the case in this country, and that is one of the reasons that we have done as well as we have, and we are losing that.

Senator ROTH. Is it not also true that many other countries, even those with a Socialist government, provide greater incentives for risk taking, greater incentives for investment, and, in many cases, do not even have a capital gains tax?

Representative STEIGER. That is correct. The figures—Senator Byrd gave some of them at the very beginning of his opening statement and, you know, those tables are going to be a part of this record. We have the highest rate of taxation on capital gains of any of the industrailized countries, including countries like Sweden and others, like Great Britain, that would be classified as certainly less enterprise

market-oriented than the United States. And they understand how that system works and the need to allow people to take a risk and to receive a return on that risk.

Senator ROTH. Congressman Steiger, it just shocks me to read the President's statement, a demagogic statement if I ever heard one. When he goes abroad, I hope he will talk to some responsible members of foreign governments, including officials from the Socialist Party, and hear their attitude in this area. It just seems to me, Mr. Chairman, that if this country is going to work its way out of its economic morass, that we had better start talking economic sense, not politics.

I congratulate you, Mr. Steiger.

Representative STEIGER. Thank you, Senator.

Senator BYRD. The Senator from Missouri is recognized, Mr. Danforth.

Senator DANFORTH. I have no questions.

Senator BYRD. Thank you, Congressman Steiger.

Representative STEIGER. Thank you, Senator, very much, No .1, for the kind of support that has been given but, most important, for holding these very timely hearings.

Senator BENTSEN. Let me comment on one thing here, if I may, Mr. Chairman, to Congressman Steiger.

I appreciate your comment about the work I have previously done on this, When it comes to some of these figures we get out of the executive department, they lack some credibility.

I noticed that when I proposed some capital gains changes in the past, they told me it was going to cost about $2 billion in revenue. Then I noticed the next year a Treasury official—this was some time back—proposed something that was somewhat comparable, and all of a sudden it was going to make money for the Treasury.

STATEMENT OF REPRESENTATIVE WILLIAM A. STEIGER

I want to commend Chairman Byrd for calling these hearings on the taxation of capital gains. This subject is important to the health of our economy and to the openness of our society.

When the President of the United States summons the nation's press to a televised news conference and then—with the full force of his high office—he proceeds to attack a "so-called Steiger amendment," which is only three sentences long, and he suggests that to lower these particular taxes is really a "two-bit" proposal, well, then, a lot of people get the feeling: there must be something to be said for this so-called Steiger amendment. They are right, of course; and this is what I hope to show the Members of your Committee this morning. Among other considerations, I will show that our President has been given misleading statistics. that he's been given some poor advice about economic growth and that he himself miscounts what it is that encourages private individuals to buy their homes and to take investment risks that ultimately create jobs and enhance the productivity of a free enterprise system.

Let me briefly explain what my proposal will do. It is, as I said, only three sentences long. The bill reduces capital-gains taxes to a rate of 25 percent, for individuals and corporations alike. This is the same rate that was in effect prior to the Tax Reform Act of 1969. Under current law, capital-gains taxes can approach 50 percent for individuals and 30 percent for corporations. The bill does not change the present treatment of capital losses. It does not change the one year holding period required for long-term capital gains.

I will not argue that the proposal known as the Steiger-Jenkins-Hansen amendment will stop inflation, produce full employment, balance the budget, eliminate the need for imported oil, or reduce the trade deficit. I do say: our Investment Incentive Act will greatly improve the economic climate in this country, simply by reducing the tax burden on our capital stock.

Since 1963, our tax policies have penalized investment and rewarded consumption. To stimulate the economy, by encouraging consumption, we have lowered income taxes for the lower and middle income taxpayer. But, at the same time, we have increased the tax burden on capital by as much as 100 percent.

Recent utterances of the Administration and of some tax "reformers" reveal a deep-rooted confusion over the difference between income and capital. Income, comprised of consumption and savings, is the reward or incentive we receive in exchange for our labor. Capital, on the other hand, is the resource that provides the tools which enable us to employ our labor. By taxing capital as income, we reduce our capital stock and our ability to invest, to create jobs, and to improve both the private and public welfare. Only a mistaken tax policy ignores the economic theory of development.

To make matters worse, our tax code is biased against capital. Income is taxed only once, when it is earned. Capital is taxed several times. We tax the income which is used to obtain a capital asset. We tax the nominal (inflated) gain on the asset when liquidated, even if it is reinvested (except in housing). We tax the income generated by the original capital asset and the reinvested capital asset. Clearly, today's tax system discourages the formation of capital. Little wonder that our economy is suffering from insufficient investment, inflation and slow growth.

I would like to include in the record an article by Lawrence Seltzer who discusses the effects of our taxes on capital gains and income. His report was published by the American Economic Association.

The view from the White House wasn't always so disheartening. In 1963, President John F. Kennedy saw the need, and I quote, "to release the forces of growth," end quote, and he recommended cutting back the tax on capital gains. President Kennedy proposed that the tax rate be reduced from 25 percent to around 20 percent. I would like to also include some remarks by Treasury Secretary Dillon on this idea.

It might be useful to briefly review economic events of the past ten years. In the process, we will see the significance of H.R. 12111.

In 1968, we were at full employment, inflation was still moderate, the stock market was rising, new companies were being formed, and the economy was healthy. The 1970's have been pretty dismal in contrast. We have gone through two recessions and double-digit inflation. The stock market has declined, and over five million individual investors have dropped out of the market. In 1968, 300 high technology companies were started. In 1976, there were none.

Let us look at one particular problem, the ability to raise capital. In 1969, 698 firms with a net worth under $5 million raised $1.4 billion in capital. In 1975, four firms raised $15 million; and in 1977, 30 firms raised $118 million. That's million, not billion. It is plain that something is wrong. High technology industries and venture investors are convinced that the root cause of inadequate capital is the Tax Reform Act of 1969, the law which increased the tax on capital gains.

This Act narrowed the gap between ordinary income and capital gains. It weakened the financial incentive to invest. An analysis by Oscar Pollock reveals that between 1969 and 1976, investments in tax-free municipal bonds increased by 52.9 percent. Investments in the stock market—a primary source of capital—declined by 5 percent. Yet, from 1962 to 1969, a period of low taxation on capital, stock market investments increased by 70.7 percent. Even Joan Robinson, the English Marxist economist, has acknowledged that people do not normally act out of altruistic motives. They need incentives. If we create disincentives, people will not invest. In short, capital-gains taxes are even more important as a determinant of investment decisions than they are as a producer of revenue. This point is fundamental, and it is one that, to my sorrow, the President's advisers fail to recognize.

Shrinking capital markets are making it difficult for firms to raise capital. Competition is fierce, but it is not competition to produce goods and services. It is competition to find whatever little capital the people are willing to make available.

A retired Michigan businessman has written to say he had planned to start a new business by selling holdings in a mutual fund. His accountant told him the tax on the sale would make the effort not worth his while. Instead of creating new jobs, therefore, his money is locked into a mutual fund.

His case is not an isolated one, as the Pollock data mentioned above indicate. Capital is locked into existing investments or flowing to tax-free bonds—thanks

to the high rate of taxes on capital gains. Another area that has had an infusion of capital is real estate. In 1962, most capital-gains revenues came from securities; 16 percent came from real estate transactions. In 1973, the most recent year studied, gains from stocks had dropped significantly, but real-estate gains rose to 23 percent. Real estate is attractive because of inflation. If Ambassador Bob Strauss is successful in moderating inflation, there will be less incentive to invest in real estate; but I will let Bob fight that battle.

One of our national goals is to achieve adequate housing. Yet, incongruosly, the Administration is concerned that we might be encouraging capital investment in real estate. I saw yesterday that the cost of lumber increased 20 percent in the past year. We will not reduce the cost of housing by maintaining a high tax on capital.

Internationally, our economy faces many vigorous competitors. It will be no easy task to maintain our competitive edge in the world markets. We have the highest capital-gains tax of any industrial country, the highest percentage of obsolete plants and equipment, the lowest productivity and one of the worst records on inflation. The relationship is clear. The question is what do we do about it.

The American Academy for the Advancement of Science this week warned that our investment in research and technology has declined dangerously. A presidential commission is to study the problem, just as another one will study capital formation, and the AAAS predicts it will be ten years before there is a change in our policy on research and development. Does anyone in this room believe that our competitors will wait? What is needed is for us to act now, and that is why my colleagues and I have proposed the Investment Incentive Act.

Some in the Administration are not ignoring the problem. Stuart Eizenstat, in a memo on industrial innovation, has recognized the difficulties that small, high-technology firms encounter in obtaining venture capital. Another encouraging sign has been Secretary Blumenthal's recent speech in Florida. He took the bull by the horns and he said: "We are not saving enough; our financial system is providing insufficient equity capital; we are not investing nearly enough in productive plant, equipment and technological innovation; profits are too low, and they are too uncertain."

Both the State and Commerce Departments are working with the semi-conductor industry to prepare them for the challenge from Japanese competitors. Crucial to this effort is increased investment, and that requires encouraging private investors to suppy the venture capital and to accept the risk. Yet, Treasury and the Executive office are working against this innovative trade policy by advocating the continued high tax on capital gains.

The Administration cites three arguments against H.R. 12111. The first is that there would be a tax loss. The static analysis shows a revenue loss of $2.4 billion. It is based on the unrealistic assumption that nothing will happen in the financial world—that people won't react to changes in taxes. In 1969, the Treasury Department likewise estimated that capital-gains revenues would increase if the maximum rate were increased. Revenues declined almost 40 percent in the first year; they have just now returned to the levels of 1968—in inflated dollars.

Four separate economic analyses have been made on the likely effects of H.R. 12111. All say that a lower tax on capital gains will stimulate investment and will lead to more jobs, a widening of the tax base, and increased revenues. I will include the studies for the record.

The Administration's second argument is that our proposal offers a tax break to the wealthy. Again we confront the view that capital is income. It is not, and it should not be taxed as income. I realize that some portion of a gain may be used for consumption. So the tax will continue. But we must encourage reinvestment; hence, the tax should be moderate. I propose 25 percent.

True tax equity and simplification would indicate that reinvested capital should not be taxed at all. Capital gains which are consumed should perhaps be taxed as ordinary income, on the basis of the real, not the nominal, gain. This would separate capital from income. For now, my approach seems to be as far as we can go.

A Treasury study reveals that the average capital-gains tax on high income is 18 percent. Only a few need to pay the maximum rate of 49.125 percent. To me, these figures indicate that the tax is ineffective, another reason for adopting H.R. 12111.

The President has claimed that taxpayers in the $15,000 to $20,000 income bracket will receive 25 cents—just "two bits"—from our proposal. Not so. Based on

actual taxpayer returns, the average benefit for people earning $15,000 to $20,000 per year is $278.

Let me take you through just one example to show how capital-gains taxes affect middle-income taxpayers. In this case, the husband and wife both have jobs.

"Mr. and Mrs. Clark's 1978 income from wages is $18,500, approximately the national median family income for a two earner family. They are 57 years old. In 1959 they bought a new home for $15,000 (the national median price for a new home that year). They lived together, raised their children and now want to sell their house and move to an apartment. If the sales price is $42,900 (the national median price for an existing house last year) they will incur a capital gain of $27,700.

"If the Clarks don't sell their home, their tax will be $2,261. With the sale, however, they must pay $6,984.50 ($6,407 plus $577.50 in minimum tax). That's a federal tax increase of more than 208 percent.

"The Steiger-Jenkins-Hansen amendment will reduce the taxes for this family by $577.50—simply by removing capital gains from the minimum tax.

"For Mr. and Mrs. Clark, $577 can't be considered an excessive tax break. And $577 isn't exactly 'just two bits' either."

I have received a number of calls from older people who want to sell property, but they feel locked in because of the tax. The capital-gains tax genuinely is a problem for middle-income taxpayers.

If we lower this tax, economic activity will accelerate. Stock market values will increase. The portfolios of private pension plans—the main source of savings of the American worker—will recover from the disasters of the 1970's. New equity capital will be available, companies can expand, employement can increase, and everyone benefits.

The last argument of the Administration is that other approaches to capital formation are better than Steiger-Jenkins-Hansen. The President said we whould lower corporate tax rates. But in his original proposal, 80 percent of the benefits would go to 0.1 percent of the corporations. One might almost object that this sounds like a fat cat proposition if there ever were one. I suggest Mr. Carter review the Tax Consistency Act, co-sponsored by Dave Stockman, Jack Kemp and myself if he wants to support an effective corporate tax cut bill.

Another proposal is the Investment Tax Credit. Senator Edward Kennedy had the Library of Congress evaluate the effectiveness of the ITC. It is not favorable. I would like to include the study in the record.

One other alternative is the double taxation of dividends. To date, we have found no formula that works. We should bear in mind that high growth companies, the ones that provide new jobs, pay almost no dividends. The average is 1 percent. An American Electronics Association survey shows that new companies paid only 0.1 percent in dividends. Easing double taxation is of no use for these companies and investors. If we expect people to tie up an investment for a long term with few dividends, there has to be an attractive reward/risk ratio. Today, the risk is still high, and the potential return is eroded by inflation and taxes.

Throughout this amazing country, there are hundreds of companies still on the drawing boards simply because they lack the capital to begin. These would-be companies represent hundreds of thousands of would-be jobs, if only the Administration would agree, in the words of President Kennedy, "to release the forces of growth," and to encourage the private investor.

Mr. Chairman, when beginning these remarks I noted that this subject is important to the health of our economy and to the openness of our society. Not every society has been endowed and has prospered by the investment decisions of its private citizens. Certainly every society has a mechanism for acquiring and deploying investment capital. In totalitarian societies, investment decisions are strictly those of the government; the rulers determine how much money will be taken and where it will be put.

In an open society, these decisions are more properly left to private individuals and private institutions. This system has proven more flexible, more efficient, more productive, and it ultimately works out to be more equitable for all.

When we see private investors dropping out of our markets by the hundreds of thousands, as we have seen since 1969, I think it is our duty as the writers of the nation's laws to ask: what are the long-range consequences of our tax policies, and how will they affect our free society.

I feel strongly that the locus of investment decisions should be with the private individual, and that the government should do as little as possible to discourage private investment and reinvestment.

Senator BYRD. The next witness is the Honorable Jack F. Kemp, Congressman from the State of New York.

Welcome, Congressman Kemp.

Representative KEMP. Thank you, Senator. I will be joined at the table by Congressman Stockman of Michigan.

Senator BYRD. Congressman Stockman, we are glad to have you.

Representative KEMP. Both of us, Mr. Chairman, would like to make brief comments for the record and then I, personally, would like to submit a written statement for the hearing record.

Senator BYRD. That is fine. Your prepared statement will be incorporated in the record.

STATEMENT OF HON. JACK M. KEMP, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Representative KEMP. Mr. Chairman, I join Mr. Steiger in thanking you and the committee for holding these extremely important hearings on one of the most important issues facing America today.

I think it is obvious, from history, that the real and lasting way to create prosperity for a people—to raise their standard of living, to create jobs, and to improve the quality of life—is to increase the amount of capital invested per person. It is also obvious from the testimony of our colleague, Mr. Steiger, as it will be from my colleague, Mr. Stockman, that the United States has a declining capital stock.

We have a declining rate of capital investment, a declining rate of savings. The attendant problems are not only tragic in terms of meeting the needs of our people, but they are also unnecessary. These are self-inflicted wounds. They need not have happened.

There is an answer to this twin dilemma of both unemployment and inflation. In that there is hope.

If you tax something, generally speaking, you get less of it, and if you subsidize something, generally speaking, you get more of it. In America today, we tax work, employment, thrift, savings, investment, growth, output, and success and we subsidize unemployment, debt, welfare, consumption, leisure, idleness, and mediocrity. Is there any wonder that we get more of that which we subsidize than that which we tax?

Senator Bentsen talked earlier about that horse race. I think the American people understand, as Senator Bentsen does, that there has to be, when you take a risk, no matter what that risk might be, a reward commensurate with one's effort and one's risk. I know steelworkers in Buffalo, N.Y., understand it. I think students understand it. I think the minority community understands it. I think the only people who do not understand it are a political leadership that is trying to frustrate the attempts of the Congress to reintroduce incentive into the American economy by the introduction of measures such as the Steiger amendment. This is a point often made by my colleague and distinguished coauthor of the Roth-Kemp Tax Rate Reduction Act.

I spoke to some students the other day, and I asked the question: What do you think would have happened last year if Reggie Jackson's salary had been taxed away and redistributed equally among all the New York Yankee's baseball team? One of the students got up in the back and said, "He'd probably hit singles." Senator Bentsen, if I can presume to suggest, I think that is what you were getting at. If you tax away the home run hitter, then you get less home runs.

Who would have gotten hurt last year on the New York Yankees baseball team if Jackson had hit three singles instead of three home runs? The whole team would have been hurt. This is what the President of the United States doesn't understand.

The President's attack on the Steiger amendment—of which I am a cosponsor—is an unfortunate thing. It will have a real impact on the economic climate, not just for investment, but ultimately, capital formation which means job creation.

The high marginal tax rates on both investment, savings, and work today are discouraging the human behavior so important for increasing the real output of the economy. Since 1969, when Congress assaulted capital by doubling the tax on capital gains through the Tax Reform Act of that year, coupled with the 1976 Tax Reform Act, there has been a sharp diminution in the rate of capital investment, and a reduction in the percentage of revenues flowing into Government from capital gains tax. A tax increase has caused a tax revenue decline in comparison to what it would have been.

Joseph Peckman of the Brookings Institution in his book, "Federal Tax Policy," the third edition, 1977, studied estimated revenues from capital gains and income taxation. He shows a direct correlation between the tax rate on capital gains and the level of revenue coming into the U.S. Treasury. In fact, it drastically changed—and negatively—in 1969 when Congress raised the tax on capital gains.

Can the President and his Secretary of the Treasury not see that there is a direct correlation between the level of tax on marginal rates of return and the level of investment and savings?

Professor Boskon of Stanford University has done similar studies. He has basically come to the same conclusion: That there is much empirical evidence over the last four decades that shows that as you reduce the rate of return on savings and investment you get less of it; that as you increase the rate of return on investment and savings, you get more of it. And, if there is anything, as Senator Roth and others on this panel have been suggesting that we need more of today, it is an increase in savings and investment which forms the capital, the equivalent of the oxygen supply, of our free enterprise system and ultimately accrues to the benefit of workers who have not only better jobs, but better tools, better means of producing the goods and services that the consumers of America want and need.

This has been labeled the trickle down theory. For years, those of us who believe in a liberal or democratic-capitalistic form of economic and political life have been accused of suggesting that if we lower the tax rate on capital gains or if we lower the tax rates on both investment, savings, and work, that somehow that is the "trickle down" theory.

Well, if we lowered the tax on capital gains in America today, as Congressman Steiger, Senator Hansen, and many others have suggested, or if we would pass what Senator Roth and I and 174 other Members of the House and Senate have advocated, or if we would give some consideration to what Congressman Stockman is proposing to change in the cost accounting structure in America from historical cost accounting to replacement cost accounting, thereby dealing realistically with the needs of modernizing and expanding plant and capacity, that is not trickle down. It would be a cascade; it would be

a Niagara Falls, and that is what our sluggish economy needs right now.

You would have growth of investment opportunities, creation of jobs, and a growth in the output of the real economy, the likes of which we have not known since the early 1960's when President Kennedy, Walter Heller, the distinguished majority leadership of the Committee on Ways and Means in the House, and the Committee on Finance in the Senate, reduced the tax rates right across the board by just about 25 percent on all of the American people.

Mr. Chairman, when President Kennedy lowered the top rate from 91 to 70 percent in the 1963–64 time frame, it increased the amount of revenue coming in to the Federal Government from people of high income because a purpose of the political process is to find that level of taxation at which people are willing to maximize their output and still pay taxes.

When you tax people heavily on capital gains, you get less capital investment, and when you tax people so heavily on work, you get less work. If we want to maximize revenues, if we really want to relieve the burden on the poor, if we really want to relieve the burden on the small taxpayer, we should find that tax rate at which people are willing to maximize their output and still pay their taxes. It is clear in history that the higher the rate of taxation on these factors of production, the less those factors of production come into play, except as disappointments.

I want to conclude my remarks by suggesting that one other evidence of the decline in investment is the fact that, in 1969, prior to the first assault on capital gains, there were 31 million investors in the United States of America. They had invested roughly about $10,000 per capita. Today, nearly a decade later, we have about 25.2 million investors in America and the average investment is still the same.

Mr. Chairman, if we had the same number of investors today as a percentage of our work force that we had in 1969 prior to the assault on capital gains, we would have 35 million investors. That is 10 million extra investors at $10,000 per capita investment, that is $100 billion of investment in our economy today. But we don't have them because of what Congress has done and what it hasn't done.

That would be close to full employment. We would be reducing the rate of inflation. We would be increasing the real output of goods and services in our society in a noninflationary way.

The American people—indeed, the world—is looking for an example of how to produce noninflationary growth today. The Steiger legislation is one very strong step in the right direction, and your efforts at bringing more attention to this strategy is very much welcomed, not only by myself but all of those of us who believe, as you do, in the private enterprise economy.

I thank you for letting me testify on this, I would like to turn it over to Dave Stockman of Michigan.

Senator BYRD. Thank you, Congressman Kemp.

[The prepared statement of Congressman Kemp follows:]

STATEMENT OF REPRESENTATIVE JACK KEMP OF NEW YORK

Mr. Chairman and members of the committee, I want to express my appreciation to the Chairman and the Committee for giving me this opportunity to testify on behalf of legislation whose objective is to get the economy moving again. Your leadership is to be commended. It will be remembered and appreciated by the working class of America, for they will be the recipients of the increased job opportunities which will flow from the enactment of this measure.

I, for one, am encouraged by the breadth of support for the Steiger capital gains legislation, H.R. 12111, the Investment Incentive Act. Support is strong on the House side, but the number of Senate cosponsors makes it almost veto proof here. That support cuts across the lines sometimes drawn on tax issues. Democrats, Republicans, liberals, moderate and conservatives, from every region of the country support its enactment. Those who oppose its enactment, or are neutral to it, are being enlightened daily, through hearings such as these.

Opposition to this legislation comes primarily from those who do not want to understand the economic consequences of the present capital gains law. These people refuse to believe that the increase in the capital gains tax rate has retarded economic growth since 1968. They cannot bring themselves to put economic fact ahead of political rhetoric.

THE ECONOMICS OF CAPITAL GAIN TAXATION

In analyzing the economic consequences of tax rates on capital gains, we are dealing with a cause and effect relationship relatively easy to demonstrate. The rationale is simple, and the data compelling.

The rationale is that our country cannot maintain satisfactory levels of growth and employment without a higher rate of investment. Phrased another way, under-investment results in both a slower growth rate and a higher unemployment rate. This is not speculation. The trend in economic indicators before and after the 1969 increase in capital gains tax rates shows that it is not.

Let's look at three 3-year trends, one before the 1969 rate increase and two thereafter:

Average of 5 years ending in—	Annual percent change: Real business investment	Annual percent change: Real gross national product	Unemployment rate (annual percent)
1968	8.0	4.8	4.2
1973	3.9	3.3	5.0
1977	1.7	2.7	6.7

Source: W. R. Grace & Co.

For the average of the 5 years ending in 1978, the last year before the rate change, real business investment grew by 8-percent, gross national product by 4.8-percent, and in 1968 unemployment was 4.2-percent. Then Congress increased the capital gain tax rates, in essence doubling them. The result? The 5-year figures, 1969–1973, show the decline in both business investment and gross national product. Business growth declined to 3.9-percent per year, the growth in GNP declined to 3.3-percent per year, and the unemployment rate increased to 5.0-percent. By 1977, real annual growth in business investment had declined to 1.7-percent. Gross national product was down to 2.7-percent, and unemployment had soared to 6.7-percent. Clearly, the doubling of the maximum tax rate on capital gains since 1968 has been detrimental to investment, growth and employment.

This should come as no surprise. The combination of inflation and tax policy during the past 10 years has almost destroyed any incentive to invest in the American economy. Investors who bought stocks and bonds in 1968 and paid taxes on the gain at the end of 1977 were left with between 33-percent and 76-percent of their original dollar investment. The losses, after tax, in the real value

of dollars placed in various investment portfolios on January 1, 1968, and held until December 31, 1977, are shown below:

LOSS AFTER TAX IN REAL VALUE ON $1 INVESTED IN ALTERNATE INVESTMENTS MADE JANUARY 1, 1968, AND HELD UNTIL DECEMBER 31, 1977

Type of investment	Value of 1968 investment	Value of investment at end of period in 1968 dollars
Value Line average	$1	$0.33
Lehman Brothers Kuhn Loeb bond index	1	.54
American Stock Exchange index	1	.60
Dow Jones industrials average	1	.65
New York Stock Exchange index	1	.65
Standard & Poor's 500	1	.66
Standard & Poor's 400	1	.66
Salomon Brothers high grade corporate bond index	1	.76
90-day Treasury bills	1	.76

Source: W. R. Grace & Co.

Let me give an example of the way in which the cumulative effect of inflation and high taxes impact on the investment climate in America.

Let us take an investor whose taxable income, after all deductions, is $100,000. In 1967 this person invested $200,000 in an asset and by 1977 that asset was worth $300,000. If the asset were sold in 1977, the capital gains tax would be $33,779. That amount, $33,779, would seem like a reasonable sum to pay in taxes on a gain of $100,000. But the gain was not $100,000. The average annual return on the investment was minus 3.1-percent per year in constant dollars. In other words, the investor has not make $100,000 pre-tax and $66,221 after-tax. He has *lost* $63,000 pre-tax and $97,779 after-tax. The total loss has been 26.7-percent over his 10-year period. I offer the following computation to backup this example:

Effect of inflation and capital gains taxes on investment returns

1. Original investment in 1967	$200, 000
2. Total percent gain/(loss) in 10 years	50
3. Current value of investment in 1977	$300, 000
4. Pretax capital gain (3)−(1)	$100, 000
Capital gains tax:[1]	
5. On capital gain alone[2]	$23, 060
6. Piggy-back to higher bracket	5, 660
7. Loss of maximum tax[3]	3, 100
8. Minimum tax[4]	1, 959
9. Total	$33, 779
10. Aftertax gain (4)−(9)	$66, 221
11. Total rate of return over 10 years (10)÷(1) (percent)	33. 1
12. Average annual rate of return (percent)	2. 9
Constant 1977 dollars:	
13. Original investment in 1967	$363, 000
14. Total percent gain/(loss) in 10 years (16)÷(13)	(17. 4)
15. Current value of investment in 1977	$300, 000
16. Pretax capital gain/(loss) (15)−(13)	($63, 000)
Capital gains tax:[1]	
17. On capital gain alone[2]	$23, 060
18. Piggy-back to higher bracket	5, 660
19. Loss of maximum tax (c)[3]	3, 100
20. Minimum tax[4]	1, 959
21. Total	$33, 779
22. Aftertax gain/(loss) (16)−(21)	($96, 779)
23. Total rate of return over 10 years (22)÷(13) (percent)	(26. 7)
24. Average annual rate of return (percent)	(3. 1)

[1] Assuming an additional $100,000 for earned income, which pushes the capital gain into a higher tax bracket.
[2] This would be the tax on $100,000 capital gain if there were no other income.
[3] Earned income is subject to a maximum tax of 50 percent, but capital gains pulls earned income out from this shelter.
[4] Minimum tax on preference income such as captial gains.

Source: W. R. Grace & Co.

These numbers do not lie. They tell us that we are bound to see a drying up of sources of capital. Why would anyone in their right mind intentionally incur at net loss of $97,779 by selling an asset or security, when the alternative is to sit on it and earn dividend income?

The cumulative result? Investors have experienced real losses, when they should have realized real gains. These losses were not caused by poor business judgment; they were caused by government taxes and by government-created inflation.

Unfortunately, the adverse, negative consequences of the 1969 capital gain tax increase do not stop with individual investors. Business and government have suffered too.

Let's look at business first.

Since 1968 the number of companies having a net worth of under $5 million offering new issues of stock has declined from 358 to 30. In 1975 it had dropped to 4. In 1968, these companies had raised nearly $1.3 billion in capital, measured in constant 1977 dollars. In 1977, that had fallen to $118 million. Moreover, since 1970 5.5 million individual investors left the stock market, a decline of 18-percent. The severity of the capital shortage for these smaller companies is shown in the following table:

CAPITAL RAISED BY COMPANIES HAVING A NET WORTH OF UNDER $5,000,000

[Dollar amounts in millions]

Year	Number of offerings	Funds raised	
		Current	Constant 1977 dollars
1968	358	$745.3	$1,298.4
1969	698	1,366.9	2,259.3
1970	198	375.0	585.0
1971	248	550.9	824.7
1972	409	896.0	1,298.6
1973	69	159.7	217.9
1974	9	16.1	19.8
1975	4	16.2	18.2
1976	29	144.8	154.2
1977	30	118.3	118.3

Source: W. R. Grace & Co.

Now, let us look at government.

In 1968, the last year before the increase in capital gain tax rates, revenue from the capital gains tax constituted 5.4-percent of the total Federal revenues. By static analysis, that used by the Department of the Treasury and the President, we would assume that the doubling of the tax rate would nearly double the capital gains tax revenue to 10.8 percent of total Federal revenue. In 1969, capital gains revenue dropped from that 5.4-percent to 3.9-percent of total Federal revenue. The following year, it dropped to 2.5-percent. The average from 1965 through 1968 was 4.5-percent. The average from 1969 through 1976 was 3.4-percent.

The cumulative results? Real GNP down from 1968 by 44-percent. Unemployment up about 60-percent. The Federal deficit up more than eight-fold.

Has this had an impact upon our country's competitive posture in the world economic community? With a maximum tax rate on capital gains of 49.1 percent, as compared to no capital gains tax in five other industrialized free world nations, the United States has had the lowest investment rate, the smallest increase in productivity, and the lowest rate of overall economic growth during the past 15 years. There is statistical evidence of this too:

Country	Maximum capital gains tax (percent)	Business investment as a percent of GNP	Average annual percent increase in productivity	Average annual percent increase in real GNP
Japan	0	32.0	8.4	8.3
France	0	22.8	5.7	! 4.8
Netherlands	0	23.7	6.9	4.6
Belgium	0	21.8	6.9	4.0
Germany	0	24.8	5.5	4.0
United States	49.1	17.5	2.7	3.5

Source: W. R. Grace & Co.

THE ECONOMIC EFFECTS OF THE STEIGER LEGISLATION

With this evidence before us, and much more available, the question is: what should Congress do? The Investment Incentive Act, popularly known as the Steiger capital gains legislation, should become law despite the threat of a Presidential veto. This legislation is vital to the Nation's economic wellbeing.

A reduction in the capital gains rate would trigger a net increase in government revenues. It will unlock billions of dollars in new capital investment. Two econometric studies performed by Data Resources, Inc., and Chase Econometric Associates, Inc., support the rationale behind this measure. The summary of those studies follows:

ESTIMATED EFFECT IN 1982 OF REDUCING CAPITAL GAINS TAXES IN 1978

[Values in dollars adjusted for price changes]

Category of effects	DRI[1]—Removal of capital gains tax	Chase Econometrics[2]—Return to 1968 maximum tax rate of 25 percent
Nonresidential capital formation would be an additional	$28,300,000,000	$7,000,000,000
Stimulated by higher capital formation U.S. gross national product would increase by	$57,400,000,000	$15,000,000,000
With more output, employment would be raised by	784,000	306,000
With higher earnings arising from greater business activity and higher employment, personal and corporate income taxes would more than offset the relatively small amount of revenue previously collected from the higher capital gains taxes, and overall, Government revenue would rise	[3] $15,400,000,000	[3] $6,400,000,000
Capital gains tax reductions and consequent stimulus to economic activity would raise stock prices, 1980–82, by (percent)	NA	40.0

[1] Data Resources, Inc., Tax Policy, Investment and Economic Growth, p. 46.
[2] Michael Evans, Chase Econometric Associates, Inc., as quoted in "The Wall Street Journal," May 5, 1978, p. 35.
[3] In current dollars, not adjusted for price changes.

This table provides compelling data in favor of reducing the tax on capital gains.

It is difficult to imagine then, why we have seen such strong opposition against enactment of this measure orchestrated by the Department of the Treasury and the White House. Politics may of course be the answer, for instance when President Carter denounced the Steiger legislation in his last televised news conference, saying it would provide "tax windfalls for millionaires and two bits for the average American." His motivation was clearly not economic reality.

While I know why the President believes it important to him to make such populist appeals against giving away the country to the rich, I respectfully submit that we live in a country, and at a time, where acts of reverse Robin-Hoodism are hardly the case. The accurate story is that the wealthier segments of society are already paying an enormously disproportionate amount of income tax relative to the poorer segments of society. In fact, about 72 percent of all Federal income taxes are paid by the top 25 percent of all income earners. Nevertheless, it appears that in the President's mind, a change in the capital gains tax rate is equivalent to a massive redistribution of income.

The President's rhetoric notwithstanding, a reduction in the capital gains tax will not force upon the shoulders of the poor an increasing tax burden. On the contrary, there is evidence that if the tax rates on capital gains were reduced, the result would be an increase in taxes collected from the wealthier segments of society, not a decrease. How? Because tax rates affect not only the proportion of taxes paid out of each dollar earned, but tax rates also affect how people work and save. Hence, it is the intention of the Steiger legislation to affect economic behavior by increasing the incentive to work and save, not to redistribute income or shift the tax burden. The underlying point of the Steiger amendment is that it is possible to increase tax revenues by promoting economic activity.

An example? A high marginal tax rate will induce investors to place their funds in tax-free municipals or tax shelters. On the other hand, lower marginal tax rates on investment income will broaden the opportunities for investment to include securities and assets which are not designed to shelter income from taxes.

It is this latter type of taxable investment which is being stifled in this country today. The Steiger legislation, is enacted, will induce investors to place their

money into tax revenue producing assets. This money will provide a shot in the arm to our high risk, high technology, capital starved industries, which have been denied investment capital from those who have the funds but not the motive for risk taking, due to low after-tax returns.

Political rhetoric cannot be permitted to confuse this type of tax cut with a rebate to the rich. The country, including the President and his Department of the Treasury, should face the fact that much of the venture capital needed for economic growth does come from individuals with strong financial positions. These persons are now, however, restricting their investments because every time they sell an asset, they are subject to capital gains tax rates as high as 49.125 percent. The natural consequence of such a tax system is that there is altogether less buying and selling of assets and securities which have appreciated in value. Funds which might have been used for investment purposes are tied up in assets and securities, and just not likely to be sold.

Mr. Chairman, in light of the data before us today, we can only ask ourselves why President Carter limits his analysis of this important legislation to its static effects. Anyone with an ounce of intuition can see that our economy relies on investment, entrepreneurship, and risk-taking, but that the cards are now stacked against such activity. There will not be a loss in revenue from this legislation's enactment. There should be an enormous gain, as thousands of investors who have shied away from selling their old assets and investing in new ones become bullish again on America.

We teach our children to work and study hard, to move ahead in our society, and they have responded. Our law schools, engineering schools and business schools are filled. Many of our non-professional young people are doing very well too. Why then do we put a limit on the opportunities available to them. They wnat their chance to reach their potential as productive members of society. They want their tomorrows to be better than their yesterdays. That is a feeling shared, I believe, by everyone of sound mind.

Congress should remove the impediments found in law to the successes these young people seek. It should remove the impediments found in our tax laws to the revitalization of the American economy. We can take a giant step toward such worthy goals by the enactment of this legislation. It is only a first step, but it is a critically important one.

Thank you.

Senator BYRD. Before Congressman Stockman begins, a member of the subcommittee, Senator Haskell of Colorado, has a statement and, without objection, I will ask it be inserted in the record immediately following the testimony of Congressman Kemp and Congressman Stockman.

Congressman, you may proceed.

STATEMENT OF HON. DAVID STOCKMAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Representative STOCKMAN. Thank you, Mr. Chairman. I want, too, to strongly support——

Senator BYRD. Excuse me a moment. Also, a statement by the Senator from Wyoming, Mr. Hansen, will be inserted in the record at that point.

Representative STOCKMAN. Thank you, Mr. Chairman. I appear here to strongly support the Steiger amendment for all of the reasons that have been given. We need to reverse the drastic decline in risk capital in this country, improve incentives, raise the rate of capital formation and so forth. But, rather than elaborate or reiterate those points, I think I would like to spend my time responding to some of the arguments that are made against the proposed Steiger amendment, because I really think they have little substance. They border on demagoguery. I would therefore like to bring to the attention of the committee a few of the facts that I have been able to assemble.

No. 1, it has been said that these changes are undesirable because 80 percent of the benefits will go to taxpayers with incomes of $100,000 or more. I think Senator Hansen hit part of the answer to that earlier this morning when he said, look at the definition of income intervals or categories the Treasury is using.

The notion, or the measurement, they are using, "expanded income class," has nohting to do with what you and I think of in commonsense terms as our income level. That expanded income class includes all capital gains realized during the year and it also includes a lot of imputed, or attributed, income that you could not very well spend because you would not have it.

Now, the point is, most taxpayers, even middle-income taxpyeras who realize at some point or another during their life a large capital gains will suddenly be thrust up for that year into the class of the wealthy because they will make a $40,000 capital gain that year on their house. A guy who built a hardware business during his entire lifetime might sell it at a $100,000 gain and that 1 year he is part of the wealthy elite in America. The next year, he goes back down to $15,000.

As a result of that kind of measurement process, by definition you are going to find a large share of the capital gains are taken at the upper level of the expanded income classes. But that does not mean that all of the people that year are rich, and that is a bias in the Treasury's statistics.

The other thing is, you have a self-fulfilling prophecy here. We are rolling back the capital gains changes enacted since 1969. Those were directed, almost exclusively, at upper-income taxpayers. Look at the two changes. No. 1 was putting capital gains under the minimum tax. As the minimum tax was originally written, you had a $30,000 deduction plus one-half of taxes paid before you even got into paying the minimum tax.

Under the original version, you would have had to have had $100,000 in capital gains if you had a $50,000 ordinary income even before you paid 1 cent of minimum tax. So obviously, this tax change was directed at the upper portion, $100,000 or above, of the income spectrum. Even with the minimum tax changes of 1976 it requires a fairly high income and capital gain before the minimum tax becomes effective.

The same thing is true with the other change, the alternate tax rate. When we remove the privilege of taking the alternate tax at 25 percent, that change only applied to taxpayers in the 50 percent or above marginal bracket. Again, that includes only taxpayers with taxable incomes of $50,000 and probably adjusted gross incomes, or gross incomes, of $70,000, $80,000 or $90,000.

Now, the point is, if we want to reverse these changes because we think they have been counterproductive from an economic policy point of view, obviously a large share of the benefits will go to taxpayers with high incomes. That is because the original policy changes were entirely targeted on them.

The equivalent example that I can think of would be to say if we made a policy mistake and raised the top marginal bracket from 70 percent to 90 percent and then found, after 4 or 5 years, fewer high incomes, we might then conclude, "This is a mistake, let's repair the

damage." Yet, if we repaired the damage and put the marginal rate back to 70 percent, obviously all the benefits would go to higher income taxpayers. But that does not invalidate repairing the mistake.

The second thing I want to call to the attention of the committee is that the Treasury has put out numbers, and I am sure you will hear about it later today, indicating well, what is all the shouting about, because the effective rate of taxation on capital gains has not gone up since 1969—and some of you have probably seen this chart.

The talk indicated that in 1968 the effective rate was 14.1 percent; in 1976, it was only 15.9 percent, so there has not been much change. Why are you worried?

Well, I have looked at that chart, and there are three big errors in it that I think the committee ought to know about.

No. 1, this is the effective rate only on returns that show a net capital gain, but obviously many investors have capital losses during a year. They do not show up in the denominator of this table and, as a result, they are overstating the true amount of capital gains being realized in any 1 year. As a consequence, the effective rate is understated.

The second thing is, we have a severe limit on carryforward in terms of capital losses that can be deducted. It is $3,000 a year.

The economy has performed so badly since 1969 that we have had a huge buildup of capital losses that taxpayers are carrying forward. Let me give you some numbers to show this.

In 1968, the carryforward of capital losses was $3.3 billion. By 1975, it was $21.3 billion in carryforward capital losses. Those carryforward capital losses, since they cannot be deducted from current years taxes, do not show up in this table, so, again, you are overstating the true net capital gains and, therefore, understating the effective rate.

And then, the final thing, is we have had a tremendous increase in the rate of inflation. As a result, if you compare to the tax paid to the nominal capital gain reported, obviously you are going to understate the rate of effective taxation on the real gain.

Let me just give you one example which I think will demonstrate this point. If you sold a capital asset in 1968 that had been held for 10 years at double its original value, a 100-percent increase in its nominal value, given the inflation that you had during that 10-year period, 75 percent of the gain would have been real and 25 percent would have been pure inflation on nominal gain. And therefore, according to this very table, the effective rate in 1968 on that sale would have been 20 percent on the average.

If you sold an asset in 1978 held over 10 years at also double the nominal value, or a 100-percent increase, the real gain during that 10-year period would have been 15 percent, not 75 percent, and the inflationary or illusory gain would have been 85 percent.

And the effective rate on the real gain of that particular sale of an asset would have been over 100 percent. It would have been a confiscation of even part of the original capital value put into it.

Well, I would suggest that if you make those kinds of adjustments on this very shoddy, methodologically deficient table you will find that there has been an enormous increase in the effective rate of taxation, capital gains taxation, on real gains and that therefore, there is

every reason in the world why you want to roll back the damaging changes made since 1968.

Then the final point, Mr. Chairman, I would make is simply this. We are concerned about investment, but I think we have to be concerned, not only with the aggregate level, whether we have a 10-percent or 12-percent rate of fixed business investment relative to GNP, but what we have to be concerned with is composition, where this capital is flowing.

Let me give you a simple illustration. If we spent $10 billion in aggregate investment in the economy. And in one case it went to the semiconductor industry, in the second case it went to textiles, and in the third case it went to building pyramids, in the current year there would be no difference on the GNP account. But obviously on down the road in future years I think we would get more kick, in terms of jobs generated, income generated, balance of payments improved, if that $10 billion went into semiconductors as opposed to if it went into textiles, and certainly than if it went into pyramids—we would get nothing, or very little in future years from the pyramids.

Now, the point is, we have stacked our tax system so that it subsidizes debt investment and it heavily penalizes equity, or risk investment. And, as a result, we are directing or biasing the flow of capital into the stagnant, mature oldline industries in this country which are having a more and more difficult time competing in international markets and we are positively blocking the flow of capital into those frontier areas, those marginal areas of the economy: The computer industry, the semiconductor industry, the advanced technology industries, where we can use our ingenuity and our stock of human capital and the advanced resources of our educational system to create new products, new industries, new processes that will make us competitive in the international markets and that will get our rate of economic growth advancing again.

And so, therefore, we have to be concerned about what the tax system is doing to the allocation of capital, well as to the total level. And that is another reason why I think we have to reduce the burden of taxation on equity, or risk capital, and we can do it with this particular measure.

Now, let me just give you a statistic which, I think, demonstrates dramatically how far we have shifted the balance in our tax system away from equity capital, risk capital and toward debt capital.

In 1950, interest earnings, earnings on debt accounted for 1 percent of the national income; profits, or earnings on equity capital, accounted for 14 percent of national income. By 1977, earnings on debt capital, interest, accounted for 7 percent of national income; profits were down to 9 percent.

In other words, you had a 14 to 1 ratio between profits and interest in 1950 and now it is almost 1 to 1. That means we are massively shifting our capital into the debt-financing form, into the stable, nondynamic, nongrowing areas of the economy and I think that is one of the reasons we are seeing this tremendous decline in our competitive viability in the international market and the serious balance-of-payments problem that we have, and so forth.

I think two other indicators of that I would like to just present to the committee very quickly, are these. We have had a tremendous falloff in R. & D. investment of a nonmilitary type.

In 1960, we were spending $216 in real terms—this is in 1978 dollars—per worker for R. & D. During the sixties, when we had that great growth in our economy, it rose to $389 by 1968. Since 1968, it has gone downhill. We have slipped to $349 per worker in real terms, and we have had a decline in the economy during this same period of time.

The other point that I wanted to make very quickly, a piece of evidence that I think will be of interest to the committee, is to look at what has happened to venture capital going to small firms with new products and new processes.

For firms capitalized under $5 million, in 1968, in real terms, they raised $1.4 billion in venture capital. By 1977, firms with capital values under $5 million were only able to raise $125 million—in other words, only a fraction—about 8 percent—of what they were able to raise in 1968.

Obviously, that means again that we are depriving, we are choking the economy of the funds, the capital funds, where it really needs it, and that is on those dynamic, innovative, technological advancing margins which I think are the source that we are going to have to look to if we want to see better, overall economic performance and an improvement of our position in international markets.

Those are some of the reasons why I so strongly support these changes that my colleague from Wisconsin has proposed.

Senator BYRD. Thank you, Congressman Stockman.

Senator Packwood?

Senator PACKWOOD. I have no questions.

Senator BYRD. Senator Bentsen?

Senator BENTSEN. I have no questions.

Senator BYRD. Senator Hansen?

Senator HANSEN. No questions.

Senator BYRD. Senator Roth?

Senator ROTH. I have no questions, Mr. Chairman. I would just like to say I appreciate the very fine statements by both of these gentlemen and, with your permission, I would like to invite them to reappear here on July 14th when we will be considering the Roth-Kemp legislation.

Senator BYRD. Senator Danforth?

Senator DANFORTH. I have no questions.

Senator BYRD. Thank you, gentlemen. Your testimony has been most helpful.

Representative STOCKMAN. Thank you, sir.

[The prepared remarks of Senator Haskell and Senator Hansen follow:]

STATEMENT OF SENATOR FLOYD K. HASKELL

One of the bills to be discussed at this morning's hearing, is S. 2428, the deferral or "rollover" of capital gains for certain small business concerns. I introduced this bill to provide a solution to the present shortage of capital for independent small businesses. It would also help farmers whose farms are independent small businesses, to obtain needed capital.

I am presently in the process of redrafting this bill, and therefore, would like to discuss it in the context of the changes which will be made. This legislation provides that if an investor who owns at least a 10 percent interest in a small business enterprise, sells his interest and reinvests at least 80 percent of the

proceeds from the sale in a qualified small business investment, that recognition of gain will be deferred until a time when the proceeds are no longer so invested. The investor will keep his basis in his original investment, and will have two years from the date of the sale to make the investment.

The investors who will be eligible for this treatment will be individuals, Small Business Investment Companies as defined in the Small Business Act, and also venture capital companies. The qualified business investment will be any active business which meets the section three definition of the Small Business Act.

Under present tax law, individuals who own interests in small businesses are encouraged to sell controlling interests to large conglomerate corporations. The corporations exchange stock for stock in tax-free transfers, thereby deferring payment of capital gains tax until the vendor of the small business ultimately sells the stock of the purchaser. Any person thinking of selling his or her business is obviously going to consider the tax consequence and these consequences certainly encourage concentration.

My bill offers individuals an alternative which will help develop a more dependable source of small business capital, therefore, stimulate competition in the marketplace.

The Small Business Committee, of which I am a member, has done extensive research into the question of the ability of small firms to raise equity capital. The committee has found that the climate for new, small family, and independent enterprises has deteriorated markedly since World War II for a variety of reasons, prominently including difficulties in raising capital in public securities markets, and periodic waves of mergers and takeovers by giant corporations.

U.S. high-technology corporations, the cream of the next generation of technological achievement, are looking abroad for capital. This means that needed jobs in our country will be filled abroad; that profits will be foreign profits—not U.S. profits. It also means that the independent farmer will have to sell out to large conglomerates.

Just recently, I received a letter from Tom West, president of United Business Investments, Inc., the nation's largest brokerage firm specializing in the sale of small businesses. Mr. West strongly endorses the rollover bill and stated in his letter:

In addition to the obvious benefits to our business and to the owners of small farms and businesses, this bill will favorably affect other areas of the economy. It would aid in the preservation of opportunity for the individual entrepreneuer. Our experience shows that many people who sell a small business go directly into the job market. Your bill would be an inducement to them to stay in the small business community. It may also entice people from the public and private sector of the job market to enter the small business community. In an age when people are rebelling against the waste and depersonalization of large-scale business and government, this is a move in the right direction.

Small business accounts for 97 percent of all U.S. business enterprises, over 55 percent of all private employment, 48 percent of the Nation's output, 43 percent of the GNP, and over half of all industrial inventions and innovations.

My bill would encourage U.S. investors to invest in independent small businesses. If passed, we will probably see a mutual fund market develop in small small business stock and securities.

The President in his 1978 tax program says that the tax reductions he recommends will provide significant benefits for small businesses. However, these reductions do nothing to encourage capital investment in small businesses.

This bill before us today, will help to keep a significant portion of the funds currently invested there from flowing into Government securities or the Fortune 500.

Statement of Senator Clifford P. Hansen

Mr. Chairman, I commend you for your leadership in calling these two days of hearings on various proposals to alter the taxation of capital gains. As you know, 62 Senators and 126 Congressmen have joined to cosponsor legislation which would roll back the rate of capital gains taxation to what it was before 1969. It is incontrovertible that our rate of investment has declined substantially since that year, when we set on a course of continually increasing the rate of taxes on capital gains, thereby steadily diminishing the incentives to take the risks that are needed to provide for the continued growth of our economy.

I am firmly committed to the notion that this country became great because we understood the value of, and the close relationships among risk, hard work and rewards. During the years of the Great Society and the decade that followed it,

some came to believe that all individuals should be shielded from the dangers of risks, and so the belief also arose that rewards must be suspect as well. We changed our tax law to reflect that veiw, and the dwindling of investment, the shortage of venture capital, the decline in research and development and the acquisition of our high technology companies by foreign investors all attest to the high penalty we have imposed on venture and enterprise.

Today and tomorrow in these hearings, we will focus on two conflicting views of tax policy. One side will assert the right of government to attempt to manage the economy by distributing the wealth of the nation as it sees fit. Other witnesses will advocate a return to more individualistic concepts, wherein the tax system is used to provide rewards to individuals who choose to make decision for themselves as to how our limited capital resources can be used to best advantage. We are testing during these next two days whether we really believe in a capitalist system which fosters enterprise, innovation and personal industry, or whether we wish to relinquish our control over our own fortunes.

As I prepared for these hearings, Mr. Chairman, I recalled how some 200 years ago, about 400 miles north of here, a lot of tea got dumped in a harbor one night by some restless Americans who decided that the government had taken more than its fair share of their money and had returned too little in the way of benefits and services. What those folks as the Boston Tea Party wanted was a chance to have control over their own resources. They weren't just a bunch of Boston particians and blue bloods. As a matter of fact, probably the wigged Tories were the equivalent of today's so-called fat cat. What the Americans who participated in the Boston Tea Party wanted was a chance to make their own modest resources grow so that they could have the best possible opportunity to take advantage of the good life this country had to offer.

I suggest today, Mr. Chairman, that those of us who favor a return to the set of incentives and rewards which existed prior to 1969 speak for that same constituency, namely those who are willing to take some risks, work hard, and then be rewarded in some small measure for their efforts.

Senator BYRD. The next witness will be the distinguished Secretary of the Treasury, the Honorable W. Michael Blumenthal.

Welcome, Mr. Secretary. We are glad to have you present today.

Secretary BLUMENTHAL. Thank you very much, Mr. Chairman.

Senator BYRD. We are always glad to see you. You may proceed as you wish.

STATEMENT OF HON. W. MICHAEL BLUMENTHAL, SECRETARY OF THE TREASURY

Secretary BLUMENTHAL. Thank you, Mr. Chairman. I appreciate this opportunity to appear before this committee and to testify with respect to three Senate bills: S. 3065, S. 2428, and S. 2608.

May I say, at the outset, Mr. Chairman, that we consider all three bills to have a most worthwhile objective: in particular, the objective in furthering capital formation; the objective of furthering economic growth; the objective of providing tax relief where it is most needed.

I have prepared a detailed statement, Mr. Chairman, which I would like to submit for the record and, with your permission, summarize some of the highlights of that statement.

Senator BYRD. Yes, that will be fine, and your complete statement will be published in the record.

Secretary BLUMENTHAL. Mr. Chairman, I would like to devote the major part of my testimony to S. 3065 which, in the House counterpart, is known as the bill sponsored by Mr. Steiger. This is a bill for which many claims are made.

It is claimed that it will help homeowners who sell their homes and have to pay tax on the capital gains. It is claimed that it is a bill to provide relief for the middle-class taxpayer.

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It is claimed that it is a bill that will substantially increase stock values. It is claimed that it is a bill which, happily will not only not lose the Treasury revenues, but will gain the Treasury revenues.

It is a bill that is claimed will substantially aid capital accumulation in this country and it is claimed that it is a bill that will help us in competing with other countries, such as Germany, who have had a good economic performance and who happen not to have a capital gains tax.

Mr. Chairman, may I, again, say that the administration fully supports all of these objectives. We have no quarrel with any of them.

The reason why we oppose the approach of this bill is that, in our judgment, there is little or no substance to any of these arguments.

What I would like to do this morning, Mr. Chairman, is to provide as many of the facts and as much of a dispassionate analysis as is possible in order to highlight these issues.

Let me first deal with some of the basic facts involved in the matter that we are considering.

First of all, who pays what in capital gains taxes?

In 1978, $10.3 billion will be paid in capital gains taxes, of which $7.8 billion will be paid by individuals and $2.5 billion by corporation.

Table 1 of my statement shows you the breakdown at 1978 levels of income and you will see that the effective tax rates on capital gains are relatively modest. They are, in fact, substantially lower than other taxes paid by Americans. An effective rate of over 25 percent is only paid by individuals making $200,000 a year.

The question has been raised, and it is often alleged, that it is possible to pay as much as 50 percent on capital gains taxes. In theory, Mr. Chairman, this is a possibility. In fact, in our research, we have not been able to produce a single taxpayer who paid as high a rate on capital gains as that, not a single one out of nearly 90 million tax returns filed.

We have been able to locate only 20 returns, Mr. Chairman, in which any taxpayer has paid more than 45 percent on any capital gains that he reported. We have been able to locate only .05 percent of the returns with capital gains in which a taxpayer paid over 40 percent.

In fact, therefore, Mr. Chairman, out of all of the returns filed that report capital gains, the actual, effective tax rate that is paid on such gains is relatively modest. The numbers which have been cited which indicate very, very high levels either do not exist or exist only in a small handful of instances.

Let me then turn to the facts about this particular proposal, S. 3065. The proposal would eliminate capital gains from computation of the minimum tax, the maximum tax, and it would extend the 25-percent alternative tax to all capital gains. It would also reduce the alternative capital gains tax for corporations—from 30 to 25 percent.

Virtually all of the claims that I have cited and that have been made for this bill either are erroneous, or they have not been proven, or cannot be proven.

First of all, is this the answer to the middle class tax revolt?

As I have indicated, if you take the amount of capital gains taxes that are paid by individuals (which involves 80 percent of all of the capital gains revenue that we collect), four-fifths of the benefits of the reduction that would result from this bill would go to those who make more than $100,000 a year.

Out of 1.8 million returns of taxpayers with incomes over $50,000 the benefit received would be relatively small. It is not until you get to those 387,000 taxpayers out of 90 million returns who receive more than $100,000 of income that the tax reduction becomes significant.

Table 2, Mr. Chairman, shows why we call this a relief bill for millionaires. I would suggest that that bill ought to be labeled the "Millionaire's Relief Act of 1978" for it is people who declare total incomes of more than $1 million who get the highest average benefit over $200,000.

Is this going to be a boon for the stock market, Mr. Chairman?

The bill, if it were implemented, would reduce taxes on stock gains by $500 million. Three different studies have been cited in support of the fact that this would be a substantial benefit to the stock market.

One study claimed that the result of this $500 million reduction for gains on stock would be to increase the stock market by an astounding 40 percent—40 percent. That, based on the present values of the stock market, is an increase in the value of stock by $300 billion. That is 600 times the size of the cut.

I think it stretches credulity beyond the breaking point to assume that a $500 million reduction in the taxes on stock gains would result in an increase in stock values by 500 times that amount.

Even the lowest of the estimates that have been made, and it shows how conjectural they are, indicates that stock values would not increase by 40 percent, but only by 4 percent to 6 percent. This implies that the stock market would therefore increase by 60 times the $500 million, or by about $60 billion, an equally unbelievable number.

A third study, on the other hand, has estimated that if you eliminated all taxes on capital gains, all of them, you would have an increase in the stock market of 20 percent.

The reality, Mr. Chairman—and I think chart No. 1 indicates this clearly—is that there is no correlation at all that we can detect, or that anyone can objectively detect, between stock market values and the level of capital gains taxes.

If you look at that chart, you will find the stock market fell in 1969 before the Tax Reform Act of 1969 was enacted and capital gains taxes were raised. Indeed, the stock market rose to a high in 1972, and again, it dropped to a low in 1974. In both periods, no change at all with regards to capital gains taxes had been enacted.

The fact, of course, is that the stock market reacts to very much more fundamental factors than this one single one and that a correlation between these factors simply cannot be determined.

Does it offer tax relief for homeowners? We also believe that homeowners need to be very carefully considered. The President's tax proposals recommend that the gain on the sale of a home be excluded from the minimum tax, so there is no difference, in that regard, between this proposal and the President's.

Is it a spur to capital formation? In that regard, Mr. Chairman, what we have to look at, of course, is whether the total tax burden on capital is affected, and how it is affected.

The capital gains tax is merely one of a whole range of taxes on capital and we have to look at all of them in order to make any judgment. We have the corporate income tax, which is an important tax on capital. We have a variety of other taxes. Table 3 shows,

Mr. Chairman, that capital gains taxes represent only 10 percent of all the taxes on capital and, obviously, the impact on capital formation has to be judged by how all of those taxes are reduced, and not by any one tax.

We happen to believe that a broad, across-the-board cut in the corporate income tax, which is much more pervasive, would be a much better spur to capital accumulation. In addition to being broader, it does not have the faults of this particular capital gains tax reduction which, in our judgment, fosters the wrong kinds of capital.

What we need is an increase in the profitability of the industrial and technological capital in the United States. This capital gains tax cut would not do much in these areas. It would greatly reduce the taxes on real estate, on commodities, on installment sales, and on a whole range of other assets which have no direct bearing on real capital accumulation.

In that regard, too, Mr. Chairman, we judge the President's program to be much better because a broad, across-the-board tax cut would not have the deficiencies I have just outlined.

Would we gain more than we lose, Mr. Chairman?

I think this is the most ingenious claim that has been made for this particular proposal; and certainly I, as the Secretary of the Treasury, would be delighted if, by reducing taxes to the tune of $2.4 billion we could gain more revenue than we are losing. Unfortunately, Mr. Chairman, the facts do not bear this out.

We have to distinguish here between the very short-term impact on the stock market—and, bear in mind that only 26 percent of all capital gains come from corporate stock transactions. We are not talking about the other 74 percent; they are saying that 26 percent will yield us more.

We have to distinguish between the very short-term, the medium-term, and the long-term effects of the proposal.

In the very short-term, it may well be that if you reduce capital gains taxes, more people will sell their stock. In other words, there will be more realizations. Actually, it is quite possible that that would depress the stock market; if a large number of people all try to sell when there is a lower tax rate, that might well result in lower prices rather than higher prices.

It could also mean that the volume will go up because there will be more transactions, and there is no way to forecast whether the difference between the depressing effect of more sales and greater volume would, in the end, result in higher or lower revenues to the Treasury. It is entirely unrealistic simply to assume that the revenues would be higher.

The medium-term impact is more difficult to assess. All of our experience at the Treasury indicates that the feedback effect from tax reductions are roughly 40 percent over time. Initially you have a significant reduction. Over time, there is clearly a feedback effect. But that is true whether you reduce corporate taxes, capital gains taxes, individual taxes, or any other tax.

The proponents that stock prices will rise significantly, and that, therefore, the feedback will be very high. But no one knows. As I indicated earlier, the numbers that have been used simply are beyond belief.

The long-term effects, on the economy and on our revenues clearly depend on the long-term sustainable growth in the economy and that, in our judgment, it most effectively accomplished by an increase in the profitability of American industry. An increase in the profitability of American industry will yield increased returns to total capital that can be put into productive industrial use and increased technological innovation. These are the kinds of things that create jobs.

Finally, Mr. Chairman, what about the international impact. Is it true that the Germans are ahead of us since they do not have a capital gains tax? And that that is the major reason.

We have looked carefully at other countries. In the case of the Germans, it is indeed true that they do not have a capital gains tax; they have a wealth tax, instead. The wealth tax really is much broader than a capital gains tax, for it taxes not only realized, but unrealized capital gains and I do not think anyone would suggest that we ought to substitute a wealth tax in the United States for a capital gains tax.

In the case of the Japanese, who certainly have been doing well economically, they have a capital gains tax which taxes most capital gains at ordinary rates of income, so it is really a much stiffer tax than we have. And in the case of the one or two other countries that do not have a capital gains tax, we have found that the economic performance of those countries is considerably behind that of the United States.

Therefore, Mr. Chairman, any objective analysis of the facts as we see them indicates that $2.4 billion in revenue would be lost; that most of it would go to the highest income taxpayers in this country; that any claims as to increases in stock values, any claims that this is the best way to accelerate capital accumulation, any claims that this is the way to compete more effectively with other countries, are just that—they are claims. They are not borne out by facts.

The President's program, which involves an across-the-board cut in corporate taxes which was most asked for by the broad segment of the business community, is the most effective way to foster investment in new capital goods in this country.

My final point, Mr. Chairman, is that if we devote substantial revenue to this particular proposal, we then have to take that revenue away from something else. Either we increase the deficit—something that we would strongly oppose; in fact, we are trying to get that deficit down, as you know, as urgently or as quickly as possible—or we have to reduce tax reductions elsewhere. Either middle and lower income individuals would get smaller cuts or we would have to take proposed reductions away from business. This would involve a smaller corporate tax cut or investment tax credit. And these are the places where tax reductions can have the most immediate and effective impact on capital accumulation and on the development of this economy.

It is for these reasons, Mr. Chairman, that we oppose S. 3065.

My statement also refers to S. 2428 and S. 2608. I will not take the time now to comment on those, but I also will be glad to answer questions with regard to either of these two bills.

Thank you.

Senator BYRD. Thank you, Secretary Blumenthal.

You mentioned Japan's taxing capital gains at ordinary income tax rates. Do you favor taxing capital gains at income tax rates?

Secretary BLUMENTHAL. No, I do not. I believe that the present system of capital gains taxation essentially is the correct one. I would further say that this whole issue really needs to be looked at very carefully.

We have, in the Treasury, a detailed study underway as to how we can accelerate capital accumulation. I made a speech 6- or 8-weeks ago in Florida, Mr. Chairman, in which I tried to deal with the urgent problem of capital accumulation in this country. It is very much needed, but it requires a look at the sum total of the way in which we tax capital, not just the capital gains tax, but also the taxes on dividends and on other forms of capital.

I would not want to increase the capital gains tax at this time in any significant way. I do think that we need to take another look at the sum total of these capital taxes.

Senator BYRD. I am confused as to the administration's position. You say you would not want to increase capital gains tax in any significant way. That indicates that you are willing to increase capital gains taxes?

Secretary BLUMENTHAL. We have suggested a minor adjustment, Mr. Chairman, which would have, under certain extreme circumstances, increased the capital gains tax in a particular instance by about 2 percentage points.

Senator BYRD. Well, now, perhaps you can enlighten the committee on this. As I understand it, President Carter has advocated the elimination of the capital gains tax and taxing all capital gains as ordinary income. Is that not correct?

Secretary BLUMENTHAL. He advocated that in the context of a total review and reform of the system of taxation. He is not advocating that in this legislation.

In the context of total review and reform, he would have reduced the tax rate on unearned income from 70 to 50 percent. In that context, we would have eliminated the double taxation of dividends and there would have been very substantial reforms.

Certainly he is not advocating that you select one particular tax and make this kind of change without also considering the other reforms that would have to go along with it.

Senator BYRD. As I recollect, during the campaign, candidate Jimmy Carter recommended, urged, and advocated, that capital gains be taxed as ordinary income. Is that not correct?

Secretary BLUMENTHAL. He did, but it was meant in the context of also eliminating the double taxation of dividends.

Senator BYRD. Well, now, I am getting to that next.

Now, during the campaign, candidate Jimmy Carter advocated the elimination of double taxation on dividends. Does the Treasury Department advocate the elimination of double taxation on dividends?

Secretary BLUMENTHAL. We would be in favor of both of those changes, along with other changes. We did not recommend them this year because we felt the debate over them would be too long, too complicated, and would take too much time.

Senator BYRD. Do you favor it, or not favor it?

Secretary BLUMENTHAL. I favor it, yes, and it is favored by the President.

Senator BYRD. Does the administration favor the elimination of double taxation on dividends?

Secretary BLUMENTHAL. We favor it as an ultimate step in a total reform of the tax system.

Senator BYRD. But you do not advocate it this year?

Senator BLUMENTHAL. That is correct.

Senator BYRD. Do you anticipate advocating it next year?

Secretary BLUMENTHAL. I cannot say, Mr. Chairman, whether the President will send another tax bill to the Congress next year and what would be in it. I would hope that he would be in a position to make proposals on these matters next year, or in the foreseeable future.

Senator BYRD. Do you favor bringing the top tax rate, which is now 70 percent, down to 50 percent?

Secretary BLUMENTHAL. I would certainly favor that. I have never understood the rationale and the distinction between earned and unearned income and the taxation at different rates. I think in order for us to be able to do that, to afford to do it, we would have to make a whole range of other reforms, many of which would be quite controversial.

Senator BYRD. My impression of tax reform, having sat through the 1969 tax reform and having sat through the 1976 tax reform, that tax reform, in reality, means a tax increase. Certainly, those two tax reform acts resulted in a tax increase for the middle economic group in our Nation.

So I, for one, and I have encouraged every audience that I speak to in Virginia, to take a very skeptical view of any piece of legislation that has the word "reform" it in. Tax reform, in the past, has meant a tax increase on the average American.

Welfare reform has meant welfare expansion, such as the present proposal, and such as was President Nixon's.

I find that most of these so-called reform bills go in what I consider to be the opposite direction.

Now, let me ask you another question. The President advocated, in his campaign, that capital gains be taxed as ordinary income, but that has gone by the board. That is not now being advocated, as I understand it.

Secretary BLUMENTHAL. That is correct.

Senator BYRD. He also advocated the elimination of double taxation on dividends. That, too, has gone by the board.

Secretary BLUMENTHAL. For this year.

Senator BYRD. And you have no assurance that it will be brought up in the future.

Secretary BLUMENTHAL. That is true.

Senator BYRD. Now, let me ask you this. As I understand it, the administration and the Treasury Department favors making permanent the investment tax credit. Now, what does that cost in dollars to the Treasury?

Secretary BLUMENTHAL. The extension of the investment tax credit at 10 percent does not cost any additional revenue.

Senator BYRD. No, not additional revenue. What is the revenue loss as a result of permitting the 10-percent investment tax credit?

Secretary BLUMENTHAL. Would you like that number at 10 percent, or what it costs us not to have it go back to 7 percent?

Senator BYRD. The total 10 percent, please.

Secretary BLUMENTHAL. I will have to get you that number, Mr. Chairman.

Senator BYRD. And then while that is being looked up—

Secretary BLUMENTHAL. The total 10 percent investment tax credit has a revenue cost of $2.5 billion to $3 billion.

Senator BYRD. $2.5 billion to $3 billion. Roughly what——

Secretary Blumenthal. Leaving it at 10 percent, not reducing it and having it go back to 7 percent has a cost of about $2.5 billion.

Senator BYRD. That was not my question, though. The 10 percent tax credit.

Secretary BLUMENTHAL. Oh. We will have to get you that total figure.

Senator BYRD. Yes. The total figure.

But leaving it at 10 percent and not going back to 7 percent has a revenue loss of $2.5 billion?

Secretary BLUMENTHAL. That is right.

Senator BYRD. Now, one other figure I would like in that connection, how much of that $2.5 billion and also how much of the unknown figure, which you will look up for me, goes to the top 10 percent of American corporations?

Secretary BLUMENTHAL. Of corporations, not individuals?

Senator BYRD. Of corporations.

Secretary BLUMENTHAL. Well, I will supply that for the record.

Senator BYRD. If we could get that percentage figure prior to the adjournment, or the end of your testimony, it would be helpful, because I think I want to relate that to your testimony on capital gains, if I might.

Senator PACKWOOD. Mr. Secretary, when Treasury appeared here in March 1969, they testified that when we raised the capital gains rate, there would be an increase in revenue, from the capital gains tax. That turned out to be dramatically wrong; revenues from the tax was down.

Why was that?

Secretary BLUMENTHAL. The numbers, I think, were affected largely by economic circumstances over the years.

Senator PACKWOOD. Well, let's just take the Treasury's projections for the first 2 years, as opposed to the revenues for those first 2 years.

Secretary BLUMENTHAL. I do not have the numbers for the revenues on capital gains. I have it for the total revenues, because it is generally put in those terms. Would you like me to give you those?

Senator PACKWOOD. No. I am only talking about the capital gains tax.

Secretary BLUMENTHAL. I do not have the breakdown over what was estimated in 1969 on, and what was actually gained.

Do you have those figures?

Senator PACKWOOD. Mr. Steiger, do you have those figures with you, out of curiosity?

Representative STEIGER. No.

Senator PACKWOOD. In any event, the Treasury testified that capital gains revenues would go up and they went down, and rather dramat-

ically. I grant you, it may have been a change in economic circumstances that Treasury did not see.

Now, Treasury is, today, testifying that there would be a revenue drop of $2.2 billion in 1979 and $2.4 billion in 1980 if enact the Steiger-Hansen capital gains tax.

What is that based on?

Secretary BLUMENTHAL. The initial revenue loss is a result of enactment of this particular——

Senator PACKWOOD. No, no. I understand that. How did you come to those conclusions?

Secretary BLUMENTHAL. It is based on a calculation of what the actual loss to the Treasury would be as a result of reducing the rates and applying the reduced rates to the realizations on capital gains that we expect in each of those years.

Senator PACKWOOD. In reaching that result, are you presuming any change in economic circumstances?

Secretary BLUMENTHAL. No other change in economic circumstances other than what we are generally projecting for other calculations that we are making about the economy. Taking the assumption that we are making about the economy for other purposes and saying, under those circumstances, what happens in the first year of enactment and then the second year and then the third year.

Senator PACKWOOD. Basically, the philosophy of the Treasury Department has not changed. You are using roughly the same philosophy you used in 1969 which, in making your projections, presumes very little change in economic circumstances. It was the change in circumstances that threw the projections off.

Secretary BLUMENTHAL. It is certainly true that, if we have a recession or if we have a great boom that the revenues of the Treasury will change. We can only go upon the best assumptions that we can make. That applies to all revenue calculations that we make.

Senator PACKWOOD. You have seen the studies of Chase, Merrill-Lynch, SIA and Curie, all of whom show revenue increases in the second year, ranging from $7.3 billion to $1 billion, but all of them revenue increases.

In your estimation, they are all wrong?

Seceretary BLUMENTHAL. That is correct, because they assume stock market price increases of 40 percent, in one instance, and 20 percent in the other instance.

Senator PACKWOOD. Only 4 to 6 percent in the case of Merrill-Lynch.

Secretary BLUMENTHAL. And 4 to 6 percent in the third.

Senator PACKWOOD. That is not an exorbitant increase in stock market prices.

Secretary BLUMENTHAL. Well, the fact is, Senator, that nobody knows. These are assertions. Nobody knows what they are.

Therefore, we can come to any result we want is we are willing to assume that the stock market will either rise or fall dramatically. We looked at the performance of the stock market and we saw that, in the past, there was no correlation.

Senator PACKWOOD. Nobody knows, then, including Treasury?

Secretary BLUMENTHAL. We look at the past, and the fact is that the past has shown no correlation; so we certainly know that it is wrong to assume a correlation that has never existed in the past.

Senator PACKWOOD. What information are these other studies based on?

Secretary BLUMENTHAL. I do not know what they looked at. I think they just programed their computers to come out with a certain result.

Senator PACKWOOD. You think they programed their computers to come up with a certain result?

Secretary BLUMENTHAL. That seems to be the case.

Senator PACKWOOD. They had a conclusion they wanted to reach and they skewed the figures to make sure they reached that result?

Secretary BLUMENTHAL. They have to speak for themselves as to how they get the 40 percent.

Sneator PACKWOOD. No; you have spoken for yourself, and I understand, now, what you are saying. These are to be dismissed because of deliberate factual inaccuracies programed to reach a preconceived conclusion.

Secretary BLUMENTHAL. Well, some of these same analyses from some of these same groups who have done similar analysis for other purposes use different assumptions and came up with different results. I cannot understand how, based on the facts as to what the stock market has done in the past and the lack of any kind of correlation, one can suddenly come around and assume that there will be a 40-percent increase, or a 20-percent increase.

Senator PACKWOOD. Are we going to have a second round of questions?

Senator BYRD. Yes.

Senator PACKWOOD. All right.

Senator BYRD. Senator Hansen?

Senator HANSEN. Thank you, Mr. Chairman.

Mr. Secretary, we are pleased to have you here, and I appreciate the difficulty in trying to say what the President's position may be. As a member of the Energy and Natural Resources Committee, I have observed that his position seems to be a rather changing one. He certainly has made a number of proposals for a solution to the energy crisis, and I find an equally fantastic number of changes in tax proposals.

Back in 1969, Treasury predicted that, if changes were made to close the loopholes in capital gains, then revenues would increase. The facts are that, by your own data, Mr. Secretary, those revenues declined 39.2 percent from $14.6 billion in 1969 to $8.9 billion in 1970.

In 1963, when President Kennedy proposed lowering taxes—and they were, indeed lowered—Treasury predicted an $89 billion reduction in revenue between the years 1963 and 1968. Actually, there were increases of $54 billion during that same time.

Now, based upon the rather dismal record that Treasury has before us—and I could state other examples to make my point—and comparing that record with the overwhelming consensus of economists, why should the American public or the Congress now place credence in Treasury's estimate of losses that will result in what you describe as a static economy. You say all you can do is look at the figures.

I am inclined to think that Treasury is looking at the reduction of the rate, assuming that nothing else is going to change. Now, do you really believe, based upon the experience you have had—and I

greatly respect your judgment and your experience—do you really believe that it is fair or accurate or even decent for Treasury to come up here and say if we lower the rates, the revenues are going to drop so much. Do you really think that is the case?

Secretrry BLUMENTHAL. Senator, I think, that you have to look at all of the taxes on capital and you have to recognize that the tax on capital gains represents a very small proportion of the total, And, on that basis, you have to make some judgments as to the extent of the impact that this kind of thing could have, and you have to look at past history and you have to see whether you can discern any direct impact.

On the first point, you conclude that it was a small portion of the total; on the second, you conclude tht it did not have such an impact in the past. It is on that that our judgment is based.

But I would like to comment on the one figure of $89 billion to which you have referred, because I think the record, really, is somewhat different.

Between 1962 an 1968, the unified budget revenue rose by $54, billion, It has been alleged that we estimated a decline of $89 billion which would have, incidentally, meant a cumulative error of $143 billion that Treasury estimated.

While I certainly was not a member of the Treasury then, I do want to set the record straight, for I have a great deal of respect for my colleagues who are professionals and who are very good at their job. In fact——

Senator HANSEN. Well, if I could interrupt for a moment, Mr. Secretary, let me say this. I greatly respect your judgment. I greatly respect the judgment of former Secretaries of the Treasury. It seems to me that you listen too much to those right around you who do not live too much in the real world. That is all.

That was the point I was trying to make there.

Secretary BLUMENTHAL. Well, in fact, Mr. Chairman, the Treasury estimators did not predict that revenues would drop by $89 billion; they estimated a rise of $52 billion. The $89 billion figure, as I understand it, was a prediction of how much less it would rise, but not whether it would rise or fall.

I think that in the historical telling of the story, that sentence simply has been dropped out. They predicted a $52 billion rise which shows that the average error, the estimated level of receipts in that period, is 4.6 percent for the year, so they are fairly accurate.

It is not that they predicted an $89 billion drop, but to predict $89 billion less than what would have happened, but still a $52 billion rise as compared to the $54 billion that actually occurred.

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

Senator BYRD. Senator Roth?

Senator ROTH. Mr. Secretary, are you satisfied with the state of our economy?

What do you foresee happening with respect to growth, employment and international trade during the next year?

Secretary BLUMENTHAL. I am reasonably satisfied with the state of the economy, but it could be better and I am certainly not fully satisfied. We do have some problems, Senator.

I think that the rate of inflation is much too high. I think that there are still areas in which unemployment is much too high, particularly for the young, for minorities, and the people in the inner cities. I think that there is not enough capital investment in the United States, and that there is not enough investment in R. & D. in the United States. All of these are problems that have to be dealt with.

And, of course, I am concerned about the energy situation and about the persistent deficit in our current accounts, our balance of trade. These are serious problems.

I foresee, over the next year or two, continued growth of the U.S. economy at a level at or above the sustainable rate of growth which we generally estimate to be about 3.5 percent in real terms.

I foresee also some general, gradual, further decline in unemployment at these levels of growth and I am hopeful that we can look forward to a gradual decline in the rate of inflation, particularly if the President's anti-inflation program and his efforts to follow a very tight budgetary policy and to reduce the deficit are effective.

Senator ROTH. Do you feel, for example, the imbalance in the current trade account for example, with Japan and the position with our foreign competition is something that can wait?

Some time ago, for example, you made the statement that, as far as the decline of the dollar was concerned, we could use sort of an approach which could be called benign neglect. Do you feel the same position is true here?

The reason I ask this question is because at the conclusion of your statement you once again say you will study the issue. How long can we wait?

We have the largest deficit in the history of our country. We are losing jobs to foreign competition. What are we going to do about modernizing our industrial plant? How are we going to get these investments? How long can we wait?

Secretary BLUMENTHAL. Senator, first of all, I must make one point clearly. Neither I nor, to the best of my knowledge, any member of this administration has ever indicated that a policy of benign neglect with regards to the dollar was a correct policy or was, indeed, acceptable in any way, shape, or form.

We have always felt, and I have stated so repeatedly, that the strength and stability of the dollar is of great importance to us and that policies we are following are clearly designed to insure that.

I think that we have to act quickly and vigorously to deal with the problem areas that I have indicated. I firmly believe, Senator, that based on months traveling around this country and talking to businessmen, large and small, in my office and elsewhere, that an across-the-board reduction in the corporate rate of taxation (which incidentally is, something that many Members of Congress, and many Republican Members of Congress, advocated a year ago) is the best way to increase the profitability of American industry and provide the additional cash flow as an incentive to modernize and to make us more competitive.

Senator ROTH. Let me ask you this question, Mr. Secretary.

In your closing paragraph, you state that a thoughtful and comprehensive study to capital income taxation is needed.

When will the Treasury be able to come up with recommendations in this area?

Secretary BLUMENTHAL. It will not be in time to affect the tax bills for this year, which I hope the Congress will pass. I have started an intensive study of this whole question of capital accumulation. That should be ready in the Treasury by the latter part of this year, by October or November.

We will then review it with the other agencies and present recommendations to the President.

Senator ROTH. Well, Mr. Secretary, I think time is of the essence. I think that we cannot afford to wait.

Unfortunately, this has been the position of this administration in the area of general tax reductions. Last year, you said that you were going to study it. You reluctantly finally came forward with a proposal. In recent weeks you have been backing off, delaying, cutting back. I think that we need a comprehensive program.

Could I ask one more question, Mr. Chairman?

In your testimony, you talked about the revenue loss or possible loss from the Steiger amendment and the difference of opinion as to whether or not that would happen. But talked about the deficit, and you never suggested that one way of minimizing that deficit would be through a reduction of Federal spending.

Now, you and many members of this administration, I think, have rightly called upon people in the private sector to use restraint. You have asked the unions to limit their wage requests. You have asked business, rightfully, to keep their prices down.

And yet, no mention is made here by you of reducing the deficit through holding down spending. I would like to ask you to comment on that because this bothers me very much. Yesterday the full Senate considered the appropriation for your department, and it was recommended that there be an increase of $888 million over the 1978 appropriation of $2.8 billion. That is a pretty big increase. I recognize that about $500 million of that is due to the social security problem that you are trying to resolve.

I also note that in that committee report on the bill the Subcommittee on Appropriations wrote that—

> The committee is increasingly concerned with the appropriations expended in Treasury for travel. Travel and transportation funds requested in fiscal year 1979 are 26 percent higher than the obligation for this purposes in fiscal year 1977.

Now, Mr. Secretary, the reason this bothers me so much is that we are, and rightfully, as I said, asking the private sector to show restraint. But I do not see where the administration itself is providing that kind of leadership.

This report comes out from the Democratic majority. It is not the words of a Republican minority.

The question I ask you is, one, what can be done about holding down spending and does this provide the kind of leadership that is going to spur the American people to do what is necessary?

Secretary BLUMENTHAL. I think, Senator, I fully agree with the need to keep down Federal spending and the President is firmly committed to do so.

The budget that he sent to the Congress for fiscal year 1979 involves a considerably smaller increase in the rate of spending than in the previous years. In fact, in real terms, it involves an increase of about 1 percent. He has indicated his determination to keep total spending to

21 percent of GNP and he has put all of us on notice that the 1980 budget will be a very, very tight budget in which there may well be no increase at all.

The real goal to which he has committed himself is to get the deficit down and to get that Federal budget into balance by 1981.

Let me say a word about the Treasury budget. I would have to look at the detailed numbers. I think some of that $800 million, really, as you have indicated, is beyond our control.

A great deal of the Treasury budget is interest on the debt over which we do not have any control at all.

But even at $800 million, I estimate out of a $2.8 billion budget—and I take your figures—that to be roughly, 3 percent. Given the rate of inflation, that is, a very small increase. Bearing in mind, also, that we have mandated a ceiling on wage and salary increases, it involves pretty tight controls. Certainly, I am doing my best in that regard within the Treasury Department with respect to those areas where we do have control.

Senator ROTH. When you ask the American people to sacrifice and use restraint, it is very difficult to be an effective leader, in my judgment, when the very agency responsible for much of the inflation fight is proposing to increase its travel by 6 percent.

That is something the American worker can understand. And while everybody says they are for holding down Federal spending, I will have to say, in all candor, that the action does not follow up the words.

Thank you, Mr. Chairman.

Senator BYRD. Senator Danforth?

Senator DANFORTH. Mr. Secretary, as is generally the case in public issues, and particularly tax matters, the question on capital gains taxation is a debatable matter. I would like to make some comments to you, and maybe elicit some from you, on the quality of the debate that is now going on.

I am a cosponsor of Senator Hansen's bill. I must say that I am not fully locked in concrete on it. I hope that I am always a person who is receptive to good, sound arguments.

But what I would like to address your attention to, and my attention to, are sort of the ground rules on which this debate is taking place, the nature of it, the way in which this battle is being fought.

Today, Congressman Steiger has appeared before us, and you have appeared before us. Very frankly, his arguments have just run circles around your arguments.

He has been substantive. He has been factual. He has addressed himself in detail to the question of capital formation. You addressed yourself for about 1¼ minute to that subject.

The people who are favoring a reduction in capital gain taxes are armed with three econometric models to shore up their position. You dismiss them very lightly as being incredible and, according to your staff report, the Treasury Department—and I am reading from it—

> Has not heretofore analyzed the proposed changes to capital gains tax rules with an econometric model. Secretary Blumenthal's letter does not indicate whether the Treasury Department has examined the impact of the proposed changes on aggregate economic activity.

You came here and you said that you were going to give us a dispassionate analysis and, very frankly, I did not see anything dispassionate about it. It seems to me that what happened was that some public relations person or press person, either in Treasury or somewhere in the administration, keyed in a couple of catch phrases which you hoped would get publicized.

When you said, "This is a relief bill for millionaries," and you suggested that it should be called the Millionaire's Relief Act of 1978.

This was the same kind of tone for this debate that was adopted by the President in his press conference, I think it was last Monday, where he said, in answer to a question about the Steiger and Jones proposals—

> Both of these proposals apply basically to a desire of some Members of the Congress to remove part of the income of very wealthy taxpayers from the minimum tax. A few years ago the Congress very wisely said that if there were loopholes or provisions in the tax law that let a wealthy person avoid paying any tax, they would at least have to pay some tax under the new, minimum tax laws.

Well, I can understand a President at a time when his popularity is apparently sinking, and the polls are showing that, trying to create groups that he attacks, but frankly, I do not think that is the kind of tone of political debate that we should be having in this country.

I really question the President of the United States flying out to the west coast and attacking the lawyers one day, and attacking the doctors the next day, and now, after his press conference last Monday, the press starts writing articles wondering whether the whole tone on capital gains taxation, the whole quality of the debate, is going to be a kind of demagogic move to transform it into something other than a sound analysis of the needs of productivity and capital formation and the general health of the economy, and just passing it off as you put it, "the Millionaire's Relief Act of 1978."

I am absolutely convinced that, more important than any program the Government comes up with is the tone of public debate, and it seems to me that the best thing that a person in public life can do is to either appeal to the best or to the worst instincts in the people who are out there listening.

That is what a Member of the Senate has. He has got basically a platform. He has got a platform from which he can speak and he can either, in his speech, appeal to the best instincts or he can appeal to the worst instincts of the American people, and if that is true for a Senator, it is certainly true for the Secretary of the Treasury and it is certainly true for the President of the United States, and I honestly believe that it is a profound disservice to this country to go running around in press conferences attacking this group or that group for the sake of political popularity.

Secretary BLUMENTHAL. Senator, I pride myself upon the belief that in my public comments, my testimony, and my speeches, I make every effort to deal with the facts, as I know them. I do not have to run for public office. I do not particularly need this job. Nevertheless, I try to do the best job I can with the available evidence given to me, based on the integrity which I hope that I have brought to whatever I have done, whether it is this job or eny I have had before, or any one that I would have afterward.

I have to deal with the facts, not with the assertions. My testimony was designed to indicate that what we are dealing with here are assertions.

Table 2 indicates how the individual tax reductions under Mr. Steiger's bill would be distributed. That is not demagoguery. Those are facts. The average tax benefit for those over $1 million is $145,000. The average tax benefit for those earning between $15,000 and $20,000 is 25 cents. That is not demagoguery; those are facts. And I think that I have an obligation to point out that taking $2.4 billion out of tax revenues and putting them into this kind of reduction, which means we must take it from somewhere else, either other corporate taxes, or individual taxes, is an unjust way of handling our taxes.

Second, I attempted as clearly as possible to summarize my full statement. That document presents my reasoning in great detail and I hope, if you have not already done so, that you will study it carefully. I have tried to analyze the validity of the claims in the models were only as the assumptions that go into them, and we all know that. The validity of the claims that there would be a significant increase in the stock market and, again, we tried to present facts.

The only facts that we have at our disposal are shown in chart 1 which indicates changes in the capital gains tax rate and the actual performance of the stock market during the past two decades. It shows that there is no correlation.

Second, I tried, based on the advice of my associates and my own training as an academic economist—atlthough I have not practiced that craft for some time—to analyze the impact of this kind of change in the very short term, the medium term, and in the long term. That is not demagoguery. I think that that is sound analysis, and I think that that analysis will be backed up, and can be backed up, by a great many economists who are a great deal better-trained and better-skilled at their craft than I am.

I think that the models cannot be dealt with on any grounds other than to question the assumptions, for if you do not assume a major increase in stock market prices, then you will not have the same result as the models show. I raise questions as to whether a $500 million reduction in the capital gains tax is going to bring forth a $600 billion or even a $60 billion increase in stock market values.

I really think that that is a relatively objective and dispassionate presentation of the issues. If you put alongisde of that the fact that across-the-board reductions of the corporate tax rate affects all businesses and makes them all more profitable—regardless of whether they have capital gains—by providing the kind of additional cash flow which American industry has been seeking, I think you would have to conclude that we are trying to deal with this thing properly and effectively.

The problem we face is that we are inundated from all sides with a vast array of claims that are not backed by facts, and many of which are not dispassionate.

The President is attacked from all sides in contradictory ways about virtually everything he says and does, and I think he has the right to point out, as he did in his press conference, exactly what this particular tax proposal would do—who it would benefit and who it would not benefit.

Senator BYRD. Mr. Secretary, as I understand it, the administration and the Treasury Department favor the continuation of the 10 percent investment tax credit?

Secretary BLUMENTHAL. Yes.

Senator BYRD. Now, the figure that has been given to me that the investment tax credit, the 10-percent credit, involves a revenue loss of $13 billion for fiscal 1979.

Secretary BLUMENTHAL. I have the figures in response to your request. They have just been handed to me. I have them at 1978 levels, and the entire 10 percent investment tax credit is estimated to be $14.6 billion.

Senator BYRD. $14.6 billion.

Now, as I understand it, of that $14.6 billion, and if we could just round it off for simplicity's sake and call it $15 billion, of that $15 billion revenue loss, 80 percent, or $12 billion goes to corporations.

Secretary BLUMENTHAL. The figure that I have now, using 1974 data, 7 percent of corporations, those with assets over $1 million, receive 91 percent of the investment tax credit.

Senator BYRD. Well, I was pursuing that in a slightly different vein, but if the figures that have been given to me are accurate, of the total $15 billion, 80 percent goes to corporations; 20 percent goes to individuals or partnerships and so forth, so that is $12 billion.

Now, of that $12 billion, if the figures submitted to me are correct, one-third of that amount, say 31 percent of the figures I have, 31 percent goes to 45 corporations. This country has 2 million corporations, 2 million corporations, yet one-third of $12 billion will go to only 45 corporations.

Now, I am not condemning that. It was done for a specific purpose. But the fact is that the administration and the Treasury advocate a program where virtually all of the proceeds and the benefits go to a very, very, very small number of corporations—45 out of a total of 2 million.

Now, I am relating that to your assertion that this bill, to follow up Senator Danforth's statement, that this bill to change the rates on capital gains, if it is enacted it will be in your designation a millionaire's relief bill, that most of the advantage would go to a relatively small number of people.

Now, if that is the rationale that you are using, how can you come in here and justify to this committee and advocate that virtually all of the investment tax credit go to a very, very, very small number of corporations? It seems to me that you are not at all consistent when you argue in such a way?

I happen to feel that the investment tax credit is an appropriate tax credit, and I support it, not because I want some few corporations to get special advantage. That is not why I support it, and that is not why you support it. That is not why the administration supports it.

I am not supporting the proposal to take a realistic view of capital gains because I want to give some special advantage to a small group of people. That is not the point of it.

Many individuals feel, many economists feel, many businessmen feel that if you get away from the very high tax on capital gains that the Government and the economy will benefit as a result, and that is the theory of the investment tax credit. Not to benefit 45 corporations

to an undue and terrific extent. The purpose of it is to help the total economy.

So I just cannot go along with your thinking just because a change in the capital gains rates might benefit a few people more than it would benefit other people. That is an inadequate reason for opposing it.

Also, I want to concur in what Senator Danforth said that to label this a millionaire's relief act does not seem to me to be a very dispassionate way to handle an extremely important problem. Now, to get headlines and to get publicity it has use, but I do not know that it sheds a whole lot of light on the subject.

Secretary BLUMENTHAL. Mr. Chairman, if you would allow me to respond, I think the essential point here is that in the investment tax credit, the greater part of the benefit going to the large corporatons is related to their having that portion of the income.

Senator BYRD. That is right. The same as with the individuals who make investments.

Secretary BLUMENTHAL. The corporations, in turn, are owned by hundreds of thousands of people, by pension funds in which the pension of millions of people are invested, and the corporations get this benefit of the basis of particular, specific, productive investments which they make, which do contribute to capital formation.

Senator BYRD. Do you not feel that individuals who invest in a venture enterprise are also not contributing to the economy?

Secretary BLUMENTHAL. If you look at table 4, Mr. Chairman, you will see that the capital gains are distributed for a whole range of purposes, many of which are only marginally productive in the sense of contributing to capital accumulation.

Certainly, the installment sales, certainly timber, commodities trading, things of that kind, are hardly the sorts of things that will lead to the goal of greater capital accumulation and productive capital in this country. I think that is the essential distinction.

I, again, refer you to table 2. Table 2, after all, does show the rather startling increase in average tax benefits as you go up the scale, and you cannot get away from the fact that we object to this particular proposal, amongst other things, because we do not feel that a $2.4 billion tax reduction instituted in this way so that taxpayers with incomes between $30,000 and $50,000 get $11 while the average benefit for those who make more than $1 million is $145,000 is an equitable way of distributing tax reductions.

Senator BYRD. Well, I am wondering whether it is equitable, then, to give some $12 billion in revenue loss to 1,142 corporations out of a total of 2 million corporations. Virtually all of those 2 million corporations get no benefit whatsoever from it.

Secretary BLUMENTHAL. Those corporations are owned by millions of shareholders and have a proportionate level of income. The millionaires have 1 percent of the total income and they would get 40 percent of the benefit of this particular provision. I think there is a discrepancy there.

Senator BYRD. Well, that is a matter of a difference of opinion there, I suppose. I think that if you are going to accept the reasoning that you use in regards to the capital gains tax, then I think that we ought to reexamine whether we are really doing what we ought to do in having a 10-percent investment tax credit where virtually all of the funds go to a handful of corporations.

I will yield to Senator Packwood.

Senator PACKWOOD. Mr. Secretary, I want to come back, again, to the 1969 act and Treasury's figures.

The receipt from capital gains from individuals in 1968 was $7.2 billion. In the fiist 2 years under the new act, the receipts from individuals were $3.6 billion and $5.3 billion respectively, despite the fact that Treasury testified that there would be an increase.

At that time, the Securities Industries Association of America testified on the bill and they indicated that if we passed capital gains provisions that we were then considering, and that we did pass, there would be a loss in revenue from capital gains taxation.

Now, factually, it turns out that Treasury was wrong and they were right; is that not correct?

Secretary BLUMENTHAL. I have not seen those numbers on capital gains taxes.

Senator PACKWOOD. All right. Treasury predicted an increase; the Securities Industries Association predicted a decreased. There was a decrease.

Now, is there any possibility that Treasury could be wrong today and the Securities Industries right today in their testimony on the present capital gains?

Secretary BLUMENTHAL. No one can claim to have absolute knowledge in this area. Of course, anyone who makes such claims could be wrong. All we can do is to go on the basis of the best analysis we can do and the available evidence relating stock market prices to capital gains tax rates in the past. We try to assess the correlations and to judge whether a $500 million reduction in those taxes is likely to bring forth a $30 billion, $40 billion, or $50 billion tax increase.

Senator PACKWOOD. All I am saying is that Treasury was wrong before; it can be wrong again. I do not think you take very kindly to heart Senator Danforth's statement. When you refer to all of these other studies as having reached their conclusions and thereby structuring their assumptions to justify their conclusions, that is not the statement of a nonpartisan, bipartisan man doing his best. That is the statement of a demagog attempting to show that those studies have been based upon ill-founded facts, almost immorally founded facts, designed to justify a preconceived conclusion.

Secretary BLUMENTHAL. I did not use the word "immoral" Senator. I have asked, and I have received no answer, as to how, based on the evidence that we have, you can conclude that there will be a 40-percent increase in stock prices. This never happened before and there is no reason to believe that it would happen in the future.

Senator PACKWOOD. The Merrill-Lynch study only presumes a 4- to 6-percent increase. You know, that does happen from time to time.

Let's scratch that. I want to go to another subject.

You are familiar, of course, with the Laffer curve?

Secretary BLUMENTHAL. Senator, if you will allow me, as I understand it, there will be testimony tomorrow by one of my colleagues who will go into detail on the technical aspects of the model that we use in order to derive our estimates. The weight of his testimony will be to provide a critical analysis of the assumptions and the way in which the other models were put together.

Senator PACKWOOD. What I am always intrigued with, Mr. Secretary, is that no matter how often Treasury comes and testifies year after year, and are wrong, they never hesitate to come back year after year and predict again and project again and be convinced that they are more right than anyone else.

They were wrong on the Kennedy tax city. They were dramatically wrong.

I want to scratch all of that. I will listen tomorrow to your witness.

You are familiar with the Lafer curve and his theory of the optimum level of taxation?

Secretary BLUMENTHAL. Generally familiar.

Senator PACKWOOD. All right. What he basically says is that there is an optimum level of taxation which will produce the greatest level of revenue for the Government.

At a zero rate of taxation, you will produce no revenue. At 100 percent rate of taxation, you are likely to receive very little revenue since few people will work if the level of taxation is 100 percent.

At some point between those two, there is an optimum level of taxation that will produce the most revenue.

Lafer says if you are above the optimum level you can cut your rates and increase the revenue. Obviously, if you are below that optimum level and you cut your rates, you are going to reduce your revenue.

I take it that the Treasury Department thinks that we are now at almost perfect level of capital gains taxation. As I think you said, you would not support any significant increase and certainly not this decrease, because you believe it will decrease revenues.

Secretary BLUMENTHAL. I am suggesting that, in the case of the capital gains tax, I have seen no evidence to indicate that a reduction by $2.4 billion will yield you more revenue that you lose.

Senator PACKWOOD. Do you know if there is any evidence within Treasury that indicates if we increase the capital gains tax that it would increase revenue?

Secretary BLUMENTHAL. Based on past performance, the evidence indicates that roughly 40 percent, in the end, is recaptured.

Senator PACKWOOD. I do not understand the answer.

Secretary BLUMENTHAL. The answer means that, if you raise capital gains taxes—if you raise taxes generally, including capital gains taxes—you do get a flowback, not a 100 percent net loss of the tax increase. You do get something back in additional revenues, but you do not get everything back. You get back roughly 40 percent of the increase.

Senator PACKWOOD. Well, are you saying if we raise capital gains taxes now we would have an increase in revenue to the Treasury?

Secretary BLUMENTHAL. Yes; we would. Maybe not in the first year, but over a period of time.

Senator PACKWOOD. But you were saying that we have not yet reached the optimum level of taxation, so that the tax on capital gains could be raised and more revenue would be produced. In your opinion, if we increase the capital gains tax, we will still get more revenue?

Secretary BLUMENTHAL. I think that is correct.

Senator PACKWOOD. I have no other questions.

Senator BYRD. Senator Hansen?

Senator HANSEN. Mr. Secretary, I want to identify myself with the observations made by Senator Danforth. It seemed to me he struck at a very vital point when he called into question the tone and the tenor of critical remarks that come from the administration regarding these bills.

I have, in my hand, your testimony and I am looking specifically at table 2 and I note that your estimates are based on expanded income classes. I am aware that by expanded income class you very neatly seize upon the once-in-a-lifetime capital sales that an individual taxpayer may make which may reflect the selling of his home so that, one time only, he becomes one of those taxpayers in the $100,000 to $200,000 expanded income class. I know some of those people. I had a letter from one of them in Wyoming.

In 1973, the average farm and ranch income per farm and ranch in the State of Wyoming was $14,788. By 1976, the average farm and ranch income in Wyoming had dropped to $241.

Now, I do not put many of those people in the $100,000 to $200,000 expanded income class. but Treasury does. I heard from one of them because this lady's husband had diabetes and their youngsters had to leave the farm because they thought there were better places to make a living than ranching east of Casper, Wyo.

They went to their tax consultants and to their accountants and they posed this question: since my husband is going to have to have a leg amputated, would we be better off to keep the ranch and to try to rent it out on a leased basis, or should we sell it.

After talking with their laywer and with their accountant, they determined that the best thing to do was to sell the place. So they sold it.

And, in the meantime, the Congress passed the tax reform laws on capital gains and we had four and a half pages of effective dates contained in that bill, which I remember very well. I can safely say that not one Member, not one Member of the House or Senate, could have told anybody what each of those effective dates meant.

Included in those date changes were a number of retroactive provisions which changed the rate on capital gains for this woman and her husband. They wound up having to pay $31,000 more than the law was at the time they made the sale.

Now, does Treasury think that sort of situation does not call out for change?

Secretary BLUMENTHAL. Let me deal with the three points, Senator.

Senator HANSEN. Well, first, if I may, I have one other question. I say this because you are giving the impression, or I think you attempt to, that these benefits are going to go to a lot of wealthy people. You talk about those in the $15,000 to $20,000 bracket, took 0.2 of 1 percent and those under $15,000 get 12 cents. Those between $15,000 and $20,000, expanded income class, you say get the 25 cent benefit.

I am talking about somebody who did not ever get into that class for a long time in Wyoming. They got socked $31,000 extra taxes. Your statement talks about averages, yet, by the average, you know if your head is in the refrigerator and your feet are in the oven, on the average you are pretty comfortable.

But I would have to say that I do not think many taxpayers are very comfortable. It may hit them only once in a lifetime, but when it hits them, they feel it. And if they sell their home and have to go into a retirement home, they feel it.

Now, explain to me how this sort of table dispassionately and fairly reflects the facts?

Secretary BLUMENTHAL. This table dispassionately and fairly reflects the facts on the basis of an income concept which we believe most closely reflects the person's economic circumstances. Expanded income is a measure that the Congress, in the Tax Reform Act of 1976, asked us to use in our reports on high-income taxpayers and it is for these reasons that we adopted it for all of our analyses.

We would be glad to provide to you, Senator, a different calculation in which we take capital gain out of expanded income. No doubt, it will show a smaller benefit than $145,000 but the general shape of the curve will not be substantially altered.

Second, while I cannot deal with the particular situation of a family missing a particular effective date, that family has to recognize that there are millions and millions of wage earners who make their savings out of after-tax income. They earn their wages and their salaries, they have to pay taxes, and whatever they save has to be after they pay their taxes.

When you own a property whether it is a ranch or a store or a business, you, in fact, are not taxed on the increase in that value that you are building up. Year after year, you are not taxed.

When you are finally taxed, you are taxed at a rate that is lower than a wage earner or a salary earner. So for that entire 20 or 30 years that that individual, or that family, has been building up its equity and its assets, it has not been taxed, in the end, it will be taxed at a lower rate.

So we are already providing a substantial benefit to that kind of taxpayer as compared to the many, many millions of taxpayers who earn a wage or a salary.

And I think that by further reducing that capital gains, we would be disadvantaging and creating a further inequity vis-a-vis the wage earners and salary earners of the country.

Senator HANSEN. I wish I had more time, Mr. Chairman. Thank you. My time is up.

Senator BYRD. Senator Danforth?

Senator DANFORTH. Mr. Secretary, you say that the administration favors additional capital formation. What tax proposals does the administration have that favor capital formation?

Secretary BLUMENTHAL. We believe that the reduction in the corporate tax by 4 percentage points, the making permanent of the investment tax credit and liberalizing it to include certain items that were not previously eligible will have a strong impact on capital formation.

The liberalization of the various elements in our tax proposal that provide particular benefits to our small business would also help in that regard.

But, in particular, it is the corporate tax reductions of some $7 billion at 1978 levels which are particularly tailored to assist capital accumulation.

Senator DANFORTH. You do not support expansion of the asset depreciation range, do you?

Secretary BLUMENTHAL. We do not support that because we do not have additional resources available and we concluded that the maximum reduction in the tax rate plus the investment tax credit would be more effective.

Senator DANFORTH. Would you oppose it?

Secretary BLUMENTHAL. We would have to see it in the context of the overall proposal that would be made. The question is what would be taken out as a result of it? I think that if it would be at the expense of the corporate tax rate reductions that have been suggested, we would probably oppose it.

Senator DANFORTH. And, with respect to the investment credit, you would just continue the present rate at 10 percent, would you not?

Secretary BLUMENTHAL. We would continue the present rate at 10 percent and make some of the definitional changes which both widen its applicability also target it to give additional investment incentives.

Senator DANFORTH. What would be the revenue cost of that?

Secretary BLUMENTHAL. If I remember correctly, the additional liberalization that we have recommended is less than $1 billion. It is just about $800 million or $900 million.

Senator DANFORTH. $800 million or $900 million by virtue of expanding the plants?

Secretary BLUMENTHAL. Yes.

Senator DANFORTH. Do you consider that to be a substantial incentive for capital formation, or a very minimal incentive for capital formation?

Secretary BLUMENTHAL. It is not a substantial additional incentive. An amount of this kind would not be. But, being specifically targeted for investment it does have a considerable impact.

Senator DANFORTH. It might hrve a negative impact, might it not, by hastening the flow of investment and plants from areas of high unemployment, such as inner cities and other areas?

Secretary BLUMENTHAL. Well, we had thought to take care of that in the President's urban program, Senator, by targeting and providing special benefits for investment in the inner cities.

Senator DANFORTH. But you would not say that under $1 billion is very substantial, would you?

Secretary BLUMENTHAL. Well, it is not a substantial amount if you relate it to a $20 billion tax program that is proposed or to a $7 billion corporate——

Senator DANFORTH. Or to a half a trillion dollar Federal budget.

Secretary BLUMENTHAL. Certainly, not if you relate it to the total budget.

On the other hand, by being targeted for investment purposes, indirectly for capital accumulation, it would have a considerable impact.

Senator DANFORTH. I would say that it has a very modest impact.

Now, you talk about reducing the corporate tax; 44 percent, that is what you have it to, is that not right?

Secretary BLUMENTHAL. That is right.

Senator DANFORTH. But how about the individual taxes, Mr. Secretary? My computations, given the initial program of the administration which were put out last January, were that for individuals, the only people who would benefit would be people with incomes of between $7,600 and $12,500 by 1980 and that the effect of the social security tax increases plus inflation's putting people in the higher brackets would mean that a family of four with over $12,500 income would be paying more in taxes after 1980 than today.

How about those people? Is there any incentive for them to save? Is there any incentive for them to invest?

Secretary BLUMENTHAL. The proposal that we made would have reduced individual income taxes for virtually all taxpayers, and relatively substantially, up to levels of about——

Senator DANFORTH. Well, we have gone through this before, Mr. Secretary, and the fact is that when you crank in social security tax increases and the effect of inflation putting people into higher brackets, that just is not the case. Most people are going to be paying more to Uncle Sam by 1980 than they are paying today, well over half of the taxpayers. And I am saying is there anything in any of your tax proposals to encourage people to be able to save and to invest?

Secretary BLUMENTHAL. Senator, I have to underline the fact that in return for paying higher social security taxes these people are also buying higher benefits that are guaranteed in the law; and second——

Senator DANFORTH. Now, that is not so. That is only for people over $18,000 whose basis is going up.

Secretary BLUMENTHAL. That's right, and those are the people that many Members of Congress are particularly concerned about, because this is where the impact is greatest.

In addition to that, after 1980, I am sure a further tax reduction will have to be considered. We have never made tax reductions with an eye toward offsetting, for everybody, the impacts of inflation.

Senator DANFORTH. Is there anything in any administration proposal to encourage anybody to save or invest a penny?

Secretary BLUMENTHAL. Well, I think the sum total of the economic proposal of the administration to contain inflation, to assure continued growth, to provide employment and to reduce the high level of unemployment that we inherited, together with the tax program and the reduction of $20 billion will do that.

Senator DANFORTH. Well, I do not see anything that would do it, and maybe I have caught you offguard, but I would like to get some idea sometime—maybe you can think about it and let me know—if the administration has ever suggested anything that would encourage anybody to save any penny.

Secretary BLUMENTHAL. Senator, I can only reiterate what I have said. I think the sum total of these programs, by providing higher real levels of income to people, providing more job opportunities, and by reducing taxes where it is most needed will provide resources for people if they wish to save.

Senator BYRD. Mr. Secretary, just one brief comment and then one brief question.

I am rather intrigued that the Treasury and the administration opposes a reduction in the capital gains tax because it allegedly benefits relatively few individuals; but, at the same time, it advocates

and supports the investment tax credit which, insofar as corporations are concerned, reduces the revenues to the Treasury by $12 billion, 91 percent of that going to corporations of million dollars or larger, but one-third of it going to 45 corporations out of a total of 2 million corporations in our Nation.

My request is, would you submit for the record the benefits received; that is, the tax credit received, by each of those 45 corporations which account for $4 billion of revenues?

Secretary BLUMENTHAL. We will attempt to undertake that.

[The following was subsequently supplied for the record:]

We are unable to supply this information since 26 U.S.C. 6103(f)(1) prohibits disclosure of tax return information exempt upon a written request from the Chairman, Committee on Finance. Any disclosure made in public session of return information which can be associated with, or otherwise identify, directly or indirectly, a particular taxpayer is prohibited.

Senator BYRD. Thank you, Mr. Secretary. We thank you for being here.

Senator HANSEN. Mr. Chairman, may I?

Senator BYRD. Senator Hansen. Excuse me.

Senator HANSEN. Mr. Chairman, members of the panel have an opportunity to submit some questions to be answered for the record?

Senator BYRD. Yes; Mr. Secretary. The panel would like to have the opportunity to submit to you questions which could be answered for the record.

Secretary BLUMENTHAL. Certainly.

Senator BYRD. Senator Packwood?

Senator PACKWOOD. Yes; I want to insert in the record at this place two quotes. I think it is difficult for any Cabinet officer to come and attempt to justify things I think that he would not necessarily justify but for being in the Cabinet. Here are two quotes from the President when he was a candidate, first from the Baltimore Sun on March 27, 1976: "I also do not think that capital gains should be treated in a more preferable way than regular income earned from manual labor."

The second from Time Magazine, August 2 of the same year: "My inclination would be to treat capital gains the same way as income earned from labor."

When you start with a President who has those views, it is perfectly understandable why this administration is opposed to this particular capital gains measure. We are starting with a President who does not like it, who does not like capital gains, who does not like the concept, and it puts the Treasury Secretary in a very difficult position.

Senator BYRD. Thank you, Senator Packwood.

Thank you, Mr. Secretary.

Secretary BLUMENTHAL. Thank you.

[The prepared statement of Secretary Blumenthal follows:]

STATEMENT OF THE HONORABLE W. MICHAEL BLUMENTHAL

Mr. Chairman and members of this Subcommittee: I welcome the opportunity to appear before this Subcommittee to present the Administration's views on three bills before you: S. 3065, S. 2428, and S. 2608.

Each of these bills would reduce the tax on capital gains for selected groups of taxpayers. Each aims at objectives of capital formation and growth. These objectives are shared by the Administration. But each bill has fatal flaws and either

would not achieve its stated objectives at all, or would do so in an inefficient and inequitable manner. Accordingly, the Administration strongly opposes all three bills.

I will devote the bulk of my testimony to S. 3065, the "Investment Incentive Act of 1978". To say that this Bill and its House counterpart have received extensive publicity is to engage in understatement. Suddenly, like flowers that bloom in the spring, the notion of reducing capital gains taxation is appearing everywhere as an all-purpose solution to the country's economic problems. Manifold and sweeping claims are made for this idea: It is advertised as a technique of middle class tax relief, or a measure to help homeowners. It is said that reducing capital gains taxes will substantially increase stock values. It is claimed that the Treasury will gain revenues by cutting these taxes. We are told that this is the best way to accelerate capital accumulation in the United States. Some even claim that other economies outperform us because they avoid taxing of capital gains.

This Administration shares the goals espoused by the supporters of a capital gains tax reduction. We too wish to see stock prices rise. We too are concerned about Treasury revenues; and we are certainly as concerned as anyone about reducing the federal deficit. We too are vitally interested in spurring capital accumulation and investment, and believe that tax incentives are needed for this. We too are anxious to employ every reasonable device to improve our performance with respect to inflation, unemployment, and exports.

Our opposition to S. 3065, therefore, is based not on disagreement with its goals. Rather we are persuaded that this bill would not advance us toward these goals or would do so only in ways that are inefficient, inadequate and unjust.

The tax reduction legislation that the Administration has proposed this year would meet two broad objectives:

First, relief for the average taxpayers of this country who are finding their incomes increasingly pinched by rising tax liabilities.

Second, a broad and significant increase in the after-tax return on capital, which will increase business investments by making them more attractive.

Mr. Chairman, a dispassionate and objective analysis of S. 3065 shows that this bill and others like it would achieve neither of these goals while wasting Treasury revenues urgently needed to achieve these critical objectives in an efficient and equitable fashion.

THE FACTS ABOUT CAPITAL GAINS TAXATION UNDER CURRENT LAW

Under current law, the net capital gain of an individual taxpayer is taxed at a rate equal to one-half of the taxpayer's rate on ordinary forms of income, such as wages, salary, dividends, interest, and rent. Those persons in tax brackets above 50% need pay only the 25% alternative rate on the first $50,000 of their net capital gains.

For corporations, net capital gains may be taxed at an "alternative" 30 percent rate instead of the maximum 48 percent rate on other income.

In addition to these basic provisions, the Tax Reform Acts of 1969 and 1976 introduced two elaborations.

First, the 1969 Act imposed a "minimum tax" on those with very large amounts of capital gains income or other income benefitting from preferential provisions. After changes in the 1976 Act, the minimum tax for individuals is 15 percent of preference income in excess of either $10,000 or one-half of regular tax liability (whichever is greater). One-half of capital gain is considered "preference income". Therefore, if a taxpayer's only preference item is capital gain, the minimum tax applies only if total gains exceed $20,000.

Second, the 1969 Act reduced the maximum tax rate on earned income—wages and salaries—from 70 percent to 50 percent, providing massive relief to high-income individuals. For these persons, the amount of earned income eligible for this special "maximum tax" ceiling is offset by the amount of preference income, including the untaxed half of capital gains.

Now, what are the consequences of this structure of capital gains taxation? Who pays what?

In 1978, capital gains taxes will raise $10.3 billion in revenue, $7.8 billion from individuals and $2.5 billion from corporations.

Let's look at the individual side of the equation, where public attention has been concentrated.

The average effective tax rate on capital gains in 1976 was 1[illegible].[illegible] percent. (See Table 1.) For most Americans with capital gains, the effective rate is quite low: for instance, 12.7 percent for those between $20,000 and $30,000 in adjusted gross

income, 16.7 percent for those between $30,000 and $50,000. Up to $200,000 a year, the effective rate is below 25 percent. Even for those over $200,000 the average effective rate is only 27.4 percent.

Typically, therefore, the great majority of taxpayers pays taxes on capital gains at modest levels, considerably below the rate on ordinary earned or unearned income, and the progressiveness of the capital gains tax is quite moderate. The rate generally rises above 25 percent only where the taxpayer's income or gains are extraordinarily large, and even in these instances, the taxes are not at all extreme.

In the current debate, much has been made of the possibility—under the maximum and minimum tax provisions enacted in 1969 and 1976—that individuals may be paying a 50 percent tax or even more on their capital gains. The facts are much less alarming than the rhetoric. Capital gain, at all income levels, is still very much a preference item in our tax system.

More than 60 percent of all capital gains is taxed at 25 percent or less. Of all returns showing capital gains, only about 7 percent is taxed above 25 percent. Though in theory the tax rate could exceed 50 percent, this would require a very implausible composition of income, and in fact we have been unable to find even one case where this has happened. We have found fewer than 20 returns—out of 5.4 million returns with capital gains—taxed at more than 45 percent. The capital gains tax very rarely goes above 40 percent. Rates over 40 percent have appeared in less than five hundredths of one percent of returns with capital gains, involving less than four-tenths of one percent of gains.

In sum, the Tax Reform Acts of 1969 and 1976 increased capital gains taxes for very high income individuals with very large gains, but these measures did not introduce unreasonable marginal rates and they left capital gains in a clearly preferred status.

THE FACTS ABOUT S. 3065

This bill is not a general measure to reduce capital gains taxes for everyone. rather, it aims to reduce the capital gains rate for the highest income individuals with the largest amount of gains. As I have just noted, the overwhelming majority of taxpayers, realizing the great bulk of capital gains each year, pays substantially less than 25 percent on capital gains. This bill is not designed for this vast majority. Its relief is focused almost entirely on the small minority who now pays more than 25 percent.

The bill would do the following. It would remove all non-taxed capital gains income from the minimum tax, rather than exempting the first $10,000 of untaxed gain (or one-half of regular tax liability), as under present law. It would eliminate the present capital gains offset against wage and salary income eligible for the maximum tax. It would extend the 25 percent alternative tax to an unlimited amount of gain, as opposed to the $50,000 of gain eligible for this rate under present law. Finally, it would reduce the "alternative" rate on capital gains for corporations from 30 to 25 percent.

For these changes in the law, very expensive claims have been made. We have examined those claims closely. Few of them stand up against such analysis. At best, it can be said that some of the claims can be neither proven or disproven. For the most part, however, the claims run flat against the available evidence.

The proponents say that S. 3065 constitutes broad based tax reduction, in line with the so-called "middle class tax revolt". The facts are otherwise. About 20 percent of the bill's benefits would go to corporations. For individuals, the bill's benefits are skewed heavily to the highest income taxpayers. Four-fifths of the bill's benefits go the those with incomes over $100,000 a year. Mr. Chairman, this bill would provide lower taxes for less than one-half of one percent of the individual taxpayers in this country and would benefit only about 7 percent of the taxpayers that have capital gains.

This is in truth a millionaire's relief bill, and I mean *income* millionaries, whose assets are usually many times greater than that. Of those million dollar earners benefitted by S. 3065, about 3,000 of them throughout the country, each would receive on average $214,000 in tax reduction. For all million dollar earners the average relief would be $145,000. By contrast, the average relief for those in the $20,000 to 30,000 class would be one dollar. (See Table 2.)

The bill's proponents assert that it would trigger a stock market boom. The studies said to show this result simply assume the fact, or rather they assume different facts. Bear in mind that the bill would reduce taxes on corporate stock gains by only $500 million. Yet, one study assumes the bill would raise stock values by 40 percent, a rise of more than $300 billion or 600 times the size of the tax cut;

another study suggests only a 4 to 6 percent rise in stock values, which is still 60 times the size of the cut. A third study, which presumes *total* elimination of the capital gains tax, rather than the selective cuts in S. 3065, predicts a 20 percent rise in stock values. This is all the sheerest conjecture. The truth is that no one has any credible evidence or theory permitting a projection of the bill's impact on the stock market, and certainly there is no basis for the extreme assumptions dominated public discussion of the bill.

If we look at recent stock market behavior, it is difficult to avoid the conclusion that the effects of capital gains tax changes, if any, are wholly swamped by other stock market influences. The bill's proponents often suggest that the 1969 Tax Reform Act lies behind the stock market's doldrums during the 1970's. However, the stock market fell sharply in 1969, before the tax increases from the Reform Act took effect. Then the market rebounded sharply from 1970 through 1972—the same period during which the reforms, were fully phased in. Then, as inflationary momentum accelerated in 1973, there was a huge fall in stock prices, though the tax law was not changed at all. (See Chart 1.)

Analysis of stock market prices over the last ten years shows no relationship between the capital gains tax and the market's level. The record does not show that the capital gains tax changes in the Reform Acts of 1969 and 1976 depressed stock prices. The assertion that repeal of those reforms would now raise stock prices is just that, an assertion, unsupported by evidence.

Proponents of S. 3065 have noted that it would provide relief for homeowners forced to pay capital gains taxes upon sale of their residences, in those instances where the gain cannot be rolled over into purchase of a new residence. This aspect of the measure, we wholeheartedly support. The President's tax package provides nearly identical relief for homeowners.

A further claim of the proponents is that this bill would greatly spur capital formation. Accelerating the rate of capital formation—particularly industrial and technological investment—is a priority objective of this Administration, but S. 3065 is not the way to go about it.

Why is this so? The test of a tax cut for investment is how generally and directly it reduces the tax burden on income from productive capital. In applying this test, it is important to keep in mind two facts. First, productive capital is taxed in many ways—by the corporate income tax, the individual income tax, the capital gains tax, etc. We don't have a single, unique tax on capital income; rather we have many taxes which together place a burden on capital. Capital gains tax is *not* the major tax on capital income. It accounts for only about 10 percent of the federal tax burden on capital. (See Table 3.)

Second, the kind of capital we particularly need to accumulate is industrial and technological capital. Many types of assets—for instance jewelry, antiques, speculative real estate, and the like—are of much less importance to our economy's ability to adapt, grow, and compete in international markets. The President's tax proposal takes these two important facts into account. Through broad based reductions in corporate and individual income tax rates, and through a liberalization of the investment tax credit, the President's package would reduce the major taxes burdening capital income by about $7 billion and would directly increase the profitability and cash flow of all productive enterprises. It is a package ideally suited to increasing the rate of formation of productive capital.

By contrast, S. 3065 is very poorly suited to this job. As I've noted, capital gains taxes constitute only about 10 percent of the federal tax burden on capital income. Reducing the capital gains tax would therefore deal with only a very small corner of the problem. Furthermore, it is in many respects the wrong corner. Only about one-quarter of realized capital gains come from corporate stock. The rest are scattered over a range of assets having little or no role to play in the kind of investment boom this country needs. For instance, another quarter of the realization is on real estate sales, 3.4 percent on livestock, 2.5 percent on commodities, 9.7 percent on installment sales, etc. (See Table 4.) This bill would create windfalls on assets all over the landscape, but it would largely detour around the central objective, which is to reduce significantly and broadly the tax burden on income from productive investment. This bill takes a very inefficient approach to capital formation.

This inefficiency is a fatal flaw for the simple reason that we do not have unlimited revenues available to stimulate capital formation. To keep the budget deficit in bounds, the Administration believes next year's total tax reduction should not exceed $20 billion. The bill before you would take up over $2 billion of that amount. This would have to come at the expense of wage and salary

earners, which would be clearly inequitable, or at the expense of the corporate income tax reductions, which would render the bill a much less effective vehicle for capital formation. The only other choice is to increase the budget deficit, which would be an inflationary and irresponsible course.

The proponents of S. 3065 try to avoid this dilemma by asserting that their bill, unlike the myriad other tax cuts promoted in the Congress, would in fact increase Treasury revenues.

The reasoning behind this assertion has never been made clear. As is often the case with this subject, we are dealing here with conjecture, not facts.

It is important, in assessing the revenue claims, to distinguish between three different time horizons: the very short term, the medium term, and the long term.

In the short term, the revenue impact of S. 3065 would turn on the so-called "unlocking" effect. With a cut in maximum capital gains rates, it is possible, at least in theory, that some taxpayers would sell assets that they had held for a very long time. Whether and how much this would occur, no one knows. If it did happen, two results would follow. First, the wave of selling might well depress asset prices, on the stock market and elsewhere. This would tend to reduce capital gains tax revenues. Second, the wave of selling would itself generate tax revenues. The net effect on revenues of these conflicting forces, no one can predict. But one thing is clear: It would be a temporary, one-shot effect. The wave of selling would not repeat itself year after year.

In the medium term, *any* tax reduction will stimulate aggregate demand—investment and consumption—and therefore tend to increase GNP toward its potential level, creating a "feedback" of tax revenues to the Treasury. There is absolutely no reason to think that S. 3065 would create larger feedback effects than any other cut in capital income taxes. Indeed, such feedback effects are much less certain with capital gain taxes that with the corporate income tax cuts proposed by the President. Cutting corporate rates and liberalizing the investment tax credit would directly increase enterprise profits and cash flow, and thus real investment and tax revenues. The advocates of S. 3065 hold out the hope—no more—that a capital gains tax cut would substantially boost stock values and that this in turn would trigger a large amount of new investment, with a consequent rise in tax revenues. But, as I have indicated, there is no perceptible relationship between capital gains taxes and the level of the stock market, and a capital gains tax cut of this size is most unlikely to affect the stock market substantially. Unfortunately, it is equally difficult to trace a casual relationship between the level of the stock market and the rate of increase of investment or GNP. Both points in the argument are thus very shaky. For the medium term, the revenue feedback effect of a capital gains tax reduction is anyone's guess.

In the long term—the most important perspective—tax revenues depend on the sustainable growth rate of the economy. In other words, the revenue feedback will be greater the more efficiently the tax cut boosts the long term trend of investment in productive assets and enterprises. It is precisely here that S. 3065 is most seriously defective. It scatters its benefits over a wide array of assets, many of little productivity, and it misses entirely 90 percent of the tax burden on capital income. It is a very poor tool for increasing the economy's long term rate of real growth, and its long term revenue feedback effects would be commensurately modest.

Finally, I wish to say a word about the very loose international comparisons that have been made in the debate on this measure. Some proponents of S. 3065 have suggested that our economic performance—in areas of inflation, unemployment, and growth—has fallen short of that of Germany and Japan because we tax capital gains while they, assertedly, do not. This line of argument ignores certain important facts. First, the United States has over the past few years outperformed most other industrialized countries, including Germany and Japan, in terms of real growth and increases in employment. Our inflation record is less satisfactory, but is nonetheless superior to several countries (e.g. Italy) having no capital gains tax. Second, Japan does in fact tax capital gains. As for Germany, it instead uses an even more comprehensive tax on annual increases in wealth, whether or not realized; I doubt that the proponents of S. 3065 would prefer the German system to ours. What all this shows is that making simplistic international comparisons on a tax-by-tax basis is a very treacherous business.

In sum, Mr. Chairman, the claims made for S. 3066 do not stand up to scrutiny:

The bill would not provide general or middle income tax relief but would instead narrowly focus its benefits on the highest income classes and would provide an unprecedented boon to millionaires.

The bill has no realistic potential for creating a substantial rise in stock prices.

The bill would not efficiently meet our urgent needs for more investment in productive enterprises.

The bill would not gain us revenue but would instead use up revenue needed for far more efficient and equitable incentives for capital formation.

There are of course many variations of S. 3065 under discussion in the other Chamber. I will not deal with them in detail. Some of the proposals escape certain problems I have noted here. However, those involving an effective repeal of the minimum tax so far as capital gains are concerned have the same defects as S. 3065: they are very expensive, and they focus their benefits on a narrow class of extremely high income individuals, with the result that many of those persons would pay very little tax. As the President has indicated, this is an unfair and ineffective response to the need of American workers and businesses for genuine tax reduction.

COMMENTS ON S. 2428

I turn now to S. 2428, the "Small Business and Farms Capital Preservation Act of 1978." This bill would extend to certain small businesses a tax-free rollover privilege similar to that available on the sale of a principal residence.

We believe such a rollover provision would be inequitable. Owners of businesses already enjoy enormous tax benefits. As a business grows and prospers, and its market value increases, the owners do not have to pay current tax on this appreciated value. A person receiving income in the form of wages, interest on a savings account, or stock dividends must first pay taxes before setting aside funds for future use. The business owner increases his wealth with before-tax dollars, while the wage earner increases his wealth with after-tax dollars. In addition, the owner of a business, when he sells, has the advantage of preferred capital gains rates. Further, any bunching of income resulting from the tax deferral can be alleviated by income averaging, made available for capital gains by the Tax Reform Act of 1969, and by the use of installment sales.

S. 2428 would provide yet another valuable tax break to those who already benefit from a number of preferential provisions. This raises serious questions of fairness.

Apart from considerations of equity, this proposal would raise considerable problems of compliance and administration. Some problems occur now with the tax-free rollover privilege afforded taxpayers on their personal residences. Individuals are asked for more information and computations than are generally required, and such data must be retained for very long periods of time. The complexity would be aggravated substantially by the rollover contained in S. 2428. Recordkeeping and computation burdens could be monumental where a taxpayer has several qualifying asset sales and purchases with overlapping one-year reinvestment periods.

The Congress has allowed the extraordinary rollover privilege for principal residences because of the peculiar social value of home ownership. We think it would be a major error in tax policy to begin extending this privilege, piece by piece. Very soon, other types and classes of taxpayers would be demanding this preference, and a wholesale erosion of the tax base would result.

COMMENTS ON S. 2608

This bill seeks correction for the appreciation of nominal asset values caused by inflation. It attempts this by excluding from taxable income a percentage of realized capital gains—a percentage that would increase with the length of time the asset had been held. The rationale is simple and understandable. It seems unfair to many that taxes should be paid on gains that are "paper gains" only, the product of inflation.

Unfortunately, there is no easy way to solve this problem. While S. 2608 is concerned with "illusory income" in the case of capital gains, the same issue arises with all types of income from capital and with debt. A balanced program of indexing income for inflation would require at least four adjustments.

Taxpayers would increase the basis of capital assets by the rate of inflation.

Owners of savings accounts and other interest-bearing obligations would deduct the loss resulting from the inflation-induced decline in their assets' real value.

Businesses would be allowed to increase their basis in computing depreciation deductions and inventory profits.

Debtors would report income whenever inflation reduced the real value of their indebtedness.

Obviously, an indexation system that included these four elements would be extremely complicated; but going only part way would create new inequities among taxpayers. For example, it is difficult to justify an inflation adjustment for owners of stock and real estate while ignoring the effect of inflation on the savings account depositor. Nor would a system be just that allowed the holder of debt-financed property to adjust the asset's basis for inflation while making no allowance for the fact that the debt was being repaid with cheaper dollars.

There is, however, a more fundamental problem with the notion of indexation. It deals with the symptoms and not the disease, itself. Indexation is a response to high inflation rates, but the proliferation indexation schemes tends to make those rates an accepted fact of economic life. These schemes tend to institutionalize the defect. Rather than accommodating to inflation, we should, in my judgment, bend all efforts to eliminate it.

Even if capital gains indexing were desirable, S. 2608 would not provide the proper means of implementing such a system. The most appropriate inflation adjustment would be to increase the basis of capital assets by the rate of inflation rather than to exclude a fraction of the gain from income during a period of inflation. This bill instead excludes from tax a larger proportion of gain the longer the asset has been held. The mechanism should work in the opposite way. The absolute amount of the illusory gain does rise as the holding period lengthens; however, the absolute size of their real gain also rises. As a matter of fact it can be shown mathematically that the ratio of real to total gain on an asset will increase the longer an asset is held. Thus, the bill's system of graduation would be perverse.

CONCLUSION

We strongly oppose these three bills on the merits, as I have explained at length. But we also object to them for a broader reason These bills approach the problem of capital income taxation in a partial and ad hoc manner. The various federal taxes on capital income—the capital gains provisions, the corporate income tax, and the personal income tax on property income—make up an interrelated and complicated structure. The Treasury is now engaged in a far-reaching study of that structure, seeking to determine how it might best be rationalized in light of capital formation problems our economy faces, and will continue to face, over the coming years. I am giving this study my closest personal attention. None of us is bringing rigid views on the taxation of capital gains into this exercise. But tinkering with bits and pieces of this structure of capital income taxation—as the bills before you do—will get us nowhere. The whole structure will become that much more complex, inequitable, inefficient, and incoherent. In the process, we will lose revenues critically needed for more efficient investment incentives. To deal properly with the capital gains tax, what is required is a thoughtful and comprehensive approach to capital income taxation generally.

For that task, the Congress needs more than the few months remaining in this very busy legislative session. The proper agenda for this year is to take relatively simple and efficient steps to cut capital income taxes across the board, as the President has proposed. There is no question that this would best serve the needs of the economy and the long term interests of the American people.

Thank you for this opportunity to present the Administration's views.

TABLE 1.—INCOME TAX ON CAPITAL GAINS—1976 LEVELS

Adjusted gross income class (thousands)	Total capital gains (millions)	Tax liability (millions)	Effective tax rate on capital gains (percent)
Less than $5	$2,697	$34	1.3
$5 to $10	2,872	110	3.8
$10 to $15	3,571	269	7.5
$15 to $20	3,418	326	9.5
$20 to $30	5,281	672	12.7
$30 to $50	6,105	1,019	16.7
$50 to $100	5,537	1,234	22.3
$100 to $200	3,613	898	24.9
$200 and over	5,939	1,625	27.4
Total	39,034	6,187	15.9

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, June 27, 1978.

TABLE 2.—DISTRIBUTION OF INDIVIDUAL TAX REDUCTIONS UNDER S. 3065

[1978 income levels]

Expanded income class	Average tax benefit	Percentage distribution of tax benefit
Less than $15,000	$0.12	0.4
$15,000 to $20,000	.25	.2
$20,000 to $30,000	1.00	.8
$30,000 to $50,000	11.00	4.0
$50,000 to $100,000	158.00	13.7
$100,000 to $200,000	783.00	14.2
$200,000 to $500,000	4,000.00	15.7
$500,000 to $1,000,000	21,540.00	11.3
$1,000,000 and over	145,302.00	39.7
Total	19.00	100.0

TABLE 3

Tax liability on capital gain income compared to tax liability on all capital income (1978 levels)

	Billions
Tax liability on all capital income:	
Corporate tax liability	$63.8
Individual tax liability	36.8
Total	100.6
Tax liability on capital gain income:	
Corporate	2.5
Individual	7.8
Total	10.3
Capital gain tax as a percent of total taxes on capital income	10.2

(Office of the Secretary of the Treasury, Office of Tax Analysis, June 20, 1978).

NOTE.—Total capital income consists of corporate profits, dividends, interest, rents, royalties, the portion of partnership and sole proprietorship income attributable to capital, and capital gains.

SHARES OF CAPITAL GAINS AND LOSSES BY ASSET TYPE—1973

[In percent]

Asset type	Gains only	losses only	Gains and losses combined
Financial assets (stocks and bonds)	28.8	55.5	17.1
Partnership, fiduciaries, and small business corporations	8.5	7.2	9.0
Prior year installment sales	9.7	(1)	14.0
Liquidation distributions	2.6	.4	3.6
Residences	10.8	0	15.5
Nonbusiness real estate	8.1	1.3	11.1
Timber	.5	(1)	.7
Retirement plan distribution	1.8	(1)	2.6
Commodities, including future	2.5	8.2	(1)
Involuntary conversions	1.1	.5	1.4
Trade or business assets	3.7	1.1	4.9
Business and rental building	3.8	0	5.5
Livestock	3.4	.2	4.8
Farm land and property	.7	.3	.8
Other assets	14.0	25.1	9.1
Total	100.0	100.0	100.0
Memorandum corporate stock only	26.1	51.0	14.8

[1] Less than 0.05 percent.

Note: Details may not add to total due to rounding.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, June 15, 1978.

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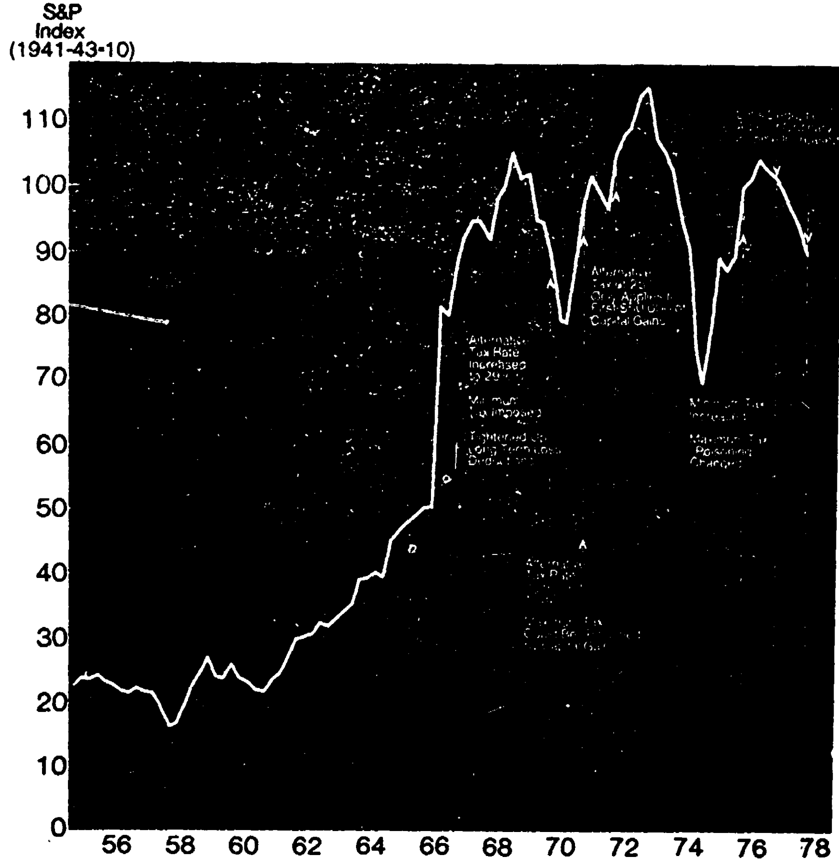
Standard & Poor's 500 Stock Index and Capital Gains Tax Changes 1955-1978



Senator BYRD. The next witness will be the Honorable Harold M. Williams, Chairman, Securities and Exchange Commission.

Mr. Williams, the committee is very pleased to have you today. If I recall correctly, this is your first appearance before this committee.

Mr. WILLIAMS. That is right, sir.

Senator BYRD. And we are delighted to have you.

I might say that since your relatively brief service as Chairman of the Securities and Exchange Commission, I have heard very fine comments about you from many mutual friends and I look forward to having the opportunity to know you as the months go by.

Welcome, and you may proceed as you wish.

Mr. WILLIAMS. Thank you, Mr. Chairman, and I also look forward to that opportunity and for, hopefully, a continued favorable reaction.

STATEMENT OF HON. HAROLD WILLIAMS, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. WILLIAMS. I would like to thank the Chairman and the members of this committee for providing me the opportunity to testify in support of S. 3065, legislation which would restore capital gains taxation to the rates which prevailed prior to 1970. I should make it clear at the outset that I am testifying as an individual rather than on behalf of the SEC. The Securities and Exchange Commission has no formal role in tax policy, although it does have an obvious interest in the capital formation process—or, more precisely, the investment process by which capital is allocated. Based in part on Commission experience, and in part on my own variety of experiences prior to coming to the Commission, I believe that legislation such as S. 3065 would contribute importantly to meeting our growing capital needs, to added confidence in the continued growth of our Nation's economy, and to the necessary revitalization of our securities markets.

It would, of course, be unrealistic to argue that adjustment in capital gains taxation, or indeed any alterations in the tax code, can fully achieve these goals—but it can make a difference. A reduction in capital gains taxation of the type presently before this committee would accomplish two things. First and foremost, it would provide increased incentive for securities investment and risk taking.

Second, to the extent that what is characterized as gain reflects the impact of inflation rather than real gain, it would reduce the confiscatory aspect of what is in part a tax on principal rather than appreciation. In my view, these would be important steps toward drawing forth additional necessary investment capital.

OUR CAPITAL NEEDS

With this perspective in mind, I want first to examine briefly some of the data assessing our capital needs. In 1975, the Department of Commerce prepared one of the most detailed and comprehensive discussions of investment requirements. In its "Study of Fixed Capital Requirements of the U.S. Business Economy, 1971 to 1980," the Department's Bureau of Economic Analysis looked at capital needs on an industry-by-industry basis. The purpose of this study was to estimate the amount of investment necessary, through 1980, in order to have an economy capable of meeting three objectives—reasonably full employment; a national program of environmental protection;

and decreased dependence on potentially unstable foreign energy sources. The Bureau found that capital investment—that is, nonresidential fixed investment—must average about 11.4 percent of gross national product.[1] Capital spending has, however, not led the economic recovery, averaging less than 10 percent for the recovery period.[2]

The Department's 1975 study also contains interesting findings with respect to the uses to which new investment would be put. The study found that the majority, about 52 percent, of capital requirements are necessary for the replacement of aged, obsolescent, and inefficient productive capacity.[1] In other words, the majority of the Department's projected national investment needs during the coming years would be employed simply to keep us from slipping below present levels. Thus, to the extent that investment is insufficient, society will pay the price in terms of fewer jobs, less productivity, a generally lower standard of living, and—perhaps most importantly—a perception that our economic system is not capable of satisfying our needs.

In evaluating the Department's study, it is important to bear in mind that, of the world's leading industrialized nations, the United States today has among the lowest rates of capital investment relative to gross national product, among the lowest rates of productivity increase, the lowest savings rate in relation to disposable income, and a rapidly declining rate of investment in research and development.[2] And, these conditions exist in the country which, perhaps better than any other, understands the role that innovation plays in producing growth and the fact that an economy that stops innovating—regardless of how efficiently it exploits existing technology—will stop growing.

Significantly, we no longer have a large untapped pool of qualified labor and cheap natural resources and energy to draw upon as a source of economic strength. We have become a capital-limited Nation in many senses of the word "capital"—natural resources, technology, labor force, stable dollar, etc.

The Commerce Department's study is consistent with other studies. In 1977, the Council of Economic Advisers estimated that business fixed investment would need to account for 12 percent of forecast GNP during the last half of the decade to achieve full employment, reasonable growth in productivity, certain environmental objectives, and greater energy independence.[1] In 1976, however, the actual rate of fixed business investment hit a 13-year low of 9.1 percent, and in 1977 it was 9.5 percent.[2]

I do not think it is necessary to elaborate on the economic and social price which we pay for this slowed rate of capital investment. New investment is essential for economic development. And the ability of U.S. products to compete in world markets depends on our ability to develop new technology—and to minimize the growth in unit labor costs—all of which depend on capital investment. We are losing our competitive position at the same time that our research and

[1] U.S. Department of Commerce, Bureau of Economic Analysis, "A Study of Fixed Capital Requirements of the U.S. Business Economy, 1971–80," p. 7 (1975).
[2] U.S. Department of Commerce, "National Income and Product Accounts, Survey of Current Business," p. S–1 (April 1978).
[1] U.S. Department of Commerce, supra note 1, at p. 5.
[2] See W. M. Blumenthal, "Address Before the Annual Conference of the Financial Analysts Federation" (Bal Harbour, Fla., May 8, 1978).
[1] Council of Economic Advisers, "Annual Report" in the Economic Report of the President, p. 23 (1977).
[2] U.S. Department of Commerce, supra, note 2.

development spending, in real terms, as a percentage of GNP has declined.[3]

Another major issue which these trends raise is whether the U.S. economy will grow in the coming decade at a rate sufficient to absorb new entrants into the labor force. Unemployment and underemployment are directly related to capital investment. Similarly, an important reason for the recent slowdown in the productivity of U.S. industry is the declining growth of capital per worker. According to the Council of Economic Advisers, the average annual growth rate for capital per worker in the private economy—after adjustment for cyclical factors—shows the following downward trend: 1948–66, 3.1 percent; 1966–73, 2.8 percent; and 1973–76, 1.7 percent.[1] The Council estimated that about one-third of the productivity slowdown in the last decade resulted from the slower growth in capital per labor hour.[2]

Moreover, slow rates of growth in productivity of capital per worker impact directly on what most people in and out of government regard as our number one economic problem—inflation. Increases in employee compensation—whether in wages or benefits—are inflationary if unmatched by increased productivity—squeezing profits and increasing the pressure for higher prices. And lagging investment in plant and equipment fan those components of inflation which are created by capacity bottlenecks in capital intensive basic materials industries. We experienced such an effect in 1973 and 1974, and some believe we are dangerously close to repeating it.

Finally, it bears emphasis that the capital shortage problem is particularly serious for growth companies. The strength and vitality of growing companies—large and small—are key to the future of our country; they are the source of much of our technological innovation the nucleus of new industries, and the major creator of new jobs on which both our economic and social future depend. If these crucial components of our economy are to meet this challenge, they cannot depend solely on internally generated capital—retained earnings—as the source of financing. For these firms, the shortage of equity capital is a matter of life and death.

We are, for example, experiencing a dearth of small company financing. In the early 1970's, these issues represented about 20 percent of the dollar value of all new issues of securities. In 1977, however, the latest year for which we have figures, now offerings by unseasoned companies accounted for only 3 percent.[1] Similarly, in the early 1970's, over half of all filings with the SEC represented offerings by unseasoned companies, while in 1977, such filings constituted only 24 percent of the total.

Other statistics further demonstrate the plight of small companies. In 1969 alone, there were 698 underwritings for companies with a net worth of $5 million or less. In the 4 years, 1974 through 1977, however, a total of less than 75 companies of that size had underwritten offerings. The offerings in 1969 raised over $1.3 billion, whereas

[3] See W. M. Blumenthal, supra, note 4.
[1] Council of Economic Advisers, supra, note 5, at p. 45.
[2] Id. at pp. 45–46.
[1] The staff of the Commission's Directorate of Economic and Policy Research has compiled the figures set forth in this paragraph based on a review of "Series M–180, Securities Registrations for Cash Sale" which appears in the Commission's monthly Statistical Bulletin.

the offerings for the 6-year period combined to produce less than $300 million.

THE INCENTIVE TO INVEST

If this picture of the undesirably low rate of capital investment in our society is accepted—and few, I think, dispute it, in principle—the problem which logically follows is to isolate the causes. The process of investing involves, for society, the sacrificing of current consumption in order to enhance future production and consumption opportunities. Just as the prudent farmer sets aside a portion of his crop for seed, society needs to put aside enough of today's income to assure tomorrow's growth. Conversely, by not providing sufficient capital for investment, we are in essence eating our seed corn.

Investors make investment decisions on the basis of the anticipated future after-tax return, considering the risk, the rate of inflation, and the return offered by alternative investment opportunities. Return can take the form of income—that is, dividends or interest, or appreciation—that is, capital gains, or a mix of the two.

Increasingly, the capital which investors make available is in the form of loans, whereas what is needed is equity financing. In my judgment, our tax policies do not encourage investors to seek out investment opportunities involving risk, but rather relatively stable, low-risk income streams with but relatively little probability of capital appreciation. And that, in turn, discourages investment in equities and particularly in the kinds of growth industries on which the future health of both our economy and economic system depend. Such low-risk investing hits hardest at growing and dynamic companies where the need for equity capital is the greatest.

Let me restate the problem this way: Firms which must raise capital from the public to grow must be able to convince investors to put their funds at risk—not on the basis of the certainty of a periodic dividend payment—but on the assumption that, over time, the investor's opportunity for after-tax appreciation in the marketplace, typically from the sale of his investment, will compensate for the risk taken. If you view the marketplace today in terms of the interest rate on instruments like bonds which guarantee a fixed annual return—the level of yield available on a no-risk or very little risk basis—and if you contrast that yield to the return for risk-taking, after the impact of capital gains taxes and inflation, the unmistakable conclusion is that the incentive for risk-taking is inadequate to encourage individual investors to make the equity investments in growth companies that we must encourage.

There are, of course, many other important factors which impact on investor attitudes and thus on the rate of capital investment. Among these factors are: the recent discouraging record of business profitability, particularly profitability measured after taxes and net of inflation; the perceived cost of complying with Federal regulations, such as those directed to protecting our environment, health, and safety, which drive up the cost of capital improvements, without directly enhancing productivity; high interest rates; fear of price controls or other direct Government intrusions in the markeplace; and the uncertainties inherent in an economy characterized by high inflation. Each of these factors—and many others could be added—

increases the volatility of expected returns on investment; that is, each increases risk. Coupled with the current rates of taxation on capital gains, minimum and maximum tax provisions, and the fact that, for example, municipal debt offerings afford opportunities for low-risk yield of 6 to 7 percent tax exempt, it is hardly surprising that investors are less than enthusiastic about committing funds to capital investment.

LEGISLATION TO MITIGATE THE IMPACT OF CAPITAL GAINS TAXATION

In my judgment, legislation which lowers the tax rate on capital gains would be an important step toward readjusting the risk/return ratio in a manner which would significantly stimulate investment. Any step which increases the potential aftertax return on investment will encourage risktaking. Similarly, a reduction in the rate at which capital gains are taxed would increase the attractivenses of capital investment as an alternative to consumption.

Further, a restriking of the balance between taxation of capital and ordinary income would indirectly aid corporations in utilizing internally generated funds for investment. It would reduce pressure for dividends by offering the stockholder greater opportunity for returns in the form of equity appreciation. Similarly, this would encourage investment in high growth companies which need to reinvest their capital and must look to a securities marketplace which reflects its confidence in investments through an enhanced price-earnings ratio.

May I continue for a couple of minutes?

Senator BYRD. Yes.

Mr. WILLIAMS. Adjustment in capital gains taxation of the type proposed in S. 3065 would also be a step toward equalizing the opportunity for individuals to invest in equities by reducing transaction costs—that is, costs incident to disposing of one capital asset and acquiring another.

The present tax structure discriminates against the individual and in favor of other major investors such as pension funds, insurance companies, and foreign investors who pay a lower tax on their capital gains, or none at all.

Moreover, any amelioration in the capital gains rate would reduce the extent to which investors are taxed on inflationary, rather than real, appreciation. At present, an investor who has held securities for a significant period of years may well find that upon sale he is subject to a substantial capital gains tax despite the fact that his so-called gain may actually represent an erosion in capital measured in constant dollars. Realistically, capital gains taxes on nominal gains during a period of inflation are a confiscatory tax on capital, not a tax on profit.

Additionally, making equity investment more attractive should stimulate securities markets and attract more money to those markets. The resulting strengthening of market depth and liquidity and stimulation to the securities industry would be valuable in themselves.

Finally, a clear governmental articulation of an appreciation for the importance of encouraging investment and rewarding risktaking could go far to improve the psychological attitude and confidence of

the marketplace and of potential investors, many of whom have been on the sidelines for years.

REDUCING THE CORPORATE TAX RATE

In emphasizing the importance of a reduction in the tax burden on capital gains, I do not want to leave the impression that I oppose other tax related steps which have been suggested as measures to stimulate captial investment. In particular, I think that a reduction in the corporate tax rate is also important to the capital problems I have described. It must, however, be recognized that corporate tax relief would serve purposes distinct from those which capital gains relief would accomplish. Reducing the corporate tax rate will directly increase aftertax profits and therefore should increase the capital available for investment and the aftertax return estimates on those investment. It may increase the market value of equities but probably not the capitalization of earnings in the market as reflected in the price-earnings ratio. Tax rate relief would not significantly benefit growth companies in need of capital infusions disproportionate to what the tax relief would provide.

With regard to a reduction in the corporate tax rate, there is another point which I have emphasized in a series of talks over the last year and which I would urge this committee to consider: In my view, the impact of inflation on the level, in real terms, of corporate profits is startling and itself a severe threat to the ability of many companies to generate and retain adequate capital internally.

Inflation distorts reported corporate earnings upward in several ways. One striking element is the consistent, substantial understatement of depreciation in an inflationary environment. Similarly, inflation-generated inventory profits also overstate income. Both of these conditions erode the value of reported earnings while adding to taxable income and thus generating tax liabilities which may, in fact, have to be paid partly out of capital.

Let me illustrate briefly. If depreciation were recomputed based on the current-cost, double-declining balance method, in order to charge against revenues a sum which more accurately reflected both the manner in which capital equipment was consumed and the cost, in inflated, current dollars of replacing it, and if inventory consumption charges, as reflected in the cost of goods sold were converted from historical to current costs, 1977 aftertax profits of nonfinancial corporations would shrink to some $50 billion—from the $85 billion figure reported.[1] In effect, corporations reported as profit on the order of $35 billion required to offset or restore capital consumption.

The results of adjusting corporate earnings for inflation also have implications from the perspective of Federal tax policy. Not only is business reporting the consumption of capital as income, but it is paying taxes on it. Inflation has increased the real rate of corporate taxation substantially because our tax system does not fully recognize the impact of inflation on reported earnings. It would, therefore, in

[1] G. Terborgh, "Inflation and Profits," p. 4, table 3 (6th republication, 1978). Mr. Terborgh's study is distributed by the Machinery and Allied Products Institute. The Federal Reserve Board has apparently compiled similar data. See A. Burns, "The Need for Better Profits," an address delivered at Gonzaga University, Spokane, Wash., Oct. 26, 1977.

my view, be appropriate for Congress to consider ameliorating this de facto tax increase by lowering the corporate tax rate.

CONCLUSION

In the 1960's, we convinced ourselves that we knew how to control the economy and economic cycles. I believe the 1970's have corrected that illusion. There is much we do not know and much we cannot prove, but we must do those things which are fundamentally logical to support and encourage investment, capital formation and the health of the private economy. In my judgment, a reduction in the burden of capital gains taxation of the type presently before this committee is one such positive and logical step.

I appreciate this opportunity to present my views to this committee and, of course, I would be happy to respond to any questions you may have.

Senator BYRD. Thank you, Chairman Williams.

May I say that I find your entire statement very interesting and provocative one. I concur with most, if not all, of the comments you have made.

I am most intrigued, however, by the latter part of your statement, which I will quote: "In the 1960's, we convinced ourselves that we knew how to control the economy in economic cycles. I believe the 1970's have corrected that illusion."

I think so, too.

Then you go on to say, "There is much we do not know and much we cannot prove, but we must do those things which are fundamentally logical to support and encourage investment capital."

Well, I concur in it. I think you are being overly optimistic if you think Washington, D.C. is going to do something which is fundamentally logical any large percentage of the time. It will do it every once in awhile, but I am not sure it will do it over any large percentage of the cases.

Mr. Williams, you have been quoted as saying, "As each dollar of corporate income becomes less potent in terms of real purchasing power, business profits dwindle in their ability to meet capital requirements."

Do you feel that inflation profits somehow should be disclosed to investors, and how could this be accomplished?

Mr. WILLIAMS. Well, sir, I believe that the impact of inflation on corporate earnings is a matter that should be disclosed. The Commission has in place now an accounting rule which does require that corporations, as supplemental information, indicate what the impact would have been if the assets of the corporation were restated on a present cost basis, which would take into account the replacement cost of a fixed asset and the impact of inflation on the value of inventory. We require this only as supplementary disclosure because the techniques and methodology are still being explored, and to require that it be actually included in financial statements might imply that the state of the art today is more sophisticated than it is in fact.

Senator BYRD. Would a reduction in capital gains rates help correct the inflationary situation?

Mr. WILLIAMS. A reduction in the capital gains rate would, in my judgment, have a very real impact in terms of not taxing what is not, in fact, a real gain. I think that one of the factors discouraging the holding of capital assets is that appreciation which may only partially compensate investors for inflation is subject to a capital gains tax.

One example is that $100 invested in 1969 in securities, in order to be at a break even point in terms of inflation, ought to be worth $163 today. Unfortunately, that $100 is not worth the $163 today. But if it were, and if the taxpayer were to sell that $163, he would pay a capital gains tax on it, when in reality, in relation to inflation, there is no real gain.

Senator BYRD. So the Government, under the present system, not only the capital gains tax but with income taxes, actually gains from inflation. If I remember the figure accurately, for every 1 percentage point that inflation increases, the Government's revenue gains 1.6.

Mr. WILLIAMS. I had not seen that.

Senator BYRD. Maybe that is one reason that there is not such a great effort to reduce inflation. I do not know.

Let me ask you another question. What is the effect of the capital gains tax upon lioked-in equity capital?

Mr. WILLIAMS. I have to give you a qualitative answer on this, Mr. Chairman. I expect that it is enormous.

Senator BYRD. You expect it is enormous?

Mr. WILLIAMS. Enormous.

Where you have large, locked-in profits, the tax burden, with State taxes, might well amount easily to a 50-percent tax rate. I cannot conceive of individuals, or investment advisers, for that matter, taking what is left after that tax payment and having any sense of confidence that they could invest in the market and do proportionately better to the point where they make up for the tax payment. Thus, I have no doubt at all that the rate of capital gains taxation at this point in time discourages the taking of gain.

Now, the only data that I can give you that has provided me any insight into this are two schedules that were produced by the Bureau of National Affairs last week. One schedule talks about returns with adjusted gross incomes of less than $50,000 as a percentage of total net gains, and the other shows adjusted gross incomes over $50,000. According to the just schedule, in 1969, 52.6 percent of the total net gains were by taxpayers with adjusted gross incomes of less than $50,000. In 1976, that percentage had grown to 62 percent. Now, that is a rather significant increase, particularly when one must assume that, with inflation at least, there are more people with adujsted gross incomes of over $50,000 in 1976 than there were in 1969.

The total gains represented in these schedules grew from $31.4 billion in 1969 to $39 billion in 1976—that is unadjusted for inflation. The taxpayers who earned over $50,000 adjusted gross income in 1969 had $14.8 billion of capital gains. The taxpayers in 1976 who earned $50,000 or more adjusted gross income had, identically, $14.8 billion in capital gains. The taxpayers under $50,000 went from $16.6 billion in gains to $24.2 billion, a 45 percent increase.

Now, that is telling us something. There have got to be a greater percentage of taxpayers at the $50,000 and over level in 1976 as compared with 1969. And we know that total gains increased in that

period. Yet the gains attributable to taxpayers at the $50,000 and over gross income category did not increase. These higher income taxpayers are either not taking gains that they are able to take or they are not going for gain. They are deploying their investment dollars differently.

The lower-income people who do benefit from a continuation of the old 25-percent rate are showing a significant increase in gains. Now, I do not have any underlying data that would help us understand more about this behavior—what the people under $50,000 are putting their money in; what the alternative places in which those over $50,000 are deploying their assets or how they are being deployed. But, at least, on the level of the data I have available to me, it suggests that something very significant is occurring.

Senator BYRD. Thank you, sir.

Senator Packwood?

Senator PACKWOOD. Mr. Chairman, it is the first time I have heard you testify and the first time I felt sorry that I left the Banking Committee where I heard you testify more often—the only thing that has made me feel sorry that I left the Banking Committee.

There is a gem on every page. It is marvelous testimony.

Let me take something you said, together with something Bill Steiger said. On page 8 of his testimony he is talking about new, high-growth companies and says:

> We should bear in mind that the growth companies, the ones that provide new jobs, provide almost no dividends. The average is 1 percent. An American Electronics Association survey shows that new companies paid only .1 of 1 percent dividends.

On page 9 of your testimony, you do not use those figures, but you say almost the same thing. "As a rule of thumb, therefore"—is this what you are saying? The closer the capital gain gets to being taxed as rate of income, the less and less that anybody is going to invest in these companies that have no dividends, or pay almost no dividends, if they are going to have to wait years and years for appreciation and then have it taxed as regular income?

Mr. WILLIAMS. At bottom, that is very close. I would qualify it only one way. It is true that, the closer the capital gains tax rate gets to the regular rate, ths less likely people are to invest. But if we go back to Secretary Blumenthal's testimony and go back to his schedule, it is interesting to me that, in table 4, half of the losses were from financial assets, but only 29 percent of the gains. There is a risk involved here—a substantial risk. And in the smaller, less-seasoned companies, the risk is greater. And when the alternative is 7 percent tax-exempt municipal bonds, the incentive has to be there. The capital gains structure as it now stands does not provide such an incentive.

Senator PACKWOOD. Give me that figure again? I did not pick it up during the Secretary's testimony.

Mr. WILLIAMS. It is on table 4.

Senator PACKWOOD. I know, and it just slipped by me. Interesting; 51.9 percent of the losses are from corporate stock?

Mr. WILLIAMS. Corporate stock.

Senator PACKWOOD. The top line of the schedule is financial assets——

Mr. WILLIAMS. Yes.

Senator PACKWOOD. That is very interesting. Thank you very much. That is most revealing.

I have no other questions.

Senator BYRD. Senator Hansen?

Senator HANSEN. Mr. Chairman, thank you very much for your appearance here.

One related problem to the decline of new issues is the acquisition of high technology, innovative firms by foreign interests. We will have witnesses later on today who can relate, from firsthand experience, how difficult it has been, given the increased tax rates on capital gains, to generate capital for large new ventures.

What would be your analysis of both the cause of and the remedy for this situation? As a matter of fact, we have written some of the Defense officials seeing how pervasive this sale of American ingenuity abroad may be. Clearly such a brain drain is not in our interest.

What do you think can be done to reverse the trend that is so disturbing in this respect?

Mr. WILLIAMS. We have to recognize that, in many respects, though our financial marketplaces are not as exciting and not as profitable as they have been in other times, they continue to be the best in the world relative to other places where one might invest dollars or other currency. It is far safer here than it is elsewhere—politically and otherwise—and I believe we will continue to attract, and increasingly attract, foreign money for investment in this country. So, in that sense, I think we can anticipate seeing more of the type of foreign investment that you are talking about.

However, there is another kind of problem. Many of the companies that you are talking about, back in the 1960's, would have had alternative places to go for capital. They could have gone to the equity markets. They could have gone to private placements, to venture capitalists. Today, they do not have those alternatives. It is now a seller's market for money, as far as those companies are concerned, and the terms are high. And I would say, in some cases at least, that foreign sources of money may offer better terms than domestic sources might offer, or be willing to pay more relative to their investment opportunities, either at home or elsewhere in the world. So I would say that, to the extent that we can free up and encourage equity investment and provide additional sources of capital, and alternative places to which these young growing companies can turn for equity, we will decrease the foreign investment.

Senator HANSEN. And this bill would do that, in your judgment?

Mr. WILLIAMS. In my judgment, it would work in that direction.

Senator HANSEN. It would move us in that direction?

Mr. WILLIAMS. Yes, sir.

Senator HANSEN. I have no further questions, Mr. Chairman.

Senator BYRD. Thank you, Senator Hansen.

I have just three questions, Mr. Williams. Would a reduction in capital gains rates benefit new, high-growth technology firms, in your judgment?

Mr. WILLIAMS. My sense is that such firms would benefit most from such a reduction.

Senator BYRD. There seems to be a concern that the individual investor is staying out of the stock market and the market is being taken over by large institutions. Is this what is happening?

Mr. WILLIAMS. Increasingly that is what is happening. I am submitting, Mr. Chairman, for the record a schedule which shows that complexion of the marketplace has shifted enormously from what it was in the early 1960's—essentially an individual investor marketplace—to one which is, today, predominantly institutional. If I recall the data correctly, I think we will find that, in 1960, 61 percent of the dollar volume of trading on the New York Stock Exchange was by individuals. In 1976, it was 30 percent.

[The following was subsequently supplied for the record:]

TABLE NO. 1.—DISTRIBUTION OF NYSE PUBLIC VOLUME BY INVESTOR

[In percent]

	Of dollar value of trading		Of shares traded	
	Individuals	Institutions	Individuals	Institutions
1960	60.7	39.3	68.6	31.4
1961	61.3	38.7	66.7	33.3
1966	52.6	47.5	57.0	43.0
1969	38.1	61.9	44.1	55.9
1970	38.1	61.9	44.1	55.9
1971	31.8	68.2	40.3	59.7
1974	31.0	69.0	41.1	58.9
1976	29.7	70.3	42.7	57.3

Note: All data for first quarters of indicated years. Public volume is all volume less exchange member trading for members' accounts.

Source: New York Stock Exchange Fact Book, various years.

Senator BYRD. It dropped by half?

Mr. WILLIAMS. It dropped by half in 16 years. I think we are seeing increasingly an institutionalized market. That lends some background to one of the observations I made earlier in my testimony—that the capital gains tax structure today, in many ways, discriminates against the individual as an investor. Many of the other institutions, whether they be pension funds or insurance companies or foreign investors are not subject to the same capital gains rates as individuals.

Senator BYRD. It seems to me—and I do not pose as an expert on it at all—but it seems to me that that is a rather dangerous, or undesirable situation, to have the market dominated to the extent that it is now by the institutional investor vis-a-vis the individual investor.

It occurs to me that we would have a much more stable and healthy market if we had 61-percent individual investors and the other 39 percent in institutional funds.

That is an outsider's viewpoint. I do not know whether that would coincide with your thinking or not.

Mr. WILLIAMS. I would like to see the investor more significantly in the marketplace. With the growth of institutional funds, particularly pension funds—as important as pension funds are—I think the day of the 60–40, with the individuals being the 60, are probably gone forever. The New York Stock Exchange did a study, I believe a year ago, which indicated that, since about 1970, some 6 million people have left the market. I cannot say that that is all attributable to the level of capital gains taxation, by any means. And, of course, that does deal with the question of the rates of investment over the period. I would venture to say, however, that individuals are not invested

as heavily as they were 8 years ago, and probably are invested more conservatively. Thus, at least in part I think for reasons of taxation and alternative opportunities for investment, people are not in the market.

Senator BYRD. It is a trend to bigness, I gather, which is, to my way of thinking, is not a good trend. I happen to think that government is too big and I am not keen on too many big businesses. I think we have too much big business and too much big government, too much big labor. Now we have gotten too much bigness in the stock market, none of which is particularly appealing to this Senator.

I just have one final question. How do you see the implications of this trend to institutional buying. Will the institutions be more conservative in their investments and less likely to invest in new and growing companies than has been the case in the past?

Mr. WILLIAMS. I would think that, generally speaking, institutions of the type we are talking about are less venturesome and less risk-oriented, and the trend of the law, both case law and, if you will, legislation, is to discourage risk taking.

Senator BYRD. And if we discourage risk taking, it seems to me we have discouraged a very important element that has made this country the great country that it is, from an economic point of view, and many other points of view.

Mr. WILLIAMS. Right.

Senator BYRD. Thank you, Mr. Williams.

Mr. WILLIAMS. Thank you, Senator.

Senator BYRD. Next is a panel. There are two witnesses on this panel: Dr. Richard Musgrave and Mr. Michael Graetz.

I want to say welcome to both of you and I would like to point out that Mr. Graetz, as I understand it, is a professor of law at the University of Virginia, and as a Virginian, I am very proud that the University of Virginia Law School is recognized as one of the finest law schools in our Nation.

We are glad to have you, Mr. Graetz and also you, Dr. Musgrave.

I do not know which of you would prefer to proceed first, but you can decide among yourselves.

Mr. GRAETZ. Perhaps, as a constituent, I should go first.

Senator BYRD. Fine. I do not want to discriminate against a nonstituent, but I am delighted to have you.

Mr. GRAETZ. Perhaps, as a constituent, I should go last.

Senator BYRD. Go ahead, Professor.

STATEMENT OF MICHAEL GRAETZ, PROFESSOR, UNIVERSITY OF VIRGINIA LAW SCHOOL

Mr. GRAETZ. Mr. Chairman, it is a pleasure to be here today to discuss with you this important proposal which would return the capital gains taxes to the maximum 25-percent rate that existed prior to the Tax Reform Act of 1969.

Let me say at the outset that I think there is a grave danger that the Congress will misread the message of California's proposition 13 and regard that vote as a signal to enact tax reduction in any form without carefully considering whether the tax reduction provided will be fair or effective in achieving its stated goals and without first carefully analyzing alternative forms of tax relief.

Such a view, in effect, would portray the American people as vigilant and concerned that direct public assistance to the poor and infirm not be wasteful or unfair, but inattentive and unconcerned when a $2.2 billion tax reduction for high-income individuals is at stake. I simply do not believe this to be the case.

In California, people were faced with a ballot measure which they had to vote for or against. Many were concerned about the form of tax relief provided by proposition 13, for example, that much of the relief would go to out-of-State landowners or corporations.

Proposition 13, however, offered homeowners a substantial reduction in their property taxes and a unique opportunity to convey the heartfelt message to the Government that it must be more restrained, more careful about its spending policies.

An overwhelming majority who voted for proposition 13 should not be regarded as signaling legislators to vote in favor of any tax reduction, no matter how wasteful and inequitable and without regard to the may serious alternatives which exist.

The proponents of proposition 13 argue that it would benefit three classes of persons. The first, and most important, homowners who are being squeezed by increased property taxes, payable without regard to their cash position.

Second, renters who expected that lower rents might result from a reduction of their landlord's property taxes.

Third, shareholders and consumers of corporate products for whom the benefits of lower property taxes on corporate landholdings might be passed.

The Steiger amendment would cost $2.2 billion of Federal revenue. How would this money be spent to benefit those who supported proposition 13?

First, the Steiger amendment would do virtually nothing to benefit homeowners. Practically all of the capital gains on the sale of a residence is currently exempt from income tax through reinvestment provisions. If homeowners are to be benefited, why not simply exempt an individual's personal residence from the capital gains tax?

Second, renters would not benefit. In general, renters realize very little in terms of capital gains themselves and it is hard to imagine how they would benefit from a reduced tax paid by their landlord if he were to sell the building they are now living in.

Third, consumers and shareholders will benefit only to the extent that reduced taxes on realized capital gains will stimulate investment. But, since less than 30 percent of annual capital gains relate to corporate investments, this class of individuals will realize only a relatively small portion of the benefits of the Steiger amendment.

If stimulating business investment is the goal, there are fairer and more efficient alternatives. What will happen to the other two-thirds of the revenue lost by the Steiger amendment?

Most of it will reduce taxes on the sale of land, timber, cattle, et cetera. Lawyers and accountants who can devise ways of diverting ordinary income into capital gains will benefit and those who promote and invest in tax shelters will benefit.

The pay-off to high-income taxpayers from converting ordinary income into capital gains will be significantly increased. This opportunity for conversions has, over the years, been among the most important structural problems in the Internal Revenue Code.

The continuing struggle of the Congress with the recapture provisions of the Internal Revenue Code, relating to depreciation deductions on both real and personal property and also those enacted in 1976 relating to intangible drilling expenses and player contracts when sports franchises are sold, are important examples of congressional efforts to restrict this problem.

Likewise, the limitation on the deduction for investment interest, enacted in 1969, is but a limited solution to conversion opportunities which arise when taxpayers borrow to invest in land or growth stocks and deduct their interest and other expenses against ordinary income under conditions where they will realize any gain as capital gain.

Similar problems have been recognized by the Congress in the context of citrus groves, motion pictures, books and records, interest and taxes during construction of real property and with respect to the syndication and organization of limited partnerships. And, in each of these cases, Congress has enacted new captalization requirements to restrict somewhat the opportunities for conversion.

The Steiger amendment will exacerbate the conversion problem. A rollback of the capital gains tax will be wasteful as a stimulus to business investment, will generate new pressures for tax shelters and will increase the complexity of the income tax laws.

Mr. Chairman, in the short time available to me in preparation for these hearings, I have become confident that there are at least 11 alternatives preferable to the Steiger amendment. If the Congress is concerned with stimulating business investment in the corporate sector, at least five alternatives are superior to the Steiger amendment.

First, corporate taxes on earnings distributed as dividends could be reduced along the lines proposed by Chairman Ullman of the House Ways and Means Committee.

Second, corporate tax rates could be cut generally.

Third, the investment credit could be increased.

Fourth, depreciation allowances could be increased.

Fifth, small businesses could be relieved entirely of the corporate income tax by amendments to simplify and expand the application of subchapter S of the Internal Revenue Code.

If the Congress desires to reduce the tax burden on individuals to induce greater investment, dividends, and interest, or some portion thereof, could be made eligible for the maximum 50 percent rate of tax available for earned income under section 1348 of the Internal Revenue Code. This would benefit the same class of taxpayers as the Steiger amendment, those with marginal rates above 50 percent, and would increase returns from investments without increasing the pressures on the capital gains/ordinary income distinction.

Or, deductions could be permitted for individuals who increase their savings or who invest in growth stocks, perhaps through liberalization of provisions governing individual retirement accounts along the lines proposed by Secretary Simons in 1975.

If the Congress is concerned with the over-taxation of inflationary gains under the income tax, first a general system of indexing for inflation could be adopted. This would be the most comprehensive and fair solution.

Or, if relief for inflation is to be focused only on capital assets, an additional exclusion of capital gains tied to inflation and the length of time assets are held could be provided.

The best approach could be along the lines of a tentative decision of the House Ways and Means Committee in 1974 which would have provided, in addition to the normal 50 percent capital gains exclusion, an additional exclusion of 1 percent of an asset's cost for each year an asset is held by a taxpayer up to a maximum exclusion of 75 percent.

In fact a return to section 117(a) of the Revenue Act of 1934, which provided a sliding scale for exclusion of capital gain depending on the length of time assets are held, would be an improvement over the Steiger amendment.

If Congress desires to stimulate new investment in risky ventures, the rules for deductibility of capital losses on future investment could be significantly liberalized or a new benefit could be provided for investments in venture capital stock.

The Treasury Department, for example, outlined such a proposal to provide a tax credit on venture capital stock in its tax option memorandums to President Carter last fall.

Mr. Chairman, support for the Steiger amendment seems to emanate from three principal concerns. First, the operation of the maximum tax offset for capital gains produces undue complexity and is often haphazard in operation.

Second, President Carter's proposal to eliminate deduction of regular income taxes in computing the minimum tax was properly recognized as an indirect increase in capital gain, taxes which would add complexity, by making the minimum tax more broadly applicable and which would often simply result in an additional flat 7.5 percent tax on capital gains.

Third, there is wide agreement that some portion of this year's tax reductions should be designed to stimulate greater investment. Each of these concerns is genuine, and should be addressed. The capital gain offset should be eliminated from the maximum tax and President Carter's minimum tax proposal should be rejected.

Direct reduction of the capital gains tax, including a rollback to pre-1969 levels should be considered and weighed against alternatives in terms of both efficiency and equity.

I am confident, Mr. Chairman, that careful reflection will reveal many alternative tax reductions which would accomplish more efficiently and more equitably the capital formation goals which are asserted on behalf of the Steiger amendment.

I have attempted to outline some of these today. Several of these may require considerable deliberation in order to be enacted. Proposals such as these—indexing for inflation, for example, or reducing the corporate tax on dividends, offer great promise and deserve the committee's attention even if such study delays their enactment until next year.

If an interim measure is desired, many simple options are available. Among the best would be a general rate reduction applicable to individuals and corporations, perhaps coupled with a special reduction in the maximum tax on dividends and interest to 50 percent. Such a measure would benefit investments and, in direct contrast to the Steiger amendment would reduce pressures to structure transactions so as to convert ordinary income into capital gains.

Perhaps, at the outset, the 50-percent maximum rate on interest and dividends should be limited to the total of an individual's earned income.

Finally, increased depreciation deductions or investment credits are to be preferred over the Steiger amendment. There are simply many better alternatives.

Surely it is the obligation of the U.S. Senate to explore alternatives which are more efficient, less wasteful. It would seem shortsighted indeed to expect the American public to applaud a tax reduction which is both inefficient and inequitable. The people of California had but one alternative: Vote "Yes" or vote "No" on proposition 13. They were not sitting as legislators to consider a range of tax reduction measures and to select the best.

The message of proposition 13 is that tax dollars are limited, that governments must assess priorities in spending and must dispose of the people's money in a more efficient and equitable manner and the people well know that tax reductions are also limited and must likewise be enacted to produce maximum efficiency and tax justice.

Dr. Musgrave, we would be very happy to hear from you.

Mr. MUSGRAVE. Senator, if I may, I have a prepared statement which I would like to submit for the record.

Senator HANSEN. It will be included in its entirety in the record and if you would like to speak off the cuff or summarize, that would be perfectly all right.

Mr. MUSGRAVE. Would it be appropriate if I, in proceeding, make some cross comments on the testimony that we have heard today?

Senator HANSEN. That would be helpful.

STATEMENT OF RICHARD MUSGRAVE, H. H. BURBANK PROFESSOR OF POLITICAL ECONOMY, HARVARD UNIVERSITY

Mr. MUSGRAVE. While most of your panel members will not be happy to hear this, I start squarely from the premise that capital gains are income which I think practically all scholars of taxation share. Equity of taxation therefore requires that capital gains be treated like other income. To be sure, there are all sorts of difficulties involved. It is not an easy matter to handle.

For instance, I recognize that an inflation adjustment is in order. I recognize that taxing, not only realized, but also accrued gains, involve some technical difficulty. Still I think it can and ought to be done. Eventually tax reform ought to move in that direction.

I therefore feel that the Steiger amendment is a turnaround toward reform "unreform," path which it would be most unfortunate to embark on.

I am also aware that equity in taxation is not the only consideration. We do have tax expenditures. Some of them are worth making. But if capital gains are given preferential treatment, this has to be justified as a superior form of tax expenditures. I do not wish to rule out such a use of taxation, but it has to be justified as accomplishing a particular purpose of tax policy, say to stimulate investment, and to do so better than can be done otherwise.

Now, without question, the Steiger proposal ranks very low on equity grounds. Therefore, a very strong defense would have to be established on incentive grounds.

The amendment ranks low because it treats, more even than now, capital income differently from wage income. It ranks low also because very largely it just benefits people with high income.

I would say on that point, in response to the question by the chairman, that the use of the expanded income is totally correct. In fact, it should not only be expanded as it is now expanded, but it should be expanded further to include unrealized gains, in my opinion. At the same time, the chairman had a good point in saying what about someone who has this large gain in a particular year. Well, the answer to that is not to exclude capital gains from income, but to put it on a basis of, say, a 5-year average. You would expand the income base, which would be the average of 5 years, so as to get around this particular problem which the chairman mentioned. I suggest the Treasury be asked to prepare such a table.

Now, with regard to Senator Danforth's question, is it fair to call this a tax relief for millionaires, or is it fair to call it a tax policy measure which will strengthen the American economy? To get away from charges of demagoguery, one must recognize that as our economy is organized, investment decisions are very largely made by high-income people. That is simply a fact, as anyone can observe. It is also the case that investment income figures very highly in the income of high-income people. Therefore, more or less by necessity, tax measures which are aimed at stimulating investment and, through investment growth turn out to be measures which benefit high-income taxpayers thus comes about without anybody having any evil intentions. But we should recognize that. There is a conflict.

I would suggest that much more could be done, by the Treasury and this committee, to try to cut this nexus between measures which are helpful to growth on the one side and measures that will cut the tax burden much more on high income than low income.

If you could break this nexus then the whole party line-up in discussing such tax policy proposals would be changed. It is not the easiest thing to do, but more can be done, and certainly the Steiger measure is about the worst from that point of view.

Now, let me just comment briefly on a point which Senator Hansen raised. The Laffer curve, of course, is nothng new. The principle underlying the Laffer curve can be found in any elementary textbook on public finance. It simply is a proposition that if you impose a tax, a commodity tax, then over the range over which demand is elastic raising the rate of tax increases revenue, beyond the point of unit elasticity it lowers it.

But there is a difference between considering the effects on tax revenue and the effect on effort. Most any tax will reduce the activity which is being taxed.

But we do need public service. This economy, this society, could not exist without public services. Therefore, we need taxes to finance them. The question is to have an arrangement of taxes which will do it as best as possible—and, by best I mean both from the point of view of equity and from the point of view of the effect on the economy.

To say that let's avoid taxes if they reduce economic incentives, really is to that let's have no public sector, and that is not very helpful. Now with regard to tax reduction, we must distinguish here between two points. One is that the effect of a tax reduction will stimulate the economy via increasing aggregate demend. That is to say, via increasing the defict at least initially, and holding expenditures constant. The charm of causation is reducing taxes, increasing demand, stimulating the economy and then hopefully increasing revenue.

The other point considers the effects on the economy from the supply side, through effects on incentives. Now, I think the Senator ought to point out which of the two he argues. The Kennedy tax cut in the midsixties was clearly the first case. I think everyone agrees, especially the Congress, that a massive tax reduction of that kind is not now in order. But if he means the supply side, then he cannot point to the Kennedy tax cut as part of his case.

I must add that if he wishes to take the late President Kennedy as his mentor on capital gains taxes, then he should read President Kennedy's first tax message in which full taxation of capital gains, including taxation of unrealized gains, was recommended.

Turning to the matter of growth, the reasoning behind the Steiger proposal appears that, by lowering capital gains taxation you would increase the effect on investment in the stock market, that that would raise share prices, that that would reduce the cost of capital and that that, in turn, will stimulate investment. So it is much the same thing as reducing the cost of investment by an investment credit. So one ought to think of what kind of investment credit would be equivalent to that kind of production of capital gains.

It seems to me that you might come out with a credit of 4 or 5 percent but, to my mind, the investment credit is much less objectionable, especially on equity grounds. The chairman has asked whether the investment credit is not just as bad because it goes to a few large corporations?

My answer would be that equity in taxation has to do with the distribution of the tax burden among individuals, not with distribution among corporations. It is simply not a comparable issue. As the Secretary pointed out, these few corportions are owned by many individuals.

If, on the other hand, the intention is to make equity investment more attractive to the investor, then I would think that the proposal for tax integration—Mr. Ullman's formulation and others—would be much more attractive.

Finally, just a word on this business of estimating the revenue. I think the congressional people were right telling the Treasury, that we do not just want to have static estimates. We want to have a dynamic estimate. Although, of course, making these dynamic estimates are extremely difficult.

The econometric models we have to date are all right for predicting GNP in the next quarter, but they just do not stand up very well for this kind of analysis.

But the revenue effect is really that important. We do want to have a tax stimulation of growth. We do want to give that stimulus in a way which does the least damage to the equity of the tax structure, which does the least to distort resource allocation in the economy, and that is the way we are going to do it.

I do not think that the Steiger amendment ranks very well on either of these.

Senator HANSEN. Thank you very much, Dr. Musgrave.

Just a few points, Dr. Musgrave, if I may respond first to you. I think it was Senator Packwood who mentioned the Laffer curve.

Second, when I was talking about what happened between the years 1963 and 1968 and what happened in the seventies, I was not trying to hold out as an ideal what any particular President may have

said or what the Congress said, but simply to underscore the fact that the track record of the Treasury is pretty darned lousy. They have come forward with statements as to what is going to happen and they have badly missed.

Secretary Blumenthal stated that all they had to go on were the basic facts, that is, if you assume that there are business transactions which would reflect, say, $20 billion a year of capital gains sales and the rate is at a certain level and you reduce it to a lower level, then Treasury income will decrease. I thought the Secretary was forthright in saying that they were not going much beyond that.

Now, I think Mr. Steiger and I and a number of other people believe that our economy is not static, that people do change their minds. As Congressman Kemp pointed out, it is generally believed that if you want to encourage some kind of an activity, there are ways by which you can do that. You can provide various kinds of incentives, of which subsidies would be one.

On the other hand, if you want to discourage something, you put a tax on it. I would assume, maybe you would agree with that—do you agree with that?

Mr. MUSGRAVE. Yes, I certainly agree that the economy is dynamic and that dynamic effects should be taken into account in estimating the revenue implications. Now, in some instances that is simpler than in others if we have a reduction in the income tax, for instance, it is relatively easy to predict what will be effective on consumption.

If we have an investment credit, it is more difficult to predict what will be the level on investment. If we have a reduction in the capital gains tax, as proposed by Congressman Steiger, it is certainly very difficult to predict how the stock market will react, because if only for the reason, you see, that we do not have many past historic cases. We do not, in our past history, have many comparable situations.

The whole idea of an econometric forecast is based on the notion that there have been such situations in the past, and these past responses tell us what the loss was, and they will tell us in the future. But in the stock market case, it is just extremely difficult.

Senator HANSEN. Well, I asked you if you agreed or disagreed with the premise that, generally speaking, if you tax something you will discourage that kind of activity; if you subsidize it, you will encourage it.

I think that, if you recall, in the final years of World War II there was great concern about the ability of the United States to produce enough wheat for our own use and provide what was necessary for our allies. As we all know, the Congress granted a guaranteed price, on wheat and we had the greatest outpouring of wheat that we have ever had, despite the fact that there was practically no help left on the farms of America. We found, to our sad regret, that the same thing would happen with potatoes. If you want to have too many potatoes produced, just put the price up.

On the other hand, we have had some experiences from which we seem to have learned very little from the oil business, and we have changed a number of laws around in oil, including lowering the depletion allowance, including other tax changes that made it generally less profitable than it had been to be in the business.

As a consequence the number of independents in this country dropped from about 40,000 down to about 10,000. Now it is going up back that way a little because we have changed so much our treatment of oil companies. Despite the efforts of Congress to see that the oil business does not become any more profitable, the forces of worldwide demand has forced the price up and, as a consequence, there is a rejuvenation of interest.

What I am trying to say, Dr. Musgrave, is that I believe most of us who support this tax proposal think that, while we give credit to, and greatly respect your recommendations that the tax laws be made just as fair as they possibly can be, we will never get a perfect system. It is one thing to say how small each piece of the pie can be cut in order to see that no one gets more than his share. It is another thing to contemplate a bigger pie and, while I may not get as much as you or someone else gets, if I get a piece that is bigger than the piece I got last year, I think generally I am going to like the plan.

Mr. MUSGRAVE. There may be a trade-off here. You may find that in introducing certain inequalities of tax treatment for various people which, you damage tax equity and you would rather not do that. We may find that the pay-off might be—we may have a situation where, if we treat certain types of incomes unequally, say tax capital gains very much lower than wages, or vice versa, that this would have a stimulating effect on the economy and that, in the end, everybody would gain. That is quite possible.

Confronted with that kind of situation, no one would say no, you must not do this, even though it is helpful to the economy, because it is bad on equity grounds. One must be flexible and recognize some tradeoff here.

I am with you on this, but in my view, the Steiger amendment is not a good trade-off.

Senator HANSEN. I certainly appreciate your view.

Mr. GRAETZ. Senator Hansen, if I could make two comments. First about the revenue estimating problem. This is comething that I came into contact with at the Teasury in 1971 when we were increasing depreciation allowances and reducing corporate taxes, and within the Treasury there was a great deal of sentiment that these changes would have a stimulative effect on the economy and therefore increase the revenues. Nevertheless, the actual revenue estimate which was used was in accordance with the Treasury practice throughout the years of showing only the first-level impact of tax provisions and showed a $3.8 billion revenue loss, as I recall it.

Accelerated depreciation increased the depreciation allowances and Treasury showed a tax reduction initially, even though there was a lot of thought that that would have a stimulative effect and that the feedback might produce greater revenue than the initial loss.

Senator HANSEN. Yes.

Mr. GRAETZ. But the difficulty was that Treasury has over the years made its estimates, not only of the aggregate revenue, but also of the distribution of tax changes by looking at the first level effects without taking feedback into account.

I think that it is important that the Congress is now interested in feedback numbers, and I am sympathetic to that, although I share

some of Dr. Musgrave's views about the reliability of those numbers as you move further and further into speculation.

My difficulty is that this bill seems either an odd place to start, or, at a minimum, it seems to me that you ought to look to the feedback effect with respect to the alternatives, some of which I have outlined. That is to say, what is the initial cost, how is it distributed, and what are the feedback effects of things like reducing the maximum rate of tax on dividends or interest, or what are the effects of adopting Chairman Ullman's dividend relief proposal.

It seems to me that if you are going to make these sorts of comparisons, you really ought to try to be very careful to be consistent in either looking at feedback or not looking at feedback and, in the Treasury's defense, the Treasury and the Congress in its revenue estimates of tax reforms and tax relief, consistently have shown first level revenue estimates without trying to quantify the feedback effects. Instead in the committee reports and in statements of Secretaries of the Treasury, comments have appeared that this change or that might be stimulative to the economy generally, but because of the difficulty of getting a precise number—and I think this debate over particular numbers is reflective of the difficulty—the difficulty of getting a precise number has meant that the revenue effect is typically shown without feedback estimates.

And I think that that is not a bad policy to continue until you can generally quantify feedback effects.

Senator HANSEN. I appreciate your comments, Mr. Graetz, and I share with you the realization of the difficulties, although I have not been exposed in as much detail as I am certain you have. I do know how difficult it is to try to to come up with positions that will guarantee a short-end result. I do not minimize at all the problems that the Treasury had in that respect.

I would say, in response to your observations, that you find it strange or unusual or at least unexpected that we would take the particular tack we have in pushing the Steiger amendment. I think there were a number of reasons why it was rather natural that we might have done it.

I happen to have, for your possible interest, a proposal which has been cosponsored by a number of members of the Finance Committee that would index capital gains which would reflect the period of time in which an asset has been held, which I think has merit.

But if I could just continue with the observation I wanted to make about this Steiger bill, a number of things, I think, have called attention to it.

No.1, the dramatic decline in stock market prices. The number of of investors who have gotten out of the market. The acutal decline in Treasury receipt from capital gains.

The inability of new corporations, new companies, to generate capital to invest in their ideas in this country and the increasing requirement that they go abroad and find the kind of venture capital that they were able at one time to find here, the drain that it brings upon our America tradition of innovation.

These are some of the things that, I think, account for the fact that there just seems to be a coalescing of sentiment that this was the way to go.

I note that my colleague from Colorado, my very good friend, Senator Haskell is here. I would be happy to yield to you at this point.

Senator HASKELL. Thank you very much, Senator Hansen, but, not having been here when they tesitfied, I do not think I should ask questions. Thank you very much.

If I may, then, let me thank you gentlemen for your——

Mr. GRAETZ. Senator, could I just comment briefly on that last point you made? It seems to me that, as you keep in mind this question of corporate growth, that the dividend problem is much more pressing, I think, than the capital gains problem. You have seen a great many tender offers by companies taking over other companies. There apparently is a good deal of liquidity in the corporate community and, in part, because of the tax burden of paying dividends, there is great reluctance to pay that money out to shareholders who might well invest in new enterprises or other enterprises, and so you have a lot of situations where you are having companies use that money by purchasing their own stock or that of other companies rather than paying it out to their shareholders, in part, because of the problem of dividend taxation.

I think that if you reduce the tax on capital gains, you increase that pressure and you also increase pressure for gamesmanship in tax practice. There has been very little attention to the lawyers in these hearings, and rightly so. This is basically an economic and political problem.

But I assure you that the ability to convert ordinary income into capital gains and the benefits from so doing, the games that will be played with various kinds of assets because of the capital assets definition are terribly important to this issue and there will be an enormous amount of waste and inequity that will result if the Steiger amendment is passed, and I hope that you will keep that in mind.

Senator HANSEN. Thank you both very much. We appreciate your appearance here.

[The prepared statement of Mr. Musgrave follows:]

STATEMENT OF RICHARD A. MUSGRAVE, H. H. BURBANK, PROFESSOR OF POLITICAL ECONOMY, HARVARD UNIVERSITY

Capital gains, like other forms of accretion, add to the recipient's ability to pay. Therefore, as a matter of tax equity, they should be treated like other income. The direction of tax reform, accordingly, should be to narrow the differential in the treatment of gains and other income and not to widen it as proposed in the Steiger Amendment. At the same time, I recognize that it may be necessary on occasion to grant tax incentives in support of policy objectives even though this offends against equity standards. Such incentives, however, should be designed to minimize the resulting damage to tax equity and to maximize the particular policy gain. The Steiger Amendment meets neither test.

EQUITY ASPECTS

Consider first its implications for tax equity. One basic requirement of equity is for people with equal income to pay equal taxes. But restoration of the pre-'69 law would leave a taxpayer with an earned income of, say, $100,000 paying nearly $44,000 in tax whereas his counterpart with a similar income in capital gains would pay $25,000 only. His liability under present law would be $32,000, so that the Steiger Amendment widens the gap by 50 percent. The damage to horizontal equity would be substantial.

It is also agreed widely that an equitable income tax should be progressive. Yet the Steiger Amendment would return us to the disgraceful (to use the President's term) pre-'69 situation when effective tax rates (ratio of tax to income) actually declined from the $100,000 to $200,000 range on up. As has been pointed out by Secretary Blumenthal, over four-fifths of the Steiger benefits would go to taxpayers with incomes above $100 000 with the capital gains rate at the top of the scale cut by over 35 percent. The reason is that capital gains as a share of income rise sharply when moving up the income scale and that the provisions of the Amendment would become generally significant only above the $100,000 level.

All this highlights a dilemma which has concerned me for quite some time. Tax proposals for economic growth usually turn out to involve high-income relief and one wonders what is the basic intent—more growth or less progression? I realize that investment decisions are made typically by high-income people, that these people provide an important share of investible funds and that capital income weighs most heavily in their receipts. There is thus a natural tendency for a linkage between tax incentives to growth and high-income benefits. Yet I believe that too little attention has been paid to designing incentives which are less subject to this nexus. More could be done to reconcile growth with tax equity. Clearly the Steiger Amendment goes all in the wrong direction. Its provisions are of little or no significance for the small and middle-sized investor, while granting substantial and growing tax reduction with rising levels of income.

GROWTH EFFECTS

Turning now to the effectiveness of the Steiger Amendment as a growth incentive, the question is not whether there would be a favorable investment response. Of course there would. The question is, by how much and with what implications for the structure of investment and at what cost to equity? In each of these respects, the Steiger Amendment to my mind, ranks poorly with avialable alternatives. Indeed, it ranks so poorly that in last year's DRI study of the problem, where six alternative plans were considered, this particular approach was not even included.[1]

I begin with the structural aspects. By widening the gap between the taxation of dividends and of capital gains, the Amendment further distorts the relative prices of retained earnings and dividends. Low dividend payments and finance by retention with by-passing of the capital market would be encouraged. As distinct from other approaches, such as corporate tax integration or even corporate rate reduction, the Amendment would do nothing to remove the existing distortion in the cost of equity versus debt finance, or in the return on stock versus other assets held by the individual investor. Instead, the Amendment would give further inducement to seek investments the income from which lends itself to translation into capital gains. All the difficulties in the Code arising from the preferential treatment of gains would be worsened.

Next note that the benefits from the Steiger Amendment would apply to capital gains from all assets and not from growth investment in plant and equipment only. Less than 30 percent of gains are realized from stocks and bonds (1973 data) and a substantial share accrues to residential real estate and other forms of property which do not involve growth investment and which are hardly in need of further tax support. Clearly, the Steiger plan is less efficient in this respect than other measures such as corporate tax integration and especially the investment credit which can be targeted at growth investment. Moreover, by inducing a general rise in the value of capital assets, including housing, the inflation problem would be worsened.

Reduction in the capital gains tax may be expected to increase investment in plant and equipment, but the question is by how much? We may expect that there would be a rise in stock prices especially in the longer run after previously locked-in assets are liquidated. This expectation, however, should not be exaggerated by blaming the poor market record since '69 entirely or largely on the capital gains legislation of that year, or focusing on the maximum rate of 49 percent which may now be payable but which in fact is paid in very few cases only. Clearly, inflation, high interest rates and other factors were major influences on the lagging market. Nevertheless I grant that the Amendment would have a favorable effect on share prices. Combined with reduced pressure for dividend distribution (due to reduced taxation of gains), this would reduce the cost of equity capital. As a result, the rate of return would rise and investment may be expected to expand.

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[1] See C. Caton, O. Eckstein, and A. Sinai, "Tax Reform and Capital Formation in the U.S. Economy," Data Resources Review, August 1977, Data Resources, Inc., Lexington, Mass.

The signs are in the right direction but it is difficult to predict the magnitudes. The recent debate on this point shows how ill-equipped econometric models are as yet to deal with problems of this sort.[3] In my judgment, the effect on investment will fall short of what might be expected from an investment credit of, say, 10 percent and the cost in lost equity would be much larger.

While I feel very critical of a broadside approach to capital gains relief, some such measure might well be especially effective with regard to attracting risk capital to small and new ventures. If so, it should be possible to work out a provision, perhaps along the lines of S. 2428, but this would be rather different from the Steiger Amendment and much more limited in its impact.

OTHER CAPITAL GAINS REFORMS

Nor do I believe that a proposed step-down in rates for longer held assets (S. 2428) would be desirable. For one thing, there is no particular economic virtue in longer holding. For another, longer held assets already benefit especially from tax deferral, a distortion which would be accentuated by the step-down approach. There are, however, some changes which I would favor at this point.

The first of these relates to the treatment of losses. Economic analysis tells us that effects on risk-taking depend greatly on the treatment of losses. It is not at all certain that a tax with full loss offset will have an unfavorable effect on risk-taking: it may be favorable as well. Certainly, liberalizing the allowance for losses will have a favorable effect. Strangely enough, this important point has fallen into total disregard in the more recent analysis of taxation effects on investment and is by-passed in the formulation of investment functions currently used in econometric models. Economic theorists are subject to fashion like everyone else. Liberalized allowance for losses, including offset against other income, is the first thing which should be done to improve the growth effects of the capital gains tax.

I also believe some form of inflation adjustment is called for. Anyone who takes tax equity seriously, as I do, must be aware that what matter is the level of real and not of nominal income. Inflation adjustments in determining capital gains are thus in order. This is the case the more so since it appears that inflationary gains are most likely to accrue in the holdings of small- and middle-income investors. The only question is, whether it is desirable to apply such an adjustment to capital gains made in the sale of assets without at the same time making similar adjustments in the debtor-creditor relationship, depreciation allowances, and other parts of the corporate balance sheet. This being a second-best world, I am inclined to accept adjustment in the sale of real assets without going all the way in inflation-proofing the income tax system, but I will do so only if the gains thus adjusted are then treated as ordinary income. Clearly this would strengthen the attractiveness of equity investment in an inflationary period.

Finally, I see no objection to eliminating the "poisoning" of the maximum rate on earned income by requiring deduction of the untaxed half of capital gains from earnings eligible for the ceiling rate. To say the least, an adjustment could be made to exclude gains from sale of first residences from this provision. Rumor has it that some members of the Ways and Means Committee were unexpectedly caught by this requirement and the same should not happen here. The concept of preference income belongs to the murky realm of the minimum tax and should be left out of the maximum rate on earnings.

CONCLUSION

I conclude that passage of the Steiger Amendment would be most unfortunate. If indeed we are entering a Prop. 13 age of public sector retrenchment and tax opposition, I would hope that its strictures can be directed at tightening and weeding (be it on the spending or taxing side) rather than be taken as an occasion for loosening preferences and sowing new inefficiencies. The Steiger Amendment, I fear, does just that. It carries to an extreme past tendencies to link growth incentives with high-income relief. Among available alternatives, it is about the least equitable, nor does it rank especially high as stimulus to growth investment. Tax distortions in the pattern of capital information would be worsened rather than relieved. Other and preferable approaches are available. Finally, capital gains taxation should be viewed as an integral part of the entire system of capital income taxation of which it accounts for only 10 percent. Capital gains reform, therefore, should not be dealt with in isolation, but as part of a broader reform package.

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[3] See the contributions by R. B. Bristol, M. K. Evans, O. Eckstein, and R. B. Bristol in Tax Notes May 15, May 29, and June 5, 1978.

Such a package might contain full taxation of gains with unlimited loss offset and inflation adjustment combined with integration of the corporation tax and, provided all these things are done, a reduction in the top bracket rate on capital income to 50 percent. Premature action in the capital gains field at this time would foreclose this more comprehensive approach.

Senator HANSEN. Our next witness will be William C. Penick, representing Arthur Andersen & Co.

Mr. Penick, I apologize that we are this far along in the afternoon before you have been called to the witness desk and I am just sorry that it has been necessary for members to go to attend other duties.

I say to my friend from Colorado, I think I should yield the Chair. I happen to be a Republican and my friend from Colorado is a Democrat and, under the rules of the Senate, he is now the acting chairman of the Finance Committee, so I yield to him.

Senator HASKELL. I think, Senator Hansen, you are doing a great job, so why do you not continue, and I will assist.

Senator HANSEN. Mr. Penick, it is good to have you here, sir.

STATEMENT OF WILLIAM C. PENICK, MANAGING DIRECTOR, TAX POLICY, ARTHUR ANDERSEN & CO.

Mr. PENICK. Thank you, Mr. Chairman, I am William C. Penick and I am the managing director of tax policy for my firm, Arthur Andersen & Co. With me on my left is Mr. William Barth who is our director of industry competence for small business. We are particularly concerned about the proposals you are considering here today, as they do affect small business.

The appropriate method of taxing capital gains has been a subject of debate for a long time. The changes made in the 1969 act, which have been discussed quite a bit this morning, and subsequent changes, when combined with the very high rate of inflation we have experienced in the last 5 years, have refocused attention on this very important subject.

We commend your subcommittee for scheduling these hearings to determine what changes should be considered at this time.

While we are concerned with most of the major issues that have been discussed this morning relating to capital gains, we would like to concentrate our remarks on Senate bill 2428 which was introduced by Senator Haskell in January of this year.

This proposal would adopt the so-called tax deferral rollover approach for the disposition of an interest in a small business concern so long as the proceeds of such disposition are reinvested in similar types of small business activities.

This approach is consistent with one suggested by our firm about 3 years ago when Mr. Barth testified at a joint hearing of the Senate Select Small Business Committee and the Finance Committee and we are delighted that it is receiving serious attention at this time.

Before talking about this bill, however, I would like to make a few general comments about the other two specific bills that are the subject of these hearings.

First, Senate bill 3065, your bill and Mr. Steiger's bill would, in effect, roll back capital gains to pre-1969 levels and impose a 25-percent ceiling. In our view, the impact of this change, which would reduce

the maximum effective rate by about one-half, would eliminate some of the disincentive to capital investment under present law, particularly in equity securities and in venture capital entities. The testimony you heard this morning, I think, is directly in line with that point.

By eliminating capital gains as a preference item, this change would also have the very desirable effect of simplifying tax reporting for the thousands of U.S. citizens who must now go through the time-consuming ordeal of preparing the schedules and making the complex preference tax calculations. To be more correct, I guess I should say that they either go through the ordeal themselves or suffer the agony, of paying our professional fees for doing it for them, but, nevertheless it is a very burdensome thing.

This problem is compounded by the preference income offset against personal service income for purposes of the maximum tax, and again, by eliminating capital gains as a perference item, considerable simplification of tax reporting will have been achieved.

I would like to talk for a moment about Senate bill 2608, which was introduced by Senator Bentsen several months ago, and I believe you, Senator Hansen, were one of the cosponsors of that bill. We agree with the concern expressed in that bill about the impact of inflation on assets that are held for long periods of time. The proposal in this bill would increase the income exclusion on gains on sales of assets held in excess of 1 year from the present 50 percent by 2 percentage points a year until a maximum of 80 percent has been reached. This proposal would also provide for a decreased recognition of capital losses on assets held for long periods of time, but we really don't understand the rationale behind this change.

We believe that a more appropriate way of recognizing the inflationary element in long-term capital asset transactions is to apply a price level index to the taxpayer's investment in the asset and then let this be the base from which gain or loss is calculated.

As indicated on pages 9 through 11 of our written statement, this approach would create quite a different answer from that under Senate bill 2608, and would more nearly recognize the taxpayer's true economic gain or loss from the sale of an asset which we think should be the appropriate basis for taxation.

Now let's switch for a moment to what I think are some particular problems and perhaps peculiar problems relating to samll business entities. Some of the unusually severe capital problems faced by small business concerns were documented in testimony before the Small Business Committee by the American Electronics Association on February 18 of this year. I won't repeat all of the details of the findings of that study, but the American Electronics Association surveyed roughly 600 manufacturers of electronics components and other companies involved in information processing industries, and received responses from over 300 of them. The survey highlighted the problems faced by young, growing companies in this industry, which is certainly quite concerned with technology, and the significant opportunities that exist for creating more employment in growing small business entities.

The surveys showed that the employment growth rate in 1976 for young companies—and for the purpose of this study, those were

defined as companies between 10 and 20 years old—was between 20 and 40 times the growth rate in employment for more mature companies. It also showed that for young companies founded since 1955 nearly $32,000 of assets were required to create each job. To obtain the funds needed to finance these assets, an average of $14,000 of risk capital was required to create each of the 130,000 jobs that were generated by these companies during that period.

On the negative side, however, and I think some of Chairman Williams' remarks this morning would bear this out, the survey showed that risk capital is becoming more scarce all the time.

Senator PACKWOOD. Let me interrupt you just a moment if I can. Senator Hansen and I have conferred, and if it is all right with Senator Haskell, we will finish with this witness and break for a short lunch and come back.

Is that all right with you?

The committee has been going since 9 o'clock this morning.

Senator HASKELL. In view of the time, I think that is very wise. In other words, we will finish with this witness?

Senator HANSEN. We have been here since 9 and a number of witnesses have been. I know I have seen them out here.

Senator HASKELL. I think that is probably not only wise, but you might say humanitarian.

Senator PACKWOOD. OK, go ahead.

Mr. PENICK. OK, fine, thank you.

During the 5-year period from 1966 to 1970, 135 companies raised an average of slightly over $1 million each of new risk capital. During the next 5-year period, ending in 1975, however, this amount had dropped to slightly over $500,000, and these were obviously in reduced dollars in terms of purchasing power, for the 77 new companies which had risk capital offerings during that period. Perhaps more alarming, however, is the fact that the group of new companies raising new capital from 1966 through 1970, had a debt-to-equity ratio of roughly 1 to 1. For those commencing in 1971 through 1975, however, the debt-to-equity ratio was well over 2 to 1.

Increased reliance on debt has led to the failure of many businesses, both large and small, when there are downturns in the economy or other business troubles emerge.

The point of this survey was to demonstrate the great needs for equity capital of young, growing businesses. Since most of these businesses cannot generate enough cash flow to pay substantial dividends to shareholders, the chance for appreciation in the value of the stock which translates to capital gains potential for the shareholders is critical to their ability to finance growth. They can't offer high dividends like A.T. & T. and GM. They have to look toward the capital appreciation in the value of the stock.

Accordingly, changes that would decrease the burden of capital gains taxation or those that would provide tax deferral rollover possibilities such as Senate bill 2428, should make equity investments much more attractive, and should help alleviate some of the problems faced by small business concerns.

Now let's talk specifically about Senate bill 2428. This would provide a unique change in the tax treatment of sales of small business investments where the proceeds of such sales are reinvested in similar

types of investments. As I mentioned earlier, about 3 years ago Mr. Barth testified before the Small Business Committee and the Finance Committee concerning a very real problem that many of our clients were facing. Let's use the example that he used.

An ambitious entrepreneur by the name of John Heath developed a thriving small company. Plant facilities were expanding, new jobs were being created, the economic well-being of his community was enhanced by the operation of this company.

After about 30 years or so of hard work, John decided for various reasons that he needed to improve the liquidity of his estate, and he decided to sell his company. Several prospective buyers expressed interest. The first purchaser was an individual who shared John's interest and pride in operating a small business entity, and he offered a good cash price for his stock. If he had been the successful bidder, it was likely that few changes in personnel or in the nature of its operations and its present location would have occurred.

Another prospective purchaser was another small business company which wished to acquire John's product line and productive capacity to complement its own. Much the same as the individual purchaser, this company offered a cash price and looked forward to continuing the operation with as little change as possible.

The third purchaser, and I think this is really the essential point in the story, was XYZ compnay, a publicly held company, and its representative emphasized the fact that there was a very significant tax advantage if John negotiated an exchange of his stock for stock of the acquiring company.

The alternatives that John faced were not at all unique. He could either make a taxable sale to the first two purchasers who would be likely to continue the operations as John had wanted them, or on the other hand, he could exchange on a tax free basis with XYZ, and it was quite likely that the operation of his company would eventually disappear into the larger company.

Purely from a tax viewpoint, he would probably be better off to make the tax-free swap, but we think there is a basic inequity in this situation which is addressed by this bill, that really puts the firxt two purchssers at a substantial disadvantage in negotiating for the acquisition of John's stock. The only consideration they could offer was cash or a promise to pay some other type of consideration, and present law would clearly hold that this would be taxable. On the other hand, XYZ can offer its stock on a tax deferred basis.

Senator Haskell's proposal would alleviate this problem to a considerable extent. It would permit John to sell his sotck to either of the first two purchasers, receive cash or similar types of consideration without paying current taxes, but it would require that he reinvest the proceeds in another small business concern to avoid current taxation.

We support the objective of this bill but do question whether the reinvestment should be limited to other small business concerns. If the major purpose of this legislation is to put purchasers who are not in a position to negotiate a tax free exchange on the same basis as a large company which can, we do not think a limitation like that now contained in the bill is appropriate.

We are running out of time. Two final points here. We do understand that certain modifications are under consideration to the original proposal. I would like to express our views on them We understand. that consideration is being given to extending the benefits of the bill to venture capital companies and small business investment companies, in addition to individual taxpayers as it now reads. We concur in the expansion of the proposal since the objectives of these two types of taxpayers seem to us consistent with the intent of the proposal. We also understand that a qualification that would limit the benefits of the proposal to shareholders who own 10 percent or more of the small business concern would be added. We would generally agree with this change because we think the rationale behind the proposal is to permit persons who wish to acquire control of a small business company to negotiate on an equal basis with a large corporate purchaser.

We appreciate very much the chance to appear before you this morning, and will try to answer any questions you might have.

Senator HANSEN. Senator Haskell?

Senator HASKELL. Mr. Penick, the reinvestment provision of the bill provides that to defer taxation you must reinvest in a small business asset. Now, the purpose, obviously, is to try and keep as much capital as possible in the small business sector. That is the purpose.

Do you think that if the bill were enacted with that type of provision it might be posssible to develop a mutual fund market in small business concerns?

Mr. PENICK. I am going to defer to Mr. Barth. He is really our small business expert.

Senator HASKELL. Mr. Barth?

Mr. BARTH. I think it would be possible, yes.

Senator HASKELL. Let's go a little further. Do you think it would be probable?

Mr. BARTH. I believe the type of person that we are really concerned about is the owner of the business who has put his whole life into it and it has been hard work. Now he would like to see the business continue the character that he has established.

For that individual at a late stage in life, he might well be better off to go into securities of large companies or investments where there is more stability. I am thinking of the man in the retirement years. We know that for investments in small companies the risk is greater, and that is one of the reasons I feel a little hesitant to say that the client we spoke of here would be anxious to invest in a mutual fund where he is going back into the risk game. He has passed that period of life.

Senator HASKELL. Well, you, I gather, Mr. Penick, would really just forget about taxing the gain on the sale of the small business. Is that your viewpoint?

Mr. PENICK. No, not at all. I think there should be some reinvestment requirement and perhaps it should be limited to securities, but I go back to——

Senator HASKELL. Then what is your objection? I guess I missed it.

Mr. PENICK. My objection really is limiting the reinvestment to securities of another small business.

Senator HASKELL. So you would merely treat a sale for cash the same as a stock swap with only the proviso that the seller for cash go into the securities market in one form or another.

Mr. PENICK. And keep it there. If he pulled it out he should be taxed.

Senator HASKELL. Well, I am concerned about the younger man who is starting up a new small business,who has an almost impossible time getting equity capital or even debt at a decent interest rate. I am interested in trying to find a larger pool of debt or equity capital for that man, and that is why I limited the reinvestment.

But you gentlemen would not think that very meritorious, I gather.

Mr. PENICK. Well, we think it is meritorious, and we think the concept behind the proposal is highly desirable, but we think it would be more meritorious, if that is a good way to describe it, if it were expanded to permit an investment in other than small business concerns.

I think you really have conflicting objectives here, to some extent.

Senator HASKELL. The only trouble is, if you do it your way, you are not increasing the pool of investment capital available for the younger man in the small business. Now, that, I think you would have to admit.

Mr. BARTH. That would be true unless the man who sold out found a small business operated by a younger man whom he was willing to support.

Senator HASKELL. I see.

Well, let me ask you this.

One of the things that concerns me is that the present law which provides a tax free stock swap, clearly favors concentration of industry.

Mr. BARTH. There is no question.

Mr. PENICK. Absolutely.

Senator HASKELL. And that is one of the things I am trying to get away from because I don't happen to feel that concentration is a desirable economic result.

On the other hand, if we allow the seller of a small business to sell out and then invest in what you call more secure equity securities, I presume that would unfortunately dilute one of the basic purposes of the bill. So I don't know whether the objective would be accomplished or not.

Mr. BARTH. Senator, it would under your concept somewhat dilute the purposes of the bill. I would suggest this, however. Our proposal would make is possible for the individual who wants to see his company continue as a small business and who wants his plant and the employment it represents to remain in the same community to achieve these objectives; it will permit the company to be sold to another small proprietor on an equitable basis. We are not suggesting any special favors for investors in small businesses. We are merely suggesting equal treatment.

Senator HASKELL. Well, of course, you are correct. It would allow the plant to be sold to another individual who would operate it in the same way, and it would keep the local character. So your suggestion as an amendment is a deferral of tax, even though the transaction is cash, provided there is a reinvestment in "the securities market". Then, of course, when you start selling those reinvested securities, I suppose that ends the tax deferral?

Mr. BARTH. Right.

Senator HASKELL. I–get your viewpoint. I am not sure I concur with it, but I get it.

Thank you very much indeed.

Senator HANSEN. Thank you, Senator Haskell, and thank you, gentlemen, for your appearance here. I should have noted that any written testimony will be printed in its entirety in the record, and we appreciated your summarizing your statement.

[The prepared statement of Arthur Anderson & Co. follows:]

STATEMENT OF ARTHUR ANDERSEN & CO.

INTRODUCTION

The appropriate method for taxing gains on sales of assets held for investment has been a subject for debate for many years. The impact of changes enacted in 1969 and subsequently, when combined with the high rates of inflation we have experienced in the last five years, have recently refocused attention on this important subject of taxation. We commend the Subcommittee on Taxation and Debt Management for scheduling these hearings to determine what changes should be considered at this time.

SUMMARY OF ARTHUR ANDERSEN POSITION

In our Firm's testimony before Congressional Tax Committees over the last several years, including hearings by this Subcommittee on April 24 of this year, we have expressed our great concern about the combined effects of inflation and taxation on the capital needs of the United States. Inflation has significant impact on many aspects of our tax system, but it is particularly important in the taxation of gains on sales of assets held for long periods of time. This is one of the most important problems to be considered in determining the appropriate method for taxing capital gains in the U.S. tax system.

There are two fundamental issues in the taxation of capital gains. First is the determination of the appropriate amount of gains to be taxed. This is where the inflationary element in such gains become so important. We believe that, in any system for taxing capital gains, the starting point should be the determination of the economic gain realized by the taxpayer, and then to decide what taxes should apply to that gain.

Second, because of the importance of capital gains taxation to a taxpayer who is considering making an investment, particularly in equity securities or venture capital entities where there is a high degree of risk, the amount of tax to be applied to the gain should recognize some incentive for the taxpayer to invest or at least minimize the disincentive created by high taxation of such gains.

It appears, therefore, that our tax policy in the area of capital gains should consider those two factors, the determination of the amount of gain to be taxed, and the type of tax incentive to be provided for the investment that may ultimately create that gain.

While the specific bills under consideration at these hearings would not in our view completely recognize these factors, nevertheless, they do relieve partially the burden of capital gains taxation which has acted as a deterrent to many investments, and we generally support them.

We are particularly pleased to support the proposal that would permit tax deferral treatment on sales of investments in small business concerns so long as proceeds are reinvested. Small business entities have unusually severe problems in meeting their capital needs and our present system of taxing capital gains is particularly burdensome on them. The approach advocated by Senate Bill 2428, introduced by Senator Haskell, is somewhat similar to a proposal made by our Firm nearly three years ago, and we are gratified that this concept is now being given serious consideration by your Subcommittee and by the Congress.

IMPACT OF CAPITAL GAINS TAXATION ON CAPITAL NEEDS

The needs for capital in the United States in the next few years have been well documented, frequently reported and widely discussed. Studies of capital availability to meet these needs indicate a very substantial "capital gap" for most of the foreseeable future. Aside from the need to stimulate the development of new sources of capital, and in particular to encourage people who own capital to invest it for productive purposes, sound tax policy requires that we be concerned about preserving the pool of capital already available. The present U.S. system for taxing capital gains both erodes the existing pool of capital and acts as a deterrent to switches in capital from one form of investment to another more productive use.

Our present system for taxing capital gains to an individual may involve three levels of taxes. First, the gain itself is taxed at rates that reach 35%. Second, one-half of the gain may be taxed as preference income at a 15% rate. Finally, the preference element may be offset against personal service income, causing it to be taxed at rates up to 70% rather than 50%. As changed by the Tax Reform Act of 1976, a reduction in preference income is permitted for one-half of the regular taxes paid. The combination of these three elements results in an effective Federal capital gains tax rate on individual taxpayers that can reach nearly 50%.

Furthermore, if a taxpayer lives in a high-tax location such as New York City, additional state and city taxes on capital gains of nearly 14% may be imposed. If the taxpayer is in the maximum Federal tax bracket of 70%, the deduction for state and city income taxes could reduce his Federal taxes by about 10% of the gains, but an added effective tax of 4% on such gains would result.

These high levels of taxes have served as a deterrent to new capital investment, particularly in equity securities and high risk ventures. Furthermore, no adjustment is presently permitted to recognize the inflation element in gains on sales of assets held for long periods of time, and this is not sound tax policy.

The present Administration has proposed that our system for taxing capital gains be made even more burdensome. It proposes (1) the elimination of the alternative capital gains tax (presently limited to 25% of the first $50,000 of gains) and (2) the complete elimination of the offset against preference income for one-half of the regular taxes paid. A maximum offset of $10,000 would be permitted. These changes would increase the maximum effective Federal tax rate on capital gains to roughly 52%.

At a time when there are concerns about capital requirements and particularly the need to encourage investment in equity securities with the risks that are inherent in them, it does not seem appropriate to increase taxes on capital gains. If anything, particularly for assets subject to inflationary pressures over long period of time, prudent tax policy would require that capital gains taxes should be decreased rather than increased. Accordingly, we support the objectives of bills such as those under consideration by this committee that would in one manner or another decrease the overall burden of capital gains taxation.

TAXATION OF CAPITAL GAINS BY OTHER COUNTRIES

While the tax policies of other countries should not control those in the United States, they should be of some interest to persons concerned with U.S. tax rules It is interesting to note that most major countries that do have relatively low effective taxes on capital gains generally enjoy a much higher rate of savings and capital investment in relation to the size of their economies than does the United States.

Attached as Appendix A is a brief summary of the methods of taxing gains on sale of securities and real estate in Belgium, Brazil, Canada, West Germany, Japan and the United Kingdom.

Gain on sales of securities

Belgium, West Germany, and Japan generally exempt capital gains on sales of securities from individual income taxes. Brazil applies a 10% tax to such gains while Canada and the United Kingdom tax them at reduced rates.

Gain on sales of real estate

Brazil exempts from tax gains from "casual" sales of real estate, while Belgium and West Germany exempt such gains if the property has been held more than eight years or two years, respectively. Canada, Japan, and the United Kingdom exempt the gain on the sale of a private residence although Japan places a ceiling (currently 30 million yen, or about $145,000) on the amount of gain that is exempt.

PARTICULAR NEEDS OF SMALL BUSINESS ENTITIES

Small businesses have for generations been the backbone of the American economic system. It is presently estimated that small business entities provide jobs for well over 50% of our non-public workers. Although it is often characterized as labor intensive in contrast with the capital intensive nature of larger companies, small business must attract enough capital to provide employment opportunities. In most small business entities a little capital may go along way towards keeping citizens off the unemployment rolls. Alarmingly, however, the Small Business Administration has reported that a steadily decreasing percentage of total capital investments is being directed to the small company sector.

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With the combined impact of increasing capital gains taxes and the fact that our present system for taxing capital gains does not adjust for or eliminate the inflationary element in such gains, it is little wonder that the small business sector has particular difficulty in attracting and retaining the capital needed to start new business entities and finance the expansion of mature ones.

DISCUSSION OF SPECIFIC LEGISLATIVE PROPOSALS

Investment Incentive Act of 1978 (S. 3065)

This proposal would change completely the current U.S. system for taxing capital gains and would in effect return to the rules that were applicable prior to adoption of the preference tax system enacted in 1969. For both individuals and corporations, it would (1) eliminate capital gains as a preference item, and (2) impose a top tax rate on such gains of 25%. We favor the reduction of the impact of capital gains taxes, and proposals like those contained in S. 3065 clearly work in that direction. Accordingly, we are pleased to support this proposal.

As noted earlier, present law would tax capital gains at rates that can reach nearly 50%. By cutting that rate in half, a significant stimulus to business investment will have been provided. In particular, investment in equity securities should be more attractive and the alarming trend toward greater reliance on debt financing should be reversed. While econometrics analyses are not within our area of practice and competence, commonsense tells one that increased investment activity would tend to increase long-term tax revenues. It seems most unlikely that taxpayer behavior after a major tax change such as this would be the same as before.

The substantial reduction in capital gains taxation would assist greatly in encouraging investment in new equity securities and in venture capital activities where substantial risks are involved. A potential investor is concerned with the likely return on an investment in choosing among alternative investment opportunities. Investments in new equity securities and in venture capital situations do involve greater risks and investors expect higher rates of return in an attempt to compensate for that factor. A significant element in determining rate of return is the amount of taxes that will have to be paid both on current income from the investment and on the gain on its disposition when the taxpayer decides to dispose of it. Capital gains taxation is a very significant factor in this equation, and a reduction in the effective tax rate such as would result from proposals like Senate Bill 3065 should make these types of investments much more attractive.

Another important benefit of this legislative change would be to greatly simplify the tax laws, particularly the preparation of tax returns, for many thousands of taxpayers who have capital gains each year. The principal impact of the preference tax system has simply been to increase the effective tax rate on capital gains. Since its enactment in 1969, more than 80% of all preference items subject to the tax have been represented by capital gains.

Furthermore, preference items are required to be offset against personal service income in determining the maximum tax to be applied to that income. The combination of preference tax reporting and the calculation of tax on personal service income results in a highly complex reporting system for many taxpayers. Proposals like S. 3065 that would remove capital gains as a preference item would greatly simplify tax reporting for the thousands of taxpayers who are affected.

Graduated exclusion for long-term gains and graduated nonrecognition of long-term losses for individuals (S. 2608)

Present law permits individuals to exclude from gross income 50% of the net gains from sales of capital assets held for more than twelve months. S. 2608 would increase this exclusion percentage by 2 percentage points per year for each year after the first twelve month holding period but not to exceed 80%. The proposal would also provide for non recognition of an equal percentage of losses on sales of assets held for more than twelve months. The purpose of these provisions is to provide some relief from the taxation of gains on sales of assets held for long periods of time which are particularly vulnerable to the impact of inflation. The proposal affecting capital gains works toward this objective,but the change with respect to capital losses does not appear to do so.

Inflation has significant impact on investments generally but in particular on those that are held for long periods of time. If a person invests $10,000 in year one and, by the end of year five, the purchasing power of those dollars has declined by 40%, even though the value at the end of the fifth year may be greater

than $10,000, he has not realized an economic gain based on his initial investment of $10,000. For example, if he sells the asset at the end of the fifth year for $18,000, present law starts from the base on an $8,000 gain, and one-half of that amount, or $4,000 ,would be taxed. Under S. 2608, the starting point is again an $8,000 gain of which 58% would be excluded and 42%, or $3,360, would be taxed.

A more appropriate method of recognizing the impact of inflation would appear to be an adjustment to basis for the change in the value of the currency in which the investment is stated. Specifically, the $10,000 invested in year one would have increased to $14,000 by the end of the fifth year, based on the change in the purchasing power of those dollars. If the asset is sold for $18,000, the "economic gain" would therefore be $4,000 and applying the present 50% exclusion factor to that amount would result in the taxation of $2,000.

Several different methods of calculating the inflation element in the gain on sales of assets have been proposed, including the use of current value or replacement cost data and applying a different type of inflation factor (or index) for different types of assets. From a theoretical viewpoint, these approaches might be more accurate, but they would introduce highly complicating and subjective factors into the determination of the appropriate amount of gain to be taxed. Accordingly, some type of index that is generally available and is recognized as a reasonable measure of the amount of inflation that has occurred, such as changes in the Consumer Price Index or the GNP deflator, would be workable and useful in reaching a practical solution to the problem of determining the gain that should be subject to tax.

Accordingly, while we agree with the objective of proposals such as S. 2608 that attempt to eliminate from taxation gains caused by inflation, we believe that a procedure that would adjust the basis of the ssset, which represents the taxpayer's investment in it, would more appropriately recognize the inflationary element than an increasing scale of exclusions applied to the amount of gain realized.

Furthermore, since the objective of this proposal is to recognize the inflationary element in capital asset transactions, we do not understand the rationale supporting lesser recognition of losses on assets held for long periods of time. Referring to the example noted above, the taxpayer's original investment of $10,000 in year one currency represents an investment of $14,000 in year five currency. If he sells the asset for $8,000 at the end of year five, he has really suffered an economic loss of $6,000. Neither present law nor the proposed amendments to Code Sections 1202 (b) and (c) contained in S. 2608 give appropriate recognition to this situation. S. 2608 would reduce the amount of loss recognized to $840 rather than $1,000 under present law.

Small Business and Farms Capital Preservation Act of 1978 (S. 2428)

This bill, which was introduced by Senator Haskell in January of this year, proposes a unique change in the tax treatment of sales of small business investments, where the proceeds of such sales are reinvested in similar types of investments. This is sometimes referred to as a tax free rollover approach. We favor legislation of this type since it recognizes an increasingly serious problem for small business entities and for our economic system.

Attached as Appendix B to this statement is a copy of testimony submitted by Mr. William D. Barth, Director of Industry Competence—Small Business for our Firm, before a joint meeting of the Senate Select Committee on Small Business and the Senate Finance Committee on September 24, 1975. In that statement, Mr. Barth discussed a hypothetical situation involving a small company which has reached the stage in its development where the founder and principal owner has decided to dispose of his investment primarily for personal reasons. He has basically two options, first a sale for cash or similar consideration that would generate taxable gain. Second would be a merger transaction with a major company which could be structured on a tax-free basis. For various reasons, the owner would be attracted to a tax-free transaction so that the total value of his investment could remain intact without the erosion of current taxation.

The suggestion made in that testimony was for a tax deferral privilege on an otherwise taxable sale of a small business investment, so long as the proceeds of the sale were reinvested within a limited period of time. That is the essence of S. 2428, and we are pleased to support it.

The present tax rules encourage dispositions of businesses like these on a tax-free basis, and this has resulted in greater concentration of smaller businesses into larger entities. This places others who want to invest in existing small business

entities at a serious disadvantage, particularly for employee groups who may wish to carry on a business when the founder and principal shareholder decides that he wants to dispose of his interest.

In the typical situation where the founder and principal shareholder of a small business concern wishes to dispose of his stock, employee groups or other "entrepreneurs" who might be interested in continuing the small business activity are not in a position to offer readily marketable securities in exchange for such stock. Generally speaking, the only consideration they can offer is cash and/or promises to pay for the investment over a period of years. From the seller's viewpoint, the receipt of cash and other consideration like notes does under present law create a taxable profit, even though under certain conditions taxation of that profit may be deferred under the installment reporting method until cash has actually been received. This is usually not as attractive to the seller as an exchange of assets or securities for securities of a listed company where tax can be deferred as long as those securities are held. This places the employee group or the small business entrepreneur who wishes to acquire the business at a significant competitive disadvantage in negotiating the transaction. This seems bad tax policy, since as noted above it creates a strong incentive for the merger of small companies into large ones and a greater concentration of economic wealth into larger entities.

Looking more specifically at S. 2428, we urge that the definition of a "small business concern" be included directly in this legislation rather than by reference to Small Business Administration regulations. Since this is such an important part of the concept, it is desirable that the requirements for qualification under this section be clearly set out in the statute. Regulations and interpretations of laws administered by another government agency may change from time to time, and we believe that the tax statute controlling these transactions should be specific on this point.

While we agree with the concept of the proposal that would extend nonrecognition treatment to reinvestment in similar types of small business concerns, we question whether it should be limited to that extent. An underlying problem addressed in our original proposal nearly three years ago was that, in disposing of a small business interest, an entrepreneur could obtain nonrecognition treatment by entering into a tax-free reorganization in which his small business is acquired by a publicly traded corporation. The objective was to provide similar nonrecognition on the sale of a small business interest to another entrepreneur in a transaction that would probably involve cash and notes, because this is usually the only form of consideration available to such a purchaser. We continue to believe that this concept is valid and that a limitation of nonrecognition treatment to situations where the reinvestment is in another small business concern is based on the inappropriate merging of differing tax objectives.

Appendix A

Capital Gains Taxation by Selected Other Countries

Belgium

1. Gains from sales of securities are generally exempt from personal income tax, except for shares of Belgian companies when a taxpayer, alone or through his immediate relatives, owns or owned at any time during the five preceding years at least 25% of the shares of the company which are being sold.
2. Capital gain from a sale of land is tax exempt if the real property is held for more than eight years. In the case of land located in a residential area, the holding period is 16 years.

Brazil

1. Capital gains from the sale of securities are generally subject to 10% withholding.
2. Gains from casual sales of real estate are not taxable. Casual sales occur when there are less than three sales in one year and less than six in the current plus prior two years.

Canada

1. The first $1,000 of interest, dividends and capital gains (aggregated) received by an individual is exempt from the individual income tax. Related interest expense is deducted from interest and dividends to determine the net amount qualifying for exemption.
2. One-half of capital gains is included in income and one-half of capital losses may be offset against the portion of capital gains included in income.
3. Gain realized on the sale of a taxpayer's principal residence is tax exempt.

West Germany

1. Gains from the sale of privately owned securities held more than six months are generally exempt from the individual income tax. Partnership interests or securities of a corporation in which the taxpayer has owned more than 25% at one time during the last five years before the sale do not qualify for exemption.

2. Gains from the sale of real estate held for two years or more are generally exempt from the individual income tax.

Japan

1. Capital gains on the sale of securities are generally exempt from the individual income tax.

2. The gain realized on the sale of the taxpayer's residence can be offset by a deduction of 30 million yen, or about $145,000.

United Kingdom

1. Capital gains are generally taxed at 30%, but relief from this tax is available for persons with small incomes and small realized gains. Their tax is assessed at only one-half the basic tax rate or 34% instead of the normal 30% capital gains tax.

2. On the sale of an interest in a unit or investment trust, a credit of 17% of the realized gain applies against the tax payable. The combination of this incentive (1) above means that gains on the sale of interests in unit or investment trusts, an investment medium traditionally popular with the small saver, are not taxed.

3. Gains realized on the sale of government securities held for more than one year are exempt from income tax.

4. Gain realized on the sale of a taxpayer's principal residence is tax free.

5. Gains on the sale of a private business by an individual upon retirement are exempt from tax. The amount of exemption is dependent upon the age of the retiree; the maximum is $20,000, or about $37,000, at age 65.

APPENDIX B

STATEMENT OF WILLIAM D. BARTH, DIRECTOR OF INDUSTRY COMPETENCE—SMALL BUSINESS, ARTHUR ANDERSEN & CO.

Before: Joint meeting of Senate Select Committee on Small Business and Senate Finance Committee.
Subject: Small Business Tax Reform.
Date: September 24, 1975.

Utilizing his entrepreneurial talents supported by an intimate knowledge of each facet of his business, John Health developed a thriving small company. Plant facilities were expanded, new jobs were created, and the economic well-being of the community was enhanced by the presence of this successful closely held company.

John's desire to enjoy the rewards of nearly thirty years of hard work and to improve the liquidity of his estate led him to the decision to sell his company. Once this decision became known, three prospective buyers indicated a desire to enter into negotiations for its purchase.

The first purchaser, an individual, found John's company much to his liking, and offered a good cash price for it. It was his intent to continue the operation in its present location, wishing to avoid changes in personnel at all levels of the organization.

The second prospective purchaser was a small, closely held company which wished to acquire John's product line and productive capacity to complement its own. Much the same as the individual purchaser, the small acquiring company offered a cash price, and looked forward to continuing the operations which John developed with as little change as possible.

A third prospective purchaser was XYZ Incorporated, a publicly held company whose representative emphasized that there was a significant tax advantage which John could realize should he dispose of his company for stock of XYZ.

Seeking counsel, John learned that the sale of his company to the individual purchaser for cash would trigger a substantial capital gains tax; thus, such a sale would be costly. The same consequences would result should John receive cash as consideration from any other purchaser, and since there was no market available for the disposition of the stock of a closely held company, cash was the only practical medium of exchange should John sell to a small company, the

second prospective purchaser. John then learned that by transferring his stock to XYZ in exchange for shares of that company, he would not effect a taxable transaction as the stock he received would take the cost basis of the stock he surrendered. Clearly, the representative of XYZ was correct when he indicated that he held a significant competitive advantage over the individual or the small company.

The foregoing information was particularly distressing to John as for years he had planned to pass-on his business to a purchaser who would continue the character of the business as John had molded it. His concern for his long-time employees in the plant and for the members of his management team, which is common among the proprietors of closely held companies, caused him to fear that XYZ might decide to combine the operations of his small company with one of XYZ's divisions, thus uprooting the company from the community and from its labor base.

If the story of John Heath represented merely an isolated incident, the consequences would not be very important to our total business community. But John Heath's predicament is being experienced each day of the year in every state of our nation. My associates and I routinely counsel the owners of small companies faced with the same painful decision that John encountered. Abandoned plants and local pockets of unemployed bear witness to the possible consequences of an ill-advised transfer of company ownership.

Simply stated, our tax rules relating to the disposition of corporate interests militate against small companies perpetuating themselves; on the contrary, they contribute significantly to the concentration of power in fewer companies which thus become even larger with the passage of time. If you believe, as I do, that small business is the cornerstone of our free enterprise system, then it is blatantly incongruous to continue to make it disadvantageous for the owner of a small business to convey the ownership of his business to another small businessman simply because he must pay for his purchase in cash, rather than stock. Isn't it ironic that the advocacy of employee ownership is in vogue, yet the employees, whether in a small group or represented collectively by an ESOP, must bargain at the same disadvantage as any other purchaser who has only cash to offer.

As a means of correcting this inequity, may I suggest that the selling shareholders of a closely held company be permitted to carry over the tax basis of their respective interests to such assets as are acquired within a limited time frame by application of the proceeds received from the sale. (You may recognize the similarity between such a plan and the opportunity now available to defer the payment of taxes on the sale of a personal residence.) It is further suggested that proceeds of sale of a closely held company not reinvested within the allowable time period would be subject to tax at reduced capital gains rates, the lesser rates giving recognition to the impact of inflation. In the event cash proceeds of sales are invested in another closely held business, the tax-deferral privilege should again be present upon the disposition of the succeeding business.

While the term "closely held" requires definition and other circumstances requisite to the transaction require formalization, the objective of this proposal should be self-evident. My belief that a successful small business means jobs and industry within a community often without a larger employer, my belief that small business should not be the victim of tax discrimination, my belief that to maintain our position as a leading industrialized nation we cannot afford to suppress the entrepreneurial talents of our people—these are but some of the more obvious reasons for asking for equal opportunity for the small entrepreneur.

Senator HANSEN. The committee will stand in recess, and we will convene at 2 p.m. in this room.

[Whereupon, at 1:09 p.m., the subcommittee recessed, to reconvene at 2 p.m. the same day.]

AFTERNOON SESSION

Senator HANSEN. The hearing will come to order.

A very distinguished citizen and a person who has been active in government and involved in this country's important actions for many, many years, involving both Republicans and Democrats alike, is our next witness, and we are very pleased to welcome to the witness table the Honorable Thomas Corcoran.

STATEMENT OF HON. THOMAS G. CORCORAN, ACCOMPANIED BY ALLEN E. THROOP

Mr. CORCORAN. Thank you, Senator, and thank you for letting me testify before the committee.

My name is Thomas G. Corcoran, a practicing lawyer in Washington, D.C. For this appearance I am not on retainer for a particular client.

I am cutting my prepared statement in order to save time, and also because many witnesses, particularly the Chairman of the Securities and Exchange Commission, have in substance agreed with what I have had to say and have supplemented the testimony I would give.

Senator HANSEN. Your entire statement will appear in the printed record, as I am certain you know, and we would be pleased to have you proceed in whatever fashion best suits your purposes.

Mr. CORCORAN. Thank you very much, Senator.

Mr. CORCORAN. I appear in support of the principle of S. 2608, introduced in the Senate by Senator Hansen and Senator Bentsen. This bill would amend the Internal Revenue Code of 1954 to provide for individuals, not corporations, a graduated exclusion from gross income for long-term capital gains, and a graduated nonrecognition of long-term capital losses, increasing by 2 percent a year the present exclusion from taxable income of 50 percent of a capital gain.

Affected would be all capital assets, representing long-range earnings of the average man, including farms, ranches, homes, personally owned businesses, employee's ownership of any kind in an employer's business, like the Sears, Roebuck employee stock ownership plan, and securities in publicly owned businesses, and it applies by its terms only to "taxpayers other than corporations."

Senator Hansen, I think this bill would answer exactly the problem that was presented by you today as to that lady from Wyoming who sold her ranch. Although S. 2608, as submitted, provides for increasing by 2 percent a year after 1 year the present exclusion from taxable income of 50 percent of a capital gain, I would suggest, in view of criticisms that have been made, that the beginning of a scale down begin at the end of 5 years, with proper gradations of say 3 percent a year to achieve whatever results for subsequent years your committee may decide. This downward gradation, beginning only after 5 years of holding, greatly reduces the ultimate cost of the Treasury, if there is any, over the cost suggested by your staff, and it meets the objection that, if the holding were only 1 year, it would be easier for people to try to contrive the transformation of short-term income into capital gains.

This committee is no stranger to the concept of the Hansen-Bentsen bill, providing for a downward gradation in the percentage of recognition of long-term capital gains. When the Tax Reform Act of 1976 was under consideration, the Senate Finance Committee, your committee, agreed to an amendment proposed by Senator Long which would provide a sliding scale for capital gains whereby capital assets held for more than 5 years, as we now suggest, would be taxed on successively smaller amounts of realized gains. The Senate did not accept that committee amendment in 1976. But now, 2 years later, the reasons for such an amendment are much more apparently compelling.

And might I say that I do not think there was any President of the United States under whom I served who was more concerned with equity as between big cats and little cats than Franklin Roosevelt. And yet in the 8 years before the war came on, just such a long-term graduated capital gains tax was enacted in the time of Roosevelt and continued until ended by the war. So that I don't see how any President of the United States could object to this principle of capital gains reform unless he thinks he is in a more sympathetic mood to the needs of the country than was Franklin Roosevelt.

I recognize that this hearing has been called to consider both S. 2608 and your other bill, Senator Hansen, S. 3065. Regardless of the merits of S. 3065, with which I agree, S. 2608 has independent merit. S. 2608 benefits both the past and the future of true long-range investor, whether he is a fat cat or a thin cat. S. 2608 offsets the inroads of inflation on capital already invested. Its treatment of long-range gains, beginning at the end of at least 5 years of holding and ending possibly at 20 or 25 years, would in part avoid penalizing the seller of a past or a future long term investment for the continuing decline in the purchasing power of the dollar invested, as compared with the dollar received on the sale.

S. 3065, the Hansen bill, not only reduces by 50 percent the taxable portion of any gain realized after 1 year, but also places a tax ceiling of 25 percent on all such capital gains without the present limit of $50,000. If this committee, in approving the across the board 50-percent provision of S. 3065, should still determine, although I hope they will not, that a ceiling of 25 percent should not be established, urge that the committee consider combining the 50-percent exclusion of S. 3065 with a graduated increase of that exclusion as provided in S. 2608. This will provide some current incentive to long-range investment in the future, and provide a partial offset to the inroads of inflation on capital already invested.

Such incentive for future long-range investment is important because of the time required for the building of a plant and the taking of the bugs out of any new process.

The benefits to the economy from such long-term investment legislation would be:

(A) to remove any tax barrier to the mobility of capital upon the owner's exercise of his option to sell; at the same time encouraging voluntary long-term investment of equity capital in developing venture enterprises, so that an investor's transactions are determine investment considerations rather by inflation and tax considerations.

(B) To maintain the waninng supremacy of United States industrial technology—the export of whose products must increasingly compensate for growing dependence on foreign raw materials—with particular encouragement of the investment of equity capital in new industrial research and technology, where the United States faces increasing competition from foreign nations who have little or no capital gains tax. The Secretary of the Treasury himself, within the last month, faced this problem and said, "Our technological supremacy is not mandated by heaven," and recognized that something would

have to be done to maintain such supremacy. The problem is how much time is there in which to do it.

(C) Another benefit would be to provide correlative protection of United States labor's job opportunities in United States industry against foreign competition.

(D) A fourth benefit would be to encourage investment in equity capital so as to further the creation of new plants and of research by American industry, thereby expanding its efficiency and productivity and so by increasing the amount of goods available benefiting the consumer in his fight against inflation.

(E) And a final benefit would be to provide the American long-range investor with an incentive comparable to that provided foreign investors.

No matter what other considerations have to be taken into account in the review of tax policy, there are two areas which are of top concern.

First, there is the certainty that if the United States, unlike England—once an industrial nation—is going to remain an industrial nation with increasing employment opportunity, rather than a service nation with decreasing employment opportunity, we have to begin thinking now about the mules that pull the wagon of jobs and labor productivity under the conditions of modern and international economic life. In the industrial field the relation of capital investment to everything else has completely changed in 10 years. Once it was understandable to say that money earned by money should not be taxed more favorably than money earned with hands. But the industrial technology and its labor correlative have now passed the point where, in the beginnings of our industry, immigrant hands could produce steel with comparatively modest investment in machinery.

The displacement of U.S. manufactured goods by products of technologically superior factories created by adequate capital investment and research, in countries like Germany and Japan, shows clearly that the disappearance of work for hands is a consequence of insufficient capital investment in plants and research. Unused labor in U.S. plants today may be substantially related to the unused capacity of plants which are technologically inadequate if not obsolete.

Now, the mule that pulls the wagon is any American who saves and invests money; and any investor who in any field creates capital is somehow adding to the economic strength of this country. Foreign countries who are competing so successfully with us in technology much of which has been acquired from us, suffer little or no impediment in the obtaining of venture capital by reason of any impact of their tax laws. As shown by the attached schedule, most of the world's industrial countries have no capital gains tax, and the tax rates of the others, the United Kingdom, Sweden, and Canada, are much less than ours.

Such tax treatment obviously fosters long-term capital investment in those countries.

[The following was subsequently supplied for the record:]

CAPITAL GAINS TAXES IN OTHER COUNTRIES

Country	Top rate	Holding period
United States	Just over 49 percent [1]	1 yr.
Australia	Exempt	1 yr.
Belgium	do	None.
Canada	22 percent [1]	Do.
Germany	Exempt	6 mo.
Italy	do	None.
Japan	do	Do.
Netherlands	do	Do.
Sweden	23 percent [1]	2 yr.
United Kingdom	30 percent	None.

[1] Excluding State and local taxes.

Note: An editorial in the Wall Street Journal of May 8, 1978, had the above information as to capital gains taxes in other countries.

Mr. CORCORAN. The second area of concern is the effect of inflation, as related both to the fairness of treatment of long-term investment already made and its relation to the willingness of the future investor to incur the risks involved in new long-term investment, with the consequent effect upon future employment and labor productivity. Irrespective of administration hopes and efforts, the American investor remains uneasy at the prospect of continuing inflation. It takes years to build a new plant or to bring a new enterprise to the profit stage. A risk which is tolerable at present costs is therefore likely to be avoided by the prudent entrepreneur, whether he is a small man risking his everything or the conservative research department of a big corporation.

Certainly, if in the deliberations of this committee, there is no inflation relief for the existing long-term investor, there is going to be little enthusiasm for long-term ventures by new investors. Therefore, I urge that S. 2608, Senator Bentsen's bill, in which you, Senator Hansen joined, with the suggested revision under which benefit would begin only after 5 years of holding, be considered a starting point in combating inflation by providing incentive to increasing long-term investment for greater U.S. employment and labor productivity to combat inflation.

Senator HANSEN. Thank you very much, Mr. Corcoran. I think that is a very impressive statement.

I know Senator Packwood has joined us here, and do you have any questions?

Senator PACKWOOD. I have nothing to add to that statement. I like it.

Senator HANSEN. I don't have anything, either. I just hope everybody in America gets to hear it. It is excellent.

I know with you is Mr. Allen Throop. Does he have any statement he would like to make?

Mr. THROOP. Thank you very much. No, thank you.

Senator HANSEN. Well, I appreciate tremendously, more than I can say, your appearance here today.

Mr. CORCORAN. Thank you, sir.

Senator HANSEN. Thank you, sir.

[The prepared statement of Mr. Corcoran follows:]

STATEMENT OF THOMAS G. CORCORAN

SUMMARY

Along the lines of Senator Bentsen's bill, S. 2608, this testimony suggests a graduated decrease in the capital gains tax depending upon the years an asset is held, which it is proposed would begin in the fifth year and end in the 20th year. The principle of such graduated treatment for long-term capital gains has earlier been accepted by this Committee in an earlier introduction of Senator Bentsen's bill revised by Senator Long in a proposed amendment to H.R. 10612 and considered in the Tax Reform Bill of 1976. The ideas incorporated in S. 2608 are a re-utilization of provisions of an act of 1934 which taxed capital gains on a scale graduated downward to 30 percent after a ten year holding period. Such Bentsen bill, with such amendments and such correlation as the Committee considers appropriate with the Hansen bill, S. 3065, and the Steiger bill in the House, H.R. 12111, is supported for the following reasons:

(1) Affected would be all capital assets representing the average man's long range savings, including farms, homes, personally owned businesses, employees' ownership of any kind in an employer's business, and securities in publicly owned businesses.

(2) Such long term treatment would in part compensate the seller for the continuing decline in the purchasing power of the dollar he invested as compared with the dollar he will receive on his sale.

(3) The benefits to the economy from such legislation would be:

(a) Removal of any tax barrier to the mobility of capital upon the owner's exercise of his option to sell; at the same time encouraging voluntary long term investment of equity capital in developing venture enterprises so that an investor's transactions are determined by investment considerations rather than by inflation and tax considerations.

(b) To maintain the waning supremacy of U.S. industrial technology whose export products have increasingly to compensate for growing dependence on foreign raw material, with particular encouragement of investment in equity capital in new industrial research and technology where the U.S. faces increasing competition from foreign nations (who have little or no capital gains tax).

(c) Correlative protection against such foreign competition of U.S. labor's job opportunities in U.S. industry.

(d) Protection of U.S. industrial and agricultural resources against acquisition by foreign investors whose subsequent sales will not be subject to capital gains taxation by the United States.

STATEMENT

My name is Thomas G. Corcoran, a practising lawyer in Washington, D.C. For this appearance I am not on retainer for a particular client. But I am deeply interested in this hearing. As an Assistant with Mr. Jesse Jones' Reconstruction Finance Corporation and as Assistant to the Secretary of the Treasury, I was a White House observer in Congressional deliberations during an attempt to meet the capital markets crisis from 1932 until the outbreak of the War. Thereafter I was involved in the work of the Board of Economic Warfare which introduced me to the strategy of raw materials. Simultaneously heading Lend-Lease for China, I was enlightened to the economic potentialities of Asia.

I appear in support of the principle of S. 2608 introduced in the Senate by Senator Bentsen for himself and Senator Hansen. This bill would amend the Internal Revenue Code of 1954 to provide a graduated exclusion from gross income for long-term capital gains and a graduated nonrecognition of long-term capital losses for individuals, increasing by 2 percent a year the present exclusion from taxable income of 50 percent of a capital gain.

Affected would be all capital assets representing the average man's long range savings, including farms, homes, personally owned businesses, employees' ownership of any kind in an employer's business like the Sears, Roebuck plan, and securities in publicly owned businesses.

In 1934, just after I had left the Treasury, there was a recognition of the long-term graduated gain principle on a scale-down which is appended to this statement. It was an attempt to get investment moving again after the first financial measures of the Roosevelt Administration in 1933 and 1934. It was supplanted in 1942 in view of the needs of the emergency wartime financing. But since it was based on a sharp 20 percent reduction after one year, with another similar reduction at the end of the second year, it tempted an investor to exercise ingenuity to turn short-term trading gains into long-term capital gains.

Accordingly, to inhibit that temptation, although S. 2608 provides for increasing by 2 percent a year after one year the present exclusion from taxable income of 50 percent of a capital gain, I would suggest that the beginning of a scale-down begin at the end of five years, with proper gradations to achieve the same end results for subsequent years as provided in S. 2608.

Such treatment of long-term gains beginning at the end of at least five years of holding and ending at 20 or 25 years would in part avoid penalizing the seller for the continuing decline in the purchasing power of the dollar he invested as compared with the dollar he will receive on his sale.

The benefits to the economy from such legislation would be:

(a) To remove any tax barrier to the mobility of capital upon the owner's exercise of his option to sell; at the same time encouraging voluntary long-term investment of equity capital in developing venture enterprises so that an investor's transactions are determined by investment considerations rather than by inflation and tax considerations.

(b) To maintain the waning supremacy of U.S. industrial technology, the export of whose products must increasingly compensate for growing dependence on foreign raw materials, with particular encouragement of investment in equity capital in new industrial research and technology, where the United States faces increasing competition from foreign nations who have little or no capital gains tax).

(c) To provide correlative protection of U.S. labor's job opportunities in U.S. industry against such foreign competition.

The next, to encourage investment in equity capital so as to further the creation of new plants and of reseach by American industry, thereby expanding its efficiency and productivity and benefitting the consumer in the fight against inflation.

And the last is to provide the American long-range investor with an incentive comparable to that provided foreign investors.

No matter what other considerations have to be taken into account in the review of tax policy, there are two areas which are of top concern.

First is the certainty that if the United States, unlike England, once an industrial nation is going to remain an industrial nation with increasing employment opportunity rather than a service nation with decreasing employment opportunity we have to begin thinking about the mules that pull the wagon of jobs and labor productivity under the conditions of modern and international economic life. In the industrial field the relation of capital investment to everything else has completely changed in ten years. Once it was understandable to say that money earned by money should not be taxed more favorably than money earned with hands. But industrial technology and its labor correlative have now passed the point where the beginnings of our industrial immigrant hands could produce steel with comparatively modest investment in machinery.

Modern technology to provide work for hands demands enormous amounts of capital. Someone has estimated that it could cost $100,000 per worker to bring an important American steel mill up to the technological competence of its Japanese or other overseas competitor. Also, it has been estimated that it costs over $30,000 of capital investment to provide employment for even one worker in a service industry. The figures can be high but they may not be impossible.

The export of our technology has gone abroad at an unbelievable pace to competitors both in Asia and in Europe. This began with the decision to provide for rehabilitation of those areas, not with our partially depreciated machinery which U.S. factories had to continue to use but with the very best in our newest technology.

The displacement of U.S. manufactured goods by products of technologically superior factories created by adequate capital investment and research in countries like Germany and Japan shows clearly that the disappearance of work for hands is a consequence of insufficient capital investment in plants and research. Unused labor in U.S. plants today may be substantially related to the unused capacity of plants which are technologically inadequate if not obsolete.

Within our own economy, as stated in a Department of Commerce report in 1977, high technology companies from 1957 to 1973 created jobs 88% faster than other businesses; and the Defelopment Fund of M.I.T., after comparing job formation from 1969 to 1974 of six giant corporations to that of five smaller technological

concerns, found that the five companies, which were one-fortieth in size, created 35,000 new jobs, compared to only 25,000 for the six corporate giants.

It is not only a matter of capital to build plants. It is a matter of capital for research. The era of government supported research has faded rapidly since the trip to the moon. For individuals and private corporations venturing on new paths, the budget for research as well as capital expansion is diminished with the prospect of diminished earnings because of the risks due to inflation.

It is reliably stated (Business Week, July 3, 1978) that the federal dollar commitment to research and development has dropped from 3% of the GNP in 1963 to 2.2% and that the amount of basic research that industry performs has dropped to 16% in 1977 from 38% of the national total in 1956. Herbert Holloman of the Massachusetts Institute of Technology states that as much as two-thirds of all R&D is now conducted by foreign laboratories.

The Secretary of the Treasury himself realizes this danger. In his recent meeting with security analysts about a month ago he stated that our technological supremacy is "not mandated by Heaven" and that unless we pay close attention to it and invest in it, it will disappear. Even in biological research, a recent visitor from Japan informed me that after visiting five Japanese hospitals, he was convinced that the Japanese were ahead of us in the biological field which since the War we have considered our own and on which for the last 20 years our pharmaceutical companies have greatly relied for their profit margin.

One of the resaons for this slowdown in our own technological supremacy has been the near impossibility of small imagination-originating business to obtain capital—particularly that second and third stage of capital necessary to work the bugs out of an inventive idea over a long period of five or ten years.

The current issue of Business Week (July 3, 1978) tells of a relatively small technological California company with a newly invented process which found that in order to obtain equity risk capital for the marketing and development of the process, it was necessary to give a Japanese camera manufacturer a 51% interest in the project.

This increasing difficulty of such companies in obtaining risk capital is not unique. A Department of Commerce survey shows that 698 small technology-oriented companies obtained $1.367 billion in public financing in 1969 as against four in 1975 and 30 in 1977. Their counterparts in foreign countries who are competing so successfully with us with technology, much of which has been acquired from us, suffer little or no impediment in the obtaining of venture capital by reason of any impact of their tax laws. As shown by the attached schedule, most of the world's industrial countries have no capital gains tax and the tax rates of the others (the United Kingdom, Sweden and Canada) are much less than ours. Such tax treatment obviously fosters long-term capital investment in those countries.

The second area of concern is the effect of inflation as related both to the fairness of long-term investment already made and the willingness to incur the risks involved in new long-term investment and its self-sustaining effect upon employment and labor productivity. Irrespective of Administration hopes and efforts, the American investor remains uneasy at the prospect of continuing inflation. It takes years to build a new plant or bring a new enterprise to the profit stage. A risk tolerable at present costs is therefore likely to be avoided by the prudent entrepreneur, whether a small man risking his everything or the conservative research department of a big corporation.

A recent Dow Theory Letter summarizes what a dollar at the time of Roosevelt's death in 1947 was worth at the end of each succeeding President's term:

President	Dates	$1 at term end (cents)
Truman	January 1949 to January 1953	90.2
Eisenhower	January 1953 to January 1961	80.7
Kennedy/Johnson	January 1961 to January 1965	77.0
Johnson	January 1965 to January 1969	67.6
Nixon	January 1969 to August 1974	48.0
Ford	August 1974 to January 1977	41.0

By the same computation today the 1978 dollar is worth 38.7 cents.

Senator Bentsen points out in his statement in introducing S. 2608, $100 invested ten years ago in 1967 is worth approximately $60 today and $100 invested in 1947, 30 years ago, has a real value of approximately $40 today.

A high capital gains tax rate when coupled with continuing high rate of inflation results in a confiscatory tax on assets sold after a long time period. Certainly if in your deliberations there is no inflation relief for the existing long-term investor, there is going to be little enthusiasm for long-term ventures by new investors.

Therefore, I urge that S. 2608, with the suggested revision under which benefit would begin only after five years of holding, be considered a starting point in combating inflation through providing incentive to increased investment for greater employment and productivity.

I recognize that this hearing has been called to consider both S. 2608 and S. 3065. Although the provisions of these bills could readily be correlated and both represent needed and helpful legislation, S. 2608 has independent merit.

S. 3065 not only reduces by 50% the taxable portion of a realized capital gain but also places a tax ceiling of 25% on all such capital gain (without limitation to $50,000 as at present). If by any chance this Committee concludes that although the 50 percent provision is needed, a tax ceiling for all capital gains fo 25 percent should not be established, I urge that the Committee consider combining the 50 percent exclusion of the S. 3065 with the graduated increases of that exclusion as provided in S. 2608. This will provide some current incentive to long-term current investment and at least a partial offset to the inroads of inflation on capital already invested.

The Committee is no stranger to the concept of the Bentsen-Hansen bill providing for a downward graduation in the percentage of recognition of long-term capital gains. When the Tax Reform Act of 1976 was under consideration, the Senate Finance Committee agreed to an amendment proposed by Senator Long to provide a sliding scale for capital gains whereby capital assets held for more than five years, as we now suggest, would be taxed on successive smaller amounts of realized gains. The Senate did not accept that Committee amendment in 1976. But now, two years later, the reasons for such an amendment are more apparently compelling. The inflation is worse, the international competition is worse, the equity market is worse—and the unemployment problem has not ended.

REVENUE ACT OF 1934

Sec.

117(a) SEC. 117. CAPITAL GAINS AND LOSSES.

(a) GENERAL RULE. In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 1 year;

80 per centum if the capital asset has been held for more than 1 year but not for more than 2 years;

60 per centum if the capital asset has been held for more than 2 years but not for more than 5 years;

40 per centum if the capital asset has been held for more than 5 years but not for more than 10 years;

30 per centum if the capital asset has been held for more than 10 years.

CAPITAL GAINS TAXES IN OTHER COUNTRIES

An editorial in the Wall Street Journal of May 8, 1978, has the following information as to capital gains taxes in other countries:

Country	Top rate	Holding period
United States	Just over 49 percent [1]	1 yr.
Australia	Exempt	Do.
Belgium	do	None.
Canada	22 percent [1]	Do.
Germany	Exempt	6 mo.
Italy	do	None.
Japan	do	Do.
Netherlands	do	Do.
Sweden	23 percent [1]	2 yr.
United Kingdom	30 percent	None.

[1] Excluding State and local taxes.

Senator HANSEN. Our next witness is Dr. Jack Carlson of the U.S. Chamber of Commerce.

Mr. Carlson, we are pleased to have you here. You are well known to the members of this committee and to most members of the Congress, having served in the very important capacity down at the Interior Department.

I am glad to welcome you back again.

Mr. CARLSON. Thank you very much, Mr. Chairman. If I may insert my longer statement in the record and just excerpt from it.

Senator HANSEN. You may indeed.

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

Mr. CARLSON. Let me summarize our position. The National Chamber recommends tax relief to encourage job-creating investment. Such tax relief should include reduction in capital gains taxes, which could include proposals in S. 2608, S. 2428, and S. 3065, the bills being considered by this committee.

The chamber supports capital gains tax relief in the form of tax rate relief, tax relief based on the holding period, or allowance for rolling over small business assets, such as is allowed for homes. For example, a $1 billion capital gains tax relief within 4 years would increase wages $4 billion to $8 billion, primarily for lower and middle income workers; add 100,000 to 180,000 jobs; increase business fixed investment by $2 billion to $4 billion; reduce long-term interest rates by 0.2 to 0.4 percentage points; increase after tax income for the average family by $35 to $60; generate additional tax receipts of $0.8 billion to $1.5 billion, which would help to lower the deficit; help small business; help farmers, timber, energy and mineral producers; and increase individual freedom.

I would endorse Harold Williams' comments about the fact that we have had a phenomenal growth in jobs, but we have had a very slow growth in productivity since the recession of 1975 and in comparison with other economic recoveries. At the same time, we have had a very slow growth of general investment and particularly venture capital investment, slower than any other business recovery, and still we are not at the same real level of investment as we were in 1975.

We are thereby asking workers, the larger number of workers, to work with less modern, less efficient, and less foreign competitive tools to produce the goods that we require.

The policies have been anti-investment not only in terms of tax policies stemming from 1968 and 1969, but also some of the acts that were passed just last year in the Congress are anti-investment in nature. I refer to the increase in the minimum wage, increase in social security taxes, increase in farm price supports, and increase in Federal pay.

So investment is not discouraged just by the large tax measures, but also by many other policies being considered by the Congress.

I might add to that list, if you are looking at pending legislation, energy tax increases, regulation of intrastate natural gas, and labor law reform measures that were pending at the end of the Congress last year, as having anti-investment features, even though the attention had been focused elsewhere as far as those bills were concerned.

It is clear from our preferences that taxpayers lose, especially in the area of stimulating investment. The President, in January of this year, proposed a $38 billion increase in spending and a $25 billion tax relief program. This spending increase was increased to $47 billion in March and then to $50 billion in June, and to make room for the deficit, reducing the deficit, not having it grow so fast, the tax relief was sacrificed and reduced from $25 billion to $15 billion. In comparison with past tax relief measures that were aimed at investment, in terms of today's economy, the tax cut of 1963–64 would be $18 billion for investment today, the tax cut of 1975 would be equivalent to $7 billion, and the initial proposals this year were a net $5 billion, clearly a downward trend.

Also, tax relief for stimulating investment has declined as a proportion of total tax relief, from one-third of the tax relief provided in 1963–64 for investment to one-fourth in 1975 and to one-fifth proposed by the Administration in January. This is in sharp contrast to the situation where citizens have decided to be decisionmakers as opposed to working through their representatives, as is the case with proposition 13 in California, where the tax relief turned out to allocate about two-thirds in the direction of business, and thereby will have some impact upon stimulating investment.

In fact, it is interesting to note that the tax relief passed by citizens in California, if it were applied at the Federal Government level, would be equivalent to a $90 billion tax relief, and the part that went to business would be equivalent to $60 billion of tax relief. And to give some other comparable figures, if other States follow suit, tax relief would be $55 billion. In comparison with the tax relief of 1963–64 in the larger economy today, it would be $52 billion, and the tax cut of 1975, would be $32 billion.

So we are actually talking about a very anemic tax relief, both in its total amount and also that proportion that is associated with investment, in both houses of the Congress and proposed by the administration.

I draw your attention to some figures that we are comfortable with in terms of estimating what $1 billion worth of capital gains tax relief will produce within 4 years, recognizing as Dr. Musgrave pointed out, that our models are not as well suited for estimating what will happen with capital gains tax relief as they are for other kinds of economic phenomena. Consequently, on page 9 of my testimony, table 5, I have both a low estimate and a high estimate of what might happen if reductions in capital gains taxes of the order of magnitude of $1 billion were provided.

And to give some idea as to the impact across the country, not just the aggregate, I have on table 6 on page 10 what the impact would mean in terms of the State of Oregon and the State of Wyoming, as well as the other 48 States.

In the State of Oregon, this capital gains tax relief would mean that from 1,184 up to 2,110 additional jobs would be created, there would be $26.4 billion to $52 billion additional investment, and an increase in family income in the State of Oregon of $33 up to $56 per family, realizing these are orders of magnitude and not intended to be absolutely correct, that we may find out from experience if we should pass this legislation.

While President Carter stresses that the initial capital gains tax relief would go to upper income families, he fails to state that first,

taxpayers are driven into upper income brackets when they must sell an asset, the example of your farm, Senator Hansen, that you referred to earlier, and second, he fails to state that the initial offsetting increases in tax receipts will disproportionately come from upper income families.

But most important, the greater growth of investment, jobs and income will disproportionately benefit middle and lower income families because a large proportion of the $4 billion to $8 billion of additional wages and salaries will be paid to semiskilled and unskilled workers as the economy continues to grow.

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

Also it is clear the capital gains will have particular impact, favorable impact for individuals, disproportionately for individuals and small business people, farmers, those in the timber industry, and coal and iron ore producers. And it is interesting to note that we are concerned about the structurally unemployed. Certainly we must do something about it. Table 10 on page 14 of my statement shows the cost, through a capital gains tax relief, for creating jobs. It turns out capital gains tax reduction will cost in terms of tax relief $5,000 to $10,000 per job. The public sector job spending program is $8,300 at the present time, estimated to go up as high as $12,000 in the years ahead. The labor intensive public works spending proposal, by the administration, would cost $25,000 to $35,000 per job. And the local public works spending program is a little higher cost per job.

So even when you are thinking about job creation, a capital gains tax reduction is a much cheaper way to create jobs than many of the other proposals that we are now pushing.

This represents my formal comments.

I would be pleased to answer any questions.

Senator HANSEN. We appreciate very much your appearance here, Dr. Carlson. I know that the charts and the information contained in the statement that you summarized will be most intersting, and I am particularly impressed with the last chart to which you formally referred, calling attention to the accomplishment of capital investment. As I understand your presentation, were this capital gains tax reduction proposal to become law, a job achieved by private capital investment would cost between $5,000 and $10,000. In contrast, public sector job spending would be $8,000 to $12,000 per job, labor intensive public work spending at $25,000 to $35,000, and proposed local public works spending $25,000 to $50,000 per job. I should think those figures would be of extreme interest to all of us as we grope for ways in which to expand job opportunities.

Mr. CARLSON. Senator, I would like to point out that that did not include the additional tax revenues that are generated because of a faster growing economy, tending to make the net tax relief much smaller, and in some cases, under some conditions, you could actually

generate additional tax revenue. So these costs should be on the high side instead of the low side.

Senator HANSEN. Thank you very much, Mr. Carlson.

[The prepared statement of Mr. Carlson follows:]

STATEMENT OF THE CHAMBER OF COMMERCE OF THE UNITED STATES, BY DR. JACK CARLSON

I am Jack Carlson, Vice President and Chief Economist for the Chamber of Commerce of the United States. We greatly appreciate the opportunity on behalf of the National Chamber's 74,000 members to present our views on S. 2608, S. 2428, and S. 3065.

POSITION

The National Chamber recommends tax relief to encourage job-creating investment. Such tax relief should include reduction in capital gains taxes, which could include proposals in S. 2608, S. 2428, and S. 3065, the bills being considered by this Committee.

The Chamber supports capital gains tax relief in the form of tax rate relief, tax relief based on the holding period, or allowance for rolling over small business assets, such as is allowed for homes. For example, a $1 billion capital gains tax relief within four years would: Increase wages $4 to $8 billion, primarily for lower and middle income workers; add 100,000 to 180,000 jobs; increase business fixed investment by $2 to $4 billion; reduce long-term interest rates by 0.2 to 0.4 percentage points; increase after tax income for the average family by $35 to $60; generate additional tax receipts of $0.8 to $1.5 billion which would help to lower the deficit; help small business; help farmers, timber, energy and mineral producers; and increase individual freedom.

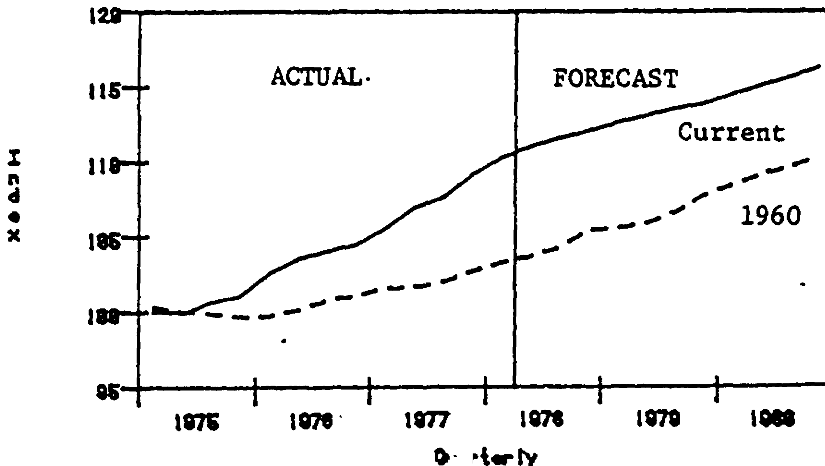
The Chamber also recommends other forms of tax relief such as: making the investment tax credit permanent and extending it to structures: more adequate depreciation; lower corporate income tax rates; and lower tax rates for small business on the first $200,000 of corporate income taxes.

Any tax relief should include at least one-third for encouraging investment.

NEED FOR JOB-CREATING INVESTMENT

The need for providing American workers with the most modern tools is greater today than at any time during the last two decades. Employment has grown at a phenomenal pace since the recession of 1975, much more rapidly than in any other economic recovery including the very long recovery of the 1960's (see Graph 1).

GRAPH 1

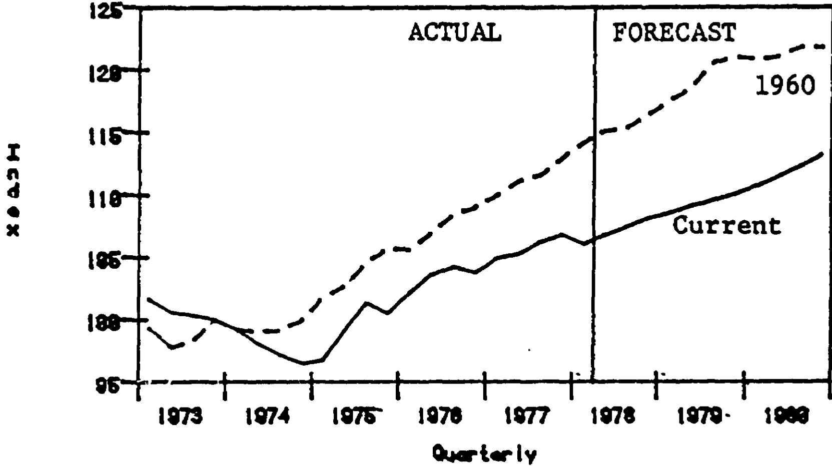


In sharp contrast, productivity of the average worker has only slowly recovered from the 1975 recession and has grown more slowly than in any business recovery including the extended recovery of the 1960's (see Graph 2).

GRAPH 2

OUTPUT PER MAN HOUR
DURING ECONOMIC RECOVERIES

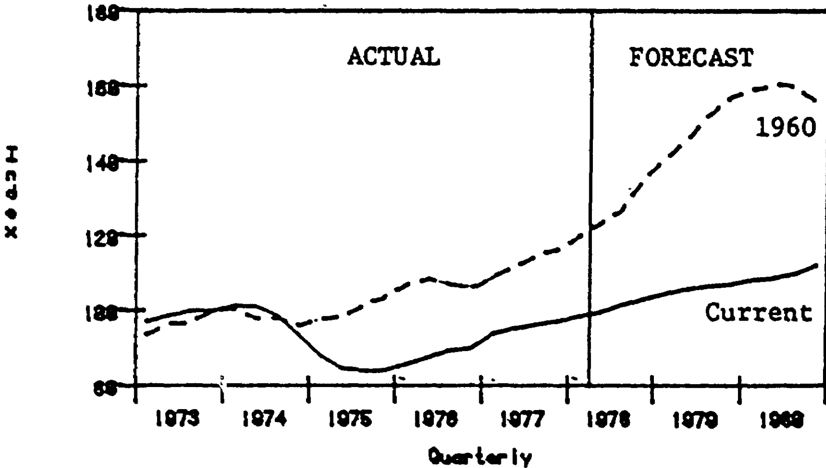
(1973:4=100)



The major reason why workers are less productive now than in the past is that they are working with less efficient tools. Business investment in plant capacity and equipment continues to track well below previous business recoveries, including the long 1960's recovery, and has not yet reached the same real dollar level that it achieved in 1973, five years ago (see Graph 3).

REAL BUSINESS FIXED INVESTMENT
DURING ECONOMIC RECOVERIES

(1973:4=100)



This can be shown over a longer period of time. The growth in real investment, adjusting for inflation, which was about 3% during most of the post war period, has grown much more slowly since 1973. Consequently, capital per labor hour has been cut nearly in half, from 3.1% to 1.7%. This in turn has meant that productivity growth has been cut from 3.3% to 1.3% in recent years (see Table 1).

TABLE 1.—GROWTH IN INVESTMENT IN PLANT AND EQUIPMENT AND PRODUCTIVITY

[In percent]

	Investment growth after adjusting for inflation	Capital per labor hour	Productivity growth
1948 to 1966	3.4	3.1	3.3
1966 to 1973	3.0	2.8	2.1
1973 to 1978	−.2	1.7	1.3

The Federal government has encouraged this undesirable trend by discouraging investment and thereby making workers less productive, and in turn causing their living standards to be lower. For example, most of the economic legislation enacted during 1977 discouraged investment. Increases in the minimum wage, social security, farm price supports and the federal pay caused investment per new worker to decline. The economic stimulus program caused investment to increase. More specifically, policies recommended by the President and *passed* by the Congress during 1977, will cause investment per new worker to decline by $950 in 1979, $2,000 by 1980 and $3,750 by 1985. If legislation *pending* at the end of 1977 were included, then the loss of tools for each new worker would be $2,150 by 1979, $5,200 by 1980 and $11,350 by 1985 compared with conditions that would have occurred otherwise (see Table 2).

TABLE 2

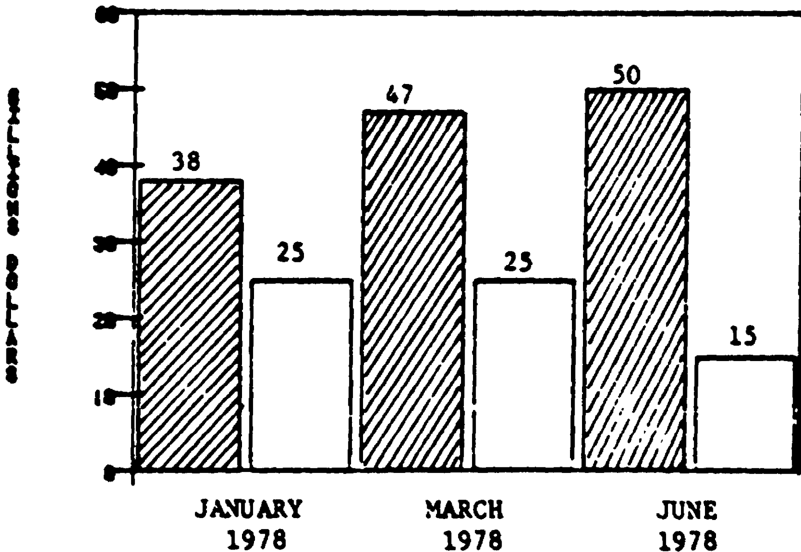
	Impact on investment for each new worker			
	1978	1979	1980	1985
Legislation enacted during 1977:				
Economic stimulus	1,450	850	350	250
Minimum wage	−150	−2,350	−2,600	−2,400
Social security taxes	0	−200	−600	−2,750
Farm price supports	−150	−250	−200	−250
Federal pay increase	−50	−100	−100	−100
Gross impact	1,050	−2,050	−3,200	−5,250
Net impact (after removing overlapping policy effects)	550	−950	−2,000	−3,750
Pending legislation:				
Energy taxes	−550	−1,800	−3,350	−7,100
Regulation of intrastate natural gas	−600	−800	−1,150	−2,350
Labor law reform	0	−100	−550	−3,600
Gross impact of enacted and pending legislation	−100	−4,500	−8,300	−18,450
Net impact of enacted and pending legislation (after removing overlapping policy effects)	−50	−2,150	−5,200	−11,350

One of the major reasons for the discouragement of investment since 1970 must be the increase in capital gains tax rates in 1969. Even with the inflation that prevailed then, such a move was of dubious value and each worker has, is and will suffer lower productivity and lower growth in their standard of living because of it.

Since inflation has accelerated, capital gains taxes are positively harmful. It is understandable why six other advanced industrial countries do not tax capital gains: Australia, Belgium, West Germany, Italy, Japan and the Netherlands. (Inflation causes not only excessive taxation of capital gains but also under-depreciation of business assets and built-in inflation premiums in interest rates.)

While there has been legitimate concern about the high Federal Unified Budget deficit, the steps taken to reduce the size of the budget have discriminated against tax relief including tax relief to stimulate investment, indicating that spending advocates tend to win over taxpayers. For example, during January 1978 President Carter proposed a $38 billion increase in spending and a $25 billion tax relief for FY 1979. During March the President proposed a higher spending increase of $47 billion, after estimating a shortfall in spending during 1978. By June both the President and the Congress accepted an even higher $50 billion increase in spending and agreed that tax relief should be sacrificed and lowered to $15 billion to limit the size of the deficit. Taxpayers lose and spending advocates win in the Federal government, in sharp contrast to the tax revolt in California and spending among the other States (see Chart 1).

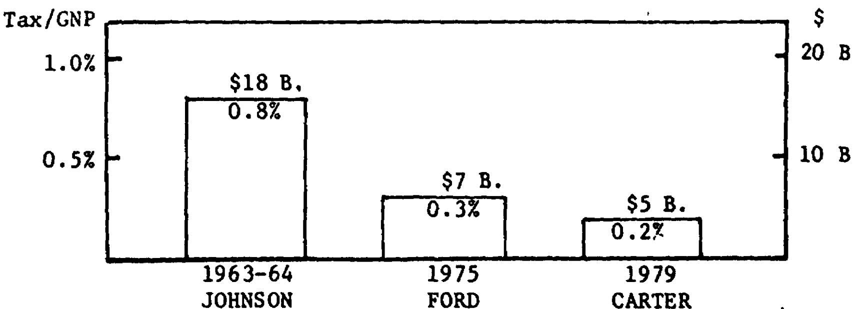
CHART 1



Tax relief for stimulating investment has been shrinking in size, $5 billion proposed for FY 79 compared to $7 billion in 1975 and $18 billion in 1963-64 (see Chart 2).

CHART 2

PAST TAX RELIEF FOR BUSINESS INVESTMENT
SIZED FOR THE FY 1979 GNP



Also, tax relief for stimulating investment has declined as a proportion of total tax relief, from one-third in 1963-64 and one-fourth in 1975 to one-fifth initially proposed by President Carter for 1979 (see Table 3).

TABLE 3.—*Proportion of tax relief for investment*

1963-64	1/3
1975	1/4
Proposed	1/5

American citizens sense the nature of the problem and are taking action that their representatives have not taken. The tax cut provided under Proposition 13 in California will allocate about two-thirds of the cut for business. This in turn will cause investment to increase, new jobs to be created, and consumer prices to decline as lower property taxes reduce the cost of home ownership, renting, or building new office buildings, plant capacity and other structures (see Table 4).

TABLE 4.—U.S. ECONOMIC IMPACT FROM PROPOSITION 13

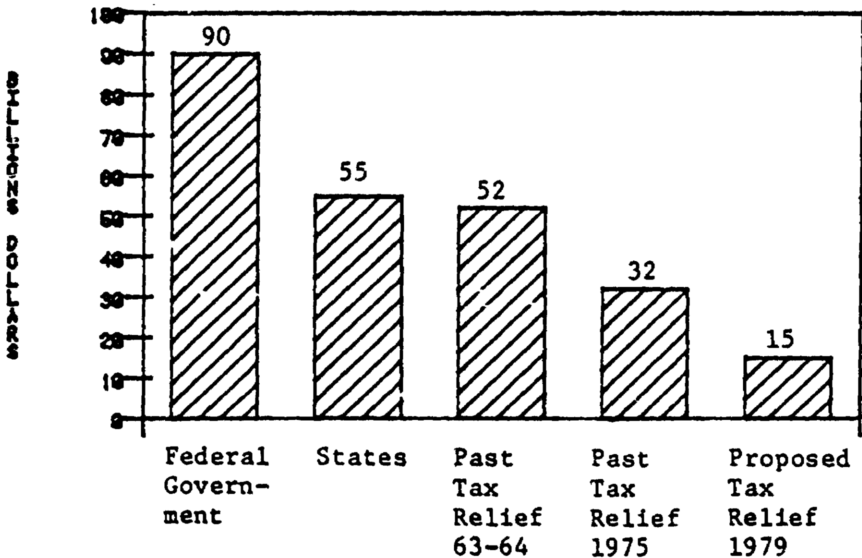
[Change in levels]

	2d half 1978	1979	1980
Real GNP (billions 1977 dollars)	0.8	2.5	3.6
Employment (jobs)	30,000	110,000	150,000
Real business fixed investment (billion 1977 dollars)	.3	.7	1.2
Consumer prices (percent)	-.2	-.3	-.4

Also, citizen lawmakers are not anemic. The single-state California tax cut of $7.2 billion is about one-half of the entire tax relief now recommended by the President. It is comparable to a $90 billion federal tax relief including about $60 billion tax relief for investment, and $55 billion if all states followed the California example. It is nearly twice as large as the $52 billion tax relief of 1963-64, 3 times as large as the 1975 tax relief and 6 times larger than the President's newly supported $15 billion "no frills" tax program (see Chart 3).

CHART 3

EQUIVALENT SIZE OF PROPOSITION 13 COMPARED WITH PAST AND PROPOSED FEDERAL TAX RELIEF (FY 1979)



ECONOMIC BENEFITS FROM CAPITAL GAINS TAX RELIEF

The tax relief that this Committee is considering will help the economy in many ways. For each *one billion of reduced capital gains taxes*, within four years the economy would respond in the following way: Gross National Product, after adjusting for inflation, would increase by $5 billion to $9 billion; wages and salaries, after adjusting for inflation, would increase by $4 to $8 billion; business fixed investment would increase by $2 to $4 billion: employment would increase by 100,000 to 180,000; family income would increase by $35 to $60; consumer prices would not increase significantly; long-term interest rates would decline; and Federal tax receipts would likely increase by more than enough to offset the initial tax cut (see Table 5).

TABLE 5.—IMPACT OF $1 BILLION OF CAPITAL GAINS TAX RELIEF WITHIN 4 YEARS

	Low estimate [1]	High estimate [2]
Gross national product (billions 1977 dollars)	$5	$9
Wages and salaries (billions 1977 dollars)	$4	$8
Investment—Business fixed (billions)	$2	$4
Jobs (thousands)	100	180
Family income	$35	$60
Consumer prices (percent)	0	.1
Long-term interest (AAA corporate bonds) (percent)	-.2	-.4
Federal taxes (billions)	$.8	$1.5

[1] Stock market reaction assumed less than 1 percent and only modestly restraining monetary policy.
[2] Stock market reaction assumed to raise by 5 percent by the 4th year and an accommodating monetary policy; assumption of larger stock market response or stimulating monetary policy could cause the results to be higher.

Each state would benefit. For example, from $1 billion of capital gains tax reduction the State of Virginia could expect 2,556 to 4,556 additional jobs, $46.2 to $91.3 million additional investment and $36 to $62 increase in the average Virginia family income within four years (see Table 6).

TABLE 6.—U.S. AND STATE BENEFITS FROM $1,000,000,000 OF CAPITAL GAINS TAX RELIEF [1 2]

[4th year impact—change in levels]

	Additional jobs		Additional investment (millions $77)		Additional family after tax income ($77 per family)	
	Low estimate	High estimate	Low estimate	High estimate	Low estimate	High estimate
United States	101,000	180,000	2,200.0	4,350.0	35	60
Alabama	1,549	2,761	52.8	104.4	27	46
Alaska	175	312	3.3	6.5	58	99
Arizona	1,138	2,029	17.6	34.8	33	56
Arkansas	959	1,710	19.8	39.1	27	46
California	10,557	18,815	154.0	304.5	39	67
Colorado	1,426	2,541	22.0	43.5	36	62
Connecticut	1,441	2,568	33.0	65.3	41	70
Delaware	290	516	8.8	17.4	40	69
District of Columbia	758	1,351	1.3	2.6	46	78
Florida	4,218	7,518	48.4	95.7	32	56
Georgia	2,485	4,428	52.8	104.4	31	53
Hawaii	412	735	3.1	6.1	45	76
Idaho	386	689	6.6	13.0	30	52
Illinois	5,026	8,956	136.4	269.7	41	70
Indiana	2,507	4,468	85.8	169.7	33	56
Iowa	1,417	2,525	30.8	60.9	35	60
Kansas	1,110	1,979	17.6	34.8	36	61
Kentucky	1,491	2,657	33.0	65.3	28	48
Louisiana	1,615	2,878	61.6	121.8	30	52
Maine	461	822	11.0	21.8	28	47
Maryland	1,915	3,413	26.4	52.2	39	67
Massachusetts	2,575	4,589	44.0	87.0	31	53
Michigan	4,006	7,139	156.2	308.8	36	61

TABLE 6.—U.S. AND STATE BENEFITS FROM $1,000,000,000 OF CAPITAL GAINS TAX RELIEF[1 2]—Continued

[4th year impact—change in levels]

	Additional jobs		Additional investment (millions $77)		Additional family after tax income ($77 per family)	
	Low estimate	High estimate	Low estimate	High estimate	Low estimate	High estimate
Minnesota	1,946	3,469	28.6	56.6	36	61
Mississippi	1,034	1,843	19.8	39.1	25	43
Missouri	2,251	4,011	35.2	69.6	33	56
Montana	345	614	6.6	13.0	32	54
Nebraska	800	1,425	8.8	17.4	37	63
Nevada	352	627	1.8	3.5	38	65
New Hampshire	394	703	6.6	13.0	32	55
New Jersey	3,261	5,811	77.0	152.3	40	69
New Mexico	519	924	6.6	13.0	27	46
New York	7,690	13,706	126.5	250.1	39	67
North Carolina	2,795	4,980	79.2	156.6	29	49
North Dakota	298	532	2.2	4.4	36	62
Ohio	5,040	8,982	151.8	300.1	33	56
Oklahoma	1,262	2,249	19.8	39.1	30	51
Oregon	1,184	2,110	26.4	52.2	33	56
Pennsylvania	5,243	9,344	123.2	243.6	34	59
Rhode Island	416	742	8.8	17.4	35	60
South Carolina	1,381	2,460	48.4	95.7	28	48
South Dakota	331	590	1.5	3.0	30	52
Tennessee	2,228	3,971	52.8	104.4	28	48
Texas	6,248	11,136	176.0	348.0	34	58
Utah	613	1,093	6.6	13.0	44	75
Vermont	203	362	4.4	8.7	29	50
Virginia	2,556	4,556	46.2	91.3	36	62
Washington	1,541	2,746	37.4	74.0	36	62
West Virginia	719	1,281	19.8	39.1	28	47
Wisconsin	2,219	3,955	50.6	100.0	35	59
Wyoming	212	379	1.1	2.2	35	60

[1] Static tax revenue assumptions for both the low and high estimates were $350,000,000 decrease for corporations and $650,000,000 for indivudals. Stock market prices for the low estimates were assumed to increase only modestly (less than 1 percent). For the high estimates, stock market prices were allowed to increase 5 percent by the end of the 4th year in the simulation period.

[2] State estimates were obtained by simulating the DRI State Area Forecasting Service (SAFS) model and applying trend data from the National Planning Association.

Source: U.S. Chamber of Commerce, Forecast and Survey Center, Assumptions and modeling by Dr. Jack Carloson and George Tresnak using the Data Resources, Inc. Macroeconomic Model and the DRI SAFS model.

HELPS MIDDLE AND LOW INCOME FAMILIES AND SEMI-SKILLED WORKERS

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

Also, in time, the greater growth of investment, jobs and incomes will disproportionately benefit middle and lower income families, because a large proportion of the $4 to $8 billion of additional wages and salaries will be paid to semi-skilled and unskilled workers as the economy continues to grow (see Table 5).

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

BENEFITS FOR INDIVIDUALS AND SMALL BUSINESS

Capital gains tax relief would directly benefit individuals rather than corporations (see Table 7).

TABLE 7.—TAX RELIEF FROM $1,000,000,000 CAPITAL GAINS REDUCTION BY 1982

	Billions of dollars	Percent
Individuals	1.2	86
Corporations	.2	14
Total	1.4	100

Source: Based upon 5-yr budget projects: Fiscal years 1979-83, Supplement on Tax Expenditures, June 1978, Congressional Budget Office.

This would directly benefit individual investors and small businesses of which 85% are taxed as individuals and not corporations.

Particularly, family farmers would benefit (see Table 8).

TABLE 8.—*Benefits to farmers from $1 billion capital gains tax relief by 1982 within 4 years*

	Millions
Individuals	$51
Corporations	2
Total farm	53

Source: Based on 5-year budget projects: Fiscal years 1979-83, supplement on tax expenditures, June 1978, Congressional Budget Office.

Timber, coal and iron ore producers would benefit and subsequently cause housing, energy and products from iron ore to cost less than otherwise (see Table 9).

TABLE 9.—*Benefits to timber, coal and iron ore producers from $1 billion capital gains tax relief by 1982 within 4 years*

	Millions
Timber	$460
Coal	126
Iron ore	24

Source: Based on 5-year budget projects: Fiscal years 1979-83, supplement on tax expenditures, June 1978, Congressional Budget Office.

Capital gains tax reduction is a preferable way to create jobs, particularly productive and permanent jobs, in comparison with billions spent on public sector jobs, local public works and the Administration proposed Labor Intensive Public Works (see Table 10).

TABLE 10.—INCREASED EMPLOYMENT FROM CAPITAL GAIN TAX RELIEF COMPARED TO OTHER POLICY ALTERNATIVES

	Tax relief or spending cost per job
Capital gains tax reduction	$5,000-$10,000
Public sector jobs spending	8,000- 12,000
Labor-intensive public works spending	25,000- 35,000
Proposed local public works spending	25,000- 50,000

SURVEY INDICATES MORE INVESTMENT

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

EVALUATION OF THREE BILLS

Although the benefits from capital gains tax relief can be generalized, each of the three bills under consideration before this Committee are unique.

Reduction in capital gains taxes

The U.S. Chamber opposed the minimum tax; supports a reduction in the captial gains tax as set forth in S. 3065; and opposes repeal of the alternative tax.

Capital gain rollover

S. 2428 provides for the deferral of tax on the gain from the scale of certain stocks if the gain is reinvested in other stocks within the requisite time period. The U.S. Chamber, as part of its eleven-point tax reform program for small businesses, supports capital gains rollover for closely held securities. Presently, the tax code discriminates against sales of stocks and securities by denying nonrecognition treatment to *sales* of securities while granting nonrecognition treatment to the following transactions, which are deemed to be mere changes in form of investment: corporate reorganizations under section 368 of the Internal Revenue Code; stocks for stock exchanges of the same corporation; like-kind exchanges of property held for investment or for productive use; reinvestment of the proceeds of involuntary conversions; and sale of a principal residence if the proceeds are reinvested in another principal residence.

Like the gradual stepdown in capital gains taxes, the need for rollover is more important to small businesses now that the carryover basis provisions have taken effect.

The U.S. Chamber urges this Committee not to stop with rollover, but to enact additional tax relief for small business, in conjunction with the rollover legislation. The U.S. Chamber's eleven-point tax program for small business includes: Increasing the corporate surtax exemption to $200,000; prompt capital cost recovery allowances; increasing the investment tax credit; increasing the minimum accumulated earnings credit; expanding the net operating loss carryback rules; expediting refunds of estimated tax overpayments; and enlarging the effects of section 1244.

Step-down capital gains tax based on length of holding period

S. 2608 provides for a gradual reduction of the amount of gain included in income in the case of assets held for more than one year. S. 2608 also provides for a step-down in the amount of losses used to offset long-term capital gains.

The U.S. Chamber supports reducing capital gains taxes in proportion to the length of time an asset is held. In many cases, capital only reflects inflation. What appears to be a monetary gain is a reflection of the decreasing value of the dollar. In addition, a gradual reduction in taxes helps solve the problem of "bunching" of income, which penalizes illiquid businesses and farms.

Because of the changes in carryover basis rules resulting from the Tax Reform Act of 1976, small firms and farms can no longer avoid the effects of inflation-caused gains by a step-up of basis at death. Thus, the need for a gradual step-down in capital gain taxes is needed by small businesses now more than ever.

In 1934, the Internal Revenue Code was amended to vary the percentage of taxable gain and deductible loss according to the length of time property was held. If held for less than one year, the asset would produce gain includible at the rate of 100%. If the asset was held for more than 10 years, the gain would be includible at the rate of 30%. Other gradations were as follows: 1 to 2 years, 80%; 2–5 years, 60%; and 5–10 years, 40%.

In 1934, the number of returns showing net capital gain for individuals was around 21,000.[1] In 1935, after this change was enacted, the number of returns showing net capital gain had jumped to 504,847 [2] which is a strong indication that gradual exclusion does not promote lock-in of capital assets.

CONCLUSION

The U.S. economy is faced with a major need for capital which we can no longer afford to ignore. It is essential that our tax policy be remolded to encourage capital formation. The three bills discussed above while they are excellent proposals must not be viewed alone but must be viewed as one piece of a larger strategy. The larger strategy is to (1) liberalize capital cash recovery allowances, (2) to reduce corporate and individual taxes, (3) to simplify small business tax policy, (4) to increase the investment tax credit, and (5) to reduce capital gain taxes.

Senator HANSEN. Our final witness will be Dr. Charls Walker, representing the American Council for Capital Formation.

Dr. Walker, we are very pleased to have you here.

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[1] Source: U.S. Treas., Statistics of Income for 1934 of Individual Income Tax Returns, Table 3, p. 6.

[2] Source: U.S. Treas., Statistics of Income for 1935 of Individual Income Tax Returns, Table 3, p. 7.

STATEMENT OF DR. CHARLS E. WALKER, CHAIRMAN, AMERICAN COUNCIL FOR CAPITAL FORMATION

Mr. WALKER. Thank you very much, Mr. Chairman. I am very pleased to be here and I am delighted that this subcommittee is holding these hearings. I also want to say that I think that you and your 61—if that is the correct count now—cosponsors of S. 3065 are to be strongly commended by the American people, especially those who want to reverse the direction we have been heading with respect to capital formation. That means economic growth, job creation, inflation control, and more international competitiveness.

I have a statement which I would like to submit for the record, and use the time allotted to me today to comment upon a handout from the office of the Press Secretary to the President. The title of it is the White House "Fact Sheet" on the Steiger proposal, or what should be called the Steiger-Jenkins-Hansen bill, the Investment Incentive Act of 1978. It is put together in a rather interesting fashion, and if you would like I would submit a copy for the record.

Senator HANSEN. I am sure that it would be worthwhile. We appreciate that, and we will take you up on your offer.

[The information referred to follows:]

THE WHITE HOUSE FACT SHEET ON STEIGER PROPOSAL

DESCRIPTION OF PROPOSAL

Tax reform legislation in 1969 and 1976 addressed some of the worst inequities in the tax system. That legislation placed limitations on the use of excessive loopholes and tax preferences by high-income individuals and corporation. The Steiger proposal would repeal those reforms as they relate to capital gains preferences and would thereby reduce the maximum capital gains rate for both individuals and corporations to 25 percent.

- Most individual taxpayers with modest amounts of preferred income now pay a capital gains tax at one-half of their ordinary rate. The capital gains tax for these ordinary investors would not be reduced by the Steiger proposal.
- Individuals in tax brackets above 50 percent now enjoy an additional preference. Rather than being taxed at one-half their ordinary rate, they can pay a special 25 percent "alternative tax" rate on the first $50,000 of capital gain annually. Steiger would extend the alternative tax preference to an unlimited amount of capital gains of these high-income taxpayers. Virtually all the revenue lost by this part of the Steiger proposal would go to taxpayers making above $100,000.
- Capital gains would no longer be subject to the minimum tax on excessive preferences. As a result, the effectiveness of the minimum tax would be substantially eroded.
- Steiger would remove capital gains as a preference item that offsets the amount of wages eligible for another preference—the special 50 percent "maximum tax" ceiling on wages and salaries. The maximum tax offset, in combination with the minimum tax, theoretically can raise the top capital gains rate to 49.1 percent; but a rate above 45 percent actually applies to fewer than 20 taxpayers. In fact, in 1978 only 7 percent of the tax returns with capital gains will have a marginal capital gains rate above 25 percent.
- Corporate capital gains would be eligible for a maximum rate of 25 percent, as opposed to the current 30 percent "alternate tax" rate. If the Steiger proposal were enacted, a wealthy investor who makes millions of dollars in capital gains could pay a lower marginal tax rate than the average worker who has $20,000 in taxable income from wages or salary. On the other hand, the Steiger prorosal would not lower the capital gains rates paid by average investors.

IMPACT OF STEIGER ON TAX FAIRNESS

Twenty percent of the benefits of the Steiger proposal would go to corporations. The remaining benefits are skewed heavily toward high-income individuals.

- Over 80 percent of the benefits for individuals would go to persons with incomes exceeding $100,000, or less than one half of 1 percent of all taxpayers.

- 3,000 millionaire taxpayers would receive cuts averaging $214,000. Individuals earning over $200,000 and currently paying the minimum tax would enjoy cuts amounting to almost $50,000 apiece. Few taxpayers with incomes under $50,000 would receive any tax savings at all.
- 110 taxpayers with incomes over $200,000 would be removed completely from the tax rolls.
- Less than 30 percent of the benefits of Steiger would be attributable to owners of corporate stock. Tax savings would also flow to such persons as commodity speculators, large lumber product companies, owners of coal and iron ore mineral rights, and real estate developers.

IMPACT OF STEIGER ON FEDERAL REVENUES

The Treasury Department estimates that Steiger would result in an annual revenue loss of $2.4 billion based on "first-order" estimates (assuming no behavioral changes and no "feedback" revenues).

- Although Steiger, like any tax reduction, would generate some feedback revenues through economic stimulus, there is no reason to believe that it would create more offsetting tax revenue over the long run than other forms of tax cuts that are vastly more equitable.
- Projections of net long-term revenue gains to the Treasury, offered by some proponents of the proposal, are indefensible estimates based on extremely unrealistic economic assumptions and inaccurate specifications fed through large-scale econometric models.

IMPACT OF STEIGER ON CAPITAL FORMATION

There is little evidence that Steiger would provide an efficient incentive for the creation of new productive capital.

- In the short run, one of the major effects of Steiger would be to provide windfall benefits attributable to gains that have already accrued on existing assets—benefits far removed from the creation of new capital in the form of plant and equipment.
- Relief would also be directed inefficiently toward enterprises which, for various technical reasons, can convert their ordinary income into capital gains. Steiger would divert much taxpayer effort into the complex maze of capital gains tax provisions and perpetuate an inefficient and wasteful allocation of economic resources.

COMPARISON OF STEIGER WITH PRESIDENT'S TAX PROGRAM

One of the effects of Steiger would be to waste revenues urgently needed to provide more efficient and equitable incentives for business investment.

- The President has proposed a $7 billion reduction in the tax burden on capital income. This would be achieved through a direct reduction in corporate and individual tax rates and a liberalization of the investment credit.
- The President's proposals would apply to middle-class investors as well as wealthy investors, and to small businesses as well as large businesses.
- The President's proposals direct relief broadly to capital income and not just to the income that happens to be classified as "capital gains." Only 10 percent of the current taxes on capital income is attributable to capital gains taxation.
- If it adopts Steiger, Congress will sacrifice widespread tax relief proposed by the President for benefits applying to a small group of taxpayers and a limited range of capital income. That tradeoff is unacceptable on tax equity grounds and inefficient on capital formation grounds.

DISTRIBUTION OF INDIVIDUAL TAX REDUCTIONS UNDER THE STEIGER CAPITAL GAINS TAX PROPOSAL

[1978 income levels]

Expanded income class	Average tax benefit	Percentage distribution of tax benefit
Less than $15,000	$0.12	0.4
$15,000 to $20,000	.25	.2
$20,000 to $30,000	1.00	.8
$30,000 to $50,000	11.00	4.0
$50,000 to $100,000	158.00	13.7
$100,000 to $200,000	783.00	14.2
$200,000 to $500,000	4,000.00	15.7
$500,000 to $1,000,000	21,540.00	11.3
$1,000,000 and over	145,302.00	39.7
Total	19.00	100.0

Mr. WALKER. I would like to comment on some of the allegations made in the "Fact Sheet."

Point No. 1: "Most individual taxpayers with modest amounts of preferred income now pay a capital gains tax at one-half of the ordinary rate. The capital gains tax for these ordinary investors would not be reduced by the Steiger proposal."

We all know that you can drown in a stream or a lake that on average is only 3 inches deep because it may be a half inch deep in one place and 20 feet deep in another. Here again we are dealing with averages, and I think this morning's editorial in the Wall Street Journal, which I submit for the record, is instructive. It is entitled "Two Bit Politics" and sets forth three examples which show how more or less typical Americans would save a great deal of tax money under your legislation. A New York cab driver who sells his medallion, $1,050; a California construction project manager who sells a house and rents an apartment, $4,050; an Iowan who sells a hardware store, $5,250; and I believe in the Monday Washington Star, Sylvia Porter had an example in her column of a $20,000 income family selling a property with $40,000 in capital gains. That family would save $1,500 in taxes under your legislation.

[The editorial referred to follows:]

TWO-BIT POLITICS

In a press conference reminiscent of the "war profiteering" attack on the oil companies last fall, President Carter Monday aimed his populist heavy cannons at the Steiger amendment, calling it a plan that provides "huge tax windfalls for millionaires and two bits for the average American."

When you consider that 60-odd Senators and a sizable chunk of the House are backing the Steiger-Hansen capital gains rollback, the President's claim takes on a burden of political implausibility. Millionaires don't have that many friends in Congress in an election year.

Matters get worse for the President when you examine the numbers he used in support of his populist rhetoric. For example, he again trotted out the estimate that the Steiger cut would "add more than $2 billion" to the federal budget deficit. This is based on the improbable assumption that cutting the maximum capital gains rate roughly in half would not encourage people to take more capital gains. Considering the beating that assumption has taken from tax analysts and economists, we thought it had been hidden away in a dark closet somewhere. As we have said here before, a good case can be made that revenues would rise, not fall, because of renewed investment incentives.

We are newly fascinated by the President's assertion that 80% of the tax benefits from the Steiger cut would go to taxpayers who "make" more than $100,000 a year. We've learned what that $100,000 figure really means, and you don't have to be a big shot to "make" that much under the President's definition.

The $100,000 figure is what the Treasury has defined as "expanded income," a description developed by tax reformers some time ago for political purposes. Expanded income means ordinary income *plus* the full amount of any capital gain. Thus, it would be possible for a family with an ordinary income of $25,000 and a capital gain of, say, $75,000 on the sale of a long-term residence to be part of that illustrious group "making" $100,000. We wonder why that point wasn't made clearer.

As to that "average" American who only gets two bits from Steiger, it is certainly true that you have to have a capital gain to benefit from a capital gains tax cut. And when you average all taxpayers the average benefit doesn't look very large. Indeed, the yield to the Treasury itself from the capital gains tax isn't very large, particularly in relation to the damage the tax does to capital formation.

But none of this means that the Steiger amendment would not yield major benefits to ordinary, nonrich Americans who have to cash a major asset and find themselves, mainly because of inflation, realizing a sizable capital gain.

By way of illustration, we asked accountants Price Waterhouse & Co. and Oscar Pollack of the Ingalls and Snyder securities house in New York to work up some examples:

A New York cabbie paid $24,000 for his licensing medallion five years ago and now sells it for $58,000. His total long-term capital gain is $34,000. His earned income was $13,200, excluding the capital gain. He has a wife and two children. Under the present law his federal income tax liability would be $8,850. With the Steiger amendment, it would be $7,800, a saving of $1,050;

A California construction project manager and his wife, in their early 60s with a taxable earned income of $25,000, want to retire on a pension and Social Security. They sell their house and rent an apartment. They bought their house 20 years ago for $24,000 and now sell it for $100,000, for a long-term capital gain of $76,000. They don't qualify for income averaging because of higher earned income in prior years. Their total tax liability under present provisions would be $26,064. Under the Steiger amendment it would be $22,014, for a saving of $4,050;

An Iowan who helped build a successful hardware retailing business wants to sell his half-interest to his partner for $100,000. His original capital contribution was $10,000 and the full $90,000 difference qualifies as a capital gain. He will have investment income of $15,000 in the year he sells. He does not qualify for income averaging because of higher income in prior years. His present liability would be $25,650. His tax under Steiger would be $20,400, a savings of $5,250.

It will be noted that none of the above are millionaires. They are ordinary individuals forced by circumstances to take a capital gain in grossly inflated dollars, and who, under present law, would pay a heavy tax on inflation. Obviously, the Congress understands all this better than the President. Backers of the Steiger amendment might be forgiven if they categorized the statements at the Monday press conference as two-bit politics.

Mr. WALKER. So a lot of hard working, typical Americans are being hit hard by the capital gains tax burden.

Point No. 2: "Individuals in tax brackets above 50 percent now enjoy an additional tax preference. Rather than being taxed at one-half of the ordinary rate, they can pay a special 25-percent 'alternative tax' rate on the first $50,000 of capital gain annually."

Well, you know and I know that this omits the impact of the minimum tax which would hit the family that Ms. Porter was referring to. It also ignores the impact from reducing income subject to the maxitax by the amount of preference income. So the rate can be more than the 25 percent in many instances.

Point No. 3: "Steiger would extend the alternative tax preference to an unlimited amount of capital gains of these high-income taxpayers. Virtually all the revenue lost by this part of the Steiger proposal would go to taxpayers making above $100,000."

But again, this is a "statistic" that ignores individual "people"—people who pay capital gains taxes—and many are not earning six figures year after year.

Point No. 4: "Capital gains would no longer be subject to the minimum tax on excessive preferences. As a result, the effectiveness of the minimum tax would be substantially eroded."

I say, hip, hip, hooray! The minimum income tax is a very bad tax. It is an add-on tax, little more than a disguised tax on capital gains. I would hope that this Congress would move toward an alternative tax approach as it considers major tax reform and reduction this year.

Point No. 5: S. 3065 "would remove capital gains as a preference item that offsets the amount of wages eligible for another preference—the special 50 percent 'maximum tax' ceiling on wages and salaries. The 'maximum tax' offset, in combination with the minimum tax, theoretically can raise the top capital gains rate to 49.1 percent, but a rate above 45 percent actually applies to fewer than 20 taxpayers. In fact, in 1978, only 7 percent of the tax returns with capital gains will have a marginal capital gains rate above 25 percent."

Remember last year, when administration officials were saying to businessmen and others, "Since the top rate on capital gains is now over 49 percent, what do you have to lose in taxing capital gains as ordinary income—raising the top rate to 50 percent—along with a reduction in the 70 percent maximum to 50 percent?"

The rhetoric used today in attacking your bill is exactly the opposite of what we were hearing a year ago.

Point No. 6: "If the Steiger proposal were enacted, a wealthy investor who makes millions of dollars in capital gains could pay a lower marginal tax rate than the average worker who has $20,000 in taxable income from wages or salaries. On the other hand, that proposal would not lower the capital gains rate paid by average investors."

That is refuted by the Pollack study. But the basic argument here is "soak the rich" with high marginal tax rates and ignore the impact on jobs, economic growth, and control of inflation that results from more capital formation.

In addition, the tremendous "unlocking" effect of your legislation would cause many more realizations of capital gains, just as the increase in the tax in 1969 decreased realizations. Therefore, these wealthy people may pay lower rates on each dollar of assets sold, but sell so many more that they pay more taxes. They would thus bear a higher portion of the Federal tax burden. We shouldn't get hung up on the question of what rate they pay.

Point No. 7: "Over 80 percent of the benefits for individuals would go to persons with incomes exceeding $100,000 * * * 3,000 millionaires would receive cuts averaging $214,000 * * * 110 taxpayers with incomes over $200,000 would be removed completely from the tax rolls."

Well, here again we have the average concept; second, we have greatly increased taxes on these people since 1969. At least 62 Members of the Senate, and I think a majority in the House, are saying that was wrong, we shouldn't have done so. Let's turn it around and go back.

Let us suppose that Congress—well, do you——

Back in the days of John Kennedy, when he became President, the maximum marginal individual tax rate was above 90 percent. It was reduced to 70 percent, and then later the 50-percent MaxiTax came in. Let us suppose that next week you decided in Congress to raise that marginal rate back to 80 percent, and a few years later you said we made a big mistake, let's go back to 50 percent. Should people say, oh, no, you can't do that—the rich people would benefit from that sort of cut.

We socked it to the capital gains people over the last 9 years, and now we try to undo that; critics say, no, you can't do that because only the rich people would benefit from it.

Point No. 8: "Less than 30 percent of the benefits of the bill would be attributable to owners of corporate stock."

Only if other things remain equal—and they won't. High taxes have driven people out of the stock market. One purpose of your legislation is to bring them back. The market has tended to dry up. A recent study showed that people are getting out of the market, or don't want to get into the market, because you can't make a bang for the buck when you consider the risk plus high taxes.

Point No. 9: "Tax savings would also flow to such persons as commodity speculators, large lumber product companies, owners of coal and iron ore mineral rights, and real estate developers."

Commodity speculators play a very important role in this economy. The price of bread is lower to you and me because these risk-takers are willing to speculate in wheat and therefore provide a hedge for millers. They shouldn't be looked down upon. They provide a very important service.

Large lumber product companies supply the wood for the houses that the American people want. More capital formation in this industry could help keep housing prices from rising so fast. The coal people are helping solve the energy problem; real estate developers provide homes.

I don't think we should dump over all the people that are trying to provide these important services.

Point No. 10: "Although Steiger, like any tax reduction, would generate some feedback * * *, there is no reason to believe that it would create more offsetting tax revenue * * * than other forms of tax cuts * * *."

I disagree. Dr. Feldstein of the National Bureau of Economic Research disagrees. People I talk to in markets disagree. There are billions of dollars in "locked-in" assets out there, and I feel certain that the realizations would go up, just as they went down in 1970, drastically, when the capital gains rate went up.

Point No. 11: "Projections of net long-term revenue gains to the Treasury offered by some proponents are indefensible estimates based on extremely unrealistic economic assumptions and inaccurate specifications fed through large-scale econometric models."

The Chase Econometric Study lays out the assumptions—one, two, three, four. They are just as clear as they can be. But yet some people say Chase experts use a "black box." If there is a "black box" around, I think the administration has it. All they will tell us is that people won't change their ways of behaving. And I think that that—to put it mildly—is an unwarranted assumption.

Point No. 12: "In the short run, one of the major effects of Steiger would be to provide windfall benefits * * * on existing assets."

But if what we have been doing is wrong, righting that wrong is fully justified.

Point No. 13: The "Fact Sheet" argues that the President's own tax proposals are far superior to S. 3065 because they "provide for a $7 billion reduction in the tax burden on capital income * * *, would apply to middle-class investors as well as wealthy investors * * *, and direct relief broadly to capital income and not just * * * 'capital gains'."

And finally, "if it adopts Steiger, Congress will sacrifice widespread tax relief * * *. That trade-off is unacceptable on tax equity grounds and inefficient on capital formation grounds."

These charges are difficult to answer because the "Fact Sheet" does not tell us which Presidential tax proposals it is talking about—the $25 billion of January, $19½ billion of May, or $15 billion of last week. But in any event, it misses the point—the alternative being discussed in the House is not the Steiger-Jenkins-Hansen Act versus

the President's proposals. It is instead the so-called Jones compromise, which would do all of the constructive things proposed by the administration and drop most "reforms." It cuts individual, business, and capital gains taxes across the board, and does so in a much more balanced and evenhanded way. It is strongly pro-capital formation.

Mr. Chairman, there are other points I could comment on but time has run out. Thank you very much.

Senator HANSEN. Thank you very much, Dr. Walker.

In the June 26 issue of U.S. News & World Report, you and Secretary Lubick debate the merits of capital gains tax cuts. In that exchange, Mr. Lubick discredits the notion that there are any secondary effects or multipliers which result from changes in the tax laws.

Would you care to comment on his assertion?

Mr. WALKER. Yes, I would.

What he said precisely was that we all know and agree that any tax cut has a second-order effect. He went on to say that if Treasury considers the "feedback effect" from the impact of a tax cut—the growing taxable income as a result of the cut itself—the Treasury would be accused, in effect, of rinky-dinking the estimates to promote its own end. Therefore, the Treasury ignores second-order efforts and assumes other things to remain equal.

The implication is that the second-order effect of every tax cut is the same, and that just flies in the fact of commonsense. A tax cut on an individual in the lowest bracket will primarily affect consumption. The second-order effect will be small. It will be a "trickle-up" effect. But a tax cut on an individual in a high-marginal bracket who saves most of his income will provide a lot of money for savings and capital formation.

Capital gains is a very special case. On my salary or your salary, you have to pay the total tax and there is no avoiding it. On capital gains, you or I don't have to pay a cent. It is strictly up to you or me. We make the decisions as to whether we pay a capital gains tax because we don't have to sell the assets.

So the second-order effect of a capital gains tax reduction has to be taken into consideration if revenue estimates are to be anywhere close. Both commonsense and econometric studies indicate that the second-order effects of a cut in capital gains taxes would be strongly positive.

Senator HANSEN. I noted in yesterday's paper that I think the President came pretty close to indicating that he would veto legislation such as is contemplated by S. 3065.

Would you care to comment on that press report?

If you choose not to, that is just fine. I am just curious to know what might be the reaction of the Congress or of people, if you would like to speculate?

Mr. WALKER. Well, I will give you an economic comment and a political comment.

The economic comment is that more and more economists are fearing a recession. I fear a recession. In fact, I think we are going to have one unless we get inflation under control. That is not a point to discuss here right at the moment, although this bill would help control inflation in the long run through more capital formation and more efficiency.

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The second aspect is in terms of equity. A lot of people have been squeezed by inflation and, given the narrow tax brackets, have moved up into higher ranges quickly. So there is a very strong case for cutting taxes and holding expenditures so that the people who have suffered such a blow, particularly in the middle-income ranges, can recapture some real income.

If I reasoned strictly as a Republican, I would say that I hope the President does veto this well-balanced tax cut, say, on October 10, shortly before the election. That would assure more Republicans in Congress next year.

However, I'm a citizen first, and I simply cannot conceive—given the overall pressing argument for a well-structured, balanced tax cut on individuals, on business, on capital gains—I simply cannot conceive that if the bill moves through as it promises, that the President will veto it. Maybe he will, but if so, his party—and more important, the country—will be the loser.

Senator HANSEN. Thank you very much, Dr. Walker. I certainly do appreciate your being here, and I want to thank again those witnesses—Dr. Carlson, the Honorable Tommy Corcoran, and you—for your appearance here.

[The prepared statement of Dr. Walker follows:]

STATEMENT OF DR. CHARLS E. WALKER CHAIRMAN, AMERICAN COUNCIL FOR CAPITAL FORMATION

Mr. Chairman and Members of the Committee: My name is Charls E. Walker, I appear before this committee as voluntary chairman of the American Council for Capital Formation. I am grateful for this opportunity to express the strong support of the American Council for legislation to reduce the Federal tax burden on capital gains. Of the several measures now under consideration, we urge enactment of S. 3065, "The Investment Incentive Act of 1978" (also referred to as "The Steiger-Jenkins-Hansen Act"). The legislation would, in effect, reduce the top tax rate on capital gains from 49.125 percent to the 1969 level of 25 percent.

The American Council for Capital Formation is supported by a diverse and growing group of individuals, business, trade and union organizations. We are deeply concerned about the lagging rate of capital formation in this country—a rate that falls short of our own past performance and is also low relative to our major competitors abroad. Productive investment must rise sharply if this nation is to create adequate jobs for a growing labor force, foster higher living standards through sustained economic growth, and limit inflationary pressures by increasing efficiency in the industrial sector.

We are convinced that a major factor impeding capital formation is a bias in the Federal tax system strongly in favor of consumption and against saving and productive investment. We therefore favor tax measures that would help eliminate the bias.

Speaking of S. 3065, I can think of no single piece of legislation whose enactment would do more, psychologically and substantively, to indicate that this nation is at long last facing up to the capital formation challenge. And this enactment would provide a substantive bonus by reducing—immediately—the Federal deficit. Administration officials profess to believe otherwise, despite the dictates of common sense and overwhelming evidence from reputable econometric models. And, since revenues would rise, legislation to cut capital gains taxes need not "crowd out" sensible and long-overdue reductions in other individual and business taxes. Indeed, revenue-raising capital gains reductions can help "pay" for those cuts.

Mr. Chairman, I could discuss at length the positive case for early enactment of S. 3065—the great benefits to homeowners; stimulation of the stock market; freeing up badly needed venture capital; a reduction in the debt/equity ratio and, therefore, less upward pressure on interest rates; greater parity with fast-growing economies such as those in Japan and West Germany, where capital gains are not taxed at all; greater mobility and therefore efficiency in the use of scarce capital funds; and so on.

But perhaps it would be better if I used my time to respond to critics of the proposed reduction. They argue that the reduction would "cost" the Treasury more than $2 billion annually; sharply erode the progressivity and horizontal equity of the income tax system; and do little for capital formation.

"COST" TO THE TREASURY

More and more observers—including many members of Congress—are beginning to question the view of Administration officials that enactment of S. 3065 would lose instead of gain revenues. To be sure, lower tax rates mean lower taxes per dollar of asset taxed. But if more dollars are available to be taxed, the second-order effects can offset and even exceed the first-order impact. Controversy still rages with respect to the size of second-order effects of individual income tax cuts, corporate rate reductions, etc. But the argument with respect to the proposed cut in capital gains taxes, if submitted to a jury of reasonable men and women, would doubtless be settled promptly.

The first point to emphasize is that a significant portion of the billions of dollars of existing "locked-in" capital gains are likely to be realized quickly if the tax take on the sales is reduced. How can one know this? Easy—talk to people, they'll tell you, and in no uncertain terms. People who know markets are convinced that a reduction along the lines of Steiger-Jenkins-Hansen would result in a tremendous "unlocking effect," with sales so large that the volume of realizations would much more than offset the cut in rates. History supports this view. When rates were raised in 1969, realizations *dropped sharply*, and so did receipts of taxes on capital gains.

What also needs emphasis is the fact that taxes on capital gains are very different from taxes on salaries and corporate profits. An individual does *not* have to pay capital gains taxes; the decision is up to him, not the Government. No sale, no tax—and more and more are electing not to sell.

Clearly, S. 3065 would not "cost" the Treasury one red cent. In fact, it would gain revenue—in the short run, as the "unlocking effect" swelled revenues; and in the long run, as capital formation promoted jobs and growth, and a consequent rise in taxable income.

IMPACT ON PROGRESSIVITY OF THE TAX SYSTEM

Few quarrel with the basic objective of progressivity in the tax system. In fact, the tax system in the United States is nicely progressive, ranging from average effective rates (*not* marginal rates) of less than zero for some of those who claim the earned income credit, to around 10 percent in the lowest bracket, up to 30-to-40 percent or more in the highest bracket. That the Steiger-Jenkins-Hansen bill would slightly decrease the progressivity of the tax system is apparent. But this loss is more than ameliorated by its impact on the economy—greater job creation, economic growth and investment. The benefits to be derived are too important and too widespread to forego—and they will be shared by all taxpayers and potential taxpayers.

As a recent editorial in the *Washington Star* pointed out:

"Admittedly, most capital transactions likely to be taxable as capital gains are indeed engaged in and of primary benefit to, those with significant capital to invest. There are those who still entertain the quaint view that this is, in essence, what "capitalism" means. It is an economic system that offers special incentives to those who save their money and invest it in productive and profitable enterprises, hoping to enrich themselves thereby.

"When you anchor tax policy entirely to your approval or disapproval of the income style of the 'rich,' you leave a lot out * * *.

"A more intelligent approach to tax policy, and one that may even point the way to greater *general* economic benefits, is to ask 'macroeconomic' questions about the capital gains tax. What effect do significant changes in the capital-gains tax rate have on the way investing people handle their funds? Is it true (as reliable figures suggest) that the higher rates since 1970 have *lessened* federal revenues from that source? Is it true (as again seems to be the case) that the post-1970 rates have made equity capital less mobile and less flexible, with the ultimate effect of creating capital shortages and driving businesses to rely the more on borrowing for expansions and acquisitions? There are those who say so; and they have impressive figures to back their claim."

It is also worth noting that—assuming our common sense assumption that S. 3065 would gain and not lose revenue—the well-to-do would be paying more taxes to help support the Government, albeit at lower rates per dollar of asset sold.

The tax system of the United States is progressive; it is not and should not be designed to "level" incomes. The goal is to raise revenues in a way that does the least damage to—and indeed promotes—social and economic goals. To be sure, a reduction in tax rates on capital gains will boost the net worth of some wealthy people—a result thoroughly distasteful to those in favor of promoting income equality by "levelling down."

But the Free World's experience with the "levelling down" theory of income redistribution shows that it actually results in a smaller overall "economic pie" with little relative change in shares of the pie. Everyone receives less. That process supports inflation and poverty—not economic growth.

IMPACT ON CAPITAL FORMATION

Capital formation is lagging badly in the United States. As Treasury Secretary W. Michael Blumenthal stated recently:

"The facts are inescapable: we are not saving enough; our financial system is providing insufficient equity capital; we are not investing near enough in productive plant, equipment, and technological innovation; profits are too low, and they are too uncertain."

There is general agreement that an increase in the rate of capital formation will provide jobs for a growing labor force; foster faster and more sustainable economic growth; and, by raising productivity, provide the best long-run answer to inflation. But the question is raised: Will a significant reduction in tax rates on capital gains—in effect a reversal of a decade-old policy of raising those rates—promote capital formation?

A growing number of people believe it will. This includes small businessmen, venture capitalists, those concerned with high technology enterprises, investors in stocks, farmers, ranchers—and many others. The risk capital needed in these sectors is sadly lacking. Because the needed funds are not available in domestic capital markets, many smaller firms now obtain such financing in foreign capital markets. Over the next few years, the United States may well pay a high price for having exported some if its high technology without having a new generation of technology coming along to replace it.

That a significant reduction in the tax on capital gains would stimulate capital formation has been supported by analyses undertaken by several leading econometric analysts. They include Chase Econometrics, Merrill Lynch Economics, and Norman B. Ture, Inc. And the result of increased capital formation is more jobs, faster economic growth and a lower Federal deficit.

CONCLUSION

The American Council for Capital Formation does not view enactment of S. 3065 (along with a cut in the corporate rate and liberalization of the investment tax credit) as the end-all and be-all of legislation to remove the bias against saving and productive investment in the Tax Code. It would instead be a first step. But after so many years of marching in the wrong direction, a first step is precisely what is needed at this time. The favorable impact, both here and abroad, will be rapid and widespread.

We can think of no better "first step" at this time and strongly urge this Committee and the Congress to approve S. 3065.

Thank you very much.

Senator HANSEN. Does anyone else have anything to say? Would anyone else like to offer a few words before we adjourn this hearing? If not, thank you very, very much, gentlemen and ladies.

The hearing will be reconvened tomorrow morning at 9 o'clock in this room. At that time we will hear from Dr. Michael Evans, Gary Ciminero, Dr. Otto Eckstein, the Honorable Daniel Brill, Dr. Edwin Zschau, Dr. Martin Feldstein, Dr. Arthur Laffer, and a panel consisting of James Davant, A. A. Milligan, Arthur Levitt, and our final witness will be Andrew J. Biemiller of the AFL-CIO.

The hearing is recessed until tomorrow morning at 9 o'clock.

[Whereupon, at 2:54 p.m., the subcommittee recessed, to reconvene at 9 a.m., Thursday, June 29, 1978.]

CAPITAL GAINS TAX BILLS

THURSDAY, JUNE 29, 1978

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
GENERALLY OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to recess, at 9 a.m. in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. (chairman of the subcommittee) presiding.

Present: Senators Byrd, Jr., of Virginia, Packwood, Hansen, Roth, Jr., and Dole.

Senator BYRD. The hour of 9 o'clock having arrived, the committee will come to order.

The impact of a reduction in the capital gains tax rates on Government revenues is a matter of some controversy. Treasury estimates of revenue losses do not take into account the feedback effect. Other studies by noted and able econometricians have pointed to a positive rather than a negative revenue effect in reduction of capital gains rates. The Treasury does not totally agree with this.

Today, we will examine this controversy in some detail.

The first witnesses are a panel of three: One from Chase Econometrics Associates; one from Merrill Lynch Economics, Inc., and one from Data Resources, Inc.

Will Dr. Michael Evans from Chase, Gary Ciminero from Merrill Lynch and Dr. Otto Eckstein please come to the witness table?

Welcome, gentlemen. The committee is very pleased to have you this morning and you may proceed as you wish.

I do not know who will be the spokesman for the panel, but you can work that out for yourselves.

Mr. CIMINERO. Shall we do it alphabetically?

Senator BYRD. That is fine.

STATEMENT OF GARY CIMINERO, MERRILL LYNCH ECONOMICS, INC.

Mr. CIMINERO. I guess I will go first.

Mr. Chairman, my name is Gary Ciminero. I am a vice president and manager of econometrics for Merrill Lynch Economics.

Mr. Chairman and members of the subcommittee, this testimony is based on a study conducted by Merrill Lynch Economics, Inc., which assessed the quantifiable economic impacts of reducing the capital gains tax rates as put forth in bills proposed by Representative Steiger and Senator Clifford Hansen.

A copy of that study, entitled: "Economic Impact Analysis of the Capital Gains Tax Reduction" is attached to the documents I am submitting today, and I would like for them to be a part of the testimony.

Senator BYRD. Yes. That will be made a part of the record.

Mr. CIMINERO. My remarks will be limited to a summary section of a rather extended statement of testimony and I will only highlight the major results and touch on some of the controversy. Other members of the panel will probably elaborate on some of these controversies that have arisen.

The proposed rollback of the maximum tax rate on long-term capital gains from current levels to 25 percent for both individuals and corporations would enhance near-term prospects for economic growth by ultimately improving economy-wide production capacity and productivity. Assuming the tax rate to be effective in the first quarter of 1978, the aforementioned study assessed the economic impact through 1980, as measured by the Merrill Lynch Economics econometric model.

As an aside, the precise time at which the tax cut would become effective does not have any substantial impact on the beneficial results recorded here, out 1 to 2 years.

In a comparison with the Merrill Lynch Economics basic forecast as a standard, the key economic impacts of the tax reduction simulation included an acceleration in GNP growth of about 0.2 percentage points—that is, GNP over the 10 quarter period increased by about 3.5 percent versus about a 3.3 percent growth under the standard forecast

The unemployment rate falls by approximately 0.2 percentage points, from 5.7 percent to 5.5 percent, essentially through the creation of over 200,000 additional jobs by 1980 which the enhanced economic activity creates.

The major channel of impact of the capital gains tax reduction, as simulated in the model, is via fixed real business investment. This indicator increases by $3.2 billion over the entire period; $2.9 billion of this goes into plant and equipment spending, and about $300 million goes into residential fixed investment, which is to say that the enhanced business fixed investment in plant and equipment does not come at the net expense of housing.

The Federal budget deficit itself declines by $2.3 billion in the terminal year 1980. This decline results from the enhanced economic activity which increases taxable income and, therefore, Treasury revenues on corporate income and individual income taxes. As we discuss later, the revenue impacts of the capital gains tax reduction itself, are essentially revenue neutral to revenue positive and therefore are a wash in the analysis of the Federal budget deffcit.

The stock market increases by 4 to 6 percent above levels forecast under the baseline. This calculated increase is based on a highly conservative stock market evaluation calculation, which causes the cost of equity capital to the firm to fall by 0.25 to 0.3 percent.

Long-term bond rates declined 5 to 10 basis points.

Virtually every economic indicator in the model improved under the tax reduction simulation. However, a few of the economic indicators recorded adverse reactions to the tax-rate rollback. These adverse

reactions were relatively minor. The rate of inflation increased by about a tenth of a percent over the standard forecast in 1980, mainly the result of enhanced real activity, and the Federal funds rate, a key, short-term interest rate on which other short-term interest rates are based, increased by about 10 basis points by 1980, mainly the result of the assumption that the monetary policy does not accommodate the increased economic activity with increased growth in monetary aggregates.

Longer term economic benefits can be assessed beyond the 1980 time horizon. These result mainly from the increase in real business investment. Heightened plant and equipment investment outlays serve to improve productivity, the well-spring of an improving standard of living, by expanding the overall capacity of the economy to produce goods and services. As a bonus, both of these effects combine to ameliorate the inflation problem in the longer term.

Now, some of the controversy surrounding these studies has involved the capital gains tax and revenue neutrality. As is well known, the Treasury, by assuming a fixed amount of capital gains realizations, calculates that a reduction in the tax rate would reduce Treasury revenues by about $2.2 billion.

In our study, we found that the decline in the tax rate is essentially offset by the increase in capital gains realizations allowing total tax revenues to improve, these total tax revenues arising from the increase in taxable income and profits, as I mentioned earlier.

Because of limitations in data availability, capital gains and associated tax revenue data are not explicitly included in the quarterly national income accounts data which underlie econometric models. However, it is fairly easy to demonstrate that, even with the understated stock market price increase of 4 to 6 percent above the standard forecast, the incremental paper gains on equities alone amount to about $42 billion over the 10-quarter forecast period. Making conservative assumptions as to what the average marginal tax rate on capital gains would be before and after the Steiger tax rate reduction, one obtains a potential revenue estimate from the $42 billion of about $2.7 billion on an annual basis.

This potential revenue estimate exceeds the $2.2 billion static revenue loss estimated by the Treasury Department.

Therefore, the understated incremental equities market gain alone involves potential tax liabilities that exceed the static revenue loss estimate. In addition to the immediate incremental gains estimated above, liquidation of longer-term unrealized locked-in gains on equities are likely. Assets other than equities should also experience incremental gains and liquidation of locked-in gains.

It is therefore easy to conclude that the incremental total capital gains on tax revenues could well exceed the statically estimated $2.2 billion revenue shortfall. However, the numbers that I have given assume that it is only a wash.

Understatement of economic benefits has been the guiding principle by which this study was conducted, and which may explain some of the differences achieved here versus the results achieved by other members of the panel.

Throughout the analysis, certain nonquantifiable or at least difficult-to-assess factors have been gaged so that the analysis would err on

the side of understating the beneficial impacts. First of all, the potential stock market strength has been minimized to that which was quantifiable from the tax-rate decline alone. Accordingly, stock prices rise by only 4 to 6 percent. An even stronger stock market, with higher economic benefits than estimated here, could easily ensue by relaxing this assumption.

The potential decline in long-term corporate bond rates that could result from lower capital gains taxes and the improvement in balance sheets as more equity is issued has also been minimized. Accordingly, the average new-issue bond rate declines by no more than 10 basic points.

Finally, we have explicitly ignored the beneficial effects of rising values of other capital assets, aside from stocks and bonds.

In conclusion, leaving aside such politically important questions as income distribution, economic opportunity and the fairness and progressiveness of the income tax, all of which are beyond the scope of this quantitative assessment, one is led inexorably to the conclusion that the proposed capital gains tax reduction would increase economic benefits pervasively and improve the allocation of capital while increasing tax revenues and improving the Federal deficit. The only quantifiable economic costs involve a slight increase in inflation and other short-term interest rates.

Obversely, leaving the current capital gains tax structure unchanged would be to continue levying considerable opportunity costs on all segments of the economy: fewer jobs; lower incomes; less production capacity and less productive capital; lower Government revenues even from the capital gains tax itself, and larger deficits; less efficient allocation of capital and lower capital gains income and portfolio values both for capitalists and wage earners who invest directly in stocks or have their pension savings invested in financial assets.

Senator BYRD. Before calling on Dr. Eckstein, I would like to say that while I have a great interest in this hearing and want to be present, at this time the Senate is now considering the New York City bail-out, or financial assistance, anyway one wants to express it. The New York City bill is a very important measure. I must oppose it for two basic reasons.

No. 1: New York City has not balanced its budget, although 3 years ago it promised the Congress of the United States that it would.

Second, I think it is a very dangerous and undesirable precedent for the Federal Government to begin to guarantee bonds of the municipalities or States of our Nation.

So I will need to go to the Senate to participate in the discussion of that proposed legislation. Otherwise, I would be present the entire time. I will get back as quickly as I can.

Dr. Eckstein.

STATEMENT OF OTTO ECKSTEIN, PRESIDENT, DATA RESOURCES, INC., AND PAUL M. WARBURG, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. ECKSTEIN. Thank you, Senator Byrd, and members of this distinguished committee.

The question that you have before you is one of the most difficult in the whole tax field, and in my lengthy testimony today, I have tried to review these basic issues. The statement is much too long to read, and I ask you that you place it in the record as I submitted it.

Senator BYRD. Your full statement will be placed in the record.

Mr. ECKSTEIN. I will quickly summarize it.

Capital gains were a central concern of tax reform since the personal income tax took its modern form. After many years of impasse, in 1969, the log jam on tax reform finally broke and a major increase in capital gains taxation was enacted. Then in 1976, another more dramatic—and still little recognized change—in taxation of capital gains and of estate and gift was brought into the tax law which had the effect of substantially raising the effective rate of taxation on capital gains and the effective taxation on property.

Now, indeed, the President's recent proposals would have pursued these lines even further and raised the rates some more.

Now, while the tax reform community was at least halfway pleased with these measures, the subsequent events have cast a good deal of doubt on the wisdom of everything that has been done and we now are at a moment where we are considering undoing part of it.

The things that have happened are these:

First, the inflation became much more severe. It has always been recognized by public finance specialists that it was inappropriate to tax capital gains created by inflation. Now, when the inflation rate was 1.9 percent, as it was from 1952 to 1969, and the rate of increase of stock prices was 8.5 percent as in those years, it did not matter all that much, and the fact that half of the gains were excluded was a more or less adequate offset to this improper taxation of inflation-created capital gains.

But, since 1969, the inflation is 6.5 percent and the stock market is not up at all and so the gains that have occurred since then are largely unreal.

Table 1 and chart 1 summarize that matter.

Second, after all of these reforms were enacted, the stock market began to act very badly and the price-earnings multiples fell from about 17 to about 9. Of course, there were many other reasons including the general economic environment, the inflation, the high interest rates, the business cycle, OPEC and all the rest; but, nonetheless, it must be faced that for the high-income individuals, who are the main subject of the tax reforms, the true situation really is one that if they invest in stocks they face a 49-percent tax if the investment is successful and the writeoffs are very small if the investment is unsuccessful.

As a result, these individuals either keep their old investments and do not realize them, or have looked for other forms of investment, in either real estate or other fields, or tax-exempt securities. They simply have left the stock market, leaving the stock market principally to tax-exempt institutions and pension funds, insurance reserves and such as that.

The third thing that happened was that the rate of capital formation fell very dramatically from about 10.5 percent of GNP to 9 percent and 9.5 percent of GNP and we are now suffering some of the results in less productivity advancements.

Well, given these unfortunate events, the question then becomes, Should we undo some of these moves and are the bills that are in front of us the right way to do it?

Well, we have run these matters through our computers, through our 800 equation econometric model, and that analysis is summarized in table 2.

I should tell you that, in some regards, the econometric models are really, as far as policy is concerned, a kind of antimiracle pill. The

policy we are analyzing here is a $2 billion reduction in capital gains taxation and, of course, any $2 billion move in a $2,000 billion economy cannot be expected to cure all of the ills of our society, to balance the Federal budget or to achieve dramatic results in any regard. It is just too small a matter.

But when you analyze table 2, you see several things. First of all, let me preface it by saying that this analysis does not assume that the Federal Reserve really goes along with it, so there is no extra increase in bank reserves that allows the interest rates to stay unchanged despite this stimulus to the economy.

So, after a few years, the extra activity that is created is largely chewed up by higher interest rates which gradually crowd out a certain amount, particularly of housing activity.

In other studies that we have performed, we have made the other assumption. We have assumed the Federal Reserve does accommodate, lets the money supply go up extra. But those studies were done before Chairman Miller took over at the Federal Reserve and he does not look to me as if he were the kind of man who would accommodate these moves.

So we have now adopted, realistically, perhaps, a nonaccommodating Federal Reserve posture.

Now, if you then look forward at these impacts, of course, it does depend, as everybody now recognizes, on what the stock market would do.

Let me give you three cases and then I will analyze which one, perhaps, is correct.

The cases are first, that the stock market goes up 1 percent; second, that it goes up 4 percent; and third, that it goes up 10 percent, in response to this not really carefully specified $2 billion move. This would not attempt to identify whether this is exactly the Steiger bill or some other bill. This is just an average reduction in capital gains taxation, including a fifth of it accruing to corporations.

What you see is some nice benefit. Business fixed investment in the extreme case, case 3, does rise 2.3 percent, which is a very major impact and is an impact larger than the initial $2 billion that is spent. So the GNP as a whole is up by half a percent which, again, implies a kind of multiplier on this particular tax change which is among the larger.

The reason why the move is as beneficial as it is is because it affects the cost of capital rather substantially and allows business to raise, not only equity capital more cheaply, but to allow debt capital more cheaply because it has a better balance sheet. Our model does represent that process.

Because consumers benefit from the greater wealth of the better stock market, and because of other minor indirect effects within the model, the result is a little reduction in unemployment, a little increase in consumer spending and, all in all, it is quite beneficial.

The impact on the Federal budget depends very much on the stock market assumption. In the most favorable case, you do gain at the peak an improvement—and it does pay for itself, in the most favorable case, with receipts of $5 billion, ultimately, and a surplus of $3.7 billion before the tight money undoes it and the Federal Reserve finally takes it away from the Treasury.

Of course, that only occurs if the stock market moves up as much as 10 percent. If the stock market goes up 4 percent, then the revenue effects still, after a couple of minus years, turns moderately positive, which is better than most tax changes. If the stock market only budges by 1 percent, there is nothing in it. Then the budget simply becomes worse.

The next question then is, what really is a probable outcome for the stock market? It is a very difficult question and I would not pretend that it is possible to come to very specific answers, but I give you some overall, commonsense quantitative perspectives on it.

Let's take the extreme case. Let's assume that everybody is in the 50 percent—that 49.1 percent bracket. If that is brought down to 25 percent you have reduced the taxation of capital gains by 25 percent. Keep in mind that half of the total return on the stock market, in the very long run—not from 1969, but from the twenties or the forties—is capital gains; the other half, roughly, is dividends. So you have reduced the taxation of the stock market as a whole by 12.5 percent which is a very major move.

But now you must chip away at that some more. By now, about a quarter to 30 percent of all of the stocks are held by people who do not pay any tax—pension funds, life insurance reserves. Keep also in mind that actually the average effective rate is not 50 percent, but 25 percent because many of the shares are still held by middle- and upper-income people who do not pay these absolute maximum rates.

So, in effect, when you go through that whole arithmetic and trace it down, what you find is that the taxation of the stock market is reduced by 3.7 percent if you enact a $2 billion capital gains tax reduction.

Now, that is only a quarter of the total tax. The $2 billion is roughly a quarter of all the capital gains taxation there is and if you enact that $2 billion move you will lower the taxation of total return on stock by 3.7 percent which, if that were the only factor affecting the stock market, in some simple, rational scheme, the stock market would go up about 3.7 percent.

So we feel that the 4 percent is, on some rationality, a reasonable assumption. It could conceivably be as high as 10 percent. We have made assumptions of that sort in past studies, assuming that there is a psychological effect, that there is importance to the marginal role of the individual high-income investor in the overall picture.

But let me now deal with two other questions which are, perhaps, more fundamental. I will do it very briefly.

On the question of the fairness of this particular bill versus other bills that would reduce capital gains taxation, I think you do have to do something also for middle-income people. These bills really do focus the benefit at the top of the income scale and, in fact, if you ask who is really being treated most unfairly, it is the middle-income group because this is the group where the inflation impact of the overstatement of capital gains has been the greatest.

My testimony cites the two major studies by Brinner and Feldstein which show that the inflation impact has been the most severe on the middle-income people, not those at the very top, because of the kinds of assets they hold and how long they hold them.

So if you are going to be fair in your measure, I would urge you strongly to give some relief to home ownership—perhaps remove the single family home altogether from capital gains taxation—and, if not that, then to begin to inject into the capital gains tax some inflation adjustment.

One final point, and then I will close. There is one other issue here that is perhaps as fundamental as any other in the entire matter, and that is this.

Since 1954, we have stimulated investment again and again and again by Presidents Eisenhower, Kennedy, Johnson, Nixon, and Ford and, in every single case, we have done it by encouraging the retention of earnings in large, capital intensive companies.

On the individual investor, on capital formation through the marketplace, we have essentially been punitive. Every measure, except the across-the-board reduction, has raised the tax on capital formed through the market.

So my own belief is that this is a good time to begin to reverse that strategy and to begin to divert a little of the money that we are diverting to investment stimulation to the market, rather than to the large corporation retained earnings approach.

Thank you.

Senator BYRD. Thank you, Dr. Eckstein.

Dr. Evans.

STATEMENT OF MICHAEL EVANS, CHASE ECONOMETRICS ASSOCIATES

Mr. EVANS. I thank you, Mr. Chairman, panel.

I would like to summarize my results briefly and concentrate on the economics without going into the econometrics too much.

I have done so with the four major points which are listed in the executive summary of my testimony.

The first point which I would like to make is that the ratio of capital spending to GNP is closely correlated to the ratio of stock market prices to construction costs by 1 year. In other words, the higher the stock market is, the better this will be for the investment climate.

This fact is generally agreed on, and, as a matter of fact, I think we could say it commands bipartisan support. In fact, the figures supporting this argument appeared in both the Republican 1977 Council of Economic Advisers report and the Democratic 1978 council report.

So I believe that the relationship between stock market prices and capital formation is well established. The reason for such a relationship is that when equity capital is relatively cheap, firms expand by creating new plant and equipment. Whereas, when equity capital is expensive and stock market prices are depreseed, firms expand by buying existing businesses which does not add to the productive stock of the economy.

And, in fact, we note that, under the present depressed stock market, mergers and acquisition activity has risen to a peak in each of the last several quarters.

So I think that those who would stimulate capital spending, which would include a wide panoply of economists of all political persuasions, would certainly argue that a higher stock market would aid in this particular endeavor.

My second point has become somewhat more controversial, which is that the maximum capital gains tax rate is one of the principal determinants of fluctuations in stock market prices.

In order to explain this, I think a little background information might be useful. For the past decade, GNP has risen at an average rate of 9 percent per year. Corporate profits have risen at an average rate of 11 percent per year. The stock market, however, has not risen at all.

A typical index—for example, the Standard and Poor's 500—is no higher than it was in 1969, the last year in which capital gains were taxed at a maximum rate of 25 percent.

So we have had this increase in GNP in profits and yet no increase in the stock market. It seems to me that those who would argue the relationship certainly would have to come up with some other reasons why the stock market has not appreciated.

Some people have suggested that inflation has cut into stock market gains, and, to a certain extent, that is true because corporate profits are now overstated because depreciation allowances which are valued at historical rather than replacement terms, are understated.

However, that does not account for very much of the increase.

Some people have suggested that interest rates' rising has had an effect but, in fact, interest rates at current levels are lower than they were in 1969, so that cannot be much of a factor.

The major change in the economic situation between now and 10 years ago has, indeed, been the increase in the capital gains rate from a maximum of 25 percent to 49.1 percent and, as a result, this has seriously injured the stock market and, according to our calculations, has resulted in a decline in the stock market relative to what otherwise would have happened at about 4.3 percent a year, or a 40 percent figure over the last 8 years.

In other words, if the Steiger-Hansen bill were to be enacted and the maximum capital gains tax rolled back to 25 percent, the stock market would rise approximately 40 percent over the next 2 years.

Even this increase would still result in a far lower price-earnings multiple than occurred during the middle and late 1960's but would certainly be a major step in the right direction.

As a result, the studies which we have undertaken show this very important result. It is based on a relationship between stock market prices and a number of key economic indicators, including profits, dividends, interest rates, the rate of inflation, and other economic variables.

The next point which I would make—point three in my executive summary—is that lowering the capital gains tax rate will reduce the Federal budget deficit. Now, of course, this finding is directly in opposition to the Treasury finding which says that it would increase the deficit by some $2.2 billion.

The Treasury analysis is a clear case of static analysis in which, as unbelievable as it may seem, the assumption is made that nothing would change, that somehow, individuals and corporations would not be attracted back in the stock market even though the rate on capital gains tax was halved.

This seems to be a wholly unrealistic assumption, particularly in view of the fact that capital gains taxes in 1968 reached an alltime peak and have never recovered that level, even in 1976, when the price level was approximately twice as high.

As a result, there seems to be very little question that the reduction in capital gains taxes would draw money from other sources, particularly tax-free municipal bonds and these funds would, instead, be invested in the stock market.

The Treasury has also pointed out that only 28 percent of capital gains relate to the stock market and that, from their point of view, appears to be an argument that we should not cut the capital gains tax. And I say exactly the reverse.

The reason that only 28 percent of the capital gains are in the stock market is because the punitive rate on capital gains has driven people out of the stock market and into other types of investment and the reversal of this would very much increase the flow of funds into the stock market and our most efficient use of capital.

My fourth point and the one that the Treasury has taken the focus on is that somehow the reduction in capital gains will only benefit "the rich." I do not know how one defines the rich. I suppose it is anybody with capital gains, these days, but, in any case, their argument is wholly falacious.

What the Treasury has done is prepare some tables showing that most of the capital gains would go to people with incomes of over $100,000 a year.

What the Treasury completely fails to realize are that many of the people in these upper income brackets do not make that amount of money every year, but they are in the upper income brackets that year only because they had a large capital gain.

The individual who makes perhaps $25,000 to $30,000 a year has a large capital gain one year because he sold his principal residence, because he sold a family farm, because he sold a small business, and that, and that alone, pushes him into these so-called rich taxpayer bracket.

As a result, the study is definitely skewed, and innumerable studies of income distribution have shown that those people in the very top income brackets are not the same people year in and year out but, in fact, those people who are pushed up by higher capital gains taxes.

As a result of this, the Treasury's argument that this bill would benefit only the rich is untrue. It would benefit only those people who have invested in capital assets who have saved some of their income and put it to use in the productive sector of the economy. Once this fact is brought out, I think that the Treasury should reverse its position.

In conclusion, I have been quite surprised by the response of the Treasury and its lack of effort to come to grips with the facts, and its lack of sophistication in terms of economic arguments.

The very lack of sophistication suggests to me, at least, that the Treasury is on very weak ground. They would certainly muster the facts to dispute these arguments if they were available and the fact that they have turned to rhetoric instead of facts suggests, at least to me, that the facts to dispute this argument simply do not exist.

As a result of this, I think that the capital gains tax is one of the most important moves that could be taken to spur capital spending in this economy. As a result of this, the growth rate of the economy would increase 0.2 percent per year, an extra 440,000 jobs would be

created over a 5-year period, and because of the additional economic activity, the Federal budget deficit at the end of 5 years would actually be reduced by some $16 billion.

Thank you very much, Mr. Chairman.

Senator BYRD. Thank you, gentlemen.

Just one or two brief questions, and then I will yield to Senator Packwood. Is it the consensus of the panel that the proposed changes in the capital gains rates would be the most efficient way to encourage risk capital, or would a reduction in corporate tax rates be a better alternative?

Mr. EVANS. I think that the capital gains reduction would be the best way, particularly where risk capital is involved. I think the corporate tax reduction would also stimulate investment, but if I would have to rank them, I would rate the reduction of capital gains tax ahead of reduction of corporate income tax.

Senator BYRD. Would the other members of the panel concur?

Mr. ECKSTEIN. Well, I do not think there is any question that a capital gains reduction would be more helpful to risk ventures than reduction in the corporate rates. However, this is not the only form of capital gains reduction which is open to the Congress, and I really do not see how you can focus the tax relief so exclusively on the upper income component of the capital gains recipient.

Mr. CIMINERO. I would concur that it is surely a way of fostering increased venture capital. As to the incidence across income brackets, that is outside the realm of analysis that we can quantify, being rather in the realm of political discourse.

Senator BYRD. Thank you, gentlemen. I yield to Senator Packwood.

Senator PACKWOOD. Gentlemen, let me read a colloquy between Secretary Blumenthal and myself yesterday relating to your studies and then ask you to comment on it. This was after I had indicated to the Treasury that I had predicted in 1969 that revenues would go up when we increased the capital gains tax, and they did not, and indeed Treasury had been wrong and, indeed, SIA had testified at the time that revenues would go down, and they turned out to be right.

Senator PACKWOOD. "You have seen the studies of Chase, Merrill Lynch, SIA—and, as I understand, Dr. Eckstein, that is your study—and Turay, all of which show revenue increases in the second year ranging from $7.3 billion to $1 billion, but all of them increases. In your estimation, they are all wrong?"

Secretary BLUMENTHAL. "That is correct, because they assume stock market increases of 40 percent in one instance and 20 percent in another."

Senator PACKWOOD. "Only 4 to 6 percent in the case of Merrill Lynch."

Secretary BLUMENTHAL. "And 4 to 6 in the third."

Senator PACKWOOD. "That is not an exorbitant increase in stock market prices."

Secretary BLUMENTHAL. "Well, the fact is, Senator, nobody knows. These are assertions. Nobody knows that they are. Therefore, we can come up with any result we want if we are willing to assume that the stock market will go."

"We looked at the stock market and we saw that, in the past, there was no correlation."

Senator PACKWOOD. "Nobody knows then, including Treasury."

Secretary BLUMENTHAL. "We looked at the past. In effect, the past has shown no correlation, so we certainly know it is wrong to assume a correlation that never existed in the past."

Senator PACKWOOD. "What information are these other studies based on—referring to your three studies?"

Secretary Blumenthal. "I do not know what they looked at. I think they just programmed their computer to cope out with a certain result."

Senator Packwood. "You think they programmed their computers to come up with a certain result?"

Secretary Blumenthal. "That seems to be the case."

Senator Packwood. "They had a conclusion they wanted to reach and they skewed the figures to make sure they reached that result?"

Secretary Blumenthal. "They have to speak for themselves as to how they get the 40 percent."

Senator Packwood. "No, you've spoken for yourself, and I understand now what you are saying. These are to be dismissed because of the deliberate factual inaccuracies programmed to reach a preconceived conclusion."

I am curious about your comments on the Secretary's charges on your study.

Mr. Evans. In general, I would say that I did not agreee with everything that the Secretary said.

First of all, I would like to point out that the claim that the Treasury does not know what we are doing is a direct flaunting of the facts. I think someone from the Treasury Department has called Chase Econometrics every day for the past 2 months—where did we get our data, and what were the data series and how come they were not up on time sharing; well, actually, they were; well, we will go on to the next question, and how did you run the regression?

The point is that they went through our data and they duplicated our results exactly and they called back and checked on it about 15 times, so ~~it is~~ not correct to say that they did not know what went into it.

Not, it seems to me that if the Treasury was on firm ground—they ran hundreds of regressions to test this thing out and they would have presented some alternative formulations which indicated the lack of importance of the stock market. But my guess is that they were not able to do this, so they just dismissed it and said, well, we cannot find any correlation and we do not know what is in there—which is not true, because, as I said, they called and checked on every facet of our equation and ran in 100 times.

So, in my opinion, the colloquy which you read is more or less an admission of defeat, that even though they tried to get rid of the capital gains term, it would not go away.

Senator Packwood. Well, it is more than that. The Secretary is basically saying that you are all hired guns and that you have been paid to come to the conclusion that the decrease in the capital gains tax will produce more revenue because the people who have hired you stand to earn lots of money if that conclusion is justified.

Mr. Evans. Well, I guess that is one man's view. It certainly would not be my view.

I think that Secretary Blumenthal has changed his opinion. When he was at Bendix view; when he was at Treasury, he took the opposite view until Eizenstat got to him. If you want to talk about changing one's mind for political purposes, I think Secretary Blumenthal might have to stand accused in that very same dock.

As far as my own work on capital gains and productivity, my views on the slowdown in productivity because of a lowering in the investment ratio, because of higher taxation rates and capital gains have been known for at least 5 years. If Blumenthal did not care to read my earlier work, this is up to him, but this is not a Johnny-come-lately view

of mine. It has been in the work for many years. And I think that any reasonable economist would come to the conclusion that investment has slowed down because of higher tax rates and that this has had a negative effect on the economy.

The productivity rate is only half of what it used to be before we raised capital gains taxes. You cannot get away from that.

As far as the hired gun goes, I guess that is a gratuitious comment, and I——

Senator PACKWOOD. That is my description. He did not say that.

Mr. EVANS. He did not say that.

Senator PACKWOOD. He just simply said you took the conclusion you wanted to reach and then just put the figures into your computer to make sure that that conclusion was reached.

Mr. EVANS. Well, we ran a careful statistical analysis and the results might have come out otherwise. A lot of the results that we come out with do not agree with various political affiliations that we have, and this happened to be one that was in favor of capital gains.

Furthermore, the fact is that Blumenthal himself used to be in favor of this, and it is only recently that he has changed his mind.

Senator PACKWOOD. I guess the thing that galls me is that I have been 6 years on this committee and I was 8 years on the Banking Committee and I have listened to Treasury over the years—this Treasury and the Republican Treasury, it does not matter which Treasury. They have one endemic economic disease and that is they are usually wrong.

How Treasury can come here year after year in the light of their past estimates and continue to say that they are the only ones that are right is beyond comprehension. I have no other statement.

Senator BYRD. Senator Hansen?

Mr. ECKSTEIN. Senator, may I respond to that question as well?

Senator PACKWOOD. Yes. It was levied at all of your studies.

Mr. ECKSTEIN. In our own case, in none of the studies with which DRI has been associated have we asserted that the stock market would respond by as much as 40 percent, even if capital gains taxation were completely terminated. We really do believe that that is an unreasonable viewpoint which really, in essence, implies that the only thing that went wrong in our economy since 1965 is the change in the tax law.

Now, we also fought in Vietnam and Cambodia. We had OPEC. We had inflation going from 1 to 7 percent. And all of these matters also impacted upon the correct choice of price-earnings multiple.

The basic DRI studies were done at our own expense in August of 1977. My own testimony here is strictly my own doing and I really—I think the Secretary got carried away a bit.

Senator BYRD. May I make a comment at this point? It is a very serious charge, that the Secretary of the Treasury has made against you three gentlemen when he says "I think they just programed their computers to come out with a certain result."

Did you want to comment on that?

Mr. CIMINERO. Yes. May I have an opportunity to respond to that?

That is a serious allegation and it implies that we plugged in the results and solved for the assumptions, which is quite the opposite of what was done.

This study was done for Merrill Lynch and Co., but at no point was I, in any way, coerced or given any guidance on what the results could, should might or would otherwise be. I suppose if the results came out to be insignificant I would not be here testifying today, however. Throughout the study we attempted to minimize the impact of the capital gains tax reduction, yet, because of the treatment—the explicit treatment of the cost of equity capital in the Merrill Lynch Economics model—the effects are on fairly solid economic grounds, certainly.

In general, the market increase of only 4 to 6 percent results largely from the fact that it is assumed that the market value, the present value, will only increase by an amount that represents the increased discounted present value of future after-tax capital gains. If the taxrate is lowered, the yield from any future after-tax capital gain will be higher. And it is only this understated revenue differential flow to the investor that is allowed to affect current market values. No attempt is made to assess any follow-on effects—follow-on effects of the type which have been discussed here—which would increase stock market values above those levels.

As a further point, we, too, at Merrill Lynch Economics have been called several times over the last few weeks concerning the details and the methodology used. And I might add that there was a general indication from Treasury staff that the techniques we used were both on fairly solid grounds and on grounds on which they had no particular technical quarrel.

Now, finally, I would guess that one could say that the static revenue estimation procedures used by the Treasury would themselves result in a foreordained conclusion. You need not go through any elaborate calculation to discover that, leaving realizations unchanged, if the Government were to decrease the tax rate, revenues would fall. That is a preordained result. On the other hand, such a technique would indicate that if capital gains tax rates were increased to 100 percent, capital gains tax revenues would rise to the full amount of realization, an absurd conclusion.

Senator BYRD. Dr. Evans, did I understand you to say that Secretary Blumenthal favored the reduction in the capital gains tax until his mind was changed by Mr. Eizenstat?

Mr. EVANS. I drew that conclusion from various statements that he made in the last few weeks, and earlier than that, yes, he did say that.

Senator BYRD. Thank you.

Senator Hansen.

Senator HANSEN. Assistant Secretary Lubick in an interview in the June 26 issue of U.S. News and World Report noted that if Treasury in its analysis of revenues did anything but assume a static economy it would be accused of doctoring the numbers, or some kind of bad faith.

Do you think it is a correct approach to assume that behavior does not change when a variable as significant as a tax law changes?

Dr. Evans, do you want to comment on that?

Mr. EVANS. Yes, thank you.

I have also heard that said, that the Treasury tax people say that their sole aim is to simply perform a static analysis, but I believe

that that is a bad rule in general, but in the case of the capital gains it is even worse, because here we are talking about a unique situation, which is to say that the owner of the capital asset has an option of whether to sell or not.

If you are talking about taxing personal income, if you make more income, basically, you have to pay higher taxes; you have no option. But in this case, there is a very definite trade-off. If capital gains taxes rise, then the owner of the asset simply holds onto it. And that, really, is the fundamental determinant of capital gains taxes, just as important as the value of the stock market or the value of real estate. Ignoring that completely begs all analysis. If you are going to assume that away at the beginning, I say you may as well not do the rest of the analysis.

Senator HANSEN. Mr. Ciminero, would you like to comment?

Mr. CIMINERO. Well, I am in general agreement with what has been said here. I am not sure what I can add to it except, again, no attempt was made in our study to assess any kind of follow-on realizations of longer term capital gains that may result from positions that may have been established a year or so prior to the enactment of the legislation and certainly that sort of follow-on gain would occur. And I would agree that the reportable income, in this case from capital gains realizations themselves, are highly at the discretion of the taxpayer.

Senator HANSEN. Dr. Eckstein, I think it was you who observed that Presidents Eisenhower, Kennedy, Johnson, and Ford each, at some time or another, had recommended a change in the tax law and there were some consequences that followed on that would seem to me to be at variance with the static assumption that Assistant Secretary Lubick takes in that context. Would you care to comment?

Mr. ECKSTEIN. The changes, not only recommended but enacted under those Presidents, all stimulated investment by reducing corporate income tax, principally for capital-intensive large companies. None of these Presidents recommended any legislation, to my knowledge, that would have encouraged the use of the market for investment, or the private investor or private capital formation.

Let me add one other point. On this question of the Treasury's own tax studies, our whole society is dependent upon the basic work that the Treasury staff does, and it is a very high quality staff. Now, on this question of revenue and this capital gains change, it really is impossible to determine what the realization response will be and what the indirect repercussion effects of revenues will be.

The Treasury cannot serve the Congress properly, or the Joint Committee on Taxation, if it makes some completely arbitrary assumption about what happens to the stock market volume. I think it is good that there are outside viewpoints, along with the Treasury's viewpoint, that the Congress can consider and I would urge you not always to follow the Treasury's advice, but we really all are dependent on the basic work of the Treasury.

Senator HANSEN. I had one other question, Mr. Chairman.

Much of the Treasury's objection to this bill is based on the fact that the average effective tax on capital gains is well below the 25-percent maximum we seek—I think yesterday Secretary Blumenthal spoke about 15 percent as being something like the average.

From an individual investor's point of view, does it do any good to consider the national average tax rate?

If I could just add one further word, I think that the point has been made here, perhaps repeatedly, that in these expanded income analyses which Treasury uses, a person may become a taxpayer in the $100,000 income bracket only once in his life—I called attention yesterday to that fact.

So in that context, or whatever context you would like to respond, I would ask you if, insofar as an individual taxpayer is concerned, the fact that the national average may be 15 percent may, indeed, not apply to him. That would be my personal feeling. Would you care to comment?

Mr. EVANS. Yes. Well, I think economists of all political persuasions and stripes have usually agreed that the marginal analysis is the correct way to proceed and that we have to look at the tax rates on the margin and, in fact, we have to look at wage costs on the margin, interest rates on the margins and factor prices of all sorts. Until quite recently—until, in fact, yesterday—this was the way in which economic analysis was usually done. So I see no grounds to suddenly switch over to a new mode of analysis and I would continue to believe the marginal rates are the important one.

Mr. CIMINERO. I would concur. The question is, for the next dollar of capital gain, how much do I pay in taxes? And that is the key comparison. Similarly, the firm has the question of for the next dollar investment, how much return results?

As an aside, the calculations given, I believe, in table 1 of the Secretary's testimony compute mean tax rates. A preferable calculation would be an average marginal tax rate.

Third, the weighted mean tax rate that is used there is based on a realizations profile across income categories that are presumably based on realizations at the upper income levels. If the tax law were changed, realizations at the upper income levels would increase; therefore, the weight given to their higher marginal tax rate would increase.

Senator HANSEN. Mr. Chairman, I wonder if Dr. Eckstein would be also permitted to respond?

Senator BYRD. Yes, fine.

Mr. ECKSTEIN. To me, the heart of the matter is that the taxed individual has really left the stock market. The public has been a net seller of stocks for at least 10 years and it has become, really, largely in the hands of untaxed institutional money.

Now, they have a marginal rate also which is zero. At least there is a chance, if there is some kind of capital gains relief, that the public will begin to come back and take an interest in the stock market.

Senator HANSEN. Thank you very much.

Thank you, Mr. Chairman.

Senator BYRD. Senator Packwood?

Senator PACKWOOD. I just wanted to ask the panel to do one thing. I want to make sure you have a copy of Secretary Brill's testimony, which will come later. In his appendix on methodology are his comments upon the assumptions that you gentlemen have made. I would appreciate it if you could respond in writing to the committee, responding to his attacks on your methodology. Thank you.

[The following was subsequently supplied for the record:]

RESPONSE TO THE TESTIMONY OF THE HONORABLE DANIEL H. BRILL, ASSISTANT SECRETARY OF THE TREASURY FOR ECONOMIC POLICY, BY OTTO ECKSTEIN

This statement is submitted in response to a request by Senator Packwood made during the hearings of June 29, 1978.

Secretary Brill's statement does not deal with DRI's tax analyses of September 1977, nor could it deal with the testimony presented before the Committee since this material was not available. Secretary Brill reviewed the Securities Industry Association (SIA) study which was conducted on the DRI model.

The SIA assumption is generally consistent with the analyses in my testimony. SIA assumes a 20% increase in the stock market for a complete abolition of the capital gains tax. My own calculation for the effect of a $2 billion reduction of capital gains tax, a reduction of about one-fifth to one-quarter, shows that a 4% rise in the stock market would be rational. This corresponds roughly to the SIA's 20% assumption for a complete termination of the tax. My testimony goes one step further in showing the impact of alternative stock price assumptions, both if the market over- and under-reacts.

The aggregate effect of the stock market change on the economy was fully presented in the SIA study on two bases: with an accommodating monetary policy and without an accommodating monetary policy. The results without the accommodating monetary policy in the SIA study are dramatically smaller. The technical appendix attached to my testimony explores three monetary assumptions: full accommodation defined as unchanged interest rates, accommodation in terms of unchanged bank reserves (which would allow the economy to increase the actual demand and supply of money through higher activity levels and prices), and finally a completely non-accommodative policy in which the Federal Reserve tightens up its interest rates to leave the money supply unchanged despite the tax cut. The range of outcomes can be seen to be quite wide, depending on the assumption. One cannot reach a completely firm conclusion on this matter because the Federal Reserve has expressed sympathy for increased capital formation. Chairman Miller's preferred strategy is more generous depreciation allowances, which falls in the tradition of the Eisenhower-Kennedy-Johnson-Nixon-Ford-Carter approach of betting all of the investment stimulative resources on the retained earnings of large, capital intensive corporations, rejecting the market approach to capital formation. Apparently, if the Congress wants to foster a stronger capital market, it will have to do so without the benefit of Administration or Federal Reserve support.

RESPONSE TO SECRETARY BRILL'S COMMENTS ON THE CAPITAL GAINS TAX ANALYSIS OF MERRILL LYNCH ECONOMICS, INC.

Mr. Chairman and Members of the Sub-Committee: This response was requested by Senator Packwood during my testimony before the Senate Finance Sub-Committee on Taxation and Debt Management of June 29, 1978. In the course of the hearings on reductions in the capital gains tax rate, Secretary Brill elaborated on charges, made by Secretary Blumenthal the prior day, that three separate studies of S. 3065 were, at best, tainted and perhaps even deliberately misleading.

I cannot answer for the other two studies he referred to but will limit my discussion to charges directly leveled at the Merrill Lynch Economics study. Generally these charges can be summarized as follows:

The Merrill Lynch Economics study "assumes" a rise in the stock market of 4 to 6 percent

The study also "assumes" that the cost of equity capital declines by 25 to 30 basis points

The historical record shows no correlated effect of changes in capital gains tax rates on stock prices

Thus the initial "assumption" of the stock market effect is spurious

Thus the entire subsequent analysis of economic impact collapses.

The first two "assumptions" listed above were never assumptions in the Merrill Lynch Economics study. The "Methodology and Assumptions" section of my written testimony delivered June 29 makes clear that the stock market effects

were *calculated* from a carefully constructed discounted present value analysis of after-tax capital gains accruals. The resultant stock market effects were not assumed but the result of the detailed analysis presented there. In persisting to characterize the stock market effects we calculated as "assumptions", Secretary Brill must be, at best, uninformed regarding this information which we carefully conveyed to his staff in the course of at least a dozen telephone calls we received during June.

Also in the course of these telephone conversations, staff members made it clear that they agreed with the methodologies we employed and, furthermore, even agreed with the magnitude of the stock market effect we calculated.

The staff's implicit agreement with our methodology is also indicated on page 4 of the appendix of Secretary Brill's testimony where our methodology is used to compute the stock market effect of eliminating the capital gains tax (up 9 to 12 percent). This point was used to " * * * cast further doubt on the reasonableness of the 20 percent rate assumed by SIA and the 40 percent rate derived from the Chase equation." The point here is that if his staff knows our methodology can be used to calculate the stock market effect of eliminating the tax why does the verbal testimony characterize our market analysis as an assumption—simply to convey the impression that the magnitude of the market effect is arbitrarily pulled out of the air?

The assertion that there is no relationship between the stock market and changes in capital gains taxes is, itself, groundless. How can the value of a stock certificate be entirely unrelated to the future tax one must pay when one sells it? In my testimony, Exhibits I and II show that the effects of capital gains tax changes on the market historically is significant, though modest. The lack of historical correlation asserted by Treasury might result from the fact that this modest effect is usually "swamped" by other factors that swing the market to extremes. Nevertheless, its effect is significant and of sufficient magnitude to lead to the beneficial economic impacts recorded in the Merrill Lynch Economics study.

A more important point to be noted is that, for the range of reduction recommended in S. 3065, the stock market gain alone creates more in potential capital gains tax liability than the statically-estimated $2.2 billion shortfall calculated by the Treasury. Importantly, the testimony of Dr. Martin Feldstein stated that, even if one assumes *no* market increase, the tax rate reduction alone would cause initial and follow-on additional capital gains realizations sufficient to exceed the statically-estimated revenue loss.

Senator BYRD. Senator Roth.

Senator ROTH. Thank you, Mr. Chairman.

I was very much interested in your recommendation that we try to broaden the capital gains tax relief to include housing.

As a matter of fact, I have a bill which I am dropping in today that would exempt the sale of homes from taxation to accomplish exactly what you are proposing. I might say any of my colleagues here who want to join me in this, I would be happy to have them as cosponsors. I think it is an important change and one that, as I understand it, is followed in many countries abroad, including Germany and Japan.

The other aspect of your statement that is of great interest, I think, to a number of us here on this side of the aisle has been indexing. Senator Dole and myself have both talked a great deal about this.

As I understand it, what you are proposing is the indexing of capital gains taxation. Is that correct?

Mr. EVANS. Yes, Senator.

Senator ROTH. I would say that I have great sympathy for that. One of the problems I have with our tax system is that much of our taxes are due solely to inflation. Just take the average person today who makes $20,000. Ten years ago, that was the equivalent of $11,000 or $12,000, so he has been pushed into a much higher tax bracket.

One question I have of you, do you think that this indexing should be across the board or just limited to capital gains, or what?

Mr. ECKSTEIN. We cannot really afford a full across-the-board indexing because the revenue loss is very large and it is a very massive change in our tax system. There is a special case for capital gains because most forms of income by now really do respond to inflation, whereas in the case of capital gains, in recent years, there really have not been any on average, so the tax is entirely levied, at the moment—virtually entirely levied—on inflation created changes in valuation.

Also, the Government has really been remiss in not giving the ordinary person a way to hedge against inflation. It has never issued a bond that is escalated. It has made it very difficult. And so the ordinary person has no way to hedge against inflation and the value of his or her savings is destroyed, gradually.

Well, here is a way, at least a small beginning, especially if you begin with the individual home, perhaps if you extend it to a capital gains adjustment of perhaps, initially, limited amounts of capital gains, that they be valued at the Consumer Price Index. Here would be way that the individual could protect his savings.

Mr. EVANS. I certainly agree that it should apply to capital gains. I have to say that, to me, it is very unfair to people in the private sector who many times do not even get full cost of living adjustments, and yet they are finding themselves being pushed to a higher tax bracket. To me, this is one of the greatest inequities to the working people of America.

Mr. ECKSTEIN. Well, we feel strongly that the personal income tax must be lowered periodically, including, hopefully, this January 1. But in the personal income tax, we are doing it informally with a periodic tax bill. It is not that we are leaving it completely unchanged.

In the case of capital gains, we have run the other way. We have raised the taxes as inflation really destroyed the capital value.

Senator ROTH. One of the most serious problems this country is facing is, of course, this question of productivity. Yesterday in discussions with the Secretary of the Treasury, he admitted that there was a need of capital formation, but in what seems to be true too often with the administration, they are only studying it. I am always suspicious when people talk about studies, because I suspect that means they are not going to do anything.

I would like to have your recommendations as to one, what can we do about productivity and, to the extent that includes capital formation, what other measures the panel would recommend to make this country more competitive with our foreign competition?

Mr. EVANS. First, Senator Roth, I would like to say just a word about indexation. I have long been in favor of complete indexation of taxes, from personal income taxes to evaluation of depreciation allowances and replacement of historical costs and indexation of capital gains. I just think that all of this cannot be accomplished all at once. It would result in a very substantial revenue loss and it would have to to be accompanied either by other forms of taxation or by much stricter limits on Government spending that are currently in existence.

So I think we ought to concentrate our efforts on the capital gains tax now and move to the indexation in future years.

As far as productivity goes, I think that, besides increasing the investment ratio, another factor which, in my opinion, has contributed to the decline in productivity growth in the last decade has been the

very sharp reduction in research and development spending relative to the GNP and, in fact, literally, funded R. & D. spending is no higher in constant prices in 1978 than it was in 1966, even though the economy has more than doubled in real terms.

And so I think that the priorities should be realined to give more weight to federally funded R. & D. and also to provide investment tax writeoffs for R. & D. in the private sector. I think that would help our productivity growth substantially.

Mr. CIMINERO. I would say also that it is not just a question of aggregate productivity growth but that the real question is the long-term sustainable growth of the economy which depends on the continuous creation of new innovations and new industries.

The question is, where will the growth industries of tomorrow come from? Where are these incipient industries today?

The answer is, their prospects are probably much depressed compared to what they would be. Most of the questions as to the cost of capital are hidden in the national income accounts when it comes to focusing on venture capital, and the kinds of productivity analysis done in aggregate focuses on the economywide concepts cutting across many industries, some of them quite old and mature.

So there are other hidden benefits here, hidden from a strictly quantitative viewpoint, that are fairly well known in terms of the innovation requirement, to keep the economy productive and to keep its products competitive, especially in the international marketplace.

Senator ROTH. Thank you.

Senator PACKWOOD. Senator Dole.

Senator DOLE. Most of the questions that I had have been answered. The increased capital gain rates became effective after the 1969 act. In the 3-year period following 1969, there was a very significant rise in the stock market.

How does that fit with the statements I have heard that by decreasing the tax rate we are going to pump up the stock markets when we had just the opposite effect?

Mr. EVANS. Well, as a matter of fact, the stock market actually declined very sharply in 1970, which was the first year——

Senator DOLE. The market reached its peak in 1973?

Mr. EVANS. Well, it reached its peak because of the tremendous growth in the economy starting in 1971, which was fueled, in part, by the reinstatement of the investment tax credit and the liberalization of depreciation allowances which resulted in 20 percent taxes.

But the stock market was pumped up, unfortunately, by the artificial growth which was generated for a short time by wage and price controls, which resulted in a very rapid rate of growth in 1972 in real terms when the price was artificially depressed; this resulted in lower interest rates which, again, gave an artificial boost to the market.

And once controls were taken off, as you are well aware, the stock market collapsed, the economy collapsed, and inflation went to a double-digit rate.

So we bought some time for a number of years, only at the expense of a great dislocation later on.

Senator DOLE. Is that your view?

Mr. ECKSTEIN. Senator, there are many other influences on the market besides the tax laws, and that is why I really fell back upon

a kind of a simple calculation of the value that is created. And, given a certain earnings and dividends stream and a certain interest rate which you value it and a certain tax which you impose on that, you can do a crude arithmetic of what the market ought to do, if it were rational and there were no other disturbances.

And if you reduce the taxation of the income from stocks in all forms by, say, 4 percent, then if the people, in the long run are rational and these other erratic forces wash themselves out, you would expect the market to respond by about 4 percent.

So I think it is really an untenable position to say that the market will not respond to a change in tax law. People would have to be completely irrational to take that approach. On the other hand, once you do that arithmetic, you realize that the stock market is not going to jump by 40 to 50 percent if you change the tax by $2 billion.

Mr. CIMINERO. There are, of course, many factors affecting the stock market. Our macromodel treats the spread between the return on the S. & P. and the key new issue, AAA utility bond rate. The variation in that spread is explained by such factors as nominal cash flow as a percent of replacement value of capital stock outstanding—which attempts to capture the bias effects of not restating profits for the effects of inflation on inventory valuation and current replacement value of depreciation.

There are also indicators in this relationship for the capital gains tax rate. We have intentionally assessed the effect of this tax rate at a minimum, as an operating assumption for the study done here.

Obviously, the market can occasionally run to extremes and it often does so, based on the effect of announcements of tax law changes and the like. There is a lot of variance in the market itself that cannot be explained by anything in particular other than some imputed running-to-extremes based on changing expectations on the economic outlook.

But the analysis used here attempted to grapple with, and quantify, on a rational, economic basis what true values in the market could gravitate toward, given the tax law change. And the effect, as you know, that we estimated was about 4 to 6 percent.

Senator DOLE. I am not sure I understand all of that, but that is not a requirement around here.

President Carter said he would veto the bill if we change the capital gains tax, and he might. I do not have any indication, but there is widespread support for a change. The Senate bill has 60-plus sponsors including, I imagine, everyone in this room. You are probably talking to the saved this morning.

I would like to put a statement in the record, Mr. Chairman.

Senator PACKWOOD. Without objection.

Senator. DOLE. Thank you.

[The prepared statement of Senator Bob Dole follows:]

STATEMENT OF SENATOR BOB DOLE

Mr. Chairman, the hearings called by the committee today are to discuss legislation which, if enacted, will have a dramatic effect upon our economic growth. I commend the chairman for convening these hearings and for the leadership of the Senator from Wyoming, Mr. Hansen, and the originator of the capital gains tax roll-back, Mr. Steiger.

For too many years, the Federal Government has been trying to manipulate the economy and individual investor decisions. We have seen the small investor

abandon the stock market. Because of the small rate of return on investment many small companies are being driven from business. Risk capital is difficult, if not impossible, to obtain.

The roll-back of capital gains tax has been criticized by the administration as a give away to the rich. However, I believe that in order to stimulate the stock market, generate capital, and produce thousands of new jobs, the Federal government must allow an individual to earn a profit. The anit-profit mentality on the part of the administration in the long-run will bring our economy to a screeching halt.

Mr. Chairman, for the past twenty years we have been trying to generate investment and employment by simply priming the Federal pump. This has been an obvious error. The Federal budget has increased 500% in the last 15 years. We have been haunted by nearly double-digit inflation for the entire decade. It seems that every time the Federal government seeks to stimulate the economy, the only thing which it achieves is to increase inflation.

The so-called Steiger amendment is quite imple. It would roll-back to 25% the maximum tax on capital gains by eliminating capital gains from the list of tax preference items subject to the minimum tax and by providing the 25% top rate for all gains, rather than just for the first $50,000. For corporations, the top rate would be reduced to 25% from 30%. The Congress should take note that while the maximum tax on capital gains has doubled since 1969, the economy has suffered from a combination of slow growth and fast inflation. I believe that these ills have been caused by insufficient investment.

I think the President is making a serious mistake by threatening the Congress with a veto on any legislation which contains added incentive for investment. A roll-back of the capital gains tax in in the best interest for inflation weary Amercans. I look forward to hearing the comments of the witnesses today.

Senator PACKWOOD. Are there any further questions?

Gentlemen, thank you very much, and doubly thanks for this information. We are going to the floor and we will have a debate. The facts you have presented to us will be most helpful.

[The prepared statements of the preceding panel follow:]

STATEMENT OF GARY L. CIMINERO, VICE PRESIDENT, MERRILL LYNCH ECONOMICS, INC.

ECONOMIC IMPACT ANALYSIS OF THE INVESTMENT INCENTIVE ACT OF 1978 (S. 3065)

Mr. Cairman and members of the subcommittee: This testimony is based on a study conducted by Merrill Lynch Economics, Inc. which assessed the quantifiable economic impacts of reducing the capital gains tax rate as put forth in bills proposed by Representative William A. Steiger (HR 12111) and Senator Clifford P. Hansen (S 3065)

A copy of that study, entitled "Economic Impact Analysis of a Capital Gains Tax Reduction", dated May 4, 1978, is attached hereto, as part of the documentation for this testimony.

I. SUMMARY OF RESULTS

A. Key near-term economic impacts of the proposed capital gains tax rate reduction

The proposed rollback of the maximum tax rate on long-term capital gains from current levels to 25 percent for both individuals and corporations would enhance near-term prospects for economic growth while ultimately improving economy-wide production capacity and productivity. Assuming the tax cut to be effective in the third quarter of 1978, the aforementioned study assessed the near-term economic impacts through 1980 as measured by the Merrill Lynch Economics Macro Econometric Model. In a comparison with the Merrill Lynch Economics Basic Forecast as a standard, the key economic impacts of the tax reduction simulation included:

An acceleration in real GNP growth of 0.2 percentage points (3½ percent versus 3.3 percent annual average growth).

A reduction in the unemployment rate from 5.7 percent to 5.5 percent through the creation of 205,000 additional jobs by 1980.

A $3.2 billion increase in real business fixed investment of which $2.9 billion goes into plant and equipment spending and $0.3 billion into residential investment.

A decline in the Federal budget deficit of $2.3 billion in 1980.

A stock market increase of 4 to 6 percent based on a highly conservative stock market valuation calculation, causing the cost of equity capital to the firm to fall by 25 to 30 basis points.

A decline in long-term bond rates of 5 to 10 basis points.

Virtually every economic indicator in the model improved under the tax rate reduction simulation. However, a few of the economic indicators recorded adverse reactions to the tax rate rollback, including:

A slightly increased rate of inflation (up 0.1 percent over the standard forecast in 1980) resulting from increased real demand.

A small increase in the Federal Funds Rate (up 10 basis points in 1980) resulting from the assumption that Federal Reserve monetary policy does not accommodate the heightened real activity with increased growth in monetary aggregates.

B. Longer-term economic benefits

In addition to these near-term impacts, longer term beneficial impacts can be inferred from the enhancement of real business investment. Heightened plant and equipment investment outlays serve to improve productivity—the well-spring of an improving standard of living—while expanding the overall capacity of the economy to produce goods and services. As a bonus, both these effects would combine to ameliorate the inflation problem in the longer term.

C. The capital gains tax and revenue-neutrality

A peculiar aspect of the capital gains tax rate decrease is that, for the range of decline proposed in the Hansen/Steiger bills, the tax cut is essentially revenue-neutral. That is, the decline in the tax rate is essentially offset by the increase in capital gains realizations allowing *total* tax revenues to improve as taxable income and profits increase.

Because of limitations in data availability, capital gains and associated tax revenue data are not *explicitly* included in the quarterly National Income Accounts data which underlie econometric models. However, it is fairly easy to demonstrate that, even with the understated stock market price increase of 4 to 6 percent above the standard forecast, the *incremental* paper gains on equities alone amount to $42 billion by the end of the 10-quarter forecast period. Using a conservative estimate that the average (across income classes) of the marginal capital gains tax rate could be as much as 36 percent below the maximum rate of 25 percent, this yields a total incremental tax liability of $6.72 billion over the 10-quarter period or $2.69 billion on an annual basis. This potential revenue estimate exceeds the $2.2 billion static revenue loss estimated by the Treasury Department. Thus, the understated incremental equities market gain *alone* involves potential tax liabilities that exceed the static revenue loss estimate. In addition to the immediate incremental gains estimated above, liquidation of longer term unrealized (locked-in) gains in equities are likely. Assets other than equities should also experience incremental gains and liquidation of locked-in gains. It is, therefore, easy to conclude that incremental total capital gains tax revenues could easily exceed the statically-estimated $2.2 billion revenue short-fall.

D. Understatement of Economic benefits

The results presented here ultimately depend on assumptions made about factors which are either nonquantifiable or, at best, difficult to assess. Throughout the analysis, these factors have been gauged so as to err on the side of understating the beneficial results:

The potential stock market strength has been minimized to that which is quantifiable from the tax rate decline alone. Accordingly, stock prices rise only 4 to 6 percent above the level calculated without a capital gains tax reduction. An even stronger stock market—with higher economic benefits than estimated here—could ensue if a very large volume of capital gains realizations unfolds resulting in a heightened "bull market" psychology as locked-in positions are liquidated.

The potential decline in long-term corporate bond rates, that could result from the lower capital gains taxes and the improvement in balance sheets as more equity is issued, has also been minimized. Accordingly, the average new issue bond rate declines by no more than 10 basis points (0.1%).

The beneficial effects of rising values of other capital assets aside from stocks and bonds has been explicitly omitted.

E. Conclusion

Leaving aside such politically important questions as income distribution, economic opportunity and the "fairness" and progressiveness of the income tax—all of which are beyond the scope of this quantitative assessment—one is led inexorably to the conclusion that the proposed capital gains tax rate reduction would increase economic benefits pervasively and improve the allocation of capital while increasing tax revenues and improving the Federal deficit. The only quantifiable economic *costs* involve a slight increase in inflation and short-term interest rates.

Obversely, leaving the current capital gains tax structure unchanged would be to continue levying considerable opportunity costs on *all* segments of the economy: fewer jobs; lower incomes; less production capacity and less productive capital; lower government revenues—even from the capital gains tax itself—and larger deficits; less efficient allocation of capital and lower capital gains income and portfolio values both for capitalists and wage earners who invest directly in stocks or have their pension savings invested in financial assets.

II. METHODOLOGY AND ASSUMPTIONS

A. Major channels of economic impact

The connecting causal thread running from the tax rate reduction to detailed economic interactions and ultimately to measures of resultant aggregate economic impact involves several key analytical stages:

I. A reduced capital gains tax will tend to increase current market prices for capital assets.

II. In particular, the prices of financial assets—especially equity-will tend to increase.

III. Increased equity and bond values reduce the cost of capital to corporations and other private sector issuers.

IV. This reduction in capital costs stimulates investment in plant and equipment.

V. The increased plant and equipment spending stimulates the economy leading to enhanced real GNP growth, more jobs, higher tax revenues via ordinary income and profits taxes, and greater productivity.

VI. The decline in the Federal deficit results from increased tax revenues and reduced transfer payments—both effects arising from the stimulated economy.

VII. The decline in the capital gains tax rate should be substantially offset, in revenue terms, by the expected increased capital gains realizations accompanying a stronger equities market.

Of the stages listed above, the first two and the last are accomplished outside the Macro Model while the other steps characterized the essential flows and interactions within the Macro Model.

In particular, stages I and II involve an explicit valuation analysis of stock prices. The current market portfolio price is viewed as the discounted present value of: 1) expected future dividends net of income taxes and 2) a terminal sale of capital representing a capital gain net of the capital gains tax (*or* a capital loss). The market portfolio and corresponding dividends are taken as the Standard & Poors Index of 500 Common Stocks. In the first stage of analysis, the historical internal rate of return is calculated as that "yield to maturity" which equates the price index to the expected future after-tax flows. The resultant time series represents the (after-tax) rate of return required by investors in equities.

On the other side of the equities market, the firm faces a current equity price which its future expected dividends support. The corporate cost of equity capital is that internal rate of return which equates the market price to future dividend payments. This cost of capital is conceptually identical to the yield to maturity concept calculated for bonds and is treated in the Macro Model as a higher risk class of long-term interest rate. Specifically, its equation in the Macro Mode relates the "yield" spread (versus new issue AAA utility bond yields) to measures of differential risk and return including after-tax cash flow return on replacement value of net plant and equipment stock outstanding. Ultimately, the corporate cost of equity capital together with bond yields are major determinants of business fixed investment spending. As an aside, much of the deterioration in the stock market in 1970 and after 1972 is explained by rapid increases in the cost of equity capital which, in turn, reflect large increases in return on competing long-term securities: in the model, this is represented by the yield on new issue AAA utility bonds. A much smaller role in recent "bear" markets can be ascribed to capital gains tax increases. This is quantified later.

To calculate the effect of a lower capital gains tax rate on the stock market and equity capital costs, the following steps were applied:

Given the after-tax *investors'* required rate of return, compute the stock market index as the discounted present value of after-tax dividends and terminal after-tax capital gains. The market index so-computed will be higher since the lower capital gains tax rate will result in a larger after-tax capital gain.

Given the higher market value computed from the first step, computed the new corporate cost of equity capital as the internal rate of return which equates the new higher market price with the expected dividend payments. Since these dividend payments were left unchanged in the first step, the higher market price causes the cost of equity capital to *fall*.

At this point, the lowered cost of equity capital is entered as a downward adjustment to the corporate cost of capital equation in the Macro Model (an autonomous shift add factor). The resultant downward shift in equity and debt cost is the key lever which leads to enhanced business fixed investment and, ultimately, leads to the economy-wide effects calculated in the Macro Model simulation. This part of the analysis corresponds to stages III to VI presented earlier.

As an aside, the *direct* effects of lowered equity capital costs are limited to the business investment sector. That is, the higher stock market does not directly affect the consumption functions since there are no wealth variables in these functions that explicitly consider the equity component. Also, since results of the last stage (VII)—which concerns the revenue-neutral calculation done outside the model—indicates that the capital gains tax rate cut is more than offset, in revenue terms, by increased capital gains and capital gains realizations, the required autonomous adjustment for personal and corporate capital gains tax payments in the Macro Model is zero: i.e., it is a "wash". Therefore, the stimulation apparent in the economic outlook under reduced capital gains tax rates does not result from the "multiplier" properties of a tax cut *per se*, since the tax cut is essentially zero—in fact, tax revenues rise on net. Rather, the stimulation results from increased investment incentives which lead to enhanced business fixed investment. The "multiplier" properties are, essentially, those of the business fixed investment multiplier.

B. Assumptions on tax law change

The study determines the economic impacts of a roll-back to 25 percent in the maximum long-term capital gains tax rates for both corporations and individuals. In effect, such a reduction would be accomplished by: 1) removing the 50 percent of the long-term capital gains item from the "list of preferences" for the minimum tax calculation and by 2) dropping the maximum rate from 35 percent (30% for corporations) to 25 percent. This would lower the maximum rate to the level in force before 1970.

The actual drop in tax rate for a given taxpayer would, of course, depend on the amount of long-term capital gain, the tax bracket, and other preference totals for the minimum tax calculation. In the extreme case, the current maximum tax can approach 50 percent [1] but tax data suggest that the amount of gains taxed at this rate must be very small. In fact, the weighted average of marginal tax rates on individual capital gains has been computed to be as much as 36 percent below the maximum rate.[2] This implies that a very large number of taxpayers are in the tax brackets with marginal rates below the maximum.

Also in support of this contention is the fact that only about 31 percent of the estimated individual capital gain tax revenues collected in 1968 were computed at the maximum rate; However, in 1969, the last year before the stepped increases in maximum rates began, maximum rate revenues were 56 percent of total individual capital gains, suggesting that high income investors were liquidating long-term gains before the tax rates increased.[3]

The 1969 surge in capital gains tax revenues computed at the maximum rate also suggests that the upper income taxpayers can (and do) significantly adjust the timing of capital gains realizations, at their discretion, in reaction to changes in the legislated maximum rate. This "announcement" effect which tends to

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[1] James W. Wetzler in Joseph A. Pechman, ed., "Comprehensive Income Taxation," The Brookings Institution, Washington, D.C., 1977 : pp 115f.

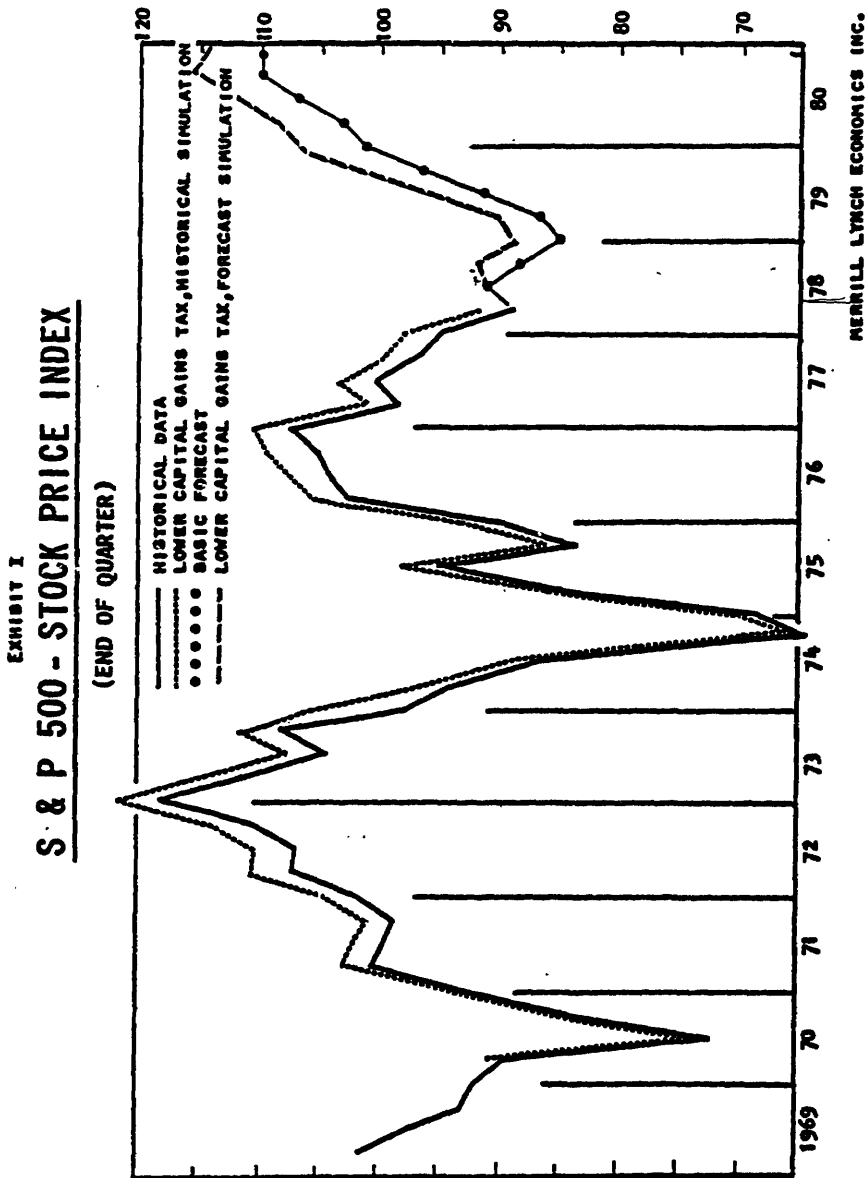
[2] Luigi Tambini in Harberger and Bailey, eds., "The Taxation of Income from Capital," The Brookings Institution, Washington, D.C., 1969 : p. 206, table 2 (for 1965).

[3] Estimates of total individual capital gains tax revenues taken from Joseph A. Pechman, "Federal Tax Policy" (third edition) table C-13, p. 352. Estimates of capital gains revenues at maximum tax rates taken from "Statistics of Income, Individual Income Tax Returns," 1968 : p. 92, chart 3A ; 1969 : p. 120, chart 3A.

increase long-term capital gains realizations in the period immediately prior to a tax rate *increase*, would tend to postpone capital gains realizations in the period immediately prior to a forthcoming tax rate *decrease*. However, after the rate decrease is in effect, postponed capital gains would come to realization in a surge which would increase tax revenues collected at the maximum rate. This would also tend to foster higher stock market volume, increasing the market above the levels already enhanced by the improved future after-tax long-term gains which the lowered tax rates generate.

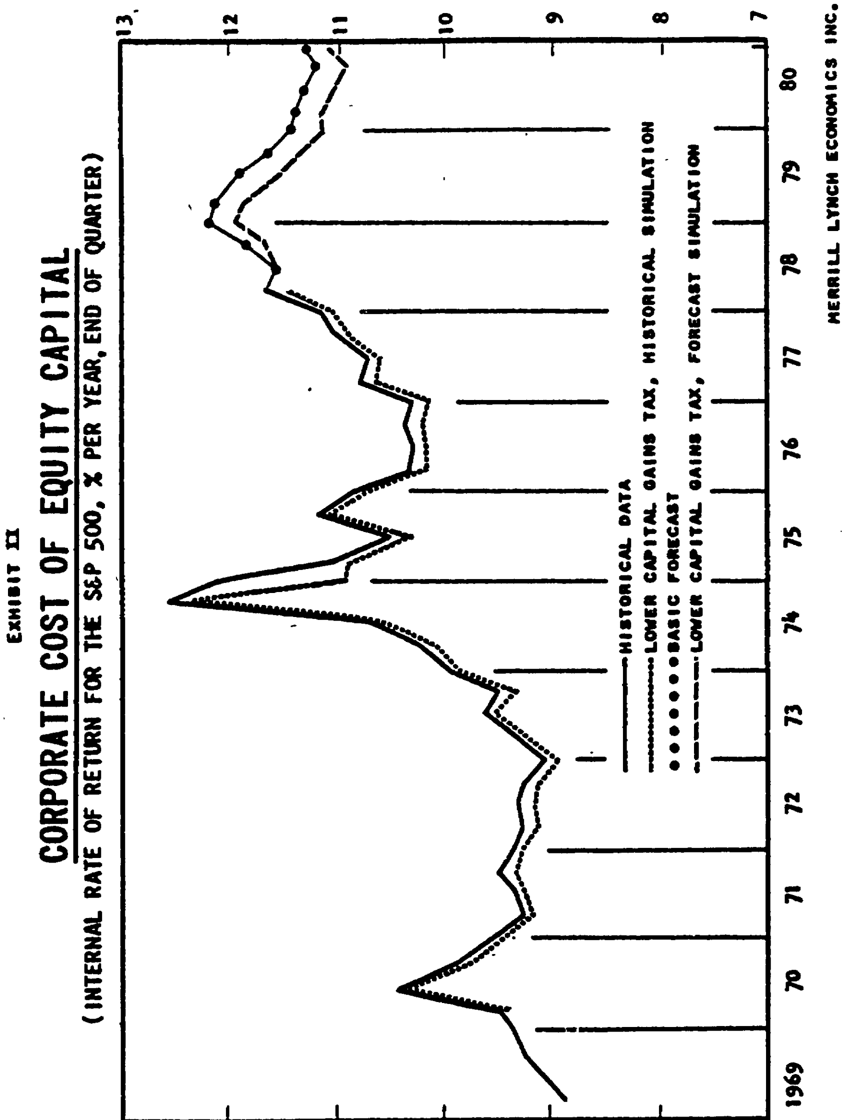
C. Effects on the S. & P. 500 market index and the corporate cost of equity capital

Exhibit I, shows the calculated historical effect, on the S. & P. 500 stock price index, of the phased increase in the maximum capital gains tax rate over the period: 1970-first quarter through 1978-first quarter. As can be seen, the average effect of



the lower tax rate serves to increase the market index a relatively modest 2–3½ percent above the actual levels. This effect captures the increase in market value that would have arisen *only* from the reduced tax on future capital gains proceeds. For a *given* future selling price, the lower capital gains tax will increase after-tax proceeds from a future sale of the asset. Since present market price is the discounted present value of all net proceeds anticipated from owning an asset, the lower tax will tend to increase the current price of that asset. The current increase would be all the greater if the tax reduction also increased *future* expected (speculative) selling prices. It is in this sense that the current analysis conservatively states the effect on current market value of a lower capital gains tax rate since it explicitly ignores the potential enhancement of future selling price expectations.

Exhibit II presents the corresponding effects on the corporate cost of equity capital. As can be seen the higher market price (under the lower tax rate alternative) results in a correspondingly lower cost of equity capital. As conservatively



calculated here, the historical effect would have *reduced* this key capital cost rate by about 10–20 basis points (that is, by about 0.1 to 0.2 percentage points).

It is via this reduced cost of capital that the main stimulative effects on business fixed investment occur in the forecast period. This can be seen in the forecast periods of Exhibits I and II wherein the reduced capital gains tax rate respectively increases the market price by about 4–6 percent and decreases the cost of capital by about 25 to 30 basis points.

D. Effects on long-term corporate bond yields

The reduced cost of equity capital would tend to increase new stock issues and/or raise earnings retention rates. As a result, debt/equity positions of corporations would tend to decline, thus having some attenuating effect on market bond yields. This effect is relatively minor, however, as bond yields are reduced by no more than 10 basis points in the forecast interval. However, this decline in bond yield combines with the more substantial decline in equity cost to reduce the weighted marginal cost of capital which fosters the enhanced capital expenditures.

III. SUMMARY OF ECONOMY-WIDE IMPACTS

Exhibit III presents a comparison, for several key economic indicators, of the Merrill Lynch Economics May Basic Forecast through 1980 versus the lower Capital Gains Taxes simulation. The tax rate decrease is assumed to be effective as of the third quarter of 1978.

EXHIBIT III.—KEY ECONOMIC INDICATORS; COMPARISON OF FORECASTS: LOWER CAPITAL GAINS TAXES VERSUS BASIC FORECAST

[All dollar values in billions of 1972 dollars unless otherwise noted]

	1978	1979	1980
Real GNP:			
May basic forecast	$1,381.2	$1,415.1	$1,474.5
Lower capital gains taxes	1,381.4	1,417.9	1,478.7
Difference	.2	2.8	4.2
Percent difference	0	.2	.3
Percent change in real GNP:			
May basic forecast	3.3	2.5	4.2
Lower capital gains taxes	3.3	2.6	4.3
Difference	0	.1	.1
Employment (1,000 of employees):			
May basic forecast	93,748	95,286	98,460
Lower capital gains taxes	93,753	95,380	98,665
Difference	5	94	205
Percent difference	0	.1	.2
Unemployment rate (percent):			
May basic forecast	6.3	6.6	5.7
Lower capital gains taxes	6.3	6.5	5.5
Difference	0	−.1	−.2
FRB industrial production index (1967 equals 100):			
May basic forecast	142.3	144.9	154.8
Lower capital gains taxes	142.4	145.4	155.6
Difference	.1	.5	.8
Percent difference	.1	.3	.5
Federal deficit (billions of dollars):			
May basic forecast	(59.0)	(71.9)	(60.3)
Lower capital gains taxes	(59.0)	(71.0)	(58.0)
Difference	0	.9	2.3
Percent change in GNP deflator:			
May basic forecast	6.6	6.3	6.2
Lower capital gains taxes	6.6	6.3	6.3
Difference	0	0	.1
Percent change in the Wholesale Price Index:			
May basic forecast	6.8	5.6	5.9
Lower capital gains taxes	6.8	5.5	6.0
Difference	0	−.1	.1
Fixed business investment:			
May basic forecast	190.8	191.9	203.6
Lower capital gains taxes	190.0	193.1	205.5
Difference	.1	1.2	1.9
Percent difference	0	.6	.9

EXHIBIT III.—KEY ECONOMIC INDICATORS; COMPARISON OF FORECASTS: LOWER CAPITAL GAINS TAXES VERSUS BASIC FORECAST—Continued

[All dollar values in billions of 1972 dollars unless otherwise noted]

	1978	1979	1980
Investment, producers' durable equipment:			
May basic forecast	91.7	93.4	96.3
Lower capital gains taxes	91.8	94.2	97.8
Difference	.1	.8	1.5
Percent difference	.1	.9	.2
Investment, nonresidential structures:			
May basic forecast	41.3	44.2	44.8
Lower capital gains taxes	41.3	44.4	45.1
Difference	0	.2	.3
Percent difference	0	.5	.7
Real consumption expenditures:			
May basic forecast	891.2	917.3	953.2
Lower capital gains taxes	891.3	918.2	954.8
Difference	.1	.9	1.6
Percent difference	0	.1	.2
Standard & Poor's 500 stock price index (end-of-year level):			
May basic forecast	85.0	101.4	110.0
Lower capital gains taxes	88.8	107.1	114.7
Difference	3.8	5.7	4.7
Percent difference	4.5	5.6	4.3
New issue rate, AAA utilities (percent):			
May basic forecast	8.93	8.83	8.18
Lower capital gains taxes	8.91	8.73	8.12
Difference	-.02	-.10	-.06
Federal funds rate (percent):			
May basic forecast	7.25	6.47	6.34
Lower capital gains taxes	7.22	6.46	6.44
Difference	-.03	-.01	+.10

Merrill Lynch Economics, Inc., Economic Impact Analysis of a Capital Gains Tax Reduction, May 4, 1978

I. SUMMARY OF RESULTS

A roll-back in the maximum capital gains tax rates from current levels to 25% for both individuals and corporations, effective in the third quarter of 1978, would have the following beneficial effects on the economic outlook through 1980: Improves the average rate of growth of real GNP to 3.5% as compared with the 3.3% rate forecast under the current tax law, reduces the unemployment rate from 5.7% to 5.5% through the creation of 205,000 additional jobs by 1980, reduces the Federal budget deficit by $2.3 billion in 1980, and instills an additional $3.2 billion in real fixed business investment over the period.

These economic impacts have been simulated with the Merrill Lynch Economics Macro Econometric Model which traces the primary causal flows from tax rate roll-back to economic benefits as follows:

A reduced capital gains tax will tend to increase current market prices for capital assets.

In particular, the prices of financial assets—especially equity—will tend to increase.

Increased equity and bond values reduce the cost of capital to the corporation.

This reduction in capital costs stimulates investment in plant and equipment.

The increased plant and equipment spending stimulates the economy leading to enhanced real GNP growth, more jobs, higher tax revenues via ordinary income and profits taxes, and greater productivity.

The decline in the Federal deficit results from increased tax revenues and reduced transfer payments—both effects arising from the stimulated economy.

The decline in the capital gains tax rate should be essentially offset, in revenue terms, by the expected increased capital gains realizations accompanying a stronger equities market.

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Any impact analysis of this sort ultimately depends on assumptions made about factors which are either nonquantifiable or, at best, difficult to assess. Throughout the analysis, we have attempted to gauge these factors so as to err on the side of understating the beneficial results:

We have minimized the potential stock market strength to that which is quantifiable from the tax rate decline alone. Accordingly, stock prices rise only 4 to 6 percent above the level calculated without a capital gains tax reduction. An even stronger stock market—with higher economic benefits than estimated here—could ensue if a very large volume of capital gains realizations unfolds resulting in a heightened "bull market" psychology as locked-in positions are liquidated.

We have minimized the potential decline in long-term corporate bond rates that could result from the lower capital gains taxes and the improvement in balance sheets as more equity is issued. Here the average new issue bond rate declines by no more than 10 basis points (0.1%).

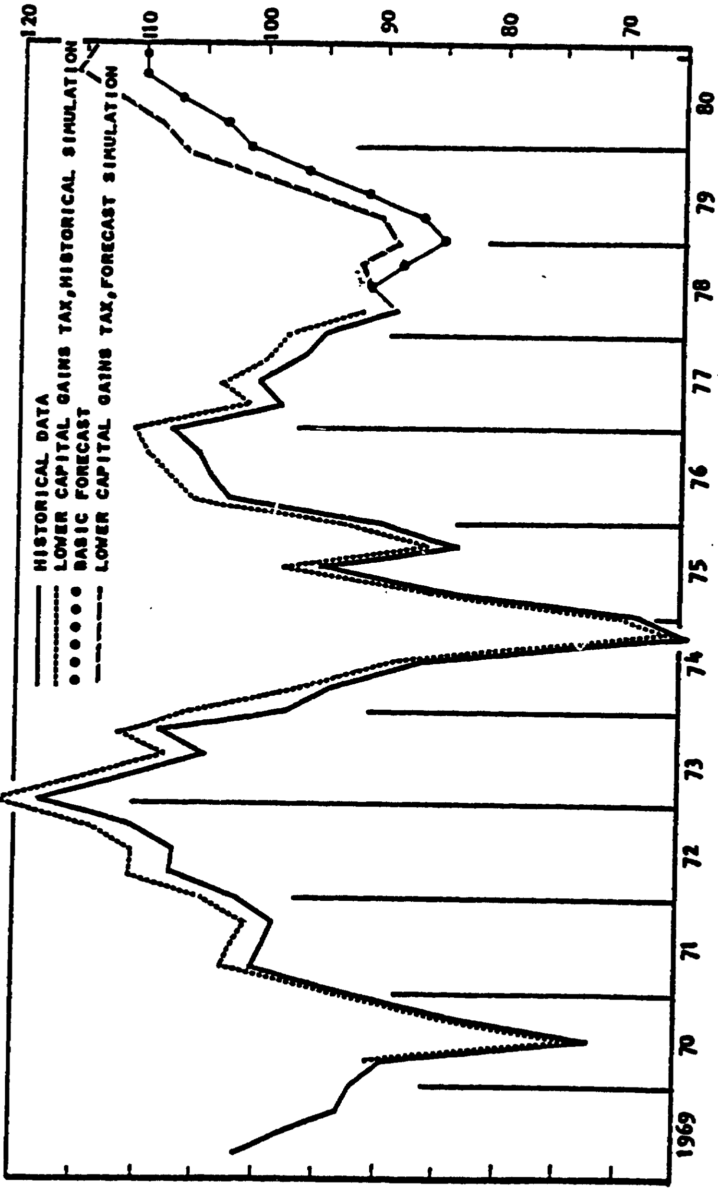
We have ignored the beneficial effects that rising values of other capital assets aside from stocks and bonds) could bring to the economy.

II. STOCK MARKET ANALYSIS AND DETAILED ECONOMIC IMPACTS

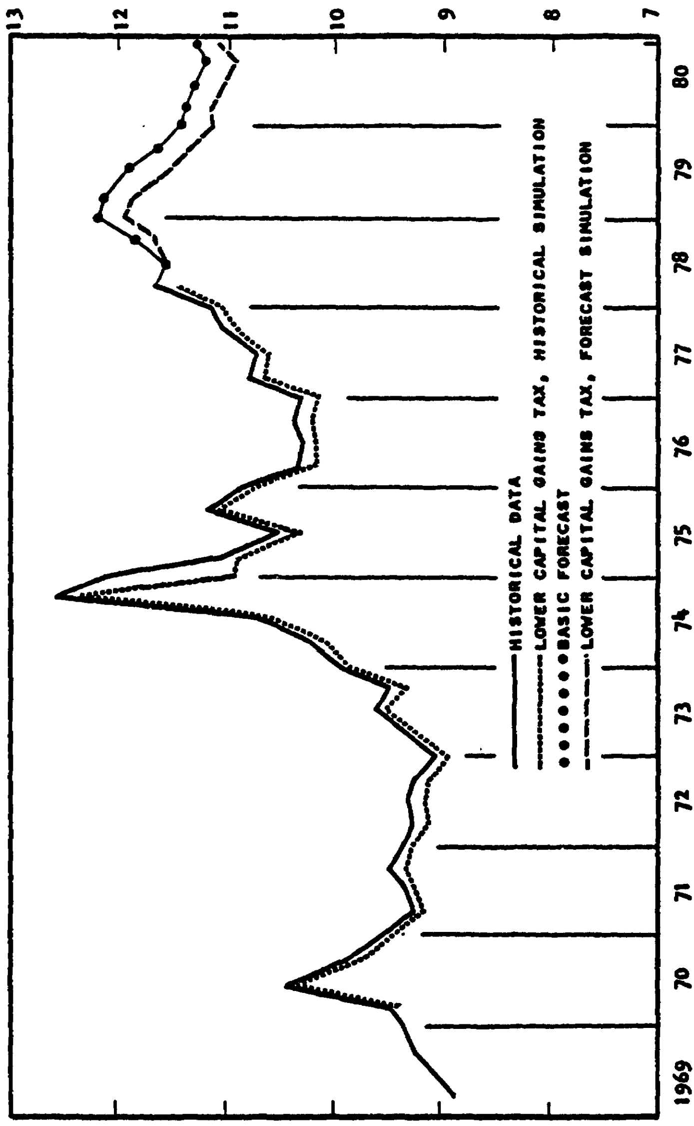
1. Exhibits I and II: Standard & Poors 500—Stock Price Index and The Corporate Cost of Equity Capital—Standard & Poors 500

The dashed line from 1970 to 1978 in Exhibit I shows that the stock market (as measured by the S&P 500) would have been about 2 to 3½ percent higher if the maximum capital gains tax had not been increased beginning in 1970. The maximum rate for individuals (excluding minimum tax) was actually increased in steps from 25 to 29.5 percent in 1970, 32.5 in 1971 and to the full 35 percent in 1972. For corporations, the maximum rate increased to 28 percent in 1971 and to 30 percent thereafter. Increases in the minimum tax, holding periods, and other provisions further heightened the capital gains tax burden. In terms of the cost of equity capital to the firm, the higher tax increased this cost by 10 to 20 basis points over the period. Comparisons of the cost of equity capital are presented in Exhibit II.

4.



As can be seen in Exhibit I, in the forecast period (third quarter 1978 to end of 1980) the reduction in capital gains would increase stock prices by 4 to 6 percent over the Basic Forecast (no change in tax rates). This translates into a 25 to 30 basis point drop in the cost of equity capital to the firm, as shown in Exhibit II.



2. *Exhibit III: Comparison of forecasts for key economic indicators*

Exhibit III presents a comparison, for several key economic indicators, of the Merrill Lynch Economics May Basic Forecast through 1980 versus the Lower Capital Gains Taxes simulation. The tax rate decrease is assumed to be effective as of the third quarter of 1978.

EXHIBIT III.—KEY ECONOMIC INDICATORS; COMPARISON OF FORECAST: LOWER CAPITAL GAINS TAXES VERSUS BASIC FORECAST

[All dollar values in billions of 1972 dollars unless otherwise noted]

	1978	1979	1980
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Difference	0	.1	.1
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Difference	0	−.1	−.2
FRB industrial production index (1967 equals 100);			
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Lower capital gains taxes	142.4	145.4	155.6
Difference	.1	.5	.8
Percent difference	.1	.3	.5
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Difference	0	.9	2.3
Percent change in GNP deflator:			
May basic forecast	6.6	6.3	6.2
Lower capital gains taxes	6.6	6.3	6.3
Difference	0	0	.1
Percent change in the Wholesale Price Index:			
May basic forecast	6.8	5.6	5.9
Lower capital gains taxes	6.8	5.5	6.0
Difference	0	−.1	.1
Fixed business investment:			
May basic forecast	$190.8	$191.9	$203.6
Lower capital gains taxes	190.0	193.1	205.5
Difference	.1	1.2	1.9
Percent difference	0	.6	.9
Investment, producers' durable equipment:			
May basic forecast	$91.7	$93.4	$96.3
Lwer capital gains taxes	91.8	94.2	97.8
Difference	.1	.8	1.5
Percent difference	.1	.9	.2
Investment, nonresidential structures:			
May basic forecast	$41.3	$44.2	$44.8
Lower capital gains taxes	41.3	44.4	45.1
Difference	0	.2	.3
Percent difference	0	.5	.7
Real consumption expenditures:			
May basic forecast	$891.2	$917.3	$953.2
Lower capital gains taxes	891.3	918.2	954.8
Difference	.1	.9	1.6
Percent difference	0	.1	.2
Standard & Poor's 500 stock price index (end-of-year level):			
May basic forecast	85.0	101.4	110.0
Lower capital gains taxes	88.8	107.1	114.7
Difference	3.8	5.7	4.7
Percent difference	4.5	5.6	4.3
New issue rate, AAA utilities (percent):			
May basic forecast	8.93	8.83	8.18
Lower capital gains taxes	8.91	8.73	8.12
Difference	−.20	−.10	−.06
Federal funds rate (percent):			
May basic forecast	7.25	6.47	6.34
Lower capital gains taxes	7.22	6.46	6.44
Difference	−.03	−.01	+.10

STATEMENT OF OTTO ECKSTEIN, PRESIDENT, DATA RESOURCES, INC., PAUL M. WARBURG, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY, AND ROGER BRINNER, DIRECTOR OF RESEARCH, DATA RESOURCES, INC.

CAPITAL GAINS AND TAX REFORM

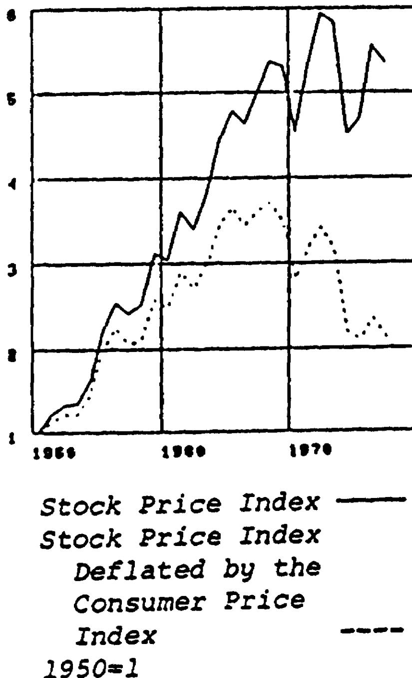
The question of capital gains taxation is one of the most difficult in terms of economic structure and performance. Issues of capital formation and competition quickly run up against issues of taxpayer equity and social justice. The long-term development strategy for the American economy—just how we intend to accomplish the necessary process of innovation and capital formation—is at stake in the current debate.

Ever since personal income tax rates were boosted to their moden peak levels in World War II, preferential capital gains rates have been the central feature of the tax code which brought down the effective tax rates for middle and high income individuals, and have therefore been at the center of the struggle for tax reform. Quite apart from their relation to normal capital gains realized on common stock, real estate and homes, the capital gains rates are an essential part of various tax shelters, many of which consisted, essentially, in transforming ordinary income into capital gains.

The tax reform movement got nowhere from World War II until the Nixon presidency, when the public became thoroughly aroused and the political impasse in the Congress was broken, As a result, major tax reform legislation was passed in 1969 and 1976, closing much of the capital gains "loophole" and reducing the benefits of the associated tax shelters. As a result, the maximum rate of taxation on capital gains increased from 25 to 49.1%. State and local income taxes also rose sharply during this period. The President's 1978 tax proposals would have pursued this line of reform further, aiming to bring the Federal maximum rate on capital gains to 52.5% and the aggregate rate in the typical industrial state close to 60%.

CHART 1

Postwar Stock Market Performance: Observed and Adjusted for Inflation



WHAT WENT WRONG?

Instead of providing general satisfaction, the reform of capital gains taxation has increasingly raised questions which have now brought us to a point where this trend is likely to be reversed. The surprises have included the following quote:

1. Inflation became severe. It was always recognized that inflation-created increases in nominal values of capital assets should not be taxed. When inflation averaged 1.9% as it did from 1952 to 1969, and the rate of increase of stock prices was 8.5%, the inaccuracy of taxing capital gains without inflation adjustment was a minor matter more than offset by the exclusion of half of capital gains from the tax base.[1] But inflation since 1969 has averaged 6.5%, and the stock market has failed to rise at all, so the effective capital gains tax burden has become confiscatory in many circumstances. Chart I and table I highlight the progressively worsening real appreciation in assets achieved by holders of common stock during the past two decades. In nominal terms, the stock market peaked in 1968 and then began to oscillate in a horizontal band; in real terms, deflating the stock price index by the consumer price index, the peak is seen in 1965 with fluctuations about a downtrend thereafter. Furthermore, the protection of capital for middle income families against inflation has proven particularly difficult, and the government has chosen not to offer any vehicle to make it easier.

TABLE 1.—STOCK PRICE GROWTH, 1955–77

	Real appreciation rate	Nominal appreciation rate
1955–59	0.120	0.137
1960–64	.063	.079
1965–69	.043	.065
1970–74	–.033	.012
1975–77	–.071	–.055
1955–77	.033	.063

Note: The rates of return are compound annual values assuming an average holding period of 5 yr.

2. The stock market acted badly after the capital gains reforms and dried up as a source of capital. To be sure, the worsening economic environment was the principal factor in the dramatic downward revaluation of earnings. Inflation brought high interest rates and lower multiples. But the increase in taxation was also a major factor. For the typical individual in income brackets that are affected by the post-1968 tax reforms, the stock market became a "tails-you-win, heads-I-lose" proposition with real gains taxed more heavily and loss offset severely limited. Institutional investors which pay no tax became the principal actors in the stock market.

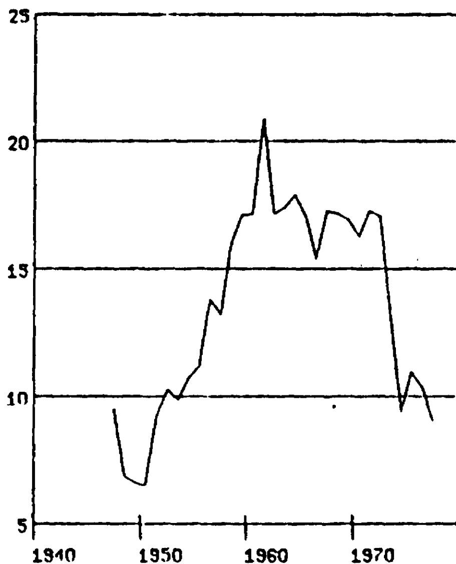
The decline in the stock market was particularly important to new and smaller companies. Many large companies do not issue stock beyond the modest sales through stock option and employee purchase plans. The utility industry, always the biggest issuer of stock, has regulated prices and so, within limits, is able to pass the high cost of equity capital forward to the consumer. But the stock market is of importance for new companies and to those growing particularly rapidly. The virtual disappearance of the "new issues" market during the 1970's has meant that this avenue for financing new enterprises has been virtually closed. Since these units are the source of much of our technological progress, this is a serious loss to economic development. Large institutions managing pension funds have no interest in small new enterprises, and even if they did, ERISA would make them supercautious.

3. The rate of capital formation fell sharply, to inadequate levels. There are many reasons for the drop in investment. The business cycles became more volatile and

[1] Roger Brinner, "Inflation and the Definition of Taxable Personal Income," in Inflation and the Income Tax, ed. by Henry Aaron, The Brookings Institution, 1976; and R. Brinner, "Inflation, Deferral and the Neutral Taxation of Capital Gains," National Tax Journal, December 1973.

the utilization rate of industry has been at abnormally low levels since 1973. The profit share and the rate of return on capital have fallen, largely as a result. The expectations of future output reflect a lessened degree of optimism, and consequently companies have marked down their long-run capital expansion plans. But the cost of capital has also been an important element in creating the low-investment situation. Debt capital, corrected for inflation, has not been expensive nor has it been scarce since the credit crunches of 1973–74. But equity capital, which for many companies is an essential ingredient to external financing in order to hold down the degree of leverage of their balance sheets, has been very difficult to accomplish and has been very costly. The volume of new issues has fallen sharply. The present earnings multiple on stocks as a whole has fallen very sharply as Chart 2 shows, and the multiples on smaller, higher risk companies are down a lot more.

CHART 2
Price and Earnings Ratio, Standard and Poors Index for 500 Common Stocks



3

DOES THE STOCK MARKET MATTER?

The accumulating research of the 1960's and 1970's points quite strongly toward important effects of stock market behavior on the economy.[2 3] Reflecting the general body of research as well as our own work, the DRI model of the U.S. economy has the following principal channels from the stock market to general economic performance.

1. It is an important determinant of the cost of capital which enters into business fixed investment decisions;

[2] For example, see (1) Barry Bosworth, "The Stock Market and the Economy," Brookings Paper on Economic Activity, 1975: 2; (2) Consumer Spending and Monetary Policy: The Linkages, Federal Reserve Bank of Boston, 1971.

[3] John J. Arena, "Postwar Stock Market Changes and Consumer Spending," Review of Economics and Statistics, November 1965, and the many other references cited in these studies.

2. It is a large and volatile component of household financial assets, and thereby substantially affects consumer spending;

3. It affects a choice in the portfolio decisions between bonds and stocks.

The stock market affects the economy in many other ways that are difficult to model. For example, we have seen in recent years that its behavior determines the attractiveness of foreign financial investment in the United States, and that a rising stock market strengthens the dollar and reduces inflation. Equally important, it affects the rate of technological progress through its provision of venture capital to innovative enterprises. Finally, the stock market affects the degree of concentration of the economy: a broad stock market facilitates capital formation by smaller companies; an excessive stock market creates a wave of mergers and monopolization.

DOES CAPITAL GAINS TAXATION AFFECT THE STOCK MARKET?

The behavior of the stock market has defied much logical analysis. In the absence of a generally accepted quantitative model of behavior, it is impossible to achieve definitive answers to the impact of any policy move—or of anything else—on the stock market.

While there is no precise theory, there are some generally agreed upon ideas with which virtually any serious student of the subject would agree. The behavior of the stock market depends upon (1) the expected future path of earnings and/or dividends; (2) interest rates to discount the future earnings/dividends streams; (3) the riskiness of the returns; (4) the returns and riskiness of alternative investments; (5) expectations about the economic and political environment and a model of their relation to returns and their valuation; (6) internal, technical factors in the market which may accentuate price swings; and (7) the tax structures, now and expected for the future, which apply to the principal participants in the market.

The potential importance of the tax factor in the stock market cannot be assessed precisely, but some general quantitative magnitudes can be identified. Over intervals as long as several decades, nominal capital gains represent about half of the total nominal return on common stocks. Therefore, as an outer limit, a universal capital gains tax of 50% could lower the after tax return by as much as 25%. However, the impact must be scaled down substantially for several factors.

First, many of the institutional participants in the stock market, typified by the pension funds and some insurance reserves, are not taxable, while others such as individual Keogh plans and IRA's are not taxable until the owner has retired and is in a lower tax bracket. Because of the existence of capital gains taxation at meaningful levels since 1941 and rapidly rising levels since 1969, the share of stocks held by nontaxable entities has risen sharply, of course. At this time, about 25% of stocks are held by them, and of the taxable holdings, a substantial percentage is not traded.[4] Second, while stock ownership is highly concentrated, about 40% of all individually held stocks are in the hands of families that are not in the 50+% tax brackets, and whose capital gains tax therefore is below 25%.[5] A crude calculation of the distribution of common stock holdings by income class suggests that the average effective tax rate, at the margin on capital gains, is approximately 25%. Finally, because the tax is levied only upon the realization of capital gains, the average effective rate is reduced through delay and, even after the important tax reforms of 1976, through partial escape at death.

The combined impact of delay, current rates less than the 49.1% maximum and substantial tax-exempt ownership is an effective marginal rate for all participants averaging only 14%.[6]

A ceiling rate of 25% on realized gains would only reduce this effective rate by 2.7% to 11.3%. This translates into a 3% increase in shareholder income (net gains plus net dividends), and a "rational" long-run stock market response would be of the same order of magnitude, though perhaps slightly higher to reflect feedback effects of the fiscal stimulus.

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[4] Estimate based on the 1971 distribution of dividends to tax-exempt entities reported in Marshall E. Blume et al., "Stock Ownership in the United States: Characteristics and Trends," Survey of Current Business, November 1974.

[5] Blume, et al., estimate that tax paying units with a 1971 adjusted gross income (AGI) of $25,000 or less controlled 40.2% of the market value of all stocks. A $25,000 AGI implies a marginal tax rate equal to or slightly below 50%.

[6] 14% = 26.3% average marginal rate on gains where realized, ×.70 reduction in implicit tax due to delay, ×.75 share held by taxable units.

Even if one had confidence in the precision of the stock market response estimate (e.g., the 3% just cited), tax receipt estimates would still be precarious. Revenue effects are particularly difficult to calculate because the tax affects the public's willingness to realize capital gains. The amount of realization incurred by individuals in the upper capital gains tax brackets is extremely small, so that the principal effect of the current tax is not to raise revenue but to reduce realizations. To the extent the lock-in effect is reduced, greater revenue will be received by the Treasury.

TABLE 2.—MACROECONOMIC AND BUDGETARY IMPACTS OF A $2,000,000,000 REDUCTION IN CAPITAL GAINS

	1979	1980	1981	1982	1983
Economic impact (percentage change from baseline):					
Average common stock price:					
Case 1	.07	1.0	0.8	0.6	0.6
Case 2	2.9	3.9	3.7	3.1	2.8
Case 3	7.1	9.7	9.2	8.1	7.5
Gross national product (at 1972 prices):					
Case 1	.1	.1	.1	.1	.1
Case 2	.1	.3	.4	.3	.3
Case 3	.1	.5	.7	.6	.5
Unemployment rate:					
Case 1	−0	−0	−.1	−0	−0
Case 2	−0	−.1	−.1	−.1	−.1
Case 3	−0	−.2	−.2	−.2	−.1
Consumer spending (at 1972 prices):					
Case 1	.1	.2	.2	.2	.2
Case 2	.1	.3	.4	.4	.4
Case 3	.2	.6	.7	.8	.8
Business fixed investment (at 1972 prices):					
Case 1	.1	.3	.4	.4	.3
Case 2	.1	.7	1.3	1.5	1.5
Case 3	.2	1.4	2.6	2.8	2.3
Budgetary impact (change relative to baseline, billions):					
Federal surplus:					
Case	−$1.5	−$1.3	−$1.3	−$1.7	−$2.2
Case 2	−1.4	−.2	.5	0	−.8
Case 3	−1.0	1.9	3.7	2.8	1.1
Federal receipts:					
Case 1	−1.5	−1.1	−.8	−.7	−.6
Case 2	−1.4	−0	1.3	2.0	2.4
Case 3	−1.0	2.2	5.2	6.4	7.0

Note: The impact is quite sensitive to the estimated stock market response and the corresponding impacts on capita costs and household wealth. Three cases were evaluated: Case 1—1 percent near-term increase in the stock market, 1 percent reduction in dividends. Case 2—4 percent near-term increase in the stock market, 4 percent reduction in dividends. Case 3—10 percent near-term increase in the stock market, 10 percent reduction in dividends. The stock market changes were phased in over 1 yr, the dividend changes over 4 yrs.

ECONOMETRIC MODEL ANALYSIS UNDER VARIOUS STOCK MARKET ASSUMPTIONS

To cast some light on the impact of a reduction in capital gains taxes on the economy, a series of simulations have been run with the DRI model under alternative stock market assumptions. The capital gains tax reduction, assuming realizations to be unaffected, is assumed to be equal to $2 billion, about the magnitude of some of the current proposals. Some 50% of this reduction is assumed to benefit owners of common stock, directly through changes in personal taxes and indirectly through changes in corporate gains taxes. If the reform focuses on fuller capital gains tax relief for homeowners or real estate investments, some of the economic effects of the solution would not materialize, particularly those aiding business fixed investment. On the other hand, construction demand would presumably strengthen.

A $2 billion reduction in capital gains taxation would represent a 20%–25% reduction in the total gains tax. Table 2 summarizes the economy-wide results under various assumptions about the stock market.[7] In the most favorable case, where the stock market rises by a full 10% after one year in response to the tax move, business fixed investment would be boosted by 2.6% by the third year, consumer spending would be up 0.7% in response to the greater household wealth

[7] The central case (case 2) is based on a "purely rational" response to the market to the change in aftertax profits, which we estimate will rise 3.6% in response to a change such as is embodied in Steiger-Hansen legislation. The dividend payout ratio is adjusted by 4% to reflect the estimated change in the opportunity cost of dividends relative to retained earnings from the shareholder's perspective. The other cases reflect hypothetical, "emotional" over- or under-reaction to the tax change.

and the stronger economy, and unemployment would be reduced by 0.2%. On the other hand, there would be some crowding out of housing activity. The Federal deficit would not be significantly affected because a stronger economy would bring in additional revenue to offset the initial loss, while simultaneously raising the cost of Federal purchases and interest payments.

The macroeconomic effects of a limited change in captial gains taxation are themselves of a rather small order of magnitude. If the only goal is to stimulate investment as a whole, about equally good, perhaps even slightly better results can be achieved by the traditional tax incentives of ever more liberal depreciation allowances and larger investment tax credits. The issue of capital gains tax relief, therefore, is not primarily a question of macroeconomic effects in the short or intermediate term. The issues are really of two sorts: first, taxpayer equity, income and wealth distribution; second, the strategy of capital formation in the evolution of the economy's industrial structure.

THE QUESTION OF INCOME DISTRIBUTION

While the increases in capital gains taxation of 1969 and 1976 principally affected the high income taxpayers, this is not sufficient reason to impost the same distributional pattern in reverse if some tax relief is to be granted. The injustice growing out of the accelerated inflation is an important factor to be considered. Consequently, from the point of view of taxpayer equity and income distribution, a capital gains tax reduction program should include a reduction of taxation of the inflation component of capital gains.

The inflation distortion of nominal capital income is greatest for low-to-middle income groups. In the area of corporate securities, high income groups have typically invested in low-payout, rapid-appreciation stocks, so that the illusory inflation share of their gains has been relatively small. In contrast, low-to-middle income taxpayers have not been able to shield their investments against inflation; their "gains" on corporate stocks and other securities largely vanish after adjusting the purchase price of their assets for the inflation which occurs between time of purchase and time of sale. Table 3 demonstrates that the distortion of income measurement caused by inflation has been greatest for low-to-middle income groups is firmly established by detailed IRS data for 1962 and 1973 (the only two years for which such data exists).

TABLE 3.—ESTIMATED NOMINAL AND INFLATION-ADJUSTED GAINS ON CORPORATE STOCK

	Corporate stock capital gains		
	Nominal gain (millions)	Inflation adjusted gain (millions)	Adjusted as percent of nominal
1962 results:[1]			
All taxable returns	$3,216	2,096	65
AGI under $10,000	−91	−319	(349)
AGI $10,000 to $50,000	718	182	25
AGI $50,000 to $100,000	593	426	72
AGI $100,000 or more	1,997	1,809	91
1973 results:[2]			
All taxable returns	4,624	−910	(−19.7)
AGI under $10,000	163	−741	(−454.6)
AGI $10,000 to $50,000	390	−2,315	(−593.6)
AGI $50,000 to $100,000	719	−255	(−35.5)
AGI $100,000 to $200,000	942	437	46.4
AGI $200,000 and over	2,415	1,964	81.3

[1] Roger E. Brinner, "Inflation and the Definition of Taxable Personal Income," in Henry J. Aaron, ed., "Inflation and the Income Tax," Washington, 1976.
[2] Martin Feldstein, "Inflation and the Excess Taxation of Capital Gains on Corporate Stock," National Bureau of Economic Research Working Paper No. 234.

Similar results are obtained for capital gains on residences and other real estate. The 1962 data indicated that the lower income groups actually suffer losses on an inflation-adjusted basis, while the well-to-do lost only approximately one quarter of their apparent gains to inflation.[8] The stronger housing market of recent years may have improved the picture for the middle class. Of course, this strength is itself principally due to the desperate effort of many Americans to

[8] Brinner, "Inflation and the Definition of Taxable Personal Income."

protect their savings—a transition of American attitudes to treat housing as a hedge against inflation. In effect, for most middle-class families, owning a home has been the only effective means of protecting their savings. Yet when those homes are sold, the "roll-over" provisions that are open to them require home-ownership until death, which is impossible for many older people as their incomes and their ability to manage separate households dwindles.

The simplest measure to help middle-class families would be to relieve them of capital gains tax on the residences even if there is no "roll-over" into a new residence. A more general relief measure would introduce an inflation step-up of the capital gains basis for tax purposes, a step-up which could be applied to all tax entities, perhaps only to certain portions, perhaps only partially. The weakness of this approach is that a similar correction is equally justifiable for the net interest received or paid on other assets and liabilities.

In summary, the proposals now most widely discussed, introduced by Congressmen Steiger and Jones and by Senator Hansen, focus too much of the attention on undoing the increases of 1969 and 1976, and do not deal sufficiently with the urgent and substantial problem of capital gains relief for middle income taxpayers who are particularly hurt by capital gains taxes applied to value changes created by inflation.

WHAT STRATEGY FOR CAPITAL FORMATION?

The proposals to reduce capital gains taxation must be partly viewed as one particular strategy for improving the country's rate of capital formation. Ever since 1954, tax policy has encouraged the retention of earnings, particularly by large, capital-intensive corporations. As Exhibit 1 shows, the principal tax changes have, with few exception, been favorable to capital formation within corporations, and unfavorable to capital formation that has to pass the test of the market. President Eisenhower liberalized depreciation practices. President Kennedy instituted the investment tax credit and liberalized depreciation once more. President Johnson reduced both personal and corporate tax rates, the only measure that can be interpreted as having at least one favorable component to market-based capital formation. In the Nixon-Ford years, depreciation was liberalized once more, the investment credit was made more generous, while the major tax reforms of 1969 and 1975 were enacted to greatly increase the taxation of individual return on capital.

EXHIBIT 1.—TAX MEASURES AND CAPITAL FORMATION

Effective in year measure	Strategy	
	Retained corporate earnings	Capital market
1954: Depreciation methods	+	
1962:		
Depreciation guidelines	+	
Investment tax credit	+	
1964: Tax cut—personal, corporate	+	+
1970: Capital gains peak rate to 35 percent; minimum tax at 10 percent		−
1975: Tax reductions	+	+
1977: Tax reform various		−

The repeated encouragement of earnings retention was of major benefit to capital formation. The preponderant body of scientific opinion accepts the effectiveness of such tax incentive measures as investment credits and depreciation allowances. This viewpoint is reflected in President Carter's proposals to apply the investment credit to industrial buildings and to the proposed corporate rate reduction.

However, unending pursuit of the earnings retention strategy gradually does change the pattern of capital formation. While the average effective rate of corporate taxation has fallen from 44.5% in 1951 to approximately 30% today,[9] the cost of externally obtained equity capital has become very high due to the stock market decline, and the availability of equity capital to new and smaller enterprises has been virtually lost.

[9] Joseph A. Pechman, Federal Tax Policy, The Brookings Institution, 1977, p. 138.

In the long run, this one-sided strategy creates an economy dominated by large, well-established enterprises, whose managements are little dependent upon their stockholders or on sources of external debt capital. A shrinking proportion of all investment is required to pass the rest of the capital market, as we rely increasingly on the plowing back of the retained earnings and depreciation flows.

If a step up in capital formation is accepted as a goal of policy—and I am aware of few observers who do not accept that premise—then there is a strong case that at least a portion of the tax resources to be devoted to that purpose be flowed through the market channel, rather than exclusively poured once more into retained earnings. The results will be difficult to assess econometrically because there has been so little experience with the market approach. But the poor behavior of the stock market since 1969 and the virtual disappearance of new common stock issues to help the smaller and newer enterprise are pretty strong evidence that increases in these taxes had a significant negative effect, and therefore raise a realistic promise that reductions in these taxes would be comparably helpful.

CONCLUSION

There is a good case for some reduction in capital gains taxation. It could be the beginning of a market-based strategy of aiding capital formation. It would also be a recognition that the recent inflation has made a portion of capital gains illusory, and therefore properly subject to some tax relief.

The exact form of the capital gains tax relief is a more difficult issue. The Steiger-Jones-Hansen proposals would limit the reductions almost entirely to the high income individuals who were affected by the tax reforms of 1969 and 1975. Capital gains relief should be applied to a broader segment of the capital-owning public. A more equitable capital gains package would include a change in the treatment of a family's home, perhaps terminating its capital gains taxation altogether. A broader reduction in capital gains taxation that would enhance the fairness of the tax system would allow an inflation adjustment of the basis of property for the tax, thereby limiting the tax to real increases in value. The administration of an inflation adjustment would be relatively simple, requiring only the addition of one easily-calculated column on the capital gains tax form and a simple table of inflation factors.

The proposed method of dealing with the inflation distortion of capital gains by writing-up the purchase price of capital assets is decidedly superior to the alternatives, mechanically changing the share of the gain included in AGI as the holding period increases. A graduated, rising exclusion, in fact, runs *counter* to the logic of adjustment for inflation. For example, it should be clear that the relatively high consumer price inflation and low stock price growth in recent years indicate that most appreciation in recently purchased shares is illusory, whereas long-held assets reflect substantial real increases. Related inflation adjustments could also be extended to savings accounts and other assets generating ordinary income and, on the reverse side, to interest payments by consumers and business.

The proposals now before the Congress pose the conflict between the question of capital formation and the question of a fair distribution of income and wealth too strongly. There are better proposals, and we would urge both the Administration and the Congress to come forth with them.

STATEMENT OF MICHAEL K. EVANS, CHASE ECONOMETRICS

EXECUTIVE SUMMARY

(1) The ratio of capital spending to GNP is closely correlated to the ratio of stock market prices to construction costs, lagged one year.

This is shown in Figure 6. The underlying data are taken from the 1978 *Economic Report of the President.*

(2) The maximum capital gains tax rate is one of the principal determinants of fluctuations in stock market prices.

During the past decade, GNP and corporate profits have increased at average annual rates of 9% and 11% respectively, yet the stock market has not risen at all. This can only be explained by two factors: the overstatement of profits due to higher inflation, and the doubling of the maximum rate of taxation on capital gains. Thus reducing this rate from 49% to 25% will raise stock market prices 40% over the next two years.

(3) Lowering the capital gains tax rate will reduce the Federal budget deficit. This move will create 440,000 more jobs over the next five years, thereby raising personal and corporate income. It will draw investable funds from many other sources, particularly tax-free municipal bonds. It will also encourage investors to unlock many of their capital gains and reinvest the proceeds. As a result of all these factors, the deficit will be diminished by $16 billion.

(4) The reduction in capital gains taxes will not only benefit the "rich." While it is true that most of the gains will go to those taxpayers with incomes over $100,000 a year, it is a grave mistake that to infer that such taxpayers have long-term average incomes above this amount. In fact, many taxpayers are in this bracket only because they realized a large capital gain that year from the sale of assets such as a principal residence, small business, or family farm.

STATEMENT

During the past decade, productivity growth has declined from 2.8% to 1.3% per year, the average rate of inflation has increased from 3% to 6%, and the unemployment rate has risen from 3¼% to 6%. While the causes contributing to this striking decline are many and varied, the most important single factor is the reduction in the investment ratio from 11½% to 9½%. This slippage can in turn be tied to the decline in the expected rate of profitability on new investment, some of which is due to the doubling of the maximum rate of taxation on capital gains since 1969.

Legislation has been proposed to return the maximum rate on capital gains to its earlier level of 25% on January 1, 1980 for both individuals and corporations. Such legislation would be quite beneficial to the overall economy. The rate of growth in constant-dollar GNP for the period 1980–1985 would average 3.6%, compared to a 3.4% annual average growth rate otherwise. An additional 440,000 new jobs would be created by 1985. Expenditures for plant and equipment would rise 5.7% per year in constant prices, compared to 4.7% otherwise. In addition, the Federal budget deficit would be $16 billion *less* by 1985 than would be the case without this reduction in capital gains taxes. These numerical comparisons are given in Table 1 and in Figures 1 through 4.

TABLE 1.—COMPARISON OF KEY ECONOMIC INDICATORS

	1980	1981	1982	1983	1984	1985
Real GNP, billions of 1978 dollars:						
Baseline	2,244	2,231	2,395	2,475	2,562	2,647
Lower capital gains taxes	2,247	2,331	2,410	2,492	2,583	2,673
Difference	3	10	15	17	21	26
Cumulative difference	3	13	28	45	66	92
Real GNP, annual percent increase:						
Baseline	3.9	3.4	3.2	3.4	3.5	3.3
Lower capital gains taxes	4.0	3.8	3.4	3.4	3.7	3.5
Difference	.1	.4	.2	0	.2	.2
Cumulative difference	.1	.5	.7	.7	.9	1.1
Employment, millions, total nonfarm:						
Baseline	89.3	91.4	93.4	95.5	97.7	100.2
Lower capital gains taxes	89.3	91.6	93.7	95.8	98.1	100.6
Difference	0	.2	.3	.3	.4	.4
Cumulative difference	0	.2	.5	.8	1.2	1.6
Fixed business investment, billions of 1978 dollars:						
Baseline	236	251	262	271	283	294
Lower capital gains taxes	239	256	269	280	292	304
Difference	3	5	7	9	9	10
Cumulative difference	3	8	15	24	33	43
Federal budget deficit, billions of current dollars:						
Baseline	77.2	62.7	60.3	59.2	52.2	49.4
Lower capital gains taxes	76.5	58.8	53.9	51.4	41.5	33.8
Difference	.7	3.9	6.4	7.8	10.7	15.6
Cumulative difference	.7	4.6	11.0	18.8	29.5	45.1

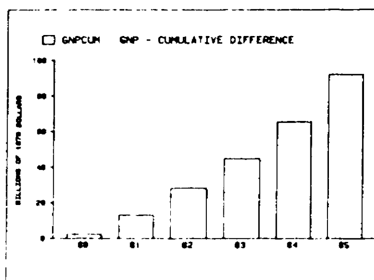

Figure 1

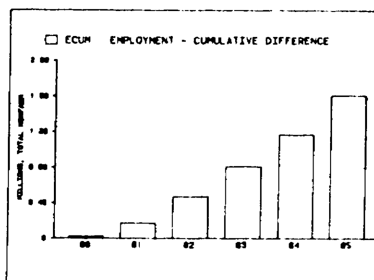

Figure 2

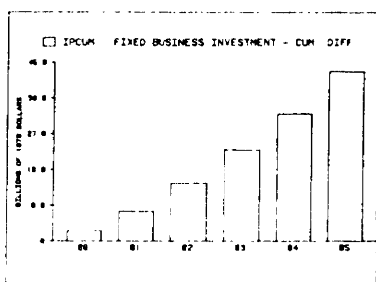

Figure 3

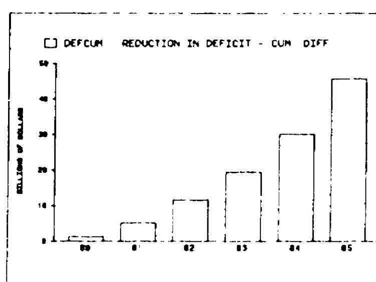

Figure 4

The reduction in capital gains taxes stimulates economic activity through the following combination of events:

(1) A reduction in capital gains taxes raises stock prices.

(2) Higher stock prices lead to a faster rate of growth in capital spending.

(3) Higher stock prices lead to more equity financing, which reduces the debt/equity ratios of corporations. As a result, interest rates are lower than would otherwise be the case.

(4) More investment creates higher levels of output, employment, and income, and reduces inflationary pressures by increasing productivity and raising maximum potential GNP.

(5) The increase in economic activity raises Federal government rdvenues, hence reducing the budget deficit. This in turn leads to lower interest rates and lower rates of inflation.

We now examine each of these linkages in greater detail.

Economists generally agree that an increase in capital gains taxes will depress the stock market, while a reduction will raise stock prices. However, the link between these two variables has not often been measured. Some studies which purport to show a link between capital gains taxes and economic activity merely assert that such a relationship does exist without providing empirical justification. However, as shown in Figure 5, the relationship is extremely important. The sharp declines in the stock market in 1970 and 1977 are due in large part to the Tax Reform Acts of 1969 and 1976.

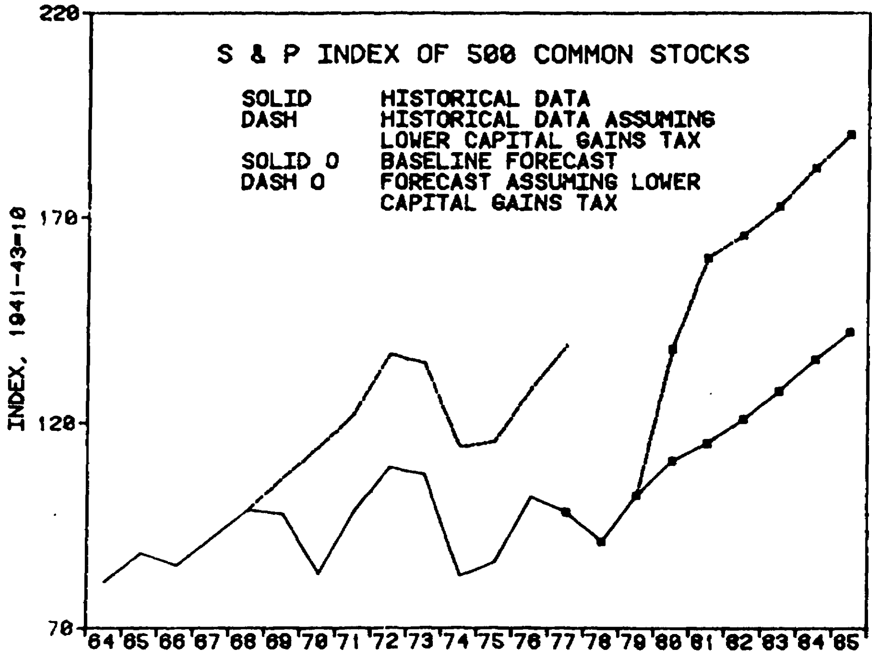

Figure 5

The latest version of the CEAI model contains an equation relating stock prices to capital gains and five other variables: corporate profits, disposable income, the ratio of dividends to profits, the prime interest rate, and the overstatement of profits due to inflation (CCA adjustment). The capital gains tax rate figures prominently in this equation, and the coefficient of this term indicates that a 10% change in the capital gains tax rate will result in a 17% change in stock prices. This result is empirically determined from multiple regression analysis and is not simply an assumption generated in order to emphasize the beneficial aspects of capital gains tax reduction.

Some economists have indicated that the 40% increase in stock prices over the next two years which we claim results from a 25% reduction in the maximum capital gains tax rate far overstates what would actually happen. Since this appears to be a fairly common misconception, we explore the matter in greater detail.

To put the reduction in average stock market prices in perspective, the average price/earnings ratio for the 1964-1968 period—after the reduction in the maximum personal income tax rate but before the increase in the capital gains rate—was 17.4; in 1977 it was only slightly above 9. This discrepancy cannot be explained without recourse to the change in capital gains taxes.

In 1969, the last year that capital gains were taxed at a maximum rate of 25%, the Standard & Poor's 500-stock price index averaged 97.8 (1941-1943=10). In 1977, it averaged 98.2, for a decidedly inferior growth rate of 0.0%. During the same period, GNP and aftertax corporate profits advanced at average annual rates of 9% and 11% respectively. Interest rates were not a factor, since the prime rate averaged 8.0% in 1969 compared to 6.8% in 1977. Two factors appear to have caused this stagnation in the stock market. First the sharp increase in inflation led to an understatement in depreciation allowances and hence an overstatement of book profits. Second, the maximum rate on capital gains is now 49.1% instead of 25%.

The econometric analysis which we have performed indicates that if capital gains taxes had remained at pre-1970 rates the stock market would be some 40% higher. Over an eight-year period that means that stock prices would have risen only 4.3% per year, compared to the nogrowth situation which actually existed. Even this figure would be way below the average increase in either GNP or profits. Seen in this light, the 40% figure does not seem so remarkable after all.

The total change in stock prices caused by a change in capital gains taxes does not occur instantaneously because of the lock-in effect. Higher capital gains taxes reduce the number of individuals willing to sell their stock at any given time; since these capital gains remain unrealized, less new funds are available for purchases of other stock and hence prices gradually decline. We have found that this effect usually takes about two years to become fully operative. Similarly, a reduction in capital gains taxes will not cause all individuals to sell their assets immediately. However, many investors will sell sooner; as this happens, more funds will be committed to purchases of equities. This will raise stock prices and cause an increasing number of investors to realize their capital gains, thus providing even more funds for equity financing. Hence we would expect the full effect of a reduction in capital gains taxes on stock prices to occur in 1981 and 1982.

Some economists have claimed that to make capital gains rate cuts revenue neutral, sellers would have to liquidate large parts of their portfolios and these liquidations would act as a dampener on asset price increases. The trouble with this analysis is that it overlooks one blade of the scissors. It concentrates solely on supply without realizing the massive increase in demand that would result from a lowering of capital gains taxes. Since investors would unlock their capital gains and use these funds to purchase additional equities, market performance would improve. In addition, billions of dollars would flow from sources such as tax-free municipal bonds into the stock market, hence raising the demand still farther.

The effect of higher stock market prices on fixed business investment has been well documented in previous issues of these reports. Figure 6 shows the exceedingly

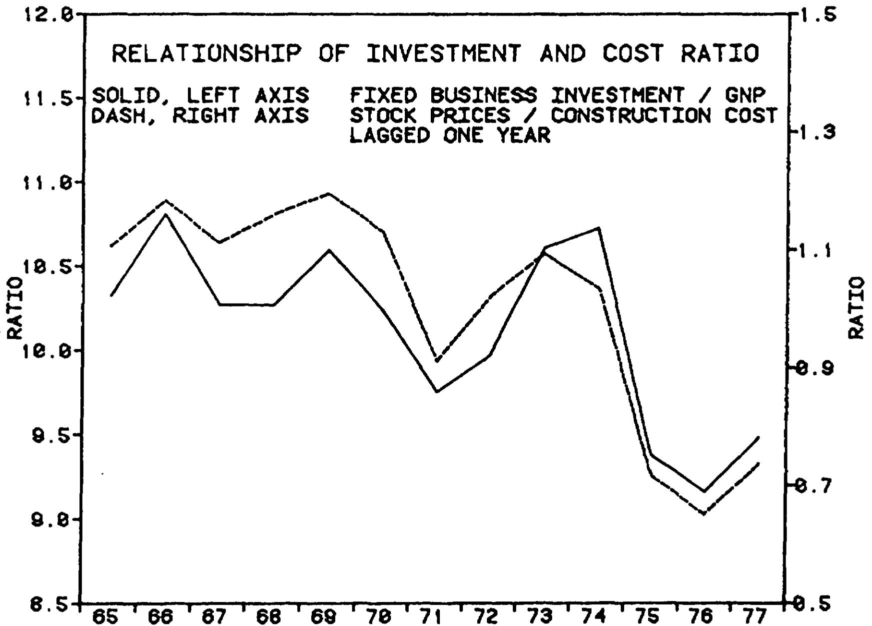

Figure 6

close relationship between the ratio of fixed business investment to GNP and the ratio of equity prices to construction costs lagged one year. The one-year lag reflects both the decision lag by entrepreneurs and corporate executives and the time necessary for actual construction and delivery of capital goods.

The third linkage is between stock market prices and interest rates, or between the debt and equity cost of capital. The declines in the stock market over the past decade have been mirrored in the sharp increase in the amount of debt financing, as shown in Figure 7. This graph shows the comparison between (a) the ratio of the market value (i.e. stock prices) to replacement cost of net assets [1]

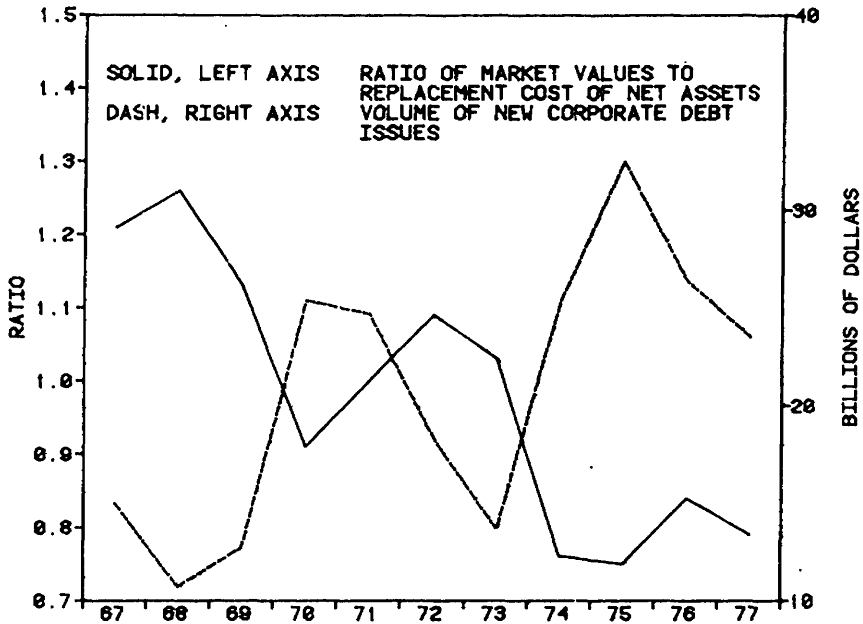

Figure 7

and (b) the volume of new corporate debt issues. In particular one should note the sharp increase in debt financing whenever this ratio dips below unity. That should come as no surprise, since firms are extremely unlikely to issue new equity issues when their stock price is below book value—as has been the case since 1974.

Our analysis indicates that a 40% increase in stock market prices, which would raise this ratio slightly above unity, would lower the volume of new corporate issues by about $5 billion per year, which would reduce long-term bond yields by about 50 basis points at any given level of economic activity. Since demand for loanable funds by both consumers and investors would rise because of the heightened level of economic activity, interest rates would not actually decline this much, but the switch from debt to equity capital would lighten the burden in financial markets and would be critical in preventing crowding out from occurring. In other words, a significant increase in the investment ratio cannot be supported in the capital markets unless the aggregate debt/equity ratio were to diminish dramatically, which in turn cannot be accomplished at present levels of capital gains tax rates.

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[1] These figures are taken from Table 8, p. 68 of the 1978 "Economic Report of the President."

The fourth linkage incorporates the multiplier effects. An increase of $1 billion in spending will result in the creation of more jobs, which will raise individual and corporate incomes and hence result in more purchases of consumer and capital goods. Most economists agree that the investment multiplier is about two, which means that every $1 billion increase in capital spending caused by higher stock market prices will result in about $2 billion more in real GNP.

It should be mentioned that the multiplier is much smaller for increases in spending which are inflationary, for the increase in prices and interest rates has a negative impact on consumer and capital spending. In general, increases in spending which do not raise productivity tend to have much smaller ultimate effects on economic activity because of the backlash of higher inflation. For this reason, the investment multiplier is usually higher than the spending multiplier for either consumption or government purchases. An increase in the amount of capital per unit of output improves the rate of growth in productivity and expands the production possibility frontier of the economy, hence lessening the probability of bottlenecks and shortages. Since goods and services are now produced more efficiently, the rate of inflation does not rise as rapidly, and the gains in individual and corporate income stemming from more jobs and higher output are not eroded by higher inflation.

For this reason, changes in fiscal and monetary policy which stimulate investment give a bigger "bang for the buck" than do other types of economic policies. The only drawback to policies that stimulate investment is that the lag is somewhat longer, since investment decisions take time to implement and investment goods take time to produce or construct. Thus the first-year effect is often not as large, although the effects in all succeeding years are significantly larger per dollar of increased stimulus.

We now turn to the critical issue of the effect of a reduction in capital gains taxes on the Federal budget deficit. Economists, businessmen and politicians are in general agreement that reducing tax rates has some positive effect on economic growth and employment. The major drawback to tax cuts is that they increase the size of the Federal budget deficit, which is thought to lead to higher interest rates and a faster rate of inflation.

Some economists have argued that the Federal budget deficit can actually be decreased through a reduction in personal or corporate income tax rates. The logic supporting this hypothesis suggests that the economic effects stemming from these tax cuts will be so large that the increase in revenue will offset the initial decline. However, this claim is unsupported by empirical evidence. In 1977, Federal government revenues accounted for exactly 20% of total GNP. Thus in order for an income tax cut to leave the deficit unchanged, the implicit spending multiplier would have to be about five, far greater than the investment multiplier of about two. While we have often argued for a reduction in personal and corporate income tax rates because of their positive effects on productivity and incentives and their beneficial long-term effects in widening the private sector tax base. we have never claimed that such a move would actually decrease the size of the Federal budget deficit.

The capital gains tax, however, is unique in its leveraged effect on the economy. The major reason for this, and the factor which distinguishes the capital gains tax from all other levies, is that the taxpayer can in large part determine whether or not he wishes to pay the tax. For most individuals who are unhappy with their high marginal tax bracket, the only (legal) option is to earn less income. Tax avoidance and tax shelters provide some limited relief, but the options are sharply constrained. However, the owner of a capital asset can delay his tax indefinitely by simple expedient of not selling the asset. Such a decision is economically inefficient, for it restrains capital from flowing to its most productive use and hence retards growth in productivity and output. However, this option is available to taxpayers with capital assets, and most of them use it.

As a result, the revenue raised from capital gains taxes is miniscule relative to the levels of Federal personal and corporate income taxes. Figures for capital gains taxes are not readily available, but Joseph A. Pechman has prepared estimates through 1973 for both personal and corporate taxpayers, which are given in Table 2.

TABLE 2.—ESTIMATES OF CAPITAL GAINS TAXES

[Dollar amounts in billions]

	Pechman estimates			Total capital gains, individual income tax returns	Percent change, stock prices
	Individual[1]	Corporation	Total		
	(1)	(2)	(3)	(4)	(5)
Year:					
1960	$1.9	$0.6	$2.5	$5.1	−2.7
1961	2.9	.8	3.7	7.6	18.7
1962	2.1	.7	2.8	5.8	−5.9
1963	2.3	.7	3.0	6.4	12.0
1964	2.7	.7	3.4	7.9	16.5
1965	3.4	.8	4.2	10.0	8.4
1966	3.4	.9	4.3	9.7	−3.3
1967	5.0	1.0	6.0	13.5	7.8
1968	7.2	1.3	8.5	17.7	7.4
1969	4.8	1.4	6.2	14.3	−.9
1970	2.3	1.1	3.4	8.7	−14.1
1971	3.8	1.3	5.1	13.1	18.1
1972	5.3	1.8	7.1	16.7	11.1
1973	5.0	2.0	7.0	16.1	−1.6
1974			[2]5.6	13.5	−22.9
1975			[2]5.5	13.7	4.0

[1] Including fiduciaries.
[2] Preliminary.

Sources: Cols. (1)–(3), Joseph A. Pechman: "Federal Tax Policy," 3d edition, table C–13, p. 352; col. (4), "Statistical Abstract."

Two facts are immediately apparent from these figures. First, the amount of tax collected is relatively small, generally less than 5% of Federal income tax. Second, and of particular interest for this study, the amount of capital gains tax paid in 1970, when rates were increased to a maximum of 35%, was less than in 1968 and 1969, the last years of 25% maximum rates. Furthermore, tax collections have remained below 1968 peaks through 1975 and are unlikely to be higher for 1976 and 1977 in view of the dismal performance of the stock market.

The counterargument to be made is that capital gains taxes have declined since 1968 because of the relatively poor performance of the market since that date. This argument is not well taken, however, for two reasons. First, the stagnation of the market itself is due to the higher capital gains taxes, as we have already shown. Second, the amount of capital gains taxes is relatively insensitive to the yearly fluctuations in the market, as can also be seen from the figures presented in Table 2. The capital gains taxes in 1971 and 1972, which were relatively good years for the market, were only about $1 billion greater than in 1974, which was a disastrous year.

Treasury Secretary Blumenthal has argued that the rollback in capital gains taxes would benefit almost exclusively those taxpayers with income in excess of $100,000 per year. However, this analysis completely overlooks the fact that many upper-income taxpayers are in these lofty brackets only because of large capital gains in that year—due perhaps to the sale of a residence, small business, or family farm. Previous income and tax studies have indicated that the same taxpayers do not inhabit the upper income brackets every year.

Senator PACKWOOD. Next, we will go to Daniel Brill, Assistant Secretary of the Treasury.

Mr. Secretary.

STATEMENT OF HON. DANIEL H. BRILL, ASSISTANT SECRETARY FOR ECONOMIC POLICY OF THE DEPARTMENT OF THE TREASURY

Mr. BRILL. Thank you, Mr. Chairman, and thank you for inviting me to participate in this dialog. I have submitted to the committee a moderately lengthy and, unfortunately, somewhat technical paper

which I would like to submit for the record this morning. I will summarize the paper briefly and then make myself available for such questions that you may have.

Inasmuch as there has been so much controversy swirling around the subject matter of these hearings, I thought it might be useful first to underscore certain basic areas of agreement.

As Secretary Blumenthal indicated yesterday, we are in full agreement on the need to spur investment in new, more efficient and productive facilities, and this is something we have made very clear. Since coming into office, we have emphasized our dedication to increasing investment in basic productive capital.

Indeed, my first assignment on joining the Treasury team was to assist the Secretary in preparation of a major address which he gave—on March 3 of last year—on the imperative need for increasing investment.

This was an assignment that I took on with much relish, coming into Government service from the business sector, I was then, and still am, acutely aware of the need to provide greater incentives for investment.

Further, I think we are all in agreement on the principal mechanism by which these incentives can be provided; namely, by lowering the cost of capital. By lowering the cost of capital, we increase profitability. We are all in agreement that profits are what make the economy go round.

We are in agreement on the need to control and reduce inflation, because inflation breeds higher interest rates. Higher interest rates, again, raise the cost of capital and hinder investment.

We are in agreement on the need to restrain and reduce Government demands on our physical and financial resources, for Government competition for these resources increases the cost of capital to the private sector.

And we are in agreement on the proposition that changes in our tax laws to lower the cost of capital can induce more investment. I think there are more substantial areas of agreement that tend to get overlooked in the controversy over a specific form of reducing the cost of capital; namely, the proposal to reduce the taxes on capital gains.

The three major studies addressed to this issue, on which I focused my attention—there are others, which I have not had as much opportunity to explore in detail—are before us this morning. They are that conducted by the Securities Industries Association, that by Merrill Lynch and that by Chase Econometrics. All three of these studies follow roughly the same path in tracing the influence of the change in capital gains taxes on the economy.

First, the influence of a change in taxation would be felt on the price of assets, particularly on stock prices. As stock prices rise, the cost of business financing would decline, therefore, stimulating business investment.

In at least one of the studies, an additional path was traced whereby the higher stock prices increased consumer wealth. This greater affluence encourages more consumption which, in turn, encourages more investment to meet the greater consumer demand.

But, basically, they are in agreement on the fundamental path. It is a plausible path. The critical question, however, is quantitative.

By how much will a change in the capital gains tax law really effect these variables and influence the total economy?

The first element in the analysis is the influence of changes in the tax on stock prices. This first step on the path is handled by two of those studies, conducted by the Securities Industry Association and by Merrill Lynch, by an assumption. There is nothing wrong with that procedure. It is a standard operating procedure in most analyses to make assumptions.

The SIA assumes that the effect of complete elimination of the capital gains tax would be a 20-percent rise in stock prices. The Merrill Lynch study assumes a stock price rise of only 4 to 6 percent as a result of partial elimination.

My reading of the history of the effects of changes in taxation on stock prices, at least over the past quarter century, does not reveal any close relationships between capital gains tax changes and changes in the stock market. Admittedly, we have no experience in this period with reductions in capital gains taxes, because in this period there have only been increases.

But even there, in analyzing the effect of increases, it is hard to read into the evidence available any marked, close relationship. In fact, the question I have is precisely that which Senator Dole has just raised. If one looks at the period surrounding the time when capital gains taxes were raised, we find that stock prices began to decline in December 1968. This was a full 6 months before there was any congressional discussion of the possibilty of raising capital gains taxes and 12 months before any legislation was enacted.

In 1968 there was a substantial decline in stock prices. The Tax Reform Act of 1969 became effective on January 1, 1970, and there was a phasing-in of higher tax rates on capital gains. But, in this period when the higher taxes were being phased in, stock prices increased. They increased some 46 percent from mid-1970 to the end of 1972.

Thereafter, the stock market has behaved poorly. To attribute the behavior of the stock market in 1973 until very recently to one factor, the capital gains tax, does stretch credulity. When we consider that there was a period of double-digit inflation, the worst recession since the thirties, the oil embargo, and the quintupling of oil prices—a host of factors which, I am sure, swamped the effect of the capital gains tax.

Therefore, I find it hard to accept the basic assumption as plausible.

The third study we are addressing, that conducted by Chase, does not assume a stock price response. It derives the expected stock price change as a result of an equation that relates fluctuations in stock prices to many variables, such as profits, cash flow, and other factors.

I have, in my testimony, indicated that there are serious methodological problems with this equation, problems that have such jaw-breaking names as multicollinearity and serial correlation. I will not bother the committee this morning with a technical discussion. It appears in an appendix to my statement.

But I think it is important to note that in many elementary texts on econometric analysis, one will find the statement that equations suffering from this problem give results that are subject to very wide statistical error.

In addition, there are standard procedures for correcting these methodological defects. When one applies these standard correction procedures, the results of the equations do, indeed, change radically.

For example, if one applies a correction for the problem of serial correlation—a standard correction technique identified in any textbook—the results of this equation are changed. The corrected results yield a rise in stock prices of only 9 percent instead of the 40 percent found in the original equation.

What this means, in my judgment, sir, is that the 40 percent estimate is no more and no less an assumption than the 20 percent that was the frank assumption in the SIA study, or the 4 to 6 percent that was assumed in the Merrill Lynch study.

There has been reference this morning to the need to look at facts. I submit that the 40 percent estimate is not a fact.

Basically, we are going on hunch. Therefore, I suggest, that it is probably inadvisable to go overboard just because some hunches are run through a computer model. Computers do not make hunches scientific. Perhaps the results of most computer models—and I have had some years of experience in both developing and using them—should bear a label, "For external use only. Dangerous if swallowed."

Not only do the hunches about the effect on stock prices vary widely, so, too, do the results of the stock price change on the total economy. Now, this is a very important difference we see among the studies, because it is the difference between the effect on the economy that influences the conclusions as to what Federal revenues will be. The resulting revenues, in a sense, define whether or not this reduction could be characterized as a free lunch. Are we getting back more than we are giving away?

The answer to that depends, very much, on what, in the jargon is called, a multiplier—simply, how much reaction will there be in the economy to a given change in stock prices. This assumes, first that we agree on how much stock prices would change. And here, again, the studies differ widely.

On one extreme, the Merrill Lynch study says the multiplier of total economic output to the change in stock prices is a multiple of 2. At the other extreme, the multiple in the Chase study is 9.

Thus, we find that the studies submitted for fact——

Senator PACKWOOD. Mr. Secretary, let me interrupt you for a moment and ask you if you could wind up. Senator Cranston had been waiting to testify and he has come back. If you could wrap up in just a couple of minutes—we have some questions for you, but I would like to put Senator Cranston on.

Mr. BRILL. I would be most happy if I could have a minute and a half to finish my point.

Senator PACKWOOD. That's fine.

Mr. BRILL. The basic point is a rather simple one. The studies differ widely in assumptions. They differ widely in the way in which they track these assumptions through to the end effect on the economy.

I think it is a very useful exercise to run basic assumptions through a variety of models. We do this all the time in our analysis. Mr. Evans was referring to the fact this morning that the Treasury staff is a very interested user of his product, and we are. We subscribe to all of them. We look at every one of the models.

In the end, we have to evaluate the results in terms of what we see as the basic assumptions and the basic flaws in these models.

Our position is that the case has not been proven that changes in the capital gains tax are, indeed, a cost-effective way of encouraging investment. We think the evidence is much more robust for the techniques in the President's tax proposals. Extending the investment tax credit and reducing the corporate tax rate, gives you a lot more investment bang for a buck; and I am sure we are all interested in the most cost-effective way of achieving the agreed-upon objective of encouraging more business investment.

Thank you, sir.

Senator PACKWOOD. Thank you, sir, and if you would just hold until Senator Cranston is finished.

Mr. BRILL. I would be most happy to.

Senator PACKWOOD. Alan.

Senator CRANSTON. Thank you very much. I appreciate very much the opportunity to testify this morning and I appreciate very much your accommodation of my schedule. I have several other things I have to do.

STATEMENT OF HON. ALAN M. CRANSTON, A U.S. SENATOR FROM THE STATE OF CALIFORNIA

Senator CRANSTON. I am delighted to have this opportunity to support Senator Hansen's bill, S. 3065. I cosponsored this measure in good part because I am convinced of the critical need for the additonal jobs that can be created through more risk capital investment. Now, more than ever, our private economy is being asked to provide millions of jobs for American workers. There are different ways to provide jobs, but in the past decade, a major source of those jobs—risk capital investment—has virtually disappeared from our economy.

California companies were able to rise more than $360 million in risk capital to finance new ventures and businesses back in 1969. That was under the old capital gains tax rate.

Last year, under the current higher rate, which approached 50 percent, California companies were able to raise only $6 million in risk capital.

I would like to point out that last year was a very good year for the California economy. It outperformed the economies of the other 15 leading industrial States. Nevertheless, only $6 million was raised in venture capital for new small businesses.

The money was there, but the rewards for the risks taken were not there. Investors, instead, turned to less venturesome, more secure, investment. Others were attracted to fast, secure turnovers at low profitability. Others went into tax shelters.

Risk venture investments are not quickie, fast buck, tax shelter gimmicks based on funny money or schemes to evade taxation. Risk venture investments are something quite different from that. The venture capitalist decides to risk all. There is little or no security for his investment, other than a share of ownership or preferred debentures. He backs individual entrepreneurs who look as if they have innovative ideas and the ability to turn their ideas into reality.

The venture capitalist provides the money. The entrepreneur provides the know how and the desire to succeed in business. The risks are great, and if the venture capitalist is patient and can wait 5 or 7 years and if the venture turns out to be successful, the venture capitalist may—and, I repeat, may—obtain great rewards by selling his interest in the business.

But the time it takes to start up a new business, to make it successful and attractive to others, costs money. Money will erode from inflation during the development period. So when the venture capitalist's ship finally comes in, what reward is there if the gain realized is taken away by taxes? Very, very little.

The facts speak eloquently for themselves. That is why there is a scarcity of venture capital for new enterprises and that is why venture capitalists have become less venturesome and have chosen to place their money in second and third stage companies seeking expansion.

In my view, the greatest danger in the loss of risk capital investment is that it is chilling the adventuresome inventive spirit which has been the genius of our economic system for so many years. People with creative ideas are constantly coming into my office—and I am sure that each of you have had this experience and it is, I think, a very disturbing experience. These people with creative ideas come into our offices seeking Government financing, not private financing, but Government financing of inventions and projects that private sources should be able to finance and have financed in the past when the capital gains laws were different—I am speaking of the time before we changed them in 1969.

Other entrepreneurs find that the only way that they can develop their ideas is to sign them over to huge corporations. Others just say, "oh, forget it; it is hopeless."

That is a loss to our country and a loss to our economy.

At this point, I would like to emphasize that changing capital gains tax rates will not solve all of our problems in producing jobs for people who need jobs. It is only one piece in the total economic picture. But I think it is a critically important piece.

What has been ignored in discussions of capital formation has been the need for so-called outside capital, raised by a business from investors who seek their reward at the end of the line, not from a phony tax write off or other gimmicks, but from their share of the success of the enterprise.

As a member of the Banking Committee with responsibility for small business and minority business loan programs, I know first hand that loans are not the answer for the brightest and most creative of our businessmen and women. They desperately need risk venture capital. They need an investor who is willing to lose his investment.

The bank is not prepared to lose its loan and the Federal Government is not prepared to give grants to businesses simply on the basis that the entrepreneur seems to have a good idea. These small business people must look to the private sector. When they do, they find few investors venturesome enough to risk capital in new businesses under present law. Our economy needs a healthy mix of investment and capital formation.

S. 3065, I believe, will restore a more favorable balance of investment in our national economy. This is not tax relief for the rich. Its

purpose is to stimulate investment in the capital requirements of our economy. This is a constant and major concern of Congress and the administration. Tax relief for individuals should not be tied with the need for investment in the capital sector of the economy.

I support the President's request for personal income tax cuts and, in fact, I voted for a more substantial tax cut in the Budget Committee. I felt then, and I think now, that our economy requires a lessening in the amount of resources that the Government takes from the people.

S. 3065 will not be a drain on the Treasury. I am confident that the spur given to a long-neglected sector of our economy will generate sufficient economic activity to pay for the capital gains tax cut, and more. I have argued on other occasions that increased spending for public jobs would produce savings in revenue to Government to offset our outlays.

This continues to be a valid argument. But, if it is valid in the public sector, it must be even more valid in the private sector.

Insufficient investment encourages inflation by causing substandard productivity, unfavorable trade balances and continued budget deficits.

The way to increase productivity and exports is through research and development of new technology and by improving plants and equipment. All of that requires incentives for risk capital, along with the other capital formation incentives now in the tax code.

The shortage of home-grown risk capital has forced many American companies to turn to foreign capital sources. How much better to encourage American investment. S. 3065 will do that. It is time we gave our own investor the benefits many foreign investors now have.

Not many realize this, but our tax law has the effect of taxing at low rates foreign investors where treaties so provide. That is one reason why so many American businesses with high technology are being purchased by foreigners presently. Placing American capital on an even footing with foreign capital is most certainly in the interests of all.

S. 3065 will do exactly that. For these, and other reasons, I support the bill and I urge very prompt action by the committee and hope that we can pass this and enact it into law before the year is done.

I thank you.

Senator PACKWOOD. You know, Alan, we spent a lot of time this morning arguing about revenue estimates. What you say about venture capital was also brought home very clearly in testimony yesterday. Most of these small venture capital companies do not pay any dividends, or they pay such slight dividends that nobody would invest in them on that basis.

So the only other way you get your money out is on capital appreciation, and if we start taxing capital at almost the same level that we tax income, there is no point in putting your money in it at all.

Senator CRANSTON. That is exactly right. We are forced into a situation where we turn to Government, not only seeking money from the Government for inventive ideas, but also for the jobs through public service employment and other programs—which I support—but which I would like to have secondary to efforts to get the private economy to do it.

Senator PACKWOOD. I have no questions.
Senator Hansen.
Senator HANSEN. I first want to compliment you and express my appreciation to you very, very sincerely for your excellent statement, Senator Cranston. I think you can understand, more clearly than most do, the important relationship between the availability of capital in the hands of people who can afford to take the risks. You said it in these words, that these small companies desperately need risk venture capital. They need an investor who is willing to lose his investment.

Of course, no one anticipates losing an investment with any jubilation or glee, but in order to find people who will put their dough on the line and take the chance, the rewards must be commensurate with that risk. They are not going to take the risk if the chances are just even-Stephen that they are going to lose.

Senator CRANSTON. Absolutely.

Senator HANSEN. And that is the reason that you think that if we lower the capital gains rates we will expand the amount of money that can go into these ventures that will stimulate companies such as you will find in such great abundance in California and some of which, unfortunately, have had to go out of the country to find capital to underwrite their operations.

Senator CRANSTON. Right.

I think this is a particular problem in California, but it exists across the Nation, and we see declining investment all across the land in ways that I think have inhibited our economy very, very badly; and I just think that we made a mistake in 1969.

Senator HANSEN. Now, Treasury has testified—they have changed the figures—up until yesterday I think it was $2.2 billion they figured would be lost by this bill. I suppose since we may be in double digit inflation, I think it is up to $2.4 billion. I mean to ask Secretary Brill about that.

Senator CRANSTON. You mean between yesterday and today?

Senator HANSEN. Well, between a week ago and yesterday. I think Secretary Blumenthal had the $2.4 billion. I do not know where they got the extra $200 million.

Do you feel, from the experience you have had and the studies you have made of the investment pattern in America that reducing the capital gains tax rates will result in a Treasury loss or wash or gain?

Senator CRANSTON. I am quite confident that it would, in not too long a time, lead to a Treasury gain. It would lead toward a more balanced budget, towards a far healthier economic situation in this country, less dependency on Government for money to stimulate the economy and less dependence on the Government for money directly to provide jobs for those who cannot find them now in the private economy.

Senator HANSEN. Thank you very much, Senator Cranston, for your support and for your excellent statement.

Senator CRANSTON. And thank you for your leadership in this matter.

Senator PACKWOOD. Bill.

Senator ROTH. I have no questions.

Senator PACKWOOD. Mr. Secretary, if you would please come back for some questions. We want to take Dr. Laffer next after you are done, but I think we have some questions for you.

STATEMENT OF DANIEL H. BRILL [RESUMED]

Senator PACKWOOD. Mr. Secretary, I am curious about Don Lubick's answer where he says he feels that Treasury is forced to use static estimates. "If we did not use static estimates, people would say we are doctoring our revenue figure to arrive at the results we wanted."

Are you saying that Treasury is simply going to stick with static estimates no matter what, no matter if we double the income tax or halve it, you would just double or halve the revenue estimates based on that? That there will be no effects that is unstatic?

Mr. BRILL. Senator, let me distinguish between assessing the initial effect of one specific tax against assessing the effects on the economy of an entire package of tax bills.

Senator PACKWOOD. No, that is not the question I am asking. If you want to answer a different question, that is fine, but that is not what I am asking you.

Mr. BRILL. I just wanted to make such a distinction because I think it is unfair to say that we do only static analysis. In our analysis of the effect of a specific tax change, we do not attempt to bring in the feedback estimates. I think the wisdom of this was well demonstrated this morning. There are evident problems involved. We have three distinguished economists, each of whom had different assumptions, plausible or not, about the effect and the path through which these results would be felt on the economy.

We do not feel that it is appropriate, in measuring the impact of a single tax change, to try to judge the entire effect on the economy including all of the feedback, particularly when there is such wide disagreement among economists on what this effect would be.

We think it would be equally incorrect to try to analyze the effect of a given expenditure in a dynamic manner. On that basis almost any Federal expenditure could be justified, because, sooner or later, the expenditure is going to come back to the Treasury as revenue.

Senator PACKWOOD. Do you mean to say, then, that if we were dealing with the personal income tax and we were considering a bill to raise it to 80, 85, or 90 percent that Treasury would not presume any difference in personal behavior based upon those rates. You would just say it would be unfair to try to guess what personal behavior would be, so we will presume that a 90-percent rate will raise an infinitely greater amount of money than at a 70-percent rate?

Mr. BRILL. No, I do not think the Treasury would make such an assumption. It has not done that in these presentations. Our contributions to the analysis of the budget were explained in the Secretary's testimony along with that of the chairman of the Council on Economic Advisors and the Director of the Office of Management and Budget——

Senator PACKWOOD. Then there are circumstances where you are not just going to project on a static basis.

Mr. BRILL. That is exactly the point that I started to make. There is a difference between analyzing the effect on the economy of a total tax package and trying to analyze the effects of a very narrow, specific change. We do both kinds.

Senator HANSEN. One matter in which we seem to agree with the Treasury and with the White House is that there is a tremendous need for massive infusions of capital in high-risk innovative technology. It is my personal belief that that kind of capital is a scarce resource.

Where do you and Secretary Blumenthal think we are going to get all of the capital unless we provide a way for the people who own the resources to put it to work?

The Secretary's chart 2 which shows benefit to expanded income classes—and I call attention, again, that expanded income puts some people in the $100,000 income tax class when they may be that way only 1 year out of a 70-year lifetime. Do you agree with that, Mr. Brill?

Mr. BRILL. That is possible.

Senator HANSEN. Well, it is not only possible but, as a matter of fact, would you not say that a lot of those people who are in that $100,000 income, expanded income class, are there because of the sale of a capital asset, not because of regularly earned income. Is that not a fact?

Mr. BRILL. I do not have the numbers with me to substantiate your statement. I believe there are some tabulations that show how many people are in that income class as the result of the sale of a capital asset. I will try to get that information for you.

Senator HANSEN. Well, would you agree or disagree with my statement?

Mr. BRILL. The only thing I have any qualification on is whether there are a lot of people in these upper brackets who are there only because, in that given year, they happen to have a capital gain. There are some I am sure. I just do not know how many.

Senator HANSEN. Well, the point I am trying to make is, if Treasury goes through its table, I make the categorical statement that they are not going to find the same taxpayers, essentially, being in the $100,000 expanded income class year after year. There is going to be John Jones who sold his store in 1965 and Mr. Smith who sold some other property in 1966 and someone else who sold a house in 1967.

You are giving the illusion, by your statement, to the people of America that this is a fat cat's bill when, in fact, the situation is that a lot of people are there maybe only once or twice in their lifetime. Now, do you agree or disagree with that statement?

Mr. BRILL. Senator, I am trying not to equivocate. However, I do not know how to answer the question about "a lot" without evidence. I will try to find out for you, but I cannot.

[The following was subsequently supplied for the record:]

For 1978 we estimate that there will be 378,000 tax returns with expanded incomes of $100,000 and over. Of these, 28,000, or about 7 percent of all such returns, would be classified in lower income groups if the various tax preference items were excluded when computing their income. Another 31,000 would be classified in lower income groups if all capital gain income were removed.

The Treasury Department now uses the "expanded income" concept for its tax analyses since we feel that income should be defined in a way that closely approximates an analytical measure of total income. Since expanded income is equal to "adjusted gross income" (AGI) plus tax preference items excluded from AGI less investment interest to the extent that it does not exceed investment income, the expanded income concept is clearly a more appropriate way to examine the effects of tax legislation on taxpayers.

We believe that Congress generally agrees with this view since the Treasury is required to use the expanded income concept for its annual report on high-income individuals mandated by the Tax Reform Act of 1976.

Senator HANSEN. All right. That is satisfactory.

Where is this venture capital going to come from if we do not take the approach, or an approach such as Senator Cranston has suggested we now take?

Mr. BRILL. At the aggregate level, I think the most important thing we can do is to reduce the demands on the available funds that come from both private, and particularly from public, consumption. In other words, we have to restrain the Federal Government's demand on our financial resources to permit more funds to be available for the financing of private investment.

That, of course, is part of our budgetary policy. We are trying to move in that direction.

Senator HANSEN. Are you suggesting an across-the-board cut on our Federal budgets?

Mr. BRILL. I am suggesting the kinds of restraint that the President has asked for in the fiscal 1979 budget. That budget has the smallest real increase in spending in the last 5 years and a commitment to keep our spending in 1980 under very tight control. So I think we are moving in that direction, to reduce the demands on output and resources which are absorbed by the Federal Government. I think this is one important step in insuring that we will have capital available to finance the risk ventures that we are all interested in seeing pursued.

Senator HANSEN. Would not a tax cut on capital achieve the same result as a budget cut insofar as making more money available?

Mr. BRILL. No, sir, I do not see the linkage as being that tight, and that goes to the heart of the analysis that was mentoned this morning. I do not see the linkage between the change in the capital gains tax and the change in stock prices. I think that point has not been proven.

Second, I am not sure that I agree with the magnitude of the so-called multipliers that have been applied to the effects of stock prices on the total economy.

Therefore, I think that a capital gains tax cut is a far less certain approach to encouraging capital formation than would be a cut in the corporate tax rate or expansion of the investment tax credit; each of which goes directly to the financing of business capital.

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

Senator PACKWOOD. Senator Roth.

Senator ROTH. I have no questions.

Senator HANSEN. I would like to ask one further question, if I may then, Mr. Chairman.

The Secretary yesterday disparaged the use of assertions in the formulation of tax policy. One of his primary targets is the Chase study figure of an increase of 40 percent in stock value.

Yet a regression analysis of Treasury's own projections of capital gains revenues for this year show an increase of 31 percent in stock value.

How do you explain that?

Mr. BRILL. I am sorry, sir. I am not aware of the Treasury regression to which you refer.

Senator HANSEN. By a regression, I meant an examination of the end result and then coming back to the primary assumption. It seems to me that what Treasury has done in taking these two positions is to wind up in a very inconsistent position for itself.

Could you get Treasury out of that hole?

Mr. BRILL. I would like very much to do so, if I could understand the nature of the hole. I must confess I have not seen this analysis. If this is an analysis that uses the Chase equation to say that capital gains receipts as estimated by Treasury for the year 1978 would, being put into the equation, result in a 31 percent increase in stock prices, I find that very difficult to understand.

Senator HANSEN. I have in my hand the Ingalls and Snyder research report of June 16, 1978.

The concluding sentence on page 17, exhibit 1, reads this way:

"The same analysis indicates that the Treasury Department's projection o net capital gains of $20.2 billion for 1978 would require an average monthly closing price of $1162.19, for 1978, an increase of over 31 percent over the average monthly closing price for 1977."

And yet, this is the same Department that earlier had criticized, had castigated, Chase's study for an increase of 40 percent in stock values as being totally unrealistic.

Mr. BRILL. It seems to me that if this estimate is right, if we had estimated $20.2 billion of capital gains this year, all of that would not necessarily come from changes in the stock market. Actually, as the Secretary indicated yesterday, only a quarter of gross capital gains last year, when the study was conducted, resulted from stock transactions. One should not expect to arrive at the $20 billion solely as a result of a given change in the stock market.

That may be one deficiency in the analysis, However, until I see what equation they were using to provide that figure, this is the only comment I can make.

It sounds to me like there is a cog missing somewhere in the explanation. It may be a valid explanation, but not enough is known for me to be sure I understand it.

Senator HANSEN. If you would like to have more time, Mr. Secretary, I would be happy to have you submit further explanation for the record.

Mr. BRILL. I would be most happy to.

[The following was subsequently supplied for the record:]

As indicated by Senator Hansen, the report prepared by Oscar Pollock for Ingalls & Snyder does allege that the $20.2 billion Treasury estimate of capital gains for 1978 would imply a 31 percent increase in stock prices. This results from a simple regression analysis with an equation that relates net capital gains and the Dow Jones Industrial Average.

The reason that the equation predicts such a large increase in the Dow Jones Index is that the 1977 capital gains estimate used as input to the model is too low. As stated on page 17 of the report, "the regression analysis would indicate net capital gains of $13.57 billion in 1977," whereas we now know that the actual figure for 1977 was $18.8 billion.

In other words, in this analysis it is necessary to go from an estimate of $13.57 of capital gains in 1977 to the $20.2 billion Treasury estimate for 1978—a change which requires a very large increase in stock prices. In fact, since we know that capital gains in 1977 were really close to $19 billion, reaching a level of $20.2 in 1979 would not require very much of an increase in stock prices if the correct figure were used in the Pollock/Ingalls & Snyder regression analysis.

Senator HANSEN. One other point, Mr. Chairman.

Treasury had repeatedly used the figure $2.2 billion as its estimate of the revenue loss that would result from the change in these tax laws as a result of the Steiger-Hansen bill. Now, as of yesterday at least—possibly before, but that is the first time I was aware of it—Treasury estimates a $2.4 billion loss.

Does this reflect your anticipated double digit inflation?

Mr. BRILL. The $2.4 billion is an estimate of the revenue loss applying to 1980, the first year the amendment would be effective. The $2.2 billion number is an estimate of the revenue loss based on 1979 income.

This difference is a reflection of all changes in the economy, including the changes in inflation.

Senator HANSEN. I have no further questions.

Senator PACKWOOD. Mr. Secretary, thank you very much. No further questions.

Mr. BRILL. Thank you, Senator.

[The prepared statement of Mr. Brill follows:]

STATEMENT OF DANIEL H. BRILL, ASSISTANT SECRETARY OF THE TREASURY FOR ECONOMIC POLICY

Mr. Chairman and members of this distinguished Committee: The issue before us today is that of determining the most effective way of encouraging more investment.

There is no disagreement among us as to the importance of this objective. It is clear, from many perspectives, that too much of our output of goods and services is devoted to current consumption, and too little to investment in new and more efficient tools of production—investment that will permit future growth in consumption.

Even after three years of recovery, real business fixed investment remains below its prerecession peak. As a result, our capacity to produce is growing too slowly, at less than a 3 percent annual rate compared with over 4½ percent in the first two postwar decades.

Paralleling this sluggish growth in investment and capacity has been a deceleration in the rate of growth of productivity, the factor responsible for a major share of U.S. economic growth. This slowdown in productivity growth adversely affects our ability to achieve price stability and our ability to remain competitive with producers abroad.

We are all dedicated, therefore, to the search for the most effective ways of promoting increased capital formation. There are before us specific proposals to encourage capital formation by reducing the tax on capital gains. Fundamentally, these proposals rest on the premise that reduction in the capital gains tax will have a very favorable effect on stock prices, and that the resulting enhancement of stock prices will, by increasing the wealth of investors and/or reducing the cost of raising equity capital, encourage a higher rate of investment.

Admittedly, the argument appears intuitively plausible. One might indeed expect some favorable reaction in stock prices if the capital gains tax were reduced. And one might also expect that a reduction in the cost of equity capital—the result of rising stock prices—would encourage some additional investment, since the inability to obtain equity funds is generally recognized as one of the barriers to investment, particularly for smaller companies.

The critical question is by how much. We have only a limited amount of resources to devote to tax preferences for investment. Is this use—a reduction in revenues from lower capital gains taxes—a cost-effective way of promoting investment?

Unfortunately, there is little direct historical evidence on which to base an analysis. There has been no reduction in capital gains tax rates in the past quarter-century, only increases.

One must, therefore, argue the case for capital gains tax reduction by assertion or anaolgy, which is just what has been done in three major studies of the problem—the study sponsored by the Securities Industry Association (SIA), the study conducted by Merrill Lynch (ML) and the study conducted by Chase Econometric Services, Inc. (Chase). I would like to comment on the methodology employed in each of the surveys, particularly with respect to those variables critical to a determination of the effectiveness of capital gains tax changes in influencing investment.

In the study sponsored by the Securities Industry Association, the argument is made by assertion. A specific and arbitrary assumption is made that complete elimination of the capital gains tax would result in a 20 percent increase in stock

prices over the first five quarters after the tax change is implemented. This assertion, along with other assumptions about the extent to which higher prices will encourage shareholders to realize their gains, are inserted into the economic model constructed by Data Resources, Inc. (DRI), and the model is run to produce estimates of the resultant growth in GNP, in business investment, and in Federal revenues resulting from the higher GNP.

The results are not surprising: higher stock prices, resulting in a greater amount of realization of capital gains, will increase incomes, investment and Federal revenues—all by substantial amounts. For example, two years after the elimination of the capital gains tax, real GNP in the SIA simulation would be about $47.5 billion (1978 $) higher, nonresidential fixed investment nearly $18 billion higher, the Federal budget deficit (NIA basis) about $10.5 billion lower, and the unemployment rate 0.7 percentage points lower.

All delightful outcomes, devoutly to be wished. But all resting very heavily on an *assumption* that stock prices would increase by 20 percent in response to the postulated change in capital gains tax, and questionable econometric relationships implying that the higher level of stock prices would spur consumption and investment to such dramatically higher levels.

Another study of the potential effect of capital gains tax reduction was undertaken by Merrill Lynch. In this study, it was assumed that the capital gains tax would be reduced in the third quarter of 1978, not to zero but to a new maximum rate of 25 percent. The result of such a tax change is assumed to reduce the cost of new equity capital by some 25 to 30 basis points. This assumption is traced through an econometric model to show the effect on overall stock prices, on investment and on gross national product. The results indicate a potential rise in stock prices of only 4 to 6 percent, an increase in 1980 GNP of only 0.3 percent, and increased Federal revenues sufficient to result in about a $2.5 billion smaller deficit despite an initial tax cut of about $2 billion.

It is most important to emphasize again that this study, as did the SIA study, rests on *assumptions* about the effects of capital gains tax rate changes on stock prices, not on any empirical evidence of the effects. In the ML case, the effects assumed are those on the cost of new equity capital, which is translated into the prices of all equity issues. The ML assumptions about stock price response are more modest than those used in the SIA study, and the projected benefits to the economy and on the Federal deficit are correspondingly more modest. But they still rest on assumptions.

The third study which we reference today is that undertaken by Chase Econometric Services, Inc. Here, the effect on stock prices of a reduction of capital gains taxation to a 25 percent maximum rate is stated to be a rise of nearly 40 percent in stock prices over the next two years which, in turn, increases gross national product, investment and Federal revenues.

The Chase analysis does not rest on an assumption about the stock price response to capital gains tax reduction. Rather it is based on an equation ". . . empirically determined from multiple regression analysis and is not simply an assumption pulled out of thin air."

It is worth examining this statement further, for any equation that can adequately explain stock price behavior is likely to be of interest to a wider audience than only those concerned with capital gains tax provisions.

The Chase study states that fluctuations in stock prices can be explained by seven factors, or variables. These variables include interest rates, corporate profits, replacement cost adjustment to capital consumption allowances, dividend payments, disposable personal income and two variables relating to maximum tax rates: the maximum tax rate on capital gains, and a variable apparently intended to capture the effect of legislated changes in the maximum tax rate on earned income. The latter is set at zero from 1955 through 1968, and at 20 for the years after 1968.

The results of the Chase equation purport to tell us that (a) changes in the capital gains tax rate explain about one-fourth of the fluctuation in stock prices over the period from 1955 to 1977 and (b) a reduction in the maximum capital gains tax rate to 25 percent would result in a 40 percent rise in stock prices within a two-year period. This is a far more dramatic effect on stock prices than is assumed in either the SIA or the Merrill Lynch study.

Are there results derived from the Chase equation statistically valid? I'm afraid they must be regarded as suspect. The methodology used commits several grievous statistical sins. In the parlance of the statistical profession, the Chase equation is guilty of multicollinearity and serial correlation, as well as improper specification.

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I will not take up the Committee's time with methodological points; these are covered in a brief technical note attached to my statement. It is important to note, however, that the existence of such a defect as multicollinearity (technical jargon for the case where two of the factors used to explain fluctuations in a third are in themselves highly interrelated) means that the measure of the relative importance of the capital gains tax in explaining stock prices is subject to large statistical error. This is borne out by the fact that if one of the redundant variables is dropped from the equation, the results change dramatically; in this case, the rise in stock prices resulting from reduction in the capital gains tax falls to 9 percent, from the 40 percent claimed for the original equation.

The existence of serial correlation—condition where differences between actual observations and the values estimated by an equation show a persistent pattern—also means that the equation is not statistically reliable. This can easily be confirmed by applying one of the standard techniques for correcting for serial correlation. When one applies this correction to the Chase equation, the importance of changes in the capital gains tax rate in explaining stock price behavior is reduced significantly.

The major point to be made about the three studies relating to the effect of capital gains taxes is that in two of them, the results rest very heavily on assumptions about the critical factor of the response of stock prices, and in the third study, the attempt to use analytic techniques instead of assumptions suffers from such serious methodological flaws as to vitiate the results. On the stock price response factor, the studies differ widely: one study asserts that complete elimination of the capital gains tax would result in a 20 percent rise in stock prices, another that only partial elimination of the tax would yield a 40 percent rise, and the third that partial elimination would result in only a 4 to 6 percent stock price increase.

The second point to be made about these studies is that they yield widely different results as to the economic benefits to be expected from a capital gains tax reduction and the ensuing rise in stock prices. The 20 percent rise in prices assumed for the SIA study would, in their calculation, produce a rise in total output—GNP—some 9 times as great as the initial tax reduction. The Merrill Lynch calculations yield a multiplier of only 2, and the Chase calculations a multiplier of about 3½. It should also be noted that most of the projected increase in GNP in the SIA study develops in consumption, not investment; the Chase study has more of the benefits accruing to investment and the Merrill Lycnh study splits its modest effects more evenly between consumption and investment. Thus, the studies are all over the map not only with respect to stock price impacts but also as to the purported benefits flowing from tax reduction.

How reasonable are the assumptions about the effect of a capital gains tax reduction on stock prices? As noted earlier, there is little directly relevant historical experience, so the argument has to be made—if at all—by analogy. Thus, some proponents of capital gains tax reductions have simply cited the record of stock prices before and after the Tax Reform Act of 1969, which raised the maximum rates payable on realized capital gains. In the eight years after enactment of higher capital gains rates (from 1969 to the end of 1977), stock prices rose only 0.4 percent, compared with a 47.6 percent rise in the eight years preceding the imposition of higher taxes. Q.E.D.: raising capital gains taxes has tended to reduce stock price gains and, therefore, the converse must be true; lowering the capital gains tax rate would raise stock prices.

But when one looks behind this glib, rather superficial analysis, a different and more puzzling story emerges. The Tax Reform Act of 1969 was signed on December 30, 1969, and most provisions became effective on January 1, 1970. Since it may have been anticipated that the capital gains tax rate would be increased, even before the change was formally enacted, one might have expected a rise in stock market volume and a decline in prices in 1969, as investors hurried to realize capital gains before the new higher tax rates were imposed. But stock prices started their decline at the end of 1968—long before any expectation of higher tax rates—and both trading volume and the volume of realized gains declined in 1969.

After the new tax rates became effective, stock prices rose from mid-70, until they reached a peak in January 1973. In the two and a half year period after higher tax rates were in effect, the stock price index rose by 46 percent.

It is difficult to explain why prices and realizations went *up* after the effective date, and it certainly raises doubts about the significance of the maximum tax rate on investor decisions, at least in the 1969-73 period.

Of course, since 1973, stock prices have behaved poorly. But it does strain credulity to attribute the behavior of stock prices to continued high capital gains taxation alone in a period marked by such events as an oil embargo, a quintupling of oil prices, a worldwide investment boom accompanied by double-digit inflation and double-digit interest rates, followed by the worst recession since 1930's. To explain stock price behavior since 1973 exclusively in terms of a higher capital gains tax, in the midst of such sweeping economic trauma, requires some stretching.

Where does this leave the analysis? I submit that the verdict any jury would deliver is "case not proven". Reductions in capital gains taxation *might*—and I emphasize might—influence stock prices by some indeterminate amount, and this change in stock prices *might*—and again I emphasize might—be conducive to some rise in investment. But none of the studies discussed today provides a sound basis—only assertion or imperfect statistical analysis—for determining what quantities would result from such tax policy changes.

Tax preferences for specific forms of income must essentially be classed as subsidies, whatever euphemism is used to disguise the subsidy. It would appear to me, therefore, a rather risky venture to dispense public funds for subsidies to investment on the basis of such meager analytical evidence as has been submitted. And the risk is particularly great when this form of subsidy would result in a significant distortion in the equity of our tax structure. Equity in our tax system is no trivial matter, in a society where every citizen is expected to pay his fair share of the cost of public services.

Moreover, it is an unnecessary risk, since other incentives to capital formation, such as extension of the investment tax credit and/or a reduction in corporate income tax rates have a more direct relationship to business investment decisions. I would urge the Committee, therefore, to devote its attention to the proposals for investment credits and tax rate reductions in the program submitted by the President, rather than to divert its attention to unproven and inequitable remedies.

Appendix on Methodology

This appendix considers certain technical details affecting the results of the analyses of the impact of a capital gains tax reduction prepared by the Securities Industry Association (SIA), Merrill Lynch (ML) and Chase Econometric Services, Inc. (Chase).

SECRUITIES INDUSTRY ASSOCIATION STUDY

Method of simulation

The Data Resources Inc. (DRI) model used in the SIA study is not readily amenable to answering questions concerning the impact of changes in capital gains taxation on economic activity. Tax rates on capital gains do not appear as explicit exogenous variables in the model. In using the DRI model, SIA simulated the impact of a complete elimination of capital gains taxation by decreasing personal and corporate income tax rates by an equivalent amount (initially $5.1 billion). The appropriateness of lowering the personal tax rate for all consumers is dubious, in that it is largely individuals in the upper income tax classes who would benefit from a capital gains reduction, rather than the public-at-large. As a consequence, the net effect of the SIA procedure is probably to over-estimate the effect on consumption, and hence the induced effect on investment, of cuts in the maximum capital gains tax rate.

The SIA study found that a complete elimination of capital gains taxes would result in a $47.7 increase in real GNP over about a two-year period. This result implies tax multipliers of about nine—four to five times as high as the empirically-derived personal and corporate income tax multipliers traditionally used in assessing the likely impact of tax changes on GNP.

Assumed increase in stock prices

The very large multiplier effect of the SIA study reflects not only the questionable manner in which the tax reduction is introduced into the simulation, but also the assumed 20 percent stock price increase which feeds back, via a household wealth equation, to consumption and investment. If smaller increases in stock market prices are assumed, much smaller GNP, consumption and investment multipliers result.

It is interesting to note that stock prices are *endogenous* in the DRI model and need not be specified exogenously. When one leaves stock prices endogenous and simulates a capital gains tax reduction, or elimination, the DRI model shows only very modest stock price changes.

CHASE STUDY

Stock price equation

Stock prices are endogenous in the Chase model. The Chase stock market prediction equation treats stock prices as a function of seven explanatory variables:

(1) the maximum capital gains tax rate (six quarter weighted average);

(2) a dummy variable set at zero from 1955 through 1968, and set at 20 for the years after 1968 intended to capture the effect of the 20-point change in the maximum rate on earned income;

(3) prime commercial bank loan rate (percent);

(4) corporate profits, after tax, with adjustments for capital consumption and inventory valuation (billions of current dollars);

(5) corporate capital consumption adjustment (billions of current dollars);

(6) dividend payout ratio; and

(7) disposable income less transfer payments to persons (billions of current dollars).

The Chase equation has several serious methodological and specification flaws which cast doubts about the credibility of its predictions.

Serial correlation

The Chase stock market equation suffers from "serial correlation." Serial correlation is a technical term to describe the situation in which differences between the actual and the estimated values derived from an equation show a persistent pattern. The presence of serial correlation in the Chase equation is indicated by the low Durbin-Watson ratio (0.69), a standard measure used by econometricians to test for this problem.

There are statistical techniques for correcting for serial correlation, e.g., the Cochrane-Orcutt correction. When one applies this particular correction to the Chase equation, then the coefficients—the values attributed to each explanatory variable—change radically. In particular, the importance of the capital gains tax rate in explaining stock price behavior drops sharply. The presence of serial correlation means, to technical workers in the field, that results derived from an equation suffering from this malady are essentially "inefficient" and hence, particularly unreliable in forecasting.

Multicollinearity

The maximum tax rate variable and the dummy variable included in the Case stock market equation are highly correlated—a 0.97 correlation out of a possib'e 1.00. Largely as a result, the equation suffers from "multicollinearity", an ailment that saps the strength of statistical results. Johnston points out that when multicollinearity is present in an equation.

"The precision of estimation falls so that it becomes very difficult, if not impossible, to disentagle the relative influences of the various . . . variables. This loss of precision has three aspects: specific estimates may have very large errors; these errors may be highly correlated, one with another; and the sampling variances of the coefficients will be very large . . . Estimates of coefficients become very sensitive to particular sets of sample data, and the addition of a few more observations can sometimes produce dramatic shifts in some of the coefficients." (*Econometric Methods*, 2nd Edition, 1972, p. 160).

A standard way of treating an equation for multicollinearity is to omit one of the collinear variable from the equation. When the dummy variable is dropped, the coefficient of the capital gains tax rate drops substantially, implying a stock market rise of only 9 percent instead of the nearly 40 percent implied by the uncorrected Chase stock market prediction equation.

In addition to the methodological flaws discussed above, the Chase equation has specification defects—such as the use of the maximum tax rate on capital gains instead of the much lower actual effective rates paid by most taxpayers.

MERRILL LYNCH STUDY

In the methodology used by ML to analyze the impact of the Steiger Amendment, calculations of pre-tax and after-tax rates of returns to investors were made outside of the ML macro-model. Assumptions regarding the extent that the firm's cost of equity financing would decrease were made based upon these calculations. These assumed cost decreases were then fed into the ML model and the impacts upon the general economy observed. A 4-6 percent increase in stock prices were predicted. When one uses the ML methodology to simulate the impact of a *complete elimination* of capital gains taxation the results are a stock price increase of 9 to 12 percent. These results cast further doubt on the reasonableness of the 20 percent rate assumed by SIA and the 40 percent rate derived from the Chase equation.

Senator PACKWOOD. Next, we will take Dr. Arthur Laffer. Doctor, glad to have you with us.

Mr. LAFFER. If I might, could I just have my testimony read into the record? I would just like to cover it, if I could.

Senator PACKWOOD. It will all be in the record.

Mr. LAFFER. All right.

STATEMENT OF ARTHUR LAFFER, PROFESSOR OF BUSINESS ECONOMICS, UNIVERSITY OF SOUTHERN CALIFORNIA

Mr. LAFFER. Two points with regard to the Hansen-Steiger bill. Basically, people do not work to pay taxes. People basically work to get an after-tax income. Likewise, businesses do not locate their plants as a matter of social conscience. They basically locate their plants in order to make an after-tax return.

A good example of the changes in incentives from the change in tax rates can be seen by using the analog of the Kennedy tax cuts in 1963. Let me just show you how the incentives work.

When Kennedy came into office, the lowest tax rate was 20 percent and the highest marginal tax rate was 91 percent. For a person earning income in the lowest tax bracket, of every dollar earned he paid 20 cents out in taxes and his incentive was 80 cents.

In the highest tax bracket, if a person earned $1 on the margin, he paid 91 cents out in taxes and his incentive was the 9 cents. They worked to get the 9 cents and the 80 cents.

What Kennedy did in his tax rate cuts was he cut the lowest bracket by 30 percent and he cut the highest bracket by a lesser figure, by 23 percent. He lowered the tax rate from 20 percent to 14 percent in the lowest bracket.

It is clear what happened to incentives. While the guy before used to make $1, paid 20 cents in taxes and kept 80 cents, now if he earned $1 he paid only 14 cents in taxes and kept 86 cents. His incentives were increased from 80 to 86 cents, or a 7½-percent increase.

But now, if you go the highest tax bracket, you can see what happens there. The tax rate cut was less. It went from 91 to 70 percent, a 23-percent cut in rates. But, look what happens to incentives.

The person before who made $1 paid 91 cents out in taxes and his incentive was 9 cents. Now if he earned $1 he paid 70 cents out in taxes and he kept 30 cents. His incentive for working and producing went from 9 to 30 cents, or a 233-percent increase in incentive.

The point of the example is, given the same tax rate cut, the higher tax rates are, the greater the increase in after-tax incentives. So the higher the level of taxes the more likely it is you will get a large increase in incentives and a subsequent large increase in output and production.

Senator PACKWOOD. Would you say that again?

Mr. LAFFER. The higher tax rates are, the greater will be the increase in incentives given a tax rate cut of a common percent. So, in other words, if you get up to a 100-percent tax rate you have zero incentive to work. As you lower that rax rate by only 1 percent, your incentive increases from zero to 1 percent.

Now, looking at the Hansen-Steiger bill, it is important to note just how high the marginal tax rates are on economic return to capital. Let me just go through an analog here. If you imagine a machine for a moment that has $1 of economic profit, under our current accounting

system and tax system the company does not report $1 at its accounting income for tax purposes. They underreport depreciation, they underreport the cost of inventories. The accounting profits will be far higher than $1 on which they will have to pay taxes. The company will also be subject to capital gains taxation. There also are sales taxes, excise taxes, property taxes, restrictions on the uses of resources, et cetera.

There are all sort of other obstacles, just to get the profit outside the corporation. Once outside the corporation, this profit is subject to personal income tax which can go as high as 70 percent and also is subject to individual capital gains taxation.

Going through all these calculations, one can easily imagine the average marginal tax rate on capital being somewhere in the neighborhood of 90 and 90-plus percent.

If you lower tax rates on capital by a small amount, you increase the incentives substantially, and this is why I think the Hansen-Steiger bill would do an amazing amount for increasing incentives for capital formation and would increase output quite substantially. As far as I can tell, there is a reasonable chance that it would not only increase capital formation but could very well increase Treasury revenues because of the expansion of tax base.

But that is number one. The higher tax rates are, the more likely a cut in tax rates will lead to an increase in revenues, not a reduction, because it increases incentives so very much.

There is a notion in a lot of statements I read in the press and a lot of statements in other testimony that somehow the incidence of a tax is the same as the burden of a tax. That is, if you cut the tax rates on capital gains that the benefits of that cut on tax rates of capital gains will fall only to those people who have capital gains. I think, this notion is a totally misleading position.

The incidence, as we know in economics, is completely different from the burden of taxation, because supplies respond. Let me just give you an example back from my home State of Ohio.

Truckdrivers' wages, for some reason, are not very high when there are no trucks around to drive. If there are no trucks around to drive, truckdrivers' wages fall to zero. When there are trucks around to drive, the wages of truckdrivers increase.

In order to entice people to either work harder or to abstain from consumption, in order to get the requisite capital to have truck formation, to be able to accumulate capital and acquire trucks, you have to pay the savers an after-tax rate of return and if that after-tax rate of return is taxed too heavily the volume of trucks in the system will fall and not only will the volume of trucks in the system fall, but the wages of truckdrivers will also fall.

Senator PACKWOOD. Let me ask you a question. We are goixg to have to vote, but I hope that we can split our time so that one of us can stay here all the time.

I have been going around explaining your theory, and I hope I am explaining it correctly. Basically you are saying there is an optimum rate of taxation that will return an optimum amount of revenue to the Government. If you have a zero rate of taxation, no revenue; 100 percent rate of taxation, very likely not much revenue, because not many people will work and pay it all to the Government.

Mr. LAFFER. Yes, sir.

Senator PACKWOOD. How do you determine where the optimum is?

Mr. LAFFER. Well, there are several things that go into the optimum, at least in the calculation of what the optimum is. Henry George's theorem long ago was what you want to do for revenue purposes is tax those factors the most—those factors of production the most—that can escape the tax the least.

Senator PACKWOOD. Say that again?

Mr. LAFFER. You want to tax those factors the most——

Senator PACKWOOD. That can escape the taxation the least?

Mr. LAFFER. The least.

And you want to tax those factors the least that can escape the most.

Senator PACKWOOD. Is that why his heavy emphasis on land?

Mr. LAFFER. That is why he had a land tax, exactly, because——

Senator PACKWOOD. Because it is very hard to hide it.

Mr. LAFFER. There is no way of getting rid of land. That is why I worry about our exceptionally high marginal tax rates on capital. Capital is fungible both across time and space.

The factor which bothers me very much, which we are not addressing today, but it is the very, very burdensome tax rates on the inner city. The marginal tax rates on the inner city—I did some calculations for Los Angeles—for an inner-city family of four. If the earnings of the family go from zero to $1,000 a month earnings, the family's spending power increases by a mere $140 because of the neceeds test, means test, income test, as well as taxes. That is an 86 percent average tax rate. That is excessive.

The inner-city dwellers, as you know, can go into the subterranean economy.

Senator PACKWOOD. Is this because you include all of the other taxes in addition to income taxes? Their local property taxes and excise taxes, and whatever else in the inner city?

Mr. LAFFER. The whole structure, yes, and especially the means test, needs test, and income test. Every time they earn a little bit more, they lose their social welfare benefits.

Senator PACKWOOD. All right.

Now, let's go back to finding this optimum again, because obviously, if indeed you can define it and we can arrive at it——

Mr. LAFFER. I cannot measure it, frankly, but I can describe to you what the characteristics of it are; yes, sir.

Senator PACKWOOD. OK.

Mr. LAFFER. Basically, the more elastic the factor of production is, the lower you will want that tax rate to be, and if you look at capital, it appears to be quite a highly elastic factor.

The next thing that is also important here is that the longer the time horizon the lower the tax should be.

Senator PACKWOOD. The longer the time horizon for what?

Mr. LAFFER. For looking at revenues, increasing revenues. Let's say a person builds a plant based on a presumed 10-percent corporate tax rate. The day after he is finished building the plant, the corporate tax rate is raised to 90 percent. The plant owner is not going to throw that plant away. More revenues are going to be collected for a while, but when something wears out, the plant owner will not replace it and, in due course, that plant will disappear.

Revenues will go up for a while and then, over time, start falling.

The question is not what happens to revenues; it is what happens to them and when. The longer the period, the more like'y the effect that you will increase revenues from lowering tax rates and that you will lower revenues from increasing tax rates.

Those are the two points I wanted to mention.

Senator PACKWOOD. I don't know what to ask. You have the capacity to make it sound like the salt box at the bottom of the sea that perpetually turns out salt.

Mr LAFFER. It spreads all over the oceans, too.

Senator PACKWWOD. Is it fair to say that you are reasonably convinced on both capital gains and general tax rates, individual tax rates, that we are on the high side of the curve and we would move more toward the optimum by lowering both capital gains and personal taxes?

Mr. LAFFER. With regard to capital gains taxation, I feel very certain about that, yes. With regard to income taxes in the upper brackets, I think it is much the same as the capital gains tax.

With regard to tax rates in the very lowest tax brackets, I feel quite confident of that, too.

I do not feel it is true in every tax category—in fact, far from it. There are a lot of taxes that, if you lowered them, revenues would not increase.

Senator PACKWOOD. But basically you support the concept of the Roth-Kemp tax cut?

Mr. LAFFER. Yes, I do.

Senator PACKWOOD. Which is, of course, an across-the-board tax cut—upper rate, middle rate, lower rate?

Mr. LAFFER. Yes.

Senator PACKWOOD. What you are saying or, at least, perhaps what I am saying, is at the lower rate, it may not be quite as productive?

Mr. LAFFER. I think at the very lowest rates it will be productive because those are the rates that are faced by the inner-city dwellers, for example, and if you look at them, they pay exceptionally high tax rates. And if you lower their tax rates, their incentives to work, produce, et cetera——

Senator PACKWOOD. Why do they pay more tax rates than somebody in the suburbs?

Mr. LAFFER. Well, let me describe a study we did out in California. I took an inner-city family of four, two adults and two children. One of the adults was assumed either disabled or unemployed. And I took that family of four, which is in the city of Los Angeles, county of Los Angeles, State of California, United States, and said, let's assume that the one adult who can work does not work. What is the maximum amount of legally available social welfare benefits that that family of four can get in any 1 month.

Then assume that that one member who can work goes out and earns $100. Now the $100 is not only gross pay, but I added in the employer's contribution to social security and also the employer's contribution to unemployment insurance. So I got $100 that the firm pays for this employee.

I then went through and calculated all of the taxes, and then went through and recalculated all of the social welfare benefits. The final figure was the family of four's net spending per month.

I did it at zero, $100, $200, $300, $400, on up to $1,000 a month which, as you know in the inner city, that is no small income for a family of four. And then I calculated the total spending power per month of that family of four.

Senator PACKWOOD. Yes.

Mr. LAFFER. If you look at the increase in spending power that family of four can have from going from zero earnings to $1,000 a month, the total is $140 increase in spending power.

Senator PACKWOOD. You mean they can get $860 in miscellaneous supplements?

Mr. LAFFER. The $860 will be reduced because they lose welfare benefits as they earn higher, and they pay taxes. But that is an 86-percent effective tax rate.

Between $400 and $800 a month, the effective tax rate is 100 percent or higher. Incentives are badly needed in the inner city.

As I look at it, it does not come as any surprise to me why black unemployment rates have increased so much relative to whites in the last 15 years, why black participation rates have fallen so dramatically relative to whites, why the mean earnings of full employed black males have not increased relative to those of white males.

Senator PACKWOOD. Isn't it because most blacks live in the inner city?

Mr. LAFFER. Also because the incentive effects in the inner city are very, very antiwork production and income itself. That is one of the areas where I believe we have to increase the incentives, or you will get people moving into the subterranian economy and you will lose revenues. Besides, it costs you a lot in spending.

If you were to look at my ex-neighborhood in Chicago, where I used to live, a black teenager would love to work for $1.50 or $1.75 an hour. It is against the law in the United States to employ a black teenager at those wages. After being unemployed for 2 or 3 years, he basically becomes unemployable.

Senator PACKWOOD. Let me ask you another question.

When 2 years ago, we were considering the Tax Reform Act of 1976, we had Charles Schultze and three other economists before us. I asked them about the Laffer curve and they all laughed. They said that was ridiculous.

Are you finding greater credence among economists today?

Mr. LAFFER. I don't think there is anyone who questions the conceptual nature of what Jude Wanniski called the "Laffer" curve—I did not name it. The question is: Where are we on it? which is the question you asked. To date we don't have specific estimates on exactly where we are.

Senator PACKWOOD. You know, it is interesting. I asked Secretary Blumenthal yesterday, and he is convinced that on capital gains we are on the bottom side, that we could raise the capital gains tax and produce more revenue.

I didn't pursue it as to how much more we could raise it in his estimation and continue to increase the revenue, but he thinks we are on the low side.

Mr. LAFFER. When I look at the other studies and the estimates and at some of the preliminary findings that we have done, it doesn't look like he is right on that.

Senator PACKWOOD. Well, to the best of my knowledge, there is no other estimate but Treasury's that says that.

Mr. LAFFER. I thought that Chase did some estimates of it; that is, Evans at Chase Econometrics.

Senator PACKWOOD. Oh, they did. There is no other study that comes to the conclusion that you can raise the tax to get more revenue.

Mr. LAFFER. Oh, I agree with that, yes.

Senator PACKWOOD. We had Otto Eckstein and Chase in, and what Treasury Secretary Blumenthal said yesterday was that their studies were all wrong because they had presumed a conclusion and then had programed their computers to reach the conclusion.

Now I have to run because I have 4 minutes left to cast my vote. Senator Hansen will be back and I will be back shortly.

[A brief recess was taken.]

Senator HANSEN [presiding]. The hearing will please come to order.

I am awfully sorry, Dr. Laffer, that I had to miss even a single word of your testimony. I think Senator Packwood will be back very shortly, too.

Were you responding to questions asked by Senator Packwood? Just where were you?

Mr. LAFFER. He had asked some questions about the other models and about what I gather are some complaints about the models. To paraphrase his question, I believe he said that the Secretary had stated that they basically put in their conclusions and he asked me to comment on that. Then he left.

Senator HANSEN. I remember, before I left, Senator Packwood was explaining his understanding of your very widely publicized curve. One of the questions I have is prompted by a statement made by Secretary Blumenthal yesterday. The record will disclose precisely what he said, but as I recall the thrust of it, it was to this effect, that we could increase the taxes on capital gains even more than they now are and that Treasury receipts would go even higher than they are now.

If anyone is here who thinks that I misunderstood or misstated that position, please let me know.

Mr. LAFFER. I heard that, yes.

Senator HANSEN. Was that your understanding, too?

Mr. LAFFER. Yes, I believe so.

Senator HANSEN. Well, as I understand your curve, no one can say precisely ahead of time where that magic point is. It may be reached where the heavier burden of taxation will result in a diminution of activity so as to make the total tax take even less than it is at that point.

Would you please comment on Secretary Blumenthal's statement of yesterday?

Mr. LAFFER. Let me just answer the same question from my own standpoint.

This is my perception of what is happening with regard to the tax rates on capital, and especially the average marginal rates on productive capital in this country. I think they are exceptionally high. As we know from theory, the higher tax rates are, the more likely a cut in those rates will increase revenues.

As far as I can tell, capital is both very elastic and the tax rates on it are very, very high. Therefore, my judgment is if you cut tax rates on capital—let's say in the Hansen-Steiger bill—I think you would increase revenues. You would increase Federal revenues. But I think even more importantly, because there is a lot else going on in the system, I think you would increase the wages of workers; I think you would help the distribution of income.

The example I used earlier was truckdrivers, you would increase their wages. I think also you would increase the fiscal solvency of State and local governments, because clearly, if you tax capital too heavily on a Federal level there is less capital around, and if there is less capital around, the State and local revenues are lower. So, it has a lot of feedback effects throughout the entire system. But I think even on Federal revenues, if you cut tax rates on capital gains, you would increase revenues very quickly in the United States, from what they otherwise would have been.

Senator HANSEN. I appreciate that answer very much. I was impressed with your observation that the hourly wage paid to truckdrivers is of little concern to a city with absolutely no trucks because they would not be affected. They become interested only where they have trucks.

Having that in mind, and having in mind the systems of major nations in the world, ours is based on a capital intensive economy: You have spoken about not only the direct effects insofar as Treasury receipts may be concerned if we were to lower the taxes on capital gains, but I understood you to say also that many peripheral events could take place, all of which could have a salutary effect on the economy and on Treasury receipts. Did I understand you correctly?

Mr. LAFFER. That's correct, sir. In fact, a lot of the revenue effects on Treasury receipts would not be directly in capital gains. In fact, if you cut the capital gains tax rates and you got more capital formation, which clearly would occur, you would increase total incomes, total wages, and Treasury receipts from the Federal income tax on wages, et cetera.

The example I used in my testimony was if you confiscated all the returns to capital, there would be no capital, and wages would go to zero. Treasury receipts would be zero, even if there were no tax on income.

Now, if you lower that tax on capital, you get some capital, you collect some revenues from that tax, but not only that, the wages rise and you collect all the other benefits around. There is one other point, too, which should not be overlooked. If you cut the tax rates on capital, you get an increase in capital formation, you get a reduction in unemployment, you get a reduction of people in the poverty categories, which will end to have the effects of reducing unemployment compensation—not because you cut the unemployment compensation per person unemployed; it would cut welfare payments—

not because you cut the amount per person in need, but because there are less people in need and there are less people unemployed.

I can't help but believe it would have a major positive effect on the U.S. budget.

In spite of all that, it is still a good policy because we still want to reduce unemployment and reduce poverty, even if it costs a dollar or two in the deficit.

Frankly, as far as I can tell, the major objectives of policy should be eliminating unemployment and getting rid of poverty, even if it did cost some in the deficit.

Senator HANSEN. Even above the goals of income redistribution and other egalitarian theories.

Mr. LAFFER. I believe very much in income distribution and redistribution. But I don't think you do it by raising tax rates on the upper income groups. Frankly, this is the mistake of what we call the "Robin Hood theorems." The "Robin Hood theorems" assume that if you raise tax rates in the upper income groups and you lower them in the lower income groups, output stays the same, or so they argue. That is just not true.

In order to tax the rich, frankly, there have to be some rich around to tax. [General laughter.]

Rich people do have capital which raises the wages of workers. There are serious problems with a lot of the income distribution efforts that was done when I was here in Washington. There are two ways of redistributing income. You have upper income people and lower income people. The way we have been following for so long, especially with our capital gains taxation since 1969, is to lower the rich. What I think we should be doing is to raise the poor. We have been doing very little on that line. We have always had soak-the-rich policies as opposed to help-the-poor policies.

Senator HANSEN. Thank you very much, Dr. Laffer.

Mr. LAFFER. Thank you, sir.

Senator PACKWOOD [presiding]. In your estimation, in comparison to the present tax, would the Roth-Kemp tax cut increase or decrease revenue?

Mr. LAFFER. In what time period? Over the next 2 or 3 years, yes, I think it would start to increase revenues. If you took it the first week, no.

Senator PACKWOOD. All right, for a year or two and beyond.

Mr. LAFFER. Yes. I think it would raise it in perpetuity, clearly. I think you would have a period, as they call it in Minnesota in the summer, a period of rough sledding. [General laughter.]

But it has future prospects. Let's take the example of the Commonwealth of Puerto Rico. The Commonwealth of Puerto Rico in January, 1977, cut tax rates across the board by 5 percent. This was Carlos Romero, the Governor of the Commonwealth of Puerto Rico.

Just take a look at what has happened to their tax revenues. They were running a deficit before and their bond yields were tax exempt for around 12 percent. That puts them in a pretty high category.

They cut tax rates across the board by 5 percent. Today I think they have a little surplus and their bond yields are down around 8 percent.

Frankly, if it works there I don't see why it wouldn't work here.

Senator PACKWOOD. This was just January 1977.

Mr. LAFFER. I believe Governor Romero was elected when he defeated the incumbent, Colón, in November 1976, and he came in in January 1977. His first act was to get rid of what they called in Puerto Rican, "la vamparita," which is the little vampire, which is the 5 percent surcharge they had put across the board on personal income taxes under Governor Colón.

Senator HANSEN. Mr. Chairman, would you yield for a question at that point?

Senator PACKWOOD. Yes.

Senator HANSEN. I have just a corollary of your observation.

From the Treasury approach I would assume that the cigarette tax revenues in New York and other States really ought to have zoomed way up because they are several times higher than they are in several other places. But apparently those States which have imposed that extra heavy tax on cigarettes have found out what we found out during Prohibition, which is that people react in different ways.

Isn't that true?

Mr. LAFFER. Yes. Let's just use another analog.

If you look at New York City, is there any question in anyone's mind that New York City should spend more money repairing roads? Is there any question in anyone's mind that they should spend more money getting more sanitation and more garbage pickup, or on their schools or on their zoo? If you go to the Bronx Zoo and compare it to what it was 10 or 20 years ago, you can see that it has deteriorated substantially. If you look at the wages of the employees of New York City, part of those wages are held in assets that are of somewhat questionable form.

The question is how do you get more spending in New York City? Do you raise the tax rates and drive the last two businesses out, or do you lower the tax rates and get some businesses coming in, get some employment there, get some people out of the poverty categories to get the city going again?

If you look at what has been happening in New York City, it is a classic case of what we have been talking about today. They have been raising tax rates to get more revenue. In fact, if you look at what has been happening, their budget is in worse and worse shape. Just compare New Hampshire with Vermont.

Senator PACKWOOD. That is very relevent to what we are voting on, on the floor, right now.

Mr. LAFFER. Oh—I didn't mean to make it relevent. [General laughter.]

I must not forget to keep my professional image.

Senator PACKWOOD. Do you have any more questions, Senator Hansen?

Senator HANSEN. No, thank you, Mr. Chairman.

Senator PACKWOOD. I have no more questions either. Mr. Laffer, thank you very, very much.

Mr. LAFFER. Thank you, Mr. Chairman.

[The prepared statement of Mr. Laffer follows:]

STATEMENT BY ARTHUR B. LAFFER, PROFESSOR OF BUSINESS ECONOMICS, UNIVERSITY OF SOUTHERN CALIFORNIA

Mr. Chairman and Members of the Committee: It is an honor to be invited to testify before you today regarding *S 3065*, "The Investment Incentive Act of 1978." This bill, in my professional judgment, is an integral part of a much-needed tax reform. Over the last decade, U.S. real economic growth has been far too slow. Needed social programs have been postponed or diverted into stopgap welfare plans which can only attempt to temper the effects of high unemployment rates, reduced after-tax incomes and generally poor economic performance.

The most debilitating act a government can perpetrate on its citizens is to adopt policies that destroy the economy's production base, for it is the production base that generates any prosperity to be found in the society. U.S. tax policies over the last decade have had the effect of damaging this base by removing many of the incentives to economic advancement. It is necessary to restore those incentives to economic advancement. It is necessary to restore those incentives if we are to cure our economic palsy.

The resources spent by the government come from the total tax burden on the economy's productive sector. Whether government spending translates into public services, transfer payments or pure waste, government resources must come from the economy's workers and producers. As such, these resources comprise a major part of the wedge driven between the payments made for factor services and the payment received by the factors themselves. Increases in this wedge, taken alone, raise wages paid for factor services, lower wages received by the factors themselves, and thereby lower the demand for and the supply of productive factor inputs. As a consequence, output falls.

The Hansen-Steiger bill does nothing *directly* to impact this aggregate wedge. To stop at this apparent conclusion, however, would miss not only the essence of Hansen-Steiger, but many of the lessons from the history of taxation as well.

Output depends as much on an individual factor's tax rates as it does on the overall tax burden. If one productive factor is faced with exceptionally burdensome tax rates, it will withdraw from the marketplace. Its departure will lower output by its production potential and, in turn, reduce the production potential of all other factors with which it is complementary.

For example, high productivity and high wages for truck drivers require the existence of trucks to drive. If trucks are taxed excessively, there simply won't be as many trucks, and thus the wages and productivity of truck drivers will decline. Output will be doubly impacted. In the limiting case, when all the returns to trucks are confiscated, no trucks will exist, and the wages accruing to truck drivers will be zero. Output, too, will be zero, as will tax receipts—even though there are no taxes on the earnings of the drivers.

As a pedogogic device, imagine that we reduce the tax rate in the example by one-half. The earnings of truck drivers remain untaxed, but now the earnings accruing to trucks are taxed on 50 percent instead of the previous 100 percent. Savers who either abstain from consumption or work harder can now obtain an after-tax rate of return by accumulating trucks. There will be more trucks, higher wages, more output, and tax receipts will rise. The increase in tax receipts is an exclusive result of the increase in production and the lowering of tax rates.

The Hansen-Steiger bill, armed with the experience of the past decade, addresses the current counter-productive constellation of individual factor tax rates. By partially correcting the stagnatory structures of current tax rates, the bill will most likely lead to a substantial increase in output and, in very short order, will probably reduce the size of government deficits from what they otherwise would have been. Net revenues could also expand, even though the rate at which capital gains are taxes is reduced. Part of the stated effect on the deficit will occur because higher output means less unemployment, less poverty and therefore lower total spending on unemployment benefits and poverty programs. In this sense, the Hansen-Steiger bill will actually reduce government spending and the overall wedge, albeit indirectly.

People don't work and save merely to pay taxes. Businesses do not acquire capital investment as a matter of social conscience. As the Durants pointed out in *Lessons from History*, it is the after-tax incentive that drives production, savings and employment. Other than the taxes levied on the innercity poor, I know of no factor more discriminated against by our tax structure than is productive capital. The Hansen-Steiger bill will catalyze the incentive effects of capital whose current tax structures are prohibitively high.

It is not difficult to see the effects of our layering of taxes on capital. Take the example of a machne that earns one dollar of economic profit. Under current required accounting procedures, the actual reported profits for tax purposes will be far higher than one dollar, because of the rules regulating allowable depreciation and inventory valuation adjustments. This machine incurs additional expenses to comply with mandated standards, and for account reporting and other legal services. Most firms feel compelled to monitor various government activities, and these staff costs, too, are partially deducted from the returns to the machine. None of these costs directly contributes to the company's main purpose for existence, its product.

Yet the story has only begun here. The company's capital must also contribute its share to sales, excise, payroll, capital gains and corporate profits taxes. On the same stream of capital, individuals are required to pay personal income taxes ranging in rates up to 70 percent, as well as personal capital gains taxes. It should be noted that a large part of these capital gains are due purely and simply to rises in the general price level, and thus do not represent an increase in real values.

The effects of the tax policy changes of the Kennedy era are an excellent example of the type of impact we could expect from tax reductions along the lines of the Hansen-Steiger and Roth-Kemp bills. The Kennedy tax program, instituted over a several-year period, included an across-the-board cut in personal income tax rates, reduced the corporate tax rate from 52 percent to 48 percent, shortened depreciable lives for legal purposes, and instituted the investment tax credit. In addition, major tax rate reductions were carried out under the Kennedy tariff cuts.

The numbers look like this. From 1961 through 1966, real GNP grew on average at a 5.4 percent annual rate. Unemployment rates fell from 6.7 percent in 1961 to 3.8 percent in 1966. Capacity utilization (as measured by the Federal Reserve Board) rose from 77.3 percent in 1961, to 91.1 percent in 1966. Annual inflation averaged 2.1 percent, 1.6 percent and 1.1 percent for the GNP price deflator, consumer price index and wholesale price index respectively. If stock prices are any indicator of growth, the ratio of *S+P 500* to GNP went from .110 in 1960 to .115 in 1967. The low was the 1960 ratio, but the peak occurred in 1965 when the ratio hit .128.

During the 1961–1966 period, Federal spending rose at a rate lower than GNP growth; 6.2 percent versus 7.5 percent. As a consequence, the overall Federal wedge fell from 18.75 percent in 1961 to 17.62 percent in 1966. There was a $3.1 billion Federal deficit in 1961, a surplus of $1.4 billion in 1965, and literal balance in 1966. Defense spending increases during this era were less than nondefense increases. Obviously, the dire consequences predicted for these shocking tax rate cuts did not materialize.

In many ways, we are being visited today by a situation similar to that of 1960. Unemployment is high; currently sitting a little above 6.0 percent. Federal spending, or the aggregate wedge, stands at about 22.6 percent; *S & P* stock prices relative to GNP are at .045. The Federal deficit in the most recent period is about $45 billion. Inflation, though, is the real kicker today, hitting well over 6 percent at annual rates.

In addition to the beneficial effects already mentioned, the Hansen-Steiger bill should have a positive impact on inflation. Inflation is primarily a consequence of too much money chasing too few goods. Excessive money growth has long been recognized as a cause of inflation. It is equally true, however, that too few goods will also cause prices to rise.

To put the relationship into clear focus, imagine the following: What would happen to prices in the United States if output were reduced to, say, the output level of Luxembourg, and the amount of money stayed unchanged? Prices would skyrocket, as would unemployment. Higher unemployment means lower output. As such, high unemployment is, by itself, a cause of high prices.

In debating the Hansen-Steiger bill, it is important to recognize that it is beginning to meaningful tax reform—not an end. Passage of Hansen-Steiger will not cure our economic ills by itself. Additional legislation such as the Roth-Kemp and Stockman bills would be complementary to the "Investment Incentive Act of 1978." Looking into the future, legislation proposing indexing and full integration of the corporate tax structure with personal income taxes is highly desirable. A more distant goal would be a proposal for the substitution of a value-added tax for other, less efficient taxes. Social Security tax and benefit reforms are also badly needed.

This view has two very attractive characteristics. First and foremost, it is supported by a large body of experience. Secondly, the policy implications offer some hope to a world badly affected by economic malaise. In the complex arena

of tax legislation, the best cannot be allowed to eclipse the good, nor should the good be allowed to wither for lack of understanding. It is fairly obviously that our economy is in trouble. Passage of the Hansen-Steiger bill, for the reasons stated, is an important step in our return to economic advancement.
Thank you.

Senator PACKWOOD. Our next witness is Dr. Edwin V. W. Zschau, representing the American Electronics Association.

Did I pronounce your name correctly, sir?

Mr. ZSCHAU. It is "Tchow."

Senator PACKWOOD. Thank you.

Please go right ahead.

STATEMENT OF EDWIN V. W. ZSCHAU, CHAIRMAN, CAPITAL FORMATION TASK FORCE OF THE AMERICAN ELECTRONICS ASSOCIATION

Mr. ZSCHAU. Thank you, Mr. Chairman.

I am Ed Zschau. I am chairman of the Board of System Industries of Sunnyvale, Calif. System Industries is about 10 years old and employs about 250 people in the United States.

Today I am representing the American Electronics Association which is a group of more than 950 high technology companies in 38 States.

The high technology companies of the American Electronics Association strongly support the Investment Incentive Act of 1978, introduced by Senator Hansen recently. We feel it would stimulate more risk capital investment and result in extraordinary benefits to our economy.

We realize that this isn't an ultimate solution, but we believe that it is a major first step in the right direction. In fact, our experiences and our analyses indicate that eliminating all taxes on income from risk capital investments would significantly magnify the benefits of the current proposal, and we urge Congress to consider that extension of the Hansen bill.

Mr. Chairman, we commend this subcommittee for conducting these timely hearings. Not only has the debate escalated a lot this week, but also the economic problems that the Hansen bill would help to solve have reached new reported levels of intensity.

Just this week major articles in Business Week, Time, and the The Wall Street Journal have told us that the U.S. leadership in science and technology has slipped badly, growth in U.S. worker productivity has declined alarmingly, our trade deficit in the first quarter of this year has reached a new record.

These problems are closely interrelated and they all seem to stem from the same cause—insufficient risk capital investment. Today we will provide you with some concrete evidence that documents that relationship and, I hope, provides some insight in this issue.

That evidence is based on a recent AEA survey of 325 electronic companies. Since we hoped that this survey would make an honest contribution to the dialog on the capital formation issue, all of the results of the survey were compiled by a public accounting firm and are contained in detail in my written statement, which I request be entered into the record.

Senator PACKWOOD. Your entire statement will be entered into the record.

Mr. ZSCHAU. Thank you.

This morning, I will highlight the major results and conclusions of the survey. I will be referring to five exhibits that were distributed to you and I will also be providing some specific examples.

As shown in exhibit 1, our survey proved that young companies create jobs faster than mature companies. In 1976, the employment growth rate of young companies, those that were less than 20 years old was 46 times greater than the mature companies.

Even more startling is the fact that these young companies created more jobs per firm than the mature companies, even though the older firms were on the average 27 times larger.

Although the young companies can create jobs faster, they need constant injections of risk capital in order to do that. Our survey showed that it takes about $14,000 of new risk capital investment in order to create each new job in the electronics industry.

Risk capital does more than create jobs. Our survey shows that a risk capital investment generates streams of benefits in the form of exports, new technology, and tax revenues. The magnitudes of these annual benefits are surprisingly large and they start very quickly after the investment.

For example, exhibit 2 shows the benefits generated in 1976 by companies that were founded between 1971 and 1975. Those companies averaged just 4 years of age at the time, but for each $100 that had been invested in them, they were already generating $70 a year in export sales, spending $33 annually in R. & D., and generating an incredible $30 a year in Federal tax revenues. This is due to the feedback effects that Dr. Laffer was just talking about. This is a specific example of those effects.

I think the survey helps us realize that investment is unique. It is like the goose that lays the golden eggs. But, unfortunately, increases in the capital gains tax in recent years have unwittingly been killing the goose that lays those golden eggs. Senator Cranston's remarks described that very eloquently this morning.

Here are the facts from our survey.

Look at exhibit 3. It shows that companies founded since 1970 were able to raise only one-half as much capital per firm as companies founded in the late 1960's. When you take inflation into account, as exhibit 4 shows, in terms of purchasing power, the companies founded since 1970 raised less capital per firm in their early years than companies founded at any time in the past 22 years.

With risk capital so scarce, the young companies have had to pursue undesirable financing strategies in order to survive. Our survey indicates that companies founded since 1971 have borrowed too much, making them vulnerable to economic downturn. Also, several companies, including my own, have turned to foreign companies for capital. However, since these investments also include the sale of technology, as well as partial ownership, such transactions reduce our technological leadership. If they persist, they will make us less competitive in the world markets. In addition, if they persist and we fail to maintain dominance in science and technology, our defense posture will be weakened.

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In the public debate on the Hansen-Steiger bill, the question is often asked: Who benefits most from a capital gains tax reduction? Exhibit 5 helps us answer that.

For each $100 invested in the 276 companies founded since 1955, the average annual potential gain to investors was estimated to be $22. Keep in mind that this is before any capital gains tax has been levied. Most of these gains are unrealized. In fact, much of them are in private companies where it is very difficult to sell the stock. This estimate also neglects inflation and ingores all the losses that the investors may have incurred in other investment.

This potential gain per year is small when compared to the annual stream of benefits that those investments produce. For example, the total taxes being paid annually per $100 investment to Federal, State, and local agencies, exceeds the potential payoff to the investor, and the jobs created by the investment pay more than three times in salary and wages what the investor can potentially earn.

Senator HANSEN. If I may interrupt, would you please repeat your last two statements. I didn't get their full thrust.

Mr. ZSCHAU. I was comparing the $22, the potential annual gain that the investor may receive, as indicated in our survey, to the annual stream of benefits that government and wage earners receive from that same $100. The total amount of taxes being paid to governments on an annual basis is now $26 per year per $100 investment, compared to the $22. The wage earner is getting in salary and wages about $70 a year per $100 investment. So, both the wage earners and the governments are getting more on an annualized basis than the potential return of the individual investor.

I guess that leads us to the answer to the question of who benefits most from the capital gains tax reduction. Our survey says all of us. Really, It is the American people. We have here a specific example of the feedback effects that Dr. Laffer was talking about. It is not just capital gains we are talking about here, but the benefits that our country gets from the increased investment resulting from the reduction in capital gains taxation.

Finally, the AEA survey provides additional evidence that a significant reduction in capital gains tax rates will increase tax revenues. This evidence does not depend upon stock price assumptions or econometric models.

Our survey shows that on the average, the 276 companies founded since 1955 are generating $22 a year in Federal income taxes for each $100 invested.

If we assume that a complete elimination of the capital gains tax rate would increase the amount of risk capital investment by just 50 percent over what is being invested today, the income tax increases from these feedback effects that we mentioned would exceed the capital gains taxes lost. In addition, the economy would benefit by the jobs, increased R. & D., and exports that would result from the increased investment.

Clearly, this isn't conclusive evidence of a revenue gain from a capital gains tax cut, but it is another data point that I think should be considered in this analysis.

Mr. Chairman, what we have tried to present today isn't just theory or conjecture. It is data, based on real entrepreneurs and real investors taking risks in order to create companies that have produced real jobs and pay real taxes.

To supplement the data, I am submitting for the record five letters—three from entrepreneurs and two from venture capital investors. They illustrate what we have been saying and provide further insight on this issue.

I would like to mention three of them, if I could.

In his letter, Ed De Castro, President of Data General, describes how his company, founded in 1968, has created 11,000 jobs in the past 10 years and paid $82 million in Federal taxes since then. He says that Data General couldn't get started in today's investment climate and he urges a zero tax on capital gains for that reason.

Bob Noyce, chairman of Intel, the pioneer of microprocessors, describes how his company, founded 10 years ago, has created 8,100 jobs since then and has paid $105 million in taxes over that period. In fact, they are currently paying a dollar a year in taxes for every dollar that has been invested in the company up until this time, He says that Intel couldn't get started in today's investment climate and he urges a zero tax on capital gains.

Ned Heizer, chairman and president of the Heizer Corp., the largest venture capital firm in the United States, describes how his firm got started in 1969 and has financed 33 companies since then. Those 33 companies have created 36,500 jobs and are generating nearly $300 million in taxable income in 1978.

Senator PACKWOOD. Let me ask you to please wind down, if you can.

Mr. ZSCHAU. Yes, sir.

Mr. Heizer says that it is doubtful that the Heizer Corp. could be formed today, and he recommends passage of the Hansen-Steiger bill.

[The five letters referred to follow:]

INTEL CORP.,
Santa Clara, Calif., June 26, 1978.

Subject: S-3065

Senator HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Senate Finance Committee, U.S. Senate, Washington, D.C.

DEAR CHAIRMAN BYRD: I strongly support the testimony of Ed Zschau.

Intel Corporation is but one of a number of companies which could serve as a case study of the effectiveness of venture capital investments in providing jobs, exports, and tax revenues to the government.

Intel was founded in 1968, with an initial paid-in capital of $3,000,000. Later, private offerings increased that figure to $7,000,000, and in 1971 we made a public offering of $7,000,000. An additional $30,500,000 has been invested by employees through stock purchase and stock option plans.

From its founding in 1968 through 1977, Intel has accrued Federal and State corporate income taxes alone of $105,592,000. By the end of 1977, we had 8,100 employees, most of whom paid Federal and State income taxes as well.

Intel has pioneered in the advanced technology of semiconductor memories and introduced the concept of the microprocessor, or computer-on-a-chip. Export sales have historically amounted to about 35% of our sales, or approximately $85,000,000 last year.

We were fortunate in founding our company at a time before the 1969 Tax Law was passed, when venture capital was readily available for new companies. I doubt that the same could be done today, since most of our stockholders have invested in what must be regarded as a high risk situation rather than in a mature company in anticipation of significant capital gain.

Approximately two-thirds of the total paid-in capital of the company has been furnished by employees, under stock option or stock purchase plans. These plans have been essential in the recruitment of qualified employees in our rapid growth situation.

Surely there are few investments which return to the Federal government alone twice the investment within a period of a few years, and will continue to bring in tax revenues of nearly $1/year for each dollar invested in the future. We believe everything possible should be done to encourage this employment of capital. In short, we believe that capital gains should not be taxed for the investor and encourage the enactment of Senate 3065 as a step in the right direction.

Sincerely,

ROBERT N. NOYCE, *Chairman.*

CARDIAC RESUSCITATOR CORP.,
Portland, Oreg., June 26, 1978.

Hon. HARRY S. BYRD, Jr.,
U.S. Senator, Chairman, Subcommittee on Taxation and Debt Management, U.S. Senate Finance Committee, *Washington, D.C.*

DEAR SENATOR BYRD: This letter and the enclosed material has been prepared in support of a change in the United States tax treatment of capital gains. Dr. Zschau and many knowledgeable Americans have marshalled a strong economic case that capital gains rates must be lowered if the United States is to meet its need for capital and new job formation.

I trust that you and the members of your Committee will support this reform of the United States tax system and will recognize the disadvantages of the Administration's reliance on investment tax credits and excelerated depreciation as the incentive vehicles for our much needed capital investment requirements.

I regret that your hearing's schedule does not allow for a personal appearance before you and your Committee, but I am grateful that you have advised Dr. Zschau that the enclosed material will be entered into the official record.

Thank you for your willingness to give us an opportunity to be heard on this important national issue.

Yours sincerely,

CRAIG L. BERKMAN,
Vice-President, Marketing and Finance.

Enclosures.

TEXT OF TESTIMONY GIVEN BY CRAIG BERKMAN, VICE PRESIDENT OF CARDIAC RESUSCITATOR CORP., PORTLAND, OREG., BEFORE THE U.S. SENATE FINANCE COMMITTEE, JUNE 29, 1978

In the U.S. approximately 600,000 people die annually from cardiac arrest. Many of these sudden death victims could have been saved if immediate and effective resuscitative measures were available.

In the early 1970, two Portland, Oregon physicians began to research the possibility of developing a cardiac resuscitator that could be used quickly and safely by laymen during a cardiac emergency.

The results of Dr. Welborn's and Dr. Diack's research confirmed that they had found a unique technical and clinically superior method to help solve a world-wide medical problem. Before you, is the productized result of their pioneering work.

This emergency device, called Heart*Aid, has the capability, when properly applied to a collapsed victim, of diagnosing and automatically delivering an appropriate electrical pulse to a victim of a ventricular fibrilation, ventricular tachycardia, or an asystolic arythmia. The time frame from diagnosis to treatment is only 12 seconds—far less than the average emergency medical response time.

Unfortunately, Heart*Aid's significant potential for saving human life came perilously close to non-existence due to the difficulties in finding capital resources to engineer, test, manufacture and market the device.

In 1973 I was asked by the inventors to raise the seed money for early engineering design and animal experimentation. An intrastate offering was prepared and $90,000 was raised from Oregon investors in exchange for 18 percent of the company. The results of this work were so promising that the corporation decided to seek further financing. My associates and I believed that we needed $750,000 to $1,000,000 of capital in order to properly develop, manufacture and market our new product.

The overall economic climate in 1974 and 1975 presented some serious obstacles for Cardiac Resuscitator Corporation. First, the United States was simultaneously experiencing double digit inflation and a recession. Second, it was financially imprudent and practically impossible to obtain Security Exchange Commission approval for a start-up S-1 or S-2 filing. Even if the Security Exchange Commission obstacle could have been overcome, it would have been most difficult to ob-

tain an underwriter, even on a best efforts basis because proven listed securities of established businesses even at a premium, were difficult to sell. Third, the private sources of risk capital, were neither "venturesome" or "capitalists". Many of these individuals and organizations had lost money during the early 70's and were re-assessing their role in our society.

Even though the S-1 and S-2 options did not appear available, we were persuaded that the investing public wanted registered securities. As a result the Corporation decided to file a regulation A offering which I as its financial Vice President would sell, as the Company's agent. As you know, this filing limits the amount of capital that a company can raise to $500,000 in any one calendar year.

It took me approximately 18 months to raise $500,000 in exchange for 20 percent of Cardiac Resuscitator Corporation. While many potential investors were impressed with the product concept, they questioned the success in relation to the hazards of attempting to operate a company in the highly regulated medical field with only $500,000. A large number of potential investors who did not invest told me that the new and proposed tax treatment of capital gains in addition to the risks inherent in a start-up company, discouraged their investment.

The current Administration needs to rethink its tax policy with regard to capital gains; instead of eliminating capital gains, as the Carter Administration once proposed, we need to encourage capital investment. If the Administration's proposal is enacted into law, it will not only adversely affect new companies such as Cardiac Resuscitator Corporation, but will have a devastating impact on the forest product industry, which accounts for a large portion of the Pacific Northwest's economy.

In summary, I would propose that your committee consider decreasing the tax for long term investors, perhaps on a sliding, downward scale as the investment matures. I believe that this tax incentive would precipitate additional investment, create new jobs, improve our competitive position in world markets, and would restore confidence in the free enterprise system. To do otherwise will, I regret to say, discourage the inventor, inhibit the development of new technologies and slow down long-term investment, which will put this nation in an uncompetitive and therefore weakened economic position.

I trust that an Administration, whose rhetoric speaks of quality, i.e. "Why not the Best?", will recognize that the capital gain treatment portion of its "tax reform package" will result in economic stagnation and technological mediocracy. I am hopeful that this Committee will use its expertise and influence to persuade the Executive Branch to excercise political courage and responsible financial judgment in reconsidering and redirecting its current tax position on capital gains.

HEIZER CORPORATION,
June 27, 1978.

Senator HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Senate Finance Committee, U.S. Senate, Washington, D.C.

DEAR CHAIRMAN BYRD: An abundance of convincing testimony, letters and reports have been written in support of the Steiger Amendment. This letter sets forth some highly relevant facts covering Heizer Corporation and its investees in further support of the Steiger Amendment.

Heizer Corporation, which is located in Chicago, Illinois, is the largest Venture Capital Firm in the United States. Heizer Corporation was founded in 1969 and has financed 33 early stage growth companies. The economic impact of these young companies is impressive beyond the money invested or the years they have been in business.

	Operating companies financed by Heizer Corp.		
	Which would not exist without Heizer Corp. support	Where Heizer Corp. support important but not critical to survival	All companies supported by Heizer Corp.
Number of companies	23	10	33
1978 sales (estimated)	$1,059,000,000	$1,005,000,000	$2,064,000,000
1978 taxable income (estimated)	$151,700.000	$134,250,000	$285,950,000
Number of employees (estimated)	20,000	16,500	36,500
Heizer Corp. investment per employee for "permanent" job created	$16,600	$8,500	$14,350

It is highly doubtful that Heizer Corporation or firms like Heizer Corporation could be formed today or that the money could be found to support the 33 operating companies financed by Heizer Corporation. The 1969 Tax Reform Act struck a devastating blow to new capital formation by raising the capital gains tax from 25 percent to 50 percent. This was immediately clear to those of us devoting our lives to new company formation and is belatedly becoming clearer to economists, legislators and perhaps someday to the Treasury Department.

The Treasury Department and the Carter Administration have stated that the Steiger Amendment would cause the U.S. Government to lose tax revenue, is not necessary to capital formation and represents an unfair tax loophole.

THE STEIGER AMENDMENT WILL INCREASE TAX REVENUE

Several economic studies have been done by highly reliable organizations showing that the Steiger Amendment would actually increase Federal Tax Revenue even in the short run. Common sense says that in the long term the Steiger Amendment would increase tax revenues.

It is self evident that on a dynamic basis (as contrasted to static basis) there is no way the U.S. Government can lose a tax revenue by passing the Steiger Amendment. No one can have a capital gain without first creating many jobs, personal income taxes, employee taxes, etc., for a number of years before any capital gains tax becomes a reality. These other taxes are collected first and mathematically have to exceed the difference between a 50 percent and a 25 percent capital gains tax.

The following real world facts on two of Heizer Coporation's most successful investees are submitted in support of this position.

	Amdahl Corp.	Fotomat Corp
Taxes already collected by U.S. Government (estimated)	$48,300,000	$97,000,000
Current annual rate of tax collection by U.S. Government	50,000,000	22,500,000
Total gross capital gain by investors from inception to date	352,700,000	37,700,000
Maximum reduction in taxes due to Steiger amendment	88,175,000	9,500,000

A CAPITAL GAINS TAX INCENTIVE IS ESSENTIAL TO CAPITAL FORMATION

Critics of the Steiger Amendment say that little capital formation process will go on irrespective of the capital gains tax rate due to the natural greed of investors. We urge you not to fall into this line of theoretical thinking. New investment in young and start-up companies was abruptly cut off by the 1969 Tax Reform Act and the flow of funds to new and growing companies today is a small fraction of that available in the 1950's and 1960's when a 25 percent capital gains tax prevailed. Unfortunately, investors pay more attention to tax rates than they do to basics and thus are more interested today in investing in tax shelters then in new capital formation under current tax laws. This is leading to economic stagnation and high unemployment rates.

IT IS UNFAIR TO TAX CAPITAL GAINS AT THE SAME RATE AS ORDINARY INCOME

Critics of the Steiger Amendment also say that a lower tax on capital gains is unfair. We submit that it is unfair to tax long term investors at the same rate as ordinary income. It takes ten to twenty years to grow a young company into a successful enterprise which can be profitably sold for a capital gain. Often this process represents a lifetime's work and a person's entire estate. In recent years, inflation has also played a major role in the increases in value. It is not fair to tax these long term gains at the same rate in the year of sale as a big company executive is taxed on his ordinary income year to year while he accrues large-tax-free pension benefits. A high capital gains tax rate encourages mergers and concentration of economic power and control.

For the above reasons, we urge you to fully support the Steiger Amendment and will be pleased to assist you in any way possible.

Sincerely,

E. F. HEIZER, Jr.,
Chairman and President.

BRENTWOOD ASSOCIATES,
Los Angeles, Calif., June 27, 1978.

HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Committee on Finance, U.S. Senate, *Washington, D.C.*

DEAR CHAIRMAN BYRD, I am a General Partner of Brentwood Associates, a venture capital investment partnership which invests primarily in new and developing companies. I am also privileged to be a director of the National Venture Capital Association (which includes 76 of the country's largest venture capital firms), and a member of the Task Force on Capital Formation of the American Electronics Association (which consists of about 1,000 high technology companies, approximately 70 percent of which are small businesses).

Senator Hansen's Bill, to roll back the capital gains tax is, in my opinion, one of the most sensible and urgently needed pieces of tax legislation proposed in several years. I am pleased, therefore, to be allowed to offer this letter in its support.

I believe we may have passed a highly significant milestone in our efforts to treat the economic malaise that currently afflicts our country: a national consensus has emerged regarding the need for a substantial increase in investment in the private sector in order to increase jobs and reduce inflation. Perhaps the most obvious means by which investment can be stimulated is simply to increase the potential rewards to those with capital to invest. The Hansen Bill is designed to accomplish this.

Much has already been written on the substantial economic benefits to the public that could result from a capital gains tax reduction. It is noteworthy that there has been almost no opposition to Senator Hansen's proposal on the grounds that it would not accomplish its intended purpose. Instead, the Bill's detractors, led by the Carter Administration, argue only that a cut in capital gains taxes would, in their view, produce disproportionate—and therefore "unfair"—benefits to some wealthy taxpayers. While I support the President's commitment to fairness and his desire to assure the public that our income tax system will be administered equitably, I believe that tax policy must also be considered in terms of its long range benefits to the public at large. To do otherwise is at best short-sighted, and may be *truly* unfair to Americans collectively.

In any event, I believe that Senator Hansen's proposed reduction in the capital gains tax is *not* unfair, and that the Administration's position is not well considered. Since the question of "fairness" seems to be the principal obstacle to adoption of this critical legislation, I have focused my remarks on this issue.

In opposing the Hansen Bill the President and his spokesmen have repeatedly described favorable treatment of capital gain income as "a loophole that shelters the rich". In fact the Hansen Bill does not provide shelter for the rich; it simply provides for a lower rate of tax (one-half of the earned income rate) for *anyone,* rich or poor, who has the fortitude to risk his precious capital, and is fortunate enough to have his investment increase in value.

The notion that capital gains are only available to the very wealthy is not correct. In fact, one-half of the taxpayers who report capital gains have adjusted gross income of $15,000 or less. Moreover, fifty percent of the dollar amount of capital gains are realized by persons with adjusted gross income of $25,000 or less. While it is true that a disproportionate amount of capital gains are realized by more affluent persons, this should be neither surprising nor disturbing. These persons simply *invest* (risk) more capital, just as they give more to charity, and pay a disproportionate share of the personal income taxes. (In 1977, persons with $23,000 or above in adjusted gross income, represented only 10 percent of the taxpayers, paid 50 percent of the total personal income taxes—including capital gains taxes.)

Notwithstanding the foregoing, the Administration suggests that a lower capital gains is somehow unjust. I strongly submit that for at least two reasons a lower capital gains rate (relative to the earned income rate) in *not* unjust; in fact, a logical case can be made that the Hansen Bill does not go far enough. I reason as follows:

First, the Bill would not truly provide for more favorable tax treatment of capital gains than for ordinary income. The capital gains tax, just like the tax on corporate dividends, is basically a *double tax* on corporate profits. Presently the stream of income generated from the employment of capital in a corporation is taxed once at about 50 percent when the profit is earned by the company, and then

a second time at rates as high as 70 percent (if it is distributed to the shareholders as dividends), or as high as 49.1 percent (if it is retained and reinvested in the business). In the latter case, the 49.1 percent represents the maximum capital gains tax rate that would be applied to the appreciation of a shareholder's stock, the principal component of which (over the long term) would be the value of accumulated undistributed *after-tax* earning. In the aggregate, then, taxes on shareholders' profits range to about 85 percent if all earnings are distributed, and to almost 75 percent if all earnings are retained and the holder sells his stock at a price approximating net worth. In the case where earnings are retained, the Hansen Bill would reduce this *second* tax (namely, the capital gains tax) to a maximum of 25 percent (one-half the maximum earned income rate), thereby reducing the total tax on income earned from capital to a maximum of *62.5 percent*. By contrast income earned from the "sweat of the brow" is taxed at a maximum of *50 percent*.

Second, capital gains income is different from personal services income, and as such is should be treated differently. The essential difference is that to realize capital gain income, a *risk of loss* must be assumed. Accordingly, it is both appropriate and fair that an additional reward be offered the investor (whether he be rich or poor) as an incentive to invest his capital in American industry.

The irony of this debate over the proper way to stimulate capital formation is that the Carter Administration, while opposing the Hansen Bill, advocates an elimination or reduction of the tax on corporate dividends as an acceptable (and apparently "fair") means of stimulating capital formation, thinking perhaps that taxing income twice is unfair, even if the people being taxed are wealthy. The logical inconsistencies here should be apparent. First, since high-bracket taxpayers receive a disproportionate amount of the dividends paid (as they do capital gains), they would also receive a disproportionate amount of the benefit from such a policy. Second, the only substantive difference between Carter's dividend proposal and the Hansen Bill would be that, in the former case, corporations would be pressured by shareholders to distribute their profits, while in the latter they would have substantial incentive to retain and reinvest them—clearly the preferred result. Third, the companies which pay dividends are generally larger, slower growing, and therefore in substanitally less need of capital than non-dividend payers or they would retain their earnings rather than distribute them. It is the smaller, more rapidly growing companies which are in greatest need of capital and which have proven to be most effective at increasing employment and productivity.

Of course this entire issue should be overwhelmed by consideration of the Bill in terms of its benefits to the public. In this regard, Hansen can offer studies by several of the most highly respected independent economic "think tanks" in the country. Using econometric models, these groups predict substantial benefits to the economy in terms of higher employment, higher GNP, *higher* (not lower) tax revenue, lower government deficits, and a lower inflation rate as a result of this legislation. In opposition, the Administration has offered only its specious "fairness" argument, and the Treasury's curious contention that there would be no stimulative effect from the cut and therefore a reduction in rate would produce a commensurate reduction in tax revenue. With all of the economic theory and evidence to the contrary, it is very difficult to accept the Treasury's position. The critical fact is that even if the Treasury were right, this bill would represent less than a 1 percent reduction in total federal tax revenues. If, on the other hand, Hansen and the highly learned economists who have studied the issue are correct, the benefits to the public would be great.

With so little to lose and so much to gain, it is hard to understand the Administration's apparent obsession with defeating this Bill. President Carter's position raises serious questions· Who will make the needed investments if not those with capital?

How can we stimulate those with capital to invest greater sums if we don't offer them the potential for higher rewards? Why should we care if, in the process of serving the overall public interest, a few wealthy persons also benefit?

I strongly urge the Senate to move quickly toward adoption of this critically needed legislation.

Very truly yours,

B. KIPLING HAGOPIAN,
General Partner.

DATA GENERAL,
Westboro, Mass., June 27, 1978.

Hon. Harry F. Byrd, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Senate Finance Committee, Dirksen Senate Office Building, Washington, D.C.

DEAR CHAIRMAN BYRD: In April 1968, I started a computer company along with another engineer, a programmer, a salesman, and a lawyer. The programmer was 23 years old and a Princeton drop-out. The salesman had never sold a computer and I had never been president of anything. We were not close boyhood friends, we did not all grow up together. We did not even know each other very well. But we did have some things in common. We were willing to work hard and did. We were competitive, knowing full well that someone else would lose when we won. And we were willing to run risks because we assumed there might be rewards for doing so.

As time went on, we gathered people around us who had these things in common. We assembled our first computer in a former beauty parlor in Hudson, Massachusetts. Our engineering department was located on two kitchen tables; our manufacturing shop on other kitchen tables in the same room. We shipped our first computer to the University of Texas. Ten years later, we are building a 280,000 square foot manufacturing plant and development laboratory in Austin that will eventually employ some 1,500 people.

The risks we and a few other start-up investors took have brought us rewards, both financial and personal. Those risks have also brought considerable rewards to Massachusetts, New England and the nation.

We have created some 11,000 jobs along the way, 4,000 of them in Massachusetts. We have paid over $82 million in taxes since 1968 and over $4 million to the Massachusetts unemployment compensation fund, although we have yet to lay off anybody. Over 30 percent of our revenues come from the export of computers manufactured in the U.S. We spend over 10 percent of our revenues on R&D, among the highest in U.S. industry, and pay no dividends. We cannot afford to. Our R&D expenditures for any year are about the same as our net income. In addition, we have produced more than 50,000 Data General computers that work somewhere helping to cut inflation and the drudgery out of somebody's life. The price per function of our product has gone down about 20 percent a year, one of the few complex products left on earth to do so.

But Data General would not exist today under the current capital gain tax rates. There is little likelihood that the $750,000 in high-risk capital we needed to get started could have been obtained at any time after 1969. We were fortunate enough to be formed in 1968. A year later the Tax Reform Act raised the capital gains tax to the 49.1 percent maximum level. Later changes in the tax treatment of capital gains made the situation even worse.

In Massachusetts more than 200 high-techonlogy companies similar to Data General were formed between 1964 and 1969. Less than 50 have been formed since then. These firms account for some 200,000 jobs in the state or one-third of all manufacturing jobs today. And they are growing 20 percent a year on average. For New England and especially for Massachusetts. which already has heavy geographic and social costs, these high-technology, brain-power industries are the only source of private sector job growth left to the area.

German and Japanese high-technology industries are prime competitors of these New England firms in the world marketplace. They have been growing as rapidly, and creating at least as many jobs, especially in computers and electronics. In 1974, for example, Japan had 22 scientists and engineers engaged in R&D per 10,000 population. Germany had 16. The United States had 24. The USSR had 38. Germany, Japan, and the USSR have been growing since then. The U.S. has been declining since then.

Both German and Japanese exports of computers and electronics to world markets have been increasing at a more rapid rate over the past five years than U.S. exports in these industries. The significant issue is not that Germany or Japan today have superior technology. They do not. But they do have superior stimulus to financing such ventures. Neither Germany nor Japan tax capital gains. And both German and Japanese capital has invested in or acquired U.S. computer and electronic-based firms in increasing munbers since 1969, particularly in California and Massachusetts where many of these firms are located.

The evidence is clear, simple and overwhelming. If you tax risk-taking at the current levels, you won't have these enterprises, nor the jobs nor the taxes nor the exports they produce.

The argument that special treatment of capital gains allows a few wealthy people to escape their share of the tax burden or that it increases speculation is both specious and irrelevant. The wealthy will pay *more* taxes through a reduced capital gains tax because they will receive more gross income from the gains they receive. Thus, Federal tax revenues will increase, not decline. If some risk-takers invest in Data General and gain from it by our performance, they will pay more taxes at a lower capital gains rate. They could have invested in the phone company.

The largest job producers of the past 10 years in the U.S. have been smaller companies investing all of their profits in new ideas, not the large, mature industries paying dividends to stockholders. Since 1969 a number of small enterprises never got created simply because they couldn't get the money.

The result is that we have caused what we were trying to prevent. We have reduced the tax revenues we set out to increase by the increased tax on capital gains. Tax revenues from capital gains have never equalled what they were in 1968. We choked off job-creating new business that would have produced far more tax revenues, that would have lowered unemployment and individual taxes. There has been less investment in new ideas, fewer small companies that made it, and greater concentration of investment in larger, mature industries that grow slower.

If Congress wishes to accelerate the concentration of capital in fewer hands, and create industrial oligopolies and monopolies, I recommend you defeat the Steiger/Hansen bills. If the Congress wishes to stimulate competition and the inevitable benefits to consumers and the economy it brings, then I recommend you support these bills.

A reduction of the capital gains tax to zero is called for by the evidence. It might make us competitive with Germany and Japan. The Hansen/Steiger bills are compromises already since they roll back the maximum tax only to the 25 percent level. Weak as they are, these bills present a unique opportunity to help create jobs, support our technological leadership and stimulate entrepreneurial risk-taking. They are unique in that they are the only tax-cuts being considered that can accomplish these things at no cost to the U.S. Treasury and may well increase tax revenues.

I urge your support.

Sincerely,

EDSON D. DE CASTRO,
President.

Mr. ZSCHAU. I think the essential point here is that there is an overwhelming body of evidence that is being generated that indicates the economic benefits of the capital gains tax cut, as proposed by Senator Hansen. But we can't be sure. We can't be sure of what the fairness of the issue is and we can't be sure of the economic effects.

What I propose is that Congress, like the entrepreneurs who made this country great, take a calculated risk on this issue. If we are right, the economic benefits we predict will accrue to the country. If we are wrong and if the Treasury figures are right, in the worst case it would be less than a 1-percent loss in Federal tax revenue.

So, let's take the risk. I think it is a good one. Let's pass the Hansen-Steiger bill.

Thank you very much, Mr. Chairman.

Senator PACKWOOD. Thank you very much.

Let me say to the other witnesses that it is our intention to work right through lunch without taking a break so that we can finish up with our agenda this morning.

I have no questions of this witness.

Senator Hansen.

Senator HANSEN. Thank you, Mr. Chairman.

First let me say that I appreciate Dr. Zschau's being here.

I do have one question that I think has relevance to this Nation, above and beyond the issue of jobs and taxes paid to the Treasury and so forth. That relates to the acquisition of high technology industry, of the small, young burgeoning company, by foreign interests. Would you expand on the significance of that trend, as you see it?

Mr. ZSCHAU. I can comment in two ways. One is a personal way. I think it might be helpful to the committee to have a specific example. Then I can talk in general about what we see happening in our industry.

About 9½ years ago, our company invented a new technology for making images, pictures, or characters on plain paper from electrical signals, much like a copy machine.

As a small company, it was very difficult to do the development. We obviously needed capital in order to do that.

We found it impossible to get money in the United States to do that research program which has now cost our company nearly $9 million. The reason is that it was a long-term development program and very risky. Also, it was not clear whether the technology would ever be successful, and even if it were, whether it could be brought to market successfully.

In order to get financing for this enterprise and this project, which I felt would be a dominant technology in the 1980's in the imaging field, we went to Japan. We sought investment from a Japanese company. I am happy to say that we received that investment. If we hadn't been able to do that, the project would have terminated and this technology might not have been developed.

But, in raising the capital—which has come to a total of nearly $7 million from the Japanese company so far—we sold not only 51 percent of ownership in our subsidiary company that owns the rights to this technology, but we also sold an exclusive license to Southeast Asia to the technology and continuing cross-license agreements so that new developments that we might make would be given to the Japanese company.

This transaction was good for us. It enabled us to bring our product to market. I am happy to say that last month we introduced the first product using this technology to the marketplace. But the fact that we couldn't get the money in the United States and the fact that by selling the technology as well as ownership, we enabled a company in a foreign country to achieve technical parity with us is disturbing to me, not only in the commercial markets, but in the noncommercial markets as well.

That is a specific instance.

We see the same kind of thing happening throughout the electronics industry. I think we have to be very concerned that with our defense posture being wedded so closely to dominance in the technology fields, the United States really must maintain technological superiority if it is going to continue to be strong, not to mention the need for technological superiority if we want to compete effectively in the world markets, including in the United States. The sellout of ownership and the sale of technologies to foreign companies as a result of risk capital drying up, as evidenced by this particular survey, is a serious matter. It is one of the major factors that Senator Cranston alluded to and one of the major reasons that I believe a bill such as this is necessary at this time.

Senator HANSEN. Thank you, Dr. Zschau.
Senator PACKWOOD. Bob.
Senator DOLE. Thank you.

I have just one question and a brief answer will suffice because I know we have other witnesses.

As I understand it, the European capital gains tax rates are either lower than ours or nonexistent. Yet, there is a scarcity of capital in Europe. How do you explain that?

Mr. ZSCHAU. I am not an expert on the tax structures of the various countries. I have been told and have read about some countries. The ones that I know about in particular are West Germany and Japan. I know there that the individual capital gains tax rates, as opposed to corporate rates, are zero or near zero. There are some exceptions to that, but very small exceptions.

In looking at the statistics, those countries seem to be doing very well in all of the measures of an economy. I don't have information on all of the countries, but I certainly don't have the feeling that capital scarcity exists in Japan and West Germany.

Senator DOLE. Thank you.

Thank you, Mr. Chairman.

Senator PACKWOOD. If there are no other questions, we thank you very much, Dr. Zschau. We appreciate your waiting.

Mr. ZSCHAU. Thank you, Mr. Chairman.

[The prepared statement of Dr. Zschau follows:]

STATEMENT OF DR. EDWIN V. W. ZSCHAU, CHAIRMAN, CAPITAL FORMATION TASK FORCE OF THE AMERICAN ELECTRONICS ASSOCIATION

Mr. Chairman and Members of this distinguished Subcommittee: I'm Edwin V. W. Zschau, Chairman of the Board of System Industries of Sunnyvale, California. System Industries, founded in 1968, is a manufacturer of minicomputer peripheral equipment. We employ about 250 people in the United States and sell about 25 percent of out total volume abroad.

Before founding System Industries, I was an Assistant Professor of Management Science in the Graduate School of Business at Stanford University and a Visiting Assistant Professor of Business Administration at Harvard University. Currently, I am a Lecturer in Business Policy at Stanford.

I am appearing before you this morning in my capacity as Chairman of the Capital Formation Task Force of the American Electronics Association (AEA), which was formerly known as WEMA.

AEA is an association of more than 950 high-technology companies in 38 states. Its members are manufacturers of electronic components and equipment or suppliers of products and services in the information processing industries. While our member companies employ more than one million Americans and include some of the nation's largest companies, two-thirds of our member companies are small, employing fewer than 200 people.

Mr. Chairman, the high-technology companies of the American Electronics Association strongly support the Investment Incentive Act or 1978 which was introduced as S. 3065 on May 11, 1978, by Senator Clifford P. Hansen of this Subcommittee and 59 Senate cosponsors. We believe that restoring the tax treatment for capital gains to what it was prior to 1969 will stimulate more risk capital investment and result in extraordinary benefits to our economy. Still, we do not view this proposal as the ultimate solution to our country's capital formation problems. Rather, it is a major step in the right direction. We believe that eliminating *all* taxes on income from risk capital investments would significantly magnify the benefits resulting from the current proposal. We urge Congress to consider that extension of the Hansen bill since it would bring our tax treatment of capital gains into line with Japan and West Germany—our major competitors in world markets.

As members of this Committee are well aware, this hearing is focusing on an extremely timely issue. Just last week major articles in Business Week, Time, and the Wall Street Journal told us:

"The U.S. leadership in science and technology, which for decades has been our chief source of economic and military strength, has slipped so badly that the White House has had to order a massive 28-agency review of the problem;

"The growth in worker productivity in the United States has declined alarmingly to a meager 2.2 percent; and

"Our trade deficit in the first quarter, 1978, reached a record $6.95 billion, topping the old record set in fourth quarter, 1977."

Reading these articles separately, it's easy to lose sight of how closely these problems are interrelated. Without sufficient advances in technology, productivity suffers and U.S. companies become less competitive not only in foreign markets but also here at home.

In the opinion of many experts, these problems all stem from the same fundamental cause—insufficient risk capital investment. Today, we will provide you concrete evidence documenting that relationship.

THE AEA SURVEY

Our testimony today in support of the Investment Incentive Act of 1978 is based on the results of a major survey of the capital formation experience of U.S. electronic companies recently conducted by the American Electronics Association. It is the most extensive survey of its kind ever conducted and provides startling new information and valuable insight in four areas important to an understanding of S3065.

First, it documents and quantifies the benefits to the United States of a tax policy that stimulates more risk capital investment. The principal benefits would be:

More jobs;

Increased R&D expenditures to develop new technologies which, by extending the powers of the human body and intellect, can improve productivity and the quality of life;

Increased exports to lessen our record foreign trade deficits;

Increased tax revenues which result from the rapid growth for which small, high-technology companies have become famous.

Second, the survey provides additional documentation that there is a serious capital shortage today, particularly for starting and growing young companies It shows that shortage has worsened sharply since 1969 when capital gains taxes were increased. As a result, small companies are not getting started or are badly undercapitalized. Another result of this shortage of homegrown capital has been a flow of foreign capital into U.S. companies which is resulting in foreign companies gaining control of U.S. companies and their most promising new technologies.

Third, we conclude from the survey that the most direct and perhaps the only solution to this risk capital shortage is to reduce significantly the tax rate on capital gains. The survey shows that the benefits of such tax reductions to the investors would be small in comparison to the benefits to the economy that their investments produce.

Finally, the survey provides additional evidence that reducing the capital gains tax rates should increase rather than decrease federal tax revenues. This evidence, rather than being based upon macroeconomic analyses, is based upon data of the surveyed companies which documents the remarkable capability of relatively modest investments to generate large federal tax revenues year after year.

The data in the survey comes from 325 companies which accounted for more than $45 billion in revenues in 1976. More than one third—$16.4 billion—of this came from exports and overseas operations. These companies employed nearly 750,000 people in the United States in 1976, spent $2.2 billion on R&D, and paid $1.8 billion in federal corporate income taxes and nearly $700 million in state and local taxes. Most of the companies in the survey are young companies—85 percent were founded in the past 22 years—and about 60 percent are still privately held. Their data is usually unavailable to the public.

Methodology of the AEA survey

The survey form contained in Appendix I was sent to all 905 members of AEA at the time. Of those, 230 were actually operating units of parent companies. Eliminating such duplication, a total of 675 separate companies were surveyed. Responses were received from 269 of these, yielding a survey response ratio of 40 percent. Also, survey forms were sent to a number of nonmember electronics companies; 56 responses were received from those.

All of the responses were sent directly to the public accounting firm of Coopers & Lybrand in Palo Alto, California. Coopers & Lybrand held the raw data in strict confidence but reviewed each response to check for apparent errors. In such cases, the firm contacted the company to clarify or correct the data.

Once the authenticity of the data had been verified, Coopers & Lybrand prepared various data summaries and performed certain statistical analyses on which our testimony is based. The data summaries are contained in Appendix II.

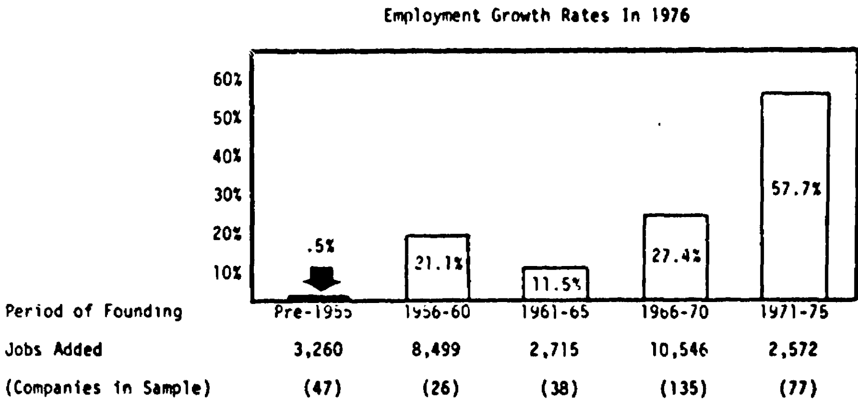
WHAT THE AEA SURVEY SHOWS

Young companies create jobs faster

The AEA survey documents the importance of young companies in solving the nation's unemployment problem. It shows that young companies create jobs much faster than mature companies.

Exhibit 1

YOUNG COMPANIES CREATE JOBS MUCH FASTER THAN MATURE COMPANIES



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If we divide the companies in the sample into four categories—"mature" (more than 20 years old), "teenage" (between 10 and 20 years old), "developing" (5 to 10 years old), and "start up" (less than 5 years old)—the survey shows that the employment growth rate in 1976 for the teenage companies was about 20-40 times time growth rate in employment of mature companies. The developing companies had an employment growth rate in 1976 that was nearly 55 times the growth rate in employment of the mature companies, and the employment growth rate for the start ups in 1976 was 115 times that of the mature companies.

Even more startling is the fact that, although the mature companies averaged 27 times more employees than the younger companies founded since 1955, in 1976 those young companies created an average of 88 new jobs per company versus an average of only 69 new jobs per mature company.

New jobs require risk capital

The AEA survey data shows that new jobs require risk capital investment.

On the average, the young companies in the survey founded since 1955 required $32,720 of assets for each job created. Moreover, detailed statistical analyses indicate a high correlation between increases in jobs and increases in assets, proving that growth in assets is necessary for growth in employment.

Asset growth can be financed by debt, retained earnings, or injections of new risk capital. Different companies use different mixes of these financial sources. However, for all companies, the amount of debt that can be used and the retained earning generated are limited. Therefore, all rapidly growing companies require new infusions of risk capital to support employment increases. For the 276 young companies in the survey, an average of $14,000 of risk capital was required to create each of the 131,000 new jobs generated since 1955.

Risk capital investments generate streams of other benefits

The creation of jobs is not the only benefit that the country reaps from risk capital investments. The AEA survey shows that risk capital investment in a high-technology company generates annual streams of export sales, R&D expenditures, and tax revenues to Federal, state and local governments. The AEA survey documents for the first time the magnitudes of these benefits. They are surprisingly large and they begin quickly.

Let's take, for example, the 77 companies founded most recently in the 1971–75 time period and look at the benefits that those companies were already providing in 1976 even though they were, on the average, just four years old. In 1976, for each $100 of equity capital that had been invested in these companies, they generated export sales of $70, spent $33 on R&D, paid $15 in federal corporate income taxes, paid $5 in state and local taxes, and generated $15 of personal federal income tax revenue through the jobs created by that investment. Notice that the Federal Government received an incredible $30 of tax revenue in 1976 for every $100 invested in these companies founded during 1971–75.

Exhibit 2.—Benefits in 1976 per $100 invested in the companies founded during 1971–75

$70 in exports.
$33 on R&D.
$15 in federal corporate taxes.
$15 in personal income tax revenues.
$5 in state and local taxes.

The table below compares the benefits generated in 1976 for every $100 of risk capital invested in companies founded during each of the time periods in the survey. Although the amounts vary somewhat, the conclusion is clear: risk capital investment is like the goose that lays golden eggs. An investment made once generates streams of benefits year after year. These benefits are large and they start soon after the investment.

BENEFITS IN 1976 PER $100 INVESTED

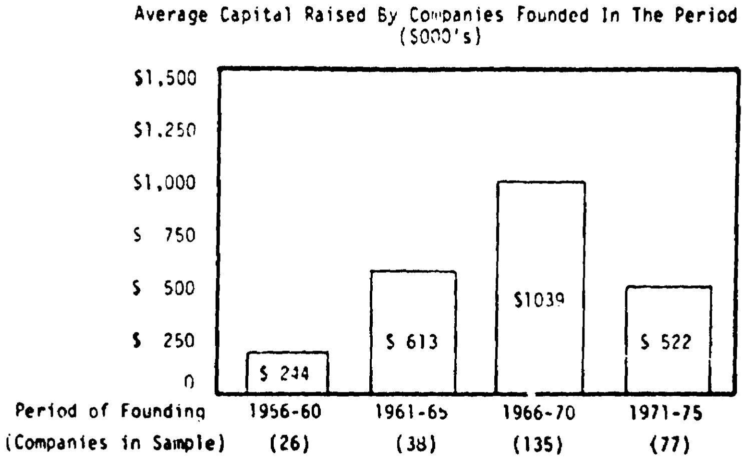
Yr. founded	Companies in sample	Foreign sales	R. & D. expense	Federal corporate tax	State and local tax	Personal income tax	Total Federal tax revenue
1956–60	26	$91	$19	$7	$3	$12	$19
1961–65	38	89	18	9	5	13	22
1966–70	135	57	29	12	4	11	23
1971–75	77	70	33	15	5	15	30
1956–75	276	76	20	10	4	12	22

Since 1970, risk capital has become scarce

Increases in tax rates on capital gains, which have made risk capital investments less attractive in recent years, have unwittingly been killing the goose that lays these golden eggs. The AEA survey documents that capital has become severely scarce even for high-growth electronics companies. The chart below, stated in current dollars not adjusted for inflation, shows that in the first years of their existence, the companies founded during 1971–75 were able to raise only one half as much equity capital on the average as those firms founded during 1966–70. By 1970, the 135 firms founded in the 1966–70 period had raised an average of $1,039,000 in risk capital, while by 1975 the 77 companies founded during 1971–75 had raised only $522,000 per firm. That was even less than the capital the companies founded during 1961–65 raised in 1961–65.

Exhibit 3

RISK CAPITAL HAS BECOME SCARCE
(Current Dollars)

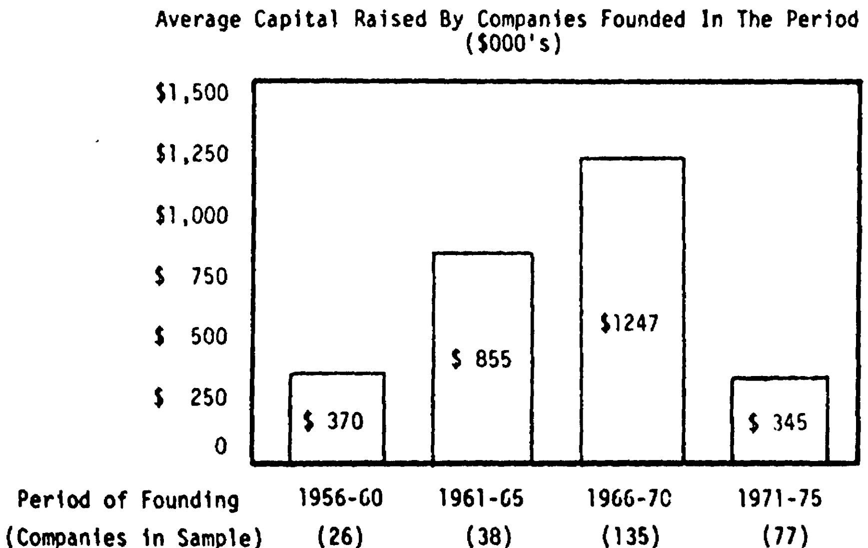


When inflation is taken into account, though, the true magnitude of the capital scarcity problem is revealed.

The chart below, stated in constant 1972 dollars, shows the firms founded in 1971–75 were able to raise on the average *less than 30 percent* as much capital as firms founded during 1966–70 raised during the 1966–70 period. In fact, in terms of purchasing power, the new companies formed since 1971 raised less capital per firm in their early years than firms founded at any time in the past 20 years.

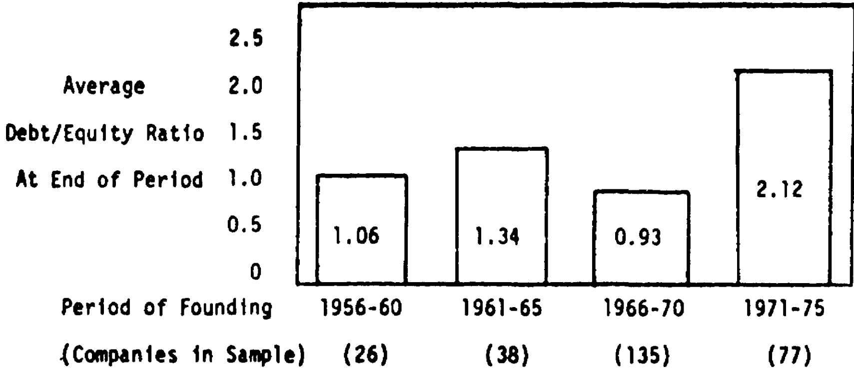
Exhibit 4

RISK CAPITAL HAS BECOME SCARCE
(Constant 1972 Dollars)



Capital scarcity makes young companies vulnerable

Some effects of capital scarcity are obvious: Firms that would get started don't, and firms that do get started may be unable to grow as rapidly as is desirable. However, the AEA survey also documents a hidden problem: The capital shortage makes the young companies that do get started more vulnerable to adverse situations in the economy and their markets.



The chart above compares debt-to-equity ratios of firms founded since 1955. For the 15 years up through 1970, the debt-to-equity ratio of the firms founded during those years was about 1:1, putting them in a relatively good position to withstand adverse circumstances. However, in 1976 the capital-starved firms founded in the period 1971–75 had an average debt-to-equity ratio of more than 2:1, making them far more susceptible to adverse events and economic fluctuations. In fact, because such highly leveraged companies often go bankrupt in economic downturns, they tend to amplify such economic fluctuations and, therefore, represent an unstable element in the economy.

This hidden effect of capital scarcity will magnify the next economic downturn unless steps are taken immediately to improve the availability of risk capital.

Risk capital investors seek capital gains

In determining how to solve the capital scarcity problem, it is important to understand the motivation of the investors that contribute risk capital to young growth companies. The AEA survey suggests that investors who invested the equity capital that permitted the young companies to get started and grow made their investments to obtain appreciation on their invested capital rather than to obtain dividends. Specifically, the survey showed that dividends paid in 1976 as a percentage of the equity capital invested were less than 0.8 percent on the average of all companies founded since 1955. Moreover, for the new companies formed during 1971–75, the dividends paid as a percent of equity invested were less than 0.1 percent. No investor would be attracted by such a low dividend yield.

There are two reasons why risk capital investors must seek capital gains in making their investments. First, since high-growth companies can't generate enough retained earnings to finance their growth, they need constant injections of new equity capital. Therefore, they can ill afford to pay out a portion of their scarce equity in dividends. Second, the risks of investing in a young high-technology company are extremely high. These risks are particularly severe in the electronics industries where the possibility of R & D failures and paid technological. obsolescence are added to the many challenges that other small companies face. In order to justify investing in such high risk ventures, the investor requires a high potential rate of return. Such high returns don't come from dividends. They are only possible from capital gains.

As members of this Subcommittee are well aware, the Tax Reform Act in 1969 and subsequent tax legislation have increased the maximum tax rate on capital gains from 5 percent to more than 49 percent. This has significantly and adversely altered the risk/reward ratio in making risk capital investments. The rewards have been reduced, but the risks of such investments have remained the same or have perhaps even increased in today's uncertain economy plagued with inflation.

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As a result, people have become unwilling to risk losing their money in new ventures. The AEA survey shows that. The goose that lays the golden eggs is dying.

Investor gains are small compared to benefits generated by their investments

AEA survey data provides important new insights into the question of who benefits most from tax legislation that stimulates risk capital investment. The table below summarizes calculations used in estimating the average annual gain to investors per $100 invested in the survey companies.[1]

ESTIMATING THE AVERAGE ANNUAL INVESTOR GAIN PER $100 INVESTED

Years founded	Estimated total market value (millions)	Total invested (millions)	Total gain (millions)	Total gain (per $100)	Average holding period (years)	Average annual gain (per $100)
1956-60	$1,266.7	$700.6	$566.1	$81	3.5	$23
1961-65	1,004.2	360.1	644.1	179	6.5	28
1966-70	1,204.7	708.5	496.2	70	3.7	19
1971-75	86.5	66.8	19.7	29	2.2	13

These estimates of potential investor gains are certainly much higher than what the investors could actually realize from their investments. Specifically:

Many of these investments are in private companies, so the investors are either unable to realize their gain through sale of the stock or the sale must be made at a discount price in a private placement;

These gains are prior to any capital gains taxes being levied;

All calculations are in current dollars, so that much of these apparent gains are nothing more than the result of inflation;

Since our survey only reached companies still in existence, these estimated gains ignore investments which were unsuccessful and in which the capital risked by these same investors was lost.

The table below summarizes these pre-tax average annual gains per $100 invested compared to the benefits to the economy that the investments produced in 1976.

COMPARING INVESTOR GAINS TO BENEFITS THEIR INVESTMENTS PRODUCE (PER $100 INVESTED)

Years founded	Investor average annual pretax gain	Benefits in 1976 to U.S. economy			
		Total taxes paid[1]	Estimated salary/wages paid	R. & D. expenses	Export sales
1956-60	$23	$22	$72	$19	$91
1961-65	28	27	78	18	89
1966-70	19	27	66	20	57
1971-75	13	35	80	33	70
1956-75	22	26	72	20	76

[1] Federal, State, local, and personal income taxes. (See table on p. 7).

[1] These estimates were made by multiplying the profits earned by the companies in 1976 by a price/earnings multiple of 10—an appropriate multiple in today's market for companies like these. The total investor gain is the difference between this market value and the amount of investment made in the companies since their inception. Dividing the total gain per $100 invested by the average holding period of the investments yields the average annual gain to the investor per $100 invested.

It's clear that the benefits our country reaps from the risks these investors take far exceed the gain they can hope to receive. It's startling to seee that, even if capital gains were not taxed at all, the annual tax revenues flowing to government as a result of these investments are about the same or even greater than the maximum potential gains of the investors. The investors took the risk but the federal, state and local governments can get an even larger return than he can!

We should also keep in mind that many of these benefits from risk capital investment, such as jobs, technology development, export sales and even tax revenues, are realized even if the companies fail. In those cases, the investors lose, but our country is still better off because the possibility of a reward motivated them to try.

CONCLUSIONS OF THE AEA SURVEY

Since 1970, risk capital has become scarce

The survey documents the risk capital scarcity problem. It shows that in recent years this needed capital has become extremely difficult to raise. The capital shortage has not only stifled formation and growth of young companies but has made those companies that were able to get started vulnerable to economic fluctuations.

The Investment Incentive Act of 1978 would stimulate more investment

Based on the results of this survey we conclude that a substantial and lasting reduction in the capital gains tax rate is the most direct and perhaps the only way to stimulate needed investment. Investors put their money into young companies for potential capital appreciation. The Investment Incentive Act of 1978, by increasing that potential after tax returns would stimulate more investment. Of course, reducing the capital gains tax rate still further would be even more effective.

More risk capital would enable new companies to get started and grow

The survey shows that young companies need constant injections of risk capital in order to get started and grow. In their formative years, they are investing heavily in development of new products and the establishment of their organizations before they begin generating profits. Later, when they are profitable, their potential growth is greater than they can finance through retained earnings and borrowings. The availability of adequate risk capital would result in many new companies being formed and growing to their full potential.

More risk capital would finance new jobs

The data in the AEA survey indicates that the young, high-growth companies are the most effective in creating new jobs. Improved availability of risk capital would enable more of these companies to get started and expand. The new jobs that would be created would be high-quality positions with a future both for the workers and their communities rather than make-work, "public service" type jobs.

More risk capital would result in advances in technology

The survey documents the relationships between invested risk capital and R&D expenditures in the high-technology industries. We need increased R&D expenditures if we are to maintain our technological leadership and to improve the productivity of our workers.

If the availability of risk capital does not improve, the young, high-technology companies will continue to seek and obtain investment from foreign sources. As in the case of my own company, System Industries, such investments from foreign sources often result in the sale of technology as well as ownership in the U.S. company, enabling foreign competitors to reach a technical parity with their U.S. counterparts. Such transactions, which have been occurring more frequently in the electronics industry recently, will reduce the favorable trade balances that the U.S. high-technology industries have enjoyed in the past, and breed increased competition from foreign companies in the U.S. market. What has occurred with television sets and now calculators will certainly occur with semiconductors and computers unless incentives for investment are improved and improved quickly.

Our failure to maintain dominance in science and technology also weakens our defense posture. This nation's strategic position in the world today is based increasingly on our ability to maintain technological rather than numerical superiority over our adversaries. Since the fields of important technology have become so broad and R&D appropriations have shrunk, our defense capabilities have become increasingly dependent on commercially-developed innovations rather than relying primarily on government funded R&D .The private sector in the United States must continue to provide the needed technology, but it needs more risk capital to do it.

Lower capital gains taxes don't mean revenue loss

Mr. Chairman, we realize that this Subcommittee must be concerned with generating adequate federal tax revenues. We also realize that tax rate reductions are usually expected to result in revenue loss. However, because of the unique ability of long-term investment to generate jobs and economic growth, reducing capital gains taxes may not decrease the federal tax revenues at all. In fact, data from the AEA survey indicates that a significant reduction in the capital gains tax rate could actually increase rather than decrease federal tax revenues.

This assertion is based on two factors that have been ignored by the "static" analyses that you have been provided by the Treasury Department. First, substantially lower tax rates on capital gains will increase the potential after-tax returns from risk capital investments, and stimulate investment of more funds. Allowing the investor to retain more of the gains will also put more capital at his disposal. Second, as the AEA survey has documented, a surprisingly large annual flow of federal tax revenues results from capital investment. The additional investment stimulated by the rate reduction would generate ordinary income tax revenues that would offset and surpass the revenue lost from the lower tax rate. Moreover, that additional investment would also result in more jobs, increased exports and new technology.

An example

An example, based on the survey data and some reasonable assumptions, may clarify how this would occur.

Let's suppose that the average return on successful risk capital investments is about 15 percent per year compounded. At that rate, a $100 investment today would be worth $200 in 5 years. If we assume a capital gains tax rate of 40 percent, then the tax revenue on the $100 capital gain earned after 5 years would be $40.

If, however, enlightened new tax legislation were enacted eliminating all federal taxes on capital gains, the Treasury would lose the $40 of capital gains tax revenue.

But eliminating the capital gains tax would increase the after-tax return on the $100 capital investment by 67 percent (old return equal $60; new return equal $100; gain equal $40; 40 divided by 60 equal 67 percent). Given this increase in returns from investments; it's reasonable to suppose that investors would increase their investments to some extent. Let's assume for this example that the level of investments increased by 50 percent.

The AE survey has shown that for companies founded since 1955, the average annual federal taxes generated by $100 of investment is $22. Therefore, we would expect that the total federal tax revenues over 5 years resulting from each additional $50 investment would be $55 ($50 divided by $100 times $22 times 5 years). This more than offsets the $40 revenue loss.

The investor's gains from investments are small compared to the benefits

The AEA survey enables us to measure the gains received by investors for risking their capital in comparison to the benefits to the economy from those investments. In the case of tax revenues, the survey shows that the investor's potential annual gains are less than the annual tax revenues to federal, state, and local governments generated by those investments. In addition, those investments generate the jobs, technological developments, and export sales needed to combat our economic problems.

EXHIBIT 5.—*Investor gains compared to benefits their investments produce*

(Per $100 invested in companies founded since 1955)

Investor: Average annual gain equals $22

But this gain:

Is pre-tax.

Is often not liquid—can't be realized.

Is largely due to inflation.

Ignores unsuccessful investments that also produce benefits.

Economy:

Benefits in 1976:

Total taxes paid equals	$26
Salary and wages paid equals	72
R. & D. expenditures equals	20
Export sales equals	76

Mr. Chairman, we believe that the essential point to be learned from the AEA survey data is that invested capital is unique in its ability to create benefits to this nation. A one-time investment can generate a stream of annual benefits.

For that reason, gains from investments should be viewed differently than ordinary income. The gains are incentives for individuals to risk their capital and make those investments. Taxes on those gains aren't just revenues to the government. They're also disincentives that discourage individuals from making such investments. Substantially reducing or eliminating those disincentives would be the most direct and perhaps the only way to stimulate the risk capital investment that this country needs so desperately.

Mr. Chairman, we hope that the AEA survey data will help this Subcommittee and the Senate Finance Committee in formulating and analyzing tax policy alternatives. In addition to the data summaries contained in this testimony, the Association would be pleased to perform further analyses of the raw data or to solicit other information from our membership that you might request.

I thank you for your attention and would welcome your questions.

APPENDIX I

WEMA CAPITAL FORMATION SURVEY OF HIGH-TECHNOLOGY COMPANIES

INSTRUCTIONS

While the form is self-explanatory, the following comments are included to help avoid any misunderstanding.

1. Each column should contain information for a single year, except for "Equity Capital Raised" which, as explained in footnote 3, should show aggregate raised during the five-year periods 1956–1960, 1961–1965, 1966–1970, and 1971–1975.
2. The first five line items all refer to income statement items. Thus, "Federal Corporate Income Taxes" (including the total of current and deferred), "State and Local Taxes," and "Company Funded R&D" should reflect the expense for the year. If R&D amounts were capitalized prior to 1975, please show the R&D expenditures actually made during the year (equivalent to the restated amounts required under SFAS #2).
3. Line items for "Total Assets," "Shareholders' Equity," "Retained Earnings," and "Total U.S. Employees" refer to balances or amounts at the end of the year.
4. "Employee Federal Income Taxes Withheld" should be the amount withheld during the year.
5. "Equity Capital Raised" should include the exercise of stock options and warrants as well as company-sponsored stock purchase plans. Companies that are subsidiaries should consider equity provided by the parent as "From Private Sources".

Divisional organizations should send this questionnaire and enclosed material to the parent company with the recommendation that the corporate office respond.

CAPITAL FORMATION SURVEY OF HIGH-TECHNOLOGY COMPANIES

(Fiscal or Calendar Year End Figures in Thousands of Dollars)

	1960	1965	1970	1975	1976
Total Revenues					
Total Foreign Revenues					
Company Funded R&D					
Federal Corporate Income Taxes (accrual basis)					
State and Local Taxes (1)					
Total Assets					
Total Shareholders' Equity (2)					
Retained Earnings					
Dividends Paid					
Equity Capital Raised During Period (2) (3)					
–From Private Sources					
–From the Public					
Total U.S. Employees					
Employee Federal Income Taxes Withheld					

________ Year company was founded.

________ Year company first sold equity securities to outside (nonmanagement) investors.

________ Year company stock was first publicly traded.

Name of Company ________

Name of Preparer ________

Telephone # ________

(1) including both income and property taxes; accrual basis.

(2) including all senior securities convertible into equity securities.

(3) for years other than 1976 show aggregate raised during the previous five-year period.

SEND DIRECTLY TO: Nicholas G. Moore
Coopers & Lybrand
Two Palo Alto Square
Palo Alto, CA 94304
(415) 493-1552

This data is submitted with the understanding that it will be held in confidence under the CPA Code of Ethics. It will be used only in aggregate industry compilations.

Appendix II

AEA SURVEY DATA

The data from the 325 survey respondents are summarized on the following pages. The data are summarized in total and by period of company foundings.

All dollar amounts are in thousands of dollars. However, all ratios involving dollars are in dollars. All other numbers are as they appear in the summaries.

The following abbreviations were used for identifying data line items.

Abbreviation	*Heading*
Tot Revenue	Total revenues.
Tot Foreign Revenue	Total Foreign revenue.
Funded R&D	Research and development expense.
Fed Inc Tax	Total Federal income tax expense.
S and L Taken	Total State and local tax expense.
Tot Assets	Total assets.
S/H Equity	Total shareholder equity (total net assets).
Ret Earning	Retained earnings.
Div Paid	Dividends paid.
Equity Raised	Equity raised.
Private	From private sources.
Public	From public sources.
Tot US Employee	Total U.S. employees.
Emp Fit W/H	Total Federal income taxes withheld from employees.
Cum Tot Equity	Cumulative Total equity raised.
Private (dollars)	From private sources ($000's).
Private (percent)	From private sources as a percentage of total cumulative equity.
Public (dollars)	From public source ($000's).
Public (percent)	From public source as a percentage of total cumulative equity.
Rev/Cum Equity	Revenues reported per dollar of cumulative equity raised.
R&D/Cum Equity	Research and development expense per dollar of cumulative equity raised.
Fed Tax/Cum Equ	Federal income tax expense per dollar of cumulative equity raised
S&L Tax/Cum Equ	State and local tax expense per dollar of cumulative equity raised.
T Asset/Cum Equ	Total assets per dollar of cumulative equity raised.
Employees	Total U.S. employees.
Period Incr	Increase in total U.S. employees.
T Asset/Job	Total assets per U.S. employee (in dollars).
Revenue/Job	Total revenue per U.S. Employee (in dollars).
Cum Equity/Job	Cumulative equity raised per U.S. employee.

For companies founded prior to 1955, the equity raised prior to 1955 was not submitted in the survey data. The employee taxes withheld were only submitted for the years 1960 and later. Therefore, data regarding these items does not appear on the following summary sheets.

ALL RESPONSES—ALL SALES (NUMBER OF RESPONSES, 325)

	1960	1965	1970	1975	1976
Total revenue	6,411,434	11,457,221	22,487,095	40,347,910	45,262,982
Total foreign revenue	873,975	2,213,450	5,941,056	14,871,016	16,392,510
Funded R. & D	218,232	431,437	1,010,159	2,027,570	2,228,119
Federal income tax	325,763	611,512	909,411	1,304,076	1,798,109
State and local taxes	64,197	215,185	328,761	645,602	689,980
Total assets	4,564,148	9,257,122	22,704,467	37,495,305	41,630,910
Stockholders equity	2,692,853	5,503,596	12,759,246	21,427,309	24,366,325
Retained earnings	1,215,502	3,126,705	6,801,380	12,910,481	15,197,088
Dividend paid	169,985	326,896	778,167	1,251,362	1,510,622
Equity raised	501,884	520,807	2,744,987	2,757,907	563,092
Private	103,842	127,345	224,657	391,135	75,145
Public	398,042	395,664	2,520,203	2,365,981	487,990
Total U.S. employee	330,612	511,780	700,985	719,174	746,851
Employee Federal income tax withholding			291,665	690,804	782,708
Cumulative total equity	501,884	1,022,691	3,767,678	6,525,585	7,088,677
Private:					
Dollars	103,842	231,187	455,844	846,979	922,124
Percent	20.69	22.61	12.10	12.98	13.01
Public:					
Dollars	398,042	793,706	3,313,909	5,679,890	6,167,880
Percent	79.31	77.61	87.96	87.04	87.01
Employees	330,612	511,780	700,985	719,174	746,351
Period increase		181,168	189,205	18,189	27,677
Total asset/job	13,805	18,088	32,389	52,136	55,741
Revenue/job	19,392	22,387	32,079	56,103	60,605

FOUNDED PRIOR TO 1955—ALL SALES (NUMBER OF RESPONSES, 47)

	1960	1965	1970	1975	1976
Total revenue	6,378,827	11,268,278	21,379,349	36,108,725	39,820,822
Total foreign revenue	873,821	2,208,009	5,753,787	13,745,599	14,982,796
Funded R. & D	217,475	420,781	915,315	1,735,316	1,857,403
Federal income tax	324,816	603,593	877,994	1,189,281	1,612,451
State and local taxes	64,025	213,355	316,555	598,515	618,165
Total assets	4,544,458	9,057,009	21,456,617	34,138,680	37,339,004
Stockholders equity	2,683,280	5,423,603	12,222,313	19,788,214	22,046,341
Retained earnings	1,214,030	3,107,298	6,787,420	12,603,072	14,533,466
Dividend paid	169,818	326,651	776,896	1,247,166	1,503,295
Equity raised	495,517	461,607	2,191,931	1,831,176	271,914
Private	99,919	94,242	66,314	73,387	15,642
Public	395,598	367,365	2,125,617	1,757,789	256,272
Total U.S. employee	329,179	503,411	657,943	612,394	615,654
Employee Federal income tax withholding			248,499	515,851	557,409
Cumulative total equity	495,517	957,124	3,149,055	4,980,231	5,252,145
Private:					
Dollars	99,919	194,161	260,475	333,862	349,504
Percent	20.16	20.29	8.27	6.70	6.65
Public:					
Dollars	395,598	762,963	2,888,580	4,646,369	4,902,641
Percent	79.84	79.71	91.73	93.30	93.35
Employees	329,179	503,411	657,943	612,394	615,654
Period increase		174,232	154,532	-45,549	3,260
Total asset/job	13,805	17,991	32,611	55,746	60,649
Revenue/job	19,377	22,383	32,494	58,963	64,680

FOUNDED 1956 TO 1960—ALL SALES (NUMBER OF RESPONSES, 26)

	1960	1965	1970	1975	1976
Total revenue	32,607	120,217	535,263	1,588,638	1,978,533
Total foreign revenue	154	3,960	103,120	525,741	636,727
Funded R. & D	807	5,106	29,386	115,179	135,550
Federal income tax	947	5,136	15,224	35,830	50,994
State and local taxes	172	1,569	6,540	17,306	21,961
Total assets	19,690	153,142	519,721	1,329,257	1,715,945
Stockholders equity	9,573	59,893	242,586	733,947	1,030,316
Retained earnings	1,472	20,536	39,942	297,630	424,304
Dividend paid	167	185	192	1,013	2,068
Equity raised	6,367	35,874	203,822	304,179	150,310
Private	3,923	25,592	52,081	83,488	7,794
Public	2,444	10,282	151,741	220,691	142,516
Total U.S. employee	1,433	5,251	18,483	40,270	48,769
Employee Federal income tax withholding			15,413	69,303	86,590
Cumulative total equity	6,367	42,241	246,063	550,242	700,552
Private:					
Dollars	3,923	29,515	81,596	165,084	172,878
Percent	61.61	69.87	33.16	30.00	24.68
Public:					
Dollars	2,444	12,726	164,467	385,158	527,674
Percent	38.39	30.13	66.84	70.00	75.32
Revenue:					
Cumulative equity	5.12	2.85	2.18	2.89	2.82
R. & D	.13	.12	.12	.21	.19
Federal tax	.15	.12	.06	.07	.07
State and local tax	.03	.04	.03	.03	.03
Total asset	3.09	3.63	2.11	2.42	2.45
Employees	1,433	5,251	18,483	40,270	48,769
Period increase		3,818	13,232	21,787	8,499
Total asset/job	13,740	29,164	28,118	33,008	35,185
Revenue/job	22,754	22,894	28,959	39,449	40,569
Cumulative equity job	4,443	8,044	13,312	13,663	14,364

FOUNDED 1961 TO 1965—ALL SALES (NUMBER OF RESPONSES, 38)

	1960	1965	1970	1975	1976
Total revenue	0	68,726	395,909	1,012,574	1,196,164
Total foreign revenue	0	1,481	67,984	280,201	320,303
Funded R. & D	0	5,550	38,907	50,253	64,152
Federal income tax	0	2,783	9,980	22,685	32,535
State and local taxes	0	261	3,685	9,340	18,625
Total assets	0	46,971	551,272	749,917	876,243
Stockholders equity	0	20,100	202,475	294,821	407,833
Retained earnings	0	−1,129	25,368	−7,535	92,882
Dividend paid	0	60	1,079	1,931	2,480
Equity raised	0	23,326	208,948	116,999	10,798
Private	0	7,511	18,614	21,925	6,036
Public	0	18,017	190,334	95,074	4,762
Total U.S. employee		3,118	16,627	23,520	26,235
Employee Federal income tax withholding	0		20,282	37,127	47 965
Cumulative total equity	0	23,326	232,274	349,273	360,071
Private:					
Dollars	0	7,511	26,125	48,050	54,086
Percent	0	32.20	11.25	13.76	15.02
Public:					
Dollars	0	18,017	208,351	303,425	308,187
Percent	0	77.24	89.70	86.87	85.59
Cumulative equity:					
Revenue	0	2.95	1.70	2.90	3.32
R. & D	0	.24	.17	.14	.18
Federal tax	0	.12	.04	.06	.09
State and local tax	0	01	.02	.03	.05
Total assets	0	2.01	2.37	2.15	2.43
Employees	0	3,118	16,627	23,520	26,235
Period increase	0	3,118	13,509	6,893	2,715
Total asset/job	0	15,064	33,155	31,884	33,399
Revenue/job	0	22,041	23,811	43,051	45,594
Cumulative equity/job	0	7,481	13,969	14,850	13,724

FOUNDED 1966 TO 1970—ALL SALES (NUMBER OF RESPONSES, 135)

	1960	1965	1970	1975	1976
Total revenue	0	0	176,574	1,482,998	2,019,745
Total foreign revenue	0	0	16,165	292,316	406,101
Funded R. & D.	0	0	26,551	111,931	143,769
Federal income tax	0	0	6,213	52,461	86,883
State and local taxes	0	0	1,981	18,900	28,123
Total assets	0	0	176,857	1,198,264	1,550,499
Stockholders equity	0	0	91,872	584,935	823,837
Retained earnings	0	0	−51,350	29,761	150,234
Dividend paid	0	0	....	1,252	2,716
Equity raised	0	0	140,286	465,287	102,953
Private	0	0	87,648	180,871	18,558
Public	0	0	52,511	283,625	84,438
Total U.S. employee	0	0	7,932	38,531	49,077
Employee Federal income tax withholding	0	0	7,471	61,723	80,873
Cumulative total equity	0	0	140,286	605,573	708,526
Private:					
Dollars	0	0	87,648	268,519	287,077
Percent	0	0	62.48	44.34	40.52
Public:					
Dollars	0	0	52,511	336,136	420,574
Percent	0	0	37.48	55.51	59.36
Cumulative equity:					
Revenue	0	0	1.26	2.45	2.85
R. & D.	0	0	.19	.18	.20
Federal tax	0	0	.04	.09	.12
State and local tax	0	0	.01	.03	.04
Total asset	0	0	1.26	1.98	2.19
Employees	0	0	7,932	38,531	49,077
Period increase	0	0	7,932	30,599	10,546
Total asset/job	0	0	22,296	31,098	31,591
Revenue/job	0	0	22,260	38,488	41,154
Cumulative equity/job	0	0	17,686	15,716	14,437

FOUNDED 1971 TO 1975—ALL SALES (NUMBER OF RESPONSES: 77)

	1960	1965	1970	1975	1976
Total revenue	0	0	0	154,980	246,787
Total foreign revenue	0	0	0	27,159	46,583
Funded R. & D.	0	0	0	14,891	21,833
Federal income tax	0	0	0	3,819	10,246
State and local taxes	0	0	0	1,541	3,062
Total assets	0	0	0	79,187	147,570
Stockholders equity	0	0	0	25,392	57,539
Retained earnings	0	0	0	−12,447	−3,799
Dividend paid	0	0	0	....	63
Equity raised	0	0	0	40,266	26,517
Private	0	0	0	31,464	26,515
Public	0	0	0	8,802	2
Total U.S. employee	0	0	0	4,459	7,031
Employee Federal income tax withholding	0	0	0	6,404	9,735
Cumulative total equity	0	0	0	40,266	66,783
Private:					
Dollars	0	0	0	31,464	57,979
Percent	0	0	0	78.14	86.82
Public:					
Dollars	0	0	0	8,802	8,804
Percent	0	0	0	21.86	13.18
Cumulative equity:					
Revenue	0	0	0	3.85	3.69
R. & D.	0	0	0	.37	.33
Federal tax	0	0	0	.09	.15
State and Local tax	0	0	0	.04	.05
Total asset	0	0	0	1.97	2.21
Employees	0	0	0	4,459	7,031
Period increase	0	0	0	4,459	2,572
Total asset/job	0	0	0	17,758	20,988
Revenue/job	0	0	0	34,756	35,092
Cumulative equity/job	0	0	0	9,030	9,498

FOUNDED 1976—ALL SALES (NUMBER OF RESPONSES: 2)

	1960	1965	1970	1975	1976
Total revenue	0	0	0	0	981
Total foreign revenue	0	0	0	0	0
Funded R. & D	0	0	0	0	412
Federal income tax	0	0	0	0	0
State and local taxes	0	0	0	0	44
Total assets	0	0	0	0	1,709
Stockholders equity	0	0	0	0	459
Retained earnings	0	0	0	0	1
Dividend paid	0	0	0	0	0
Equity raised	0	0	0	0	600
Private	0	0	0	0	600
Public	0	0	0	0	0
Total U.S. employee	0	0	0	0	85
Employee Federal income tax withholding	0	0	0	0	136
Cumulative total equity	0	0	0	0	600
Private:					
Dollars	0	0	0	0	600
Percent	0	0	0	0	100
Public:					
Dollars	0	0	0	0	0
Percent	0	0	0	0	0
Cumulative equity:					
Revenue	0	0	0	0	1.64
R. & D	0	0	0	0	.69
Federal tax	0	0	0	0	0
State and local tax	0	0	0	0	.07
Total asset	0	0	0	0	2.85
Employees	0	0	0	0	85
Period increase	0	0	0	0	85
Total asset/job	0	0	0	0	20,105
Revenue/job	0	0	0	0	11,541
Cumulative equity/job	0	0	0	0	7,058

Senator PACKWOOD. The next witness is Dr. Martin Feldstein Doctor, it is good to have you with us again.

STATEMENT OF MARTIN FELDSTEIN, PRESIDENT, NATIONAL BUREAU OF ECONOMIC RESEARCH AND PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY, CAMBRIDGE, MASS.

Mr. FELDSTEIN. Thank you, Senator.

I am very pleased to have this chance to talk with you this morning.

During the past 3 years, I have been doing research on the taxation of capital gains on corporate stocks. I think the findings of these studies, which we are just finishing up now, bear directly on the proposals that you are currently considering.

This morning I want to summarize briefly the results of two studies. The first describes the way that inflation actually affects the taxation of capital gains. The second deals with the impact of the capital gains tax rate on the selling of corporate stock and the realizing of capital gains. I think the latter study is the first bit of hard evidence on the actual effect that the kinds of proposals you are considering would have on the realizing of capital gains, and therefore on Treasury tax revenue.

I am submitting for the record copies of two papers that provide more complete reports of these studies.

Senator PACKWOOD. Those will be included in the record.

[The information referred to follows:] (Hearing continues on p. 322.)

THE EFFECTS OF THE CAPITAL GAINS TAX ON THE SELLING AND SWITCHING OF COMMON STOCK

(By Martin Feldstein,* Harvard University, Cambridge, MA 02138, U.S.A., and the NBER; and Shlomo Yitzhaki, Rehovat University and the Falk Institute, Jerusalem, Israel. Received February 1977)

I. INTRODUCTION

The present method of taxing capital gains is one of the most widely criticized features of the U.S. tax system. Under current law, capital gains are taxed only when an asset is sold and are generally subject to a special tax rate that is less than or equal to half of the tax rate that would apply to ordinary income; the tax applies to the nominal increase in value with no adjustment for inflation. Reformers in the Haig-Simons tradition advocate taxing all realized capital gains at ordinary tax rates and regard the current system as a $5 billion tax subsidy to wealthy investors. Other suggestions for reform include taxing capital gains on an accrual basis (usually by adjusting the tax liability at a time when gains are realized for the implicit postponement of taxes), adjusting the amount of the capital gain for the effects of inflation, eliminating the 'alternative tax' procedure that limits the tax rate to 25 percent, reducing the tax rate as a function of the holding period, taxing all capital gains at the death of the owner, or abandoning the taxation of capital gains completely in favor of a tax on consumption or wealth.[1]

The choice between the present tax law and any of the proposed reforms should reflect the way in which the behavior of investors is affected by taxation. For example, the criticism that the current rules keep investors 'locked into' previously purchased securities (because taxes are postponed until the asset is sold) would apply with even greater force to the proposal to tax realized gains at ordinary tax rates but would be avoided by appropriate systems of accrual taxation or by the substitution of a consumption tax. The importance of this issue depends on the extent to which tax considerations do influence investors' decisions to sell assets.

The present paper presents what we believe to be the first econometric estimates of the effect of taxation on the selling of common stock.[2] Our analysis indicates that investors are quite sensitive to tax considerations in their decisions to sell common stock. An important feature of our data is that it permits separating 'switches' of common stock (i.e. sales followed by purchases of different stock or other financial assets) from 'net sales' in which the proceeds are not reinvested; the evidence indicates that the portfolio reallocation decisions ('switches') are particularly sensitive to tax considerations.[3]

The first section of the paper discusses the way in which taxes and other variables might be expected to affect the common stock sales of individual investors. Section 2 describes the household survey data that is used in the current study. The estimated parameters are discussed in sections 3 and 4 and simulations of three alternative tax policies are presented in section 5. There is a brief concluding section in which we indicate possible directions for future work.

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[1] Alternative proposals to reform the taxation of capital gains are discussed in (among others: Andrews (1974), Break and Pechman (1975), Brinner (1973), David (1968), Diamond (1975), Feldstein (1976b), Fleming and Little (1974), Surrey et al. (1976). The estimated tax subsidy is presented in U.S. Senate (1976).

[2] There have, of course, been previous studies of the likely effect of taxation on the sale of stocks and other assets but none of these presented specific econometric evidence. See in particular the valuable studies by Bailey (1969), David (1968), Holt and Shelton (1962), McClung (1966) and Barlow et al. (1966).

[3] There is the further issue of how the tax treatment of capital gains affects the way that investors allocate their wealth between common stock and other assets. Feldstein (1976a) presents evidence that the current rules substantially increase investment in common stock by individuals with high marginal tax rates.

2. TAXATION AND COMMON STOCK SALES

In considering how taxes are likely to affect the sales of common stock, it is useful to begin with the prior question of why individuals sell the stock that they own. Two quite different types of selling can be distinguished. First, individuals sell stock to finance consumption during retirement or to pay for the college education of children, the purchase of an automobile, or other large expenses. We shall refer to such transactions as 'net sales' because the proceeds are not reinvested. Second, individuals sell stock to reallocate their portfolios into different stocks and other financial assets. The data analyzed below indicate that most of the proceeds of stock sales are in fact reinvested in other stock; we shall refer to such sales as 'stock switches.' More generally, 'financial switches' (i.e. sales of common stock with the proceeds reinvested within one year in stocks or other financial assets) account for about two thirds of the value of common stock sales.

Although the theory of efficient markets might at first seem to imply that individuals can do as well by holding their initial portfolios as they can by switching securities,[4] there are two distinct reasons why a rational investor who believes in the efficiency of the stock market would sell one stock and buy another. The general theory of optimal portfolio selection implies that even with unchanged expectations and tastes, individuals should continually rediversify their portfolios by selling some of the stocks which have appreciated in value and buying more of the stocks that have declined in value.[5] In addition, the optimal portfolio of an individual will change if there is a change in his risk aversion, induced for example by a change in his wealth.[6] In practice, of course, individual investors frequently believe that stocks do have different ex ante expected yields even with the same risk characteristics; i.e. investors implicitly reject the idea that the stock market is fully efficient and believe that their insights, judgments and tips are sufficient to 'beat the market.' Each of these reasons implies that, in the absence of transaction costs and tax considerations, investors would engage in frequent and substantial asset switches.

The current tax law should reduce 'switch sales' and may also reduce 'net sales.' Switch sales are deterred because the seller cannot reinvest all of the proceeds but must pay some of his receipts as a capital gains tax. This tax is an increasing function of both the individual's marginal tax rate and of the fraction of the sale proceeds that represents capital gain. More specifically, the rate of tax on capital gains is one half of the individual's tax rate for ordinary income, up to a maximum capital gains tax rate of 25 percent; no capital gains tax is due when an investor dies and all assets are then revalued to the current market price, thereby permanently eliminating any tax liability for previous gains.[7] An example will illustrate the potential importance of these rules. An individual with a 50 percent marginal tax rate who sells $100 worth of stock that has doubled in price since he bought it [8] pays a capital gains tax of $12.50. This tax could be postponed and therefore reduced in present value if the stock were instead sold at a later date; the tax would be avoided completely if the individual died before the stock was sold. The higher an individual's marginal tax rate on capital gains, the greater the deterrent to switch selling.

The effect of the tax on *net* sales is ambiguous because of two countervailing effects that are similar to substitution and income effects. The 'substitution' effect of the higher tax rate induces the investor to postpone consumption, to reduce the size of major purchases, and to plan larger bequests. The offsetting 'income' effect occurs because a higher rate means that a larger gross sale must be made to obtain any given amount of after tax revenue. If the expenditures to be financed by selling assets cannot easily be postponed or reduced in size, the effect of the tax will be to increase net selling. Since an increase in the individual's marginal tax rate on capital gains strengthens both the income and substitution effects, the relation between net selling and the individual's marginal tax rate is ambiguous.

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[4] For a brief summary of the theory of efficient markets and extensive references, see Jensen (1972).

[5] See, for example, the analyses of Merton (1969) and Samuelson (1969).

[6] If money is not regarded as a riskless asset (because of uncertain inflation), a change in risk aversion would in principle require a general reallocation of portfolio wealth and not just changing the shares of money and non-money assets.

[7] This was the rule prevailing in the year for which our data were collected (1963). The maximum tax rate for ordinary income was then 92 percent. Assets held less than 6 months were subject to tax at the ordinary income rate; we ignore the special 6 months rule in our current analysis.

[8] On average, stock bought in 1954 had more than doubled in price by 1963 (the year of the survey).

The special provision for revaluing assets when the investor dies (known as 'stepping up' the basis of the asset to market value) implies that the tax deterrent to selling should increase with the investor's age. For any given positive marginal tax rate, an older investor has a higher expected tax saving by postponing a sale for a year. This is reinforced by the tendency for the assets of older investors to have a higher ratio of accrued gain to market value. Both of these reasons should make selling and especially switching a decreasing function of age. We shall refer to this as the pure age effect.

The effects of the individual's age and marginal tax rate also interact to reinforce each other. The greater deterrent to selling that is associated with a higher marginal tax rate is an increasing function of age. Similarly, the greater deterrent to selling that is associated with older age is an increasing function of the individual's marginal tax rate. This suggests that we consider the possibility of a positive age-tax interaction effect.

Age also has an effect on net selling that has nothing to do with taxes. Older individuals are more likely to be net sellers in order to finance retirement consumption. This makes the effect of age ambiguous for net selling but dows not alter the implications for switch selling.

Two other variables are likely to affect the individual's decision to sell common stock and the fraction of all such stock that he sells: the value of the stock in the individual's portfolio and the level of the individual's income. To understand the likely effect of the size of the portfolio or the probability and value of different types of asset sales, it is useful to think of the portfolio as a collection of different individual stock. A larger portfolio is likely to have a greater number of different stocks so that the probability of selling at least one stock should be an increasing function of portfolio size. Individuals with large portfolios may also be more likely to switch securities because they can justify a greater investment of time and resources in acquiring relevant information. Although the probability of selling is therefore likely to be an increasing function of portfolio size, the ratio of sales to portfolio value is likely for two reasons to vary inversely with the size of the portfolio. First, switching two of three securities in a small portfolio could involve switching 50 percent of the portfolio's market value. In addition, any net sale of stock to finance a major consumption expenditure could more easily represent a large fracton of a small portfolio.

The probability of switching at least some stock and the ratio of such switch sales to the total value of stock should both, ceteris paribus, increase with the investor's income. Higher income individuals can afford the risks of speculation, generally have greater confidence in their own ability to make good investment decisions, and are more likely to have access to relevant investment information. Again net sales are not likely to follow the same pattern as switches; individuals with lower money incomes are more likely to be retired or otherwise below their permanent income and therefore more likely to want the proceeds of the net sales of common stock.

3. DATA AND DEFINITIONS

In 1963 and 1964, the Board of Governors of the Federal Reserve System conducted a national survey of 2557 households.[9] With the assistance of the Internal Revenue Service, the survey was able to oversample greatly the high income population; for example, 18 percent of the sample but less than one percent of the population had incomes over $25,000. Although the survey was done more than ten years ago, these data remain the best source of information for the current analysis because they permit separate measurement of 'switch' selling and 'net' selling.

The survey includes detailed information on the composition of assets, the sources of income, and the sales and purchases of assets during 1963.[10] Of the 2557 households, 646 usable observations had common stock at the end of 1962;[11] these 646 observations, representing a population of 7.7 miiiion common stock owners,[12] are the basic data used in our study.

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[9] See Projector and Weiss (1966) for a description of the survey methods and for counts of the number of respondents by income, wealth etc. Ferber (1969) discusses the problems of reporting errors in these data. Feldstein (1976a) used these data to analyze the effects of taxation on portfolio composition.

[10] There is no reliable information on the amount of gain realized on these common stock sales.

[11] There were 751 observations with common stock but 105 of these lacked other information required for our study.

[12] This estimate is based on the sampling weights in the survey. Note that it treats a household as a single owner

Based on our sample, 27 percent of stock owners in the population sold common stock in 1963.[13] The value of the shares sold by this group was 12 percent of the total value of the common stock that they owned. A majority (56 percent) of those who sold stock during the year also purchased other stock, i.e. were 'switch sellers.' An additional 11 percent of stock sellers purchased financial assets other than stock; [14] i.e. financial switch sellers consituted 67 percent of all stock sellers. Half of this group (33 percent of all stock sellers) reinvested all of the proceeds of their stock sales (net of tax) in stock or other financial assets.

Stock switches accounted for 58 percent of the value of common stock sales, i.e. 58 percent of the value of common stock sale proceeds were reinvested in common stock by the end of 1963.[15] Using the broader concept of 'finarcial switches,' i.e. reinvestment in stock or other financial assets, raises the value of switches to 65 percent of stock sales. The stock sellers who reinvested all of their proceeds in stocks or other financial assets accounted for 28 percent of stock sales.

The marginal tax rate that is relevant for decisions about the sale of common stock is equal to the lesser of (1) one half of the individual's marginal tax rate and (2) 0.25. To prevent simultaneity between common stock sales and the marginal tax rate, we use the marginal tax rate applicable to the first dollar of capital gains. The survey did not specifically ask for the individual's taxable income or marginal tax rate. To estimate the relevant marginal tax rate, we first calculated total income from all taxable sources excluding capital gains. We then subtract the value of personal exemptions and an estimate of total deductions based on the value of the individual's residence, his outstanding debt, and the mean of the other itemized deductions in his income class. With this as an estimate of taxable income before capital gains, we use the relevant tax schedule to find the individual's marginal tax rate.[16]

The survey contains information about the age of the household head, the value of common stock owned at the end of 1962, and the total income (including tax free income but excluding capital gains) for 1962 and 1963. We average the incomes of 1962 and 1963 to achieve a better measure of permanent income. Finally, in our estimates we use classificatory dummy variables for age, wealth and income to avoid imposing any unnecessary constraints on the form of the functional relations.

4. COMMON STOCK SALES: BASIC ESTIMATES

Although we have emphasized the likely behavioral differences between switch sales and net sales, we begin our econometric analysis by studying all sales combined. This yields a measure of the overall tax impact and provides estimates that can be compared with future results in other bodies of data that lack information on reinvestment.[17]

The estimates presented in table 1 imply that higher tax rates are a substantial deterrent to the sale of common stock. To appreciate the magnitude of this effect, it is useful to discuss the tax rate coefficient in equation (1) in some detail

[13] This percentage and the other figures in this and the next paragraph are estimates of population values based on the sampling probabilities associated with our 646 observations.

[14] That is, made net investments in other financial assets. We exclude cash and demand deposits in defining financial assets.

[15] More formally, the value of "switch sales" is the minimum of the values of sales and stock purchases, both in 1963. Since stock sold in 1963 and reinvested in stock in 1964 is not counted, the 58 percent is likely to be an underestimate.

[16] The use of mean deductions by income class implies that the estimated marginal tax rate for each individual will not be an exact measure but (to a linear approximation) the mean value for such individuals. This type of measurement error introduces no bias in the estimated regression coefficients because the error is uncorrelated with the observed value. A different problem results from our inability to observe accounting losses (e.g. oil depletion allowances, accelerated depreciation, etc.) that reduce the adjusted gross income of high income individuals. To the extent that such losses still leave the individual's marginal tax rate above 50 percent (i.e. a taxable income of $36,000 for a married couple in 1963), they have no effect on the estimated marginal tax rate for capital gains; this is the likely effect since investments with substantial accounting losses are generally unprofitable at lower tax rates. Insofar as the actual capital gains tax rates of high income individuals are lower on average than the values we have used, our estimated coefficient will understate the responsiveness of sales to the tax rate.

[17] All of the equations in this study have been estimated by ordinary least squares: The equations might have been estimated by a logit regression but, with nearly half of the sample selling stock, there is likely to be little difference between logit and linear ordinary least squares regression. A Two-bit procedure would be inappropriate for the equations dealing with the ratio of sales to value since the total value of the individual's common stock has opposite effects on the probability of selling and the conditional value of the sales.

before turning to the other equations. The dependent variable of this equation is the ratio of the value of common stock sales to the value of the initial holding of common stock.[18] The capital gains tax rate variable has a coefficient of −3.2 with a standard error of 1.0. This point estimate indicates that the capital gains tax has a very powerful effect. It implies, for example, that a capital gains marginal tax rate of 0.15 (based on an ordinary marginal tax rate of 0.30) reduces the ratio of sales to value by 0.48.[19] This is twice the sample mean of the sales-value ratio (0.24), implying that in the absence of the capital gains tax the value of common stock sales for individuals with this marginal rate would have been about three times as large as it was in 1963.

Although this may seem a very large response to a seemingly small tax change, two things should be borne in mind. First, many investors already sell very much more than the average. Since the standard deviation of the sales-value ratio in the sample is 0.82, the calculated change of 0.48 represents an increase of about one-half a standard deviation. Second, the tax rate may not be small in relation to the gains that would otherwise motivate individuals to sell assets. An individual might well sell one stock and buy another for an expected gain of 5 percent if there were on tax but would be dissuaded from making the switch if a tax of as little as say 6 percent (i.e., a 15 percent tax on a gain equal to 40 percent of the value of the stock to be sold) had to be paid.

TABLE 1.—THE EFFECTS OF TAXATION ON COMMON STOCK SALES.[1]

Explanatory variables	Ratio of sales to value			Decision to sell			Ratio of sales to value among sellers	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Tax rate on capital gains	−3.20	−3.16	−2.15	−0.65	−0.84	+0.21	−4.93	−4.7
	(1.04)	(1.10)	(1.36)	(.58)	(.62)	(.76)	(1.95)	(2.04)
Age:								
Less than 35	.15		1.10	.16		.42	.01	
	(.14)		(.34)	(.08)		(.19)	(.31)	
36 to 45	.04		.18	.14		.33	−.06	
	(.12)		(.29)	(.06)		(.16)	(.24)	
46 to 55	.01		.31	.08		.28	−.03	
	(.11)		(.28)	(.06)		(.16)	(.22)	
56 to 65	.02		.11	.03		.28	.07	
	(.10)		(.28)	(.06)		(.16)	(.21)	
Tax rate—age interaction:								
Less than 35		−.16	−6.66		.61	−1.58		−1.45
		(.84)	(2.13)		(.47)	(1.19)		(1.68)
36 to 45		.02	−.78		.49	−1.09		−.18
		(.62)	(1.56)		(.34)	(.88)		(1.13)
46 to 55		−.23	−1.68		.22	−.22		−.30
		(.55)	(1.45)		(.30)	(.81)		(1.00)
56 to 65		−.03	−.54		−.06	−1.37		.30
		(.51)	(1.42)		(.29)	(.80)		(.95)
Value of common stock:								
Less than $4,000	.32	.36	.34	−.46	−.45	−.46	1.71	1.75
	(.13)	(.13)	(.13)	(.07)	(.07)	(.07)	(.29)	(.28)
$4,000 to $10,000	.42	.44	.45	−.23	−.22	−.22	1.05	1.08
	(.14)	(.15)	(.14)	(.08)	(.08)	(.08)	(.28)	(.28)
$10,000 to $50,000	.16	.17	.19	−.30	−.30	−.29	.44	.44
	(.12)	(.12)	(.12)	(.07)	(.07)	(.07)	(.22)	(.23)
$50,000 to $200,000	.25	.26	.28	−.18	−.17	−.17	.49	.51
	(.12)	(.12)	(.12)	(.06)	(.07)	(.07)	(.21)	(.21)
Income:								
Less than $10,000	−.73	−.73	−.76	−.25	−.26	−.27	−1.11	−1.10
	(.19)	(.19)	(.19)	(.11)	(.10)	(.11)	(.40)	(.39)
$10,000 to $25,000	−.52	−.53	−.55	−.15	−.15	−.17	−.87	−.88
	(.15)	(.15)	(.15)	(.08)	(.08)	(.08)	(.29)	(.29)
$25,000 to $60,000	−.13	−.13	−.14	.01	.01	.01	−.14	−.15
	(.10)	(.10)	(.10)	(.06)	(.06)	(.06)	(.18)	(.18)
Constant	.91	.93	.72	.82	.89	.67	1.37	1.36
	(.27)	(.27)	(.32)	(.15)	(.15)	(.18)	(.51)	(.49)
R^2	.04	.04	.06	.17	.17	.18	.19	.19
Sample size	646	646	646	646	646	646	263	263
Mean	.24	.24	.24	.41	.41	.41	.59	.59
S.D.	.82	.82	.82	.49	.49	.49	1.20	1.20
Population mean	.12	.12	.12	.27	.27	.27	.22	.22

[1] Coefficients of the omitted groups for age, tax-age interaction, value of common stock, and income are all zero by construction. Standard errors are shown in parentheses.

[18] Readers should note that a high sales-value ratio can indicate that a large fraction of shares are sold or that a small fraction is subject to very frequent turnover or any combination of these two.

[19] A marginal tax rate of 0.30 is approximately the weighted average of the marginal tax rates for common stock owners at the present time, weighing by the amounts of dividends that they receive.

Equations (4) and (7) show that taxes affect both the decision to sell (i.e. the probability that a stock owner will sell any positive amount) and the conditional ratio of sales to value among those who do sell. The estimated effect on the conditional sales-value ratio is both larger and statistically more significant than the effect on the probability of selling. The difference between the two coefficients and the fact that less than half of the stock owners sold anything suggests that there may be three different types of investors: those who prefer to sell nothing under the current tax rules and are not affected by variations of tax rates within the observed sample; those whose decision of whether or not to sell at all is sensitive to differences in the tax rate; and those who sell a positive amount that varies with the tax rate. Only a different kind of longitudinal data would permit a further analysis of this idea. In any case, the very powerful response of the conditional ratio of sales to value indicates either that the effect of taxes on switch-selling dominates a countervailing effect on net-selling or both effects operate in the same direction.

The coefficients of the age variables generally support the importance of the tax effect. The ratio of sales to value decreases monotonically with age in equation (1).[20] This implies that the tax incentive not to sell that results from the stepped-up basis at death and the likely increase in the gain-value ratio with age outweigh (or at least offset) the greater volume of net sales that would be expected in older age to finance retirement consumption. Comparing equations (4) and (7) shows that age affects the decision to sell rather than the ratio of sales to value among sellers. The probability of selling in the youngest age group exceeds the probability of those over age 65 by 0.16 (s.e. = 0.08) and the differential declines monotonically with age.

The same picture emerges when the age and tax variables are allowed to interact. In equation (5) the age dummy variables are each multiplied by the individual's capital gains tax rate. This implies that the coefficient of the tax rate varies from -0.23 $(=-0.84+0.61)$ for those under age 35 to -0.90 $(=-0.84-0.06)$ for those age 55 to 64 and -0.84 for those over age 65. The tax effect on the decision to sell thus changes from a rather mild deterrent in the youngest age group to a quite powerful effect for those for whom the gain-value ratio is higher and the stepped-up basis at death appears as a more significant consideration; with a capital gain marginal tax rate of 0.15, the coefficient of -0.23 implies a reduction in the probability of selling of 0.034 (about 13 percent of the population's average probability of selling) while a coefficient of -0.90 implies a reduction in the probability of 0.135 (about 50 percent of the population's probability of selling). Equation 6 shows that the data are not rich enough to yield useful separate estimates of a pure age effect and an age-tax interaction effect. Equation (8) shows no age-tax interaction effects, just as equation (7) had shown no pure age effect. An equation with both a pure age effect and an age-tax interaction (not shown) provided no further indication of any age effect.

We indicate in section 1 why the probability of at least one sale is likely to increase with the size of the common stock portfolio while the conditional ratio of sales to value is likely to decrease. Equations 4 through 6 show that the probability of a sale does increase substantially with portfolio size. The probability differs between the smallest and largest portfolio classes by 0.46, nearly twice the mean probability for the population as a whole. Equations (7) and (8) also conform to our expectations, registering a sharp drop in the conditional ratio of sales to value with increasing portfolio size. The net effect, shown in equations (1) through (3), is a relatively weak pattern in which the sales-value ratio does not differ significantly among small and moderate size portfolios but is significantly lower among the largest portfolios.

All of the equations show that the probability of selling and the conditional value of sales increase with income. This seems to confirm that those with higher income act as if they have more information, more confidence in their ability to make choices, and a greater ability to bear risk. These effects appear to dominate retirement and other departures from permanent income as influences that would tend to increase selling at lower income levels.[21]

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[20] Note that the coefficient of the omitted age group variable (age 65 and older) is zero by construction. One such dummy variable must be omitted from each of the classificatory variable groups to prevent complete collinearity.

[21] It is of course possible that the income and tax variables are not measured well enough so that some of the observed pattern of the coefficients reflects interdependent measurement error. Differences in incomes and tax rates are so great that we doubt this but further analysis must await a better set of data.

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5. SWITCHING VERSUS NET SELLING

The estimates to which we now turn indicate that there is a substantial difference between switching and net selling. As we should expect for the reasons discussed in section 1, the tax has a much more powerful effect on switching than on net selling.

For the equations in table 2, switching is defined as selling common stock and buying other common stock. All sellers who are not switchers are classified as net sellers; i.e. a stock owner is classified as a net seller if he sold common stock in 1963 but did not buy any. The value of switches for each individual is the minimum of his sales and his purchases of common stock. Net sales are defined as the value of sales since, by definition, net sellers buy no stock.

Equation (1) of table 2 shows that the ratio of switches to value is significantly and substantially reduced by higher tax rates on capital gains.[22] The coefficient of −2.78 (s.e.=0.94) implies that a capital gains tax rate of 0.15 reduces the ratio of switches to total value by 0.42 .For comparison, the mean switch-value ratio in the sample is 0.16 and in the population it is 0.07.[23] The coefficients of the age variables are not significantly different from zero but have such large standard errors that they are also consistent with a variety of other possible patterns.

TABLE 2.—EFFECTS OF TAXATION ON COMMON STOCK SWITCHING AND NET SELLING.[a]

Explanatory variables (partial list)[b]	Switching to common stock				Net selling			
	Ratio of switches to value		Decision to switch		Ratio of net sales to value		Decision to sell net	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Tax rate on capital gains	−2.78	−2.63	−0.04	−0.42	0.02	0.01	−0.60	−0.42
	(.94)	(1.00)	(.53)	(.56)	(.32)	(.34)	(.42)	(.44)
Age:								
Less than 35	.08		.16		.03		0	
	(.12)		(.07)		(.04)		(.05)	
36 to 45	−0		.14		−0		−.01	
	(.10)		(.02)		(.04)		(.05)	
46 to 55	−.04		.12		.02		−.03	
	(.10)		(.05)		(.03)		(.04)	
56 to 65	−.01		.05		.01		−.02	
	(.09)		(.05)		(.03)		(.04)	
Tax rate—age interaction:								
Less than 35		−.59		.49		.31		.11
		(.76)		(.43)		(.26)		(.34)
36 to 45		−.16		.63		−.06		−.14
		(.56)		(.32)		(.19)		(.25)
46 to 55		−.39		.52		.05		−.30
		(.49)		(.28)		(.16)		(.22)
56 to 65		−.12		.22		.03		−.28
		(.46)		(.26)		(.16)		(.21)
R^2	.03	.03	.18	.18	.12	.02	.02	.02
Sample size	646	646	646	646	646	646	646	646
Mean	.16	.16	.29	.29	.06	.06	.12	.12
S.D.	.74	.74	.45	.45	.25	.25	.33	.33
Population mean	.07	.07	.15	.15	.02	.02	.12	.12

[a] A "switcher" is anyone who sells common stock and also buys common stock. The value of "switches" is the lesser of the values of the sales and the purchases. "Net sellers" are all others who sell common stock.

[b] The variables for the value of common stock and income and the constant term are not presented but were included in the regression. The coefficients for the omitted groups for age and tax-age interaction variables are zero by construction. Standard errors are shown in parentheses. Population means in cols. 1, 2, 5, and 6 are weighted by value of common stock. See text for more detailed definitions.

[22] Note that equation (1) of table 2 has exactly the same right-hand side explanatory variables as equation (1) of table 1. To simplify presentation, the coefficients of the income and wealth variables and the constant term are not shown. These coefficients are also omitted in all of the remaining equations of tables 2 and 3. Tables with the missing coefficients are available from the authors on request.

[23] The population mean of 0.07 weights observations by the value of common stock; this is equivalent to defining the population mean as the ratio of aggregate sales to aggregate value.

While the probability that an individual will switch some stock (equations (3) and (4)) does not appear to be influenced by differences in tax rates, the coefficients of the age variables do suggest that individuals are sensitive to the stepped-up basis at death or the greater gain-value ratios that are associated with older age. There is a slight fall in the probability of selling as age rises to about 50 years old, followed by quite substantial and statistically significant reductions for investors over age 55.

Table 2 does not present estimated equations for the conditional value of switches (analogous to equations (7) and (8) of table 1). It is, however, clear from a comparison of equations (1) and (3) that the powerful effect of taxes on the ratio of switches to value is due to the effect that taxes have on the conditional value of switches among those who do switch.

Equations (5) and (6) show that on balance taxes have no effect on the ratio of net sales to value. Equations (7) and (8) show a small tax effect on the probability of a net sale but the effect is statistically weak. Of course, this absence of any overall effect is not evidence that investors ignore tax considerations when deciding whether and by how much to reduce the value of their common stock holdings. As we explained in section 1, taxes have offsetting income and substitution type effects which make the overall impact indeterminate even if each effect is substantial separately. Similarly, while the substitution effect of the tax should be a more powerful deterrent to net sales among older persons, sales of stock to finance retirement consumption offset this pure tax effect; this could in principle account for the essentially monotonic decrease in the probability of net selling until age 65 followed by a substantial increase.

Recall that 'financial switches'—i.e. sales of common stock in which the proceeds are reinvested in stock or other financial assets (excluding cash and demand deposits)—account for about two-thirds of the value of all common stock sales. The estimates of table 2 (as well as other equations not presented here in which net selling is defined with respect to financial assets and not just stock) also indicate that such financial switches are also the primary if not the sole way in which the capital gains tax affects the actual value of assets sold. In the remainder of this section we shall therefore examine the effect of taxes on financial switches in more detail.

Table 3 distinguishes 'partial' switching to financial assets from 'total' switching A 'partial switcher' is anyone who sells common stock but does not dissave the entire amount of the sale, i.e. who reinvests some of the proceeds in stock or in the net accumulation of other financial assets. The value of the partial switch is the lesser of the value of the stock sold and the sum of the purchases of common stock plus other additions to net financial assets. A 'total switcher' is anyone who sells common stock and switcher all of the proceeds (net of tax) into either new common stock or other financial assets.[24] It is clear from these definitions that all 'total switchers' are also partial switchers. The importance of 'total switchers, is that they represent the pure case in which stock is sold to change the mix of portfolio assets and not to finance any consumption or nonportfolio investment. Unfortunately, such 'total switching' is relatively uncommon and therefore difficult to study; only 20 percent of sample stock owners were total switchers in comparison to the 41 percent who sold any stock. In the population, total switching accounted for only one-fourth of the value of stock sales. Moreover, the line between total switching and partial switching places too much emphasis on the discrete distinction of total reinvestment; this is bound to be a source of random variation that weakens the estimated effect.

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[24] The tax is calculated on the assumption that 40 percent of the value of the sale is taxable gain.

TABLE 3.—EFFECTS OF TAXATION ON SWITCHING TO ALL FINANCIAL ASSETS.[a]

Explanatory variables (partial list)[b]	Partial switching to financial assets				Total switching to financial assets			
	Ratio of switches to value		Decision to switch		Ratio of sales to value		Decision to switch	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Tax rate on capital gain	−2.26	−2.29	−0.05	−0.27	−1.07	−0.90	0.27	0.26
	(.85)	(.90)	(.55)	(.59)	(.67)	(.71)	(.49)	(.52)
Age:								
Less than 35	.15		.14		.12		.05	
	(.11)		(.07)		(.09)		(.06)	
36 to 45	.10		.10		−.02		.03	
	(.09)		(.06)		(.07)		(.05)	
46 to 55	.04		.09		−.00		.02	
	(.09)		(.06)		(.07)		(.05)	
56 to 65	.01		.03		.00		.02	
	(.08)		(.05)		(.07)		(.05)	
Tax rate—age interaction:								
Less than 35		−.25		.59		−.30		−.01
		(.68)		(.45)		(.54)		(.40)
36 to 45		.27		.37		−.36		−.02
		(.50)		(.33)		(.39)		(.29)
46 to 55		−.05		.33		−.20		−.04
		(.44)		(.29)		(.35)		(.25)
56 to 65		−.19		.03		−.18		−.01
		(.42)		(.27)		(.33)		(.24)
R^2	.03	.02	.15	.15	.02	.02	.09	.09
Sample size	466	646	646	646	646	646	646	646
Mean	.15	.15	.31	.31	.10	.10	.20	.20
S.D	.66	.66	.46	.46	.52	.52	.40	.40
Population mean	.08	.08	.18	.18	.03	.03	.09	.09

[a] A "partial switcher to financial assets" is anyone who sells common stock but does not dissave the entire amount of the sale. The value of the switch is the lesser of the value of the stock sold and the sum of the purchases of common stock plus other additions to net financial assets. "A total switcher" is anyone who sells common stock but switches all of the proceeds net of tax into either new common stock or other financial assets.

[b] The variables for the value of common stock and income and the constant term are not presented but were included in the regression. The coefficients for the omitted groups for age and tax—age interaction variables are zero by construction. Standard errors are shown in parentheses. Population means in cols. 1, 2, 5, and 6 are weighted by value of common stock. See text for more detailed definitions.

The first four columns of table 3 describe the effects of taxes and age on partial financial switching.[25] These dependent variables are quite similar to the common stock switching analyzed in table 2. The results are also quite similar and need not be reviewed in detail. One difference might be noted: with the broader definition of switching used in table 3, the pure age effect shows a clearer pattern of sales that decrease monotonically with age.

The results for total switching are generally consistent with the corresponding partial switching coefficients. The arbitrariness of the total switching classification and the decrease in the number of nonzero observations make the coefficients rather unreliable. But, taken at face value, the point estimate of the tax variable in equation 5 (−1.07 s.e.=0.67) implies a quite powerful effect relative to the mean value of this ratio of total switch sales to market value; a 15 percent capital gains tax rate reduces the ratio of sales to value by 0.16, more than 150 percent of the current mean sample value of that ratio. In relation to the population mean switch to value ratio of 0.03, the effect of the capital gains tax is relatively much larger.

6. SIMULATIONS OF ALTERNATIVE CAPITAL GAINS TAX POLICIES

The parameter estimates described above can be used to simulate the possible aggregate effects of alternative tax treatments of capital gains. In considering the simulations that will be presented in this section, readers should bear in mind the relatively small simulation sample to which we are restricted. For policies that will reduce the selling of stock, the simulation can only make use of the 263 households with sales in 1963. Moreover, the value of sales is highly concentrated; for example, 50 percent of the value of common stock sales were from portfolios with

[25] As in table 2, the income and portfolio size variables were included in the regressions but the coefficients are not presented here in order to save space.

common stock of more than $200,000, a group represented by only 90 sellers in the sample. In short, although the data can be used to estimate reliable regression coefficients, the simulation results must be regarded as illustrative and indicative rather than precise.

Three alternative policies have been simulated. The smallest change ('option 1') is to remove the 25 percent ceiling on the capital gains tax rate[26] and tax capital gains at one-half of the tax-payer's marginal tax rate. Since tax rates in 1963 rose to 92 percent, this change could increase some investor's capital gain tax rate from 25 percent to 46 percent. Our 'option 2' change is the full Haig-Simons treatment of capital gains; i.e. capital gains are taxed fully at the taxpayer's ordinary income tax rate.[27] Finally, our 'option 3' is to eliminate all taxation of capital gains. While option 3 is no doubt politically as unviable as option 2, this simulation can indicate the effect that the actual law had in 1963.

Our simulations use the effect of the tax rate estimated in equation (1) of table 1. The change in each individual's common stock sales is calculated as −3.2 times the change in his marginal tax rate.[28] To derive the individual's 'new' level of sales, this change is added to the observed actual 1963 sales.[29] If the calculated decrease in sales is so large that the implied 'new' level is negative, the new sales are set equal to zero. For option 3 we make the very conservative assumption that all of the increased sales are made by individuals who were already selling under the 1963 law. The stock sales of all the individuals in the sample are aggregated to national totals by using the appropriate sampling weights as adjusted for non-response and missing data. Since we are interested in the total effect of each proposed tax change, we make no distinction in the simulations between switches and net sales.[30]

The results of the simulations are presented in table 4. Although separate analyses are presented by income and by common stock value, these figures must be regarded with great caution since each group contains only about 60 sample observations. Note that the sample implies that there were 7.7 million households with common stock worth $191 billion at the end of 1962.[31] Of these, 2.1 million households sold stock in 1963 worth $23 billion.

Removing the 25 percent ceiling on the capital gains tax rate (option 1) is calculated to reduce the number of sellers by only 4 percent (column (6)) but to cut the value of sales by 23 percent (column (8)). Almost all of the reduction occurs among high income individuals since they are the only ones for whom the 25 percent ceiling is a binding constraint. Although the effect appears large, e.g. individuals with incomes over $60,000 cut sales by 74 percent, it must be remembered that in 1963 a married couple reached the 50 percent tax rate with $36,000 of taxable income and a 75 percent rate with $100,000 of income.

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[26] This 25 percent ceiling is known as the "alternative tax" method of calculating the tax on capital gains. Since 1963, the tax law has been modified to restrict this 25 percent ceiling to the first $50,000 of gains that a taxpayer realizes each year.

[27] We do not, however, introduce constructive realization at death or when gifts are made.

[28] The simulations thus take the initial value of the individual's common stock as given even though over time investors would adjust their holding of common stock in response to the change in the effective tax rate on the gains from common stock.

[29] Note that this is equivalent to using equation (1) of table 1 to predict each individual's level of sales for the specific tax option with the individual's constant term modified by adding his residual from the initial regression equation.

[30] Readers should note the simplification involved in applying a fixed tax coefficient to large changes in the tax rate. Moreover, the capital gains tax rates involved in options 1 and 2 lie outside the range of experience.

[31] This figure is lower than other estimates of the value of stock owned by individuals [see e.g., Internal Revenue Service (1967)], perhaps reflecting response bias in the survey.

TABLE 4.—SIMULATIONS OF ALTERNATIVE TAX POLICIES.[1]

	Number of common stock		Value of common stock (millions)			Ratio of predicted number of sellers to actual 1963		Ratio of predicted sales value to actual 1963		
	Owners, 1962 (thousands)	Sellers, 1962 (thousands)	1962	Of sellers, 1962	Sales, 1963	Option 1	Option 2	Option 1	Option 2	Option 3
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Income:										
Less than $10,000	5,036	1,063	$62,429	$21,186	$6,976	1.00	.65	1.00	0.17	2.07
$10,000 to $25,000	2,193	780	28,144	13,051	7,143	1.00	.41	1.00	.74	1.97
$25,000 to $60,000	403	185	35,539	22,761	3,428	.87	.13	.74	.15	6.15
$60,000 plus	102	70	64,629	52,178	6,104	.23	.06	.26	.00	7.82
Value of common stock:										
Less than $4,000	4,488	913	4,714	894	715	1.00	.85	1.00	.59	1.55
$4,000 to $10,000	1,087	433	6,480	2,720	2,142	1.00	.36	1.00	.69	1.54
$10,000 to $50,000	1,533	408	30,325	7,615	2,323	.99	.22	.98	.25	2.80
$50,000 to $200,000	373	170	30,029	13,898	6,215	.94	.09	.95	.64	2.31
$200,000 plus	251	173	119,194	84,049	12,256	.65	.02	.59	.04	5.88
All common stock owners	7,732	2,097	190,736	109,173	23,651	.96	.49	.77	.30	4.12

[1] These simulations use the estimated tax parameter of equation (1) of table 1. Individual observations are weighted to represent the entire 1963 population of common stock owners. Because these simulations are based on a total of only 646 observations with 264 sellers in 1963, the simulated predictions must be regarded as subject to substantial sampling variation. The alternative policies are: Option 1, remove 25 percent ceiling; option 2, tax capital gains at 1963 ordinary income rates; option 3, no tax on capital gains.

Taxing all capital gains at ordinary rates (option 2) would entail a dramatic rise in tax rates and results in a sharp fall in selling. The simulation (column (7)) indicates that half of those who sold in 1963 would not sell anything in their capital gains tax rate were increased by 100 percent or more as it would be under option 2. Since the relative tax rate increase is greater for higher income individuals (who would lose the 25 percent ceiling as well) the predicted *value* of sales falls by an even greater percentage. With this treatment of realized gains, the value of sales is predicted to fall to 30 percent of its 1963 level. The fall is particularly dramatic for investors with high incomes.[32]

Finally, the elimination of the capital gains tax is predicted to increase sales to more than four times their 1963 level. Note that applying the factor of 4.12 to the 1963 sales of $23.7 billion implies sales of $97.6 billion, somewhat less than the value of the common stock of those who sold in 1963 ($109.2 billion).

In concluding this section, we should reiterate that the simulations are based on only 263 observations and must therefore be regarded as subject to substantial sampling variations. The details are particularly unreliable. But the simulations as a whole are indicative of the powerful effect that the current tax law and alternative changes in the treatment of capital gains can have.

7. CONCLUSION

In this paper we have presented a first set of econometric estimates of the effect of the capital gains tax on the selling of common stock. The evidence indicates that there is a very substantial effect, especially on the 'switching' that constitutes about two-thirds of all common stock sales.

There are several directions in which this empirical work might be extended as appropriate data become available. A possible first step would be to analyze how the distribution of holding periods varies among individuals with different tax situations. A more complete analysis would include information on the extent of capitl gains and losses as well as on the volume of sales. It would clearly be useful if the effects of the tax could be analyzed within a model of investor behavior that could be used to infer how such complex changes as varying the tax rate with the holding period would affect selling decisions.

[32] Such a fall in sales would actually decrease total tax revenue even though the tax rates on capital gains would more than double.

The present estimates do provide at least a preliminary basis for reexamining the desirability of alternative changes in the taxation of capital gains. The apparent sensitivity of investors to tax rules indicates the importance of considering the incentive and efficiency consequences as well as equity criteria when redesigning this aspect of the current tax law.

APPENDIX

The two tables presented in this appendix contain the regression coefficients that were omitted in the presentation of tables 2 and 3.

SUPPLEMENT TO TABLE 2.—EFFECTS OF TAXATION ON COMMON STOCK SWITCHING AND NET SELLING.[1]

Expanatory variables (partial list)	Switching to common stock				Net selling			
	Ratio of switches to value		Decision to switch		Ratio of net sales to value		Decision to net	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Value of common stock:								
Less than $4,000	0.24	0.27	−0.42	−0.41	0.10	0.10	−0.04	−0.04
	(.11)	(.11)	(.06)	(.06)	(.04)	(.04)	(.05)	(.05)
$4,000 to $10,000	.36	.39	−.30	−.30	.06	.06	.07	.07
	(.13)	(.13)	(.07)	(07)	(.04)	(.04)	(.06)	(.06)
$10,000 to $50,000	.12	.13	−.32	−.33	.05	.05	.02	.03
	(.11)	(.11)	(.06)	(.06)	(.04)	(.04)	(.05)	(.05)
$50,000 to $200,000	.19	.21	−.22	−.21	.05	.05	.04	.04
	(.10)	(.11)	(.06)	(.06)	(.04)	(.04)	(.05)	(.05)
Income:								
Less than $10,000	−.64	−.64	−.16	−.17	−.01	−.01	− 09	−.09
	(.17)	(.17)	(.10)	(.10)	(.06)	(.06)	(.08)	(.08)
$10,000 to $25,000	−.45	−.46	−.08	−.08	−.04	−.03	−.07	−.07
	(.14)	(.14)	(.08)	(.08)	(.05)	(.05)	(.06)	(.06)
$25,000 to $60,000	−.11	−.12	.05	.05	−.01	−.01	−.04	−.04
	(.09)	(.09)	(.05)	(.03)	(.03)	(.03)	(.04)	(.04)
Constant	.80	.79	.53	.62	−0	−0	.29	.27
	(.25)	(.24)	(.14)	(.14)	(.09)	(.08)	(.11)	(.10)

[1] A "switcher" is anyone who sells common stock and also buys common stock. The value of "switches" is the lesser of the values of the sales and the purchases. "Net sellers" are all the others who sell common stock.

Note: These coefficients are from the equations presented in table 2 and omitted there to simplify presentation.

SUPPLEMENT TO TABLE 3.—ADDITIONAL COEFFICIENTS FOR EFFECTS OF TAXATION ON SWITCHING TO ALL FINANCIAL ASSETS.[1]

Explanatory variables (partial list)	Partial switching to financial assets				Total switching to financial assets			
	Ratio of switches to value		Decision to switch		Ratio of sales to value		Decision to switch	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Value of common stock:								
Less than $4,000	0.04	0.08	−0.38	−0.37	0.07	0.10	−0.20	−0.19
	(.10)	(.10)	(.07)	(.07)	(.08)	(.08)	(.06)	(0.)
$4,000 to $10,000	.17	.19	−.24	−.23	.17	.19	−.13	−.13
	(.12)	(.12)	(.08)	(.08)	(.09)	(.09)	(.07)	(.07)
$10,000 to $50,000	.02	.03	−.24	−.24	.04	.05	−.14	.13
	(.10)	(.10)	(.06)	(.06)	(.07)	(.08)	(.06)	(.06)
$50,000 to $200,000	.21	.13	.18	−.18	.02	.03	−.14	−.13
	(.09)	(.10)	(.06)	(.06)	(.07)	(.07)	(.05)	(.06)
Income:								
Less than $10,000	−.37	−.38	−.19	−.20	−.20	−.20	−.13	−.13
	(.15)	(.15)	(.10)	(.12)	(.12)	(.12)	(.05)	(.09)
$10,000 to $25,000	−.23	−.23	−.10	−.10	−.11	−.12	−.08	−.08
	(.12)	(.12)	(.08)	(.08)	(.10)	(.10)	(.07)	(.07)
$25,000 to $60,000	.03	0	−.01	−.01	−.03	−.03	0	0
	(.08)	(.08)	(.05)	(.05)	(.07)	(.07)	(.05)	(.05)
Constant	.61	.65	.56	.62	.32	.31	.31	.33
	(.22)	(.22)	(.14)	(.14)	(.17)	(.17)	(.13)	(.13)

[1] These coefficients are from the equations presented in table 3 and omitted there to simplify presentation.

Note: A "partial switcher to financial assets" is anyone who sells common stock but does not dissave the entire amount of the sale. The value of the switch is the lesser of the value of the stock sold and the sum of the purchases of common stock plus other additions to net financial assets. A "total switcher" is anyone who sells common stock but switches all of the proceeds net of tax into either new common stock or other financial assets.

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INFLATION AND THE EXCESS TAXATION OF CAPITAL GAINS ON CORPORATE STOCK

(By Martin Feldstein* and Joel Slemrod*)

SUMMARY

The present study shows that in 1973 individuals paid nearly $500 million of extra tax on corporate stock capital gains because of the distorting effect of inflation. A detailed analysis shows that the distortion was greatest for middle income sellers of corporate stock.

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*Harvard University and the National Bureau of Economic Research. This study is part of the NBER program of research on business taxation and finance. We are grateful to Daniel Frisch, Sy Rottenberg, and Shlomo Yitzhaki for helpful discussions, to the U.S. Treasury for providing the data, and to the National Science Foundation for financial support. This paper has not been reviewed by the NBER Board of Directors.

In 1973, individuals paid capital gains tax on more than $4.5 billion of nominal capital gains on corporate stock. If the costs of these shares are adjusted for the increases in the consumer price level since they were purchased, the $4.5 billion nominal gain becomes a real capital loss of nearly $1 billion. As a result of this incorrect measurement of capital gains, individuals with similar real capital gains were subject to very different total tax liabilities.

These findings are based on a new body of official tax return data on individual sales of corporate stock.

Inflation distorts all aspects of the taxation of personal income but is particularly harsh on the taxation of capital gains. When corporate stock or any other asset is sold, current law requires that a capital gains tax be paid on the entire difference between the selling price and the original cost even though much of that nominal gain only offsets a general rise in the prices of consumer goods and services. Taxing nominal gains in this way very substantially increases the effective tax rate on real price-adjusted capital gains. Indeed, many individuals pay a substantial capital gains tax even though, when adjustment is made for the change in the price level, they actually receive less from their sale than they had originally paid.

The present study shows that in 1973 individuals paid nearly $500 million of extra tax on corporate stock capital gains because of the distorting effect of inflation. The detailed evidence presented below shows that this distortion is greatest for middle income sellers of corporate stock.

More specifically, in 1973 individuals paid capital gains tax on more than $4.5 billion of nominal capital gains on corporate stock. If the costs of these shares are adjusted for the increases in the consumer price level since they were purchased, the $4.5 billion nominal gain becomes a real capital loss of nearly $1 billion. As a result of this incorrect measurement of capital gains, individuals with similar real capital gains were subject to very different total tax liabilities.

These findings are based on a new body of official tax return data on individual sales of corporate stock. The first section of the paper describes the data and the method of analysis. The basic results are presented in section 2. The third section analyzes the extent to which equal real gains are taxed unequally under current rules. Several alternatives to the current law are then examined in detail. A final section examines how a permanent inflation rate of 6 percent would quadruple the effective rate of tax on capital gains.[1]

1. The Data and estimation method

Each year the Treasury Department and the Internal Revenue Service select a large scientific sample of tax returns with which to study various aspects of income sources and tax liabilities. In order to provide adequate information on high income taxpayers, the sample contains a much larger fraction of high income returns than of low and middle income returns. Since the sampling rates are known, the sample can be used to construct accurate estimates for the entire population.

In 1973, the information collected for the annual sample of tax returns was extended in a special study to include detailed data on capital asset transactions. The complete record on each sale of a capital asset (as recorded in Schedule D of Form 1040) was combined with the other information from that taxpayer's return. In the current study, we consider only the sales of corporate stock. Our sample consists of information for 30,063 individuals and 234,974 individual corporate stock sales in 1973.[2]

We supplemented the record for each transaction by calculating a price indexed capital gain. More specifically, we multiplied the acquisition price of the stock by the ratio calculated by dividing the consumer price index (CPI) for 1973 by

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[1] For previous discussions of the taxation of capital gains in an inflationary economy see Brinner (1973, 1976) and Diamond (1975). The theory of the effect of income taxation in an inflationary economy, including the tax treatment of interest and capital gains, is developed in Feldstein, Green and Sheshinski (1978).

[2] In a relatively small number of transactions, there is a discrepancy between the reported gain or loss and the difference between the reported purchase and sale prices. These nonmatching transactions were dropped from our sample, reducing the total capital gain on corporate stock from $5.01 billion to $4.63 billion. Our sample also excludes transactions in which the taxpayer did not specify the asset type and transactions recorded on partnership and fiduciary returns. Our estimate of the excess tax paid because of inflation is therefore an underestimate of the true value.

the CPI for the year of purchase. This has the effect of restating the cost of the stock in 1973 dollars. Subtracting this price-indexed cost from the amount for which the stock was sold in 1973 yields a correct real capital gain in 1973 dollars. Since the CPI was higher in 1973 than in any previous year, the real capital gain is less than the nominal gain for all regular sales and greater than the nominal gain for all short sales.[3]

Of the $4.63 billion in nominal capital gains, transactions representing $1.79 billion do not have a correctly coded year of purchase, presumably because the taxpayer failed to provide this information on his tax return. In order to calculate the price-adjusted cost of these stocks, we estimated the year of purchase by using the adjusted gross income (AGI) of the taxpayer and the ratio of the selling price to the original cost of the transaction. More specifically, all of the transactions for which we have correctly coded years of purchase were classified into one of eight AGI groups and one of 25 classes of the ratio of selling price to original cost. For each of these 200 categories, the average holding period was calculated. This average holding period was then applied to each of the transactions that had no purchase date on the basis of the taxpayer's AGI and the transaction's ratio of sale price to purchase price. When the holding period predicted in this way involved a fraction of a year, the price index was interpolated between the two bordering years' indices.[4]

To assess the excess tax that resulted from the mismeasuring of the capital gains, we must calculate the tax liability that individuals incurred in 1973 on their nominal capital gain and the liability that they would have incurred if the real capital gain had been included instead. To do this we use a special computer program that incorporates the relevant features of the income tax law as of 1973 and that calculates each individual's total tax liability for different measures of capital gain.[5] Comparing the total tax laibility based on the nominal capital gain (or loss) as recorded for 1973 with the liability if there were no gain (or loss) on corporate stocks provides the value for each individual of the actual capital gains tax on nominal gains. Similarly, comparing the total tax liability with the real capital gain for 1973 as described above with the liability if there were no gain provides the value for each individual of the capital gains tax on real gains. These tax calculations distinguish short-term and long-term capital gains in the usual way.

All calculations are done using the provision of the law of 1973 that limited the loss to be charged against current income to $1,000. Because using a real capital gains measure makes capital losses much more common than they now appear to be, we also show the effect of removing the loss limitation. Several other changes in the tax law were also studied and will be described below.[6]

2. The excess tax on capital gains

The current practice of taxing nominal capital gains resulted in a tax liability of $1,138 million on the sales of corporate stock in 1973.[7] If capital gains were measured instead in real terms, the tax liability would only have been $661

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[3] Since the seller generally does not get the use of the proceeds of short sales, this also tends to understate the true excess tax.

[4] Although there is no reason to believe that our procedure introduces any bias in the calculation of the excess tax, there is no way to test this directly. As a partial test of our method, the real gains of the transactions with known purchase dates were calculated using the predicted holding period rather than the actual. The resulting distribution of real gains is very similar to the actual real gains. To the extent that the transactions with purchase year missing are similar to those with a correctly coded date, our procedure will accurately approximate the real gain.

[5] The program includes such features as the alternative tax, the preference tax and the limit on tax losses as well as full information on each individual's income, deductions, etc. This TAXSIM program is described and used in Feldstein and Frisch (1977).

[6] Because of the new Treasury data, our method represents a substantial improvement over the estimation procedure used by Brinner (1976). He worked with published data on capital gain in 1962 and did not have adequate measures of individual marginal tax rates on capital gains. Moreover, 1962 came after a period of relative price stability; the CPI rose at an average annual rate of less than 1.3 percent during the previous decade. Brinner was of course careful to warn his readers of these limitations.

[7] Recall that our sample excludes sales in partnership and trusts and omits a small fraction of sales in which the reported gain or loss did not correspond exactly to the difference between selling price and original basis.

million.[8] The excess tax was thus $477 million, an increase of more than 70 percent. If the current limit on deducting capital losses were also eliminated, the tax on real capital gains would only have been $117 million.

Table 1 shows the detailed calculations by income class that underlie these total figures. The first row presents the net capital gain as defined by the current law. For each of the eight adjusted gross income (AGI) classes, the net capital gain figure is the weighted sum of all of the individual net capital gains of taxpayers in that AGI class; the weights reflect the sampling probabilities, making our total figure a valid estimate of the total net capital gain for all taxpayers in that class.[9] Note that the current law's nominal measure of the capital gains implies that there is a positive net gain in each income class. The sum of these gains is $4.63 billion.

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[8] This calculation and all other calculations in the current paper are based on the actual stock sales in 1973. Changing the law to tax only real capital gains would of course increase the amount of stock that is sold. On the sensitivity of common stock sales to the taxation of capital gains, see Feldstein and Yitzhaki (1978) and Feldstein, Slemrod and Yitzhaki (1978).

[9] See footnote 7 above.

TABLE 1.—CAPITAL GAINS AND ASSOCIATED TAX LIABILITIES

[In millions of dollars]

	Adjusted gross income class								
	Less than zero	Zero to $10,000	$10,000 to $20,000	$20,000 to $50,000	$50,000 to $100,000	$100,000 to $200,000	$200,000 to $500,000	More than $500,000	All
1. Nominal capital gains	86	77	21	369	719	942	1,135	1,280	4,629
2. Real capital gains	−15	−726	−895	−1,420	−255	437	839	1,125	−910
3. Tax on nominal capital gains	1	−5	23	80	159	215	291	374	1,138
4. Tax on real capital gains	0	−25	−34	−52	58	141	235	337	661
5. Tax on nominal capital gains, no loss limit	0	−7	−6	−31	91	191	288	372	897
6. Tax on real capital gains, no loss limit	−1	−38	−94	−259	−97	72	209	325	117
7. Total tax liability, those with corporate stock capital gain	10	224	1,556	5,492	3,986	2,467	1,582	1,133	16,450
8. Total tax liability, all individuals	16	15,490	40,895	32,275	10,367	4,922	2,480	1,638	108,084

Note: See text for source and method. All figures relate to capital gains on corporate stock sold in 1973.

Row 2 presents the corresponding real net capital gains. This adjustment for the rise in the price level changes the $4.63 billion nominal gain into a $910 million real loss. Although adjusting for the price change reduces the gain at every income level, the effect of the price level correction is far from uniform. For taxpayers with AGI's below $100,000, the price adjustment indicates that real capital gains were negative. This group had $1.27 billion of nominal capital gains but, after adjusting for the rise in consumer prices, had a real capital loss of $3.31 billion. In contrast, taxpayers with AGI's above $100,000 had nominal gains of $3.36 billion and real gains of $2.40 billion.

The tax liabilities corresponding to these two measures of capital gains are compared in rows 3 and 4. In calculating these tax liabilities, individuals losses are subject to the limit of $1,000. In each AGI class up to $50,000, recognizing real gains makes the tax liability negative. At higher income levels, tax liabilities are reduced but remain positive on average; the extent of the current excess tax—both absolutely and relatively—decreases with income. Thus taxpayers with AGI's between $50,000 and $100,000 paid an excess tax of $101 million or nearly three times the appropriate tax on their real capital gains. By contrast, taxpayers with AGI's over $500,000 paid an excess tax of $37 million or only 11 percent more than the tax on their real capital gains. This pattern of capital gains and of tax liabilities shows why the total tax on real capital gains remains positive even though total real capital gains are negative.

The substantial real capital losses for taxpayers with AGI's below $100,000 that are shown in row 2 suggest that the limit on the deductability of capital losses has a substantial effect on tax liabilities when capital gains are measured in real terms. Lines 5 and 6 show the tax liabilities corresponding to nominal capital gains if the loss limitation is disregarded.[10] For nominal capital gains there is only a modest difference since the general rise in prices substantially reduces losses. The total tax liability is reduced from $1.14 billion to $0.90 billion, with almost all of the difference in the liabilities of taxpayers with AGI's between $20,000 and $100,000. By contrast, with real capital gains the current loss limit raises tax liabilities by $544 million or more than 80% of the $661 million tax liability.

The importance of the current excess taxation of capital gains can be seen by comparing the excess tax with the total tax liabilities shown in rows 7 and 8. Row 7 shows the total tax liabilities for taxpayers who had any capital gain or loss on corporate stock. The excess tax liability can thus be compared with the total liability for the same groups of individuals. With the current loss limitation retained, this excess tax is roughly constant as a percentage of total tax for all groups with AGI's over $20,000. For example, individuals with AGI's between $20,000 and $50,000 paid $132 million in excess tax or 2.4 percent of their total tax liability of $5.49 billion. For individuals with AGI's between $100,000 and $200,000, the extra tax is $74 million or 3.0 percent of their total tax of $2.47 billion. A maximum of 3.3 percent occurs for those with AGI's over $500,000.

3. Taxing equal gains unequally

The mismeasurement of capital gains does more than raise the effective tax rate on real capital gains. It also introduces an arbitrary randomness in the taxing of capital gains. Two individuals with the same real capital gain can pay tax on very different nominal gains. This section presents striking evidence that equal real capital gains are taxed unequally to a very substantial extent.

Table 2 compares the tax liability that would be due on real capital gains with the tax liability that was actually assessed on nominal gains.[11] There is very substantial variation among individuals in the ratio of the tax liability on real gains to the liability on nominal gains. Consider for example the taxpayers with adjusted gross incomes between $20,000 and $50,000. Only 26.5 percent of the actual tax liability on nominal gains was incurred by taxpayers whose liabilities on real gains were between 90 percent and 100 percent of these nominal liabilities. An additional 18.4 percent of the actual tax liability was incurred by taxpayers whose liabilities on real gains would have been between 80 and 90 percent of their actual liabilities. The remaining 55 percent of actual tax liabilities were incurred by individuals whose liabilities on real gains would have been less than 80 percent of their actual statutory liabilities.

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[10] Recall that we are looking only at the stocks actually sold in 1973. Allowing unlimited deduction for losses would induce more sales of stocks with accrued losses. Our estimates should be interpreted as the extent of overtaxation of the stocks actually sold rather than as estimates of the effect of changing the law to remove the limit.

[11] We have considered here only those returns with a positive nominal gain so as to avoid ambiguity in interpreting the sign of the ratios.

The disparities are even greater for taxpayers with lower AGI. Among those with AGI's between $10,000 and $20,000, 27 percent of actual liabilities were incurred by taxpayers whose liabilities on real capital gains were less than 40 percent of their actual statutory liabilities while an equally large amount (28.4 percent) of liabilities were incurred by taxpayers whose liabilities on real gains would have been nearly as large as their liabilities on nominal gains.

TABLE 2.—DISTRIBUTION OF ACTUAL TAX LIABILITIES BY TAX LIABILITY ON REAL GAINS AS A PERCENTAGE OF TAX LIABILITY ON NOMINAL GAINS

Tax liability on real gains as percentage of tax liability on nominal gains:	Adjusted gross income (thousands)							
	0 to $10	$10 to $20	$20 to $50	$50 to $100	$100 to $200	$200 to $500	$500 plus	All taxpayers
Less than 0	13.5	11.0	6.1	5.6	2.5	1.1	0.3	3.4
0	21.7	8.8	3.8	4.1	1.6	1.1	.4	2.6
10	.8	1.7	.8	1.3	1.0	.4	.1	.7
20	1.6	.8	1.7	2.1	1.8	.8	.8	1.3
30	3.8	4.5	5.0	4.1	1.7	1.2	.3	2.5
40	9.0	9.3	2.0	3.6	2.3	1.7	1.1	2.4
50	9.7	5.3	4.4	3.4	3.5	2.5	.6	2.9
60	8.5	5.1	17.1	6.2	7.0	4.1	2.0	6.7
70	2.3	9.2	14.1	12.9	11.7	8.5	3.9	9.6
80	16.0	16.0	18.4	20.3	18.6	16.2	11.2	16.4
90	24.5	28.4	26.5	36.3	48.2	62.3	79.3	51.5

Note: Each entry is the percentage of the tax liability on the nominal capital gains as actually incurred by taxpayers in that AGI class. Computations consider only those returns which showed a positive nominal gain on corporate stock capital gains.

Table 3 shows this pattern of unequal taxation of real capital gains in a different way. This table shows the numbers of taxpayers at each level of liability on real capital gains who pay quite different amounts on nominal gain.[13] Thus, more than 220,000 of the taxpayers with real capital losses paid tax on nominal capital gains. Within this group, more than 3,000 paid capital-gain taxes of over $2,000 and nearly 1,000 paid taxes of over $5,000. Similarly, among taxpayers who had real gains but with corresponding tax liabilities of less than $1,000, more than 40,000 paid tax liabilities of more than $1,000 and nearly 1,000 paid tax liabilities of more than $5,000.

The same sense of substantial and arbitrary randomness is evident if we look at the rows of the table. For example, if we look at the 3,355 taxpayers who incurred tax liabilities of $20,000 to $30,000, we find that 463 would have had liabilities of less than $10,000 on their real gains.

In short, the effect of taxing nominal gains rather than real gains is of very little significance for some taxpayers but involves a very substantial distortion for others.

[13] Our calculation ignores the small number of taxpayers whose short sales meant that their nominal gain would actually be less than their real gain.

TABLE 3.—NUMBERS OF TAXPAYERS CLASSIFIED BY TAX LIABILITIES ON REAL GAINS AND NOMINAL GAINS

	Tax liability on real capital gains (thousands)									
	Negative	0 to $1	$1 to $2	$2 to $5	$5 to $10	$10 to $20	$20 to $30	$30 to $50	$50 to $100	Greater than $100
Tax liability on nominal capital gains:										
Negative	1, 281, 463									
0 to $1,000	213, 632	1, 083, 048								
$1,000 to $2,000	7, 416	33, 820	36, 055							
$2,000 to $5,000	2, 212	7, 033	19, 269	29, 083						
$5,000 to $10,000	708	477	753	8, 038	11, 453					
$10,000 to $20,000	196	174	49	616	2, 617	6, 402				
$20,000 to $30,000	54	34	127	40	208	1, 049	1, 843			
$30,000 to $50,000	23	13	10	19	30	135	722	2, 111		
$50,000 to $100,000	12	9	4	5	6	13	42	359	1, 804	
Greater than $100,000	1	5	0	1	0	2	3	19	234	1, 810

Note: Tax liability on nominal capital gains is the actual 1973 liability. The tax liability on real gains is the corresponding liability if real gains were calculated by adjusting the basis for the change in the CPI.

4. Alternative tax rules

This section examines the implication of price indexing the basis of capital gains in combination with two other proposals that have been frequently advocated: (1) taxing all corporate stock capital gains like short-term capital gains, i.e., eliminating the alternative tax method and the current exclusion of one-half of long-term gain, and (2) limiting income tax rates to 50 percent on so-called "unearned income" as well as "earned income." [13] Again we limit our attention to the tax consequences for the stocks actually sold in 1973 and thus disregard the way in which portfolio selling would be altered by these tax changes.

The current treatment of capital gains could be modified in either of two different ways. First, the current method of excluding one-half of long-term capital gains and of allowing the alternative tax could be ended while still limiting the deductible losses to $1,000. Alternatively, the limit on loss deductibility could be suspended at the same time. Table 4 shows the effects of applying each of these rules to the corporate stock sales in 1973.

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[13] Tax rates can still be somewhat higher than this because of the minimum tax.

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TABLE 4.—TAX LIABILITIES WHEN CAPITAL GAINS ARE TAXED LIKE ORDINARY INCOME

[In millions of dollars]

	Adjusted gross income class								
	Less than zero	Zero to $10,000	$10,000 to $20,000	$20,000 to $50,000	$50,000 to $100,000	$100,000 to $200,000	$200,000 to $500,000	More than $500,000	All
1. Tax on nominal capital gains	1	−5	23	80	159	215	291	374	1,138
2. Tax on real capital gains	−0	−25	−34	−52	58	141	235	337	661
3. Tax on nominal capital gains; no loss limit	−0	−7	−6	−31	91	191	288	372	897
4. Tax on real capital gains; no loss limit	−1	−38	−94	−259	−97	72	209	325	117
5. Tax on nominal capital gains with all gains treated as short-term gains	9	30	109	406	469	562	676	804	3,065
6. Tax on real capital gains with all gains treated as short-term gains	6	−8	14	174	285	421	569	736	2,196
7. Tax on nominal capital gains with all gains treated as short-term gains; no loss limit	7	19	44	183	340	514	665	799	2,571
8. Tax on real capital gains with all gains treated as short-term gains; no loss limit	4	−38	−112	−216	14	302	523	715	1,193

Note: See text for source and method. All figures relate to capital gains on corporate stock sold in 1973.

For convenience, the first four rows show the tax liabilities based on the current exclusion and alternative tax rules. The next four rows show the corresponding tax liabilities when the exclusion and alternative tax rules are eliminated. Simply eliminating these features while retaining the use of nominal gains and the loss limitation would have raised the tax liability from $1.14 billion (row 1) to $3.06 billion (row 5). Taxing only real gains but eliminating the exclusion and alternative tax would nearly double the 1973 tax liability from $1.14 billion to $2.20 billion (line 6). Only the combination of no loss limit and the taxation of real capital gains (row 8) would leave the total tax essentially unchanged at $1.19 billion. Note that the distribution of this tax burden would be very different from the actual 1973 tax liabilities: liabilities would almost double for those with AGI over $200,000 with offsetting falls for those with incomes under $100,000.

A maximum tax rate of fifty percent would have little effect if the current definition of taxable income is maintained. This is shown in rows 5 through 8 of Table 5. The standard results for the current law and for price indexed capital gains are shown for comparison in rows 1 through 4. The combination of a 50 percent maximum rate and the elimination of the capital gains exclusion and alternative rate (row 9 and 10) significantly raises total tax liabilities. Only if this is combined with the taxation of real gains only and a full offset of losses is the total tax kept to its current level. Again, there is a substantial redistribution within this total.

TABLE 5.—TAX LIABILITIES ON CAPITAL GAINS WHEN THE MAXIMUM TAX RATE IS 50 PERCENT

[In millions of dollars]

	Adjusted gross income class								
	Less than zero	Zero to $10,000	$10,000 to $20,000	$20,000 to $50,000	$50,000 to $100,000	$100,000 to $200,000	$200,000 to $500,000	More than $500,000	All
1. Tax on nominal capital gains	1	−5	23	80	159	215	291	374	1,138
2. Tax on real capital gains	0	−25	−34	−52	58	141	235	337	661
3. Tax on nominal capital gains; no loss limit	0	−7	−6	−31	91	191	288	372	897
4. Tax on real capital gains; no loss limit	−1	−38	−94	−259	−97	72	209	325	711
MAXIMUM TAX RATE OF 50 PERCENT									
5. Tax on nominal capital gains	2	−5	23	80	164	211	255	293	1,022
6. Tax on real capital gains	1	−25	−34	−52	64	142	207	265	568
7. Tax on nominal capital gains; no loss limit	0	−7	−6	−31	99	190	252	292	789
8. Tax on real capital gains; no loss limit	−1	−38	−94	−258	−85	81	187	256	49
MAXIMUM TAX RATE OF 50 PERCENT—ALL CAPITAL GAINS TREATED LIKE SHORT-TERM GAINS									
9. Tax on nominal capital gains	7	29	109	402	453	494	537	584	2,615
10. Tax on real capital gains	5	−9	13	171	276	374	455	535	1,819
11. Tax on nominal capital gains; no loss limit	6	18	44	180	329	452	529	580	2,137
12. Tax on real capital gains; no loss limit	3	−38	−112	−218	15	296	419	520	857

Note: See text for source and method. All figures relate to capital gains on corporate stock sold in 1973.

5. Concluding comments

The evidence presented in this paper shows that the taxation of capital gains is grossly distorted by inflation. In 1973, the tax paid on corporate stock capital gains was $1,138 million, nearly twice the $661 million liability on real capital gains. If the limit on the deduction of real capital losses is disregarded, the net tax liability falls to only $117 million. By this standard, nearly all of the tax paid on nominal capital gains represents an excess tax caused by inflation. Moreover, our current tax rules introduce an arbitrary randomness in the taxing of capital gains; with inflation, taxpayers with equal real capital gains are often required to pay tax on very different nominal gains.

The taxation of capital gains is distorted because, when there is inflation, our current tax rules mismeasure capital gains. Other aspects of capital income and expenses, primarily interest and depreciation, are also mismeasured in the presence of inflation. The taxation of capital income is therefore more severely distorted than the taxation of wages and salaries which are correctly measured. All types of personal income, including wages and salaries as well as capital income, are subjected to artificially high tax rates because of the progressivity of the tax structure, but this "bracket rate effect" is small in relation to the distortions that result from mismeasurement.

Our estimates relate to 1973 because that is the only year for which data of the type that we have analyzed is available. There is, however, no reason to think that the tax distortion for 1973 was any greater than for other recent years. Indeed, since share prices were relatively high in 1973, the ratio of real capital gains to nominal gains would also be expected to be high. More generally, it is useful to consider the effect of our current tax law on an individual who invested twenty years ago in a diversified portfolio of common stock and sold this stock at the end of 1977. According to the Standard and Poor's Index, the price of such a portfolio approximately doubled betweeen 1957 and 1977. However, the CPI also doubled in this twenty-year period, implying that there was no real increase in the value of the stocks.[14] If the investor pays a 25 percent tax on the nominal capital gain when the stock is sold in 1977, he will actually have lost about 15 percent in real terms on his investment over the 20-year period.

The problem of excess taxation of capital gains when there is inflation in not peculiar to the past 20 years but is inherent in our current tax system. Unless this aspect of the tax law is changed, the problem will continue in the future. If we abstract from fluctuations in the price-earnings ratio, the effect of retained earnings should make the real value of common stock rise at about 2 percent a year.[15] If these accruing capital gains are taxed at an effective rate of 20 percent, the net after-tax yield is 1.6 percent a year. With a 6 percent steady rate of inflation and a constant price-earnings ratio, share prices would be expected to rise at 8 percent a year. This still leaves the same real before-tax increase of 2 percent that would occur without inflation.[16] But a 20 percent capital gains tax on the 8 percent nominal capital gain leaves an after-tax nominal gain of only 6.4 percent. After subtracting the 6 percent inflation, the real after-tax gain is only 0.4 percent. The effective tax on real capital gains is thus 80 percent when the inflation rate is 6 percent. An 8 percent rate of inflation would make the effective tax rate equal to 100 percent!

The distorting effect of inflation on the taxation of capital gains could be remedied by adjusting the original cost of assets for the rise in the general price level.[17] This would reduce the effective rates of tax on real capital gains and would thereby reduce the loss in economic welfare that results from such taxation of capital income.[18] Measuring in real terms would capital gains have the futher advantage of reducing the penalty for switching assets which currently distorts investor behavior.

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[14] The increase in both the Standard and Poor's Index and the CPI was actually between 115 percent and 120 percent.

[15] If we correct the measurement of retained earnings for the artificial depreciation and inventory figures, the ratio of retained earnings to price averaged 1.8 percent for the period from 1958 through 1977.

[16] Our calculations show that the effective rate on realized nominal capital gain was 24.5 percent in 1973. Since then tax legislation has raised significantly this effective tax rate through changes in the minimum tax and maximum tax. We use a 20-percent effective rate on accruing capital gains to reflect the advantages of postponement.

[17] The substitution of a cash-flow or expenditure type income tax for our current system would also eliminate all such problems. See Andrews (1974) and U.S. Treasury (1977).

[18] See Feldstein (1978) for a discussion of the welfare loss of capital income taxation.

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206	Martin Feldstein and Anthony Pellechio.	Social Security and Household Wealth Accumulation: New Microeconomic Evidence.	October 1977 (revision).
207	Martin S. Feldstein and Daniel Frisch.	Local Government Budgeting: The Econometric Comparison of Political and Bureaucratic Models.	October 1977.
208	H. M. Shefrin and Richard Thaler	An Economic Theory of Self-Control	Do.
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211	Victor R. Fuchs	The Service Industries and U.S. Economic Growth Since World War II.	Do.
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213	Linda N. Edwards and Michael Grossman.	The Relationship Between Children's Health and Intellectual Development.	Do.
214	John S. Flemming	Aspects of Optimal Unemployment Insurance: Search, Leisure, and Capital Market Imperfections.	Do.
215	Jerry R. Green	Mitigating Demographic Risk Through Social Insurance.	Do.
216	John B. Shoven	An Evaluation of the Role of Factor Markets and Intensities in the Social Security Crisis: A Progress Report.	Do.
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218	Zvi Bodie and Benjamin M. Friedman.	A Heterogeneous-Expectations Model of the Value of Bonds Bearing Call Options.	December 1977.
219	Dov Chernichovsky and Douglas Coate.	The Choice of Diet for Young Children and Its Relation to Children's Growth.	Do.
220	B. Peter Pashigian	Occupational Licensing and the Interstate Mobility of Professionals.	Do.
221	Michael J. Boskin and Lawrence J. Lau.	Taxation and Aggregate Factor Supply: Preliminary Estimates.	Do.
222	J. Huston McCulloch	The Cumulative Unanticipated Change in Interest Rates: Evidence on the Misintermediation Hypothesis.	Do.
223	Martin S. Feldstein	The Private and Social Costs of Unemployment	January 1978.
224	James L. Medoff	The Earnings Function: A Glimpse Inside the Black Box.	Do.
225	Richard B. Freeman	Job Satisfaction as an Economic Variable	Do.
226	Robert E. Hall	Fluctuation in Equilibrium Unemployment	Do.
227	William M. Landes and Richard A. Posner.	Salvors, Finders, Good Samaritans and Other Rescuers: An Economic Study of Law and Altruism.	Do.
228	Michael D. Hurd	Estimating the Family Labor Supply Functions Derived from the Stone-Geary Utility Function.	Do.
229	Victor Zarnowitz	On the Accuracy and Properties of Recent Macroeconomic Forecasts.	Do.
230	Edward P. Lazear and Robert T. Michael.	Family Size and the Distribution of Per Capita Income	Do.
231	Benjamin M. Friedman	Who Puts the Inflation Premium into Nominal Interest Rates?	February 1978.
232	Martin S. Feldstein and Lawrence Summers.	Inflation, Tax Rules, and the Longer Term Interest Rate.	Do.
233	George J. Borjas	Job Mobility and Earnings Over the Life Cycle	Do.
234	Martin S. Feldstein and Joel Slemrod.	Inflation and the Excess Taxation of Capital Gains on Corporate Stock.	Do.

Mr. FELDSTEIN. Let me first discuss the impact of inflation on the taxation of capital gains.

As you know, inflation distorts all aspects of the taxation of personal income, but it is particularly harsh on the taxation of capital gains. When corporate stock or any other asset is sold, current law requires that a capital gains tax be paid on the entire difference between the selling price and the original cost, even though much of the nominal gain only offsets a general rise in the prices of consumer goods and services.

Taxing nominal gains in this way very substantially increases the effective tax rate on the real price-adjusted gain. Indeed, many individuals pay a substantial capital gains tax now, even though, when you adjust for the change in the price level since they bought their stock, they actually receive less from their sale than they had originally paid.

In a recent study at the National Bureau of Economic Research we measured the total excess taxation or corporate stock capital gains caused by inflation and the extent to which this distortion differs among individuals. For this study, we used the Treasury Department's sample of individual tax returns for 1973. Our sample therefore consisted of over 30,000 individuals and more than 230,000 individual stock sales for that year. Although the individuals aren't identified in the Treasury sample, the sampling rates are known, so that the sample can be used to make quite accurate estimates in the way the Treasury does for all taxpayers.

What did we find?

We found that in 1973, individuals paid capital gains tax on $4.6 billion of nominal capital gains on corporate stock. But—and this is the key thing—when the cost of these shares are adjusted for the increase in the consumer price level since they were purchased, this gain of $4.6 billion becomes a loss of nearly $1 billion.

The $4.6 billion of nominal capital gains resulted in a tax liability in 1973 of $1.1 billion. The tax liability on the real capital gains would only have been $661 million.

Inflation thus raised tax liabilities on capital gains on corporate stock alone by $500 million, approximately doubling the overall effective tax rate on corporate stock capital gains.

Although adjusting for the price change would reduce the taxable gain at every income level, the effect of the price level correction is far from uniform. In particular, the mismeasurement of capital gains under current law is most severe for taxpayers with incomes under $100,000.

Exhibit 1, which is in the material that has been circulated, compares the nominal and real capital gains and the corresponding tax liabilities for each income class. Briefly, the first row shows the net capital gains in millions of dollars as defined under the current law.

The second row represents the corresponding real net capital gains. In the highest income class, there is little difference between nominal and real capital gains. In contrast, taxpayers with incomes below $100,000 suffered real capital losses on average, even though they were taxed on positive nominal gains.

The tax liabilities corresponding to these two different ways of measuring capital gains are compared in the next two rows. In each income class up to $50,000, recognizing real capital gains instead of the nominal gains that the current law looks to, would make the tax liability negative. At higher income levels, tax liabilities are reduced, but remain positive.

In short, our study showed that inflation has substantially increased—roughly doubled—the overall effective tax rate on corporate stock capital gains. Although this estimate relates to 1973, because that is the only year for which the Treasury has this type of data, the continuing high rate of inflation means that the tax distortion for more recent years is likely to be even greater.

I will turn now to the effect of the differences in capital gains tax rates on the selling of corporate stock and the amount of capital gains that is actually realized for tax purposes.

There has long been speculation about the extent to which high tax rates on capital gains deter individuals from selling stock, but there has been little hard evidence on this lock-in question.

In collaboration with two colleagues, I recently completed what I believe are the first econometric estimates of the effect of capital gains tax rates on the selling of corporate stock and the realizing of capital gains.

We carried out two quite different studies of the same question using two very different bodies of data. Both studies indicate the same thing, that capital gains tax rates have a very substantial effect on individuals' decisions to sell corporate stock.

The first study analyzed the experience of a sample of high income investors whose portfolio behavior was recorded in a special survey carried out by the Federal Reserve Board in 1963. An important finding in an analysis of that data was that two-thirds of the value of the proceeds of corporate stock sales were reinvested in corporate stock and other financial assets within the same year. Since some of the remaining one-third of the proceeds were held in cash and reinvested in the following year, the data indicate that less than one-third of the proceeds of corporate stock sales were used to finance current consumption.

The evidence in that study showed that the amount that individuals sell is quite sensitive to their tax rate. For example, on the basis of our statistical estimates of the tax rate sensitivity of individual selling, we calculated the effect of removing the 25 percent ceiling that was in effect in 1963 and taxing individuals at one-half of their ordinary income rates. We found that this change would have reduced the value of corporate stock sales by 23 percent.

Our second study used the same 1973 Treasury sample that I referred to a few moments ago in discussing the effects of inflation. This analysis again found that individuals' selling of corporate stock is very sensitive to their tax rates.

We used this estimated behavior to calculate the effect of changes in the 1973 law. We found, for example, that limiting the rate of tax on long-term gains to 25 percent would have nearly doubled corporate stock sales in that year, from $29.2 billion to $49.5 billion.

The Treasury data also permitted us to evaluate the impact of differences in tax rates on the amount of capital gains that individuals realize. I think this is really the crucial point for you.

We found that the realization of gains is even more sensitive to taxes than the selling of stock.

Using the statistically estimated tax sensitivity, we calculated that limiting the capital gains rate to 25 percent would have caused an almost three-fold increase in the total value of net gains realized in 1973.

Because of this great increase in the realization of gains, the reduction in tax rates would have substantially increased capital gains tax revenues. Our calculation indicates that the tax revenues on corporate stock capital gains would have more than doubled if the tax rate had been limited to 25 percent.

Let me emphasize that the extra revenue does not come from expanded business activity, greater profit, greater investment or from higher share prices. This is all before that.

Senator PACKWOOD. This is just unlocking, basically.

Mr. FELDSTEIN. This is just unlocking, the release from being locked-in.

That alone, I think, is sufficient to more than offset the revenue loss predicted by the Treasury.

Senator PACKWOOD. You just gave us this study—you apparently just handed it in, though I do not have it now.

Has this study been published? Was it out before?

Mr. FELDSTEIN. Two of the three studies have been published. The third one has just been completed—the one I am just talking about.

Senator PACKWOOD. Is this the one on the revenue estimates?

Mr. FELDSTEIN. The one with the revenue estimates is just being completed and is not yet published.

Senator PACKWOOD. How soon will it be ready?

Mr. FELDSTEIN. I can have a copy for you very soon.

[The following was subsequently supplied for the record:]

[From the National Bureau of Economic Research, Inc.]

THE EFFECTS OF TAXATION ON THE SELLING OF CORPORATE STOCK AND THE REALIZATION OF CAPITAL GAINS

(By Martin Feldstein*, Joel Slemrod*, Shlomo Yitzhaki**)

SUMMARY

This study provides the first econometric analysis of the effect of taxation on the realization of capital gains. The analysis thus extends and complements the earlier study by Feldstein and Yitzhaki (1978) of the effect of taxation on the selling of corporate stock. The present analysis, using a large, new body of data obtained from individual tax returns, supports the earlier finding that corporate stock sales are quite sensitive to tax rates and then shows that the effect on the realization of capital gains is even stronger.

More specifically, the estimated tax sensitivity implies that limiting the capital gains tax rate to 25 percent would have caused an almost three-fold increase in the total value of the net gains realized in the 1973 sample year. As a result, the reduction in tax rates would have substantially increased the revenue produced by the capital gains tax rate.

The effective rates at which capital gains are taxed have increased very substantially in recent years. Debate continues on proposals to change the tax law in ways that would further increase these tax rates as well as on proposals to reduce the effective tax on capital gains. The present paper uses a new, rich body of microeconomic data to estimate how taxation effects the selling of corporate stock and the realizing of capital gains. The results indicate that the current high rates of tax on capital gains substantially reduce the selling of corporate stock, particularly sales that would involve recognizing net capital gains.

Until 1969, the tax rate on long-term capital gains,[1] was limited by a ceiling of 25 percent. Individuals whose marginal tax rates were below 50 percent could exclude half of their gains, thereby paying a tax rate of less than 25 percent. Higher income individuals could use the "alternative tax" method that subjected the entire gain to a 25 percent tax. Since then, several statutory changes have combined to raise the tax on capital gains. The alternative tax method is now limited to the first $50,000 of capital gains per taxpayer; since 50 percent of the gains in excess of this amount are excluded from taxable income, the personal tax rate on marginal capital gains can now be as high as 35 percent. A "minimum tax," originally introduced in the Tax Reform Act of 1969, now subjects the excluded half of capital gains for some taxpayers to an additional tax of 15 percent. In 1969, the tax on capital gains was effectively raised further for some high income individuals by a provision which made the tax rate that such individuals

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[1] At this time, the long-term capital gain rate applied to assets held for at least 6 months.

must pay on wage and salary income depend on the amount of capital gains that they realize.[2] The combination of these tax changes makes the current marginal capital gains tax rate exceed 40 percent for many individuals, substantially more than the previous 25 percent maximum.[3]

In addition to these statutory tax changes, the effective tax on real capital gains has been raised substantially by inflation. Under current law, the capital gains tax is levied on nominal capital gains with no adjustment for changes in the price level since the stock was acquired. This not only overstates the value of real capital gains but, by converting real losses to nominal gains, reduces investors' opportunities to offset capital losses against capital gains. Feldstein and Slemrod (1978) analyzed the corporate stock sold by individuals in 1973; they found that adjusting the costs of these stocks for the increase in consumer prices since they were acquired would change the $4.6 billion gain on which taxes were paid to a loss of nearly $1 billion and would cut the corresponding tax liability in half.

A wide range of proposals to change the taxation of capital gains is being actively discussed.[4] The Treasury has proposed eliminating the alternative tax completely. Other proposals to increase the tax on capital gains include raising the minimum tax or even eliminating the 50 percent exclusion. The effective tax rate would be lowered by proposals to tax only real gains or to decrease the tax rate with the length of the holding period, or to repeal the minimum and maximum tax rules related to capital gains. More radical proposals include extending the "rollover" provision (in which capital gains are not taxed if the proceeds are reinvested) to corporate stock or a more general substitution of an expenditure tax for the current income.

A prerequisite for sound policy decisions is an understanding of how alternative tax rules would affect investor behavior. It is particularly important to know whether high tax rates "lock investors in" existing stocks, thereby reducing the efficiency of the capital market. Similarly, it is important to know whether increasing the tax rate on capital gains would actually increase revenue or, by substantially reducing the realization of gains, would decrease revenue.

This study provides the first econometric analysis of the effect of taxation on the realization of capital gains. The analysis thus extends and complements the earlier study by Feldstein and Yitzhaki (1978) of the effect of taxation on the selling of corporate stock. The present analysis, using a large, new body of data obtained from individual tax returns, supports the earlier finding that corporate stock sales are quite sensitive to tax rates and then shows that the effect on the realization of capital gains is even stronger.

The first section of the paper discusses the data used in this analysis. Section 2 presents estimates of the effect of the tax on common stock sales and compares these results with those of the earlier Feldstein-Yitzhaki study. The third section discusses the corresponding estimates of the response of realized capital gains. Simulations of the effects of several alternative policies are presented in section 4. There is a brief concluding section.

1. Data and definitions

Each year the Internal Revenue Service and the Treasury select a stratified random sample of approximately 100,000 individual tax returns with which to study income sources, deductions and tax liabilities. The information for each taxpayer consists of the major items on the individual's tax return (form 1040). The sample is drawn so that the sampling fraction increases to 100 percent for for taxpayers with adjusted gross incomes over $200,000. As a result, the sample can be used to make accurate estimates even for the high income groups which consists of relatively small numbers of people. Moreover, because the sampling probabilities are known, unbiased estimates for all taxpayers or for any subgroup can be constructed.

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[2] Under the "maximum tax" provisions, the marginal tax rate on wages, salaries and other personal services income is limited to 50 percent. The 1969 change provides that, for each two dollars of capital gain, the individual must reduce the income that he subjects to the 50 percent "maximum tax" by one dollar and subject that dollar to his ordinary tax. This reclassified dollar may then be taxed at a personal rate of up to 70 percent. For an individual with a 70-percent marginal tax rate, this reclassification adds 20 cents per two dollars of capital gain.

[3] Several other statutory changes have also raised the tax on capital gains: the holding period required to qualify as long-term capital gains has increased; the basis of capital assets transferred at death is no longer increased to market value; the ability to donate capital gain property to charities has been limited; etc. In addition, State income tax on capital gains have become increasingly importnt.

[4] See, among others, Break and Pechman (1975), Brinner (1973) and David (1968).

In 1973, the Treasury collected more detailed information on the capital gains and losses reported on these tax returns. In addition to the usual information on each tax return, this special study recorded for each sale of a capital asset (as reported on schedule D of form 1040) the nature of the asset (stock, real estate, etc.), the purchase price, date acquired, sale price, and date sold. Our analysis focuses exclusively on the sale of corporate stock.

In order to study the effect of tax rates on the selling of corporate stock, we require a probability sample of all the taxpayers who own stock and not just those who sold stock in 1973. Although the tax returns provide no direct information about the ownership of corporate stock, we can use the receipt of dividends to identify stockholders. Our sample consists of 53,523 taxpayers who received dividends in 1973; the sample weights imply that this group represents a population of 11.5 million taxpaying units which owned stock in 1973. All taxpayers without dividend income are eliminated from the sample.

The analysis that we present in the following sections of this paper relates the value of the stock sold and of the net capital gain realized by each stockowner in the sample to his "capital gains tax rate" and to other determinants of sales and gains. To calculate each individual's "capital gains tax rate" we use a sophisticated computer program (TAXISM) that embodies the basic features of the tax law as of 1973. This program calculates the effect on the individual's total tax liability of another dollar of capital gains, including such calculations as the use of the alternative tax, the extra "minimum tax," and the change in the standard deduction for those who do not itemize their deductions. The "capital gains tax rate" is a marginal tax rate defined as the extra tax liability due on an additional dollar of capital gain.

Since the capital gains tax rate of an individual can vary with the amount of capital gain that he realizes, there are several possible ways of calculating our capital gains tax rate variable.[5] The simplest procedure is to use the capital gains tax rate that would apply to the first dollar of corporate stock capital gain that the individual realizes, i.e., the extra tax liability that would be due on a dollar of capital gain if the individual had no other sales of corporate stock. This "first dollar capital gains tax rate" has the statistical advantage of being exogenous in the sense that it is independent of the individual's decision about how much gain to realize.[6]

However, for very wealthy individuals who typically realize large gains, these "first dollar" rates could differ substantially from the tax rates at which marginal decisions were actually made in 1973. The most appropriate rate to use for each individual is the "last dollar capital gains rate," i.e., the additional tax liability that would be incurred if the individual increased his capital gain in 1973 by one dollar. Because this tax rate is endogenous to the individual's decision, an equation using this rate cannot be estimated by ordinary least squares. We therefore use a consistent instrumental variable estimation procedure.[7] Fortunately, both definitions of the tax rate yield quite similar results.

The specification of the equations that we have estimated and the precise definitions of the other variables will be discussed in the following section where the estimates of selling behavior are presented. Before turning to this, it is useful to comment briefly on the difference between the data used in the current study and the data used in the earlier Feldstein-Yitzhaki analysis. That study was based on the 1963-64 Federal Reserve Board survey of 646 households that owned common stock at the end of 1962. The information collected for each household included the value of common stock owned at the end of 1962 and the amounts sold and purchased during 1963. This permitted studying "stock switching" and "net selling" separately. There was no reliable information on the amount of gain realized and tax rates had to be estimated on the basis of income data reported in the survey. Despite these problems and the relatively small sample, the Feldstein-Yitzhaki analysis found clear evidence that the sale of corporate stock is very sensitive to individual differences in capital gain tax rates.

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[5] In effect, the individual faces a schedule of captial gain tax rates rather than a single rate.

[6] There is, of course, the possibility that the individual adjusts his other taxable income during the year to the amount of gain that he realizes, thus making even this "first dollar" tax rate endogenous. To reflect this would require a much more elaborate behavioral model than we have.

[7] The instrumental variables are the exogenous "first dollar capital gains tax rate" and a "predicted last dollar capital gains tax rate" based on the average caiptal gains of individuals with that income and dividends.

2. The selling of corporate stock

Our analysis of the selling of corporate stock focuses on the value of corporate stock sales per dollar of dividends received during 1972. We use dividends in this way to represent the value of the stock in each individual's portfolio since the tax returns contain no direct measure of the portfolio value. There is some evidence that the ratio of dividends to portfolio value varies inversely with the adjusted gross income (Blume, Crockett, and Friend; 1974); this suggests that the tax rate appears to have a smaller effect on the sale-dividend ratio than it actually does on the sales-value ratio and therefore that our parameter estimates understate the effect of the tax on the selling of corporate stock.

The 1973, the average dividend yield on corporate stock was approximately three percent.[8] By restricting our sample to taxpayers with at least $3,000 of dividends, we limit our attention to individuals with portfolio of approximately $100,000 or more. Such taxpayers accounted for 79 percent of all dividends reported by individuals for 1973. Restricting the sample in this way eliminates the implausibly high ratios of sales to dividends that occur in smaller portfolios because of chance fluctuations and measurement errors. Taxpayers with larger portfolios are also less likely to distort the estimates by altering the timing of capital gains and losses to take advantage of the very small opportunities to offset long-term losses against short-term gains, etc.

The age of the taxpayer affects the selling decisions in a number of ways. The tax rules that prevailed in 1973 provided that the basis (or "cost") of assets transferred at death would be revalued to the current market value. This implies that the tax deterrent to selling should increase with the taxpayer's age and should be particularly strong for older taxpayers. Older taxpayers are also likely to have held their stock for a longer time, thus increasing the ratio of gain to total share value and increasing the incentive not to sell. These considerations apply to selling in order to reinvest the proceeds in other assets. Feldstein and Yitzhaki (1978) contrasted this "switch selling "with the "net selling" used to finance consumption. Older individuals are more likely to be net sellers in order to finance consumption. Although the tax return data does not include an exact age, we can distinguish taxpayers who are age 65 or older; we include a dummy variable wherever at least one individual is at least age 65. Since our data do not allow us to distinguish switch selling from net selling, the overall effect of age is ambiguous.

Two other variables are likely to affect the individual's decision to sell common stock: the value of the stock in his portfolio and the level of the individual's income. Although the probability of selling at least some stock is likely to increase with portfolio size, the ratio of sales to dividends is likely for two reasons to vary inversely with the size of the portfolio. First, any net sale of stock to finance a major consumption expenditure or nonportfolio investment could more easily represent a large fraction of a small portfolio. In addition, switching two or three securities in a small portfolio could involve selling a very large fraction of the total value of the portfolio. Although we do not have a direct measure of the value of stock to include in the equation, we can again use the value of dividends to represent the value of the stock. We include the logarithm of dividends so that the variable will not be dominated by the larger portfolios.

Individuals with lower money incomes are more likely to be retired (or below their permanent income for other reasons) and are therefore more likely to want the proceeds of the net sales of common stock. Again, switch sales are not likely to follow the same pattern as net sales. Higher income individuals are more likely to switch stocks because they can better afford the risks of speculation and are more likely to have access to relevant investment information. We include the logarithm of adjusted gross income in our equation without any a priori theory about its sign.[9]

Equation 1 of Table 1 presents the estimated coefficients for this equation. The coefficient of the tax variable (-67.9 with a standard error of 4.05) indicates that the taxation of capital gains has a very powerful effect on the selling of corporate tax. For example, a ten percentage point increase in the tax rate on capital gains reduces the sale-to-dividends ratio by 6.8.

[8] The yield on the Standard and Poors 500 stocks was 0.031.

[9] To eliminate the simultaneity of adjusted gross income and sales, we exclude the actual capital gains included in AGI from AGI but add back in a predicted value of "included" capital gains based on a tabulation by income and dividends.

TABLE 1.—EFFECTS OF TAXATION ON THE SELLING OF CORPORATE STOCK AND THE REALIZATION OF CAPITAL GAINS

	Estimated coefficients					
Equation—Dependent variable: Population	Tax	Age 65	Logarithm of dividends	Logarithm of adjusted net AGI	Constant	Sample size
1—Sales dividends: All	−67.9	−1.38	−3.87	−0.505	71.4	27832
Adjusted standard error of estimate	(4.05)	(.652)	(.221)	(.197)	(2.57)	
2—Probability of selling: All	−.906	−.0334	.00916	.0309	.400	27832
Adjusted standard error of estimate	(.0393)	(.00633)	(.00215)	(.00191)	(.0249)	
3—Sales dividends: Aged only	−22.1		−2.35	−.362	41.1	9348
Adjusted standard error of estimate	(5.60)		(.148)	(.192)	(1.86)	
4—Probability of selling: Aged only	−1.25		.0106	.0391	.380	9348
Adjusted standard error of estimate	(.103)		(.00382)	(.00496)	(.0481)	
5—Gains dividends: All	−35.6	.513	−1 20	−1.38	39.9	27832
Adjusted standard error of estimate	(2.16)	(.348)	(.118)	(.105)	(1.37)	
6—Gains dividends: Aged only	−7.93		−.643	−1.41	28.0	9348
Adjusted standard error of estimate	(2.92)		(.109)	(.141)	(1.37)	

Note: In all cases the sample is limited to returns with at least $3 000 in dividends.

The negative coefficient on the age variable indicates that older taxpayers are less likely to sell than younger taxpayers. The tax incentives to postpone switch selling thus dominate the need to finance retirement consumption. The sales-to-dividend ratio also varies inversely with portfolio size and income.

Several variants of equation 1 which have been estimated (but are not presented) deserve comment. Using the "first dollar" marginal tax rate, i.e., the marginal tax rate on capital gains that the individual would face before he realized any capital gains, reduces the coefficient of the tax variable only slightly (from −67.9 to −55.7) and leaves the other coefficients essentially unchanged.[10] Extending the sample to all shareholders (and not just those with more than $3,000 of dividents) eliminates the estimated effect of the tax; the coefficient of the tax variable is very small and less than its standard error. As we noted above, we believe that this reflects the problems of measuring behavior of investors with small protfolios but it may also indicate that such investors are less sensitive to tax considerations.

In 1973, 50 percent of shareholders with more than $3,000 in dividends sold some corporate stock. Equation 2 of Table 1 shows that the decision to sell anything, as well as the amount of selling, is sensitive to the individuals tax rate. The tax coefficient of −0.906 (with a standard error of .0393) implies that a 10 percentage point increase in the marginal tax rate reduces the probability of selling something by 9.1 percentage points. The other estimated coefficients show that older people are less likely to sell, that investors with larger portfolios are more likely to sell something, and that higher income individuals are also more likely to sell.

Equations 3 and 4 describe the selling behavior of taxpayers age 65 and over.[11] The tax coefficient in equation 3 is lower than in equation 1 but is still substantial. The probability os selling (equation 4) shows an even greater sensitivity for older taxpayers than for the population as a whole.

The evidence in this section confirms the earlier findings of Feldstein and Yitzhaki (1978) that current tax laws have a very substantial effect on the sellIng of corporate stock. Indeed, the basic tax coefficient estimate of −67.9 in our sales-to-dividend equation is quite similar to the earlier estimate that the sales-to-market value responds to the marginal tax rate with a coefficient of −3.20 (standard error=1.04). Since the dividend-to-market value ratio is approximately 0.03, the current estimate of −67.9 is equivalent to −2.04 in the units of the earlier study.

[10] Using marginal tax rate based on "predicted capital gains" introduces substantial random error and results in a substantially reduced tax coefficient.

[11] More precisely, at least one "age exemption" was claimed by these taxpaying units.

Two problems should be borne in mind in interpreting the current estimates and the results presented in the next section. First, we have information on the individual's tax rate only for 1973. An individual whose tax rate varies substantially from year to year will tend to sell more when his rate is low. To the extent that low rates in 1973 are only temporarily low, our estimates will overstate the sensitivity of selling to the tax rate. We have no way of knowing how important this is. Second, our analysis is based on the 1973 experience and therefore on the bequest rules that applied then. In 1973, the tax rules provided for a full revaluation of assets transferred at death. Current law provides only for a carry-forward of the basis of assets that are bequeathed. Since this change reduces the advantage of not selling, investor behavior may be somewhat less sensitive to tax rates now than in 1973.

3. The Realizing of Capital Gains

A unique advantage of our current set of data is that it contains accurate information on capital gains and losses. We are therefore able to make the first estimates of the effects of the tax law on the realizing of net capital gains. This section follows the structure of the previous one and focuses on the net capital gains (positive or negative) realized in 1973 per dollar of dividends. We again examine the effect of the marginal tax rate and the taxpayer's age, portfolio size and income.

Equation 5 of Table 1 shows that the realizing of capital gains is very sensitive to the marginal tax rate. The coefficient of −35.6 (with a standard error of 2.16) implies that a ten percentage point change in the marginal tax rate changes the gain-to-dividend ratio by 3.56. An important implication of this high coefficient is that a reduction in the tax rate on capital gains would actually increase the total revenue collected.[12]

The realization of capital gains varies with portfolio size and income in the same way that selling does. The effect of age is more difficult to interpret. Equation 5 indicates that age does not have a statistically significant effect when the tax rate, income and portfolio size are taken into account. Comparing equations 1 and 5 thus suggests that the ratio of capital gains to sales rises with age, a quite plausible implication since older taxpayers are likely to have held their assets longer. Limiting the sample to older taxpayers (equation 6) indicates that they are less responsive to the tax rate. This lower sensitivity to the tax suggests that age per se may be more important than equation 5 indicates since older taxpayers generally have lower marginal tax rates.

4. Simulating Alternative Tax Rules

The estimated coefficients imply that corporate stock sales and the recognition of capital gains are both very sensitive to marginal tax rates. In this section, we use the estimated parameter values to calculate the impact of alternative tax rules on the aggregate volume of selling and the aggregate value of capital gains. For this purpose, we contrast the observed behavior under the 1973 law with two alternatives: Option 1 limits the rate of tax on long-term capital gains to 0.25 (and eliminates the minimum tax) while Option 2 taxes all capital gains as short-term gains, thus eliminating both the alternative tax and the exclusion.[13]

Our simulation of the effect of tax changes on selling uses the tax coefficient in equation 1 of Table 1, −67.9. For each individual, we calculate the tax rate change implied by going from the 1973 law to the option being studied.[14] We then multiply this difference between marginal tax rates by −67.9. This yields the predicted change in the individual's ratio of sales-to-dividends. This is added to his actual 1973 sales-to-dividend ratio to get a new predicted value. This new predicted value is multiplied by the individual's actual 1973 dividends to get a predicted sales for the individual. This predicted value (or zero if the predicted

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[12] When this equation is re-estimated for the "first dollar" marginal tax rate, the coefficient estimates are very similar: the tax coefficient is −30.3 (standard error 1.84). When the sample is extended to all dividend recipents, the standard errors are large and the parameter estimates are unstable.

[13] For both options, net capital losses are constrained to be less than $3,000, the value anticipated in the current (1978) tax rules. For the sake of comparison, this constraint has been imposed on the 1973 "current law" simulations as well.

[14] More specifically, we use the marginal tax rate on the last dollar of actual capital gain under the two alternatives.

value is negative) is aggregated over all individuals using the appropriate sampling weights. This gives the total predicted sales for the particular option. A similar calculation is done for capital gains using the coefficient of −35.6 from equation 4. In both cases, the calculation is limited to individuals with dividends of at least $3,000; this causes our calculations to understate the effect of tax changes, but the understatement is small since these individuals represent 79 percent of the dividends and, having generally higher incomes, are more sensitive to changes in the tax rules.[15]

The results of our simulation are presented in Table 2, for seven adjusted gross income classes as well as for all taxpayers together.

Consider first the impact of the tax options on the value of corporate stock sales. Limiting the long-term capital gains tax rate to 0.25 (option 1) nearly doubles corporate stock sales to $49.5 billion from the $29.2 billion under the 1973 law. In contrast, treating all capital gains like short-term gains (option 2) reduces selling to $16.6 billion, nearly one-half its 1973 level. Not surprisingly, the relative changes are greatest for the higher-income taxpayers.

The changes in realized gains are even more dramatic than the changes in sales. Limiting the tax rate to 25 percent causes a nearly three-fold increase in realized gains, from $5.4 billion to $15.8 billion. The higher tax rates under option 2 would substantially contract the value of realized gains.

It is interesting to note the revenue effects of the tax changes. A decrease in the tax rate causes a substantial increase in tax revenue while a rise in the tax rate causes tax revenue to fall sharply.[16]

TABLE 2.—SIMULATIONS OF ALTERNATIVE TAX POLICIES

[Millions of dollars]

	Adjusted gross income class							
	Less than $10,000	$10,000 to $20,000	$20,000 to $50,000	$50,000 to $100,000	$100,000 to $200,000	$200,000 to $500,000	More than $500,000	Total
1973 LAW								
Sales	1,652	2,149	7,337	6,677	4,654	3,730	3,050	29,249
Net gains	153	277	1,111	801	904	1,016	1,152	5,416
Tax liability	6	29	162	177	245	324	406	1,349
OPTION 1								
Sales	1,652	2,232	7,733	9,576	9,601	10,319	8,390	49,503
Net gains	153	321	1,317	2,270	3,426	4,406	3,908	15,801
Tax liability	6	40	314	540	840	1,093	971	3,704
OPTION 2								
Sales	1,466	1,148	3,051	3,786	2,591	2,418	2,128	16,594
Net gains	158	120	258	356	484	660	829	2,869
Tax liability	−6	7	40	84	150	254	369	859

Note: Option 1 limits the rate of tax on long-term corporate stock capital gains to 0.25. Option 2 taxes all corporate stock capital gains as short-term gains. All figures refer to population with dividends greater than $3,000. For both options, net gains are constrained to be greater than −$3,000 for each return. For the sake of comparison, this constraint has been imposed on the 1973 law estimates as well.

5. Conclusion

The estimates presented in this paper confirm the earlier finding of Feldstein and Yitzhaki (1978) that the selling of corporate stock is sensitive to the tax rates and show that the realizing of capital gains is even more responsive. More generally, this study provides further evidence of the powerful effects that our tax system has on the process of capital formation.

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[15] Note that we do not use all of the estimated coefficients of equations 1 and 5 to predict selling and gains under alternative tax rules. The very low explanatory power of the equations would make such predictions very inaccurate. We use instead the quite precisely estimated tax coefficient to calculate changes in selling and gains. An alternative way of describing our procedure is to say that we add the calculated residual for each individual to the predicted value based on all the coefficients. Predicted capital gains are constrained to be zero whenever predicted sales are zero.

[16] Note that this calculation, like all the analysis in this paper, refers only to corporate stock. The total revenue effect for all capital gains cannot be determined without further analysis of other asset types.

The revenue estimates that are presented in table 2 use the following approximations. For the 1973 law and option 1, the actual last dollar marginal tax rate on short-term capital gains is applied to all gains. More detailed simulations of the tax revenue effects of alternative tax laws are to be the subject of future research.

The results indicate that reducing the tax on capital gains would not only encourage a more active market in corporate stock but would also increase tax revenue. There are a number of other proposals to alter the taxation of capital gains that would also increase selling; adjusting the cost of assets for the general rise in the consumer price level; constructive realization of gains at death; taxing accrued gains directly or retroactively with interest; or allowing tax-free rollovers. Analyzing the effects of such proposals requires a more complete model of the decision to sell corporate stock. The development of such a model would be an important extension of the current analysis.

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196(C)—John E. Dennis, David M. Gay, and Roy E. Welsh.	An Adaptive Nonlinear Least Square Algorithm	Do.
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199(N)—Jacob Mincer	Family Migration Decisions	Do.
200(W)—Anna Luiza Ozorio de Alneida	Share-tenancy and Family Size in the Brazilian Northeast.	Do.
201(C)—Martin Feldstein	The Welfare Cost of Permanent Inflation and Optimal Short-Run Economic Policy.	Do.
202(W)—Robert T. Michael	Two Papers on the Recent Rise in U.S. Divorce Rate	September 1977
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233(W)—George J. Borjas	Job Mobility and Earnings Over the Life Cycle	Do.
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235(C)—Benjamin M. Friedman	Price Inflation, Portfolio Choice, and Nominal Interest Rates.	January 1978 (revision).
236(W)—Victor R. Fuchs	The Supply of Surgeons and the Demand for Operations.	March 1978
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249(W)—Robert J. Willis and Sherwin Rosen.	Education and Self-Selection	Do.
250(C)—Martin Feldstein, Joel Slemrod, and Shlomo Yitzhaki.	The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains.	Do.

[1] 2 Copies of (the same or different) working papers can be obtained free of charge by writing to the appropriate issuing office: (N) New York—261 Madison Ave., New York, N.Y. 10016; (C) Cambridge—1050 Massachusetts Ave., Cambridge, Mass. 02138; (W) NBER West—204 Junipero Serra Blvd., Stanford, Calif. 94305. Orders for more than 2 working papers from a single office should be accompanied by $1 for each additional copy. Please make check payable to National Bureau of Economic Research, Inc.

Senator PACKWOOD. Has Treasury seen it? Do they know of your conclusions?

Mr. FELDSTEIN. They have seen preliminary versions.

Senator PACKWOOD. What do they say about it?

Mr. FELDSTEIN. One of the things that they point out, and I think correctly, is that this relates only to corporate stock capital gain.

But, I think other than that, they have expressed no particular reservation about the statistical estimates.

Senator PACKWOOD. They have expressed continual reservation about any study so far that shows a revenue increase.

Mr. FELDSTEIN. This is a very different study from the ones done by the first panel.

Senator PACKWOOD. Theirs have different estimates than yours because you don't have to worry about stock prices or other variables.

Mr. FELDSTEIN. Right. This is all before you even get to that.

Senator PACKWOOD. I understand that. So Treasury's argument might be that it is an unlocking and, therefore, a short-term effect rather than a long-term effect. But they still wouldn't even agree with you that there would be a revenue effect justfrom unlocking.

Mr. FELDSTEIN. I am very glad you asked that question, Senator. I think the right way to interpret these estimates is not as a short-run unlocking, but as a permanent unlocking. After all, what we are studying is differences among taxpayers that continue from year to year. I think what we are estimating here is that there would continually be more turnover in the market, more realizing of gains, and less postponement than there is today.

I think this is probably a slight overestimate of the permanent extra revenue that would be produced but a substantial underestimate of the immediate effect of unlocking.

Senator PACKWOOD. You do see how critical it is that you get this study to me as quickly as you can. Indeed, if these studies are close to unassailable, it means the only justification for the high capital gains rates is just for the sheer fun of taxing the rich—not for revenue, not for any other purpose—just for the fun.

Now there are some who would support that theory. But I don't think they are a majority in the Congress.

Mr. FELDSTEIN. I think that is why the issue of whether this is more cost effective than changing the investment tax credit doesn't really matter.

Senator PACKWOOD. It doesn't matter.

Mr. FELDSTEIN. That's right.

Senator PACKWOOD. There is nothing wrong with the investment tax credit. It may have a perfectly desirable effect. It doesn't mean that you have to trade-off that for this.

Mr. FELDSTEIN. I think that is correct.

Senator PACKWOOD. Thank you.

I have no other questions.

Senator Hansen.

Senator HANSEN. Thank you.

Dr. Feldstein, I, too, as I am sure Senator Dole, will look forward to receiving a copy of your study. I would suggest that there may be one other motive aside from the sheer fun of taxing the rich, and that is in an election year there is a certain demogogic appeal to pointing your finger at someone who may be the envy of perhaps 51 percent of the voters in this country.

I am not making this charge, but I cannot escape personally wondering if the fact that the President has dammed this particular approach to tax reform may not have influenced some of the utterances made by members of this administration. It just occurs to me that it may not be healthy or may not create longevity in an official position if you differ with your chief. Some members of the military, at least, have found that experience to be so.

I just wonder if, indeed, there may not have been some tilt in some of the studies or the lack of studies that have been undertaken by the Treasury to try to find some evidence to support the conclusion that has been reached by the President.

Mr. FELDSTEIN. They are very clear that their estimates assume no behavioral response and that that is the general way in which they talk about any specific tax change. But I think it has to be understood as exactly that, and in this case that is a completely inappropriate assumption.

Senator PACKWOOD. Would the Senator yield?

Senator HANSEN. Of course.

Senator PACKWOOD. I don't know how anybody could come to the conclusion, if he didn't do a study. If the capital gains rates were lowered people who now hold stocks might more readily se'l them.

Mr. FELDSTEIN. There is no question about the direction of the effect. The question is quantitative—would it be large and would it be large enough to offset the revenue loss?

Senator PACKWOOD. I mean, the Treasury would assume a static effect.

Mr. FELDSTEIN. That's right.

They don't assume it and assert that it is true. They assume it, tell you that they have assumed it, and tell you that that is the only thing that they are prepared to offer as an estimate.

Senator HANSEN. I think Secretary Brill, when he was testifying, made the assertion that a cut in the Federal budget would do more for venture capital than a cut in the taxation of capital.

Would you care to comment on that?

Mr. FELDSTEIN. I think this is a much more targeted approach in that this would have a clearer effect on venture capital than on capital formation in general. Moreover, I am afraid that we may have gotten to the point where the willingness to invest, rather than the total availability of capital, may be the constraining force in our economy. If we don't increase the incentives to do that investment, merely providing more funds will not be sufficient.

Senator HANSEN. Some people criticize a sliding scale on the ground that it would create a lock-in of capital by giving people an incentive to hold onto their assets longer than would be optimal for the economy.

What is your view of that, Dr. Feldstein?

Mr. FELDSTEIN. I think the sliding scale is clearly inferior to either an outright reduction and/or a change in the treatment of inflationary gains. I think that those who have invested for the last few years have suffered substantial losses simply because of inflation and the sliding scale wouldn't really undo that.

Senator HANSEN. Thank you. I think I should give Senator Dole a chance to ask some questions.

Senator DOLE. Thank you.

I only want to pursue the one question I have, and that concerns a statement on page 3 regarding inflation.

It was suggested earlier there should be an inflation adjustment for capital gains. Do you subscribe to that theory?

Mr. FELDSTEIN. I do, yes.

Senator DOLE. What about it?

Mr. FELDSTEIN. I think it would be very easy to do. I think it would change the equity of the taxation of capital gains. You wouldn't have an arbitrary taxation. It would simply reflect the inflationary increases.

I would say one further thing. There has been so much talk about this as a tax cut for the rich. One of the implications of the estimates that there will be more tax revenue is that, in fact, the current holders of corporate stock, the current shareholders, will actually pay more tax and not less tax. They will be happier. They will be better off. They will be able to move their funds from less efficient to more efficient uses in the market. But they will actually pay more taxes.

Senator PACKWOOD. Mr. Feldstein, we have no further questions. But please send your other study to us.

Thank you.

Mr. FELDSTEIN. Thank you, Mr. Chairman.

[The prepared statement of Mr. Feldstein follows:]

STATEMENT OF MARTIN FELDSTEIN,[1] PRESIDENT, NATIONAL BUREAU OF ECONOMIC RESEARCH AND PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

THE TAXATION OF CAPITAL GAINS

I am very pleased to be here this morning. During the past three years, I have been doing research on the taxation of capital gains on corporate stock. I think the findings of that research bear directly on the proposals that your are currently considering.

This morning I will summarize briefly the results of two studies. The first describes the way that inflation affects the taxation of capital gains. The second deals with the impact of the capital gains tax rate on the selling of corporate stock and the realization of capital gains. I am submitting copies for the record of two papers that provide more complete reports of these studies.[2]

INFLATION AND THE TAXATION OF CAPITAL GAINS

Inflation distorts all aspects of the taxation of personal income but is particularly harsh on the taxation of capital gains. As you know, when corporate stock or any other asset is sold, current law requires that a capital gains tax be paid on the entire difference between the selling price and the original cost even though much of the nominal gain only offsets a general rise in the prices of consumer goods and services. Taxing nominal gains in this way very substantially increases the effective tax rate on real price-adjusted gains. Indeed, many individuals pay a substantial capital gains tax even though, when adjustment is made for the change in the price level, they actually receive less from their sale than they had originally paid.

In a recent study at the National Bureau of Economic Research, we measured the total excess taxation of corporate stock capital gains caused by inflation and the extent to which this distortion differs capriciously among individuals. For this study we used the Treasury Department's sample of individual tax returns for 1973. Our sample consisted of over 30,000 individuals and more than 230,000 stock sales in 1973. Although the individuals are not identified, the sampling rates are known; the sample can therefore be used to construct accurate estimates of totals for all taxpayers.

We found that in 1973 individuals paid capital gains tax on $4.6 billion of nominal capital gains on corporate stock. When the costs of these shares are adjusted for the increase in the consumer price level since they were purchased, this gain becomes a loss of nearly $1 billion.

The $4.6 billion of nominal capital gains resulted in a tax liability of $1.1 billion The tax liability on the real capital gains would have been only $661 million. Inflation thus raised tax liabilities by nearly $500 million, approximately doubling the overall effective tax rate on corporate stock capital gains.

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[1] President, National Bureau of Economic Research, and Professor of Economics, Harvard University. The viewpoints expressed here are my own and not necessarily those of either the NBER or Harvard.

[2] M. Feldstein and J. Slemrod, "Inflation and the Excess Taxation of Capital Gains," National Bureau of Economic Research (to be published in the National Tax Journal, June 1978) and M. Feldstein and S. Yitzhaki, "The Effects of the Capital Gains Tax on the Selling and Switching of Comomn Stock," Journal of Public Economics, 1978.

Although adjusting for the price change reduces the gain at every income level, the effect of the price level correction is far from uniform. In particular, the mismeasurement of capital gains is most severe for taxpayers with incomes under $100,000. Exhibit 1 compares the nominal and real capital gains and the corresponding tax liabilities for each income class. The first row presents the net capital gains as defined by the current law. Row 2 represents the corresponding real net capital gains. In the highest income class, there is little difference between nominal and real capital gains; in contrast, taxpayers with incomes below $100,000 suffered real capital losses even though they were taxed on positive nominal gains.

The tax liabilities corresponding to these two measures are compared in rows 3 and 4. In each income class up to $50,000, recognizing real capital gains makes the tax liability negative. At higher income levels, tax liabilities are reduced but remain positive on average; the extent of the current excess tax decreases with income.

Inflation not only raises the effective tax rate, but also makes the taxation of capital gains arbitrary and capricious. Individuals who face the same statutory rates have their real capital gains taxed at very different tax rates because of differences in holding periods. For example, among taxpayers with adjusted gross incomes of $20,000 to $50,000, we found that only half of the tax liability on capital gains was incurred by taxpayers whose liabilities on real gains would have been between 80 and 100 percent of their actual liabilities. The remaining half of tax liabilities were incurred by individuals whose liabilities on real gains would have been less than 80 percent of their actual statutory liabilities.

In short, our study showed that inflation has substantially increased—roughly doubled—the overall effective tax rate on corporate stock capital gains. Although this estimate relates to 1973 (because that is the only year for which data of this type is available), the continuing high rate of inflation means that the tax distortion for more recent years is likely to be even greater.

CAPITAL GAINS TAX RATES AND THE SELLING OF CORPORATE STOCK

Although there has long been speculation about the extent to which high tax rates on capital gains deter individuals from selling stock, there has been little hard evidence on the subject. In collaboration with two colleagues. I recently completed what I believe are the first econometric estimates of the effect of capital gains tax rates on the selling of corporate stock and the realization of capital gains.

We actually carried out two studies using two quite different bodies of data. Both studies indicate that capital gains tax rates have a very substantial effect on individuals' decisions to sell corporate stock.

The first study analyzed the experience of a random sample of high income investors whose portfolio behavior was recorded in a special survey carried out by the Federal Research Board in 1963. An important finding in an analysis of that data was that two-thirds of the value of the proceeds of corporate stock sales were reinvested in corporate stock and other financial assets within 1963. Since some of the remaining one-third of the proceeds were held in cash and reinvested in the following year, the data indicate that less than one-third of the proceeds of corporate stock sales were used to finance current consumption.

The evidence in that study showed that the amount that individuals sell is quite sensitive to their tax rate. For example, on the basis of our statistical estimates of the tax rate sensitivity of individual selling, we calculated the effect of removing the 25 percent ceiling that was in effect in 1963 and taxing individuals at one-half of their ordinary income rates. We found that this change would have reduced the value of corporate stock sales by 23 percent.

Our second study used the same 1973 Treasury sample that I referred to a few moments ago in discussing the effects of inflation.[3] This analysis again found that individuals' selling of corporate stock is very sensitive to their tax rates. We used this estimated behavior to calculate the effect of changes in the 1973 law. We found that limiting the rate of tax on long-term gains to 25 percent would have nearly doubled corporate stock sales, from $29.2 billion to $49.5 billion.

The Treasury data also permitted us to evaluate the impact of differences in tax rates on the amount of capital gains that individuals realize. We found that the realization of gains is even more sensitive than the selling of stock. Using the statistically estimated tax sensitivity, we calculated that limiting the capital gains rate to 25 percent would have caused an almost three-fold increase in the

[3] This study is reported in M. Feldstein, J. Slemrod and S. Yitzhaki, "The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains," National Bureau of Economic Research, 1978.

total value of net gains realized in 1973. Because of this great increase in the realization of gains, the reduction in tax rates would have substantially increased capital gains tax revenues. Our calculation indicates that the tax revenues on corporate stock capital gains would have more than doubled if the tax rate had been limited to 25 percent.

That concludes my summary of the studies of capital gains taxation. I hope that you find that these facts are useful to you as you consider proposals to reduce the taxation of capital gains.

EXHIBIT 1

CAPITAL GAINS AND ASSOCIATED TAX LIABILITIES

[Millions of dollars]

	Adjusted gross income class								
	Less than 0	0 to $10,000	$10,000 to $20,000	$20,000 to $50,000	$50,000 to $100,000	$100,000 to $200,000	$200,000 to $500,000	More than $500,000	All
1. Nominal capital gains	86	77	21	369	719	942	1,135	1,280	4,629
2. Real capital gains	−15	−726	−895	−1,420	−255	437	839	1,125	−910
3. Tax on nominal capital gains	1	−5	23	80	159	215	291	374	1,138
4. Tax on real capital gains	0	−25	−34	−52	58	141	235	337	661

Senator PACKWOOD. Next we will have a panel consisting of Mr. James Davant, Mr. A. A. Milligan, and Mr. Arthur Levitt.

Gentlemen, please come forward.

Excuse me.

Senator HANSEN [presiding]. Gentlemen, if you would be seated at the witness table and identify yourselves for the benefit of the reporter, it would be helpful.

May I have your name, sir.

Mr. MILLIGAN. My name is Milligan, Senator.

Mr. LEVITT. I am Arthur Levitt, Senator.

Mr. DAVANT. James W. Davant, Mr. Chairman.

Senator HANSEN. Thank you very much, gentlemen. Who would like to go first?

Mr. DAVANT. Well, since we are in competition with a ham sandwich, I guess I had better start and do it as fast as I can.

Senator HANSEN. As you undoubtedly know, there is a vote in progress. Senator Packwood has just gone to vote, and before the vote is completed, Senator Dole and I will be leaving here, too. Hopefully Senator Packwood may have returned. If not, we will just have to recess briefly until one of us gets back here.

Gentlemen, before you begin, let me say that your entire statements will be included in the record. I can assure you that they will be read. If you would like to summarize and take perhaps 5 minutes each as a starter, that might get us off and running a little quicker.

STATEMENT OF JAMES W. DAVANT, CHAIRMAN OF THE BOARD, PAINE WEBBER, INC., NEW YORK, N.Y.

Mr. DAVANT. I am James W. Davant. I am chairman of the board of Paine Webber, Inc. Our firm serves about half a million individual investors and we have some knowledge of their feeling.

Capital formation basically is our business and I am here because I do sense and share a growing public concern about the falling rate of capital formation in the United States.

We are becoming what I think someone has called a dis-developing country.

I believe the enactment of S. 3065 would be a major beginning toward arresting and reversing this trend. At the same time, it could reduce unemployment without aggravating inflation. I would like to concentrate by brief remarks on this proposal.

The Hansen bill deals directly with two major interrelated aspects of the capital formation problem: The withdrawal of the individual investor from our capital markets and the disproportionate impact of capital scarcity on new and smaller businesses. I think we are just beginning to understand the dimensions and the importance of these twin trends.

The Nation's smaller businesses are suffering most from the capital shortage. This is crucial, because of the special character of their contribution to economic growth.

There is a gathering body of evidence confirming that smaller businesses are a principal source of new ideas, new jobs, and new economic growth.

Yet, in the past decade, smaller companies have found it much more difficult to obtain the capital they need to grow. I will illustrate the point.

In 1969, for instance, companies with a net worth of less than $5 million sold 548 new issues totaling $1.5 billion. In 1975, this type of company offered only four new issues for a total of $16 million. Initial public offerings, which we can safely presume to come mainly from smaller companies, declined from 646 in 1972 to just 46 last year.

I think you will also find that larger companies can go to market whereas smaller ones can't.

In 1972, we had quite a few initial public offerings. Last year, we had none. These are the companies that are growing, idea companies.

The same thing is true in private placement areas. You need to be larger now to go and get private placement from institutions.

In the venture capital area, the same thing again is true. In 1968, there were 300 high technology companies formed and none were formed in 1976. This is consistent with our experience.

At the same time, the individual investor seems to be becoming an endangered species. The number of individual investors, after reaching an alltime high of 32 to 33 million in 1972, declined 18 percent in the next 5 years.

Traditionally these individuals have been the primary source of equity capital for smaller businesses. They have been net sellers of about $5 billion of corporate stock a year for the past 5 years.

The Treasury doesn't always gain from this. I know of a situation just last week where a stockholder found that he could give away his stock to an institution of higher learning. The Treasury got nothing out of it and, of course, he came out better on his tax bill than he would if he hadn't given it away.

Today, more and more individual savings flow into capital markets through financial intermediaries, which are less and less willing to invest in smaller businesses.

I don't think there is any real mystery behind these related trends. They are largely the result of public policy. Individual investors are abandoning the capital markets in part because they feel abused, ignored, and disenfranchised, and tax policy is a fundamental cause.

In the name of tax reform, we have piled heavier and heavier penalties on people who save and invest. The measures which provide investors with some limited protection from the full force of these penalties are often called "loopholes." But these loopholes just did not appear. They were written into the tax code to achieve specific purposes. They are not part of some underhanded regressive income redistribution scheme designed to benefit the well-to-do. They were specifically designed to encourage investment because investment creates jobs and helps restrain inflationary pressures—and so is likely to redistribute income more effectively than a dozen simple-minded soak the rich schemes.

Somehow we have lost sight of these central public policy goals. Since 1969, the maximum tax on capital gains has effectively been doubled. This narrowing of the differential between tax rates on ordinary income and the tax rate on capital gains is undoubtedly the single most important factor inhibiting direct individual investment in equities.

Other penalties on capital gains were imposed at the same time. The 1969 act provided, for the first time, that $2 of long-term capital losses would be required to offset $1 of ordinary income. The 1976 act extended the holding period for capital gains to 1 year.

No other major industrial country penalizes capital gains so severely. Even in the U.K.—hardly an economic model—the top rate is 30 percent and there is no holding period. Our principal competitors in the world markets—Japan and Germany—exempt capital gains from taxes, as does Italy. Our rate is twice that of socialist Sweden.

These tax "reforms" have been advanced in the name of a plausible principle, that all income, however derived, should be taxed equally. Yet, the tax reformers want to enforce this equality unequally. They want capital gains treated as ordinary income, but they don't want capital losses to be fully offset against ordinary income.

It is more than coincidence, in my opinion, that the stagnation of our equity markets and the decline in the number of individual investors date roughly from the passage of the 1969 Tax Reform Act.

The root cause of the investor's disenchantment may be that simple. The contraction of the securities sales network—accelerated by other governmental actions—has followed inevitably. As the number of offices and salesmen has declined, the individual investor has further tended to withdraw, in a kind of self-reinforcing spiral.

The capital problems of small businesses are the clear consequence of these policy-induced trends. The final result is aggravated unemployment, rates of inflation without precedent, and a declining rate of productivity.

I think that the elimination of taxes on capital gains would be a major factor toward solving virtually all these problems.

Senator HANSEN. If I could, let me observe that more than half the time allotted for voting has expired. Mr. Davant, if you would take just one more minute to wind up, we will then leave to cast our votes.

Mr. DAVANT. I will try.

Senator HANSEN. Please be assured that I will read your entire statement.

Mr. DAVANT. Thank you.

I think that the final word on progressivity and fairness belongs to you, Senator Hansen. When you introduced S. 3065 last month, you said, "It is both fair and right to offer the possibility of a meaningful profit in return for assuring the risk of a new endeavor."

Messrs. Blumenthal, Eizenstat. Jordan, et. al. should be made to write this on the blackboard about 100 times before they go home from school.

The administration also tells us that the Hansen bill would cost the Treasury $2.2 billion annually, claiming this would add unacceptably to the deficit.

But to accept this figure, we must accept an absurdity, that cutting the capital gains tax will produce no changes in economic behavior. The stock market will not go up; the rate of realization of capital gains will not increase: the dividend payout ratio will stay the same.

I think this is static analysis and it certainly doesn't bear scrutiny.

Surely the stock market went up 10 percent in the last 60 days. I think that is not beyond the realm of anticipation.

I do want to point out that the administration offers a slight reduction in the corporate tax rate and a boost in investment tax credit. But a corporation must have profits to benefit from these proposals and they would do little to relieve the capital raising problems of new and smaller businesses and they would do nothing to stimulate the entrepreneurial impulse. The largest corporations would stand to benefit most.

Not long ago, Senator, I would like to say that Secretary Blumenthal seemed to be thinking along the same lines.

"I find it hard to argue with common sense," he said in a speech in Florida on the eighth of May. "The fall-off in equity capital, it seems to me, can hardly help but encourage a trend toward dominance by larger companies, a corporate sector abnormally skittish about economic fluctuations, and a dearth of new, small companies dedicated to testing, generating,and spreading technological innovations."

On the plane back from Florida, the Secretary must have been reading Emerson, who tells us that "A foolish consistency is the hobgoblin of little minds."

Senator HANSEN. I am going to have to run.

Mr. DAVANT. It is difficult to think of any other explanation for his denunciations of the Hansen bill.

Thank you very much.

[The prepared statement of Mr. Davant follows:]

STATEMENT OF JAMES W. DAVANT, CHAIRMAN OF THE BOARD, PAINE WEBBER, INC.

My name is James W. Davant. I am Chairman of the Board and Chief Executive Officer of Paine Webber Incorporated and its largest operating subsidiary, Paine, Webber, Jackson & Curtis Incorporated. Paine Webber is one of the largest full-service securities and investment banking firms. We have 147 offices and more than 2,400 registered representatives. Paine Webber provides a broad range of financial products and services to individual and institutional investors, and to corporations and public agencies. We serve about 500,000 individual investors.

Capital formation is our business, and I am here because I sense and share a growing public concern over the falling rate of capital formation in the United States. We are becoming what someone has called a dis-developing country. I believe the enactment of S. 3065 would be a major beginning toward arresting and reversing this trend. At the same time, it could reduce unemployment without aggravating inflation. I would like to concentrate my brief remarks on this proposal.

The Hansen bill deals directly with two major interelated aspects of the capital formation problem—the withdrawal of the individual investor from our capital markets and the disproportionate impact of capital scarcity on new and smaller businesses. We are just beginning to understand the dimensions and the importance of these twin trends.

The nation's smaller businesses are suffering most from the capital shortage. This is crucial, because of the special character of their contribution to economic growth. There is a gathering body of evidence confirming that smaller businesses are a principal source of new ideas, new jobs and new economic growth.

Yet, in the past decade, smaller companies have found it more and more difficult to obtain the capital they need to grow. In 1969, for example, companies with a net worth of less than $5 million sold 548 new issues totaling nearly $1½ billion. In 1975, these companies offered only four new issues for a total of a little over $16 million. Initial public offerings, which we can safely presume to come mainly from smaller companies, declined from 646 in 1972 to 46 last year.

These aggregates are reflected clearly in the day-to-day activities of our company. Five years ago, for example, we were able to consider initial public offerings for companies with after-tax earnings of $1 million or more. Today, we cannot even discuss an initial public offering with a company unless it has after-tax earnings of well over $2 million—plus unusual visibility or some exceptional potential. In 1972, Paine Webber managed four initial public offerings. Last year, we managed none. In other words, most smaller, younger companies are now effectively foreclosed from "going public"—the traditional first step for small companies on the way to becoming bigger ones.

In the private placement market, too, the situation is particularly difficult for smaller companies. Five years ago, a company with as little as half a million in after-tax earnings could think in terms of a private placement. Now it must have at least a million.

In the venture capital area, the situation is no better. Venture capital pools, which once specialized in start-up situations, now seem to be focusing more and more on later stage financings or re-financings of established companies. This year, Paine Webber's venture capital operation is considering only one start-up situation. It was reported recently that while 300 high-technology companies were formed in the United States in 1968, none were formed in 1976. This is consistent with our experience. From our vantage point, the business birth rate seems to be approaching zero.

At the same time, the individual investor seems to be becoming an endangered species. The number of individual investors, after reaching an all-time high of 32.5 million in 1972, declined 18 percent in the next five years. Now only about 25 million people own equities. Individuals—traditionally the principal source of equity captial for smaller business—have been net sellers of about $5 billion of corporate stock a year for the last five years.

Today, more and more individual savings flow into capital markets through financial intermediaries, which are less and less willing to invest in smaller businesses. And the network of brokerage firm sales offices and salesmen serving individual investors has been shrinking. I can tell you from personal experience that when a securities firm closes a branch office, more often than not it is closing the door to some sources of small business capital. The industry's branch office network has been the life support system for the nation's smaller businesses.

There's no real mystery behind these related trends. They are largely the result of public policy. Individual investors are abandoning the capital markets in part because they feel abused and ignored and disenfranchised, and tax policy is a fundamental cause.

In the name of tax reform, we have piled heavier and heavier penalties on people who save and invest. The measures which provide investors some limited protection from the full force of these penalties are often called "loopholes", but these "loopholes" didn't just appear. They were written into the Tax Code to achieve specific purposes. They are not part of some underhanded regressive income redistribution scheme designed to benefit the well-to-do. They were specifically designed to encourage investment, because investment creates jobs and helps restrain inflationary pressures—and so is likely to redistribute income more effectively than a dozen simple-minded "soak the rich" schemes.

Somehow we lost sight of these central public policy goals. Since 1969, the maximum tax on capital gains has effectively been doubled. This narrowing of the differential between tax rates on ordinary income and the tax rate on capital gains is undoubtedly the single most important factor inhibiting direct individual investment in equities.

Other penalties on capital gains were imposed at the same time. The 1969 Act provided, for the first time, that $2 of long-term captial losses would be required to offset $1 of ordinary income. The 1976 Act extended the holding period for capital gains to one year.

No other major industrial country penalizes capital gains so severely. Even in the U.K., the top rate is 30 percent and there is no holding period. Our principal competitors in world markets—Japan and Germany—exempt capital gains from tax, as does Italy. Our rate is twice that of socialist Sweden.

These tax "reforms" have been advanced in the name of a plausible principle—that all income, however derived, should be taxed equally. Yet, the tax reformers want to enforce this equally unequally. They want capital gains treated as ordinary income, but they don't want capital losses to be fully offset against ordinary income.

It is more than coincidence, in my opinion, that the stagnation of our equity markets and the decline in the number if individual investors date roughly from the passage of the 1969 Tax Reform Act. The root cause of the individual investor's disenchantment may be that simple. The contraction of the securities sales network—accelerated by other Government actions—has followed inevitably. As the number of brokerage offices and salesmen has declined, the individual investor has further tended to withdraw, in a kind of self-reinforcing spiral. The capital problems of small businesses are the clear consequence of these policy-induced trends. The final result is aggravated unemployment, rates of inflation without precedent, and a declining rate of productivity.

The elimination of taxes on capital gains would be a major step toward solving virtually all these problems. The egalitarian "reformers" would like us to see this as a radical departure. In fact, it would do no more than bring the United States into line with the majority of industrialized countries. According to the DRI/SIA study, it would also bring a $200 billion gain in real GNP, create three million additional jobs, and increase tax revenues by some $38 billion over the next five years. The study conducted by Chase Econometrics arrives at similar conclusions.

I am told, however, that the outright elimination of the capital gains tax is a political impossibility. If that is so, I strongly support the alternate proposal embodied in the Hansen bill. The tax treatment of capital gains should be restored to its pre-1969 level. I believe this roll-back would produce such dramatic results that an informed public debate on the merits of the outright elimination of the capital gains tax would soon become politically feasible.

By providing incentive for the renewed participation of individual investors in our equity markets, the Hansen bill would also help restore the flow of capital to small businesses. Yet the Administration threatens to veto tax legislation containing such a provision, all the while assuring us of its concern for capital formation. At best, this is naive. At worst, it is demagogic.

The Hansen bill imperils "progressivity" and "fairness", the Administration tells us, pointing to the fact that a large portion of the "relief" would go to higher-income taxpayers. Here the Administration has set itself against an intractable reality: there is no way to increase investment that will not increase the rewards to people who invest. If, to encourage growth, it is necessary to reduce taxes on the returns from capital, the owners of capital will surely benefit.

Must we sacrifice economic growth to simplistic notions of what is progressive and fair? When capital gains tax rates were raised in 1969, Government revenues fell. Who kept the money the Treasury didn't get? These same higher-income taxpayers, of course—by deferring the realization of capital gains or by shifting into tax-free municipals and other assets that are less productive but harder to tax.

The fact is that while some higher-income taxpayers would be the most visible beneficiaries of capital gains tax reform, they would not necessarily be the principal beneficiaries. Workers would benefit as new jobs were created. Robert Strauss might lose one of his jobs, but the rest of us would benefit significantly from a reduction in inflationary pressures.

The final word on "progressivity" and "fairness" belongs to Senator Hansen. When he introduced S. 3065 last month, he said: "It is both fair and right to offer the possibility of a meaningful profit in return for assuring the risk of a new endeavor." Messrs. Blumenthal, Eizenstat, Jordan, et. al. should be made to write this on the blackboard one hundred times before they go home from school.

The Administration also tells us that the Hansen bill will cost the Treasury $2.2 billion annually, claiming this would add unacceptably to the deficit. But to accept this figure, we must accept an absurdity: that cutting the capital gains tax will produce no changes in economic behavior. The stock market will not go up; the rate of realization of capital gains will not increase; the dividend payout

ratio will stay the same. I believe the economists call this static analysis, and I believe there is a growing awareness of its limitations. Static analysis also produces the conclusion that higher tax rates on capital gains will bring higher revenues. Yet when rates were raised in 1969, revenues fell. They are only now approaching pre-1969 levels, and this in inflated dollars.

In contrast, a recent test of the Hansen proposal on the DRI model predicts the following results for the period 1979-83: a $98 billion increase in real GNP; a $46 billion increase in capital formation; 520,000 more jobs; an increase of $33 billion in Federal tax revenues. Such simulations, the Administration tells us, are are based on unreasonable assumptions. The Administration objects, principally, to the assumption that a cut in the capital gains tax rate will cause the stock market to go up. Yet the DRI test assumed only a 10 percent market rise. The stock market rose that much between mid-April and mid-May—in part, no doubt, merely in anticipation of the passage of some sort of capital gains tax relief. Is it more reasonable to assume a modest risei in the stock market in response to a cut in the capital gains tax, or to assume that nothing, including the stock market, will change?

In lieu of the Hansen bill, the Administration offers a slight reduction in the corporate tax rate and a boost in the investment tax credit. But a corporation must have profits to benefit from these proposals. They would do little to relieve the capital-raising problems of new and smaller businesses, and they would do nothing to stimulate the entrepreneurial impulse. The largest corporations would stand to benefit most from them.

Not so long ago, Secretary Blumenthal seemed to be thinking along the same lines. "I find it hard to argue with common sense," he said in a speech in Florida on the 8th of May. "The fall-off in equity capital, it seems to me, can hardly help but encourage a trend toward dominance by larger companies, a corporate sector abnormally skittish about economic fluctuations, and a dearth of new, small companies dedicated to testing, generating and spreading technological innovations." On the plane back from Florida, the Secretary must have been reading Emerson, who tells us that "A foolish consistency is the hobgoblin of little minds." It is difficult to think of another explanation for his denunciations of the Hansen bill, which began just a few days later.

I believe the Hansen bill would provide relief where it is most needed, where its effects would show up most promptly, and where its leverage would be greatest. By providing direct incentives for the purchase of equities by individuals, it would help restore the flow of capital to new and smaller businesses, our principal source of new jobs and new economic growth. It would help improve productivity and reduce inflationary pressures. I strongly support the Hansen bill and urge this Committee to act favorably on it.

I thank the Committee for this opportunity to present my views. I will be glad to try to answer any questions.

[A brief recess followed.]

Senator PACKWOOD. [presiding]. Gentlemen, please go ahead. Be sure to talk into the microphone so that the people in the back can hear you reasonably well.

Mr. Levitt, are you next?

Mr. LEVITT. Yes, Mr. Chairman.

STATEMENT OF ARTHUR LEVITT, JR., CHAIRMAN, AMERICAN STOCK EXCHANGE, NEW YORK, N.Y.

Mr. LEVITT. Mr, Chairman. my name is Arthur Levitt, Jr., and I am chairman of the American Stock Exchange. I am here today because of my firm conviction that private equity capital formation within the American economy must be significantly increased if we are going to maintain our economic well-being and even our traditional and cherished ways of life.

The administration, represented by what the Wall Street Journal has called a "coterie of income levelers" at the Treasury Department,

has taken an ideological position on what it calls "tax reform" which becomes less and less defensible as the facts are brought forward.

The administration's inflammatory attacks on the proponents of a reduction in capital gains tax have polarized the Nation on the basis of arguments that I believe are totally unsupportable. I am here to take a position on the other side of those arguments.

I am convinced that the smaller corporation and the individual investor must have the encouragement which would be symbolized by a favorable change in our tax policy.

Furthermore, I believe that this issue cuts across the traditional lines to reach not only the smaller corporation and the individual investor, but also labor unions, minority groups, urban leaders, and others who are interested in innovation, jobs, and economic growth.

The American Stock Exchange has recently mobilized representatives of all of these groups to join us in presenting to the Congress porposals for a sound and sensible Federal tax policy, which will encourage the individual to return to the market to provide an important source of equity financing for the smaller corporation. Mayors Tom Bradley of Los Angeles and Ed Koch of New York, as well as former Governor Terry Sanford of North Carolina, a black businesswoman form Brooklyn, and a leader of a major national labor union joined us in this testimony.

We are not talking about the needs of General Motors of duPont.—we are talking about the grassroots of the American economy. We are talking about companies like Drug Fair in Alexandria, Va.; Flowers Industries in Thomasville, Ga.; the Golden Cycle Corp. in Colorado Springs; Discount Fabrics, Inc., in Portland, Oreg.; Phoenix Steel in Claymont, Del.; and the Wyoming Bancorporation in Cheyenne. These are only a few of our nearly 1,100 listed companies whose interests we are endeavoring to safeguard.

I strongly feel that the tax disincentives have played a significant part in the decline of stock ownership that has occurred in the last few years.

For years, American investors have endured burdensome taxes on profitable investments without corresponding relief for losses.

The administration has talked about the urgent need to expand and strengthen our economy by stimulating capital formation and productivity, but its tax proposals on capital gains and losses would have had the opposite effect.

I have spoken out against the administration's suggestion at every opportunity, including a meeting this past Monday with top members of Secretary Blumenthal's staff. The administration's proposals would, in my opinion, worsen the already critical situation in the equity capital markets without achieving any measure of tax equity.

Along with the bill's 60 cosponsors, I strongly support Senator Hansen's bill which would restore the rate of tax on capital gains to the 25 percent maximum which had been in effect for years.

I think the administration's efforts in opposition to the Hansen-Steiger proposals have been totally misguided. Its economic analysis demonstrates, in my judgment, a misleading negative bias against these vital proposals. The Treasury predicts a $2.4 billion revenue loss based upon a static analysis which assumes no increase in securities transactions or securities prices as the result of the tax decrease.

Yesterday, Mr. Blumenthal told you that there is no credible evidence permitting a projection of the bill's impact upon the stock market. I think he is wrong. Commonsense and sophisticated econometric studies predict a totally different result.

The administration's resort to an illusory tax "equity" to support a hazardous alteration of our entire capital market structure is most disturbing. Of course high tax bracket payers would be the direct beneficiaries of a rollback in capital gains taxes to pre-1969 levels—they bore the entire brunt of the increase from those levels. The real benefits we are talking about here are the benefits of increased employment and economic expansion. These benefits, which should vastly overshadow any direct revenue loss to the Treasury, would go in large measure to low bracket taxpayers and to the general population.

The administration must be made to realize that productive capital investment cannot be stimulated by modest tax cuts for individuals, the bulk of which will only result in inflationary consumer spending. What we need—and I believe the public understands this despite the administration's demagogery—are incentives to saving, not incentives to spending. It is savings that will be translated into productive investment and solid economic growth. The Companies and investors that I represent are frustrated and discouraged by the administration's economic nit-picking of constructive tax proposals.

The administration claims that what it calls tax "equity" requires a change in the manner in which capital gains are taxed. Even if this were true, the solution would not be to impose taxes which deter high bracket taxpayers from capital investment. It would be vastly more desirable to reduce taxes on capital gains of lower bracket taxpayers and provide them with the incentive to make capital investments.

In my testimony before the House Ways and Means Committee on March 7 of this year, I suggested a proposal which was designed to accomplish precisely that goal. I proposed that a credit be allowed to individuals against their tax liability of 10 percent of their investment during the year in new issues of common and preferred stock of small- to medium-sized corporations. The credit would be limited to $500.

Under the proposal, the benefits would also flow to small- and medium-sized businesses, where they are most needed. The credit would be allowed only in the case of new issues by corporations with net equity of $25 million or less.

I would like to thank the committee for its time and patience.

I hope my testimony has been of assistance.

Senator PACKWOOD. Thank you very much. Your entire statement, of course, will appear in the record.

[The prepared statement of Mr. Levitt follows:]

STATEMENT OF ARTHUR LEVITT, JR. OF THE AMERICAN STOCK EXCHANGE

Mr. Chairman and members of the Committee. My name is Arthur Levitt, Jr. I am Chairman of the American Stock Exchange. I would like to thank the Committee for giving me the opportunity to testify on a subject which I believe is of crucial importance to the American economy—the taxation of capital gains and losses.

More than one-half of the trading on the American Stock Exchange is done by individual investors. The Exchange provides a market for the securities of more than 1,000 small and medium-sized businesses. As Chairman of the Exchange I am constantly in contact with the chief executive officers of numerous of these businesses.

I am here today, Mr. Chairman, because I am of the firm conviction that private equity capital formation within the American economy must be significantly increased if we are to maintain our economic well-being and even our traditional and cherished ways of life. The Administration—represented by what the Wall Street Journal has called a "coterie of income levellers" at the Treasury Department—has taken an ideological position on what it calls "tax reform" which become less and less defensible as the facts are brought forward.

I am here to take a position on the other side of that philosophical argument. I am convinced that the smaller corporation and the individual investor must have the encouragement which would be symbolized by a favorable change in our tax policy.

Furthermore, I believe that this issue cuts across traditional lines to reach not only the smaller corporation and the individual investor but also labor unions, minority groups, urban leaders, and others who are interested in innovation, jobs, and economic growth.

In the last few months the Amex has asked representatives of all of these groups to join us in presenting to the Congress proposals for a sound and sensible federal tax policy which will encourage the individual to return to the market to provide an important source of equity financing for the smaller corporation. Mayors Tom Bradley of Los Angeles and Ed Koch of New York, recognizing the crucial importance of younger, growing corporations to the revitalization of urban areas, testified with us, as did former Governor Terry Sanford of North Carolina, a black businesswoman from Brooklyn, a leading consumer advocate, a leader of a major national labor union, and the heads of two Amex listed companies who have had to look outside of the United States for the capital to expand.

We aren't talking about the needs of a General Motors or a duPont—we're talking about the "grass roots" of the American economy.

We're talking about companies from your home states: companies like Drug Fair in Alexandria, Virginia; Flowers Industries in Thomasville, Georgia; The Golden Cycle Corporation in Colorado Springs; Discount Fabrics, Inc. in Portland, Oregon; Phoenix Steel, in Claymont, Delaware; Alaska Airlines; and the Wyoming Bancorporation in Cheyenne. These are only a few of the nearly 1100 companies listed on the Amex whose interests we are attempting to safeguard. They are interested, as I am, in bringing Main Street back to Wall Street.

In earlier years, businesses relied on equity capital as a major source of new investment. Today, the situation has changed dramatically. Debt financing is now the major source of capital. In 1977 the amount of debt financing was ten times as large as equity financing. The debt-to-equity ratio of American companies, particularly smaller companies, has become uncomfortably high, making them increasingly vulnerable to changing credit conditions and more dependent on banks and other lenders. Consequently, they are forced to emphasize caution at the expense of initiative, innovation and expansion.

The decline of equity capital as a source of business expansion was described by Secretary Blumenthal in a speech to the Bond Club of New York in November of 1977. The Secretary noted that public offerings of equity securities by industrial firms had fallen from an annual average of $7.4 billion in the period 1968 through 1972 to only $2.6 billion from 1973 to the present. Companies offering equity securities for the first time were able to place only $230 million of equity capital during the first six months of 1977, only a trickle compared to the $3.3 billion in first issues which were placed in 1972.

In the last few years it has been virtually impossible for small and medium-sized American businesses to raise adequate capital through the sale of common stock. In 1969, the last year that the 25% maximum tax rate for long term capital gains was in effect, companies with less than $5,000,000 in net worth raised $1.5 billion in 698 successful common stock offerings. In 1972, companies of this size raised $918 million in 418 stock offering. In the entire four year period from 1974 through 1977, these equity-starved smaller companies were able to make only 80 successful offerings, raising an average of only $100 million a year.

Furthermore, I focus on equity capital because the American Stock Exchange perceives that the participation of the average American citizen in equity investments in American enterprises has over the years been an essential factor in the relative harmony of various groups within our economic system. Since 1970 we have seen a drastic downturn in individual share ownership. By 1975, the United States shareholder population had dropped from 30 to 25 million individuals, a decline of more than 18 percent and the shareholder percentage of the entire population was down to 11.8 percent, or scarcely one in eight. The percentage of

shareholders with total investments of under $10,000 fell from 62 percent to less than 50 percent; those with total investments of under $5,000 fell from 41 percent to less than one-third.

Equally disturbing are the findings of a recent survey that there will be relatively few new American stockholders in the immediate future. Of those who are former owners of stock, only 8 percent indicated that they might again become shareholders; and of those who had never owned sotck only 2 percent thought they might acquire stock this year. Also, the fact that the average age of American shareholders increased from 48 to 53 between 1970 and 1975 demonstrates that America's young adults are not continuing in the tradition of citizen ownership and that the shareholder population can be expected to continue to decline unless effective measures are taken to make equity investment more attractive.

I strongly feel that tax disincentives have played a significant part in the decline of stock ownership and the important source of equity capital which it represents, particularly with respect to the kinds of small- and medium-sized businesses listed on the American Stock Exchange. For years American investors endured burdensome taxes on profitable investments without corresponding relief for losses. Obviously such a system hits hardest at equity investment in small- and medium-sized companies where the inherent risk of loss tends to be greater. During recent years, limitations on the alternative tax and the imposition of the minimum tax have created additional investment disincentives.

The President has talked about the urgent need to expand and strengthen our economy by stimulating capital formation and productivity, but his tax proposals on capital gains and losses would have had the opposite effect. I have spoken out against the Administration's proposals at every opportunity, including a meeting this past Monday with top members of Secretary Blumenthal's staff. The Administration's proposals would in my opinion worsen the already critical situation in the equity capital markets without achieving any measure of tax equity.

On the other hand, I believe Senator Haskell's bill, S. 2428, would be a very positive step in the right direction. The proposed "roll-over" should substant ally improve the ability of qualified small businesses to raise equity capital without a substantial direct revenue loss to the Treasury. This additional capital in the hands of these innovative labor-intensive concerns would produce a very positive overall impact on the economy.

Furthermore, along with the bill's sixty co-sponsors, I strongly support Senator Hansen's bill, S. 3065, which would restore the rate of tax on capital gains to the 25 percent maximum which had been in effect for years. Of course, any tax on a transaction is a deterrent to those who would otherwise participate. Our most successful economic competitors, including Germany and Japan, impose no tax on long-term equity investments; a 25 percent maximum would merely bring us in line with Canada, Great Britain, and Sweden. Our own experience has proved that taxing capital gains at the rates currently in effect in the United States sharply curtails equity investments.

I think the Administration's efforts in opposition to the Hansen/Steiger proposals have been totally misguided. Its economic analysis demonstrates a misleading negative bias against these important proposals. The Treasury predicts a $2.4 billion revenue loss based upon on a static analysis which assumes no increase in securities transactions or securities prices as the result of the tax decrease. Sophisticated econometric studies, such as the ones undertaken by Data Resources, Incorporated for the Securities Industry Association and by Chase Econometric Associates, predict a totally different result.

The Administration's resort to an illusory tax "equity" to support a hazardous alteration of our entire capital market structure is most disturbing. Of course high bracket taxpayers would be the direct beneficiaries of a roll-back of capital gains taxes to pre-1969 levels—they bore the entire brunt of the increase from those levels. The real benefits we are talking about here, however, are the benefits of increased employment and economic expansion. Those benefits, which should vastly overshadow any direct revenue loss to the Treasury, would go in large measure to low bracket taxpayers and to the general population.

The Administration must be made to realize that productive capital investment cannot be stimulated by modest tax cuts for individuals, the bulk of which will only result in inflationary consumer spending. What we need—and I believe the public understands this despite the Administration's demagoguery—are incentives to saving, not incentives to spending. It is savings that will be translated into

productive investment and solid economic growth. The companies and investors that I represent are completely frustrated and discouraged by the Administration's economic nitpicking of constructive tax proposals.

The Administration claims that tax "equity" requires a change in the manner in which capital gains are taxed. Even if this were true, the solution should not be to impose taxes which deter high bracket taxpayers from capital investments. It would be vastly more desirable to reduce taxes on capital gains of lower bracket taxpayers and provide them with the incentive to make capital investments. Instead of stifling investment by those in a position to provide the capital which is essential to our economy, let us encourage investment by those who are not participating. We should provide incentives to bring the individual investor back to the market and encourage investment in smaller corporations.

In my testimony before the House Ways and Means Committee on March 7th of this year, I suggested a proposal which was designed to accomplish precisely that goal. I proposed that a credit be allowed to individuals against their tax liability of 10 percent of their investment during the year in new issues of common and preferred stock of small to medium-sized corporations. The credit would be limited to $500. Under the Amex proposal, the benefits would also flow to small and medium-sized businesses, where they are most needed, since the credit would be allowed only in the case of new issues by corporations with net equity of $25,000,000 or less.

Utilizing a credit, as opposed to a deduction, and limiting the credit to a specific dollar amount, would assure that the benefits would flow primarily to the intended recipients, middle income taxpayers. In essence, this would amount to a tax credit for investors, a concept that the tax law has recognized as critical to stimulate investment in other areas.

While it is difficult to assess the precise revenue impact of this proposal, a preliminary study has indicated an initial direct revenue loss in the range of $25 million to $50 million. We are confident, however, that any direct revenue loss would be minimal in relation to gains in employment and economic growth and to the social utility of providing a broader base of ownership for the American economy and strengthening the capital structure of America's small and medium businesses.

I wish to thank the Committee for its time and patience. I sincerely hope that my testimony has been of some assistance.

[From the American Stock Exchange Inc., June 29, 1978]

AMEX CHAIRMAN LEVITT SAYS ADMINISTRATION'S STAND ON CAPITAL GAINS TAXATION WILL CONTINUE TO KEEP INDIVIDUAL INVESTOR OUT OF MARKETPLACE AND DISREGARDS ESSENTIAL EQUITY CAPITAL NEED OF SMALL AND MEDIUM-SIZED COMPANIES

Washington, June 29—American Stock Exchange Chairman Arthur Levitt, Jr., today warned that the Administration's stand on capital gains tax reductions would continue to keep the individual investor out of the stock market and therefore would "worsen the already critical situation" for small and medium-sized companies to raise equity capital—the key to maintaining this country's economic well-being.

"The President has talked about the urgent need to expand and strengthen our economy by stimulating capital formation and productivity, but the Administration's tax proposals on captial gains and losses would have had the opposite effect," Levitt told a Congressional panel.

In voicing support for a bill introduced by Sen. Clifford P. Hansen (R-Wyoming), which would restore the rate of tax on capital gains to the 25 percent maximum which had been in effect for years, the Amex chairman said that taxing gains at the rates currently in effect in the United States sharply curtails equity investments and places the United States at a decided competitive disadvantage with other countries. The Hansen bill is the Senate equivalent of a measure proposed in the House by Rep. William A. Steiger (R-Wisc.).

CITES COMPETITIVE ASPECTS

"Our most successful economic competitors, including Germany and Japan," said Levitt, "impose no tax on long-term equity investments. A 25 percent maximum would merely bring us in line with Canada, Great Britain and Sweden."

STRONG VOICE BEFORE CONGRESS

Levitt testified before the Senate Subcommittee on Taxation and Debt Management which is holding hearings on capital gains tax bills. Levitt's testimony marked his third appearance before a congressional panel in less than four months in which he has strongly urged lawmakers to pass tax legislation that will provide investment incentives and stimulate equity capital formation.

In previous testimony before the House Ways and Means Committee and the Senate Select Committee on Small Business, Levitt proposed that individuals be allowed a 10 percent credit against their tax liability investments made during the year in new issues of common and preferred stock of small and medium-sized corporations.

CAPITAL FORMATION: HIGHEST PRIORITY

Additionally, Levitt has met in America's key financial centers with the investment community, municipal and labor leaders, chief executive officers of Amex listed and prospect companies, and the news media to focus attention on the problem of capital formation of this country and the need to attract the individual investor back into the marketplace and to afford small and medium-sized companies easier access to equity expansion capital.

Levitt also stated the case for elimination of tax disincentives to equity investment at a meeting this week with U.S. Treasury Secretary Michael Blumenthal in Washington.

BENEFITS: MORE EMPLOYMENT, LOWER PRICES

Although noting that high bracket taxpayers would be the direct beneficiaries of a roll back of capital gains taxes to pre-1969 levels, Levitt said "the real benefits we are talking about here, however, are the benefits of increased employment and economic expansion that a roll back to the capital gains tax would produce. Those benefits, which should vastly overshadow the direct benefits, would go in large measure to low bracket taxpayers and the general population," He added:

"If tax 'equity' is lacking in the taxation of capital gains, it is not necessary to impose taxes which deter high bracket taxpayers from capital investments. It would be vastly more desirable to reduce taxes on capital gains of lower bracket taxpayers and provide them with the incentive to make capital investments. Instead of stifling investment by those in a position to provide the capital which is essential to our economy, let's encourage investment by those who are not participating."

Levitt said participation of the average citizen in equity investments in American enterprises over the years has been an essential factor in the relative harmony of various groups within our economic system. However, he said that studies have shown that in recent years, middle income America has been dropping out of the equity capital markets at an alarming rate. He cited these figures: in 1970, nearly 31 million individual Americans owned stock in America's corporations—over 15 percent of the population. By 1974, the United States shareholder population had dropped to 25.3 million—less than 12 percent of the population.

SHAREHOLDER AGE RISING

Noting that the decline occurred principally among small investors, Levitt said the percentage of shareholders with total investments of under $10,000 fell from 62 in 1970 to less than 50 in 1975, and those with total investment of under $5,000 fell from 41 percent to less than one-third.

The average age of American shareholders increased from 48 to 53 during those years, Levitt said, demonstrating that America's young adults are not continuing in the tradition of citizen ownership and that the shareholder population can be expected to continue to decline unless effective measures are taken to make equity investment more attractive. He noted that this "disturbing" expectation is further supported by the findings of a recent survey that there will be very few new American shareholders in the immediate future.

The Amex chairman said the prospect of a continuing decline in the participation of American citizens in the equity capital markets "is as disruptive to our social and economic system as are the direct economic consequences of this decline on capital formation."

RELIANCE ON EQUITY CAPITAL

In earlier years, he said, businesses relied on equity capital as the source for a significant portion of new investments. Today he added, the situation has changed dramatically with debt financing now the major source of capital. He noted that 1977 companies borrowed about ten times as much as they obtained through the sale of equity.

"The debt-to-equity ratio of American companies, particularly smaller companies, has become uncomfortably high, making them increasingly vulnerable to changing credit conditions and more dependent on banks and other lenders. Consequently they are forced to emphasize caution at the expense of initiative, innovation and expansion."

Citing government figures, Levitt said public offerings of equity securities by industrial firms had fallen from an average of $7.4 billion in the period 1968 through 1972 to only $2.6 billion from 1973 to present. He said companies offering equity securities for the first time were able to place only $230 million of equity capital during the first six months of 1977, "only a trickle compared with the $3.3 billion in first issues which were placed in 1972.

"In the last few years it has been virtually impossible for small and medium-sized American businesses to raise adequate capital through the sale of common stock," he said.

MIDDLE INCOME TAXPAYER TO BENEFIT

Levitt said his proposal for a tax credit, as opposed to a deduction, would assure that the benefits would flow primarily to the intended recipients, middle income taxpayers. "In essence, this would amount to a tax credit for investors, a concept that the tax law has recognized as critical to stimulate investment in other areas."

Under Levitt's proposal, which would carry a $500 credit limit for individuals, the benefits also would flow to small and medium-sized businesses. He said this is where they are most needed, since the credit would be allowed only in the case of new issues by corporations with net equity of $25 million or less.

While he estimated the initial revenue loss to the government would be in the $25 million to $50 million range, Levitt said any direct revenue loss would be minimal in relation to gains in employment and economic growth and to the social utility of providing a broader base of ownership for the American economy and strengthening the capital structure of America's small and medium-sized businesses.

Senator PACKWOOD. Mr. Milligan.

STATEMENT OF A. A. MILLIGAN, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. MILLIGAN. Mr. Chairman, I am here in my role as president of the American Bankers Association. Our attitude and philosophy was very appropriately and completely stated, quite by chance by a fellow Californian, Senator Cranston, this morning. We would subscribe to his entire statement without any hesitation or qualification. We have prepared remarks, but they would undoubtedly constitute a redundancy and we will not inflict them on you. Our primary concern here, is for the long-range economic health of the United States and the problem that inflation poses for it. We feel very strongly that this bill will attack that problem directly.

We are completely of the conviction that this proposal will, in fact, encourage investment in risk captal, which will encourage investment in new productive capacity. We believe this will give U.S. industry the opportunity to grant noninflationary wage increases. It will remove the inflationary aspects of the wage increases which we are presently experiencing, where wages are rising without appropriate and commensurate increases in productivity.

We feel that one of the major effects of this bill will be attitudinal. We think that this is very important, something that we cannot overlook. The fact is, if a bill of this sort is passed by the Congress, it will demonstrate to the business and industrial sectors of the United States that the attitude of the Congress is constructive and that it means what it says when it states that capital formation is of utmost importance to the Nation. We must do everything that we can to eliminate what has been an apparently adversary relationship, and this certainly would be one step along that route.

In rebuttal of the argument that this is a rich man's bill, we think that the chance for the small man, if you will—small in current economic circumstances—to have a rise in his prosperity does not lie only in his ability to earn and save. Partially it does, but if he is going to have any substantial rise, it is going to have to be on the basis of capital gains. This has been the history of this country. It is what has made it great economically. If the person who is currenty small in total resources is deprived of this opportunity, it will not operate for the long-range good of the country.

There is a further side effect here which we discuss in the testimony we have submitted to the committee. There is a further benefit in this bill to counteract some of the things included in the 1976 tax bill that were not all that healthy or promotive of the economic well-being. One of them was the carryover basis provision. The result of a lowering of the capital gains tax would be to ameliorate the blow that has been given to estates by that carryover basis provision. It would not, of course, attack the carryover provision directly; it would simply serve as an amelioration thereof.

Mr. Chairman, I think that will conclude my remarks. As I said, we did have formal remarks, but in the interest of time and by virtue of the fact that it would be a redundancy to read them, we are very grateful to you for the opportunity to be present here and to support this bill.

Senator PACKWOOD. All of your statements will appear in the record.

You are all very tolerant to have sat here this long, especially while we have to run off and vote occasionally.

Let me say that generally the information we have received so far has been extraordinarily helpful. I know that on occasion witnesses may wonder if politicians care about facts or pay any attention to facts. I can tell you that when it comes time for politicians to argue and convince other politicians, that the kind of facts that we have reviewed this morning are absolutely critical. I appreciate your effort very much.

I have no further questions.

Seuator Hansen?

Senator HANSEN. Thank you, Mr. Chairman. I have no questions. I would just echo the well-thought-out statement made by the chairman and would add that I think politicians understand matters better than they may generally be believed to understand them.

It is important to make the right decisions, because a lot of these fixes, though they may be only temporary, if things don't work out the way we hope they would work out, will come back to haunt us. So, I subscribe entirely to the statement of my chairman in saying that it is terribly important that we have the best advice we can get in an area that is as esoterically filled with information as this one is.

I appreciate very, very much the wisdom and experience you have all brought here today. Thank you very much.

Senator PACKWOOD. Thank you again, gentlemen, very much.

Mr. MILLIGAN. Thank you, Mr. Chairman. It has been very obvious to those of us sitting here in the audience this morning that you Senators have studied this issue quite well. There is no doubt lingering in anybody's mind on that score.

Senator PACKWOOD. Thank you.

[The prepared statement of Mr. Milligan follows:]

STATEMENT OF A. A. MILLIGAN, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. Chairman and members of the Subcommittee, I am A. A. Milligan, President of the Bank of A. Levy, Oxnard, California, and President of the American Bankers Association, a trade association whose membership includes more than ninety-two percent of the nation's 14,383 insured full service banks. I am appearing today on behalf of our Association to testify on S. 3065, a proposal introduced by Senator Hansen to change the tax treatment of capital gains.

Since 1968, long term capital gains taxes have been raised to a maximum of 35 percent and inclusion of the gains in computing minimum tax liability has pushed the tax rate to nearly 50 percent for some taxpayers. In addition, the holding period for assets to become taxable at the long term capital gains rate has been extended to one year from six months. Under the Hansen proposal, which has also been introduced in the House by Representative Steiger, the holding period would remain one year but the maximum effective capital gains tax rate would revert to 25 percent for individuals and corporations after January 1, 1980.

SUMMARY—AMERICAN BANKERS ASSOCIATION, STATEMENT BEFORET HE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE SENATE FINANCE COMMITTEE

We support the Hansen/Steiger proposal because: It will encourage investment in risk capital.

This in turn will encourage investment in new productive capacity which will counter inflation.

The enhanced productive capacity will facilitate the granting of non-inflationary wage increases.

The increased investment in productive capacity will stimulate incomes and employment.

Much of the increased investment will be in equity capital which will counter a trend towards the use of debt and encourage sounder capital structures.

The proposal will move towards facilitating rather than hindering the sale of appreciated assets.

The improved functioning of the capital markets resulting from the proposal will aid newer businesses which, although risky in nature, have a high rate of technological innovation and job creation.

Revenue losses to the Treasury are likely to be minimal because of the increased incomes and sales of assets the proposal will generate.

Finally, since many capital gains have, in fact, been losses after adjustment for inflation, the proposal will lessen the taxation of assets whose value is already being substantially diminished by the hidden tax of inflation.

The Hansen/Steiger proposal must be considered within the context of the turbulent economic conditions that have buffeted our economy during the last twelve years. The biggest problem has been roller coaster inflation and our inability to come to grips with it. Price controls only made matters worse and the various types of jawboning have only caused confusion and uncertainty. Restrictive monetary policies have helped, but they have had undesirable side effects. The inability of the Goverment to curb deficit spending and come to grips with inflation has diminished confidence in our leadership and prompted ordinary citizens to ask their representatives for new approaches.

Unemployment has also followed a roller coaster pattern but its long run average seems to have increased. Demographic factors, including increased labor force participation of second wage earners and the entry into the labor force of people born during the baby boom of the fifties, account for some this trend. But economic instability undoubtedly accounts for much of it. Some policymakers have proposed to cure the unemployment problem by increased public sector jobs and even making the government an "employer of last resort." To taxpayers, who perceive mediocre performance in many government programs and increasing numbers of stultifying government regulations, such a solution is clearly inadequate. They want the solution to be oriented towards the private sector.

Throughout the difficult ups and downs in the business cycle, longer term problems have been surfacing which have also disturbed ordinary citizens and policymakers. Our ability to grant noninflationary wage increases to our workers has been limited by slow growth in the productivity and the amount of the capital they have had to work with. We have been saving less of our income than our major trading partners. We rank very low in terms of the percentage of tax revenues received through taxes on consumption. Relative to other nations we are near the top in terms of percentage of tax revenues received from corporate and household income. And we have one of the most burdensome capital gains taxes in the world. These facts have led many to conclude that our economic problems stem primarily from the restrictions and burdens Government places on private activity. Relief of the excessive burdens of the capital gains tax is a solution many are finding increasingly attractive.

We are well aware of the concerns members of this Subcommittee have for the effect tax reduction proposals have on revenues to the Federal Treasury. Public debate between representatives of the Treasury and the proponents of S. 3065 on this aspect of the Hansen/Steiger proposal has been quite illuminating. The Treasury initially focused only on its revenue loss, implicitly ignoring all other behavioral changes that might occur in the private sector because of such a tax reduction. This assumption is highly unrealistic for two reasons. First, this form of tax reduction will lead to increases in investment in risk capital which in turn will generate investment in plant and equipment, employment, and increased incomes. The increased incomes and employment will ultimately lead to additional revenues for the Treasury. Second, the current high level of the capital gains tax creates an incentive for many people to hold on to assets they would otherwise want to sell. The reduction in the tax would prompt additional sales of such assets thereby increasing Treasury revenues from the capital gains tax.

Some have even said the Hansen/Steiger proposal would involve no revenue loss to the Treasury. While we are not prepared to endorse any particular study or estimates, we do suggest, for reasons cited above, that this type of tax reduction would have a significant feedback effect which would probably result in less revenue loss to the Treasury than most other forms of tax reduction. Consideration of feedback effects is most important for any tax reduction proposal and, indeed, all forms of public interference in the private economy. Consideration of only direct revenue effects is tantamount to assuming that government taxes have little or no indirect influence on private behavior. In this case, the evidence seems to point in exactly the opposite direction. Namely, that the structure of our tax system and the economic instability brought on by our monetary and fiscal policies have had a very deleterious effect on savings and capital formation.

Two of the most undesirable effects of the high level of the capital gains tax have already been mentioned. The tax tends to penalize investment in new ventures. In the past, such ventures have become highly productive. The tax also encourages investors to hold on to assets long after they might have otherwise sold them. The third, and perhaps most undesirable effect of all, is that it does not distinguish between real and nominal capital gains. Recent research has indicated that a substantial portion of the capital gains tax is being collected from people whose gains, after adjustment for inflation, are, in fact, losses. Such taxes have destroyed a substantial portion of the capital available for investment in risk assets. Congress has sporadically recognized the deleterious effect inflation has had on real incomes and, from time to time, adjusted income tax rates downward to some extent. No such adjustments have been made in capital gains tax rates. In fact, the Tax Reform Act of 1969 adjusted these rates upward. The ensuing eight years have been marked by turbulence and decline in stock prices and substantial inflation. A more balanced approach to the adjustment of capital gains tax rates for the effect of inflation would be most constructive.

As managers of capital on a fiduciary basis, bank trust officers are acutely aware of the problems caused by the capital gains tax because of its impact on investment decisions. I would like to present three hypothetical situations which illustrate the burdens the capital gains tax places on the management of capital by trust departments.

The first situation, and one banks see constantly, is when a customer turns to a bank trust department for investment management or advice on securities he has acquired over a period of years. Upon analysis it becomes clear that while the securities have appreciated substantially in dollar value, their dollar value falls significantly short of the price paid for the securities if adjusted for inflation. In the years between 1968 and 1978 the cumulative inflation has been approximately 87 percent but few investment portfolios have done that well. Despite the loss in real dollars, if securities are sold, a capital gains tax which might amount to almost 50 percent will have to be paid on the nominal appreciation.

Another situation trust departments see involves the case of the successful small businessman. As he reaches the age when he wishes to retire, he would like to sell the stock of his company to someone and invest in a diversified portfolio to protect his savings. Unless his prospective successor in the business can buy a substantial interest in the company, he is unlikely to be interested in the business. Unfortunately, our small businessman finds himself with a practically zero cost basis and any sales of stock will mean a substantial capital gains tax. His alternatives are to sell the business over a period of years if he can find a purchaser who wants to run the business, or find a conglomerate which is interested in acquiring his business in a tax free exchange of securities. This latter course is possibly a good answer to his problems. He would, in effect, achieve some diversification by being able to invest in a conglomerate. However, it is unlikely that a small businessman will find a conglomerate or any other corporation that is interested in a securities exchange as opposed to outright purchase of the assets of the business. There are also few purchasers available for installment sales. The only courses usually available to the retiring small businessman is outright sale and payment of the capital gains tax or holding on to the business while someone else runs it.

Thus, aside from being a strong disincentive for initial stock investment, the capital gains tax also exerts a significant negative impact on capital preservation. This impact has prompted some to suggest that capital gains should be taxed only when they are consumed, and not when they are reinvested in other capital assets.

In 1976 Congress changed the law relating to the income tax basis of property passing at death by adopting carryover basis. This change has further complicated investment policies and practices in managing portfolios of estates and trusts. Suppose a person dies with an estate consisting primarily of a stock portfolio. The decedent's cost basis information is necessary to ascertain gain or loss consequences on prospective asset sales, and it is an important element in planning the most advisable distribution program for heirs. The cost basis can only be determined after difficult and lengthy research, but during this period liquidation of assets will be necessary to cover estate taxes and liabilities. The Tax Reform Act has placed many individuals and fiduciaries in the untenable position of having to act on the incomplete information with unknown consequences, or not acting and accepting uncertain market and financial risks. Tax consequences depend on whether a gain or loss (and the amount) will occur on sales and to determine this the executor must know the decedent's cost, December 31, 1976 value, and date of death value of the assets to be sold. Also the executor needs to know the decedent's acquisition date to determine whether this would be a long-term or short-term transaction. Obviously, until these data are available, which may take years to determine with all the complications added by carryover basis, any action to sell the stock would be based on incomplete information with unknown potential financial impact (and liability) for the estate. The higher the capital gains rate, of course, the greater the impact of any decision to sell a stock having an uncertain basis. Carryover basis will also subject heirs to greater capital gains tax burden on the sale of property they have received from a decedent. Lowering the capital gains rate will not help to solve the massive paperwork and technical burdens carryover basis has created, but it will lessen the heavy tax burden imposed on property passing through estates. Of course, the real solution to this problem is the complete repeal of carryover basis, a move we strongly recommend to the Congress.

The changes in the capital gains tax in the Tax Reform Act of 1969 were based on a particular type of tax philosophy that has economic implications that were not completely anticipated at the time and perhaps should be reviewed more thoroughly by this subcommittee. An extreme form of this philosophy says that capital gains should be treated as ordinary income and subject to the same progressive tax rates as other types of incomes. Coupled with this has been a movement to indirectly eliminate the value of tax incentives for activities Congress has deemed to be socially desirable. Thus, not only were capital gains tax rates increased in response to theoretical arguments that the gains were no different from other forms of income, but capital gains were put under minimum tax provisions under the theory that such income, taxed at less than ordinary income tax rates, should be subject to an additional minimum tax. We believe the evaluation of different types of income for tax purposes is a decision of the Congress that should be governed by economic realities and not abstract theories of taxation or the definition of income. Proponents of treating capital gains as ordinary income also stress the need for a minimum tax. They frequently cite statistics indicating that small numbers of people with high income pay no taxes. They rarely seem to discuss the fact that consistent treatment of both capital gains and losses as ordinary income could lead to increases in the number of people paying no taxes during years of declining asset values. It is our opinion that Federal tax policy should be determined by an assessment of economic realities and priorities determined by the Congress. We believe the time is ripe for tax reduction that would stimulate investment in risk capital.

Our strong endorsement of the Hansen/Steiger proposal does not indicate a lack of recognition or support for the Carter Administration's attempt to deal with the problem of capital formation and saving. The lower corporate tax rate and extension of the investment tax credit are useful devices which should not be viewed as substitutes for the Hansen/Steiger proposal. The probability of strong revenue feedbacks under the Hansen/Steiger proposal indicates it should be considered separately. It should be noted that past tax changes have had the effect of reducing corporate rates while increasing capital gains rates. While a case can be made for a general reduction in corporate taxes, specific treatment of capital gains within the overall package will create a more balanced approach to tax reduction as it affects capital formation and saving.

Senator PACKWOOD. Our next witness is Mr. Andrew J. Biemiller, legislative director of the AFL-CIO.

Mr. Biemiller, welcome to the committee today.

Andy, thank you for your patience, also.

STATEMENT OF ANDREW J. BIEMILLER, LEGISLATIVE DIRECTOR, AFL-CIO, ACCOMPANIED BY RUDOLPH OSWALD, DIRECTOR, DEPARTMENT OF RESEARCH, AFL-CIO

Mr. BIEMILLER. Thank you, Senator. I am pleased we were able to get here today.

I am accompanied by Dr. Rudolph Oswald, the director of the department of research of the AFL-CIO.

Mr. Chairman, we are pleased to have this opportunity to present our views on the three bills before this subcommittee which in various ways would reduce taxes on capital gains income.

We should like to state at the outset that we are opposed to all three of the proposals.

All would widen a tax preference which we consider the most serious inequity in the Nation's tax laws; each of the three bills is costly in terms of lost Federal revenue; each measure conveys its benefits almost exclusively to wealthy individuals and/or corporations; and each would complicate the tax code even further. And, as important, congressional approval of any of these loophole widening measures would reinforce and intensify taxpayer unrest, cynicism, and distrust.

S. 3065, the Hansen-Steiger proposal, would undo the steps toward capital gains reforms made in 1969 and at the same time would remove the presently untaxed half of capital gains income from the list of tax preference items that are subject to the minimum tax.

Since capital gains account for over 80 percent of the preference items covered by the minimum tax, the measure would, in effect, destroy the minimum tax, a measure put into law in 1969 as an attempt to see that wealthy tax avoiders made some contribution to the Nation's tax burden.

The measure has been estimated to amount to an annual loss to the Treasury of some $2.4 billion. High income individuals would receive $1.9 billion. The measure would also lower the tax on corporate capital gains from 30 percent to 25 percent, providing an estimated $500 million in benefits to corporations.

The data developed showing the distribution of the benefits of this measure rank this proposal as one of the most regressive measures we have ever seen. We have attached a table showing the distribution of the benefits by income group. Among the features demonstrated by the table are: (1) only a tiny minority, less than 0.5 percent, of all the Nation's taxpayers receive any benefit; (2) the vast majority, 98 percent, of low-, middle, and upper-middle-income taxpayers receive nothing from the proposal; (3) two-thirds of the revenue loss would go to 37,000 taxpayers with incomes of over $200,000. Their average cut would be over $33,000.

We would also like to call the committee's attention to a Treasury analysis of an identical measure proposed by Congressman Steiger in the Ways and Means Committee, H.R. 12111.

Treasury Secretary Blumenthal, in a May 11, 1978, letter to the Ways and Means Committee pointed to the unfairness of the measure and noted: "Proponents of these measures have said they will gain rather than lose revenues. These claims are based on extremely unrealistic economic assumptions. For instance, the proponents assume that the measures would produce an enormous boom in the stock market—a 40-percent increase in stock values in one study—an effect supported by neither evidence nor logic.

"Focusing tax relief in this limited area would severely unbalance the allocation of resources within the investment sector. Great amounts of relief would flow to existing assets rather than toward stimulating new investment. Similarly, relief would be inefficiently distorted toward those enterprises which, for various technical reasons, can convert their income into the capital gains form. One result would be an increase in the expensive charade of elaborately structuring business deals so as to transform ordinary income into capital gains."

S. 2428 would permit individuals to avoid tax liability on profits from the sale of a business investment if the investor reinvests at least 80 percent of the proceeds within a 12-month period.

We assume from the bill's title, the "Small Business and Farms Capital Preservation Act," that this is a device intended to help small business. Yet, as we understand the measure, the tax benefits go not to small business, but to investors and only to those investors that can reap a profit from selling or exchanging "small" business assets.

While it is conceivable that such a measure might shift some investment funds in the direction of smaller businesses, the measure would also encourage speculation and rapid investment turnover. At the same time, it would not help small businesses that are just starting up or are marginal. But it would encourage wealthy, successful "smaller businessmen" to sell out to large companise.

Moreover, there is really no way to evaluate the beneficiaries. The bills' benefits are, for example, limited to "qualified small business investments" which are "within the meaning of section 3 of the Small Business Act."

Mr. Chairman, we have attached a copy of that particular section of the Small Business Act, and would like to call this committee's attention to the broad and extremely loose criteria for defining "small business."

For example, section 3 of the Small Business Act defines a small business as: "including, but not limited to, enterprises that are engaged in the business of production of food and fiber, ranching and raising of livestock, aquaculture, and all other farming and agricultural related industries, independently owned and operated, not dominant in its field of operation."

No specific criteria are given and even the general criteria are hedged and vague.

Such a loose definition might be appropriate for the types of aid available under the Small Business Act and the administrative procedures established; but it is surely not an appropriate definition for targeting a tax reduction.

The major feature of S. 2608 is to increase the present 50-percent exclusion of capital gains income by as much as 80 percent, depending on the length of time the asset is held.

Under this bill, the present 50-percent exclusion would increase by 2 percent for each year the asset was held by the taxpayer. The measure, therefore, increases the preferential tax treatment available to those who receive capital gains.

The justification for such a measure completely escapes us. It is our understanding that most advocates of even more liberalized treatment of capital gains income claim that the capital gains tax causes a so-called lock-in effect leading taxpayers to hold on to assets longer than would be justified on pure economic or financial efficiency grounds.

Increasing the tax benefits incrementally, as this measure does, would, in our view, merely increase the effect of tax considerations on decisions to buy, sell, invest, or reinvest.

Section 2 of S. 2608 would repeal the alternative tax for individuals. Under current law, a 25-percent ceiling applies to the tax on the first $50,000 of capital gains. Such a measure was proposed by the administration last January; and though it represents only a modest step toward capital gains reform, it is a step in the right direction.

Last December, the AFL-CIO convention spelled out a series of tax reform measures to promote "tax justice."

The first item on the AFL-CIO's agenda was an end to the capital gains loophole and the convention stated that the capital gains preference "represents the single most significant impediment to tax justice."

This past February, the AFL-CIO Executive Council stated, "We believe there is no justification for the capital gains loophole, the most glaring loophole in the tax structure, benefitting mostly those at the top of the economic ladder."

We urge you to consider the capital gains reform measure we recently suggested to the Ways and Means Committee in our testimony on the administration's tax proposal.

Specifically do the following.

Reduce the present 50-percent exclusion for individual capital gains in three steps so that in the first year only 33⅓ percent of such gains would be excluded; in the second year the exclusion would drop to 16.7 percent; and in the third year such gains would be taxed as ordinary income. We would support under such circumstances appropriate liberalizations in the treatment of capital losses and measures to protect homeowners.

Establish a comparable phase-in for taxing the appreciated value of gains passed on at death with appropriate exemptions and exclusions for spouses, smaller estates and family farms. Such taxes should then be allowed as a deduction for estate tax purposes.

For corporate capital gains, the present 30-percent tax could be increased by 6 percentage points per year to bring it up to the full corporate tax rate after a 3-year period.

Mr. Chairman, we urge you to reject S. 3605, S. 2428, and S. 2608 and any and all other attempts to widen the capital gains loophole even further.

Mr. Chairman, may I request that we attach to our testimony a copy of the letter which President Meany sent to President Carter backstopping the President's point of view.

Senator Hansen [presiding]. That and your statement will be included in the record.

Senator HANSEN. Mr. Biemiller, let me state first that Senator Packwood just got word that a member of his family was seriously ill. That is why he had to leave. He wanted me to tell you that and to extend his appreciation for your appearance here today.

Mr. BIEMILLER. I am sorry to hear that.

Senator HANSEN. We know that these hearings have a way of dragging on and keeping people longer than they earlier had believed they would be here. We certainly do appreciate your appearance here this morning and your testimony.

Would the ALF-CIO favor an absolute exclusion from taxation of the proceeds of the sale of a home?

Mr. BIEMILLER. I will refer that to my colleague, Dr. Oswald.

Mr. OSWALD. Senator, the AFL-CIO feels that it would depend upon the particular circumstances. If it is the sale of homes that have been owner-occupied, particular accommodation would have to be made so that there would not be complete taxation on the increase that might come about from selling that home.

As you know, currently tax law allows the postponement of taxing gains that result when an owner sells his home—he does not pay a capital gains tax if he reinvests in a new home of equal or greater value. We would feel that at some time, which frequently takes place prior to retirement, that a person sells his home and moves into

either rental property or something else, some adjustment would then have to be made to take account of the capital gains which has come about as a result of that sale of owner-occupied home.

Senator HANSEN. If I could interrupt you on that point, we have a number of letters in my office which come not only from Wyoming but from other places as well, which come from older persons whose principal asset is a home. The present provision in the law I don't think addresses their problem at all, because they would not be reinvesting in a home. They are moving out of a home which they own. I do think they deserve better treatment than what they now receive. Is that what you are saying, too?

Mr. OSWALD. Yes.

Mr. BIEMILLER. Yes.

Senator HANSEN. In your testimony, Mr. Biemiller, on page 4, you speak with reference to the sliding scale provision in S. 2608—that is on the top of the page. You spoke against the bill.

Part of the concept behind that provision was to take into account the erosive effects that inflation has.

Now, in many of the adjustments that have been made in our economy, as you know, wage increases, so far as people in the private sector go, and wage increases being paid to government workers, the salary increases, have reflected the fact that inflation erodes the purchasing power of everyone. I gather that you do not not feel that this same consideration is due a person who sells a capital asset. Is that what you are saying?

Mr. OSWALD. Senator, if I may respond, currently people selling capital assets are already given the favorable treatment of paying a tax on only half of the capital gain. You do give the example of the wage earner who pays a tax on his full wage. Today that is also not indexed.

Obviously Congress periodically reconsiders the tax situation and has made some adjustments to try to offset some of the drag on the economy of just the higher inflation impact. But we feel that in terms of this particular feature capital gains, it is already taken care of.

It may be something to take into consideration if you moved into direction that we urge, which would be to remove completely the capital gains preference. But in the current situation, which this would build on, where capital gains are only taxed at a 50-percent rate, you will find that capital gains are already more than adequately compensated for.

Senator HANSEN. Back in the time of President Franklin Roosevelt, he had a tax change brought into effect which reflected a long term capital gains tax, that is, reflecting the fact that the longer you have had an asset, the more favorable should be the tax treatment on that asset when it is sold.

What is your position on that concept, Mr. Biemiller?

Mr. OSWALD. Senator, if I may, at that time the whole tax structure was such that the tax rates were much different than they are today. I think the response that we gave to the previous question is significant in that it would treat capital gains the same way.

As we said, if capital gains were taxed the same as ordinary income, then some sort of consideration might be given for the real depreciation or appreciation of capital gain. But currently it is only taxed at 50 percent of the normal rate. The benefit is more than adequately taken care of.

Senator HANSEN. Does your answer imply that the tax rate, the overall thrust of taxation, was even more oppressive in President Roosevelt's day than it is now?

Mr. OSWALD. No.

Senator HANSEN. Would it have been less then than now?

Mr. OSWALD. Senator, the tax rates that were in effect in the early part of the President Roosevelt's tenure were very low; but in the latter part, during World War II, obviously the rates were substantially higher.

Senator HANSEN. After we got involved in the war I know that we enacted a lot of war taxes.

Is it your understanding that this long term capital gains tax was enacted in response to the heavy burden of wartime taxes?

Mr. OSWALD. No, sir. Capital gains were in existence far before that.

The thrust of my response, Senator, is that at that time, most working people paid no income tax whatsoever, because of the way that the tax structure was set up.

What President Roosevelt was doing was he was looking at a situation where effective tax rates were essentially only on, effectively, the wealthy, and to that extent capital gains were a different situation.

I think today we are looking at a situation where the heaviest tax burden is precisely on the working people, where capital gains provisions treat those types of incomes substantially different than earnings from wages and salaries.

I think one cannot make the comparison today where the tax burden is so heavy on wage earners and say that we can apply the same logic that President Roosevelt used in the thirties to today. That situation doesn't exist anymore. In terms of equity, we need to look at who is paying the heavy share of the taxes, and are we treating income from two different sources, from capital gains, substantially different from income, from working. The answer is that today we do.

Senator HANSEN. It would be my belief that there were practically no taxes, if any, during Roosevelt's day on the typical wage earner. But there are a number of taxes on him now, as I am certain you and I would agree. It would seem as though this sliding scale for capital gains would be of benefit to most workers today who do have some property. At one time or other they are going to sell it.

Are you opposed to taking into account the effects of inflation?

Mr. OSWALD. Senator, we have indicated that for owner-occupied homes there should be a separate type of consideration; but not for all capital gains; and not as long as all capital gains are only treated as being half-taxed, taxed on only half their value. We are making that distinction between an owner-occupied home that is eventually old, where there should be a separate consideration, versus the general treatment.

Senator HANSEN. I think we have had a lot of testimony in the last few days as to the merits of that insofar as the labor force is concerned, because this is a capital intensive country and it takes money to create jobs, at least the kind of jobs that I know you people so successfully represent, I am interested in that, too. With that thought in mind, wouldn't there be an inducement provided to the rank and file people in this country to save some of their income and to invest it in job-creating opportunities or investments of one kind or another if there

were a provision, a sliding scale provision, that there would be an advantage in making an investment and keeping it in there in that they would pay a lower tax or have a hedge against inflation—whether it might be a lot or an interest in a building or some stock? Does that have no appeal to you?

Mr. OSWALD. Senator, we are very interested in investment. However, the bills' proposals, first of all, would have no impact at all in terms of working people being induced to invest. It only affects people whose marginal tax is above 50 percent. That is not the worker.

What you are really proposing is to reestablish the 25 percent maximum tax.

Second, in terms of saving rates, the individual savings rate in terms of disposable income for the whole country is higher today in the seventies, since the 1969 amendments, than they were before the 1969 amendments. So, the savings rate in our economy by individuals is higher than it was earlier.

In terms of the capital formation, we find that the activities of the Federal Reserve Board today by their raising of interest rates have more to do with the ability of corporations to attain funds than anything that you will do in terms of the tax proposals you have before you currently.

The Fed has raised interest rates substantially and reduced the amounts of funds available for investment. This is having a substantial dampening effect on investment. More so the proposals that you have before you and that have been addressed by the earlier discussants here today, would not offset the dampening effect of the Fed's actions.

Senator HANSEN. Gentlemen, let me thank you for your appearance here.

I want to thank all of the witnesses who have been so patient in staying on and for the time you have taken in the preparation of your testimony.

The hearing will remain open. I believe the chairman announced yesterday, for the inclusion of written statements. Perhaps, Mr. Biemiller, you or our other witnesses may want to have added testimony appended to the record.

Mr. BIEMILLER. We may want to add some material.

Senator HANSEN. We would be very happy to have it, sir.

Mr. BIEMILLER. Thank you, Senator.

[The prepared statement of Mr. Biemiller follows:]

STATEMENT OF ANDREW J. BIEMILLER, DIRECTOR, DEPARTMENT OF LEGISLATION, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

We are pleased to have this opportunity to present our views on the three bills before this Subcommittee which in various ways would reduce taxes on capital gains income.

We should like to state at the outset that we are opposed to all three of the proposals. All would widen a tax preference which we consider the most serious inequity in the nation's tax laws; each of the three bills is costly in terms of lost Federal revenue; each measure conveys its benefits almost exclusively to wealthy individuals and/or corporations; and, each would complicate the tax code even further, And, as important, Congressional approval of any of these loophole-widening measures would reinforce and intensify taxpayer unrest, cynicism and distrust.

S. 3065—the Hansen-Steiger Proposal—would undo the steps toward capital gains reform made in 1969 and at the same time would remove the presently untaxed half of capital gains income from the list of "tax preference" items that are subject to the "Minimum Tax." Since capital gains account for over 80 percent of the preference items covered by the minimum tax, the measure would, in effect, destroy the minimum tax—a measure put into law in 1969 as an attempt to see that wealthy tax avoiders made some contribution to the nation's tax burden.

The measure has been estimated to amount to an annual loss to the Treasury of some $2.4 billion. High income individuals would receive $1.9 billion. The measure would also lower the tax on corporate capital gains from 30 percent to 25 percent, providing an estimated $500 million in benefits to corporations.

The data developed showing the distribution of the benefits of this measure ranks this proposal as one of the most regressive measures we have ever seen. We have attached a table showing the distribution of the benefits by income group. Among the features demonstrated by the table are:

(1) Only a tiny minority (less than .5 percent) of all the nation's taxpayers receive any benefit.

(2) The vast majority (98 percent) of low, middle and upper middle income taxpayers receive nothing from the proposal.

(3) Two-thirds of the revenue loss would go to 37,000 taxpayers with incomes over $200,000. Their average cut would be over $33,000.

We would also like to call the Committee's attention to a Treasury analysis of an identical measure proposed by Congressman Steiger in the Ways and Means Committee (H.R. 12111). Treasury Secretary Blumenthal in a May 11, 1978 letter to the Ways and Means Committee pointed to the unfairness of the measure and noted:

"Proponents of these measures have said they will gain rather than lose revenues. These claims are based on extremely unrealistic economic assumptions. For instance, the proponents assume that the measures would produce an enormous boom in the stock market (a 40 percent increase in stock values in one study), an effect supported by neither evidence nor logic . . . .

"Focusing tax relief in this limited area would severely unbalance the allocation of resources within the investment sector. Great amounts of relief would flow to existing assets rather than toward stimulating new investment. Similarly, relief would be inefficiently distorted toward those enterprises which, for various technical reasons, can convert their income into the capital gains form. One result would be an increase in the expensive charade of elaborately structuring business deals so as to transform ordinary income into capital gains."

S. 2428 would permit individuals to avoid tax liability on profits from the sale of a business investment if the investor reinvests at least 80 percent of the proceeds within a 12-month period. We assume from the bill's title, the "Small Business and Farms Capital Preservation Act," that this is a device intended to help small business. Yet, as we understand the measure, the tax benefits go not to the small business, but (1) to investors and (2) only those investors that can reap a profit from selling or exchanging "small" business assets. While it is conceivable that such a measure might shift some investment funds in the direction of smaller businesses, the measure would also encourage speculation and rapid investment turnover. At the same time, it would not help small businesses that are just starting up or are marginal; but it would encourage wealthy, successful "smaller businessmen" to sell out to large companies.

Moreover, there is really no way to evaluate the beneficiaries. The bills' benefits are, for example, limited to "qualified small business investments" which are "within the meaning of Sec. 3 of the Small Business Act." Mr. Chairman, we have attached a copy of that particular section of the Small Business Act and would like to call this committee's attention to the broad and extremely loose criteria for defining "small business." For example, Sec. 3 of the Small Business Act defines a small business as ". . . including but not limited to enterprises that are engaged in business of production of food and fiber, ranching and raising of livestock, aquaculture, and all other farming and agricultural related industries . . . independently owned and operated. . . . not dominant in its field of operation." No specific criteria are given and even the general criteria are hedged and vague.

Such a loose definition might be appropriate for the types of aid available under the Small Business Act and the administrative procedures established, but it is surely not an appropriate definition for targeting a tax reduction.

The major feature of S. 2608 is to increase the present 50 precent exclusion of capital gains income by as much as 80 percent depending on the length of time the asset is held. Under this bill, the present 50 percent exclusion would increase by 2 percent for each year the asset was held by the taxpayer. The measure, therefore, increases the preferential tax treatment available to those who receive capital gains. The justification for such a measure completely escapes us. It is our understanding that most advocates of even more liberalized treatment of capital gains income claim that the capital gains tax causes a so-called "lock-in" effect leading taxpayers to hold on to assets longer than would be justified on pre-economic or financial efficiency grounds. Increasing the tax benefits incrementally as this measure does would, in our view, merely increase the effect of tax considerations on decisions to buy, sell, invest, or reinvest.

Sec. 2 of S. 2608 would repeal the alternative tax for individuals. Under current law, a 25 percent ceiling applies to the tax on the first $50,000 of capital gains. Such a measure was proposed by the Administration last January; and though it represents only a modest step toward capital gains reform, it is a step in the right direction.

Last December, the AFL-CIO Convention spelled out a series of tax reform measures to promote "tax justice." The first item on the AFL-CIO's agenda was an end to the capital gains loophole and the Convention stated that the capital gains preference "represents the single most significant impediment to tax justice." And this past February, the AFL-CIO Executive Council stated, "We believe there is no justification for the capital gains loophole, the most glaring loophole in the tax structure, benefiting mostly those at the top of the economic ladder."

We urge you to consider the capital gains reform measure we recently suggested to the Ways and Means Committee in our testimony on the Administration's tax proposal. Specifically:

* Reduce the present 50 percent exclusion for individual capital gains in three steps so that in the first year only 33⅓ percent of such gains could be excluded, in the second year the exclusion would drop to 16.7 percent, and in the third year such gains would be taxed as ordinary income. We would support under such circumstances appropriate liberalizations in the treatment of capital losses and measures to protect homeowners.

* Establish a comparable phase-in for taxing the appreciated value of gains passed on at death with appropriate exemptions and exclusions for spouses, smaller estates and family farms. Such taxes should then be allowed as a deduction for estate tax purposes.

* For corporate capital gains, the present 30 percent tax could be increased by 6 percentage points per year to bring it up to the full corporate tax rate after a three-year period.

Mr. Chairman, we urge you to reject S. 3605, S. 2428 and S. 2608 and any and all other attempts to widen the capital gains loophole even further.

TABLE 1.—DISTRIBUTION OF REVENUE LOSS OF S. 3065 BY INCOME CLASS

Income	Percent of total taxpayers	Percent of tax cut from proposal	Dollar amount of reduction (millions)	Percent total of taxpayers benefitting	Average amount per taxpayer receiving benefits
0 to $30,000	88.7	0.5	$16	0 06	$356
$30,000 to $50,000	8.8	4.0	76	1.6	768
$50,000 to $100,000	2.1	13.7	260	8.8	2,063
$100,000 to $200,000	.3	14.2	269	4.7	4,203
$200,000 and over	.1	66.8	1,267	47.4	33,342
Total	100.0	100.0	[1] 1,898	.5	

[1] Total estimated revenue loss equals $2,400,000,000 of which $1,900,000,000 is individual and $500,000,000 is corporate.

Source: AFL-CIO Research Department Joint Committee on Taxation Staff.

THE SMALL BUSINESS ACT OF 1958, AS AMENDED

Sec. 3. For the purposes of this Act, a small-business concern, including but not limited to the enterprises that are engaged in the business of production of food and fiber, ranching and raising of livestock, aquaculture, and all other farming and agricultural related industries, shall be deemed to be one which is independently owned and operated and which is not dominant in its field of operation. In

addition to the foregoing criteria the Administrator, in making a detailed definition may use these criteria among others: Number of employees and dollar volume of business. Where the number of employees is used as one of the criteria in making such definition for any of the purposes of this Act, the maximum number of employees which a small-business concern may have under the definition shall vary from industry to industry to the extent necessary to reflect differing characteristics of such industries and to take proper account of other relevant factors.

NEWS FROM THE AFL-CIO, DEPARTMENT OF PUBLIC RELATIONS

AFL-CIO President George Meany today hailed President Carter's "strong leadership in opposition to the proposed cut in capital gains taxes."

In a letter to the President released today, Meany agreed with the President's description of the proposal as "a windfall for the rich." Meany pledged continued AFL-CIO support for the basic thrust of President Carter's tax-cut proposals, and said the labor federation would "strongly" oppose any widening of the capital gains loophole.

Text of the Meany letter follows:

American workers applaud your strong leadership in opposition to the proposed cut in capital gains taxes, which you correctly describe as a windfall for the rich.

Any reductions in capital gains taxes—which are already only half taxed—would only encourage speculators, while denying equity to the vast majority of taxpayers. We made that point in our letter last week to the members of the House Ways and Means Committee opposing the capital gains tax cut.

The benefits of such a cut would go principally to the wealthiest individuals, who already enjoy tax loopholes not available to average taxpayers. The proposal is little more than a continuation of the discredited "trickle-down" theory of economics, where the rich get richer and maybe someday a few crumbs will reach those at the lower economic rungs.

The AFL-CIO will continue to support the basic thrust of your tax-cut proposals, since they provide the most benefit to the most people, and we will work strongly to oppose any widening of the capital gains loophole.

Again, thank you for your forthright leadership on this vital issue.

AMERICAN FEDERATION OF LABOR AND
CONGRESS OF INDUSTRIAL ORGANIZATIONS,
Washington, D.C., July 11, 1978.

DEAR MR. CHAIRMAN: Mr. Chairman, we would like to supplement our remarks.

The supposition behind S. 3065 is that the reforms of 1969 decreased the willingness of individuals to save and thus provide the funds for investment. The data on individual savings do not support the hypothesis of S. 3065. Savings as a percent of disposable personal income has been substantially higher in the eight years since the 1969 reforms than in the previous 20 years. In the 20 years, 1950 to 1969, savings averaged 6.1 percent of disposable income, while in the eight years, 1970 to 1977, savings averaged 6.8 percent. Clearly the 1969 reforms did not decrease the willingness of individuals to save and thus provide funds for investments.

A recent report (July 7, 1978) by the investment reporting service "The Value Line," projects that capital growth will be easy to finance. I ask that their projects on pages 678 and 680 of their report be made a part of this record.

We also want to bring to the Committee's attention a recent poll (June 15, 1978) by Roger Seasonwein showing a sharp decline in the public's belief that a capital shortage exists.

Thank you for the opportunity to supplement our remarks.

Sincerely,

RUDY OSWALD,
Director, Department of Research.

Enclosures.

[From the Value Line Selection & Opinion]

GROWTH WILL BE EASY TO FINANCE

The improved capital retention rate is significant because it means that while corporations will increase the amount of long-term debt outstanding by an estimated $90 billion over this period, the debt-to-equity ratio is expected to decline from 38.3 percent in 1977 to 36.5 percent in the years 1981–83.

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A better capitalization ratio is foreseen even though the companies comprising the Industrial Composite are unlikely to seek out more than $5–$7 billion of new equity financing in any one year. Nevertheless, the $20–$25 billion of common equity financing projected through 1982 is significantly greater than the $13.7 billion of the last 5 years. (See Table 3 for a detailed record of the Composite's flow of funds, income statement, and balance sheet.)

The healthier debt-to-equity ratio is important given the expectation that inflation will remain a problem. It would be disheartening were the relationship of debt to equity forecast lower in the future. Reason: too much leverage in an inflationary environment can lead to too much risk being assumed by the debt holder who would in that case be forced into the risk-taking position normally held by stockholders. That greater risk would in turn require an escalation of the interest rate charged.

Total "cash flow" is expected to be strong in the years ahead. The sum of the "cash flows" in each of the next five years is likely to be on the order of $740–$750 billion, far more than the $447.5 billion of the last 5 years, and—along with the projected debt and equity financing—adequate to support plant spending on the order of $590–$595 billion, dividend payments of a shade more than $180 billion, additional working capital of $120 billion needed to support sales growth, and retirement of old debt slated to come due. Fully $59.8 billion of long-term debt matures over the 5-year span, but the companies in the aggregate are not expected to have difficulty refinancing—especially if profitability and return rates rise as projected here.

LIQUIDITY HAS STABILIZED

The sharp decline in liquidity that began about 1960 seems to have been halted. It appears that American corporations cannot, currently, run with less than the equivalent of 15 percent of sales in working capital. (See Chart 6.) The working capital-to-sales ratio has been in the 15 percent to 16 percent range for four years now. While it may be that this lower ratio reflects only a technical—related to the severe 1975 recession—halt in a long-term downtrend, we think the recent trend of the ratio of "net" working capital to sales (where "net" working capital is defined as working capital less long-term debt) suggests that it may be more fundamental in nature. The "net" working capital-to-sales ratio is important because it measures not only the company's current ability to support sales with its working capital but also its ability to fully repay its creditors. As can be seen in Chart 6, there was a steep slide in the "net" working capital-to-sales ratio through 1970. Although low, the ratio has been fairly stable now for almost a decade, and in Value Line's flow of funds analysis out to 1981-83 this particular ratio is not forecast any lower. In fact, a modest improvement is projected to a little less than 3 percent by then.

An improving debt-to-equity ratio, coupled with stability or modest improvement in liquidity over the long term, would be a favorable development. It suggests that corporate need for funds will not be as demanding as it could be, and therefore will be less inflationary.

Value Line projections do not provide for an explosion in plant and equipment spending over the next 3 to 5 years. A substantial increase in plant and equipment spending is forecast, but in terms of plant support to sales, corporate planner are not expected to overbuild. The ratio of gross plant to sales was 53 percent at the end of 1977. Plant modernization will allow this ratio to drift downward modestly to 52 percent in the early 1980s. This improvement in capital turnover is one reason for projecting a moderately higher operating profit margin on average (13 percent to 18½ percent) in the years 1981–83.

PROSPECTIVE AVERAGE ANNUAL TOTAL RETURN LOOKS GOOD

"Cash flow" per share is expected to grow more rapidly than sales per share over the next 5 years with share earnings to grow even faster and, because of the widening payout ratio, dividends to advance at an even more rapid annual rate: 13 percent. The projected average annual growth rate of dividends, 13 percent is better than the average annual Gross National Product growth rate foreseen over this period: 10.6 percent.

Current divident yield (4.9 percent) plus projected company growth through 1981–83 (11.1 percent) suggest an even more substantial potential total return of 16 percent a year. And if the trend in average annual P/E ratios takes a turn for the better, as seems probable, the average annual total return could be enhanced

by 4 to 14 percentage points—yielding a possible average annual return from common stocks in the form of price appreciation and dividends of from 20 percent to 30 percent. Even if this projection turns out to be on the high side and the total return is limited to simply yield plus dividend growth (i.e., 16 percent a year), this is significantly better than the interest income an investor can derive by placing his money in bonds. (The yield on high grade quality bonds is currently between 8½ percent and 9 percent.) Adjusted for a base inflation rate of 6 percent, the return on stocks comes to 10 percent (assuming no improvement in the P/E trend) vs. 2 percent–3 percent for bond issues similarly adjusted.

THE ROGER SEASONWEIN POLL,
New Rochelle, N.Y., June 15, 1978.

SHARP DECLINE IN PUBLIC'S BELIEF THAT CAPITAL SHORTAGE EXISTS

The public's belief that business faces a capital shortage has been sharply reduced in the past two and a half years.

At the end of 1975, when this question was first asked, a majority felt there was a shortage. In this year's survey, only a minority do. In both surveys, people were asked whether they agree or disagree with this statement: "Right now, business faces a shortage of capital."

[In percent]

	Now	October 1975
Whether business faces capital shortage:		
Agree	44	53
Disagree	43	32
Don't know	13	15

Those who agree that business faces a capital shortage are now a 44 percent minority of the public—9 points lower than the 53 percent majority that felt this way in 1975.

APPENDIX A

Description of S. 2428, S. 2608, and S. 3065 relating to Capital Gains and Losses

[COMMITTEE PRINT]

DESCRIPTION OF S. 2428, S. 2608, AND S. 3065

RELATING TO

CAPITAL GAINS AND LOSSES

LISTED FOR A HEARING

BY THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON JUNE 28 AND 29, 1978

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

JUNE 27, 1978

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C. Reduction in maximum capital gains tax rate (S. 3065) 12

I. INTRODUCTION

The bills discussed in this pamphlet, S. 2428, S. 2608, and S. 3065, have been scheduled for a hearing on June 28 and 29, 1978 by the Subcommittee on Taxation and Debt Management of the Committee on Finance. The bills relate to the tax treatment of capital gains and losses.

In connection with this hearing, the staff of the Joint Committee on Taxation has prepared a description of the bills. The description indicates the present law treatment and its background, an explanation of what changes each bill would make, its effective data, and its possible revenue effect.

II. SUMMARY

A. Nonrecognition of Gain on Sales of Certain Small Business Investments (S. 2428)

The bill would provide for the elective nonrecognition of an individual's long-term capital gain from the sale or exchange of certain small business investments if at least 80 percent of the proceeds are reinvested in another small business within 12 months of the sale. Under the election provided in the bill, gain would be recognized, and the recapture rules would apply, to the extent that the amount realized on the sale exceeds the total of the individual's qualified small business investments made during the 12 months following the sale. Where a taxpayer makes the nonrecognition election under the bill, the basis of the acquired small business investment would be required to be reduced by an amount equal to the unrecognized gain realized on the sale.

To be eligible for the nonrecognition election, the bill would require that both the interest sold and the interest subsequently acquired constitute "qualified small business investments."

The provisions of the bill would apply to sales made after December 31, 1977.

B. Graduated Exclusion of Capital Gains and Losses (S. 2608)

The bill would provide noncorporate taxpayers with a graduated exclusion from gross income for a percentage of long-term capital gains. The exclusion would start at 50 percent of the gain on the sale or exchange of a capital asset held for more than one year, and would increase by 2 percentage points for each additional 12-month period, up to a maximum exclusion of 80 percent of gain on a capital asset held for more than 192 months (16 years). Similarly, the bill would provide a graduated nonrecognition of long-term capital losses for noncorporate taxpayers—starting with 50 percent of the loss on the sale or exchange of a capital asset held for more than one year, and increasing by 2 percentage points for each 12-month period in excess of one year, up to a maximum of 80 percent after 16 years.

In addition, the bill would repeal the present 25-percent alternative capital gains tax (applicable to the first $50,000 of net long-term capital gain) for individuals.

The provisions of the bill would apply to taxable years beginning after December 31, 1979.

C. Reduction in Maximum Capital Gains Tax Rate (S. 3605)

The bill would remove capital gains as an item of tax preference subject to the minimum tax for both corporate and noncorporate taxpayers. The bill also would provide that the present 25-percent alternative capital gains tax on the first $50,000 of net long-term capital

gains for individuals would be applicable to all such capital gains, and it would reduce the alternative capital gains rate for corporations from 30 percent to 25 percent.

The provisions of the bill would apply to taxable years beginning after December 31, 1979.

4

III. DESCRIPTION OF BILLS

A. Nonrecognition of Gain on Sales of Certain Small Business Investments (S. 2428)

Present law

Present law generally requires recognition of the entire amount of gain or loss realized on the sale or exchange of property (sec. 1001(c)). However, in a number of instances, the Code also provides for the nonrecognition of gain or loss, *e.g.*, sec. 351 (relating to transfers to corporations controlled by the transferor), sec. 354 (relating to exchanges in certain reorganizations), sec. 721 (relating to certain partnership contributions), sec. 1031 (relating to certain exchanges of business or investment property), sec. 1033 (relating to certain involuntary conversions), sec. 1034 (relating to certain residential sales or exchanges), and sec. 1039 (relating to certain sales of low-income housing projects). Generally, none of these nonrecognition provisions would apply to gain realized on the sale of a small business investment.[1]

Description of S. 2428

The bill would provide for the elective nonrecognition of an individual's long-term capital gain from the sale or exchange of certain small business investments if at least 80 percent of the proceeds are reinvested in another small business within 12 months of the sale. Under the election provided in the bill, gain would be recognized, and the recapture rates would apply, to the extent that the amount realized on the sale exceeds the total of the individual's qualified small business investments made during the 12 months following the sale. Where a taxpayer makes the nonrecognition election under the bill, S. 2428 would require the reduction of the basis of the acquired small business investment by an amount equal to the unrecognized gain realized on the sale.

To be eligible for the nonrecognition election, the bill would require that both the interest sold and the interest subsequently acquired constitute "qualified small business investments." Under the bill, a "qualified small business investment" is defined as any equity or unsecured investment in any small business concern, within the meaning of section 3 of the Small Business Act (15 U.S.C. sec. 632).[2] In addition, the investment would have to be a capital asset with respect to the taxpayer.

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[1] Nonrecognition treatment would be available, of course, if the sale and acquisition of the small business investments met the requirements of section 1039, relating to certain sales of low-income housing projects.

[2] A small business concern is one which is independently owned and operated, and which is not dominant in its field of operation. The Small Business Act charges the Administrator of the Small Business Administration with the formulation of a definition of small business concerns. While the definition will vary from industry to industry to reflect differing characteristics and other relevant factors, the Administrator may take the number of employees and the dollar volume of business into account, among other items (15 U.S.C. sec. 632). A list of small business concerns is contained in 15 C.F.R. sec. 121.3.

S. 2428 also would establish a special procedure under which the statutory period for the assessment of any deficiency would not expire until 3 years from the time that the taxpayer notifies the Secretary of the Treasury of the qualified small business investments acquired or of the failure to make such investments timely.

Effective date

The amendments made by S. 2428 would apply to sales made after December 31, 1977.

Revenue effect

It is estimated that the provisions of S. 2428 would result in a revenue reduction of $600 million annually. This estimate assumes no changes in economic behavior in response to the tax change.

B. Graduated Exclusion of Capital Gains and Losses (S. 2608)

Present law

Under present law, a noncorporate taxpayer generally deducts from gross income 50 percent of the amount of any net capital gain for the taxaple year (the excess of net long-term capital gains for the year over net short-term capital losses for the same period). The remaining 50 percent of the net capital gain is includible in gross income and taxed at the regular tax rates. However, for noncorporate taxpayers, an alternative 25-percent capital gains tax rate is available for the first $50,000 of the taxpayer's net capital gain (sec. 1201(b)). (This is beneficial where the taxpayer's marginal tax rate exceeds 50 percent.) Regardless of the manner in which the tax on capital gains is computed, present law treats one-half of a noncorporate taxpayer's net capital gain as an item of tax preference subject to the 15-percent minimum tax (sec. 57(a)(9)). As an item of tax preference, one-half of an individual's net capital gain reduces the amount of personal service income eligible for the 50-percent maximum tax (sec. 1348(b)(2)).

Under present law, the capital losses of noncorporate taxpayers generally are deductible in full against capital gains. For taxable years beginning after 1977, capital losses in excess of capital gains may be deducted only against up to $3,000 of ordinary income each year. However, only 50 percent of net long-term capital losses in excess of net short-term capital gains may be deducted from ordinary income. As a result, for example, $2,000 of net long-term capital losses is required to offset $1,000 of ordinary income. Capital losses in excess of the applicable limitations may be carried forward to future years indefinitely.

Present law does not require a graduated nonrecognition of capital losses.

Background

While present law contains no provision which allows a graduated exclusion of long-term capital gains, or which requires a graduated nonrecognition of long-term capital losses, based on the length of the taxpayer's holding period, such a provision was enacted by Congress as part of the Revenue Act of 1934.[1] Under this provision, which replaced the 12½ percent alternative rate capital gains tax which Congress had enacted in 1921, progressively smaller percentages of capital gains were included in a taxpayer's income, depending upon the length of time that the asset had been held. Where gain was recognized on the disposition of an asset which had been held for more than 10 years, taxpayers were permitted to exclude 70 percent of the gain.

Congress modified this "sliding scale" exclusion provision in the Revenue Act of 1938, citing as reasons for change complexity and the

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[1] Revenue Act of 1934, sec. 117(a), 48 Stat. 680, 714 (1934).

reluctance of some taxpayers to dispose of assets until the percentage of gain includible in income was low enough. The 1938 Act provided a 15-percent alternative tax rate, and divided long-term capital gains into two classes, with the percentage excludible from income depending upon the length of the holding period. One-third of the gain from assets held for more than 18 months but less than 2 years was excludible from income, and 50 percent of gain from assets held for more than 2 years was excludible. These two classes of gain were eliminated in 1942 when Congress adopted the 50-percent deduction now contained in section 1202 of the Code, and the predecessor of the present alternative tax.

Prior to the Tax Reform Act of 1969, the 25-percent alternative tax applied to all of a noncorporate taxpayer's net long-term capital gains. Thus, where a noncorporate taxpayer's marginal tax rate was over 50 percent, the alternative capital gains rate was more beneficial, and such gains were subject to a 25-percent tax rate. In the 1969 Act, Congress limited the availability of the alternative tax to the first $50,000 of a noncorporate taxpayer's net capital gain. Also, that Act made capital gains eligible for income averaging, but only if the taxpayer does not elect the alternative tax.

In addition, in 1969 Congress classified one-half of a noncorporate taxpayer's net capital gain as an item of tax preference subject to the minimum tax, and as an item which was to reduce the amount of personal service income eligible for the 50-percent maximum tax.[2] These changes were implemented because Congress felt that previously applicable rules, which allowed taxpayers to avoid tax on certain portions of their economic income, resulted both in an unfair distribution of the tax burden, and in large variations in the tax burdens placed on taxpayers who receive different kinds of income.[3]

Prior to the Tax Reform Act of 1969, if a noncorporate taxpayer's capital losses exceeded its capital gains, the taxpayer could deduct on a dollar-for-dollar basis up to $1,000 of the excess losses against ordinary income. Any remaining excess loss could be carried forward indefinitely and deducted against either capital gains or ordinary income, subject to the applicable $1,000 annual limitation on deductibility of capital losses against ordinary income. In the 1969 Act, Congress provided that only 50 percent of net long-term capital losses in excess of net short-term capital gains could be deducted from ordinary income. This change was intended to provide parallel tax treatment for net long-term capital losses and net long-term capital gains, only 50 percent of which are included in a noncorporate taxpayer's income.

For taxable years beginning after 1977, the Tax Reform Act of 1976 increased to $3,000 the amount of ordinary income which could be offset by excess capital losses.

The Finance Committee, in its consideration of the Tax Reform Act of 1976, approved and reported a provision which was similar

[2] Both the minimum and maximum tax provisions were amended by the Tax Reform Act of 1976. The minimum tax rate was increased from 10 percent to 15 percent, and the $30,000 exemption and deduction for regular taxes of prior law were replaced with an exemption equal to the greater of $10,000 or one-half of regular tax liability. The Act also repealed the carryover of regular taxes paid.

With respect to the maximum tax, the 1976 Act eliminated both the $30,000 exemption to the preference offset and the 5-year averaging provision.

[3] Senate Report No. 91-552, 91st Cong., 1st Sess. 122 (1969).

to S. 2608.[4] The Finance Committee amendment would have provided a deduction, in addition to the existing 50-percent deduction, equal to 1 percent of an individual's capital gain on an asset multiplied by the number of years in excess of 5 years that the asset was held. The additional deduction would have been limited to 20 percent of the gain recognized on the disposition of a qualifying asset. Thus, the maximum allowable deduction would have been 70 percent of the capital gain recognized on the disposition of a property which had been held by the taxpayer for more than 25 years. The 1976 provision also would have limited a taxpayer's total capital gain deduction to 75 percent of the net capital gain (the excess of net long-term capital gains over net short-term capital losses) for the taxable year. In addition, the committee's 1976 amendment would have repealed the alternative tax rate of 25 percent on the initial $50,000 of a noncorporate taxpayer's net long-term capital gain.

This committee amendment was not adopted by the Senate.

[4] Senate Report No. 94-938, Part II (H.R. 10612), 94th Cong., 2d Sess. 70 (1976).

Description of S. 2608

The bill would provide noncorporate taxpayers with a graduated exclusion from gross income for long-term capital gains, and a graduated nonrecognition of long-term capital losses. In addition, it would repeal the alternative tax for individuals.

S. 2608 would provide noncorporate taxpayers with a graduated exclusion from gross income for a percentage of their long-term capital gain, *i. e.*, recognized gain from the sale or exchange of a capital asset held for more than 12 months. The excluded amount would equal 50 percent of the gain from the sale or exchange of a capital asset which has been held for more than 12 months. The excluded amount of gain would increase by 2 percentage points for each 12-month period in excess of 1 year for which the taxpayer held the property from which the gain was derived.[5] However, no more than 80 percent of the gain from the sale or exchange of a capital asset would be excludible under the bill. For example, 52 percent of the gain from the sale of a capital asset held for more than 2 years would be excluded under S. 2608, and 80 percent of the gain derived from the sale of a capital asset held for more than 16 years would be excluded. (See table 1.) The balance of any gain not excluded from gross income, or offset by capital losses, would be taxed at ordinary income rates.

TABLE 1.—APPLICABLE PERCENTAGE OF CAPITAL GAIN EXCLUDED OR LOSS UNRECOGNIZED UNDER S. 2608

Holding period in excess of the following number of yeasr:	*Percentage of gain excluded or loss unrecognized*
1	50
2	52
3	54
4	56
5	58
6	60
7	62
8	64
9	66
10	68
11	70
12	72
13	74
14	76
15	78
16	80

The bill would provide a graduated nonrecognition of a noncorporate taxpayer's long-term capital losses. The amount of loss realized which would not be recognized would be equal to 50 percent of the loss for the taxable year from the sale or exchange of a capital asset which has been held for more than one year. The amount of the unrecognized loss would increase by 2 percentage points for each year in excess of 1 year for which the taxpayer held the property on which the loss was realized.[6]

[5] In the case of an estate or trust, S. 2608 would apply by excluding the applicable percentage from the beneficiary's gross income where capital gains are includible in the beneficiary's income pursuant to sections 652 or 662.

[6] In the case of an estate or trust, S. 2608 would apply the same graduated nonrecognition rule, subject, however, to the general provisions of subchapter J which pertain to capital losses.

Under S. 2608, the maximum amount of any unrecognized loss would be equal to 80 percent of the loss realized on the sale or exchange of any capital asset. This point would be reached with respect to a loss realized on the sale or exchange of a capital asset which had been held for more than 192 months (16 years). (See table 1).

Recognized losses and included gains generally would remain subject to all other Code provisions presently applicable to capital gains and losses.

S. 2608 also would repeal the alternative tax rate of 25 percent on the initial $50,000 of a noncorporate taxpayer's net long-term capital gain.

Effective date

The amendments made by S. 2608 would apply with respect to taxable years beginning after December 31, 1979.

Revenue effect

It is estimated that the provisions of S. 2608 would result in an annual revenue reduction of $1 billion. This estimate assumes no change in economic activity as a result of the bill.

C. Reduction in Maximum Capital Gains Tax Rate (S. 3605)

Present law

Noncorporate taxpayers

Under present law, a noncorporate taxpayer generally deducts from gross income 50 percent of the amount of any net capital gain for the taxable year (the excess of net long-term capital gains for the year over net short-term capital losses in the same period). The remaining 50 percent of the net capital gain is included in gross income and taxed at the regular tax rates. This can lead to a capital gains tax rate of up to 35 percent, *i.e.*, one-half the maximum individual tax rate of 70 percent.

In lieu of taxing 50 percent of long-term capital gains at the regular tax rates, an alternative tax applies if it results in a lower tax rate than that produced by the normal method (sec. 1201(b)). The alternative tax consists of a 25 percent tax on the first $50,000 of net long-term capital gain. Therefore, the alternative tax is applicable and beneficial only to those noncorporate taxpayers whose income is subject to marginal tax rates exceeding 50 percent. Taxpayers who elect the alternative tax are not eligible for income averaging.

Regardless of the manner in which the tax on capital gains is computed, present law treats one-half of a noncorporate taxpayer's net capital gain as an item of tax preference subject to the 15-percent minimum tax (sec. 57(a)(9)(A)). The minimum tax for individuals equals 15 percent of a taxpayer's tax preferences, reduced by either $10,000 or one-half of regular tax liability, whichever is greater. As an item of tax preference, the excluded half of the capital gain reduces the amount of personal service income eligible for the 50-percent maximum tax (sec. 1348(b)(2)).

Generally, the effect of classifying one-half of a noncorporate taxpayer's capital gains as an item of tax preference is to increase the maximum rate of tax on capital gains to 39.875 percent. This is the sum of the highest applicable rate of regular tax (35 percent), and a 4.875 percent minimum tax (the effective rate of the minimum tax after giving effect to the deduction for regular taxes).[1] In some isolated cases in which the taxpayer uses the $10,000 exemption instead of the deduction for one-half of regular taxes, the combined minimum and regular tax rates may equal 42.5 percent. If the impact of the 50-percent maximum tax on earned income, under which the capital gain preference reduces the amount of the income eligible for maximum tax, is taken into account, the highest potential tax rate on capital gains generally is 49.125 percent. This is the sum of a 35 percent regualr tax, a tax increase in earned income equal to 10 percent of the capital gain (a tax increase from 50 percent to 70 percent on an amount of earned income equal to one-half the gain), and a 4.125 percent minimum

[1] On a $1 gain, the minimum tax is 15 percent of half the gain (50 cents), reduced by one-half the regular tax on the gain (17½ cents), or 4.875 cents.

tax.[2] In certain very unusual circumstances, the rate of tax on a capital gain can be as high as 52.5 percent, *i.e.*, where due to various tax credits the minimum tax exemption is not increased by the regular income tax on the capital gains because the taxpayer elects the $10,000 exemption instead of the deduction for one-half of regular taxes.

Corporate taxpayers

Under present law, the alternative tax on corporate capital gains (the excess of net long-term capital gain over net short-term capital loss) is 30 percent (sec. 1201(a)). No special deduction for 50 percent of a long-term capital gain is available for corporations as is the case with noncorporate taxpayers. Use of the corporate alternative tax will not be advantageous to a corporation if its gain is subject only to the normal corporate rate (which is less than 30 percent), rather than the combined normal and surtax rate of 48 percent.

Under present law, 18/48ths of a corporation's net long-term capital gain is treated as an item of tax preference subject to the 15-percent minimum tax (sec. 57(a)(9)(B)). For corporations, the minimum tax exemption equals the greater of $10,000 or all of regular tax liability (instead of half as with noncorporate taxpayers). Also, a series of special rules apply to capital gains from timber and reduce the minimum tax on that item of tax preference.

Background

Noncorporate taxpayers

Prior to the Tax Reform Act of 1969, the 25-percent alternative tax was not limited to the initial $50,000 of a noncorporate taxpayer's net long-term capital gains. Thus, where a noncorporate taxpayer's marginal tax rate was over 50 percent, the alternative capital gains rate was applicable, and the entire amount of gain was subject to a 25-percent tax rate. In the 1969 Act, Congress limited the availability of the alternative tax to the first $50,000 of a noncorporate taxpayer's net capital gain, and made capital gains eligible for income averaging.

In addition, Congress classified one-half of a noncorporate taxpayer's net capital gain as an item of tax preference subject to the minimum tax, and as an item which reduces the amount of personal service income eligible for the 50-percent maximum tax. These changes were implemented because Congress felt that previously applicable rules, which allowed taxpayers to avoid tax on certain portions of their economic income, resulted both in an unfair distribution of the tax burden, and in large variations in the tax burdens placed on taxpayers who receive different kinds of income.[3] These changes generally were effective for taxable years beginning after December 31, 1969.

Both the minimum and maximum tax provisions were amended by the Tax Reform Act of 1976. The minimum tax rate was increased from 10 percent to 15 percent, and the $30,000 exemption and deduction for regular taxes of prior law were replaced with an exemption equal to the greater of $10,000 or one-half of regular tax liability. The Act also repealed the carryover of regular taxes paid. With respect to the

[2] On a $1 gain, the minimum tax is 15 percent of half the gain (50 cents) reduced by one-half the regular tax liability (one-half of 45 cents, or 22½ cents), or 4.125.

[3] Senate Report No. 95-552, 91st Cong., 1st Sess. 122 (1969).

maximum tax, the 1976 Act eliminated both the $30,000 exemption to the preference offset and the 5-year averaging provision.

Noncorporate taxpayers

Prior to the Tax Reform Act of 1969, the corporate alternative tax on net long-term capital gains was 25 percent.

In the 1969 Act, Congress classified 18/48ths of corporate capital gains as an item of tax preference. The denominator of this ratio is the regular corporate tax rate (48 percent), and the numerator is the regular corporate tax rate less the rate generally applicable to corporate capital gains (48 percent minus 30 percent). The Tax Reform Act of 1976 increased the minimum tax rate from 10 percent to 15 percent, and replaced the $30,000 exemption and deduction for regular taxes, which were enacted in 1969, with an exemption equal to the greater of $10,000 or regular taxes. The 1976 Act also eliminated the carryover of regular taxes paid.

Description of S. 3065

The bill would eliminate both corporate and noncorporate capital gains as an item of tax preference subject to the 15-percent minimum tax and, for individuals, the preference offset to the maximum tax.

The bill also would amend the alternative tax for capital gains to provide that the maximum tax rate applicable to any taxpayer's net capital gain would be 25 percent.

Effective date

The amendments made by S. 3065 would apply with respect to taxable years beginning after December 31, 1979.

Revenue effect

The Treasury estimates that S. 3065 would reduce receipts by $2.2 billion at 1979 income levels and by $2.4 billion in 1980. Of the projected 1979 revenue loss, $1.3 billion would result from removing capital gains from the minimum and maximum taxes for individuals, $0.4 billion from repealing the $50,000 ceiling on the alternative tax rate for individuals, $0.1 billion from removing capital gains from the minimum tax for corporations, and $0.3 billion from reducing the corporate alternative capital gains rate from 30 percent to 25 percent. These estimates assume no change in economic activity as a result of the tax act.

Several private studies have critized these revenue estimates. These include studies by Chase Econometrics Associations, Inc. (sponsored by the American Council for Capital Formation), the Securities Industry Association (using the Data Resources, Inc., econometric model), Merrill Lynch Economics, Inc., and Norman Ture (in conjunction with the National Association of Manufacturers). Each of these studies attempts to quantify the effects of the tax cut on the economy and the "feedback" effect on Federal revenues. The estimated effects of S. 3065 on the Federal revenues in the second year after the effective date derived by these studies are as follows:

	Billions
Chase	$3.9
Merrill Lynch	2.3
SIA	7.3
Ture	1.0

The Chase, Merrill Lynch and SIA studies are similar in many respects. They each assume an increase in the extent to which taxpayers realize their accrued capital gains in response to the tax cut. The SIA study assumes a 10-percent increase in realizations, which would cause the revenue gain from additional realizations by individuals to offset slightly more than half of the initial revenue loss. The Chase and Merrill Lynch studies each assume sufficient additional realizations to lead to no revenue loss (for individuals, about 18 percent more realizations).

Also, each study assumes a significant increase in stock prices as a result of the bill—40 percent in the Chase study, 10 percent in the SIA study and 4 to 6 percent in the Merrill Lynch study. An increase in stock prices would reduce the cost of raising equity capital, thereby stimulating investment, and would raise each household's wealth, thereby encouraging consumer spending. Each of these effects would increase national income and, therefore, increase Federal revenues.

The Ture study is somewhat different. It assumes no change in realizations, not because it does not believe that there will be some increase, but rather because it believes there is insufficient evidence to quantify this effect. Also, the Ture study assumes no increase in stock prices on the grounds that sales of assets because of "unlocking" in response to the reduction in capital gains rates will reduce stock prices, while additional purchases of stock in response to the greater attractiveness of common stocks will increase them, so that the net effect on stock prices will be indeterminate. Rather in the Ture study, the main economic effect of lower capital gains taxes is to increase savings, which is assumed to increase investment and gross national product, thereby generating additional revenue.

The Treasury has disputed the conclusions of these studies, asserting that they are based on unwarranted assumptions.

Appendix B

Communications received by the committee showing an interest in these hearings

Air Products and Chemicals, Inc.,
Allentown, Pa., July 7, 1978.

Re S3065.

Hon. Harry F. Byrd, Jr.
Senate Finance Committee, Subcommittee on Taxation and Debt Management, U.S. Senate, 2227 Dirksen Senate Office Building, Washington, D.C.

Attention: Michael Stern, Staff Director

Dear Sir: Air Products and Chemicals, Inc. supports the enactment of S3065. It is believed that enactment of this provision will result in a significant long term benefit to the economy.

The existing three-tier system of taxing capital gains at rates up to 50 percent is a deterent to economic growth and increased national competitiveness because it: (1) discourages equity investment in new companies attempting to develop high-risk innovative concepts; (2) involves multi-layers of taxation of corporate profits; and (3) constitutes a tax on inflation generated "gain".

The pending bill represents a practical and simple means of reducing these disincentives to capital formation.

INVESTOR INTEREST IN HIGH-RISK INNOVATIVE COMPANIES

Innovative companies, especially those based on new technological ideas and methods, have been a major force in the growth and competitiveness of American industry.

Air Products and Chemicals, Inc. is a good example. In 1946, when the Company first offered equity capital to the public, it had a net worth of $300,000, less than $600,000 in assets and less than one hundred employees. Company assets now exceed $1,100,000,000 and it has in excess of 14,000 employees.

This growth was the result of application of innovative technological concepts and a willingness of investors to accept the attendant risks. This then new small company, challenged established companies and successfully brought about a fundamental transformation in many of the practices of the industrial gas industry. The result was a more efficient and productive industry to the benefit of the entire economy.

The success of Air Products was dependent on the equity capital provided by investors, many of modest means, who were willing to both assume high risk and encourage reinvestment of earnings to satisfy the growing capital needs of the then struggling company.

The prospect of eventual profit subject to a favorable capital gain tax rate was the incentive.

If the present system of capital gain taxation existed 30 years ago, it is doubtful that Air Products could have obtained the needed "venture" capital. Investors are not willing to place funds in risk situations with the prospect of up to 50 percent tax on both the real and inflationary gain. Evidence of this lack of willingness to assume high risk has been pointed out by representatives of the security business who indicate that in 1969 there were 540 stock offerings totaling nearly $1.5 billion by companies with a net worth of under $5 million. In 1975, there were only four offerings, and they raised only $16 million.

Long-term solutions to the American energy problem will depend on development of new and efficient ways to produce and use energy. This requirement when added to the previously existing need for technological development provides new and exciting demands for innovative solutions. However, statistics clearly show that technological innovation is declining in the United States.

A lower capital gains tax rate will result in more equity capital becoming available to finance technological innovation, which in turn will benefit the entire country.

TAX ON INFLATIONARY PROFITS

The present high tax on capital gains is a tax on capital, not income, to the extent that appreciation reflects inflation. S3065 would not eliminate this problem, but it would significantly reduce the adverse affect in a simple and practical manner.

ELIMINATION OF DOUBLE TAXATION ON CORPORATIONS AND SHAREHOLDERS

Multiple levels of taxation of the corporation and the shareholder are a deterrent to capital formation. This has been recognized in various proposals for partial elimination of double taxation through credits to be given shareholders receiving dividends. These proposals have met opposition from many business sources. In part, this opposition is attributable to the recognition that a credit at the shareholder level on dividends will shift the relative attractiveness of investment from the growth company that reinvests earnings to the mature company or the service company in position to distribute current earnings as dividends.

As a matter of policy, we should encourage the growth company that is providing new technology and less costly and improved methods of production.

While the bill does not eliminate double taxation, it would reduce the impact of multiple layers of tax and would tend to reduce some of the opposition to the shareholder dividend credit proposal.

The proposed bill is an imperfect solution to the problem of providing incentive for capital formation and encouragement of companies with new technological developments. Its enactment, however, would constitute a substantial positive step. The bill would also simplify the taxation of capital gains. Enactment of the proposed bill would constitute a substantial incentive for capital formation and would result in more equity capital becoming available to the Company with new innovative technology.

Sincerely,

EDWARD DONLEY.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS,
Washington, D.C., June 28, 1978.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: In connection with the hearings on various bills affecting the taxation of capital gains to be held June 28 and 29, 1978 by the Senate Finance Committee's Subcommittee on Taxation and Debt Management, the American Institute of Certified Public Accountants is pleased to submit the following comments.

Basically, the positions adopted by the Institute oppose any further erosion of the capital gains preference. Indeed, we believe that the capital creation needs of the country urgently require relief from the current heavy capital gains tax burden. We are, therefore, very encouraged that significant relief is being considered by the Congress.

Our detailed views are set forth in the AICPA's Statement of Tax Policy Number 1, Taxation of Capital Gains. Copies of this publication are enclosed as a part of this written statement for the consideration of the Subcommittee in connection with these hearings.* It is interesting to note that two of the recommendations included have already been adopted, that is, extending the holding period for long-term capital gains to 12 months and increasing the limit on capital loss deductions.

The AICPA has also submitted its position on certain aspects of the taxation of capital gains in its comments on the President's 1978 Tax Program. The Institute position on these aspects of capital gains taxation are reproduced as follows.

CAPITAL GAINS—REPEAL OF ALTERNATIVE TAX

The AICPA opposes any further increase in the Federal income tax burden on long-term capital gains.

Retention of the alternative tax on the first $50,000 of annual long term capital gains serves a particularly useful purpose. It must be remembered that the alternative computation provides a "ceiling" on the tax. The actual liability may, of course, be lower—it can't be higher. In our judgment, this tax relief provides a meaningful incentive for taxpayers with some investable funds to make the decision to invest. There is, we believe, general recognition of the importance of increasing the pool of investors in this country. The tax incentives for that purpose should, if anything, be increased rather than diminished.

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*The booklet was made a part of the official committee file.

MINIMUM TAX FOR INDIVIDUALS

The AICPA favors the elimination of the application of the minimum tax to the capital gain recognized upon the sale of an individual's principal residence.

The AICPA is opposed to the elimination of the 50 percent of the regular taxes paid reduction in determining tax preference items subject to the minimum tax. Such elimination broadens the scope of the minimum tax beyond what is necessary to accomplish the intended purpose. The current proposal to completely eliminate the reduction for a portion of regular tax converts the "minimum" tax system into an "additional" tax system on preference items. This is particularly notable in the area of tax preferences representing timing differences in that the tax imposed in the year of preference is not offset by a reduction in tax liability in the later year when the timing difference reverses. The Institute further believes that the broadening of the minimum tax would be counterproductive to the President's goal of capital information by discouraging investments in certain activities.

PURPOSE OF THE PREFERENCE TAX

The minimum tax provisions were enacted in the Tax Reform Act of 1969 to ensure that high-income persons paid their fair share of taxes. As these provisions were not fulfilling their intended purpose, the Tax Reform Act of 1976 substantially revised the preference tax by (1) repealing the carryover of regular taxes paid as a reduction of preference items, (2) increasing the minimum tax rate to 15 percent from 10 percent, (3) replacing the $30,000 exemption and reduction for regular taxes with an exemption equal to the greater of $10,000 or one-half of the regular tax liability, and (4) expanding the list of preference items subject to the tax.

The changes, effective for taxable years beginning after December 31, 1975, effectively ensure that most individuals pay at least a minimum tax on income each year.

The complete elimination of the deduction for regular taxes paid would effectively repeal the concept of a "minimum tax" on preference items and replace it with the concept of an "additional tax" of 15 percent on all items of tax preference. If this is the intent of the Administration's proposals, then Congress should consider confronting the particular preference item situations squarely and directly change the tax consequences rather than attempt to achieve the same result through the use of a device which no longer serves the objective for which it was originally designed.

REVERSING PREFERENCE DIFFERENTIALS

The elimination of the 50 percent regular taxes paid deduction would, to a much greater extent than under current law, effectively impose the minimum tax twice on the same so-called tax shelter investment. For instance, accelerated depreciation on leased personal property is a preference item subject to minimum tax each year in which accelerated depreciation exceeds straight line depreciation. Such accelerated depreciation also reduces an individual's basis in such property for purposes of determining gain on the subsequent disposition of the leased property. A portion of the subsequent gain will be ordinary income under the depreciation recapture rules; however, some of the gain may qualify as a capital gain and the minimum tax provisions would again apply. With no offset for 50 percent of the regular taxes paid, an individual would twice pay minimum tax on the same piece of property. This same, or similar, rationale applies equally to (1) accelerated depreciation on real estate, (2) stock acquired by exercise of qualified stock options, (3) percentage depletion, (4) amortization of child care facilities, and (5) intangible drilling costs.

Clearly, such elimination of the 50 percent of regular taxes paid deduction would produce an entirely inquitable result not intended by Congress.

We would appreciate the inclusion of this statement in the record.

Sincerely,

ARTHUR J. DIXON.

ARTHUR ANDERSEN & CO.,
Washington, D.C., July 7, 1978.

Hon. FLOYD K. HASKELL,
U.S. Senate, 4104 Dirksen Senate Office Building,
Washington, D.C.

DEAR SENATOR HASKELL: Bill Barth and I were pleased to appear before the Senate Finance Subcommittee on Taxation and Debt Management on June 28, 1978, and we especially appreciated the opportunitity to discuss with you our firm's position regarding the proposal to defer recognition of gain on the sale of a small business. Such a proposal can serve a number of objectives, each related to maintaining and expanding that amount of capital available to small businesses. We perceive that the differences between the proposal we have supported and the one encompassed in your recent bill (S. 2428) are largely matters of emphasis among the various objectives. Accordingly, we would like to make a few additional comments regarding the manner in which the various objectives might be covered by a single proposal.

Our original proposal for the deferral of gain on the sale of a small business (before the Select Committee on Small Business and the Finance Committee on September 24, 1975) emphasized the bias in the current tax law toward the acquisition of a small business by a large publicly-held corporation. Under the reorganization provisions of the Internal Revenue Code, such transactions may be accomplished in a manner which permits the "seller" to defer recognition of gain on the sale of his business. On the other hand, should the entrepreneur desire to sell his successful small business to another entrepreneur or a group of key employees, he will generally be required to recognize gain on the transaction, since the normal consideration in such a transaction is cash or a combination of cash and debt. Accordingly, we recommend that in a sale transaction, the seller be permitted to obtain substantially the same results as in a tax-free reorganization; i.e., the deferral of gain recognition coupled with a reduction in the basis of property acquired with the proceeds from the sale of the business. Limiting our concern to the achievement of tax equity with regard to dispositions of a small business, we saw no need to limit the type of reinvestment by the selling entrepreneur and contemplated that, in fact, the proceeds would generally be invested in stocks, bonds, real estate, etc.

We believe such a change in the tax law would encourage small business capital formation in two respects. First, there is the obvious ability to keep a small business in the small business sector after the founder is ready to dispose of it for whatever reason. Secondly, removal of the tax burden on the sale of a small business will be an additional incentive for prospective entrepreneurs to create small businesses in the first place.

A number of commentators, and more particularly Senate Bill 2428, have taken this idea one step further and provided that the deferral of gain will apply only when the proceeds, or a substantial part thereof, are reinvested in another qualifying small business. This supplements the original objectives by providing a level of assurance that the capital represented by these proceeds will also be utilized in the small business community. Based upon your comments during our recent discussion at the hearing, we understand that you would contemplate such an investment to be (1) in either a specific small business, or (2) in a fund which in turn invests in a number of small businesses.

We are reluctant to see such a requirement attached to the initial reinvestment of the proceeds of a small business, since there are circumstances in which such an investment might be inappropriate for the seller. For example, an elderly small businessman wishing to retire may, from a purely investment standpoint, be better served by investing in relatively safe, perhaps fixed income, securities. On the other hand, there is a strong benefit to be obtained from a reinvestment in the small business community and we agree that an additional incentive toward this end is appropriate. Accordingly, we would suggest that while the initial reinvestment be unrestricted, the subsequent investment in a qualifying small business (or a small business fund) be included in the legislation as a means of extending the nonrecognition benefit.

Our original proposal provided that the sale of the replacement investment, e.g., publicly-held stock, would trigger the previously deferred gain. We suggest that you incorporate in your proposal a provision that would provide that such gain continues to be deferred so long as any reinvestment after the first such transaction is made in the small business community. This would provide the incentive to make investments in small businesses, but would not force the seller who is approaching retirement to reinvest in high risk ventures.

In conjunction with this approach of merging several objectives in the legislation, we would point out that in our statement before the Select Committee on Small Business on May 15, 1978, we recommended the creation of a new type of security, the Small Business Participating Debenture, which we hope will provide an excellent vehicle for reinvestment of the proceeds of a small business, particularly if a fund investing in the debentures issued by many small businesses were to come into existence. We hope that you will give further consideration to our proposal for the creation of such an instrument as a means of bringing together the various small business proposals now before the Congress.

If we can be of further assistance to you in the consideration of this legislation, please do not hesitate to contact us.

Very truly yours,

By WILLIAM C. PENICK.

BODINE SOUNDRIVE CO.,
Los Angeles, Calif., July 7, 1978.

Re Capital Gains Tax.

SENATE FINANCE COMMITTEE,
Senate Office Building,
Washington, D.C.

HONORABLE SENATORS: Before the enactment of the 1954 tax code there was a major problem as regards launching much needed new technology in American industry. Those pre 1954 years had the problem that an inventor/developer of new technology was almost forced to form a new venture company in order to launch a new product design. This was about the only way we could finance the developments.

I am an inventor, holding some 300 patents, primarily specializing in the industrial application of a new technology of physics involving the use of low frequency sound waves. Notable in these developments are our Sonic Oil Well Drill, Sonic Pile Driver, Sonic Earth Moving Equipment, Sonic Foundry Equipment, Sonic Plastics Working Equipment, Sonic Metal Working Machines, etc., all based upon low frequency sonic technology, and all involving considerable development and consequent need for venture financing. I have been in this segment of our industrial picture for a number of years, and because of this experience I serve on the Advisory Committee to the United States Patent Office, the Planning Council of the American Management Association, the Sonic Engineering Committee of the American Institute of Physics, and an Associate of California Institute of Technology. I have been hard at it since finishing at Cal Tech some years ago.

The pre 1954 tax and financing problems made it necessary that for each venture we had to set up a separate, new, struggling, hardly able, little corporation which would then try to grow and do its job of introducing the new technology. We formed Soundrill Corporation, for the oil well drill; we formed Soundrive Pump Company for the oil well pump; we formed Soundrive Engine Company for the application of sonics to engines and their manufacture; Sonic Process Company for the commercialization of foundry techniques, etc. These new companies, each one a separate corporation, grew very slowly because of typical financing problems, and their technologies were held back accordingly as regards helping the industrial picture in our Country.

Then came the 1954 tax code, with its section 1235 which establishes capital gains position for inventors and holders. This of course made real sense because in those days capital gains tax was held to 25 percent, as you know. Immediately thereafter, because of this wisely written tax law, we were able to launch a new approach which simply involved making license arrangements with large corporations. The license royalties payable to our entity (Bodine Soundrive Company is a sole proprietorship, and therefore I function as an individual inventor actually) were subject to only 25 percent tax, for the years after 1954 until 1969, and therefore we had funds to move into further developments into other fields of application. A really active new applications program was carried on during those years.

It is significant that during those enlightened tax years, from 1954 to 1969, American technology really led the world. Since 1969 our United States picture has slumped into technical doldrums, and foreign technology is now forging ahead of us, leaving American export in a not-to-happy position.

In addition to being a great boon for United States technical leadership, the enlightened tax years, 1954 to 1969 also effectively aided the industrial and employment picture within our Country itself. For example, because of the 1954 tax code (and the 25 percent limitation on capital gains tax) we were able to license our Sonic Oil Well Drill to Borg-Warner Corporation, and Borg-Warner expended close to $6,000,000 in the development of the Sonic Oil Well Drill.

This was about 100 times the financing we are able to accomplish on our own before the 1954 tax code and the 25 percent tax limitation. These millions of dollars created very substantial employment and very substantial purchases of hardware, all of which resulted in payroll taxes, excise taxes, etc., which were of course a great aid to our Country's tax financing. We licensed our Sonic Pile Driver to Shell Oil Company, and they put out close to $8,000,000 in launching that project, again a repeat of the type of benefit to our Country as was the Borg-Warner situation with the drill. Another good example was our being able, because of the enlightened tax years, to license our manufacturing process patents to General Motors. They too started millions of dollars moving right away.

So, it can be seen that the small concession of the 25 percent capital gains tax to our own small entity resulted in some real money starting to move on the part of large and abled companies. The net benefit to our Country was orders of magnitude greater than the net concession to the small technical entrepeneur.

Then came 1969, and the devestating change in the tax picture. Since that year our position has radically changed. No longer do we have the rapid introduction of our technology such as the Sonic Dental Tool, the Sonic Pile Driver, Sonic Foundry Techniques, Sonic Drills, Sonic Pumps, and all of the other really big goodies that occured before 1969.

We have subsequent developments that are just as big, but they pretty well hang around in our files since the devastating effects of the 1969 tax revisions on capital gains. We have had almost ten years now to see the bad effects on the 1969 enactment and subsequent similar trends in tax code. In order to try to survive in spite of the devestating policies of the United States Tax Collector we have been looking to companies outside the United States such as joint ventures and God knows what all. And yet President Carter has a committee trying to figure out what has gone wrong with United States technology leadership!

There is a unhealthy lethargy, and the United States leadership is slipping behind. Our little entity sincerely hopes that your Honorable Committee will be able to turn things around, back to the 25 percent picture that really made the wheels turn.

I would be more than pleased to provide further details in any manner you might find desirable.

Very truly yours,

ALBERT G. BODINE,
President.

Enclosure papers on new technologies.[1]

STATEMENT OF BARRY C. BRODEN, ASSOCIATE PROFESSOR, DEPARTMENT OF ACCOUNTING, UNIVERSITY OF MIAMI

The economic system in the United States has long been referred to as capitalism. Our country was founded on the principle of free enterprise for profit and to such a system capital investment at risk is its heartbeat. In recent years, the federal, state and local government's role in our economy has grown to such an extent that a healthy partnership exists between the socialistic and capitalistic aspects of our economy for mutual benefit.

Our system must be constantly monitored so that an adequate balance exists between private and public capital. To discourage private capital formation will tend to lessen individual incentive and reduce our economic growth. Such action would be counter to the basic ideals on which our Founding Fathers began our country. Our country must always provide incentives and opportunities for the individual to succeed on their own.

[1] Papers were made a part of the committee file.

The 1969 Tax Reform Act and subsequent revenue acts had a number of provisions which narrowed the difference between the maximum tax on capital gains (49.1 percent) and the maximum tax on professional service income (50 percent). This effectively eliminated the appearance of an incentive in the tax rates for capital investment. Capital gain tax rates should be lowered for additional reasons. In many respects, effective tax rates on capital gains are higher than on ordinary income sources. For example, capital gains are an aggregate of increases in values produced or earned over a number of years and includes a much larger increment of so-called "illusory profits" due to inflation. Such "illusory profits" are taxed at even higher graduated rates because they are lumped together in one year when recognized rather than taxed over the number of years when realized. Although a small measure of relief may exist if one can income average, no provision exists for eliminating taxes on illusory profits due to inflation. Therefore, capital gain tax rates should be lower for three basic reasons; the adverse tax effects of lumping the gain in one year, eliminating the tax on inflation gains and providing an incentive for investment. Additionally the ill effects of the minimum tax on individuals that sell their personal residence or receive lump sum pension distributions was not the original intent of Congress. Furthermore, the elimination of one half of the individuals capital loss deduction is unfair due to the yearly limitation on capital loss deductions, high inflation rates and the full deductibility of ordinary losses. In fact, President Carter's tax package calls for eliminating sale of personal residences from the minimum tax. The President also calls for the elimination of the alternative tax as a step towards tax simplification. I support such Presidential recommendations but feel that elimination of capital gains as tax preference item entirely would do more good for tax equity and simplification in the long run.

Ideally, such eliminations: capital gains as a tax preference item, the alternative tax computation, and one half of the individuals' capital loss deduction, would be a just compromise by lowering the effective maximum rate on capital gains to 35 percent. Remember, one should not criticize provisions which on the surface seem to be aiding the rich at the expense of the public but look to the long term effects on the welfare of our society. The situation reminds me of the old principle that in order to reap benefits for the many, you must incur what one group may consider distasteful costs. After much thought, the so called "seasoned professional" will accept these costs as necessary.

STATEMENT BY IRA G. CORN, JR., CHAIRMAN, MICHIGAN GENERAL CORP., ON THE TAXATION OF CAPITAL GAINS, ON BEHALF OF THE COMMITTEE OF PUBLICLY OWNED COMPANIES

Mr. Chairman and members of the subcommittee: I appreciate this opportunity to file a statement on behalf of The Committee of Publicly Owned Companies. This Committee is an organization of Chief Executives of about 700 companies whose stock is publicly owned and traded on the New York or American Stock Exchanges or over-the-counter. We have members in nearly every state of the Union. Our primary focus is capital formation. Most of us are small or medium-sized companies, although a growing number of large companies have joined forces with us as the problems of raising equity capital have intensified.

I am a member of the Executive Committee of The Committee of Publicly Owned Companies, and I am Chief Executive Officer and co-founder of Michigan General Corporation which is traded on the American Stock Exchange, as well as a director or officer of various other companies. I am the author of several books and a number of articles, mostly relating to business, economic and financial matters; and I was for some years Assistant Professor of the School of Business Administration, Southern Michigan University.

The Committee of Publicly Owned Companies strongly supports the bill introduced by Senator Hansen with 61 co-sponsors, the effect of which would be to reduce the maximum tax rate on net capital gains to 25 percent. This is a proposal, in speeches and articles, which I have advocated for a number of years. My support of this position is based upon my own studies and my experience as the founder and developer of 24 companies during the past 30 years.

I don't propose to burden you with a detailed statement of the statistical facts and projections supporting our position. These are or will be in your record in great detail. I really do not believe there is much room for argument about economic

facts. A roll-back of the capital gains tax to 25 percent will have a powerful, stimulating effect on our economy. In my opinion, the estimates of Dr. Norman Ture who, I think, is well-known to you as a sound and reliable expert in the field, are about as accurate as estimates can be. Enactment of the Hansen bill, Dr. Ture concluded, "would have a significant expansionary effect on the economy and would modestly increase Federal tax revenues." Dr. Ture estimates that in the third year after enactment of the Hansen bill, the effect of the roll-back would be as follows (for that year alone): 100,000 additional jobs; $12 billion increase in gross capital outlays for plant and equipment; $15 billion increase in GNP; and $1 billion net increase in Federal tax revenues.

I think the economic benefits of the roll-back are so clear that its enactment would be assured except for one thing: The argument that you shouldn't enact a measure which will clearly and powerfully aid the Nation and all of its people because it would also benefit rich people who would receive a substantial part of the tax reduction.

Now, with all respect, I submit to you that the facts do not support this type of reasoning. The purpose of a roll-back of the capital gains tax is not to reduce taxes, it's to create jobs and to encourage equity investment—the single most critical aspect of the American economic system. A capital gains roll-back could have the effect of (1) expanding the production of goods and the provision of more services; (2) reducing inflation; (3) restoring to Americans the maximum opportunity to start new businesses and to develop them into strong, thriving concerns; and very importantly, (4) providing competition.

Under our American system, there's really only one way to accomplish this, and that is to make it sensible and attractive for people to invest savings in the equity—the common stock—of corporations. For some years now, because of the sharp increases in the capital gains tax, investment in common stock to supply new and additional equity capital has been neither attractive nor sensible. That's why the equity capital market, especially for smaller and newer enterprises, has been practically non-existent. In my own companies, for example, we have not been able to go to the public market for equity since 1969—and that's true of most if not all of the 700 members of our Committee. To be sure, we have enjoyed rapid growth since 1969, but virtually all of it has been funded by debt.

We're not growing prudently. We wish to continue to expand plants and production, to provide new jobs, new technology and more products and services to fight inflation—and to do so on a strong foundation which will make the next ten years successful. The real entrepreneurs—the smaller companies capable of growth and vigorous competition—are not coming on-stream. They just can't raise equity capital. They don't have retained earnings that they can use for capital. Most of them are at or beyond the prudent limits of borrowing; and debt financing, when available, has to be at high interest rates which threaten their very existence and adds to inflation. The ratio of corporate debt to equity in our Nation's enterprises is truly dangerous; since 1960, the ratio of debt to equity has deteriorated more than 50 percent.

Now, if we're going to get equity capital, its got to come from public investors. Government doesn't—and shouldn't—supply the venture capital that's needed. But with present capital gains rates, public investment in new equity capital is practically non-existent. This is particularly true with respect to the types of equity investment most helpful to the Nation: that is, investment in the smaller, growing, dynamic companies which provide most new jobs, new technology, and real competition. The risk involved is so great that it is not prudent or sensible to make the investment. Even if you are lucky and successful, you have to pay a capital gains tax of 50 percent or more. In these days of galloping inflation, no responsible government should tolerate a 49⅛ percent federal capital gains tax rate, plus state rates that can go up to 8 or 9 percent (after federal deduction.) It is an obvious absurdity for any government to claim that a gain which is sheer inflation, and represents no real improvement in one's economic position, is "income" to a person and should be the target of punitive taxation.

It has been estimated that more than 70 percent of all American businesses lose money or barely break even. The only reason to take the risk of equity investment is the hope of substantial profits, after-tax, if and when you've been smart enough and lucky enough to put your money on one of the winners.

If we can get the people of America back into the equity market—to invest in the stock of companies, to become partners in America's growth—there is no doubt that the benefits to the Nation will be enormous, and everybody will share

in it. President Kennedy, who certainly was not interested in conferring special benefits on those in the higher income brackets, proposed in 1962 a reduction in the then existing maximum 25 percent capital gains tax. He advocated this for a very good reason which he summarized in this way:

"A rising tide", said President Kennedy, "lifts all boats."

Mr. Chairman and members of the Subcommittee, we earnestly hope that you will approve the Hansen bill.

STATEMENT BY GEORGE E. JOHNSON, PRESIDENT, JOHNSON PRODUCTS CO., INC., ON THE TAXATION OF CAPITAL GAINS, ON BEHALF OF THE COMMITTEE OF PUBLICLY OWNED COMPANIES

Mr. Chairman and members of the subcommittee: My name is George E. Johnson. I am the founder and President of Johnson Products Company. We are the Nation's only predominantly Black-owned company whose shares are public held. Our stock is traded on the American Stock Exchange.

We are engaged in the manufacture and sale of hair products, cosmetics and men's fragrances, designed primarily for Black consumers. Our products are sold throughout the United States and in selected foreign markets.

We directly employ over 400 persons. In 1969, we were able, for the first time, to raise some equity capital by a public offering of our common stock. This made it possible for us to expand our facilities and hire more employees. As a result, both our sales and the number of jobs we were able to supply has more than tripled.

We have long recognized that the best hope for Black enterprises in this country is access to the public, equity markets through purchase of our stock largely by individual investors. It is for this reason that we became and still are a charter member of The Committee of Publicly Owned Companies which has taken the lead in promoting access to equity capital by small and medium-sized companies.

Black enterprises have the same problems that other small and new businesses have—only more so. We are Johnny-come-latelys. Very, very few of us have a long earnings history—or any kind of long history, so we can't finance our businesses out of retained earnings. For example, of the top 100 Black owned or controlled businesses in the Uhited States, 84 were started after 1965.

We are all appreciative of the policy of the Congress and the Administration to aid Black and minority enterprises. This is good social policy, and it's good economic policy. I'm confident that eventually we, the Black and minority enterprises, will contribute greatly to the economic vitality and prosperity of the Nation.

But giving us a chance to get government contracts, and giving us access to loans, however appropriate and desirable, won't do the job as it should be done. These programs have to be supplemented by giving us, as well as all other businesses, no matter who owns or controls them, access to equity—to venture capital. That's the only way that we can grow—the only way that many of us can survive. We can't do it if our only access to capital is to borrow money. New enterprises, new entrepreneurs, who are new entrants into the capitalist system, can't survive the burden of debt and the threat of the sheriff if we miss a payment. We are too vulnerable to economic adversity and management error to stand this.

We need stockholders—investors—partners. Without this, either we can't get going at all; or if we borrow for our capital needs to build plants and employ people, we're in hock over our heads. If there's a little recession, or a little setback because of economic conditions or a slight management mistake, we can't handle it, and our companies collapse. There's just no fat to absorb even a little shock.

Debt, of course, creates instability—and debt is pretty much all that some of us—fortunately not my own company—have by way of capital. For example, in just the last year, 17 Black companies were displaced from the list of 100 leading companies in that category. This is to be compared with the fact that only 18 companies disappeared from last year's list of 500 top American companies.

We're not here requesting a handout. We're not asking for special treatment. It's your policy to encourage small and medium-sized businesses, and especially to give a long-denied chance to minority enterprises. It's a good policy because, as your records show, those are the businesses that supply new jobs and new technology, and open new markets, and provide competition, and give life to the great American dream of upward mobility.

And we're not asking for a chance to "con" the public. We're asking for a tax reform which makes it sensible—and not foolish—for the public to invest in new or young companies. Any company offering to sell stock to the public has to provide them with all the facts. But for investment in any of these companies to be sensible, the public must have a reasonable basis to anticipate that they've got a chance to make enough profit, after taxes, to justify the risk that's always present when you put money in young companies, and especially in companies whose management, like that of most minority companies, has not necessarily got a background of 20 years as president of another company.

I respectfully submit that the only way to do this—the American way—is to reduce the capital gains tax and to reduce it enough to provide the incentive that is needed. The Hansen bill will do this, and we strongly support its approval.

In connection with this statement, I offer for the record an article which appeared in the New York Times of June 14, 1978, and a Wall Street Journal editorial of June 9, 1978.

[The New York Times, Wed., June 14, 1978]

BLACK BUSINESS: INSIDE VIEW

(By Winston Williams)

When the 100 leading black business executives gather at the White House today for a meeting with President Carter, they will include 17 newcomers who will have replaced representatives of companies that have folded, merged into larger companies or fallen behind the pack.

The changes in the top 100 list, published for the last six years by Black Enterprise magazine, highlight one of the biggest problems of black entreprenuers—instability caused by management and financial problems. In comparison only 18 companies disappeared in the last year from the list of the 500 top American industrial companies that are publicly held.

"The black business situation is still very fluid," said Earl G. Graves, publisher of Black Enterprise, "It took us 300 years to get to the White House," he said, referring to black businessmen. "Its' going to take us a while longer to master big business."

The combined sales of the entire group would place it 264th on the top 500 list, ahead of the Brown Group, a St. Louis shoe manufacturer.

TWO COMPANIES LIQUIDATED

In fact, last year was a fairly good one for the group. Only two companies were liquidated. Group sales advanced 15.6 percent to $896 million. The cutoff point for inclusion in the ranking rose to $3.6 million this year from $2.5 million the year before and the sales of the largest company, Motown Industries, jumped 22 percent to $61.4 million.

But concern about the takeover by white-controlled businessmen of last year's seventh-and-ninth-ranked companies have raised new questions. Some social activists view the development of healthy black-controlled business as an important part of a larger plan to rebuild the black communities and to provide work for the unemployed.

"A lot of blacks react to the idea of merger as if it's going to take something away from them," said Mr. Graves, "I guess we're possessive because we're so new at business."

Henry Parks, the chairman of H.G. Parks when it was No. 9 on the list, sold his sausage company to the Canadian-based Norrin Company last year for $10 a share when it was trading over the counter in the $3-to-$4 range. He thinks the fear of takeover is unjustified.

"We started out from day one aimed at the general market. We were not selling exclusively in the black market," he said, "No one wants to fight social problems over the breakfast table." Mr. Parks said that Parks management had remained unchanged as a subsidiary of Norrin, a financial services company. He said it has also created potential new corporate opportunities for Parks executives. Norrin has also acquired a kosher sausage company, which the Parks subsidiary is running.

The management of Garland Foods Inc. of Dallas, which held the No. 7 place last year with sales of $16 million, remained unchanged after a mixed racial group bought the concern from the estate of the dead owner.

Few of the businesses on the Black Enterprise list are candidates for take-over, however. Only one company, Johnson's Products, a Chicago cosmetics company, is publicly owned and most are burdened with heavy debt. The loans, according to J. Bruce Llewellyn, chairman of Fedco Foods (No. 3 this year), are usually short-term bank borrowings that can spell disaster when a little trouble comes.

VICTIM OF DROUGHT

Such was the case with Harris & Stroh, a San Francisco-area sporting goods distributor, which ranked No. 20 on last year's list. International Fasteners is now in the process of liquidating Harris & Stroh's inventory. The company, which was highly leveraged, could not survive the recent drought in California, which brought fishing and hunting to a near stop.

But management problems made matters worse. The Urban National Corporation, a Boston-based small-business investment company that owned Harris & Stroh and that specializes in minority businesses, delegated to a financial expert the responsibility of running the company after Richard Banks, the former chairman, took an executive job at Levi Strauss & Company.

"What the company really needed was a marketing man to attract and keep the chain-store business," Mr. Banks said. He left the company because Levi Strauss offered him a vice president's title with responsibility for the women's junior sizes division. "I found out I'm more of a corporate animal," he said.

Two of the companies delisted last year, Philadelphia International Records and K.C. Buick of San Francisco, were erased because it could not be determined if they were actually controlled by blacks. But most of the companies that did not reappear on this year's list were outdistanced by the newcomers, most of whom were automobile dealers.

TOP BLACK-OWNED/CONTROLLED BUSINESS IN THE UNITED STATES[1]

Ranking				Sales (thousands)	
This year	Last year	Company and location	Type of business	1976	1977
1	1	Motown Industries, Los Angeles	Entertainment	$50,000	$61,400
2	2	Johnson Publishing Co., Inc., Chicago	Publishing	47,600	50,150
3	4	Fedco Foods Corp., Bronx	Supermarkets	37,000	45,000
4	3	Johnston Products Co., Inc., Chicago	Manufactures hair care products and cosmetics.	43,500	38,047
5	......	Afro International Corp., New York	Exports		25,000
6	6	H. J. Russell Construction Co., Inc., Atlanta	Construction and development	21,000	25,000
7	8	Wallace & Wallace Chemical & Oil Corp., St. Albans, N.Y.	Fuel oil import and distribution	15,476	17,540
8	9	Drummond Distributing Co., Inc., Compton, Cal.	Liquor wholesaling	13,500	14,500
9	11	Dick Gidron Cadillac, Inc., Bronx	Auto sales and service	12,130	13,900
10	20	Terry Brantley Greenbrier Lincoln-Mercury Sales, Inc., Atlanta.	Auto sales and service	9,000	13,000

[1] Based on gross sales. Excludes banks, savings and loan associations, life insurance companies, and firms with professional orientation such as brokerages, architectural offices.

Source: Black Enterprise magazine.

[The Wall Street Journal, June 9, 1978]

REVIEW AND OUTLOOK

BLACK CAPITAL

At the 1976 Republican Convention in Kansas City, Wendell Gunn, a black vice president at Chase Manhattan, argued before the platform committee that blacks had struggled for decades for the right to buy a ticket to the train, and just when they won that right the train stopped running.

The thrust of his remarks was that just as blacks were finally breaking through legal and social barriers to growth in the mid-1960s, the "peculiarly black tax of discrimination" was being replaced by government tax and regulatory policies

that stifle economic growth for black and white alike. The truly successful businesses and really significant fortunes were built prior to the mid-1960s and as a result are exclusively white.

We're reminded of these observations by the June issue of Black Enterprise, which lists the top 100 black owned and/or controlled businesses in the United States. Of these, 84 were started since 1965. The biggest, Motown Industries of Los Angeles, had only $61 million in sales last year. To make the Fortune 500 in 1977 took $355 million in sales. It takes only $3.6 million in sales to make the top 100 as a black enterprise. And only one of Black Enterprise's 100 is publicly held.

Those blacks who share Mr. Gunn's views are growing in number and becoming increasingly vocal, recognizing that the major obstacle to black capitalism is no longer racial discrimination but the tax and regulatory structure. One of the major reasons why there is so much steam behind the Steiger amendment to President Carter's tax package is that it has been endorsed by black energy and banker groups and by Mayor Tom Bradley of Los Angeles.

The tightening of capital gains taxation in 1969 is precisely the kind of barrier to new growth that changed the rules just as blacks were getting into the game. The Steiger measure would roll the tax back to where it was in 1969, at a top of 25% instead of the current roughly 50%. The principal beneficiaries would be successful but small enterprises now ready to expand, like those on the Black Enterprise list.

In retrospect, it is puzzling that such a destructive change in the tax laws could be made in 1969, the first year of Richard Nixon's presidency, with his blessing and with so few voices in the business and financial community raised against it. But it becomes easier to understand when we reflect on the fact that in 1969 the lower capital gains rate was perceived by the corporate bureaucracy not as a boon but an irritant.

The Fortune 500, after all, have little to gain directly by a lower rate. Big business has already gained most of the risk capital it needs and generates expansion capital internally. What was happening in the late 1960s, spurred by the Kennedy tax cuts of 1962–64, was an economic boom built on venture capital. The brightest and most adventurous managers and engineers were leaving the Fortune 500 and starting enterprises of their own. They could sell their ideas of better mousetraps to investors who could see that with a 25% top rate on capital gains there would be a potential payoff that would match the risks attendant on fledgling companies. Corporate bureaucrats felt nothing but harassment from this vigorous new competition.

With the passage of the Steiger amendment in some form, there would almost surely be a great burst of entrepreneurial activity, along with an exodus of talent from the Fortune 500. Risk capital would be available for new ventures, allowing more blacks to try their hand at forming businesses. The more successful of them—the ones on the Black Enterprise list—would be able to raise money by going public. This means the black entrepreneurs would take home a big capital gain personally, have more money to expand their businesses, and still be chief executives. To realize their personal gains and get expansion capital under the current tax structure, they have to sell out to a white conglomerate, which is why this year's Black Enterprise list has lost H.G. Parks Inc., the Parks sausage people.

Those black leaders who still believe black enterprise can only be built via government subsidies or contract favoritism have a pleasant surprise coming. There is a vast population of talented, educated and adventurous blacks bottled up in corporate America for want of venture capital. They will be freed if only we can change the rules to get the train moving again.

Statement of George A. Strichman, Chairman, Committee to Reform Double Taxation of Investment

This statement supporting sound treatment of capital gains is submitted on behalf of the Committee to Reform Double Taxation of Investment. The Committee has over 800 corporate members (representing over 31 million individual shareholders), 17,000 individual members and others who participate in informational activities provided by the Committee.

The Committee was formed in 1976 to support legislative action to phase out the inequitable and burdensome double taxation of distributed corporate earnings. Its members urge such action as an essential ingredient in the formation of sufficient capital to meet the needs of our economy now and in the years ahead.

But our purpose in this statement is not to dwell on the essentiality of action on the double tax issue, since the occasion for these hearings is to examine the alternatives to current law fixing treatment of capital gains. Because our Committee was organized to explain the need for improvement of the tax climate for capital generation and because capital gains plays such a vital role in that process, we believe reform of capital gains deserves high priority.

Since 1969—through the imposition of higher rates or through such "backdoor" vehicles as the Minimum Tax on Tax Preference—there has been a steady increase in the effective tax rates on capital gains. The maximum rate for individuals has risen from 25 percent to almost 50 percent, when the minimum tax is included. For corporations, the differential between ordinary income and capital gains rates has been narrowed from 23 percent to 18 percent, and the Minimum Tax has further diminished the incentive for capital gains in the corporate sector.

Several alternatives have been proposed to restore needed incentives to the capital gains tax structure. The most beneficial action would appear to be a rollback of capital gains rates to the pre-1969 levels, with a maximum of 25 percent on both individual and corporate gain. Concurrently, the capital gains "rollover" concept—which would provide a graduated exclusion of long-term capital gains and graduated non-recognition of capital losses—as proposed by Dr. William F. Ballhaus, President of Beckman Instruments, Inc.—also deserves full positive consideration by the Congress.

As President Carter has pointed out, it is true that the tax laws are out of balance; but the problem is that they are tipped too heavily on the side of consumption rather than savings and investment. This trend, along with the larger role of the Federal Government in "income tranfer" programs, has combined to place the United States in a subordinate position among the industrial nations of the world in a ratio of savings to consumption. The trend in recent years in the treatment of capital gains is the most glaring example of our inattention to vital capital requirements.

It is ironic that reductions in the capital gains incentive has coincided with startling growth in capital investment needs. Without sufficient capital, we have been unable to keep pace with a growing labor supply, and as a consequence, our economy suffers in many ways—through the burden of excessive unemployment benefits and through the social problems that arise from youth idleness. Our economy is struggling to cope with a phenomenal increase in financial resources that must be diverted from production to protection and enhancement of the environment, to improved safety and health standards, and to consumer protection.

Thus, your hearings are important. That is why it is essential that the true impact of equitable capital gains tax rates must be impressed upon our national consciousness. That is why it is also important to consider as early thereafter as practical eliminating the double taxation of corporate earnings.

We wish to make it clear that the membership of the Committee to Reform Double taxation of Investment fully recognizes the priority needs to revise capital gains rates. The double tax and capital gains issues are not mutually exclusive; they are interdependent, and the resolution of one problem cannot be viewed as a total solution to the capital shortage problem. It will require wise actions on both of the above and on other elements of our tax laws if we are to fully realize the potential of our economy to meet the needs of a growing population and a population more sensitive to social and environmental advancements.

We commend the Subcommittee for providing the opportunity to bring these issues to the forefront, and we thank you for permitting me to present our views.

Statement of Martin David, University of Wisconsin, Madison, Wis.

I am qualified to speak authoritatively on capital gains taxation by my contributions to study of the tax. I have authored the most recent comprehensive economic analysis of the tax, Alternative Approaches to Capital Gains Taxation. I have prepared the only analysis of the persistence of capital gains in taxpayer's reports on income extending over several years (David, 1975). I have studied alternatives to preferential capital gains rates, such as income averaging (David, 1969). I am currently a member of the Governor's Commission on Tax Reform for the State of Wisconsin. I teach economic analysis of tax systems and I have extensive experience in studies of the distribution of income.

I oppose the legislation before you. My reasons follow. The taxpayer revolt of this country is a revolt against capricious taxation, taxation that binds during inflation, and taxation that entails professional intervention to comply with the

burdens of the average citizen. The bills under consideration treat symptoms of what is wrong with our tax structure, while failing to attack root causes. They will not heal the frustration of taxpayers; indeed more complain can be predicted if these bills become law.

I can demonstrate;

1. Alleviating capital gains taxation directs tax favors to groups who are not the main target of increasing real tax burdens.
2. Alleviating capital gains taxes moves away from simplications.
3. Non-recognition of gains increases the distortion of investment decisions by tax incentives.

Tax reform requires:

1. Broadening of the tax base, and a lowering of all rate schedules.
2. Indexation of personal exemptions, and the dollar values affecting the level at which positive tax payments are required from nondependent individuals.
3. Withholding at the source on corporate income attributable to stockholders plus increase in basis for taxes paid.

Each of these points is explained below.

TAX REFORM

The bills before you are destructive of the fabric of Federal Taxation. They create incentives for tax-motivated behavior that have little to do with sound capital accumulation, and will do a great deal to offer a few individuals the power to manipulate the amount of income tax that they pay.

How can that be? It is because the definition of capital gains is an arbitrary legal construct that cannot be clearly distinguished from ordinary gain or loss. Tax shelters are largely skillful devices to convert ordinary gain or loss into a receipt that can be labelled capital gain. The incentive to create such shelters depends on the invidious distinction among types of income in the tax law. For a decade the Congress has been moving towards reducing the value of that invidious distinction—It is to be commended for that effort.

What Congress must recognize now is that the frustration of the American taxpayer can be met by statesmanlike reform that will give all taxpayers an incentive to participate in a creative economy, or it can be met by the current bills which allow us the opportunity to return to a discarded legal structure, and like the dog chasing its tail, realize that we are going nowhere. The product of a statesmanlike reform will be to reach islands of income that are not now taxed and thereby create an opportunity to lower tax rates. It will be a reform that recognizes the impact of inflation and reduces the burden of inflation on the lower and middle income taxpayer (not the high income taxpayer). It will be a reform that eliminates widespread evasion of taxes by non-reporting of dividend and interest income. The reform cannot be accomplished by piecemeal adjustment of capital gains provisions.

1. The target group benefitting from capital gains tax provisions

Much misplaced sympathy is tendered on recipients of capital gains. Capital gains accrue on wealth. Recipients of such gains have wealth. Capital gains are taxed when they are realized. Recipients of gains have cash to pay taxes when gains are realized (in practically all cases). No crocodile tears need to be shed for the taxpayer who realizes a $40,000 gain on his residence, or his stock, or his small business. The fact is that such gains represent success and the accumulation of gain merely reflects the fact that the government is tardy in keeping its records straight with taxpayers who have wealth or property rights.

My own studies of capital gains (David, 1975) document the fact that capital gains are regular sources of income for the taxpayers claiming them. Capital gains are not the isolated result of a single transaction for an individual entrepreneur, they are commonplace for persons reporting dividends, interest, or rent. Finally, gains are selectively received by persons with five times the amount of interest, seventeen times the amount of dividends, and five times the amount of rent of non-recipients.

Alleviating the tax on capital gains is thus a device for allowing the wealthy to prescribe themselves a cut in taxes. It is not an across-the-board cut in tax rates that gives every individual the incentive to start a business (by increasing his income from both labor and savings invested); it is a tax cut that favors those who have arrived—Older persons with accumulated wealth who cry all the way to the tax accountant when they file their returns.

The Treasury analysis of tax expenditures in 1977 provides devastating evidence that capital gains provisions benefit high income persons. Nearly eighty percent of the benefits from capital gains provisions went to taxpayers with incomes over $50,000. (The proposed legislation under S. 3065 operates primarily to increase that percentage.) All capital gains provisions applying to individuals account for more than one dollar out of every six dollars of tax expenditures. Moreover, these dollars are the least defensible in view of their impact of the performance of the economy and their erosion of equity. The non-recognition of capital gains at the time of transfer of assets allows the accumulation of economic privilege and its transmission to children without taxation. The non-recognition of gain permits "double-dipping" and self-serving income increases to some taxpayers who donate appreciated property to charity. It is possible for a taxpayer to have a larger disposable income or disposable estate after giving to charity because of the non-recognition feature. These opportunities are the exclusive domain of the most wealthy in our society. A vote for preferential capital gains taxation is a vote for the creation of caste in our democratic society.

If it is the wealthy who are liable for capital gains taxes, if it is a recurrent form of income for those taxpayers, why should we be concerned about the level of capital gains taxation? Two legitimate concerns are raised: The discretionary timing of taxation of capital gains allows taxpayers to choose when taxes are paid and a higher rate of tax may induce some postponement. The lumpiness of taxes accumulated on gains that accrue over long periods of time may require averaging to limit rate progression or installment payment to eliminate cash flow problems. The obvious solution to both problems is to require the taxation of gains as they accrue, not to tax gains when they are realized. Such a reform is possible and I am on record favoring taxation on accrual nine years ago (David, 1969).

What concerns about capital gains taxation are not legitimate? Many persons declare that because gains are the product of inflation and revaluation of assets, therefore gain realized on sale of assets should be protected. This argument fails on three counts:

1. There is no reason why the argument does not apply equally to the taxes owing on earnings. A nominal increase in my wage without an increase in purchasing power should not call forth more tax burden on my earnings, it can be argued. It is surely inequitable to give the wealthy a tax break on their inflation-induced gains without at the same time giving the average citizen a break on his cost of living increase in earnings. We conclude that inflation-related change in the tax system must be more general than piecemeal changes affecting computation of capital gains taxes alone.

2. A second argument invalidates appeal to the capital gains provisions as a means of "inflation-proofing" gain or loss on the sale of assets: The preferential capital gains tax has nothing to do with the rate of inflation. For some holding periods the reduction in tax liability exceeds any reasonable allowance for inflation; for other holding periods the reduction falls far short of an inflation adjustment (Diamond, 1975).

3. The last argument destroying the assertion that preferential capital gains should be used to "inflation-proof" the tax system comes from the pattern of benefits. Pechman (1977) shows that the capital gains provisions begin slicing more than one percentage point from nominal tax rates at an income level of $50,000. For persons with over $200,000 the nominal rate is reduced by 9.4 percentage points, and for persons with over a million dollars of total income the nominal rate is reduced by twenty percentage points. The result is that actual tax rates peak at 32.7 percent for persons with incomes in the range $200,000 to $500,000 and decline thereafter. The real benefits to preferential gains are captured by very high income persons.

Over time, we know that increasing nominal incomes push taxpayers into higher rate brackets. This rate progression is most severe for taxpayers (married filing joint returns) whose taxable income is in the range $10,000 to $50,000: The marginal rate more than doubles in this range, from 22 to 50 percent. These people feel the impact of inflation, but they benefit to a very limited extent from capital gains provisions. Less than 20% of tax expenditures associated with capital gains go to this group.

The high-income taxpayers whose rates are substantially sliced by capital gains feel little or no increase in rates because of inflation. Yet they get the tax preference.

Another argument for preferential capital gains that has no validity pertains to non-recognition of gain or loss. Non-recognition is required to protect the

integrity of an investment in a particular line of business it is asserted. Non-recognition is given to many types of real property exchanges, and homeownership. It is argued that forcing the payment of tax at the time of realization of an exchange will withdraw essential risk capital from the enterprise and roll-over should therefore be permitted. This specious argument can be restated: Since taxation was deferred from the appropriate point in time (accrual), and present value of tax payments are thereby reduced, we should exempt the property generating the income from tax indefinitely. Obviously this is a non sequitur. Existence of the gain indicates an ability to pay; realization of the gain produces an opportunity to obtain cash; even full taxation of gain on realization does not create parity between the owner of physical assets and the woner of fixed value assets who is required to report all receipts as current income.

Non-recognition of gains for the roll-over of particular lines of investment generally increases tax-distorted holding of investments as the ratio of tax-saving to asset price also increases (Holt and Shelton, 1962).

2. Tax simplification

Stanley Surrey has estimated that more than half of the present Internal Revenue Code would fall away, if the present distinction between ordinary gain and loss and gain and loss on capital assets were obliterated. Tax simplification requires that we move towards a system in which transactions can be treated in an obvious way and general rules can be made to apply to all situations. It is a curiosity that the present capital gains provisions were enacted as a device to minimize losses to the Treasury during the great depression when it was feared that losses on capital assets would wipe out tax liabilities and revenue for the government. The original conception of income taxation did not include special provisions for some asset sales, and it is wise in the reform of the tax laws to return to the simplicity of a general formulation for all asset transactions.

No value would accrue to tax shelters based on deferral of income to future tax years if gains can be taxed as they accrue. Proponents of reduced taxes on capital gains must accept the responsibility for the costs of making and administering the invidious distinction between these types of income and they must accept the responsibility for a vastly more complex system of taxation.

A POSITIVE BASIS FOR TAX REFORM

The Tax expenditure analysis for 1977 indicates that over $80 billion is estimated to be released from tax liabilitites by comparison with a comprehensive income tax base. Over half that amount can be identified as capricious and creating little of social value. The implication is that tax rates could be cut by as much as 25 percent if base-broadening reform were undertaken. The several provisions according capital gains tax privileges stand at the top of a list of excisions essential to base-broadening reforms. With base-broadening that permits a reduction of tax rates by 25–30 percent, it is realistic to make the top bracket rate a maximum of under 50 percent. Such a reform will divert energy that is now tied to tax avoidance towards productive and creative economic activity.

Beyond base-broadening and rate reduction, the major, and simple, measure that can be taken to reduce inflation-induced rate progression is to tie the value of personal exemptions to a cost of living index. This measure would do far more to assuage the frustrations of an over-taxed middle class than the prospect of non-recognition of gains in a buisness or the lower rate of capital gains tax that is offered by the bills before you.

Lastly I note that we still have a problem with compliance. A substantial proportion of interest and dividends are not reported on personal income tax returns. The Congress needs to provide for withholding at the source for these payments. There is no excuse, in this day of automation, for letting the owner of property escape tax payment on the yield on that property when we require persons working at the minimum wage to be withheld on their earnings.

To summarize:

1. Wealth is required to produce capital gains.
2. Reduction in capital gains taxation allows the wealthy to manipulate their property rights to produce income that is taxed at preferential rates.
3. The incentives for such manipulation increase with the tax differential.
4. Preferential capital gains provisions do not solve legitimate problems that arise out of taxation at realization instead of taxation of accrual.
5. Capital gains provisions are not a suitable route for indexing the tax to ameliorate tax increases in times of inflation.

The bills before you are asking you to endorse self-seeking tax reduction by the wealthy. The bills before you aggravate our national crisis in perceived tax inequities. The bills before you create tax motivated avoidance behavior to a much greater extent than they induce real productive investment activity.

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EMPLOYEE RELOCATION COUNCIL,
Washington, D.C., July 24, 1978.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: The Employee Relocation Council is a nonprofit organization concerned with the various problems surrounding the transfer of corporate employees between various employment locations. We would like to call your attention to what we feel is an unintended effect caused by the amendment of section 1034 of the Internal Revenue Code of 1954, "Sale or Exchange of Residence", by the Tax Reduction Act of 1975 (1975 Act).

As you are aware, the 1975 Act amended section 1034 by lengthening the replacement period from twelve months to eighteen months. Congress' intent in lengthening the replacement period was to benefit taxpayers by allowing them more time to replace their previous residences and still defer the tax upon any gain. However, because of some parallel amendments to certain rules of detail of sections 1034(c)(4) and 1034(d), the 1975 amendment has had the opposite and unintended effect of increasing the tax burden of some relocating effect of increasing the tax burden of some relocating employees. An example of this unintended effect follows:

"Assume that an employee realizes a $5,000 gain on a sale of house A for $30,000 in month 1, purchases and occupies house B for $30,000 in month 2, sells house B for $45,000 in month 17, and purchases house C for $45,000 and occupies it in the same month. In such event, the $15,000 gain with respect to house B would be taxable, pursuant to section 1034(d), while the $5,000 gain with respect to house A would be deferred. Prior to the 1975 Act, the gain with respect to both houses A and B would have been deferred."

Requiring taxpayers who move to a new principal place of work to recognize gain upon the sale of their homes is inequitable. Imposition of capital gains tax in such a situation may well result in a taxpayer not having sufficient aftertax funds to afford a new residence of quality anywhere near comparable to his prior residence. This is clearly inequitable and a deterrent to the mobility of the American worker.

We propose that a new subsection 1034(i) be added to the Code to read as follows:

"(i) Moving to a new principal place of work.—Subsection (d) shall not apply with respect to the sale of a taxpayer's residence within the 18-month period designated therein, provided such sale is in connection with a move resulting in an allowable deduction to the taxpayer for moving expenses pursuant to section 217.

The sale of a residence satisfying the conditions of the preceding sentence shall terminate the 18-month periods (or 2-year periods if paragraph (5) of subsection (c) is applicable) of subsection (a) and of paragraph (4) of subsection (c) with respect to the sale of a former old residence for which such periods have not previously terminated and only the residence sold satisfying the conditions of the preceding sentence may constitute the new residence with respect to such former old residence."

As you can see, the above proposed amendment operates in conjunction with section 217. It relieves a present inequity by permitting a taxpayer to receive the benefits of section 1034(a) even if he has sold a prior residence within eighteen months of the sale of his present home if he has incurred allowable moving expenses under section 217. We hope that in examining this proposed amendment you will conclude that it is both an equitable and necessary correction to the present law which you can and will actively support. Inasmuch as we intend to seek the quick passage of an amendment such as the above, we would greatly appreciate receiving your comments at the earliest possible time.

Sincerely yours,

H. CRIS COLLIE,
Executive Director.

Enclosure: Technical explanation.

TECHNICAL EXPLANATION OF PROPOSED SECTION 1034(i) DEALING WITH THE SALE OF A RESIDENCE IN CONNECTION WITH A MOVE GIVING RISE TO ALLOWABLE MOVING EXPENSE DEDUCTIONS UNDER SECTION 217

The examples below illustrate the operation of new section 1034(i). In all the examples it is assumed that all sales took place within 18 months of the first sale and that a purchased residence is used as a principal residence:

Example 1

a. Sell residence No. 1.
b. Purchase residence No. 2.
c. Sell residence No. 2 not pursuant to a move.
d. Purchase residence No. 3.
e. Sell residence No. 3 pursuant to a move.

In this example, residence No. 1 receives §1034(a) treatment and is matched with residence No. 3 irrespective of any subsequent purchases within 18 months of the sale of residence No. 1 since the sale of residence No. 3 pursuant to a move terminates the 18-month periods with respect to residence No. 1. Residence No. 2 does not receive §1034(a) treatment because of the limitation of §1034(d). Residence No. 3 is entitled to §1034(a) treatment if another residence is purchased within 18 months of the sale of residence No. 3. (Residence No. 2 cannot be a new residence with respect to residence No. 3 by reason of §1034(c)(3).)

Example 2

a. Sell residence No. 1.
b. Purchase residence No. 2.
c. Sell residence No. 2 pursuant to a move.
d. Purchase residence No. 3.
e. Sell residence No. 3 pursuant to a move.

Residence No. 1 receives §1034(a) treatment and is matched with residence No. 2 since the sale of residence No. 2 pursuant to a move cuts off the 18-month time periods with respect to residence No. 1. Residence No. 2 also receives §1034(a) treatment and is matched with residence No. 3. Residence No. 3 is likewise entitled to §1034(a) treatment if another residence is purchased within 18 months.

Example 3

a. Sell residence No. 1.
b. Purchase residence No. 2.
c. Purchase residence No. 3.
d. Sell residence No. 2 pursuant to a move.

Example 3 illustrates the reason for the language, "and only the residence sold satisfying the conditions of the preceding sentence may constitute the new residence with respect to such former old residence". Without such language the sale of residence No. 1 would be matched with the purchase of residence No. 3. There would then be no purchase with which to match the sale of residence No. 2. The above language would match the sale of residence No. 1 with the purchase of residence No. 2. Thus, the sale of residence No. 2 could then be matched with the purchase of residence No. 3.

FIDELMAN, WOLFFE & WALDRON,
ATTORNEYS AT LAW
Washington, D.C., March 10, 1978.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Senate Finance Committee, Dirksen Senate Office Building, Washington, D.C.

DEAR SIR: This letter is a personal plea for the Congress to look long and hard at the current proposal to reform the tax laws by abolishing the optional tax treatment of capital gains.

I oppose the change; I submit that legislative enactment of this "reform" could well have disastrous economic and social consequences for this country.

Unfortunately, I represent nobody but myself, and write this letter because organized defenders of the capital gains concept are too narrow in vision.

In this narrow area of which I now write, I am as expert as anyone. I invest (in stocks) with moderate success. My legal calling is to secure patents for inventors. From the sidelines I watch my inventors attempt to secure financial backing. For years I have observed how the tax laws affect the roots and seedlings of our economy. The outlook is already poor. Passage of the proposed reform will make the outlook worse.

PREFACE

Legislation can guarantee an equality of opportunity to all. In addition, legislation can endeavor to distribute the fruits of our economy equitably.

However, it is beyond the capability of legislation to create any equality in individual abilities. Therefore, the Congress should look at legislative proposals posed in the name of fairness, and as attacks on special privileges etc. to see if the legislation would discourage the able and competent members of our society from working up to the full measure of their abilities. In this regard, Congress has legislated poorly. To a significant degree the current malaise in the stock market and our import-export imbalance are the fruits of past tax legislation.

The key to much of our economic problems is the tax treatment of capital gains.

THE CONCEPT OF A CAPITAL GAIN

For simplicity I will define a capital gain as an increase in the value of an investment, i.e. money making money through appreciation (as distinct from running income such as interest, rents and dividends). I also make the well known point that throughout our economic structure are instances where no income return on an investment can be forseen for many years. Traditionally, investors are induced to invest by promises of substantial increases in the value of their investment, i.e. the capital gain. This situation exists for every new enterprise, but then again new enterprises offer hope for the greatest appreciation. Therefore any decrease in the attractiveness of capital gains (as against running income) distorts our entire economic structure. New enterprises abort for lack of seed capital. Small and large corporations alike find themselves unable to raise equity capital. (The attached article #1 from the Washington Post, March 1, 1978 reports the current existence of such a distortion).

Almost everybody will accept capital gains, but those who avidly seek for capital gains include disproportionately the well educated high income persons in our society, i.e. the able and competent among us. Attached is an article #2 from the Wall Street Journal of February 14, 1978 reporting on the present attitude of investors; it also describes the investing public.

BACKGROUND OF THE CURRENT MALAISE

The current malaise among investors is a cumlination of many things, among which are the (successive) increases in capital gains taxes and the reduction of the maximum tax rate for earned income to their present levels.

I have always believed (and still do) that one of the forces which generated the bull market of the 1950–1960 decade was the confiscatory taxes applied to high earned incomes. At that time capital gains were taxed at a maximum rate of 25%. This favored tax treatment of capital gains skewed our entire economy toward capital investment, new enterprises etc. Coincidentally (but not by coincidence) our unemployment rate 1950–1960 was at a peace time low. In that era investment losses could be shurgged off as only money that would otherwise have gone to the tax collector; in contract capital gains would become cash in hand.

During the 1950–1960 decade major industries could trade upon the capital gains attitude of investors. Utilities for example, offered only nominal cash dividends, but did express assurances that their continued growth would generate an ever higher value for their stock (i.e. capital gains). For a long time things worked out exactly as promised. Utilities could issue stock without difficulty, and in many instances at levels so far above book value that stock issues were less costly to the utility than debt (e.g. bonds) even though dividends on the stock were paid with after-tax dollars. The capital gains were received by stockholders only when and as they sold the stock to (new) stockholders. (The utility and its customers neither received nor paid any of the gains).

Since those halcyon days of 1950–1960 the maximum tax rate, on earned income has dropped to 50% and, between Keogh tax plans, Individual Retirement Act plans (IRA accounts), corporate retirement plans, whatever, and tax free Municipal Bonds the need for high income individuals to seek out capital gains has vanished. Besides, the high income individual investor knows full well that (except for the alternative tax computation) the capital gains could exceed 40% on large gains.

Individual investors are constantly reminded that their investments can produce tax free income. Some of the material from municipal bond funds include elaborate tables which factor in tax rates and purport to demonstrate how poorly taxable investment income compares to a tax free income from municipal bonds. (See Attachment #3). If the alternative tax computation for capital gains is abolished I fully expect to see the bond funds add an additional table comparing after tax capital gains income to tax free income (along with some text about the risk of loss inherent in efforts to secure capital gains).

To demonstrate how far we have come since the halcyon days of 1950–1960 I again allude to the utilities. They continue to be a highly rated investment vehicle. They still need capital. In fact utilities are virtually the only industry group presently raising equity capital. However, the stock now offered to the public is priced at very close to book value and offers a high current rate of return. Instead of the capital gains potential of an investment in utility stocks, brokers talk about what percentage of the annual dividend represents a (tax free) return of capital.

CAPITAL GAINS ARE A SNARE AND A DELUSION

In all likelihood everything I have written up to this point has been said before (by representatives of the securities industry, no doubt), but I can not conceive that the Congress has been told flat out that most investors lose their shirts, or skirts.

The slogan that "money makes money" is sheer nonsense insofar as the slogan implies that capital gains are the ordinary results obtained from careful investment of money. The usual result is a nominal to large loss, the extraordinary and relatively rare result is a capital gain.

Most individual investors do in fact lose money. With prudent professional management the loss is minimized. Attached #4 is a recent article from the Wall Street Journal (page 43, January 25, 1978) describing the 5 and 9 year investment results of equity funds. Prior to about 1970 apologists for the stock market quoted 9% compounded as the return 1880 to 1970 from an investment in the stocks that make up the Dow Jones Industrials of The Standard and Poors Index. However, the so called 9% return ignored many factors which created a significant upward tilt to the Dow Jones Industrial Index and the Standard and Poors Index. My estimate is that the past 5 and 9 year results of the equity funds are representative of investment results 1880-date.

However, poor investment results are an overall phenomena. Some individual investors do make money from investments in real estate, securities, art objects. securities, art objects, whatever, and pay (capital gains) tax when and as the gain is realized. At least in stocks, they do. All too often the same investor loses his or her gains in a future year. Certainly this happened to most of the pre-1929 and pre-1972 winners in the stock market. In fact the stock market has been critized as an enormous gambling institution. Since taxes are levied on gains, but the deductability of lossess is limited, it would seem that the Treasury Department recognizes the gaming aspects of the stock market. (Fair is fair, if money makes money, and the present administration is doing no more than reform the tax laws, how about a trade-off that abolishes both the alternative tax computation and the limit on deductability of capital losses.)

Unfortunately the well being of the more innovative portions of American industry are so tied to the continued existence of the stock market game that for the Congress to misconceive the almost no-win character of the capital gains game is dangerous for the future of our country. Money does not make money; only people make money.

CAPITAL GAIN TAXES ARE COUNTERPRODUCTIVE

The truth of the matter is that most new enterprises fail (a well documented situation), and the capital investment therein becomes lost. Then most of the corporations that survive long enough to go public fail and equity capital raised from the public is lost (the S.E.C. can provide hard statistics). Losses in moneys invested in new enterprises and invested in "new issues", are, on a statistical basis, surprisingly close to 100%

If memory serves me right a study made to ascertain who lost the some $2 billion dollars that vanished during the "new issue" madness of 1960–62 concluded that the losers were doctors, lawyers, accountants and the like, people, the study said, who could afford the losses. Parenthetically I note that saddened, perhaps wiser too, these otherwise competent people had to work all the harder at their calling, so that on the whole the country did not suffer from their losses. Still some of the "new issue" companies stayed in business and remain in the business community to this day. The investors in those companies had a capital gain.

However, remember also that success stories exist. Every once in a while a big winner comes along (much like winning $100,000 or more in a lottery) for example Xerox, Kodak, IBM, Boeing, Marriott. A few investors do become wealthy. Excitement all out of proportion to the chances for repeating such an investment success races through the investing community. Unfortunately, it has not happened lately.

For the past 10 or 15 years the flow of speculative funds into stocks has diminished almost year by year. Currently, seed money is almost non-existent. New issues are very rare. Even established sound corporations find themselves unable to secure equity capital. (I myself know of at least 3 reasonably good new-product type of situations that are certain to abort for lack of access to seed capital.) Some apologists for the stock market would blame the current lack of speculative interest on the Congress. I do not.

I do, however, believe that the Congress should look closely to what will happen if its treatment of capital gains becomes so severe speculative interest (in stocks) never revives.

Losses suffered by investors and speculators year by year amount to a most diffuse invisible voluntary tax paid (in some part) on behalf of American trade and industry. The losses are large and recur year after year, even though the losers are relatively sophisticated individuals, and even though investment bankers (and the S.E.C.) screen out the worst of the seekers for investment money. (The siren song of the entrepreneur is hard to resist.)

Entrepreneurs are a resourceful class of people. Attached No. 5, is a recent letter to the Wall Street Journal (page 19 March 6, 1978) for its good capsule description of entrepreneurs.

Already the Congress funds a Small Business Administration. States and local communities are now in active competition for new businesses. If speculative interest stays dormant, entrepreneurs will change their tune and pitch their siren song to the appropriate government agencies. Then the tax will no longer be selective to those able to pay the tax, and will become quite visible. (How much money has the Small Business Administration made or lost to date?) The odds against investment success will not change because the gamblers are different.

If anything investor losses will be all the larger. Traditional sources of speculative/investment funds lose their own money. Investment bankers lose their customer's money, then their customers. The traditional sources have a personal interest in success for the business. Except at the height of a speculative boom, entrepreneurs must convince some very hard nosed individuals of good chances for business success. I cannot conceive of government administrators successfully investing year by year, decade by decade where individuals and professional money managers alike have failed.

My conclusion is that the proposed change in the tax treatment of capital gains would become a very dangerous piece of legislation, legislation that is most likely to bring in virtually no revenue, and engender billions of expense.

Yours very truly,

MORRIS FIDELMAN.

Enclosures.

UNDERWRITING DROUGHT HITS SECURITIES FIRMS

(By Jack Egan, Washington Post Staff Writer)

NEW YORK.—In the throes of sinking stock and bond markets, Wall Street securities firms have a new concern to add to their list of worries—the lightest corporate underwriting calendar in recent memory.

The week of Feb. 13 was notable because not a single corporation came to the market to raise money through a common stock, preferred stock or bond offering—an occurrence that no one on Wall Street can recall in modern market history except for the traditional lull during the Christmas-New Years holiday period.

A tabulation by the Investment Dealers' Digest for January shows total corporate financing of $1.86 billion, down more than 40 percent from the same month in 1977. Although totals for February are not yet in, the month is expected to weigh in at least as light as January.

And the supply of announced new underwritings for the next 30 days totals a slim $1.177 billion. That is about one-third of the monthly average in 1977 when corporate underwritings for the year totaled $36.7 billion, in turn down 13 percent from 1976.

Almost all of those corporate issuers who are coming to market are public utilities which face the continuing and unavoidable need to finance large capital projects. That merely emphasizes the almost total absence of industrial borrowers.

With many securities firms already under considerable profit pressure from the low daily turnover in the stock market, cutthroat competition on institutional brokerage rates, and trading losses on both stocks and bonds, the dearth of new underwritings only is making matters worse.

Of last year's estimated $7 billion in brokerage industry revenues, about 20 percent came from the underwriting and distribution of corporate securities, E. F. Hutton & Co. President George L. Ball estimated.

"Obviously the effect on any securities firm is adverse when there is such a paucity of underwriting business being done," said Ball.

"For the last several months, conditions in the securities industry have not been good," said Virgil Sherrill, president of Bache Halsey Stuart Shields Inc., whose parent firm, the Bache Group Inc., last week sliced its dividend in half because of a sharp drop in earnings.

Sherrill cited the renewed rise in interest which has depressed bond prices; the general decline in stock prices which has affected brokerage commissions because, for example, firms charge less to buy and sell a stock trading at $20 than at $30 a share; the decline in average stock market volume to well below the 20-million-share-a-day level which is now considered break-even; the effects of the winter's blizzards in further curtailing business; and the lack of corporate underwriting.

"The January calendar, from an underwriting and investment banking point of view, was one of the worst we'd ever seen," commented Sherrill. "But we said that before February came along. And March also looks pretty barren."

Sherrill said that although diversified firms such as his own—which is already the product of several mergers—would ride out the current doldrums. "This kind of period just accelerates the pace of mergers on the Street."

The current Wall Street slump is not yet as bleak as the darkest days of 1974. Then, double-digit inflation and double-digit interest rates had the markets on their knees and the securities industry, as a whole, in the red. But the pressure on many firms is said to be intense, and merger talk is rampant. The only solid areas of profitability are in the merger-acquisition and related risk-arbitrage field—though this activity is limited to a handful of firms—as well as in municipal bond underwritings which have held up better than corporate issues.

Wall Street experts meanwhile cite a number of reasons for the current corporate underwriting drought, ranging from the depressed state of the securities markets to a general lack of confidence.

"The stock market is down and companies are more inclined to do equity financing when their shares are moving up," said H. Fred Krimendahl II, the Goldman, Sachs & Co. partner in charge of corporate finance. "Interest rates have also been increasing sharply since the end of last year and that has affected some companies that would have come to market." Krimendahl said. "And most large companies are also pretty well financed today."

"There is a reluctance to make major commitments on the whole capital spending side," said Richard B. Fisher, the Morgan Stanley & Co. managing director responsible for trading and sales. "I think it's a lack of confidence in the entire business climate. Business is very uncertain about what will happen in some areas like energy and tax policy, and that in turn affects the returns they get on new investments."

Fisher sees "no sign for the next 2 to 4 months" that the underwriting tempo will pick up.

But others think that a turnaround could happen sooner. James W. Davant, chairman of Paine Webber Inc., believes many corporations are waiting until they have tallied all of their 1977 financial figures before proceeding to raise capital, and that a pickup in underwriting filings therefore should become discernible by the end of March.

"It's a bad period and business is not good, but we've seen a lot worse than this." said Davant. "After all, it's a cyclical business."

Few New Customers Will Enter Stock Market This Year, Public-Attitude Survey Indicates

(By Charles J. Elia)

Brokers who yearn for a return of the days when much of the public wanted to own "a share of America," to use a slogan out of the New York Stock Exchange's past, may have a long wait.

One adult American in six, or 16%, currently owns corporate stock directly but, for all the talk of how "cheap" stocks are at current levels, few new customers will enter brokerage houses this year. That's one of the findings of a survey completed little more than a month ago by R. H. Bruskin Associates of New Brunswick, N.J.

The firm does market research and is a consultant to 175 corporations, most of them on the Fortune 500 list of largest companies. Its survey of stock-market attitudes was based on 2,508 personal interviews with adult men and women representing what pollsters call a probability sample of U.S. households.

"I was somewhat surprised and disappointed that so many people were so negative about stock market investment," says Richard H. Bruskin, chairman. "This tremendously negative attitude toward stocks gives me the feeling that no real attempt has been made to talk to people about the merits of investment."

The Bruskin poll found that only 9% of the respondents plan to buy stock this year. Of this group, many are people who already own stock. Among those who once owned stocks but don't any longer, only 8% think they may be enticed back to the market this year, while only 2% of those who have never owned stock are interested.

Fully 78% of the 2,508 persons interviewed have never owned stock directly. Another 6% have sold off their holdings over recent years; 1% of the sample group got out stocks in 1977 and another 1% in 1975–76. "Past owners have been selling off holdings at a fairly even rate for the past several years," says Mr. Bruskin.

The exodus from stocks was evident in all geographic regions, age groups and income levels covered by the survey. "Lower-income families, when they hold stock at all, sold more often than those in the higher brackets." Mr. Bruskin says. "Young adults sold off more often than older ones, men more often than women."

Why? Usually for financial reasons. The leading reason among those who don't own stock any longer-given by 35% of the group—was that they can't afford it. That was also the reason given by 52% of the 2,291 adults who haven't any intention of buying stocks this year. Market risk and unreliability, disinterest and a preference for other investments also were among reasons for staying out of stocks.

The survey indicates that interest in stocks remains most lively the further up the income and education ladders people go; 33% of families with incomes of $20,000 or more and 26% of the college-educated own stocks.

"The study suggests the existence of several large segments of the public." Mr. Bruskin says. "There range from active stockholders, well-educated high-income men and women who became interested in stocks when they were 30 to 40 years old, to the 'can't-afford' group, perhaps 100 million people, who won't have money to buy stocks in 1978. In between are the mildly interested, who invest only occasionally, the uninterested and the disillusioned."

* * *

Goldman Sachs & Co. is scaling down its 1978 profit expectations for the industrial equipment sector. Analyst Terry L. Nagelvoort reduced his estimates on seven machinery companies.

"Unless the (plant) utilization rate rises materially in the next few months," he says in a report to clients, "1978 could be a year more similar to 1977 than we had anticipated earlier." In addition, he expects Western Europe and Canada to contribute little to growth in industry shipments this year.

The accompanying table lists 1977 results, actual or estimated, for the seven companies and the analyst's old and new 1978 per-share estimates.

	1977	Old 1978 estimate	New 1978 estimate
Bucyrus-Erie	$2.57	$2.80	$2.60
Clark Equipment	4.39	5.25	5.05
Cummins Engine	8.22	9.75	8.25
Ingersoll-Rand	5.66	8.50	6.35
Joy Manufacturing	[1] 3.92	4.25	3.65
Parker-Han	[2,3] 3.25	4.00	3.75
Timken	6.65	8.45	7.15

[1] Year ended Sept. 30, 1977.
[2] Estimate.
[3] Year ending June 30, 1978.

Mr. Nagelvoort left unchanged his estimates for six other machinery companies. They are Bearings Inc., $3.50 a share in the year ending June 30, 1979, up from an estimated $3 a share in the year ending next June 30; Caterpillar, $6.05 a share, up from $5.15 a share in 1977; Deere, $3.95 a share in the year ending Oct. 31, down from $4.24 a share a year earlier; Gardner-Denver, $1.75 a share, up from an estimated $1.15 a share in 1977, with both figures adjusted for sale of a foundry; Massey-Ferguson, $3 a share in the year ending Oct. 31, up from $1.26 a share a year earlier, and Sundstrand, $5.60 a share, up from $4.62 a share in 1977.

Mr. Nagelvoort says he considers real volume the most critical variable for the industry's outlook rather than the concern over balance sheets and foreign-currency fluctuations on which investors have focused recently.

BACHE HALSEY STUART SHIELDS INC.,
Washington, D.C., March 1978.

DEAR INVESTOR: On March 31st, you will probably be credited with the first quarter interest on your Savings and Loan or Credit Union passbook accounts at the annual rate of 5¼–6½ percent.

At this "interest" juncture, you might want to seriously consider obtaining a higher yield through quality tax-exempt bonds. In March, we have a municipal vehicle coming to market on which we anticipate an approximate 6½+ per cent return.[1] The savings and loan interest is fully taxable at your current income tax rate, while the municipals offer tax-free income which accrues on a daily basis.

If you'd like to receive additional facts and information regarding this subject, please contact me on my direct line 293–4456. It's certainly worth your time to "get the facts" and then determine what action, if any, you should take.

Very truly yours,

EDWARD T. BRITTON,
Registered Representative.

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[1] Please see table for equivalent taxable yields.

TAX-FREE VERSUS TAXABLE INCOME

[*Example:* A couple, filing a joint return with txable income between $36,000 and $40,000, would need to receive a 14.55 percent taxable return on their investment, to have the same spendable income that an 8 percent tax-free return would provide]

Single return[1]		$12 to $14	$14 to $16		$16 to $18	$18 to $20	$20 to $22		$22 to $26	$26 to $32	$32 to $38	$38 to $44	$44 to $50	$50 to $60	$70 to $80	Over $100
Joint return[1]	$16 to $20			$20 to $24		$24 to $28		$28 to $32		$36 to $40	$44 to $52	$64 to $76	$88 to $100	$100 to $120	$140 to $160	Over $200
	Percent tax bracket															
	28	29	31	32	34	36	38	39	40	45	50	55	60	62	66	70
Tax-exempt yields:																
6.00	8.33	8.45	8.70	8.82	9.09	9.37	9.68	9.84	10.00	10.91	12.00	13.33	15.00	15.79	17.65	20.03
6.10	8.47	8.59	8.84	8.97	9.24	9.53	9.84	10.00	10.17	11.09	12.20	13.56	15.25	16.05	17.94	20.37
6.20	8.61	8.73	8.99	9.12	9.39	9.69	10.00	10.16	10.33	11.27	12.40	13.78	15.50	16.32	18.24	20.60
6.25	8.68	8.80	9.06	9.19	9.47	9.77	10.08	10.25	10.42	11.36	12.50	13.89	15.63	16.45	18.38	20.83
6.30	8.75	8.87	9.13	9.26	9.55	9.84	10.16	10.33	10.50	11.45	12.60	14.00	15.75	16.58	18.53	21.00
6.40	8.89	9.01	9.28	9.41	9.70	10.00	10.32	10.49	10.67	11.64	12.80	14.22	16.00	16.84	18.82	21.33
6.50	9.03	9.15	9.42	9.56	9.85	10.16	10.48	10.66	10.83	11.82	13.00	14.44	16.25	17.11	19.12	21.67
6.60	9.17	9.30	9.57	9.71	10.00	10.31	10.65	10.82	11.00	12.00	13.20	14.67	16.50	17.37	19.41	22.00
6.70	9.31	9.44	9.71	9.85	10.15	10.47	10.81	10.98	11.17	12.18	13.40	14.89	16.75	17.63	19.71	22.33
6.75	9.37	9.51	9.78	9.93	10.23	10.55	10.89	11.07	11.25	12.27	13.50	15.00	16.87	17.76	19.85	22.50
6.80	9.44	9.58	9.86	10.00	10.30	10.62	10.97	11.15	11.33	12.36	13.60	15.11	17.00	17.89	20.00	22.67
6.90	9.58	9.72	10.00	10.15	10.45	10.78	11.13	11.31	11.50	12.56	13.80	15.33	17.25	18.16	20.29	23.00
7.00	9.72	9.86	10.14	10.29	10.61	10.94	11.29	11.48	11.67	12.73	14.00	15.56	17.50	18.42	20.59	23.33
7.10	9.86	10.00	10.29	10.44	10.76	11.09	11.45	11.64	11.83	12.91	14.20	15.78	17.75	18.68	20.88	23.67
7.20	10.00	10.14	10.43	10.59	10.91	11.25	11.61	11.80	12.00	13.09	14.40	16.00	18.00	18.95	21.18	24.00
7.25	10.07	10.21	10.51	10.66	10.98	11.33	11.69	11.89	12.08	13.18	14.50	16.11	18.13	19.08	21.32	24.17
7.30	10.14	10.28	10.58	10.74	11.06	11.41	11.77	11.97	12.17	13.27	14.60	16.22	18.25	19.21	21.47	24.33
7.40	10.28	10.42	10.72	10.88	11.21	11.56	11.94	12.13	12.33	13.45	14.80	16.44	18.50	19.47	21.76	24.67
7.50	10.42	10.56	10.87	11.03	11.36	11.72	12.10	12.30	12.50	13.64	15.00	16.67	18.75	19.74	22.06	25.00
7.75	10.76	10.92	11.23	11.40	11.74	12.11	12.50	12.70	12.92	14.09	15.50	17.22	19.37	20.39	22.79	25.83
8.00	11.11	11.27	11.59	11.76	12.12	12.50	12.90	12.11	13.33	14.55	16.00	17.78	20.00	21.05	23.53	26.67
8.10	11.25	11.41	11.74	11.91	12.27	12.66	13.06	13.28	13.50	14.73	16.20	18.00	20.25	21.32	23.82	27.00
8.20	11.39	11.55	11.88	12.06	12.42	12.81	13.23	13.44	13.67	14.91	16.40	18.22	20.50	21.58	24.12	27.33
8.25	11.46	11.62	11.96	12.13	12.50	12.89	13.31	13.52	13.75	15.00	16.50	18.33	20.63	21.71	24.26	27.50
8.30	11.53	11.69	12.03	12.21	12.58	12.97	13.39	13.61	13.83	15.09	16.60	18.44	20.75	21.84	24.41	27.67
8.40	11.67	11.83	12.17	12.35	12.73	13.13	13.55	13.77	14.00	15.27	16.80	18.67	21.00	22.11	24.71	28.00
8.50	11.81	11.97	12.32	12.50	12.88	13.28	13.71	13.93	14.17	15.45	17.00	18.89	21.25	22.37	25.00	28.33
8.75	12.15	12.32	12.68	12.87	13.26	13.67	14.11	14.34	14.58	15.91	17.50	19.44	21.87	23.03	25.74	29.17
9.00	12.50	12.68	13.04	13.24	13.64	14.06	14.52	14.75	15.00	16.36	18.00	20.00	22.50	23.68	26.47	30.00

[1] Taxable income in thousands.

FEBRUARY 23, 1978.

From: Merrill Lynch, Pierce Fenner & Smith Inc.

If you consistently lose a good portion of your annual income in Federal income taxes and you would like to find out how to obtain current income that's all yours, our FREE booklet "Investing In Municipal Bonds For Tax Free Income" is must reading for you.

Dealing with safety, liquidity and comparative investments, our booklet shows why so many individuals are now enjoying the same tax advantage that has been common to big institutions and estates for years.

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This concise booklet is both useful and informative. To get your copy, without obligation, just return the mailing label above. The possible benefits outlined should not be overlooked.

Sincerely,

PAUL P. MEHLER.

MANY MANAGERS OF POOLED FUNDS FOR INSURERS, BANKS "BEAT THE MARKET IN 1977," SURVEY SHOWS

(By Charles J. Elia)

Few professional managers at banks and insurance companies can boast about making money in the 1977 stock market decline, but many believe they had a good year, nonetheless.

The reason: by one of the few available measures, more of these investment managers "beat the market" in 1977 than have done so for some time. Among 161 pooled equity funds accounting for more than $14 billion in stock investments, 106 either ended the year with smaller losses than Standard & Poor's 500-stock index or, in the case of 18 funds, were up for the year.

This picture of investment results for the pooled funds, used by banks and insurers in managing part of their clients' pension-fund accounts, emerges from a preliminary survey by Rogers, Casey & Barksdale, Stamford, Conn., financial consultant to pension funds. It is a condensed version of a more detailed report being prepared by the firm for a quarterly service of Pensions & Investments, a Crain Communications publication.

In addition to pooled equity funds, the data cover 142 pooled fixed-income funds with assets of $6.4 billion. Among the latter, more than 90% outperformed the Salomon Brothers high-grade bond index last year.

"It was a year in which diversification, flexibility in raising cash reserves, and stock selection outside the S&P–500 and among the smaller companies within the index paid off for managers," says Edgar Barksdale of the consulting firm.

Some of the better gains in last year's fourth quarter and for the full year were recorded by pooled equity funds that moved 25%, 35% or even more of assets out of stocks and into cash or short-term investments.

"This kind of switch is substantial for pension accounts," says Mr. Barksdale, "but there has been an increasing willingness to raise cash reserves."

In assessing their own relative performance, money managers were going up against declines in the S&P–500, adjusted for dividends, of 7.2% for the full year and 0.1% in the fourth quarter.

The best 1977 equity fund result in the Rogers Casey sample was turned in by a $6 million fund managed by Guardian Insurance & Annuity Co., New York City, up 7.9%; the worst was by a $42 million fund of U.S. Trust Co. of New York, off 12.6%. The best fourth quarter reading was registered by a fund of the Fifth Third Bank, Cincinnati, Ohio, up 4.9%; the lowest reading was a New Jersey National Bank, Trenton, fund, off 5%.

Despite the relatively good marks for a majority of pooled funds last year, the managers' results for longer periods still remain well below average. Only one in five bank and insurance pooled equity funds has matched or exceeded the 2.8% annual total return of the S&P–500 over the nine years since year-end 1968. The split is about the same over the past three, five and seven years—about 80% of the funds lag behind the S&P returns.

The accompanying table, compiled from Rogers Casey data, shows investment results for selected bank and insurance equity funds for the fourth quarter and full year 1977, and annual average rates of return over the five- and nine-year spans.

	Percent change		Average retirement (percent)	
	4th quarter	1977	5 yr	9 yr
Banks:				
Bank of America	+1.4	−3.3	−4.6	(1)
Bank of New York	−1.0	−12.4	−1.7	+1.2
Bankers Trust	+2.0	−5.9	−7.6	−2.5
Chase Manhattan	+.2	−11.9	−4.7	−2.0
Chemical Bank of New York	+1.5	−4.3	−2.3	−.2
Citibank	−1.3	−11.1	−5.8	+.9
Continental Illinois	−1.0	−10.4	−6.7	−2.1
Crocker National	−.2	−8.9	−1.6	+2.9
First Pennsylvania	+.9	3.3	+3.2	+3.5
Harris Trust	−.1	−8.6	−2.7	+1.2
Irving Trust	+1.1	−7.3	−6.8	−1.4
Manufacturer's Hanover	+1.3	−7.9	−7.1	−.2
Marine Midland'	+.9	−1.9	(2)	+1.2
Mellon Bank	(2)	−9.7	−6.1	(1)
Morgan Guaranty	−1.1	−11.2	−4.4	+1.9
Provident National	+2.6	−.4	+.1	+3.0
U.S. Trust	−.8	−12.6	−9.8	−3.4
Insurers:				
Aetna	+.04	−5.9	−2.3	−1.5
Bankers Life	+4.0	+.5	+5.2	+4.7
Connecticut General	+.4	−6.6	−2.3	+.9
College Retirement Equities Fund	+.1	−6.4	−3.2	+1.0
Equitable	+.5	−10.3	−2.0	+2.8
Metropolitan Life	(2)	−8.4	−6.2	−.1
Mutual of New York	+.7	−7.5	−5.2	+.6
Prudential	−.3	−9.6	−1.7	+1.5
S. & P. 500	−.1	−7.2	−.2	+2.8

[1] Not available.
[2] Even.

In the fixed-income sector, all but a handful of the bank and insurer pooled funds did better last year than the 1.7% return registered by Salomon Brothers high-grade bond index. A $61 million fund managed by Pacific Mutual Life, Newport Beach, Calif., led the fixed-income pack with a 7.9% gain. Over the past nine years, about half the funds matched or exceeded the 6.4% average annual return of the index.

Fringe Benefits and Corporate Owners

Your "Tax Report" of Feb. 15, regarding the proposed limit on fringe benefits for people who own more than 10% of a corporation, points out our growing national commitment to equality of result.

You quote a Treasury official as saying, "Something should be done about owners who get 'free' medical and life coverage from their firms and give employees little or nothing."

Anyone who, like myself, spent the better part of the last 17 years involved in designing employe benefit programs for owners and employes of closely held corporations can tell you nothing is "free" for the owner. What Treasury and Labor Department rulings have started over the last 17 years, ERISA finished. It is simply not possible for an owner-employe of a closely held corporation to take any significant fringe benefit from his corporation without offering a proportionate benefit to his employes.

For example, an owner may establish a group life insurance program based upon a multiple of salary, but he cannot establish one which would include just himself and a few favored employes. Similarly, he can establish a retirement plan which is based upon earnings, but he must also include every employe who works at least 1,000 hours a year, has reached age 25 and has completed a minimum of one year of service.

I continue to be astonished that "small businessman" President Carter shows so little understanding of the psychology of the entrepreneur. A man becomes a business owner because he likes risk and challenge and because there is an opportunity for reward as a result. The entrepreneur is not in business because he wants to provide a job for his fellow man. He needs his fellow man to help him achieve his goals, and he certainly should treat his fellow man (employe) fairly and decently. However, if the owner's potential for reward is not commensurate with his risk and labor the entrepreneurial incentive is lost.

To be sure, there are those businessmen who attempt, sometimes successfully, to take undue advantage of their status. But to attempt to control the abusers by punishing the innocent hardly seems morally justified. And it certainly is bad politics, and worse economics.

The small businessman is still the backbone of the American economy. If we continue to discourage this man from investing his time and his money and his energy, the millions of employes who are currently working in these businesses will soon find themselves on the welfare rolls. President Carter and his Georgia playmates still need considerable toweling behind the ears.

DAVID F. WOODS.

INVESTOR RETURNS AND TAX POLICY

A STUDY BY MARILYN V. BROWN, C.F.A. FOR THE AD HOC TAX COMMITTEE OF THE FINANCIAL ANALYSTS FEDERATION

The Financial Analysts Federation, founded in 1947, is a non-profit professional organization devoted to the advancement of investment management. It is composed of 48 Financial Analysts Societies located in the major cities in the United States and Canada. These Societies have an aggregate of 14,500 members who are engaged in security analysis, portfolio management, and executive direction of the investment function. The affiliated Institute of Chartered Financial Analysts awards the professional designation of "Chartered Financial Analyst" to qualified members upon successful completion of three examinations.

Marilyn V. Brown, a chartered financial analyst, serves as a consultant to the Financial Analysts Federation. In addition, she is President of Marilyn V. Brown, Inc. which provides consulting services on changes affecting the investment process: government legislation and regulation, accounting principles and corporate disclosure.

FOREWORD

The 14,500 member Financial Analysts Federation (FAF) is the association of investment professionals in the United States and Canada. As managers of investment portfolios and advisors to both individual and institutional investors, the FAF's members play a vital role in the allocation of investment capital in our economy.

The key element in the investment decision making process is the determination of the rate of return expected from that investment. This return is realized in the form of income or capital gains, or a combination of the two and is measured on an annualized basis over the period the investment is to be held.

There has been widespread debate over the various tax proposals intended to stimulate capital formation and numerous econometric studies of the effects on the overall economy and tax revenues. Yet there had been no study of their effect on investors' returns to determine which, if any, of these proposals would encourage investors to make new equity investments—which from the investors' point of view would be most effective in stimulating capital investment.

The FAF, therefore, asked its consultant, Marilyn V. Brown, to conduct a study of how each of the various proposals might affect investor returns. Specifically, the study examines the following tax proposals:

a. reducing the corporate tax rate from 48% to 44%.

b. reducing the maximum capital gains tax rate from approximately 50% to 25%.

c. reducing double taxation of dividends under Congressman Ullman's 10% dividend integration proposal.

The techniques of securities analysis are used to project the possible effects on investors' returns from both dividends and capital gains, holding stock market price relationships constant. The various proposals, singly and in combination, are then compared for their impact on equity investments.

POLICY IMPLICATIONS OF THE STUDY'S CONCLUSIONS

RATES OF RETURN ANALYSIS

In measuring the effects of prospective tax changes on investor returns, the study provides startling insights into the effects of present tax policy on equity investment.

At present tax rates the average equity investment opportunity does not offer sufficient potential return to warrant undertaking the investment risk. As Treasury Secretary Blumenthal said recently, "It no longer pays enough to invest enough."

The study shows that at present tax rates prospective after tax returns for higher tax bracket investors are, on average, lower *on an absolute basis* than those offered by alternative investments such as municipal bonds. For lower tax bracket investors equity investments provide a higher absolute return than investment alternatives, but insufficient returns on a risk adjusted basis. These investors tend to invest largely for dividend return and to be averse to risk.

Reducing the maximum capital gains tax rate from approximately 50% to 25% would be the most effective inducement to equity investment among the tax proposals examined.

While after tax returns from the average investment would remain below those offered by investment alternatives, prospective returns from select equity opportunities, including those carrying higher risk, would likely be increased by a level sufficient to induce higher tax bracket investors to move meaningful amounts of their capital back into the equity markets.

Reducing the corporate tax rate to 44% would improve investor returns marginally.

For the higher tax bracket investor, returns on the average equity investment would remain lower than those from alternative investments. For investors in all tax brackets, dividend returns would remain below those offered by lower risk investments.

Reducing double taxation of dividends would raise investor returns slightly.

It would be of greatest benefit to lower tax bracket investors who tend to seek dividend returns. It would provide only modest incentive to higher tax bracket investors.

If the lower tax brackets reducing double taxation of dividends would increase after tax dividend returns more than would a cut in the corporate tax rate. At higher tax bracket levels, it would have approximately the same effect as reducing the corporate tax rate. For all tax brackets, reducing the corporate tax rate would have a greater effect on total after tax returns.

The tables contained in the study provide a simple means for comparing the effects of the specific proposals and possible combinations thereof.

"WINDFALL" PROFITS

The data on historical and prospective returns from equity investments speak to the question of possible "windfall" profits. Capital gains occur (and can be taxed) only when an investment is made and later sold at a profit. As Table XIV shows, the compound annual capital gain over the 50 year period, 1927–1977, was only 3.4% *pre tax*.

In terms of the future, analysis of prospective returns based on three sets of experience parameters hardly suggest these returns could be considered excessive. If, as a result of changes in tax policy, actual returns do prove to be substantially higher, it will be due to a significant rise in stock market prices caused by an increase in demand for equity capital investment, exactly the result the tax changes were intended to accomplish.

BENEFITS TO PUBLIC POLICY

A flow of capital back into equity investment would serve the public policy in many ways. A few are enumerated below:

1. A revitalized equity market would enable corporations to increase their use of equity capital vs. debt, thereby reducing their reliance on debt capital and their leveraged exposure to economic downturns. Correspondingly, the risk associated with equity capital investment would be reduced.
2. An improved environment for equity investment should generate a more receptive market for the smaller and technologically innovative companies which historically have provided the wellspring for new competition and technological progress.
3. Studies show these same companies are also an important source of new jobs.

CONCLUSION

Treasury Secretary Blumenthal gave a major address on capital formation before the annual conference of the Financial Analysts Federation in Miami on May 8, 1978. In that speech he said, "Investment is lagging for the simple reason that it has become less profitable. The rational investor, before he leaps, looks to expected real returns and to the probability of getting them. This vista of return and risk has been deteriorating."

We believe this study brings additional useful information to the debate on tax policy. We also believe it demonstrates that of the three major choices, a reduction in capital gains tax rate, possibly in combination with reduction in the corporate tax rate and partial elimination of double taxation of dividends, is essential to achieving an effective increase in equity capital formation.

THE FINANCIAL ANALYSTS FEDERATION.
ROBERT D. HEDBERG
MICHAEL F. CARR
FRANK T. PARRISH
DAVID L. UPSHAW
Ad Hoc Tax Committee.

INVESTOR RETURNS AND TAX POLICY

INTRODUCTION

The investment decision making process is a complex one, requiring assessment of a lengthy list of variables. Ultimately, however, the rational investment decision is made on the basis of the prospective return from that investment and the risks to be undertaken in achieving that return.

RETURN

For the investor in corporate equities, total return may be said to consist of three parts: dividend return, i.e., cash dividend distributions; appreciation return, i.e., an increase in the company's value based on some objective measure such as book value or earnings; and speculation return, a function of the change in the relationship of demand and supply for corporate equities.

RISK

Modern portfolio management theory attempts to determine risk by objective measurement. Rating agencies such as Standard and Poor's and Moody's have applied quality ratings to securities for many years. In general, short term Treasury bills are considered to be essentially risk free. Treasury bonds, municipal bonds and corporate bonds are considered to carry respectively rising degrees of risk. Equity investments, representing ownership participation in corporations are, in general, assigned the highest degree of risk.

COMPARISON WITH ALTERNATIVE INVESTMENT OPPORTUNITIES

In making his investment decision the investor will assess not only the returns and risk associated with one possible investment, but the risks and returns available from alternative investments as well. For the taxable investor, the return measured is that remaining after taxes.

The equity investment decision then is affected by: changes in tax rates, changes in the perceived level of risk and changes in the rates of return and associated risk of other investment opportunities.

In recent years, the rates of return from lower risk non-equity investments have risen almost steadily, while tax burdens on equity returns have been increased. Now there are under consideration several proposals, each of which is intended to reduce the tax burden on equity capital and enhance equity capital formation.

Numerous econometric studies have estimated the macroeconomic effects of these various tax proposals. This study attempts to assess the effects from the viewpoint of the individual investor: how changes in tax policy might affect the rate of return portion of the investment decision making process.

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SUMMARY AND CONCLUSIONS

Investor Returns and Tax Policy uses the techniques of securities analysis to isolate and assess the effects of various tax proposals on investment returns to the taxable equity investor. Specifically, it examines and analyses the effects of: reducing the corporate tax rate from 48% to 44%, reducing the maximum capital gains tax rate from approximately 50% to 25%, and reducing double taxation of dividends under Congressman Ullman's 10% dividend integration proposal. In constructing its analysis the study uses three different data sets: non-financial corporations as a whole, taken as a proxy for average investment returns; the Standard and Poor's Index of 400 of the nation's largest corporations; and a corporate model designed to facilitate specific examination of the corporate tax rate cut.

Financial statement ratios for 1977 were used as a base for projections. These ratios were then extended into the future and altered to incorporate the various tax proposals. Since the 1977 financial ratios used represent the upper end of recent business experience, it is believed that the return projections incorporate an optimistic bias. However, the projections hold constant all elements other than the tax proposals. Therefore, they should not be viewed as estimates of experience in a dynamic economy. Rather, they are intended to present orders of magnitude as aids in tax policy decisions. Logically, the three data sets produce different rate of return results, but all point to the same conclusions.

The study concludes that:

1. At present tax rates, prospective after tax appreciation and dividend returns are not competitive with alternative investment opportunities. For higher tax bracket investors, prospective returns from the average equity investment are lower on an absolute basis. For lower tax bracket investors, who are risk averse and invest largely for dividends, returns appear to be uncompetitive on a risk adjusted basis.

2. Reducing the corporate tax rate from 48% to 44% would marginally improve investor returns. Total returns on average would remain uncompetitive for the higher tax bracket investor.

3. Reducing the maximum capital gains tax rate from approximately 50% to 25% would have a significant effect on after tax investment returns.

While returns from the average investment would remain lower than alternatives for the higher tax bracket investor, prospective returns from above average investment opportunities should become sufficiently attractive to warrant a return of some of their capital into equity markets.

4. Reducing double taxation of dividends would be of greatest benefit to lower tax bracket investors. It would provide only modest incentive to higher tax bracket investors.

5. On average, reducing the corporate tax rate to 44% would have greater impact on investors' returns than reducing double taxation of dividends at the 10% integration level. However, at the lower tax brackets, dividend integration would increase after tax dividend returns more than a cut in the corporate tax rate. At higher tax brackets levels, dividend integration and reducing the corporate tax rate would affect after tax dividend returns about equally. For all tax brackets, reducing the corporate tax rate would increase total after tax returns more than dividend integration.

6. In a high interest rate environment a combination of tax cuts would be necessary to bring equity investment returns in the average corporation up to a level competitive with alternative investment opportunities such as government, municipal or corporate bonds.

SUMMARY TABLE

The summary table displays the basic findings of the study, illustrating the relative effects of the various tax proposals on investor after tax returns.

The table uses as a base for its projections two corporate models developed from Department of Commerce and Federal Reserve Board data for non-financial corporations in 1977. In Model A, 45% of after tax corporate earnings are paid out in dividends, the dividend payout ratio of non-financial corporations in 1977. In Model B, no dividends are paid and all earnings retained and reinvested.

A description of the methodology used in constructing return projections for all three data sets follows:

TABLE—RELATIVE EFFECT OF VARIOUS TAX PROPOSALS ON INVESTOR RATES OF RETURN

[In percent]

	Equity investment									Fixed income investment alternatives[1]		
	48 percent corporate tax rate			46 percent corporate tax rate			44 percent corporate tax rate					
	45 percent dividend payout			45 percent dividend payout			45 percent dividend payout					
	Without dividend interest	With 10 percent dividend interest	No dividend	Without dividend interest	With 10 percent dividend interest	No dividend	Without dividend interest	With 10 percent dividend interest	No dividend	3 mo Treasury bills	Bell System bonds	Municipal bonds
Pretax returns:												
Capital gains return[2]	6.2	6.2	11.3	6.4	6.4	11.7	6.7	6.7	12.2			
Dividend/interest return[3]	5.4	5.4		5.6	5.6		5.9	5.9	6.7	9.0	6.6	
Total return	11.6	11.6	11.3	12.0	12.0	11.7	12.6	12.6	12.2	6.7	9.0	6.6
After tax returns:												
50 percent capital gains/70 percent dividend tax:												
Capital gains return[2]	3.2	3.2	6.0	3.3	3.3	6.2	3.5	3.5	6.4			
Dividend/interest return[3]	1.6	1.8		1.7	1.9		1.8	2.0		2.0	2.7	6.6
Total return	4.8	5.0	6.0	5.0	5.2	6.2	5.3	5.5	6.4	2.0	2.7	6.6
35 percent capital gains/70 percent dividend tax:												
Capital gains return[2]	4.1	4.1	7.6	4.3	4.3	7.9	4.5	4.5	8.3			
Dividend/interest return[3]	1.6	1.8		1.7	1.9		1.8	2.0		2.0	2.7	6.6
Total return	5.7	5.9	7.6	6.0	6.2	7.9	6.3	6.5	8.3	2.0	2.7	6.6
25 percent capital gains/70 percent dividend tax:												
Capital gains return[2]	4.7	4.7	8.7	4.9	4.9	9.0	5.1	5.1	9.2			
Dividend/interest return[3]	1.6	1.8		1.7	1.9		1.8	2.0		2.0	2.7	6.6
Total return	6.3	6.5	8.7	6.6	6.8	9.0	6.9	7.1	9.2	2.0	2.7	6.6
25 percent capital gains/50 percent dividend tax:												
Capital gains return[2]	4.7	4.7	8.7	4.9	4.9	9.0	5.1	5.1	9.2			
Dividend/interest return[3]	2.7	3.0		2.8	3.1		2.9	3.2		3.4	4.5	6.6
Total return	7.4	7.7	8.7	7.7	8.0	9.0	8.0	8.3	9.2	3.4	4.5	6.6
12.5 percent captial gains/25 percent dividend tax:												
Capital gains return[2]	5.5	5.5	10.0	5.7	5.7	10.4	5.9	5.9	10.8			
Dividend/interest return[3]	4.1	4.5		4.2	4.6		4.4	4.8		5.1	6.7	6.6
Total return	9.6	10.0	10.0	9.9	10.3	10.4	10.3	10.7	10.8	5.1	6.7	6.6

[1] Salomon Brothers estimates for bellwether issues, June 21, 1978.
[2] Compound annual rate of return.
[3] Average annual rate of return.

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Description of Methodology

CRITERIA ESTABLISHED

Several different criteria were established in setting up the analytical procedures for this study.

1. Isolation of the critical variables, i.e., the effects of tax changes on investor returns, from exogeneous factors, such as changes in the economy and stock market prices.
2. Use of real world experience, to the extent possible.
3. Simplification of presentation, to the extent possible.

METHODOLOGY USED

Three different bases were used to project investor rate of return experience under the various tax proposals: data for non-financial corporations, the Standard and Poor's list of 400 of the nation's largest corporations and a corporate model. The results of these three sets of projections are shown in the section following.

For the non-financial corporations and the Standard and Poor's 400 list, 1977 financial statement data were used as a starting point. The corporate model was constructed on the basis of non-financial corporation data and adjusted in order to examine the effects of cutting the corporate tax rate from 48% to 46% or 44%.

For non-financial corporations and the Standard and Poor's 400 list, the projection process started with 1977 pre tax profits as a percentage of equity capital (book value). This pre tax return on equity ratio was then held constant throughout the projection period. It was assumed that the percentage of earnings paid out as dividends remained constant and that retained earnings were reinvested to maintain the base period pre tax return on equity. One set of projections was made at present effective corporate tax rates, another incorporating Treasury Department data on the corporate tax rate cut proposal.

The corporate model began with the non-financial corporations' after tax return on equity capital and assumed that this return was earned after a 48% tax rate. The new, higher pre tax return on equity was then held constant and the corporate tax rate reduced to 46% and 44%.

Although equity investments are generally made with the anticipation that these investments will be held for a considerable period of time, for ease of presentation a three-year time frame was selected. (Annual rates of return would not be measurably affected by a longer holdingperiod.) It was assumed that investment was made at the beginning of year one and sold at the end of year three.

Capital gains were totaled, taxed and then calculated on a compound annual return basis. Dividends were added, taxed and the average return calculated.

Rates of return for non-financial corporations and the S & P 400 list were measured using two standards for purchase and sale price: book value and market value. In projecting market value it was assumed that market value at the end of year three bore the same relationship to book value at the end of the period as beginning market value held to beginning book.

Separate calculations were made incorporating the effects of Congressman Ullman's 10% dividend integration proposal. In making the dividend integration calculations it was assumed that all corporations in the data set would have a tax base large enough to support the full 10% gross up and credit. To thet extent the effects of dividend integration are overstated. However, since a 10% integration level is used throughout, and under the proposal the level would be increased to 12% after two years, the effects may be slightly understated.

All of the projected returns were compared with those currently anticipated from three investment alternatives: three month Treasury bills, Bell System bonds, and municipal bonds.

VARIABLES OMITTED FROM THE METHODOLOGY

An investor in making his investment decisions will incorporate into this investment decisionmaking process his predictions and assumptions on a very lengthy list of variables. Isolating the specific effects of changes in tax rates and illustrating those effects in a simple to understand format requires eliminating some of those variables. Three very important variables which have been eliminated from the analysis are: the outlook for the economy, the effects of inflation on corporate financial statements, and changes in demand and supply for securities, i.e., stock price fluctuations. Since all are interrelated in terms of their real world impact on investor returns, these variables are discussed briefly.

In selecting results in 1977 as a basis for projections, and analysis uses a year when after tax return on book value was at a record level for the data period 1965–77. Thus, projections of future return on equity, made on the basis of recent period record levels, likely introduce an optimistic bias into the appreciation return assumptions, particularly at this point in an aging economic cycle.

Secondly, using book value to establish purchase and sale price ignore the effects of inflation on corporate financial statements and on the replacement costs of assets recorded and depreciated on the basis of historic costs. Recent analyses suggest that market value, set by demand and supply for equity investment, does incorporate an adjustment for inflation. At the end of 1977, market value for non-financial corporations was below book value. For the S & P 400 list, market was some 20% higher than book value.

As stated earlier, stock market fluctuations, i.e., speculation returns, have been omitted from the analysis. However, as Tables XIII and XIV show, recent experience has been largely negative. Those wishing to incorporate assumptions on stock market prices may do so by adjusting end of year three market values and calculating compound annual rates of appreciation return on their own bases.

ASSUMPTIONS

It was also necessary to make certain assumptions. Significant among these were the matter of additional outside capital and a constant 45% dividend payout ratio. The use of debt in the corporate capital structure rose steadily until 1974 when the recession vividly demonstrated the hazards of high financial leverage. Since then, debt/equity ratios have declined slightly. Consequently, projecting a stable debt/equity ratio into the future seemed reasonable and in line with the real world environment. Using book value as a basis of purchase and sale eliminated possible complications of additional equity financing. Neither appreciation nor dividend returns would be affected. The market value calculations assume no additional equity financing.

Non-financial corporations were selected because they were felt to present a more typical investor experience than would including financial corporations. The S & P 400 list likewise excludes financial corporations as well as transportation and utility companies.

Because investment is a prospective process, precise projections of investment returns are never possible. True results are known only in retrospect. This analysis was not designed to achieve that impossible precision but rather to provide some useful first order of magnitude parameters as guidance for tax policy decisions.

PROJECTIONS AND ANALYSES

(Nonfinancial corporations data base)

TABLE I

Description and analysis

Table I uses 1977 data for non-financial corporations as a whole to project investor returns under present effective corporate tax rates.

In Table I-a it is assumed purchase was made at book value at the beginning of year one, equal to actual book value at the end of 1977. Profits were projected by assuming that each year retained earnings were reinvested to produce a pre tax and after tax return on equity equal to that earned in 1977, i.e., 18.9% and 11.3%, respectively. Thus, the $806.2 billion in capital produced pre tax profits of $152.4 in the first year following purchase and after tax profits of $91.1. It was assumed that, as in 1977, 45% of after tax profits were paid out in dividends. Retained earnings were added to equity and assumed reinvested to produce an 18.9% pre tax return and an 11.3% after tax return. This same procedure was then continued to the end of year three, at which time the investor sold his investment at the projected book valued of $966.0.

The difference between end of year three equity and beginning year one equity of $159.8 billion was then taxed at various capital gains tax rates from 50% to 12.5%, and the compound annual after tax capital gains or appreciation return calculated. At a 50% capital gains tax rate the compound annual appreciation return was 3.2%, at a 12.5% capital gains tax rate, 5.5%.

Dividends for years one, two and three were added and then taxed at rates ranging from 70% to 25%. After tax dividends were annualized and an average annual dividend return calculated. At a 70% dividend tax rate, annual average dividend return was 1.6%, at a 25% tax rate 4.1%.

In Table I-b, purchase at market value, end of 1977, equal to beginning of year one, was assumed. In order to project market value at end of year three, a constant relationship between market value and book value end of 1977/beginning of year one and market value end of year three was assumed. Using this constant relationship appreciation returns remain unchanged from Table I-a. Since market value at the end of 1977 was below book value, dividend returns are increased—at the 70% tax rate level from 1.6% to 2.0%, at 25% tax rate from 4.1% to 4.9%.

TABLE I-A.—NONFINANCIAL CORPORATIONS: 1977 EFFECTIVE TAX RATES PURCHASE AND SALE AT BOOK VALUE

Financial data	1977 (billions)	Projection		
		Year 1	Year 2	Year 3
Pretax profits	$141.8	152.4	161.8	171.9
Taxes	57.0	61 3	65 0	69 1
After tax profits	84.9	91.1	96.8	102.8
Dividends	38.2	41.0	43.6	46.3
Retained earnings	46.7	50.1	53.2	56.5
Beginning year equity	750.5	806.2	856.3	909.5
Return of equity pretax (percent)	(18.9)	(18.9)	(18.9)	(18.9)
Return on equity after tax	(11.3)	(11.3)	(11.3)	(11.3)
End of year equity	806.2	856.3	909.5	966.0
Taxes as percent of pretax profits	(40.2)	(40.2)	(40.2)	(40.2)
Dividends as percent of after tax profits	(45.0)	(45.0)	(45.0)	(45.0)

Capital gains (appreciation) returns	Capital gains tax rates (percent)			
	50	35	25	12.5
Increase in equity beginning year 1 to end year 3	159.8	159.8	159.8	159.8
Increase in equity after tax	79.9	103.9	119.8	139.8
Year end 3 equity after tax	886.1	910.1	926.0	946.0
Divided by beginning year 1 equity	806.2	806.2	806.2	806.2
Equals total appreciation return after tax	1.0091	1.1289	1.1486	1.1734
Compound annual after tax appreciation return (percent)	3.2	4.1	4.7	5.5

Dividend returns	Dividend tax rates (percent)		
	70	50	25
Total dividends	130.9	130.9	130.9
Dividends after taxes	39.3	65.5	98.1
Divided by 3 equals average annual dividend after tax (percent)	(13.1)	(21.8)	(32.7)
Divided by beginning year 1 equity	806.2	806.2	806.2
Equals average annual dividend return (percent)	1.6	2.7	4.1

Sources: 1977 data, Department of Commerce, Federal Reserve Board Flow of Funds Account. Data for years 1 to 3 constructed projecting 1977 financial ratios.

TABLE I-B.—NONFINANCIAL CORPORATIONS: 1977 EFFECTIVE TAX RATES PURCHASE AND SALE AT MARKET VALUE

Capital gains (appreciation) returns	Capital gains tax rates (percent)			
	50	35	25	12.5
Year end 3 market value (estimated at 82.9 pct. of year end 3 book value)	800.8	800.8	800.8	800.8
Minus beginning year 1 market value	668.3	668.3	668.3	668.3
Equals increase in market value beginning year 1 to end year 3	132.5	132.5	132.5	132.5
Increase in market value after tax	66.2	86.1	99.4	115.9
Year end 3 market value after tax	734.5	754.4	767.7	784.2
Divided by beginning year 1 market value	668.3	668.3	668.3	668.3
Equals total appreciation return after tax	1.0991	1.1288	1.1487	1.1734
Compound annual appreciation return after tax (percent)	(3.2)	(4.1)	(4.7)	(5.5)

Dividend returns	Dividend tax rates (percent)		
	70	50	25
Total dividends	130.9	130.9	130.9
Dividends after tax	39.3	65.5	988.1
Divided by 3 equals average annual dividends after tax	13.1	21.8	32.7
Divided by beginning year 1 market value	668.3	668.3	668.3
Equals average annual dividend returns (percent)	(2.0)	(3.3)	(4.9)

TABLE II

Description and analysis

Table II incorporates in the projections the Administration's proposed reduction in the corporate tax rate. This was done by allocating to non-financial corporations 80% of the estimated reduction in federal tax revenues resulting from reducing the tax rate for all corporations. Treasury Department estimates for 1978, 1979 and 1980 were assigned respectively to years one, two and three. Projection procedures were similar to those in Table I, with the obvious exception, that as the effective tax rate declines, after tax return on equity increases. At the end of year three the equity value at $973.2 is $7.2 higher than in Table I. Pre tax appreciation is similarly higher. On the basis of an assumed constant 45% dividend payout ratio, total dividend payments are also higher by $5.7.

As a result, after tax returns from both appreciation and dividends are modestly higher. At the top tax rate of 50% tax on capital gains and 70% on dividends, the compound annual appreciation return would be increased to 3.3% from 3.2%.

In Table II-a, with purchase and sale at book value, dividend returns to the top tax bracket investor rise from 1.6% to 1.7% as a result of the cut in the corporate tax rate. In Table II-b, with purchase and sale at market value, dividend returns to the top tax bracket investor remain unchanged at 2.0% after the corporate tax rate cut. For the 25% tax bracket investor dividend returns are increased to 5.1% from 4.9%.

TABLE II-A.—NONFINANCIAL CORPORATIONS: INCORPORATING ADMINISTRATION'S PROPOSED REDUCTION IN CORPORATE TAX RATE PURCHASE AND SALE AT BOOK VALUE

Financial data	1977 (billions)	Projection Year 1	Year 2	Year 3
Pretax profits	$141.8	152.4	162.0	172.5
Taxes	57.0	60.3	60.4	62.6
After tax profits	84.9	92.1	101.6	109.9
Dividend	38.2	41.4	45.7	49.5
Retained earnings	46.7	50.7	55.9	60.4
Beginning year equity	750.5	806.2	856.9	912.8
Return on equity pretax (percent)	(18.9)	(18.9)	(18.9)	(18.9)
Return on equity after tax	(11.3)	(11.4)	(11.9)	(12.0)
End of year equity	806.2	856.9	912.8	973.2
Taxes as percent of pretax profits	(40.2)	(39.6)	(37.3)	(36.3)
Dividends as percent of after tax profits	(45.0)	(45.0)	(45.0)	(45.0)

Capital gains (appreciation) returns	Capital gains tax rates (percent) 50	35	25	12.5
Increase in equity beginning year 1 to end year 3	167.0	167.0	167.0	167.0
Increase in equity after tax	83.5	108.5	125.2	146.1
Year end 3 equity after tax	889.7	914.7	931.4	912.3
Divided by beginning year 1 equity	806.2	806.2	806.2	806.2
Equals total appreciation return after tax	1.1036	1.1346	1.1553	1.1812
Compound annual after tax appreciation return (percent)	(3.3)	(4.3)	(4.9)	(5.7)

Dividend returns	Dividend tax rates (percent) 70	50	25
Total dividends	136.6	136.6	136.6
Dividends after tax	41.0	68.3	102.4
Divided by 3 equals average annual dividend after tax	13.7	22.8	34.1
Divided by beginning year 1 equity	806.2	806.2	806.2
Equals average annual dividend return (percent)	(1.7)	(2.8)	(4.2)

Sources: 1977 data, Department of Commerce, Federal Reserve Board Flow of Funds Accounts, Department of Treasury, "The President's 1978 Tax Program." Data for years 1-3 constructed projecting 1977 financial ratios.

TABLE II-B.—NONFINANCIAL CORPORATIONS: INCORPORATING ADMINISTRATION'S PROPOSED REDUCTION IN PURCHASE AND SALE AT MARKET VALUE

Capital gains (appreciation) returns	Capital gains tax rates (percent)			
	50	35	25	12.5
Year end 3 market value (estimated at 82.9 percent year end book value)	806.8	806.8	806.8	806.8
Minus beginning year 1 market value	668.3	668.3	668.3	668.3
Equals increase in market value beginning year 1 to end year 3	138.5	138.5	138.5	138.5
Increase in market value after tax	69.2	90.0	103.9	121.2
Year end 3 market value after tax	737.5	758.3	772.2	789.5
Divided by beginning year 1 market value	668.3	668.3	668.3	668.3
Equals total appreciation return after tax	1.1035	1.1347	1.1555	1.1814
Compound annual appreciation return after tax (percent)	(3.3)	4(.3)	(4.9)	(5.7)

Dividend returns	Dividend tax rates (percent)		
	70	50	25
Total dividends	136.6	136.6	136.6
Dividends after tax	41.0	68.3	102.4
Divided by 3 equal average annual dividends after tax	13.7	22.8	34.1
Divided by beginning year 1 market value	668.3	668.3	668.3
Equals average annual dividend return (percent)	(2.0)	(3.4)	(5.1)

TABLE III

Description and analysis

Table III compares the projected return from investment in non-financial corporations using the 1977 effective tax rate of 40.2% and the Administrations's proposed cut in the corporate tax rate. The table also illustrates the effects of incorporating Congressman Ullman's dividend integration proposal at the 10% level. In incorporating the effects of dividend integration, we have assumed that all dividend paying corporations would have a sufficiently large tax base to provide a 10% gross-up and credit. Table III-a uses purchase and sale at book value, Table III-b at market.

The table also contains projected annual rates of return from possible investment alternatives, i.e., three-month Treasury bills, Bell Telephone bonds, and municipal bonds using Salomon Bros. estimates of bellwether issues.

Using the non-financial corporation data base one can compare after tax returns at various levels of taxation to assess the relative effects on investor returns resulting from: the Administration's corporate tax cut proposal, reducing the capital gains tax, lowering the marginal tax rate on dividends, and Congressman Ullman's proposal for reducing double taxation of dividends. These returns can then be compared with those currently projected for alternative investments.

TABLE III-A.—NONFINANCIAL CORPORATIONS: PROJECTED RETURN COMPARISONS PURCHASE AND SALE AT BOOK VALUE

[In percent]

	Without dividend integration		With 10-percent dividend integration		Fixed income investment alternatives		
	1977 effective tax rates	Incorporating administration's corporate tax cut	1977 effective tax rates	Incorporating administration's corporate tax cut	3 mo Treasury bills [1]	Bell System bonds [1]	Municipal bonds [1]
Pretax returns:							
Capital gains return [2]	6.2	6.5	6.2	6.5			
Dividend/interest return [3]	5.4	5.6	5.4	5.6	6.7	9.0	6.6
Total return	11.6	12.1	11.6	12.1	6.7	9.0	6.6
Aftertax returns:							
50-pct capital gains/70-pct dividend tax:							
Capital gains return [2]	3.2	3.3	3.2	3.3			
Dividend/interest return [3]	1.6	1.7	1.8	1.9	2.0	2.7	6.6
Total return	4.8	5.0	5.0	5.2	2.0	2.7	6.6
35-pct capital gains/70-pct dividend tax:							
Capital gains return [2]	4.1	4.3	4.1	4.3			
Dividend/interest return [3]	1.6	1.7	1.8	1.9	2.0	2.7	6.6
Total return	5.7	6.0	5.9	6.2	2.0	2.7	6.6
25-pct capital gains/70-pct dividend tax:							
Capital gains return [2]	4.7	4.9	4.7	4.9			
Dividend/interest return [3]	1.6	1.7	1.8	1.9	2.0	2.7	6.6
Total return	6.3	6.6	6.5	6.8	2.0	2.7	6.6
25-pct capital gains/50-pct dividend tax:							
Capital gains return [2]	4.7	4.9	4.7	4.9			
Dividend/interest return [3]	2.7	2.8	3.0	3.1	3.4	4.5	6.6
Total return	7.4	7.7	7.7	8.0	3.4	4.5	6.6
12.5-pct capital gains/25-pct dividend tax:							
Capital gains return [2]	5.5	5.7	5.5	5.7			
Dividend/interest return [3]	4.1	4.2	4.5	4.6	5.1	6.7	6.6
Total return	9.6	9.9	10.0	10.3	5.1	6.7	6.6

[1] Salomon Bros. estimates for Bellwether issues, June 21, 1978.
[2] Compound annual rate of return.
[3] Average annual rate of return.

TABLE III-8.—NONFINANCIAL CORPORATIONS: PROJECTED RETURN COMPARISONS PURCHASE AND SALE AT MARKET VALUE

[In percent]

	Without dividend integration		With 10-percent dividend integration		Fixed income investment alternatives		
	1977 effective tax rates	Incorporating administration's corporate tax cut	1977 effective tax rates	Incorporating administration's corporate tax cut	3 mo Treasury bills [1]	Bell System bonds [1]	Municipal bonds [1]
Pretax returns:							
Capital gains return [2]	6.2	6.5	6.2	6.5			
Dividend/interest return [3]	5.4	5.6	5.4	5.6	6.7	9.0	6.6
Total return	11.6	12.1	11.6	12.1	6.7	9.0	6.6
After tax returns:							
50-percent capital gains/70-percent dividend tax:							
Capital gains return [2]	3.2	3.3	3.2	3.3			
Dividend/interest return [3]	2.0	2.0	2.2	2.2	2.0	2.7	6.6
Total return	5.2	5.3	5.4	5.5	2.0	2.7	6.6
35-percent capital gains/70-percent dividend tax:							
Capital gains return [2]	4.1	4.3	4.1	4.3			
Dividend/interest return [3]	2.0	2.0	2.2	2.2	2.0	2.7	6.6
Total return	6.1	6.3	6.3	6.5	2.0	2.7	6.6
25-percent capital gains/70-percent dividend tax:							
Capital gains return [2]	4.7	4.9	4.7	4.9			
Dividend/interest return [3]	2.0	2.0	2.2	2.2	2.0	2.7	6.6
Total return	6.7	6.9	6.9	7.1	2.0	2.7	6.6
25-percent capital gains/50-percent dividend tax:							
Capital gains return [2]	4.7	4.9	4.7	4.9			
Dividend/interest return [3]	3.3	3.4	3.6	3.7	3.4	4.5	6.6
Total return	8.0	8.3	8.3	8.6	3.4	4.5	6.6
12.5-percent capital gains/25-percent dividend tax:							
Capital gains return [2]	5.5	5.7	5.5	5.7			
Dividend/interest return [3]	4.9	5.1	5.4	5.6	5.1	6.7	6.6
Total return	10.4	10.8	10.9	11.3	5.1	6.7	6.6

[1] Salomon Bros. estimates for bellwether issues, June 21, 1978.
[2] Compound annual rate of return.
[3] Average annual rate of return.

TABLE IV

(Corporate models data base)

Description and analysis

In Table IV two corporate models are constructed to enable isolation and examination of the effects of reducing the corporate tax rate from 48% to 46% or 44%. Table IV projects a 48% corporate rate.

The corporate models use as a starting point the 11.3% after tax return on equity of nonfinancial corporations in 1977. However, for non-financial corporations that return was after a 40.2% effective tax rate. In order to isolate and examine the effects of reducing the corporate tax rate from 48% to 44% in the corporate models, it was assumed that return was achieved after a 48% tax rate. Thus, the assumed pre tax return on equity was increased to 21.7%. (Increasing the pre tax rate of return avoided a possible downward bias in the return projections.)

In Model A it was assumed that 45% of after tax profits were paid out as dividends, as was the case for non-financial corporations in 1977. Retained earnings were assumed to be reinvested to sustain a 21.7% pre tax return on equity. As in the previous tables it was assumed that purchase was made at the beginning of year one and sale at the end of year three. The corporate model uses book value as the purchase and sale price. (The beginning of year one book value was derived from the year one after tax profits base of 100, i.e., 100=11.3% of 885.0).

The capital gain was then taxed at varying rates and the compound annual appreciation rate determined. Dividends were treated as in Tables I and II—added over the three year period, taxed at the various tax rates and the average annual rate of dividend return on beginning of year one equity calculated.

Model B was constructed to simulate a real world situation. Here, as in some corporations, it was assumed that no dividends were paid. Therefore, all after tax profits were reinvested to produce a 21.7% pre tax return on equity value. With all net earnings reinvested, book value increases more rapidly, and, accordingly, the compound annual after tax appreciation return for the period of ownership is higher. Of course, there is no dividend return.

TABLE IV.—CORPORATE MODEL: 48 PERCENT CORPORATE TAX RATE INDEXED TO AFTER TAX PROFITS YEAR 1

Financial data	Model A: 45 percent dividend payout (projection)			Model B: No dividend (projection)		
	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3
Pretax profits	$192.3	$204.0	$216.7	$192.3	$213.7	$237.9
Taxes	92.3	97.9	104.0	92.3	102.4	114.0
After-tax profits	100.0	106.2	112.7	100.0	111.3	123.9
Dividend	45.0	47.8	50.7			
Retained earnings	55.0	58.4	62.0	100.0	111.3	123.9
Beginning year equity	885.0	940.0	998.4	885.0	985.0	1,096.3
Return on equity pretax (percent)	(21.7)	(21.7)	(21.7)	(21.7)	(21.7)	(21.7)
Return on equity after tax (percent)	(11.3)	(11.3)	(11.3)	(11.3)	(11.3)	(11.3)
End of year equity	940.0	998.4	1,060.4	985.0	1,096.3	1,220.2

Capital gains (appreciation) returns	Capital gains tax rates (percent)				Capital gains tax rates (percent)			
	50	35	25	12.5	50	35	25	12.5
Increase in equity beginning Year 1 to end year 3	$175.4	$175.4	$175.4	$175.4	$335.2	$335.2	$335.2	$335.2
Increase in equity after tax	87.7	114.0	131.5	143.5	167.6	217.9	251.4	293.3
Year end 3 equity after tax	972.7	999.0	1,016.5	1,038.5	1,052.6	1,102.9	1,136.4	1,178.3
Divided by beginning year 1 equity	885.0	885.0	885.0	885.0	885.0	885.0	885.0	885.0
Equals total appreciation return after tax	1.09910	1.12882	1.14859	1.17345	1.18937	1.24621	1.28407	1.33141
Compound annual after-tax appreciation return (percent)	(3.2)	(4.1)	(4.7)	(5.5)	(6.0)	(7.6)	(8.7)	(10.0)

Dividend returns	Dividend tax rates (percent)		
	70	50	25
Total dividends	$143.5	$143.5	$143.5
Dividends after tax	43.1	71.8	107.6
Divided by 3 equals average annual dividend after tax	14.4	23.9	35.9
Divided by beginning year 1 equity	885.0	885.0	885.0
Equals average annual dividend return (percent)	(1.6)	(2.7)	(4.1)

TABLE V

Description and analysis

Table V illustrates the effects on investor returns of reducing the corporate tax rate from 48% to 46%, while holding pre tax return on equity constant at 21.7% and, in Model A, maintaining the dividend payout ratio at 45%. As is shown, reducing the corporate tax rate from 48% to 46% increases after tax profits in year one from the base 100 to 103.8 or by 3.8%. The after tax return in equity is rasised from 11.3% to 11.7%.

At the 50% tax rate for capital gains the compound annual appreciation return is increased to 3.3% from 3.2%. At the 70% marginal tax rate on dividends, average dividend return rises from 1.6% to 1.7%.

Model B illustrates the effects if no dividends are paid. Here the compound annual appreciation return after a 50% tax rate would rise from 6.0% to 6.2%.

TABLE V.—CORPORATE MODEL: 46 PERCENT CORPORATE TAX RATE INDEXED TO AFTER-TAX PROFITS YEAR 1 AT 48 PERCENT CORPORATE TAX RATE

Financial data	Model A: 45 percent dividend payout (projection)			Model B: No dividend (projection)		
	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3
Pretax profits	$192.3	$204.4	$217.6	$192.3	$214.6	$239.7
Taxes	88.5	94.0	100.1	88.5	98.9	110.5
After-tax profits	103.8	110.4	117.5	103.8	115.7	129.2
Dividend	46.7	49.7	52.9			
Retained earnings	57.1	60.7	64.6	103.8	115.7	129.2
Beginning year equity	885.0	942.1	1,002.8	885.0	988.8	1,104.5
Return on equity pretax (percent)	(21.7)	(21.7)	(21.7)	(21.7)	(21.7)	(21.7)
Return on equity after tax (percent)	(11.7)	(11.7)	(11.7)	(11.7)	(11.7)	(11.7)
End of year equity	942.1	1,002.8	1,067.4	988.8	1,104.5	1,233.7

Capital gains (appreciation) returns	Capital gains tax rates (percent)				Capital gains tax rates (percent)			
	50	35	25	12.5	50	35	25	12.5
Increase in equity beginning year 1 to end year 3	$182.4	$182.4	$182.4	$182.4	$348.7	$348.7	$348.7	$348.7
Increase in equity after tax	91.2	118.6	136.8	159.6	174.4	226.7	261.5	305.1
Year end 3 equity after tax	976.2	1,003.6	1,021.8	1,044.6	1,059.4	1,111.7	1,146.5	1,190.1
Divided by beginning year 1 equity	885.0	885.0	885.0	885.0	885.0	885.0	885.0	885.0
Equals total appreciation return after tax	1.10305	1.13401	1.15457	1.18034	1.19706	1.25616	1.29548	1.34475
Compound annual after-tax appreciation return (percent)	(3.3)	(4.3)	(4.9)	(5.7)	(6.2)	(7.9)	(9.0)	(10.4)

Dividend returns	Dividend tax rates (percent)		
	70	50	25
Total dividends	$149.3	$149.3	$149.3
Dividends after tax	44.8	74.7	112.0
Divided by 3 equals average annual dividend after tax	14.9	24.9	37.3
Divided by beginning year 1 equity	885.0	885.0	885.0
Equals average annual dividend return (percent)	(1.7)	(2.8)	(4.2)

TABLE VI

Description and analysis

Table VI illustrates the results of reducing the corporate tax rate to 44% while holding the pre tax return on equity constant at 21.7%.

After tax profits in year one become 107.7, a 7.7% increase over the after tax profit of 100 with a corporate tax rate of 48%. Accordingly, return on equity capital rises to 12.2% in contrast to the 11.3% return at a 48% corporate tax rate. In Model A the compound annual appreciation return after a 50% capital gains tax rate is 3.5%. Average annual dividend return after a 70% marginal tax rate is 1.8%.

In Model B, where all earnings are reinvested, the compound annual appreciation return would be 6.4% after a 50% capital gains tax vs. 6.0% at a 48% corporate tax rate.

TABLE VI.—CORPORATE MODEL: 44 PERCENT CORPORATE TAX RATE INDEXED TO AFTER TAX PROFITS YEAR 1 AT 48 PERCENT CORPORATE TAX RATE

Financial data	Model A: 45 percent dividend payout (projection)			Model B: No dividend (projection)		
	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3
Pretax profits	$192.3	$204.9	$218.6	$192.3	$215.4	$241.7
Taxes	84.6	89.7	95.7	84.6	94.3	105.8
After-tax profits	107.7	115.2	122.9	197.7	121.1	135.9
Dividend	48.5	51.8	55.3			
Retained earnings	59.2	63.4	67.6	107.7	121.1	135.9
Beginning year equity	885.0	944.2	1007.6	885.0	992.7	1113.8
Return on equity pretax (percent)	(21.7)	(21.7)	(21.7)	(21.7)	(21.7)	(21.7)
Return on equity after tax (percent)	(12.2)	(12.2)	(12.2)	(12.2)	(12.2)	(12.2)
End of year equity	944.2	1007.6	1075.2	992.7	1113.8	1249.7

Capital gains (appreciation) returns	Capital gains tax rate (percent)				Capital gains tax rates (percent)			
	50	35	25	12.5	50	35	25	12.5
Increase in equity beginning year 1 to end year 3	$190.2	$190.2	$190.2	$190.2	$364.7	$364.7	$364.7	$364.7
Increase in equity after tax	95.1	123.6	142.6	166.4	182.4	237.1	273.5	319.1
Year end 3 equity after tax	980.1	1008.6	1027.6	1051.4	1067.4	1122.1	1158.5	1204.1
Divided by beginning year 1 equity	885.0	885.0	885.0	885.0	885.0	885.0	885.0	885.0
Equals total appreciation return after tax	1.10745	1.13966	1.16113	1.18802	1.20610	1.26791	1.30904	1.36056
Compound annual after-tax appreciation return (percent)	(3.5)	(4.5)	(5.1)	(5.9)	(6.4)	(8.3)	(9.2)	(10.8)

Dividend returns	Dividend tax rates (percent)		
	70	50	25
Total dividends	$155.6	$155.6	$155.6
Dividends after tax	46.7	77.8	116.7
Divided by 3 equals average annual dividend after tax	15.6	25.9	38.9
Divided by beginning year 1 equity	885.0	885.0	885.0
Equals average annual dividend return (percent)	(1.8)	(2.9)	(4.4)

TABLES VII AND VIII

Description and analysis

Tables VII and VIII compare the returns for the corporate models at varying corporate tax rates and individual tax rates for capital gains and dividends. Table VII illustrates the effects without Congressman Ullman's 10% dividend integration proposal. Table VIII includes the approximate effects of 10% dividend integration.

Tables VII and VIII also list estimated returns for three selected investment alternatives—three-month Treasury bills, Bell System corporate bonds, and municipal bonds.

The tables provide an easy system for comparing the effects of various tax proposals on investor returns. By moving down and across the columns it is possible to determine the theoretical effects of a reduction in the corporate tax rate compared to a reduction in the capital gains or dividend tax rates.

As the tables show, at a 48% corporate tax rate total annual returns from our corporate Model A would be 4.8% to the top tax bracket investor. Reducing the corporate tax rate to 44% would increase the total annual return to 5.3%. Reducing the capital gains tax rate maximum to 25% would increase total return for this investor to 6.3%. Dividend integration would increase returns modestly.

For investors paying a 25% dividend tax rate and a 12.5% capital gains tax rate, reducing the corporate tax rate from 48% to 44% would increase his total return in Model A from 9.6% to 10.3%, in Model B from 10.0% to 10.8%. At the 48% corporate tax rate level, dividend integration would raise returns on Model A from 9.6% to 10.0%, and at the 44% corporate tax rate level from 10.3% to to 10.7%.

TABLE VII.—CORPORATE MODELS: PROJECTED RETURN COMPARISONS

[In percent]

	Equity investment						Fixed income investments [1]		
	48 percent corporate tax		46 percent corporate tax		44 percent corporate tax		3 mo Treasury bills	Bell System bonds	Municipal bonds
	45 percent dividend	No dividend	45 percent dividend	No dividend	45 percent dividend	No dividend			
Pretax:									
Capital gains return [2]	6.2	11.3	6.4	11.7	6.7	12.2			
Dividend/interest return [3]	5.4		5.6		5.9		6.7	9.0	6.6
Total return	11.6	11.3	12.0	11.7	12.6	12.2	6.7	9.0	6.6
Aftertax:									
50 percent capital gains/70 percent dividend tax:									
Capital gains return [2]	3.2	6.0	3.3	6.2	3.5	6.4			
Dividend/interest return [3]	1.6		1.7		1.8		2.0	2.7	6.6
Total return	4.8	6.0	5.0	6.2	5.3	6.4	2.0	2.7	6.6
35 percent capital gains/70 percent dividend tax:									
Capital gains return [2]	4.1	7.6	4.3	7.9	4.5	8.3			
Dividend/interest return [3]	1.6		1.7		1.8		2.0	2.7	6.6
Total return	5.7	7.6	6.0	7.9	6.3	8.3	2.0	2.7	6.6
35 percent capital gains/70 percent dividend tax:									
Capital gains return [2]	4.7	8.7	4.9	9.0	5.1	9.2			
Dividend interest return [3]	1.6		1.7		1.8		2.0	2.7	6.6
Total return	6.3	8.7	6.6	9.0	6.9	9.2	2.0	2.7	6.6
25 percent capital gains/50 percent dividend tax:									
Capital gains return [2]	4.7	8.7	4.9	9.0	5.1	9.2			
Dividend/interest return [3]	2.7		2.8		2.9		3.4	4.5	6.6
Total return	7.4	8.7	7.7	9.0	8.0	9.2	3.4	4.5	6.6
12.5 percent capital gains/25 percent dividend tax:									
Capital gains return [2]	5.5	10.0	5.7	10.4	5.9	10.8			
Dividend/interest return [3]	4.1		4.2		4.4		5.1	6.7	6.6
Total return	9.6	10.0	9.9	10.4	10.3	10.8	5.1	6.7	6.6

[1] Salomon Bros. estimates for bellwether issues, June 21, 1978.
[2] Compound annual rate of return.
[3] Average annual rate of return.

TABLE VIII.—CORPORATE MODELS: PROJECTED RETURN COMPARISONS WITH 10 PERCENT DIVIDEND INTEGRATION

[In percent]

	Equity investment						Fixed income investments [1]		
	48 percent corporate tax		46 percent corporate tax		44 percent corporate tax				
	45 percent dividend	No dividend	45 percent dividend	No dividend	45 percent dividend	No dividend	3 mo Treasury bills	Bell System bonds	Municipal bonds
Pretax returns:									
Capital gains return [2]	6.2	11.3	6.4	11.7	6.7	12.2			
Dividend/interest return [3]	5.4		5.6		5.9		6.7	9.0	6.6
Total return	11.6	11.3	12.0	11.7	12.6	12.2	6.7	9.0	6.6
Aftertax with 10 percent dividend integration:									
50 percent capital gains/70 percent dividend tax:									
Capital gains return [2]	3.2	6.0	3.3	6.2	3.5	6.4			
Dividend/interest return [3]	1.8		1.9		2.0		2.0	2.7	6.6
Total return	5.0	6.0	5.2	6.2	5.5	6.4	2.0	2.7	6.6
35 percent capital gains/70 percent dividend tax:									
Capital gains return [2]	4.1	7.6	4.3	7.9	4.5	8.3			
Dividend/interest return [3]	1.8		1.9		2.0		2.0	2.7	6.6
Total return	5.9	7.6	6.2	7.9	6.5	8.3		2.7	6.6
25 percent capital gains/70 percent divident tax:									
Capital gains return [2]	4.7	8.7	4.9	9.0	5.1	9.2			
Dividend/interest return [3]	1.8		1.9		2.0		2.0	2.7	6.6
Total return	6.5	8.7	6.8	9.0	7.1		2.0	2.7	6.6
25 percent capital gains/50 percent dividend tax:									
Capital gains return [2]	4.7	8.7	4.9	9.0	5.1	9.2			
Dividend/interest return [3]	3.0		3.1		3.2		3.4	4.5	6.6
Total return	7.7	8.7	8.0	9.0	8.3	9.2	3.4	4.5	6.6
12.5 percent capital gains/25 percent dividend tax:									
Capital gains return [2]	5.5	10.0	5.7	10.4	5.9	10.8			
Dividend/interest return [3]	4.5		4.6		4.8		5.1	6.7	6.6
Total return	10.0	10.0	10.3	10.4	10.7	10.8	5.1	6.7	6.6

[1] Salomon Brothers estimates for bellwether issues, June 21, 1978.
[2] Compound annual rate of return.
[3] Average annual rate of return.

TABLE IX

(Standard & Poor's 400 List Data Base)

Description and analysis

Table IX uses as a basis for return projections the 1977 experience parameters for Standard & Poor's list of 400 of the nation's largest corporations. These experience parameters were then converted into an index, using after tax earnings in year one as a base of 100. The procedures followed were similar to those used for the non-financial corporations tables and the corporate model tables. In Table IX-a, purchase was made at equity value beginning of year one, with sale at equity value at end of year three. In Table IX-b, purchase was made at market value. To project market value at end of year three a constant relationship between book value beginning of year one/market value beginning of year one and market value end of year three/book value end of year three was assumed.

Dividend payout was held constant at 44.2% of after tax profits, the same payout ratio as in 1977. It was also assumed that retained earnings were reinvested to produce pre tax and after tax rates on return of equity similar to the experience in 1977. It was further assumed there was no other equity financing and that debt capital increased in line with the internal growth in equity capital.

It is important to note these are not formal economic estimates of projected earnings for the S & P 400. Such projections are beyond the scope of this analysis. Use of the S & P 400 data is intended to provide a third basis for estimating rate of return parameters. However, the projected gains shown here for years one and two do, in fact, reside within the range of S & P 400 estimates for 1978 and 1979 made by stock market analysts.

Table IX-a shows that with purchase and sale at book value the compound annual appreciation return for top tax bracket investors would be 4.3%. Dividend return after a 70% tax rate would be 2.1%, for a combined after tax return of 6.4%. For the investor paying a 12.5% capital gains tax rate the appreciation return would be 7.4%. Dividend returns after tax would be 5.4% at a 25% dividend rax rate.

Table IX-b demonstrates returns based on purchase and sale at market value. Appreciation returns are the same as in Table IX-a. However, because market value is higher than book, dividend returns are reduced, at a 70% dividend tax rate from 2.1% to 1.7%, at the 25% tax rate from 5.4% to 4.4%.

TABLE IX-A.—STANDARD & POOR'S LIST OF 400 CORPORATIONS: 1977 EFFECTIVE TAX RATE INDEXED TO AFTER TAX PROFITS, YEAR 1, PURCHASE AND SALE AT BOOK VALUE

Financial data	Year 1	Year 2	Year 3
Pretax profits	194.7	211.0	228.5
Taxes	94.9	102.8	111.3
Aftertax profits	100.0	108.4	117.4
Dividends	44.2	47.9	52.0
Retained earnings	55.9	60.5	65.5
Beginning year equity	671.5	727.5	788.0
Return on equity pretax (percent)	29.0	29.0	29.0
Return on equity after tax (percent)	14.9	14.9	14.9
End of year equity	727.5	788.0	853.5
Taxes as percent of pretax profits	48.7	48.7	48.7
Dividends as percent of aftertax profits	44.2	44.2	44.2

Capital gains (appreciation) returns	Capital gains tax rates (percent)			
	50	35	25	12.5
Increase in equity, beginning year 1 to end year 3	182.0	182.0	182.0	182.0
Increase in equity after tax	91.0	118.3	136.5	159.2
Year end 3 equity after tax	762.5	789.8	808.0	830.7
Divided by beginning year 1 equity	671.5	671.5	671.5	671.5
Equals total appreciation return after tax	1.1355	1.1762	1.2033	1.2371
Compound annual aftertax appreciation return (percent)	4.3	5.6	6.4	7.4

Dividend returns	Dividend tax rates (percent)		
	70	50	25
Total dividends	144.1	144.1	144.1
Dividends after tax	43.2	72.0	108.1
Divided by 3 equals average annual dividend after tax	14.4	24.0	36.0
Divided by beginning year equity	671.5	671.5	671.5
Equals average annual dividend return (percent)	2.1	3.6	5.4

Source: Based on preliminary 1977 S. & P. 400 index data.

TABLE IX-B.—STANDARD & POOR'S LIST OF 400 CORPORATIONS: 1977 EFFECTIVE TAX RATE INDEXED TO AFTERTAX PROFITS, YEAR 1 PURCHASE AND SALE AT MARKET VALUE

Capital gains (appreciation) returns	Capital gains tax rates (percent)			
	50	35	25	12.5
Year end 3 market value (projected at 1.23 times year end 3 book value)	1,049.7	1,049.7	1,049.7	1,049.7
Minus beginning year 1 market value (1.23 times 1977 book)	825.9	825.9	825.9	825.9
Equals increase in market value beginning year 1 to end year 3	223.8	223.8	223.8	223.8
Increase in market value after tax	111.9	145.5	167.8	195.8
Year end 3 market value after tax	939.4	971.4	993.7	1021.7
Divided by beginning year 1 market value	825.9	825.9	825.9	825.9
Equals total appreciation return after tax	1.1374	1.1762	1.2032	1.2371
Compound annual after tax appreciation return (percent)	4.3	5.6	6.4	7.4

Dividend returns	Dividend tax rates (percent)		
	70	50	25
Total dividend	144.1	144.1	144.1
Dividends after tax	43.2	72.0	108.1
Divided by 3 equals average annual dividend after tax	14.4	24.0	36.0
Divided by beginning year 1 market value	825.9	825.9	825.9
Equals average annual dividend return (percent)	1.7	2.9	4.4

TABLE X

Description and analysis

Tables X–a and b show projected returns for the S & P 400 list incorporating the effects of the Administration's proposed reduction in the corporate tax rate. The Treasury Department's estimated reductions in corporate income tax revenues resulting from reducing the tax rate for all corporations in 1978, 1979 and 1980 were allocated respectively to years one, two and three.

Projection procedures used were similar to those for Tables IX–a and b, with the obvious exception that, as the effective tax rate declines, the after tax return on equity increases and at the end of year three the equity value is higher than in Table IX.

Table X–a uses book value as the purchase and sale price. Incorporating the effects of the Administration's proposed reduction in the corporate tax rate raises the compound annual rate of appreciation return on book value by less than one half of a percentage point after tax. Assuming a constant 44.2% dividend payout ratio with the corporate tax rate reduced, dividend returns would be increased two to three-tenths of a percentage point after tax.

Table X–b uses market value as the purchase and sale price. Once again, in order to establish market value at the end of the holding period it was assumed that at the end of year three market value bore the same relationship to book value as it did at the beginning of year one. As was shown in earlier projections, using constant assumptions, appreciation return based on market value is the same as that based on book value. However, since market value of the S & P 400 was higher than book value at the end of 1977/beginning of year one, dividend returns are lower, specifically, 1.9% after a 70% tax rate compared to a 2.3% return based on purchase at book value. To the investor paying a 25% tax rate on dividends, annual dividend return is reduced from 5.7% to 4.6%.

TABLE X-A.—STANDARD & POOR'S LIST OF 400 CORPORATIONS: INCORPORATING ADMINISTRATION'S PROPOSED REDUCTION IN CORPORATE TAX RATE INDEXED TO AFTERTAX PROFITS, YEAR 1, TABLE IX, PURCHASE AND SALE AT BOOK VALUE

Financial data	Year 1	Year 2	Year 3
Pretax profits	194.7	211.0	229.9
Taxes	93.2	95.4	101.4
Aftertax profits	101.5	115.8	128.5
Dividends	44.9	51.1	56.7
Retained earnings	56.6	64.6	71.7
Beginning year equity	671.5	728.1	792.8
Return on equity pretax (percent)	29.0	29.0	29.0
Return on equity after tax (percent)	15.1	15.9	16.2
End of year equity	728.1	792.8	864.5
Taxes as a percent of pretax profits	47.9	45.2	44.1
Dividends as a percent of aftertax profits	44.2	44.2	44.2

Capital gains (appreciation) returns	Capital gains tax rates (percent)			
	50	35	25	12.5
Increase in equity, beginning year 1 to end year 3	193.0	193.0	193.0	193.0
Increase in equity after tax	96.5	125.4	144.8	168.9
Year end 3 equity after tax	768.0	796.9	816.3	840.4
Divided by beginning year 1 equity	671.5	671.5	671.5	671.5
Equals total appreciation return after tax	1.1437	1.1867	1.2156	1.2515
Compound annual aftertax appreciation return (percent)	4.6	5.9	6.7	7.8

Dividend returns	Dividend tax rates (percent)		
	70	50	25
Total dividends	152.7	152.7	152.7
Dividends after tax	45.8	76.4	114.5
Divided by 3 equals average annual dividend after tax	15.3	25.4	38.2
Divided by beginning year equity	671.5	671.5	671.5
Equals average annual dividend return (percent)	2.3	3.8	5.7

Source: Based on preliminary 1977 S. & P. 400 Index data.

TABLE X-B.—STANDARD & POOR'S LIST OF 400 CORPORATIONS: INCORPORATING ADMINISTRATIONS PROPOSED REDUCTION IN CORPORATE TAX RATE INDEXED TO AFTER TAX PROFITS, YEAR 1, TABLE IX, PURCHASE AND SALE AT MARKET VALUE

Capital gains (appreciation) returns	Capital gains tax rates (percent)			
	50	35	25	12.5
Year end 3 market value (projected at 1.23 times year end 3 book value)	1,063.3	1,063.3	1,063.3	1,063.3
Minus beginning year 1 market value (1.23 times 1977 book)	825.9	825.9	825.9	825.9
Equals increase in market value beginning year 1 to end year 3	237.4	237.4	237.4	237.4
Increase in market value after tax	118.7	154.3	178.0	207.7
Year end 3 market value after tax	944.6	980.2	1,004.0	1,033.6
Divided by beginning year 1 market value	825.9	825.9	825.9	825.9
Equals total appreciation return after tax	1.1437	1.1868	1.2156	1.2515
Compound annual after tax appreciation return (percent)	4.6	5.9	6.7	7.8

Dividend returns	Dividend tax rates (percent)		
	70	50	25
Total dividends	152.7	152.7	152.7
Dividends after tax	45.8	76.4	114.5
Divided by 3 equals average annual dividend after tax	15.3	25.4	38.2
Divided by beginning year 1 market value	825.9	825.9	825.9
Equals average annual dividend return (percent)	1.9	3.1	4.6

TABLE XI

Description and analysis

Table XI illustrates return comparisons using as a data base the 1977 financial statement ratios of the S & P list of 400 corporations. Table XI-b shows returns based on book value purchase and sale comparing returns at 1977 effective cor-

porate tax rates, incorporating the effects of the Aministration's proposed cut in the corporate tax rate and with and without a 10% rate of dividend integration.

Table XI-b uses market value end of 1977 as a basis for establishing purchase price. Since market value was higher than book value, dividend returns are lower. Appreciation returns remain the same, since in establishing sale price at market a constant ratio of market to book was assumed.

Each table compares the projected return with three alternative investment opportunities: three month Treasury bills, Bell System bonds and municipal bonds. In comparing rates of return among the fixed income alternatives and the S & P 400 data base it is important to keep in mind that these fixed income investments are generally perceived to carry lower risk than equity investments.

Both tables show that the greatest impact on after tax rates of return would result from reducing the capital gains tax rate. Both dividend integration and reducing the corporate tax rate would have only modest effect on investor rates of return.

It should be noted that in applying 10% dividend integration it was assumed that all S & P 400 corporations would have a tax base sufficient to support the full 10% gross up and credit. While 1977 data are incomplete, this was not the case in 1976. Presumably, not all 400 corporations would provide a full gross up and credit based on 1977 results. Accordingly, the effects of dividend integration would be overstated.

TABLE XI-A.—STANDARD & POOR'S: PROJECTED RETURN COMPARISONS—PURCHASE AND SALE AT BOOK VALUE

[In percent]

	Without dividend integration		With 10 percent dividend integration		Fixed income investment alternatives [1]		
	1977 effective tax rates	Incorporating administration's corporate tax cut	1977 effective tax rates	Incorporating administration's corporate tax cut	3 mo treasury bills	Bell system bonds	Municipal bonds
Pretax returns:							
Capital gains return [2]	8.3	8.8	8.3	8.8			
Dividend/interest return [3]	7.2	7.6	7.2	7.6	6.7	9.0	6.6
Total return	15.5	16.4	15.5	16.4	6.7	9.0	6.6
After tax returns:							
50 percent capital gains/70 percent dividend tax:							
Capital gains return [2]	4.3	4.6	4.3	4.6			
Dividend/interest return [3]	2.1	2.3	2.3	2.5	2.0	2.7	6.6
Total return	6.4	6.9	6.6	7.1	2.0	2.7	6.6
35 percent capital gains/70 percent dividend tax:							
Capital gains return [2]	5.6	5.9	5.6	5.9			
Dividend/interest return [3]	2.1	2.3	2.3	2.5	2.0	2.7	6.6
Total return	7.7	8.2	7.9	8.4	2.0	2.7	6.6
25 percent capital gains/70 percent dividend tax:							
Capital gains return [2]	6.4	6.7	6.4	6.7			
Dividend/interest return [3]	2.1	2.3	2.3	2.5	2.0	2.7	6.6
Total return	8.5	9.0	8.7	9.2	2.0	2.7	6.6
25 percent capital gains/50 percent dividend tax:							
Capital gains return [2]	6.4	6.7	6.4	4.7			
Dividend/interest return [3]	3.6	3.8	4.0	4.2	3.4	4.5	6.6
Total return	10.0	10.5	10.4	10.9	3.4	4.5	6.6
12.5 percent capital gains/25 percent dividend tax:							
Capital gains return [2]	7.4	7.8	7.4	7.8			
Dividend/interest return [3]	5.4	5.7	5.9	6.3	5.1	6.7	6.6
Total return	12.8	13.5	13.3	14.1	5.1	6.7	6.6

[1] Salomon Bros. estimates for bellwether issues, June 21, 1978.
[2] Compound annual rate of return.
[3] Average annual rate of return.

TABLE XI-B.—STANDARD & POOR'S LIST OF 400 CORPORATIONS: PROJECTED RETURN COMPARISONS—PURCHASE AND SALE AT MARKET VALUE

[In percent]

	Without dividend integration		With 10 percent dividend integration		Fixed income investment alternatives[1]		
	1977 effective tax rates	Incorporating administration's corporate tax cut	1977 effective tax rates	Incorporating administration's corporate tax cut	3 mo treasury bills	Bell system bonds	Municipal bonds
Pretax returns:							
Capital gains return[2]	8.3	8.8	8.3	8.8			
Dividend/interest return[3]	5.8	6.2	5.8	6.2	6.7	9.0	6.6
Total return	14.1	15.0	14.1	15.0	6.7	9.0	6.6
After tax returns:							
50 percent capital gains/70 percent dividend tax:							
Capital gains return[2]	4.3	4.6	4.3	4.6			
Dividend/interest return[3]	1.7	1.9	1.9	2.1	2.0	2.7	6.6
Total return	6.1	6.5	6.2	6.7	2.0	2.7	6.6
35 percent capital gains/70 percent dividend tax:							
Capital gains return[2]	5.6	5.9	5.6	5.9			
Dividend/interest return[3]	1.7	1.9	1.9	2.1	2.0	2.7	6.6
Total return	7.3	7.8	7.5	8.0	2.0	2.7	6.6
25 percent capital gains/70 percent dividend tax:							
Capital gains return[2]	6.4	6.7	6.4	6.7			
Dividend/interest return[3]	1.7	1.9	1.9	2.1	2.0	2.7	6.6
Total return	8.1	8.6	8.3	8.8	2.0	2.7	6.6
25 percent capital gains/50 percent dividend tax:							
Capital gains return[2]	6.4	7.8	6.4	7.8			
Dividend/interest return[3]	2.9	3.1	3.2	3.4	3.4	4.5	6.6
Total return	9.3	10.9	9.6	11.2	3.4	4.5	6.6
12.5 percent capital gains/25 dividend tax:							
Capital gains return[2]	7.4	7.8	7.4	7.8			
Dividend/interest return[3]	4.4	4.6	4.8	5.1	5.1	6.7	6.6
Total return	11.8	12.4	12.2	12.9	5.1	6.7	6.6

[1] Salomon Bros. estimates for bellwether issues, June 21, 1978.
[2] Compound annual rate of return.
[3] Average annual rate of return.

TABLES XII, XIII, XIV

(Historical data)

Description and analysis

Tables XII, XIII, and XIV provide data for analysis of historic returns. Table XII contains financial statement data for non-financial corporations for the period 1965–1977. Tables XIII and XIV calculate compound annual appreciation returns (including speculation returns) for non-financial corporations and for the Standard & Poor's 500 Stock Index Composite. (The 400 Index was just recently introduced, therefore historical data do not exist.) In Table XIII compound annual appreciation returns are shown for periods ending in 1977 and extending back to 1947. For example, purchases made at market value, 1947 and sold at market value, 1977 would have realized a pre tax compound annual appreciation return of 7.1%. The compound annual appreciation return between 1967 and 1977 was only 0.3%, pretax.

In Table XIV compound annual appreciation returns for the S & P 500 Index are shown for periods extending back to 1927. The data show that purchase made in 1927 and sold in 1977 would have realized a pre tax compound annual return of 3.4%. For the 1947–1977 period the pre tax compound annual rate of appreciation return was 6.3%. For the most recent ten year period, 1967–1977, the return was negative.

TABLE XII.—NONFINANCIAL CORPORATIONS: BOOK VALUE PROFITS (1965-77, CURRENT DOLLARS)

[Dollar amounts in billions]

Year	Book value beginning of year [1]	Profits before tax [2]	Profits before tax as a percent of book (2) (1)	Profits after tax [2]	Profits after tax as a percent of book (4) (1)	Dividends	Dividend payout ratio (6) (4)	Retained earnings
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1965	$337.0	$64.4	19.1	$37.2	11.0	$21.0	56.5	$16.2
1966	359.0	69.5	19.4	40.0	11.1	18.1	45.2	21.9
1967	381.8	65.4	17.1	37.7	9.9	18.9	50.1	18.8
1968	409.2	71.9	17.6	38.3	9.4	20.7	54.0	17.6
1969	430.4	68.4	15.9	35.1	8.2	20.7	59.0	14.4
1970	460.2	55.1	12.0	27.9	6.1	19.9	71.3	8.0
1971	478.8	63.3	13.2	33.3	7.0	20.0	60.0	13.3
1972	503.9	75.9	15.2	42.4	8.4	21.7	51.2	20.7
1973	534.5	92.8	17.4	53.1	9.9	23.9	45.0	29.2
1974	572.2	102.8	18.0	60.2	10.5	26.0	43.2	34.2
1975	621.6	102.3	16.5	61.6	9.9	29.0	47.1	32.6
1976	679.6	130.6	19.2	76.9	11.3	32.4	42.1	44.5
1977	750.5	141.8	18.9	84.9	11.3	38.2	45.0	46.7
1978 [3]	806.2							

[1] Federal Reserve Board flow of funds accounts, end of prior year book value.
[2] Department of Commerce.
[3] 1978 figure an unpublished preliminary estimate.

TABLE XIII.—NONFINANCIAL CORPORATIONS CAPITAL GAINS RETURNS, 1947-77

Year	Book value (billion)	Periods: Beginning	Periods: Ending	Compound annual appreciation returns (percent): Pretax	Capital gains tax rates: 50 percent	35 percent	25 percent	12.5 percent
Purchase and sale at book value:								
1947	$108.142	1947	1977	6.9	4.9	5.6	6.1	6.5
1957	238.502	1957	1977	6.3	4.0	4.8	5.2	5.8
1967	409.204	1967	1977	7.0	4.0	5.0	5.6	6.3
1968	430.432	1968	1977	7.2	4.1	5.1	5.8	6.5
1969	460.170	1969	1977	7.3	4.1	5.1	5.8	6.5
1970	478.752	1970	1977	7.7	4.3	5.4	6.1	6.9
1971	503.715	1971	1977	8.2	4.5	5.6	6.4	7.3
1972	534.506	1972	1977	8.5	4.6	5.9	6.7	7.6
1973	572.186	1973	1977	9.0	4.8	6.1	6.9	7.9
1974	621.573	1974	1977	9.1	4.7	6.1	6.9	8.0
1975	679.567	1975	1977	8.9	4.6	5.9	6.8	7.8
1976	740.494	1976	1977	8.9	4.4	5.8	6.7	7.8
1977	806.225							
Purchase and sale at market value:								
1947	84.922	1947	1977	7.1	5.1	5.8	6.2	6.7
1957	242.470	1957	1977	5.2	3.2	3.9	4.3	4.8
1967	651.771	1967	1977	.3	.1	.2	.2	.2
1968	736.974	1968	1977	(−1.1)				
1969	646.923	1969	1977	.4	.2	.3	.3	.3
1970	649.391	1970	1977	.4	.2	.3	.3	.4
1971	760.466	1971	1977	(−2.2)				
1972	862.427	1972	1977	(−5.2)				
1973	636.969	1973	1977	1.2	.6	.8	.9	1.1
1974	426.349	1974	1977	16.2	8.7	11.0	12.5	14.4
1975	597.007	1975	1977	5.8	2.9	3.8	4.8	5.1
1976	734.118	1976	1977	(−9.8)				
1977	668.296							

Source: Federal Reserve Board flow of funds accounts.

TABLE XIV.—STANDARD & POOR'S 500 STOCK INDEX COMPOSITE CAPITAL GAINS RETURNS 1927-77

Year	Yearend price	Periods		Compound annual appreciation return (percent)				
					Capital gains tax rate			
		Beginning	Ending	Pretax	50 percent	35 percent	25 percent	12.5 percent
S. & P. 500 stock index:								
1927	$17.66	1927	1977	3.4	2.3	2.7	3.0	3.2
1937	10.55	1937	1977	5.7	4.1	4.7	5.0	5.4
1947	15.30	1947	1977	6.3	4.4	5.1	5.4	5.9
1957	39.99	1957	1977	4.4	2.7	3.2	3.6	4.0
1967	96.47	1967	1977	(−.1)				
1968	103.90	1968	1977	(−1.0)				
1969	92.06	1969	1977	.4	.2	.3	.3	.3
1970	92.15	1970	1977	.5	.2	.3	.3	.4
1971	102.10	1971	1977	(−1.2)				
1972	118.10	1972	1977	(−4.4)				
1973	97.55	1973	1977	(−.6)				
1974	68.56	1974	1977	11.5	6.1	7.8	8.9	10.2
1975	90.19	1975	1977	2.7	1.4	1.8	2.0	2.4
1976	107.46	1976	1977	(−11.5)				
1977	95.10							

STATEMENT OF THE COMMITTEE ON TAXATION, FINANCIAL EXECUTIVES INSTITUTE*

The Committee on Taxation of Financial Executives Institute urges enactment of legislation that will reduce effective tax rates on capital gains. Reducing these rates would provide a strong stimulus to investment and growth in our national economy. In our opinion, previously expressed before the Senate Committee on Finance, such stimulus must be a prime objective of any new tax legislation. The bills that are subject of this hearing recognize the need for that stimulus.

Those who set the lower rates for taxation of capital gains that existed before the Tax Reform Act of 1969 did so for good reason. They recognized the element of risk in capital investment, risk that is often substantial. They recognized the benefits to the nation of encouraging the acceptance of risk, particularly in bringing new products and new processes into being and new entrepreneurs into action. They recognized that any tax on capital gains adds a layer of tax on the returns from savings, thus contributing to the tax bias against saving and investment and in favor of consumption. They sought to lessen that effect.

Since the raising of capital gains tax rates and holding periods in 1969 and subsequently, the fluidity of capital has been impeded, restricting its formation and its movement from matured investment to new investment. This can be seen in the poor performance of the stock market, in high interest rates and in the heavy load of debt financings. The results are particularly detrimental to small business and high risk, high technology business.

These undesirable results have occurred because:

(1) The burden of tax on gains has increased, without significant relief on capital losses.

(2) The adverse impact has been increased of taxing in one year gains that have accrued over extended periods.

(3) The rates of tax can go as high as 49%, because of changes made in the minimum and maximum tax provisions. Complexity of tax computation has been greatly increased.

(4) Changes in the estate tax now result in the decedent's tax basis carrying over to the heir, who then pays a higher capital gains tax when he sells the investment.

(5) The competitive disadvantage is increased vis-a-vis foreign industrial countries which impose no tax on capital gains or a lesser tax.

(6) With the tremendous burst of inflation over the years since 1970, much of the gain that is taxed does not represent real income.

In 1969, little empirical evidence existed upon which to forecast the effets of changes in capital gains taxation. Now we have experience and several studies to indicate that the present level of taxation is detrimental to savings and growth.

*Financial Executives Institute is the recognized professional association of approximately 10,000 members who are senior financial and administrative officials in approximately 5,000 companies, large and small, throughout the United States and Canada.

The results of some of these studies have been presented at these hearings. Among them, the recent analysis produced by Data Resources, Inc. concludes that capital gains tax relief would increase gross national product, capital formation, man years of employment and federal tax revenue. We strongly urge your favorable action on such beneficial legislation.

Statement of Forest Industries Committee on Timber Valuation and Taxation

This statement is presented on behalf of the Forest Industries Committees on Timber Valuation and Taxation, a voluntary organization of over 4,000 timber growers of all sizes and from every region of the country. The Committee was formed in the early 1940's for the purpose of overcoming then existing inequities in the capital gains treatment of timber. It has served since that time to advocate federal income, estate and capital gains tax policies which will make possible sufficient investment in timber growing enterprises to meet the nation's expanding need for lumber, paper, chemicals and the many other products of our forest resources.

Seventy-two percent of the nation's commercial timber is in private ownership. Fifty-nine percent is owned by individuals, farmers, partnerships and smallc orporations. Thirteen percent is owned by integrated forest products companies. All have a stake in the development of tax policies which adequately take into account the long investment cycle and the extraordinary risks in timber growing.

On many occasions in the past we have had the opportunity to report to your Committee and other Committees of Congress on the specific economic and social benefits which have resulted from the application of capital gains tax rates to the full spectrum of capital transactions in timber.

In 1944, before Congress corrected inequities in the law, there existed powerful disincentives for sustained-yield management of private timber tracts. The decline in the nation's timber growing stock prior to 1944 reflected that unwise policy. The dramatic reversal in investment patterns subsequent to 1944 clearly domonstrates that, when given fair treatment in relation to other capital investment opportunities, timberland owners are able to respond to consumer demands for forest products.

The specific details of this renaissance in private sector timber management is a matter of record. To provide you with the most recent accounting, we are including with this statement a copy of our March 9, 1978 testimony before the House Committee on Ways and Means. In it we relate the improvements which have occurred in the private timber sector resulting from the application of Sections 631(a) and (b) of the Internal Revenue Code. These provisions ensure that capital gains applies to the full range of transactions common to the production and disposal of timber, including those required for sustained-yield management. In those hearings we also provided our analysis of President Carter's proposed changes and our recommendations regarding cap''al gains, the minimum tax, and the investment credit as they would affect timber investments.

General Capital Gains Discussion

It is the purpose of your hearings to examine general capital gains provisions and their impact on the full range of capital investment. Therefore, we will not repeat those details with respect to the justification for Sections 631(a) and (b) treatment of timber transactions and which are a matter of record in past hearings.

It is appropriate, however, that timber investments be cited as a unique example of the need for more moderate capital gains tax rates. We know of no other single enterprise where the time required to bring an initial investment (forest plantings) to economic maturity is so great. Depending upon the quality of the growing site, the region of the country, species and other factors, that period can range from 25 to 75 years. During the growing period the investment generates no income, only expenses. The risks of loss by fire, disease, windstorm and other natural causes is high; and insurance against such losses is unobtainable. The liquidity of such an investment is very poor. Imputed interest costs for the lock-in of capital for such long periods without current income is extremely high. The after-tax rate of return on timber growing has historically been unacceptably low. The rate of return in the forest industries sector for all functions, including manufacture, has averaged below that of the manufacturing sector generally.

With all of these built-in handicaps to the attraction of capital, the timber growing sector is an illustration of what is happening in many areas of capital

investment today—and what could well happen in more favorable investment areas in the future unless adequate recognition is given in tax policy to capital formation requirements.

To summarize briefly: during that period when the maximum capital gains rate for both individuals and corporations was 25 percent, the nation's timberland owners were investing in improved timber management at a rate sufficient to keep up with expanding consumer requirements and at the same time build a cushion of supply for the future. The latter is essential because of the length of time required to nurture a timber crop to economic maturity. Trees which were planted in the late 1940's and early 1950's are only now becoming available for harvest and some that were planted during that period won't be harvested for another 10, 20 or 30 years. The timber investment activity of the 30-year period following 1944 had the beneficial effect of warding off a "timber famine" which had been predicted by government and private experts to be upon us by the 1970's and 1980's.

But the timber supply-demand relationship continues to be a major concern. The U.S. Forest Service predicts that by the year 2000 we will need 20 billion board feet more timber each year than will reach normal harvest stage each year. (That amount of wood would satisfy the needs of 400,000 single-family dwellings.) But the same tax incentives which were in effect from 1944 to 1969 are no longer there.

INCENTIVE EFFECTS OF CAPITAL GAINS

The essence of the capital gains incentive is the differential between the applicable capital gains rate and corresponding ordinary income tax rate. Among other things that differential serves two vital functions in the process of capital formation and retention: 1) it encourages capital savings and investment, and 2) it mitigates the effects of inflation on nominal gains and reduces the amount of real capital taxed away by the government.

In the United States today there is a real need for both functions. Of all the major industrial nations of the free world, the United States has the lowest ratio of savings to income. On the second point, the tax on inflated gain and subsequent reinvestment in value-inflated assets often leave the investor with less real capital after a transaction than before. This not only deprives the taxpayer of his savings—on which taxes have already been paid—but also robs our economy of the benefits of real growth in capital assets.

With both of these factors working against us, it is simply not possible for our economy to do what is needed to provide the capital stock to support a growing labor market, to provide the innovations and efficiencies needed to hold down the prices of consumer products, and to provide the overall economic growth necessary to meet the revenue needs of local, state and federal governments for essential public services.

It is no accident that the sluggish growth in the nation's capital stock coincides with the diminution of the differential between capital gains and ordinary income taxes.

DIMINUTION OF CAPITAL GAINS BENEFITS

Savers and investors have seen the capital gains tax differential shrink dramatically over a period of less than ten years.

Prior to 1969, the effective capital gain rate for individuals was 50 percent of the ordinary rate, with a maximum of 25 percent. For corporations, it was a flat 25 percent. The 1969 Revenue Act and subsequent enactments departed from that historic pattern. The differential for corporate capital gain, i.e., the difference between ordinary income tax rates and capital gains tax rates has been reduced from the 27 percent that prevailed for many years to 18 percent at the present time. Earlier this year, President Carter submitted a series of tax recommendations to the Congress which, if adopted without change, would further reduce the differential to only 14 percent.

While the basic inclusion of "one-half the gain" in the ordinary income tax calculation is still in the law for individual capital gains, the elimination of the alternative 25 percent tax on all but the first $50,000 of gain and the adoption of the Minimum Tax on Tax Preferences have reduced the overall incentive for risk investments by individuals.

The extent to which recent enactments have diminished the stimulus for savings is greater than most people realize. The so-called Minimum Tax alone has resulted in a 60 percent increase in the maximum rate of capital gain of individuals. If President Carter's recommendations were adopted, it would be even higher.

When you consider the effect of treating one-half of long-term capital gains as a preference for computing the Maximum Tax on Earned Income as well as the Minimum Tax on Tax Preferences, the maximum tax rate on capital gain of individuals has almost doubled in less than 10 years.

The following table illustrates this dramatic shift in federal tax policy on capital gain.

Maximum rate on individuals per $100 of long-term capital gains (percent)

(Includes effect of minimum tax on tax preferences)

Pre-1969	25
1969 act	36.5
1976 act	39.875
Carter proposal	42.5

Maximum rate on individuals per $100 of long-term capital gains (percent)

(Includes effect of both maximum tax on earned income and minimum tax on tax preferences)

Pre-1969	25
1969 act	45.5
1976 act	49.125
Carter proposal	52.5

Thus, when both the minimum and maximum taxes are considered, the top rate on capital gains is nearly 50 percent. This hardly squares with the rhetoric we so frequently hear. Nor does it square with sound national policy. When political cliches are put aside and our need for capital is viewed realistically, it is abundantly clear that present policies are not adequate for the task.

CAPITAL GAINS DIFFERENTIAL FOR CORPORATIONS

When we consider the corporate capital gains structure, the detrimental erosion of the past several years is even more dramatic.

Prior to 1964, the differential in corporate capital gain was 27 percent, representing the difference between the statutory 52 percent corporate rate and the flat 25 percent capital gain rate. When the corporate tax rate was reduced to 48 percent, the differential was thereby narrowed to 23 percent. In 1969, the corporate capital gain rate was increased to a flat 30 percent and corporate gain was also made subject to the minimum tax, making the differential between ordinary income and capital gain 18 percent or less. If President Carter's corporate tax reduction proposal is adopted without a corresponding reduction in the corporate capital gains rate, the differential would be only 14 percentage points—approximately one-half the pre-1964 capital gains incentive . . . and it affects all corporate gain, whether ordinary earnings are high or low.

RECOMMENDATIONS

It is apparent from the history of recent tax changes that the importance of capital investment has not been fully recognized in the evolution of our tax laws. Certainly for timber growers—and just as likely for investors in other types of assets—the capital gains incentive has been gradually eroded to the point where it is grossly inadequate to meet national needs. The trend toward closing the differential between capital gain and ordinary income represents a direct tax on capital. The trend must be reversed.

The Forest Industries Committee on Timber Valuation and Taxation reiterates its long-held position that the capital gains structure should be returned to its pre-1969 status. We see absolutely no conflict in this position with the concept of tax equity or with the need of government entities to generate sufficient revenue to provide public services. To the contrary, history amply demonstrates that economic activity expands as incentives for capital formation are enacted. As economic activity expands, so do revenues for every level of government and so do the opportunities for gainful employment and for capital savings by a larger segment of the population.

We congratulate you, Mr. Chairman, and the members of your Subcommittee for conducting these hearings. A full examination of policies affecting the taxation of capital gains and the impact of those policies on our economic vitality is greatly needed. We hope the information we have provided and the suggestions made will be helpful to you in that process.

Summary and Statement of Forest Industries Committee on Timber Valuation and Taxation

PURPOSE OF FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION TESTIMONY

To oppose changes in the Internal Revenue Code which will diminish the capability of landowners to invest in modern forest management practices and to urge adoption of new capital recovery provisions which will help make possible the needed high level of investment in the nation's forestlands to meet predicted future needs for wood and fiber.

PRESIDENT CARTER'S RECOMMENDATIONS

The President's proposal to revise the minimum tax and to eliminate the capital gains alternative tax represent a continuation of the steady erosion that has occurred in the capital gains tax benefit over the past several years. When coupled with the failure to recommend a reduction in the corporate capital gain rate to correspond with the proposed reduction in the ordinary income tax rate, the President's tax package would further diminish capital investment incentives at a time when the balance has already been tipped too far against savings and investment.

FEDERAL TAX POLICY AND TIMBER SUPPLY

The historic relationship between fair timber tax policies and improvement in the nation's private sector timber supply is clearly demonstrable. There is vivid contrast between the pre-1944 era (when capital gains treatment was denied to timber owners who managed their lands for continuous production) and the post-1944 era during which capital gains treatment has served as the cornerstone of a remarkable renaissance in the management of the nation's private forest resources.

PROJECTED DEMANDS FOR TIMBER

Government studies clearly indicate that substantial shortages of timber will begin to affect our economy within the next two decades. By the year 2000, the shortfall is projected to be 20 billion board feet per year—enough to build 1,400,000 single family homes each year. If we wait until the shortage is upon us it will be too late because it takes from 25 to 50 years to produce timber suitable for conversion to lumber and plywood.

TIMBER IS A UNIQUE RESOURCE

Because it is constantly renewable, timber is unlike any other basic raw material. Public policies which fail to recognize and capitalize on that renewability by making it economically advantageous to accelerate the regeneration and growth processes are shortsignted policies. On the other hand, the adoption of specific measures designed to overcome the natural and economic risks involved in long-term timber investments will bring dividends of an assured future supply of a critical commodity, both short-term and long-term job creation, and higher future revenues to all levels of government.

DIFFICULTIES OF ATTRACTING CAPITAL

It is estimated that $16 billion in capital is needed now and in the very near future to enable private timber owners to bring their commercial timberlands to an adequate level of production to prevent shortages of supply. Approximately $13 billion of this is needed on the 59 percent of commercial timberland controlled by individuals and farmers. The historical low rate of return and the long-term illiquidity of funds invested in timber will make it virtually impossible to attract that much capital under present conditions.

RECOMMENDATIONS

The Forest Industries Committee on Timber Valuation and Taxation:

1. Recommends that the minimum tax concept be reevaluated and if it is to be retained that it be converted to a true "minimum" tax instead of being an additional tax on already taxed income as at present. If the existing concept is retained in the law, the deduction for "other taxes paid" should be restored to 100% instead of being eliminated as proposed by the President;

2. Recommends retention of the capital gains 25% alternative tax;
3. Recommends reduction in the corporate capital gain rate by 4 percentage points to correspond with the proposed reduction in the corporate ordinary income tax rate; and
4. Recommends that the 10 percent investment tax credit be extended to capitalized forest regeneration expenses and that such expenditures be amortized over a seven year period.

Statement of Forest Industries Committee on Timber Valuation and Taxation

This statement is presented on behalf of the Forest Industries Committee on Timber Valuation and Taxation, a voluntary organization of over 4,000 timber owners who support the adoption and maintenance of federal tax policies which are compatible with the economics of intensive regeneration and management of the nation's private timber resources.

Represented among the Forest Industries Committee's supporters are timberland owners of all sizes and from all timber producing regions of the country—from small tract owners and forest farmers to the largest of the integrated forest products enterprises. Our industry is easily the least concentrated of the resource based industries with approximately 80 percent of the privately-held commercial forest acreage being in the hands of non-industrial owners.

There is no question about the unanimity among all sectors of the industry when it comes to the important role of federal tax policy in determining the quantity of growing timber which will be available for harvest in future years and in determining the extent to which the resource can be managed for higher productivity. Virtually all growers have a stake in those policy decisions—in proportion to their contributions to the nation's supply of wood for processing into comsumer products.

President Carter's Recommendations

It is our intention in this statement to address several specific aspects of President Carter's income tax recommendations of January 20, 1978 as well as the general impact on timber producers of present and proposed federal income, estate and capital gains tax provisions.

It is the President's purpose, as stated in his message, that proposed tax reductions and improvements in the investment credit provisions "will provide the consumer purchasing power and business investment strength we need to keep our economy growing strongly and unemployment moving down."

We applaud the proposed individual and corporate tax reductions as being generally conducive to those objectives. However, there are other elements of the President's proposal—and there are omissions in the proposal—which would adversely impact timber growers in relation to other sectors of the economy.

Problems in President Carter's Recommendations

The capital gains provisions of the Internal Revenue Code—specifically Sections 631(a) and 631(b)—have historically served to help overcome the extraordinary natural and economic disincentives for long-term capital investment in timber growing. Other incentive provisions of the Tax Code which are intended to benefit raw material production do not apply to timber. Nor does the investment credit currently apply to capital investments in reforestation. Capital gains treatment is the sole existing tax incentive.

Yet, in three major aspects, the pending proposal would significantly reduce the incentive effects of capital gain. Each of these will be covered in detail in this statement but our concerns can be summarized as follows:

The essence of the capital gain incentive is the differential between the applicable capital gain rate and the corresponding ordinary income tax rate. Prior to 1969, the effective capital gain rate for individuals was 50 percent of the ordinary rate with a maximum of 25 percent. For corporations, it was a flat 25 percent. The 1979 Revenue Act and subsequent enactments departed from that historic pattern. The differential for corporate capital gain, i.e., the difference between ordinary income tax rates and capital gains tax rates, has been reduced from the 27 percent that prevailed for many years to 1 percent at the present time. If the President's recommendations are adopted, the differential would be further reduced to only 14 percent. Our testimony will demonstrate that the risk capital needed to meet national goals for timber supply is not likely to be forthconing under such conditions.

While the basic 50 percent factor is still in the law for individual capital gain, the elimination of the alternative 25 percent tax on all but the first $50,000 of gain and the adoption of the minimum tax on tax preferences have reduced the incentive for risk investments by individuals. The largest acreage of timber in the United States is in individual or farm ownerships. These offer the greatest potential for improved supply if the owners can afford to implement the current state of the art in forest management. But, the trend of reductions in capital gain benefits and the constant threat of even greater adverse actions have made it more difficult for these owners to justify higher investments in reforestation and intensive management. The President's proposal would—in two significant ways—contribute to those difficulties.

The first of these is the proposed complete elimination of the alternative tax for individuals which will affect those who can best afford to practice intensive forestry on their lands.

The second is the proposed change in the minimum tax which would further reduce the capital gains incentive—and certainly would give non-industrial, individual timber owners even more reason to question the advisability of instituting timber management programs.

Therefore, while the President says his intention is to provide "business investment strengths," the specifics of his proposal would clearly have the opposite effect on the potential of timber growers to generate the large amounts of capital required to meet public policy objectives.

SUMMARY OF RECOMMENDATIONS

Ultimately, the nation can realize the full potential of its privately owned forests only through a carefully formulated combination of incentives. These incentives must recognize the long-term commitment necessary to forest management and the greater—and different—risks imposed by this unique requirement.

Therefore, the Forest Industries Committee on Timber Valuation and Taxation makes the following recommendations which are explained in greater detail at the conclusion of our statement.

We recommend that the maximum rate for timber capital gains should not exceed one-half the rate for ordinary income and, in the case of individuals, should be limited to a rate of 25 percent.

The corporate capital gain rate should be lowered by the same number of percentage points as the ordinary corporate rate is reduced. This would maintain the level of incentive which currently exists—a level already critically low because of changes in the capital gains structure brought about by recent enactments.

If the so-called minimum tax is to be retained in the law, it should be made a true minimum tax rather than an additional assessment on specific forms of income which have already been taxed at the full statutory rate. Since the greatest negative impact of the Minimum Tax is on capital gain, another solution would be to eliminate capital gain from the definition of "preference income".

In the area of estate taxation, it is important that we emphasize the need to avoid such burdens as to force the breaking up of private timber holdings. Specifically, the "carryover of basis" rule should be repealed.

Finally, we believe the President's proposal to extend the 10 percent investment tax credit to new classes of property should include capitalized reforestation costs, along with a seven year amortization of those expenditures.

These policies would more adequately recognize the existing need for heavy initial investment in reforestation as well as the long period required before the investor realizes a return on that investment.

With that introduction, we wish now to recount briefly the historical relationship between federal tax policy and private sector timber supply, the difficulties of attracting capital investment to timber growing, and the crisis that is certain to develop within the next 2 or 3 decades if those difficulties are not overcome. And, finally, we will address the specific proposals pending before your Committee as they relate to the timber producing sector of the economy.

FEDERAL TAX POLICY AND TIMBER SUPPLY

There is probably no more dramatic example of the direct relationship between tax policy and producer response than is clearly evident in the history of the timber economy throughout the 20th century.

It is common knowledge that the nation's timber resource was in a state of alarming decline during the period up to the early 1940's. For the most part, timber operations were conducted similar to mining or petroleum production . . . the emphasis was on extraction. There was a difference with timber, of course, and the difference was that the harvested timber resource could be regenerated—either by natural means or by careful management to accelerate the reforestation and growth processes. Unfortunately, the federal income tax policies then in effect weighed heavily against the latter.

Prior to 1944, timber was recognized as a qualified capital asset—along with land and improvements for farm or business use, commercial properties and equity interest in other enterprises—but only if the timber was liquidated by the owner in a lump-sum transaction. If, on the other hand, the owner chose to manage the resource on a sustained yield basis—if he replanted or managed it as an ongoing investment through selective or periodic harvests—the owner was denied capital gains treatment. Also, if the owner harvested timber for processing in his own plant, he was denied capital gains treatment.

These anomalies came about because of a ruling by federal tax authorities that such transactions indicated that the timber was not a capital asset but instead was being held primarily for sale to customers in the ordinary course of trade or business. In other words, sustained yield timber operations—which in some areas required up to 50 years or more to complete a marketing cycle—were viewed for tax purposes the same as a food crop planted in the Spring and harvested in the Fall or as inventory in a hardware store.

Thus, the tax laws of the time fostered a continuation of economically wasteful and counter-productive practices on private forestlands. In effect, they imposed a severe tax penalty on those who wished to manage their lands wisely. As a consequence, there was too much indiscriminate cutting; soil and watershed values were lost; vast acreages were abandoned for taxes because the owners could not afford to do anything with them; and far too much timberland was converted to marginal farm production—with sorrowful consequences for both the land and the operators.

1944 ACT OF CONGRESS

In 1944, Congress eliminated this major disincentive to sustained yield private forestry. By extending capital gains treatment of timber transactions to sales of managed timber and to the transfer of timber assets for manufacture in a mill operated by the timber owner, Congress declared it to be in the public interest to stimulate capital reinvestment and improved management of timberlands.

The response of timberland owners must have surprised even the most optimistic advocate of the tax reform. Up until 1944, the inventory of growing stock on private forestlands was declining by 7 billion cubic feet per year.[1] This trend was dramatically reversed immediately following Congress' action, demonstrating that landowners were philosophically committed to the proper management of their lands but had simply not been able to justify it economically. In the 33 years since adoption of what are now Sections 631(a) and 631(b) of the Internal Revenue Code, the nation's inventory of standing timber has increased by more than 175 billion cubic feet. Planting of seedlings—which was almost nonexistent prior to 1944—is now in the hundreds of millions each year. In some of the better managed lands, 5 or more seedlings are planted for each mature tree harvested.

In the years immediately preceding 1944, government and private experts were predicting a "timber famine" by the 1960's and 1970's. And, the predictions were based on what have since proven to be substantial underestimates of consumer demands for wood products. But, in spite of those unexpected demands, the timber growers of the country have not only kept pace with the needs of our economy, they have actually grown more each year than is harvested.

TIMBER SUPPLY AND DEMAND TO THE YEAR 2000 AND BEYOND

Now we face a new crisis. In its 1973 comprehensive report, "The Outlook for Timber in the United States", the U.S. Forest Service tells us where we are going in terms of what is currently known about consumer requirements and the state of the nation's timber resources. The study concludes that by the year 2000, the United States could experience a shortfall in timber production of over 20 billion board feet per year.[1] That amount of lumber would build 1,400,000 single-family

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[1] There are approximately 6 board feet per cubic foot.

homes each year. But, homebuilding is not the only sector which would be adversely affected by such a damaging shortage of timber. Over 5,000 consumer products are derived from our forests—commodities which are essential to education, communication, sanitation and health and many of which contribute in unique ways to the maintenance of the American standard of living.

Enlightened tax policies have made significant contributions in the past to the development of our renewable forest resources. But, now, more than ever, there is need to avoid tax changes which will make that development more difficult; and there is need to make substantial improvements if national objectives are to be achieved.

Just as an earlier timber famine was avoided by the adoption of wise public policies, current predictions of future shortages can also be thwarted. But, it will require foresight on the part of those responsible for enacting and implementing the nation's laws.

TIMBER IS A UNIQUE RESOURCE

Because timber is fully renewable, it differs from other basic raw materials which are finite in supply. A forest, in its natural state, is in a constant cycle of destruction and renewal. And, contrary to some popular misconceptions, man has yet to devise harvesting techniques which are as fast and "efficient" as those brought to bear by nature through fire, infestation or disease. But, regardless of how a forest is brought to the renewal stage—whether by man's harvesting or by natural means—the natural process of regeneration is too slow and too haphazard in most cases. Man's intervention through reseeding, planting, protection from pests and disease, and other practices can have enormous beneficial impact. Active management, while a young forest grows to maturity, can more than double the volumes of usable wood produced on a given acreage.

Since these facts have been amply demonstrated in recent years, it may well be asked, "Why doesn't every timber grower adopt these practices?"

The answer is two-fold.

1. DIFFICULTIES OF ATTRACTING CAPITAL

The renewability of forest resources and their potential abundance in this country are strengths enjoyed by few other nations. Yet the commitment of major amounts of capital over unusually long periods of time is required to develop, maintain and utilize that resource in the most efficient way. It has been reliably estimated that $16 billion or more is required for investment now and in the very near future if we are to meet projected market requirements in the year 2000 and beyond.

The principal deterrent to capital investment in forest productivity is the long period before investment in a forest can be recovered. In the West, the capital invested may lie in a dead account for 30 years only then to be amortized over the harvest cycle—a total of 50 years or more. In the South, capital is held in a dead account for 13 or more years only then to be amortized over the harvest cycle—a total of 25 years or more.

Coupled with the extraordinarily long investment cycle is the historically low rate of return on timber investments. Federal Trade Commission reports indicate the return on lumber, paper and allied products for the period 1966–1975 was 5.8 percent compared with a return of 6.5 percent for all durable and nondurable goods produced. University and government studies show comparable low rates of return on timberland in all regions of the country and in all categories of ownership. (These figures are shown in greater detail on page 5 of the attached material entitled "America's Renewable Resource".

The risks involved in timber management are unusually high. Compare, if you will, the situation of two landowners who suffer total destruction of standing timber by fire. One had left his land to natural regeneration and, therefore, his loss was limited to the delay in future income he could expect to receive. The other, however, had invested large sums in seedlings, mechanical site preparation, spraying, fertilizing, thinning and other practices. He had constructed roads and bridges to make it possible to conduct an intensive management program. He had employed the counsel of professional foresters and had expended a great deal of his own productive time in the development of the young timber resource. Consequently, he lost not only the anticipated income from the property but all of his capital investment and all of the money expended for non-capital costs. He collected no insurance because insurance is simply not obtainable to cover such a loss by a timber owner. And, current tax laws restrict the amount of his deduction for such a casualty loss to his original cost basis rather than the economic value

of his loss. Clearly, the owner who was doing the best job of managing his timberland would suffer the greater loss in such a catastrophe.

It has to be concluded, therefore, that the timber capital gains incentive has not been a windfall to timber growers. At best, the tax incentive can be said to have only partially offset the negative factors of an extraordinarily long investment cycle, ongoing carrying costs, high risks, and potentially slender economic return.

These are the handicaps which must be addressed by the Congress and by the Executive Branch if it is to be our national policy to properly anticipate and prepare for the timber supply needs of the United States by the year 2000 and beyond . . . because we cannot wait until the shortage is upon us to take remedial action. We will never find a way to grow a tree in that short a time.

2. CAPITAL GAINS EROSION—IN GENERAL

As stated earlier, the incentive impact of the capital gain tax rate is in direct proportion to the differential between capital gain and ordinary income tax rates. Traditionally individual capital gains have been taxed at one-half of ordinary rate with a maximum of 25%. The corporate capital gain rate was for many years, prior to 1969, a flat 25 percent.

Starting in 1964 and 1965 and continuing through the Tax Reform Act of 1976, the capital gains differential for corporations has been steadily eroded. And, starting with the Revenue Act of 1969, a similar erosion has occurred in the area of individual capital gain.

(a) *Individual incentives*

In 1969, the 25 percent alternative tax for individuals was eliminated on all but the first $50,000 of capital gain. This becomes a significant factor when applied to the typical, medium-sized timber growing operation. There are two valid reasons for this:

(1) there usually must be substantial income before there is even the possibility of an individual investing in timber and (2) the pattern of income (capital gain) from small and medium-sized timber ownerships is generally such that it will be "bunched" rather than being distributed evenly over the years. The combination of these factors makes it more likely that the individual's tax liability on timber income will exceed the traditional 25 percent maximum which had been in effect for many years.

Also in 1969, the so-called "minimum tax" was adopted. While its stated purpose was to put an end to tax avoidance through use of certain tax deductions, it has not had that effect. Many of those who paid no taxes on substantial incomes still pay no taxes. But, many who were already paying the full statutory rate on capital gain have had their tax liabilities increased through the minimum tax assessment. When first adopted, the minimum tax at least allowed the taxpayer to fully deduct "other taxes paid". Then, in 1976, this deduction was cut in half. The President's pending proposal would eliminate entirely the deduction for such taxes paid, stripping away completely the pretense that it is indeed a "minimum" tax and clearly making it an additional levy on income which has already been fully taxed under the law.

While the list of "tax preferences" subject to the minimum tax is extensive, in reality—according to Treasury Department studies—it boils down to being essentially an additional tax on cpaital gain. Over 80 percent of minimum tax collections from individuals is attributed to higher assessments on capital transactions.

The increasing tax burden on capital gains due to the minimum tax can be illustrated by the following table:

Maximum rate on individuals per $100 of long-term capital gains

(Includes effect of minimum tax on tax preferences only)

Pre-1969	25
1969 act	36.5
1976 act	39.875
Carter proposal	42.5

Thus, the effect of the Carter proposal is to raise maximum capital gains rates to a level 70 percent above pre-1969 levels. The increase is even more dramatic when you consider the effect of treating one-half of long-term capital gains as a prefernece for computing the maximum tax on earned income as well as the minimum tax on tax preferences.

Maximum rate on individuals per $100 of long-term capital gains

(Includes effect of both maximum tax on earned income and minimum tax on tax preferences)

Pre-1969	25
1969 act	45. 5
1976 act	49. 125
Carter proposal	52. 5

Thus, when both the minimum and maximum taxes are considered, the top rate on capital gains will exceed 50 percent. This would still be true even if the rate cuts in the President's Tax Program are considered. The effect of the Carter Proposal, therefore, with both the minimum and maximum taxes considered, is to increase the maximum tax on capital gains to a level 110% higher than pre-1969 levels.

Therefore, through the combination of restrictions on the use of the alternative tax, the imposition of higher taxes on capital gain by means of the minimum tax, and through changes in the maximum tax on earned income, many non-corporate timber growers have seen the capital gains incentive whittled down from what they had anticipated when they first made their investment and others have very likely been discouraged from making such investments because of the pattern of steadily decreasing benefits.

(*b*) *Corporation capital gain rate differential*

In the corporate capital gains structure, the detrimental erosion of the past several years in timber tax treatment is even more dramatic.

Prior to 1964, the differential in corporate capital gain was 27 percent, representing the difference between the statutory 52 percent corporate tax rate and the flat 25 percent capital gain rate. When the corporate tax rate was reduced to 48 percent, the differential was narrowed to 23 percent. In 1969, the corporate capital gain rate was increased to a flat 30 percent and corporate gain was also made subject to the minimum tax making the differential between ordinary income and capital gain 18 percent or less.

President Carter now proposes that the corporate rate for ordinary income be phased down to 44 percent but he has not asked for a reduction in the corporate capital gain rate. Without a corresponding change in the corporate capital gain rate, the differential, which is the essence of the incentive to make risk investments, would be only 14 percentage points—approximately one-half the pre-1964 capital gains incentive.

As stated earlier, we believe the President's proposed individual and corporate tax reductions will have beneficial impact on our economy. They will help stimulate general economic activity. However, if they are not balanced by proportional incentives for new capital investment, they will not accomplish their full intended effect.

The proposed changes in the investment tax credit, by making the 10 percent rate permanent and by extending its application to industrial buildings, will have a salutory effect on some segments of the economy. But, as presently constituted and as the President has proposed it be changed, the investment tax credit would not alleviate the critical need for greater capital investment in timber growing. We believe it is logical to bring about a better balance in its stimulus impact by extending it as well to the capitalized planting costs for timber.

It is apparent from this history of recent tax changes that the importance of capital investment to timber growing has not been fully recognized in the development of tax policy. The incentive that was enacted into law in 1944—and which served so superbly in the national interest—has gradually been made less effective until it is now inadequate to offset the unique problems of timber growing.

Therefore, we are urging that certain elements of President Carter's tax recommendations be rejected by the Congress, that the historic differential between capital gain and ordinary income taxes be restored and that additional incentives be provided to make possible the level of investment needed to keep America's renewable forest resources as productive as possible in our national interest.

RECOMMENDATIONS

The Forest Industries Committee on Timber Valuation and Taxation, after thorough consideration of President Carter's tax package, urges that the Congress make several changes which we believe are fully consistent with the President's intentions and with the acknowledged need to stimulate new investment in timber growing.

1. We recommend that the "minimum tax" concept be reevaluated to determine its impact as a disincentive for taxpayer investments or activities which have been determined by Congress to be socially or economically desirable. If the concept is to be retained, the formula should be revised to make it a true "minimum" tax rather than an additional tax on certain forms of income as at present. One way of accomplishing this would be to adopt the formula in the Ways and Means Committee tax reform draft of September, 1974. This proposal was an alternative tax on "economic income" rather than an added tax on preferences. If the existing formula is to be retained, we strongly urge that capital gain be deleted from the definition of "preference income". And, we strongly oppose the President's suggestion that the existing minimum tax be retained and made even more regressive by eliminating the provision for deducting a portion of "other taxes paid". Indeed, the deduction which was reduced last year to 50 percent should be fully restored if the present system is to remain in the law.

2. We recommend that the alternative tax on the first $50,000 of capital gain be retained. The revenue impact of eliminating the alternative tax is minimal yet, in our particular industry, there is considerable reliance on investment funds from individuals who would be affected by the change. We believe the potential benefits in terms of individual timber ownerships far outweigh any arguments we have heard for repeal.

3. We recommend that the corporate capital gain rate be reduced by 4 percentage points to maintain the present differential between the capital gain and the proposed ordinary corporate income rate. We believe a point-for-point reduction is fully justified until corporate capital gain is taxed at one-half of ordinary income.

4. Even with capital gains benefits fully restored to the pre-1969 level, economic studies indicate that the investment needs of the forest products sector will likely be met only if another major impediment to investment is eliminated from the tax laws. Cost recovery (depletion) on timber is now delayed until the timber is sold or harvested—which, as we have indicated, may be 50 or more years from the time of the investment in planting. For this reason, we recommend that the 10 percent investment tax credit be extended to capitalized forest regeneration expenses and that such expenses may be amortized over a seven year period.

The investment credit has been remarkably effective in increasing capital investment in various other sectors of the economy and we believe it also can be beneficial in stimulating productivity and creating new jobs in the timber growing sector. We recommend specifically that such costs as site preparation, planting, timber stand improvement and other activities related to forest productivity be treated the same as other job producing capital. The resulting increase in timber supply will benefit the nation in many respects, not the least of which is the future increase in tax revenue.

5. Although somewhat apart from the central theme of your current hearings, the issue of estate taxation—and particularly the implementation of the carryover basis provisions of the Tax Reform Act of 1976—warrant attention by the Congress. The overall effect of the carryover basis provisions on closely held businesses and farm operations have been well publicized. We point out that, in some respects, the impact on timber assets in an estate can be more severe than on other types of capital assets. Premature liquidation of timber assets will be the result in some instances and the locking-in of such assets after the death of the owner will likely result in other instances. The carryover basis provision results in a form of double taxation through payment of an inheritance tax on the market value of the timber at the time of inheritance and payment of a capital gains tax at the time the timber is sold based on the difference between the original cost and market value at the time of death. In no case can we see any compensating revenue or public interest benefits to offset the wrenching disruption that the new carryover provisions will bring to individual ownerships and to closely held timber owning companies.

CONCLUSION

Several times in recent years we have appeared before your Committee on various tax proposals giving you our views on how they would affect the timber growing business. Many of the points made in earlier testimony have not been repeated in this statement. Such factors as the environmental benefits of wood utilization compared to substitute products, the energy conserving characteristics of wood products processing and manufacture and the broadly based economic and employment patterns of our industry throughout every region of the country have been covered in detail in the past. There is, however, one significant factor that deserves repeating on this occasion.

33-578 O - 79 - 29

Other nations have moved far ahead of the United States in their recognition of the unique importance of timber resources in this era of resource decline. In those free market economies where forest taxation practices have been studied, there has been a universal acceptance of the concept that timber producing property is a uniquely valuable capital asset and that tax incentives are essential to overcome the inherent handicaps to investment and higher productivity. The trend in such countries as Great Britain, Norway, Sweden, Holland, West Germany, France, Finland, Switzerland, Brazil, Australia, New Zealand and Japan, in fact, in all free nations which have been studied, is not to reduce tax incentives for timber production but to broaden and improve them.

Existing conditions in the United States are discouraging sufficient investment in timber growing to meet tomorrow's needs. And, every year of delay in implementing more adequate policies means a year of delay somewhere into the future in realizing the tangible benefits in terms of needed wood supplies.

Therefore, we take this opportunity to urge a new and fresh look at the problems outlined in this statement. We hope that the information provided and the suggestions made will be helpful to the Committee in that process.

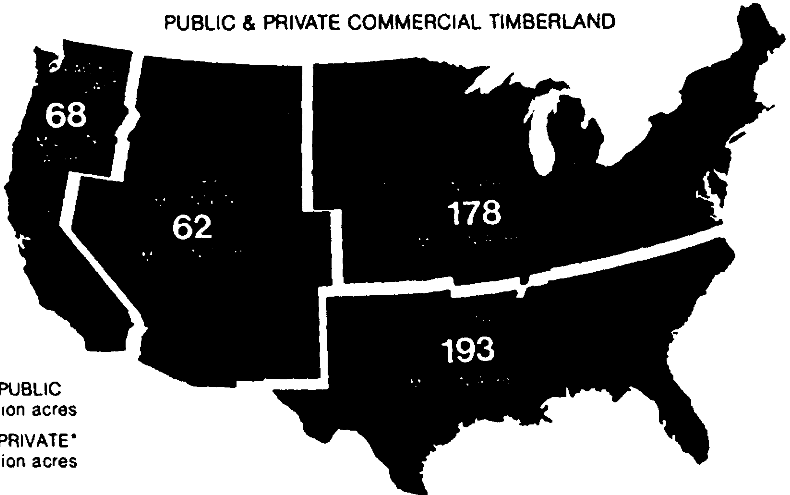
Thank you.

America's Renewable Resource

Seedlings take from 30 to 75 years to produce timber for lumber and plywood and 20 to 30 years for pulpwood. And with proper reinvestment in new planting after harvest and careful management during growth, the timber can be renewed.

The Congress long ago saw the need to clear a path for those with faith in the future and who could furnish the nation's timber needs. The statesmen of that time lightened the load of taxation on those who had the nerve and vision to invest in uncertain, but potential, long-range gains.

Those involved with our nation's forests must have an eye on tomorrow. If coming generations are to be served, planning must occur today. The effect expended now will be felt largely in the future.



* Details do not add to total due to rounding

For the forest owner, federal tax treatment for timber has had dramatic impact. Impressive gains in planting and productivity have flowed from fair tax treatment.

But of late, public policies and pronouncements too often have encouraged consumption over investment. Many of our current economic problems are rotted in this short-sighted view of how the public interest should be served.

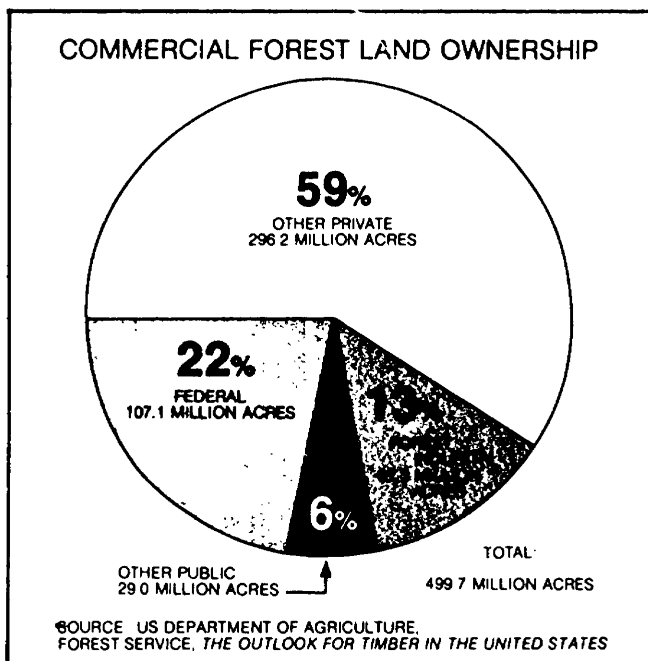
Today, more than ever, efforts to encourage capital investment and to reward risk are required. More than ever, tax incentives for forest owners are particularly necessary.

Otherwise, we face future scarcities with enormous social and economic consequences. Part of the reason for this lies in the widespread ownership of forest land and the myriad uses of its products.

Forest entrepreneurs—whether industrial or small private owner—are found in nearly every section of the nation. They are more than four million strong, and they own woodlands encompassing more than 70 percent of the forests that can be harvested commercially.

The future of these forest owners is linked to the future needs of all Americans who seek a decent home and whose children drink from a milk carton, swing a baseball bat or study a history book. For all, the forest is their source.

Understanding how the taxation of timber relates to the present and future supply of wood and wood fiber begins with an understanding of the distinctive characteristics of this vital natural resource.



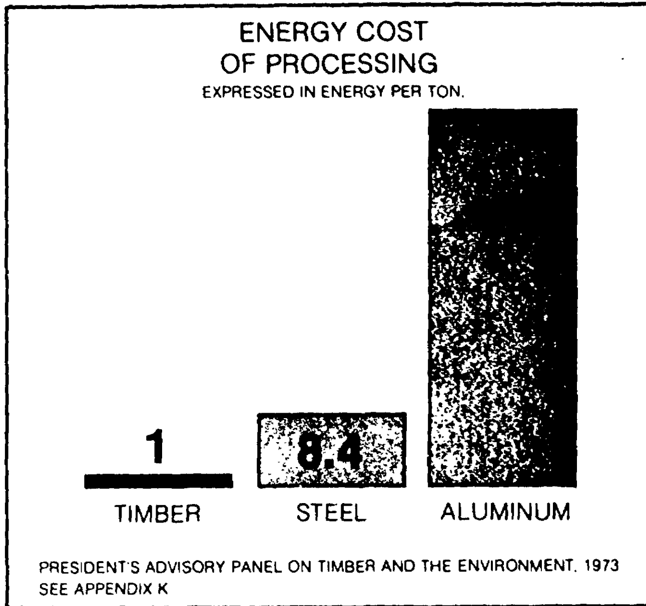
Approximately 4 million private individuals own 59% of those U.S. forest lands suitable for commercial timber production. Only 13% is owned by industries engaged in forest products manufacture. The remaining 28% is in public ownership.

Environmental Benefits of Wood

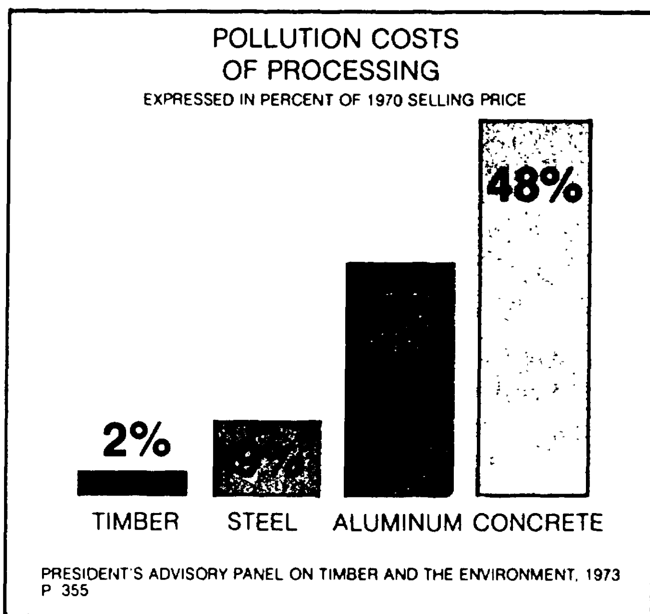
We are blessed with the fact that the forests, unlike other basic resources, are renewable. Wood fiber has served man well through the centuries and, if properly

managed, it can serve the rising demands of the future. In this era of anxieties over energy supplies and environmental quality, timber is seen as our most abundant, most versatile and most valuable material resource.

Steel, aluminum, and plastic have supplemented wood in some of its traditional uses. But the eventual supply of all substitutes is limited. Moreover, timber products are produced and processed with much lower energy requirements and with relatively little adverse environmental effect. Processing steel for construction, for instance, takes four times the energy of processing lumber for the same purpose. For aluminum, it takes 20 times the energy. The chart (below) shows the comparison in terms of energy per ton.



Production of wood substitutes also creates more air, water and solid waste pollution than does the production of wood. Much of wood fiber can be recycled. What is not is biodegradable and returns to the earth. The chart (on p. 449) compares the low pollution cost of timber with other substitutes.



Importantly, in these days of energy scarcity, growing trees consume only solar energy, an inexhaustible power source.

Demand for Timber is Increasing

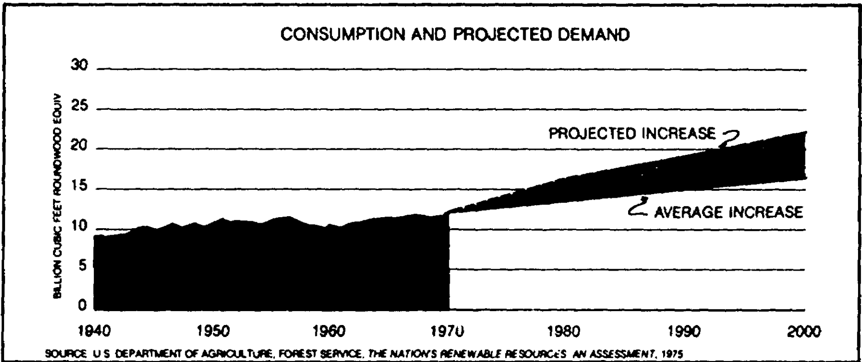
Authoritative studies of timber supply and demand and of the nation's housing needs for the years ahead make clear that our wood demand could double by the end of the century. Supply must increase 40 percent just during the 1970s to meet the national housing goal set by Congress: 26 million new and rehabilitated units.

Besides the major economic importance of wood and its multitude of products, the nation's forests offer watershed enhancement, habitat for wildlife and incomparable opportunities for recreation and scenic enjoyment.

Although the United States now enjoys an annual surplus of timber growth over what is harvested, during peaks in demand, products from some species are in short supply. Moreover, government studies indicate that, unless present levels of forest investment and management are increased to the levels now being practiced by the better industrial and government forest operations, consumer requirements for wood products and paper will, within 20 to 30 years, exceed total timber production.

We know how to replenish timber supplies faster and more efficiently through protective care and intensive forest management. But it is expensive, and it will require a much greater investment per acre than in the past.

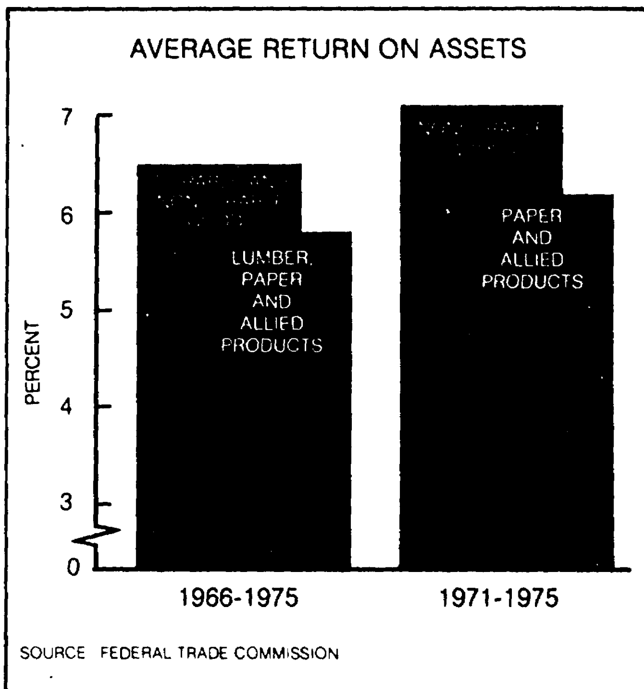
Other circumstances contribute to the problem of meeting the nation's future needs for timber. It takes many years to produce timber that is ready for harvest. This makes for a long investment cycle from seedling to mature tree. Because of this time factor, the nation's total timber supply cannot respond to short-term price rises. Harvesting can be accelerated temporarily to react to a peak in demand and price. But new supplies for the longer run can only be assured by increased planting and more intensive management. Thus we cannot rely on price fluctuations to assure long term supply.



Consumer demand for forest products has been rising over the past 30 years but is expected to increase even faster between now and the year 2000.

Return on Timber Is Low—Risk Is High

Historically, low rates of return on timber also have discouraged investments in timber growing. Return on investment has been far below the average of other industries. Federal Trade Commission reports indicate the return on lumber, paper and allied products for the period 1966–1975 was 5.8% compared with a return of 6.5% for all durable and nondurable goods produced. Using the last five year period through 1975, the average return on paper and allied products was 6.2% compared to a return for other nondurable goods of 7.1%. University and government studies show comparable low rates of return on timberland in all regions of the country and in all categories of ownership.



Return on timber investment is very volatile because of fluctuations in demand and price. In most years, return is below other comparable industries.

Unlike most assets, timber's value can be adversely affected by uninsurable risks—weather, insects, disease, and fire—during its decades of growth. For example, in 1976 forest fires destroyed 5,110,000 acres of forested area; and it was estimated that forest insects killed millions of trees and defoliated or infected millions of additional acres. In 1973 killing, defoliation and infestation by certain insects, although expressed in a variety of terms by the Forest Service, was estimated as follows: Douglas Fir tussock moth, one billion board feet; Mountain Pine beetle, four million trees; Western Spruce budworm, 3.5 million acres; Southern Pine beetle, 47 million acres; Gypsy moth, 1.8 million acres, and Spruce budworm, 2.5 million acres.

PREDICTED RATES OF RETURN
ON TIMBER INVESTMENTS
(AFTER TAXES)*

AREA	RATE OF RETURN
North Central and Eastern	1.0 - 4.2%
Southern	0.7 - 8.3%
Rocky Mountain	1.1 - 6.5%
Pacific Coast	
Redwood	1.1 - 3.6%
Douglas Fir	1.1 - 4.1%

**Measured on most suitable investment opportunities, including conversion to other species.*

SOURCE U S FOREST SERVICE
DIVISION OF FOREST ECONOMICS & MARKETING RESOURCES
NOVEMBER 19, 1973
Unpublished data as adjusted for federal taxes by staff of Forest Industries Committee on Timber Valuation and Taxation

Studies show low rates of return (in every region of the country and in virtually all timber species). The range of returns indicated reflects varying species climatic and site conditions. The studies demonstrate the marginal feasibility of long-term investments in forest planting and management.

It is significant that commercial insurance against fire, insect and disease losses is not available to timber owners.

Despite these disadvantages, the forest products sector requires a heavy capital investment.

Timber Taxes in Other Countries

Most industrialized countries of the world have encouraged risk-taking investors through preferential tax treatment. Special tax provisions to encourage investment in future timber crops and sound forest management have ranged from tax credits to special expense deductions to favorable treatment of gains from sales of capital

assets. Similarly, over 30 States in this country have enacted special rules recognizing that unless the long-term growing requirements of timber are taken into account it can be taxed out of production.

A Thought for Today . . . And Tomorrow

Forestry investment decisions being pondered today may have no tax or revenue effect in our lifetime because of the long timber growing cycle. However, if the decisions go the wrong way because the ultimate tax treatment compared with other investment opportunities is unfavorable, much has been lost. The economic loss resulting from a disruption of investment in forest management can never be recovered because time is an essential ingredient in the development of forest resources.

Fair Tax Treatment is Needed

There are other factors affecting our potential forest productivity. Urban expansion, rural homesites, highway and power line construction in forest areas all reduce the total acreage available for production of wood. Almost 10 million acres have been withdrawn from the national forests for the Wilderness System, and more has been proposed. Inadequate budgets for national forest management have further reduced the public sector share of the country's sawtimber harvest.

This puts more burden on the roughly 70 percent of the commercial forest lands under private ownership to supply the nation's needs. And how can the necessary level of private investment be assured? Fair tax treatment of timber income is a key element in this equation. If forest owners are sure that tax treatment will fully reflect the long-term, high-risk nature of their investments, more timber will be planted and produced. On the other hand, if timber investments are penalized in relation to other investment opportunities, the capital so greatly needed for forest management will flow elsewhere.

History of U.S. Timber Tax Policy

Soon after the U.S. Congress enacted a national income tax, the lawmakers realized that a distinction had to be made between ordinary income (wages, salaries, dividends, rent, profits) and the increase in value of long-term capital assets.

As in other countries dependent on private investment, our Congress recognized that to do otherwise would so restrict capital mobility that innovation, productivity and national growth would suffer. In 1921 a formula was adopted for taxing the gain realized when a capital asset is transferred. Although some countries have excluded such gain from taxes altogether, America at least softened the burden.

The theory behind this tax treatment was that if an investor left his money in an asset for a period of time specified by law, he was rewarded for the long-term risk taken and was allowed to keep a larger share of the growth in value he had helped to create than was a speculator dealing in short-term gambles.

Timber was eligible for the capital gains rate in those earlier years, but only when liquidated or disposed of in a lump-sum sale. Sustained yield timber management was not recognized for capital gains purposes. In other words, if you sold your timber gradually under a cutting agreement or cut it for processing in your own mill, your proceeds were taxed at ordinary income tax rates—generally twice the rate applying to other capital transactions. As a result the forest resource suffered.

But dramatic change came, at last, in 1944. That year Congress changed the law. Forest management for a continuous supply of timber would no longer be penalized.

How Timber Capital Gains Works

Timber is now treated similarly to other capital assets, whether sold outright, managed and sold under contract, or processed in the owner's plant. If the statutory holding period is satisfied, the difference between the cost and sales price or

the market value of the standing timber is the "capital gain" and is taxed at the long-term capital gain rate. Any added value subsequent to the harvest—from the sale of logs, the processing or marketing of forest products—is taxed at ordinary income rates.

Present tax law provides that the long-term capital gain of individuals is taxed at one-half the rate applicable to ordinary income. Thus, the effective capital gains tax rate for individuals varies from 7 to 35% on amounts in excess of $50,000. Since the top tax rate for individuals is 70 percent, the maximum effective rate on such gain in excess of $50,000 is 35 percent, subject to an additional "minimum tax" assessment. The top rate on the first $50,000 of capital gain is 25%.

The long-term capital gain rate for corporate taxpayers is 30 percent, compared with the generally applicable rate of 48 percent on ordinary corporate income, and again such gain is subject to a minimum tax assessment.

Also, other provisions of the federal tax laws applying to forest owners certainly are not lenient. Timber owners are restricted as to what they can deduct as operating expenses and what must instead be capitalized and recovered over a period of many years as the timber is cut. Likewise they are confined as to the kinds and amounts of casualty loss that are deductible for tax purposes.

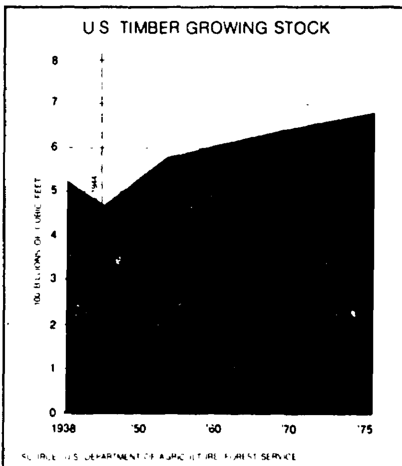
What Has Been Accomplished

Still in all, the most dramatic growth developments in the history of American private forestry followed the 1944 enactment of the timber capital gains provisions. If these tax rules had not been enacted the United States likely would already be suffering a severe crisis of wood supply. The more equitable tax treatment quickly brought both increased plantings and higher productivity on private forest lands.

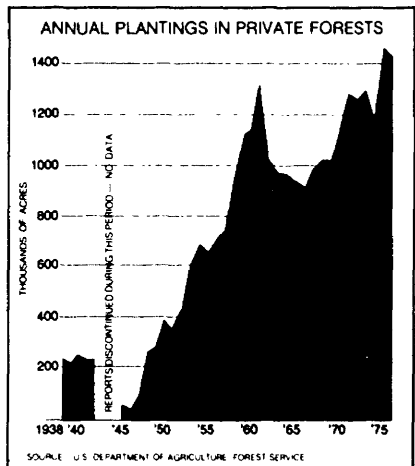
Before 1944, the United States had less timber at the end of every year than at the start. After the capital gains treatment become effective, that trend was reversed.

Over 26 million acres of private lands have been planted, compared to only 3 million acres in all previous years. Scientific forest management is now practiced in all regions of the country.

Industrial forest land ownerships have been the most responsive to the capital gains incentive. Those lands are now the most productive in the nation. Farm and other small ownerships have also shown considerable improvement.



Prior to 1944, the growing stock in United States forests declined at an average rate of 7 billion cubic feet per year. Since that time, the volume of growing wood fiber has increased until today it is approximately 175 billion cubic feet more than in 1944. This dramatic difference was made possible in large measure by the capital gains incentive for increased investments in reforestation and timber-stand improvement, as well as by increased government and industry cooperation in better forestry management.



The dramatic effect of anticipated capital gains treatment of proceeds from timber growing is illustrated by the number of acres of private land planted to trees since the tax incentive was enacted in 1944. In 1970, six acres were planted in trees for every one acre in the period preceding World War II.*

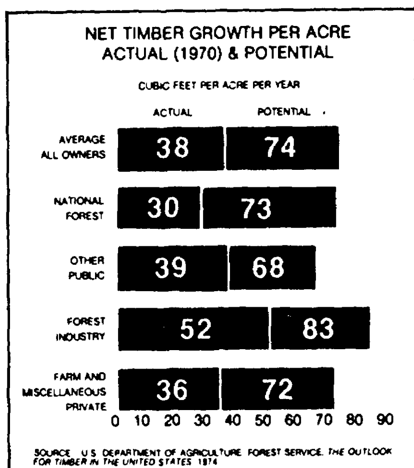
*Adjusted to exclude new plantings generated by the Soil Bank Program

Greater economic stability exists in forest areas now than in earlier periods when sustained forest management was not economically feasible. Employment is more dependable, local tax revenues have grown, and expanded investments in permanent manufacturing facilities have resulted. Small lumber manufacturers can be more competitive because they can utilize capital-conserving harvesting contracts instead of having to buy timber on a lump-sum basis.

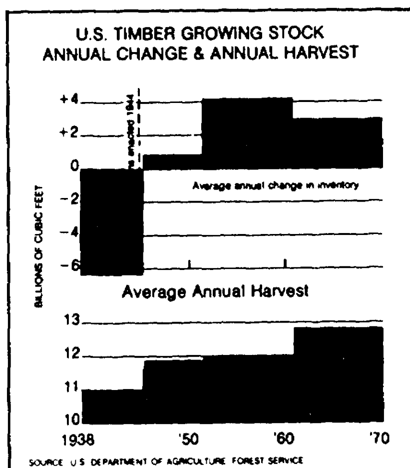
Communities, which in former days would have been hurt economically as timber was cut over, now can look forward to a continuing supply of raw material for local industries. Gone are the timber boom towns turned ghost towns.

With greater industry stability and investment in new technology and equipment, a higher percentage of each harvested tree is utilized in making consumer products.

Most important, the expanded forest resource made possible by the 1944 enactment of fairer timber tax laws is now available at a time when we have the greatest need for dependable raw material supplies.



There is potential for improvement among all sectors of forest ownership, but the highest rate of growth in cubic feet per acre has resulted from the high level of investment made by industrial owners in improved technology and intensive management.



It is only in the last 10 years, as a result of greatly increased requirements for wood products, that the average annual increase in growing stock has declined. Although we are still producing more than we are harvesting, the trend emphasizes the importance of continued investment in costly forest management practices.

Importance of Future Tax Policy

Congress several times has reviewed the justification for giving capital gains treatment for timber and has found it was achieving the objective of better forest management.

Recent trends in tax policy, however, are discouraging. Although many economists warned that capital shortages can be as damaging to our social needs as shortages of energy or raw materials, capital gains rates were increased in 1969 and have been kept at that higher level despite the need to lower them. Lower rates could stimulate needed capital formation. A so-called "minimum tax" on capital gains—which in reality is an additional tax on persons already paying tax—has also increased the effective capital gains rates.

Continued inclusion of long-term gain from harvested timber within the capital gains structure is essential. Restoring the lower rate, which was on the statute books before 1969, would help assure still greater supplies of wood.

Any proposed changes in the tax laws obviously should be carefully analyzed to determine the effects on our economic objectives, human needs, environmental improvements and our global role. This is especially true in the case of taxation of timber.

Eliminating or restricting capital gains treatment would inevitably produce severe shortages, sharp price rises, dependence on inadequate substitutes and higher imports. It would be a serious blow to our balance of payments.

The loss of the capital gains incentive could jar the economic well-being not only of companies and individuals but of many communities, It would make forestry uneconomical and impractical. And it would destroy the vigor, if not the existence, of the nation's forests on which we all must depend.

We must look to the future. And we must realize that a tree not planted represents potential timber growth that cannot be recovered.

It is within the power of men to assure in their lifetimes the continuation of adequate forests forever.

INGALLS & SNYDER,
New York, N.Y., July 10, 1978.

HON. CLIFFORD P. HANSEN,
U.S. Senate
HON. WILLIAM A. STEIGER,
U.S. House of Representatives,
Washington, D.C.

GENTLEMEN: This letter is in reply to the following testimony of Secretary of the Treasury W. Michael Blumenthal, before the Byrd subcommittee of the Senate Finance Committee, on June 28, 1978:

"Finally, I wish to say a word about the very loose international comparisons that have been made in the debate on this measure. Some proponents of S. 3065 have suggested that our economic performance—in areas of inflation, in employment, and growth—has fallen short of that of Germany and Japan because we tax capital gains while they, assertedly, do not. This line of argument ignores certain important facts. First, the United States has over the past few years outperformed most other industrialized countries, including Germany and Japan, in terms of real growth and increases in employment. Our inflation record is less satisfactory, but is nonetheless superior to several countries (e.g. Italy) having no capital gains tax. Second, Japan does in fact tax capital gains. As for Germany, it instead uses an even more comprehensive tax on annual increases in wealth, whether or not realized; I doubt that the proponents of S. 3065 would prefer the German system to ours. What all this shows is that making simplistic international comparisons on a tax-by-tax basis is a very treacherous business."

While Secretary Blumenthal did not specify to which international comparisons he was referring, the Ingalls & Snyder study entitled "The Diminishing Incentives to Invest", dated May 9, 1978, did contain a part, prepared by Price Waterhouse & Co., that outlined the main capital gains tax provisions for individual investors in ten major industrialized countries. Therefore, we should answer some of the points raised by the Treasury Secretary.

Our study does not indicate that Japan has no capital gains tax. Japan does have capital gains tax provisions, but very few individual investors are affected by them. This should be clear when one considers the following excerpt from page 34 of our study:

"Capital gains on portfolio investments (of individuals in Japan) are generally exempt from tax, with the following principal exception. If an individual makes more than 50 trades during the year comprising a total of more than 200,000 shares of stock, the individual will be taxed at ordinary rates on short-term capital gains (five year holding period) and on one-half of the long-term capital gains. The individual is also permitted a statutory deduction of about $1,700 in computing the capital gain which is taxed."

Unless a Japanese individual investor is extremely active in buying and selling securities (i.e. almost a professional trader) he is not subject to either long-term or short-term capital gains taxes.

In Germany, "long-term capital gains (six months holding period) on portfolio stock investments are exempt from taxation. Short-term capital gains are taxed at ordinary rates" (ibid, page 34). There is a net assets tax, however, which is imposed on individuals as well as companies and other institutions.

The net assets tax is an annual tax. Individuals are allowed liberal exemptions from it. There is an allowance of DM 70,000 for the taxpayer himself, an equal allowance of DM 70,000 for his spouse and one of DM 70,000 for each child under 18 years of age (and for each child between 18 and 27 years of age, if he is being educated and maintained mainly at the taxpayer's expense). A single taxpayer is also allowed a deduction of DM 10,000 from the value of investments, bank balances, etc. and a married couple is allowed a deduction of DM 20,000. Thus a family of four with an investment portfolio would have allowances totaling DM

300,000 (almost $150,000) that can be deducted before computing the net assets tax.

The annual rate of the net assets tax for individuals amounts to 0.7 percent of the assessable net assets. Because of the allowances the net assets tax is not applicable to the average German family. For the wealthy investor it is a factor but not a very significant one. When one considers that there are no taxes on long-term capital gains in Germany and that there are special credits for individuals aimed at alleviating the double taxation of dividends, we believe that very few German investors would be willing to exchange their investor tax provisions, plus the net assets tax, for ours.

The Price Waterhouse & Co. booklet "Doing Business in Germany" contains further information on the net assets tax which is somewhat complex in its application.

Making "international comparisons on a tax-by-tax basis" is not a simplistic approach to the problem of predicting one future impact of changes in tax laws. In effect, it is one of the few ways of making an educated guess about how U.S. taxpayers will behave, based on how people in industrial societies such as ours have responded to similar economic stimuli in the past. The outline we presented in our May 9th study was based on a considerable body of research and experience which all points to the same conclusion: our tax provisions for individual investors, particularly for larger investors, are confiscatory compared to those of other major industrialized countries. For example, much more extensive comparison of individual tax provisions in various countries, including tax provisions for investors, can be found in the Effects of Tax Policy on Capital Formation by Norman B. Ture and B. Kenneth Sanden, published by Financial Executives Research Foundation, in 1977, which was referred to in our text.

What has been the impact of the substantial increases in our capital gains tax rates since 1969 on our economic performance vis-a-vis other large countries, particularly those with no capital gains taxes? Obviously this is a complicated question. But the U.S. has the lowest saving rate among the major industrialized countries and our onerous tax provisions for individual investors must contribute to that unfavorable comparison. In turn, our capital investment in relation to Gross National Product is lower than for other major countries. Lagging capital investment aggravates a range of problems including our poor growth in productivity, our serious inflation and the difficulties experienced by many of our industries and companies when they compete in world markets.

Yours very truly,

OSCAR S. POLLOCK.

THE ECONOMIC WASTE IN CUTTING CAPITAL GAINS TAXES

(By Calvin H. Johnson, associate professor, Rutgers Law School, Newark)

S. 3065 would cut the maximum tax rate on capital gains to 25 percent. Under current law the tax rate on capital gains can be as high as 49.1 percent, though it rarely is.[1] The Carter administration has opposed the cut and its current tax reform proposals, without affecting the maximum rate, would increase the amount a high bracket taxpayer pays on his first capital gains.[2] Compromises the House Ways and Means Committee seems to be considering now would lower rather than increase current capital gains taxes.[3]

Because a cut in the highest rate of tax can benefit only taxpayers who would otherwise pay tax at that highest rate, the initial benefit of any cut in capital gains taxes can go only to the richest taxpayers in the country.[4] Proponents of

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[1] 35 percent of maximum arises because half of capital gains can be taxed like other income, which itself can be subject to 70 percent rates. The other 14.1 percent of the maximum arises because capital gains is a tax preference, which is subject to minimum tax (after the first $10,000) and which disqualifies a taxpayer in part from the benefits of the 50 percent ceiling on the rate for his salary and other service income. Most high bracket taxpayers have so many preferences that they have already lost the benefit of the ceiling, and for them the maximum rate is 39.1 percent.

[2] The Carter proposals would eliminate the alternative tax under which the first $50,000 of capital gains is subject to a maximum 25 percent rate if the general rule that only half of such gains are taxed would yield higher tax.

[3] Representative Jones, Democrat of Oklahoma, for instance, would cut the maximum rate to 35 percent by terminating capital gains' treatment as a tax preference. He would, however, also adopt the Carter proposal.

[4] S. 3065 cannot give any direct benefit to a married individual with less than $52,000 taxable income. According to the Treasury Bill Report on H.R. 12111, over 80 percent of benefits go to taxpayers with over $100,000 income.

S. 3065 and its House equivalent, H.R. 12111, however, argue as if the sciences of economics and econometrics prove that everyone including the government will ultimately be better off by enacting the cut, so that only envy or spite would deny the initial benefits to the rich. Proponents assert that the government revenue will increase if the Bill were enacted, in the short run, because past capital gains will be realized and, in the long run, because the increase in GNP to result from the cut will give higher revenue, even at the lower rates. The debate has seemed so far somewhat like a duel between Star War computer models generated by the new science of econometrics.[5] To too large an extent, the difficulty of econometric models has given them authority that they do not deserve. They are not verifiers. As one commentator has put it, "The data [for econometric models] were not powerful enough to test and to choose among theories. As a result, econometrics shifted from being a tool for testing theories to being a tool for exhibiting theories." [6]

A long and healthy tradition of economic analysis has launched such devastating criticisms of the preferential tax rate for capital gains under current law that the economic claims for S. 3065 should be viewed with considerable skepticism. The primary economic difficulty with any cut in capital gains tax is that its benefits go only to a "sale or exchange of a capital asset." Since the benefits don't go to investments in general, those investments that depend on returns that are not such sales would be hurt by the cut. Since a sale is a dissavings or the liquidation of an investment, rather than an increase in investment, most of the benefit of the cut goes to old capital and not to the formation of new capital. Since the benefits depend upon dissavings or liquidation, too much of the benefit is lost to immediate consumption. It is, in sum, a fallacy to equate capital gains with investment, or to equate a capital gains tax cut with efficient aid to investment.

INITIAL IMPACT

The failure to tie the benefits of a capital gains cut to reinvestment means first that there is an unnecessary dissipation of the costs to consumption. The initial $2 billion cost of the S. 3065 would increase by the same $2 billion the spending money of taxpayers who would otherwise pay more than 25 percent on their gains. Nothing in the bill requires that the $2 billion be put to good use. Significant amounts of that $2 billion will in fact be spent and represent resources consumed and destroyed for the benefit of those high bracket taxpayers. Before economic reactions are taken into account, the relationship between consumption, savings and government revenue is a zero sum game: any amounts consumed represent a dollar for dollar reduction either in the amounts available for investment or reducing government deficit.

Of course, consumption by high bracket taxpayers is not an evil; it can be expected to increase the welfare of the consumer and increase demand for goods and services, the production of which will generate jobs. However, giving consumption to the less well-to-do would meet more pressing needs and desires and have the same effect on the demand for production. Moreover, although there is no value-free way to prove it, I suspect most people would agree that a dollar spent by the government would also be a greater good; in any event, a dollar spent by a bureaucrat also has the same effect on demand as a dollar spent for consumption.

Proponents of S. 3065 assert, however, that the lure of added consumption will mean that a high bracket consumer will give back more to the economy than he withdraws. The purported returns can be divided, roughly by time, into two sorts: those associated with unlocking past capital gains and those with the formation of new and future capital. For both effects, however, there are fairer and more effective means to the end.

UNLOCKING PAST CAPITAL GAINS

The capital gains tax is among our more voluntary taxes. Any United States tax is avoidable by emigrating and renouncing citizenship, but within a large

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[5] See Bristol, Pitfalls in Using Econometric Models: The Chase and DRI Capital Gains Estimates, 6 TAX NOTES 531 (May 15, 1968); Evans, Capital Gains Taxes and Econometric Models, A Rebuttal to Ralph Bristol's May 15th Article, 6 TAX NOTES 593 (May 29, 1978); Eckstein, The Use of Econometric Models to Evaluate Capital Gains Changes, A Further Response to Ralph Bristol's May 15th Article, 6 TAX NOTES 611 (June 5, 1978); Bristol, Pitfalls in Equation Construction, 6 TAX NOTES 6[illegible] (June 5, 1978).

[6] Thurow, Economics 1977, 106 DAEDALUS No. 4 at 83 (Fall 1977).

range of reasonable behavior taxes must be paid. Thus, it is not rational to stop all purchases, to stop all work and to store one's savings in a mattress to avoid sales and income taxes. One's welfare is usually increased by purchases and income, even after taxes. Capital gains taxes, however, are paid only upon realization of gains and, so long as other income is adequate, realizing capital gains that have already accrued is postponable by the taxpayer by not selling the property. Because of the tax toll on realization there are cases in which a taxpayer will not move from a poorer to better investment where he should and absent the tax he would.

Not all lock-ins are bad: resources committed to the poorer investment may be contributing more than would be contributed by the consumption of the resources. Tax does not prevent all investment shifts. Shifts in which the private benefit exceeds the tax cost are readily made. However, there are clearly significant laudatory investment shifts that are avoided solely because of tax and the higher the tax the more that shifting is suppressed.

A fairer and more efficient way to reduce the lock-in effect is to move away from the voluntary character of payment somewhat and collect the capital gains tax at other than sale. Any revenue gain that arises from merely reducing the toll on realization of past gains is a short term gain only. For example, assume that a city were to allow past-due parking tickets to be paid 10¢ on the dollar. If so, the city might collect a lot of dimes very quickly. But the dimes arise only at the cost of forgiving past fines forever and a city that was trying to make money from its parking tickets would simply make more in the long run from $10 tickets than $1 tickets and improving its enforcement efforts. Similarly, with a cut in capital gains the taxpayers may rush to unlock past gains, but after the initial balloon, that does not mean that past gains will pay their share of the tax burden. Arithmetic says that if the rate is going to be cut in half, from roughly 50 percent to 25 percent, then the taxable amount must double to keep revenue from past gains constant. Since past gains are now fixed and they would be realized eventually anyway, it seems intuitively obvious that S. 3065 won't double realized past gains, especially since the comparison must be made with other means of increasing realization. Thus, a tax cut would mean a reduction in the tax burden past gains would bear. Like forgiving past parking tickets, forgiving tax on past capital gains has a cost.

Gains, including capital gains, represent wealth and consumable resources that should bear a fair portion of the given overall tax burden. It would be shocking to impose the tax that should be borne by the consumable wealth in capital gains on wages instead, merely because wages are less avoidable.

The most efficient recent proposal for unlocking capital gains is to tax unrealized appreciation at death: it would add no administrative chore to those already required for estate taxes and heirs could then sell immediately without any gain and without any toll on sale—not even a 25 percent one. Finding even other occasions besides sales to tax appreciation would further ease the lock-in problem. One should not confuse an improvement in the tax structure achieved by bringing items into the base with a tax raise or bigger government. Realization at death would not mean an increase in the tax burden on business or investment if the revenue gains were returned to investment.

FORMATION OF NEW CAPITAL

Anything said about past gains would apply with respect to future gains, except that proponents of the S. 3065 argue that the cut will substantially increase not just realization but the gains themselves. For the long term, proponents seem to rely less on the unlocking of gains than on the incentive that lower rates will give to new investment.[7] Even assuming the importance of good investment incentives, however, a cut in the capital gains tax is a wasteful incentive, and introduces independent inefficiencies into the economy.

Evans' statement is misleading, first, because it implies that purchasers of stock, as an aggregate, will get a 47.3 percent increase in their return: the 47 percent return increase is the maximum given only to the segment of stock purchasers at

[7] Michael Evans, who prepared the Chase Econometrics model, argues:

On a strictly theoretical basis a reduction in the maximum capital gains tax rate from 49.1 percent to 25 percent raises the after tax return of investors by 47.3 percent, for each pretax dollar of profits is now worth 75 cents instead of 50.9 cents. In view of this fact, we would expect the value of stock prices to climb even more than the [40 percent and $300 billion which Chase Econometrics estimated would occur]. Capital Gains and Ecomometric Models, 6 tax notes at 594 (May 29, 1978).

the top of the scale, most suppliers of equity capital would get no increases and his 47 percent is useless as an indication of how much aggregate demand for stock might be expected to increase. It is also an error to imply that the cut is a focused incentive for equity capital since two-thirds would go to investments, such as land speculation and timber, other than the supply of equity capital.

Finally, "Mr. [Evans] also states that the [after tax return of investors] would [increase] by 47.3 percent. Technically, this is [correct,] but it is misleading. The [maximum] tax would be reduced from [49.1 percent] to [25 percent], according to [Evans'] calculations. While this is [a 47.3 percent increase in after tax amount], it is only [24.1] percentage points, which is usually the way tax rate statistics are quoted." Evans, Letter to Rep. Steiger Commenting on Treasury Secretary Blumenthal's Opposition to Steiger Bill ¶6, Daily Exec. Rpt. No. 110 at J-14-15 (BNA June 6, 1978). (Brackets change the quoted material to make Evans' point apply to his own rather than to Blumenthal's use of statistics.)

The cut is wasteful, first, because it is mostly retroactive. For many years to come the benefit will go almost entirely to capital which has already been supplied. Subsidy theory tells us that one can count as a beneficial product of a subsidy only those things which would not otherwise be produced. Benefits received by those who have already undertaken the meritorious activity are windfalls to the recipient without reciprocal return for the cost. If the S. 3065 were a serious incentive program, it would cut out a large chunk of the windfall by making the cut apply only to investments planned and undertaken after the effective date of the amendment.

Moreover, a capital gains cut generates inefficiencies because it is not an incentive to investment in general, but rather is contingent only upon liquidation. Active entrepreneurs would much prefer any increase in returns to be given in the form of reduced tax on current and periodic income since they wouldn't have to wait until they sell out to get the benefit. Entrepreneurs liquidating their investments are often at the end of their productive period. Under the Tax Code, some industries, especially timber, are given the right to treat their periodic returns as if they were sales or exchanges so that liquidation is not always required. That, however, creates its own difficulties since it can be expected to create shifts, detrimental to market efficiencies, away from industries not so privilged and into things such as timber.

There would be other inefficiencies created as investments shift from non-favored to capital gains investments. The capital gains cut would work at cross purposes to one of the serious reform proposals in the area of capital formation, that of integration of the corporate tax. One of the major purposes of corporate integration is to reduce or eliminate the relative tax detriment of distributing dividends and the relative tax advantage of accumulating corporate earnings until a point when distributions can qualify as a sale or exchange. Reducing the relative burden on dividends by integration of the corporate tax would encourage distributions and more efficient use of capital. Cutting the capital gains tax, by contrast, would largely neutralize the benefits by weighting the tax balance once more in favor of corporate accumulations. This results in more uneconomic accumulations in which the corporation is using the money in less profitable ways than the shareholders would. With or without partial corporate integration, a decrease in capital gains tax locks corporate earnings into the corporation. Another wasteful byproduct of the cut would be the expense of the legal planning and litigation arising from increased pressure on the accumulated earnings penalty tax. Throughout the economy, in fact, increasing the differential between ordinary income and capital gains tax will increase both uneconomic shifts into tax favored investments or forms of return and expensive but wasteful tax planning to take advantage of the differential.

Shifts into capital gains investments will do damage to other investments, including those that Congress has tried to assist through the tax system. Thus, machinery with its 10% investment tax credit will look relatively less attractive as an investment than raw land eligible for capital gains. Rapid write-offs for pollution control devices and research and development will be less helpful if low tax capital gains are available as an alternative. The benefits to municipalities from the tax exemption for municipal bonds will decrease just as New York City, for one, goes into another crisis over financing.

The criticisms of preferential capital gains taxes are not attacks on investment incentives or capital formation. The government should certainly provide incentives for those investments which would not otherwise be undertaken but which will return their costs for the common good. Part of the difficulty, of course, is

that so little is known about the actual process of capital formation. Why, for instance, do the Japanese save such a higher proportion of their salary than Americans do? What makes people work hard for greater production that will give them only long deferred, if any, consumption? When in a democracy, can the government legitimately suppress consumption to favor investment? One thing that is clear is that the process of forming new capital (apart from the process of just shifting existing capital) must involve the entire country. Whatever incentives they receive, the highest bracket taxpayers do not have the new capital that would be needed. Moreover, the public cannot be a ward of a tax-favored few for its future investment and well-being.

Given the economic criticisms of the cut for capital gains tax, it seems as if someone has evaluated the benefits with rose colored glasses. The econometric models are presuming that capital gains cut is a focused and effective incentive and ignoring its cost. None of the criticisms of capital gains preferences are new. If anything, they represent, with possible variations of dialect, the establishment and consensus among academic tax lawyers and public finance economists. What is surprising is that, given the seriousness of the S. 3065, Congress seems to have forgotten or ignored the criticisms. Of course, any Congressman would like to be able to offer a benefit to any constituent, whether in one's district or not. Capital gains is a benefit with historical precedence, however bad. But, alas, not all benefits—and certainly not a capital gains tax cut—are compatible with broad perspective improvement of the tax system.

Statement of the Machinery and Allied Products Institute

The Machinery and Allied Products Institute appreciates having this opportunity to submit its views to the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance with respect to pending bills and recommendations to reduce the current federal income tax burden on capital gains.

As the national organization of manufacturers of capital goods and allied products, MAPI has a substantial direct interest in federal tax policies which impact on savings and investment. Our interest in having adequate and high levels of capital formation in this country—including national economic policies that are conducive to that objective—is one that we would hope the Congress and the Carter Administration would share.

THE RECENT DIALOG

The recent dialog sparked by proposals to cut federal income taxes on capital gains has been very revealing. On the one hand, there is the compelling logic of those who wish to turn the clock back to earlier times when the federal tax penality on savings was less severe. Both S. 3065 and its companion bill, H.R. 12111, are courageous admissions of past tax-policy error with respect to capital gains, and it is noteworthy that these bills to remedy matters have considerable bipartisan support. Other meritorious proposals to reduce the tax burden on capital also recognize that the direction of policy change vis-a-vis capital gains since the Tax Reform Act of 1969 has been 180° out of phase with national economic objectives.

Still the Carter Administration—with its professed worry about the lagging pace of investment in the United States—has no place in its program for lower taxes on capital gains and, in fact, would increase these taxes. Capital formation in its view is desirable, but not if it interferes with the Administration's objectives of more income redistribution, more income tax progressivity, and tax simplification.

WHY SOMETHING MUST BE DONE

In our opinion, appropriate tax treatment of capital gains and losses is essential to savings and investment, and liberalization is long overdue. Most observers would agree that the pace of investment in this country in recent years has slackened to unsatisfactory levels, in both absolute and relative terms. A contributing factor is that the rate of return on investment has been adversely affected over the last decade by increases in capital gains taxes. Notwithstanding the admonitions of the business community and investors, Congress and recent Ad-

ministrations have allowed the tax disincentives to savings to grow to a point where the diminishing prospects of after-tax rewards for investments scarcely justify taking any risks; where many existing investments having a gain—real or nominal—are locked in place because of the sizable tax-take associated with re-investment; and where it is increasingly more desirable to consume than to save.

SUMMARY OF MAPI POSITION

Clearly, something must be done to remedy this malady of under-investment. Without reference to any specific proposal before the subcommittee, we endorse in principle those recommendations that would ameliorate in a responsible way the unacceptable and confiscatory situation with respect to capital gains that now exists and that the current Administration seeks to worsen. To state our position briefly—

1. We do not believe that capital should be taxed.
2. Assuming that Congress favors some capital gains tax, we feel that such a tax should be substantially lower than the one on regular income.
3. Any tax on capital gains should apply only to real gains, not to illusory ones from inflation.
4. Any tax on capital gains should not be compounded by imposition of the minimum tax on so-callled tax preferences.
5. We believe that any tax on capital gains should be deferred in reinvestment situations.
6. As an alternative to Recommendation 5, above, the capital gains tax could be restructured on a sliding scale, with relatively higher rates for shorter holdings and lower rates reducing to zero for longer holdings.

PROCEDURAL POINTS

As to the parliamentary aspects of this, we believe that tax reform for capital gains should be taken up in the context of the current dialogue involving H.R. 12078, the Administration's tax cut—"tax reform" program. There has been altogether too much piecemealing in the formulation of tax policy recently, with major bills on social security, energy, and tax reform being considered almost in isolation and without attention to their cumulative impacts and interactions. Tax and economic policy should be fashioned in a coherent and coordinated way. Otherwise, business will be faced with intolerable and repressive uncertainty.

We believe further than capital gains tax revisions should not be viewed as alternatives to the investment tax credit changes proposed by President Carter. Nor should they displace either the proposed corporate rate reductions or any of those proposed tax cuts for individuals that are not redistributive in character. In this connection, we concede that the huge national debt and dangerous annual deficits must be taken into consideration in formulating tax policy.

Our more detailed comments on capital gains taxation are set forth below following a background note.

BACKGROUND

Capital gains always have been subject to the federal income tax, notwithstanding that many distinguished commentators have questioned the propriety of such a capital levy and have pointed out that capital gain is quite different from wages, dividends, and "income" generally.

Application of the income tax to capital gains seems to rest mainly on the idea—however myopic—that accretions of wealth in the form of capital gain should not escape taxes that would apply if such accretions were via wages instead. Also, it can be rationalized that capital gains, if realized, do have a taxpaying capacity. At the beginning of the federal income tax law, capital gains were taxed like ordinary income, probably because the differences between capital and income did not warrant special recognition while the applicable rates were low. However, since the Revenue Act of 1921, preferentially lower rates have been applied to capital gains.

BEFORE THE 1969 LEGISLATION

Although the taxation of capital gains underwent frequent changes in the early years, it settled into a pattern during the 1940s and remained there until the Tax Reform Act of 1969. The pattern consisted of taxing one-half of the capital gains on assets held more than six months as if they were ordinary income. However, the tax rate on such gains was limited to 25 percent.

In the late 1960s, certain tax revision activists set about to change all of this. They made much of the fact that some wealthy individuals pay no federal income taxes because they "exploit" tax preferences in the system—e.g., provisions for exclusions, exemptions, deductions, and low-taxed or untaxed income, sometimes preroyatively called "loopholes." This was portrayed as being unfair and an evasion of civil responsibility, although use of the preferences was responsive to Congress wish to lower tax disincentives to certain kinds of activity. Overall, the impression was given that the tax system favored the "idle rich," and that average working people were paying more than their fair share as a result.

THE TAX REFORM ACT OF 1969

Although the arguments for higher taxes on capital transcended reason and constituted a threat of sorts to the economy, they were politically potent. The Tax Reform Act of 1969 introduced the minimum tax on "preference" income, and the untaxed half of capital gains was listed as one of the preferences. The minimum tax was set at 10 percent of the taxpayer's preference income, reduced by a $30,000 exemption and the regular income tax liability (less allowable credits). Another change affecting capital gains restricted the 25 percent ceiling rate to the first $50,000 of gain, meaning that gain above that amount was to be taxed initially—i.e., before application of the minimum tax—at rates up to 35 percent. For corporations, the maximum rate on capital gains, not counting the minimum tax, was set at 30 percent.

THE TAX REFORM ACT OF 1976

In the Tax Reform Act of 1976, the taxes on capital gains were raised again. Among other things, the minimum tax rate was increased to 15 percent from 10 percent; the dollar exemption was scaled down from $30,000 to the greater of $10,000 or one-half of regular tax liability;[1] a carryover provision for unused regular taxes was repealed; and three more preferences were added to the 10 or so items alresdy covered. Also, the 1976 legislation lengthened the holding period for capital assets, and cut into the taxation of capital gains indirectly by providing that earned income qualifying for the 50 percent maximum tax on such income must be reduced dollar-for-dollar by the amount of capital gains excluded from regular taxation.

Although the focus of this discussion is on the taxation of capital gains, it should be noted that the minimum tax exerts a drag on capital formation with respect to all the items of "preference income" that are subjected to the levy. Also, this drag was substantially increased by the 1976 legislation, which moved strongly in the direction of having the tax become a straight add-on to regular tax liability instead of being a substitute tax as originally conceived.

THE CUMULATIVE EFFECTS

The cumulative effect of legislation since 1969 has been to boost the top federal income tax rate on capital gains for individuals from 25 percent to 49.125 percent.

The top rate is figured as follows: (1) the regular tax on half the gain is 35 percent—assuming an individual in the 70 percent tax bracket; (2) another 10 percent of regular tax is due to the fact that the preference income reduces earned income eligible for the 50 percent maximum tax, leaving it subject to the 70 percent maximum, a 20 percent difference which reduces to 10 percent in this computation because the adverse effect on earned income is felt only as to the excluded half of capital gains; and (3) another 4.125 percent results from applying the minimum tax at a 15 percent rate to the excluded half of capital gains (i.e., 50 percent) less one-half of regular taxes paid (i.e., less 22.5 percent, which is 45 percent—item (1) plus item (2)—divided by two).

Of course, relatively few persons are situated so as to be exposed to the full 49.125 percent federal income tax on capital gains. On the other hand, when one considers state and local taxes on the same gains in addition to the federal take, it is clear that the total burden can be very high. By any objective measurement, the taxes on capital gains have soared upward from the 25 percent federal income tax ceiling in existence before the 1969 legislation.

ADMINISTRATION PROPOSALS

Seemingly oblivious to the effects of this, the Carter Administration has seriously considered taxing all capital gains as if they were ordinary income. This dubious

[1] For corporations, the dollar exemption is the greater of $10,000 or the full amount of regular tax liability.

"tax reform", which remains an Administration objective but has not yet been formally proposed, would be pursued in the name of tax simplification and egalitarianism. Due to the outcry in opposition to any such change, the Administration apparently decided instead in its 1978 tax legislative program to chip away at capital gains a bit more before administering the coup d'etat. For one thing, the President proposed to eliminate the alternative tax which puts a 25 percent ceiling on the first $50,000 of capital gains. Secondly, he proposed to eliminate the deduction from preference income on one-half the taxpayer's regular liability before imposing the minimum tax.

In a comprehensive statement of March 6, 1978 to the House Committee on Ways and Means concerning the Administration's tax cut-"tax reform" proposals, MAPI expressed strong oppostion to these premeditated and ill-advised attacks on capital gains and investment generally.

OTHER LEGISLATIVE RECOMMENDATIONS

It is now apparent to many perceptive individuals that the direction of tax policy with respect to capital gains since the Tax Reform Act of 1969 has not been in the public interest. The companion bills (H.R. 12111 and S. 3065) of Congressman Steiger (R.-Wis.) and Senator Hansen (R.-Wyo.) would amend the Internal Revenue Code to provide for taxation of capital gains as it existed prior to the Tax Reform Act of 1969. A compromise tax cut-tax reform proposal developed by Congressman Jones (D.-Okla.) would, among other things, practically roll back the existing oppressive tax burden on capital gains by eliminating the untaxed half of such gains as a tax preference. However, this proposal also would eliminate the 25 percent alternative tax ceiling on the first $50,000 of capital gains.

Other recommendations for relief that have significant sponsorship either in Congress or among tax practitioners and scholars involve (1) the indexation of capital gains to deflate them to "real" gains before assessing taxes; (2) the use of sliding-scale rates to tax capital gains at relatively higher rates for shorter holdings and at relatively lower rates for longer holdings; (3) a rollover approach which assesses no tax on capital gains as long as funds are invested or reinvested, but does tax the gains when such amounts are removed from savings for consumption; and (4) no taxes on capital gains at all.

MORE DETAILED COMMENTS ON THE TAXATION OF CAPITAL GAINS

The remaining portion of this letter consists of our comments on (1) the capital formation situation; (2) inflation and the taxation of capital gains; (3) the case for lower capital gains taxes; (4) the arguments against relief; and (5) tax reform we favor for capital gains.

CAPITAL FORMATION—WHERE DO MATTERS STAND?

Whether one should tax capital gains or not, or do so at preferentially lower rates, there is little denying that the taxation of capital gains—euphemistically called the "taxation of capital income" by some persons—is the taxation of capital itself.

Inasmuch as capital is a factor of production and the rate of growth in fixed investment is acknowledged to have a direct bearing on our economic welfare, it is relevant in any discussion of taxes on capital to inquire where matters stand and where we want to be. Fortunately, we need not dwell at length on this subject because there appearss to be an almost universal recognition now that the U.S. rate of capital formation is inadequate and is impeding progress toward our economic goals. According to Treasury Secretary W. Michael Blumenthal—[3]

The facts are inescapable: We are not saving enough; our financial system is providing insufficient equity capital; we are not investing nearly enough in productive plant, equipment and technological innovation; profits are too low, and they are too uncertain.

Savings by households and businesses.—As indicated by the Treasury Department, American households have, for some time now been saving no more than 6 percent of their disposable income as compared to 10 percent in Canada; 14 percent in the United Kingdom; 15 percent in West Germany; 17 percent in France; and 25 percent in Japan. Meanwhile, the financial self-reliance of the U.S. business

[3] Remarks at the Annual Conference of the Financial Analysts Federation, Bal Harbour, Fla., May 8, 1978.

sector—which normally is responsible for a very significant proportion of total U.S. savings—has suffered a decline. Specifically, the flow of internal funds—once about equal to the fixed and variable capital expenditures of business—has fallen to about 80 percent of capital spending. As Treasury itself recognizes, we are not setting aside enough of today's income for tomorrow's growth.

The dissipation of equity capital.—In addition, as business turns more and more to the financial markets to fund its investment, the result is borrowing. As reflected in government statistics, the ratio of debt to equity for manufacturing companies has risen from about 25 percent in the early 1960s to 40 percent at the end of 1977. According to the New York Stock Exchange Census of Share Ownership, the individual-shareholder population has dropped from about 30.85 million persons in 1970 to 25.27 million in 1975, the last year in which the quinquennial census was performed. Also, whereas in 1969 1,703 companies raised new equity capital totalling $7.481 billion through public offerings, the number declined to 238 in 1977 and totalled $6.413 billion.[3] Obviously, the climate for risk investment has changed. Moreover, the drying up of equity capital has been particularly harmful to small firms and new ventures, and to technological innovation generally.

Fixed investment, real growth, and productivity.—With respect to real investment in plant, equipment, and productive processes, government statistics indicate that average non-resisential fixed investment in the United States for the period 1969–1974 was 13.5 percent of national output. In contrast, the average for the larger countries in the Organization for Economic Cooperation and Development (OECD) was 18 percent, including 20 percent for West Germany and 25 percent for Japan. These differentials in investment contributed to sharp differentials in average real growth over the period, such as 3.8 percent for the United States; 4.6 percent for West Germany; and 9.7 percent for Japan.

Similarly, a 1976 MAPI study of fixed investment and productivity growth in selected OECD countries found the United States, in the years 1960–1973, to have the lowest average annual percentage growth in real gross domestic product per civilian employee and in output per man-hour in manufacturing in a group consisting of the United States, Belgium, Canada, Denmark, France, Italy, Japan, The Netherlands, Sweden, Switzerland, the United Kingdom, and West Germany.[4] The MAPI study also found a remarkably close correlation between investment and productivity.

The Administration's investment objective.—Last year, our investment performance improved. Real investment in the United States grew about 8 percent and, for a change, exceeded that of most OECD countries. However, there is no certainty that we will continue at this pace, and the 8 percent level still is too low in any event.

The Administration estimates that real fixed investment must rise by about 10 percent per year in order to achieve President Carter's objectives for the economy generally and for employment in particular, and to prepare for the massive capital needs of the 1980s. In contrast, thus far in the 1970s, annual increases in real investment have averaged less than 2 percent. For another measure of the problem. Treasury states that productive capital per worker grew at about 3 percent per year in the 1960s, but has been virtually stagnant in the last five years. Not surprisingly, the growth in productivity per worker in the 1970s has fallen by about 25 percent.

Clearly, there is a good deal of catching up to do, not to mention a need for new investment at much higher average rates than have prevailed to date in the current decade.

The decline in real profits.—A careful study of lagging U.S. investment in the 1970s could fill volumes with relevant analysis. The central finding, however, would almost certainly have to be that real profits have become too low and uncertain as Treasury Secretary Blumenthal and others have acknowledged.

According to goverment figures, after-tax rates of return on capital have declined from around 8 percent in the mid-1960s to between 3 and 3.5 percent in recent years. Also, as a percent of corporate product, profits have declined from more than 11 percent in the mid-1960s to around 8 percent in recent years. For another measure of the decline, a study by George Terborgh, MAPI Economic Consultant, indicates that the adjusted after-tax profits of nonfinancial corporations in 1977 were only 70 percent of those in 1965. Even worse, adjusted retained earnings for 1977 were only 30 percent of the 1965 amount.[5] Also, Terborgh notes

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[3] Source: SEC Statistical Bulletin.

[4] "Fixed Investment and Productivity Growth in Major Industrial Countries, 1960–1973," MAPI Capital Goods Review No. 102, February 1976.

[5] "Inflation and Profits," by George Terborgh, MAPI economic consultant, MAPI Memorandum G–70, as revised and republished April 1978.

that the earnings coverage of net interest payments for nonfinancial corporations has declined from a multiple of 11.8 in 1965 to a multiple of 3.4 in the first quarter of 1977.[6]

Although the decline in corporate profitability can be laid to a number of factors, there is no question that government is prominent in the picture; that federal income tax policy has been one of the culprits; and that tax changes should be a part of the solution.

Capital gains taxes and underinvestment.—Any careful look at federal tax policy and U.S. underinvestment in the 1970s necessarily includes consideration of the taxation of capital gains. If we want to know why there no longer is much risk capital to be had, we might logically begin with a major levy affecting that capital. It is not the only factor in the equation, to be sure, but it is an important one. Inasmuch as the only reward possibly to be realized from a risk investment is an after-tax reward, any question concerning the feasibility of such an investment must deal with the tax impact. Also, it is perhaps no coincidence that the drying up of risk capital has been contemporaneous with the new tax increases imposed on capital gains since 1969.

Both intuition and evidence lead us to scrutinize the taxation of capital gains, and we can only conclude that the existing set-up is unsatisfactory. First of all, because of inflation, the federal government currently taxes phantom gains in huge amounts, thereby eroding capital itself before even getting to capital gain. Secondly, the effective rate of federal income taxes on real capital gains—not to mention that rate combined with taxes imposed on the same gains by other governments—has been raised to a point where the potential return on an investment must be fairly high to justify any risk at all, especially by middle- and upper-income individuals.

INFLATION AND THE TAXATION OF CAPITAL GAINS

On the inflation aspect of this, under the present system, the federal government collects billions of dollars every year on fictitious capital gains. Whether it is good public policy to tax "capital gains" or not, we should at least agree that it is totally unacceptable to tax away the original investment itself. That is precisely what is happening because the federal government now taxes nominal rather than real gains.

George Terborgh has spelled this out using a table—below—that traces the effect of a 25 percent tax on the unadjusted capital gains from 10 different transactions.[7] These involve the same asset, with the same cost, but different holding periods. Specifically, the asset is purchased for $1,000 in each of the years 1 to 10 and is sold in the year 11 at a price representing an appreciation of 10 percent a year. The general price index by which the historical cost is restated is also assumed to advance 10 percent a year.

NOMINAL AND REAL CAPITAL GAINS FROM THE SALE IN YEAR 11 OF AN ASSET PURCHASED FOR $1,000 IN EACH OF THE PRECEDING 10 YEARS

	Historical-cost calculation					Adjustment for inflation		
Year of purchase	Cost in dollars of the year of purchase (1)	Realization in year 11 (2)	Nominal gain before tax (2)−(1) (3)	Tax (at 25 percent) (4)	Nominal gain after tax (3)−(4) (5)	Cost restated in year 11 dollars (6)	Real gain before tax (2)−(6) (7)	Real gain after the tax on nominal gain (7)−(4) (8)
1	$1,000	$2,594	$1,594	$399	$1,195	$2,594	0	−$399
2	1,000	2,358	1,358	340	1,018	2,358	0	−340
3	1,000	2,144	1,144	286	858	2,144	0	−286
4	1,000	1,949	949	238	711	1,949	0	−238
5	1,000	1,772	772	193	579	1,772	0	−193
6	1,000	1,611	611	153	458	1,611	0	−153
7	1,000	1,464	464	117	347	1,464	0	−117
8	1,000	1,331	331	83	248	1,331	0	−83
9	1,000	1,210	210	53	157	1,210	0	−53
10	1,000	1,100	100	25	75	1,100	0	−25
11	1,000	1,000	0	0	0	1,000	0	0

[6] "Corporate Earning Power in the Seventies: A Disaster," by George Terborgh, MAPI economic consultant, MAPI, August 1977.
[7] "Inflation and the Taxation of Capital Gains," by George Terborgh, MAPI economic consultant, MAPI, March 1978.

The Terborgh study points out that the inflation adjustment converts nominal gains into real after-tax losses, and these losses measure the erosion of real capital by the tax. The case depicted in the table is a special one based on the assumption that the asset appreciation rate equals the inflation rate. However, Terborgh points out that as long as there is any inflation over the holding period, the real after-tax losses are larger (or the gains smaller) than their nominal counterparts.

Whether capital gains are proper or not, certainly it is reasonable to ask that any country that goes in for such taxation should see to it that the gains upon which it levies are real. We would add that Congress and the Carter Administration cannot credibly profess to be worried about underinvestment and, at the same time, allow capital erosion of this sort to continue.

Today, some 50 million homeowners are confronted with paying taxes, now or in the future, on phantom capital gains—increases in market values of their home induced by inflation. This appears to have been overlooked by the Administration although it is the circumstance which was largely responsible for an explosion of California taxpayers known as "Proposition 13."

THE REASONS FOR LOWER CAPITAL GAINS TAXES

Whereas the case for eliminating taxes on phantom gains is clear cut, reasonable minds apparently differ on whether and how to tax real gains. Historically, the compromise in our Internal Revenue Code has been to tax these gains at preferentially lower rates than ordinary income.

Inducing risk capital.—Risk-taking is at the heart of the case for a lower tax burden on capital gains. In that regard, we note with interest that Chairman Harold O. Williams of the Securities and Exchange Commission felt so strongly about the connection between capital gains taxes, risk-taking, and capital formation that he appeared and testified as an individual before the Subcommittee on June 28, 1978 in favor of proposals to lower the taxes on gains. On the matter of risks and rewards, he stated in part, as follows:

Let me restate the problem this way: Firms which must raise capital from the public to grow must be able to convince investors to put their funds at risk—not on the basis of the certainty of a periodic dividend payment—but on the assumption that, over time, the investor's opportunity for after-tax appreciation in the marketplace, typically from the sale of his investment, will compensate for the risk taken. If you view the marketplace today in terms of the interest rate on instruments like bonds which guarantee a fixed annual return—the level of yield available on a no-risk or very little risk basis—and contrast it to the after-capital gains tax and inflation return for risk-taking, the incentive for risk-taking is inadequate to encourage individual investors to make the equity investments in growth companies that we must encourage.

In our judgment, real capital gains should be taxed at the lowest rates politically acceptable so as to induce equity investment. It is elementary that people will not take risks in investing unless there is a probability of an after-tax reward in some amount sufficiently great to justify the risk of loss. If no taxes were involved, a risk investment could be made based solely on the merits of the investment itself. On the other hand, if the tax on gains were 100 percent, there presumably would be no reward to justify any risk and, hence, no investment would be made.

Obviously, the threshold for risk-taking rises as the taxes on gains rise. How much risk, one wonders, will a rational person take when the government is standing by ready to skim, say, 50 percent of the gain? Or 30 percent? The "deck" has increasingly been stacked against equity investment since the Tax Reform Act of 1969 as the federal government's take has risen from a top rate of 25 percent to one of 49.125 percent. To aggravate matters, inflation has increased so as to worsen the tax on illusory gain, thereby confiscating captial itself. As we already have noted, individual investors have been abandoning the stock market, and new issues of common stock are seen much less frequently now than in the past.

To worsen matters, Congress has done little to alleviate the spiraling federal income tax burden on ordinary income. As inflation has ratcheted people upward into progressively higher tax brackets, even when they have had no real gains in income, the only response has been ad hoc tax cuts deliberately skewed to the lower incomes. Notwithstanding expert testimony to the contrary, prior to the current reassessment of the tax issues involved, Congress seems to have adopted the view that only the poor are affected by inflation and rising taxes. With government as everyone's "silent partner" taking a high percentage of every dollar of income and capital gains, including chunks of capital itself, it is no wonder that we are becoming a consumption society.

It is remarkable to us that there is so much hand-wringing by government about underinvestment under circumstances such as these where the existing tax system is perverse and much of the new legislation in recent years has been punitive with respect to savings. Although cutting taxes on capital gains alone is no panacea, it would be a major step in the right direction to inducing risk investment. In our opinion, those who carry the banner for this tax reform deserve commendation, and those who oppose it should be held to task for the consequences.

The "bunching" problem and fairness.—One of the basic reasons for having a preferentially lower tax on capital gains is simply fairness to the taxpayer. When an asset has been held for several years and has gained in value, it would be unfair to tax the gain at ordinary income rates upon realization. The difficulty is that, under a progressive rate structure, the realization of gain accumulated over several years can thrust the taxpayer upward into a higher bracker than would have been the case had the gain been taxed as it accrued. This is not to argue for taxation of unrealized gains and losses as they accrue, because that would be absolutely unmanageable. However, the bunching problem does support the case for special treatment of capital gains.

We should mention in that connection that income averaging is not an answer to the bunching problem beacuse it is complicated and would have a lock-in effect with respect to investment. Even more basically objectionable is the fact that capital gains, under averaging, still would be subject to tax at high ordinary-income rates that would discourage risk investment.

In considering the dampening effect of high taxes on investment, it should be remembered that investments normally are made solely on the basis of anticipated monetary returns. Unlike personal services, investments usually do not have anything to offer in the way of non-pecuniary reward (e.g., self-accomplishment, self-aggrandizement, pride of workmanship, etc.).

Reducing the lock-in effect.—Not the least important consideration in the taxation of capital gains is the lock-in effect of high rates. As anyone who presently has a large gain can attest, it is not easy to disinvest or change position because the taxing authorities are waiting in the wings to claim their "share". Consider the individual who invested $10,000 ten years ago in ABC Corporation and had it rise to $20,000 today. If he would like to sell that investment and buy XYZ Corporation in its place, he is faced with the following: (1) assuming a capital gains rate of 25 percent, government will take $2,500 of the proceeds, so the choice is between keeping $20,000 of ABC Corporation or reinvesting and acquiring $17,500 of XYZ Corporation; and (2) inasmuch as the real value of the $10,000 investment now is $11,186;[8] the effective rate of tax on the real gain is 210.8 percent.

It is clear from this example that there is a lock-in effect and that it can be substantial. The tax burden on capital gains not only interferes with the fluidity of investment capital; it also reduces the rate of realizations, thereby curtailing capital gains revenues to government. Obviously, a lowering of taxes on capital gains would help the situation.

U.S.-foreign comparisons.—We do not wish to rely on the argument that this country should do everything that its neighbors do. However, it is of critical importance to domestic and foreign investment that we not deviate substantially from the mainstream unless government is willing to make accommodations for the disruptions which may occur. The current Administration, in our opinion, has been poorly advised on this point in proposing punitive and atypical taxes for U.S. citizens working abroad; for companies with unremitted foreign subsidiary earnings; and for capital gains. We have heard this rationalized as "leadership" in international tax-policy affairs by those who advocate such change. If this is leadership, then it is leadership without a following and to the great detriment of American citizens.

In respect of capital gains, other nations with lower capital gains taxes or nore at all include Australia, Belgium, Canada, France, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and West Germany. As all can see, there still are many nations of the world with tax systems that strive to minimize the tax deterrents to savings and investment. We would do well to follow suit.

THE ARGUMENTS AGAINST RELIEF

There is an opposite school of thought from ours which contends that capital gains should be taxed as ordinary income, although in fact it is no such thing. In

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[8] Based on the Gross National Product Implicit Price Deflator at 141.29 for 1977 and 79.02 for 1967.

defense of this proposition, it is argued that we should (1) have steeper progressivity of tax rates; (2) have more income redistribution from the "rich" to the "poor"; (3) eliminate the capital gains preference to simplify taxation: (4) keep the federal revenues flowing in at ever-higher levels; and (5) have all accretions of wealth be taxed the same way.

Progressivity.—It is true that capital gains tax relief would lessen the progressivity of the system somewhat. However, the existing structure has become much too progressive for most taxpayers due partly to higher taxes because of inflation, congressional inaction on such taxes, and various revisions to the Code starting with the 1969 legislation. The progressivity changes have been severe in the middle-and upper-middle income brackets. In our opinion, Congress should not fashion tax policies solely by reference to their impacts on the top five percent of the income population. More specifically, Congress should not make decisions adverse to capital just because a handful of wealthy individuals would derive some relief.

We find the progressivity arguments to be very short-sighted, and feel that Congress might better look not to who derives the tax relief but to who benefits from the investment induced by the change. Reducing the tax disincentives to investment will create jobs and help to control inflation, either one of which should be higher on anyone's list of priorities than more tax progressivity. As to those Congressmen who think the Code has not become too progressive, we think they would do well to begin talking to their middle-income, including upper-middle income, constituents.

Income redistribution.—The attack on capital gains is in large part an attack on wealth disparity because ownership of capital is believed to be concentrated in the hands of the few. Actually, capital gains derive from many kinds of assets so the "rich" alone are not involved. Also, the benefits of capital (e.g., jobs) are rather well diffused through the economy. Whether income is suitably distributed among the citizenry is a very subjective matter. Also, whether the tax system and federal spending should constantly be adjusted to achieve some optimum distribution is another question all its own, and one that raises doubts in a market economy.

We need not become engaged in this debate beyond noting that taxes do affect income distribution, and that too much income is being siphoned away from the middle- and upper-middle income brackets. Wherever the immediate benefits of capital gains tax cuts would fall, we believe that they ultimately would serve the economy well. Moreover, we are not concerned that they might take a few more wealthy taxpayers off the tax rolls. Some of these individuals now are tax-free because of foreign tax credits, investment tax credits, and tax-exempt investment. We support those tax provisions as well as lower capital gains taxes because they benefit the economy and that is the overriding consideration.

On a related point, inasmuch as there seems to be some presumption, and careless and emotional assertions even by persons in high office, that only the rich benefit directly from tax concessions to capital gains and dividends, we would like to point out some figures to the contrary. According to data compiled by the Internal Revenue Service, the total net capital gains reported on all returns by individuals in 1976 was $19,868,817,000.[9] Of this amount, 61.96 percent was reported on returns having an adjusted gross income of less than $50,000, and 46 percent was reported on returns of less than $30,000. Dividends reported for the same year in the IRS publication showed a similar pattern. Of the $24,451,749,000 total, 53.59 percent was reported in returns of under $50,000, and 37.55 percent was reported in returns of less than $30,000.

Finally on income distribution, Congress should not consider tax burdens in isolation. When one factors in the distribution of income and other benefits from government welfare and other transfer programs, it becomes clear that this country is not only keeping the tax collector away from the poor and disadvantaged, but also is delivering fairly well on income and services to the same group.

Tax simplification.—If there is one objective of tax policy that is shopworn and frequently misapplied but maintains some popular appeal, it is tax simplification. Clearly, taxation would be simpler without a "preference" for capital gains. It also would be simpler without deductions, credits, exclusions, and all the other "irregularities" that exist in the name of equity or fairness but complicate compliance. We take no issue with bona fide simplification as an objective of tax

[9] See "Statistics of Income, Preliminary 1976, Individual Income Tax Returns," Department of the Treasury, Internal Revenue Service, Publication 198(4-78).

policy, but it is not the kind of thing that should be elevated too far. In order to have fair taxation, including concessions to "capital income" which induce investment or at least do not deter it, we are entirely willing to have some complexity.

Alongside employment and inflation control, both of which respond favorably to increased investment, simplification is relatively low on our list of "priorities" for tax policy, at least at this time.

Revenue cost.—The recent discussions about capital gains tax rollbacks has been dominated by assertions and counter-assertions about the cost to government of the rollback proposals. Those in favor of lower capital gains taxes contend that their proposals would pay for themselves and deliver additional revenues as well. In this plausible scenario, the capital gains tax cuts lead to a more buoyant market for capital, including common stock, because the tax disincentives to savings and investment are reduced. Improved market conditions then lead to more realization of gains and assorted other benefits which translate into better collections for the Treasury Department.

Critics of the capital gains proposals disagree that there would be favorable revenue impacts. They note, accurarely, that econometric simulations are no better than the assumptions built into them. In this case, the skeptics are incredulous that capital markets would respond favorably to tax cuts for capital gains, although intuition and everyday experience suggest that activity will increase when disincentives to that activity are removed. To support their view that these tax cuts would involve intolerable cost, the critics then roll out their own econometric model featuring "static" analysis.[10] Although the economy is dynamic rather than static, the model in question measures inflow or outgo as if nothing changed but the tax provision under analysis.

We do not intend to join in this debate with the econometric modelers beyond noting that common sense and some historical experience is on the side of those who contend for tax cuts once taxes have reached repressive levels. Although we can do no more than speculate about this, we believe that the revenue cost of a complete rollback of capital gains taxes to pre-1970 levels would be nil and that such a change might be a gainer as its proponents have contended.

Egalitarian principles.—Values come into play everywhere in the capital gains debate, but nowhere so much as in the rhetoric about taxing every dollar of income the same way and being sure that all persons with identical income are taxed the same amount (i.e., horizontal equity). Both positions are unacceptable to us in this context because they derive from the premise that capital gains are "income." If capital gains are not income, or if they are different from other income such as wages, then the contentions about taxing all "income" the same way are inapposite.

Capital gains, as we already have mentioned, are capital even though they can be liquidated and spent. As students of tax policy have always been taught—by analogy—the vegetation represented by the growth in an apple tree (i.e., capital gains) is quite different from the fruit (i.e., income) yielded by the tree. It may be quite all right to pick the fruit (i.e., tax the income), but sawing off the limbs (i.e., taxing the capital or capital gain) is something else again. Until recently, our federal tax policy on capital gains has tolerated some pruning of the tree—to extend the analogy. Now, though, things have gotten out of hand.

Fruit trees aside, the fact that capital gains differ from income accords with most individuals' perceptions of the matter. People will spend wages, dividends, or interest payments for everyday needs, but they usually do not dip into the savings account or sell land or stock—however much the unrealized gain—for these purposes short of special circumstances. We are struck by the disingenuousness of those who, contrary to their own personal behavior in this respect, insist on characterizing capital gains as income when, in fact , they too know it to be something different.

It is one thing to say that we should tax capital gains in some small amount because they happen to have a taxpaying capability when realized and the revenue is needed for some purpose; it is quite another matter to make these gains out as being something they are not in order to levy on them at full regular income rates.

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[10] For example, Secretary Blumenthal, relying upon such analysis, declared without qualification in his testimony before this subcommittee that the proposed reduction of capital gains rates would reduce revenues by $2 billion.

TAX REFORM FOR CAPITAL GAINS

We concur in the view that taxes on capital gains have been raised too high, and that the campaign to tax these gains like ordinary income must be derailed for all reasons heretofore given.

Although we have very strong views about the impropriety of taxing capital, we do not wish to seem doctrinaire in proposing remedial measures. The central idea we espouse is that the tax burden on capital must be lowered. Of cours, this can be done any number of ways, including adjustments to capital gains taxes; the investment tax credit; depreciation; integration of the taxes on distributed corporate income; lower individual and corporate tax rates; etc. Capital gains taxes are the central issue at this time because they are high by past experience; they are directly connected with savings and investment which are low now by most measures; and the United States has strayed away from international norms in this area of taxation.

Real gains.—For amendments to the tax on capital gains, we favor ending the tax on nominal gains as the first reform, at least in terms of a logical progression of reform. It stands to reason that if the United States is to continue to tax capital gains, then the tax should be applied to real gains rather than phantom ones. Deflating the gain to real terms is the first step, and failure to take it will continue the current confiscation of capital.

If indexation of the gain is too complex for Congress to consider now, then this step can be delayed to a later date. For example, a simple rollback to pre-1970 capital gains taxation would not entail indexation and could be implemented first if necessary. However, government's work in reforming the taxation of capital gains will not be done until a way has been found to restate these amounts to real terms.

Tax rates.—We feel that, as a relatively modest proposal, 25 percent is about as high as the rate on capital gains should go, and that the excluded half of capital gains should be eliminated as a tax preference. Regarding the tax rate, it is clear that a zero rate would impose no impediment to savings and investment and that a 100 percent rate would be prohibitive. We know that some point is reached between zero and 100 percent where the rate of return on an investment, as diminished by the federal tax, is just marginal vis-a-vis other uses (e.g., consumption) to which accumulated wealth might be put. There is no way to determine scientifically what this marginal or ceiling rate is. However, 25 percent was the limit before 1970, and we know what has happened to risk capital since Congress began tightening the screws.

The preference item.—Our complaint about the minimum tax and the bad policy reflected therein is a long-standing one, and has been fully articulated by MAPI on the public record.[11] Rather than restate the indictment, a copy of the same is attached.[12] As already indicated, some 14.125 percent of the increased tax burden on capital gains at the maximum rate since the tax Reform Act of 1969 is due to the inclusion of the excluded half of capital gains as a preference items subject to the minumum tax. Eliminating this preference item would be a step in the right direction for capital gains tax reform. Eliminating the minumum tax itself would be a cause for celebration, expunging from the federal income tax system perhaps the poorest, most misrepresented, and least well understood instrument of tax policy enacted in recent years.[13]

A rollover provision.—A final step in renovating capital gains taxation would be to establish a deferral of tax on realized gains provided that they are reinvested within a stated period of time. The highly respected tax scholar, Dan Throop Smith, has long advocated this concept. In discussing the lock-in effect of current taxation earlier, we gave illustrations of the capital erosion that occurs in reinvestment situations. The lock-in effect impairs the liquidity of capital markets and reduces the level of capital gains realizations, interfering with investment flow, capital allocation, and revenues as well. A rollover provision, such as applies in the case of a taxpayer's primary residence, would be beneficial to capital formation, in our opinion. Also, it would finally recognize in the tax law that capital gains are capital, and would not tax them until realized and consumed.

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[11] For a bill of particulars, see "The Minimum Tax on Tax Preferences—The Back-Door Route to Federal Tax Increases," MAPI, March 1977.

[12] We would appreciate this study being accepted for the record in the discretion of the subcommittee.

[13] For another statement in opposition to the minimum tax, see the testimony of Professor Boris I. Bittker, Yale University Law School, to the House Committee on Ways and Means, June 23, 1975.

Sliding-scale rates.—In the event that a rollover provision might present problems in administration and compliance, consideration could be given to the use of sliding-scale tax rates for capital gains. The same recordkeeping as now applies to capital assets would continue under this new regime. Only the rates would be adjusted, to tax short holdings at relatively higher rates and longer holdings at lower rates, preferably down to zero after some designated period of time. Of all the new ideas that could be pursued in reforming capital gains taxation, this is one of the simplest and most easily understood.

Other current proposals.—In making a case for improvements in capital gains taxation, we do not wish to be considered in opposition to certain other proposals now being studied in favor of savings and investment. More specifically, we think that the Carter Administration's investment tax credit and corporate rate reduction proposals are meritorious, as would be various tax cuts for individuals if they were not redistributive of income. Within budgetary constraints, capital gains reform should not sidetrack or displace these other tax changes having a similar purpose, because tax relief for capital is a priority matter and substantial relief is in order.

On another point, we believe that all capital gains proposals should be considered in the context of the existing tax legislative program of the Administration. As previously stated, we are of the view that there has been too much piecemeal consideration of tax policy in the 95th Congress, and failure of coordination need not happen as to the capital gains proposals as well.

It is a pleasure to be able to present our thoughts on capital gains taxation to the Subcommittee on Taxation and Debt Management of the Senate Finance Committee. If we can be of further assistance, please do not hesitate to call on us.

THE MINIMUM TAX ON TAX PREFERENCES—THE BACK-DOOR ROUTE TO FEDERAL TAX INCREASES

INTRODUCTION

Notwithstanding the passions aroused by taxation, the Internal Revenue Code (hereinafter, the "Code") has proven itself over the years to be one of the more successful systems of voluntary self-assessment yet devised by a democratic government. This record is all the more remarkable when it is considered that the Code has been relied upon to finance government; attempt to provide cyclical economic stabilization; regulate economic growth; reward, encourage, deter and/or punish various specific activities; balance international payments; and achieve a host of social objectives, including the redistribution of income. Because the tax laws are put to such a variety of uses and because they directly influence the allocation of scarce resources through greater or lesser interference with private initiative, it is not surprising that the Code is both complicated and controversial.

One fairly recent manifestation of the public concern with the complexity and fairness of the Code is a new form of tax, the minimum tax on so-called "tax preferences." As more fully described below, this tax was first enacted in the Tax Reform Act of 1969 [1] and then substantially enlarged by the Tax Reform Act of 1976.[2] One purpose of the minimum tax was, and is, to ensure that all taxpayers pay their "fair share" of the costs of government through curtailing the benefits obtainable from "excessive" use of tax preferences, sometimes described as tax loopholes. This purpose is, to an extent, achieved by the minimum tax. However, there is a costly trade-off in that the tax undercuts certain laws (i.e., the tax preferences) earlier approved by Congress to reduce federal income tax disincentives—or, alternatively, to provide incentives—to activities and investments believed to be in the public interest. Moreover, in imposing this new burden on capital formation and increasing the bias in our tax system against investment, the minimum tax actually complicates rather than simplifies the tax law.

Although recent federal tax legislation has significantly enlarged the minimum tax, we believe that it is an unsound device for legislating fiscal policy change and should be repealed. If tax preferences have become a legitimate cause for concern, Congress should deal directly with those items to which substantial questions have been raised.

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[1] Public Law 91-172, as described in MAPI Bulletins 4394, 4395, 4398, 4400, 4403, 4407, and 4408, and MAPI Memorandum T-40.

[2] Public Law 94-455, as described in MAPI Bulletin 5491.

This study reviews the events and the series of legislative proposals leading to adoption of the minimum tax and then examines in some detail the character and effects of that tax.

BACKGROUND

As already indicated, the minimum tax on "tax preferences" came into existence as a part of the Tax Reform Act of 1969. This tax revision gained momentum late in the Johnson Administration when much publicity was given to the fact that, in 1966, some 154 federal income tax returns with adjusted gross incomes of $200,000 or more (not including those with income exclusions which did not show on the returns) were filed without any tax due at all. The alleged "problem" was that the tax law provided preferential tax treatment to certain types of income through special exemptions, exclusions, deductions, deferrals, credits, rate reductions, or similar mechanisms. As a result, these types of income were totally or partially excludable from the income tax base, and some wealthy taxpayers so inclined could structure their affairs with one or a combination of these items so as to reduce or eliminate their current tax liabilities.

This matter of certain wealthy persons paying little or no tax was a natural and limited consequence of the government having selectively reduced federal income tax disincentives to certain economic activities. However, it was represented by certain tax revision advocates to be a gross and intolerable inequity in the system which favored the wealthy at the expense of ordinary income earners, and which, in their view, might well lead to a taxpayers' rebellion, failing remedial action. The alleged "abuses" of "tax preferences" became a rallying point both for persons perceiving a need for selective reform—including the payment of some amount of taxes from all economic income—and persons seeking radical socioeconomic change through tax law revision. "Remedial" action in the form of the minimum tax on tax preferences was the eventual result.

The Johnson administration (1968) proposal

The original proposal of the U.S. Treasury Department for a minimum tax was published in 1968. At that time, the minimum tax-to-be was conceived as an alternative to the tax otherwise due under the regular tax rules, and it would have been applied only to individual taxpayers. First, a taxpayer would have figured his regular tax liability without regard to special rules. Then he would have figured his liability under rules which included certain tax preferences in income but applied rates at one-half of those in the regular rate schedule. If the latter computation (i.e., the minimum tax) yielded more liability than the former (i.e., the regular tax), then the minimum tax would have been due instead of the regular tax.

This minimum tax would have been a comparative levy (i.e., the regular liability being compared with the minimum tax, and the larger of the two amounts being due) rather than an add-on tax. The rate structure for this minimum tax, being half the usual schedule, would have been progressive. Due to lack of time for consideration of "tax reform" in the 90th Congress, no action was taken on the Johnson Administration's version of the minimum tax.

The Nixon administration (1969) proposal

In early 1969, the Nixon Administration proposed a minimum tax which involved a somewhat different computation than the one considered in the prior Congress, although the concept was the same and the tax still would have applied only to individual taxpayers. In this case, the idea was to prevent the use of tax. preferences from excluding from federal income taxation more than one-half of adjusted gross income plus certain specified preferences. Amounts of "disqualified" tax preferences (i.e., amounts in excess of one-half of adjusted gross income increased by certain stated preference income) would have been includable in the tax base subject to regular rates of tax.

This type of minimum tax was approved by the House Committee on Ways and Means during consideration of what was to become the Tax Reform Act of 1969, and it included a small but controversial group of designated tax preferences (among them, for example, interest on state and local government bonds). As in the case of the Johnson Administration's proposal, the Nixon Administration's minimum tax would have been a comparative tax involving the existing progressive rate structure.

The Senate (1969) version of the minimum tax

When the Tax Reform Act of 1969 came up for consideration on the Senate side, the minimum tax was thoroughly overhauled by the Finance Committee.

Among other things, it was extended to corporate as well as individual taxpayers. Further, it was turned into a supplemental, or add-on, tax applicable to preference income in excess of a $30,000 exemption, irrespective of the amount of that income in relation to all income of the taxpayer. Also, a flat rate of tax was proposed instead of using the regular progressive scale or some configuration thereof.

Then, on the Senate floor, a liberalizing amendment successfully offered by proponets of a comparative rather than a supplemental minimum tax provided a deduction for regular taxes paid in computing minimum tax liability. The $30,000 exemption, the deduction for regular taxes paid, and the relatively low flat tax rate (i.e., 10 percent), all added on the Senate side and eventually accepted by Joint Conferees, tended to blunt the impact of the minimum tax to the chagrin of certain tax revision advocates who—it will be seen—eventually managed to change all three such characteristics of the tax. Also, the list of preferences was modified to make it more nearly acceptable to broad constituencies.

Tax Reform Act of 1969 and the mimimum tax

As finally enacted in the Tax Reform Act of 1969, the minimum tax applied to individuals and corporations. The minimum tax was equal to 10 percent of the taxpayer's items of tax preference, reduced by a $30,000 exemption and the regular income tax liability (in turn, reduced by any foreign tax credit, retirement income credit, or investment credit). Regular taxes not used to offset preferences in the current year were allowed to be carried over for up to seven additional years. Also, it was possible to defer some or all of the minimum tax for a year in which the taxpayer had a net operating loss which could be carried over to another year.

The tax preferences covered were (1) the excluded portion of capital gains; (2) the excess of the natural resources depletion deduction over the adjusted basis of the property: (3) the excess of accelerated over straight-line depreciation on real property; (4) the excess of the fair market value of optioned stock at the time of exercise over the option price of the stock; (5) accelerated depreciation in excess of straight-line depreciation on personal property subject to a net lease (subsequently amended to exclude the acceleration resulting from use of the Asset Depreciation Range system enacted in the Revenue Act of 1971);[3] (6) the excess of rapid amortization over accelerated depreciation for certified pollution control facilities; (7) the excess of rapid amortization over accelerated depreciation for railroad rolling stock; (8) bad debt reserves of financial institutions to the extent they exceed amounts allowable based on an institution's own experience (or industry experience in the case of new institutions); and (9) the excess of investment interest expense over net investment income.

As a result of an amendment to the minimum tax in the Revenue Act of 1971, another tax preference was added representing the excess of rapid amortization taken on job training or child-care facilities over accelerated depreciation.

Tax preferences and tax expenditures

As to the "tax preferences" themselves, to which the minimum tax applies, it should be noted that they are considered by the "reformers" as synonymous with "tax expenditures." These are amounts, according to the supporters of such concepts, by which government "subsidizes" various activities through concessions in the tax base, whether those concessions be special exemptions, exclusions, deductions, credits, deferrals, rate reductions, or whatever. The name "tax expenditures" was coined and popularized by foes of these modifications of the tax base who contend that they amount to government spending by indirection which might better not be done at all, or, alternatively, be performed by grant or other direct means. These persons also argue that the very existence of tax preferences leads to abuses by the well-to-do, including tax shelter syndications and related phenomena, which curb the progressivity of the tax structure and lead to assorted intolerable inequities.

Although opponents of "tax expenditures" established their most important beachhead in 1969 with enactment of the minimum tax in Public Law 91-172, they gained still another significant foothold in the Congresssional Budget and Impoundment Act of 1974. The statute institutionalized in the federal budget process an annual practice of reporting on amounts of federal revenues believed foregone as a result of "tax expenditures," item by item. This listing of concessions in the federal tax base is, of course, an important document to all persons concerned with the revenues and expenditures of the federal government. More than that, though, the annual appendix to the federal budget dealing with

[3] This particular preference did not apply to corporations.

tax expenditures has become both a basic reference piece and "shopping list" for tax revisionists who oppose some or all tax preferences.

Tax Reform Act of 1976 and the minimum tax

The Tax Reform Act of 1976 significantly tightens and enlarges the minimum tax for both individuals and corporations. For individuals, the minimum tax rate is increased to 15 percent from 10 percent; the dollar exemption is scaled down from $30,000 to the greater of $10,000 or one-half of regular income tax liability; and the seven-year carryover of unused regular taxes has been repealed. Three more tax preferences have been added for individual taxpayers, in summary as follows: (1) itemized deductions (other than medical and casualty loss deductions) in excess of 60 percent of adjusted gross income; (2) intangible drilling costs in excess of the amount deductible if capitalized and amortized over 10 years; and (3) accelerated depreciation on all personal property subject to a lease, including the acceleration resulting from use of the Asset Depreciation Range system but not bonus first-year depreciation.

For corporations, the minimum tax rate is raised to 15 percent from 10 percent. The dollar exemption is reduced from $30,000 to $10,000 or the full amount of regular income tax liability, whichever is greater. Also, the carryover of unused regular taxes has been repealed. The items of tax preference have not been changed for corporations, except for timber income. There, special rules applicable to gains from the cutting of timber and long-term gains from the sale of timber have the effect of exempting timber income from the increase in the minimum tax for corporations.

The Secretary of the Treasury is instructed by the new minimum tax legislation to issue regulations under which there will be no such tax when individuals or corporations do not receive any tax benefit from a tax preference.

Generally speaking, the minimum tax changes for both individuals and corporations in the Tax Reform Act of 1976—which was signed into law on October 4, 1976—were made effective for taxable years beginning after December 31, 1976. Therefore, for most affected taxpayers, the changes adverse to them were structured so as to have a limited retroactive application as well.

A CRITIQUE OF THE MINIMUM TAX

As a review of the recent history of the minimum tax indicates, the congressional majority has a predilection towards its continuation and enlargement. With the amendments to the minimum tax accomplished by the Tax Reform Act of 1976, many more taxpayers will become liable for this levy in greater amounts on more kinds of income than ever before. Moreover, the minimum tax, which was originally conceived as a comparative tax, seems to be evolving in the direction of becoming a supplemental or add-on levy applicable to tax preferences without reference to their magnitude in relation to income otherwise taxable.

The trend line is clear. What once was offered as a means to curtail an alleged overindulgence in tax preferences by some wealthy individuals has become increasingly an instrument for curtailment by indirection of the preferences themselves. Also, the tax no longer is wholly restricted to "wealthy" individuals. It now affects many taxpayers well below the so-called wealthy class and is applied to corporations as well.

As more fully described below, the minimum tax is unsatisfactory on a number of counts, and the consequences of the tax entend far beyond those individuals and corporations subject to it. To summarize the shortcomings of the minimum tax: (1) it is an objectionable vehicle for legislating tax policy and lacks the visibility normally attached to significant tax increases; (2) it complicates, rather than simplifies, the Code; (3) it should not apply to corporations in any event; (4) it derives its impetus more nearly from popular prejudice than from objective consideration of resource allocation via the tax laws; and (5) it is a further penalty on savings and investment at a time when capital formation already is inadequate in this country.

Legislative procedures

As a mechanism of tax revision, the minimum tax is at best an expedient. The various provisions of "tax preference" in the Code were, prior to the coming of the minimum tax, considered individually on their own merits and similarly voted into law. In enacting these provisions, Congress and the Executive Branch of government carefully determined that the federal income tax disincentive to various activities should be wholly or partially relieved. The minimum tax, to

the contrary, is a tax legislative mechanism whereby this disincentive is partly reinstated without altering the Code provisions originally enacted to reduce the disincentive.

Whether or not one agrees that there should be a minimum level of federal income tax liability for every citizen, there can be little disagreement that the minimum tax is a "scattershot" device. For example, it is possible to amend the minimum tax by reducing the fixed-dollar exemption or the deduction for regular federal income tax liability, and thereby to reduce a dozen or more tax preferences without giving individual attention to the specific economic activities impacted by the change. Whereas the tax impacts on these activities were directly and carefully considered in the first instance, the minimum tax affords means by which tax preferences can be reduced in a composite and indirect way. Along the same lines, the accountability of a legislator to his constituents for taking a position on the minimum tax which may be adverse to one or more economic activities is diffused if not obfuscated by the mechanism.

Also the results can be haphazard and run against the grain of what otherwise is sound and settled tax policy. Consider the application of the minimum tax to the difference between the fair market value and the exercise price of a qualified stock option.[4] In this case, the tax is levied, notwithstanding that no cash to use in payment of the liability is generated by exercise of the option, and not withstanding that the employee cannot even liquidate optioned stock to pay the tax liability without violating the holding period requirements to which the qualified stock option benefits are tied. Also, the basis of the optioned stock is not increased by the minimum tax paid; the tax paid on the "paper" gain is not recoverable if the optioned stock is later sold at a loss; and, if the transaction ultimately results in a capital gain, the employee may incur another minimum tax partially duplicative of the one incurred on exercise. One wonders whether Congress even considered these matters in enacting its minimum tax.

To take another example, the Tax Reform Act of 1976 extended Code section 169 on rapid amortization of certified pollution control facilities. Because of the heavy burden of capital expenditures for statutorily mandated environmental protection, Congress not only extended rapid amortization, but added a 5 percent investment tax credit for qualifying facilities.[5] This new allowance is somewhat more advantageous than the depreciation and investment tax credit otherwise available, as intended, but that result may not obtain where the taxpayer is subject to the minimum tax. Indeed, the advantage may be almost completely eliminated by related minimum tax liabilities for some companies in those industries most in need of the legislated advantage. Could Congress have intended such a capricious result as to have a taxpayer lose these new tax benefits simply because his regular tax liability in a particular year is so low—through misfortune or the normal application of other operative Code provisions—as to expose him to a minimum tax liability?

Complication, not simplification

The tax revision objective most often recognized in the breach is, of course, tax simplification. For evidence of this, a person need only contemplate what was wrought by Congress in terms of complication of federal income taxation by enacting the Tax Reform Acts of 1969 and 1976. As one specific example, consider the minimum tax on tax preferences. It is true, as some tax revisionists vigorously contend, that the tax preferences hit by the minimum tax (e.g., the untaxed portion of capital gains) are a complicating feature of the Code. However, these preferences reflect value judgments of the body politic as to activities which should not bear the full burden of federal income taxation, and it would be both unrealistic and unwise to have a taxing system without any such concessions. Superimposed on these tax preferences is the minimum tax. The minimum tax is a complicating element because it adds to the framework of tax preferences already in the Code an entirely new set of computations to be made with respect to them.

As more and more taxpayers come within the range of potential liability for the minimum tax—the number having been increased tenfold, by some estimates, by

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[4] Except for qualified stock options granted under transitional rules, the Code provisions conferring special tax attributes in this area were repealed by section 603 of the Tax Reform Act of 1976. The discussion herein of the minimum tax in this particular context is intended only to demonstrate that application of the minimum tax can be at cross-purposes with settled tax policy.

[5] A somewhat larger "bonus" investment tax credit than finally enacted was considered but then rejected because of budgetary pressures.

the Tax Reform Act of 1976—they will find themselves with several difficult tax computations to make instead of one. Along with the new computations associated with the minimum tax, there will be new complications, and, for government, an enlarged bureaucracy to deal with them. Also, regrettably for tax simplification, it is to be expected that the minimum tax, for so long as it is perpetuated in the Code, will be subject to periodic congressional tinkering with the rates, exemptions, deductions, and list of preferences. The very concept on which the minimum tax is predicated, that of having every taxpayer pay a "fair share" of tax on his "economic income," is one which bears the seeds of literally endless debate. If the experience to date is any indication, the outlook is for a complex addition to the Code, the minimum tax, to become even more unwieldy with the passage of time.

Ironically, too, the objective of some tax revisionists to "bleed" tax preferences through the minimum tax until they become easy targets of repeal seems unlikely to succeed, notwithstanding the harm that the tax will cause in curtailing the capital flow to various desirable activities. For example, experience to date shows that various preferences (e.g., the exclusion of interest income from state and local bonds), of the dozens which could be subjected to the minimum tax, command the interest of a sufficiently broad and active taxpayer base to be reasonably secure from even the most ardent of tax revisionists. Meanwhile, new legislation—e.g., the Tax Reform Act of 1969, the Revenue Act of 1971, and the Tax Reform Act of 1976—creates new preferences where Congress deems that appropriate, and the new preferences do not necessarily become part of the minimum tax base. "Tax simplification" may not be the antithesis of the minimum tax, but it seems fair to say that simplification and the minimum tax have little in common.

A minimum tax on corporations

One reason advanced for having a minimum tax is that the tax preferences in the Code tend to disturb the intended progressivity of the federal income tax structure. It is contended that, given the existing rate structure, there is a special incentive for persons of high income to use tax preferences. To the extent that this is done, it is possible for these persons to reduce their taxable incomes (as compared to their "economic" incomes) to levels where the applicable tax rates are relatively low. Hence, it is reasoned, the intended progressivity of the rate structure is diminished, and that is a justification for the minimum tax. A fallacy in this line of reasoning as it applies to the corporate minimum tax is that the federal income tax for corporations is not very progressive at all. In fact, for corporations above the surtax exemption level of income, the rate is flat. Accordingly, there generally is no special incentive for a corporation of "high" income, as compared to one having low income, to use tax preferences. Also, there is very little progressivity to be distorted by the use of such preferences.

Why, then, is there a minimum tax for corporations? The Johnson Administration, which first proposed the minimum tax, intended it only for individuals. The Nixon Administration, which subsequently accepted a minimum tax as one of its tax reform objectives, similarly intended it only for individuals. The device was extended to corporations by the Senate Finance Committee in its consideration of the proposed Tax Reform Act of 1969. In Senate Report No. 91-552, the Finance Committee stated, as follows:

". . . [C]orporations with long-term capital gains, accelerated depreciation, intangible drilling and development expenses and percentage depletion, and financial institutions with special deductions for additions to bad debt reserves tend to pay smaller amounts of tax than other corporations.

* * * * * * *

". . . [T]he House provisions for a limit on tax preferences and allocation of deductions would apply only to individuals and not to corporations. In large measure, this is because these provisions [i.e., the House-passed provisions as compared to those reported by the Senate Finance Committee] do not lend themselves to the taxation of preferences enjoyed by corporations. For example, a corporation with sufficient tax preferences to be affected by these provisions could arrange to escape from their impact by merging with other corporations with relatively small amounts of tax preference income."

It would appear from these assertions of the Senate Finance Committee that that the only reason for extending the minimum tax to corporations was a generalized distaste for tax preferences. For persons who might question the adequacy of this rationale, a closer look at the legislative background is instructive. In particular, the Senate Finance Committee found it desirable to reject two related

provisions of the Tax Reform Act of 1969 as passed by the House of Representatives. These were the "limit on tax preferences" and the provision for the allocation of deductions between taxable and nontaxable income, both of which were considered to be too complex and objectionable in certain other respects. The Finance Committee replaced the limit on tax preferences with what came to be known as the minimum tax on tax preferences, but it did not replace the item dealing with the allocation of deductions. Some observers believe that the minimum tax was extended to corporations solely to pick up the revenue loss occasioned by deleting the deductions provision from the bill.

Popular prejudice

Like certain other public policies reflected in the statute books, the minimum tax is more nearly a reflection of "popular prejudice" than of objective economic analysis. A part of this popular prejudice is to feel that persons—especially those of means—are evading civic responsibility unless they participate through regular and sizable federal income tax payments in the cost of the U.S. government. In this particular view of "wealth" and the responsibilities which go along with it, there is no latitude for argument that taxes due were determined in full compliance with the law. One reason for this is that persons who derive all of their income from personal services—i.e., the majority of taxpayers—as compared to those who earn some or all of their income from capital do not feel that they have equal access to tax preferences. This, of course, is incorrect because many "tax preferences" are available only to persons of low and middle incomes, and these preferences are not now subject to, and probably will not ever be made subject to, the minimum tax. Also, some tax preferences now subject to the minimum tax are used by persons and entities at moderate as well as high-income levels.

Advocates of the minimum tax exploited this prejudice in 1969 when they decried the existing condition which permitted 154 taxpayers having adjusted gross income in excess of $200,000 in 1966 to be free of federal income tax. In 1976, supporters of an enlarged minimum tax again made much of the fact that 244 persons at the same level of income (not adjusted for inflation) in 1974 reported no federal income tax. Corporate taxpayers find themselves subject to the same kind of review now by persons purporting to report annually on those entities which, allegedly, have not paid a "fair share" of taxes, irrespective of the reasons why. The idiom employed by persons exploiting this popular prejudice includes such "carefully" chosen words as "freeloader," and expressly or impliedly indicates that the real progression in the federal income tax structure is from those with the greatest ability to pay at the bottom to those with the least ability to pay at the top.

The allegations and implications which have led to the minimum tax do not hold up well under close analysis. For example, former Treasury Department Assistant Secretary (Tax Policy) Edwin S. Cohen testified on "Tax Subsidies and Tax Reform" before the Joint Economic Committee of Congress in July 1972, and he spoke directly to this point. Using preliminary 1970 data, Mr. Cohen noted that there were some 100 individuals in that year who had adjusted gross incomes of $200,000 or more but paid no federal income tax. However, there were 15,200 other individuals at the same level of income who paid this tax at an effective rate of 44.1 percent of adjusted gross income and 59.5 percent of taxable income. Mr. Cohen concluded as follows:

"From this, it is perfectly clear that in general the rich are paying federal income taxes in large amounts. And they are paying more than they were in 1968 while other taxpayers are paying less."

Turning to the few nontaxable persons with adjusted gross income above $200,000, Mr. Cohen and his staff had performed further analysis. In several cases, the absence of U.S. tax liability was due to operation of the foreign tax credit in situations where the effective foreign income tax rate for the individuals had averaged 62 percent of adjusted gross income and 70 percent of taxable income. In another group of cases, the 1970 federal income tax liability was eliminated because of deductions for state income taxes paid in 1970 pertaining to large amounts of nonrecurring 1969 income of which substantial amounts of federal income tax had been paid in 1969. In another group, the principal element in elimination of federal income tax liability was charitable contributions under circumstances in which Congress, in amending the law in this area in 1969, recognized that some instances of nontaxability still would result. In the remaining cases, the principal deduction was either "interest paid" or "miscellaneous deductions." Mr. Cohen felt as to some of the persons in this latter group that

the existing definition of "adjusted gross income" might be giving them the appearance of having high income, whereas their large business and investment expenses suggested to the contrary.

In concluding the portion of his presentation dealing with this subject, Mr. Cohen stated, as follows:

"Now I do not mean to imply from this review of the 106 cases that there is not a constant need for vigilance and improvement in the tax laws. Most assuredly there is a definite need. I mean only to indicate that there is relatively little guidance to be gained from these particular returns in relation to major issues of tax policy, and the attention that has been devoted to them is unwarranted and unwise."

Notwithstanding the facts presented on the public record by Mr. Cohen and his advice about the undue attention given to a few, nontaxable, high-income taxpayers, the peculiar "chemistry" of popular prejudice that propels the minimum tax and favors still more redistribution of wealth persists and grows. As already mentioned, the Tax Reform Act of 1976 substantially enlarged the minimum tax. In addition, Congress instructed the Secretary of the Treasury to publish statistics on the tax liability of people with high total income, including the number and average income of high-income people with no income tax liability (after credits); the specific deductions, exclusions, and credits used to avoid tax; the overall number of high-income individuals; and the total income and tax liability of the high-income group.

A penalty on savings and investment

Whatever else the minimum tax may be, it is a penalty on savings and investment. Whereas Congress once enacted special tax provisions to reduce the disincentives of federal income taxation to savings and investment, through the minimum tax Congress has enacted further provisions to partially reinstate the disincentives. While this may seem contradictory as a reflection of public thinking about tax incentives for capital formation, the question of capital formation does not enter significantly into the tax revision dialogue as it deals with this levy. This is because the dialogue is preempted by the rhetoric of popular prejudice to which the situation addressed by the minimum tax so conveniently lends itself. As a result, the minimum tax is popularly thought of as a deterrent to tax avoidance by the rich, not as a deterrent to capital formation. The irony of this is that the minimum tax is most certainly an impediment to capital formation in those areas otherwise favored by the taxed preferences, but it does not ensure that the rich (e.g., those few who now have high income but escape tax) will be subject to tax. As indicated earlier, this is a costly tradeoff.

In reviewing the list of tax preferences—which, as already mentioned, does not include those destined to remain inviolate due to a broad and active taxpayer base—one encounters one anomaly after another. For example, capital gains are given preferential treatment in the Code because of a general understanding that it is inappropriate to tax capital on the same basis as income from capital. Indeed, in some taxing jurisdictions abroad, capital is not taxed all because it is realized at that capital is the "seed corn" of economic activity and growth. In establishing the excluded portion of capital gains as a tax preference and later reducing the minimum tax exemption while increasing the rate, did Congress consider that it was moving in the direction of taxing capital gains as ordinary income? Would Congress have taken action to reduce the excluded portion of capital gains had the issue been considered directly and in isolation rather than in the minimum tax concept? We hope not.

Continuing, Congress has provided for rapid amortization of the cost of various types of facilities where that is believed to be in the public interest. However, Congress also has listed as a tax preference the excess of rapid amortization over accelerated depreciation for these facilities. If the objective of having "tax expenditures" for these facilities is so important, does it really matter to Congress that a small handful of taxpayers might funnel their income into these investments in such a great amount as to reduce their current tax liabilities below what is perceived in some minds to be a "fair share"? What is a "fair share" anyway? If Congress were to consider these investment incentives individually on the public record, would it conclude that they should be reduced? Does Congress really believe, in curtailing tax preferences such as those which facilitate private savings and investment, that the federal government rather than taxpayers should administer the "spending" programs to which the preferences relate?

In these times of so much active concern about capital formation, not to mention the employment and economic activity which is derived from capital, it is nothing short of remarkable that the minimum tax is not only tolerated but also increased. The tax directly erodes tax concessions to investment activity and it is imposed on those persons with the greatest ability and propensity to save and invest. The effect of the tax is to increase the burden associated with savings and investment, and the increased burden can only serve to dampen that activity. As noted earlier, the small number of wealthy individuals who have avoided tax in the past can, at some modest inconvenience to themselves, continue to do so if they are so inclined. The "penalty" of the minimum tax is borne not by these celebrated few, but by a large segment of the tax structure and the economy at large.

CONCLUDING COMMENT

There is good reason to conclude that the economic and fiscal policy objectives of this country are not well served by the minimum tax on tax preferences. It is a scattershot taxing mechanism which is deficient in concept and execution. It results in tax policy inconsistencies; it complicates an already complex Code; it works in contravention of laws intended to facilitate the allocation of scarce resources to desired objectives; and it is significantly hidden by the inherent nature of the mechanism. All of this is accomplished in a purported effort to squeeze further tribute from some wealthy taxpayers who have legally reduced their federal income tax liability to low levels, notwithstanding that their situations are not typical of persons of high income generally and, in many cases, are not a result of "overindulgence" in tax preferences. Ironically, the impact of the minimum tax is much more widely felt and is borne directly by activities on which Congress otherwise has conferred favored tax status. As indicated herein, the situation is bad in this regard and it is worsening on a progressive basis. It represents federal tax policy at its worst—a classic example of bad government.

Before more harm results from the minimum tax, it should be repealed. To the extent that there continues to be public concern about "abusive" use of tax preferences, Congress should deal with the preferences individually, including the matter of any limitations to be imposed on their use.

MANUFACTURING CHEMISTS ASSOCIATION,
Washington, D.C., July 14, 1978.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Committee on Finance, U.S. Senate, Washington, D.C. 20510

DEAR MR. CHAIRMAN: This letter is submitted by the Manufacturing Chemists Association (MCA) in connection with the public hearings before the Subcommittee on Taxation and Debt Management of the Finance Committee on S. 3065, a bill to amend the Internal Revenue Code of 1954 to provide pre-1969 tax treatment of capital gains.

The Manufacturing Chemists Association is a nonprofit trade association having 192 United States company members representing more than 90 percent of the production capacity of basic industrial chemicals within this country.

The Manufacturing Chemists Association strongly supports legislative proposals that tend to stimulate capital formation. The Association favors the principles embodied in the President's tax proposals to reduce corporate tax rates, to make permanent the 10 percent investment tax credit and to extend the investment tax credit to industrial structures. MCA believes that S. 3065 will supplement those proposals by stimulating individual capital investment. Both corporate and individual incentives to captial formation are necessary.

The object of S. 3065 is to return the law in regard to capital gains tax rates to the state that existed before enactment of the Tax Reform Act of 1969. Capital gains of corporations would be taxed at a 25 percent rate, the alternative tax of 25 percent for individuals would be available and capital gains would not constitute a tax preference item for purposes of the minimum tax and the maximum tax.

The 1969 Tax Reform Act changes had a sobering impact on the turnover of capital investment. Despite the fact that the Treasury Department in 1969 estimated tax liabilities at the individual level of $165 million would rise to $275

million by 1972 due to increased capital gains rates, relevant tax revenues actually declined. Recent studies, such as those done by Chase Econometrics, Merrill Lynch Economics, and Data Resources, Incorporated, show that elimination of the disincentives introduced by the 1969 Act would substantially increase tax revenues.

Capital investment by individuals in corporate equity securities has been lacking in recent years. We believe individuals must be encouraged to invest in corporate equity securities to provide new capital that will be needed for business to modernize its plants and equipment in a potentially energy-scarce era.

The present high capital gains tax has a severely chilling effect on the ability to attract equity investment in companies that are most in need of that investment. The only incentive to an individual to invest in the stock of a company that reinvests earnings, rather than pays substantial dividends, is the possibility of a capital gain on sale of the stock. If that capital gain is taxed at high rates and the impact of inflation is considered, an investor may choose to purchase stock in a company that does not have the need to reinvest all of its earnings.

Representative William A. Steiger (R-WI) emphasized this point when, in testifying before your Subcommittee, he stated:

"In 1969, 698 firms with a net worth under $5 million raised $1.4 billion in capital. In 1975, four firms raised $15 million; and in 1977, 30 firms raised $118 million.

"It is plain that something is wrong. High technology industries and venture investors are convinced that the root cause of inadequate capital is the Tax Reform Act of 1969, the law which increased the tax on capital gain."

The effect of inflation on our tax rate structures has been the subject of extensive study in recent years, and complex remedies, such as some forms of indexing, have been proposed to ensure that only income, and not capital, is being taxed. Although a lower capital gains rate will not prevent the taxation of the appreciation in capital caused by inflation, taxation of such inflation gains would of course be minimized by the passage of S. 3065.

To recapitulate, the capital-intensive chemical industry requires large amounts of capital to enhance its productive capacity. We, therefore, support legislation which will stimulate capital formation, such as the provisions contained in the Administration's tax proposal (H.R. 12078) which would reduce corporate income tax rates, make permanent the 10 percent investment tax credit and extend it to industrial structures. We also support the concept contained in S. 3065, which would encourage investment by individuals, but with the caveat that any cut in capital gains tax rates should not be offset by a reduction in other capital formation incentives. We recommend, instead, that any loss of revenue which might result from these tax cuts be compensated by a comparable reduction in Federal spending.

Sincerely,

W. J. Driver.

Statement of William H. Straw, Vice President Finance and Treasurer, Meridith Corp.

Before the Committee on Finance—Subcommittee on Taxation and Debt Management—relating to H.R. 3050 which has to do with Tax Acconting Methods.

This statement by Meredith Corporation relates only to the portion of H.R. 3050 pertaining to publishers who sell magazines on newsstands.

We support H.R. 3050 inasmuch as it proposes to adopt a tax accounting rule for the return of magazines that is more consistent with the generally accepted accounting principle of matching income and expenses.

Background

It has traditionally been the practice of magazine pulishers to distribute more copies of magazines to newsdealers than will be sold in order to (1) have adequate magazines available to meet sales' demands during their admittedly short shelf-life, and (2) provide an effective display on the newsstands. As a result of this procedure Meredith has experienced a return rate averaging between 30–40% per issue during the last several years. Like other publishers, Meredith has agreed and continues to agree to accept the return of unsold copies. In practice, when a succeeding issue of one of our magazines is shipped to the retailers, the unsold copies of the prior issue are returned to us.

PRESENT CONDITIONS

Under generally accepted accountt procedures publishers of magazines are required to maintain a reserve to provide for refunds payable regarding magazines returned after the close of the taxable year in which they are sold. Under current tax law, however, such reserves are considered non-deductible even though the publisher and/or distributor intentionally overdistribute for the reasons mentioned previously. It requires publishers to pay income tax on non-existi ng income. It is a prepayment of a tax on income which will theoretically never be earned.

H.R. 3050

H.R. 3050 would eliminate to a great degree the effect of distorting the income of magazine publishers. It would allow these taxpayers an elective right not to include in income for a taxable year products returned within two months fifteen days after the close of that year, provided the taxpayer has a legal obligation to accept the returns.

This bill would authorize a tax treatment for excess distribution of magazines more consistent with economic realities than that which presently exists. Meredith, as well as other publishers and distributors would no longer be required to report inflated income attributable to excess shipments of products which will never be sold.

It is of interest to note that since 1918 Treasury regulations have provided a similar method of accounting for manufacturers of food and other products who issue redeemable coupons as well as the practice of issuing trading stamps. H.R. 3050 would allow this practice to become consistent for similar methods of business. It places the practice of magazine distribution and returns in a more correct economic focus and we respectfully urge the adoption in its present form.

STATEMENT OF NATIONAL ASSOCIATED BUSINESSMEN, INC., CONCERNING S. 3065, INVESTMENT INCENTIVE ACT OF 1978

The subcommittee is to be commended for its initiative in bringing to the forefront of discussion what may be the most significant tax revision proposal of this decade—S. 3065, the Investment Incentive Act of 1978.

Built into our current tax structure is the invalid assumption that the dollars people used to buy property years ago have the same real value as an equal number of dollars at the time of sale. For example, if we generously assume that inflation can be kept to an annual rate of six percent herafter, a family buying a home today for $40,000, and keeping it for about 20 years, would have to realize $130,000 upon its sale in order to get back their initial investment and avoid a real capital loss. If they were to do exactly that, they would owe capital gains tax on $90,000, though the real value of the property has not increased at all.

The problem is much more severe with higher rates of inflation. At 1974's 12.2 percent rate of inflation, a $40,000 home purchased then would have to be sold for about $400,000 in 1994 if its real value were to be held constant.

This inequity in the treatment of capital gains is even more apparent in the case of the typical investor in America's equity markets. According to the economics department of Citibank, New York, an individual could have gone to his stock broker in 1957 and purchased the equivalent of a current share each of Exxon, AT&T, and General Motors for a total of $86.36 plus commissions. By 1976, his investment would have grown to $195.62 Had. he sold those shares, his capital gains would have been $109.26.

Under present laws, his taxes would be $16.39 assuming a 30 percent marginal tax bracket. But if we adjust for inflation, the story is radically changed. As measured in 1976 dollars, the investor paid $177.98 for the shares, not $86.36. So the actual gain in real wealth or purchasing power was $17.65, one-sixth the nominal gain and only $1.26 more than the capital gains tax. Is it any wonder why 1 out of 5 share owners have dropped out of the stock market since 1970?

WHITHER FEDERAL REVENUES?

Since 1946, this organization has consistently and strongly supported fiscal responsibility in the conduct of the public's business. Thus, we are not oblivious to concern that has been expressed over the potential impact on federal budget deficits as a result of a reduction in capital gains taxes.

Which rate, then, shall you legislate? Which rate gives you revenue? The answer is, which rate gave you revenue in the past?

In his testimony of June 28, 1978, before the Subcommittee, Treasury Secretary Blumenthal discounted the stock market's downturn in the 1969–1970 period as being largely due to economic circumstances and not, as Senator Packwood suggested, as a result of the sharp increase in capital gains taxes imposed by the 1969 tax reform act. So we will throw out this recent experience with gains tax revision and look further back in U.S. economic history:

In the period 1917 to 1921 there was a high rate and the percentage of capital gains revenue to total income was less than 1 per cent.

In the period 1922 to 1924 there was a moderate rate and the percentage of capital gains receipts jumped from 1 per cent to 48 per cent.

Under a low base from 1925 to 1929 the percentage of net gains was 66. These were "boom" years for the U.S. economy, so we will throw them out also. In the depression years 1930 to 1932, capital gains were a higher per cent under low rates than in the recovery from 1933 to 1936 under high rates. In the depression years. 1930 to 1931 was a period of falling profits, and low tax rates gave a 30 per cent net income. But in the recovery period, when stock prices went from an index of 40 to 190, gains taxes were high; the percentage of gains dropped from 30 per cent to 10 per cent in the boom.

How do we account for that change? The business situation had improved and, therefore, tax collections should have been higher. But the rates were increased and the 12½ per cent rate that prevailed in the period 1930 to 1931 was raised. They had a sliding scale back then—100 per cent, then 80, 60, 40, and 30—with the lowest rate 30 percent as against 12½ per cent before. (See further—77th Congress, 2d Session, hearings before the Committee on Ways and Means on Revenue Revision of 1942, Part 12, Mar. 20, 1942.)

The lesson to be learned from our past? High capital gains rates produce little revenue; low rates produce more revenue. The lower the rates, the greater gains taken.

National Associated Businessmen strongly supports a cut in the maximum rate on capital gains taxes from 49.1 per cent to 25 per cent and urges prompt passage of the Investment Incentive Act of 1978 to accomplish this.

An increase in the amount of capital available for investment benefits everyone—not just the wealthy. Benefits accrue in the form of employee productivity, more housing, new products and services, energy sources, environmental improvement, and so on. Compared to the benefits obtainable through government subsidy programs, the longer-run consequences of capital growth are exceptionally attractive.

Passage of legislation to reduce capital gains taxes would signal a recognition by the Congress that freedom and incentives—not tax dodges or loopholes—are what inspire people to work, to save and to invest.

Statement Submitted by the National Association of Manufacturers

The National Association of Manufacturers is pleased to have the opportunity to submit to the Subcommittee this statement regarding the federal tax treatment of capital gains. The increased level of congressional interest in reducing capital gains taxes is a welcome development. NAM urges the Congress to act favorably on proposals to reduce such taxes.

The NAM represents over 12,000 member firms engaged in all types of manufacturing activities. Approximately 80% of these members are small businesses employing fewer than 500 employees. In addition to NAM members, over 130,000 firms are affiliated with the NAM through the National Industrial Council.

Overview

The federal income tax structure in general imposes counterproductive levies on both capital and income from capital. This results in a disincentive to new capital investment—investment which increases productivity, modernizes and expands America's industrial base and produces additional jobs and higher real incomes for both employees and investors.

Such counterproductive features of tax law include the double tax on dividends, the 70% maximum rate on individuals, the minimum tax, the outdated depreciation system among others.

A principal problem area is the taxation of capital gains. The combination of capital gains taxes and the minimum tax on preference items (which include the

untaxed portion of capital gains) can result in an effective tax rate approaching 50% for high income investors. In conjunction with inflation, capital gains taxes can result in *real* tax rates of more than 100% for taxpayers in all income levels.

These conditions tend to diminish the creation of new capital and the active movement of the existing capital stock by deterring those who might become new investors and inhibiting transactions by those who would like to change investments. They should be reduced as one part of a general tax reduction program. Such action would generate increased investment which would expand the country's economic base.

IMPACT OF CAPITAL GAINS TAXES

High capital gains taxes impose a drag on economic growth by impeding capital formation. Individual investors discouraged by lower rates of return on high-risk investments withdraw from the stock market and potential investors turn away. The 1977 Fact Book, published by the New York Stock Exchange, reports that between 1970 and 1975 the number of investors declined by 18%, from 31 million to 25 million. This process followed the enactment of the Tax Reform Act of 1969 which raised capital gains rates and created the minimum tax.

A significant portion of long-term capital gains is offset by inflation, particularly the gains generated during recent years. When inflation is high, capital gains appreciation may actually be overcome by inflation. In this situation, paying taxes out of the "gain" leaves the investor worse off in real terms than when the original purchase was made. A study by the National Bureau of Economic Research dated February, 1978, demonstrated that capital gains taxes levied on $4.5 billion of gain in 1973, if adjusted for inflation, actually produced a real capital loss of nearly $1 billion.

A reduction in capital gains taxes would tend to reduce the overall "cost of capital" by making investment relatively less expensive than under current law. This reduction in the cost of capital can generate more investment in corporate stock, in new businesses and in other productive assets. With increased stock activities, corporations could rely more on equity financing rather than debt. This would ease troublesome debt/equity ratios as well as the corporate demand for loan funds. As the cost of making investments is reduced, the high risk new venture is also made more attractive.

The cost of capital significantly affects the level of business investment in plants and longterm assets. While the U.S. is technology-rich—a position that is continually being challenged due to decreased outlays in research and development—it has remained investment-poor. Our two strongest competitors, Japan and West Germany do not tax capital gains from portfolio investment. According to Department of Labor statistics, West Germany's labor productivity increase was two times and Japan's three times greater than that of the U.S. during 1977.

What this situation portends is outlined in a 1976 study by the Department of Commerce, Bureau of Economic Analysis, entitled "Study of Fixed Capital Requirements of the U.S. Business Economy, 1971 to 1980." The study revealed that the U.S. has the lowest rate of capital investment relative to GNP, has among the lowest productivity increases, and has the lowest investment in research and development. According to the study, new nonresidential fixed investments have fallen short of the expected percentage of GNP and these investments are only capable of keeping the U.S. economy from regressing in productive capacity. If this trend continues, U.S. industry will not be able to modernize, to rexpand and to meet the needs of a growing labor force and the desire of consumers.

ECONOMIC IMPACT ANALYSIS

Until recently, there has been no systemic method for assessing potential "feedback" effects of tax changes on the overall economy. Therefore, capital gains tax changes, like all others, have been analyzed only by the static revenue estimate which indicates an impact on federal revenues assuming that there are no changes in taxpayer behavior. With the advent of econometric models, it has become possible to estimate the dynamic effects of tax changes on employment, economic growth and tax revenues.

Releasing the private sector from restraining taxes and other obstacles can affect the federal Treasury in two positive ways. First, the increased economic activity will reduce the number of persons receiving government transfer payments by creating more paying jobs. Second, while the shortrun effect of lowering tax

rates can cause a decline in the tax revenues, this decline in revenues can be equalled or substantially offset as the tax base is expanded by increased economic activity.

The Administration has attempted to politicize the current capital gains debate by arguing that the present capital gains tax rates are necessary taxes on millionaires. They have used the static revenue analysis to argue that a capital gains rollback would benefit only a relative few taxpayers while reducing federal revenues by over $2 billion. This suggests that the high capital gains taxes have created new revenues—a suggestion which is analogous to a seller's belief that higher and higher prices will continually increase profits. Just as buyers look for substitutes when confronted with high prices, investors also look for alternatives when high taxes on productive investments become a deterrent. In addition to consumption expenditures, these include tax-exempt bonds, risk-free securities and so-called "shelters." New ventures and blue stocks alike are the adversely affected parties.

The NAM's Tax Impact Project (TIP) sponsored the development of the Ture/TIP model by Norman B. Ture, Inc., economic consultants in Washington. A memorandum is attached outlining the Ture/TIP findings with respect to a rollback in capital gains taxes. Notwithstanding the comments made to this Subcommittee on June 28 by Secretary Blumenthal, this model was not programmed to reach a preconceived result. Its elements are not altered to suit our purpose. We welcome any in depth discussion of it.

CONCLUSION

The capital gains tax structure has grown so oppressive that longterm investors are reluctant to turn over their assets because the tax cost is too high. Potential investors are deterred from high risk new ventures by the further risk that real growth will be paid out as taxes.

Reduction of such burdens would generate new capital and remove an obstacle to much needed productive investment. The effects would spread throughout the economy, far beyond the millions of investors directly impacted by capital gains taxes. A dynamic analysis of a major proposal in this area indicates significant favorable economic results without adverse federal revenue effects.

NORMAN B. TURE, INC.,
ECONOMIC CONSULTANTS,
Washington D.C., May 18, 1978.

To: Congressman WILLIAM A. STEIGER
Subject: Effects of H.R. 12111 on the economy and on Federal tax revenues.

Enactment of H.R. 12111, restoring the pre-1969 alternative tax treatment of net long-term capital gains and eliminating capital gains as a preference item for minimum tax, would have a significant expansionary effect on the economy and would modestly increase Federal tax revenues. Assuming the bill's enactment as of the beginning of 1978, full-time equivalent employment would increase by 90,000 over the levels projected under present law for 1978 (although the provisions of the bill would not be effective until January 1, 1980, the saving and investment response by both individuals and corporations would initiate with enactment of the legislation); in 1987, there would be 150,000 more full-time equivalent employed persons than the projected present-law level.

This increase in jobs would reflect both the increase in the demand for and supply of labor services resulting from the net additions to the stock of business capital in response to the reduction in the overall marginal rate of tax on capital income effected by H.R. 12111. The estimated response would be an $8 billion increase in gross capital outlays in the first year, increasing to $19 billion in the fifth year as adjustment to the lower cost of saving and of capital was completed; on the new, higher growth path of the economy, gross capital outlays would be $13 billion more than under present law 10 years hence; net capital additions would be $6 billion more (measured in constant 1977 dollars).

These larger additions to the amount of business capital would increase the productivity of labor and real wage rates—by $90 a year in the first year, increasing to $150 a year 10 years later (in constant 1977 dollars). Together with the increase in the gross returns to the larger stock of capital, the increased labor income resulting from the expansion in employment and in real wage rates would

raise GNP by $12 billion over the present-law level in the first year and by $27 billion 10 years later (measured in constant 1977 dollars). Of this increase in GNP, the increase in total real wages would amount to about $10 billion in the first year, rising to about $19 billion in 1987.

In response to the reduction in tax on the returns on investment, individuals would increase their saving by increasing amounts during the first five years. In the fifth year, as the adjustment was completed, consumption outlays would be slightly less than under present law, although greater than in the previous year. Thereafter consumption would increase; 10 years after enactment, consumption spending would be about $14 billion greater than under present law.

The initial-impact revenue effect would be to reduce Federal tax revenues by about $2 billion in 1980 and by about $3 billion in 1987 (constant 1977 dollars). These estimates, however, are grossly misleading; they assume no economic effects from enactment of the bill. Taking those effects into account, there would be an immediate revenue gain of $3 billion in 1978. The increase in revenues would taper off thereafter; in 1978, the net effect on Federal tax revenues would be a gain of about $1 billion.

These revenue estimates ignore the possible effects of H.R. 12111 on the extent to which taxpayers would choose to realize capital gains. The present tax treatment of capital gains not only increases the total tax on the returns to saving and investing, it also acts as a transfer tax on the disposition of capital assets. Reducing the capital gains tax rate, particularly for taxpayers with large amounts of capital assets, would in all likelihood induce an increase in the volume of realization. The data on gain realization, however, afford no basis for reliable estimation of the increase in realization in response to a reduction in the capital gains tax rate in any given period of time.

Our revenue estimates also do not take into account the effects of H.R. 12111 on capital asset values. Reducing the marginal rate of tax on capital gains should tend to raise the market value of capital assets; the magnitude of this effect is difficult to estimate. Insofar as H.R. 12111 resulted in a significant increase in realization, this would tend to curb the increase in the market value of sasets. Hence, the larger the estimate of the feedback revenue gain from additional transactions, the smaller is the likely revenue gain from increases in the market valuation of assets. If one were to assume that the combined effect of additional realizations and increase in market value is a 10 percent increase in the amount of gains reported and included in taxable income, the net effect on Federal tax revenues would be an increase of about $1 billion over the amounts shown in the attached Table 1.

In any event, our estimates of the new revenue effects should be seen as lower limits. Actual revenue gains are likely to be modestly greater than shown in the attached Table 1.

TABLE 1.—ECONOMIC AND FEDERAL TAX REVENUE EFFECTS OF H.R. 12111

[Dollar amounts in constant 1977 dollars]

	1978	1980	1982	1987
Increase or decrease in:				
Employment (thousands of full-time equivalent employees)	90	100	110	150
Annual wage rate	$80	$90	$110	$150
Gross national product (billions):				
Total	12	15	18	27
Business sector	10	12	14	21
Capital outlays (billions)				
Gross	8	12	19	13
Net	8	11	16	6
Consumption (billions)				
Federal tax revenues (billions)				
Initial impact	0	(2)	(3)	(3)
Net of feedback	3	1	0	1

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

TABLE 2.—EFFECTS OF H.R. 12111 ON REAL WAGES AND RETURNS TO CAPITAL[1]

[In billions of 1977 dollars]

	Real wages	Returns to capital
1st yr	10	3
3d yr	11	4
5th yr	13	4
10th yr	19	6

[1] Returns to capital exclude income imputed to owner-occupied houses and income from abroad.

STATEMENT OF STANLEY C. GOLDER, PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Mr. Chairman and members of the subcommittee, I am Stanley C. Golder, President of the First Chicago Capital Corporation of Chicago, a small business investment company which is wholly-owned by First Chicago Corporation. I am currently also President of NASBIC, the SBIC trade association that represents three-fourths of all licensed SBICs and MESBICs which, in the aggregate, account for approximately 90 percent of the industry's assets.

The venture capital industry, which includes SBICs, is pleased that your panel is holding these hearings on proposals to increase the flow of equity capital to American businesses by lightening the impact of present capital gains taxes. Small and growing businesses have been especially harmed by Congressional actions during the past ten years which have imposed ever-increasing taxes on successful investments.

Small and medium sized firms have found it all but impossible to raise equity capital through public securities offerings during the past six or seven years. Back in 1969, 548 firms with net worth of less than $5-million raised almost $1.5-billion in first-time public offerings. In 1975, only four small businesses went public for the first time and their offerings totalled only $16-million. The picture improved somewhat in 1977 when 29 smaller companies were able to raise $100-million—but that's still only 7 percent of the 1969 figure. Obviously, we cannot attribute the entire shortfall on increases in capital gains taxes, but I assure you that those higher levies deserve a major portion of the blame.

Your Subcommittee's 1977 hearings on capital formation brought together much valuable testimony on the dangerous ramifications of a shortage of venture capital to the American economy. NASBIC appeared before you at that time and summarized several studies documenting the lessened flow of equity capital to new and growing businesses.

In these 1978 hearings, NASBIC again urges that the Subcommittee, the Finance Committee, and the Congress give the highest priority to revisions in the Internal Revenue Code which would encourage Americans to save and to invest, thus providing the dollars needed to provide new jobs, increase competition, encourage technological innovation, and improve the nation's balance of trade position. Specifically, we enthusiastically support S. 3056, Senator Hansen's bill rolling back the capital gains tax rates to pre-1969 levels.

Our Association wholly rejects the claim that a cutback in capital gains taxes is "a huge tax windfall for millionaires", as President Carter claimed earlier this week. We have participated in the birth and growth of thousands of small businesses where entrepreneurs have left a secure position in a big business, or in academic and risked every nickel they owned. These people have put their dollars and many years of their lives into their businesses; they have been willing to buck all the odds. They have been locked into their investments for years on end; they have given up consumption and leisure, devoting both dollars and hours to their enterprise. If they are successful, after many years, they have finally made a profit on their monetary investments. Speaking very frankly, I must say that I was most disappointed to read the President's remarks on capital gains taxes, because they fell short of the real business world that I have been operating in over the past 20 years.

A return to pre-1969 tax rates on capital gains will have two immediate beneficial effects so far as small and medium sized business is concerned: first, the change will encourage more Americans to invest more dollars in long-term investments in independent businesses; and second, it will encourage more qualified individuals to become entrepreneurs.

Industrial concentration is a matter of concern to observers of the American economy. High tax rates on capital gains almost inevitably lead to the sale of successful small and medium sized firms to major corporations, both because the public is not willing to invest the necessary growth dollars in non-Fortune 500 companies, and because the owners of the successful smaller firm are able to defer the capital gains tax bite through an exchange of stock with the big public corporation.

The nation's unprecedented deficit in foreign trade is another problem which can be attributed partially to the high rates of capital gains taxes here and the situation in other countries, many of which impose no taxes at all on capital gains. The Senate Small Business Committee held hearings earlier this year at which several entrepreneurs told why they had sold out their successful independent businesses to foreign corporations.

The excellent study of the American Electronics Association which has already been presented to your Subcommittee proves the value of venture capital to the U.S. economy and, conversely, the loss to the nation when such equity funds are not available.

In sum, then, NASBIC wholeheartedly and enthusiastically supports S. 3065, Senator Hansen's bill. Our members are absolutely certain that a return to pre-1969 tax rates on capital gains will set loose a surge of investment capital which will, in turn, give a tremendous boost to the American economy.

Thank you for the opportunity to make this statement.

COMMENTS ON S. 2423 AND S. 2608

Our Association commends Senator Haskell for introducing S. 2428, the Small Business and Farms Capital Preservation Act of 1978. Basically, this a capital gains roll-over measure which would defer capital gains taxation so long as most of the proceeds of a sale were reinvested in another small business. NASBIC supports the roll-over concept, but would broaden the Haskell bill by permitting corporations (at least SBICs), as well as individuals, to elect that form of tax deferral.

Similarly, we believe that Senators Bentsen and Hansen have adopted a sound principle in designing S. 2608 which provides a sliding scale of capital gains tax rates based upon the holding period. I personally think that the 2-percent additional exclusion per year falls far short of the erosion of purchasing power of the dollar, so I question its ability to spur capital investment by individuals.

I would again call to the attention of your Subcommittee the provisions of S. 1815, the Venture Capital Act of 1977, introduced by Senators Nelson, McIntyre, and Weicker. We believe that the capital gains roll-over provision in Title IV of that bill would be more effective in promoting capital formation.

STATEMENT OF THE NATIONAL CATTLEMEN'S ASSOCIATION ON S. 2428, S. 2608, AND S. 3065

The National Cattlemen's Association strongly supports the passage of the above-referenced bills. Each of the bills being heard by the Subcommittee will benefit the nation's economy as well as the livestock and agricultural industry by mitigating the adverse effects of the high capital gains tax. The magnitude of the present tax on capital appreciation exercises a depressing effect on the economy in general and has a particularly acute impact on the cattle industry.

The National Cattlemen's Association does recommend that two amendments be made to S. 2428 as outlined in the Statement.

S. 3065

S. 3065, introduced by Senator Hansen and co-sponsored by sixty Senators, would be particularly advantageous to the nation's economy as well as to cattlemen and the agricultural industry. Essentially, this bill would remove capital gains from the maximum tax provision and would reduce the maximum tax on capital gains from its current level of almost 50 percent to 25 percent. Reduction of the maximum tax on capital gains to this level would greatly assist farmers and ranchers in building their herds, expanding their operations, and making other capital improvements. The benefits from these actions would be passed along to the consumers and would promote the continued well-being of the economy.

Furthermore, S. 3065 has the advantage of simplicity. In a world where livestock operators are increasingly faced with a bewildering array of complex tax laws and government regulations, a law which is simple to understand, simple to comply with, and simple to administer is clearly advantageous to both taxpayer and government alike.

S. 2608

S. 2608, introduced by Senator Bentsen, would provide a graduated exclusion from gross income for long-term capital gains and a graduated nonrecognition of long-term capital losses for individuals. The NCA does not view this bill as being as vital an approach to the capital gains problems as S. 3065; however, the Association does support its passage.

S. 2428

NCA supports S. 2428, introduced by Senator Haskell. This bill would encourage the reinvestment of equity capital in small businesses and in farms and ranches. The Association does recommend two changes in the existing language. First, the definition of a "qualified small business investment" should be expanded to include an interest in section 1231 property. Second, a "small business concern" should either be defined in the bill or authority should be delegated to the Secretary of Treasury to promulgate such a definition.

The definition of a "qualified small business investment" contained in subsection (a)(2) of proposed section 1041 is limited to an equity or unsecured investment in any small business concern which, in the hands of the taxpayer, is a capital asset within the meaning of section 1221 of the Internal Revenue Code of 1954. While this definition would probably cover partnership interests and shareholder interests in such corporations, it may not be sufficiently broad to cover the interest of a sole proprietor whose business property is directly owned. Although gains from the sale of property owned directly by a taxpayer and used in the taxpayer's trade or business are generally taxed at capital gains rates, such property is technically not a capital asset under section 1221 of the Code, but "property used in the trade or business" under section 1231 of the Code. Since many cattlemen own their business property directly and operate as sole proprietors, as opposed to a partnership or a corporation, NCA submits that this is a potentially serious defect in the bill which could be remedied by expanding the definition of a "qualified small business investment" to include an interest in section 1231 property.

The Association is also concerned with the fact that a qualified small business investment is defined by reference to a "small business concern" as that term is used in section 3 of the Small Business Act. Section 3 of the Small Business Act is somewhat unclear in its definition of a small business concern and delegates authority to the Administrator of the Small Business Administration to determine the definition. It is doubtful that the regulations adopted by the Administrator, with the goals and administrative needs of the Small Business Act in mind, would be responsive to the goals and administrative needs of a taxing statute. NCA suggests that this problem can be solved either by specifically defining a small business concern in the statute, or by delegating authority to the Secretary of the Treasury to promulgate regulations defining a small business concern for purposes of section 1041 of the Code.

RELIEF FROM THE CURRENT HIGH RATE OF TAX ON CAPITAL GAINS IS NECESSARY TO THE CONTINUED VITALITY OF THE AGRICULTURAL INDUSTRY

The maximum effective tax rate currently imposed on long-term capital gains is almost 50 percent. A tax of this magnitude on capital appreciation discourages replacement of worn out or obsolete equipment and other capital items, retards capital expansion, inhibits the creation of new jobs, and exercises a depressing effect on the economy in general.

In the cattle industry, the impact of the high rate of tax on capital gains is especially acute. Livestock operations require significant capital investment in land, equipment and animals and, even under the best of conditions, normally require several years before profitable status is achieved. Even when profits are realized, they produce a rate of return which is one of the lowest of all national industries. In addition, livestock is a very high-risk business. Uncertain and

damaging weather conditions, diseases, precipitous market fluctuations, government regulation, foreign imports, and ever-increasing production costs are constant threats to economic survival. As a consequence, it is not uncommon for a cattle operation to produce little or no income, or even to operate at a loss, for long periods of time. For many cattlemen, capital gains from the sale of breeding animals, equipment or land may represent most, if not all, of their income in a taxable year. Moreover, these capital gains can sometimes be of considerable size. For example, circumstances beyond the control of a cattleman may force him to make a dispersal sale of the breeding herd or sell a large parcel of ranch land, thereby generating recognition of large capital gains.

The current high rate of tax on capital gains is, therefore, of vital concern to cattemen and the agricultural industry. When a substantial portion of a recognized capital gain must be paid to the government in taxes, the ability of a farmer or rancher to reinvest the proceeds in the farm or ranch operation and to modernize his operation and make it more productive and cost effective is correspondingly reduced. Moreover, in most cases, the impact of the capital gains tax can go beyond merely reducing the farmer's or rancher's ability to expand his operation. Frequently, the gain on which taxes are paid is nothing more than a paper profit produced by inflation, and does not reflect any true economic gain. In this situation, the tax bite can prevent a cattleman from simply maintaining the status quo, let alone expanding or improving his operation, since he usually does not have enough after-tax income to replace the capital taken by the government in the form of taxes. In an industry which requires a high degree of capital investment to yield a relatively small return, this contraction of capital through taxation can prove fatal.

CARRYOVER BASIS INCREASES THE PROBLEMS CAUSED BY HIGH CAPITAL GAINS TAX

The high rate of tax imposed on capital gains also has a particularly devastating impact on the estates of farmers and ranchers because of the new carryover basis rules enacted into law by the Tax Reform Act of 1976. Farm and ranch estates, which are generally severely illiquid, may be forced to sell assets to pay expenses or meet the estate tax burden imposed by reason of the decedent's death. Under prior law, the step-up in basis which the estate received prevented such a sale from triggering a further tax liability. However, under the new carryover basis provisions, this is no longer true, The result is that, if the estate is required to sell appreciated assets, such as breeding livestock, in the ordinary and normal course of continuing the farm or ranch operation, or if there is the need to sell any appreciated farm or ranch assets to pay estate costs and death taxes, such sales will precipitate a further tax burden in the form of a capital gains tax. This in turn will result in greater illiquidity, requiring further sales of farm and ranch property, generating still further tax liability. Obviously, the higher the capital gains tax in such cases, the more the problem is magnified as a result of the adverse impact of carryover basis. The net effect is that, by the time the estate has sold sufficient property to pay estate costs and death taxes and the capital gains taxes generated by such sales, the estate's assets may be so severely depleted that operation of the farm or ranch is no longer a viable possibility for the heirs.

The current high rate of tax on capital gains is therefore a substantial threat to the continued vitality and growth of the agricultural community in general, and the cattle industry in particular. With some studies predicting a food crisis in coming years, and considering our nation's world position in agricultural production, it is increasingly important not to discourage the proper growth and development of livestock production and the agricultural industry. Instead, such growth and development should be encouraged and fostered by tax and other laws to assure abundant supplies of food and fiber.

CONCLUSION

Relief from the current high rate of capital gains tax will significantly assist and encourage farmers and ranchers to increase their capital investment and generally improve their operations. The three bills currently before this Subcommittee would, in varying degrees, provide such relief and are strongly supported by the National Cattemen's Association.

NATIONAL REALTY COMMITTEE,
Washington, D.C., June 29, 1978.

Re subcommittee hearings on S. 3065 (the Investment Incentive Act of 1978), S. 2608 and S. 2428.

Hon. HARRY F. BYRD, Jr.
Chairman, Subcommittee on Taxation and Debt Management, Committee on Finance U.S. Senate, Russell Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: The National Realty Committee ("NRC") is a non-profit business league whose membership includes owners, operators and developers of all types of residential, commercial and industrial real estate throughout the United States. In the interest of the Subcommittee's time, we did not request the opportunity of presenting oral testimony before the Subcommittee at your hearings on June 28 and 29, 1978, concerning the captioned Bills. However, we do wish to take this opportunity to advise you and the members of the Subcommittee of, and to include in the record of these hearings, our views concerning these Bills and our judgment as to their importance to real estate investment and development and to economic growth generally.

NRC is in full agreement with certain clear, expressed priorities of the Administration and the Congress: the strengthening of our nation's economy, the stimulation of business investment and the revitalization of our cities. The nation's economy, while much improved, is still recovering from the drastic recession of three years ago. Progress in reaching full recovery has been seriously hampered by inflation. Prospects for continuing vigorous economic expansion are far from certain. In addition, the outlook for real estate is substantially cloudier than that for the economy as a whole.

America's real estate industry has lagged behind the pace of general economic recovery. Current unemployment rates remain at extremely high levels in construction. With the exception of single family home construction. real estate investment and development remains well below previous levels. Based upon data contained in the study Real Estate in the U.S. Economy (conducted for NRC by the independent economic research firm of Norman B. True, Inc.), during the period from 1971 through 1976 the real estate industry grew much less rapidly than other private business—1.99% per year compared to 3.02% per year for the total private sector. Real growth between 1971 and 1976 showed the industry subsectors of real estate services and finance and insurance services both up about 16%, but the private contract construction sector of the industry—responsible for the bulk of the industry's jobs—showed no growth during the period, and in fact a decline of 4% from the peak year of 1972.

Real estate development is a process involving an extended peroid of planning, valuation and construction before the structure is completed, occupied and generating revenue. More than most other sectors of the pirvate business community, real estate developers and investors need consistency and certainty in applicable federal policies—and particularly in federal tax policies. Real estate development also is capital-intensive—requiring major commitments of both debt financing and, particularly, equity capital, much of it of a risk or venture capital nature. America's real estate industry consists predominantly of a very large numbers of small enterprises, with a large portion of real estate investment occurring in non-corporate forms. These characteristics, coupled with the fact that real estate investment is largely a discretionary activity, highly sensitive to net rate of return considerations, cause real estate investment decisions to be unusually sensitive to tax policy changes. Furthermore, tax policies which increase the difficulty of obtaining the capital necessary to support the continued growth of real estate inevitably would affect the rental costs of existing structures, the level of jobs and income in the industry and the source of revenues available to state and local governments to finance needed public services.

In summary, based on the observations and analysis set forth above and in light of current and prospective economic conditions and uncertainties, NRC submits that it would be a costly mistake to enact tax changes which would further penalize saving and investment and add to present tax burdens. Conversely, we submit that it would be sound policy, consistent with those national priorities identified above and stimulative of real estate investment and development which is so vital to continued economic growth and urban revitalization, to enact tax changes which lighten or eliminate present disincentives to saving and investment.

Consistent with the foregoing, NRC is pleased to record its endorsement of and support for the initiative to reduce capital gains taxation as implemented in S. 3065,

the proposed Investment Incentive Act of 1978, introduced in the Senate by Senator Clifford P. Hansen (and the corresponding House Bill—H.R. 12111—introduced by Congressman William A. Steiger). We are in full agreement with the view of the sponsors and the many other supporters of these Bills that a roll-back in capital gain tax rates would be an effective and significant stimulant to capital formation.

As we have noted above, America's real estate industry is composed predominantly of smaller entrepreneurs, and much real estate investment is conducted in non-corporate forms. As a result, the availability and liquidity of equity capital is of the greatest importance in increasing real estate investment, and few possible tax changes could be more effective or important in stimulating real estate capital formation than the concept embodied in S. 3065.

NRC makes use of an econometric Real Estate Tax Impact Model, developed for us by the respected economist Dr. Norman B. Ture. Dr. Ture has applied the Model to the capital gains taxation proposal of S. 3065; attached as an Exhibit to these comments of the economic and federal revenue effects of S. 3065 on real estate alone. The Exhibit is self-explanatory and clearly illustrates that a reduction in the taxation of real estate-related capital gains as contemplated by S. 3065 would cause significant increases in real estate investment, GNP, employment and federal tax revenues. Specifically, in the first year alone, S. 3065 would:

"Increse real estate investment by $2.8 billion.

"Increse GNP originating in real estate by $4.2 billion.

"Increase real estate-related employment by 27,000 jobs.

"Increase federal tax revenues originating in real estate by $900 million."

NRC appreciates this opportunity to make known its support for and endorsement of S. 3065. We urge this Subcommittee and the Congress as a whole to accept and enact this proposal as an important and effective action to help achieve the nation's priority goals of capital formation and economic growth.

NRC will be pleased to supply any additional information which you, other members of the Subcommittee or staff representatives may wish in connection with S. 3065 and its impact on real estate investment and development.

Very truly yours,

KENNETH G. HANCE, Jr.,
President.

Attachment.

ECONOMIC AND FEDERAL REVENUE EFFECTS OF S. 3065

[Dollar amounts in billions of 1977 dollars]

	Effects on real estate			
	Investment	GNP	Employment (thousands of FTEE)	Federal revenues
1st year	$2.8	$3.2	27	$0.9
3d year	3.6	4.2	35	.7
5th year	5.8	6.8	64	1.5
10th year	3.6	4.2	14	.5

STATEMENT OF THE NEW ENGLAND COUNCIL, PRESENTED BY JOHN DANE, JR., CHAIRMAN, NEW ENGLAND COUNCIL TASK FORCE ON FEDERAL TAXATION, JUNE 29, 1978

This presentation of the New England Council with respect to S. 3065, S. 2608 and S. 2428 will be restricted to a discussion of the impact of the present taxation of capital gains on the health of the New England economy and the capacity of that economy to supply more and better paying job opportunities for the citizens of our area. We feel sure that, as a result of the favorable nation-wide reception which these bills have received, the major reasons why the burden of the capital gains tax should be decreased will be adequately presented by other witnesses before the Subcommittee on Taxation and Debt Management.

The New England region has not shared in the industrial expansion which has taken place in recent years in other sections of the country, primarily the southeast and the so-called "Sun Belt".

Some of the reasons for the slow development of the New England economy are geographical; i.e., distance from major markets and sources of raw materials, high utility and freight rates. These retarding factors are, of course, outside of the

jurisdiction of this subcommittee. However, inadequate capital for plant expansion and modernization is one of the most important reasons why New England has lagged behind the rest of the country. The decision which this subcommittee, and eventually the Congress, will reach on the subject of capital gains taxation will, in large measure, determine whether or not this inadequacy will be remedied.

New England is basically a high technology area as is evidenced by the development along Route 128 and more recently in the southern tier of counties in New Hampshire. High technology industries almost invariably begin on a very small scale, most often as the brainchild of a single technology sophisticated individual or group of individuals. In most cases, they have their origin in a single idea, the development and implementation of which involves a very high degree of financial risk. The result of all this is that an initial public offering of stock is out of the question. If adequate funds are to be received, they must come from a small group of individuals who can afford the risks involved.

It is at this point that the deadening impact of the present capital gains tax is felt. Potential investors in high technology enterprises often do not have substantial sums available in the form of bank accounts or treasury bills. In order to secure funds for a new venture, they must sell other securities. If they have to pay a tax equal to approximately 50% of their gain on those other securities, they may well be dissuaded from making the new investment at all, and even if they do decide to make it, they will have just that much less to invest.

The foregoing analysis discloses the true nature of the capital gains tax. It is a tribute exacted every time a successful investor attempts to change investments, and the prospect of paying this tribute is often enough to persuade the investor not to make a change in his present holdings. Every time an investor sells security A and buys security B, he runs the risk that he may be wrong both ways. A may go up and B may go down. When you add the capital gains tax into the equation, you greatly increase the risks of loss.

Surely it is not just a coincidence that the great majority of the high technology companies in the New England area were formed prior to 1969 when the first of the increases in the capital gains tax were enacted. It is also not just a coincidence that in recent years, several New England high technology companies have been forced to look to sources in Germany and in Japan, countries which do not have a capital gains tax, for additional capital. There are, therefore, good reasons to believe that if the Steiger amendment, which would eliminate the post-1969 increases in the capital gains tax, is enacted, the New England area will witness the creation of new, and the expansion of old, high technology companies.

Lack of new investment has been a major reason for the nationwide growth recession in science related industry. Because of the geographical handicaps mentioned earlier in this presentation, any deterioration in the health of high technology industry nationwide is intensified in Massachusetts. If the national economy sneezes, New England gets pueumonia. Thus, while any development which provides capital formation and investment, such as a decrease in the capital gains tax, would be welcome in any part of the country, it is essential in New England.

A great deal has been made by opponents of capital gains tax reform of the asserted fact that much of the benefits would go to high-bracket taxpayers. This is undoubtedly true if we look solely at who pays the capital gains tax; but this only part of the picture. We must look at the whole picture, we must analyze who profits from a greater availability of risk capital. Admittedly, a lower capital gains tax may save taxes for some wealthy investors, but let us not forget that it may save the jobs of many low-bracket taxpayers who would otherwise lose these jobs because their employer could not raise sufficient funds to make this plant competitive. What is more, a lower capital gains tax with the resulting increase of investment capital may well get others off food stamps and onto a payroll.

The Council urges the subcommittee to turn a deaf ear to those who are more interested in preventing the upper-bracket investors from keeping more of his profit than they are in helping the unemployed get a job.

Turning to the bills before the Subcommittee, the New England Council feels that the adoption of either S3065 or S2608 would give a big lift to the New England economy. We cannot say as much for S2428. Apparently, the theory behind this bill is that most of the new capital for small business comes from the sale of securities of other small businesses. We know of no evidence to support this.

Statement of the New York Stock Exchange, July, 1978

SHARPENING THE CAPITAL GAINS INCENTIVE—AN URGENT NEED IN A FALTERING ECONOMY

Introduction

The New York Stock Exchange appreciates this opportunity to participate in the public debate on various legislative measures affecting the taxation of capital gains. The Subcommittee on Taxation and Debt Management is to be commended for its most timely consideration of this topic.

The bills before you—S. 2428, S. 2608 and S. 3065—have, as a common feature, provision for relief of capital gains taxation imposed by current law. The Subcommittee's focus on these measures is encouraging, for it is imperative that we ease the burden which our tax code places on productive capital if we are fully to realize the growth necessary for economic well-being. Accordingly, the Exchange welcomes Congressional consideration of these and other pending proposals designed to enhance the confidence of our nation's investors, whose commitment to risk taking goes hand-in-hand with a healthy economy.

By now it is clear that the lag in economic growth is chronic. Standard monetary and fiscal policy prescriptions simply are inadequate to the task of restoring the growth rate to its longer-run trend. While balanced economic growth requires a range of policies, there should be no doubt that the incentive for capital gain is central to undertaking risk investment, the wellspring of growth.

During the course of these hearings, the Subcommittee has had presented to it many of the mounting number of recent studies which testify to the efficacy of capital gains tax incentives in stimulating risk investment and savings. According to these studies, easing the punitively high burden on long-term capital gains will be rewarded by a more vibrant economy. More and more jobs will be spawned, productivity growth will rebound and, paradoxically, the Treasury will reap greater tax revenues.

In this context, any of the legislative measures now being addressed by the Subcommittee would be welcomed, because each would impact favorably on economic growth. We would like to think that this Subcommittee's current review represents what will be one aspect of a comprehensive and thorough review of the entire area of investment taxation and its impact on our economy.

Background

By almost every measure of performance, the American economy has turned in a dismal record over the past decade or more. Unemployment has been unacceptably high. The typical American worker's weekly paycheck is worth less today in terms of real purchasing power than it was six years ago. Gains in worker productivity—the foundation of long-term improvement in economic well being—have been lagging badly. Inflation has remained stubbornly high despite a sharp recession and an unemployment rate which reached 9%.

Low productivity gains provide the bedrock for chronic inflation. Thus, the long-term solution to this country's economic ills and related social problems is to lift productivity growth from the depressed levels which have prevailed over the past decade. Only by substantially increasing output per hour worked can the historic expectation of continual improvement in living standards be realized. Failure to do so will continue to fuel the inflationary fire.

The substandard performance of productivity in large measure reflects a slowdown in the growth of business investment in plant and equipment. Productivity improvement and economic growth historically have been linked to the provision of new and better physical facilities. But the impact of inflation on capital goods costs, real corporate profits and real investment values, as well as the depressed equity markets, have weakened the incentive for risk investment.

As recent experience attests, efforts of each economic group to "beat" inflation and improve its own real economic well-being reinforce inflation. This inflationary psychology which feeds upon itself has become embedded in the American psyche. It has warped business and personal decisionmaking to the detriment of stable long-term growth. Erosion of real investment values and the great uncertainties in an inflationary economy have created an aversion to risk which underlies the serious shortfall in business investment.

The Exchange's recently-published Public Attitude Survey found the American public deeply shaken by inflation and fearful of more to come. This concern has been largely responsible for inducing defensive investment policies among individual investors. Indeed, as our survey shows, avoidance of risk has become a

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major national characteristic and problem. Accordingly, policies must be adopted which would both stimulate saving and encourage the flow of savings into risk investment.

PUBLIC ATTITUDES TOWARD INVESTING: A PROFILE OF RISK AVERSION

It is the perception of the American public that the rewards for investment in corporate securities are not commensurate with the risk. That conclusion is underscored by the findings of the Exchange's recently released survey of Public Attitudes Toward Investing, which was conducted by Opinion Research Corporation. (A copy is attached as Exhibit A.)

Pervasive concern and pessimism over inflation has generated widespread reluctance to assume even moderate economic risks. Fully 70% of the people who make the spending and investing decisions in the 45 million U.S. households with annual incomes of $10,000 or more describe themselves as unwilling to take more than "bare minimum" or "small" risks in the hope of adding to their financial assets.

As one business analyst put it: "A sense of futility is revealed between the lines of the New York Stock Exchange study of American investment attitudes." He went on to say, "It need not be emphasized that this is hardly the mood that built America—that pushed back the geographical and technological frontiers because the potential rewards made the risks worth it." [1]

Similarly, in testimony before this Subcommittee on June 29, Professor Feldstein noted that the crux of the investment problem is not so much the lack of capital as the unwillingness to commit funds to risk investment.

The psychological gloom revealed by the study verifies the inferences regarding negative investor attitudes we and others drew from the Exchange's 1975 Survey of Shareownership. This statistical profile of shareowners measured an 18% decline in the shareowner population between 1970 and 1975—from 30.9 million to 25.3.

The deep vein of caution about equity investment does not stem from either pessimism over business prospects or a feeling that stock investment is extraordinarily risky. Indeed, about two of every three persons queried felt the outlook was favorable for business profits. As regards riskiness, listed common stocks were regarded as having only moderate risk.

Whatever their fears, investors and prospective investors are very sensitive to the impact of Federal taxes on investment income. When asked their reaction to each of a series of possible favorable investment tax changes, the respondents attitudes toward equity investment improved considerably. Interestingly, the favorable responses were not significantly different between present and former stockholders.

Clearly, Americans are not insensitive to incentives. The inertia regarding risk investment would be overcome by aftertax returns which prospective investors regard as balancing their risks. Obviously, less burdensome investment taxes would lift net returns to more acceptable levels.

Buoyed by the prospect of greater rewards, funds would be committed to risk investment. In turn, higher levels of business investment in plant and equipment modernization and expansion, would be stimulated. This would prop sagging economic growth and also improve the competitiveness of U.S. manufacturers in world markets.

The Economic Scoreboard

The litany of areas of economic weakness during this decade is all too familiar. However, in the day-to-day bombardment of economic news, it is sometimes hard to maintain a perspective on just how badly the economy has fared.

Below is a scoreboard of the growth records of seven key interrelated economic series which capsulizes long-term and more recent U.S. economic performance. Growth during the 1970's is contrasted with the postwar average through 1969. The years 1962 to 1969 are isolated because it was a period of high economic growth. Not coincidentally, it was also an era of business and personal income tax liberalization and less punitive capital gains tax arrangements. Taken together, the data provide a thumbnail sketch of the economy's performance and the interrelationships among the various economic indices.

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[1] John Cuniff, Associated Press Business Analyst, the Gary Post Tribune, June 7, 1978.

GROWTH RATES OF KEY ECONOMIC INDICATORS

	Average annual percent increases		
	1947–69	1962–69	1969–77
Measures of output:			
Real GNP	3.9	4.4	2.7
Industrial production	4.8	6.4	2.7
Measures of well-being:			
Real weekly earnings (private nonagricultural)	2.0	1.4	0
Unemployment rate (average for period)	4.7	4.4	5.4
Growth-inducing factors:			
Productivity (output/man-hours)	3.2	3.2	1.6
Real nonresidential fixed investment	3.9	7.1	1.3
Inflation (GNP deflator)	2.6	3.0	6.2

Source: Department of Commerce; Department of Labor; Federal Reserve Board.

A comparison of performance of the various indices for the relatively high growth years between 1962 and 1969 with that for the slow growth 1969–1977 period affords a vivid illustration of the linkages between output, general economic well-being, and productivity and business investment.

The growth of real output plummeted in the period 1969–1977. Specifically, at 2.7% a year, the rate of GNP increase was some 40% lower than the 1962–1969 average. The rate of growth of industrial output for 1969 to 1977 was almost 60% off the pace for the earlier period. Real weekly earnings growth stagnated during the later period, compared with an average annual gain of 1.4% for the years 1962 to 1969. (Indeed, the typical worker's gross weekly paycheck declined in real terms in 1974 and still has not reattained 1973 levels.) At 5.4%, the unemployment rate over the 1969 to 1977 period averaged a full point higher than in 1962–1969.

The sluggish 1969–1977 economic performance reflects a halving of the rate of productivity gain from the 3.2% average for both long-term pre-1969 growth and for the 1962–1969 period. This precipitous drop stems from the dampening of spending on productive plant and equipment. Though spending on real nonresidential fixed investment showed minimal gains (a 1.3% annual rate) over the 1969–1977 period, an increased proportion of total investment was diverted to non-productive projects—pollution abatement, health and safety measures and fuel conservation and conversion projects.

A similar comparison between the post-1969 period and the longer-term (1947–1969) trend would further confirm the simple truism that productivity improvements and job creation are sustained by business investment. Thus, the lag in risk investment lies at the crux of this country's economic problems, as was underscored by the unanimity of opinion during this Subcommittee's hearings on the capital gains tax.

Impacts of a Strengthened Capital Gains Incentive

The key role of incentives in the operation of our free enterprise economy has never been seriously questioned during the long history of debate over investment tax policy. It has been generally recognized that the spur of capital gains induces saving and investment and that the greater the riskiness of a venture, the higher the prospective return required. It is also accepted that capital mobility—the redeployment of invested capital—is necessary to achieve the most efficient allocation of the limited pool of investment funds.

Consequently, the capital gains tax debate has focused, first, on the extent to which specific changes in tax levels and provisions mute or stimulate investment and savings and capital mobility; and, second, weighing those results against other public policy objectives. However, the analysis is not static. Impacts of any mix of tax policies would differ, depending on the state of the economy and investor attitudes.

As underscored by our Public Attitude Survey, existing incentives are insufficient to whet investors' appetites for risk investments. What might have seemed to be an appropriate mix of capital gains tax policies in 1969 has, in retrospect, proved inadequate to sustain economic growth at an acceptable level.

The spate of recent studies on the subject of capital gains—many of them presented to this Subcommittee—provide ample demonstration that a strengthened capital gains incentive would help pull the U.S. economy out of the doldrums.

Three of this country's most eminent econometricians—Dr. Evans of Chase Econometrics; Dr. Eckstein of Data Resources, Incorporated; and, Mr. Ciminaro Merrill Lynch—have demonstrated that a lower capital gains tax burden would stimulate general economic growth and job creation, spur productivity improvements and increase tax yields—including capital gains tax collections. [2]

An important reason for the increase in capital gains tax collections if rates are lowered is the lessened tendency to "lock-in" to highly appreciated investments. This was demonstrated in the two pioneering studies which Dr. Feldstein, discussed at the Subcommittee's hearings.

In a third study he spotlights the need for measures to overcome the deleterious effects of taxing the inflation-induced appreciation of investments. This classic problem has had a particularly chilling effect on investment incentives in the new climate of chronic inflation, as is emphasized by our Public Attitude Survey results.

The logic behind the findings of the empirical studies cited above has been demonstrated by Dr. Laffer, both in his presentation to this Subcommittee and in his published work.

A recent study by Professor Michael J. Boskin [3] of Stanford University—not to our knowledge presented to this Subcommittee—should be crucial to its deliberations. (A copy is attached as Exhibit B.) Professor Boskin measured the responsiveness of saving to changes in real after-tax rates of return.

Previous studies have generally looked either at pre-tax or nominal rates of return, or both. Professor Boskin estimates that a 10% increase in the real after-tax rate of return will induce a healthy 4% increase in saving. In the jargon of economists, savings elasticity with respect to real, after-tax returns is 0.4. He also concludes that the current capital gains tax induces overconsumption and insufficient savings. He estimates the resulting loss in economic welfare to be almost $60 billion per year! Professor Boskin concludes his pioneering study thus:

"Taken as a whole, the results reported here substantially strengthen the case for reforming the tax treatment of income from capital . . . for example . . . switching from income to consumption taxes." [4]

Conclusion

The need for capital gains tax relief is pressing. If prompt action is not taken to spur investment, economic problems will continue to build as U.S. industrial capacity is strained, with obsolete plant and equipment continuing to put a drag on productivity. The resulting increased unit costs and production bottlenecks would ratchet inflation, which contributes substantially to the disillusionment of the nation's wage earners and to the apprehension of its investors.

Again, the New York Stock Exchange applauds the Subcommittee's valuable contribution to the public discussion of this issue, particularly its role in drawing attention to the urgent need for Congress to ease the tax burden now placed upon our capital resources.

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[2] Secretary of the Treasury Blumenthal and Assistant Secretary Brill, have criticized the conclusions that a decrease in capital gains taxes would raise Treasury revenues in part due to an increase in stock prices—Dr. Eckstein estimated a 5% rise; Dr. Evans, 40%; and Mr. Ciminaro, 20%. The Treasury cites these three divergent estimates as partial evidence that any assumption with regard to the response of stock prices is arbitrary. Therefore, they argue one should estimate no change. The NYSE respectfully submits that the Treasury assumption is arbirrary to the nth degree.

Obviously, tax policy plays a vital role in a dynamic economy. Imperfect as they may be, assessments of prospective policies provide the only basis for choosing that combination of possible tax arrangements which hold out the most promise for achieving agreed upon goals.

[3] Michael J. Boskin, "Taxation, Saving and the Rate of Interest," Journal of Political Economy, April 1978 (vol. 86, No. 2, pt. 2).

[4] Boskin, p. 525.

NYSE Exhibit A

Introduction

This is the New York Stock Exchange's first major survey since 1959 of public attitudes toward investing. Anyone who is concerned with America's prospects for sound economic growth will find the results deeply disturbing and challenging.

The survey was prompted largely by the desire to understand why millions of Americans with investable funds have continued to turn their backs on corporate shareownership during a period of relative national prosperity. The Exchange's 1975 "Census of Shareowners" showed a net decline of some 5½ million individual owners of corporate stocks or mutual fund shares between 1970 and 1975; and there is no indication that the trend has been reversed. Many reasons have been suggested. In this survey, we asked investors, former investors and non-investors to tell their own stories.

Focusing on the views and comments of financial decision-makers in households with annual incomes of $10,000 or more, the survey found pervasive public preoccupation with "preserving" capital and purchasing power to keep abreast of inflation. Investments that are perceived as involving the least amount of risk rank highest today in the estimation of people who have funds to invest. Investments in corporate stocks are viewed as entailing "moderate" risks which most investors say they are unwilling to assume as they try to keep up with escalating living costs.

But if the public's expectations of worsening inflation are correct, avoidance of all risk may be the most dangerous alternative of all. The deeply cautious attitudes toward financial risk-taking that permeate the survey findings may foreshadow the erosion—rather than the desired protection—of household assets and purchasing power, if the real value of what is so diligently "preserved" in fact declines.

It is not surprising that this is not more widely recognized, since financial decision-makers at all income levels readily admit they lack knowledge about many types of investments, while many have significant misunderstandings of the relative risks and rewards associated with different types of investment vehicles.

At the same time, the public does recognize that changes in the relationships between risks and rewards can strongly influence the setting of investment goals and the choice of investment vehicles. This is evident from a deeper probing of attitudes toward stock investments.

At first glance, some of the attitudes expressed may seem illogical. It is widely believed, for example, that corporate profits will increase substantially over the next few years; yet, financial decision-makers are reluctant to commit investable funds to equity ownership that would give them the best opportunity to participate directly in the anticipated profits.

But investors and non-investors alike made clear that changes in current tax treatment of investment return would strongly stimulate their interest in equities. In other words, increasing the reward side of the risk/reward ratio would reduce their reluctance to assume reasonable risks.

What lessons can we glean from the detailed findings presented in this report?

Clearly, we must stimulate better understanding of the risks and rewards associated with all investment vehicles that compete for the public's discretionary funds. That suggests an urgent need for broadly based educational programs aimed at providing financial decision-makers with the basic knowledge needed to make informed investment decisions that are most appropriate to their individual household circumstances.

Equally urgent, we must realistically re-evaluate—and, where necessary, change—public policies which inhibit rather than encourage individual public investment in America's economic future.

Failure to act in both areas can only aggravate the growth, inflation and productivity problems already plaguing our nation.

Negative public attitudes toward investing in corporate securities most seriously threaten the prospects of thousands of smaller and medium-sized growth-oriented companies which desperately need equity capital to maintain their position on the leading edge of technological innovation. These are the companies—the vast majority of which are not listed on the New York Stock Exchange—that offer the greatest potential for creating new jobs across the entire spectrum of our national economy.

Much of America's greatness stems directly from our long tradition as a nation of venturesome men and women who are willing to take reasonable economic risks in the hope of earning the rewards that our unique form of private enterprise makes possible. We must act decisively to assure that misunderstanding, lack of knowledge and unrealistic public policies do not transform us from a nation of risk-takers into a nation of economically timid souls.

Chairman
New York Stock Exchange

Summary of Findings

Based on in-depth interviews with 2,740 households with annual income of $10,000 or more.

1. The American public, shaken by inflation and fearing more to come, is deeply cautious about managing its money.

- Primary financial goals are defensive: To avoid loss of both principal and purchasing power.
- 70% are unwilling to take more than barest minimum or small risk.
- The most widely held investment vehicles are those perceived as involving the smallest element of risk.

2. Despite the prevailing mood of caution, the public clearly believes in investment and expects to invest more during the next few years.

- The suggestion that it makes more sense to spend than save is strongly rejected.
- Preferred vehicles are passbook savings, savings certificates, home ownership, other real estate, and life insurance.
- People who traded stock in the past year view common stocks more favorably than those who did not. Others think stock investments will become more attractive if inflation is brought under control.

3. Optimism about corporate earnings is outweighed by concerns about further inflation and dissatisfaction with the risk/reward ratio for common stocks.

- Most financial decision-makers' expect corporate profits to increase but do not expect to participate through stock ownership
- "Safety and stability" and higher dividend returns would be important inducements to invest in stocks. Key deterrents are lack of funds and perception of the market as "too risky"

4. Changes in the tax laws would significantly influence financial decision-makers' willingness to invest in stocks.

- Elimination of personal taxes on dividend income would strongly stimulate stock investment
- Financial decision-makers would also respond strongly to more liberal tax treatment of capital gains and losses, elimination of the corporate income tax on dividends, and significant reduction of taxes on unearned income.
- Elimination of all special treatment of capital gains would have a very strong negative impact on stock investment.

5. Misunderstanding and lack of knowledge about most types of securities investments critically influence public attitudes toward, and participation in, the market.

- Barely one-fourth of all financial decision-makers consider themselves knowledgeable about listed common stocks
- Most financial decision-makers do not view brokerage products as appropriate to meeting their very important needs.
- Fewer than half of all current stock owners' consider themselves knowledgeable about brokerage products other than listed common stocks (Active traders' rate their own knowledge more highly)
- Misunderstandings about securities are most evident among those who have never owned stock

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[1] A "financial decision maker" is the person (or persons) in a household who is most influential in making decisions about saving, investing or spending discretionary income

[2] A "stock owner" is a household in which one or more family members directly owns listed common stock, preferred stock, unlisted common stock or stock mutual fund shares

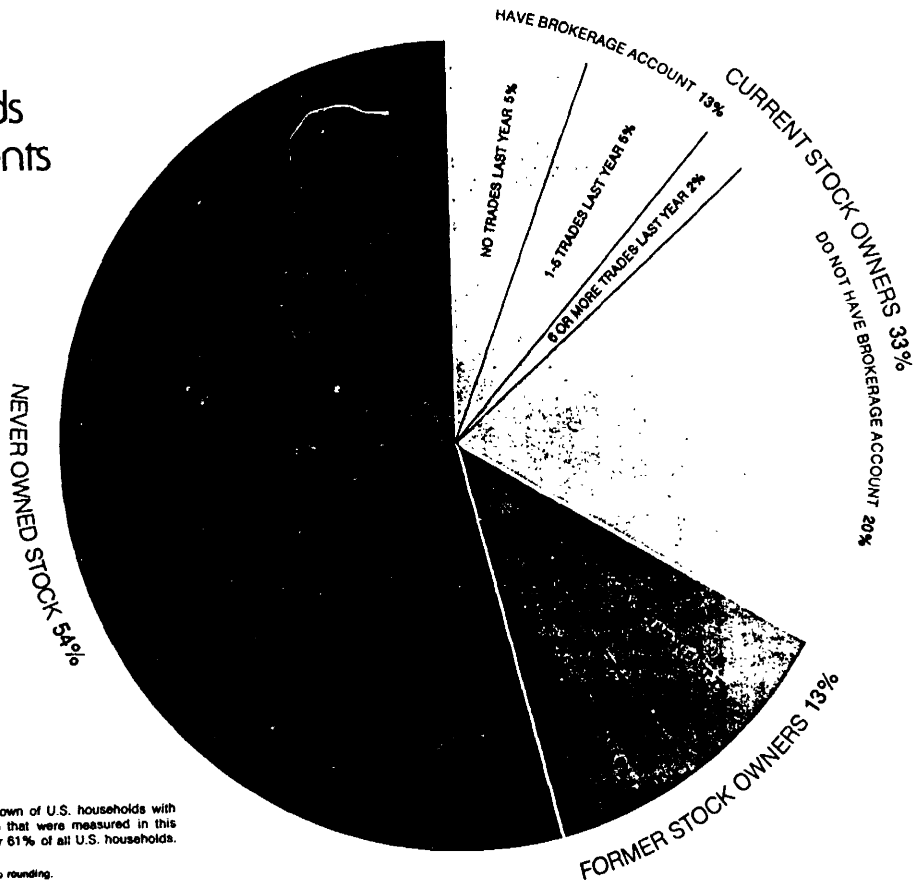
[3] An "active trader" is a stock owner with a brokerage account who made six or more stock trades during the preceding 12 months

Similarly, an "infrequent trader" is a stock owner with a brokerage account who made 1-5 trades during the preceding 12 months

An "inactive investor" is a stock owner, with or without a brokerage account, who made no trades during the preceding 12 months

CHART I

Households by Segments



This chart shows the breakdown of U.S. households with incomes of $10,000 and up that were measured in this study—a total of 45 million or 61% of all U.S. households.

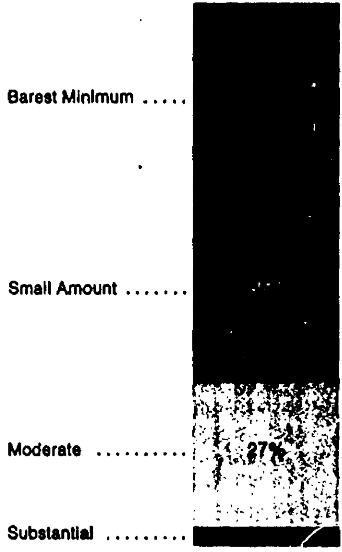
Figures may not add exactly due to rounding.

I. The Current Investment Climate: A Prevailing Mood of Caution

[illegible]

CHART III

ACCEPTABLE DEGREE OF RISK TO ACHIEVE CERTAIN LEVEL OF FINANCIAL GAIN FROM OWN INVESTMENTS



Degree of risk broken down by current stock owners (with and without brokerage accounts), former stock owners, and those who never owned stock is shown in Appendix B.

■ *Most* financial decision-makers regard these five financial goals as "very" or "fairly" important:
. . Generating income to meet normal expenses.
. . . Keeping up with inflation.
. . . Protection for the family.
. . . Income for retirement.
. . . Personal control of assets.
By contrast, *less than half* the financial decision-makers view these goals as important:
. . . Long-term capital appreciation.
. . . Quick (short-term) profits.
. . . Accumulating money for large purchases.

■ As might be expected, younger and less affluent financial decision-makers do not stress the same goals as their older and more affluent counterparts.
. . . Those under 35 and those with incomes below $15,000 give much greater importance to income for normal expenses, improving their standard of living and buying a home than do other groups.
. . . Younger people are also more concerned than their elders with college expenses, the personal challenge of investing, short-term profits, accumulating money for large expenditures, and minimizing taxes.
. . . Households with incomes above $25,000 put above-average emphasis on capital appreciation, minimizing taxes, minimizing downside risk, maximizing leverage, and diversification of investments.

■ A majority of financial decision-makers regard three investment vehicles as most appropriate for meeting their own financial goals—Life insurance, cash savings (both of which are widely considered to be necessities) and real estate other than one's own home.

TABLE I

RANKING OF FINANCIAL GOALS BY DEGREE OF IMPORTANCE

"VERY" OR "FAIRLY" IMPORTANT TO MAJORITY OF HOUSEHOLDS

	Total	Stock Owners
Income/normal expenses	91%	85%
Keeping up with inflation	88	85
Protection for family	87	86
Income/retirement	87	85
Personal control of assets	82	84
Improved standard of living	78	70
Estate for spouse/children	74	70
Tax minimization	67	67
Purchase of home	65	55
Guaranteed fixed return	62	61
Children's college expenses	59	55
Liquidity—cash or equivalent	54	59

"VERY" OR "FAIRLY" IMPORTANT TO MINORITY OF HOUSEHOLDS

	Total	Stock Owners
Long-term capital appreciation	47%	61%
Fun/challenge	45	41
Minimal downside risk	42	45
Maximum leverage from available funds	40	49
Quick profits	31	28
Savings/investing for "big ticket" expenditure	27	30
Diversification	24	39
Action—frequent trading	12	10

TABLE II

INVESTMENT VEHICLES VIEWED AS BEST MEETING MOST IMPORTANT FINANCIAL GOALS

Goal	Vehicle (Percent of Households)
Protection for family	Life Insurance (57%)
Income/normal expenses	Real Estate Other Than Home (22%), Savings Certificate (19%)
Income/retirement	Life Insurance (25%), Savings Certificate (22%), Real Estate Other Than Home (19%)
Keeping up with inflation	Real Estate Other Than Home (32%)
Personal control of assets	Savings Certificate (25%), Real Estate Other Than Home (24%)
Purchase of home	Savings Certificate (21%), Real Estate Other Than Home (20%)
Estate for spouse/children	Life Insurance (47%), Real Estate Other Than Home (26%)
Improved standard of living	Real Estate Other Than Home (30%)
Children's college expenses	Savings Certificate (34%), Life Insurance (26%)
Tax minimization	Real Estate Other Than Home (24%)
Guaranteed fixed return	Savings Certificate (21%), Life Insurance (20%)

TABLE III

OWNERSHIP OF INVESTMENT VEHICLES

	Own Now	Once Owned
	(Percent of Households)	
Life Insurance	92%	4%
Passbook Savings Account	86	4
Own Home	83	3
U.S. Savings Bonds	47	22
Employee Savings Plan	34	12
Savings Certificate	34	8
Real Estate Other Than Home	30	9
Tangible Investments	29	2
LISTED COMMON STOCK	27	11
Employee Profit-Sharing Plan	25	10
Ownership in Private Company	19	10
Investment Retirement Account	16	1
Stock Mutual Funds	11	9
Annuity	10	2
Unlisted Common Stock	9	8
Preferred Stock	9	5
Long-Term U.S. Bonds	6	5
Municipal Bonds	5	5
Convertible Securities	5	5
U.S. Treasury Bills	5	4
Corporate Bonds	5	3
Tax Free Mutual Funds	3	1
Tax Shelters	2	2
Money Market Mutual Funds	2	1
Options	1	2
Warrants	1	2
Commodity Contracts	1	1

■ The most widely held investment vehicles, in addition to one's own home, are those perceived as involving the smallest element of risk—life insurance, various types of fixed-income savings, and other real estate.

. . . Treasury bills and municipal bonds are rated low-risk but are not widely held—possibly because most financial decision-makers are not very familiar with them.

. . . Common stock, considered moderate in risk, is ranked 6th riskiest of 20 vehicles.

■ Holders of listed common stock are likely to have a number of other investments.

. . . Nearly all have life insurance, a passbook savings account and own their own home or apartment.

. . . Smaller, but significant, numbers have U.S. savings bonds, savings certificates, participate in an employee savings plan, own other real estate or such tangibles as gems or art.

. . . 25% also hold unlisted common stock, preferred stock or stock mutual funds.

■ One-third of those who own real estate other than their home also hold listed common stock; half as many hold unlisted common stock, preferred stock or stock mutual funds.

TABLE IV

RISK PERCEPTION OF INVESTMENT VEHICLES FINANCIAL DECISION-MAKERS SAY THEY ARE KNOWLEDGEABLE ABOUT

3.0 = Maximum or highest risk score
1.0 = Minimum or lowest risk score

Investment Vehicle	Total	Total Stock Owners	Former Stock Owners	Never Owned Stock
Tax Shelters	2.4	2.5	2.7	2.1
Unlisted Common Stock	2.3	2.3	2.5	1.9
Put or Call Stock Options	2.3	2.3	2.7	2.0
Commodity Contracts	2.2	2.4	1.9	2.2
Warrants	2.1	2.3	2.0	1.9
LISTED COMMON STOCK	2.0	2.0	2.1	1.8
Stock Mutual Funds	1.9	1.9	1.7	2.2
Money Market Mutual Funds	1.8	1.8	1.6	2.0
Convertible Securities	1.7	1.8	1.9	1.6
Tax-free Mutual Funds	1.6	1.6	1.6	1.6
Preferred Stock	1.6	1.5	1.7	1.9
Corporate Bonds	1.6	1.6	1.4	1.6
Real Estate Other Than Home	1.5	1.5	1.5	1.5
Municipal Bonds	1.5	1.5	1.5	1.4
Life Insurance	1.3	1.2	1.3	1.4
Annuity	1.3	1.3	1.3	1.2
U.S. Treasury Bills	1.3	1.2	1.2	1.5
Investment Retirement Account or Keogh Plan	1.2	1.2	1.3	1.3
Long-term U.S. Government Bonds	1.2	1.2	1.1	1.3
Savings Certificate	1.2	1.1	1.1	1.2

TABLE V

DUPLICATION OF OWNERSHIP BETWEEN LISTED COMMON STOCK, REAL ESTATE OTHER THAN OWN HOME, AND OTHER INVESTMENT VEHICLES

	Own Listed Common Stock and	Own Real Estate Other Than Own Home and ....
Life Insurance	95%	93%
Passbook Savings Account	93	84
Own Home or Apartment	92	92
U.S. Savings Bonds	60	49
Savings Certificate	53	47
Tangible Investments	44	32
Employee Savings Plan	41	38
Real Estate Other Than Home	39	—
LISTED COMMON STOCK	—	34
Unlisted Common Stock	27	15
Stock Mutual Funds	26	17
Preferred Stock	25	15
Household Base	12,177,000	13,530,000

2. The Desire to Invest

Despite the prevailing mood of caution, the public clearly believes in investment and expects to commit more funds to virtually every type of investment vehicle in the next few years. However, the most preferred vehicles are passbook savings, savings certificates, home ownership and other real estate, and life insurance.

- The public strongly disagrees with the statement, "I like to take substantial financial risks to realize significant financial gains."
- Nevertheless, financial decision-makers give no evidence of a live-for-today attitude. They also strongly reject the statement that "spending money on things I enjoy makes more sense than saving it."
  ... Widespread participation in such "free" or "painless" investments as employee savings plans (34% of households) and employee profit-sharing plans (25%) is not diverting people from direct investment.
  ... A high proportion of financial decision-makers agree that "many common stocks will be a good investment as soon as the economy gets healthy and inflation is brought under control."
- People who traded stock during the past year view common stock more favorably than those who did not.
  ... A majority of active traders say they intend to invest more in common stocks and rated listed common stocks as the most favored vehicle for increased investment.
  ... Former stock owners, however, are far more concerned with avoiding risk than are current stock owners or people who have never owned stock. They show the strongest preference of any group for savings accounts, savings certificates, life insurance and real estate as future investment vehicles.

TABLE VI

PUBLIC BELIEVES IN INVESTMENT

Most of public strongly *agrees* with these statements:

It's best to plan for the long run when you invest in the stock market

Because of inflation, it is hard to beat investments in real estate.

To make money, an investor must be prepared to take substantial risks

Investing in the stock market is just gambling and should only be done with money you can afford to lose

I really can't afford to invest in stock

Most of public strongly *disagrees* with these statements:

I like to take substantial financial risks to realize significant financial gains.

Investing money is not worth the effort.

The way things are going now, spending money on things I enjoy makes more sense than saving it

Because of Social Security and pension funds, I don't have to worry about investing extra money.

CHART IV

NEAR-FUTURE INVESTMENT INTENTIONS

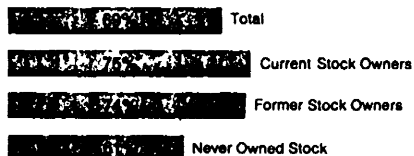
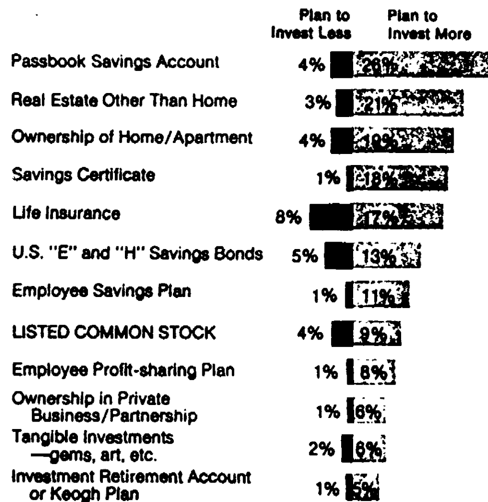


CHART V

FUTURE INVESTMENT PLANS



3. Perceptions of Common Stock

The public is optimistic about corporate earnings prospects over the next few years. But this is clearly not sufficient to overcome *ingrained concerns* about further inflation and implied dissatisfaction with the current risk/reward ratio with respect to common stock investments.

■ A large majority of financial decision-makers expect business profits to increase. But only a minority expect to participate directly in those profits through stock ownership.
. . . About one-quarter expect profit increases to be sharp.
. . . Only one-eighth expect corporate profits to decline.

■ Common stock is regarded as the best vehicle for achieving investment diversification.
. . . But diversification is ranked 19th on a list of 20 important financial goals.
. . . *Common stocks are perceived* as inappropriate for meeting such major goals as income for regular expenses, guarding against inflation, and family protection.

■ These perceptions are underscored by attitudes toward *future investments* in common stock.
. . . People who have never owned stock, but who are considering entering the market in the near future, would be attracted principally by "*safety and stability*" and by higher dividend returns. Only a small minority of this group say they would buy stock if they had more money to invest.

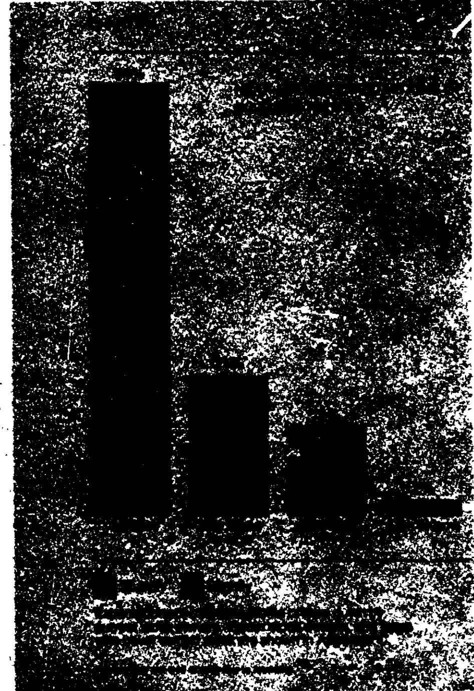


TABLE VII

INDUCEMENTS TO BUY COMMON STOCK

	Total	Former Stock Owners	Never Owned Stock
Safe investment, stability	24%	25%	23%
Good return	22	29	18
Reliable, honest broker	11	2	16
Increase in income and capital	10	23	4
Good growth potential	8	8	7
More money, income to invest	7	3	10
Interest in named specific type of stock	6	2	9
Specific service/innovation from brokerage firm	5	—	7

... Among those who say they are unlikely to enter the market in the near future, the principal deterrents are lack of funds and perception of the market as "too risky."

■ Former owners of stock cite two principal types of reasons for leaving the market:

... A preference for investments involving less risk—and a transfer of funds into such investments as home ownership and other real estate.

... A need for money for major household expenses such as college costs and medical bills—or other unspecified purposes.

■ One in seven former owners say they left the market because they lost money.

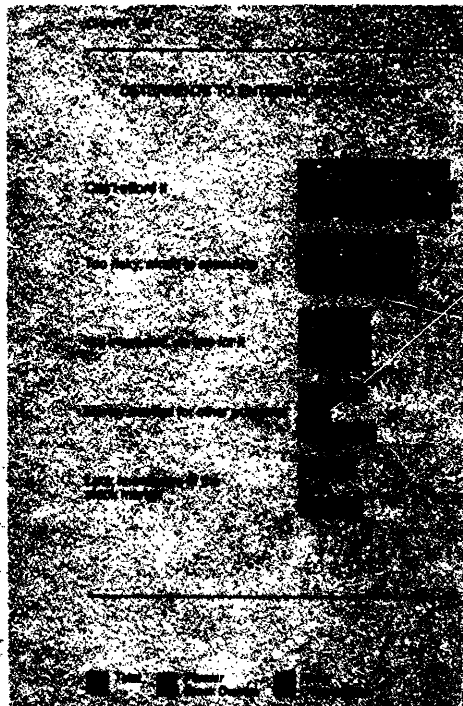


CHART VIII

FORMER STOCK OWNERS' REASONS FOR LEAVING MARKET

Prefer safer, less risky investments

Put money in other investments—home, real estate, etc.

Suffered a loss, market went down

Needed the money (reason not given)

Major household expenses—college education, medical bills, etc.

Have less to invest now

4. The Impact of Taxation

Current tax policies appear to be a major deterrent to stock ownership. Changes in the tax laws would significantly influence financial decision-makers' willingness to invest in stocks.

■ Nearly half of all former and current owners say they would re-enter the market or add to their portfolios if dividends were no longer taxed as personal income.

. . . Significant numbers of current and former stock owners believe corporate dividend payouts are too small. Dissatisfaction is strongest among those who traded during the past year.

■ Various steps to liberalize capital gains tax treatment would induce households to add to their stock holdings. While the effect of any one change might be moderate, several such changes in combination would have a significant impact.

■ Other changes in the tax laws would also strongly encourage participation in the market by both present and former owners. The most frequently cited incentives are:

. . . Elimination of the corporate tax on income distributed as dividends.

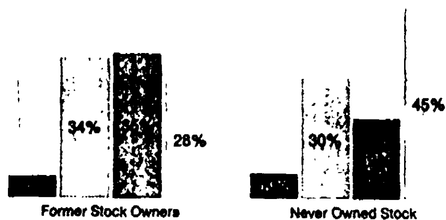
. . . Reduction of more than 25% in the income tax on unearned income.

■ On the other hand, elimination of all special treatment of capital gains would prompt significant numbers of present stock owners to reduce their portfolios or leave the market entirely, and would strongly inhibit former owners from returning. (Owners who have a current brokerage account would react most strongly. Fully one-third say they would decrease or liquidate their portfolios if all special capital gains treatment were eliminated.)

■ Among investment vehicles regarded as tax shelters, real estate is widely recognized and used. Municipal bonds and tax-free bond funds are much less popular—in part, perhaps, because investors are far less familiar with them.

ƆWNERS' AND FORMER STOCK OWNERS' PORTFOLIOS

Reduce Stock Portfolio		Leave Stock Market		Net Change: Add vs. Reduce	
Present	Former'	Present	Former'	Present	Former'
*%	1%	2%	1%	+44%	+47%
4	1	2	1	+23	+19
2	2	4	1	+19	+19
6	2	3	2	+ 9	+14
5	3	4	1	+ 3	+ 4
5	3	6	6	0	− 4
10	11	2	12	−12	−17
2	1	2	3	+ 5	+12



Figures may not add exactly due to rounding

5. Misunderstandings About Investment

Widespread misunderstanding and lack of knowledge about all but the most commonly used investment vehicles are clearly critical factors influencing public attitudes toward, and participation in, all types of investments—particularly securities.

- Although active stock owners tend to rate their own knowledge of brokerage products relatively highly, fewer than half of all current owners consider themselves knowledgeable about any brokerage product other than listed common stock.
- Misunderstanding is particularly widespread among those who have never owned stock—even those who consider themselves knowledgeable. For example, many of these people believe that real estate is a liquid investment and that savings certificates offer long-term capital appreciation and maximize leverage. They also perceive the following groups of investments as involving comparable degrees of risk:

. . . Unlisted common stock, warrants and preferred stock.
. . . Money market mutual funds and stock options.
. . . Stock mutual funds and commodity contracts.
. . . Real estate and U.S. Treasury bills.

- No more than one-fifth of the public considers itself knowledgeable about corporate bonds, Treasury bills, preferred stock or convertible securities. But these are perceived as relatively low-risk investments, and the public generally considers low-risk investments as appropriate for keeping up with inflation and meeting other important financial goals.
- One in eight financial decision-makers who are unlikely to buy stocks in the near future cite lack of knowledge of the market as the principal reason.

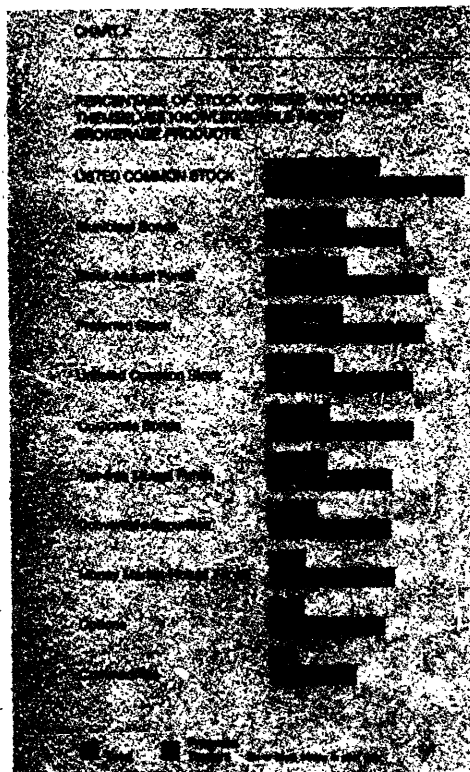


TABLE IX

KNOWLEDGE OF DIFFERENT "INVESTMENT VEHICLES"

Vehicle	Households Considering Themselves Knowledgeable
Life Insurance	68%
Savings Certificate	56
Real Estate Other Than Home	54
Long-Term U.S. Government Bonds	37
LISTED COMMON STOCK	26
Investment Retirement Account or Keogh Plan	25
Municipal Bonds	25
Stock Mutual Funds	22
Annuity	22
U.S. Treasury Bills	20
Preferred Stock	19
Unlisted Common Stock	16
Corporate Bonds	16
Tax Free Mutual Funds	14
Tax Shelters	13
Convertible Securities	10
Warrants	10
Money Market Mutual Funds	10
Put or Call Stock Options	9
Commodity Contracts	8

6. Brokers and Their Customers

More than half the U.S. households with at least $10,000 annual income—nearly 25 million—have never owned stock. A projected total of 15 million households have one or more stock owners—but fewer than 6 million currently have brokerage accounts.

- People with current accounts give their own registered representatives high marks for over-all job performance, but express dissatisfaction with the timeliness of buy and sell advice.
  ... Attitudes toward brokers and brokerage firms in general are substantially less favorable.
  ... Savings banks, commercial banks and life insurance companies are the most highly regarded financial institutions.
- Better than one in four former stock owners say they are likely to return to the market during the next few years. About one in seven who have never owned stock say they are likely to enter the market for the first time.
  ... However, those who have never owned stock far outnumber those who are former owners. Thus, the actual indicated numbers of prospective new buyers are 1.6 million former owners and 3.5 million who have never owned stock.

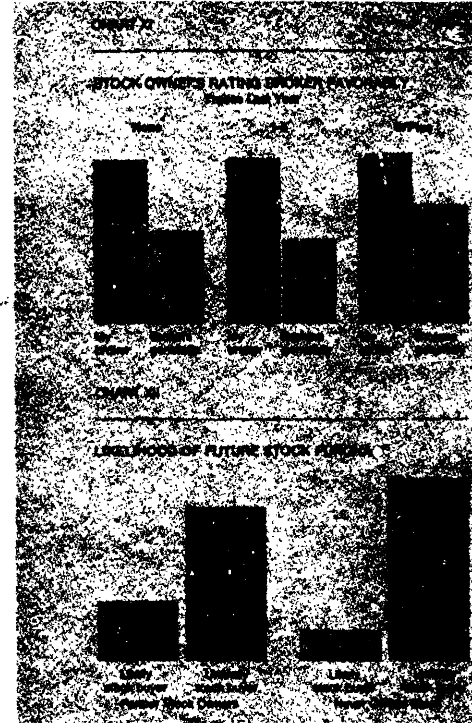
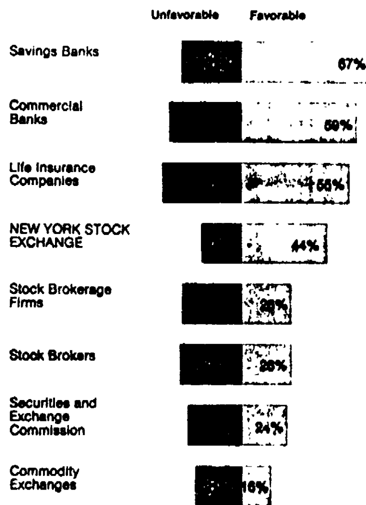


CHART XIII

ATTITUDES TOWARD BANKS, BROKERS, AND OTHERS



Attitudes toward various financial institutions broken down by former stock owners, those who never owned stock, and current stock owners by account and trade activity are shown in Appendix D.

100% less sum of favorable and unfavorable are "don't know."

7. Awareness of The New York Stock Exchange

Most present and former stock owners are aware of differences between NYSE-listed stocks and stocks traded elsewhere. They are also aware of distinctions between NYSE member organizations and non-members, and express a clear preference for doing business with NYSE member organizations.

■ The public shows little awareness of securities markets other than the New York and American Stock Exchanges.
... Nevertheless, financial decision-makers in more than half the households that have never owned stock—a majority of all households with annual income of $10,000 or more—say they do not know enough about the NYSE to have a favorable or unfavorable attitude.
... The public, including current stock owners, has virtually no awareness of investor protection provided by the Securities Investor Protection Corporation (SIPC).

■ Those who are most aware of the NYSE—current and former stock owners—regard surveillance of trading and regulatory oversight of member firm operational and financial activities as the Exchange's most important functions.

TABLE X

KNOWLEDGE ABOUT NYSE
(Percent of Households Considering Statement Definitely or Probably True vs Definitely or Probably Untrue)*

Statement

"I would prefer to do business with a brokerage firm that is a member of the NYSE"

"The NYSE regularly audits or checks on the selling practices of its member brokerage firms"

"The Exchange's rules require a continuous market in all its listed stocks—you can buy or sell any time the market is open"

"Companies listed on the NYSE have to satisfy stiffer financial qualifications than companies listed on other exchanges"

"Brokerage firms that are members of the NYSE have to satisfy stiffer financial requirements than other brokerage firms do"

"You tend to get a better price when you buy or sell your stock on the NYSE"

"The NYSE doesn't do a good job representing the individual investor in Washington, D.C."

"If I had a complaint against a brokerage firm that is a member of the NYSE, it would be very difficult for me to get anyone at the Exchange to do anything about it"

*100% less sum of True and Untrue are "don't know"

TABLE XI

IMPORTANCE OF NYSE FUNCTIONS TO EXPERIENCED STOCK

Require member firms to be well capitalized . . . .

Investigate, act on justified customer complaint . . . .

Establish standards for well-trained member firm brokers . . . .

Require brokerage firm honesty in advertising, market letters, etc . . . .

Take action against member firm/brokers who violate Exchange rules . . . .

Total	Current Stock Owners	Former Stock Owners
69/12%	70/12%	67/11%
68/5	69/4	66/9
66/11	66/10	64/12
55/16	56/14	54/23
50/16	51/14	47/22
43/21	44/21	41/23
20/35	20/32	18/42
15/57	16/56	13/58

)WNERS

	Current Stock Owners With Current Account:		
Total	Frequent Traders	No Current Account	Former Stock Owners
48%	45%	27%	39%
39	17	43	52
37	46	29	33
36	31	41	52
34	52	29	25

APPENDIX A

NEAR-FUTURE INFLATION EXPECTATIONS

	Total	Current Stock Owners	Former Stock Owners	Never Owned Stock
Increase	77%	78%	74%	77%
Sharply	36	32	31	40
Slightly	41	46	43	37
Stay Same As Now	17	18	21	15
Decrease	5	3	4	6
Slightly	4	2	3	5
Sharply	1	1	1	1
Don't Know	1	1	2	1

Figures may not add exactly due to rounding

APPENDIX B

ACCEPTABLE DEGREE OF RISK TO ACHIEVE CERTAIN LEVEL OF FINANCIAL GAIN FROM OWN INVESTMENTS

	Substantial	Moderate	Small Amount	Barest Minimum
Total	3%	27%	35%	35%
Current Stock Owners	2	32	43	23
With current brokerage account	3	40	35	21
Without current brokerage account	1	26	49	24
Former Stock Owners	2	29	45	24
Never Owned Stock	2	24	29	45

Figures may not add exactly due to rounding

APPENDIX C

NEAR-FUTURE EXPECTATIONS OF BUSINESS PROFITS

	Total	Current Stock Owners	Former Stock Owners	Never Owned Stock
Increase	64%	62%	53%	68%
Sharply	25	18	27	29
Slightly	39	44	27	39
Stay Same As Now	21	21	23	20
Decrease	13	16	22	8
Slightly	11	15	17	8
Sharply	1	1	4	1
Don't Know	2	1	2	4

Figures may not add exactly due to rounding

APPENDIX D

ATTITUDES TOWARD BANKS, BROKERS, AND OTHERS

		Current Stock Owners								Former Stock Owners	Never Owned Stock
			With Current Account								
				Trades Last Year			# Accounts:				
	Total	Total Stock Owners	Total	None	1-5	6/Plus	One	Two/Plus	No Current Account		
Savings Banks											
Favorable	67%	73%	74%	75%	71%	81%	74%	71%	72%	59%	66%
Unfavorable	27	25	25	24	28	18	24	28	24	40	26
Don't know	5	3	2	1	1	1	2	1	3	1	8
Commercial Banks											
Favorable	59	61	55	61	49	70	55	64	64	50	60
Unfavorable	34	35	40	34	49	25	40	34	31	45	31
Don't know	7	5	4	5	3	5	5	2	5	5	9
Life Insurance Companies											
Favorable	55	51	45	55	39	33	46	38	54	56	58
Unfavorable	37	42	47	39	49	64	48	46	40	43	32
Don't know	8	7	8	7	12	3	6	16	6	1	10
NEW YORK STOCK EXCHANGE											
Favorable	44	57	65	64	60	70	64	61	52	54	34
Unfavorable	18	22	24	24	25	28	26	23	20	21	15
Don't know	38	21	11	12	15	2	10	16	28	25	51
Stock Brokerage Firms											
Favorable	26	37	49	43	47	53	46	49	29	28	19
Unfavorable	27	40	43	48	40	45	47	36	38	34	17
Don't know	47	23	9	9	12	1	7	15	33	38	64
Stock Brokers											
Favorable	26	36	46	44	40	56	47	35	30	31	19
Unfavorable	28	40	45	49	46	43	46	50	37	25	22
Don't know	46	24	9	7	15	1	7	15	33	44	59
Securities and Exchange Commission											
Favorable	24	32	36	38	34	30	34	35	30	28	19
Unfavorable	25	36	42	33	42	64	43	42	32	36	17
Don't know	50	32	22	29	23	6	23	23	39	36	64
Commodity Exchanges											
Favorable	16	19	16	19	16	15	17	15	21	14	14
Unfavorable	21	26	25	16	21	48	24	27	27	28	17
Don't know	63	55	59	65	63	36	59	58	52	58	69

Figures may not add exactly due to rounding.

METHODOLOGY

The Public Attitude Survey was conducted for the New York Stock Exchange by Opinion Research Corporation, Princeton, N.J. ORC was assisted in the development stage by Alvin J. Rosenstein and Associates.

Sample Design

ORC conducted in-depth interviews with financial decision-makers in 2,740 households. Participants were selected by ORC to provide a fully projectable national probability sample. The findings are applicable to the 45 million U.S. households with 1976 gross incomes of $10,000 or more, or 61% of all U.S. households.

To ensure adequate responses and minimal sampling errors for respondents in the smallest sub-groups, households in the $25,000 to $49,999 and the $50,000-and-higher income groups were over-sampled. Respondents were weighted back to the distribution of all U.S. households with an income of $10,000 and over as follows:

Annual Household Income	Distribution of Respondents	Final NYSE Weighted Sample	U.S. Households (March 1977)*
$10,000-$14,999	492	30%	31%
$15,000-$24,999	959	45	45
$25,000-$49,999	831	21	21
$50,000 and Over	458	4	3
TOTAL	2,740	100%	100%
Median Income	—	$18,900	$19,[illegible]00

*Source: U.S. Department of Commerce, Bureau of the Census. Consumer Income, Series P-60, No. 109, January 1978.
Note: U.S. Census data are based on head of household responses which may vary somewhat from Public Attitude Survey respondents.

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Reliability of Survey Percentages

Results of any sample are subject to sampling variation. The magnitude of the variation is measurable and is affected by the number of interviews and the level of the percentages expressing the results.

The table below shows the possible sample variation that applies to percentage results reported in this study. The chances are 95 in 100 that results would not vary, plus or minus, by more than the indicated number of percentage points from the result that would be obtained if the interviews were repeated using the same sampling procedures.

Approximate Sampling Tolerances Applicable to Percentages at or Near These Levels[1]

Size of Sample on which Survey Result is Based	10% or 90%	30% or 70%	50%
2,700 interviews	2%	2%	2%
2,000 interviews	2	3	3
1,000 interviews	2	4	4
500 interviews	3	5	5
250 interviews	5	7	8
100 interviews	7	11	12

[1]Based on 95 chances in 100.

Sampling Tolerances When Comparing Two Subsamples

Tolerances are also involved in the comparison of results from different parts or groups of any one sample. A difference, in other words, must be of at least a certain size to be considered statistically significant. The table below is a guide to the sampling tolerances applicable to such comparisons.

Size of Samples Compared	Differences Required for Significance At or Near These Percentage Levels[a]		
	10% or 90%	30% or 70%	50%
1,000 and 1,000	3%	5%	6%
1,000 and 500	4	6	7
500 and 500	5	7	8
500 and 200	6	9	10
200 and 200	7	11	12
200 and 100	9	14	15
100 and 100	10	16	17

[a]Based on 95 chances in 100.

Questionnaire Development and Interviewing

The survey questionnaire was developed in consultation with members of the financial community, individual investors and non-investors. In-depth interviews with top level individuals in the securities industry were conducted by Opinion Research Corporation and Alvin J. Rosenstein Associates; the latter also conducted ten focus group sessions throughout the United States to develop hypotheses for the questionnaire. The ORC interviewing staff pretested the questionnaire and was responsible for its administration and processing.

The questionnaire was administered through personal interviews undertaken with respondents 21 years of age or over who reported themselves to be either "co-equal" or "chief" household financial decision-makers (see Definition of Terms.) All interviewing was conducted between September 1977 and January 1978, with the average interview lasting an hour and a quarter.

DEFINITION OF TERMS

Term	Definition
Financial Decision-Maker	The person (or persons) in a household who is most influential in making decisions about saving, investing or spending discretionary income.
Stock Owner	A household in which one or more family members own listed common stock, preferred stock, unlisted common stock or stock mutual fund shares.
Stock Owner With An Account	As above, where individuals report having a current account at a brokerage firm where "you could call them and place an order without filling out any forms."
Former Stock Owner	A household in which one or more family members once owned any of the above four types of stock but did not own any at the time of interview.
Never Owned Stock	A household in which no family member has ever owned any of the above four types of stock.
Frequent Trader, Active Trader	A stock owner with a brokerage account who made six or more stock trades during the preceding 12 months.
Infrequent Trader	A stock owner with a brokerage account who made 1-5 trades during the preceding 12 months.
Inactive Investor	A stock owner, with or without a brokerage account who made no trades during the preceding 12 months.

TAXATION, SAVING, AND THE RATE OF INTEREST

(By Michael J. Boskin)

This study presents new estimates of consumption functions based on aggregate U.S. time-series data. The results are striking: a variety of functional forms, estimation methods, and definitions of the real after-tax rate of return invariably lead to the conclusion of a substantial interest elasticity of saving. The implications of this result for the analysis of the efficiency and equity of the current U.S. tax treatment of income from capital are explored. In reducing the real net rate of return, current tax treatment significantly retards capital accumulation. This in turn causes an enormous waste of resources and redistributes a substantial fraction of gross income from labor to capital. Rough estimates of the lost welfare exceed $50 billion per year (a present value close to $1 trillion! and of the redistribution from labor to capital exceed one-seventh of capital's share of gross income. It also suggests that the usual calculations of tax burdens by income class substantially overestimate both the progressivity of the income tax and the alleged regressivity of consumption taxes.

The effect of interest rates on economic behavior, particularly on saving and consumption, has been a central concern of economists at least since the development of classical macroeconomics. Not only has the rate of interest been viewed as the mechanism for equation saving and investment in pre-Keynesian macroeconomic models, but it also has been at the center of virtually all microeconomic models of intertemporal consumer behavior. It is thus curious that empirical studies of the effects of interest rates on saving are few and far between.[1] Most such studies conclude that interest rates have only a negligible effect on consumption or saving.[2]

The notion that saving is perfectly interest inelastic has received widespread acceptance among empirical and policy-oriented macroeconomists. While I shall present below considerable evidence that nothing could be further from the truth, it is worthwhile exploring just how important the interest elasticity of the saving rate is in the analysis of a wide variety of vital issues of economic policy. In so doing, I hope to point out how costly it has been (and will continue to be) to accept the conjecture—based on evidence which is flimsy at best and dangerously misleading at worst—that the interest elasticity of the saving rate is negligible. This is done in Section 1.

Section II discusses several previous studies of saving behavior. I deal with possible biases in previous estimates of the interest elasticity of the saving rate. Special attention is paid to the notion, which has come to be called "Denison's Law," that the saving rate is essentially constant and unaffected by changes in the tax system or other changes in the real after-tax rate of return to capital. An analysis of data for the United States in Section III leads me to conclude that no behavioral significance can be attributed to the conventionally measured gross private saving rate: it measures neither saving nor income in the appropriate manner, and attempts to do so reveal a saving rate which can hardly be called constant.

Section III also presents detailed sets of estimates of private consumption functions. A variety of functional forms, definitions of the variables, and estimation methods all lead to the conclusion that private saving is indeed strongly effected by changes in the real after-tax rate of return. The estimated total (income plus substitution) interest elasticities of private saving cluster around 0.3–0.4. While this is hardly an enormous elasticity by conventional standards, it is substantially larger than virtually all previous estimates and the conventional wisdom and has drastic implications for the effect of tax policy on income, welfare, and income distribution.

Section IV reports estimates from this same body of data of Harrod neutral CES production functions. Again, a variety of estimation techniques yields similar estimates of the elasticity of substitution of approximately one-half. Combined with our estimates of the interest elasticity of the saving rate, this immediately implies that policies which raise the after-tax rate of return will increase labor's gross share of income in the long run.

Section V summarizes the implications of the empirical results for the analysis of the effects of various policies on income, welfare, and income distribution.

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[1] Thus, Break (1974, p. 151) notes, "Unfortunately, empirical evidence on the interest elasticity of the saving rate is rare."

[2] A discussion of why these studies may have biased the estimated interest elasticities toward zero is presented below.

Briefly, policies such as switching from an income tax to a consumption tax which raise the after-tax rate of return to capital will increase income substantially, remove an enormous deadweight loss to society resulting from the distortion of the consumption-saving choice, and redistribute income from capital to labor. Section VI concludes with a discussion of the limitations of the study and avenues for further research.

I. THE ISSUES AT STAKE

I shall discuss in turn five basic concerns of economic policy: the effects of the income tax on the distribution of income, the differential incidence of a consumption and an income tax, the tax treatment of human and physical capital, the effect of inflation on the capital intensity of the economy, and the debate over whether the saving rate is high enough in the United States. We shall see that the interest elasticity of the saving rate is the key parameter in the analysis of each of these issues. The potential importance of the interest elasticity of saving in the analysis of the effect of monetary policy is obvious and well-known enough that repetition here is unnecessary.

Virtually all empirical estimates of tax burdens by income class allocate income taxes according to income; that is, they assume the tax is not shifted.[3] In an economy in which either the private saving rate is sensitive to the real after-tax rate of return or the marginal propensity of the public sector to invest out of revenues is different from the private sector's marginal propensity to save out of private income, this assumption is incorrect. Since an income tax both decreases the after-tax rate of return on capital and transfers resources from the private to the public sector, it affects the national saving rate and capital labor ratio. If saving responds positively to increases in the rate of return and/or the public propensity to save falls short of the private propensity to save,[4] an income tax retards capital accumulation and leads to a lower level of income and lower wage/rental ratio than would otherwise exist.[5] Further, labor's share of gross income will fall with increases in income taxation if the elasticity of substitution falls short of unity.[6] In these circumstances, a proportional income tax is quite different from a tax which is borne in proportion to income; indeed, it transfers income from labor to capital and, hence, is regressive, relative to such a tax.

A closely related question concerns the differential incidence of an income and a consumption tax. While most economists recognize the efficiency advantages in taxing consumption rather than income, the general argument against a consumption tax has been that it is regressive because it excludes interest income from the base tax. This analysis is correct as far as it goes, for interest income does accrue disporportionately to the wealthy. However, it overlooks two basic points. First, the rate structure may be set differently under a consumption tax; second, the exemption of interest income from the tax base may increase the saving rate, the capital labor ratio, the productivity of labor, and the wage rental ratio. This long-run transfer of income from capital to labor must be offset against the short-run gain to capital from the interest income exemption. The net outcome, of course, depends upon the particulars of the two taxes being compared. Again, however, the prevalent view is that of Pechman (1971): ". . . The differential effect on consumption and saving between an income tax and an equal yield expenditure tax is likely to be small in this country" (p. 65).

A related issue concerns the relative tax treatment of physical and human capital. I have argued elsehwere (Boskin 1975) that the tax system probably biases capital accumulation toward investment in human capital and away from physical investment because most human capital investments are financed out of tax-free forgone earnings. This is equivalent to instantaneous depreciation of this component of human investment. Since we do not allow instananeous write-off of investment in physical capital (except R & D expenditures), the current system of income taxation probably reduces the after-tax rate of return on physical capital relative to that on human capital. Hence, the deadweight loss from the misallocation of a given amount of investment in physical and human capital will depend upon, among other things, the interest elasticity of the saving rate.

Attention has recently been focused on the economic effects of inflation. In a Tobin-type monetary growth model with taxes, Feldstein (1978) demonstrates how inflation may decrease the capital intensity of production and hence affect the real economy. Again, a key issue appears to be whether saving responds positively to increases in the real net rate of return.

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[3] E.g., see Pechman and Okner, 1974.
[4] I present evidence to support this position below.
[5] See the analysis in Feldstein (1974a, 1974c). Also see the contributions by Sato (1967).
[6] I present evidence to this effect in Section IV.

Finally, we come to the perennial issue of whether we are saving enough in the United States. A variety of economists and politicians have continually expressed concern over the slower rate of real economic growth in the United States than in Japan and western Europe. Hardly a day goes by when a major speech is not given on "the capital shortage." While the issue is complex and I can hardly hope to deal with it in detail here, suffice it to say that under a not implausible set of assumption's a major component of the answer reduces to whether or not current taxes, in driving a wedge between the gross marginal social yield and net marginal private yield on investment, distort the timing of consumption over the life cycle; a sufficient condition for this to occur is a positive (pure-substitution) interest elasticity of the saving rate.[7]

Thus, if the saving rate displays some interest elasticity, our notions about tax incidence, about the effects of inflation on the real economy, and about intertemporal allocative efficiency will have to be revised drastically. I shall return to a more complete discussion of these issues in Section V below.

II. PREVIOUS STUDIES AND DATA DESCRIPTION

A. Previous work on saving behavior

For several decades, econometric work on saving behavior consisted largely of estimating Keynesian-type consumption functions. The inclusion of an interest-rate variable in such analysis was the exception rather than the rule. Further, when interest rates were included, nominal before-tax rates rather than real after-tax rates were used. Feldstein (1970) has demonstrated that such a procedure almost certainly biases downward the estimated interest elasticity. Since most of the early work on consumption and saving focused on issues other than the effect of interest rates, perhaps it is not surprising that little attention was paid to the weak, and sometimes negative, relationship between saving and the rate of interest. Musgrave and Musgrave (1974, p. 478) report that "studies of the relationship between saving and the rate of interest differ in their conclusion. Some hold that there is a substantial negative relationship, while others attribute little weight to the rate of interest in the consumption function." It is curious, however, that little attention is paid to interest rates in consumption functions in the large-scale econometric macromodels in widespread use today.

Several recent studies of saving have included interest rates as determinants of saving. Wright (1969) includes a measure of after-tax rates of return on stocks and bonds in estimating consumption functions from U.S. annual time-series data. His estimates imply an interest elasticity of saving of approximately 0.2. As he himself notes, this is substantially larger than the usual assumption and, despite his efforts, may be closer to the total than the pure-substitution elasticity. However, his measures of consumption and income suffer from several deficiencies, and his data refer to the period prior to 1958. Hence, at the very least, his results must be improved and updated.

Weber (1970, 1975) examines the impact of interest rates on aggregate consumption. He finds a positive relationship between consumer expenditures and nominal interest rates. In the second study, he includes the expected inflation rate as a determinant of consumer expenditures but finds no evidence that expected inflation affects consumption.

In a study of quarterly U.S. aggregate postwar data, Taylor, 1970 estimates an enormous interest elasticity, approximately 0.8. Since his study is directed toward other issues, he merely reports this result without attempting to explain why his estimate is several times larger than that of other researchers. Perhaps this is because it is unclear that he is estimating a structural equation rather than a reduced form from some larger system.

Finally, in a though-provoking reexamination of Denison's Law. David and Scadding (1974) document the continued constancy of the gross private saving rate, the constancy of the saving rate augmented to include consumer durables purchases in saving and rental flow from durables in income, and changes in the composition of private saving between the household and business sectors. They interpret this relative constancy of the gross private saving rate as evidence that

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[7] This question is analyzed in detail in Feldstein (1978).

taxes—either through a reduction in private income or a reduction in the real net rate of return on capital—do not affect private saving behavior. While this argument also has been made by a large number of other economists. I shall demonstrate below that drawing such behavioral inferences from these data is not warranted.

In brief summary, there is very little empirical evidence from which to infer a positive relationship (substitution effect outweighing income effect) between saving and the real net rate of return to capital. Surprisingly little attention has been paid to this issue—particularly in light of its key role in answering many important policy questions—and those studies which do attempt to deal with it can be improved substantially.

B. The Data

The data used in this study came from a variety of sources reporting on aggregate U.S. annual time series from 1929 to 1969. Most of the data are derived from the complete—and consistent—accounting system for the private sector of the U.S. economy developed by Christensen and Jorgenson (1973). These data include information on private income, gross saving, wealth, consumer expenditure, labor compensation, property compensation, rates of return on capital disaggregated into four sectors, depreciation, replacement, and revaluation of assets. They are worked up from the U.S. national income and product accounts and other sources: Divisia price and quantity indexes are used throughout.

Data are also used directly from the national income and product accounts, the *Statistics of Income*, and a variety of miscellaneous sources. The definitions of the main variables used in the study, with emphasis on how they differ from conventional definitions are as follows:

Gross private saving.—This constitutes national income accounts' (NIA) definition of gross private saving plus personal expenditures on durable goods plus statistical discrepancy. Christensen and Jorgenson (1973) include the surplus in the social insurance trust funds; for the period under study this makes little difference. I present gross private saving rates with and without the surplus included in tables 1 and 2 below.

Net private saving.—This is gross private saving less replacement and depreciation. Depreciation is estimated for each type of capital good and assumed to be geometric; while this may or may not be the best form to impose on the data, it is probably a substantial improvement over the NIA depreciation figures (which are reconciled to IRS tax depreciation figures which, in turn, bear no simple relationship to true depreciation. Use of other measures of depreciation does not alter the conclusions reached below.

TABLE 1.—GROSS PRIVATE SAVINGS RATE, U.S. ECONOMY, 1929-69

Year	GPS GNP	GPS. GNP	Year	GPS GNP	GPSS GNP
1929	0.222	0.221	1950	.243	.240
1930	.184	.183	1951	.244	.232
1931	.168	.166	1952	.236	.226
1932	.102	.099	1953	.237	.228
1933	.104	.102	1954	235	.228
1934	.146	.144	1955	.246	.239
1935	.173	.171	1956	.238	.230
1936	.203	.199	1957	.237	.230
1937	.204	.187	1958	.225	.225
1938	.176	.163	1959	.227	.223
1939	.206	.193	1960	.219	.212
1940	.225	.213	1961	.217	.214
1941	.255	.241	1962	.228	.223
1942	.298	.282	1963	.227	.219
1943	.286	.266	1964	.239	.231
1944	.307	.286	1965	.243	.236
1945	.275	.253	1966	.249	.236
1946	.222	.245	1967	.248	.236
1947	.212	.196	1968	.240	.230
1948	.236	.224	1969	.251	.237
1949	.239	.230			

TABLE 2.—SAVING OUT OF PRIVATE INCOME AND NET SAVING RATE, U.S. ECONOMY, 1929-69

Year	GPS DPI	NPS NNP	NPSS NNP
1929	0.18	0.062	0.061
1930	.14	−.005	−.007
1931	.11	−.039	.042
1932	.06	−.150	−.153
1933	.06	−.131	−.134
1934	.08	−.048	.050
1935	.11	.010	.008
1936	.14	.068	.063
1937	.15	.069	.050
1938	.11	.017	.002
1939	.14	.067	.052
1940	.17	.099	.085
1941	.21	.147	.130
1942	.19	.199	.181
1943	.18	.200	.179
1944	.21	229	.206
1945	.21	.195	.171
1946	.22	.139	.111
1947	.22	.108	.091
1948	.24	.126	.112
1949	.24	.116	.106
1950	.27	.122	.118
1951	.27	.119	.106
1952	.26	.106	.093
1953	.28	.108	.098
1954	.27	.099	.092
1955	.30	.118	.110
1956	.29	.099	.090
1957	.29	.092	.083
1958	.28	.072	.072
1959	.29	.083	.078
1960	.29	.074	.066
1961	.29	.071	.068
1962	.32	.093	.086
1963	.32	.092	.083
1964	.35	.109	.099
1965	.36	.116	.198
1966	.38	.126	.110
1967	.39	.119	.105
1968	.39	.140	.097
1969	.38	.096	.080

Disposable private income.—Unlike the NIA definition, I include retained earnings as part of disposable income. Also included is the rental flow from durables.

National income (net and gross).—This includes the rental flow from consumer durables.

Wealth.—This is the market value of private nonhuman assets.

Rates of return.—These are nominal after-tax rates of return from Christensen and Jorgenson (1973). Also used were the Moody's Aaa bond rate, adjusted for the average marginal tax rate on interest income, from *Statistics of Income*, and Standard and Poor's high-grade tax-free municipal bond rate.

Expected inflation rate.—This rate is estimated from an adaptive expectations model of price expectations, truncated after 8 years, with varying speeds of adjustment. Expectations were projected forward to form long-run average rates for 5, 10, and 20 years.

Miscellaneous.—This category includes population, unemployment rates, price data, and other components of income from NIA or the Economic Report of the President. All magnitudes are expressed in constant 1958 prices from Christensen and Jorgenson (1973); aggregate magnitudes are expressed in per capita terms.

III. PRIVATE SAVING

The relative constancy of the gross private saving rate—the ratio of gross private saving to gross national income—so well documented by David and Scadding (1974) fails to reveal a variety of important features of private saving in the United States. For the sake of comparison, table 1 presents gross private saving rates for the U.S. economy, 1929-69, with and without the social insurance fund surplus included in the measure of gross saving. Again, the relative constancy of this ratio in years of full employment is obvious. In the postwar period, it ranges from 20 to 24 percent, with most of the observations at 22 or 23 percent.[8]

[8] Recall that the inclusion of consumer durables raises this rate from 15 percent to 16 percent of the conventional measure.

The gross private saving rate is the product of the saving rate out of disposable income and the ratio of disposable income to total income, that is,

$$GPSR = \frac{GPS}{GNP} = \frac{GPS}{DPI} \times \frac{DPI}{GNP}. \qquad (1)$$

We know that taxes as a percentage of total income have risen substantially over this period. Hence, the saving rate out of disposable income must have increased substantially to offset the decline in the ratio of private to total income. Table 2 documents this fact: indeed, the saving rate out of private net-of-tax income has increased by more than 50 percent since the early postwar period. The behavioral interpretation given to these data by David and Scadding (1974) is that taxes and present consumption are essentially perfect substitutes: the rise in taxes is offset by an equivalent decline in current consumption. They go on to explore a variety of intriguing conjectures concerning consumer behavior.

Three basic points need to be made concerning this conjecture. First, most theories of consumer behavior relate saving to disposable income. If this is correct, the saving rate varies substantially. A direct test of whether disposable income or total income is the appropriate variable in a private saving function is presented below.

Second, it indeed would be surprising if consumers made this type of rational calculation vis-a-vis the government and business sectors in terms of gross saving and income. Consumers know their capital depreciates. Again, our economic theories generally relate to how consumers choose their net position. Further, except for some possible embodied technical change, it is net saving that is relevant to the issue of whether taxes affect capital accumulation. Table 2 presents calculations of the net private saving rate—net saving dividend by net income. This series exhibits substantially more relative variation than the gross series and can hardly be called constant, even if we confine ourselves to the postwar period.[9] While depreciation series are notoriously unreliable, use of several alternative series based on tax, replacement cost, etc. depreciation still yields substantial variation in the net private saving rate. I take this to be a strong indictment of the structural interpretation of Denison's Law.

Third, even if total gross income and gross saving are examined, there still may be an independent effect of real net rates of return on saving. Even if taxes and present consumption are perfect substitutes the public sector is doing its benefit cost analyses properly, free-rider issues are ignored, etc.), the share of private wealth consumed today publicly or privately) will depend upon the net, or after-tax, return to saving, whereas gross income is the flow from private wealth at the gross return. Hence, taxes decreasing the net return to saving may cause a decrease in saving.

Before proceeding to a variety of estimates of saving equations, it is perhaps worthwhile to offer a brief conjecture on the apparent constancy of the saving rate. Consider two motives for saving: smoothing of consumption over the life cycle and bequests. Further, assume bequests (broadly construed to include provision of education as well as pure financial bequests) are luxuries. Hence, real income growth would tend to increase saving. However, if saving is also positively related to the real net return on capital, the slight decline in this rate would lead to a decrease in saving. Hence, the two effects offset one another. No doubt many other effects have been at work as well. Thus, I find it extremely difficult to give any structural or behavioral interpretation to the constancy of the gross private saving rate.

Merely pointing out some difficulties in interpretation of some data does not suffice to reject the conjecture outright nor does it provide an alternative behavioral interpretation. Hence, I turn now to estimates of the effect of taxes on private saving, that is, to estimates of consumption functions.

Equation (2) presents my basic estimate of a (private) consumption function:[10]

$$\begin{aligned} LGCONSP = & \underset{(1.3)}{-3.8} + \underset{(0.12)}{0.56}\ LGDPI + \underset{(0.08)}{0.18}\ LGDPI(-1) \qquad (2) \\ & + \underset{(0.06)}{0.28}\ LGWLTH(-1) - \underset{(0.01)}{0.003}\ LGUNEM - \underset{(0.31)}{1.07}R, \end{aligned}$$

$R^2 = 99$: SSR=0.001 1; SE=0.0088;

[9] If one took the broader view of saving as inclusive of human investment, use of Kendrick's (in press) data reveals still more variability in the total saving rate, gross as well as net.

[10] All equations delete 1941–46. The Cochrane-Orcutt adjustment for serial correlation has been made in this and subsequent equations when necessary.

where LGCONSP is the natural logarithm of real per capita private consumption, DPI is disposable private income, WLTH is wealth, UNEM is the unemployment rate, R is the real after-tax return on capital, (−1) indicates a one-period lag. SE is the estimated standard error of the regression, and SSR is the sum of squared residuals. Estimated SEs appear in parentheses below the estimated coefficients.

The equation performs quite well by conventional standards. The estimated SE is a tiny fraction of the mean value of the dependent variable. The individual coefficients are measured relatively precisely and have the expected signs. The important thing to note is the positive real rate-of-return effect; the estimated interest elasticity of saving at mean values of the variables is approximately one-fourth. Also note that the implied income elasticity of saving exceeds unity.

A variety of authors have conjectured on the effect of inflation on saving. For example, Mundell (1963) argues that inflation increases saving because it destroys the value of accumulated wealth and consumers attempt to restore their wealth-income position. There is also an uncertainty argument which leads to a similar result: consumers hedge by spreading the loss of income over more than one period. These effects may offset any indirect effects of the rate of inflation acting through the real rate of return. We have thus entered the expected rate of inflation (π) an as additional regressor in the basic equation. This yields

$$\begin{aligned} \text{LGCONSP} = & -\underset{(1.34)}{0.46} + \underset{(0.12)}{0.5}\ \text{LGDPI} + \underset{(0.08)}{0.18}\ \text{LGDPI}(-1) \\ & + \underset{(0.07)}{0.26}\ \text{LGWLTH}(-1) - \underset{(0.011)}{0.003}\ \text{LGUNEM} - \underset{(0.33)}{1.07}\ \text{R} - \underset{(0.06)}{0.29}\pi \end{aligned} \quad (3)$$

$$R^2 = .99; \qquad \text{SSR} = 0.0017; \qquad \text{SE} = 0.0091.$$

The estimated real net rate-of-return elasticity is still substantial, virtually unchanged at about one-quarter. The other coefficients are hardly affected, and expected inflation does have the expected negative sign for consumption holding π constant.

A loglinear specification gives similar results:

$$\begin{aligned} \text{LGCONSP} = & -\underset{1.29}{0.60} - \underset{0.12}{0.56}\ \text{LGDPI} + \underset{0.08}{0.17}\ \text{LGDPI} - 1 \\ & + \underset{0.06}{0.28}\ \text{LGWLTH} - 1 - \underset{0.04}{0.004}\ \text{LGUNEM} - \underset{0.011}{0.044}\ \text{LGR}. \end{aligned} \quad (4)$$

$$R^2 = .99; \qquad \text{SSR} = 0.0017: \qquad \text{SE} = 0.0088.$$

Again, the estimated interest elasticity is around one-fourth, and the other estimated coefficients are quite similar to those from the semilog specifications.[11]

The measure of the real net rate of return on capital involves three elements: the nominal rate of return, the tax rate, and the inflation rate I have experimented not only with alternative methods lag structure, forward projection, adjustment speed of estimating the expected inflation rate but also with alternative measures of the nominal net return. Use of the Moody's Aaa bond rate in an equation analogous to 2 yielded an estimated coefficient of −0.6 with an estimated SE of 0.2. This implies an interest elasticity of slightly less than 0.2. Use of Standard and Poor's high-grade municipal bond rate makes it unnecessary to measure marginal tax rates on capital income: this also yielded an estimated coefficient of −0.6 with an estimated SE of 0.2: this produced an interest elasticity of slightly less than 0.2.

There is always a problem in interpreting saving or consumption functions estimated by single equation methods. It is difficult to believe that the rate of return or wealth or income is exogenous. Since the saving function is embodied in a larger model of economic activity—whether a simple growth model or a monetary growth model or a fullscale macroeconometric model the parameter estimates obtained with single equation methods may be biased. Since I do not wish to specify a complete macroeconometric model, I proceed as follows: I estimate consumption functions by an instrumental variable technique using as instruments principal components of the exogenous variables from the Hickman-Coen annual macroeconometric model. The problem is thus reduced to one of manageable

[11] Likewise, different adjustment speeds for inflationary expectations and different length of forward projection of π produced virtually identical results.

proportions. The exogenous variables from which the principal components are formed include tax rates, monetary instruments (such as the discount rate and reserve ratio), population, time, etc. Use of these principal components as instruments yields consistent estimates of the structural parameters (see Amemiya 1966; Jorgenson and Brundy 1973). This procedure yields.[12]

$$\begin{aligned} LGCONSP = & -5.83 + 0.55\ LGDPI + 0.32\ LGDPI(-1) \\ & \ (1.55)\ \ (0.13) \qquad\qquad (0.23) \\ & +0.72\ LGWLTH(-1) - 0.031\ LGUNEM - 2.28\ R - 0.36\ \pi, \\ & \ (0.03) \qquad\qquad\qquad (0.014) \qquad\qquad (0.62) \quad (0.21) \\ & R^2 = .99; \quad SSR = 0.0087; \quad SE = 0.021. \end{aligned} \tag{5}$$

The equation performs quite well by conventional measures. The (consistent) estimate of the interest elasticity is somewhat larger than with ordinary least squares, slightly larger than 0.4. Again, it is measured quite precisely. While much more work with such estimators is necessary, these estimates are preferable to those reported above.

Finally, the estimated coefficients for the other variables are quite similar to the ordinary least-squares estimates except for that on lagged wealth. Allowing different combinations of the real net rates, wealth, and income to be endogenous produced a range of estimated wealth elasticities spanned by those reported here. It may well be that ordinary least-squares estimates of wealth coefficients are substantially biased downward.

Since the period 1929–69 includes the depression, the mere inclusion of the unemployment rate may not be sufficient to account for cyclical fluctuations in saving. Hence, I reestimated the basic equation using postwar data only:

$$\begin{aligned} LGCONSP = & -3.85 + 0.62\ LGDPI + 0.007\ LGDPI(-1) \\ & \ (1.76)\ \ (0.21) \qquad\qquad (0.24) \\ & +0.72\ LGWLTH(-1) - 0.003\ LGUNEM - 2.08\ R + 0.007\ \pi, \\ & \ (0.05) \qquad\qquad\qquad (0.02) \qquad\qquad (0.81) \quad (0.14) \\ & R^2 = .99; \quad SSR = 0.0025; \quad SE = 0.0139. \end{aligned} \tag{6}$$

The now familiar pattern of a substantial interest elasticity is repeated with these data. The equation performs less well by the usual measures, since there is somewhat less variation in each of the series, and the sample size is reduced sharply when confined to the postwar era. Once again, however, I estimate a substantial elasticity of saving with respect to the real net rate of return, about 0.4.

Alternative measures of permanent income produced similar results. Using the natural logarithm of current and lagged labor income yielded an estimated interest-rate coefficient of −3.32 with an estimated SE of 1.7; this corresponds to an interest elasticity of 0.6. The worse fit and less plausible estimated coefficients on the other variables are typical of this theoretically more appealing specification and lead me to reject these estimates in favor of those reported above.

Finally, the alternative real net rate of return measures yielded estimated interest coefficients of −1.32 (estimated SE, 0.29) and −1.33 (estimated SE, 0.29) on the Moody-based real net yield on bonds and the Standard and Poor-based real net yield on tax-free municipals, respectively; these coefficients correspond to an elasticity of about 0.3.

TABLE 3.—ESTIMATED REAL AFTER-TAX RATE OF RETURN ELASTICITY OF PRIVATE SAVING

	Ordinary least squares	Instrumental variables
Semilog, R1	−0.3	0.4
Log-linear, R1	−.3	.4
Semilog:		
R2 and R3	−.2	.3
Labor income		−.6
Postwar only		.4

Source: R1 derived from Christensen-Jorgenson 1973, nominal rate of return. R2 derived from Moody's Aaa nominal bond yields, and R3 derived from Standard and Poor's high-grade municipal bond yields.

[12] Since the data on the principal components, which were supplied kindly by M. Hurd, go only through 1966, this equation excludes 1967–69.

Table 3 summarizes the empirical results reported above. In brief summary, alternative sample periods, estimation techniques, measures of the real after-tax rate of return on capital and measures of permanent income all lead to the conclusion of a nonnegligible interest elasticity of private saving. The range of estimates goes from just under 0.2 to around 0.6 and clusters at about 0.3 to 0.4; the estimate I prefer on statistical grounds is that from equation (5), about 0.4.

IV. PRODUCTION

In order to gain further insight into the effects of tax-induced changes in capital accumulation on the distribution of income, I have estimated production functions from the same data used to estimate private saving. Recall that a key issue in my two-factor aggregate model is the size of the elasticity of substitution between capital and labor. Increases in the capital labor ratio will lead to increases (decreases) in labor's share of gross income if the elasticity of substitution is less (greater) than unity. Further, the increase in the wage rental ratio due to an increase in the capital/labor ratio varies inversely with the elasticity of substitution.

Since I am dealing with a two-factor model, I estimate a CES production function with Harrod-neutral technological progress.[13]

$$y_t=\gamma[K_t^{-\rho}+(E_L L_t)^{-\rho}]^{-1/\rho} \tag{7}$$

where y is output, K is the capital input, L is the labor input, t is time, $E_L=E_L$ ( ) $e^{-\lambda t}$, λ is the exponential labor augmenting rate,[14] and σ, the elasticity of substitution, equals 1 $(1+p)$.

Rearranging (7), it appears that

$$\log\left(\frac{wL}{y}\right)=e+(l-\sigma)\log w+(\sigma-l)\lambda t, \tag{8}$$

where e is a constant and w is the wage rate.

Estimating (8) on data for 1929–69, deleting the war years, for the private economy yields

$$\log\left(\frac{wL}{y}\right)=\underset{(0.06)}{-0.45}+\underset{(0.034)}{0.554}\log w-\underset{(0.0021)}{0.0045t}, \tag{9}$$

$$R^2=.99; \qquad SE=0.033; \qquad SSR=0.033$$

The equation fits the data quite well. The SE of the regression is a small fraction of the mean value of the dependent variable, and the estimated coefficients are measured rather precisely. The estimated elasticity of substitution is 0.45, which is quite similar to the usual time-series estimates.[15] This immediately implies that labor's share of gross income varies in the same direction as the capital labor ratio. The derived estimate of r, the labor-augmenting rate, is 0.009.[16]

Fit to postwar data alone, I obtain

$$\log\left(\frac{WL}{y}\right)=\underset{(0.18)}{-0.42}+\underset{(0.13)}{0.52}\log w-\underset{(0.006)}{0.005t}, \tag{10}$$

$$R^2=.98; \qquad SE=0.046; \qquad SSR=0.0045.$$

The estimated elasticity of substitution is 0.48; unfortunately, while the point estimate of the labor-augmenting rate is quite similar to that of the whole period, its estimated SE is quite large.

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[13] Diamond 1965 has demonstrated that Harrod neutrality is the only type of technological progress compatible with balanced growth. I interpret my results as derived from a Harrod-neutral CES production function. If technical change, e.g., was Hicks-neutral, the coefficient of log a is interpretable as a direct estimate of the elasticity of substitution. Indeed, this is the interpretation originally given by Arrow et al. (1961). Note, however, that the estimate of the elasticity of substitution is still about one-half.

[14] This specification thus avoids the "impossibility" problem pointed out by Diamond and McFadden 1965.

[15] See Nerlove (1967 for a survey of estimates of CES production functions. My estimate is quite similar to usual time series estimates, which in turn are usually smaller than cross-section estimates. While time-series estimates may be biased downward because of lagged adjustments. Lucas 1969 rejects this conjecture. Cross-sectional estimates suffer from a variety of problems; *see* Lucas 1969).

[16] One might think of this as including some exogenous human investment.

As with the estimates of saving functions, the issue of potential bias in the estimates must be confronted. Possible measurement error and the endogenicity of wages in a full model lead me to follow the same procedure as described above for consumption saving. I use an instrumental variables estimator, using principal components from the exogenous variables in the Hickman-Coen model as instruments. This yields

$$\log\left(\frac{wL}{y}\right) = \underset{(0.02)}{-0.53} + \underset{(0.04)}{0.56}\log w - \underset{0.002}{0.005}\,t, \tag{11}$$

$$R^2 = .99; \qquad SE = 0.034; \qquad SSR = 0.032.$$

Again, the equation fits quite well. The estimated elasticity of substitution is 0.44, and the estimated labor-augmenting rate is 0.009; both estimates are quite close to those reported above.

While increases in the capital/labor ratio will increase the wage rental ratio (which is probably a more insightful way to analyze tax incidence in a growing economy than examining factor shares) regardless of the elasticity of substitution, these results suggest that policies which increase capital accumulation will increase labor's gross share of national income.

I now turn to a more detailed examination of the implications of my empirical results.

V. IMPLICATIONS FOR INCOME, WELFARE, AND INCOME DISTRIBUTION

As discussed in Section I, these results have striking implications for tax policy. The current tax treatment of income from capital—primarily the personal and corporate income taxes—decreases the net rate of return to capital accumulation; the modest positive real net of interest elasticity thus implies a substantial tax-induced decrease in saving and the capital intensity of production, a reallocation of consumption from the future to the present, and a substantial transfer of gross income from labor to capital. To estimates of these effects I now turn.

A. Welfare

The welfare anslysis of intertemporal resource allocation involves a variety of complex issues which are beyond the scope of this paper. For example, external benefits to saving and investment (e.g., learning by doing) may render the social rate of return higher than the private rate, other distortions (e.g., lack of a complete set of futures markets) may be important. If, however, I proceed in the usual manner and ignore all distortions other than taxes and argue that to a first approximation the saving rate would be efficient in the absence of taxes, I may adopt the usual consumer surplus measure of lost welfare: one-half the product of the tax-induced increase in the price of future consumption and the compensated change in future consumption. Feldstein (1978) shows that this product may be written as

$$\Delta 11 = -12\left(1 + \frac{\epsilon_{SR}}{rT}\right)\left(\frac{T_1 - P_0}{P_1}\right)^2 S_1, \tag{12}$$

where P_0 and P_1 are the prices of future consumption before and after taxes on capital income are imposed ($e^{(-rTl-\mu)}$ and e^{-rT}), μ is the marginal rate of tax on capital income, r is the net rate of return on capital, T is the length of time between saving and dissaving, S_1 is saving for future consumption, and ϵ_{sr} is the compensated interest elasticity of the saving rate.

Recall that, since the private sector is a net saver, the income and substitution effects of a change in the rate of return work in opposite directions. Hence, my estimates are lower bounds on the pure-substitution elasticity. The real net rate of return, r, averages about 3 or 4 percent over my sample period; T, the average length of time between saving and dissaving, is probably around 25 years. Hence, examining (12), it can be seen that the contribution of the real net rate-of-return elasticity to lost welfare is magnified by the factor 1 $rT \simeq 4/3$.

While μ varies substantially by the type of capital and the progressive rate structure of the personal income tax makes it difficult to measure marginal, as opposed to average, tax rates, I adopt 50 percent as a reasonable estimate of μ. Harberger (1969) suggests that 60 percent is a good approximation; Pechman and Okner (1974) argue that 40 percent is better. The former figure does not deal adequately with the nonprofit sector, whereas the latter fails to impute any indirect business taxes to capital. Since S_1 is saving for future consumption, total net private saving understates S_1 because of the dissaving of the elderly population

during retirement. If the population grows at 1–2 percent and real income grows at 3 percent per year, and $T=25$ years, S_1 equals about one and one-half times total net private saving, about $200 billion. Estimates of the annual welfare loss resulting from the tax-induced distortion of the timing of consumption over the life cycle for different values of $E_{s\gamma}$ and γ are reported in table 4. My preferred estimate, based on $\gamma=0.4$. and $E_{s\gamma}=0.4$, yields an estimate of the annual welfare loss of close to $60 billion! This estimate is rather insensitive to variations in γ and only modestly sensitive to variations in $E_{s\gamma}$.

In comparison with previous studies of the welfare loss from differential taxation of different types of capital, these numbers are enormous.[17] They amount to an astounding waste of resources. Recall that these estimates are annual costs to society. The present value of these costs is a large multiple of the annual costs (the exact relation depending upon the assumed rate of discount) and can easily amount to hundreds of billions of dollars. Viewed another way, if we abolished taxes on income from capital this year, by the end of the decade welfare would have increased by close to $200 billion, or about twice the current annual yield of the individual income tax!

TABLE 4.—ESTIMATED ANNUAL WELFARE COST OF CURRENT CAPITAL INCOME TAXATION

[In billions of dollars]

τ	ϵ 0.2	0.3	0.4
0.03	14.6	48.3	32.1
0.04	48.0	32.0	36.0
0.06	48.3	52.3	36.3

These estimates highlight the fact that the current tax treatment of income from capital induces consumers to save less for consumption later in life—primarily old age—than is socially optimal. It seems strange simultaneously to reduce substantially the return to saving—and, hence, private provision for retirement—and to attempt to increase provision for retirement publicly through social security, which in turn may well decrease private saving.[18] While both the taxation of capital income and the social security system serve other goals, they are in basic conflict in the attempt to provide retirement or old-age consumption.

Do such enormous welfare costs make sense? First, extrapolating the estimated interest elasticity over a large change in tax-induced variations, in the real after-tax rate of return may not be warranted. On the other hand, the estimated elasticities are a lower bound on the pure-substitution elasticities, since they include a negative income effect of interest rate increases on saving.

Second, substituting taxes on labor income for those on capital income can produce a distortion in labor markets, for example, in the allocation of work between home and market. While most estimates of labor-supply functions suggest an aggregate supply of labor which is quite wage inelastic, it is quite difficult to measure labor supply in the envelope sense—subsuming effort and human investment—and taxes affect human investment in a variety of offsetting ways.[19] Since one reason a person works early in life is to save for future consumption, cross elasticities as well as own elasticities are important: the interested reader is referred to Feldstein (1978) for a detailed discussion. I merely note that my estimates must be adjusted downward to get the net effect of substituting labor income taxes for capital income taxes.

Finally, one might expect that such an enormous inefficiency would result in an intense pressure to revive the tax laws or to provide retirement consumption. Indeed, social insurance benefits have grown rapidly, and increasingly generous treatment of income placed in retirement plans has been a key feature of recent tax reform.

B. Income and Its Distribution

The long-run effect of changes in the structure of capital income taxes on income and its distribution depends upon the exact change being considered. For example, integration of corporate and personal income taxes or switching from

[17] See Harberger 1966 and Shoven and Whalley 1972.
[18] See Feldstein 1974b and Munnell 1975.
[19] See Boskin 1976.

income to consumption as the base of personal taxation, or both, will increase income substantially if the rise in the real net rate of return is not offset by other policies (government saving, monetary policy, etc.). Assuming that no other policies are enacted which affect the real after-tax rate of return and that an equal current-yield consumption tax replaces current capital income taxation,[20] the real net rate of return, with $\mu = 0.5$, will double in the short run. This will lead to an increase in saving and in the capital labor ratio and wage rates and to a fall in the gross rate of return to capital.

Feldstein (1974*a*) derives the relationship between the net rate or return to capital and capital income taxes in a growth model with factor taxes and variable saving rates. The estimates reported above (real net-interest elasticity of saving of 0.4, elasticity of substitution of 0.45, etc.) imply an elasticity of the net rate of return with respect to capital income tax rates of 0.3 (an elasticity of substitution of 1 would imply 0.6).[21] Hence, a complete abolition of capital income taxation would increase the real net rate or return some 30 percent (or more if the elasticity of substitution is larger). Since the capital labor ratio increases in proportion to Sx, where S is net saving and x is labor's share of gross income, my estimates imply a new steady-state capital labor ratio some 15-20 percent larger than currently.

From the production function and competitive factor markets.

$$\log \frac{W}{r} = C + (1+\rho) \log k, \tag{13}$$

where ρ is the substitution parameter in the CES form, that is, $\rho = 1\alpha - 1$, where σ is the elasticity of substitution. Hence, my estimate of ρ at around 1.2. Thus, a 15–20 percent increase in k would result in a 33–44 percent increase in the wage/rental ratio; the abolition of capital income taxation transfers gross income from capital to labor.

Further.

$$\log \frac{wL}{rK} = C + \rho \log k, \tag{14}$$

so the 15–20 percent increase in k implies an increase in this ratio of factor shares of about 18–24 percent. Since the factor-share ratio is currently around 3, it would increase to about 3.6. Thus, capital's share of gross income would fall by around 15 percent.

With the general distributional pattern developed above. I mention briefly two other important tax-incidence issues. First, the results presented above imply a substantial shifting of capital income taxes from capital to labor due to the decreased capital labor ratio caused by current tax treatment. Again, Feldstein (1974*a*) develops a formula to measure this differential incidence; my estimates imply that capital shifts approximately one-half of the burden of capital income taxes onto labor. Failure to account for tax shifting via decreased saving has led many researchers to conclude that taxes on income from capital are much more progressive than they really are in fact; for example, the excellent study by Pechman and Okner (1974) ignores these long-run effects: capital income taxes are generally considered borne by capital and general income taxes in proportion to income.[22] The results reported here suggest that each of these procedures may overstate substantially the progressivity of such taxes.

Second, my results on the interest elasticity of the saving rate suggest that proposals to integrate the corporate and personal income tax which are financed by increases in labor income taxation or consumption taxation would increase saving, the capital labor ratio, welfare, the wage rental ratio, and labor's share of gross income.

These transfers of gross income from capital to labor from tax policies which decrease capital income taxation must be offset against the decrease in taxes on income from capital and possible increase in taxes on labor income to compare after-tax incomes. Further, the full transfer of gross income will take a period of years to occur.

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[20] It is quite likely that a personal consumption tax would have progressive rates; indeed, the often overlooked fact makes the distributional effects of switching from income to consumption taxes much more palatable.

[21] Extrapolations over such a large range are somewhat habardous. I present here only illustrative calculations.

[22] Pechman and Okner (1974) do provide careful estimates based on a variety of generally accepted incidence assumptions; however, the case of a large share of capital income taxes being borne by labor is not included.

This immediately raises the issue of what to assume about tax revenue and rates along the new growth path. Further, I have ignored government saving. The net increase in the capital labor ratio must net out any changes in government saving.[23] Since the increased capital labor ratio will result in a corresponding increase in per-capita output, tax revenues at constant rates will increase well above what they would have been before an initial year equal-yield change. One may choose to compare situations with equal revenue year by year, or with equal shares of taxes in gross income, or with the initial rates continuing, or with still other scenarios. Hence, to give an accurate picture, one must compare changes in after-tax incomes under some well-defined set of assumptions about the course of tax rates.[24]

I shall not attempt to deal with this conceptual issue here. I merely note that in addition to the usual efficiency arguments in favor of abolishing taxes on interest income,[25] and the often overlooked potential horizontal equity arguments in favor of consumption taxation,[26] the analysis and empirical evidence described above cast serious doubt on the usual comparison of the distributional effects of income and consumption taxes.

Again, while the net effect on income and its distribution depends upon the specific set of assumptions made, the general argument remains the same: the modest positive interest elasticity implies that tax policies—from corporate and personal income tax integration or switching to consumption taxes—which lower taxes on income from capital will increase saving, the capital intensity of production, income, and welfare and, further, will transfer gross income from capital to labor.

C. The Social Opportunity Cost of Public Investment

The results reported above on the interest elasticity of the saving rate have striking implications for the social opportunity cost of public funds and hence the rate of discount to be used in public benefit-cost analyses. Two schools of thought have emerged on this issue. One group of writers suggests that the gross-of-tax marginal product of capital in the private sector is the appropriate rate. Another group of writers suggests that the social rate ought to be lower than the private rate due to intergenerational external economies. Leaving the issue of reducing the social rate of discount to account for such effects aside, I note that the gross-of-tax marginal product of capital in the private sector is appropriate only if the public funds are obtained exclusively from a reduction in private investment. This generally is assumed to occur as government borrowing drives up the rate of interest and chokes off private investment.

TABLE 5.—ESTIMATED SOCIAL OPPORTUNITY COST OF PUBLIC FUNDS

Marginal product of capital ρ (percent)	Social opportunity cost of public funds ω (percent)
7	5.6
12	8.9

My results, however, suggest that such an increase in the rate of interest will call forth an increase in private saving. Hence, the public funds come partly from decreased private investment and partly from increased private saving. Hence, the social opportunity cost of the public funds as pointed out by Harberger [1969] is a weighted average of the opportunity costs of the foregone investment and private consumption foregone in favor of increased private saving, that is of the gross-of-tax marginal product of capital in the private sector and the net-of-tax real rate of return to savers the supply price of private saving. The weights, of course, reflect the relative proportion of decreased private investment and increased private saving in providing the public funds; that is, they depend upon

[23] My preliminary estimates reveal a much lower government propensity to invest out of revenues than the private sector's propensity to save out of income.

[24] And other policies.

[25] See Musgrave 1959, chap. 12.

[26] Since consumption is a more stable function of permanent income than is current income, a consumption tax may improve our ability to tax persons with the same permanent income at the same rate.

the interest elasticity of investment and saving, respectively. The formula is the following:

$$\frac{rS\epsilon_s - \rho l\eta_1}{S\epsilon_s - l\eta_1} = (!) \cdot$$

where r and p are the real net return to savers and the real gross marginal product of capital, S and I are saving and investment, and $r.$ and $n.$ are the interest elasticity of saving and investment, respectively.

The real net return to saving, r. is much smaller than the gross marginal product of capital, p, due to business and personal income taxes: r is about 0.03; for the production function estimated above, p is 0.07. Typical estimates of p based on Cobb-Douglas production functions are around 0.12. Table 5 presents estimates of the social opportunity cost of public investment for estimates of p of 0.07 and 0.12, current estimates of S and I, and estimates of $n.$ of -1.0 and a of 0.4: The social opportunity cost of capital in each case is substantially smaller than the gross marginal product of capital. Hence, social cost-benefit analysis should discount future benefits and costs at a rate substantially below the margin product of capital in the private sector, irrespective of any intergenerational external economics. Indeed, use of the gross marginal product of capital as the discount rate causes both an underinvestment and an inefficient composition of public investment in favor of short-lived projects.

VI. CONCLUSION

I have presented a good deal of evidence which suggests that there is a positive relationship between private saving and the rate of return. A variety of definitions of variables, functional forms, and estimation methods all led to this conclusion. This relationship has immensely important implications for economic policy. Among the more important are that the current tax treatment of income from capital induces an astounding loss in welfare due to the distortion of the consumption/saving choice and that reducing taxes on interest income would in the long run raise the level of income and transfer a substantial portion of capital's share of gross income to labor. The overall distributional effects of such a policy combine this long-run effect with that of the exemption of interest income from taxation.

Taken as a whole, the results reported here substantially strengthen the case for reforming the tax treatment of income from capital in the United States, for example, integration of the corporate and personal income taxes or, better yet, switching from income to consumption taxation.

They also have obvious implications for the potential effectiveness of monetary policy in the short and long run.

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PINEHURST AIRLINES, INC.,
Pinehurst, N.C., June 2, 1978.

Hon. W. G. HEFNER,
Congress of the United States,
House of Representatives,
328 Cannon House Office Building,
Washington, D.C.

DEAR BILL: This requires no answer; just a little meditation on your part. I thought your statement of the issues in the last issue of the Pilot was right on point.

Inflation, unemployment, the administration's lack of a concerted, coordinated, consistent policy for dealing with the national economy is all part and parcel of the same problem—uncertainty in the business community.

While an across the board tax cut appeals to more voters, it is like applying a series of bandaids to a candidate for major surgery.

Small business is the guts of our industrial state. The views and beliefs of employers are more persuasive with the rank and file of these voter employees (mostly non union) than all else. Their welfare is directly tied to the prosperity of the company for whom they work.

Capital formation is the single most important achievement for these individual companies and collectively for our whole nation. Restoration of the capital gains incentive is the single most vital ingredient in capital formation.

Let me give you a case in point: In 1963 I formed an engineering company to design and supervise highway construction in Saudi Arabia. The undertaking was profitable and under the existing law I was required to wait ten (10) years to repatriate my off-shore earnings. This I did, and began to bring them back in 1974.

About ten years ago I bought some undeveloped land in Springfield, Missouri. Because of some sort of capital gains penalty tax in effect for 1977 my accountants figured that the election to take capital gains treatment, rather than treat the sale as ordinary income would have cost me $2,900.00 in additional tax. This was because the gain would have been on top of the gain realized from the Saudi Arabia profits brought home in 1977.

I submit that this sort of tax treatment certainly discourages a person, or a company, from making capital investments or improvements to provide employment and increased productivity.

In my view if the administration persists in this type fiscal policy it is going to kill the goose that has been laying the golden eggs for 200 years.

Sincerely,

L. C. BURWELL Jr., *Chairman.*

STATEMENT OF PROF. SCOTT C. WHITNEY

Mr. Chairman, Members of the Senate Finance Committee. I appreciate this opportunity to present a statement and a supporting study which address the important problem of capital formation to meet the ever-increasing capital requirements of American industry to comply with environmental pollution abatement laws and regulations. The attached study, which I respectfully request be made a part of the hearing record, is an analysis I prepared which has been published by the Columbia University Environmental Law Journal shortly after Congress recognized the merit of enacting an environmental investment tax credit in the 1976 Tax Reform Act. Subsequnetly, the Executive Branch has also recognized the importance of this problem, and President Carter included in his January, 1978 tax message to the Congress a recommendation that Congress enact a ten percent pollution facility investment tax credit and allow accelerated depreciation (five years) for such facilities.

In the interval since I first wrote the attached study, the trends toward increased environmental capital requirements have continued. The most recent report of the President's Council on Environmental Quality (CEQ) indicates that for the period through 1985, significant increases will result in capital requirements. These forecasts are in my judgment substantially understated. Consider, for example, that capital requirements increased by $12 billion in a single year merely to adjust for inflation. Moreover, the CEQ forecast includes only a partial list of environmental programs—air, water, noise, solid waste and radiation. In

1977 Congress enacted new air and water legislation that will be far more stringent and costly to comply with. In 1976 Congress enacted the Toxic Substances Control Act, the Hazardous Waste Management provisions and in 1977 the Strip Mining legislation. States and local entities of government have significantly expanded costly environmental regulation. Most of these programs prescribe timetables that mandate increasingly stringent pollution abatement requirements.

I respectfully suggest that if Congress in its wisdom mandates this kind of environmental reform, that it must assess the cost of such reform and it must address the important issue of how to finance these programs. The economic aspect is of crucial importance. The attached study contains rather bleak forecasts concerning capital formation shortfalls that responsible financial sources predict in the $1 trillion range by the early 1980's. 1977 was the worst trade year this country has experienced, and 1978 shows ominous trends that suggest the presently unfavorable balance of trade and payments will worsen. The U.S. dollar in world conversion rates must be regarded as embattled.

I earnestly recommend that Congress enact the environmental investment tax credit at a level of ten percent, provide for accelerated depreciation of pollution abatement facilities, and, key to the effectiveness of such provisions, adopt the following definition of qualifying facilities:

"The term 'air or water pollution control facility' means any facility (including buildings and equipment necessary to the installation or functioning of the facility) the primary purpose of which is to abate, contain, control, or prevent actual or potential pollutants, wastes or heat from contaminating the atmosphere or bodies of water."

I reiterate my appreciation for the opportunity to submit this statement.

Capital Formation Options To Finance Pollution Control

(Scott C. Whitney)*

The economic cost of environmental pollution and the cost of implementing far-reaching corrective measures are increasingly recognized as significant national problems.[1] Extensive effort has been expended in recent years to analyze and quantify pollution abatement and control costs and forecast capital demands that will be necessary to comply with environmental laws and regulations.[2]

As this analysis has become more sophisticated, environmental costs have been classified into four basic categories: damage costs, avoidance costs, abatement costs, and so-called "transaction" costs.[3] Although official concern for pollution

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*Professor of Law, Marshall-Wythe School of Law, College of William & Mary; A.B., University of Nevada, 1949; J.D., Harvard, 1952.

[1] See, e.g., Council on Environmental Quality, Environmental Quality: The Sixth Annual Report of the Council on Environmental Quality 494 (1975) [hereinafter cited as Sixth Annual Report]:

The U.S. economy has been experiencing severe economic problems over the past few years. Inflation, unemployment, and capital scarcity have affected everyone. These difficulties have focused attention on the economic effects of government programs. Environmental programs in particular have come under close scrutiny in their effects on both jobs and prices. The changed economic climate makes it more important than ever to subject these programs to rigorous economic analysis.

Also see Council on Environmental Quality, Environmental Quality: The Seventh Annual Report of the Council on Environmental Quality 150 (1976) [hereinafter cited as Seventh Annual Report]:

Concern about sufficiency of capital has grown during the last year. Will the economy be able to generate enough capital to make all the investments needed to satisfy our society's many goals—e.g., for a cleaner environment, energy self-sufficiency, more goods and services, and better housing?

See also Council of Economic Advisers, Economic Report of the President 39–47 (1976).

[2] See, e.g., U.S. Environmental Protection Agency, The Economics of Clean Water (1973); National Commission on Water Quality, Staff Draft Report (1975); The Economic Impact of Environmental Regulations: Hearings Before the Joint Economic Comm., Cong. of the U.S., 93d Cong., 2d Sess. (1974); U.S. Environmental Protection Agency, The Cost of Clean Air, Annual Report of the Administrator of EPA to the Congress in Compliance with Public Law 91–604, The Clean Air Act, As Amended (1974); Energy and Environment Group, Office of Planning and Evaluation, Environmental Protection Agency, The Economic Impact of EPA's Air and Water Regulatons on the Electric Utility Industry, vols. I–IV (1975); U.S. Department of Commerce: The Effects of Pollution on International Trade, vol. I (1973), vol. II (1974), vol. III (1975).

[3] Council on Environmental Quality, Environmental Quality: The Fourth Annual Report of the Council on Environmental Quality 74 (1973). The CEQ was created by Title II of the National Environmental Policy Act of 1969 (NEPA), 42 U.S.C. §§ 4321–47 (1970), for the purpose *inter alia* of developing and recommending programs and policies to the President to foster and promote the improvement of environmental quality. For enumeration of the duties and functions of the CEQ, *see id.* § 204, 42 U.S.C. § 4344 (1970). Under the CEQ cost classification, damage costs include such items as blighted crops, ill health, corrosion of buildings and the like. Avoidance costs include buying an air or water filtration system or the cost of moving to an unimpacted area. Abatement costs include those resources expended to reduce or eliminate pollution including indirect costs arising from the impact of these expenditures on economic growth, productivity or employment. Transaction costs include the value of resources allocated to research, planning, monitoring and similar activities necessary for pollution abatement.

abatement costs dates from 1972,[4] and although increasingly frequent studies of this problem have subsequently been undertaken,[5] it has generally been recognized that this analysis is still in its infancy.[6]

Despite the difficulties of cost quantification and the recognition that forecast environmental costs are at best approximations, it seems clear that environmental costs will be a major factor affecting the national economy in the foreseeable future. Similarly, it is not feasible at this time to forecast with precision the capital investment that will be required by the private sector during the next decade and beyond to comply with existing federal environmental laws and regulations, and the various state and local requirements. The most recent comprehensive forecast was published by the Council on Environmental Quality (CEQ) in its 1976 Annual Report.[7] The CEQ estimates incremental[8] pollution control expenditures for the private sector alone during the period 1975–1984 will exceed $300 billion, of which approximately $275 billion will consist of capital investment and capital costs.[9]

This analysis considers legislative and regulatory options available to cope with future private sector capital requirements to meet both "conventional" and environmental needs. While by no means agreed as to the precise amount of these needs, virtually all studies imdicate they will be immense and will place great strain on the national economy.[10]

Moreover, it must be recognized that these pollution abatement costs will tend to increase rather than decrease. The as yet unchecked force of inflation is of course one important factor contributing to this problem. More importantly, most existing statutory environmental abatement programs are structured in a way that progressively increases the stringency of environmental requirements and consequently their cost. For example, the incremental cost to achieve national secondary ambient air quality standards will undoubtedly significantly exceed the cost to achieve primary standards.[11] Furthermore, the law requires that once the national ambient air quality standards are attained, they must then be maintained. This maintenance will necessitate an indefinitely ongoing comprehensive nationwide air quality maintenance program.[12] Furthermore, compliance with the judicially enunciated goal of no significant deterioration of the air quality in regions with air cleaner than that required by secondary standards will likewise create increasing direct and indirect incremental costs.[13]

The same cost augmentation phenomenon is built into the Federal Water Pollution Control legislation, which likewise envisions implementation of progressively more stringent standards culminating in the goal of eliminating discharges

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[4] *See* the summary relating to cost classification in Sixth Annual Report, *supra* note 1, at 496–532.

[5] *See* note 2 *supra*.

[6] Sixth Annual Report 496–511. For an account of the methodological difficulties of environmental cost quantification, *see* Whitney, *The Trade Act of 1974: Coping with Unequal Environmental Control Costs*. 16 B.C. Indus. & Com. L. Rev. 577, 585–92 (1975). *See also* Environmental Protection Agency, Environmental News, The Impact of Environmental Regulations on Capital Markets and on Industry Capital-Raising Problems 2 (1975) [hereinafter cited as EPA Capital Study], in which it is candidly admitted that "EPA analysis of the impacts of capital requirements for pollution control has been quite limited so far and is limited by the state-of-the-art to only modest improvements."

[7] Seventh Annual Report, *supra* note 1.

[8] Incremental costs are expenditure necessitated by designated federal environmental legislation beyond those expenditures that would have been made absent the legislation. The designated legislation includes air, water, radiation, noise and solid waste. Estimates for land reclamation, strip mining, coastal zone planning, ocean dumping, oil spills, pesticides and other environmental categories are not included. Likewise, the cost of compliance with state and local environmental laws and regulations is not included.

[9] Seventh Annual Report, *supra* note 1, at 167, Table 1–37.

[10] B. Bosworth, J. S. Duesenberry, & A. S. Canon, Capital Needs in the Seventies (1975) (published by the Brookings Institution), the most optimistic study, concludes "[w]e can afford the future, but just barely." The Brookings forecasts are confined to the decade of the Seventies. The methodology of the Brookings forecasts excludes consideration of abatement costs for air pollution, radiation, solid waste, noise, land reclamation, strip mining, pesticides, coastal zone management and other categories including the cost of compliance with state and local programs. The New York Stock Exchange Study, probably the most pessimistic analysis, forecasts an overall capital gap of $650 billion during the period 1974–1985. EPA Capital Study, *supra* note 6, at 4. CEQ in its most recent analysis posed the question, "[w]ill the economy be able to generate enough capital to make all the investments needed to satisfy our society's many goals—e.g. for a cleaner environment, energy self-sufficiency, more goods and services, and better housing?" CEQ noted 'the answer is probably no." Seventh Annual Report, *supra* note 1, at 150.

[11] National primary ambient air quality standards are standards the attainment and maintenance of which are requisite to protect the public health. National secondary ambient air quality standards are standards the attainment and maintenance of which are requisite to protect the public welfare from any known or anticipated adverse effects associated with the presence of such air pollutant in the ambient air. Clean Air Amendments of 1970, §§ 109(b)(1), (2), 42 U.S.C. §§ 1857c-4(b)(1), (2) (1970).

[12] *Id.* § 110, 42 U.S.C. § 1857c-5 (1970).

[13] Sierra Club v. Ruckelshaus, 344 F. Supp. 253 (D.D.C. 1972), *aff'd*, 412 U.S. 541 (1973) (no opinion). *See also* 39 Fed. Reg. 42510-17 (1974).

of all pollutants by 1985.[14] Like the clean air strategy, maintenance of water quality is required once the mandated goal is achieved. Here too, this maintenance will necessitate costly continued planning and regulatory strategies to accommodate the apparently inevitable national growth while yet adhering to the no discharge requirement.[15]

To date no environmental cost forecast methodology has evolved accurate indicia to measure this phenomenon of disproportionately increasing costs, but it is essential to consider this factor when considering what legislative, regulatory or other action is appropriate to devise effective capital formation and/or capital recovery strategies.

Before considering possible specific legal-legislative options for capital formation, two basic policy issues must be considered: first, whether it is appropriate for the federal government to assist the private sector to meet the costs of federally enacted environmental laws and regulations, and second, if it is determined that it is either necessary or desirable that the federal government assist private sector compliance, what form the assistance should take.

I. FEDERAL GOVERNMENTAL OPTIONS OR INTERNALIZATION OF ABATEMENT COSTS?— A CRITICAL NATIONAL DECISION

For the private sector to be able to alter its plants and processes to comply with existing environmental laws and regulations it must develop the funds to pay for abatement. The CEQ correctly recognizes that these costs and capital needs are "incremental"; that is, expenditures are necessitated by the designated federal environmental legislation beyond those "business as usual" expenditures that would have been made absent the legislation.[16] Consequently these incremental environmental requirements are *additional* to the so-called "conventional" capital requirements that are necessary to a growing and productive economy capable of assuring that the *other* vital national goals of adequate employment and containment of inflation are achieved. Given the forecast capital shortfall during the coming decade,[17] there is a distinct likelihood that rival claims on existing capital supply by the productive sector of the economy versus legally mandated environmental reform may well increase the cost of capital to the point that expansion of productive capacity and economic growth may be retarded with adverse effects on employment and the ability to control inflation. The Environmental Protection Agency (EPA) notes that "this spectre is particularly troubling because of the experience of 18–30 months ago when capacity shortages in the basic materials-producing industries seemed to throttle economic growth and spur inflation with unemployment at very high levels."[18]

Consequently, the nation is faced with the reality that *additional* capital formation methods (beyond those necessary to meet "conventional" needs) must be devised if we are to achieve the multiple national goals of a healthy economy and a protected environment.

Two basic possibilities of forming the necessary capital exist: (1) some form of federal assistance (grants, subsidies, tax incentives or "tax expenditures" of various kinds), or (2) "internalization" of environmental costs by inclusion of the environmental increment into the pricing of goods and services to the consumer.

The CEQ has considered the option of imposing effluent charges set at a sufficiently high level to compel extraction of most of the pollutant, with the effluent charge being passed on to the consumer in the form of higher prices.[19] This option entails serious disadvantages. First, to "internalize" environmental costs of the magnitude involved by passing them to the consumer in the form of higher prices would aggravate the inflationary price spiral and create further stresses between

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[14] The Federal Water Pollution Control Act of 1972, 33 U.S.C. §§ 1251-1376 (Supp. V 1975), structures a progressively more stringent control program which requires by July 1, 1977, "the best practicable control technology currently available" and by July 1, 1983, "the best available technology economically achievable" which will result in "reasonable further progress" toward the elimination of all discharges of pollutants by 1985. *Id.* § 301(b), 33 U.S.C. § 1311(b) (Supp. V 1975).

[15] *Id. See, e.g., id.* § 208, 33 U.S.C. § 1288 (Supp. V 1975) (areawide waste treatment management planning); *id.* § 209, 33 U.S.C. § 1289 (Supp. V 1975) (basin planning). Other examples of cost augmentation include the increasing cost of federal decision-making arising from judicially expanded NEPA requirements. Current aircraft noise abatement regulations pursuant to the Noise Control Act of 1972, 42 U.S.C. §§ 4901-4918 (Supp. V 1975), likewise involve increased incremental cost.

[16] See note 8 supra.

[17] See note 10 supra.

[18] EPA Capital Study, supra note 6, at 3.

[19] Report of the Tax Policy Advisory Committee to the Council on Environmental Quality 21 (1973) [hereinafter cited as Tax Policy Report].

labor and management. The environmental cost increment added to the price of goods and services would undoubtedly give rise to increased wage demands and the cost would in large part rebound to industry in the form of higher labor costs. Moreover, imposition of effluent charges only indirectly addresses the critical problem of how to rid the environment of pollution. If a given plant simply pays the charge and continues to pollute then the pollution is not abated. If instead, the plant chooses to install appropriate abatement equipment and avoids the effluent charge the problem of how to obtain the capital to buy the abatement equipment remains unanswered.

An additional disadvantage of internalizing environmental costs is that to do so would further weaken the United States international trade position by further pricing United States goods out of competitive markets. The "distortions" arising from unequal environmental control costs incurred by the United States private sector vis-a-vis competitors from its eleven principal trading partners constitute a major national problem which Congress sought to address in the Trade Act of 1974.[20] Given the national commitment to contain inflation within acceptable limits, it is rather clear that the nation's pricing structure cannot be expected to absorb some 300 billion dollars of additional environmental costs.

Moreover, the CEQ concept envisions use of varying charge levels to achieve desired degrees of pollution abatement:

Since the costs of removing any given pollutant presumably will vary as between processes, products and plants, a requirement of the same proportionate reduction, or a reduction to the same absolute level, would impose high costs on some and relatively low costs on others. The same aggregate reduction in an area could be achieved by an effluent charge which will lead to substantial or very large proportionate reductions in pollution where that could be achieved relatively inexpensively, with little reduction where it was relatively more expensive to make improvements.[21]

To be effective, this system must produce a program of pollution abatement which results in compliance at any given time with statutory environmental standards. Coordination of a schedule of fees which might well vary from industry to industry and from plant to plant to produce pollution levels that comply with standards required by law would be extraordinarily difficult to determine accurately and costly to administer. Thus it would appear that "internalization" could not produce adequate net capital accretions and would create problems at least as troublesome as those it seeks to solve.

Finally, it seems clear that Congress by enacting the various environmental laws has elevated environmental protection to a major national policy not unlike public health (with which the environmental quality is closely related), law enforcement and national security. Consequently, whenever private sector compliance is either impossible as an economic matter, or is attainable only at the expense of major impacts on the national economy, it seems appropriate, in fact necessary, that public funds, whether in the form of so-called tax expenditures, in the form of tax incentives, or in the form of grants, guaranteed loans or subsidies, be used to achieve the national goal of environmental protection. Congress has repeatedly recognized this principle in its appropriation of grants for, *inter alia* publicly owned treatment works, environmental planning, research and development, and monitoring systems.

II. ASSUMING FEDERAL FISCAL ACTION, WHAT FORM SHOULD IT TAKE?

Given the determination that federal fiscal action is preferable to "internalization" of environmental costs in the price structure, the *form* this federal action should take is controversial. Leaving out of account certain tax incentives devised to influence conduct that tends to have beneficial environmental consequences,[22] Professor Stanley Surrey [23] has identified two basic federal options:

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[20] See Whitney, "The Trade Act of 1974: Coping with Unequal Environmental Control Costs," 16 B.C. Indus. & Com. L. Rev. 577 (1975).

[21] Tax Policy Report, *supra* note 19, at 21.

[22] *See, e.g.*, S. Rep. No. 938, 94th Cong., 2d Sess. 24 (1976), which lists various energy related activities for which Congress through special tax provisions provides incentives to develop environmental beneficial programs.

[23] Professor Surrey is Professor of Taxation at the Harvard Law School and has served as Assistant Secretary of the Treasury for Tax Policy.

1. "Direct government expenditure programs," a process under which programs are normally given direct and searching budget management evaluation (this would include grants, subsidies and loan guarantees).[24]

2. "Tax subsides" or "tax expenditures," a process by which some program or project is financed by tax liability concessions of one kind or another (this would include investment tax credits, accelerated depreciation and tax exemption).[25]

Professor Surrey opposes "tax expenditures" because they "tumble into the law without supporting studies, being propelled instead by cliches, debating points, and scraps of data and tables that are passed off as serious evidence." [26] Apart from this rhetoric, it appears that Professor Surrey's *substantive* objections to use of the "tax expenditure" option are:

(1) That need for programs supported by tax expenditure receives inadequate or at least less consideration than the need for direct expenditure programs.

(2) That the costs and benefits of a program are given less or inadequate consideration when tax expenditures are employees;

(3) That program effectiveness evaluation is less likely to occur when programs are supported by tax expenditures;

(4) That program objectives of tax expenditure programs are more apt to be obscure.[27]

Professor Surrey advocates that the antidote to ill-considered programs supported by tax expenditures is to "restate the tax program as a direct expenditure program and ask whether such a program represents a desirable policy.[28] But even if the program when "directly" evaluated turns out to be a "desirable policy," Professor Surrey still believes that support of the program should be in the form of a direct expenditure program:

"Thus, for example, if it is decided that elimination of tax expenditures for natural resources should be accompanied by government assistance in oil and mineral exploration, the direct programs can be readily devised." [29]

Whether some, many or all tax expenditure programs in fact "tumble into the law" without the four-fold program evaluation Professor Surrey advocates is a question that need not be resolved herein. It is elementary good government that all programs should receive such evaluation regardless of what funding process is utilized. In the ensuing portions of this analysis devoted to consideration of the various capital formation and/or recovery options available through tax legislation such direct program evaluation will in fact be undertaken. Such direct evaluation demonstrates that adoption of improved investment tax credit measures, a special environmental investment tax credit system, and improved capital recovery measures are all essential to achieve the multiple national goals of a sound economy and environmental protection.

The fundamental dispute arises over the proposition that tax expenditure programs should or must be "translated" into direct government expenditure programs to be effective and accountable.

One of the primary realities that must be recognized is that the investment tax credit and the special environmental credit are not "tax subsidies." As shown hereinafter,[30] *neither* will produce any revenue dilution but rather, based on some fifteen years' experience, will *stimulate* treasury receipts due to the increased production of pollution abatement devices which thereby increases the private sector taxable basis.

In contrast, given the presence of perennial budget deficts, to address capital formation problems by direct grants would aggravate the federal deficit picture and necessitate further federal borrowing to obtain grant funds that would otherwise be available through tax credits without incurring interest charges, Thus a direct expenditure approach to the capital formation problem would be more costly in absolute numbers of dollars and would contribute in increasing the national deficit. Moreover, the various investment tax credit provisions are virtually self-administering, thereby obviating the cost of additional grant administration personnel.

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[24] *Hearings on Tax Subsidies as a Device for Implementing Government Policy: A comparison with Direct Government Expenditure Before the Subcomm. on Priorities and Economy in Government of the Joint Economic Comm.*, 92d Cong., 1st Sess. 48–59 (1972) (statement of Stanley S. Surrey).

[25] *Id.*

[26] *Id.*

[27] *Id.*

[28] Id.

[29] Id.

[30] See notes 34–36 and accompanying text infra.

The importance of the foregoing is underscored by the fact that the federal government is already heavily involved in direct environmental grant programs that are increasing rapidly: $5.9 billion in 1975, $7.1 billion in 1976 (estimated) and $8.6 billion in 1977 (estimated).[31] Moreover, the federal government also expends substantial amounts to assist state and local governments in bearing their share of environmental abatement costs and programs. CEQ forecast that the federal government will subsidize state and local governments by more than $3 billion between 1975 and 1983 quite apart from the above-noted grants.[32]

III. CAPITAL FORMATION BY TAX LEGISLATION

A. *The Investment Tax Credit*

During the period 1962 through 1975, the various investment tax credit measures have provided an important source of capital for American industry. Experimentation with the investment credit during this period has demonstrated that it is a particularly effective means of controlling the level of capital supply thereby significantly affecting productivity, employment levels, and the rate of inflation.[33] Moreover, use of the investment credit can be made without incurring dilution of Treasury revenues.[34] The increased productivity resulting from investment credit expenditures increases the corporate income base and thus produces corporate tax revenues to the Treasury which substantially exceed revenue dilution. This factor was implicitly recognized by the Congress in its recent enactment of the Tax Reform Act of 1976[35] which extended the existing investment credit until December 31, 1980 (which would otherwise have expired December 31, 1976).[36] In addition, there is a long-lasting continued increase in budget revenues as a result of the investment tax credit.

While a four year extension constitutes some progress, it is evident that *indefinite* extension of investment credit provisions is a minimum essential merely to accommodate *existing non-environmental* capital needs. Former Secretary of the Treasury Simon recently stressed the serious effects of corporate borrowing, which has sharply increased during the past decade as internally generated corporate funds and equity financing fell short of meeting capital needs.

"One of the factors which can inhibit the future growth of needed capital formation is the financial condition of American corporations. Analysis of debt-equity ratios indicates that corporate balance sheets have shown signs of deterioration over the past decade, which is a break from the pattern which persisted in earlier periods. Debt has increased dramatically, both in absolute terms and relative assets and income. Interest costs have risen appreciably, roughly doubling over the past ten years. The combination of increased debt financing and higher interest rates has resulted in a decline in the coverage ratios reported by American corporations—that is, the ratio of earnings to interest charges. The ratio of liquid assets to debt has shrunk. As a result of these developments, there is a serious question about the potential capability of companies to be able to finance the capital investment that will be required to achieve our basic economic goals of reducing unemployment and inflation as I outlined earlier in my testimony."[37]

The investment credit device offers significant advantages. First, the taxpayer is entitled to the credit *only* when the proceeds are in fact used for the designated statutory purpose thereby assuring that the purpose of the credit is achieved. It thus possesses the advantage of being for all practical purposes self-administering, unlike direct government expenditure programs.

Second, the investment credit is a highly effective means of "capital deepening" and can, over the years, contribute significantly to the capital base of the economy that will be necessary for increased productivity and employment, and containment of inflation to an acceptable rate. To achieve these goals the investment credit must be both adequate in amount and of sufficiently long duration.

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[31] Seventh Annual Report, supra note 1, at 349.

[32] Id. at 151.

[33] See R. H. Gordon and D. W. Jorgenson, Policy Alternatives for the Investment Tax Credit 13 (1975) [hereinafter cited as Policy Alternatives Study].

[34] Internal Revenue Service, U.S. Department of Treasury, Tax Revenue Statistics (1961–1975).

[35] Public Law No. 94–455, 90 Stat. 1520 (1976).

[36] Tax Reduction Act of 1975, § 301(a)(1), 26 U.S.C. § 46(a)(1) (Supp. V 1975), amended by Tax Reform Act of 1976, Public Law No. 94–455, § 802(a), 90 Stat. 1580. See H. Conf. Rep. No. 1515, 94th Cong., 2d. Sess. 443 (1976). The Tax Reducton Act of 1975 had increased the prior level from 7 percent (4 percent for certain utility property) for qualified investments to 10 percent. Tax Reduction Act of 1975, § 301, 26 U.S.C. § 46 (Supp. V 1975).

[37] Tax Reform Act of 1976: Hearings on H.R. 10612 Before the Senate Committee on Finance, 94th Cong., 2d Sess. 2367 (1976) (statement of William Simon, then Secretary of the Treasury).

As to the amount, Congress in its wisdom in the Tax Reform Act determined that 10 percent was appropriate during the period through December 31, 1980. Yet virtually every responsible economic forecaster predicts that the "capital gap" will increase during the next decade and probably for the remainder of the century.[38] It would have been more consonant with economic realities had Congress followed the Senate bill [39] and enacted an investment credit provision of indefinite duration. Moreover, such investment credit should be structured to increase in amount from the basic irreducible 10 percent to higher rates which would generate increasing capital necessary to maintain acceptable levels of productivity and employment. By such a system the amount of investment credit could be adjusted to keep pace with capital requirements without resort to the time-consuming process of enacting new tax legislation periodically, and in addition the long term continuity that is essential would thereby be provided. Experience with the Tax Reduction Act of 1975 demonstrates that due to long lead times in obtaining heavy equipment, there must be a long term investment credit program if companies are to utilize the credit effectively.

The Tax Reform Act of 1976 contains other important provisions that facilitate capital formation. Congress modified the prior limitation of the investment credit to $25,000 of tax liability plus 50 percent of liability in excess of $25,000 [40] and provided a three year carry-back and a seven year carry-forward for credits not used due to the above-noted limitations.[41] Under this system, credits accruing in a given taxable year are applied against the tax liability for that year before any carry-overs or carry-backs of unused credits from other taxable years become applicable.

In addition, under the 1976 Act a so-called "first-in first-out" method of handling investment credits was adopted. Thus in a given taxable year the *oldest* pending credit is used first, the next oldest next, and so on.[42] The effect of this provision is to enhance the likelihood that credits will be fully utilized by effectively extending the duration of credit eligibility. Lengthening the potential duration of earned credits likewise increases somewhat the possibility that unprofitable or marginally profitable companies may utilize such credits.

B. Environmental Investment Tax Credit

Prior to enactment of the Tax Reform Act of 1976, federal tax provisions provided little in the way of "tax expenditures" to meet pollution control capital requirements. One such provision provides that the interest earned on industrial development bonds shall not be included in the gross income of the bondholder if he either qualifies as an "exempt person" (*i.e.*, an Internal Revenue Code Section 501(c)(3) entity exempt from tax under Section 501(a)) or if substantially all of the proceeds of the bond are used, *inter alia*, (A) for sewer or solid waste disposal facilities, or (B) for air or water pollution control facilities.[43] However, provision (A) may well (among other disadvantages and limitations) actually encourage waste disposal rather than recycling; and as to air and water pollution control facilities, most if not all bond proceeds would inure to the benefit of state or local governments rather than meeting private sector needs.[44]

The other "environmental" provision prior to passage of the 1976 Act allows "every person" to elect five year amortization for "any certified pollution control facility" which is "a new identifiable treatment facility which is used, in connection with a plant or other property in operation . . . to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, or storing of pollutants, contaminants, wastes or heat" if both the state and federal "certifying authorities" approve.[45] By virtue of the definition of "new identifiable

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[38] See note 10 *supra*.

[39] See S. Rep. No. 94-938, 94th Cong., 2d Sess., pt. 1 at 17-18 (1976).

[40] Tax Reform Act of 1976, Pub. L. No. 94-455, § 802(a)(2), 90 Stat. 1581, *amending* 26 U.S.C. § 46 (1970), *as amended* (Supp. V 1975).

[41] Tax Reform Act of 1976, Pub. L. No. 94-455, § 802(b)(2), 90 Stat. 1582. A ten year carry-forward is available for unused pre-1971 credits.

[42] *Id.* § 802(a), 90 Stat. 1580.

[43] I.R.C. § 103(c).

[44] One article forecast that during the period 1973-1980 approximately 25 percent of an estimated capital requirement of $26 billion might be derived by industrial development bonds. Bus. Week, July 29, 1972, at 51. Whatever may be said of the accuracy of these forecasts it is clear that such funds as are derived will not be available to meet or provide a substitute for private sector capital needs. A minor possible exception would be a situation in which a private corporation purchased either a recycling facility or an air or water pollution facility (both would have to be available for general public use) and under I.R.C. § 48(h)(12) obtained an investment credit and took depreciation under either section 167 or 169. Such situations must be rare if they occur at all.

[45] *I.R.C.* § 169.

treatment facility" this five year amortization can be elected only as to "tangible property" (not including a building and its structural components, other than a building which is excusively a treatment facility) which is of a character subject to the allowance for depreciation provided in section 167 "but only if the construction is completed after December 31, 1968 and placed in service before January 1, 1976.[46] The amortizable basis of such a facility was not eligible for the investment credit.[47]

The 1976 Act provides for two significant improvements:

1. As to qualifying facilities constructed after January 1, 1969, but before January 1, 1976, the taxpayer can elect a five year amortization plan *and* take one-half the investment credit provided the investment did not lead "to a significant increase in output or capacity, a significant extension of useful life, or a significant reduction in total operating costs for such plant or othr property (or any unit thereof), or a significant alteration in the nature of a manufacturing production process or facility." [48]

2. As to qualifying facilities placed in service after December 31, 1976, the taxpayer can elect *both* a five year amortization schedule *and* an investment credit not to exceed two-thirds of the 10 percent standard investment credit.[49]

Adoption of the principle of a special environmental investment credit by the Congress is of the utmost importance. As already noted [50] it is highly doubtful the capital formation produced by the standard investment credit provision of section 802 will be sufficient to meet future needs and, as suggested above, should be keyed flexibly to increasing capital requirements. Without special provision for an environmental investment credit to meet capital requirements created by private sector compliance with federal environmental laws and regulations, an unhealthy competition for capital would arise which would both impede productivity and related employment and thwart or delay unduly compliance with national environmental objectives. In this latter connection it should be stressed that a number of environmental statutes condition compliance and attainment of standards upon economic practicability.[51] Hence congressional recognition of the need for special environmental investment credits is of landmark significance.

It should be further noted that were Congress to adopt the "sliding scale" approach to the regular investment credit, as advocated, the special environmental credit for qualifying facilities placed in service after December 31, 1976, which amounts to two-thirds of the regular credit would likewise escalate when the regular credit escalated to meet increased capital needs.

Although Congress in the 1976 Act expanded somewhat the definitional scope for qualifying facilities, it still remains unduly circumscribed. The credit should be available not only for pollution abatement equipment and buildings that are entirely pollution abatement facilities, but for other buildings and structures as well. The credit should extend to environmentally designed production facilities and processes as well if reform objectives are to be realized. In future years when the national air and water quality goals have, hopefully, been reached, then the predominant regulatory objective will be the maintenance of these standards. Necessarily, with anticipated growth in population and industrial activity, air and water quality maintenance objectives will be feasible only by fundamental redesign of many plants and processes. Extension of investment credits for plants would provide a needed stimulus to phase out existing opprations which are costly and not optimally feasible to modify, and to replace these with environmentally designed plants better capable of achieving future standards at acceptable maintenance and operation cost levels. It is widely recognized that the incremental cost of achieving higher levels of environmental purity mounts steeply as stricter

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[46] *Id.*

[47] H.R. Rep. No. 1515, 94th Cong., 2d Sess. 498 (1976).

[48] *Id.* "Significant" was deemed by the Conferees to mean a change of more than five percent, a standard applied to the operating unit most directly associated with the pollution control facility.

[49] *Id.* at 498-99. To achieve maximum capital formation it is essential that investment credit provisions and depreciation rates be coordinated rather than working against each other. When the tax credit was first implemented in 1962, the so-called Long amendment subtracted credit claims from the basis used to calculate depreciation schedules. The effect was to dilute total capital recovered and was thereby counterproductive to the objective of maximizing capital supply. The provision was deleted in 1964 in part because it substantially complicated calculation of depreciation writeoffs. Apart from administrative complications, the subtraction of credits from basis is essentially self-defeating. It must be recognized that any constraint on achieving total available investments credits runs counter to basic capital formation goals and should be avoided

[50] See note 44 and accompanying text *supra*.

[51] See, e.g., note 14 *supra*. The Noise Control Act of 1972, 42 U.S.C. §§ 4901–4918 (Supp. V 1975), and the Clean Air Amendments of 1970, 42 U.S.C. §§ 1857–1857*l* (1970), also contain economic conditions.

goals are met and maintained.[52] In the long run it will thus be cheaper to convert to plants and processes which have been designed to achieve a high degree of environmental protection rather than continue to "fix," or modify or retrofit, existing plants to meet and maintain increasingly stricter standards.

To be fully effective, tax incentives should be available for *any* control facility or abatement procedure required by federal, state or local environmental laws or regulations. Accordingly, existing law should be amended to include a broad tax incentive definition, such as:

"The term 'pollution control facility' means any facility (including buildings and equipment) the primary purpose of which is to abate, control or prevent actual or potential environmental pollution."

While air and water pollution control at present appears to comprise the major portion of forecast environmental cost, Congress has enacted extensive legislation addressed to other kinds of pollution.[53] Abatement strategies for stripmining, solid waste, pesticides, oil spills, ocean dumping and other categories are in their infancy. As regulatory programs in these areas are developed, significant additional costs will undoubtedly result. Congress, therefore, should provide for comprehensive environmental tax incentives keyed to the full range of environmental protection and reform programs that it has enacted.

While there has as yet been no actual experience with implementation of the environmental tax credit, available data suggests it will offer all the same advantages that the conventional credit provides. Like the conventional credit, the environmental credit program is self-administering and avoids the cost of grant administration personnel. Furthermore, recent CEQ economic studies conclude that funds spent on environmental abatement will not only significantly enhance the productivity of existing firms that manufacture or build abatement equipment and facilities but will attract new private sector activity as well.[54]

While these CEQ studies do not undertake to quantify the amount by which Treasury tax receipts are increased by the new economic activity stimulated by the "environmental industry," CEQ does estimate "that approximately 300,000 people are now employed who would not otherwise be." [55] CEQ adopted a rule-of-thumb indicator that a billion dollar expenditure generates directly or indirectly about 70,000 jobs.[56] Thus given the expenditure of the forecast private sector environmental capital requirements during the period 1975-1984,[57] it is evident that the federal tax base will be expanded enormously, and such expansion will increase the Treasury tax revenue yield as well. Thus there is every reason to conclude that the revenue yield history of the conventional investment credit will also hold true for the environmental tax credit.

Moreover, since it is virtually universally conceded that a protracted period of capital shortage will prevail, it is evident that without the environmental tax credit, every investment dollar diverted from "conventional" production activity to meet legally mandated environmental requirements will thereby increase the expected capital gap and so contribute to less productivity, lower employment and, correspondingly, less tax revenues.

Finally, to the extent that the special environmental credit contributes to the ability of United States industry to compete effectively costwise with our eleven leading trade partners, the credit will contribute to solution of the "distorton" problem arising from unequal United States versus foreign environmental costs without recourse to import relief measures.[58]

C. Accelerated Capital Recovery

As with investment credits, United States policy with respect to capital recovery provisions must take into account both the so-called conventional needs of the economy to achieve increased productivity and employment and the

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[52] *See* Tax Policy Report, *supra* note 19, at 20.

[53] *See* note 8 *supra*.

[54] Council on Environmental Quality, Environmental Tax Program and Employment 1 (1975): "Environmental programs are stimulating construction, equipment, and research expenditures that would not otherwise be undertaken." *See also*, Council on Environmental Quality, Pollution Control and Employment 8 (1976):

In brief then, pollution control expenditures are seen as having a net positive impact on employment at the present time. And a new industry has been established which has been a source of growing employment during the past few years. This industry has the opportunity and challenge to devise innovative abatement systems which will conserve natural resources, save energy, and reduce costs. If it is successful in meeting this challenge, this industry will not only provide a source of continuing employment itself, but will help contribute to the continued viability and stability of our whole economy.

[55] Council on Environmental Quality, Pollution Control and Employment 8 (1976).

[56] *Id.* at 7.

[57] *See* note 10 and accompanying text *supra*.

[58] *See* note 20 and accompanying text *supra*.

special demands resulting from environmental pollution abatement. Despite the recent upturn in the United States economy, certain basic long-term indicators suggest that major increases in investment will be necessary to restore its vitality. The United States has lagged significantly behind other industralized nations in terms of productivity growth during the period 1960-1973.[59] This trend is particularly ominous because in the past the United States has been able to preserve viable market shares against foreign competition despite price disadvantages by virtue of superior worker productivity.[60]

A similarly bleak trend is evident in the comparative real gross national products (GNP) per employed civilian of several nations during the period 1950-1972. The declining worker productivity in the United States has produced a condition in which the GNP per worker in the United States has fallen below that enjoyed by such nations with troubled economies as Great Britain, France and Italy. Given the well-established relationship between the level of investment and growth, it is clear that expanded capital recovery provisions are necessary to augment capital supply and production investment to counter these trends. It is no coincidence that virtually all of the industralized nations have more liberal capital recovery provisions than those presently in force in the United States under the Asset Depreciation Range (ADR) System.[61] These facts suggest the immediate need to increase the permissible range under the ADR System for depreciating capital assets from 20 percent to a significantly higher level.

A further important corrective measure would be the elimination of the salvage increment in depreciation schedules. During periods of inflation, depreciation allowances based on original cost fail to recover capital adequate to finance facilities having significantly higher replacement costs. Moreover, during such inflationary periods corporate profits, unless adjusted for inflation, are overstated. It has heretofore been noted [62] that the inability to generate sufficient capital from corporate profits has weakened the economy by creating increasing dependence on debt financing with resultant deterioration of debt-equity ratios. This shortfall in capital recovery during a period of higher replacement costs and declining profits is aggravated by inclusion of a salvage factor in depreciation schedules. It must be recognized that the salvage increment is a holdover from the archiac policy of gearing depreciation schedules to the actual life of assets. Retention of such anomalies in the tax law impedes attainment of adequate capital supplies and is thus counterproductive.

Given the magnitude of capital requirements to increase productivity and employment, the additional drain on capital funds created by environmental requirements mandates special treatment. Pollution control costs have increased and are forecast to continue to increase dramatically. The CEQ study notes that expenditures for pollution control totalled $12.3 billion for capital expenditures in 1974, and that these are forecast to reach $27.5 billion for operating and maintenance and $27.8 billion for capital expenditures in 1983,[63] In view of the increasingly high incremental cost of attaining progressively stricter goals that are structured into major existing environmental laws, these estimates may indeed be low.

IV. CONCLUSION

For at least the remainder of this century the United States faces uniquely complex and difficult challenges. It must cope with already well-established trends of declining productivity, inflation and unemployment. To do so, adequate domestic energy resources must be developed at economically viable levels and industrial productivity must be expanded. Both goals also involve major impacts on the environment which will be increasingly costly to control within acceptable limits. What constitutes acceptable limits has been defined by Congress in terms of legal deadlines established by comprehensive legislative and regulatory programs. These programs were structured by Congress to impose progressively more stringent standards which will become increasingly costly to achieve. Moreover, environmental control programs are likely to expand—*e.g.*, to protect more effectively ocean, outer continental shelf and coastal resources. Significant additional effort will be required in the areas of research, planning and environmental design.

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[59] Internal Revenue Service, U.S. Dept of Treasury, Tax Revenue Statistics (1961-1975).
[60] U.S. Dept of Labor, Bureau of Labor Statistics (1960-1973).
[61] Treas. Reg. § 1.167(a)-11 (1971).
[62] *See* note 37 and accompanying text *supra*.
[63] Sixth Annual Report, *supra* note 1, at 564.

All of these efforts must be undertaken and implemented contemporaneously. Consequently, the government must devise capital formation and recovery provisions capable of financing *all* of these deeply interrelated activities. At a minimum the following program appears to be indispensable:

1. Continuation on an indefinite basis of existing investment credit provisions amended to provide sliding scale adjustments to reflect changes in capital requirements.
2. Adoption of the perfecting amendments to existing investment credit provisions.
3. Continuation of the special investment credit for environmental control expenditures keyed to the level of the standard investment credit as adjusted by the sliding scale procedure.
4. Reform of existing capital recovery provisions for non-environmental investment.
5. Expensing in the year invested rather than depreciating facilities installed pursuant to environmental requirements.

Anything short of this multi-dimensional program will seriously jeopardize the prospects for attaining one or more indispensable national goals. With the exception of certain suggested improvements the validity of all of the foregoing has been recognized in principle by the Congress in the Tax Reform Act of 1976 These measures have in fact been carefully scrutinized, their costs and benefits weighed, and the ultimate program objectives considered. Important improvements and refinements remain to be made but it is clear that the tax legislative approach is a far sounder method of coping with capital formation requirements and offers many more advantages than the direct government expenditure alternative.

THE TAX COUNCIL,
Washington, D.C., June 27, 1978.

Hon. HARRY F. BYRD, Jr.,
U.S. Senate, Room 417, Russell Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: Further to our telephone conversation yesterday, there is an original suggestion in my statement which I thought you might like to know about in advance of the beginning of your Subcommittee's hearings tomorrow.

As an alternate to enacting proposals reducing capital gains taxes in relation to the length of time an asset has been held, such as included in Senator Bentsen's bill, S. 2608, the suggestion is a cap on taxing capital gains of five percent of the total value of the property involved. The proposal is explained and illustrated in the footnote on page 6 of the statement.

The reference to Dick Wagner's writing, enclosed with my letter to you of May 23rd, is the footnote at the bottom of page 3.

If your group should consider reacting policy wise to the President's criticism of the Hansen/Steiger bill, while not yielding on getting capital gains out of the minimum income tax, you might find interesting the Council's proposal for a 65 percent exclusion which would result in a 24.5 percent top rate on gains (making the alternate tax unnecessary) while reducing the rates on all capital gains a minimum of 30 percent, page 4 of my statement.

With every good wish and great appreciation of the leadership which you are providing to restore some economic sanity to the taxation of capital gains.

Sincerely,

JOHN C. DAVIDSON.

Enclosure.

STATEMENT OF JOHN C. DAVIDSON—A WASTEFUL AND REPRESSIVE TAX

I am President and a Director of The Tax Council.

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

My statement relates to the three bills—S. 3065, S. 2608 and S. 2428—sponsored by Senators Hansen, Bentsen and Haskell, respectively. Hereinafter, S. 3065 will be referred to as the Hansen/Steiger bill.

A TURNING POINT

The support for these bills would seem to indicate we are close to if not at an historic turning point in the political attitude towards tax reform. To the present

the professional tax reform movement has influenced a dialogue concerned only with direct tax effects, that is, who pays or does not pay taxes. The Carter Administration, unfortunately, has chosen to persist in this vein in reacting to the Hansen/Steiger bill. But their exaggerated rhetoric and opportunistic use of statistics implies a lack of confidence in the correctness of their stand.

For example, when Administration spokespersons launched in January a year ago their campaign to have all capital gains taxed at income rates, the principal point used privately and publicly was that the rates were all but at the 50 percent level already (remember, at that time, they were talking about bringing the top rate on all personal income down to 50 percent). The point reflected their obsession with the idea that only the rich were significantly affected by taxes on capital gains. In fact, in a discussion with a Treasurer analyst working in the high income area, he expressed surprise at my statement that people other than the rich have capital gains. Even after the Council published an analysis of 1975 IRS data showing that the great bulk of capital gains are realized by people who are far from being rich, Administration spokespersons continued for many weeks to use the same tired old line that "present rates are only a step away from 50 percent".

Now, with the Hansen/Steiger bill directed at reversing the 1969 legislation which was aimed squarely at the rich, the Administration has reversed its story on who pays capital gains taxes. Relatedly, they discover only 14 taxpayers with rates pushing 50 percent because of the interplay of the minimum and maximum taxes and, further, release a study confirming what we said a year ago about the concentration of capital gains in the middle and lower income brackets.

A NATIONAL ASSET

Regardless of the Administration's verbal and statistical gymnastics on the subject, or perhaps influenced somewhat by them, the support in the Senate for the Hansen/Steiger bill, and for further relief from the tax erosion of capital such as is incorporated in S. 2608 and S. 2428, seems to say that there has emerged a new political recognition that whoever does the saving and whoever owns capital at any given time, the act of saving is a public service and the stock of capital is a national asset which serves all the people.

It is past time for this to happen. The nation has run out of easy choices. Over the past decade, there has been serious deterioration in the rate of our economic progress while the economics of our major competitors in world markets have surged ahead. It would be a mistake to attribute too much of our problem to federal tax policy. But it would be inexcusable not to adjust that policy to accord with the national need for a better economic performance. In addition to its repressive effects, the taxation of capital is wasteful of a national asset. Such taxation commits the cardinal economic sin of diminishing the capacity to produce. Moderate transfer taxation of capital may be tolerable. But viewing capital as a revenue-raising tax object in the nature of income is a collosal economic mistake.[1] It hardly needs to be stated that a capital gain, realized or not, is inseparable from the capital of which it is part (just as is a loss in reverse). Although a tax is measured by the amount of gain, it is a tax on the capital itself.

A MODEST PROPOSAL

Viewed in the light of economic truths, the Hansen/Steiger bill is a modest proposal. It would simply correct two mistakes made in 1969 in the highly charged atmosphere created by the initial disclosure that a few high income taxpayers paid little if any tax in a particular year.

The first mistake was based on the assumption that the tax treatment of capital gains under the income tax system was preferential. Thus, the excluded half of gains was listed as a tax preference under the minimum income tax. Aside from the further erosion of the capital supply inevitably to result from the listing, this action was misguided in viewing the tax treatment of gains as preferential. The treatment reflected earlier Congressional recognition that capital gains are in fact something quite apart from income; that they are in fact part and parcel of a person's capital and not of his or her income. The treatment was decided upon not with the intention to grant a preference but as a matter of judgment as to the level of taxation of gains which would be appropriate. The method used, a

[1] The magnitude of the mistake perhaps has been best illustrated by VPI's Professor of Economics Richard E. Wagner in his book "Inheritance and the State . . .". The relevant material is excerpted and attached hereto. On page 44 he uses an apple orchard as the case model for making his ultimate point "Simultaneous taxation of the income flow and the capital value would, of course, double the rate of taxation; in other words, it would represent double taxation".

partial exclusion under the income tax system, was a matter of legislative convenience and not of substantive policy. If the same rates had been enacted in a separate schedule, there would have been no semblance of basis for the label of preference. Needless to say, the Council opposed the listing from the beginning.

The second mistake in the 1969 legislation was to restrict use of the ceiling which, as an alternate tax, had been placed on capital gains in 1942. The legislation restricted use of the alternate tax to gains not in excess of $50,000. This resulted in tax rates topping out at 35 percent (70 percent tax on one-half of gains) on gains no longer protected by the alternate tax.

By eliminating the two 1969 enactments, the Hansen/Steiger bill would restore the tax treatment of gains which had existed since 1942, that is, effective taxation at one-half of the taxpayer's marginal income tax rate(s) up to a top rate of 25 percent.

CONTRAST TO ADMINISTRATION PROPOSALS

The Hansen/Steiger bill is in contrast to the proposals in the President's 1978 tax program for (a) completing the transformation of the minimum tax from one designed to impose a minimum tax on high income people who otherwise paid little if any income tax to an additional tax measured by so-termed preference income regardless of income level or the amount of income taxation and (b) eliminating the alternate tax from the code. With capital gains providing over 80 percent of the revenue yield from the minimum tax, the Administration in supporting documents and testimony presented to the Ways and Means Committee made no effort to disguise its objective of moving steps closer to the goal of taxing all gains at income tax rates.

In considering the President's proposal for entirely eliminating the alternate tax, the Council's Tax Policy Committee, meeting in March before emergence of the Hansen/Steiger bill, was strongly of the view this should be done only if the top rate otherwise were brought down to 25 percent or below. Thus, the Committee proposed increasing the exclusion from 50 to 65 percent which would result in a new top rate of 24.5 percent and reduce all rates of capital gains tax by a minimum of 30 percent.

The Committee did not by its action intend to infer that such an exclusion should be the final answer insofar as the taxation of capital gains is concerned. To oldtimers like myself, it seems like only yesterday when the late President John Kennedy was recommending a 70 exclusion which would have produced a top rate of 21 percent. We got off the track in 1969 and, except for disenchantment in the Congress, the Administration would have driven us over the precipice of tax disaster this year. The Hansen/Steiger bill would get us back on the track of how best to tax capital gains.

FURTHER REDUCTIONS

Beyond this landmark bill, the question which this Committee and the Congress must decide is whether the problem of tax erosion of capital through the capital gains tax shall be resolved directly or only mitigated in special situations as contemplated in S. 2608 and S. 2428. Certainly, in the context of the present rate situation or that which would exist after enactment of the Hansen/Steiger bill, or even that which would exist with a 65% exclusion, both bills have merit. But for the good of the economy, and in the interests of a less complicated tax code, further reduction in the rates paid on all realized gains certainly would be preferable to specially targeted mitigating enactments.

There also is a matter of equity. Professional tax reformers claim that horizontal equity would be served by taxing all gains at ordinary income tax rates, but the wish obviously is the father of the thought. The fact is that the taxing of capital gains as an addon under the income tax system results in unequal tax on equal gains. For example, a hardworking entrepreneur, executive or professional with a $100,000 income and $50,000 of capital gains will pay tax on the gains at his or her marginal income tax rates. But a person with $50,000 in gains but little or no income will pay at much lower rates.

Of course, the inequality in tax would be increased under higher rates on gains but decreased under lower rates. Whatever the rates on capital gains, a new level of inequality would be introduced by enactments granting relief to a selective group or groups.

Thus, on three grounds—economics, simplicity and equality of treatment—it would seem that bills like S. 2608[2] and S. 2428 should be a last resort for coping with the problem of uneconomic taxation of capital gains. It could even happen that the American dollar, now so battered in World markets, would gain new respect and strength if the United States should follow the example of its major competitors and tax capital gains only very lightly if at all.

THE SIMPLEST CASE

Perhaps inadvertently, the simplest case for ending the erosion of the capital supply by taxing gains has been stated by Secretary of the Treasury Michael Blumenthal: "The facts are inescapable. We aren't saving enough . .". Why, then, waste established capital by converting it into government spending? How inefficient can a political society be when it uses taxes to destroy capital on the one hand while it is talking about reducing taxes to increase the capital supply on the other? In the aggregate, savings out of current income must compensate for the tax erosion of existing capital before there is net addition to the capital supply. At current rates of saving, it takes something like $15 of personal income to produce one dollar of new saving.

CEILINGS ON TAX REDUCTION

A familiar ploy of an Administration proposing tax reduction is to set a ceiling on the total and then preempt the whole. The question here is whether it would be appropriate or rational for the Congress to accept any ceiling on tax reduction generally as a limitation on reducing taxes on capital.

When you are cutting taxes outside the control of budget balance, there is no magic number. There is no experience which gives us any guidelines as to how much we can or can't cut in the face of a large deficit and high level inflation. This does not mean that there are no other conditions which do or could justify reducing taxes this year. An illusive, on-again-off-again condition is the trend in consumption. The principal reason given late last fall when the decision was made to cut taxes this year was the need to stimulate consumption. Now, such need is not currently evident but there are those who believe it will return by the turn of the year. But, it is a changing, iffy area and, if taxes are to be cut to beef up consumption in the face of a large deficit and high level inflation, the only guideline is not to overdo it whatever that may mean.

The concern, however, in these hearings is another condition which undeniably justifies cutting taxes in the face of the deficit and despite the inflation. In fact, correcting this condition is one means for controlling and diminishing inflation over time. That condition is the inadequacy of savings emphasized by Secretary Blumenthal.[3] It is usual to refer to the need for investment incentives or to stimulate investment to ameliorate this condition but such words tend to misrepresent or avoid the tax responsibility for the condition. The need is to diminish the limiting effect which taxes have on savings out of current income and to curtail the tax destruction of established capital.

If the personal income tax were proportional instead of progressive there could be no claim that it limits savings any more than it limits any other private uses of income. Thus, to move the system towards one of neutrality on savings, there would have to be some reversal of progression. To serve the objective, the first most efficient step would be to reduce the top tax rate of investment income to the 50 percent applicable to personal service income and the second would be to take the curve out of the line of progression below 50 percent.

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[2] While the objective of S. 2608 seems so fair and sensible, it does have the inherent weakness of dealing only partially with the problem of the locked-in effect of the tax on gains. For example, take two persons, A and B, both holding stock which they purchased for $25 a share and which now trades at $100. If they sell at the same time, both would realize the same total of gains. Under S.2608, however, A—who had purchased his stock 20 years before it started to move in price—would pay a much smaller tax than B who had held his stock for only two years. As a practical matter, B would be no more inclined to sell than A would have been except for the special relief from tax. The point to be made is that the locked-in effect of the tax on gains results from a high ratio of appreciation in value over original cost to the current value of an asset and not to the length of time it has taken to realize such appreciation.

If reduction in tax rates should not solve the problem of being locked-in for all who own taxable assets, a way for doing this would be to put a cap on the amount of the tax as a percentage of the total value of the property involved. For example, take a stock or other asset worth $50,000 of which 90 percent is appreciation of value over cost. A 20 percent tax on the gain would come to $9,000—18 percent of the value of the property. A five percent cap in tax on the value would hold the dollar amount to $2,500—still a rather tidy sum as the tax price for changing the form in which capital is held.

[3] Because the record in these hearings will be replete with statistics on lagging productivity and the inadequacy of capital spending, they are not repeated herein.

While the level of personal savings and the aggregate of the nation's stock of capital are of major importance to the total of business capital spending over time, a rise in the funds generated internally is the green light for larger appropriations for capital spending in corporate board rooms at any time. The recommendations in the President's January program for cutting the corporate rate and improving the relief from taxes provided by the investment credit would seem the bare minimum in light of the need for more business capital spending in the months and years immediately ahead. A ceiling on tax cutting which forced a lower cut in the corporate area would be unfortunate in my opinion. The reductions were not proposed to help those who manage or own businesses but to enable a higher level of business capital spending for the benefit of the economy and our citizens as a whole. Such reductions are a break for the economy, not a gift to business.

When it comes to cutting the tax on capital as measured by realized gains, it simply falls outside the concept of a ceiling on income tax cuts. The tax object is totally capital and in no sense income. Whatever the level of ultimate Administration/Congressional decision on an income tax cut ceiling, there is no fiscal or economic reason to include capital gains under the ceiling. Cutting capital gains taxes would be a counter-inflationary move and, the larger the cut, the greater the counter-inflationary effect over time. With a federal budget in the range of half a trillion dollars, a deficit in the range of $60 billion and views on an income tax cut ceiling ranging from $15 to $25 or more billion, an official display of fiscal concern over the couple of billion dollars attributed to the Hansen/Steiger bill cannot be taken seriously. Even the six or so billion dollars which would be attributed to ending or effectively ending the capital gains tax is much less than the range of ideas about ceilings on income tax cuts, the range of estimates about how large the deficit will turn out to be next year or the shortfalls of spending over budgeted totals over the past couple of years. But what would at the extreme be only a modest and temporary ripple in the stream of federal finances would be a great boon to the economy. Six or seven billion dollars is a lot of capital by any measure and a capital market free of penalizing taxation is an entreprenuer's dream. Looking back a decade later, it might well be seen that such a constructive move was the torch which lighted the way to a much better economic performance in the 1980s than has been the case in the 1970s, in regard to the ratio of capital spending to GNP, productivity, inflation, competitiveness in international markets, the ratio of equity to debt in corporate financing and, probably most important of all, vitality in the American genius for starting new businesses, developing new products and improving old ones. This may be a vision which is ahead of its time, but the emergence of the Hansen/Steiger bill at a time when the professional tax reformers had launched their ultimate drive to tax all capital gains at income tax rates suggests the light at the end of the tunnel of outrageous taxation of gains may shine more brilliantly than any had dared to think.

THE ART OF TAXATION

More seriously than jokingly, the art of taxation has long been likened to the art of plucking the goose—in both cases,the objective is to get the most with the least squawk.

That art is no longer good enough for America. The time has come when the American people need to be told that, regardless of the overall burden of spending and taxes or of their individual burdens, the nation is the loser when established capital is taken in taxes and when incomes which generate the most savings are taxed at excessive rates. In my years of work in the federal tax policy area, I have hoped that a Chief Executive of our Nation would be this forthright with the people. In this period in which the Congress has freed itself from the professional tax reformer's obsession with loading it on the rich, perhaps the kind of dialogue needed will originate in the Congress.

At this stage of history, the only art of taxation which is good enough for America is telling it like it is.

CONCLUSION

The Hansen/Steiger bill would be good for the nation because anything beyond modest taxation of capital gains has to be bad for the nation. In correcting mistakes of the past, it deserves the enthusiastic support of all who recognize the importance of capital to human wellbeing. Having already developed so much interest and support, failure to enact the bill this year could have a decidedly negative influence on capital markets and wherever entrepreneurs dream about and plan projects for the future.

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UNREALIZED APPRECIATION BEFORE THE TAX REFORM ACT OF 1976

Before the Tax Reform Act of 1976, estates were accorded different tax treatment depending on the extent to which capital appreciation was realized or unrealized. Realized capital appreciation was and still is treated as income during the year in which the appreciation is realized: one-half of the appreciation is entered as income in computing liability for income tax for that year. Whether the appreciation represents an increase in the real value of the asset or whether it merely reflects the inflation of prices is irrelevant. The tax treatment is the same in either case. The tax treatment of realized capital appreciation, it should be noted, is strictly a problem of income taxation. The issues it raises are those surrounding the definition of income within a system of income taxation. No issues pertaining to estate taxation are involved.

Unrealized capital appreciation, by contrast, raises issues relating both to income taxation and to estate taxation. Prior to the 1976 act, unrealized capital appreciation was not subject to income taxation, though the appreciation entered into the base of the estate tax. If the appreciation had been realized before death it would have been subject to income tax; held until death, however, the unrealized appreciation was not subject to income tax. In either case, the estate tax was assessed against the market value of assets in the decedent's estate. Contention arose because less tax was paid on the devolution of an estate that included unrealized capital appreciation than on that of an estate in which capital appreciation had been realized before death; the tax paid on realized appreciation was not paid on unrealized appreciation. This differential tax treatment was reinforced by the ability of the successor to value the assets at their current market value in forming his basis from which any subsequent capital gains would be computed. In this manner, unrealized appreciation completely escaped liability for income tax.

UNREALIZED APPRECIATION SINCE 1976

This ability of capital gains transferred upon death to escape income taxation inspired numberous suggestions for revision. The Treasury Department, in its 1969 proposals for tax revision, suggested that such capital gains be included in the decedent's final income-tax return. This proposal, known as constructive realization, was supported on the grounds that it would make the taxation of unrealized appreciation consistent with the taxation of realized appreciation. This would be accomplished by treating a taxpayer upon death as if he had realized all capital gains before death—that is, by including such gains in the decedent's final income-tax return.

In place of constructive realization, the 1976 act provided that unrealized capital gains should continue to be ignored for tax purposes, but that the donor's basis would be carried forward to the donee. Thus, realized and unrealized appreciation receive similar tax treatment under the present law. In this case, however, the focus is not on the owner of the asset, but on the asset itself. That is, tax liability depend on the sale of the asset, not on the death of the owner. The principle that gains are taxed only when realized is maintained, only now all capital realization will carry a liability for income tax.

Some simple arithmetic can illustrate the differences among the three approaches. Suppose assets initially purchased for $100,000 are valued at $300,000 at the time of the owner's death. Under the rules prevailing before the 1976 act, the $200,000 of capital appreciation would not be taxed in the decedent's final income-tax return. The hier, moreover, would have been able to enter $300,000 as his basis value for the asset. Should the value of the asset subsequently rise to $500,000 and then be sold, the realized capital gains would be $200,000. Under the 1969 proposal for constructive realization, a capital gain of $200,000 would have been declared in the decedent's final income-tax return. A second gain of $200,000 would have been declared in the heir's income-tax return when he sold the assets for $500,000 .Under the provisions of the 1976 act, no capital gains would be declared at the time of the owner's death. The heir's basis, however, would remain at $100,000. The subsequent sale for $500,000, therefore, would produce a capital gain of $400,000 to be declared in the heir's income-tax return. This last is the procedure now in force.

It was often argued that the pre-1976 tax treatment of unrealized capital appreciation created a "lock-in" effect. The idea was that some investments were maintained in their present form rather than being liquidated and placed in new form because the act of liquidation would call forth a tax liability that could be postponed if the old pattern of investment were continued. The new investment

opportunities might well offer a higher return gross of tax. But to switch investments would require the investor to realize the gain on his former investment. Once the tax that would be assessed on this realization were taken into account, it might prove rational to retain the former investment pattern. This lock-in effect, to the extent that it exists, is a result of the progressive rate structure of our personal income tax. Because of this progressivity, the potential tax liability increases with disproportionate rapidity as unrealized capital gains increase. So the larger the capital gains, the stronger will be the lock-in effect due to the rising relative tax burden.[4] The carrying forward of the original basis adopted in the 1976 act, it is clear, will tighten this lock-in effect. Because the capital gains, which are taxed according to a progressive rate structure, will tend to be larger when they are realized by the heirs than if they had been realized a generation earlier, tax considerations will come to weigh more heavily in decisions whether to realize capital gains in order to switch investments.

CAPITAL AND INCOME

The reason for the 1976 revision in the tax treatment of unrealized appreciation was the inconsistency in the tax treatment of realized and unrealized appreciation. Although the act is now law, it is worth noting that this inconsistency could have been removed in one of two ways. The first, that actually adopted, is the requirement that the old basis be carried forward to the new owner, which brings the tax treatment of unrealized appreciation into line with that of realized appreciation. Unrealized capital appreciation now carries a potential tax liability that can no longer be erased by death.

It would also have been possible to bring the tax treatment of realized appreciation into line with that of unrealized appreciation. If one person is taxed more heavily than another when it is judged that the two should be taxed equally, there are two ways of achieving equal treatment. One is to raise the tax on the person less heavily burdened. It is also possible, however, to lower the tax on the person more heavily burdened. The existence of two alternative avenues for removing the inconsistency in tax treatment warrants further examination, for their respective merits depend on some fundamental principles regarding the meaning of capital and income.

Is capital appreciation appropriately defined as income? If so, it is an appropriate object of taxation under a system of income taxation. The suggestion that unrealized appreciation should be taxed upon death in the decedent's final income-tax return is based upon the presumption that such appreciation is properly classified as income. But if capital appreciation is not appropriately defined as income, the tax treatment of unrealized capital appreciation becomes the standard for the taxation of realized capital appreciation as well.

The Haig-Simons definition of income has been used to rationalize the taxation of capital appreciation.[5] Income, in this case, is defined as the sum of annual consumption and all changes in net worth over the year. Capital appreciation, even if unrealized, is clearly income within this definition, for it increases net worth. While it is usually recognized that the annual taxation of capital appreciation is the ideal under this definition, it is also usually acknowledged that the delay of taxation until the asset is sold is an expedient alternative. Taxation upon realization is generally regarded as a reasonable and workable compromise.

The Haig-Simons definition of income, however, is not the only possible definition. Moreover, it is generally regarded as severely flawed. Its most glaring conceptual weakness is that it confounds terribly the important distinction between capital and income, between the stock value of an asset and the flow value of the output emanating from that asset.

While many authors have attempted to develop definitions that distinguish between capital and income, the most generally accepted approach has been that of Irving Fisher.[6] An economy may be characterized at any time as containing

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[4] For a sample of this literature, see Gerard M. Brannon, *The Lock-in Problem for Capital Gains: An Analysis of the 1970–71 Experience* (Washington: Fund for Public Policy Research, 1974); Martin David, *Alternative Approaches to Capital Gains Taxation* (Washington, D.C.: Brookings Institution, 1968); and Henry C. Wallich, "Taxation of Capital Gains in the Light of Recent Developments," *National Tax Journal*, vol. 18 (June 1965), pp. 133–50.

[5] A statement and defense of this concept of income is contained in Henry C. Simons, *Personal Income Taxation* (Chicago: University of Chicago Press, 1938).

[6] Irving Fisher, *The Theory of Interest* (New York: Macmillan, 1930). For a recent discussion of the confounding of capital and income, which is epitomized in proposals to tax capital appreciation as income, see Dan T. Smith, "Capital Gains, Losses in Income Taxation," *Tax Review*, vol. 33 (December 1972), pp. 45–48.

a stock of productive assets, and these assets will be capable of yielding some sustainable flow of output. The value of the stock of assets is the value of capital, and capital appreciation refers to increases in the value of this stock of assets. The value placed on the flow of output from that stock of assets is income. This distinction between capital and income does not, it might be noted, imply acceptance of the Crusonia plant metaphor, for the potential output is not automatic and permanent; it will not be realized and maintained in the absence of continual and appropriate economic calculation and decision making. Rather, it suggests that the stock of productive assets and the rate of output that potentially can be produced by that stock of assets are two distinct magnitudes.

CAPITAL APPRECIATION IN A SYSTEM OF INCOME TAXATION

The operation of these alternative approaches to capital appreciation in a system of income taxation may be illustrated quite simply. Under the Haig-Simons definition, income is equal to consumption plus changes in net worth. Income is, in other words, the maximum amount of consumption that could be undertaken without reducing the capital value of assets. Consider a person who owns an apple orchard containing 1,000 trees, with each tree yielding, on average, 500 apples annually. This orchard will run the gamut from newly planted trees to fully mature trees, with each year the oldest trees being replaced by new trees. It so happens that the steady-state sustainable yield of this orchard is 500,000 apples annually. Suppose the annual yield of 500,000 apples yields a net income of $50,000 annually, deductions having been made for expenses of production and of replacing aged trees. While each apple has a net value of ten cents, each tree would have a net value also. Suppose each tree would have a net value of $50, reflecting a 10 percent rate of interest. Under these cirumstances, the income from the orchard is $50,000 annually and the capital value of the orchard is $500,000.

Now suppose that, in response to the rising cost of medical services, people began eating an apple a day. As a result of this rise in demand for apples, the price of apples rises. Let us assume that the price doubles. The 500,000 apples produced annually by the orchard would now bring in a net income of $100,000. The doubling of the value of the orchard's yield would, in turn, increase the value of the orchard itself. It is reasonable to assume that the value of the orchard would rise to $1 million, for there is no reason to assume any change in the rate of time preference and the interest rate. Under the Haig-Simons definition of income, the owner of the orchard would have had an income of $600,000 in the year in which the price of apples double. Of this amount, $100,000 would represent the net income from the sale of apples, and $500,000 would represent the appreciation in the value of the orchard itself.

The conceptually superior Fisherian definition of income brings a quite different perspective to the matter. One must begin by asking: Why has the value of the orchard increased to $1 million? The answer, of course, is that it has increased because the price of apples and, thereby, the income from the orchard have risen. The rise in capital value, in other words, is merely a reflection of the increased income yielded by the orchard. A failure to tax the capital appreciation is not a defect or loophole in a system of income taxation. On the contrary, such nontaxation of capital appreciation is necessary for the very integrity of a system of income taxation. The capital gain of $500,000 should not be taxed simply because it is not income. The rise in capital value is reflected in the larger income flow, and in a system of income taxation it is the income flow that should be subject to tax. The $500,000 increase in capital value is simply incidental to the $50,000 increase in annual net income. The capital gain is nothing but the capitalization of the increased income flow.

To tax both the income flow at its larger rate and the gain in capital value is to engage in a double counting that totally confounds the fundamental distinction between a flow of services and the stocks of assets that produce those services. The capital appreciation is merely the reflection, the present value, of the enlarged income flow which is already being taxed. Taxation of the income flow at, say, 20 percent annually would be equivalent to taxation of the capital value at 2 percent annually, under the postulated conditions of a 10 percent rate of interest. Simultaneous taxation of the income flow and the capital value would, of course, double the rate of taxation; in other words, it would represent double taxation. In this regard, not only the expansion in the income-tax coverage of unrealized appreciation that occurred in the 1976 act should be reversed, but also the other

instances of taxing capital appreciation within our system of income taxation should be curtailed.[7]

Excerpted from: "Inheritance and the State—Tax Principles for a Free and Prosperous Commonwealth", by Richard E. Wagner, Prof. of Economics at Virginia Polytechnic Institute and State University, American Enterprise Institute for Public Policy Research, 1977, pages 40–45.

UNITED BUSINESS INVESTMENTS, INC.,
Paramount, Calif., June 12, 1978.

Senator FLOYD HASKELL,
Room 452, Russell Senate Office Building,
Washington D.C.

DEAR SENATOR HASKELL: I recently called your Washington office to offer support and assistance to the Small Business and Farms Capital Preservation Act of 1978. Our firm is the nation's largest brokerage firm specializing in the sale of small businesses, and we heartily endorse the bill.

In addition to the obvious benefits to our business and to the owners of small farms and businesses, this bill will favorably affect other areas of the economy. It would aid in the preservation of opportunity for the individual entrepeneuer. Our experience shows that many people who sell a small business go directly into the job market. Your bill would be an inducement to them to stay in the small business community. It may also entice people from the public and private sector of the job market to enter the small business community. In an age when people are rebelling against the waste and depersonalization of large-scale business and government, this is a move in the right direction.

In my opinion, this bill will also help offset some of the deterrants to engaging in small business, such as the high cost of insurance, government regulation, etc. I am sure that I speak for many people in the small business community who are not even aware of this pending legislation, as well as all of us at UBI, when I thank you for introducing the Small Business and Farms Capital Preservation Act of 1978. Certainly, if our firm or I can be of any service in this matter please do not hesitate to contact us.

Very truly yours,

THOMAS L. WEST, *President.*

STATEMENT OF JOHNNIE M. WALTERS

I. INTRODUCTION

My name is Johnnie M. Walters. I am a partner in the law firm of Hunton & Williams, Washington, D.C. I am representing Virginia Electric & Power Company (VEPCO), an investor-owned electric power company which supplies electricity throughout the State of Virginia. However, I am sure that my views are widely shared by other investor-owned electric power companies.

Initially, I prepared this statement for oral presentation to the Subcommittee during its June 28–29 hearing. Not having had the opportunity to appear at that time, I now submit the written statement for consideration by the Subcommittee and inclusion in the Record in accordance with the Senate Finance Committee Staff Director's June 23, 1978 mailgram.

II. ELECTRIC POWER INDUSTRY NEEDS

Today, there is an undeniably critical need for substantial additional capital investments to finance additions to and modernization of electric energy production facilities. With some exceptions, however, our internal revenue laws do not adequately encourage capital formation and capital construction, both desperately

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[7] Admittedly, this statement regarding the nontaxation of capital gains is something that would be tempered by certain pragmatic considerations, for pragmatic implementation is not as simple as the conceptual illustration may suggest. Capital assets will not necessarily generate corresponding income flows. The tax treatment of owner-occupied housing serves as a good example. The flow of services from such housing is not taxed as income, while capital gains on sales of residences are taxed, though many countries do tax the imputed income of owner-occupied housing. Similarly, common stocks may yield no dividends, while appreciating in value nonetheless. In either of these two cases, as well as in many others, annual measures of income may not correspond closely with income interpreted as a sustainable flow of services from an asset. In many respects, the replacement of our system of personal income taxation with one of consumption taxation might have much to commend it, for consumption is a more accurate indicator of permanent income on the one hand, and such a shift would avoid such problems as that illustrated by the appreciation of common stock on the other hand. These possibilities, however, are beyond the scope of this volume.

needed to stimulate the economy generally and to provide the means to increase our capability to keep up with the growing demand for electric energy. The electric power industry is particlarly capital-intensive, accounting for one-fifth of all business plant investment in the United States. In 1977 alone, it committed twenty-five billion dollars for new construction. In the electric power industry, a $4 capital investment is required to produce an annual revenue of $1. Thus, a large share, approximately one-third, of total business financing (debt and equity) is required by the electric power industry. In addition, roughly one-half of new issue common stock annually marketed by all United States corporations comes from the electric power industry. In 1977, the industry's long-term financings aggregated $16 billion—1 percent of the gross national product (up from ½ percent a decade earlier). Thus, it is clear that this industry not only must favor but also must actively encourage measures that would assist in capital formation.

III. S. 3065

Accordingly, VEPCO favors legislative proposals aimed at encouraging or stimulating capital formation and investment to support capital construction. Reduction of the tax on capital gains, such as that proposed by S. 3065, introduced by Senator Hansen, would do that; therefore, we favor that bill.

However, a capital gains tax would provide an incentive for only a portion of the capital formation that is essential to a healthy and viable national economy. A reduction of the capital gains tax will increase the funds generally available for capital investment and capital construction, although the amount of funds which the capital gains tax reduction will make available for investment in the most capital-intensive industry of all, the electric power industry, will be small as compared to the capital which will find its way into industries offering "growth" stocks. This is due to the fact that many investors will invest in "growth" stocks rather than in public utility stocks in an attempt to maximize the advantage of lower capital gains rates. Due to the heavily regulated nature of the economies of the electric power industry, the stocks marketed by the electric power companies ordinarily are not considered "growth" stocks.

Since our industry, which has the greatest need for capital, will not receive sufficient stimulus from capital gains tax cuts alone, we urge the Subcommittee to consider and support complementary proposals which would enhance capital investment in the electric power industry and enable us to supply the Nation's electric energy needs in the coming decades.

IV. COMPLEMENTARY PROPOSALS

There are several proposals before the Congress that will help meet the Nation's electric energy requirements. One of the items in President Carter's tax proposals is critically important to the industry. The President recommends making permanent the 10 percent investment tax credit and raising the limitation to 90 percent of the taxpayer's liability. The present 10 percent credit (available to utilities only since 1975) has been a significant factor in the generation of funds internally to finance ever-increasing construction programs. The present credit is scheduled to be reduced from 10 percent to 4 percent for the electric power industry (to 7 percent for other industries). For the electric power industry, the present 80-percent limitation of tax liability reduces in steps to 50 percent after 1980. These reductions will affect all industries, but they will impact severely of the electric power industry. If allowed to occur, the scheduled investment tax credit reductions will work against the undeniable needs of the electric power industry for capital construction; whereas, enactment of the President's investment tax credit proposal will complement other capital formation proposals such as the Hansen bill.

There is still another investment tax credit problem that needs Congressional attention. While the ordinary capital requirements of the electric power industry are quite substantial, the requirements to install mandatory pollution control facilities are staggering. Current law permits the full investment tax credit on pollution control faciliteis amortized over 10 years, but limits it to one-half the credit generally should the taxpayer elect to amortize the cost of the investment over a 60-month period. (This is so even though the pollution control facilities do not contribute to the production of energy.) The Administration proposes to eliminate the tax exemption on industrial development bonds issued to finance pollution control facilities. This proposal by the President would further restrict the already severe limitations on the use of exempt industrial development bonds and would intensify the already difficult financing programs of the industry as it struggles to comply with the laws and rules to clean up the environment. To

eliminate the use of tax-exempt bonds in financing pollution control facilities when the industry is hard-pressed to finance even the energy producing facilities is counterproductive and illogical. Therefore, the President's proposal to eliminate tax-exempt bond financing should be rejected.

In lieu of the President's proposal, the proposal of Congressman Jim Jones of Oklahoma should be endorsed. The Jones proposal would authorize the industry to elect to take the full investment tax credit for pollution control facilities amortized over 60 months, or to take one-half the full investment tax credit for those pollution control facilities financed by tax-exempt industrial development bonds.

Another proposal worthy of the Subcommittee's serious consideration is that to encourage dividend reinvestment programs. That proposal is before the Committee on Ways and Means in H.R. 12182, introduced by Congressman Pickle. Under the Pickle bill, taxation on dividends reinvested in additional new stock of the dividend-paying corporation would be deferred until the recipient disposes of the stock, at which time the taxpayer would report a capital gain or loss on the transaction and pay tax accordingly.

A number of electric power companies, including VEPCO, already have dividend reinvestment programs. Even though these programs are not encouraged by any tax deferral under current law, they produce significant additional capital for their companies. For instance, in 1977, VEPCO shareholders participating in its dividend reinvestment program reinvested over $5 million in new VEPCO stock. It is estimated that this would result in an estimated $500–$600 million annual deferral of taxes, with no over-all net revenue loss, if applied only to the electric power industry, and a $1 billion deferral annually if applied to industry generally. The electric power industry deferral would be a relatively modest cost for the goals to be achieved: expansion of capital facilities, greater electric energy availability to meet projected demand, and increased employment.

V. CONCLUSION

In conclusion, the electric power industry is unique in that it is faced with monumental needs and requirements for capital if it is to meet the Nation's energy and environmental requirments. It is essential to the good health and welfare of the Nation that the industry attract that capital; therefore, we urge the Subcommittee to consider and endorse these proposals.

Statement of the Small Business Advertising Council

PRESENT CAPITAL GAINS TAXATION DISCRIMINATES AGAINST SMALL BUSINESS PROPRIETORS

1. Current taxation on capital gains applied to a small business is a strong deterrent to the retention of tax-paid profits as savings in the business for the formation of essential operating capital. As the business operates, it requires continued increases in its working capital to finance the escalation of accounts receivable and inventories, even if only from annual inflation, plus funds for the purchase of capital or productive equipment. Big business, able to use almost unlimited equity financing, i.e., bonds, stocks, not available to small business for working capital, is handed a definite competitive advantage. Lacking working capital essential to compete, many small business entrepreneurs are forced to close, or alternatively, merge with big business which stifles competition and free enterprise.

The only source of such capital available to small business is through the retention of after-tax income, but the aggregate of capital gains/minimum/alternative taxes which would apply to such capital in the future are such as to make it more costly in taxes to retain earnings than to withdraw them, as explained in the example on page 2.

2. An important factor in capital gains taxation is inflation. To tax enhancement of value due to inflation is another disincentive toward capital formation. It is counter-productive to growth, stability, and employment opportunities. Capital asset appreciation should be valued in constant dollars, and appreciation resulting from inflation should not be taxed.

3. Current taxes on capital gains applied to a small business which must be sold because of retirement due to age or disability are destroying retirement plans.

We do not believe that our elected representatives intended to exact such taxes from small business owners, but they have, and it needs to be corrected. We support the Steiger-Hansen proposal and the Jones compromise, but for the reasons set forth above believe small business should receive the treatment proposed herein:

OUR PROPOSED SOLUTION

a. Capital gains be taxed at a decreasing rate for each year held, with zero (0) or nominal taxation for assets held 25 years or more . . . such tax to be applicable regardless of the method of liquidation. Such tax reform would be really helpful to millions of small business people who depend on liquidating the businesses to retire after a lifetime of labor, and live on their savings retained in the business. It would separate capital formation investment from speculation gain.

b. Tax constant dollars by reducing capital gains by the annual rate of inflation for each year the asset is held. Such monetary correction would offset gain resulting from inflation.

c. Return the capital gains tax to a maximum of 25% on any amount under any circumstances.

Such measures would favor long-term investors of any kind, including union, teachers, and employee pension funds, and, for instance, life-time employees of big businesses who invested in their companies through stock purchase plans. All of these people contributed to working capital, and through their investment (savings) provided for much of their own old age retirement. Our proposal is for tax legislation to:

(*a*) Remove disincentives to capital formation for small business through tax-paid income retained in the corporation.

(*b*) Offset the tax penalty resulting from inflation.

(*c*) Protect the savings (invested in their businesses) of small business entrepreneurs and other steady-working, thrifty people who do not want to become wards of social agencies, but seek to live in dignity as they reach retirement age.

(*d*) Present Congress with an opportunity to apply ". . . the declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small business concerns in order to preserve free competitive enterprise." (Public Law 85-536, as amended, section 2(a), Small Business Act.)

SMALL BUSINESS IMPACT ON THE ECONOMY [1]

Small Business—

Accounts for 96.7 percent of the Nation's business concerns.

Provides jobs for 55 percent of the Nation's private, nonagricultural work force.

Accounts for 43 percent of the Gross National Product.

Accounts for 48 percent of the Gross Business Product.

Constitutes 64 percent of the total dollar volume by wholesaling.

Constitutes 73 percent of the total dollar volume by retailing.

Constitutes 57 percent of the total dollar volume by service industries.

Constitutes 76 percent of the total dollar volume of construction.

Directly and indirectly provides the livelihood for 100 million Americans.

STATEMENT OF MARGARET COX SULLIVAN, PRESIDENT, STOCKHOLDERS OF AMERICA, INC.

Mr. Chairman and members of this distinguished subcommittee, I want to thank you for the opportunity and the privilege of expressing our views in behalf of Stockholders of America, Inc. on taxation of capital gains. We are grateful to this Committee for scheduling these hearings at this time.

And now for my credentials. I am Margaret Cox Sullivan, President of the national, nonprofit, nonpartisan membership organization known as Stockholders of America, Inc., established in 1972 and headquartered in Washington, D.C. The purpose of our organization is to represent the interests of stockholders. We are not concerned with what stock a member owns, or the size of his/her portfolio.

[1] SBA estimates based on 1972 IRS data.

NOTE.—Under SBA's definition, there are 10 million businesses (not including farm enterprises) which qualify as small business.

We do not enter class action suits, proxy fights, or the internal affairs of any company. We do not give investment advice or counseling, but we are deeply concerned with public issues that affect stockholders. Therefore, we have an abiding concern for the tax structure, particularly the treatment of capital gains, the structure of the markets, the health of our system, and our national economy.

Today I bring you no new economic study. We are all aware of the several scholarly, technical, in-depth studies which are before this Committee, showing the imperative demands of attacking the current capital gains tax, which is stifling the economy of our country. I believe we can be helpful in the Committee's deliberations if we address our remarks to the current circumstances surrounding the individual stockholders—the little guys who have always been known as the backbone of the American capital system. This system, which has had an amazing success record for 180 years and is considered the best in the world, is now in jeopardy.

For the first time since 1952 when such records were kept, the number of stockholders did not substantially increase from year to year, but dropped from 32 million to 25 million, or 18 percent, in the period between 1970 and 1975, and their median age is older (NYSE figures). The plight of the stockholders can be seen by their flight from the market. This is particularly alarming alongside estimates that there should be 50 million stockholders by 1980 to meet the expanding capital needs for a growing work force, to maintain industrial leadership in the world, and to keep our country strong and our standard of living high. Today, approximately 61 percent of all stock is held by institutions, whereas in the 1960's it was the reverse—60 percent was held by individuals. Further, it must be recognized that at the same period in our national history when the number of stockholders was growing, we, as a country, were enjoying rapid, prosperous economic expansion.

Today in our country, the need for investment capital is critical. It has been estimated that over the next ten years industry will need $4.5 trillion. We have allowed our great American business machine to get rusty, our equipment is becoming obsolete, and many industries operate short of capacity. We have to realize that 67 percent of all metal working machinery in this country is more than 12 years old. Whereas in Japan, the figure is only 30 percent and in Germany 37 percent. That's typical of all our plant and equipment, and it shows why our long-term production advantages are fading, as in Great Britain.

Given the equity investment capital needed, we can rebuild our great economic engine and expand our economy. Jobs can be created in the private sector and our country can return to a lower unemployment rate.

Then we can work towards creating jobs for the ten million more who will be coming into the work force by 1980. This equity investment will have to come from the American people.

Historically, it has been the individual investors, the stockholders, the little guys who have been the main source of equity capital. They've been called the strongest ingredient of our capital markets; their role is vital. They are the capital force of our country. Just as the millions of workers in the labor force supply labor services, so capital services are supplied by the capital force—the millions who invest in the American business system.

Our markets will not work without them—the individual investors make the market. The millions of differing individual decisions made daily in diversified market transactions are needed for liquidity, for a true auction, and a more realistic value of stocks. Further, the individual has a different pattern of investing than the large financial institutions. Fund managers, either because of regulations or fiduciary responsibilities, invest primarily in the well-established companies and for the most part in a favored few. The individual, in his own frame of interest and judgment, with his own capital, may make investment in the smaller, often more venturesome high risk companies—which may become the General Motors, the IBS's or the DuPonts of the future. Further, it is the small or medium size growth companies where the needed job opportunities will be created.

One only has to follow the financial press these days to see the great lack of new issues and certainly a great lack of new companies. This is at a time when capital needs for research and development of new technologies in many fields—energy and defense to name a couple—are enormous and vitally necessary, as we know.

There is another reason which should not be overlooked. The exorbitant tax on capital gains is a contributor to the dangerous increase in corporate debt/equity ratios in recent years. In 1977, the amount of debt financing was ten times as large as equity financing. The proposed roll-back of capital gains taxes to pre-1969 levels, as proposed in S. 3065, would increase the effective return on equity to

the investors, making equity more competitive with debt. Climbing debt ratios make business highly vulnerable to business cycle changes. The growth of high debt ratios is a very undesirable development which tends to cause bankruptcies, generally suppresses economic growth, and stymies the ability of companies to expand and modernize.

Therefore, it is imperative that we encourage and attract back into the market the millions of stockholders who have left, and we also have to rekindle the interest in investing in America and the American business system, to bring out venture capital—new risk capital, new stockholders. And that means we must have incentives, not penalties. Therefore, we support the "Investment Incentive Act of 1978" (S. 3065).

We have to revitalize that American spirit—there really is one. Americans are willing to work, they want their children to be educated, and they want to be able to build and grow with the country. This takes courage and it takes risk. Our economic system—peoples' capitalism—has made this possible. We have built out of a wilderness the greatest industrialized country in the world with its people enjoying the highest standard of living. We are a nation of owners. We must not let taxes rob us as a nation of our vitality and vigor and growth, and make us a nation of stale, stagnant people, burdened with taxes and overwhelmed with inflation. Fighting the battle, of what's the use?

We are becoming a nation of consumers and spenders, and have left our tradition of saving and investing. The consideration of this proposed roll-back in capital gains is very timely. Unlike what the opponents say, it will help the little guy. Its stimulative effects will ripple throughout the entire economy, for the benefit of all Americans. It will provide increased employment and economic expansion. It will attract new investors, providing a broader base of ownership and strengthening the capital structure of small and medium size companies, particularly new companies. It will unlock capital and allow stockholders to sell stocks and invest in new ventures. They will be making investment decisions, not tax decisions. Stock prices will rise to more realistic levels. This all brings added revenue to the Treasury, reducing the federal deficit and alleviating inflationary pressures.

This would touch the very heart of America, because stockholders are a varied and diversified group. They come from all walks of life. They are not just a few of the so-called rich. We know that because of the make-up of our membership. We have members in every state and we can't possibly know every one of them individually, although we wish we could. We do know that they are a representative group. The profile of a stockholder is the profile of an American. They are the nurses and schoolteachers, telephone operators, linemen, barbers, shopkeepers, salesmen, office workers, construction workers, pilots, truck drivers, doctors, lawyers, military personnel, retired people, and the factory workers who have bought stock through their employee stock purchase plans.

They have only one thing in common: they are all capitalists. That's our system—people's capitalism.

And the people will be watching this decision for tax relief. The opportunity is here and now, and it is yours. There is a momentum in favor of this. In fact, I would like to say that there is a groundswell. In the interest of all Americans and the economic health of our nation, Stockholders of America, Inc. urges this Committee to take action in support of the "Investment Incentive Act of 1978". Please don't let this opportunity slip by.

Again, thank you.

Senator HANSEN. Thank you all so much.

This hearing is adjourned.

[Whereupon, at 1:01 o'clock, p.m., the subcommittee adjourned, to reconvene upon the call of the Chair.]