REVENUE ACT OF 1978

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-FIFTH CONGRESS

SECOND SESSION

ON

H.R. 13511

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

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

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REVENUE ACT OF 1978

WEDNESDAY, AUGUST 23, 1978

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

The committee met, pursuant to notice, at 9:00 a.m. in room 2221, Dirksen Senate Office Building, Senator Russell B. Long (chairman of the committee) presiding.

Present: Senators Long, Talmadge, Ribicoff, Byrd, Nelson, Bentsen, Hathaway, Moynihan, Curtis, Hansen, Dole, Packwood and Danforth.

The CHAIRMAN. This hearing will come to order. I am pleased to see my dear, long-time friend Wilbur Mills in the audience. I would like to invite the former chairman of the Ways and Means Committee to come up here and sit with us; if he is so inclined, I would appreciate it. I enjoyed working with him down through the years. His wisdom may rub off on some of us.

Our first witness this morning will be Mr. Charles I. Derr, senior vice president, Machinery and Allied Products Institute, accompanied by a panel of Daniel K. O'Connell, chairman, Committee for a Uniform Investment Tax Credit; Mr. James Morrison, Ad Hoc Committee for an Effective Investment Tax Credit; Mr. Leon B. Musser, National Machine Tool Builders Association.

Gentlemen, I see Senator Chafee here, so Senator, why do you not just take the microphone over here and make your statement to us. I know you have other business.

STATEMENT OF HON. JOHN H. CHAFEE, A UNITED STATES SENATOR FROM THE STATE OF RHODE ISLAND

Senator CHAFEE. Thank you, Mr. Chairman. I appreciate having the opportunity to make my statement here this morning, and I am grateful to you for putting me on first.

What I am going to discuss briefly with you and members of the committee are some of the problems facing the smaller businesses in our country, and I will be brief.

The real problem is a shortage of investment. I know that has been a matter you have been addressing and will continue to address in the consideration of the tax legislation before you. I have just a couple of remarks.

We must consider the devastating decline in the offerings of new equity by small businesses. It dropped from nearly $1 billion in 1972 to a mere $16 million 3 years later. During that same time, large business offerings actually rose by 50 percent to a total of $41 billion. It was not that the equity market totally dried up. For the bigger businesses it was there; for the smaller businesses it was not.

The reason for that, Mr. Chairman and members of the committee, was a lack of public willingness to invest in smaller enterprises bcause public policies work against a fair return on investment. This alarming trnd has accelerated to the point where small companies face a capital shortage estimated at $8 billion a year nationwide.

The reason I am concerned about that is just not for small businesses, as entity in themselves. Small businesses provide jobs. There are millions of smaller firms in the United States and we count on these smaller firms for 56 percent of our national private sector employment. Fifty-six percent of the private sector jobs are in small businesses in this country; 43 percent of our gross national product and over half of our important innovations and inventions came from the small business community.

Mr. Chairman, I have come up with three bills which are before this committee which I would urge that you consider. The first calls for an increase of the corporate surtax exemption from the current level of $50,000 to a new level of $150,000. I know you are considering this. It is my understanding that the House came up with increase, I believe, to $100,000.

The current law as, of course, you know, assesses 20 percent on the first $25,000 of a company's profits. Then it goes up to 22 percent on the next $25,000. Under my bill, it would be a flat 20 percent for the entire $150,000 before the surtax goes into effect.

The resulting tax saving will amount to as much as $28,500 per company. That does not seem much to General Motors, but it means an awful lot to smaller businesses trying to accumulate some capital.

Senator Hathaway, I understand, has similar legislation to this.

The second bill would permit investors to defer the tax on any capital gain as long as they reinvest their holdings in a small business within 2 years. If you make a profit on a small business venture and you reinvest it within 2 years you will not incur the capital gains. Of course, you will carry the same basis.

The third bill simplifies depreciation rules and allows companies greater flexibility in depreciating the cost of their new investments. What it does is shorten the useful lives in three categories of depreciable property that are set forth in the bill.

The bill allows the taxpayer to depreciate an amount not in excess of $200,000 in 1 year. These bills, Mr. Chairman, I believe will help remedy this very, very severe problem which I know you are conscious of, and members of the committee are, and I will commend them to your attention. I appreciate it.

The CHAIRMAN. Thank you very much. Thank you for a good statement. We will certainly consider your suggestions.

Senator CHAFEE. Thank you.

[The prepared statement of Senator Chafee follows:]

STATEMENT BY SENATOR JOHN H. CHAFEE

SMALL BUSINESS INVESTMENT AND EMPLOYMENT INCENTIVES

Mr. Chairman, I appreciate having the chance to appear before the Finance Committee this morning. Now that I've gotten a foot in the door, I can think of a dozen weighty problems I'd like to have you straighten out. But, with time being a factor, I'll confine my remarks to a few of the problems facing smaller businesses in our country and what we can do about them.

I'll be brief. There is a shortage of investment.

Hand in hand with this country's troublesome unemployment picture and sluggish economic performance has been an increasing inability of our smaller enterprises to raise money for new capital investments. The uncertain state of our economy in past years and other recent trends in the financial markets have combined to virtually cut off the small business community from outside financing. Both the individuals and banks who were once willing to risk lending money to new or smaller businesses have turned instead to bigger established corporations which offer more secure investments.

Consider the devastating decline in the offerings of new equity by small businesses: from $918 million in 1972 to a mere $16 million 3 years later. During that same time, large business offerings actually rase by 50% to a total of $41 *billion*. The reason for the lack of public willingness to invest in small enterprises lies not in the creativity and innovative capacity of small businessmen, but in public policies which work against a fair return on investment.

This alarming trend has accelerated to the point where small companies face a capital shortage estimated at $8 billion a year nationwide. Who can begin a business, much less expand one, when it cannot raise the money? In such a climate, is it any wonder why four out of five new businesses fail and go bankrupt in their first 10 years? Is it surprising to see so many older, antiquated factories in New England and elsewhere going out of business? When you think about it, it is sad but not particularly surprising.

I am not just concerned, however, because small businesses are having trouble making a profit or getting money from the bank. I am concerned because it is the small businesses which provide most of the jobs in this country. Mr. Chairman, this is a jobs issue. There are millions of smaller firms in the United States—over 86,000 in the State of Rhode Island alone. We count on them for 56 percent of our national private sector employment, 43 percent of the gross national product, and over half of our important industrial inventions and innovations.

The enormous potential of our small business community gives us a chance to tackle some of our most severe social and economic problems without setting up more top-heavy government programs.

Last October, a New England Conference on Balance National Growth and Economic Development was held so that our regional planners could prepare recommendations for the subsequent White House Conference on Balanced National Growth. A strong emphasis was placed on job creation, and it was shared by every other delegate to the conference.

They said that Government policy must encourage jobs in the private sector. They said that government policies to increase the availability of investment capital are crucial if the private sector is going to meet the problems of economic growth and development. And they said that revising national tax policy is key to making this system work at its best.

In addition, Mr. Chairman, a recent report of the Congressional Joint Economic Committee stressed that the percentage of GNP going to business investment over the next several years must be higher than in the past decade if the Nation's employment and productivity goals are to be fulfilled.

A strong flow of private investment back into smaller companies must be regained if we are to take advantage of their highly labor-intensive potential. This message is clear.

And contributing to this goal, Mr. Chairman, I have introduced three bills which I would urge the Committee to study and adopt as it proceeds with consideration of the tax reform/tax cut legislation before it. Each of my bills takes a different, yet coordinated, tack toward encouraging greater investment in smaller businesses.

The first bill, S. 2497, calls for an incerase of the corporate surtax exemption from the current level of $50,000 to a new level of $150,000. Whereas current law assesses a tax rate of 20% on the first $25,000 of a company's profits and a rate of 22% on the next $25,000, my bill requires a flat tax rate of only 20% on profits up to $150,000.

The resulting tax saving will amount to as much as $28,500 for each company with taxable earnings of $150,000 or more. My formula gives smaller companies a substantially larger portion of the corporate tax cut pie than either proposed by President Carter or adopted by the House. While $28,500 may not mean a lot to General Motors, it could be a lifesaver to a small firm in Pawtucket or Hoboken or Des Moines. According to a study cited by the Smaller Business Association of New England, with whom I have worked closely on this legislation, the reinvestment of such a sum could result in the creation of as many as 4 new jobs.

Mr. Chairman, I am aware that Senator Hathaway has also introduced similar legislation, and I applaud him for that.

My second bill, S. 2498, will permit investors to defer the tax on any capital gain as long as they reinvest their holdings in a small business within 2 years. This treatment is much the same as that allowed homeowners who sell one house at a profit then buy another. I consider this measure essential to encouraging the flow of investor dollars back into small businesses.

My third bill, S. 2499, will simplify depreciation rules and allow companies greater flexibility in depreciating the cost of their new investments. Essentially, this proposal assigns shortened "useful lives" to 3 categories of depreciable property: 1) highway transportation equipment, tools, and dies, 2 years; 2) machinery, rail, water, and air transportation equipment, office furniture, equipment, and fixtures and leasehold improvements, 5 years; and 3) certain real estate and real estate improvements. The bill allows the taxpayer to depreciate an amount not in excess of $200,000 in one year. Again, Mr. Chairman, this proposal would be especialliy attractive to new and smaller businesses.

I hope the Committee will give serious thought making these proposals part of Senate tax cut legislation. Thank you.

The CHAIRMAN. Now we will hear from Mr. Charles I. Deer.

STATEMENT OF CHARLES I. DERR, SENIOR VICE PRESIDENT, MACHINERY AND ALLIED PRODUCTS INSTITUTE

Mr. DEER. Mr. Chairman and members of this distinguished committee. My name is Charles I. Deer. I am senior vice president of Machinery and Allied Products Institute, which is, as you may know, a national organization representing capital goods and the allied products industries.

We appreciate this opportunity to comment on H.R. 13511, the proposed Revenue Act of 1978, as passed by the House of Representatives. We have submitted to the committee staff an extended written statement on this measure, and we ask leave of the Chair that it be included in the published record of these hearings.

We commend the House and the Committee on Ways and Means for the legislative product embodied in this bill. Wisely, in our judgment, the Ways and Means Committee and the House have rejected a considerable number of original administration recommndations for tax legislation and have substantially modified much of the original proposal that has ben retained.

We do not wholly approve the final product, as is made clear in our principal statement, but we think that it is a responsible piece of work and one vastly superior to the original administration proposal.

Permit me to comment briefly on three aspects of the proposal before the Committee which we consider of major importance.

No part of the House action is of greater importance, in our judgment, than the series of steps taken in H.R. 13511 to encourage capital formation and investment. We endorse the action of the House in extending indefinitely the 10-percent investment tax credit. We also support the House action in increasing the present 50 percent limitation on investment credits to 90 percent.

Although we agree with this section, we would prefer to have the Finance Committee go the full distance to 100 percent and perhaps accelerate the phasein schedule.

We agree with the corporate rate reductions enacted by the House. As the Ways and Means Committee has indicated, reduction of corporate tax rates is necessary to reduce unemployment and to stimulate economic growth through capital investment.

There are, in our judgment, better ways of spurring capital investment than through simple rate reductions, although we understand that rate relief is the kind of tax reduction with the broadest appeal and is the simplest to enact and implement.

We are pleased to note that the House bill has coupled rate reductions with other more direct incentives to capital formation, such as making the 10-percent investment tax credit permanent and reducing capital gains tax rates.

As for capital gains, Mr. Chairman, the institute's general position on this issue is set forth in our statement of July 5 to the Senate Finance Subcommittee on Taxation and Debt Management.

In brief, we do not believe that capital should be taxed. Assuming, nevertheless, that there will be a capital gains tax, we feel that it should be substantially lower than the tax on regular income. Any such tax should apply only to real gains. Any such tax should not be compounded by the minimum tax on tax preferences. Finally, any such tax should be deferred in reinvestment situations a la the suggestion of Senator Chafee. As an alternative to item 5, the tax should be constructed on a sliding scale with relatively higher rates for shorter holdings and lower rates reducing to zero for longer holdings. For the reasons behind these recommendations, we refer the Finance Committee to our statement in the record of public hearings in Senator Byrd's subcommittee.

We approve generally the action of the House Subcommittee on capital gains with one major exception. The authority for 25 percent alternative rate on the first $50,000 of capital gains should be retained.

Let me add one final word on capital gains. The administration has suggested that benefits on capital gains tax reduction will accrue almost wholly to the very rich. According to IRS figures—specifically the "Statistics of Income Preliminary 1976, Individual Income Tax Returns," Publication No. 198—total net capital gains reported on all returns of individuals in 1976 was $19,868 million. Of this amount, 62 percent was reported on returns having adjusted gross income of less than $50,000; 46 percent was reported on returns of less than $30,000.

Let me comment briefly on another issue concerning which the institute has very strong convictions. Although MAPI represents capital goods and allied product manufacturers, we have concluded that no action is more urgently needed than major tax reform in the personal income tax structure. As the committee knows, personal income taxes have been substantially increased as a result of inflation, even as the ability to pay is reduced by the same inflation.

Moreover, the burden of increased taxation has been made substantially greater by enactment of very substantial increases in social security taxes that become effective in 1979.

The steadily increasing burden of personal income taxes has fallen most heavily on people in the middle and upper-middle income tax brackets in part as a result of the consistent policy of removing those with lower incomes altogether from the tax rolls, and with the revenue loss thus created, offset in part by increased impositions—induced by inflation—on those in higher brackets.

The CHAIRMAN. Thank you very much, sir.

Next we will call on Mr. Daniel O'Connell, chairman for a Uniform Investment Tax Credit.

STATEMENT OF DANIEL K. O'CONNELL, CHAIRMAN, COMMITTEE FOR A UNIFORM INVESTMENT TAX CREDIT

Mr. O'Connell. Thank you, Mr. Chairman. We appreciate the opportunity to testify today and to give you the views of the Committee for a Uniform Investment Tax Credit.

The committee's single purpose is to promote the uniform application of the investment tax credit by removing the present unfair and unjustified discrimination against investors in shorter-lived qualified capital assets.

As you know, the full investment tax credit now is available only to investors in capital assets that have a useful life of 7 years or more. Only one-third of the credit is available for assets that have a useful life of 3 or 4 years, and two-thirds of the credit is available for assets with useful lives of 5 or 6 years.

This discrimination adversely affects a broad range and diverse sizes and types of American business. The businesses that are affected would include the automotive tranportation industry, the computer industry, farmers, farm equipment manufacturers and dealers, repair shops, food processors and beverage bottlers, the construction industry, the contract drillers and well servicing companies, electric utilities which have nuclear core, and the communications industry.

That is just a part of those companies which are affected by this.

The present restrictions are unfair. Let me illustrate why I say that.

If party A purchases a $9,000 capital asset with a useful life of 9 years, he is allowed a tax credit of $900. That reflects the full 10 percent investment tax credit.

B, on the other hand, buys a $3,000 asset with a useful life and a service life of 3 years and during the same 9-year period he replaces that asset each 3 years. So during that 9-year period he has also expended $9,000 for capital equipment. However, on these $9,000 expenditure he is allowed only three credits of $100 each, totally $300, whereas A has received a credit of $900 on his $9,000 investment.

A's effective tax credit rate is 10 percent and B's is only 3⅓ percent.

These discriminatory provisions also result in unnecessary complexity and uncertainty for the taxpayer in his compliance and planning, for employees and employers who wish to take advantage of the extra additional credit for employer stock ownership plans, and for the Internal Revenue Service in its administration of the law.

There are not only three different tax credit rates, but there are also the recapture rules, which are a necessary but undesirable corollary of the useful life restrictions.

In fact, the denial of a uniform investment tax credit can actual operate to discourage the timely replacement and modernization of productive equipment and, in this regard, these restrictions operate exactly opposite to the economic and job stimulation purposes of the credit.

It is a common practice in our economy for equipment that has a useful life, or an economic life, of more than 7 years to be replaced by the first user with more efficient and more productive equipment before the expiration of its full economic life. The replaced equipment, in turn, becomes available to secondary users who require it for less demanding service.

We should keep in mind that shorter-lived equipment is among the Nation's most productive equipment. I am speaking of tools, trucks, computers, office equipment, farm equipment. They are all examples.

The CHAIRMAN. Next we will call on Mr. James Morrison, Ad Hoc Committee for an Effective Investment Tax Credit.

STATEMENT OF JAMES MORRISON, AD HOC COMMITTEE FOR AN EFFECTIVE INVESTMENT TAX CREDIT

Mr. MORRISON. Thank you, Mr. Chairman and members of the committee. I am assistant general counsel and director of Government Relation for Esmark, Inc., a holding company based in Chicago, Ill., with interests in foods, chemicals and industrial products. I am appearing this morning for our president and chief executive offficer Donald P. Kelly who is also the chairman of the Ad Hoc Committee for an Effective Investment Tax Credit. It is on behalf of that voluntary group of 366 business organizations and 51 supporting business associations that this testimony is presented.

The ad hoc committee's principal abjective is to urge the improvement of capital recovery provisions of the tax code with special emphasis on the investment tax credit. The committee supports the business tax proposals of H.R. 13511 that, in addition to reducing the corporate rate, would make the investment credit permanent, expand its application to rehabilitated industrial or other productive buildings, permit the utilization of the credit against 90 percent of tax liability instead of 50 percent, and allow the full credit along with 5-year amortization for the costs of pollution control equipment.

While the House-passed bill is a substantial start in the right direction, the ad hoc committee feels that more is in order—is required—to meet the desired economic goals of expanded productivity, full employment and an increased standard of living.

Specifically, the ad hoc committee urges, first, with respect to the investment tax credit: in addition to being made permanent, that the rate be increased to 12 percent with an additional 2 percent where contributions are made to ESOP's; that it be made applicable to new industrial, office and other business buildings as well as the rehabilitation of existing buildings; that the credit be usable against 90 percent of the tax liability instead of 50 percent as the House bill provides. However, we feel that this increase should be made effective immediately and not be phased in. That, in any event, it be usable in full against the first $150,000 of tax liability instead of the current $25,000; that the required life of an asset for getting the full credit be reduced from 7 years to 3 years; and, that the limit as to qualifying used equipment be raised from $100,000 to $200,000.

Second, with respect to capital recovery allowances, it is urged that the ADR variance be increased from 20 percent to 40 percent immediately; and, that in the near future, a more simplified capital recovery system be considered and established.

Third, with respect to pollution control facilities, it is urged that a 20-percent credit be established, short of that goal, no limitation regarding use of 5-year amortization or use of any particular source of

financing should be enacted; and that the definition of qualified facilities be amended to include all facilities which are used for pollution control purposes including buildings and equipment used in new construction.

In the judgment of the ad hoc committee, economic studies have demonstrated that the most effective mechanism for increasing business investment is the investment tax credit, followed closely by liberalized capital recovery allowance. Other tax measures, including corporate rate reductions are, in our opinion, less efficient. Expanded business investment can create new jobs, increase productivity, and therefore help alleviate inflation; it can go a long way toward providing for a higher standard of living, improving our trade balances, and, not the least important perhaps, increasing Federal revenues through the building of a healthier, expanding economy.

The CHAIRMAN. Thank you very much, sir.

Now we will hear from Leon B. Musser, National Machine Tool Builders Association.

STATEMENT OF LEON B. MUSSER, NATIONAL MACHINE TOOL BUILDERS ASSOCIATION

Mr. MUSSER. Good morning, Mr. Chairman and members of the committee. My name is Leon B. Musser. I am vice chairman of the Kearney & Trecker Corp., a Milwaukee Machine Tool Manufacturer, and am vice chairman of the Government Relations Committee of the National Machine Tool Builders Association, in whose behalf I appear today.

NMTBA believes that H.R. 13511, as passed by the House, is a giant step in the direction of repairing the damage done to our economy by past efforts at income redistribution through the tax system.

We urge your committee to expand the capital gains tax cuts contained in H.R. 13511; and that you retain both the Archer amendment, which indexes capital gains to account for inflation, and the 10 percent alternate tax on the capital gains exclusion, which the House wisely substituted for the current 15 percent minimum add-on tax.

We also urge you to retain H.R. 13511's emphasis on individual tax cuts aimed at middle-income taxpayers, instead of succumbing to the siren's song of income redistribution.

The business tax reductions contained in H.R. 13511 should be retained and expanded.

NMTBA recently conducted a study of the annual reports of 16 leading metalworking companies—our major customers. The results of this study are contained in our full statement. Let me summarize its conclusions for you.

Since 1970, America's metalworking industry, has, in fact, been in unconscious and involuntary liquidation, caused by inflation and inadequate funds to replace overage equipment. In order to maintain the real value of their fixed assets, these 16 companies should have spent $10.6 billion on new equipment in 1977. But they only spent $6.1 billion. Over the 6-year period since 1971, the capital spending needed to stay even was about twice the actual spending by these 16 companies.

But, given our inadequate capital cost recovery system, capital spending at these levels was impossible.

Is it any wonder that large segments of the American metalworking industry—including our own—are being eaten alive by more efficient, more productive foreign competitors?

We strongly urge your committee to reverse this rush to involuntary liquidation. This can be accomplished most effectively by adding an additional $2 to $3 billion in business tax cuts to H.R. 13511 and by targeting these tax cuts to the following five improvements in the capital cost recovery system.

One, we believe that a 12 percent investment tax credit is vital to stimulate the level of capital spending necessary to raise lagging productivity, increase capacity, boost employment, and hold down inflation.

Two, NMTBA urges the improvement of the depreciation system. Regardless of the method used, the time over which capital equipment costs may be recovered must be shortened.

Three, salvage values in computing depreciation allowances should be eliminated.

Four, we recommend to your attention Senator Danforth's suggestion that the investment tax credit may be taken against 100 percent instead of 90 percent of a company's tax liability.

And five, we urge you to adopt Senator Bentsen's proposal to shorten the time over which OSHA-related equipment can be depreciated, thus improving both the capitatl cost recovery system and the safety of America's workplaces.

If, in the judgment of this Committee, available funds do not permit institution of both a 2 percent rate reduction and a 12 percent investment tax credit, NMTBA believes that the size of the rate reduction should be sacrificed for an improved capital cost recovery system.

To keep America's balance of trade from deteriorating even further than it has, we urge retention of both DISC and deferral.

NMTBA also urges this committee to substitute a $100,000 corporate surtatx exemption for the graduated corporate tax contained in H.R. 13511. Imposing taxation through graduated rates upon the small businesses, which constitute 70 percent of our membership, does not impress us as doing them much of a favor.

Finally, we urge you to adopt the product liability tax relief measure advanced by Senator Nelson. Over one-fifth of our members cannot afford product liability insurance and another 20 percent are forced to retain huge deductibles. America's capital goods industry urgently needs the immediate adoption of S. 3049 and we urge you to include its provisions in the tax bill now before you.

NMTBA appreciates this opportunity to review our industry's suggestions for the improvement of H.R. 13511. Thank you.

The CHAIRMAN. Senator Talmadge?

Senator TALMADGE. I have no questions.

The CHAIRMAN. Senator Danforth?

Senator DANFORTH. No questions.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. No questions.

The CHAIRMAN. Senator Byrd.

Senator BYRD. Two brief questions, Mr. Chairman.

Mr. Musser, you mentioned a 12 percent investment tax credit. Is that what you advocate?

Mr. MUSSER. Yes, sir.

Senator BYRD. You do not think a 10 percent credit is reasonable and about as high as one ought to go?

Mr. MUSSER. Senator Byrd, we have found in studies by our association that in the past where there have been the off-again, on-again type of investment tax credit, the addition of the investment tax credit has stimulated both productivity and employment in the metalworking industries.

Senator BYRD. I am not talking about off-again, on-again. I agree with you. But it occurs to me that 10 percent is a very substantial tax credit. You are advocating going beyond that.

Mr. MUSSER. Yes, sir, we are.

Senator BYRD. On indexing, you favor the Archer amendment.

Mr. MUSSER. Yes, sir.

Senator BYRD. How does one justify indexing capital gains, but not indexing regular income?

Mr. MUSSER. The indexing of capital gains would prevent the actual taxing of capital which is the effect of inflation on the capital gains laws at the present time.

Because of inflation, we are actually taxing capital, and the indexing will, in effect, tax the increase in the value, but not the capital itself.

Senator BYRD. I agree. I agree with that. In a way, I would like to see it done, but it occurs to me that if you index capital gains then it is going to be difficult to resist indexing the entire Tax Code, and if you do that, it seems to me, that could be a pattern for continued and more inflation.

Mr. MUSSER. Sir, I do not think we are setting a precedent here. We have already indexed such things as social security benefits. We have indexed Federal retirement benefits, the Archer amendment is merely another step toward alleviating the effects of inflation on taxes.

Senator BYRD. Thank you, sir.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much. Mr. Mills?

Mr. MILLS. No questions.

The CHAIRMAN. Thank you very much, gentlemen.

[The prepared statements of the preceding panel follow:]

STATEMENT OF THE MACHINERY AND ALLIED PRODUCTS INSTITUTE

In capsule, the MAPI statement in August 1978 to the Senate Committee on Finance concerning the House-passed "Revenue Act of 1978," H.R. 13511, takes the following positions:

In general

1. The House of Representatives deserves high commendation for moving decisively, and in the face of Administration opposition, to write and then pass responsible tax reduction legislation.

2. MAPI agrees that the existing temporary tax cuts must be made permanent and that additional permanent tax cuts must be enacted in order to reduce the drag of inflation and social security taxes on the economy and help extend the current recovery.

3. We continue to oppose Administration-initiated or other efforts to increase the progressivity of the federal income tax; to redistribute more income; to accomplish "petty" tax reform; to broaden the tax base through wholesale and indiscriminate elimination of deductions and exclusions; and to penalize export activity and foreign investment.

4. The overall size of the tax reductions approved by the House is not inappropriate in light of current economic conditions, but we believe it could prudently be increased somewhat to accommodate larger cuts with respect to savings and investment.

5. Subject to certain specific suggestions, we endorse all the tax reductions approved by the House for individuals, businesses, and capital gains, but request reconsideration of certain of the proposals that have been made in the name of simplification, base-broadening, and/or equity.

6. MAPI urges the Senate Finance Committee to steer clear of controversial amendments that could jeopardize the timely delivery of substantial tax relief to all persons and entities subject to the federal income tax.

In more detail

7. We endorse the House changes with respect to (a) the income-bracket widening for individuals; (b) the increase in the personal exemption and the repeal of the general tax credit; (c) preserving the tax status of private nonqualified deferred compensation plans and cash or deferred profit-sharing plans; (d) lowering and restructuring the corporate tax rates and increasing the number of income brackets; (e) improving the investment credit—as far as the changes go; (f) raising the "small issues" exception to industrial development bond tax treatment; (g) tax improvements for small business; (h) the reduction of the maximum capital gains tax and the indexation of gains; and (i) more liberal rules for sales and exchanges of principal residences.

8. We take exception on various grounds to the House bill's provisions concerning (a) the repeal of deductions for state and local nonbusiness gasoline and other motor fuel taxes; (b) a tightening up of deductions for medical, dental, and related expenses; (c) the taxation of certain unemployment compensation benefits; (d) the repeal of first-year depreciation for larger businesses; (e) the repeal of the alternative tax for capital gains; and (f) the imposition of an alternative minimum tax.

9. Additional tax cuts for middle-income persons should be substantial and be made available further up into the middle income brackets than has been proposed.

10. As to the minimum tax, we favor complete repeal of the existing levy and do not approve of any supplemental taxes on capital gains, but recognize that the House-passed alternative minimum tax is superior to the existing version.

11. The investment credit should be extended to spending for new industrial structures as well as to rehabilitation expenditures, and the taxable income limitation should be eliminated altogether.

12. More tax relief should be provided with respect to expenditures by business taxpayers for environmental controls, including pollution abatement and occupational safety and health spending.

Statement

Introduction

The Machinery and Allied Products Institute (MAPI) deeply appreciates this opportunity to submit a statement once again to the distinguished members of the Senate Committee on Finance. We apologize for the length of our presentation, but we have made every effort to eliminate unnecessary coverage and at the same time do justice to the main issues involved in a lengthy and comprehensive bill.

As Committee members will recall, MAPI is the national organization representing the capital goods and allied product industries of the United States. The Institute's program features original economic and management research and, within that context, places a high priority on all aspects of business investment policy and the economics of capital formation. In addressing these matters over the years, MAPI has directed substantial attention to tax policy and administration, and frequently has presented recommendations to Congress and the Executive Branch based on the findings of such research.

To summarize our thoughts at the outset of this statement, we believe that the House of Representatives and the House Ways and Means Committee in particular deserve high commendation for moving in the face of stern and unyielding Administration resistance to write and then pass H.R. 13511. As a compromise aimed at winning the support of a divided House, the bill is a masterful stroke

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and accomplished its end with consummate ease by clearing the House on a vote of 362 to 49. Although the measure does not go as far as we would like in respect of taxation affecting capital, it does contain meaningful new initiatives for the investment credit and capital gains. Similarly, the bill would bring about important changes in corporate taxes, including new brackets with graduated rates. On another point, for a change, the badly needed tax reductions for individuals are very nearly proportionate through the various income brackets, with some provisions even tending to focus relief into the middle incomes where the combined effects of inflation and payroll taxes have been most severe.

Without intending to overdo the compliments for the House and H.R. 13511—about which we later offer significant recommendations for improvement—we should add that many criticisms we voiced to the Ways and Means Committee on March 6, 1978, with respect to the President's proposals, do not apply to the House bill. Specifically, the House bill seems more sensitive than did the President's program to the debilitating impacts of inflation on individuals and businesses, including their investment activity; it wisely rejects the Administration's proposals to increase the tax law's progressivity and to redistribute additional income away from middle- and upper-middle income people; it rejects various "petty" tax reforms that are more bother than they are worth; it rejects—with some exceptions—the Administration's extensive base-broadening initiatives involving wholesale elimination of deductions and exclusions; and it does not contain, as nearly as we can tell, any provisions that threaten the export activity or foreign-source income of U.S.-based businesses.

As to the "piecemealing" of tax policy that has characterized the Carter Administration's offerings, we are pleased to note that circumstances have changed in such a way now as to lessen the problem. Specifically, although for the most part ill-conceived, the social security financing amendments have been in the law since December of 1977 and will begin to take effect January 1, 1979. H.R. 13511 is partly designed to absorb the initial impact of this legislation, so there is coordination in that respect. Secondly, as already suggested, the threat to middle income individuals and to capital of the Carter Administration's tax legislative program has receded for now. Thirdly, if moderation prevails, the Administration's potentially disruptive tax proposals in its energy program will be allowed to expire quietly without final congressional approval. Finally, the House Committee on Ways and Means has reported important substantive amendments to Code section 911 dealing with the foreign earned income exclusion, and that matter will be settled more or less in sequence with the Revenue Act of 1978. Although things are falling into place more by circumstance than by design, the improved "visibility" will facilitate more intelligent policy-making.

On the other side of the ledger—to revert to H.R. 13511—we believe that it can be improved. Beyond approving all of the bill's tax reductions for individuals, businesses, and capital gains, our major recommendations are as follows:

1. The additional tax cuts for middle-income persons should be provided further into the upper-middle income brackets than has been proposed. [It is interesting that the term "upper-middle income" tax brackets has come into use, indicating a broader recognition of the tax punishment being imposed by government on those individuals who carry the bulk of the Federal, state, and local tax burden.]
2. The investment credit should be extended to spending for *new* industrial structures as well as to rehabilitation expenditures.
3. More tax relief should be provided with respect to expenditures by business taxpayers for environmental controls.[1]
4. The 25 percent alternative tax for capital gains should be retained.

Although we also have offered numerous other suggestions for change in our detailed commentary, we fully understand that the Finance Committee must operate within budgetary constraints. Also, as stated in our general comments to follow, we believe that certain limitations must be recognized in view of current economic conditions.

In this respect, however, it should be recognized that inflation is a two-edged sword. The Secretary of the Treasury in testimony during these hearings has expressed concern about the inflationary effects of tax cuts that are too large. On the other hand, inflation has created an unlegislated tax increase by moving taxpayers into higher tax brackets and by causing the taxation of illusory profits and unreal income. The Administration chooses to overlook or play down the latter effect.

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[1] By "environment," we refer to both the ambient and workplace environments, including, e.g., spending required by rules of the Environmental Protection Agency and the Occupational Safety and Health Administration.

Our comments to follow are both general and detailed in nature. Also, they are addressed mainly to the provisions of H.R. 13511 because we consider that to be the appropriate point of departure for the Finance Committee's consideration of tax reductions at this relatively late juncture in the 95th Congress. Because of the overriding importance of extending current tax cuts and putting significant tax reductions in place before adjournment, we hope that the Finance Committee will reject any controversial "tax reform" amendments that might delay the bill or place the tax cuts in jeopardy.

IN GENERAL

Our comments below follow the pattern of the discussion of "General Reasons for the Bill" in House Report No. 95-1445.

Inflation and economic growth

As already suggested, like the House, we are of the view that the additional tax burden resulting from the interaction of inflation and the progressive individual income tax structure, and from increasing social security taxes, makes it essential this year to make permanent the temporary tax cuts currently in effect and to provide additional tax relief as well. As the Finance Committee may know, federal revenue in the current fiscal year are running at about 19.6 percent of Gross National Product (GNP)—somewhat above the customary percentage—and would rise to approximately 22.3 percent of GNP, according to estimates of the Office of Management and Budget, if no action were taken besides extending the existing temporary tax reductions. This increase in percentage would represent a substantial new tax burden on the private sector on top of a situation that has become oppressive due to the increasing tax bite at each level of government. Also, it implies a significant increase of government presence in the overall economy.

Meanwhile, the current economic recovery is slowing—assuming, as is generally thought, that 1978's second quarter was an aberration—and there is a fairly widespread belief that economic growth will taper off as 1978 continues. We believe, as does the House, that a tax cut of appropriate size would help to sustain the recovery. Also, we agree with the proposition that the reductions should not be so large as to overstimulate the economy and worsen inflation. In that connection, it must be remembered that employment now is relatively full and capacity utilization is close to levels at which inefficiencies tend to manifest themselves in production processes. Although inflation almost certainly will abate somewhat from the unsatisfactory rates of previous months, inflationary expectations remain high and the economy does not appear to have much slack. Accordingly, we take no strong exception to the modest reductions of the House bill, although we would prefer larger cuts in several areas.

Regarding the proposals for massive tax reductions that have been discussed in both chambers of Congress, we neither align with nor disavow them at this time, although we are attracted to the thought of more sizable cuts than the House endorsed. For one thing, we are not wholly convinced that a substantially widened deficit—even a temporary one—from a massive cut would be beneficial at this time in view of the current rate of inflation and continued weakness of the U.S. dollar in foreign-exchange markets. Also, it does seem to us that any such changes would have to be phased in gradually and might best be accompanied by provisions aimed at curbing growth in the federal government's spending. Of course, the securing of a commitment to restrain government spending is a large order by itself, although the idea is eminently sensible and could be executed in a responsible way.

In short, we agree that something must be done now to reduce the drag on the economy of inflation and social security taxes so that these factors alone will not gradually extinguish the current recovery. At one and the same time, the tax reductions must be substantial enough to defeat the dampening effects of these factors, but not be so large as to establish a "boom and bust" pattern. How far to go in striking this difficult balance obviously is a judgment matter. As our comments to follow will indicate, we believe that even more could be done in the area of savings and investment than the House has proposed, in the interest of future real growth and without adding imprudently to aggregate demand at this time.

"Economic incentives"

Several provisions of the House bill are intended to improve the effect of the tax system on economic incentives, according to the Ways and Means Committee. In this category are the changes in the investment credit, the reductions

in capital gains taxes, and a targeted jobs credit. Nearly all of these amendments would improve measurably on the current system. As we see it, the House is to be commended for acting boldly on its own initiative in the face of an intransigent Administration, particularly as to capital gains taxation where the President and his advisors have been very dogmatic. Considering the importance of these changes to high levels of employment, inflation control, and real economic growth, it is remarkable to us that the Administration could only identify itself with important relief for capital in the context of a total package including very unpopular "reforms."

Regarding the Ways and Means Committee's reference to "economic incentives," it bears repeating that investment credits and preferential tax rates for capital gains are more accurately described as selective reductions in the tax *dis*incentives to affected activities. There is an inclination of some persons in the tax policy arena to consider all wealth as properly inuring to government. Because of this, any income that is not siphoned off in the form of taxes is often described as "preference income," "tax expenditures," or tax incentives. We do not wish to be fussy about the semantics of this beyond registering our disagreement with the underlying philosophy. Further, in the context of capital cost recovery allowances, it is inaccurate to refer to income tax measures as incentives where they do no more than insulate capital itself from the levy.

As to the "economic incentives" in the House bill that are directed to savings and investment, we feel that the investment credit changes are meritorious and the capital gains proposals are of landmark significance. Our only regret is that the House did not go further with these reforms, and we urge that the Senate Finance Committee consider bolder action, within budgetary constraints. There are at least two factors favoring broader tax relief for capital at this time. First, a higher rate of capital formation is, we think, consistent with current economic objectives, and we note additionally that business spending has been one of the less ebullient performers to date in the present recovery. Second, cuts in the taxation of capital gains hold some promise, however uncertain, of generating significant feed-back revenues through a higher rate of gains realizations. If there is such a thing as a self-financing tax cut—and there most assuredly is once taxes have reached repressive levels—this is where it might be encountered because of the "unlocking" effect of the reductions.

Tax incentives and equity

Under the heading of "tax incentives and equity," the House has proposed extending the "at risk" rule for tax shelters; indexing capital gains; eliminating the untaxed half of capital gains as a "tax preference" and an offset to personal services income otherwise eligible for the maximum tax; and enacting an alternative minimum tax. We already have discussed in general terms our support for the capital gains tax reductions, and will not repeat them here. As to the tax shelter provisions and the new alternative minimum tax, they manifest a lingering concern of Congress that everyone with economic gain should pay some amount of federal income taxes. This proposition may have an appealing egalitarian ring, but it also causes mischief. Specifically, to mention just one of several concerns, we are disturbed by the ambivalence reflected in Code provisions that favor certain activity in the national interest but then withdraw the benefits when taxpayers respond to the call.

We will not dwell on this here beyond noting our strong objection to the existing minimum tax and our feeling that tax provisions favorable to increased savings and investment should not be hedged about by limitations, restraints, and add-on taxes that deny their effectiveness.

Base broadening and efficiency adjustments

Tax reform theorists often are drawn to the idea that everyone would be better off if all the concessions in the existing tax base were eliminated. Then, it is supposed, tax rates could be lowered substantially for everyone, and tax compliance and administration would be vastly simplified. All accretions of wealth would be taxed; everyone would pay a "fair share"; and the tax system would somehow become generally more efficient than it now is. Although we disagree with certain aspects of this fantasy, we do not fault those who strive continuously to improve taxation within such a framework. Fiscal policy is an evolving, dynamic thing that reflects changing economic conditions, social values, etc., and must be periodically restudied to determine whether it is performing to expectations. We would simply note that the road to be traversed between current practice and

any "ideal" system is not an easy one. As the Congress knows from ist own experience and the public's reaction to the Carter Administration's tax program, every nook and cranny in the tax base has a constituency waiting in the wings to rally in defense when others propose repeal. The chairman of this committee has been very realistic in his appraisal of this scenario. This resistance to change may frustrate some individuals, but we see it as being entirely proper. Most existing concessions in the tax base were deliberate rather than accidental, being conscious decisions of Congress to favor certain activities relative to others. The determinations to repeal any such provisions should be made as deliberately as were the actions to enact them in the first instance.

Our testimony of March 6, 1978 to the Ways and Means Committee took extensive issue with the base-broadening initiatives of the Administration program, and we are pleased that the Committee and the full House put most of them aside. Specifically, as to certain of these, we concur in the plan of the Ways and Means Committee to subject fringe benefits to examination by a Task Force. It will be seen from our comments to follow that we still have difficulty with the remaining items in the bill aimed at base-broadening by curtailment of deductions and exclusions.

A point of order

As a prelude to our detailed remarks on the House bill and other initiatives that the Senate might take, we acknowledge that H.R. 13511 is a laboriously wrought compromise and that it contains some favorable and unfavorable items depending on one's vantage point. In an effort to be more communicative to the Finance Committee about our views on the variety of tax issues embodied in H.R. 13511, and a few that are not, we chose to address each provision of interest to our membership on the merits rather than to argue for some and concede others as apparently was done by the House Committee members who fashioned the measure. Lest we give any impression of general disapproval, in our detailed analysis, we repeat that the bill overall is an important contribution, a step in the right direction toward keeping the economy on an even keel, and reflects many sound tax policy principles.

At this point, we wish to emphasize that MAPI is appalled by the Administration's acknowledged effort to introduce more progressivity into the tax system; to mislead the public by trying to create the notion that capital gains is a "bad" word and that such gains are of primary interest to millionaires; to misuse the rationale of simplification when the motivation is otherwise unsound; to completely disregard the real national interest in retaining the present tax treatment of foreign earnings; to offer petty "tax reforms" which are transparently political; and to ignore the almost confiscatory effect of the total tax burden on the middle- and upper-middle income tax brackets, properly defined. On the last point, these taxpayers have recently been characterized, and properly so, as "The New Poor."

Although we would like to see the Senate move more affirmatively in areas conducive to capital formation, we do not quarrel with the House bill in this respect as far as it goes. Moreover, we would hope that the modest relief for taxpayers in H.R. 13511 would not be placed in jeopardy by the introduction into the dialogue on the Senate side of controversial issues not presently reflected in the bill.

DETAILED ANALYSIS OF "THE REVENUE ACT OF 1978" AS PASSED BY THE HOUSE OF REPRESENTATIVES

*Widening of tax brackets, rate cuts, etc. (section 101(a))**

Section 101(a) of the House bill would provide new tax rate schedules in place of each of the tax rate schedules of present law. One change would be to increase the "zero bracket" amount in the joint rate schedule from $3,200 to $3,400, and to increase the amount from $2,200 to $2,300 for single persons. For heads of households, the increase would be $100 in amount, to $2,300. For married persons filing separate returns, the increase would be from $1,600 to $1,700. A second rate schedule change would widen the tax brackets in excess of the zero bracket by 6 percent. Finally, the bill would reduce the present 19, 22, and 25 percent rates by one percentage point to 18, 21, and 24 percent, respectively.

The changes in the tax rate schedule, including the higher zero bracket amount would be effective for taxable years beginning after December 31, 1978. Fiscal

*Section numbers refer to those of the House Bill.

year taxpayers would be given the benefit of the rate cuts and increase in the zero bracket amount (as well as the personal exemption increase, described later) for that part of their fiscal year which falls in 1979.

These changes are estimated to reduce calendar year liabilities by $10.6 billion in 1979, $12.2 billion in 1980, and $19.1 billion in 1983.

MAPI comment.—As we understand these changes, they are intended to increase the federal income tax threshold to approximately the poverty level; to provide across-the-board tax relief for inflation at a 6 percent rate; and to target additional relief to persons with taxable income of more than $7,640 but less than $20,360. The stated purpose of the Ways and Means Committee was to provide stimulus to the economy; partly offset the scheduled increase in social security taxes as well as inflation taxes; and to direct a significant part of the tax reductions to middle- and upper-middle income individuals. These are all commendable goals, but we question whether the House either provided adequate total relief or in any material way skewed it to the middle- and upper-middle incomes.

By and large, the changes here discussed are modest in all income ranges as compared to the punishment taxpayers are taking now from inflation and will increasingly feel on January 1, 1979 from social security. Also, with an exception for the rate changes in three brackets, we think that the relief is more nearly proportionate across the income classes rather than target as the Ways and Means Committee suggests. Although the percentage distribution of the proposed tax decreases is heaviest in the "expanded income" classes from $10,000 to $50,000, that is because most of the taxpayers are in that range. Even if the only change were to widen each bracket by the same percentage, essentially giving identical relief to everyone, the percentage distribution would be focused in the middle incomes. We do not think of this as targeting benefits to middle income people, and, in our opinion, these individuals need and deserve positive tax reductions over and above those granted to others.

We recommend that the Senate design its own tax relief for individuals; provide significant cuts a cross-the-board; and then focus added reductions on the middle- and upper-middle income persons who have been whipsawed most by the combination of inflation and the progressive income tax structure. This additional relief might appropriately be spread through those existing income brackets currently subject to rates of from 25 to 50 percent, in our judgment. As we view the matter, the conferees should be given a choice between the modest House provision and something more responsive to the problem.

Increase in the personal exemption (section 102)

Section 102 of the House bill would provide a permanent increase in the personal exemption from $750 to $1,000. The existing general tax credit, which equals the greater of $35 per exemption or 2 percent of the first $9,000 of income with a maximum of $180, would be allowed to expire on schedule at the end of 1978.

The increase in the personal exemption would be effective for taxable years beginning after December 31, 1978, and the general tax credit would no longer apply for taxable years ending after December 31, 1978. The increase in the personal exemption, net of the expiration of the general tax credit, is estimated to reduce calendar year liabilities by $1.3 billion in 1979, $1.4 billion in 1980, and $1.7 billion in 1983.

MAPI comment.—We full concur in this amendment of the House. The exemption increase is long overdue, and we urge the Finance Committee to go along with the House on this particular item. As to those who seem to prefer credits to deductions, we would simply point out that the value of deductions to persons in different brackets is one incident of the progressive income tax structure. A $1,000 personal exemption is just that—no more and no less—to everyone who claims it, and it is irrelevant that a high-bracket person is spared by the deduction from turning over more taxes to the government than is a low bracket person.

There have been too many specious arguments from "credit"-seekers who want themselves off the tax rolls and would have the middle- and upper-middle income people finance government on their own.

State and local nonbusiness gasoline and other motor fuel taxes (section 111)

Section 111 of the House bill would repeal the itemized deduction for state and local taxes on gasoline, diesel, and other motor fuels not used by the taxpayer in business or investment activities.

Repeal would be effective for taxable years beginning after December 31, 1978, and it is estimated that this provision would reduce calendar year liabilities by $1.1 billion in 1979 and more in later years.

MAPI comment.—We recommend retention of this deduction and frankly see little merit in the reasons that were given by the Ways and Means Committee for change. Gasoline and other motor fuels are commodities that are taxed at several levels of government, and the price of such fuel has undergone a meteoric rise due to the cartel of the Organization of Petroleum Exporting Countries. Thus, automobile fuel costs are punishing enough already, without compounding the impact by recission of the tax deduction. The federal income tax deduction that now exists with respect to this type of commodity. The deduction also minimizes the encroachment of the federal government on this particular state tax base.

On other points, the Finance Committee will not that elimination of this deduction is, in effect, a selective tax increase. In fact, it is a regressive tax increase and we are surprised that the base-broadening "tax reformers" do not seem worried about that. The assertion of the Ways and Means Committee that its action indicates a concern with gasoline consumption may be well-intentioned, but we fail to see any connection between repeal of the gasoline deduction and consumption of the commodity. The repeal in question would not add sufficiently to the cost of motor fuels to induce more conservation, and the potential for more conservation from this action would be limited in any event, in our opinion.

As to the vaunted objective of tax simplification—an objective which has been carelessly applied in some tax change rationalizations—the gasoline deduction is, in our opinion, one of the simplest to use because of the tables which have been provided. Furthermore, computing the deduction is not the guessing game portrayed by the Ways and Means Committee because taxpayers generally know approximately how far they drive in a year.

On a final point, the Ways and Means Committee characterized the present deductions as relatively small to taxpayers, as if they should not care. However, nearly every itemized claims the deduction, and we can assure the Finance Committee that taxpayers care about every dollar of tax liability, particularly with the total burden at the current oppressive levels. Indeed, the estimated first-year revenue pick-up from repeal would be $1.1 billion, making it the third largest revenue raiser in the House bill behind repeal of the general tax credit and the general jobs credit.

Medical, dental, etc., expenses (section 112)

Section 112 of the House bill would repeal the provision of present law which allows an itemized deduction for one-half of the cost of medical insurance premiums (up to $150) without regard to the general limitation that medical expenses are deductible only to the extent they exceed 3 percent of adjusted gross income. In view of highly escalated "health costs" in general and the wide use of self-financed medical insurance, this proposal seems ridiculous. Also, the bill would repeal the special limitation which now permits deduction of prescription and nonprescription medicine and drug costs only to the extent they exceed 1 percent of adjusted gross income. The bill provides that only "prescribed drugs" and insulin would be eligible for the medical expense deduction.

Because of these modifications, the full amount of medical insurance premiums, the costs of prescription drugs (and insulin), and other qualifying medical expenses would be deductible to the extent that in the aggregate they exceed 3 percent of adjusted gross income.

These changes would be effective for taxable years beginning after December 31, 1978, and it is estimated that this provision would reduce calendar year liabilities by $40 million in 1979, and more in later years.

MAPI comment.—As if the cost of medical and dental services were not very high already and moving out of sight, the Ways and Means Committee has proposed to worsen matters in the name of tax refinement and simplification. Although the "damage" would not be intolerable, we strongly feel that the House bill moves in the wrong direction. First of all, medical insurance should be encouraged, and the deduction of one-half of related premiums up to $150 provides some element of encouragement as well as relief for the beleaguered person who is trying to protect himself from the escalating costs of medical and dental services. Until there is a program of national health insurance—assuming that there will be such a program, an issue on which we take no position at this time—any changes in the federal income tax system vis-a-vis medical and dental expenses should increase rather than diminish this modest indirect participation by the federal government.

In that connection, we believe that the medical insurance premium deduction should be changed to raise the ceiling on the deduction to at least $200. Even a

$200 ceiling would not begin to account for inflation's effects on the costs of medical services since the $150 amount was legislated.

Regarding the 1 percent floor on medicine and drugs, the Ways and Means Committee states that the purpose behind this separate floor below the 3 percent floor for medical and dental expenses was to provide a rough method of distinguishing between qualifying expenditures and other goods that may be bought in a pharmacy. A more important purpose, we believe, was to recognize that persons afflicted by illness often have expenses for medicine and drugs that continue long after the major costs of physicians' services, hospitalization, etc., have been incurred. Also, these expenses are extraordinary in nature even if they are less severe than the ones experienced at the hands of medical service providers. To make this deduction less accessible, as the House bill would do, increases the financial burden of sickness for everyone, most noticeably for those persons least able to pay for such misfortune.

We would prefer to see the Finance Committee leave the medicine-and-drugs deduction as it is. If there must be a single floor for all medical expense deductions, we suggest that it be set at 2 percent of adjusted gross income. As to the redefinition of qualifying medicines and drugs, we have no objection as long as the new definition does not narrow the IRS concept of eligibility now in effect.

Unemployment compensation (section 114)

Section 114 of the House bill would provide that a portion of benefits in the nature of unemployment compensation paid pursuant to government programs would be included in the recipient's adjusted gross income. In effect, the exclusion would begin phasing out at income levels of $20,000 for single people and $25,000 for married couples.

This provision would apply to unemployment compensation paid after December 31, 1978, in taxable years ending after that date. It is estimated that this provision would increase calendar year liabilities by $251 million in 1979, rising to larger amounts in subsequent years.

MAPI comment.—We cannot, on grounds of equity, support the taxation of unemployment compensation paid under legislatively provided social benefit programs for promotion of the general welfare. As the Finance Committee surely knows, people tend to live on a scale that reflects their income. In addition, they have fixed expenses, some of which cannot be altered or can be changed only in the longer term and under circumstances of forced liquidation. For persons who suddenly find themselves unemployed and who qualify for unemployment compensation, whatever their income, wke see no justification for government's extracting tax amounts from the meager benefit provided to lessen the blow.

The Ways and Means Committee's attempt to compare public unemployment compensation with that under private supplemental unemployment compensation plans is inapposite. As the Finance Committee must recognize, the relief from public programs is basic relief; is paid for by nearly all working people through employer contributions; and is something to which they are entitled in time of need. To tax unemployment compensation is to provide help with one hand and to withdraw it with the other. In fact, the proposal would even interfere with the automatic stabilizer effects of unemployment compensation programs.

The only suitable word to use in describing this proposal is "crass." It is an inauspicious remnant of the discredited Carter Administration "tax reform" program which sought new tribute from not only unemployed taxpayers but also from sickly ones—via severe amendments to Code section 213—and from the survivors of those who passed away—via amendments to Code section 105. We are confident that the Finance Committee will improve on H.R. 13511 in most every respect, including rejection of this proposal.

Before leaving the subject we would like to comment on the Ways and Means Committee's assertion that failure to tax unemployment compensation is a work disincentive. One might similarly contend that unemployment compensation itself is a work disincentive. Rather than suggest anything so absurd and narrow, we would simply state that if there is any disincentive element in untaxed amounts of unemployment compensation currently being paid, then the tax-writing and labor committees should deal with that by adjusting benefits accordingly. On a related matter, we observe that the work disincentive alleged to exist would be present at every income level if it were there at all—which we doubt. We urge the Finance Committee to scuttle section 114 of the House bill.

Private nonqualified deferred compensation plans (section 121); certain other matters

Among the changes in the tax law that would be made by section 121 of the House bill are ones which would stipulate that compensation deferred under unfunded deferred compensation plans of taxable employers would be subject to the principles of law in effect on February 1, 1978. The practical effect of this would be to leave the tax law with respect to deferred compensation in this context where it was before IRS issued proposed regulations adverse to taxpayers' interests in February 1978.

This section would be effective for taxable years ending on or after February 1, 1978, and the effect thereof upon budget receipts would be negligible.

MAPI comment.—The House deserves commendation for proposing to curb IRS with respect to unfunded deferred compensation plans of states, local governments, and taxable employers. In a move that increasingly has become characteristic of IRS in the current Administration, the IRS proposed last February 3 to reverse policies and procedures that have been settled in this area for nearly two decades.

We fully concur in the thinking of the House that the doctrine of constructive receipt should not be applied as IRS proposed. Further, we agree that the uncertainty surrounding the status of private nonqualified deferred compensation plans caused by IRS is not desirable and must not be permitted to continue. Many individuals have had their retirement planning thrown in jeopardy by the careless and arbitrary action of IRS and we urge Congress to put a stop to it.

We should add that deferred compensation is not the only area in which IRS recently has engaged in policy change. Two others are "fringe benefits" and the foreign tax credit. On the subject of fringe benefits, we applaud both the House and Senate—and particularly the tax-writing committees—for moving to freeze the status quo on taxation in this area through 1980. Our impression is that IRS will grasp any slim reed of logic to support taxation of any benefit to which it believes a value can be attributed or imputed. In addition, we are coming to believe that the Service will find "wages" subject to withholding wherever that can be done, and not be too troubled by the impracticalities of such a finding. Although the recent U.S. Supreme Court and Tax Court decisions provide some channel markers through rather uncertain waters, they have raised more questions than they resolved. Rather than have IRS set tax policy by administrative decree, it is time for Congress to take a look. We strongly agree that IRS must be held at bay in the interim.

Another arena in which Congress may have to intervene is that of the foreign tax credit, and our purpose in mentioning this is anticipatory in character. In brief, we think that members of both tax-writing committees should be aware—if they have not already been apprised—that IRS has issued a series of foreign tax credit rulings in 1978 which may have far-reaching implications.[1]

Incrementally IRS has used the ruling process to "refine" and sharpen the rules dealing with the characteristics of creditable taxes. In our judgment, new policy is being made along the way and the effect invariably is to more sharply circumscribe the area within which foreign income taxes paid or accrued qualify for creditability.

Inasmuch as it is not the province of IRS to set new policy, the rulings are being represented to be mere interpretations of existing requirements. Also, some of them are being allowed to apply retroactively to open years as well as prospectively to future taxable years, as if the new positions had always been embraced by IRS. The upshot of it all is that some—perhaps many—taxpayers have sudden potential tax liabilities of material size, and the matter is almost certain to find its way to the courts. Whether Congress does anything now or not, the Committee and its staff might usefully keep in mind that IRS may have to be curbed on the foreign tax credit question as well as deferred compensation and fringe benefits. The double-tax implications of what is happening with the credit are serious.

Cash or deferred profit-sharing plans (section 125)

Under section 125 of the House bill, new cash or deferred profit-sharing plans could be tax-qualified and could consist in part of tax-exempt trusts. Also, employers covered by such plans would be permitted to exclude from income employer contributions to them provided that the plans satisfy the law with respect

[1] See, e.g., Revenue Rulings 78–61, 78–62, 78–63, and 78–284.

to cash or deferred profit-sharing plans as it was administered before January 1, 1972. Detailed instructions would be given to the Service as to how Congress expects IRS to administer the law in this area.

This amendment would be effective for taxable years beginning after December 31, 1977, and there would be no effect on budget receipts because the provision simply extends present law.

MAPI comment.—In general, we concur in the decision of the House to allow new cash or deferred profit-sharing plans to be tax qualified, containing tax-exempt trusts and allowing covered employees to exclude from income employer contributions where the plans satisfy the law as administered prior to 1972. This is another area of the tax law in which arbitrary IRS proposals threatened to derail the compensation affairs and planning of many individuals and their employers. It is altogether fitting that the Congress is closing the book on yet another administrative override atempted by IRS. We might add that this provision will be especially welcome to smaller businesses and their employees.

Corporate rate reductions (section 301)

Section 301 of the House bill would repeal the present normal tax and surtax on corporations and, in their place, impose a five-step tax rate structure for corporate taxable income. Under the bill, the new tax rate structure applicable after December 31, 1978 would involve the following: (1) a 17 percent tax on taxable income from $0 to $25,000; (2) a 20 percent tax on taxable income from $25,000 to $50,000; (3) a 30 percent tax on taxable income from $50,000 to $75,000; (4) a 40 percent tax on taxable income from $75,000 to $100,000; and (5) a 46 percent tax on taxable income over $100,000.

This provision would be effective for taxable years beginning after December 31, 1978. However, for fiscal year corporate taxpayers, the new rates and brackets would be applied in such a way that these corporations would derive the benefits of the changes for that part of their 1978–79 fiscal year which falls in 1979.

This change in the law would reduce calendar year liabilities by $5.1 billion in 1979, and more in subsequent years. This revenue estimate does not include the revenue effect from making the current "temporary" corporate rate reductions permanent.

MAPI comment.—We agree with the changes here, including the tax reductions and the addition of several income brackets with graduated rates to lessen the tax bite on incremental income. As indicated by the Ways and Means Committee, the reduction of the corporate tax rates is necessary to reduce employment and stimulate economic growth through capital investment. Also, the application of graduated rates may to some minor extent reduce the impact of the tax laws in the selection of a form of organization for the operation of a small business. Although we see merit in the substitution of five income brackets with graduated rates for three, we do not wish to overemphasize the importance of such a change. It does introduce some complication. Also, we can imagine with despair some persons next asking for progressivity in the rate structure although any good reasons for imposing such a change are unknown to us.

On the point about spurring capital investment, we can of course think of better ways to go about it than through small rate reductions. However, we fully understand that rate relief is the kind of tax reduction with the broadest appeal, and is the simplest to enact and implement. The House bill wisely couples rate reductions with other more direct incentives to capital formation, discussed later.

Permanent increase and revisions in investment credit (section 311)

Under section 311 of the House bill, the temporary investment credit rate of 10 percent for all taxpayers, which is scheduled to return to 7 percent (4 percent for utilities) in 1981, would be made permanent. Also, the present temporary $100,000 annual limitation on used property eligible for the credit, which is scheduled to return to $50,000 in 1981, would be made permanent.

These amendments would become effective on January 1, 1981, when the temporary extensions are scheduled to expire. The changes would reduce calendar year liabilities by $4.7 billion in 1981, increasing in subsequent years.

MAPI comment.—Although nothing is "permanent" in the law when Congress can act on its own initiative to change things, we fully agree with the action taken by the House to extend indefinitely the 10 percent investment credit and $100,000 limitation on used property. The uncertainty associated with temporary extensions of the investment credit interferes with the incentive effect the

credit otherwise has. If business decision-makers cannot depend on the credit being in force when equipment is acquired and placed in service, then they will not factor the credit into their decisions to invest. Also, we should add that there is a substantial lead-time in planning for and carrying out programs of equipment acquisition and replacement. Therefore, we think that the timing is right for making the changes in issue, and that they should not be put off until the next Congress.

As for the 10 percent credit rate that is being made permanent, the Finance Committee may wish to consider whether under current inflationary conditions the 10 percent investment credit and existing depreciation options allow sufficient capital recovery and provide an appropriate spending incentive in addition, as is intended. If not—and we believe this may be the case—the committee should consider increasing one allowance or the other, assuming that this can be done within budgetary constraints. In proposing this, we fully understand that an increased credit or faster depreciation might necessitate a different distribution of revenue loss than is reflected in the House bill. However, capital spending is a priority matter, and proper tax allowances in this area are central to any program to deal with inflation and unemployment and to improve productivity.

As a final thought on the adequacy of the credit and existing depreciation provisions, we would point out that capacity utilization now is relatively high and not far from the point where symptoms of stress usually appear. Although significant shortages have not yet developed to our knowledge, the potential is present and the consequences for the economy could be serious. Obviously, nothing the Finance Committee does at this time with respect to tax allowances for capital spending will avert in a significant way any capacity squeeze that may be imminent. Still, we do not feel that it is either too late or too soon to begin upgrading the Code in this respect.

Increase in credit limitation to 90 percent (section 312)

Section 312 of the House bill would increase the present 50 percent limitation on investment credits to 90 percent, to be phased in at an additional 10 percentage points per year beginning with taxable years which end in 1979. As a result, the limitation would be 60 percent for taxable years ending in 1979, 70 percent for 1980, 80 percent for 1981, and 90 percent for 1982 and subsequent years. No change would be made in the existing provision which allows investment credits to offset the first $25,000 of tax liability on a dollar-for-dollar basis.

These amendments would be effective for taxable years ending after December 31, 1978. The reduction in revenues for calendar year 1979 is estimated at $287 million; for 1980, $629 million; and for 1983, $728 million.

MAPI comment.—We agree with this increase in the credit limitation, but would prefer to see the Finance Committee go the full distance to 100 percent and perhaps accelerate the phase-in schedule. The only reason ever advanced for stopping at 90 percent is the notion of some individuals that everyone should pay some tax even if a tax incentive otherwise would eradicate the liability.

This is the kind of thinking that underlies the minimum tax, which we consider to be a perverse and self-defeating fiscal tool that should be repealed. It is remarkable to us that the House would approve an amendment of this kind designed to help businesses of relatively low taxable income which cannot fully utilize their credits, and then begrudge them to the last 10 percent of limitation.

We suggest that the Finance Committee approve a 10 percent taxable income offset for the credit, and do so in part in the name of "tax simplification," assuming that some further rationale is needed. When the committee studies structural improvements in the credit again in the future, it may wish to consider improving the carryback as another way of helping businesses utilize their credits. In general, we believe that the investment credit should be made as effective as possible for all qualifying taxpayers.

Increased credit for pollution control facilities (section 313)

In accordance with section 313 of the House bill, a full investment credit would generally be allowed on pollution control facilities which are amortized over five years and which have actual useful lives of at least five years. Pollution control facilities which have useful lives of three or four years would continue to be subject to the present law which, in effect, limits the credit to one-third of the full credit.

A limitation would be provided where five-year amortization is elected and the pollution control facility also has been financed in whole or in part by tax-exempt industrial development bonds (IDBs). Specifically, the bill would limit

the amount of credit to, in effect, one-half of the full credit. Where the proceeds of IDBs have been used to partially finance the construction of a plant or factory, including a pollution control facility for which the taxpayer elects five-year amortization, a pro rata portion of the tax-exempt financing would be allocated to the pollution control facility for purposes of applying this limitation.

This amendment would apply to pollution control facilities acquired or constructed after December 31, 1978. It is estimated that calendar year liabilities would be reduced by $8 million in 1979, $25 million in 1980, and $112 million in 1983.

MAPI comment.—According to recent data, the costs to business of complying with environmental controls (including employee safety and health investments) have risen to the point where more than 9 percent of capital spending now is devoted to this purpose. For some companies in industries heavily impacted by environmental controls, as much as one-fourth or more of the fixed asset acquisitions currently are for basically nonproductive facilities intended to keep the environment clean and the workplace safe. As the House realized, environmental controls benefit everyone and the Congress has established both high standards and a short timetable for the clean-up program. Meanwhile, the situation has been complicated by the energy problem, with "shortages" of cleaner fuels requiring an increasing use of the more abundant but ecologically less desirable types. In order to achieve the nation's economic and environmental goals and avoid dislocations particularly in such basic industries as the electric utilities, steel, nonferrous metals, petroleum, and chemicals, we think that more of the cost of pollution abatement should be borne by the general revenues.

Although we endorse the House proposal to allow a full investment credit for facilities qualifying under Code section 169 for 60-month amortization, we feel compelled to add that the participation of government to date in diverting resources for this purpose has been another example of "too little, too late." The simple fact of the matter is that environmental control facilities typically do not generate revenues. Consequently, even though such facilities normally have service lives in excess of one year, tax policy should come as close to expensing as possible.

To analogize, Congress long ago decided that taxpayers could expense research and development (R&D) expenditures, under Code section 174. Also, in financial reporting, financial statement preparers *must* deduct R&D costs as incurred, in accordance with Statement of Financial Accounting Standards No. 2. The basic reason for accounting for R&D in this manner is that R&D often does not generate income. Where income eventually does result, the timing of the same and the relationship to particular R&D costs incurred almost always is highly uncertain. Rather than have taxation be a disincentive to R&D, Congress provided the existing election to expense. We feel that an equivalent election should be available for qualifying environmental control facilities.

Although we strongly feel that the Finance Committee should take bolder action than did the House with respect to taxation and mandated equipment, we also realize that this might not happen. In looking at the feasibility of a full investment credit plus rapid amortization, the Finance Committee should determine whether the result will be more desirable than the Asset Depreciation Range (ADR) system plus a full investment credit. If the credit-and-amortization option is not *substantially* better than the credit-and-ADR option, taxpayers will not elect it because there must be more than a little benefit just to justify the burdensome certification procedures. In the case of a taxpayer with a relatively short composite equipment life, we question whether the discounted cash flows from the credit-and amortization approach result in a significant betterment of his circumstances. Obviously, a full investment credit would improve on the situation for some taxpayers and a still larger credit would help that much more.

On the matter of rapid amortization, it has atrophied from nonuse, and we sometimes wonder whether Code section 169 was not actually designed with nonuse in mind. The tax allowance itself almost always has been inadequate relative to normal capital cost recovery and relative to the priority put by Congress on clean-up of the environment. As if that alone were not enough, the restrictions on qualifying equipment have been unreasonably strict, for example, in requiring that the facilities be used only in connection with older plants and not yield any significant savings. The amendments provided in the Tax Reform Act

of 1976 helped some, but did not go nearly far enough. We think that the Finance Committee should consider what it might do to allow more environmental control facilities to qualify—including spending required to comply with Occupational Safety and Health Administration rules—and to streamline the certification procedure, assuming that rapid amortization is to become a viable option for these assets.

To conclude on this subject, we reject the House proposal to limit the investment credit in this context where tax-exempt financing is used. This is an example of the myopic and unduly severe approach still being taken with respect to pollution abatement facilities where the Congress should instead be accommodative, consistent with the priority it put on environmental control. In our judgment, there should be no new restrictions put on industrial development bond (IDB) financing for this or any other purpose, including indirect restrictions of the type represented by the proposal credit limitation. In fact, we think the Finance Committee's Taxation and Debt Management Subcommittee would provide a useful public service by looking into the IRS' administration of the relevant provisions of Code section 103. We are told by concerned business taxpayers that the ruling policy of the Service does not seem very sympathetic with the purposes underlying this section of the law.

As the Finance Committee may know, the Small Business Administration now has an authority under which it guarantees IDB issues for groups of qualifying small enterprises, in effect giving them "triple A" credit. We strongly support not only this program to make IDB's more generally available but also any actions that the Finance Committee might take to improve administration of Code section 103 itself. To go the other way under the current circumstances of "forced march" with respect to the environment is unthinkable.

Credit for rehabilitation expenditures (section 314)

Section 314 of the House bill would extend the investment credit to rehabilitation expenditures incurred in connection with existing buildings used in all types of business or productive activities, except buildings, such as apartments, which are used for residential purposes. In order to qualify, the expenditures would have to be incurred after July 26, 1978, in connection with the rehabilitation or reconstruction of a building which has been in use for a period of at least five years before the commencement of the rehabilitation. Also, rehabilitation of a building or a major portion thereof which had previously been rehabilitated would not be eligible for the credit until five years after completion of the prior rehabilitation, generally speaking. To exclude minor repairs or improvements, the bill would require that the costs in question be required under current law to be capitalized rather than expensed, and be incurred for property which has a useful life of at least five years.

Qualifying expenditures would be eligible for a two-thirds investment credit if the improvements attributable to the spending have a useful life of five or six years, and a full credit where the useful life is seven years or more. "Useful life" would be the same as used by the taxpayer for depreciation purposes. Also, existing rules for credit recapture would apply. Generally speaking, qualified rehabilitation costs would be considered as incurred for new property, and, therefore, not be subject to the $100,000 used property limitation.

In most cases, these amendments would be effective for taxable years ending after July 26, 1978, with respect to qualifying rehabilitation expenditures incurred after that date. It is estimated that this provision would reduce calendar year liabilities by $237 million in 1979, $276 million in 1980, and $355 million in 1983.

MAPI comment.—Extension of the investment credit to industrial structures is something we have long advocated and, accordingly, we approve of the rehabilitation expenditure initiative as far as it goes. We would prefer, of course, that new plants qualify for the investment credit too, along with rehabilitation expenditures, and we regret that certain urban interests though their causes were advanced by opposing extension of the credit to new structures. For one thing, we do not believe that the investment credit differential alone will be the controlling factor in decisions of taxpayers to remain in the central cities or move to the suburbs. To the extent that the credit does sway decisions, it will do so not just for urban taxpayers looking outward but also for "country" taxpayers contemplating a move to town. In brief, we believe that the House limited its proposed extension of the credit for a reason that is generally not valid and, at best, should not have been controlling.

We recommend that the Finance Committee vote in favor of a full investment credit for new industrial structures as well as for spending on the rehabilitation of old ones. The question to be answered is whether an investment credit is appropriate for new buildings, in light of economic objectives and simple fairness to taxpayers who are entitled to full capital cost recovery. If the answer is "yes"—and we think it clearly is—then it should not matter that some investment patterns within the overall economy may change minimally because of the new allowance.

To emphasize, let us carry this discussion further. Some obsolete industrial structures—too many, in fact, from the public interest standpoint—do not sufficiently lend themselves to "rehabilitation." In these cases, the only remedy is to build a new facility. It should be added that national policy on this subject, to a substantial extent, has been blind as to the very important tie-in between modern equipment and modern industrial structures. Further, new industrial structures frequently facilitate the achievement of greatly improved environmental results and safer workplaces.

Targeted jobs tax credit (section 314)

Under section 314 of the House bill, a targeted jobs tax credit would be enacted to encourage the hiring of members of seven target groups. The credit allowed in any taxable year would be equal to 50 percent of qualified first-year wages and 16⅔ percent of qualified second-year wages. Not more than $6,000 of wages during either the first or second year would be taken into account for any individual. Thus, the maximum credit per individual would be $3,000 in the first year of employment and $1,000 in the second year of employment. However, because the deduction for wages would be reduced by the amount of the credit, the actual reduction in the employer's taxes for hiring a member of a target group who earns $6,000 would range from $900 (for an employer in the 70 percent tax bracket) to $2,580 (for an employer in the 14 percent bracket).

The target groups are described in detail in the House bill, and would include certain (1) work incentive (WIN) program registrants; (2) vocational rehabilitation referrals; (3) "food stamp youths"; (4) "food stamp Vietnam veterans"; (5) Supplemental Security Income recipients; (6) general assistance recipients; and (7) cooperative education students. A certification procedure would be administered by the Secretary of Labor, who also would carry out an aggressive promotion program with respect to the credit.

To prevent the hiring of targeted employees from displacing a substantial number of nontargeted persons the bill provides that qualified first-year wages during a taxable year could not exceed 30 percent of aggregate Federal Unemployment Tax Act (FUTA) wages for all employees during the calendar year ending in that taxable year.

MAPI comment.—We wish we could be more encouraging and report to the Finance Committee that employment tax credits work. Unfortunately, we have no evidence that this is so—at least to date—and some larger employers who have commented to us about the general jobs tax credit have indicated that the credit is too insubstantial to have any effect. In any event, their additions to their workforces are governed by current levels of business for the most part, and it is not clear to us that the credit is considered even in "marginal" hiring situations. In sum, we doubt that the credit has induced much employment that would not have occurred anyway, even though it has cost some $2.5 billion a year in revenues.

As we view the matter, the preferred kinds of tax incentives for employment are general rate reductions and improved investment allowances. If the experimentation with employment tax credits is to continue, then we agree with the House that the credit should be focused on the more intractable unemployment situations.

"Small issues" exception to IDB tax treatment (section 321)

Section 321 of the House bill would increase from $5 million to $10 million the amount of the limitation on the size of the "small issue" election for tax-exempt industrial development bonds (IDB). The bill would not increase the size of the regular $1 million limitation, and would not change the existing "capital expenditures" and "serial issues limitations of the small issues election.

This provision would be effective for bonds issued after December 31, 1978, in taxable years ending after that date. It is estimated that this provision would reduce calendar year liabilities by $2 million in 1979, $10 million in 1980, and $34 million in 1983.

MAPI comment.—The House increased the small-issue exemption to accommodate for loss of the purchasing power of the dollar since 1968, and we definitely approve of the amendment. We also are pleased that the House did not complicate this IDB exemption by limiting it to depressed areas. Although "targeted" tax concessions or abatement is theoretically attractive, it also can be complicated. We think the states and localities should continue to decide for themselves where and when and for what purposes they wish to lend their names to this kind of financing. Further on IDB exemptions, we wish to repeat a view expressed earlier: namely, that Congress should not put new limitations on the exemption for financing pollution control facilities.

Depreciation for small business (section 336)

In general, section 336 of the House bill revises the provisions for additional first-year depreciation to provide a greater deduction and to target the deduction to small businesses. The additional first-year depreciation percentage would be raised from 20 percent to 25 percent and the dollar limitation on eligible property would be increased from $10,000 ($20,000 for individuals filing joint returns) to $20,000 ($40,000 for individuals filing joint returns). The effect would be to increase the maximum deduction from $2,000 ($4,000 in the case of individuals filing joint returns) to $5,000 ($10,000 in the case of individuals filing joint returns).

Also the bill would limit the benefits to small businesses by providing that the additional depreciation is to be available only for taxpayers with depreciable assets whose adjusted basis as of the beginning of the taxable year is less than $1 million. For this purpose, a controlled group of corporations would be treated as one taxpayer.

This provision would apply to taxable years beginning after December 31, 1978. It is estimated that these changes would reduce calendar year liabilities by $379 million in 1979, declining to lower amounts in subsequent years.

MAPI comment.—We do not wish to make a "federal case" out of the proposal to limit the first-year depreciation allowance to small businesses, but the proposal does involve taking some element of capital cost recovery away from other businesses. Although the loss would be relatively minor, we consider it wholly inappropriate under present circumstances to diminish capital cost recovery in any amount. With taxes encroaching as they are on capital due inflation,[1] the only acceptable change in capital allowances is to increase them. Even with the proposed improvements in the investment credit and capital gains taxation, Congress will not have fully corrected the problem that exists, and future revenue acts may have to contain bolder remedies. We urge the Senate to allow Code section 179 to remain available to all businesses.

Although we are not giving separate attention in this statement to the other "small business" provisions of the House bill, we approve of them in principle and feel that the changes proposed for "section 1244" stock would be especially beneficial.

Reduction in the maximum capital gains tax rates; alternative minimum tax (sections 401–403)

Sections 401 through 403 of the bill would eliminate capital gains as an item of tax preference subject to the existing 15 percent minimum tax. As a result, capital gains would no longer reduce the amount of personal service income eligible for the 50 percent maximum tax. To assure that all noncorporate taxpayers pay some tax with respect to their capital gains, the bill would provide an alternative minimum tax on capital gains that would be payable only if it exceeded a taxpayer's regular tax liability.

In addition, the bill would repeal the 25 percent alternative tax on the first $50,000 of a noncorporate taxpayer's net long-term capital gain. As a result of these changes, the maximum capital gains tax rate applicable in the case of noncorporate taxpayers would be 35 percent (i.e., one-half the highest individual tax rate of 70 percent).

The bill also would remove a corporation's net long-term capital gain from the classification as an item of tax preference subject to the 15 percent minimum tax. No change would be made in the present alternative tax for corporate capital gains.

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[1] For an analysis of what is happening, see "Inflation and Profits" by George Terborgh MAPI Memorandum G-70 of January 1974 as revised and republished in April 1978. Also see "Inflation and the Taxation of Capital Gains," by George Terborgh, MAPI, March 1978.

Further as to the House bill's proposed alternative minimum tax for capital gains, it would be applied at a rate of 10 percent of one-half of a noncorporate taxpayer's net capital gains, reduced by a $10,000 exemption, if that amount exceeds the taxpayer's regular tax liability as computed after the application of tax credits. This tax would apply to individuals, estates, and trusts. Subject to certain conditions, the alternative minimum tax base would exclude any capital gains realized on the sale or exchange of an individual's principal residence.

These provisions would be effective for taxable years beginning after December 31, 1978.

MAPI comment.—As set forth in much more detail in our statement of July 5, 1978 to the Senate Finance Subcommittee on Taxation and Debt Management, (1) we do not believe that capital should be taxed; (2) assuming that there nevertheless will be a capital gains tax, we feel that it should be substantially lower than the tax on regular income; (3) any such tax should apply only to "real" gains; (4) any such tax should not be compounded by the minimum tax on tax preferences; (5) any such tax should be deferred in reinvestment situations; and (6) as an alternative to item 5, the tax should be restructured on a sliding scale, with relatively higher rates for shorter holdings and lower rates reducing to zero for longer holdings. For the reasoning behind these recommendations, we refer the Finance Committee to our statement in the record of public hearings of Senator Byrd's Subcommittee.

To the extent that the House bill conforms to our recommendations for capital gains, we concur in the measure. To the extent that the bill does not provide the appropriate solution we have recommended, we urge the Finance Committee to go the extra distance. In our opinion, the taxation of capital has gotten to the point where harm is being done to the economy. There is only one way to go from the precarious position in which Congress has inadvertently placed everyone through oppressive taxation of capital under the "Tax Reform" Acts of 1969 and 1976. That way is a return to the taxation of former days when moderation prevailed and there was at least some potential reward to be had in exchange for taking a risk. We are among those who believe that major tax reductions with respect to capital gains can only be salutary.

As to the change which would eliminate the untaxed half of capital gains from the list of tax preferences that are subject to the minimum tax and reduce personal services income eligible for the maximum tax, we heartily agree. In fact, we would go further and urge the Finance Committee to repeal the minimum tax itself, because it is perhaps the poorest, most misrepresented, and most misunderstood instrument of tax policy ever enacted.[1] If the Senate Finance Committee feels that individuals should pay some amount of tax—which is one of the notions underlying the minimum tax—then the alternative minimum tax approved by the House for the capital gains realized by individuals is the more sensible way to proceed. It will be recalled that the original minimum tax enacted by Congress in 1969 was rather like the proposed alternative minimum tax just passed by the House, but it was allowed to evolve into an add-on levy much different in concept and purpose. We hope the Finance Committee will vote to recast the minimum tax in the alternative form for all preferences, if it must be kept at all.

Regarding the alternative 25 percent rate which may be elected for the first $50,000 of capital gains, we recommend that the Finance Committee keep the provision and not repeal it.

Indexing of basis of certain capital assets (section 404)

Section 404 of the House bill would provide for an inflation adjustment to the basis of certain assets for purposes of determining gain or loss upon sale in a taxable transaction. The inflation adjustment would be based on the Consumer Price Index in the month the asset is purchased compared with the Index for the month of sale. Assets generally eligible for the indexation adjustment would be common stock, tangible personal property, and real property, where these assets are capital assets or assets used in a trade or business for more than one year.

The inflation adjustment would apply only to increases in the Consumer Price Index occurring after 1979, regardless of whether the asset was acquired prior to that time. Extensive rules would be provided with respect to assets eligible for the adjustment, the determination of adjusted basis, the determination of the inflation ratio, and related matters.

[1] For a detailed statement of the case against the minimum tax see "The Minimum Tax on Tax Preferences—The Back-Door Route to Federal Tax Increases," MAPI March 1977.

This provision would apply to sales and other dispositions taking place after December 31, 1979 in taxable years ending after that date.

MAPI comment.—We already have expressed favor for taxing only "real" capital gains, assuming that capital must be taxed at all. That this is essential is borne out by the hypothetical but not unusual case of 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 now, he is faced with a capital gains tax of $2,500, assuming a 25 percent rate for purposes of illustration. Yet the real value of the $20,000 investment is only $11,186.[1] In this situation, the effective rate of tax on the real gain is 210.8 percent. Clearly, the failure of existing capital gains taxation to recognize inflation's effects is punishing to investors, impedes capital formation, and interferes with the fluidity of financial capital.

George Terborgh, MAPI Economic Consultant, has spelled out the effects of the current federal income taxation of nominal rather than real capital gains by using a table that traces the effect of an assumed 25 percent tax on the unadjusted capital gains from 10 different transactions.[2] The Terborgh study points out that the inflation adjustment converts nominal gains into real after-tax losses, and that these losses measure the erosion of *real* capital by the tax. Whether taxes on capital gains are proper or not, according to Terborgh, certainly it is reasonable to ask that any government 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.

Accordingly, we strongly support the House provision, including the decisions to use the Consumer Price Index for All Urban Consumers and to exclude debt from the inflation adjustment altogether. We only wish that this tax reform could be put in place sooner.

Exclusion of gain on sale of residences; rollover of gain on sale of residence (sections 405 and 406)

Section 405 of the House bill would repeal the provisions of present law relating to gain realized on the sale of a principal residence by a taxpayer aged 65 and over. Instead, any individual, regardless of age, could elect to exclude from gross returns) of any gain realized on the sale or exchange of his or her principal residence (including both condominiums and shares of stock in cooperatives). The exclusion would apply only once in a taxpayers' lifetime, and would apply only as to qualifying sales or exchanges of a residence which the taxpayer has owned and occupied as his or her principal residence for periods aggregating two years out of the last three-year period which immediately precedes the sale.

Under section 406 of the House bill, existing law would be changed to provide for the rollover of gain realized on the sale of more than one principal residence where an individual relocates for employment purposes more than once within a period beginning 18 months from the time that his or her first principal residence is sold.

Both of the provisions just described would be effective for sales and exchanges of personal residences after July 26, 1978.

MAPI comment.—The $100,000 exclusion provision was approved by the House in recognition of recent inflation levels and the increasing cost of housing. The liberalized rollover item is intended to remove or lessen the tax burden on employees and self-employed persons who must relocate more than once during any 18-month period. We favor both changes, and urge the Finance Committee to include them in the bill it reports to the full Senate.

* * *

It is a pleasure for MAPI to be able to present its views to this distinguished Committee concerning the House-passed version of H.R. 13511 and actions which the Senate might take in developing an appropriate tax reduction measure of its own.

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[1] Based on the Gross National Product (GNP) Implicit Price Deflator at 141.29 for 1977 and 79.02 for 1967. A similar computation could be made using any appropriate index.

[2] "Inflation and the Taxation of Capital Gains," by George Terborgh, MAPI, March 1978. Also see the MAPI statement of July 5, 1978 to the Senate Finance Subcommittee on Taxation and Debt Management.

33-049 O - 78 - 3

Statement of Daniel K. O'Connell, Chairman, Committee for a Uniform Investment Tax Credit

Mr. Chairman, Members of the Committee, we thank you for the opportunity to testify today and to present the views of the Committee for a Uniform Investment Tax Credit.

The Committee's single purpose is to promote uniform application of the investment tax credit by removing the present unfair and unjustified discrimination against investors in short-lived assets—those assets with useful lives of at least 3 but less than 7 years. This discrimination adversely affects broadly diverse types and sizes of businesses, including the computer industry; automotive and transportation industry; farmers and farm machinery business; construction industry; food processors and beverage bottlers; contract drilling and well servicing; electric utilities; and the communications industry.

Our Committee is a joint undertaking on behalf of diverse businesses enterprises—small, medium, large, unincorporated, and incorporated—who invest in shorter-lived equipment eligible for the Investment Tax Credit and who therefore are adversely affected by this discrimination.

We urge that this discrimination be eliminated by the enactment this year of legislation amending Section 46 (c) (2) of the Internal Revenue Code to reduce from 7 to 3 years the useful life required for entitlement to the full investment tax credit. The amendment we suggest would do this on a phased-in schedule, commencing on a limited basis as to assets placed in service in 1979 and taking full effect as to assets placed in service in 1981.

The legislation we propose fits what we understand to be some of the principal objectives that made guide the shaping of tax legislation to be approved by your Committee for enactment this year: (1) equity, (2) simplification, and (3) economic stimulus to business investment and the creation of new jobs. The change we propose should have a positive effect down the line—from manufacturer, to dealer, to the first commercial user, to secondary and subsequent users, and especially to labor for whom new jobs are created.

Repeal of the present useful life restrictions, and the resulting virtual elimination of recapture, will greatly simplify the administration of ESOPs, and remove one of the important impediments to their wider adoption.

Present Law

Under the present law, a taxpayer investing in qualifying property is entitled to an investment credit to be offset against a portion of its tax liability. At present, the rate of the credit is temporarily set at 10 percent of the amount of the investment. Generally, qualifying property consists of tangible personal property with a useful life of at least 3 years. However, only property with a useful life of at least 7 years is entitled to a full credit. Property with a useful life of 5 or 6 years is entitled to only ⅔'s of the credit, and property with a useful life of 3 or 4 years is entitled to only ⅓ of the credit. Useful lives for this purpose are initially established at the time the property is first placed in service. If there is a disposition of the property before it is held the requisite number of years, complex "recapture rules" come into play requiring a repayment of the Government of all or part of the credit initially allowed. For example, if equipment costing $9,000 with an initial useful life of 7 years were replaced by the first user after being held only 4 years because of technological advancement, $600 of the $900 credit initially allowed would be "recaptured."

Legislative History of Discrimination

A review of the legislative history of the useful life provisions of the investment credit clearly indicates that no sound rationale exists for the present discrimination against shorter-lived assets.

On a number of occasions, leading Administration officials and impartial authorities on the subject have questioned the wisdom of discriminating against investors in shorter-lived assets and recommended removing restrictions against qualifying assets with useful lives of at least 3 years.

During the 1971 Ways and Means Hearings regarding reenactment of the investment credit, the Secretary of the Treasury questioned the soundness of discriminating against short-lived property. However, he stated that, in the interest of quick action, the Administration proposal was tailored as nearly as possible to legislation enacted in prior years. In stating that the Administration may have done things differently if it were starting afresh, he remarked:

"I don't know, for instance, why you don't give any credit on property with a life under 4 years. I could question that, and why you only give a third credit on property with a life from 4 to 6 years, two-thirds on property with a life from 6 to 8 years. You have to buy equipment that has a life of over 8 years before you get the full credit. I think that is subject to debate and question." [1]

In 1974, the Administration, as one of several proposals for restructuring and improving the investment tax credit, recommended to Congress removal of the restriction on assets with lives of at least 3 years. The White House Fact Sheet stated the Administration proposal follows:

"Eliminate the limitation based on useful life so that all property with a life in excess of three years will qualify for the full credit.

In support of this proposal, the Fact Sheet stated:

The restructuring of the credit will eliminate existing restrictions that now limit the incentive value of the credit and that discriminate unfairly between types of taxpayers and investments that qualify for the credit."

Frederic W. Hickman, then Assistant Treasury Secretary for Tax Policy, in remarks delivered on December 9, 1974,[2] criticized the unfairness of discriminating against investors in shorter lived assets and pointed out the disadvantages to business and the economy resulting from the credit's lack of neutrality in that regard.

Emil M. Sunley, Jr., another knowledgeable and disinterested commentator, has criticized the lack of neutrality in the useful life restrictions of the credit.[3]

The late Dr. Laurence Woodworth, then Assistant Secretary of the Treasury for Tax Policy, in his June 15, 1977 statement to the Senate Finance Subcommittee on Taxation and Debt Management Hearings on Capital Formation, specified the proper criteria to apply in choosing among the alternative ways of stimulating investment (of which the investment tax credit is one such alternative) as follows:

"Where possible, incentives for capital formation should be provided in a nondiscriminatory manner. This means that market forces rather than the opportunity for specific tax advantages should determine the particular kinds of investment to be undertaken as well as the particular firms and industries which undertake it. The allocation of investment will be much more efficient when investors respond to market signals which reflect the wishes of consumers for particular goods and services.[4]

RECOMMENDED LEGISLATIVE SOLUTION

The Committee for a Uniform Investment Tax Credit recommends a simple solution to end the discrimination against short-lived assets. It recommends an amendment to section 46 (c) (2) of the Code so that the "applicable percentage" with respect to all qualified property acquired after December 31, 1980 would be 100 percent.

This uniform treatment would be phased in. For assets with useful lives of 3 to 4 years the "applicable percentage" (which is now 33⅓ percent) would be 50 percent for calendar year 1979 and 75 percent for 1980. For assets with useful lives of 5 and 6 years the "applicable percentage" (which is now 66⅔ percent) would be 75 percent for 1979 and 1980.

The effect of this amendment, after the completion of the phase-in period, is to allow a full credit for investment in qualifying assets with a useful life of at least 3 years.[5]

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[1] Statement of John B. Connally, Secretary of the Treasury, Hearings before the Committee on Ways and Means on the Tax Proposals Contained in the President's New Economic Policy, 92d Cong., 1st sess. (1971), p. 111.

[2] Remarks delivered to the Federal Tax Division of the American Institute of Certified Public Accountants meeting in Palm Beach, Florida.

[3] Sunley, "Towards a More Neutral Investment Tax Credit," 26 *National Tax Journal* 209 (1973). Mr. Sunley now is Deputy Assistant Secretary of the Treasury for Tax Analysis.

[4] Statement of Laurence N. Woodworth, Assistant Secretary of the Treasury for Tax Policy, Hearings before the Subcommittee on Taxation and Debt Management of the Committee on Finance on Incentives For Economic Growth, 95th Cong., 1st sess. (1977), p. 353.

[5] A legislative draft of our proposed amendment appears at the end of this statement. Note well: This simple amendment would not remove the requirement that property have a useful life of at least 3 years to qualify for the investment credit, since the minimum 3-year useful life requirement is contained in section 48 (a) (1) of the Code as an essential part of the definition of "Section 38 property."

REASONS FOR CHANGE

The present restriction on the investment credit for shorter-lived assets should be removed because: (1) it operates in a discriminatory manner and is therefore patently unfair; (2) it is a source of unnecessary complexity in the tax law; (3) regardless of one's view of the overall effectiveness of the credit as an economic stimulus, the present useful-life restrictions on the credit, by discouraging replacement and modernization of assets before they are held 7 years, can operate in a manner exactly opposite to the purpose of the credit; and (4) no sound rationale exists for continuing the present discrimination.

1. The present restriction operates in a discriminatory manner

The present system discriminates against users of short-lived assets and is therefore patently unfair. A simple example vividly illustrates this point.

Example. A purchases a $9,000 asset with a useful life and service life of 9 years and is allowed a credit of $900. B buys a $3,000 asset with a useful life and service life of 3 years, and replaces the asset at the end of each 3-year period, so that at the end of 9 years B also has expended $9,000. B is allowed 3 credits of $100 each totaling only $300. A's effective credit is 10 percent, but B's is only 3⅓ percent.

2. The present restriction is a source of unnecessary complexity in the tax law

The mere fact that the present useful life limitation results in three different rates of credit is in itself an unnecessary source of complexity.

Moreover, the "recapture rules" are a necessary corollary to the useful life restrictions of section 46(c)(2) of the Code. The recapture rules serve to greatly increase the complexity of the investment tax credit, in compliance and planning by taxpayers and also in administration of the provision by the Internal Revenue Service. Elimination of the present restriction on useful life would greatly simplify Service administration and taxpayer compliance.

ESOP Encouragement. Removal of the recapture rules with respect to qualified assets held 3 years or more, as a result of our legislative proposal, will greatly simplify the administration of ESOPs and eliminate one of the major impediments to their wider adoption.

Simplification of tax return forms. The simplification in taxpayer compliance and IRS administration of the investment tax credit that would result upon full implementation of the uniform tax credit proposal is illustrated by the attached copy of the investment credit tax return forms with possible revisions.

Four of 8 lines, and 3 of 4 columns, of Item 1 of the Investment Credit Computation Form 3468 would be eliminated. 11 of 13 columns could be eliminated on Recapture Form 4255.[6]

It may be feasible to eliminate Form 4255 entirely by adding one sentence to Form 3468 to read: "If property which you held less than 3 years was disposed of during this taxable year, enter the amount of the investment credit previously claimed and utilized for such property on this line and the appropriate line on your tax return."[7]

3. Regardless of One's View of the Effectiveness of the Credit As An Economic Stimulus, the Present Useful Life Restriction, By Discouraging Replacement and Modernization of Assets Before They Are Held 7 Years, Can Cause the Credit to Operate In A Manner Opposite To Its Purpose.

Most authorities today view the investment credit as an effective economic stimulus. From my own experience in the business of my company, Ryder Systems, Inc., I am a strong believer in its effectiveness. I recognize, however, that there are those who question the effectiveness of the credit as a stimulus. Whatever one's view in this regard may be, we can agree that the credit should not operate as a discentive to timely replacement and modernization of plant and equipment.

The denial of a full investment tax credit for shorter-lived assets can actually discourage the timely replacement and modernization of productive equipment because of the substantial recaptures that will be required upon disposition.

It is a common practice in our economy for equipment with an economic or service life of more than 7 years to be replaced by the first user with more effi-

[6] See Exhibits A and B.
[7] See Exhibits C and D.

cient and productive equipment before the expiration of its full economic life. The replaced equipment then becomes available to secondary users who require it for less demanding service. The time the equipment becomes available to secondary users is often determined under present law by investment credit considerations rather than by the economic and business considerations that ought to govern.

Furthermore, the investment credit should not operate to artificially encourage investment in longer-lived and over shorter-lived assets. Investment selection should be on the basis of efficiency and productivity; and the investment credit law should be neutral in this regard. Short-lived assets comprise some of our nation's most productive and efficient assets, such as computers, office equipment, oil well drilling and service equipment, trucks, farm equipment and tools. In spite of this, present investment tax credit law treats these short-lived assets as stepchildren.

Another unfortunate consequence of the useful life restriction on the credit could be to place similarly situated competitors in unequal competitive positions. The company with the shorter asset replacement policy will arbitrarily receive a lesser investment credit subsidy from the Government. To the extent that the company with the greater credit can pass the increased credit along to its customers in the form of price reduction, the company with the shorter asset replacement policy is placed at a competitive disadvantage, even though it may be a more modern and efficient business enterprise.

REVENUE EFFECT OF RECOMMENDED PHASE-IN OF FULL INVESTMENT CREDIT

Asset placed in service (calendar year)	Percentage of full credit—Useful life of—	
	3 or 4 years	5 or 6 years
Before 1979	[1] 33⅓	66⅔
During 1979	50	75
During 1980	75	75
After 1980	100	100

[1] Existing law.

Revenue effect (cash basis, by Government fiscal year) [1]

[In billions]

1978	0
1979	−$.2
1980	−.7
1981	−1.3
1982	−1.6
1983	−1.7

[1] Prepared by Dr. Gerard M. Brannon, formerly Deputy Assistant Secretary of the Treasury for Tax Analysis.

[2] Assumes (1) 10 percent rate of credit, and (2) all other features of existing law remain unchanged.

LEGISLATIVE DRAFT

At the propert place in the bill, insert the following new subsection:

(1) Uniform Qualified Investment.—Effective with respect to property placed in service after December 31, 1978, section 46(c)(2) (relating to applicable percentage) is amended to read as follows:

"(2) Applicable percentage.—For purposes of paragraph (1), the applicable percentage for any property placed in service by the taxpayer after December 31, 1980, shall be 100 percent and for any property placed in service by the taxpayer during the calendar year 1979 or 1980 shall be determined under the following table:

"If the useful life is—	And the property is placed in service during—	
	Calendar year 1979, then the applicable percentage is—	Calendar year 1980, then the applicable percentage is—
3 years or more but less than 5 years	50	75
5 years or more but less than 7 years	75	75
7 years or more	100	100

"For purposes of this subpart, the useful life of any property shall be the useful life used in computing the allowance for depreciation under section 167 for the taxable year in which the property is placed in service."

CONCLUSION

We submit that no sound rationale exists for discriminating against users of short-lived property. The mere fact that unwarranted discrimination has existed for the past 15 years is no reason to suport its continuation. There are many cogent reasons for eliminating the discrimination, and Congress should act this year to do so.

EXHIBIT A

Form 3468 — Department of the Treasury, Internal Revenue Service

Computation of Investment Credit — 1977

▶ Attach to your tax return.

Name | Identifying number as shown on page 1 of your tax return

1 Use schedule below to list qualified investment in new and used property acquired or constructed and placed in service during the taxable year; and also list qualified progress expenditures made during the 1977 taxable year and qualified progress expenditures made in 1974, 1975, and 1976 taxable years providing a proper election as prescribed in section 46(d)(6) was made for such prior years. If progress expenditure property is placed in service during the taxable year, do not list qualified progress expenditures for this property. See instruction for line 1.

If 100% investment credit is being claimed on certain ships, check this block. ▶ ☐ See instruction K for details.

Note: *Include your share of investment in property made by a partnership, estate, trust, small business corporation, or lessor.*

Type of property		Line	(1) Life years	(2) Cost or basis (See instruction G)	(3) Applicable percentage	(4) Cost or basis Qualified investment (Column 2 x column 3)
New property		(a)	3 or more but less than 5		33⅓	
		(b)	5 or more but less than 7		66⅔	
		(c)	7 or more		100	
Qualified progress expenditures	1974, 1975 and 1976	(d) (b)	7 or more		20	
	1977	(e) (c)	7 or more		60	
Used property (See instructions for dollar limitation)		(f) (d)	3 or more but less than 5		33⅓	
		(g)	5 or more but less than 7		66⅔	
		(h)	7 or more		100	

2 Qualified investment—add lines 1(a) through (h) (d)
3 10% of line 2
4 7% (4% for public utility property) of certain property (see instruction for line 1)
5 Corporations electing the additional investment credit for contributions to Employee Stock Ownership Plans—Attach election statement. (See Instruction I and instruction for line 5.)
(a) Additional 1% credit—Enter 1% of line 2
(b) Additional credit not to exceed .5%—Enter allowable percentage times adjusted line 2 (attach schedule)
6 Carryback and carryover of unused credit(s). See instruction F—attach computation
7 Tentative investment credit—Add lines 3 through 6

Limitation

8 (a) Individuals—Enter amount from line 37, page 2, Form 1040
(b) Estates and trusts—Enter amount from line 26 or 27, page 1, Form 1041
(c) Corporations—Enter amount from line 9, Schedule J, page 3, Form 1120
9 (a) Credit for the elderly (individuals only)
(b) Foreign tax credit
(c) Tax on lump-sum distributions (see instruction for line 9(c))
(d) Possession Tax Credit (corporations only)
(e) Section 72(m)(5) penalty tax
10 Total—Add lines 9(a) through (e)
11 Line 8 less line 10
12 (a) Enter amount on line 11 or $25,000, whichever is lesser. (Married persons filing separately, controlled corporate groups, estates, and trusts, see instruction for line 12.)
(b) If line 11 exceeds line 12(a), enter 50% of the excess. (Public utilities, railroads, and airlines, see instruction J.)
13 Total—Add lines 12(a) and (b)
14 Investment credit—Amount from line 7 or line 13, whichever is lesser. Enter here and on line 41, Form 1040; line 10(b), Schedule J, page 3, Form 1120; or the appropriate line on other returns

Schedule A If any part of your investment in line 1 or 4 above was made by a partnership, estate, trust, small business corporation, or lessor, complete the following statement and identify property qualifying for the 7% or 10% investment credit.

Name (Partnership, estate, trust, etc.)	Address	Property: Progress expenditures	Property: New	Property: Used	Property: Life years
		$	$	$	

If property is disposed of prior to the life years used in computing the investment credit, see Instruction E.

Form 3468 (1977)

Form **4255** (Rev. Oct. 1977) Department of the Treasury Internal Revenue Service

Tax from Recomputing a Prior Year Investment Credit

(Computation of Recapture Tax)

▶ Attach to your income tax return.

For the calendar year 19 ...., or other taxable year beginning ...., 19 ...., and ending ...., 19 ....

Name | Identifying number as shown on page 1 of your tax return

Do not use this form if (1) there is an unused investment credit attributable to the disposed asset or (2) the disposed asset is progress expenditure property. (See example (c) and instructions for line 2, column 13 on the back.) Compute the recapture tax for these items on separate schedules.

1. Original Investment Credit							Recomputed Investment Credit					Recapture Tax
(1) Description of property (also state whether new or used)	(2) Date placed in service	(3) Cost or basis	(4) Estimated useful life	(5) Applicable percentage	(6) Qualified investment (column 3 x column 5)	(7) Original investment credit (column 6 x applicable rate)	(8) Date item ceased to be investment credit property	(9) Actual useful life	(10) Applicable percentage	(11) Qualified investment (column 3 x column 10)	(12) Recomputed investment credit (column 11 x applicable rate)	(13) (1) Unearned original investment credit
(A)												
(B)												
(C)												
(D)												
(E)												
(F)												
(G)												
(H)												

2. Total tax from recomputing a prior year investment credit—add lines (A) through (H), column (13), and, if applicable, combine this total tax (line 2) with any other recapture tax that has been computed on separate schedule(s). Enter this total on the line provided on your tax return 2

Note: The recapture tax is an addition to your income tax for the year in which you dispose of investment credit property. Do not use the recapture tax to offset the current year's investment credit on Form 3468.

EXHIBIT B

EXHIBIT C

Form 3468 Department of the Treasury Internal Revenue Service	Computation of Investment Credit ▶ Attach to your tax return.	1977

Name	Identifying number as shown on page 1 of your tax return

1 Use schedule below to list qualified investment in new and used property acquired or constructed and placed in service during the taxable year; and also list qualified progress expenditures made during the 1977 taxable year and qualified progress expenditures made in 1974, 1975, and 1976 taxable years providing a proper election as prescribed in section 46(d)(6) was made for such prior years. If progress expenditure property is placed in service during the taxable year, do not list qualified progress expenditures for this property. See instruction for line 1.
If 100% investment credit is being claimed on certain ships, check this block. ▶ ☐ See Instruction K for details.

Note: *Include your share of investment in property made by a partnership, estate, trust, small business corporation, or lessor.*

Type of property		Line	(1) Life years	(2) Cost or basis (See Instruction G)	(3) Applicable percentage	(4) Qualified investment (Column 2 x column 3) Cost or Basis
New property		(a)	3 or more but less than 5		33⅓	
		~~(b)~~	~~5 or more but less than 7~~		~~66⅔~~	
		~~(c)~~	~~7 or more~~		~~100~~	
Qualified progress expenditures	1974, 1975 and 1976	~~(d)~~ (b)	7 or more		20	
	1977	~~(e)~~ (c)	7 or more		60	
Used property (See instructions for dollar limitation)		~~(f)~~ (d)	3 or more but less than 5		33⅓	
		~~(g)~~	~~5 or more but less than 7~~		~~66⅔~~	
		~~(h)~~	~~7 or more~~		~~100~~	

2 Qualified investment—add lines 1(a) through ~~(h)~~ (d) . . . .
3 10% of line 2 . . . .
4 7% (4% for public utility property) of certain property (see instruction for line 1) . . . .
5 Corporations electing the additional investment credit for contributions to Employee Stock Ownership Plans—Attach election statement. (See Instruction I and instruction for line 5.)
(a) Additional 1% credit—Enter 1% of line 2 . . . .
(b) Additional credit not to exceed .5%—Enter allowable percentage times adjusted line 2 (attach schedule) . . . .
6 Carryback and carryover of unused credit(s). See Instruction F—attach computation . . . .
7 Tentative investment credit—Add lines 3 through 6 . . . .

Limitation

8 (a) Individuals—Enter amount from line 37, page 2, Form 1040 . . . . }
(b) Estates and trusts—Enter amount from line 26 or 27, page 1, Form 1041. . . . . . }
(c) Corporations—Enter amount from line 9, Schedule J, page 3, Form 1120 . . . . . }
9 (a) Credit for the elderly (individuals only) . . . .
(b) Foreign tax credit . . . .
(c) Tax on lump-sum distributions (see instruction for line 9(c)) . . . . . .
(d) Possession Tax Credit (corporations only) . . . .
(e) Section 72(m)(5) penalty tax . . . .
10 Total—Add lines 9(a) through (e) . . . .
11 Line 8 less line 10 . . . .
12 (a) Enter amount on line 11 or $25,000, whichever is lesser. (Married persons filing separately, controlled corporate groups, estates, and trusts, see instruction for line 12.) . . . .
(b) If line 11 exceeds line 12(a), enter 50% of the excess. (Public utilities, railroads, and airlines, see Instruction J.) . . . .
13 Total—Add lines 12(a) and (b) . . . .
14 Investment credit—Amount from line 7 or line 13, whichever is lesser. Enter here and on line 41, Form 1040; line 10(b), Schedule J, page 3, Form 1120; or the appropriate line on other returns . . . . .

Schedule A If any part of your investment in line 1 or 4 above was made by a partnership, estate, trust, small business corporation, or lessor, complete the following statement and identify property qualifying for the 7% or 10% investment credit.

Name (Partnership, estate, trust, etc.)	Address	Property: Progress expenditures	Property: New	Property: Used	Life years
		$	$	$	

~~If property is disposed of prior to the life years used in computing the investment credit, see Instruction E.~~ Form 3468 (1977)

15. If property which you held less than 3 years was disposed of during this taxable year, enter the amount of investment credit previously claimed and utilized for such propert on this line and the appropriate line on your tax return.

EXHIBIT D

Form 4255 (Rev. Oct. 1977)
Department of the Treasury
Internal Revenue Service

Tax from Recomputing a Prior Year Investment Credit

(Computation of Recapture Tax)

▶ Attach to your income tax return.

For the calendar year 19 ...., or other taxable year beginning .... 19 ...., and ending .... 19 ....

Name | Identifying number as shown on page 1 of your tax return

Do not use this form if (1) there is an unused investment credit attributable to the disposed asset or (2) the disposed asset is progress expenditure property. (See example (c) and instructions for line 2, column 13 on the back.) Compute the recapture tax for these items on separate schedules.

1.	Original Investment Credit						Recomputed Investment Credit					Recapture Tax
(1) Description of property (also state whether new or used)	(2) Date placed in service	(3) Cost or basis	(4) Estimated useful life	(5) Applicable percentage	(6) Qualified investment (column 3 x column 5)	(7) Original investment credit (column 6 x applicable rate)	(8) Date item ceased to be investment credit property	(9) Actual useful life	(10) Applicable percentage	(11) Qualified investment (column 3 x column 10)	(12) Recomputed investment credit (column 11 x applicable rate)	(13) Column 7 less column 12
(A)												
(B)												
(C)												
(D)												
(E)												
(F)												
(G)												

2. Total tax from recomputing a prior year investment credit—add lines (A) through (G), column (13), and, if applicable, combine this total tax (line 2) with any other recapture tax that has been computed on separate schedule(s). Enter this total on the line provided on your tax return . . . . .

Note: The recapture tax is an addition to your income tax for the year in which you dispose of investment credit property. Do not use the recapture tax to offset the current year's investment credit on Form 3468.

STATEMENT AND SUMMARY OF DONALD P. KELLY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, ESMARK, INC., ON BEHALF OF THE AD HOC COMMITTEE FOR AN EFFECTIVE INVESTMENT TAX CREDIT

The Ad Hoc Committee for an Effective Investment Tax Credit is a voluntary group of 366 business firms and 51 supporting business associations. It is representative of virtually all segments of industry including manufacturing, retail, minerals, transportation and utilities. The objective of the Committee is to improve the capital recovery provisions of the Internal Revenue Code with particular emphasis on the investment tax credit and capital recovery allowances.

RECOMMENDATIONS

The Ad Hoc Committee supports the business tax proposals of H.R. 13511, the Revenue Act of 1978, which would reduce the corporate rate, make the investment credit permanent, expand the credit by making it applicable to rehabilitated industrial or other productive buildings, permit taxpayers to utilize the credit against 90 percent of tax liability in lieu of the present 50 percent, and allow the full credit along with five-year amortization for pollution control equipment.

However, the Committee feels that these measures are not sufficient to meet the desired economic goals of expanded productivity, full employment, and an increased standard of living. Therefore, it is urged that the following measures be enacted by Congress:

1. Investment credit

The investment credit rate should be expanded to 12 percent on a permanent basis with a permanent two percent additional credit where contributions are made to ESOPs. The credit should apply to expenses incurred for the construction of new industrial, office and other business buildings as well as those incurred in the rehabilitation of existing buildings. The increase from 50 percent to 90 percent of tax liability against which the credit may be used should be adopted immediately. The present rule permitting full credit to be utilized against $25,000 of tax liability should be retained and expanded to $150,000, primarily to benefit small businesses. Finally, the required life for full credit should be reduced from seven to three years and the maximum amount of qualifying used equipment should be increased from $100,000 to $200,000.

2. Capital recovery allowances

As an immediate measure to offset inflation and provide a reasonable capital recovery allowance system, the ADR variance should be increased from 20 percent to 40 percent. In addition, the ADR system should be simplified. Finally, over the long run a simplified capital recovery system depreciating equipment over five years and buildings over ten years is a desirable goal for our tax system.

3. Pollution control equipment

In order to offset the drain of capital from investments in productive facilities to socially desirable nonproductive pollution control facilities, a special 20 percent credit should be adopted for investments in pollution control facilities. Other technical changes should also be made in both the House version of H.R. 13511 and the basic legislation to make the credit a more meaningful incentive.

JUSTIFICATIONS

Economic studies have demonstrated that the most effective mechanism for increasing business investment is the investment credit followed closely by liberalized capital recovery allowances. Other tax measures such as a reduction in the corporate income tax are significantly less efficient. Due to the lag in business capital investment over recent years, it is essential, if our short and long-term economic goals are to be met, that sufficient incentives be provided to expand business investment. Expanded business investment will create new jobs; increase productivity and therefore alleviate inflation; allow for a higher standard of living; improve trade balances; and as a result of a healthy, expanding economy, increase Federal revenues.

SUMMARY

The Ad Hoc Committee for an Effective Investment Tax Credit is a voluntary group of 366 business firms and 51 supporting business associations. A list of the member companies and supporting associations is attached (see Appendix A).

The membership of the Ad Hoc Committee share the belief that the continued growth of our economy requires immediate economic stimulus. In addition, they believe that the central economic concern facing this country presently and in the years ahead is the formation of sufficient capital to meet the unprecedented projected requirements for job-producing investments in American business and industry.

I. ECONOMIC PROSPECTS

Many aspects of our current economic recovery are disappointing. Without significant new action, full recovery will continue to be a slow process. Employment rates are still lagging, production and business investment have only recently surpassed pre-recession levels. Our real economic growth in labor productivity is disappointing. Total savings are grossly insufficient to meet projected capital investment needs over the next decade. And in many of these categories we are lagging behind the other major industrial nations of the world.

Recent events underscore the precarious position of the economic recovery. The latest Department of Labor productivity estimates show a gain of only 0.1 percent in the second quarter of 1978 following a disastrous decline of 4.6 percent in the first quarter. Manufacturing productivity, according to those estimates, also gained in the second quarter after consecutive declines in the two previous quarters. Similiarly, the dramatic decline of the dollar over the past year clearly demonstrates the loss of faith throughout the world in the U.S. economy and its ability to compete in world markets. Of course, the decline in dollar values promises to add significantly to inflation rates and further exacerbate our economic difficulties.

A. The Revenue Act of 1978 (H.R. 13511)

The Ad Hoc Committee is pleased that the House version of the Revenue Act of 1978 (H.R. 13511) includes tax incentives for job-creating business investments. The recognition of the need to strengthen and maintain the current economic expansion and insure the productivity of the economy is essential to the nation's future economic advancement.

In particular, the inadequacy of growth in the stock of production capital must be addressed. Over the short and long run the proportion of the GNP devoted to business investment must be increased. The problem was summarized in the Treasury Department's Detailed Descriptions and Supporting Analyses of President Carter's 1978 Tax Program:

The tax cut is also designed to stimulate business investment. In recent years, the growth in the stock of productive capital in the United States has been inadequate. During the current recovery, the level of business investment has been particularly sluggish. Real business investment during the fourth quarter of 1977 was three percent below its previous peak (during the first quarter of 1974). This weakness was particularly noticeable in investment in non-residential structures which, during the fourth quarter of 1977 (corrected for inflation), remained 14 percent below its peak during the third quarter of 1973.

The sluggishness of business investment could become a major long-run problem. For the longer term, an increasing portion of GNP must be devoted to investment in order to facilitate the introduction of new technology and to expand and modernize the nation's stock of capital, thereby raising the overall productivity of the economy and reducing inflationary pressures. Additional capital is needed to equip a growing labor force, to meet the goals of the National Energy Plan, and to provide a cleaner environment and safer workplaces. In addition, the real income of workers can grow over the long run only if labor productivity is enhanced. Increased capital formation, which provides new and more efficient productive facilities, can help accelerate the growth of labor productivity, offsetting inflationary pressures and improving U.S. competitiveness in world markets.

B. Independent analysis

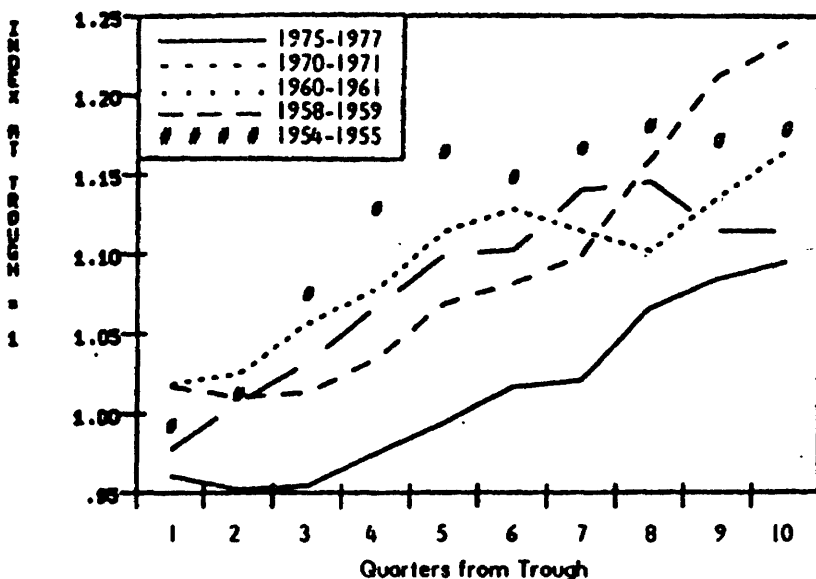
Independent analysis by Dr. Allen Sinai and Data Resources, Inc. substantiates these concerns. Dr. Sinai's statement before the Ad Hoc Committee for an

Effective Investment Tax Credit on January 12, 1978, summarized the problem as follows:

Business Fixed Investment, Capital Formation, and the U.S. Economy

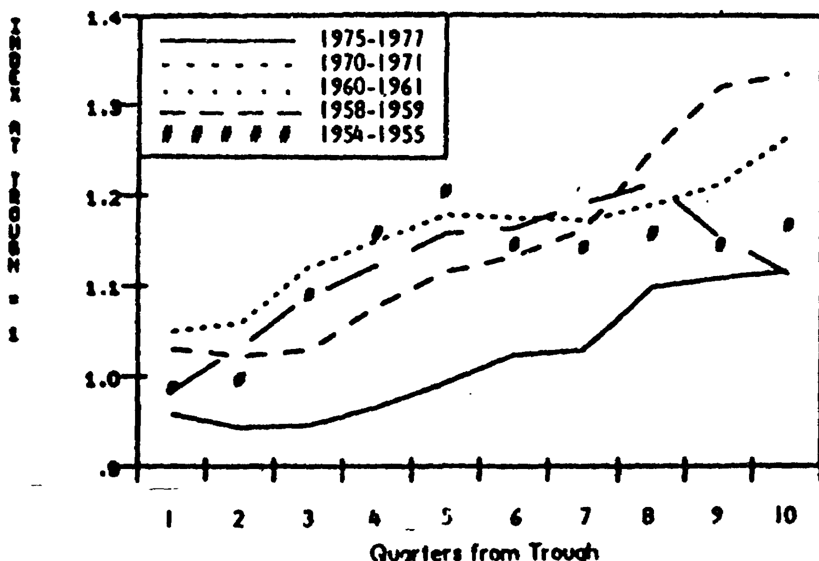
The current economic expansion had entered its 33rd month, a ripe chronological age for a business upswing. However, the recovery has been unusual in that the impetus for growth has rested primarily on a long series of gains in consumer spending, a strong housing boom, periodic bursts of government expenditures, especially at the state and local level, and only occasional periods of strength in the accumulation of business inventories. There has been an inordinately sustained weakness in business fixed investment and the record trade deficit has provided a drag on economic growth. Chart 1 indicates that the typical recovery pattern is characterized by a surge in business spending much earlier. Charts 2 and 3 indicate that the lagging performance has occurred in both the equipment and plant components of business spending, with the difference more pronounced in the case of real producers' durable equipment.

Thus, a key to sustaining the current business expansion will be business capital formation. Recent concern with the pace of capital formation has primarily been focused on the business sector. One line of reasoning has the capital needs of the U.S. economy so great that adequate financing will not be forthcoming in the next decade. As a corollary, business fixed investment would be insufficient to create the necessary productive capacity for preventing a recurrence of the shortages that characterized the economy in 1973 and 1974. Labor productivity and growth in potential output also would be limited. Another serious round of accelerating inflation would result, then a deep recession as policymakers once again applied restrictive measures in order to contain the inflation.



Source: Allen Sinai, "Business Taxation and Capital Formation," remarks presented before the Ad Hoc Committee for an Effective Investment Tax Credit, Washington, D.C., January 12, 1978.

CHART 2. Real Producers' Durable Equipment in Recovery



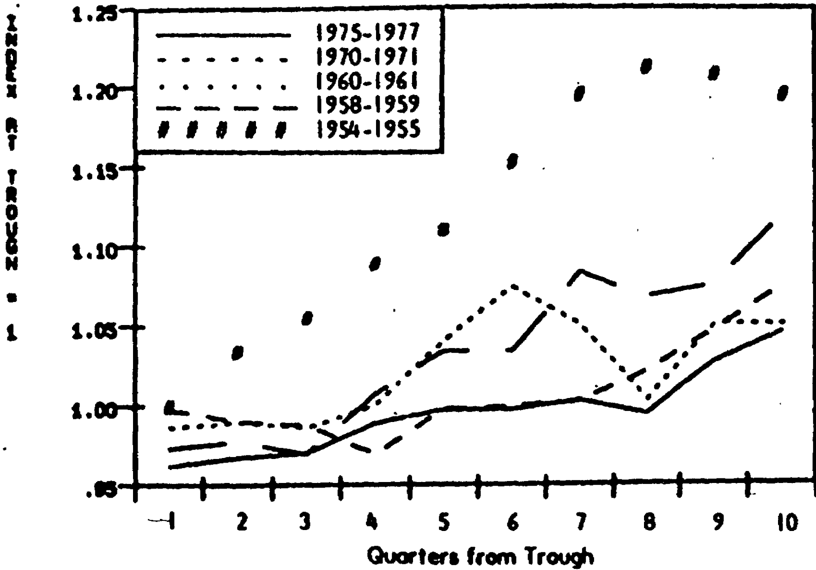
Source: Allen Sinai, "Business Taxation and Capital Formation," remarks presented before the Ad Hoc Committee for an Effective Investment Tax Credit, Washington, D.C., January 12, 1978.

Indeed, as Table 1 and Charts 1–3 show, the rate of business capital formation has been quite weak since the recession trough in March 1975. The ratio of business fixed investment to GNP less pollution outlays was 9.3 percent in 1975, only 9.1 percent in 1976, and 9.4 percent last year. These figures compare with averages of 9.4 percent during 1955 to 1964 and 10.1 percent in 1965 to 1974. The only other years when the proportion of business fixed investment to GNP has been as low or lower than the current figure were 1930 to 1946, 1952 to 1954, and 1958 to 1964. Furthermore, the upswing in real business fixed investment since the trough of the recession in 1975 is the weakest in the postwar period.

Several factors account for the recent poor record of capital formation by business. First, the 1973–75 recession was the most severe of the postwar period. Aggregate demand dropped sharply late in 1974, providing a sudden shock to business' sanguine expectations of future final sales. In addition, this episode, in contrast to others, was characterized by extraordinarily high interest rates, greatly diminished cash flow, and badly deteriorated balance sheets. Corporate leverage moved dangerously high, debt burdens became overwhelming, the average maturity of outstanding debt shortened considerably, and the ratio of financial assets to short-term liabilities reached a record low. Serious threats of bankruptcy and default arose for many corporations. Debt or equity finance became near impossible to obtain at any cost. Under these conditions, business spending had to be severely cut back and is still suffering from the debt of this last recession.

Second, the expansion has been only moderate in its pace in contrasts to periods of more boom-like conditions in other years of strong business fixed investment. There is considerable slack in the labor market and capacity utilization rates have only slowly recovered, so that much excess capacity remains to be eliminated in relation to the same stage in other expansions. Without the pressure of increased final sales relative to utilization, probably the most important deter-

CHART 3. Real Plant Expenditures in Recovery



Source: Allen Sinai, "Business Taxation and Capital Formation," remarks presented before the Ad Hoc Committee for an Effective Investment Tax Credit, Washington, D.C., January 12, 1978.

minant of capital spending, business has had little incentive to invest. Further, fears of continued instability in the economy, similar to the ups and downs of 1965 to 1975, have kept businessmen cautious about commitments to heavy doses of capital outlays.

Third, the ratio of product price to the effective cost of capital, a measure of profitability, has steadily dropped, primarily from the high inflation of capital goods prices. The rising costs of capital equipment have hurt the purchasing power of business, already down because of historical cost depreciation expensing and outmoded methods of inventory valuation. High interest rates and low stock prices have helped keep the margin between product prices and the cost of capital low, diminishing the expected profitability of investment.

Fourth, the weakness in business additions to capacity is even more of a problem because so much spending has been directed into "non-productive" channels. As Table 1 shows, the 1977 average 9.4 percent ratio of investment to GNP less polution outlays is equivalent to only a 9 perent ratio when pollution and abatement equipment expenditures are considered.

Finally, an unprecedented concern with restructuring balance sheets and strengthening liquidity has prevented business capital outlays from sharply rebounding. With the resurgence of cash flow relative to capital outlays in 1975 and 1976, business increased financial assets relative to liabilities, retired a record amount of short-term debt, restructured debt maturities to a longer term, sharply reduced the burden of debt service, and lowered debt-equity ratios for the first time in many years. Much lower inflation and a relatively easy monetary policy helped by reducing interest rates and easing the external risk to balance sheets. The return to this process of corporate "reliquification" in terms of reduced risk, higher credit ratings, reduction of prior claims on income, returns on financial assets, and accumulation of the liquidity to finance future outlays, far exceeded the expected rate of return on the acquisition of physical assets. Recently, corporations have begun to spend more heavily, but balance sheet constraints still loom heavily in their calculations.

TABLE 1.—BUSINESS FIXED INVESTMENT RELATIVE TO GNP (PERCENT)—HISTORICAL PROFILE AND FORECAST TO 1990[1]

	Business fixed investment/GNP	Business fixed investment/GNP less pollution outlays/GNP	Business fixed investment/GNP (constant dollars)
1953	9.4	9.4	9.0
1954	9.3	9.3	9.4
1955	9.6	9.6	9.8
1956	10.4	10.4	9.7
1957	10.5	10.5	9.7
1958	9.3	9.3	9.7
1959	9.3	9.3	9.0
1960	9.4	9.4	9.7
1961	9.0	9.0	9.9
1962	9.1	9.1	9.8
1963	9.0	9.0	9.3
1964	9.4	9.4	9.3
1965	10.4	10.4	10.0
1966	10.8	10.8	10.3
1967	10.3	10.2	10.3
1968	10.3	10.2	10.6
1969	10.6	10.4	10.2
1970	10.2	10.0	10.7
1971	9.8	9.5	9.0
1972	10.0	9.6	10.6
1973	10.4	10.0	10.4
1975	9.8	9.3	9.2
1976	9.5	9.1	9.2
1977	9.8	9.4	9.5
1978	9.9	9.4	9.6
1979	10.1	9.7	9.8
1980	10.4	9.9	10.1
1981	10.6	10.1	10.3
1982	10.7	10.2	10.3
1983	10.8	10.4	10.4
1984	11.1	10.6	10.6
1985	11.2	10.8	10.7
1986	11.4	11.0	10.9
1987	11.7	11.2	11.1
1988	11.6	11.2	11.0
1989	11.7	11.2	11.0
1990	11.8	11.3	11.

[1] Forecast by Data Resources, Inc.

Sources: Department of Commerce, Bureau of Economic Analysis, Data Resources, Inc. Allen Sinai, "Business Taxation and Capital Formation," remarks presented before the Ad Hoc Committee for an Effective Investment Tax Credit, Washington, D.C., Jan. 12, 1978.

The current weakness in business fixed investment is not without precedent, however. As noted, similar patterns appeared during the 1930's early 1950's, and in 1958 to 1964. In particular, the 1958 to 1964 experience was characterized by an approach to full employment without any decided rise in the ratio of business fixed investment to GNP. Thus, full employment has not necessarily been precluded in the past because of weakness in business plant and equipment spending. In each case, however, the process of getting to full employment took many years, and in this sense it can be argued that capital formation was inadequate.

Despite some recent improvement in the performance of the key spending aggregates, the sluggish rebound in business fixed investment has become a primary concern of policymakers. Expenditures on plant and equipment lead to the formation of business capital and are critical to economic expansion for the following reasons:

1. business spending for plant equipment is a source of aggregate demand, helping to speed the pace of expansion and providing a source of added employment to the economy;

2. the pace of business fixed investment also is important to the supply side the economy, a source of considerable inflationary pressures during 1973 and 1974. Capital formation increases the productive capacity of the economy and eases the inflationary pressures that stem from the pressure of demands against supplies;

3. capital formation improves the productivity of labor, helping to keep wage inflation down. This mitigates against price inflation since markups over wage costs are common.

Thus, concern for sustaining the momentum of the expansion, increasing productive capacity to fight both price and wage inflation, and a desire to improve the productivity of labor, has led to a general consensus that a more rapid pace of business fixed investment would be desirable.

C. Productivity and other economic indicators

Appended to this statement is a detailed review of the various factors which weigh heavily in favor of permanent economic stimulus to put and keep the United States on a par with other industrialized nations of the world (See Appendix B). Such factors as productivity trends, real growth, real income, capital requirements, business earnings, job creation, and savings and investment rates are inexorably related to the capital recovery systems in effect in various countries.

While most industrial nations have suffered greatly as a result of the economic slump of the past several years, there are ominous signs that—in the absence of substantive changes in the U.S. capital recovery system—there may result long-range dislocations in the U.S. economy which would bring about a realignment of international roles. This need not be the case. If the U.S. is relegated to a lesser status in the world economy it will be because we have failed to recognize in our tax laws the need for proper balance between capital investment and consumption.

In reviewing some of the specific indicators which argue forcefully for more realistic capital recovery provisions, it is appropriate that we look at those by which we can measure U.S. economic performance against that of other industrialized nations—Canada, France, West Germany, Japan, Italy and the United Kingdom.

The United States has fallen dramatically behind these trading partners in many respects, the most important being manufacturing productivity. During one year of the recent recession, we experienced the first known decline in productivity in the history of the country—and certainly the first since records of economic indexes have been maintained. Although manufacturing productivity increased in the most recent quarter, it did so after two consecutive quarters of productivity decline. In this respect, the U.S. lags behind all of those countries mentioned, and very far behind most of them.

Capital formation is the major factor in productivity changes. A high rate of capital formation increases employment and productivity and permits higher real wages and an increased standard of living without excessive inflation. An inadequate rate of capital formation will make such national goals unattainable. In the past the U.S. has had the highest capital-to-labor ratio in the world, but the gap has narrowed over the past two decades as the U.S. rate of investment per worker has declined. If our economy is to perform at the level required to provide sufficient capital for jobs, for environmental protection, for energy independence, for government programs of security for the elderly and the disabled, for needed housing, for national defense, and for adequate research and development, these trends must be reversed.

How are sufficient savings to be generated to make increased investment possible? Historic levels of national savings would not be adequate to meet projected needs to the year 1985 and beyond. Clearly, extraordinary measures must be undertaken to make these essential investments possible. Virtually everyone agrees that corporate earnings must be a substantial source for reinvestments, but corporate profits have stagnated over the last decade, and capital recovery provisions have failed to keep pace with replacement costs of depreciated equipment and plant. In fact, the U.S. capital recovery system ranks at or near the bottom among the major industrialized nations. Many of these nations are continuing to liberalize their systems, making the gap even wider.

There is no question that liberalized depreciation provisions and the investment credit have been effective in the past in increasing employment and productivity, enhancing real growth, and improving federal revenues.

In each instance following adoption of the investment credit or changes in its incentive effects, new capital goods orders were correspondingly affected for good or bad. So were employment statistics and federal revenues. In spite of this demonstrated record of the value of capital recovery improvements to the overall economy, there are still those who believe that the benefits accrue only to the taxpayer.

We sincerely hope that, through the cooperative efforts of the Administration and the Congress, this negative impression of the role of capital recovery in our

economy can be reversed, and that we can get on with doing those things that are beneficial to the entire national economy.

D. Summary

Without stimulus to business investment, it is highly unlikely that we will be able to further reduce unemployment, create sufficient new jobs for the future, and advance our economy at a satisfactory real growth rate. Dr. Sinai concluded that "without changes in monetary or fiscal policy to stimulate business investment, Data Resources, Inc. studies indicate the economy will reach a point of near recession by late 1978 or early 1979."

II. H.R. 13511

A. House proposals regarding the tax treatment of business

In order to stimulate capital formation in the near future and over the long term, various business tax provisions are contained in the House version of H.R. 13511. Particular emphasis is placed on increasing the after-tax rate of return on business investment which has been on the downward trend since the mid-1960's. The Ad Hoc Committee applauds the recognition of these problems by Congress and the Administration and is greatly encouraged by their initiative for the enactment of tax changes stimulating business investment. The House bill contains the following provisions which are of particular interest to the Ad Hoc Committee for an Effective Investment Tax Credit:

(1) A graduated corporate tax rate structure would be implemented, with the top corporate tax rates reduced from 48 percent to 46 percent after December 31, 1978 and the lowest rate reduced from 20 to 17 percent.

(2) A permanent 10 percent investment credit applicable to the rehabilitation of industrial and other business buildings. Further, in lieu of the present rule permitting the credit to offset 50 percent of tax liability, this offset would be increased in four steps of 10 percent per year to 90 percent by 1982.

(3) The full 10 percent investment tax credit would be available in the case of pollution control equipment in addition to 5-year amortization, except to the extent that equipment is financed by industrial development bonds. In the latter case, such equipment would be eligible for the current 5 percent credit.

(4) Small business tax proposals liberalizing Subchapter S, depreciation and the use of small business stock.

B. Ad hoc committee comments

The House bill provides a good program in that it combines various types of business incentives. The reduction in corporate tax rates increases the after-tax return on investments and frees corporate funds which may be utilized for investment. The investment credit changes should stimulate new investment particularly in renovation of existing industrial structures. The small business proposals will assist that segment of the business community.

However, the Ad Hoc Committee is concerned that the proposal does not provide adequate incentive for business investment. The bulk of the incentive is in the rate reduction which frees funds for any number of uses but not necessarily investment in expansion of plant and equipment. On the other hand, the investment tax credit and depreciation allowances are tied directly to business investment. These incentives are not applicable unles the business invests in plant and equipment.

Simply stated, the major impact of the corporate tax reduction is a generalized increase in cash flow which results in additional expenditures reducing liabilities and for physical assets and labor. Initially liquidity increases followed later on by acquisition of capital goods. However, as capital outlays increase, liquidity decreases and the business turns to external financing.

Increased investment credit and liberalized depreciation allowances decrease the cost of plant and equipment thereby increasing after-tax returns and making capital expenditures more attractive. This results in a triple-barreled impact: (1) increased profitability of spending on capital goods; (2) a lower price of capital relative to labor; and (3) increased liquidity with positive income effects on assets and negative effects on liabilities.

Data Resources, Inc. used its economic model to examine the various approaches to capital formation and concluded that the most effective and cost efficient means of stimulating business investment is through increased investment credit followed closely by liberalized depreciation with decreased tax rates lagging behind.

In order to compare various combinations of business incentives, Data Resources, Inc. estimated the effects on plant and equipment outlays of the original Carter tax proposal and then substituted first a 12 percent investment tax credit and second a 10 percent reduction in depreciable lives, without changing the overall revenue figure for business tax reduction. The following charts contain the results for the years 1979 and 1980.

TABLE 2.—EFFECTS OF CARTER TAX POLICY ON BUSINESS CAPITAL FORMATION, INFLATION, UNEMPLOYMENT, AND INTEREST RATES (DIFFERENCES FROM BASELINE SOLUTION)

	79:1	79:2	79:3	79:4	80:1	80:2	80:3	80:4
Business capital outlays (billions of 1972 dollars)	0.6	1.3	2.1	2.9	3.6	4.4	5.2	5.9
Plant	.4	.8	1.1	1.5	1.8	2.1	2.4	2.6
Equipment	.2	.6	1.0	1.4	1.9	2.4	2.8	3.3
Business fixed investment as percent of real GNP		.1	.1	.2	.2	.2	.3	.3
Inflation—GNP deflator (percent)			.1	.1	.1	.2	.2	.2
Unemployment rate (percent)		−.1	−.1	−.1	−.2	−.2	−.3	−.3
Prime rate (percent)	−.15	−.20	−.25	−.26	−2.7	−.25	−.23	−.20
90-day Treasury bill rate (percent)	−.30	−.07	−.08	−.08	−.06	−.05	−.02	.01
New issue corporate bond rate (percent)	.01	.01	.03	.04	.06	.08	.11	.14
Gain in real business fixed investment per dollar loss in tax revenue	.08	.19	.32	.45	.48	.60	.71	.80
	1979				1980			
Annual gain per dollar revenue loss	0.26				0.65			

Source: Allen Sinai, "Business Taxation and Capital Formation," remarks presented before the Ad Hoc Committee for an Effective Investment Tax Credit, Washington, D.C., Jan. 12, 1978.

TABLE 3.—EFFECTS OF MORE INVESTMENT TAX CREDITS ON BUSINESS CAPITAL FORMATION, INFLATION, UNEMPLOYMENT, AND INTEREST RATES (DIFFERENCES FROM BASELINE SOLUTION)

	79:1	79:2	79:3	79:4	80:1	80:2	80:3	80:4
Business capital outlays (billions of 1972 dollars)	0.8	1.9	3.2	4.7	6.1	7.6	8.9	10.1
Plant	.4	.8	1.2	1.5	1.9	2.2	2.5	2.8
Equipment	.4	1.1	2.0	3.2	4.3	5.4	6.4	7.3
Business fixed investment as percent of real GNP		.1	.2	.3	.3	.4	.5	.5
Inflation—GNP deflator (percent)			.1	.1	.2	.2	.3	.3
Unemployment rate (percent)		−.1	−.1	−.2	−.2	−.3	−.4	−.4
Prime rate (percent)	−.15	−.19	−.22	−.18	−.13	−.05	.06	.16
90-day Treasury bill rate (percent)	−.03	−.06	−.06	−.03	.01	.07	.13	.19
New issue corporate bond rate (percent)	.01	.01	.03	.04	.08	.12	.16	.20
Gain in real business fixed investment per dollar loss in tax revenue	.11	.28	.48	.73	.82	1.04	1.19	1.31
Annual gain per dollar revenue loss			1979			1980		
			.39			1.08		

Source: Allen Sinai, "Business Taxation and Capital Formation," remarks presented before the Ad Hoc Committee for an Effective Investment Tax Credit, Washington, D.C., Jan. 12, 1978.

TABLE 4.—EFFECTS OF ACCELERATED DEPRECIATION ON BUSINESS CAPITAL FORMATION, INFLATION, UNEMPLOYMENT, AND INTEREST RATES (DIFFERENCES FROM BASELINE SOLUTION)

	79:1	79:2	79:3	79:4	80:1	80:2	80:3	80:4
Business capital outlays (billions of 1972 dollars)	0.8	1.9	3.1	4.4	5.6	6.9	8.0	9.0
Plant	.5	1.0	1.5	1.9	2.3	2.7	3.0	3.3
Equipment	.3	.9	1.6	2.5	3.3	4.2	5.0	5.7
Business fixed investment as percent of real GNP		.1	.2	.2	.3	.4	.4	.5
Inflation—GNP deflator (percent)			.1	.1	.2	.2	.3	.3
Unemployment rate (percent)		−.1	−.1	−.2	−.2	−.3	.4	−.4
Prime rate (percent)	−.16	−.22	−.26	−.25	−.23	−.17	−.10	−.02
90-day Treasury bill rate (percent)	−.03	−.07	−.08	−.07	−.03	.01	.06	.11
New issue corporate bond rate (percent)	.01	.01	.03	.05	.08	.11	.15	.19
Gain in real business fixed investment per dollar loss in tax revenue	.12	.28	.43	.71	.77	.97	1.11	1.23
Annual gain per dollar revenue loss			1979			1980		
			.38			1.03		

Source: Allen Sinai, "Business Taxation and Capital Formation," remarks presented before the Ad Hoc Committee for an Effective Investment Tax Credit, Washington, D.C., Jan. 12, 1978.

The tables demonstrate that, in terms of business capital outlays, business fixed investment as a percent of GNP, reduction in the unemployment rate, and increases in business fixed investment per dollar of revenue loss, the increase in the investment tax credit achieves the greatest result followed by the increase in depreciation with the Carter proposal last. The best way to summarize the results of the data is that the increase in business investment per dollar of revenue loss for the year 1980 is .65 for the Carter proposal, 1.09 when a 12 percent investment tax credit is substituted and 1.03 when the depreciation allowances are increased.

Although the specific provisions of the House bill are somehow different from the President's original business tax proposals, the analysis outlined above is generally applicable to them as well. Thus, while the House bill is generally a move in the right direction, and Ad Hoc Committee's position is that the current economic climate calls for a greater stimulus to business investment and increased employment. This can be achieved by changing the House bill to include additional incentive through the investment credit and liberalized depreciation.

III. AD HOC COMMITTEE PROPOSALS

The Ad Hoc Committee supports the corporate rate reduction proposals, the proposed modifications of the investment tax credit, and liberalized treatment of small business. However, we do not support the limitation placed on use of the full investment credit and five-year amortization in connection with pollution control equipment financed through tax-exempt industrial development bonds.

In order for the Revenue Act of 1978 to achieve adequate economic goals of stimulating business investment, reducing unemployment, increasing productivity and thereby reducing inflation, it should include the following changes:

1. The investment tax credit should be made permanent at a 12 percent rate.
2. The ADR depreciation variance should be increased from 20 to 40 percent.
3. The investment tax credit on all qualified pollution control facilities should be 20 percent. In addition, the definition of qualified pollution control facilities should be amended to prevent unwarranted restriction on necessary investments.
4. The investment tax credit should be modified by increasing immediately the limitation to 90 percent of tax liability and by applying the credit to new structures as well as rehabilitating existing structures, and by making other modifications indicated below.
5. The additional investment tax credit where contributions are made to an ESOP should be made permanent at an additional two percent without requiring employee contributions.

A. Permanent 12 percent investment tax credit

The Ad Hoc Committee recognizes that businesses must be provided a tax climate favorable to investment in order for the nation's capital investment to be sufficient to provide satisfactory economic growth in the future. We advocate the immediate enactment of a 12 percent investment tax credit as the most effective means of stimulating business investment.

The effectiveness of the investment tax credit as a business stimulus is demonstrated by the Data Resources, Inc. study. It is also supported by the history of the credit. Since the investment tax credit was first proposed by President Kennedy in 1961 and enacted by Congress in 1962, it has proven to be one of the most effective economic stimuli ever incorporated into the tax system. The success of the credit is illustrated by the impressive economic record for the years it has been in effect as opposed to the adverse economic impact for years when it was suspended or repealed. A more detailed discussion of this history is provided in Appendix B.

The key to the effectiveness of the investment tax credit is the fact that taxpayers must earn the benefit through the purchase of productive equipment and facilities—purchases which result in more jobs to both the manufacturer and purchaser. Thus, employment and productive capacity are expanded, inflationary pressures are reduced through efficiencies in operation, and federal revenues are most likely increased far beyond any initial cost to the Treasury.

However, it is clear that the credit should not be used as a counter-cyclical device. The credit is unsuited to this purpose and its past, and in particular present, effectiveness has been reduced by uncertainties of its availability and appli-

cability to capital investments. This is particularly true in the case of large acquisitions with long lead times.

These aspects of the credit were analyzed in a paper entitled Policy Alternatives for the Investment Tax Credit by Professors Roger H. Gordon and Dale W. Jorgenson of Harvard University which conclude:

The value of the tax credit for stabilization depends on the ability of the administrator to forecast future trends. From the historical choice of credit rates, it appears that this ability was so poor as to make use of a flexible instead of a constant credit rate detrimental to stabilization . . . Uncertainty facing the administrator seems to be too large to make a flexible policy worthwhile. For example, reduction or suspension of the investment tax credit in late 1964 would have required accurate anticipation of the course of the Vietnam buildup. In 1964 U.S. fiscal policy was headed in precisely the opposite direction. In that year a major tax cut was instituted and the effectiveness of the investment tax credit was enhanced. . . . The implication of the changing defense policy were not apparent to fiscal policy makers until considerable time had elapsed. . . . The investment tax credit was repealed in 1969 and not re-introduced until 1971. In retrospect this change in policy was in precisely the wrong direction. The investment tax credit should have been increased very substantially in order to counterbalance the effects of the Vietnam de-escalation.

The tax credit, however, remains a powerful device to stimulate capital deepening. A constant fifteen percent credit rate for the next ten years would cause the capital stock in 1985 to be 12.5 percent higher than it would be under a seven percent rate. Thus our basic conclusion is that the choice of a rate for the investment tax credit should be based on long run objectives of capital deepening and desired average levels of demand for an extended period, and not on short run stabilization objectives.

The credit should be established at a meaningful level on a permanent basis. A permanent 12 percent rate is clearly justified as an immediate and long-term economic stimulus.

B. Capital recovery allowances (ADR)

The simplification of the Asset Depreciation Range (ADR) system would be a meaningful step to encourage small business to adopt the system. In addition, there are many economic reasons for liberalizing the system. The Ad Hoc Committee urges that the ADR system be liberalized to allow a 40 percent variance from guideline lives.

1. Economic effects

The Data Resources, Inc. analysis illustrates the effectiveness of the investment credit and liberalized depreciation in increasing business investment and reducing unemployment. In addition, the economic effects of a 12 percent investment credit and 40 percent ADR variances were calculated by Norman B. Ture, Inc., in 1976. That study projected that the adoption of these provisions would result by 1977 in $16.8 billion of additional capital outlays, 1,580,000 additional jobs and $51.6 billion of additional GNP. Additionally, the increased economic activity would result in an increase of $9.6 billion in Federal revenues. In summary, there are numerous economic studies which provide more than sufficient justification for the adoption of a 12 percent investment credit in conjunction with 40 percent ADR variances.

2. Inflation

Another reason justifying liberalized depreciation is the inadequacy of the present system due to inflation. A recent study using data from the Securities and Exchange Commission and Chase Econometrics found that the Federal Government overcollected $12.6 billion from corporations during 1977 because of underdepreciation due to inflation. In other words, the present tax system computes the current tax on inflated income while depreciation deductions are computed on pre-inflation costs. This factor makes it very difficult for businesses to replace worn out production facilities and invest in new production facilities. The following table summarizes the results of the study on an industry basis.

TABLE 5.—DEPRECIATION POLICIES, INFLATION, AND CORPORATE OVERTAXATION

[In millions of dollars]

	Depreciation expenses under present policy, 1977	Adjusted for inflation, 1977	Difference, 1977	Estimated overtaxation 1977
Agriculture	1,210	1,500	290	106
Mining	2,180	2,470	290	137
Construction	3,340	3,470	1,130	441
Manufacturing				
Food and kindred products	3,320	4,310	990	463
Tobacco	370	520	150	70
Textiles and apparrel	1,290	1,760	470	21
Wood, paper, and furniture	3,120	3,403	310	145
Publishing	1,260	1,620	350	163
Chemical products	4,860	5,950	1,090	521
Petroleum products	7,690	9,860	2,170	1,036
Rubber	900	1,160	260	121
Stone, clay, and glass	1,370	1,830	460	215
Primary metals	3,580	5,570	1,990	949
Fabricated metal products	1,680	2,760	1,080	492
Machinery, except electrical	4,270	5,220	950	446
Electrical machinery	2,950	3,650	700	331
Motor vehicles	2,910	3,610	700	335
Transportation equipment, except motor vehicle	1,420	1,880	460	191
Instruments and related products	820	860	40	20
Miscellaneous	480	650	170	80
Transportation	6,210	7,930	1,720	760
Communications	9,350	13,330	3,980	756
Wholesale and retail trade	10,200	12,240	2,040	841
Finance	8,050	10,000	1,950	882
Services	8,050	10,610	2,560	940
Utilities	10,470	14,930	4,460	2,117
Total	101,300	132,100	30,800	12,600

Source: House Republican Research Committee.

This is only one recent example of numerous studies showing the inadequacy of our present depreciation system and demonstrating the need to provide a more realistic system.

3. Comparison of U.S. capital recovery to other nations

A research study and report prepared for the Financial Executives Research Foundation during 1977 by Dr. Norman B. Ture and Mr. B. Kenneth Sanden entitled The Effects of Tax Policy on Capital Formation compared the United States capital recovery system to those of other industrial nations. Of the countries studied, the systems of Belgium, Canada, France, West Germany, Italy, Netherlands, Sweden, and the United Kingdom were clearly more favorable than the U.S. system. The systems of the two remaining countries studied, Japan and Australia, were more favorable in some aspects and not in others. Table 13 in Appendix B provides more detail on the comparison of our capital recovery system to those of other industrialized nations.

The economies of other industrial nations are continuing to grow in terms of capital formation and productivity more rapidly than the U.S. economy. Our negative balance of payments continues to increase rapidly and the value of the dollar has declined precipitously as a result. In order for U.S. business to be more competitive on an international basis and to improve our balance of payments, a more realistic capital recovery system should be adopted.

4. Summary

As an immediate step, the ADR variance should be increased to 40 percent. This will increase business investment and employment. Further, our capital recovery system will become realistic in relation to inflation and we will be more competitive abroad.

The 40 percent ADR variance is urged as a simple first step toward obtaining an equitable and meaningful capital recovery system in the U.S. In the long run, the Ad Hoc Committee feels that a simple capital recovery system depreciating equipment over five years and buildings over ten years should be adopted (this

system has been described in detail in prior testimony). There is also substantial support for a more complex capital recovery system based on inflation indexes. However, at this time, the simplest way for our capital recovery system to be made fair and equitable is the adoption of the 40 percent variance urged by the Ad Hoc Committee.

C. Pollution control facilities

The House provision that the full 10 percent investment tax credit be allowed for pollution control facilities in addition to five year amortization is a more in the right direction. However, in view of the tremendous drain these government-required expenditures place on capital which could otherwise be used for productive assets, the Ad Hoc Committee recommends a 20 percent investment tax credit on pollution control facilities. Moreover, the House limitation regarding industrial development bonds and other technical limitations restrict even the lower credit in an unwarranted manner and should be eliminated.

1. Economic rationale

Environmental requirements have caused a major drain on capital funds which otherwise would have been invested in production facilities. For example, the Eighth Annual Report of the Council on Environmental Quality estimates expenditures for pollution control as $8.9 billion for operating and maintenance and $6.1 billion for capital expenditures in 1976 alone. In determining the capital expenditure estimates, the Council uses the cost of interest and depreciation only. By 1985, these costs are estimated to reach $20.6 billion for operating and maintenance and $21.7 billion for capital expenditures. For the decade 1975 through 1984 the overall cost is estimated at $289.1 billion of which $144.3 billion will be spent for operating and maintenance and $144.8 billion for capital expenditures.

The following table from the CEQ Report shows projected incremental pollution control expenditures, by category, through 1985.

The Seventh Annual Report also contained the following charts demonstrating the impact of these pollution control costs on inflation, interest rates, the gross national product, and employment.

The adverse effect of pollution control requirements on capital formation and employment is clear. In addition, consumers are already paying a substantial portion of this cost through inflation. While many of these requirements are essential, and others are certainly desirable, every effort should be made to reduce the resulting burden on capital and employment through tax incentives and other government programs.

2. Legislative history

Throughout the past decade, Congress has recognized the need to encourage investment in pollution control facilities and to accelerate the rate at which such investments were made to meet the nation's environmental goals. At the same time, Congress has sought to prevent such investment from creating a "drag" on productive capital needed to advance other economic goals.

Thus, in 1968, Congress permitted continuation of tax exempt treatment of industrial development bonds used to finance pollution control facilities. Moreover, in 1969, Congress enacted Section 169 of the Internal Revenue Code, permitting five-year amortization of such investments. However, Section 169 was of little benefit since a taxpayer's election to use it precluded use of the investment tax credit.

In 1976, the Congress recognized the need for new tax treatment in the pollution control area. Section 2112 of the Tax Reform Act of 1976 reinstated section 169 of the Internal Revenue Code providing for five year amortization of pollution control facilities. In addition, prior law was changed to allow 50 percent of the investment tax credit for facilities qualifying for five year amortization. Finally, the definition of "pollution control facility" was amended to include the prevention of pollution as well as removing, altering, disposing or storing pollutants.

Unfortunately, the 1976 provision remains overly restrictive. It is only applicable to equipment installed in old plants and it only applies to the percentage of cost of the equipment equal to the ratio of 15 years over estimated useful life.

TABLE 6.—ESTIMATED INCREMENTAL POLLUTION ABATEMENT EXPENDITURES,[1] 1976–85

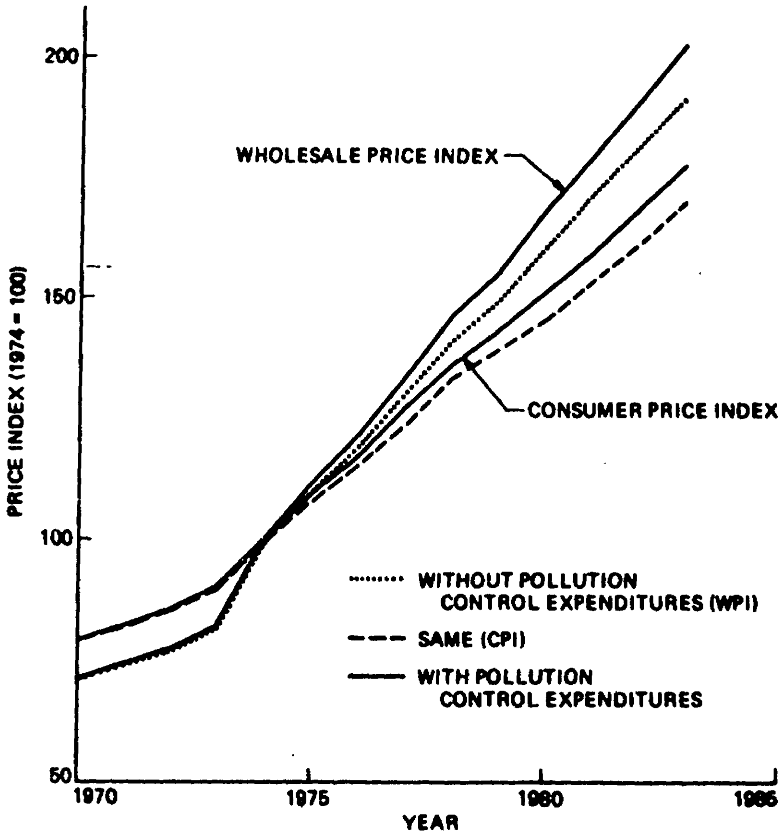
[In billions of 1976 dollars]

	1976			1985			Cumulative (1976–85)			
	Operation and maintenance	Capital costs [2]	Total annual costs [3]	Operation and maintenance	Capital costs [2]	Total annual costs [3]	Capital investment	Operation and maintenance	Capital costs [2]	Total annual costs [3]
Air pollution:										
Public	0.1	0.1	0.2	0.7	0.2	0.9	2.0	4.5	1.9	6.4
Private:										
Mobile	3.4	2.0	5.4	.8	7.5	8.3	52.5	18.4	53.8	72.2
Industrial	1.1	1.1	2.2	2.4	2.8	5.2	13.3	16.7	20.8	37.5
Utilities	8	.8	1.6	3.1	3.1	6.2	16.2	18.5	18.5	37.0
Subtotal	5.4	4.0	9.4	7.0	13.6	20.6	84.0	58.1	95.0	153.1
Water pollution:										
Public	1.2	.3	1.5	4.5	2.2	6.7	24.0	28.5	12.5	41.0
Private:										
Industrial	1.3	1.2	2.5	5.9	4.4	10.3	35.2	34.5	28.3	62.8
Utilities	.5	.3	.8	.9	.6	1.5	2.3	8.1	4.9	13.0
Subtotal	3.0	1.8	4.8	11.3	7.2	18.5	61.5	71.1	45.7	116.8
Radiation: Nuclear powerplants	<.05	<.05	<.05	<.05	<.05	.1	.2	.1	.3	.4
Solid wastes:										
Public	.2	.1	.3	.3	.1	.4	1.1	2.6	.8	3.4
Private	.3	.2	.5	.9	.4	1.3	1.4	5.9	1.0	6.9
Subtotal	.5	.3	.8	1.2	.5	1.7	2.5	8.5	1.8	10.3
Land reclamation: Surface mining	(4)	(4)	(4)	.5	(4)	.5	(4)	3.6	(4)	3.6
Toxic substances	(4)	(4)	(4)	.2	(4)	.2	(4)	1.1	(4)	1.1
Noise	(4)	(4)	(4)	.4	.4	.8	2.7	1.8	2.0	3.8
Total	8.9	6.1	15.0	20.6	21.7	42.4	150.9	144.3	144.8	289.1

[1] Incremental costs are expenditures made pursuant to Federal environmental legislation beyond those that would have been made in the absence of such legislation.
[2] Interest and depreciation.
[3] Operation and maintenance plus capital costs.
[4] Not available.

Source: The 8th Annual Report of the Council on Environmental Quality (1976).

CHART 4.—Estimated consumer and wholesale price indices (CPI and WPI) with and without pollution abate expenditures



Source: The Seventh Annual Report of the Council on Environmental Quality (1976).

More important than the restrictions placed on the ability to use the new provision is the fact that the incentive provided is not sufficient to encourage taxpayers to elect it. In fact, under most circumstances, the taxpayer receives more benefit from using regular accelerated depreciation under ADR and the full investment tax credit. For example, as Table 7 indicates, using the 16 year guideline life of the pulp and paper industry and the 18 year guideline life of the steel industry, the benefits without electing section 169 would be $498,000 and $490,729 respectively as opposed to $481,000 for both if the new provision is elected (assuming four and one-half percent after-tax present value factors). Obviously, these major industries along with virtually all other industries will not elect the new provision.

The current House bill would provide for the full 10 percent investment credit plus five-year amortization—another step in the right direction. However, the House limitation on use of the full credit where industrial development bond financing is employed is unnecessary and a step in the wrong direction. This restriction would once again render the investment credit-amortization option meaningless (since IDB financing, a full credit and normal depreciation would provide greater incentives) and would again frustrate the need to alleviate the eroding effect of such facilities on captial and Congress' desire to address that need.

To illustrate, a 30-year $1 million industrial revenue bond is issued at a two percent interest saving over conventional financing. The present value of the after-tax interest saving (one percent) when computed using 4½ percent after-tax present value provides the company with a savings of $148,000.

Table 7 demonstrates that the steel industry would only save an additional $40,000 ($531,000-$490,729) with a 10 percent credit and five-year amortization. Thus, a pollution control facility qualifying for tax exempt financing would under the House proposal be penalized by over $100,000 ($148,000-$40,000) when compared to present law. Even with a 20 percent credit the restriction on tax exempt financing provides a detriment of over $40,000 when compared to present law.

3. Ad Hoc committee proposal

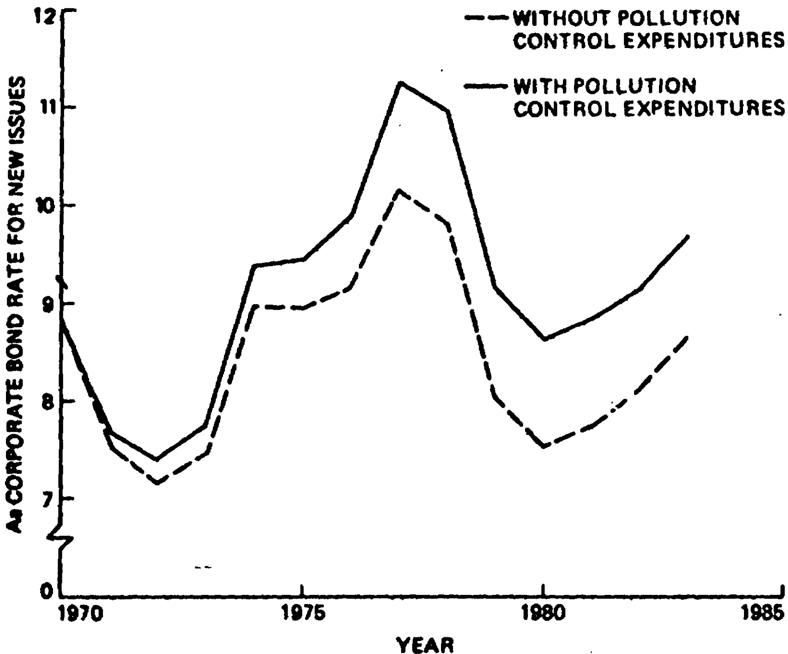
The extension of a full investment credit to pollution control equipment by the House version of the bill is appreciated by our Committee; however, the above analysis demonstrates the need for more meaningful provisions.

First, the Ad Hoc Committee supports a 20 percent investment tax credit for pollution control facilities in lieu of five-year amortization under section 169. Second, the new credit should be applicable to all pollution control facilities, including buildings as well as equipment.

The following simplified definition should be adopted for purposes of the new credit:

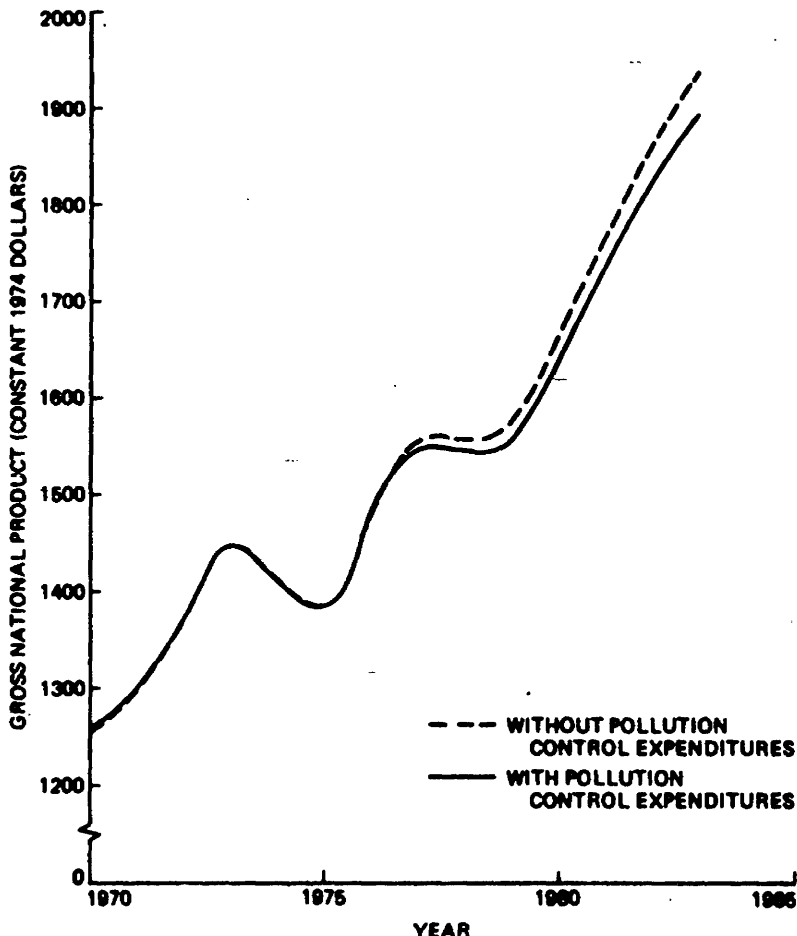
The term "air or water pollution control facility" means any facility (including buildings and equipment) the primary purpose of which is to abate, contain, control, or prevent actual or potential pollutants, wastes or heat from comtaminating the atmosphere or bodies of water.

CHART 5.—Estimated interest rates with and without pollution control expenditures



Source: The Seventh Annual Report of the Council on Environmental Quality (1976).

CHART 6.—Estimated gross national product with and without pollution abatement expenditures



Source: The Seventh Annual Report of the Council on Environmental Quality (1976).

Third, this incentive should be prospective as well as corrective, and extended to new facilities. Fourth, the current restriction on "profitability" of such investments should be amended to include all costs associated with the acquisition, operation and maintenance of qualified facilities.

The adoption of these changes would prevent the erosion of capital for nonproductive purposes and should increase rather than decrease employment. Further, it would advance our nation's environmental goals at a significantly more rapid pace.

4. Summary

The Ad Hoc Committee urges that meaningful relief be provided to acquisitions of pollution control facilities. Congress has intended to provide relief in the past but unfortunately the amount of the relief was never sufficient. The enactment of a 20 percent credit would clearly be meaningful. In addition, technical restrictions regarding the definition of qualified equipment, eligibility of new plants and facilities, and secondary profits should be removed.

D. Improved investment tax credit

The House bill would make the investment credit more effective by applying it to 90 percent of tax liability in lieu of 50 percent (phased in over four years) and applying it to costs of rehabilitating industrial and other existing business structures. The Ad Hoc Committee supports these proposals and urges their adoption. However, there are additional steps which should be taken to make the credit even more effective.

1. Application to tax liability

The investment credit is presently fully applicable to the first $25,000 of tax liability. In recognition of inflation and particularly to assist small businesses, the $25,000 should be raised to the first $150,000 of tax liability.

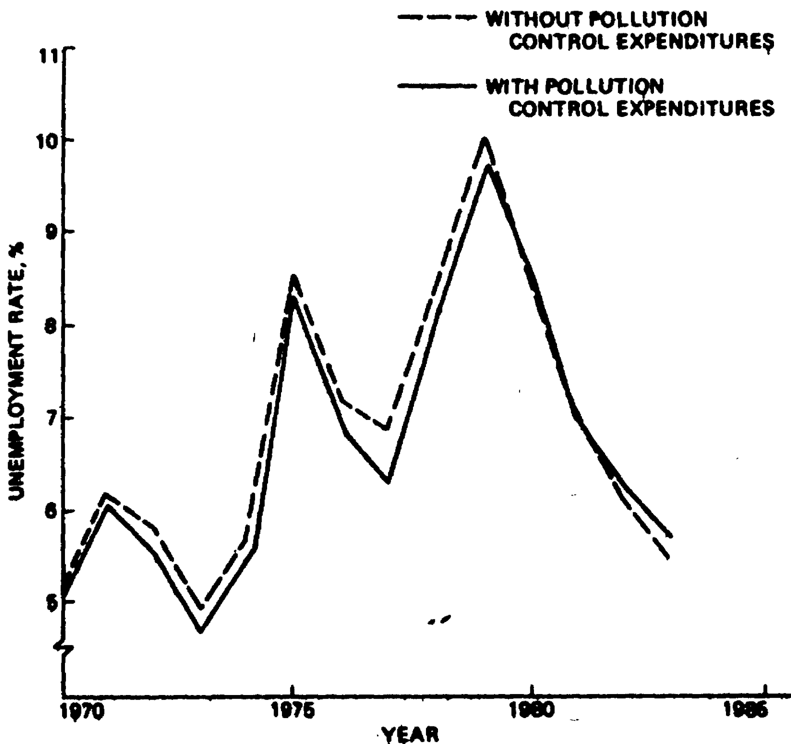
2. Application to structures

The credit should be applied to new structures as well as existing industrial and other business structures.

3. Asset life for full investment tax credit

Under present law the full 10 percent credit is only available for assets with a seven year or longer life. Even in cases of a seven year life, there are complicated recapture rules for early dispositions. The seven year life requirement should be reduced to three years. This would make the investment credit more effective and would eliminate the complex problems with varying levels of credit and recapture of credits in future years.

CHART 7.—Estimated unemployment rate with and without pollution abatement expenditures



Source: The Seventh Annual Report of the Council on Environmental Quality (1976).

TABLE 7.—COMPARATIVE CASH FLOW BENEFITS PULP AND PAPER—PRIMARY STEEL INDUSTRIES—INVESTMENT, $1,000,000

[Using 4½ percent aftertax present value factors]

Current law	Current value of cash flow	
	Pulp and paper	Steel
Depreciation plus: [1] 10 percent Investment Credit	$498,000	$490,729
5-yr amortization [2]—½ of 10 percent investment credit	481,000	481,000
Proposals:		
(1) Depreciation plus: 20 percent investment credit	598,000	590,729
(2) Current deduction—No credit	480,000	480,000
(3) Current deduction Plus: 10 percent investment credit	580,000	580,000
(4) Current deduction—½ of 10 percent credit	530,000	530,000
(5) 5-yr amortization—10 percent credit	531,000	531,000
(6) 5-yr amortization—⅓ of 10 percent credit	497,000	497,000

[1] Depreciation: Pulp and paper—16-year guideline reduced to 13 yrs lower ADR limit, using DDB switching to SYD after 1½ yrs. Primary steel—18-year guideline reduced to 14½ yrs lower ADR limit, using DDB switching to SYD after 1 ½ yrs.

[2] Enacted in sec. 2112 of the Tax Reform Act of 1976.

4. Used property

The maximum amount of acquired used equipment qualifying for the credit should be increased from $100,000 to $200,000. This change would recognize the impact of inflation and primarily assist small businesses.

5. Effective date of increased limitation

The implementation of the increased limitation from 50 percent to 90 percent should be taken in one step (i.e., not phased in) and the effective date of the increased limitation should be January 1, 1977.

E. Investment credit ESOP's

The adoption of Employee Stock Ownership Plans (ESOPs) is growing in popularity. However, many companies have hesitated in instituting an investment credit ESOP because the additional one percent credit is not a permanent part of the Internal Revenue Code. Further, the one-half percent additional credit in the case of employer-matched-employee contributions has proved complicated and cumbersome.

The Ad Hoc Committee recommends the adoption of a permanent two percent additional investment credit where contributions are made to an ESOP. This will simplify the present provisions and encourage companies to adopt ESOP plans because they can base their decision on a permanent credit. Finally, the ESOP credit has the added benefit of providing employees with stock ownership in addition to generating capital formation.

IV. CONCLUSION

Leading economists and numerous economic studies agree with the Treasury's conclusion that business investment must be stimulated for the present economic recovery to continue to a full-employment economy. Without increased investment in productive capacity, the nation's short and long run economic picture is not encouraging.

A dynamic growing economy is required if we are to reduce unemployment and provide jobs for the growing labor force, meet the problems caused by energy and other raw material shortages, prevent further deterioration and maintain or improve our position in the world economy, improve our environment and, most important, achieve a rising standard of living for all Americans based on increased productivity and without the hardships caused by inflation.

The capital recovery system is inexorably related to productivity trends, real growth, real income, capital requirements, job creation, and savings and investment rates. In view of our capital recovery system ranking at the bottom when compared to those of other industrial nations, it is not surprising that our economy lags behind those of other industrial nations when these important indicators are considered.

The House bill is welcomed by the Ad Hoc Committee because it recognizes the need to stimulate business investment and proposes concrete measures to that end. However, the program is not adequate to achieve the employment, business investment, and other economic goals of the nation. In particular, in view of the Administration's statements that there is no more substantial tax reform planned during the President's present term of office, it is essential that adequate measures be adopted his year.

The Ad Hoc Committee believes that an improved permanent 12 percent investment tax credit, 40 percent ADR variances, a 20 percent credit for pollution control facilities, and a permanent 2 percent ESOP credit, when coupled with the proposed tax reduction, will provide the immediate required economic stimulus and provide adequate capital formation to ensure future economic growth. We respectfully urge that the members of the Committee on Finance and the Congress adopt these proposals.

APPENDIX A

MEMBERSHIP OF AD HOC COMMITTEE FOR AN EFFECTIVE INVESTMENT TAX CREDIT

AMP Incorporated
A-T-O Inc.
Acme-Cleveland Corporation
Air Products and Chemical Inc.
Airco, Inc.
Akzona Incorporated
Albany International Corp.
Allegheny Ludlum Industries, Inc.
Allied Products Corporation
Allis-Chalmers Corporation
AMAX, Inc.
Amerace Corporation
American Brands, Inc.
American Can Co.
American Financial Corporation
American Greetings Corporation
American Hoist & Derrick Co.
American International Group, Inc.
American Natural Gas Service Company
American Petrofina Inc.
American Telephone and Telegraph Company
Ampex Corporation
Amtel, Inc.
Anchor Hocking Corporation
Apache Corporation
Arcata National Corporation
Arkansas Best Corporation
Arvin Industries, Inc.
Ashland Oil, Inc.
Atlantic Richfield Company
Avnet, Inc.
Avon Products, Inc.

Bache Halsey Stuart Shields Inc.
Ball Corporation
Baltimore Gas and Electric Co.
BankAmerica Corporation
Baxter Travenol Laboratories Inc.
Beatrice Foods Co.
Beech Aircraft Corporation
Beldon Corp.
Bemis Company, Inc.
Betz Laboratories, Inc.
The Boeing Company
Brunswick Corporation
The Budd Company
Bucyrus-Erie Company
Bunker Ramo Corporation
Burlington Industries, Inc.
Burroughs Corporation
Butler Manufacturing Company

CBS Inc.
CCI Corporation
CF Industries, Inc.
CPC International Inc.
Carlisle Corporation
Carnation Company
Carpenter Technology Corporation
Carrier Corporation
Castle & Cooke, Inc.
The Ceco Corporation
Cessna Aircraft Company
Champion International Corp.
Chemetron Corporation
The Chesapeake Corporation of Virginia
Chesapeake & Ohio Railway Company
Chesebrough-Pond's Inc.
Chicago Bridge & Iron Company
Chicago Pneumatic Tool Company
Chromalloy American Corporation
The Citizens & Southern National Bank
Clark Equipment Company
Clow Corporation
Coachmen Industries, Inc.
Coastal States Gas Corp.
Coca-Cola Bottling Co. of N.Y., Inc.
Collins & Aikman Corporation
Colt Industries Inc.
Columbia Gas Systems Service Corporation
Columbus McKinnon Corporation
Commercial Shearing, Inc.
ConAgra, Inc.
Congoleum Corporation
Consolidated Foods Corporation
Consumers Power Co.
Container Corporation of America
Continental Group, Inc.
Continental Machines, Inc.
Continental Oil Company
Cooper Tire & Rubber Company
Copper Range Company
Crankshaft Machine Company
Crouse-Hinds Company
Cubic Corp.
Cyclops Corporation
Cyprus Mines Corporation

Dana Corporation
Dart Industries, Inc.
Daylin, Inc.
Deere & Company
DeLaval Turbine, Inc.
Dennison Manufacturing Company
Detroitbank Corporation
Diamond Shamrock Corporation
Dibrell Brothers, Inc.
A. B. Dick Company
Di Giorgio Corporation
Dixie Yarns, Inc.
DoAll Company
Donaldson Company, Inc.

R. R. Donnelley & Sons Company
Dover Corporation
Dresser Industries, Inc.
Dynamics Corporation of America

ESB Incorporated
E-Systems, Inc.
Eagle-Pitcher Industries, Inc.
Earth Resources Company
Eaton Corporation
Echlin Mfg. Co.
Economics Laboratory, Inc.
Elgin National Industries, Inc.
Eltra Corporation
Emerson Electric Co.
Emery Industries, Inc.
Esmark, Inc.
Evans Products Company
Ex-Cell-O Corporation

FMC Corporation
Fairfield Manufacturing Co., Inc.
Farmland Industries, Inc.
Federal-Mogul
Federal Paper Board Company, Inc.
Federated Department Stores, Inc.
First Bank System Inc.
The First National Bank of Chicago
The Flintkote Company
The Foxboro Company
Franklin Electric Co., Inc.
Fruehauf Corporation
Fuqua Industries, Inc.

Gamble-Skogmo, Inc.
Gannett Co., Inc.
Garlock Inc
General Cable Corporation
General Cinema Corporation
General Dynamics Corporation
General Portland Inc.
General Signal Corporation
General Telephone & Electronics Corporation
Getty Oil Company
Giddings & Lewis, Inc.
Globe-Union, Inc.
Gould, Inc.
Great Northern Nekoosa Corporation
Grief Bros. Corporation
Greyhound Leasing and Financial Corporation
Grow Chemical Corporation
Gulf Oil Corporation

H & H Industries, Incorporated
Harnischfeger Corporation
Harris Corporation
Harris Trust & Savings Bank
Harsco Corporation
Hart Schaffner & Marx
Hayes-Albion Corporation
Walter E. Heller International Corp.
Hesston Corporation
Hewlett-Packard Company
Hillyer Corporation
Edward Hines Lumber Company
Houdaille Industries, Inc.
Household Finance Corporation
Hughes Tool Company
Hurco Manufacturing Co., Inc.

IC Industries, Inc.
Ideal Basic Industries, Inc.
Ingersoll-Rand Company
Inland Steel Company
Intel Corporation
International Business Machines Corporation
International Minerals & Chemical Corporation
International Multifoods Corporation
International Paper Company
International Telephone & Telegraph Corporation
Iowa Beef Processors, Inc.

JLG Industries, Inc.
Jewel Companies, Inc.
Josten's Inc.
Joy Manufacturing Company

Kaiser Cement & Gypsum Corporation
Keebler Company
Kennametal Inc.
Kennecott Copper Corporation
Kerr-McGee Corporation
Kewanee Industries, Inc.
Kingsbury Machine Tool Corporation
Kirsch Company
Kraft, Inc.
Kuhlman Corporation

The LTV Corporation
Laclede Steel Company
Lance, Inc.
Land O'Lakes, Inc.
Lear Siegler, Inc.
Leaseway Transportation Corp.
Lehigh Portland Cement Co.
Longview Fibre Company
The Louisiana Land and Exploration Company
Louisiana-Pacific Corporation
Lucky Stores, Inc.
Ludlow Corp.
Lukens Steel Company

MBPXL Corporation
MCA Inc.
Macmillan, Inc.
Marathon Manufacturing Company
Marathon Oil Company
Marquette Company
Maryland Cup Corporation
Masonite Corporation
McGraw-Edison Company
Melville Corporation
Memorex Corp.
Mesa Petroleum Company
Michigan General Corporation
Michigan National Corp.
Microdot, Inc.
Midland-Ross Corporation
Modern Industrial Engineering Co.
Modine Manufacturing Company

Mohasco Corporation
Monsanto Company
Moore McCormack Resources, Inc.
Morton-Norwich Products, Inc.

NL Industries, Inc.
NVF Company
Nabisco, Inc.
Nalco Chemical Company
National Automatic Tool Company
National Distillers & Chemical Corporation
National Gypsum Company
National Presto Industries, Inc.
National Standard Company
National Starch and Chemical Corporation
Newmont Mining Corporation
Norris Industries, Inc.
Northwest Industries, Inc.

Oak Industries Inc.
Olin Corporation
Otis Elevator Company
Owens-Illinois, Inc.
Oxford Industries, Inc.

Pantasote Company
Parker-Hannifin Corp.
Pechiney Ugine Kuhlmann Corporation
Pennsylvania Power & Light Company
Perkin-Elmer Corporation
Peter Paul, Inc.
Phelps Dodge Corporation
Philip Morris Incorporated
Phillips Petroleum Company
Pitney-Bowes, Inc.
Pittsburgh-Des Moines Steel Company
Pittsburgh Forgings Company
Pittway Corporation
Portec, Inc.
Potlatch Corp.
Public Service Electric and Gas Company
Purex Corporation

Raybestos-Manhattan, Inc.
Reeves Brothers, Inc.
Reliance Electric Company
Riegel Textile Corp.
A. H. Robins Company, Inc.
Rockwell International Corp.
Rohm and Haas Company
Rohr Industries, Inc.
Roper Corporation
Roto-Finish Co.
Royal Industries
Rubbermaid, Inc.
Russell Corporation

SWECO, Inc.
Safeguard Industries, Inc.
Safeway Stores, Inc.
St. Joe Minerals Corporation
St. Regis Paper Company
Sangamo Weston Inc.
Scott, Foresman & Company
Scott Paper Company
Seaboard Coast Line Industries, Inc.
G. D. Searle & Co.
Sears, Roebuck and Co.
Seattle-First National Bank
The Signal Companies, Inc.
Signode Corp.
Soundesign Corp.
Southwest Forest Industries, Inc.
Sprague Electric Co.
Stanadyne, Inc.
Standard Brands Incorporated
Standard Oil Co. California
Standard Oil Co. (Indiana)
Standard Oil Co. (Ohio)
Standard Pressed Steel Co.
Standard Register Co.
Stanley Home Products, Inc.
The Stanley Works
Stauffer Chemical Company
Sterling Drug Inc.
J. P. Stevens & Co., Inc.
Storage Technology Corp.
Sunbeam Corporation
Sundstrand Corporation

TRW, Inc.
Tandy Corp.
Technicon Corporation
Tecumseh Products Company
Texaco, Inc.
Texas Commerce Bancshares, Inc.
Texas Eastern Corporation
Texas Industries, Inc.
Texasgulf, Inc.
Thiokol Corporation
Thomas & Betts Corporation
Tiger International, Inc.
Time Incorporated
The Timken Company
Todd Shipyards Corporation
Transcontinental Gas Pipe Line Corporation
Tropicana Products, Inc.
Tyler Corporation
Ty-Miles, Inc.

UAL Inc.
UOP Inc.
UV Industries
Uarco, Incorporated
Unarco Industries, Inc.
Union Carbide Corporation
Union First National Bank of Washington
United States Filter Corporation
U. S. Tobacco Co.
United Telecommunications, Inc.
Universal Leaf Tobacco Co.

VF Corporation
VSI Corporation
The Valeron Corporation
Van Dorn Company
Vulcan Materials Company

Ward Foods, Inc.
Warner-Lambert Company

Warner & Swasey Company
Wean United, Inc.
Western Electric Co., Inc.
Western Publishing Company
Weyerhaeuser Co.
Wheelabrator-Frye Inc.
Whirlpool Corporation
The Williams Companies
Winn-Dixie Stores, Inc.
Woodward Governor Company
F. W. Woolworth Co.
Wm. Wrigley Jr. Co.
Wylain, Inc.
Wyman-Gordon Co.

Xerox Corporation

SUPPORTING ASSOCIATIONS

Air-Conditioning & Refrigeration Institute
American Boiler Manufacturers Association
American Chamber of Commerce Executives
American Consulting Engineers Council
American Dental Association
American Feed Manufacturers Association
American Iron & Steel Institute
American Land Development Association
American Machine Tool Distributors Association
American Meat Institute
American Pipe Fittings Association
American Textile Machinery Association
Apartment Owners & Managers Association of America
Associated General Contractors of America
Concrete Plant Manufacturers Bureau
Dairy and Food Industries Supply Association
Edison Electric Institute
Expanded Shale Clay & Slate Institute
The Ferroalloys Association
Foodservice and Lodging Institute
Foreign Credit Interchange Bureau
The Gummed Industries Association, Inc.
Imported Hardwood Products Association, Inc.
International Quorum of Motion Picture Producers
Meat Machinery Manufacturers Institute
Mechanical Contractors Association of America
Narrow Fabrics Institute, Inc.
National Air Transportation Associations
National Association of Business and Educational Radio, Inc.
National Association of Coin Laundry Equipment Operators
National Association of Home Manufacturers
National Canners Association
National Concrete Masonry Association
National Industrial Distributors Association
National Ocean Industries Association
National Paper Box Association
National Ready-Mix Concrete Association
National Tank Truck Carriers, Inc.
National Wool Growers Association
Northeastern Lumber Manufacturers Association
Packaging Machinery Manufacturers Institute
Portland Cement Association
Printing Industries of America, Inc.
Railway Progress Institute
Rubber Manufacturers Association
Screen Printing Association International
Shipbuilders Council of America
Truck Mixer Manufacturers Bureau
United Fresh Fruit & Vegetable Association
Woodworking Machinery Distributors Association
Woodworking Machinery Manufacturers of America

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Appendix B

SUPPORTING ECONOMIC DATA AND ANALYSIS

I. PRODUCTIVITY AND OTHER ECONOMIC INDICATORS

In reviewing some of the specific indicators which argue forcefully for more realistic capital recovery provisions, it is appropriate that we look at those by which we can measure United States economic performance compared to other industrialized nations—Canada, France, West Germany, Japan, Italy and the United Kingdom.

The United States has fallen dramatically behind our trading partners in many respects, the most important being manufacturing productivity. In 1974, we experienced a 2.2 percent decline in productivity—the first such decline, according to government sources, known to have occurred in the 200 year history of our country, and certainly the first since records of economic indexes have been maintained. In 1975 productivity incerased, but only in the extremely small amount of 0.2 percent. The accompanying Chart 8 shows the changes in real GNP per employed civilian in the period 1950 to 1972, with the United States at the bottom of the scale in relation to other countries.

REAL GNP PER EMPLOYED CIVILIAN, 1950-72

Indexes, 1950 = 100

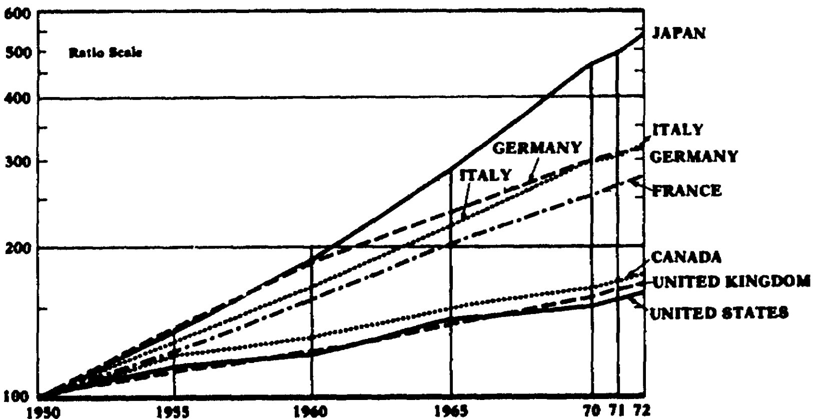

Chart 8
Source: Bureau of Labor Statistics

The following graph measures the same national economies in terms of productivity growth over the period 1960–1975, with the United States again lagging behind all, and very far behind most.

This poor performance is not surprising in view of the level of United States investment during this period, and in view of the well established correlation between investment and real growth. The following table illustrates that United States investment as a percent of real national output has lagged behind that of other nations—in fact, being only one-half the ratio in Japan and West Germany.

Capital formation is the major factor for increasing productivity. Without adequate capital formation U.S. productivity will decrease and our competitive position in world markets will be eroded. This result is already being seen, with an accompanying plummet in dollar values. In addition, a high rate of capital formation increases employment and productivity and permits higher real wages and increased standard of living without excessive inflation.

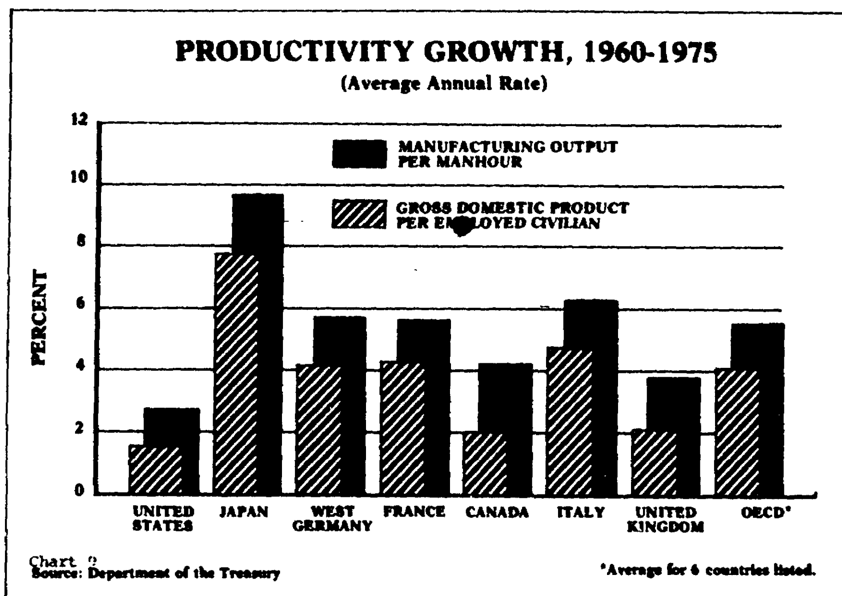

Chart 2

TABLE 8.—INVESTMENT AS PERCENT OF REAL NATIONAL OUTPUT 1960-73[1]

	Total fixed	Nonresidential fixed
United States	17.5	13.6
Japan	35.0	29.0
West Germany	35.8	20.0
France	24.5	18.2
Canada	21.8	17.4
Italy	20.5	14.4
United Kingdom	18.5	15.2
11 OECD countries (1960-72)	24.7	19.4

[1] OECD concepts of investment and national product. 1973 estimated.
[2] Including residential.

Sources: OECD; U.S. Department of Treasury.

One of the most striking parallels is the relationship between capital investment and wage rates by industry. Table 9 shows 1971 capital investment data and compares it with production worker average earnings by related industry groupings.

Reviewing this data indicating higher average earnings as capital per employee increases during his testimony before the Joint Economic Committee in mid-1975, the then Secretary of Labor Dunlop concluded:

...creation of jobs through investment capital broadens opportunities, thus allowing more upward mobility in salary and skills as people are promoted and new jobs created . . . the most basic and far-reaching objective for national policy in this context should be to encourage development of new technologies and the formation of new capital. . . . Also, the increase in output and income implied by new capital formation means a higher level of living and income for all Americans, whether or not they are employed by the industries involved with new capital formation and productivity gain.

In the past the U.S. has had the highest capital-to-labor ratio in the world; however, other nations have narrowed the gap significantly in the past two decades as the rate of investment per worker added to the labor force has fallen off in the U.S.

TABLE 9.—CAPITAL INTENSITY AND WORKER EARININGS

Industry	Capital per employee		Production worker average earnings	
	CPE	Rank	Per hour	Rank
Group 1:				
Petroleum and coal	$87,190	1	$4.57	1
Chemicals	36,450	2	3.94	3
Primary metals	35,060	3	4.23	2
Paper	29,440	4	3.67	4
Stone, clay, and glass	20,550	5	3.66	5
Food	14,160	6	3.38	7
Rubber/plastics	14,140	7	3.40	6
Tobacco	12,690	8	3.15	8-9
Lumber	10,270	9	3.15	8-9
Miscellaneous	6,490	10	2.97	10
Furniture	5,210	11	2.90	11
Leather	2,530	12	2.60	12
Apparel	2,110	13	2.49	13
Group 2:				
Transportation equipment	12,080	1	4.41	1
Nonelectric equipment	11,640	2	3.99	3
Fabricated metals	11,540	3	3.74	5
Ordnance	10,560	4	3.84	4
Instruments	9,410	5	3.52	6
Electrical equipment	8,830	6	3.48	7
Printing	8,580	7	4.20	2
Group 3: Textiles	10,840		2.58	

Source: Department of Labor.

TABLE 10.—*Gross nonresidential fixed investment per person added to civilian labor force (in 1958 dollars)*

Period:	Amount
1956 to 1960	$49,500
1961 to 1965	55,300
1966 to 1970	46,400
1971 to 1974	[1] 41,000

[1] Estimate based on incomplete data for 1974.

Source: Statement of Paul W. McCracken before the Committee on Ways and Means, Jan. 29, 1975. Basic data from the Department of Commerce and Labor.

The evidence is overwhelming. If our economy is to perform at the level required to provide sufficient capital for jobs, for environmental protection, for energy independence, for government programs of security for the elderly and the disabled, for needed housing, for national defense, and for adequate research and development, these trends must be reversed.

II. CAPITAL FORMATION REQUIREMENTS (1976-1985)

There have been a number of meaningful projections of capital requirements for the decade 1976 through 1985 with conclusions falling in the range of $4 to $5 trillion. One method of calculating capital requirement utilizes as a goal the maintenance of the post-war average rate of increase in labor productivity and real wage rates while, at the same time, avoiding an unacceptable rate of unemployment. From previously cited comparisons with the record of other countries over the same period, such a goal is clearly only a minimum. By projecting these rates in employment and the capital-labor ratio through 1985, it is seen that business capital outlays will have to be in the range of $2.37 trillion (in constant 1974 dollars). By adding capital outlays for housing, environmental protection and predicted government sponsored programs, the figure rises to $3.54 trillion in constant 1974 dollars. (See zero inflation Table 12 *infra.*) And finally, assuming a conservative Federal deficit of $10 billion per year and a three percent inflation factor, the total capital need rises to $4.3 trillion. (If the projection assumes a more realistic inflation factor of five percent, the total would be $4.9 trillion.)

We cite this example to demonstrate that what we are talking about in terms of needed capital formation is not "pie in the sky." It is absolutely fundamental to this nation's continued existence as a major economic force in the world.

Other examples were summarized in former Secretary of the Treasury Simon's statement to the Committee on Finance on March 7, 1976:

Consider, for example, a recent study by the Bureau of Economic Analysis of the Departmentof Commerce on projected capital needs of the country in 1980—only four years away. That study concluded that, in order to achieve our goals of full employment, greater energy independence and pollution abatement, the ratio of fixed business investment to GNP for the decade of the seventies must be increased.

The following Table 11 contained in the Treasury statement summarizes a number of other studies containing similar findings.

III. SAVINGS REQUIRED TO MEET CAPITAL NEEDS

We know that we must have the capital for productive investments. The next question is, how do we generate sufficient savings to much such investment possible?

The post-war average rate of national savings has been 15.7 percent. At this average level, assuming no change in price level, there will be a $816 billion gap in capital formation for the years 1976 through 1985. Assuming a more realistic three percent inflation factor, the capital formation gap could be $983 billion for this period. At a five percent inflation rate, the gap rises to a staggering $1.113 trillion. The following Table 12 illustrates the required levels of private savings at varying rates of inflation. The United States has not been able to achieve these levels of savings in the past, and it is clear that extraordinary measures must be taken to make it possible in the future.

IV. CORPORATE PROFITS AND FINANCIAL PROBLEMS

The flow of internal funds cannot keep pace with nominal capital outlays since depreciation allowances are based on original cost and not on replacement prices. Due to inflation, real corporate profits have been overstated. For example, the Treasury has stated that non-financial corporations reported after tax profits of $60.1 billion in 1975 as compared with $37.2 billion in 1965. These figures, when adjusted for inflation, are $35.8 billion in 1975 and $35.6 billion in 1965. Thus, there has been no real increase in corporate profits over the last decade. However, the corporate tax is applied to the profits without adjustment for inflation, resulting in a rise in the effective tax rate on true corporate profits from 43 percent in 1965 to 51 percent in 1975.

TABLE 11.—ACTUAL AND PROJECTED INVESTMENT AS A PERCENT OF GNP

	Average 1965–74	NYSE[1]	Bosworth, Duesenberry, Carron[2]	Friedman[3]	GE[4]	DRI[5]	Chase Econometrics[6]
Gross private domestic investment	15.1	16.4	15.5	15.8	15.8	15.7	15.9
Nonresidential fixed	10.4	12.1	11.3	11.5	11.4	11.0	11.8
Inventory	1.0	.3	.8	.8	.4	.8	.8
Residential	3.8	3.9	3.5	3.5	4.0	3.8	3.3

[1] The New York Stock Exchange, "The Capital Needs and Savings Potential of the U.S. Economy: Projections Through 1985," September 1974. Figures shown are based on cumulative projections in current dollars, 1974–85.

[2] Barry Bosworth, James S. Duesenberry, and Andrew S. Carron, "Capital Needs in the Seventies," the Brookings Institution, 1975. Figures shown are based on estimates for 1980 in current dollars from table 2-12, p. 39 (note the constant dollar 1980 figures in table 2-11 project gross private domestic investment as 15.8 percent of GNP).

[3] Benjamin M. Friedman, "Financing the Next 5 Years of Fixed Investment" in President's authority to adjust imports of petroleum, public debt ceiling increase; and emergency tax proposal; hearings before the Committee on Ways and Means, House of Representatives, January 1975, pp. 710–726. Figures shown are based on 1975–79 averages of current dollar projections.

[4] Reginald H. Jones, "Capital Requirements of Business, 1974–85," testimony submitted to Subcommittee on Economic Growth, Joint Economic Committee, May 8, 1974. Figures shown are based on cumulative projections in current dollars, 1974–85.

[5] Data Resources, Inc., summer 1975, "Special Study: The Capital Shortage." Summary table on inside cover. 1985 data only, current dollars, standard forecast.

[6] Chase Econometrices August 1975. "The Next 10 Years: Inflation, Recession and Capital Shortage." 1984 data only, current dollars. Table, p. 1 of 14. No recession run.

TABLE 12.—PROJECTIONS OF CAPITAL REQUIREMENTS AND GROSS PRIVATE SAVINGS, 1965–85

[In billions of dollars]

Year	Capital requirements	Gross private saving	Savings gap
(a) Zero inflation:			
1976	321.7	266.1	55.6
1977	335.6	275.5	60.1
1978	349.8	285.4	64.4
1979	365.5	295.5	70.0
1980	381.7	306.1	75.6
1981	399.1	317.0	82.1
1982	417.5	328.3	89.2
1983	437.1	340.0	97.1
1984	458.3	352.1	106.2
1985	480.6	364.6	116.0
Total	3,946.9	3,130.6	816.3
(b) 3-percent inflation:			
1976	331.3	274.1	57.2
1977	356.0	292.3	63.7
1978	382.2	311.9	70.3
1979	411.4	332.6	78.8
1980	442.5	354.9	87.6
1981	476.5	378.5	98.0
1982	513.5	403.8	109.7
1983	553.7	430.7	123.0
1984	598.0	459.4	138.6
1985	645.9	490.0	155.9
Total	4,711.0	3,728.2	982.8
(c) 5-percent inflation:			
1976	337.8	279.4	58.4
1977	370.0	303.7	66.3
1978	404.9	330.4	74.5
1979	444.3	359.2	85.1
1980	487.2	390.7	96.5
1981	534.8	424.8	110.0
1982	587.5	462.0	125.5
1983	645.8	502.3	143.5
1984	711.0	546.2	164.8
1985	782.8	593.9	188.9
Total	5,306.1	4,192.6	1,113.5

Source: Ture and Sanden, "The Effects of Tax Policy on Capital Formation," Financial Executives Research Foundation New York) 1977, p. 35.

Corporations have increasingly turned to borrowing to finance capital investment. Average outside financing was 30 percent in 1964. In 1974, outside financing increased to over 60 percent of total capital needs. This result can be attributed to the effect of inflation on capital needs and profits.

Former Secretary of the Treasury Simon, in his March 7, 1976, statement, summarized the financial effects of increased corporate borrowings as follows:

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 to 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.

Due to these changes in corporate financing, the liquidity of corporate balance sheets is severely reduced. Therefore, corporations are far less able to withstand even minor recessions, resulting in reduced confidence in lenders and

investors. The final result is reduced corporate investment due to a reduction in available funds.

V. CAPITAL RECOVERY IS KEY TO BUSINESS SAVING AND INVESTMENT

While recognizing there are various avenues that must be explored for increasing total capital savings, by both business and individual savers, it is the intention of the Ad Hoc Committee in this statement to address the question of business savings only.

Commerce Department figures show that business savings, as a percent of total national savings, increased from 48.1 percent of the total in 1947 to 65.9 percent in 1974. Consequently, business saving is now the largest factor to be considered in an examination of the issue.

In turn, the major factors in the business savings are the capital recovery allowances of the Internal Revenue Code. In 1974, these allowances accounted for 58 percent of total savings—the major provision being depreciation.

VI. INTERNATIONAL COMPARISON OF CAPITAL RECOVERY SYSTEMS

The low rate of capital investment and productivity increase in the United States is due, at least in part, to the fact that in recent years our capital recovery system ranks at or near the bottom among major industrial nations. This is illustrated by the comparison in the following Table 13. It illustrates that, at the end of 1975, with the exception of Japan where special factors apply, the U.S. requires substantially longer cost recovery periods for its machinery and equipment than its major trading partners.

And of course, many of these nations have recently taken significant steps to liberalize their capital recovery systems or are in the process of liberalizing that system. The comparison between the United States' capital is shifting in their favor—and we are already ranked close to the bottom of the list.

A. HISTORIC EFFECTS OF CHANGES IN DEPRECIATION PROVISIONS AND THE INVESTMENT CREDIT

There is no question that liberalised depreciation provisions and the investment credit have proven in the past to be effective in increasing employment and productivity, thus combating inflation and enhancing real growth. This fact can be illustrated in terms of capital investments, employment and Federal revenues.

1. Effects of changes in capital recovery provisions on investment in capital facilities, 1962–1972

Following enactment of the original investment credit and adoption of the reduced guideline lives for depreciation in 1962, new orders for machine tools increased rapidly by 251 percent—from $144 million in the last quarter of 1961 to $514 million in the first quarter of 1966. New orders for producers capital goods increased by 82 percent—from $8.9 billion in the fourth quarter of 1961 to $16.2 billion in the third quarter of 1966.

The suspension of the investment credit in the third quarter of 1966 was followed in the next two quarters by a sharp drop in new orders for machine tools and producers capital goods—$180 million and $2.8 billion, respectively.

Restoration of the credit in the second quarter of 1967 led to a rapid buildup in orders—producers capital goods increased 36 percent from $13.8 billion in the first quarter of 1967 to $18.8 billion in the second quarter of 1969. Machine tool orders in the same period increased 70 percent from $328 million to $558 million.

The repeal of the credit in 1969 resulted in a drop of $2.7 billion in new orders for producers of capital goods through the second quarter of 1970. Machine tool orders were off $417 million, almost 75 percent, from the second quarter of 1969 through the end of 1970.

Following enactment of the new investment credit and the Asset Depreciation Range (ADR) System in 1971, orders for producers capital goods increased by $4.5 billion from the second quarter of 1971 through the third quarter of 1972. Machine tool orders rose by $103 million—almost 60 percent—in the same period, from $182 million to $285 million. The pattern is unmistakable. Capital facility investment is powerfully affected by changes in depreciation and particularly by changes in the investment tax credit.

TABLE 13.—COMPARISON OF COST RECOVERY ALLOWANCES

	Representative cost recovery periods (years)	Aggregate cost recovery allowances (percentage of cost of assets)		
		1st taxable year	1st 3 taxable year	1st 7 taxable years
United Kingdom	1	100.0	100.0	100.0
Canada	[1] 2	57.5	105.0	105.0
Netherlands	[2,3,4] 5	14.0	58.0	108.0
Sweden	[5] 5	60.0	95.7	130.0
Australia	[6] 6	65.0	97.8	140.0
Italy [7]	[2] 6	[8] 19.6	[8] 67.9	100.0
France	[9,10] 8	31.3	67.5	[11] 94.9
	[12] 8	25.0	57.8	86.7
West Germany	[13] 9	[14] 16.7	49.6	[15] 88.8
Belgium	[16] 10	[17,18] 20.0	48.8	[19] 89.0
Japan	[20] 11	[21] 34.5	56.9	81.4
	[22] 11	[21] 37.1	63.9	88.1
United States:				
1962 law [23]	[16] 13	[24] 21.7	47.9	80.1
1969 law [25]	[16] 13	7.7	33.9	66.1
1971 law [26]	[27] 10½	[24] 23.5	54.7	88.5
1975 law [26]	[27] 10½	[24] 29.5	60.7	94.5

[1] Canada has recently enacted an investment tax credit of 5 percent of the cost of new buildings, machinery, and equipment acquired between June 24, 1975, and June 30, 1977, inclusive, to be used in manufacturing and processing and other sepcified activities. Taxpayers will be permitted to apply the credit to their Federal income taxes up to $15,000 plus ½ of the amount by which their Federal tax otherwise would exceed $15,000. Any unused credit may be carried forward for up to 5 years. The cost of the property acquired will be reduced by any investment tax credit received. The effect of this credit is relatively small in view of the 2-yr writeoff allowed in Canada and the reduction in basis for depreciation purposes. In the 1st taxable year the 50 percent aggregate cost recovery would be 57.5 percent with full recovery still allowed in the 2d yr. Aggregate recovery would by 105.

[2] Straight line method.

[3] Depreciation periods are fixed by agreement. With multiple shift operations, a 5-year life is normal.

[4] Additional 4 percent investment allowance permitted in 1st and 2d yr.

[5] Modified declining balance method—30-percent rate plus additional 30-percent allowance in 1st taxable year (such additional allowance does not produce recoverable cost); accumulated cost recovery may not be less than 20 percent of cost for each year asset is in service. A special investment allowance of 10 percent will apply to machinery and equipment acquired for use in business, agriculture, or forestry, provided a purchase agreement has been signed after Oct. 15, 1975 and delivery made before the end of 1976. Losses resulting from the allowance may not be carried forward. As an alternative to the investment allowance, mainly for small businesses or those not making profits, an investment grant will be available under the same conditions. The investment grant is not taxable income and will be 4 percent of the purchase cost of up to S.Kr.500,000 for each financial year.

[6] Depreciation in Australia is based on an estimate of effective life and taxpayers may elect to use either the prime cost (straight line) method or the 150 percent declining balance method. This computation is for assets acquired after July 1, 1976 (when double depreciation allowance was terminated), and takes into consideration the recently enacted investment allowance of 40 percent on capital expenditure contracted after Jan. 1, 1976.

[7] In terms of a law introduced on Dec. 5, 1975, companies may revalue the carrying value of assets and the related accumulated depreciation and place the resulting credit to a tax-free reserve. This provision applied to machinery and equipment acquired before Dec. 31, 1972.

[8] Includes additional for shortened allowances of 15 percent and 15 percent in 1st, 2d, and 3d taxable years respectively

[9] 250 percent declining balance method.

[10] Although not considered, effect may be given to multiple shift operations by reducing service life of assets.

[11] Method changed to straight line in 6th taxable year.

[12] Machinery and equipment purchased between June 30, 1974, and July 1, 1975, limited to 200 percent declining balance method applicable to an asset with an 8-yr life.

[13] The average cost recovery period for machinery and equipment in West Germany is 8 to 10 yr to which additional allowances are permitted for multiple shift operations; 25 percent of allowance for 2-shift operations and 50 percent of allowance for 3-shift operations. Allowances may be further increased when plant is located in certain areas such as Berlin and areas bordering on Iron Curtain countries. The above table sets forth cost recovery allowances based on an average cost recovery period of 9 yr. The double declining balance method is used. A 25-percent additional allowance for 2-shift operations is taken into account beginning with the 5th year when the method is changed to straight line. The corporate depreciation rate thus computed is slightly over the maximum 20-percent rate permitted on a declining balance method to reflect that:

(a) The straight line method produces more depreciation than does the double declining balance method for certain short-lived assets; and

(b) Items of machinery and equipment costing under US $320 can be expensed.

[14] Full year allowance in 1st taxable year for assets acquired in 1st half of such year; half year allowance for assets acquired in 2d half.

[15] Method changed to straight line in 5th taxable year. (See 13 above.)

[16] Double declining balance method.

[17] Full year allowance in 1st taxable year.

[18] Although not considered, installation costs are allowed as current deduction which reduces recoverable base cost.

[19] Method changed to straight line in 5th taxable year.

[20] Modified double declining balance method; 18.9 percent per Japanese Government rate table, salvage built into rate.

[21] Includes special 1st year allowance of 25 percent, allowance reduces recoverable base cost in 2d and succeeding years.

[22] Depreciation in addition to ordinary depreciation in 20 above is allowed to give effect to multiple shift operations. Depreciation multiplied by factor of 1.28 gives effect to 8 hr of daily average excess usage of an item of machinery and equipment.

[23] With investment credit but without ADR.

[25] Without either investment credit or ADR.

[26] With both investment credit and ADR.

[24] Includes 14 percent allowance equivalent to 7 percent investment credit at effective 50-percent income tax rate. Credit does not reduce recoverable base cost.

2. Employment effects, 1962–1972

Employment in capital goods and machine tool manufacturing industries in 1962–1972 also parallels changes in capital recovery tax provisions. Following enactment of the investment credit and adoption of the shorter guideline lives for depreciation in 1962, the number of employees in producers durable goods industries increased rapidly by 23 percent from 6.1 million in 1962 to 7.5 million in 1966. Suspension of the credit in the third quarter of 1966 slowed employment increases to only 2⅔ percent in 1967. Following restoration of the credit in the second quarter of 1967, employment increased to about 8 million in 1969.

With the repeal of the credit in 1969, employment dropped by about 900,000 jobs—roughly 11¼ percent—in 1971. After enactment of the new credit and the ADR in 1971, employment increased from 7.1 million to 7.8 million—about 10 percent—in 1973.

The number of employees in machine tool manufacturing alone rose by 41 percent or 34,000 from 1962 through 1967. Output and employment in this industry was adversely affected by the cutback in the space program in 1968; between 1967 and 1969, employment dropped by 5 percent or 5,800 jobs. Repeal of the investment credit in 1969 resulted in a much steeper drop in jobs, from 110,600 in 1969 to 78,400 in 1971, a decline of 29 percent. After enactment of the new credit and the ADR in 1971, machine tool employment increased by 3,700 jobs or by 4.7 percent in 1972.

The above discussion covers the capital goods sector only. Through the multiplier effect, the beneficial impact of the credit on employment in the capital goods sector was also reflected in higher employment throughout the economy by a factor of two to three times.

3. Revenue effects of changes in capital recovery allowances, 1962–1972

The investment tax credit and the shortening of tax lives have added an estimated $2.6 billion to Federal tax collections from all sources since 1962. In every year that the investment tax credit was in effect, Federal revenues were above the level they would otherwise have been, amounting to approximately $1 billion in 1972 alone.

Conversely, tax receipts fell each time the credit was removed. Suspension of the credit in 1966–67 and its repeal from 1969 until 1971 resulted in a $760 million decrease in Federal tax revenues below what would otherwise have been collected had the credit remained in effect.

These estimates follow from a calculation of the amount by which tax changes altered the cost of capital outlays resulting from enactment of the credit and issuance of the guideline lives in 1962, removal of the basis adjustment in 1964, suspension of the tax credit for two quarters in 1966 and 1967, its restoration in 1967, repeal in 1969 and reinstatement and approval of the Asset Depreciation Range in 1971. Each favorable change raised output, wages and profits, thereby expanding the Federal tax base. Conversely, each tax law change which increased the cost of capital outlays resulted in a lower level of output, wages and profits than would otherwise have occurred.

The patterns of fluctuations in these key areas demonstrate:

(1) That the investment credit accomplishes what its original proponents intended; and

(2) That it can be fully effective in stimulating needed, long-term growth only if its basic provisions (particularly the rate of the credit) are permanent features of the Tax Code.

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[27] 13-yr recovery period reduced by 20 percent and rounded to nearest ½ year. Double declining balance method.

[28] Includes 20 percent allowance equivalent to 10 percent investment credit (temporary credit enacted in the Tax Reduction Act of 1975) at effective 50-percent income tax rate. Credit does not reduce recoverable base cost.

Note: The table summarizes a comparison of cost recovery allowances for industrial machinery and equipment in leading industrial countries with similar allowances in the United States. The capital cost recoveries for each of the foreign countries have been computed on the assumption that the investment qualifies for any special allowances, investment credits, grants, or deductions generally permitted. The deductions in the United States have been determined under the double declining balance method without regard to the limited 1st year allowances for small business.

It is common practice in many countries, prior to investment in fixed assets therein, for investors to agree with the tax authorities as to the rate of depreciation and other benefits available. Such agreements would, in many cases, have the effect of substantially increasing the cost recovery allowance.

Source: Ture and Sanden, "The Effects of Tax Policy on Capital Formation," Financial Executives Research Foundation (New York) 1977, pp. 150–151.

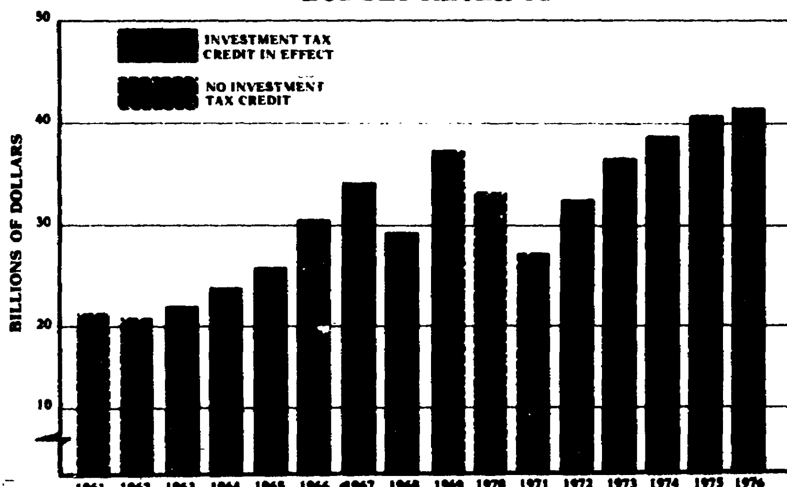


Chart 10
SOURCE: NORMAN B. TURE, INC.

TABLE 14.—ESTIMATED CHANGE IN FEDERAL REVENUES RESULTING FROM TAX CREDIT AND SHORTER TAX LIVES, 1962-72

[In millions of dollars]

	Revenue change	
Calendar year:		
1962	160	
1963	330	
1964	50	
1965	110	
1966		−50
1967	140	
1968	390	
1969		−230
1970		−480
1971	440	
1972	1,000	
Total	2,620	−760
Net change [1]	1,870	

[1] Net change differs from sum of individual changes shown due to rounding.

Source: Norman B. Ture, Inc.

STATEMENT OF NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION

The NMTBA is a national trade association with about 400 member companies accounting for 90 percent of the United States' machine tool production. Our industry's shipments in 1977 were $2,280,750,000, and net new orders totalled $2,996,900,000.

Most of the member companies are small businesses. Over 70 percent of these companies employ less than 250 people. The entire industry employs approximately 92,000 workers.

We are grateful for this opportunity to present our industry's views on the type of tax bill we would like to see reported out of this Committee and to give our suggestions on how we believe the House bill, H.R. 13511, may be strengthened to encourage even greater capital formation, higher employment, and greater economic opportunity through a more productive industrial base.

Economists and the Government increasingly have come to acknowledge that the relatively small but essential machine tool industry is a most reliable barometer for measuring the economic health of the nation, and for determining the impact and effect on industry of changes in depreciation laws, corporate taxes, the investment tax credit and capital gains laws. Therefore, we believe our testimony given today should be viewed in a larger light than just the machine tool industry. Moreover, any tax revisions impacting on investment capital will have resounding effect on this capital-intensive industry.

The machine tool producer is unique, in that he not only sells capital goods, but by necessity purchases from other machine tool builders much of the machinery to manufacture his product. For this reason any real business investment stimulus increases his sales and his purchasing power, which in turn enlarges his productive capacity.

Failure of our tax laws to provide adequate investment opportunities will result in continuing inflationary pressures, higher unemployment, and a steady decline in productivity which would threaten our economic health and position as a leader in world trade. If we are to reverse this trend, we must intensify our efforts to expand and modernize U.S. industry. Only in this way can we achieve increased productivity, sales, profits and employment.

Employment is directly related to capital expenditures and increased industrial capacity. To view employment in a vacuum without concern for its sources is a short-term, nearsighted approach which forbodes future economic chaos. To remain competitive, American industry needs the financial capacity to increase its productivity through the purchase of more efficient capital goods. Direct investment tax incentives and, to a lesser extent, a reduction in corporate taxes will provide the stimulus to expend more corporate resources on capital goods.

However, no government can or should expect business to invest in productive facilities if the after-tax cost is so great, and the cost recovery period so long and uncertain, that business has no assurance of recouping its cost or realizing a reasonable return on its investment.

NMTBA ENDORSES H.R. 13511 IN PRINCIPLE

Earlier this month, the House of Representatives thankfully reversed the entire thrust of recent tax reform legislation. Past Congresses have apparently considered the terms "tax reform" and "income redistribution" to be synonomous.

NMTBA believes that H.R. 13511, as passed by the House, is a giant step in the direction of repairing the damage to our economy caused by this unfortunate and fallacious confusion and mis-definiiton of terms. But, in our judgment, H.R. 13511 does not go far enough.

We are hopeful that this Committee will finish the job.

We commend the House of Representatives for its foresight in recognizing that the reform of capital gains taxes is an important means of increasing capital investment. We urge this Committee to make the same assessment and to build further reductions in the capital gains tax upon the strong base contained in H.R. 13511.

One of the most important features of H.R. 13511 is the so-called "Archer Amendment", which indexes capital gains to account for inflation, using an asset's value on December 31, 1979 or upon acquisition, whichever is later, as the basis for determining a taxable capital gain. NMTBA strongly supports this provision, because it removes illusory gains caused by inflation from taxable income. We urge this Committee to retain this imminently fair provision in the Bill.

It is irrefutable that a capital gain, realized or not, is inseparable from the capital of which it is part. Consequently a tax on a gain is a tax on capital itself. Therefore, it is a colossal economic mistake to view capital as a revenue-raising tax object akin to earned income. It is more accurate to view capital and its reinvestment as a means of increasing productivity, income, and consequently revenue.

NMTBA urges, therefore, that this Committee expand the capital gains tax cuts contained in H.R. 13511, and, in the interest of tax equity, that you retain the 10% *alternate tax* on the capital gains exclusion, which the House wisely substituted for the current 15% minimum add-on tax.

We urge you to retain H.R. 13511's emphasis on individual tax cuts aimed at middle-income taxpayers, instead of succumbing to the Siren's-song of income redistribution. The increased personal exemption and 6% bracket widening contained in H.R. 13511 are clearly a step in the right direction.

THE BUSINESS TAX REDUCTIONS CONTAINED IN H.R. 13511 SHOULD BE REVISED AND EXPANDED

With the exception of the graduated corporate income tax for small businesses, NMTBA finds little to quarrel with in the business tax cut section of H.R. 13511. Making the 10% Investment Tax Credit permanent, expanding its usability, and cutting the corporate tax rate by two points are measures which are long overdue.

But they are also woefully inadequate in light of what we are about to relate to you concerning inflation's erosive impact on today's economy.

Our concern over the capital investment practices of American industry is not new. The machine tool industry knows that investment in productivity improving production machinery has not kept pace with the growth of the U.S. economy during recent years. However, we became especially alarmed when we heard knowledgeable businessmen make public statements like: "We are in liquidation," "Business had paid its dividends out of capital," or "Some businesses may be in the process of unconscious liquidation."

To find out what was really going on in the metalworking industry, we selected 16 major metalworking companies and extracted data from their annual reports. The 16 companies include four automakers, four off-road and farm equipment manufacturers, three steel firms, two mining equipment manufacturers, and three companies that manufacture parts and components for the transportation, aerospace, building and pollution control industries.

Without question, the companies we selected are leaders in their industries. Ten of them are in the top hundred of the Fortune 500 and every one of the 16 would be considered a blue chip on Wall Street. But, to make sure that our sample of the metalworking industry was representative of American industry, we compared their output, profits, and capital expenditures to those of all durable goods manufacturers.

The output of our 16 companies (Chart 1) tracked durable goods production closely. But, as would be expected, our sample of industry leaders has performed somewhat better than the durable goods industry in this decade.

Throughout the 1960's our sample meshed its profitability very closely with durable goods (Chart 2). And again, in the 1970's our 16 leaders were ahead of the industry.

The capital investment history (Chart 3) of our 16 selected metalworking companies also closely paralleled the investment of all durable goods manufacturers, particularly in recent years.

So, we concluded that these 16 companies, if anything, have slightly out-performed the remainder of America's durables industry during recent years. Any conclusions we draw from the sample's performance can certainly be extended to the metalworking industry in general.

After steady growth through the 1960's these metalworking companies seemed to be on an even faster track in the 1970's. (Chart 4)

But, the double-digit inflation of the early 1970's straightened out the accelerated sales curve. So, in real terms, our 16 metalworking companies have merely continued their historic sales pattern during the 1970's. But even so, sales are not the complete measure of success.

Profits, (Chart 5) as a precent of sales for the 16 selected metalworking companies, have followed a downward trend line from 7 percent in 1960 to 3½ percent in 1977—a 50 percent decline in just 17 years.

But declining profitability is only a small part of the problem, and it is a symptom not a cause. It is one of the early-warning signals to America. It is a signal that our economy is not performing properly and that trouble lies ahead unless corrective action is taken, and taken promptly.

Chart 6 shows capital spending history of our 16 metal-working companies. The beneficial effect of the confidence and stability of the early 1960's can be clearly seen. Then their capital spending stayed on a plateau that lasted seven years. In 1972 current-dollar capital spending took off again; but gains were almost entirely wiped out by inflation. Real capital spending has been declining, and declining rather steadily, since 1965. (Almost all of the 1977 increase shown here resulted from a virtual doubling of government-mandated investment by just two of the auto companies.)

The decline on Chart 6 is even worse than it appears. It is worse because the character of industry's capital investment has been changing substantially. In the 1960's much of the capital spending of companies like these 16 was for new plant and equipment that was directly related to production. But in the early 1970's all

of that changed and an increasing share of the spending was for compliance with new government regulations like those from EPA and OSHA. So not only was capital spending declining in real terms but also capital spending for productivity-improving plant and equipment, and new capacity must have been declining at an even faster rate.

Now if the sales of these companies had been declining there would be good reason for capital investment to decline, but sales were rising. As a result, when capital spending is viewed as a percentage of sales (Chart 7), the decline is dramatic. Since 1965 the portion of every sale dollar reinvested by these 16 companies has fallen nearly 40 percent: from 6.6 percent of sales to 4.1 percent of sales.

Chart 8 shows the reported book value of the fixed assets of the 16 metalworking companies. The book value of our sample (in current dollars) nearly tripled in the 17-year span. It looks like a stock broker's dream.

But from 1960 to 1967 when the annual inflation rate averaged about 2 percent, the real value of these 16 corporations was healthily growing. Then, at the turn of the decade, when the inflation rate was averaging nearly 4½ percent, real growth came to a halt. During the last few disastrous years with inflation averaging over 6 percent, the real asset value of our sample companies declined substantially.

INDUSTRY LIQUIDATION

Since 1970 Chart 8 indicates that America's metalworking industry has, in fact, been in unconscious and involuntary liquidation. And the same probably holds true for almost all of America's manufacturing industries.

It is no wonder that industrialists are concerned! It is no wonder that they are talking about de-facto liquidation! It is no wonder Wall Street is cautious! And, with this kind of evidence, can anyone fail to understand why American industry is losing its competitiveness, and why we have had a balance of payments crisis for the past few years?

And what about jobs? How can anyone expect to solve America's unemployment problem when its industrial asset base is shrinking? Those are the very assets that create jobs. And without assets there can be no employment in industry.

Lest anyone doubt that the decline in real fixed asset value is an indicator of a loss of competitiveness, look at Chart 9. It shows the sales of our 16 metalworking companies as they relate to the value of their assets. Throughout the 1960's the graph fluctuated up and down with the business cycle. But since 1970 the trend has been upward.

At first glance this might look good. It says that these companies are getting more dollars of product output per dollar of fixed assets. But think of the implications for a moment. What the growth in sales per dollar of fixed assets really means is that these companies have to be relying on aging, depreciated and probably obsolete equipment to produce the extra sales. In other words, their sales are going up, their assets are aging, and their plants are becoming more and more obsolete. The result has to be a loss of efficiency and a decline in America's competitiveness vis-a-vis the world. There can be no other conclusion.

Chart 10 shows the bottom line results of this de-facto liquidation. The return on the assets of these 16 companies has been following a downward trend throughout the 17-year period. In other words, inadequate investment, in tandem with intolerable inflation during the past few years, has caused a decline in virtually every indicator of the health of America's metalworking industry. Chart 11 shows that during the 17-year period capital expenditures hovered about an average value of $1.57 of new capital investment per dollar of depreciation. And until 1971, that was sufficient to keep industry out of liquidation.

But since then, during the 1972–1977 period, the capital investment required just to stay even leapt to $2.92 per dollar of depreciation because of inflation. Hence, for every dollar of depreciation claimed by a company, the company had to spend $2.92 for new capital equipment just to avoid de-facto liquidation.

The effect of inflation is absolutely devastating. It has completely changed the rules of the game. Companies that were progressive capital spenders for years suddenly found themselves under-spending. Were the funds available? Or was it bad management?

Net cash flow is depreciation plus net profit. Chart 12 shows capital spending as a percentage of the net cash flow of our 16 companies. The line at 100 is net cash flow. It shows that, for the past 17 years, the 16 metalworking companies

spent 60% of their net cash flow for capital investment. In the lean-profit years the percentage was even higher.

But what should they have spent to avoid de-facto liquidation? Again, the ground rules changed and since 1971 the average required spending was 114% of every dollar of available funds, and that means no dividends for the stockholders.

NOT ENOUGH MONEY

Obviously, for these companies to maintain the real value of their fixed assets and pay dividends to their stockholders, they would have been required to borrow heavily from 1974 through 1977, much of it during times when funds were short and interest rates were sky-high.

Chart 13 shows what the 16 companies actually spent in current dollars, and what they would have had to spend to maintain the real value of their fixed assets since 1971.

Instead of spending about $6.1 billion in 1977, they should have spend $10.6 billion. Over the entire six-year period the capital spending needed to stay even was about twice the actual capital spending for these companies. But given our depreciation policy, capital spending at those levels was impossible!

Is it any wonder that large segments of the American metalworking industry—including the machine tool industry—are being "eaten alive" by more efficient, more productive foreign competitors? We strongly urge this Committee to reverse this rush to involuntary liquidation. This can be accomplished most effectively by adding an additional $2 to $3 billion in business tax cuts to H.R. 13511 and by targeting these tax cuts to improvements in the capital cost recovery system.

Given the obsolescence of American industrial plants and equipment, we believe an additional 2 percent investment tax credit is vital to stimulate the level of capital spending necessary to raise lagging productivity, increase capacity, boost employment, and hold down inflation. The investment tax credit has had an "on-again-off-again" history since its inception during the Kennedy Administration. Chart 14 shows that the 1962 enactment of a 7 percent investment tax credit brought a marked increase in domestic machine tool new orders; a similar jump in sales occurred in 1967 and 1971, when the 7 percent credit was reinstated. In the years 1966 and 1969, when the credit was repealed, the volume of new orders plummeted. These figures indicate that even a modest 7 percent investment tax credit encouraged industry to update its plants and equipment. Furthermore, since 1975, when a 10 percent investment tax credit was adopted, orders have almost tripled. If a temporary 3 percent increase in the investment tax credit was this effective, a permanent 12 percent investment tax credit should have an even more profound impact on capital spending.

Chart 15 shows that when the investment tax credit was in effect, and when, consequently, sales were high, employment in the machine tool industry increased. It is axiomatic that workers cannot be productive without the tools of production, which, due to inflation, are becoming increasingly expensive. The positive impact of the 10 percent investment tax credit in 1975 has been reduced by the ravages of inflation. Thus, a 12 percent investment tax credit is necessary in 1978, if the 1975 momentum is to be sustained. The current 10 percent credit simply has not kept pace with inflation's impact on replacement costs with the need to modernize American industry in the fact of ever-increasing foreign competition (much of which is supported by direct government subsidies).

Although the increase in the investment tax credit in 1975 sparked an upturn in orders, this increase started from the second lowest level of new orders since 1961. We cannot hope to improve employment in the machine tool industry without a much greater increase in our customers' capacity to purchase new machine tools. We believe that a 12 percent permanent investment tax credit is required to sustain current employment trends and to provide new jobs in the machine tool and capital goods industries.

Like a 12 percent permanent investment tax credit, a 40 percent Asset Depreciation Range (ADR), or in the alternative shorter depreciable lives for capital equipment (or indexing depreciation to account for inflation) is a direct investment incentive. Only through capital outlays can its tax benefits be realized. Among the various business tax cut proposals, a 40 percent ADR along with a 12 percent investment tax credit, should receive top priority in any tax package designed to increase capital investment and expand productivity.

Currently the I.R.S. lists the lifetime of a machine tool at 10 years. With the current 20 percent ADR these machines may be depreciated over 8 years. To

keep up with the rapidly advancing technology of machine tools, U.S. corporations need to constantly upgrade their equipment. An eight-year write-off period for machine tools is too long a depreciation period to provide for realistic replacement cost recovery—particularly when inflation is taken into account. Few businesses can even begin to accurately forecast their sales for an eight year period and fewer still can incorporate capital improvements needs into those projections.

A shorter lifetime or greater ADR will allow U.S. corporations to more quickly recoup their costs for machinery and equipment and consequently allow them to modernize their plants' machinery and equipment. Such modernization will lead to increased productivity, more employment, and a healthier competitive posture in the world economy. Otherwise our capital cost recovery time will remain disasterously long compared with almost all other industrial nations, and will place our manufacturers at a severe competitive disadvantage. In any case—regardless of the method used—the time over which capital equipment costs may be recovered must be shortened.

NMTBA also endorses the Administration's original recommendation for the elimination of salvage values in computing depreciation allowances. We believe this should be corollary to an increased ADR and shorter depreciable lives for capital equipment.

Therefore, we urge substantial improvements in the capital cost recovery system, including a 12 percent investment tax credit. If, in the judgment of this Committee, available funds do not permit institution of both a 2 percent rate reduction and a 12 percent investment tax credit, NMTBA believes that the size of the rate reduction should be sacrificed for an improved capital cost recovery system.

We also urge this Committee to modify H.R. 13511 so that a 12 percent investment tax credit may be taken against 100 percent instead of 90 percent of a company's tax liability. This would further accelerate a company's ability to write-off capital expenditures and to make new capital improvements sooner. The alternative is the continued involuntary liquidation of American industry.

EXPENSING OF FEDERALLY CAPITAL ACQUISITIONS

In conjunction with a 40 percent ADR and shorter depreciable lives on capital equipment, NMTBA favors the expensing of federally-mandated, non-productive capital investments. While we support efforts to provide a better environment and safer workplace, NMTBA believes any equipment required by the EPA, OSHA, or the like, should be expensed. While such investments work to society's benefit, they siphon off funds which a company could invest in increasing productivity through capital expansion.

Senator Bentsen has introduced S. 3404, which provides for a faster write-off for all federally-mandated acquisitions. At a minimum, we urge you to include it in H.R. 13511.

RETENTION OF DISC AND DEFERRAL

Among the most widely used export-related tax provisions is DISC. It is inconceivable to NMTBA that some would suggest that DISC be repealed at a time when unemployment exceeds 6%; investment capital in short supply; and our balance of trade deficit is one of the worst in recent history. DISC repeal would have the effect of reducing the export business of hundreds of companies, many of them small companies in the machine tool industry, thus reducing U.S. jobs and exacerbating the U.S. balance of trade deficit. They would have to lose much of their business to foreign plants.

The continuance of DISC is tremendously important to the relatively small companies in the machine tool industry. Many of these companies because of capital shortages cannot invest in plant facilities abroad or finance other operations there to supply their foreign markets. They have relied on cash flow provided by the DISC to increase capital investment and jobs here in the U.S. so as to compete more effectively in foreign markets.

The DISC was enacted in 1971 when there was a deficit in the U.S. balance of payments. Following its enactment between 1971 and 1975, the United States achieved a favorable balance of trade, despite the tremendous increase in oil payments to the OPEC countries. The U.S. experienced the worst balance of payments deficit in our history last year, but DISC-stimulated exports have kept the deficit from going even higher. For example, the American machine tool industry experienced a decline in export shipments from the high 1975 levels ($567.6 million) to $546.5 million in 1976 and to $452.1 million in 1977. It makes

little sense to eliminate a program such as DISC which has been a most important factor in keeping exports from declining further.

To keep our export picture from turning even greyer, we ask this Committee to retain DISC along with its step-sister deferral.

Deferral of foreign-source income has allowed American corporations to gain a foothold in overseas markets. Deferral enables U.S. exporters to compete with foreign governments who directly subsidize their exporters.

In recent years many small machine tool companies have expanded their manufacturing and sales facilities at home and abroad at the urging of the U.S. Government in order to increase foreign sales and help offset the growing deficit. To abruptly withdraw promised tax benefits before such corporations have become firmly established abroad, and in their place substitute tax penalties far more severe than any other industrial nation imposes on any of our foreign competitors would not only be unfair to them, but highly detrimental to U.S. foreign trade. U.S. industry must have a reliable and stable tax base for its foreign operations because of the many unusual risks involved, if it is to meet strenuous competition in world markets and achieve a favorable balance of trade.

Furthermore, any proposal to phase out deferral is contrary to long-established international tax policy. In no case do the laws of any foreign country where the subsidiary's parent corporation is a national impose taxes on those same earnings until they are distributed as dividends, unless it can be etsablished that the earnings have been improperly diverted from the parent company. Imposition of such a tax by the United States would not only be misunderstood and resented by foreign governments (and also by a foreign corporation's minority shareholders and employees), but it might well be considered by some governments as an incursion on their sovereignty and invite retaliation. Certainly it would not improve international relations or international trade.

The loss of international markets to our foreign competitors would have a drastic effect on our national economy and defense capability. U.S. Government and other surveys have shown that there is clearly a net benefit from foreign operations and that they have contributed tremendously to the increase in industrial plants and jobs in the United States. The 1972 Department of Commerce study of multinational corporations estimates that more than 500,000 jobs would be lost if there was no U.S. foreign direct investment. The study concluded that 250,000 employees, principally production workers, would be out of work; that another 250,000 jobs would be eliminated in the home offices of U.S. multinational companies; and that an additional 100,000 jobs for supporting workers would also be lost.

A January 16, 1978 Government Accounting Office (GAO) study entitled "Domestic Policy Issues Stemming From U.S. Direct Investment Abroad" substantiates this conclusion. Included in the GAO study is a summary by Business International Corporation, which reveals that, between 1960 and 1972 the most intensive foreign investing companies increased their domestic employment by about 40%, compared with an 11 percent increase for firms not as aggressive.

Critics charge that controlled foreign corporations are a means of circumventing more expensive domestic labor. Those charges are refuted by the GAO study. A vast majority of controlled foreign corporations are located in Europe and Canada, where total labor costs are comparable to those in the U.S. As a corollary, these critics allege that U.S. controlled foreign corporations export many of their products to the U.S. to compete with domestically-produced goods. The GAO survey shows only 7 percent of controlled foreign corporation products are exported to the U.S. Significantly, only 1 percent of all Japanese exports to the U.S. are produced by American companies with facilities in that country.

Some Administration economists see controlled foreign corporations as a drain on U.S. currency which, in effect, distribute income to foreign countries. Again, the charge is refuted by the GAO study which shows that about two-thirds of controlled foreign corporation capital is borrowed abroad.

In a DoC-sponsored 1972 study headed by Professor Robert Stobaugh of the Harvard Business School, it was revealed that foreign direct investment in manufacturing had created about 600,000 U.S. jobs and had a positive effect on the U.S. balance of payments of $3.0 billion or more. Consequently, we urge this Committee to extend the lives of these export-related incentives—DISC and deferral—which have had such a positive effect in keeping the U.S. balance of trade from deteriorating further.

CORPORATE SURTAX EXEMPTION

NMTBA also supports an increase in the corporate surtax exemption from $50,000 to at least $100,000. The $25,000 surtax exemption (temporarily $50,000 until 1979) was enacted in 1950 as a mechanism to protect all but the largest firms from the top corporate rate. Since 1950, however, inflation and business growth have dramatically increased the number of small- and medium-sized companies whose earnings exceed the $25,000 exemption. In 1969, some 93,000 taxable corporations, or 12 percent of the total, had incomes above $50,000. By 1979 projections place this group at 195,000 companies, or 19 percent of all taxable U.S. corporations.

H.R. 13511 replaced the outdated corporate surtax exemption with a graduated corporate income tax on income between $25,000 and $100,000. An alternate proposal raising the corporate surtax exemption to $75,000 with no graduation was rejected. We believe the alternate is the more sensible proposal for the following reasons.

Unlike most individual taxpayers, corporations within the same graduated corporate tax bracket would vary greatly. A family-run grocery with 10 employees earning $50,000 might be quite successful, whereas, a machine tool builder employing 100 people and owning $2 to $3 billion in capital assets might consider a $50,000 profit alarmingly small. The grocer has lower overhead and few capital expenditures compared to the large plant facilities and expensive machines and equipment requried by the machine tool builder.

A graduated corporate tax would compound the adverse impact of inflation on the current tax structure. A company growing at the rate of 10% a year (7 percent inflation plus 3% real growth) would almost double its income every seven years, moving it through several rate increases. The surtax exemption, being a one step system, minimizes the inequitable effects of inflation on corporate taxes.

Finally, the graduated corporate tax would greatly exacerbate a situation often cited by surtax exemption opponents, who claim the large surtax rate jump from 22 percent to 48 percent encourages small firms to perform unnatural economic acts to delay moving into the higher bracket. A graduated series of rate steps, under this reasoning, would make Houdini's of small businessmen in preparing their cooperate tax returns. Again, the corporate surtax exemption would minimize these alleged corporate economic contortions.

NMTBA urges this Committee to re-establish the original purpose of the 1950 surtax exemption—that being to tax all but the larger corporations at a lower rate—by substituting a $100,000 surtax exemption for H.R. 13511's graduated corporate tax.

PRODUCT LIABILITY TAX RELIEF

Thus far in our testimony, we have outlined steps which must be taken to remedy the perilously low rate of investment in capital goods. But, I am sad to report an even worse problem exists for many of our members—a problem which has serious implications for the survival of the machine tool industry. That problem is product liability.

The inability of approximately 22 percent of NMTBA's members to either afford or obtain product liability insurance has become a grave concern to us. Under the present Tax Code a self-insurance reserve may be created only with after-tax dollars. Many small companies in our industry already faced with liquidity problems due to insufficient investment tax incentives must go bare.

A nexus exists between a machine tool builder's ability to take advantage of internal capital formation incentives and his product liability insurance situation. To those NMTBA members wthout product liability coverage who desperately need new equipment to stave off involuntary liquidation and to remain competitive, a 12% investment tax credit or 40% ADR may prove meaningless if they have to expend large sums of money to defend product liability lawsuits.

Product liability insurers insist that product liability exposure in the machine tool industry is so unpredictable that the risks involved are unratable. As a consequence they explain that they must charge perilously high premiums to lower catastrophic losses. Since 1970 the average machine tool builder's product liability insurance premium has skyrocketed from $10,000 to $141,700, a 1317 percent increase. To a machine tool builder who has a severe product liability insurance problem and who is a part of an industry with a historically low profit

margin, several relatively small judgments coupled with the enormous attorney's fees needed to defend even the most frivolous product liability suits can be crippling or lethal, if he has inadequate coverage.

To alleviate this impending crisis, Senators Nelson and Culver have introduced S. 3049 which permits companies with product liability insurance problems to create self-insurance reserves with pre-tax dollars to be used only for product liability expenditures.

S. 3049 permits those with an acute product liability insurance problem—defined as the inability to obtain first-dollar $1,000,000 coverage for less than 3 percent of gross sales—to deduct a funded reserve of up to $100,000 annually. Those with a less severe problem may deduct up to $25,000. The initial year cost to the Treasury, as estimated by the Joint Committee on Internal Revenue Taxation, would amount to approximately $180 million. However, because it is a tax-deferral concept, S. 3049's impact would level off to about $25 million by the fifth year.

This Committee established a precedent for S. 3049, when, under the leadership of Chairman Long and Senator Hansen it permitted tax deductible self-insurance reserves for Black Lung benefits. Like the Black Lung Act, S. 3049 severely limits the use of the funded reserves. If product liability reserves are used for anything other than product liability matters, S. 3049 enacts harsh tax consequences for these misdirected funds.

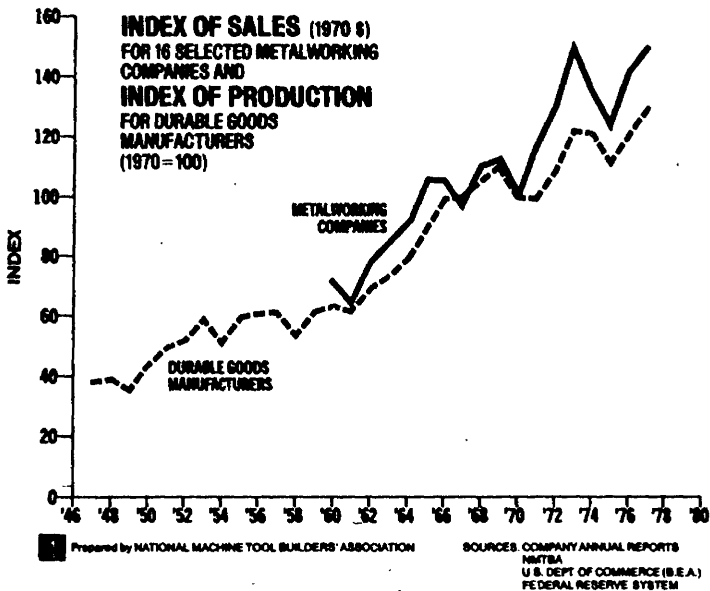
The Carter Administration unfortunately rejected S. 3049's self-insurance approach in favor of a plan permitting businesses to carryback product liability losses ten years instead of three. Standing alone, this proposal primarily aids those companies with catastrophic product liability losses which cannot be completely written off within the present three year period. The ten year carryback proposal would be of help only to the relatively few taxpayers, who experience catastrophic product liability losses which exceed their total profits over a three year period. Consequently the carryback proposal would do little to ameliorate the present plight of most manufacturers and would not give them the protection of an existing fund to be used for smaller, but more numerous product liability settlements and defense costs. Moreover, many of our members' customers require the vendor have product liability coverage or some type of self-insurance before the completion of a proposed sale. A funded reserve may meet this requirement. The carryback proposal clearly does not.

NMTBA urges this Committee to include in H.R. 13511 a product liability self-insurance mechanism similar to that contained in S. 3049, coupled with the Administration's $10 million carryback proposal. This product liability tax relief package will provide adequate protection from both large and small product liability losses to busineses with severe product liability insurance problems. We are confident that this Committee can fashion such a comprehensive product liability tax relief program within the confines of a modest revenue loss under $100 million.

CONCLUSION

NMTBA appreciates this opportunity to express our views on tax legislation which is vital to America's economic health.

CHART 1



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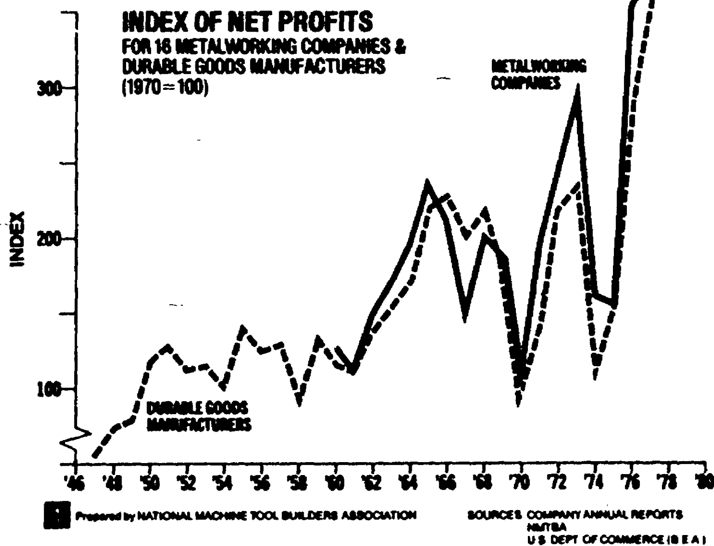

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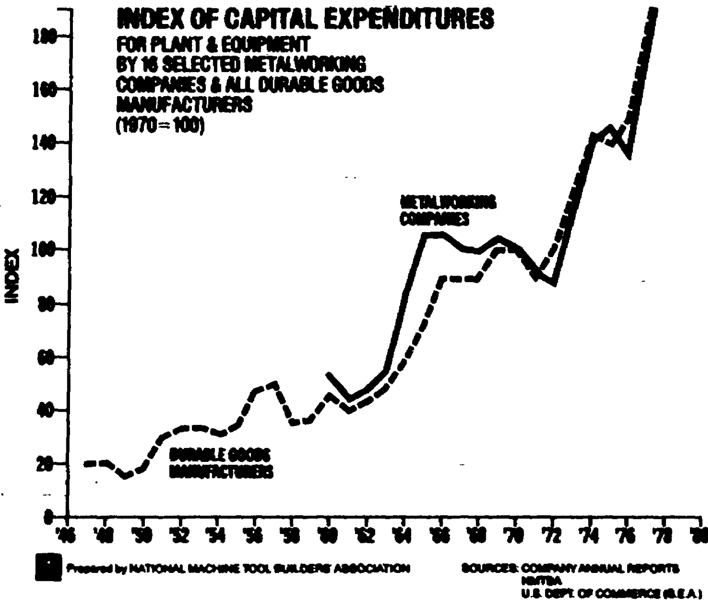

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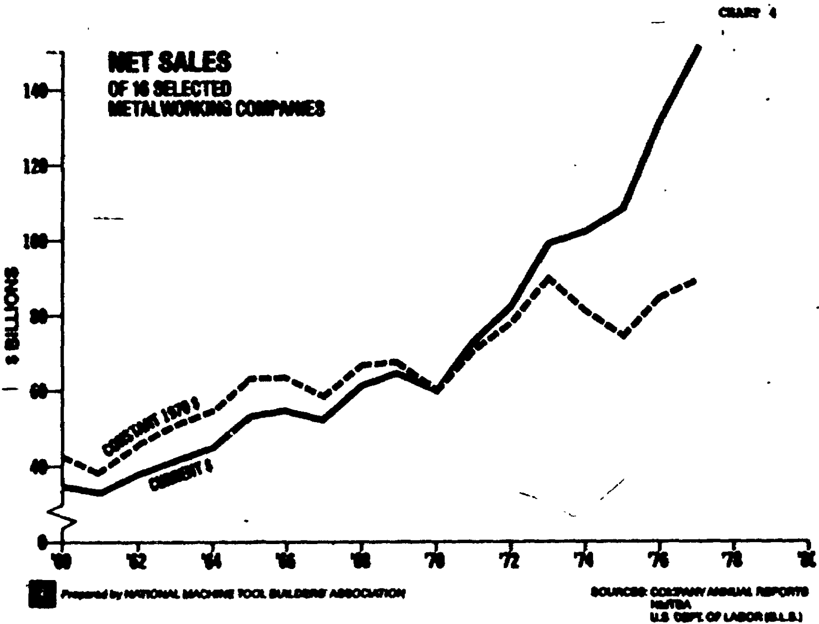

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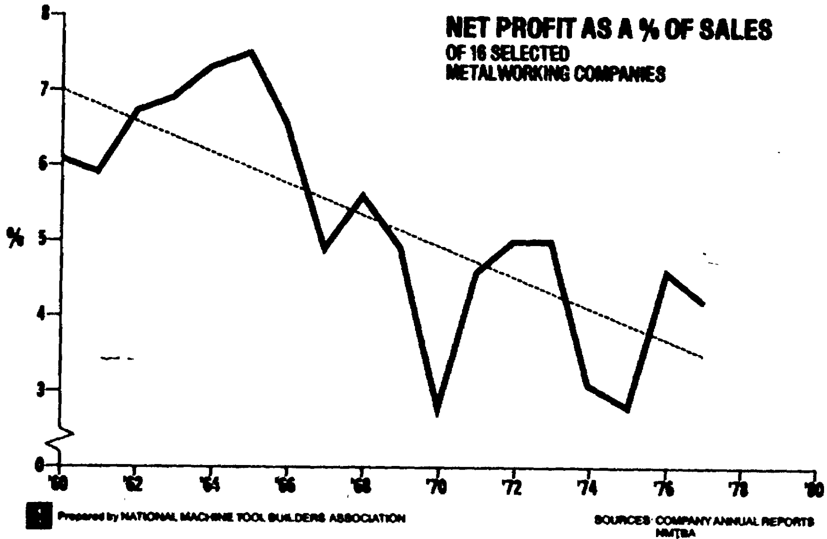

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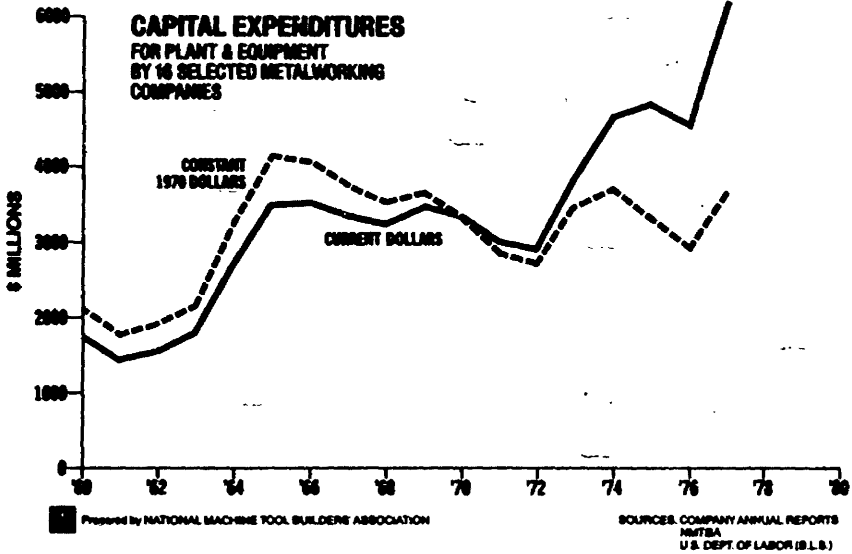

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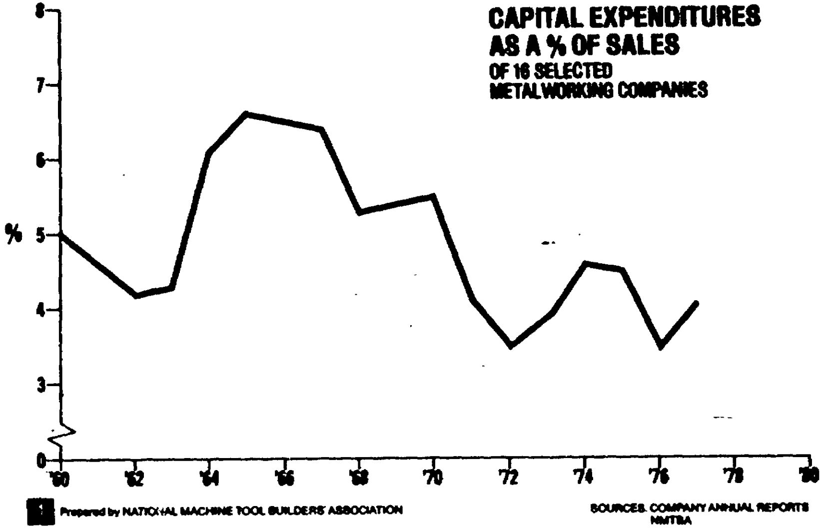

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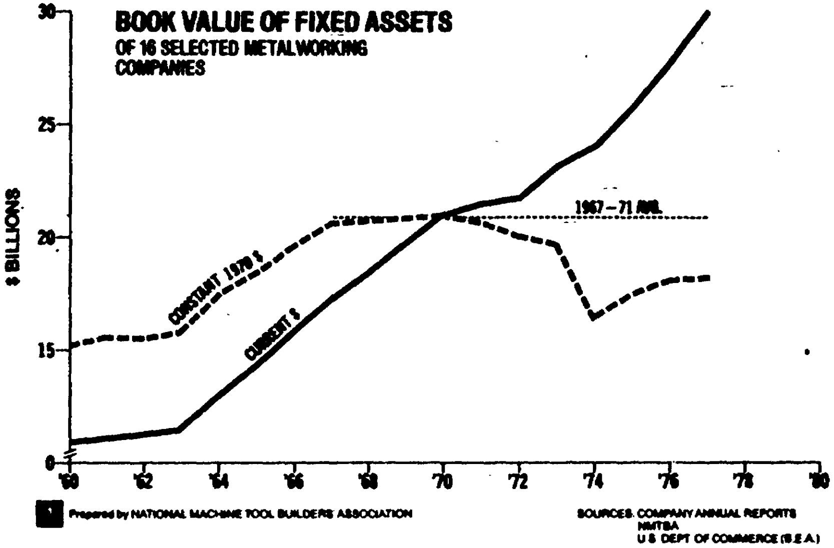

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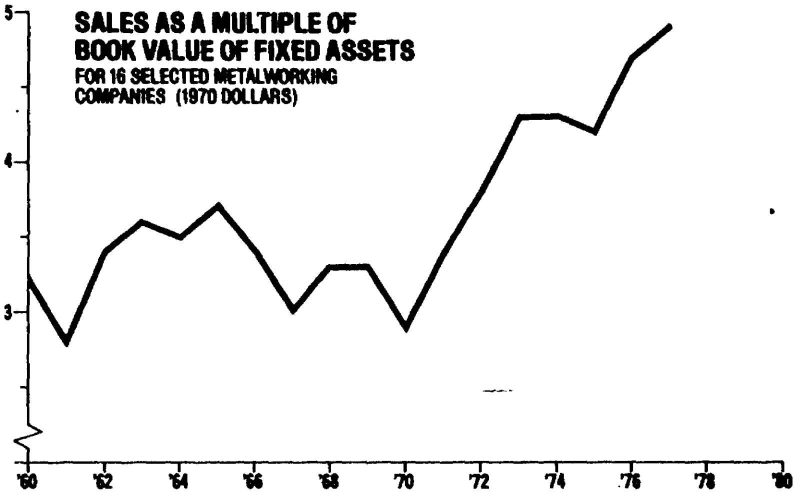

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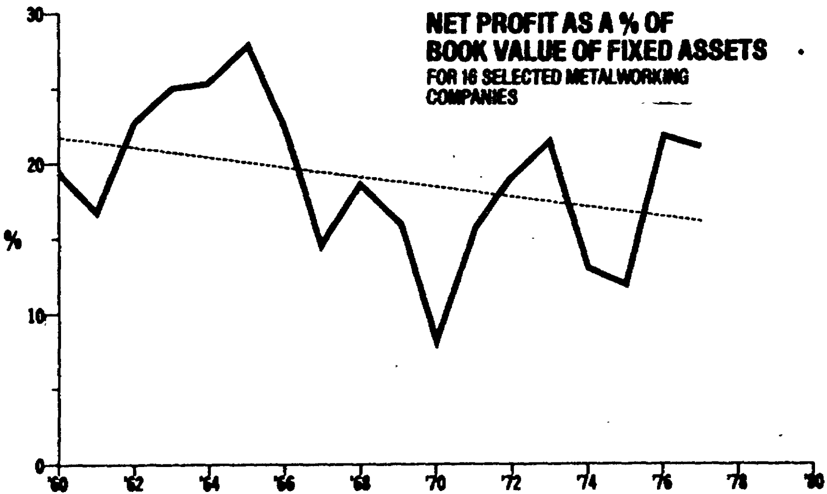

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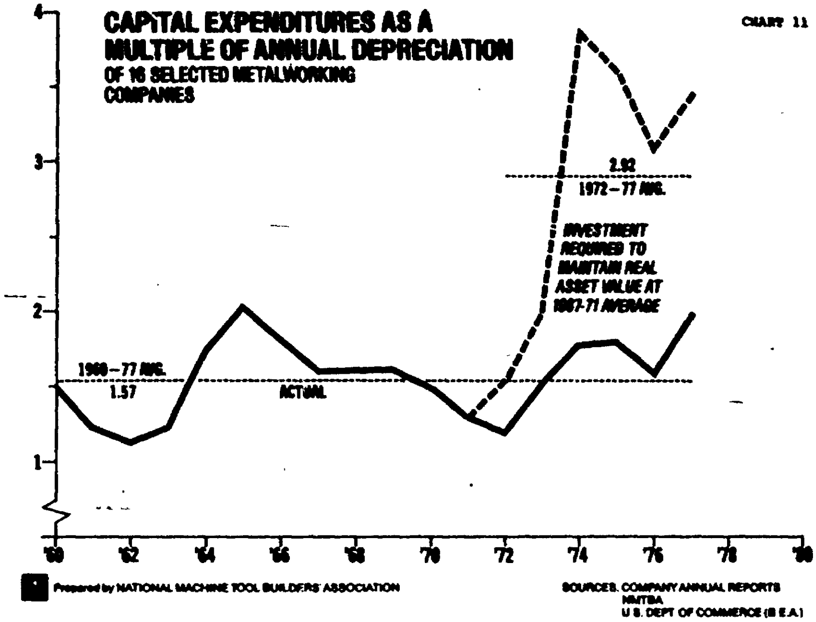

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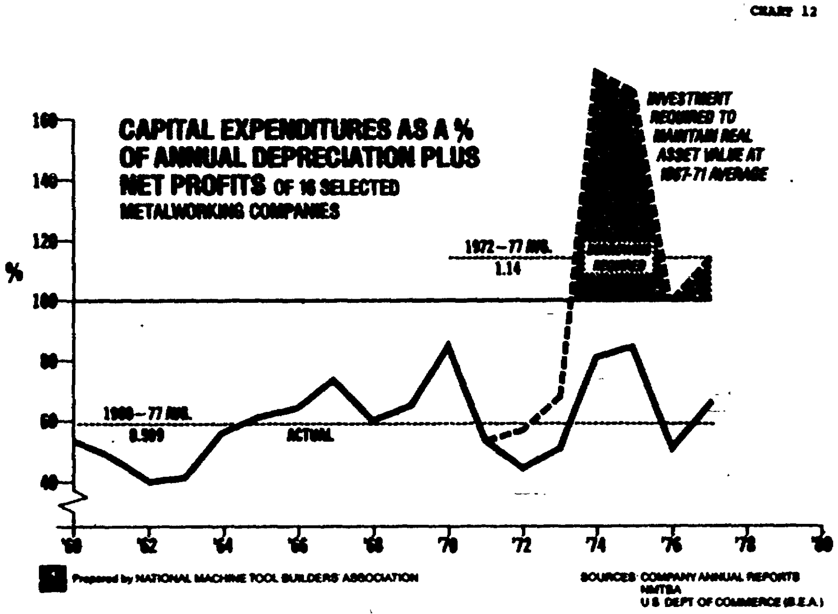

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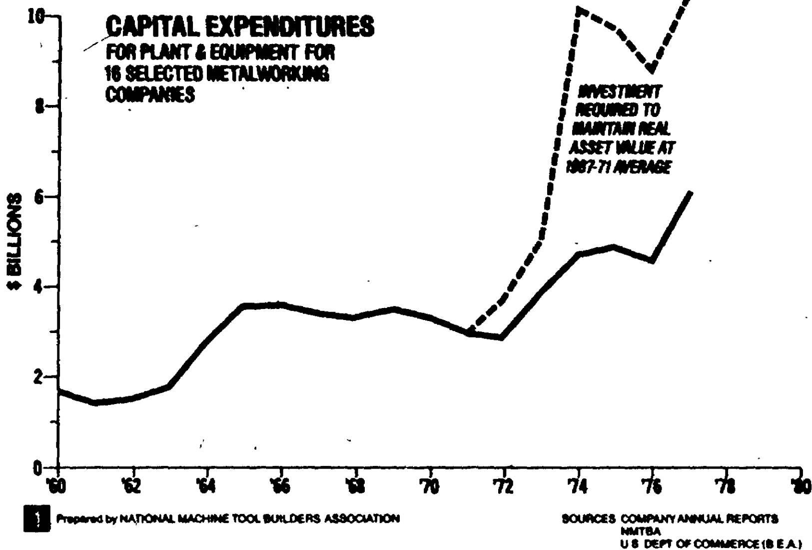
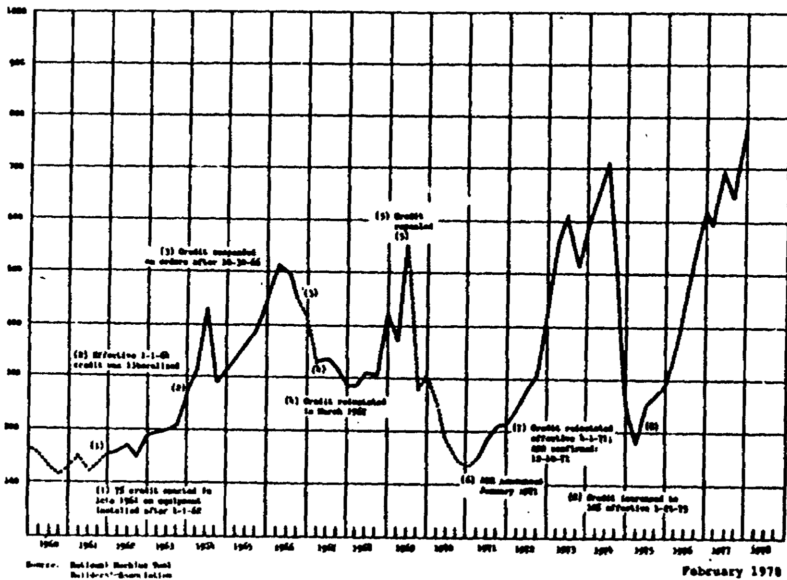


MACHINE TOOLS - Domestic New Orders

Quarterly

CHART 14

Millions of Dollars



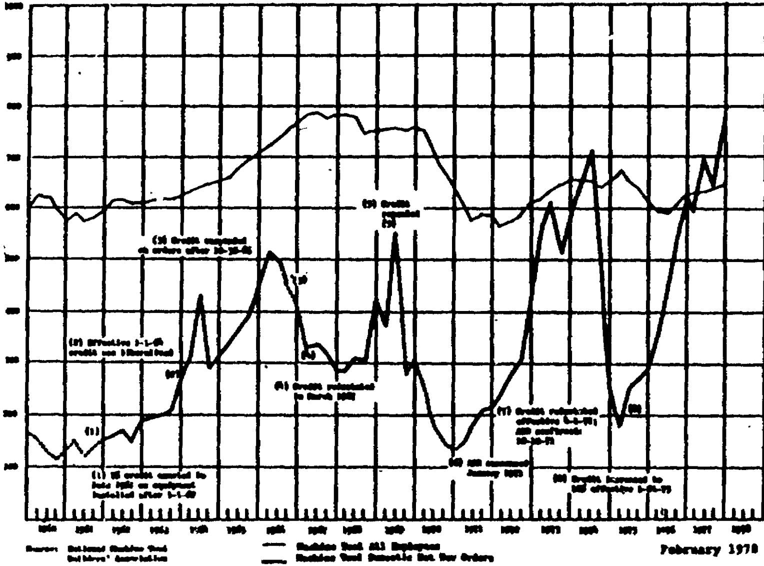


CHART 15
February 1978

The CHAIRMAN. Next we will call Mr. Michael McKevitt; Mr. Don J. DeBolt; Deane Stewart; Mr. Arthur Livitt; Mr. Mark Singer; Mr. William C. McCamant.

Mr. McKevitte, speaking for the National Federation of Independent Businessmen, will be the first witness.

Gentlemen, if you would just hold your place, I am going to ask Senator Weicker to take a seat up here on the dais and make a statement. We are trying to accommodate Senators so they can get on to other business.

STATEMENT OF HON. LOWELL P. WEICKER, Jr., A U.S. SENATOR FROM THE STATE OF CONNECTICUT

Senator WEICKER. Thank you very much, Mr. Chairman and members of the committee. I have a complete statement to submit to you for the record. I will just go ahead and read an abbreviated one at this time.

I would like to discuss H.R. 13511 and complementary tax proposals presently before the Finance Committee, focusing my testimony on measures designed to promote capital formation.

I am encouraged by the fact that H.R. 13511 removes capital gains from the list of tax preferences which are subject to the individual and corporate minimum tax and which reduce the amount of an individual's personal service income eligible for the 50 percent maximum tax. This change will go a long way toward stimulating investment.

However, I urge this committee to adopt even stronger measures. As you know, I joined Senator Hansen and more than 60 of our colleagues in cosponsoring S. 3065. This bill, which would stimulate risk capital investment by reducing the maximum tax rate on net capital gains from today's high level of nearly 50 percent for individuals and more than 30 percent for corporations to the 25-percent level that existed before the Tax Reform Act of 1969, is essential for the stimulation of investment. In my prepared remarks I document the need for restoring the capital gains tax to pre-1969 levels.

I believe it is essential that this Congress enact legislation which will reduce the tax imposed on capital gains. However, other steps must be taken to insure our Nation's economic vitality.

As ranking minority member of the Select Committee on Small Business, I recently chaired hearings on the capital formation problem confronting this Nation's smaller businesses. Senator Hathaway joined me in a hearing which was held on Wall Street in May. The severity of the problem was attested to by an outstanding array of individuals representing diverse interests. Their testimony conclusively confirmed that the capital formation problem has had an acute impact on our Nation's small and medium businesses. I provide statistics documenting this dire situation in my prepared remarks.

These small businesses which are being deprived of the equity necessary for survival and growth are the companies which held the key to solving America's future employment needs. Recent studies conducted by the MIT Development Foundation and the American Electronics Association, which are detailed in my formal statement, showed the ability of small, newer businesses to provide new jobs at a faster rate than large, established firms.

According to the Commerce Department, the Nation will require 1.5 million new jobs anually until 1985. As evidenced by the MIT and

AEA studies, smaller businesses, with their capacity to produce new jobs, will play a key role in satisfying this need.

At the same time that smaller, growth-oriented companies are being squeezed out of the capital markets, individual investors have been steadily withdrawing from these markets. The extent of this exodus is documented in my prepared remarks. In addition to denying small businesses an important source of capital, this flight of the individual investor from the securities market has resulted in a growing concentration of economic power in too few hands. Perhaps most importantly, because the individual's stake in the economic system has been sharply curtailed, he is less likely to fight to protect it. This alarming trend therefore threatens to undermine the essence of our free enterprise system.

During the course of the hearings held by the Small Business Committee, witnesses testified that investors have turned away from investments in smaller businesses because the risk-to-reward ratio has been substantially altered. The risk inherent in investing in a small business has been increased by the economic uncertainties caused by inflation, increasing Federal regulations, and a breakdown in the distribution system for small business securities.

Concomitant with this increased risk there has been a reduction in the possible rewards to be reaped by the investor. The maximum tax rate for capital gains, coupled with preference taxes and the minimum tax, is nearly double what it was in 1969. The effect of these changes in the tax laws is that the effective capital gains tax rate has been increased to a point where it is almost as high as the ordinary income tax rate.

A reduction in the capital gains tax rate will stimulate investment in the equity markets. The expansion in the supply of capital caused by such a reduction would benefit small businesses which must compete in the capital market for funds. However, it is likely that many investors will prefer a relatively secure position with a large company, and direct equity investment in small businesses, which involve greater risks, will not increase appreciably. Thus, something more must be done to attract investors in smaller businesses.

In response to this particular problem, Senator Hathaway and I introduced S. 3320, the Small Business Investment Incentive Act. This legislation, which I feel should be enacted as a complement to capital gains reform, would provide the stimulus needed to get the individual investor to participate in the solution of the capital formation problem confronting America's small and medium businesses.

Pursuant to this bill, the investor will be given a credit against tax of 10 percent of the first $7,500 investment in qualifying new stock issues during the taxable year. In the case where a joint return is filed, a credit of 10 percent would be given on the first $15,000 invested. This legislation is thus designed to induce the marginal investor to invest in smaller corporations. That is, it is designed to remove the final barrier to investment in smaller, riskier corporations and thereby enable these corporations to compete effectively with large, established corporations for the investment dollar.

Utilizing a credit, as opposed to a deduction, and limiting the credit to a specific dollar amount, assures that the benefits of this legislation will flow primarily to middle-income taxpayers, whose participation

in the marketplace is essential to the viability of our free enterprise system. However, dependents would be ineligible for the credit, thereby preventing a child who has income from a trust fund from applying the credit against the tax on the trust fund or other investment income.

Thus, the legislation will not result in "a windfall to millionaires." However, it would provide an incentive to higher income investors who would otherwise invest less than $7,500 in qualifying stock to invest to that limit. The beneficiary of this added investment would be the smaller business which would not have had access to the equity but for the credit provided by this bill. Foreign citizens would not be eligible for the credit.

The credit provided by this legislation would be recaptured if the stock is disposed of in any way before being held more than 1 year. The only exceptions to the recapture rule are for transfers of ownership by reason of death or gift, and even in these cases the stock must be held by the transferee until a time more than 1 year from the date of original purchase. This 1 year holding period reflects the tax code provision regulating the availability of preferential capital gains rates for long term capital gains.

The credit would be available only for investment in common or preferred stock newly issued in a public offering for less than $25 million by a corporate with a net equity or less than $25 million. The size limitation imposed on the issuing corporation is based on findings made by the 1977 SBA Task Force on Venture and Equity Capital.

Presently, in excess of 3,500 small and medium corporations would be eligible under this size criterion, and it is hoped that many of the small businesses which are presently partnerships might incorporate to take advantage of this legislation.

The term public offering includes all primary security issues of stock registered with the SEC for immediate cash sale to the public pursuant to the requirements of the Securities Act of 1933 or regulation A of the act. By limiting the credit in this manner, protection of the investor is enhanced by the involvement of the SEC in the policing of the adequacy of disclosure in the registration statement. Furthermore, the very costs inherent in complying with SEC rules helps assure that the issuing corporation will not be a fly-by-night operation.

To assure that the equity capital raised pursuant to this legislation is used by small businesses for their active operations, the credit is available only if there has not been an acquisition of the corporation's stock, within 6 months, which exceeds 10 percent of the aggregate sales price of the qualifying stock.

Furthermore, the credit will not be available in those situations where the issuing corporation and members of a controlled group, as defined in the Internal Revenue Code, have passive investment in excess of 20 percent of the gross receipts for the year.

The revenue impact of this legislation will be directly proportional to the new capital brought into the market. In 1976 and 1977 a total of approximately $1.6 billion in new issues would have qualified for the credit. Thus, the initial revenue reduction for these 2 years combined would have been only $160 million, assuming that each dollar of stock bought was within the limits of the credit. The Joint Committee on

Taxation has estimated an annul revenue loss of $70 million. A copy of the joint committee's letter is attached to my prepared statement.

The benefits to be derived from the legislation are immense in comparison to the estimated revenue loss. By providing a stimulus for investment in smaller businesses, a new source of equity capital will be made available. The unhealthy debt to equity ratio of these businesses will be remedied. There would be significant gains in employment and economic growth caused by the strengthening of the capital structure of the Nation's small and medium businesses. Furthermore, an important consequence of this bill would be the broadening of the base of stock ownership for the American economy which will result from increasing the participation of individuals in our free enterprise system. I therefore strongly urge that the provisions of S. 3320 be adopted as part of the tax legislation reported out by this Committee.

The CHAIRMAN. Thank you very much, Senator.

Senator Talmadge?

Senator TALMADGE. No questions.

The CHAIRMAN. Senator Danforth?

Senator DANFORTH. Senator Weicker, Senator Hathaway cannot be here and asked that I ask you the following questions. Could you briefly cite some statistics on the decline of stock offerings by small to medium-sized firms in the last several years?

Senator WEICKER. According to figures compiled by the Securities and Exchange Commission, there were 698 underwritings for companies with less than $5 million in assets in 1969. However, only 80 companies of that size made public offerings in the 4 years from 1974 to 1977.

To repeat, the underwritings went from 698 in 1 year to 80 in 4 years. The offerings in 1969 raised almost $1.5 billion, whereas the offerings for the 4-year period combined produced $415 million.

Equally disturbing is the decline in the number of corporations of all sizes making first-time public offerings. In 1972, 633 corporations went public and raised $1.7 billion. However, there were only 125 initial offerings in a 3-year period from 1975 to 1977, and these first-time offerings raised just $459 million.

The situation has not improved. There were only six initial offerings in the first 3 months of 1978 and these raised $10 million.

Another indication of the difficulty which small businesses are having in obtaining equity capital is that the number of regulation A offerings which were filed with the SEC shrank from 998 in 1972 to 158 in 1977. Of those regulation A offerings which were filed, the 650 which cleared in 1972 raised $256 million, while the 124 which cleared in 1977 raised only $46 million. In the first 3 months of 1978, only 36 regualtion A offerings have cleared the SEC, raising merely $12 million.

Senator DANFORTH. Do you not believe that the primary beneficiary of your proposal will be the small technology and innovative research and development firms which are the great hope of our export picture?

Senator WEICKER. I do not have statistics to verify that, but it would seem to be true.

We know that in the actual analysis—and you have documented in the full statement I have given you—that was done concerning the job opportunities created by several new businesses as compared to es-

tablished businesses, that the number of jobs created over a 4- or 5-year period by smaller companies was much greater than the new jobs created by the larger corporation.

There is no question in my mind what we as a country have to export to the world is not cheap labor. Indeed, that is what gives us some of our grief nowadays, because cheap labor is what we are importing to this country. But we must export the brains that we have. That has always been this Nation's most valuable commodity.

Ours is a very small nation. It is this type of small corporation, that, given the chance to establish itself, will be able to export the goods which the wakening world is looking for.

I do not think there is any questoion, Mr. Chairman and members of the committee, that as you go ahead and modify the capital gains situation in this country that there will be additional equitable capital available for large corporations. I do not doubt that.

What is important here, both in the sense of product and jobs and the sense of competition, is the smaller corporation. Rather than having the U.S. Government come down and lower the boom on some of our corporations that have been successful internally, the best way to go ahead and regulate them is by having competition. And the only way you are going to get that is to go ahead and take care of the small businesses, which at the present time are absolutely frozen out of our capital markets.

Senator DANFORTH. Senator Hathaway's third question to ask, it has been suggested that there is no way of predicting individual investor behavior and corporate responses to this credit. Was this not the same argument advanced for the investment tax credit? What has been our experience there?

Senator WEICKER. Outstanding. The investment tax credit served its purpose admirably. Since its enactment in 1962, the investment tax credit has been an effective incentive to investor-qualified equipment. Statistics on such equipment shows a positive relationship between the level of investment and the reaction to real change in the way of credit.

Investment has increased when the credit has been made available and decreased when the credit was rescinded. The effect of the credit arises from the fact that the rise in the purchase price of the equipment increased the net cash flow of the investor.

It is not as though we do not have test cases, if you will, that prove these points, whether it is on capital gains treatment, or whether it is the investment tax credit. Many of the statistics which are coming forth from the European nations as to productivity, as to equipment, as to their exports, et cetera, can provide us with precedents.

The answer clearly is that there has been a successful operation in that area. I hope that it will also be in this area concerning investment in small businesses.

I plead with the committee, as you look at this overall problem—I know under the chairman's leadership you are not afraid to innovate—please, if you are believers in the free enterprise system, understand that the encouragement of small businesses really is at the heart of making this system of ours work.

I am not here to criticize those who have been successful and gotten big. In order for this country to be great, I want somebody coming up from behind all the time to keep that fellow on his toes. Right now,

smaller businesses do not have the means available for them to fulfill this role.

Senator DANFORTH. Thank you.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. No questions.

The CHAIRMAN. Senator Byrd?

Senator Bentsen?

Senator BENTSEN. No questions.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. No questions.

The CHAIRMAN. Senator Dole?

Senator DOLE. No questions.

The CHAIRMAN. Let me thank you for your very fine statement.

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

The CHAIRMAN. I think some of the figures and information that you produced to support your case have a way of getting through to us after we hear them the fourth or fifth time. People have been making this point enough times that it is beginning to get through to us, at least, I speak for myself. We have got to do something to help and encourage people to do more.

I am concerned about the people who know how to make a business succeed, who know how to meet a payroll and ought to be taking a risk. It is so discouraging.

You take this 50-percent limitation that you are talking about. We thought we were voting for something where a person could keep half of what he made, but if you make him take his earned income first and then his dividend income, or any other income that comes on top of that, the effect is that he does not get to keep 50 percent of what he makes by his personal services.

Theoretically, we have said he can keep half of what he earns and, as a practical matter, it does not work out that way. That is one of the things that we ought to look at. We have made it so that it is not worth a man's while to take the risk and do all the work that he would do to make money if he were one of these able people who could make his business expand and make it succeed and start another business.

Thank you very much.

Senator WEICKER. Thank you, Mr. Chairman.

[The prepared statement of Senator Weicker follows:]

STATEMENT OF SENATOR LOWELL P. WEICKER, JR.

Mr. Chairman and members of the Committee, thank you for the opportunity to discuss H.R. 13511 and complementary tax proposals presently before the Finance Committee. I would like to focus my testimony on measures designed to promote capital formation.

Economists have expressed great concern over the expected gap between the need for new capital investment and the funds which will be available to meet the $650 billion by 1985. A 1977 study conducted for the Financial Executives Research Foundation concluded that the total gap between capital needs and anticipated savings for the next 10 years would be approximately $1 trillion, depending on the rate of inflation. Clearly, steps must be taken to alleviate this situation.

I am encouraged by the fact that H.R. 13511 removes capital gains from the list of tax preferences which are subject to the individual and corporate minimum tax and which reduce the amount of an individual's personal service income

eligible for the 50 percent maximum tax. This change will go a long way toward stimulating investment.

However, I urge this Committee to adopt even stronger measures. Since 1969, a counterproductive taxation of capital gains has reduced the investor's incentive to invest. This underinvestment, in turn, has resulted in a slower rate of economic growth and higher levels of unemployment. In addition to causing a stagnation in the domestic economy, this policy has inhibited competition of American companies for world markets. According to a study by the United States Treasury, in the 1960–1973 period Japan devoted 26.9 percent of its GNP to investment and was rewarded with an average increase in productivity of 10.5 percent annually. Investing 19.1 percent of its GNP, West Germany gained 5.8 percent in productivity. By comparison, the United States with an investment ratio of 13.9 percent had an average productivity growth rate of only 3.3 percent during that period. Similarly, the export performance of the United States has recently been dismal, reaching a record trade deficit of $26 billion in 1977.

I joined Senator Hansen and more than 60 of our colleagues in cosponsoring S. 3065. This bill, which would stimulate risk capital investment by reducing the maximum tax rate on net capital gains from today's high level of nearly 50 percent for individuals and more than 30 percent for corporations to the 25 percent level that existed before the Tax Reform Act of 1969, is essential for the stimulation of investment.

The importance of providing pre-1969 tax treatment for capital gains was stressed by numerous witnesses who testified before the Small Business Committee. James Davant, Chairman of the Board of Paine Weber Incorporated, stated that:

Since 1969, the maximum tax on capital gains has effectively been doubled. . . . (T)his 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. . . . No other major industrial country penalizes capital gains so severely. Even in the U.K., the top rate is 30% 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 as much as 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, as a recent Wall Street Journal editorial pointed out, 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 a coincidence, in my opinion, that the beginning of the stagnation of our equity markets and the decline in the number of individual investors roughly coincide with the passage of the 1969 Tax Reform Act. The cause of the individual investor's disenchantment may be that simple.

The importance of reducing the capital gains tax rate was also discussed by Wallace O. Sellers of Merrill Lynch & Co., Inc., who concluded that:

We believe that the evidence is overwhelming that increases in capital gains taxes are counter-productive. The higher the capital gains tax, the less incentive there is to invest in high risk enterprises and the overall loss to the economy, as well as the Federal tax revenues, is substantial. . . . In our judgment, the single most effective step that the Congress can take to benefit not only small business, but the over all economic health of the nation, is to roll back capital gains taxes. We predict that such a step will revitalize our capital markets and stimulate investment in the most productive areas of our society to the benefit of all.

Restoration of the capital gains tax to pre-1969 levels is essential to the well being of our economy. However, other steps must be taken to ensure our nation's economic vitality.

As ranking minority member on the Select Committee on Small Business, I recently chaired hearings on the capital formation problem confronting this nation's smaller businesses. The severity of the problem was attested to by an outstanding array of individuals representing diverse interests. Their testimony conclusively confirmed that the capital formation problem has had an acute impact on our nation's small and medium businesses.

In response to this particular problem, Senator Hathaway, who joined me at these hearings, and I introduced S.3320, the Small Business Investment Incentive Act. This legislation, which would provide a credit for investment in new issues of stock of smaller corporations, targets its benefits to these businesses and would complement a capital gains tax rate reduction.

Statistics conclusively show that small and medium businesses have been unable to obtain the equity financing which is instrumental for growth. According to figures compiled by the Securities and Exchange Commission (SEC), there were 698 underwritings for companies with less than $5 million in assets in 1969. However, only 80 companies of that size made public offerings in the 4 years from 1974 to 1977. The offerings in 1969 raised almost $1.5 billion, whereas the offerings for the 4-year period combined to produce merely $415 million. Equally disturbing is the decline in the number of corporations, of all sizes, making first-time public offerings. In 1972, 633 unseasoned corporations went public and raised nearly $1.7 billion. However there were only 125 initial offerings in the 3-year period from 1975 to 1977, and these first-time offerings raised just $459 million. The situation is not improving, as shown by the fact that there were only six initial offerings during the first 3 months of 1978, and these raised merely $10 million.

Another indication of the difficulty which small businesses are having in obtaining equity capital is that the number of Regulation A offerings—offerings of less than $500,000—which were filed with the SEC shrank from 998 in 1972 to 158 in 1977. Of those regulation A offerings which were filed, the 650 which cleared in 1972 raised $256 million, while the 124 which cleared in 1977 raised only $46 million. In the first 3 months of 1978, only 36 Regulation A offerings have cleared the SEC, raising merely $12 million.

The failure of the public equity markets to supply a major portion of the necessary business capital presents a dangerous problem. The smaller corporation is driven to debt-financing, with the attendant financial inflexibility and increased risk of business failure. Arthur Levitt, Jr., Chairman of the American Stock Exchange, discussed this situation at a hearing held by the Select Committee on Small Business:

With the decline of equity investment, debt financing has now become the major source of capital. In 1977, the amount of debt financing was 10 times as large as equity financing, in contrast to less than 5 times as much in 1972. The debt-to-equity ratio of American business, particularly smaller companies, has become uncomfortably high—the average debt-equity ratio for American manufacturing companies rose to nearly 40 percent in 1977. This increase in debt makes these companies increasingly vulnerable to changing credit conditions, and more dependent on banks and other lenders. Consequently, it tends to place the emphasis on caution at the expense of corporate initiative and innovation. Furthermore, a high debt-equity ratio makes corporate shares more volatile and speculative. These results are not healthy either for our society or economy.

These smaller businesses which are being deprived of the equity necessary for survival and growth are the companies which hold the key to solving America's future employment needs. A recent study conducted by the MIT Development Foundation compared five small, new companies with six large, mature corporations, and found that the small companies, despite having combined annual sales less than one-fortieth of the giants, created 10,000 more new jobs over a 5-year period than did the larger corporations. Over this period, the small companies experienced an average annual growth in jobs of 41 percent, while jobs at the larger corporations were created at an annual rate of less than 1 percent.

Further evidence of the enormous potential for job creation was adduced by the American Electronics Association ("AEA") at a hearing held by the Select Committee on Small Business. A study of AEA members disclosed that young companies—less than 20 years old—had a growth rate in employment in 1976 of over 57% while mature companies had a growth rate in employment of only one-half of one percent in that year. Furthermore, the absolute increase of new jobs per firm was greater for young companies than for mature companies, even though the mature companies were 27 times larger, in terms of employment, then the young ones. In 1976, the young companies created an average of 88 new jobs per firm while the mature companies created only 69 new jobs. According to the Commerce Department, the Nation will require 1.5 million new jobs annually until 1985. As evidenced by the MIT and AEA studies, smaller businesses, with their capacity to produce new jobs, will play a key role in satisfying this need. Yet, these companies are unable to obtain the equity financing they need to enable them to grow and provide jobs.

At the same time that these smaller, growth-oriented companies are being squeezed out of the capital markets, individual investors have been steadily withdrawing from these markets. In addition to denying small businesses an

important source of capital, this flight of the individual investor from the securities market has resulted in a growing concentration of economic power in too few hands. Perhaps most importantly, because the individual's stake in the economic system has been sharply curtailed, he is less likely to fight to protect it. This alarming trend therefore threatens to undermine the essence of our free enterprise system.

The number of individual investors after reaching an alltime high of 32.5 million in 1972, declined by 18 percent over the past 5 years to a level where only about 25 million Americans now own stock. Individuals have been net sellers of approximately $5 million of corporate stock annually over the last 5 years. 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 stock, 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.

The individual investor has been replaced by financial institutions, which traditionally have been less willing to invest in small businesses. For example, although institutions owned, by value, less than 15 percent of New York Exchange (NYSE) common stock in 1949, they now own more than 33 percent. In 1976, institutions were responsible for more than 70 percent of the value of all shares traded on the NYSE, while individuals accounted for less than 30 percent. Twenty years ago these proportions were the opposite. Institutions have also become increasingly active in the market for stocks traded on the American Stock Exchange. Further evidence of the increased domination of financial institutions in the capital markets is found in the fact that in 1976 over 80 percent of the funds raised by new issues of debt and equities were invested by institutions.

The potential ramifications of this trend are quite disturbing. The decrease in the number of individual investors and the concomitant dominance of financial institutions portends an increased concentration of economic influence in the hands of a powerful few. And if the individual does not have a stake in our economic system, he will not fight to protect its viability and integrity. In testimony before the Small Business Committee, John Whitehead of Goldman, Sachs & Co., discussed the impact of the flight of the individual from the capital markets:

I would suggest that the very essence of the American system is involved with the stock ownership of our great American corporations spread very broadly. When we have 30 million stockholders, we avoid concentration of power and concentration of ownership that I think all of us feel is an important part of America and that possibly distinguishes us from other developed countries such as Japan and Germany where their large corporations are not broadly owned, and where there is a concentration of ownership in the hands of a small number of institutions.

Investors have turned away from investments in smaller businesses because the risk-to-reward ratio has been substantially altered. The risk inherent in investing in a small business has been increased by the economic uncertainties caused by inflation, increasing Federal regulations, and a breakdown in the distribution system for small business securities. Concomitant with this increased risk there has been a reduction in the possible rewards to be reaped by the investor. The maximum tax rate for capital gains, coupled with preference taxes and the minimum tax, is nearly double what it was in 1969. The effect of these changes in the tax laws is that the effective capital gains tax rate has been increased to a point where it is almost as high as the ordinary income tax rate.

A reduction in the capital gains tax rate will stimulate investment in the equity markets. The expansion in the supply of capital caused by such a reduction would benefit small businesses which must compete in the capital market for funds. However, it is likely that many investors will prefer a relatively secure position with a large company, and direct equity investment in small businesses, which involve greater risks, will not increase appreciably. Thus, something more must be done to attract investors in smaller businesses.

S. 3320 would provide the stimulus needed to get the individual investor to participate in the solution of the capital formation problem confronting America's small and medium businesses. Pursuant to this bill, the investor will be given a credit against tax of 10 percent of the first $7,500 investment in qualifying new stock issues during the taxable year. In the case where a joint return is filed, a credit of 10 percent would be given on the first $15,000 invested. This legislation is thus designed to induce the "marginal" investor to invest in smaller corporations. That is, it is designed to remove the final barrier to investment in smaller, riskier, corporations and thereby enable these corporations to compete effectively with large, established, corporations for the investment dollar.

Utilizing a credit, as opposed to a deduction, and limiting the credit to a specific dollar amount assures that the benefits of this legislation will flow primarily to middle income taxpayers, whose participation in the marketplace is essential to the viability of our free enterprise system. However, dependents would be ineligible for the credit, thereby preventing a child who has income from a trust fund from applying the credit against the tax on the trust fund or other investment income. Thus, the legislation will not result in "a windfall to millionaires". However, it would provide an incentive to higher income investors who would otherwise invest less than $7,500 in qualifying stock to invest to that limit. The beneficiary of this added investment would be the smaller business which would not have had access to this equity but for the credit provided by this bill. Foreign citizens would not be eligible for the credit.

The credit provided by this legislation would be recaptured if the stock is disposed of in any way before being held more than 1 year. The only exceptions to the recapture rule are for transfers of ownership by reason of death or gift, and even in these cases the stock must be held by the transferee until a time more than 1 year from the date of original purchase. This one year holding period reflects the tax code provision regulating the availability of preferential capital gains rates for "long term" capital gains.

A tax credit for investors, such as this, is a concept that the tax laws have recognized as instrumental in the stimulation of investment in other areas. The prime example of the efficacy of such a policy is found in the investment tax credit. As stated in the Report of the Committee on Ways and Means of the House of Representatives on H.R. 13511:

"Since its enactment in 1962, the investment tax credit has been an effective incentive to investment in qualified equipment. Statistics on such investment show a positive relationship between the level of investment and the enactment, reenactment, suspension, repeal, or a change in the rate of the credit. Investment has increased when the credit has been made available and decreased when the credit was rescinded. The effectiveness of the credit arises from the fact that it reduces the purchase price of the equipment and in effect increases the net cash flow after taxes to the investor."

It is expected that a similar salutary effect on investment in smaller businesses would result from enactment of S. 3320.

The credit would be available only for investment in common or preferred stock newly issued in a public offering for less than $25 million by a corporation with a net equity of less than $25 million. Presently, in excess of 3500 small and medium corporations would be eligible under this size criterion, and it's hoped that many of the small businesses which are presently partnerships might incorporate to take advantage of this legislation. The term "public offering" includes all primary security issues of stock registered with the SEC for immediate cash sale to the public pursuant to the requirements of the Securities Act of 1933 or Regulation A of that Act. By limiting the credit in this manner, protection of the investor is enhanced by the involvement of the SEC in the policing of the adequacy of disclosure in the registration statement. Furthermore, the very costs inherent in complying with SEC rules helps assure that the issuing corporation is not a "fly-by-night operation". Studies have shown that under the small offering exemption of Regulation A, compliance with SEC rules costs on the average 18 percent of the offering price. A SEC study shows that the cost of registered offerings for small issuers are even more prohibitive. During the 1971–1972 period, expenses borne by issuers of registered primary offerings of common stock with an offering price under $500,000 averaged approximately 24 percent of the gross proceeds of the undertaking. These costs will assure that only fiscally responsible corporations undertake stock issues.

Frequently an offer of original issue common or preferred stock to the public by a domestic corporation will be combined with the sale of stock to the public by

large stockholders of the same corporation pursuant to the same registration with the SEC under the Securities Act of 1933. Generally there is no ready way of determining whether shares acquired by an investor in such a public offering are the shares newly issued by the issuing corporation or shares sold by stockholders of the corporation. In such situations, an investor acquiring qualifying stock would be considered to have acquired stock issued by the issuing corporation, and would qualify for the credit to the extent of the ratio that the number of shares to be issued by the issuing corporation bears to the total number of shares to be sold in the public offering. The Secretary of the Treasury would issue regulations designed to achieve this effect. The sale price of any stock included in the registration which is not being sold by the issuing corporation, but instead is being sold by large stockholders of the corporation, would not be included in determining whether the dollar limitation imposed by the bill has been exceeded.

The size limitation imposed on the issuing corporation is based on findings made by the 1977 SBA Task Force on Venture and Equity Capital. The Task Force recommended that "pension fund managers (should be relieved) of ERISA restrictions in investing up to 5 percent of pension funds in companies having less than $25 million in net worth and larger companies having limited marketability for their securities." A review of corporations with equity capital less than $25 million discloses that the limited marketability for their securities brings them within the guidelines recommended by the Task Force.

To assure that the equity capital raised pursuant to this legislation is used by small businesses for their active operations, the credit is available only if there has not been an acquisition of the corporation's stock, within six months, which exceeds 10 percent of the aggregate sales price of the qualifying stock. Furthermore, the credit will not be available in those situations where the issuing corporation and members of a controlled group, as defined in the Internal Revenue Code, have passive investment in excess of 20 percent of the gross receipts for the year.

The revenue impact of this legislation will be directly proportional to the new capital brought into the market. In 1976 and 1977 a total of approximately $1.6 billion in new issues would have qualified for the credit. Thus, the initial revenue reduction for these 2 years combined would have been only $160 million, assuming that each dollar of stock bought was within the limits of the credit. The Joint Committee on Taxation has estimated an annual revenue loss of $70 million. A copy of the Joint Committee's letter is attached.

The benefits to be derived from the legislation are immense in comparison to the estimated revenue loss. By providing a stimulus for investment in smaller businesses, a new source of equity capital will be made available. The unhealthy debt to equity ratio of these businesses will be remedied. There would be significant gains in employment and economic growth caused by the strengthening of the capital structure of the nation's small and medium businesses. Furthermore, an important consequence of this bill would be the broadening of the base of stock ownership for the American economy which will result from increasing the participation of individuals in our free enterprise system. I therefore strongly urge that the provisions of S. 3320 be adopted.

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON TAXATION,
Washington, D.C., August 22, 1978.

Hon. WILLIAM D. HATHAWAY,
U.S. Senate,
Washington, D.C.

DEAR SENATOR HATHAWAY: Your bill, S. 3320, to provide a credit for investment in original issue stock of small- and medium-sized corporations would reduce budget receipts by $70 million per year. Taxpayers would receive a 10 percent nonrefundable credit on the purchase price of new equity issued by corporations with less than $25 million in equity. The maximum credit would be $750 for single taxpayers and $1,500 for joints.

Sincerely yours,

BERNARD M. SHAPIRO.

The CHAIRMAN. Next, we will call the panel. We will hear from Mr. Michael McKevitte of the National Federation of Independent Businessmen.

Mr. DEBOLT. I do not think that Mr. McKevitt has arrived yet at the moment.

The CHAIRMAN. How about Mr. Don DeBolt?

STATEMENT OF DON DeBOLT, CHAIRMAN, SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. DEBOLT. Mr. Chairman, we would appreciate the opportunity to have our detailed statement included in the record.

My name is Don DeBolt, and my appearance before the Committee is based on three strong commitments.

First, my personal background as owner of a small men's wear store in the late fifties brought me into immediate contact with the undercapitalization problems of small business. That experience convinced me that change must occur.

My past 10 years serving as executive director of Menswear Retailers of America, a national trade association with 4,000 member firms operating nearly 10,000 store units, has further impressed upon me the severity of the capital formation problems of small business.

Finally, as chairman of the Small Business Legislative Council, we have verified the fact that the problems of men's wear stores are duplicated in every small industry group.

The critical issue today is no less than small business survival. That is why 56 leading national associations spearhead the involvement of about 4 million small firms through the Small Business Legislative Council. The SBLC was organized just this past year so you—the Congress—can be aware that the small business community has common problems.

These problems are so serious and so pervasive that only through a coalition do we believe an opportunity exists to focus attention on the problems where we have to correct serious inequities.

The SBLC enables us to speak to the issues clearly and distinctly, avoiding the confused maze that each of us in the small business community pursued individually prior to formation of the SBLC.

We appreciate the opportunity to present our views today. Capital formation is one of the most pressing problems of small business. It does not have the ability to raise money through stock offerings, favorable borrowing of long-term credit from financial institutions, issuance of bonds, borrowing at the prime rate, adequate use of the investment tax credit, and—in the retail industry—the ability to take advantage of normal depreciation on plant and equipment which can measurably aid critical cash flow needs.

Capital formation dollars are of critical importance to small business, and we sincerely believe that action in the form of basic tax code changes will reaffirm in a tangible way the commitments on the part of Congress to "aid, counsel, assist, and protect, insofar as is possible, the interests of small business concerns in order to preserve free competitive enterprise."

We know that this commitment exists for each of you individually because you all have small business constituents to whom you have communicated this commitment.

Our primary recommendation today is that you seize this opportunity to restructure the tax code as a clear signal to the small business community that Congress does have the ability to shape their legislative efforts to match personal commitments.

Our first recommendation is that we believe that there must be lower taxes for all small business. This would allow smaller companies to plow back more of their earnings for necessary expansion and improvements. By strengthening small business, competition would be fostered, with the consumer the beneficiary.

Most small businesses of this country are in agreement on the need for a graduated business tax system. Ninety-one associations share the Small Business Legislative Council position that graduated business tax rates make just as much tax equity sense as graduated personal tax rates. Among the taxes that should be graduated: corporate income tax; the investment tax credit; the capital gains tax; estate and gift taxes; and depreciation allowances.

SBLC applauds the historic step by the House in its passage of a graduated corporate income tax in H.R. 13511. However, we believe the graduated tax should be further strengthened by adoption of S. 2669 sponsored by Senator Nelson and 17 cosponsors.

We further recommend lowering the rate on the first $25,000 of taxable income to 12 percent. We show a comparison of the various rate schedules in our detailed statement. The revenue effect under S. 2669 would be about the same as that proposed by the Administration. However, the tax savings for small business under S. 2669 would be substantially increased. In fact, about twice the benefits of the Administration's proposal.

A graduated income tax for corporations is the first step toward catchup for small business.

Our second recommendation is that the jobs credit, a unique incentive to spur small business to help solve our Nation's unemployment problem which was adopted in early 1977 by Congress, that we retain this, that we extend it, expand it and simplify it, and extend it to a minimum of at least 5 years.

Our third recommendation regards the explosion of litigation in the medical malpractice and product liability areas that have brought insurance premium increases of 1,000 percent and more, coupled with unavailability of coverage to many very small business firms.

This immediate problem demands an interim solution such as that being proposed in S. 2864 called the Product Liability Insurance Tax Equity bill. The same business deductions for insurance premiums should alos be available for payments by small business firms into a reserve fund to protect small business from catastrophic product liability losses.

Senator TALMADGE. Thank you.

Our next witness is Mr. Deane Stewart, National Oil Jobbers Council.

Mr. STEWART. I request that my full testimony be inserted in the record.

TESTIMONY OF DEANE STEWART, NATIONAL OIL JOBBERS COUNCIL

Mr. STEWART. Good morning, Mr. Chairman and members of the committee. My name is Deane Stewart, and I am president of Stewart Oil Co., Urbana, Ill. I also represent the National Oil Jobbers Council, a federation of 43 States and regional federations representing over 12,000 independent and small business marketers of petroleum products.

These small petroleum markets are threatened by Government neglect which results in the cruelest tax of all being imposed on small business—Government redtape and paperwork.

For example, marketers are currently faced with the dilemma of whether to pay Federal excise tax on gasoline when purchased from the supplier, thus paying taxes on gallons that they will lose through shrinkage and other ways, or pay taxes and sell it under an unrealistic payment schedule that requires that taxes be remitted within 9 days of the semimonthly period.

The National Oil Jobbers Council recommends that the payments schedule be modified and marketers be given at least 20 days after the payment period to remit the Federal tax. Therefore, our perspective in talking today and discussing the House bill will be that of the small businessmen in the petroleum industry.

Most tax analysts agree that with the House-approved cuts individuals would be paying more taxes in 1979 due to scheduled social security hikes. NOJC feels strongly that the individual minimum rate reduction must fully compensate for increases in social security taxes.

The full House of Representatives approved an interesting formula for indexing capital gains taxes that would take effect in 1980. Although the proposal looks very attractive, I am concerned with the problems that the small businessman may have implementing it in the real world.

NOJC does not feel that all indexing proposals must be complicated. Senator Gary Hart has introduced legislation that would index on the tax brackets and the standard deduction proportionate to the rate of inflation. This would be an excellent first step for the concept of indexing and would provide a framework for studying the possibility of extending indexing to other aspects of the tax code.

The House took a dramatic step when it approved the graduated corporate income tax for corporations with taxable income of less than $100,000. The House bill created two new brackets which demonstrated that body's concern with small business, but it could have, and should have, gone much further.

A bill sponsored by Senator Nelson would also create two new tax brackets to be taxed at the rate of 30 and 40 percent respectively. These brackets are obviously wider and would provide greater assistance to small businessmen in capital formation. The independent marketers also support the House action on investment tax credits, particularly in the provision allowing both the 5-year amortization and the full 10-percent investment tax credit for pollution control equipment.

With the current consumer demand for self-service gas stations, many operators are using freestanding canopies over the pumps to

protect consumers from inclement weather. The Treasury argues that the law prohibits them from allowing the investment tax credit for canopies. We hope this point can be clarified as a part of this legislation.

I would also like to discuss several other items this morning. First, NOJC endorses the House action of reducing the effective rate on corporate capital gains. We support the amendment offered by Senator Dole and recently approved by this committee that would recognize the independent contractors status of individuals who have been treated consistently, in good faith, as independent contractors, in reliance on rulings, cases, past IRS audit practices, industry practices, or the taxpayers' own longstanding practice.

We urge the committee to include this amendment as a part of the tax reduction legislation.

Finally, we feel that it is incumbent upon this committee to remove from the energy tax bill those sections which are most critical to the interests of consumers, the tax credits for solar and other conservation devices. Many consumers have acted to insulate their homes over the past 16 months on the assumption that a tax credit would be approved as a part of the National Energy Act. Now they are faced with the prospect of receiving no credit.

NOJC recommends that this committee approve as a part of the tax reduction bill a 20 percent tax credit for either solar or other conservation devices made eligible under the Senate-passed energy tax bill. We are especially concerned that the replacement of boilers and furnaces remain on the list since the energy conservation potential of such devices is enormous.

Thank you for the opportunity to appear before this committee.

Senator TALMADGE. Thank you.

I believe Mr. Michael McKevitt has arrived, the National Federation of Independent Businessmen.

STATEMENT OF JAMES D. McKEVITT, NATIONAL FEDERATION OF INDEPENDENT BUSINESSMEN

Mr. McKEVITT. I am Mike McKevitt. I appear as Washington counsel for the National Federation of Independent Business, a small business group with 540,000 members.

There are seevral things we are interested in. Before I touch on them, I would like to point out the fact that we have had a tremendous growth of jobs in the last decade. Small business particularly has been the creator of those jobs.

We have several basic concerns. One of our concerns is inflation. Probably the biggest gripe that we have is the regulatory abuse and paperwork problems. The biggest need we have is tax relief.

The House has started in the right direction with the bill that passed the House just 2 weeks ago. We would like to see the Senate go further, particularly with Senator Nelson's bill, as far as graduation of the corporate surtax is concerned. I know it is a new concept, but it would be a tremendous benefit to our members in the small business community.

Under the present system, the code's complexity makes it too difficult for small business to understand or use it to their advantage. We estimate, for example, that 5 percent of our members do not use ADR. We find many are taxed on paper profits; others use cash accounting with inventory, even though they are supposed to be using accrual accounting.

We feel a significant cut as far as personal cuts are concerned would be beneficial to those businesses that are unincorporated.

I would like to just touch on these points. First of all, we would recommend the inclusion of a $150,000 graduated corporate surtax exemption with rates beginning at 15 percent on the first $25,000 and topping out on 45 percent on all income over $100,000 as proposed by Senator Nelson. This would provide significant tax relief to small corporations, allowing them to retain enough of their earnings to feed their own growth.

In addition, if an inflation factor were applied to the surtax exemption from the time that it was originally set at $25,000 to the present, it would amount to over $125,000 in current dollars.

Secondly, we recommend a new 3-year straight line depreciation proposal for small capital intensive firms with $100,000 or less in depreciable assets acquisitions a year. The depreciation provisions in H.R. 13511 are beneficial to small business and close the gap in the rate at which it can recover invested capital vis-a-vis ADR users. The House passed depreciation proposal is beneficial to small business, but it does not address the complexity in the depreciation rules which the IRS states is the No. 1 compliance problem for small firms. This proposal, on the other hand, would both equalize the rate of return and dramatically simplify depreciation rules and regulations.

We favor the 3-year write-off because if you were to sell the property you would not be caught with salvage value. You would have a recapture if you sold it and did not buy new equipment. On the other hand, it would give you a faster writeoff and would better the cash position, cash flow, and also capital formation.

The next point is a simplified version of the general jobs credit with an option to target the jobs tax credit.

There is a lot of talk about targeted jobs tax credits. We do not think that is the answer, per se. We think there should be a general tax credit as well, as was passed by the House in 1977. In that year, complexities were picked up on the Senate side and more were added by the Department of Treasury in their regulations. As a result, it was difficult to utilize or implement it.

We found a great deal of enthusiasm from our membership for the jobs tax credit. We do not think it should be replaced by the targeted jobs tax credit. If you want to go two-tier, that is another story.

We do feel this is an incentive for job creation and we strongly urge the Senate to continue the jobs tax credit which was passed in 1977.

The next provision allows retailers and wholesalers under $1 million of gross sales to use the cash method of accounting. Under present IRS rules, any business in which inventory is an income-producing factor must use the accrual accounting method.

Accrual accounting creates serious problems for small retailers, particularly newer ones. It requires professional assistance. It makes businesses be taxed with inflation-generated paper profits.

In closing, Mr. Chairman and members of the committee, I would like to say I think the biggest thing that can be done for small business for many years in the future would be tax relief. God knows, we need it.

The CHAIRMAN. Thank you very much, sir.

Next, we will hear from Mr. Arthur Levitt, chairman of the American Stock Exchange.

STATEMENT OF ARTHUR LEVITT, CHAIRMAN, AMERICAN STOCK EXCHANGE

Mr. LEVITT. Mr. Chairman and members of the committee, my name is Arthur Levitt, Jr. I am grateful for this opportunity to testify as to the crucial importance to the American economy of restoring the tax on capital gains to a historically acceptable level and of providing a vital stimulus for equity investment.

In particular, I am here to ask the committee to support the adoption of S. 3320, introduced last month by Senators Hathaway and Weicker, which would provide tax incentives to individual investors for investment in new equity issues of small and medium-sized businesses.

I am chairman of the American Stock Exchange. We at the Amex think that it plays a special role in the capital formation process. More than one-half of our trading is done by individual investors. We provide a market for the securities of 1,100 small and medium-sized businesses.

The auction market which the Amex provides has the effect of seasoning the securities of small and medium-sized companies, some of which eventually transfer to the NYSE. An indication of how successful this process has been in the fact that more than 50 percent of NYSE listed companies were once traded on the Amex. These include such companies as Xerox, the Standard Oils of Ohio, Indiana, and California, A. & P., Alcoa and virtually every airline and aircraft manufacturer.

In general, securities are sold to the public by underwriting syndicates, not through the use of stock exchanges. Nevertheless, the exchanges play a most important role in capital formation by providing a liquid market and a pricing mechanism which enables securities that have been brought in an underwriting to be resold quickly and efficiently. Without the assurance of such a secondary market the flow of new investment to businesses would be halted or slowed.

In recent years, the equity markets have not been performing their function of raising capital for American industry. Debt financing is now the major source of capital. In 1977 the amount of debt financing was 10 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.

Public offerings of equity securities by industrial firms fell 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 6 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.

I am also greatly disturbed by the sharp decline in the participation of the average American citizen in equity investments in American enterprises since 1970. By 1975, our shareholder population has dropped from 30 to 25 million individuals, a decline of more than 18 percent. America's young adults are not continuing in the tradition of citizen ownership and the shareholder population can be expected to continue to decline unless effective measures are taken to make equity investment more attractive.

I strongly support Senator Hansen's bill, S. 3065, which would restore the tax on capital gains to the 25-percent maximum rate that has been in effect for years.

I think, Mr. Chairman, that your suggestion of decreasing the reduction for long-term capital gains from 50 to 70 percent has much merit, but I am concerned, however, that unless the proponents of reduction in capital gains get together behind a single good proposition, there will be no reduction at all enacted this year.

In addition to a capital gains cut, this proposal should include specific incentives to bring individuals back into the marketplace in order to provide vital equity financing for small- and medium-sized businesses.

In testimony earlier this year, I suggested a proposal that was designed to accomplish precisely these goals. 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. I am extremely gratified that this proposal is now substantially embodied in a bill, S. 3320, the Small Business Investment Incentive Act of 1978.

Under this act, the credit for investment is limited to $750. The benefits will flow to small- and medium-sized business, where they are most needed, since the credit will be allowed only in the case of new issues by companies with a net equity of less than $25 million. Utilizing a credit rather than a deduction and limiting the credit to a specific dollar amount will assure that the benefits will flow primarily to middle-income taxpayers.

In essence, this bill amounts to a tax credit for investors, a concept that the tax law has recognized as critical to stimulate investment in many other areas. The fact that this proposal is targeted to benefit middle-income taxpayers and smaller corporations should add greatly to the political appeal of the overall tax package of which it is a part. In all the swirling debate over the taxation of capital gains, virtually no one has challenged the need for incentives and relief targeted to these two vital groups.

Further, this credit-for-investment proposal cuts across additional political lines with basic appeal to labor unions, minority groups,

urban leaders and others who are interested in innovation, jobs, and economic growth.

We are not, today, talking about the needs of a General Motors or a Du Pont. We are talking about support for the "grassroots" of the American economy. We are talking about the hopes and dreams of energetic and innovative young people aspiring to establish businesses across the country. In short, we are talking about bringing Main Street back to Wall Street.

Thank you.

The CHAIRMAN. Thank you very much, sir.

Now we will hear from Mr. Mark M. Singer, president, National Food Brokers' Association.

STATEMENT OF MARK M. SINGER, PRESIDENT, NATIONAL FOOD BROKERS' ASSOCIATION

Mr. SINGER. I am Mark Singer, president, National Food Brokers' Association, whose members are all small business people. In order to conserve the time of this committee hearing, I would like to waive the reading of my statement and request that it be made a part of the record.

I would like to take about a minute to summarize, stating that the National Food Brokers' Association recommends that substantial individual and business tax reductions be made for 1978 in order to relieve the effects of inflation and to contribute to economic growth.

We have seven recommendations which I will just read. The explanations are in the full statement.

One, we recommend the income tax burden on all individual taxpayers, but especially middle-income taxpayers, be reduced by lowering the rates on taxable income and by widening individual income tax brackets.

Two, provide employees, self-employed persons and employers a refundable 5-percent social security income tax credit.

Three, the inflationary impact on small business be relieved by raising the corporate surtax exemption from $50,000 to $100,000, and tax on corporate income above $100,000 at 44 percent. The first $50,000 of corporate income should be taxed at 16 percent and the next $50,000 at 18 percent in order to give some relief to the small businesses most in need of capital resources.

Four, the maximum additional first-year depreciation allowance in dollars be raised from $2,000 to $10,000.

Five, the accumulated earnings limit be raised from the current $150,000 to $200,000.

Six, rules for deductible expenses that meet the ordinary and necessary needs of conducting business should remain unchanged. This includes the so-called business lunch.

Seven, reform of the new carryover tax basis that already adversely affects owners and heirs of closely-held corporations is badly needed.

Those are our recommendations. As I indicated, the details are covered in the full statement.

Thank you.

The CHAIRMAN. Thank you very much, sir.

Now we will hear from Mr. William C. McCamant, executive vice president, National Association of Wholesale-Distributors.

STATEMENT OF WILLIAM C. McCAMANT, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF WHOLESALER DISTRIBUTORS

Mr. McCamant. Thank you, Mr. Chairman.

My name is William C. McCamant. I am executive vice president of the National Association of Wholesaler-Distributors. I would ask, Mr. Chairman, that the entire text be placed in the record and I will summarize my comments.

Our particular industry, the wholesaler-distribution industry, employs 4 percent of those employed in the Nation. We are composed primarily of small business enterprises. Most of our businesses are owned and operated by individuals or by families. First, I would like to emphasize the need for increasing the corporate surtax exemption to $150,000. We would also like to see this at a single rate of 17 percent, and I would like to explain why.

The $25,000 exemption was placed in the tax code back in 1938. The Senate Small Business Committee, in their report of April 17, 1978, indicated if that $25,000 exemption had been increased in relation to purchasing power according to the GNP price deflator, it would require an exemption of $124,000.

This means that the Congress has permitted the gradual increase in the tax on this particular group because the value of the exemption has been eroded and it has been eroded very severely.

Congress did make an improvement on the exemption when they increased it from $25,000 to $50,000, but we believed that it would be better to go to the $150,000 and also in one fell swoop, with just one bracket.

In our studies of smaller businesses, we do not detect a great deal of difference in the financial operations between a company that makes a $25,000 profit, a $50,000 profit, or a $75,000 profit. These are the companies that do not have any access to the equity markets. They cannot sell stock nationally or locally. They do not have many lines of bank credit. They are virtually locked in as far as capital is concerned to retained earnings, and therefore, their problems are very similar.

When you get into the large corporations, the ones that have profits of $150,000 or more, they are more likely to be able to have alternate lines of bank credit, being able to borrow for longer terms than those that are below $150,000.

The Secretary of the Treasury the other day commented on certain aspects of not increasing that particular exemption, but I would like to point out what happens right now in terms of inflation. If a wholesaler has an inventory of $100,000 and he earns 3 percent on sales and he turns his inventory over four times, he would have a profit of $12,000 on which he would have to pay some kind of a tax.

If the tax is 20 percent, then he would have $9,600 left over. To replace his inventory at a 10 percent increase in inflation, he has to put in another $10,000 to maintain the same size of inventory.

So to maintain his current level of business, he must put in everything he has earned. Wholesalers are not the only ones, as this applies to all businesses which do not have access to the capital markets.

We would also support the increase of the investment credit to 10 percent. We would support removing the limit of $100,000 on used equipment. We think that there should be no limit whatsoever.

We also supported the jobs credit, the extension. We do not like to see it tied up with too many technicalities.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, sir.

Senator Danforth?

Senator DANFORTH. No questions.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. No questions.

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. Mr. Chairman, I would like to thank our panel, particularly my good friend, Mr. Levitt, who presents to us, as do all the panelists, the question of the problem of capital formation. We have become deeply concerned with this in the committee. The data on new issues and on balance of money that is going into capital formation through the equity markets is very disturbing to us. It is more pronouncedly a problem for smaller businesses as against the large corporations.

I hope you will not be dissatisfied with the work of this committee which will be much informed by your testimony.

I thank you all, and particularly you, sir.

Mr. LEVITT. Thank you very much, Senator.

The CHAIRMAN. Senator Hathaway.

Senator HATHAWAY. Thank you, Mr. Chairman.

I want to express my thanks also to the panel for a very enlightening testimony. I want to direct my questions particularly to Mr. Levitt, whom I am glad to see here, and whose idea Senator Weicker and I have put into bill form and hope to attach to the tax bill.

The other day, Mr. Levitt, when Secretary Blumenthal was testifying, he had, I think, two criticisms of the bill. One was that there may be some problems with respect to "fly-by-night" corporations.

Could you answer that, how the public would be protected against that?

Mr. LEVITT. I bridle a little at the implication of the "fly-by-night" corporation because it casts an image of the growing vital, new companies in America in a disparaging way. I think that is an unfortunate implication.

But, specifically the credit is only available to the purchase of stock which is registered under section 12 of the Securities Exchange Act. That is registered stock.

The credit is also recaptured if the stock is sold within a 1-year period of time.

Philosophically, while the credit is going to provide incentives for the purchase of stock in smaller companies, American investors, in my judgment, are sophisticated enough to evaluate this in terms of an overall investment objectives, not as the totality of the reason to make an investment.

So that I think the argument of "fly-by-night" investments simply does not hold up. I do not subscribe to that. I think it is an unfortunate use of language.

Senator HATHAWAY. It is going to be fairly difficult for small businesses to comply with all the rules that they will need to comply with in order to have their investors become eligible for the credit, or can this be simplified?

Mr. LEVITT. I really do not think so because, as you know, there are

two basic registration proceedings. One procedure is the regular registration, which is filed through the SEC for large corporations; the other is a procedure called regulation A which provides an exemption from the Securities Act registration for smaller issues, issues which do not exceed $1.5 million.

It is used by small companies making their initial public offering because it is substantially simpler and less expensive. That is because it is substantially simpler and less expensive. That is because financial statements do not have to be certified in this proceedings. Also, they require less historical financial information, the liability for disclosure errors is slightly more limited, and the review of the filing is handled locally in the Commission's regional office rather than in Washington.

Senator HATHAWAY. Secretary Blumenthal also criticized the bill on the grounds that he thought that any tax benefits should only be for a gain, as a result of the sale of the stock, and not just allow a tax credit on the purchase and still have the person get a loss or a gain.

What is your answer to that?

Mr. LEVITT. I have one major problem on this. We have lost more than 7 million individuals investors in the equity markets. I think all of the proposals we are talking about may be valid in terms of addressing themselves to the issue of investors once they get into the market. This proposal is unique. It is unique that it gives those people who are out of the market an incentive to come back into equities.

The Secretary also criticized a number of proposals before this committee on the basis that they benefited investment other than equity investment. This proposal goes directly to the heart of that issue and goes directly to equity investment, and I think it is the reason why people like me or Tom Bradley and Ed Koch and a number of unions have been a part of a coalition in support of programs of this kind.

So that I think that that is my long-winded answer to your question.

Senator HATHAWAY. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Nelson?

Senator NELSON. Mr. Levitt, I was conducting another hearing so I could not be here for your testimony, but looking at your testimony, you comment on the number of individual shareholders in the market. You state, the shareholder poupulation has dropped from 30 to 25 million individuals. On your last page, you also state, we are talking about support for the grassroots of the American economy. In short, we are talking about bringing Main Street back to Wall Street.

There is, as you know, the capital gains proposal that passed the House. There is a similar one, the Steiger bill, that has been introduced and cosponsored by 60 Members of the Senate.

I am not knowledgeable enough to have a conviction as to whether we ought to do something about capital gains and, if so, how much, but in looking at the House proposal, it benefits the large income groups. The statistics indicate that it would benefit 327,000 individuals, but very few people in the lower income levels would benefit at all.

There is a proposal pending before the committee which would provide an exclusion of the first $1,500 of capital gains for an individual and an exclusion of the first $3,000 for a couple. That would benefit 4,250,000 investors versus the 327,000 that benefit under the House bill. Moreover, 90 percent of the benefits in the House bill would go on to people in the brackets over $50,000 whereas the calculations that

we have indicate that some 70 percent of the benefits under this latter proposal of giving an exclusion of $1,500 or $3,000 would go to individuals of under $50,000 with 22 percent of it going to people with incomes under $20,000.

In view of your comments about bring Main Street back to Wall Street, would not that kind of proposal have more impact in achieving that end than the House proposal?

Mr. LEVITT. I really do not think so, Senator, and I think that for this reason—I do not think it goes far enough. I think that when we get embroiled in the statistics of who is affected by which proposal we lose sight, really, of the flesh and blood issue here. It is unfortunate that the Nation has been polarized, and that the discussion of capital gains has been couched in terms of millionaires on the one side and the poor people on the other side, because there is a vast group in between that has not been reached by this.

I think that the implication of the Steiger and Hansen proposals go to job formation, an improvement of our rate of productivity, and to the whole psychological climate which is sweeping the Nation today in terms of lack of business confidence.

I think that there is an enormous coincidence of interest shared by labor unions and municipal workers in every tax bracket in terms of tax relief. I think that the Hansen and Steiger proposals must be viewed merely not in terms of the cost to the Government, because I think that is a rather static way of doing it, but in terms of "what will this do to the psychology of investment in the United States? What is this going to do to business attitudes toward expansion, creating jobs and new factories, and raising money domestically rather than from foreign sources?"

Senator NELSON. I have one further question that I was asked to raise for Senator Haskell. Since I am over my time, could I ask it?

Senator MOYNIHAN. Please do.

Senator NELSON. Senator Haskell wanted the question raised with anyone on the panel who wishes to respond to it on the question of jobs credits, whether they ought to be targeted as in the House bill, that is, targeted to structurally unemployed or not targeted at all.

Does anybody have a comment on it?

Mr. DEBOLT. Senator Nelson, we have present, just behind me at the witness table, Herb Liebenson of the National Small Business Association whom, I believe possesses a great, vast storehouse of expertise. I wonder if he may respond.

Mr. LIEBENSON. As you gentlemen know, the Congress, 2 years ago passed an experimental program on jobs tax credits. Senator Haskell conducted hearings several weeks ago which pretty much—concluded that the Treasury had dragged their feet. The rules and regulations were much too complex for the small business community and too late to utilize and therefore, the program was not utilized to the extent that we had hoped. It was a trial program to be concluded at the end of 1978. What we are hoping for is that Senator Haskell's proposal to expand, extend and simplyfy the current program be considered by this committee.

On the question of targeting, we did not generally propose that the targeting take place in the same form that was proposed in the House bill. What we would prefer to see is targeting take place but directed at the major areas of unemployment.

By that, if there is a 15-percent unemployment area, let that area receive a higher credit for new jobs creation. If there is a 12.5-percent unemployment rate, let the credit go down to 45 percent, and so forth. Actually we should give the major incentive to the areas that need it most, that type of targeting rather than the type of targeting suggested in the House proposal would be much more acceptable, I feel, to the total business community and certainly more fair to the country as a whole.

Senator NELSON. As you know, the argument goes, one, if you do not target in fact there may be no relationship at all between hiring additional employees and getting the benefit of the credit. There may be no relationship between those two.

In fact, it would simply be—and, in many cases would be, most of them, a situation where business is just expanding, that is all.

But whereas the other argument addresses itself to the structurally unemployed, which is a very major, crisis situation in this country, with such a high incidence of underemployment, with no skills, trying to get them into the labor market, those who have that argument say we should be addressing ourselves to this crisis situation, giving credit to the hiring of that kind of individual and not another indivdual.

Mr. LIEBENSON. It seems logical from the studies we have made that the type of targeting the administration is talking about would still be achieved by the method that we are talking about, because the areas of high unemployment are in the major urban areas, and certainly they would receive the major incentive, and therefore the minorities and disadvantaged that you are talking about in the targeted program would still be reached.

Senator NELSON. The problem with that is that you will have all kinds of cities in this country that will drop below whatever target you name and you have to have an unemployment rate of something in order to be realistic. So if it is 6.5 percent, when Milwaukee goes below it, nothing has happened to that structurally unemployed individual. Even though the unemployment has dropped, he is still there.

Senator MOYNIHAN. Senator Hathaway?

Senator HATHAWAY. Mr. Chairman, I just wanted to ask another question of Mr. Levitt, if I may.

Mike, did you want to say something?

Mr. MCKEVITT. I just wanted to comment, first of all, Senator Nelson, I strongly support two tier. You may have some follow up on it. In a recent survey, we found the biggest tax problem small businesses have are our payroll taxes. Remember we are labor intensive, create the jobs. Give the incentive.

The problem we had with the last jobs credit was that it was not even favorably received in the administration. Treasury did not move on it. All of a sudden it is like they invented the wheel down there. They are hyped up over it. But they want to target it now. Last year we got comments on the then proposed credit from our members. Senator Long and Senator Haskell exhibited them on the floor. The incentive it gives greater jobs. I think the jobs tax credit, given a year to breed new publicity with a Treasury cover, regulations, the whole bit.

Now that it is a good idea and people like it, now they say we want to target it. I think you should have two-tier. If you are going to have

targeting, you should give the small business community in general an incentive to create new jobs because the effect is well worth it.

I have talked to our members. They think it is gang busters.

I hope the Senators will continue the credit, not just the target aspect, because it would be a tremendous shot in the arm for us.

Senator HATHAWAY. We wanted to affect the large investors; it is not enough to have the small investors looking for something more secure than the fledgling corporation. It seems to me that if he has some money to invest, he will tend to put it into General Motors or another bluechip company.

Mr. LEVITT. I really do not think that is valid. I think America's investors are the most opportunistic investors in the world. This proposal is so dramatic in its implication, offering a tax credit rather than a deduction to people that invest, a credit which in many cases would be more than the brokerage commissions that would be involved in the cost of investment.

So I think it is significant—$750 is not a small amount of money and $1,500 for a joint return is more than that. So I think it would be significant.

More important, it is symbolic. It is symbolic that the Congress stands behind individual investors and is doing something.

Senator HATHAWAY. Thank you very much.

Thank you, Mr. Chairman.

Senator MOYNIHAN. We thank the panel. You have been most helpful to us.

Senator Dole?

Senator DOLE. I do not have any questions. However, it would be very helpful if the committee had some information on the jobs tax credit. We have heard testimony that the credit should not be targeted. The idea has been kicking around for 15 years. It used to be called the Human Investment Credit Act. The administration dragged their feet after the credit was passed. They do not want it now. They do not like it.

We were told at one point that the credit was going to be used only by McDonald's and the fast food restaurants. It would be helpful if the committee could look at it—examples in your association where the credit has been used and has been helpful.

Senator MOYNIHAN. This is a matter of particular interest to this committee. We would appreciate that.

[The following was subsequently supplied for the record:]

The primary criterion for membership in NFIB is that a firm must be "independent." That means a publically owned firm or a subsidiary are ineligible for membership. Since the NFIB surveys were conducted over random samples of our members, only independent firms were included.

Many small firms hold one or more franchises and remain independent businesses. We estimate the number to be between 5 percent and 10 percent of the total number of small employers. Examples of such franchises include: gasoline stations, auto dealerships, soft-drink bottlers, and fast food operations. Thus, it is conceivable that a McDonald's (an independent franchise, not a company owned store), a Kentucky Fried Chicken, etc., were a part of the samples.

The following table illustrates the nature of firms which have utilized the jobs tax credit according to the NFIB surveys. For this table, firms utilizing the credit for its intended purpose in all three surveys have been consolidated.

Distribution of small businesses utilizing the jobs tax credit by size and sector

	Distribution of firms (percent)
Gross annual receipts:	
Under $50,000	6
$50,000 to $99,999	14
$100,000 to $199,999	14
$200,000 to $249,999	15
$350,000 to $799,999	23
$800,000 to $1,499,999	12
$1,500,000 or more	16
Sector:	
Construction	22
Manufacturing	14
Transportation	2
Wholesale	9
Retail	28
Agriculture	3
Finance services	5
Nonprofessional services	10
Professional services	6

The second table provides a distribution of firms utilizing the Jobs Tax Credit for its intended purpose by the number of employees the credit influenced them to hire.

Distribution of firms utilizing the jobs tax credit by the number of tax jobs per firm

Distribution of firms:	
Jobs tax per firm:	*Percent*
1	43
2	37
3	6
4	7
5	3
6 to 9	2
10 to 14	1
15 to 25	1
26-plus	3

We thank the panel for very helpful and informative testimony.
[The prepared statements of the preceding panel follows:]

STATEMENT OF SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. Chairman, my name is Don DeBolt and my appearance before the Committee is based on three strong commitments.

First, my personal background as owner of a small men's wear store in the late 1950s brought me into immediate contact with the under-capitalization problems of small business. That experience convinced me that change must occur.

My past ten years serving as Executive Director of Menswear Retailers of America, a national trade association with 4,000 member firms operating nearly 10,000 store units, has further impressed upon me the severity of the capital formation problems of small business.

Finally, as Chairman of the Small Business Legislative Council, we have verified the fact that the problems of men's wear stores are duplicated in every small industry group.

The critical issue today is no less than small business survival. That is why 56 leading national associations spearhead the involvement of about 4 million small firms through the Small Business Legislative Council. The SBLC was organized just this past year or so—the Congress—can be aware that the small business community has common problems.

These problems are so serious and so pervasive that only through a coalition do we believe an opportunity exists to focus attention on the opportunities we have to correct serious inequities.

The SBLC enable us to speak to the issues clearly and distinctly, avoiding the confused maze that each of us in the small business community pursued individually prior to formation of the SBLC.

We appreciate the opportunity to present our views today. Capital formation is one of the most pressing problems of small business. It does not have the ability to raise money through stock offerings, favorable borrowing of long-term credit from financial institutions, issuance of bonds, borrowing at the prime rate, adequate use of the investment tax credit, and—in the retail industry—the ability to take advantage of normal depreciation on plant and equipment which can measurably aid critical cash flow needs.

Capital formation dollars are of critical importance to small business, and we sincerely believe that action in the form of basic Tax Code changes will reaffirm in a tangible way the commitments on the part of Congress to ". . . aid, counsel, assist, and protect, insofar as is possible, the interests of small business concerns in order to preserve free competitive enterprise. . ."

We know that this commitment exists for each of you individually because you all have small business constituents to whom you have communicated this commitment.

Our primary recommendation today is that you seize this opportunity to restructure the Tax Code as a clear signal to the small business community that Congress does have the ability to shape their legislative efforts to match personal commitments.

RECOMMENDATION NO. 1—THE SMALL BUSINESS LEGISLATIVE COUNCIL SUPPORTS A GRADUATED BUSINESS TAX SYSTEM

Given the difficulty smaller businesses face in raising capital for investment, as compared to the ready access to capital markets enjoyed by the larger companies, there must be lower taxes for all small businesses. This would allow smaller companies to plow back more of their earnings for necessary expansion and improvements. By strengthening small business, competition would be fostered, with the consumer the beneficiary.

Most small businesses of this country are in agreement on the need for a graduated business tax system. Ninety-one associations (see Attachment A) share the Small Business Legislative Council position that graduated business tax rates made just as much tax equity sense as graduated personal tax rates. Among the taxes that should be graduated: corporate income tax; the investment tax credit; the capital gains tax; estate and gift taxes; and depreciation allowances.

SBLC applauds the historic step by the House in its passage of a graduated corporate income tax in H.R. 13511. However, we believe the graduated tax should be further strengthened by adoption of S. 2669 sponsored by Senator Nelson and 17 co-sponsors.

The revenue effect under S. 2669 would be about the same as proposed by the Administration earlier this year. However, the tax savings for small business under S. 2669 would be substantially increased—in fact about twice the benefits of the Administration's original proposal.

While the SBLC applauds the initiatives of both the Nelson bill, S. 2669, and H.R. 13511 as positive first steps toward a realistic graduation, we would recommend that a new lower corporate rate of 12% be established for small business in the $0–$25,000 income bracket. These firms constitute more than 70% of all U.S. corporations. This, in our view, would serve to redress the imbalance in our tax laws that has effectively discriminated against these small enterprises and their owners. It helps most, where the help is needed most.

Here is a comparison of the rate schedules:

[In percent]

Taxable income	S. 2669	H.R. 13511	SBLC recommendations
None to $25,000	15	17	12
$25,001 to $50,000	20	20	20
$50,001 to $75,000	30	30	30
$75,001 to $100,000	30	40	30
$100,001 to $150,000	40	46	40
Over $150,000	45	46	45

The Small Business Legislative Council firmly believes that the tax systems embodied in both H.R. 13511 and S. 2669 are concepts whose enactment is long overdue. We respectfully urge the members of this Committee to embrace their potential to redress the inequalities currently existing in our tax system.

The graduated tax for individuals places the burden on the broadest back. It is equitable. It works. The same principle should be applied to the corporate income tax. There is a real difference between Joe's Machine Shop and General Motors in ability to pay. Because of small business' inability to take advantage of many of the provisions of the Tax Code, small business is disadvantaged. It pays a higher effective tax rate. Plowback of profits through a graduated tax enables Joe's Machine Shop, which does not have the resources of capital availability of the giant corporation, to expand. A graduated corporate income tax is the first step toward catch-up for small business.

RECOMMENDATION NO. 2—THE SMALL BUSINESS LEGISLATIVE COUNCIL SUPPORTS EXTENSION, EXPANSION AND SIMPLIFICATION OF JOBS TAX CREDIT

The Jobs Tax Credit, a unique incentive to spur small business to help solve our nation's unemployment problem, was adopted in early 1977 by Congress. The Jobs Tax Credit can be a vital force in putting people to work. The Small Business Legislative Council recommends that it be extended, expanded and simplified. Thus many more small businesses would take advantage of it and help move our nation toward full employment. The minimum extension should be for five years.

It is labor-intensive small business, not capital-intensive big business, that creates jobs. A recent study by the Subcommittee on Antitrust, Consumers and Employment of the House Small Business Committee, reveals that from 1969 to 1976 the 1,000 largest U.S. corporations generated less than 75,000 new jobs—about ½ of 1% of the new jobs. About 99½% of the increase, other than government employment, in new jobs came from smaller businesses.

The Jobs Tax Credit is included in the Revenue Act of 1978 as passed by the House. While the proposal calls for expaosion of the credits, it narrows the field of applicable employees to hard-core unemployed, such as welfare recipients and unemployed Vietnam veterans.

Despite hostility of the Treasury, there is evidence that the jobs Tax Credit enacted last year does work. It puts Americans on non-government payrolls—where they should be.

On July 26, 1978, at joint hearings on the Jobs Tax Credit held by the Senate Committee on Finance and the Senate Select Committee on Small Business, Professor John Bishop of the University of Wisconsin reported on his computer study of the effects of the employment tax credit enacted in April 1977:

"Statistically significant increases in employment are found to have occurred in construction and retailing in response to the credit. The two stage least squares estimates imply the credit by March 1978 had induced an 8 percent increase in employment in construction and a two to three percent increase in retailing. For the industries studied the total increase seems to be 400,000. . . . The most startling finding is that there has been a decline in the margain between the retail and manufacturer's wholesale price of commodities the timing of which coincides with the operation of the Jobs Tax Credit. The point estimates derived from the price equations imply that in April 1978, the consumer price index for commodities was slightly less than one percentage point lower than it would otherwise have been."

For each one percent increase in employment, there is a $16–17 billion gain to the Federal government through the payment of various taxes.

Small business should be the employer of first resort in reducing unemployment, and the incentive is a simplified Jobs Tax Credit but one not limited to hiring of the hard-coré unemployed. Alternative proposals to give an even larger percentage of credit to employers who hire low-income, unskilled new workers have considerable merit. Incentives make our economy thrive.

Eighty-nine associations support the principle of a Jobs Tax Credit for small business. (See Attachment B.)

RECOMMENDATION NO. 3—THE SMALL BUSINESS LEGISLATIVE COUNCIL SUPPORTS CHANGES IN THE TAX CODE TO ALLOW AS BUSINESS DEDUCTIONS PAYMENTS TO A PRODUCT LIABILITY TRUST

Within recent years, there has been an explosion of litigation in the medical malpractice and product liability areas. The result of the increasing numbers of cases and the large judgments awarded to plaintiffs in these cases has been a corresponding explosive increase in product liability insurance rates. Many manufacturers have experienced increases in their premiums of 1,000 percent, and some increases have been much larger. A growing number of companies find that product liability insurance is unavailable at any price.

The causes of the increase in product liability suits are many. Relatively recent changes in tort law governing the area (making it much easier to pursue a successful suit against the manufacturer and distributor of a product) are largely responsible for the upsurge in product liability litigation, but other factors, such as the increasing cost of medical care and the relatively low level of State administered Workers' Compensation awards, have also contributed to the problem.

While a solution to the product liability problem lies ultimately in statutory or judicial changes in the tort law of product liability, the immediate and serious problems of the manufacturer and distributor seeking to obtain some type of protection against this liability demand an interim solution.

One approach being offered is S. 2864 sponsored by Senators Mathias and Bayh. Called the "Product Liability Insurance Tax Equity" (PLITE) bill, this proposal would allow companies and professionals to self-insure against risk by establishing a reserve fund in trust, and take advantage of the tax provisions available to those who deal with insurance companies.

The bill (S. 2864) would allow business deductions for payments made into a reserve fund, as insurance premiums are deductible. It would also exempt the reserve fund from taxation and from charges of undistributed dividends by corporate shareholders.

PLITE would do this by establishing a legal device known as a product liability trust. As long as the funds in the trust were withdrawn only for payment of (1) administrative costs of the trust, (2) legal or investigative costs in connection with a liability claim, and/or (3) settlement of a claim, the funds would be deductible as a business expense when put into the trust, and tax-exempt while they remain in the trust. Money withdrawn from the trust for purposes other than those listed above would be taxable. This would put the person who established a reserve fund for self-insurance in the same position regarding taxes as the person able to get a policy from an insurance company.

The small companies whose existence is threatened now by the product liability situation cannot afford to wait years for the picture to change. They need immediate relief.

The PLITE bill would allow smaller companies that cannot obtain coverage from insurance companies to protect themselves against the potentially catastrophic results of product liability litigation.

The SBLC urges this Committee's adoption of this unique approach to a grievous problem for small business. (See Attachment C.)

RECOMMENDATION NO. 4—THE SMALL BUSINESS LEGISLATIVE COUNCIL SUPPORTS A GRADAUTED INVESTMENT TAX CREDIT

Our major concern with the Investment Tax Credit provisions of H.R. 13511 is that the House bill calls for a flat percentage for all corporations, large or small. A flat percentage for the Investment Tax Credit accelerates the growth of big business, and widens the gap between large and small business. It is estimated that about 350 companies obtain more than 50 percent of the Investment Tax Credit dollars. To enable small business to "catch-up" to big business, the Investment Tax Credit should be graduated. If it is 10 percent for the larger corporations, it should be substantially more for smaller companies.

Further, we believe that the Investment Tax Credit should give more consider-

ation to the nature of small business, it abilities, and its needs. The treatment given used machinery is illustrative:

To permit capital recovery for small manufacturers, the Tax Credit for used machinery is vital. Because of limited resources, a small business simply cannot afford to purchase new equipment nor will the small business man risk investment in new machinery to produce new or emerging products. The effect of the Investment Tax Credit can be expanded to encourage small businesses to increase their productive capacities by purchasing used equipment in addition to the Investment Tax Credit's existing benefit of encouraging development of new machinery being purchased by big business.

Businesses that largely benefit from the Tax Credit today are those who can afford to modernize via new equipment acquisition. However, a significant sector of American industry is denied this stimulation and we believe this limitation is unfair and unnecessary. There are nearly 140,000 small manufacturing firms within industries represented by 11 Standard Industrial Classifications who purchase used equipment annually in this country.

Existing law limits the amount of used property eligible for the Investment Tax Credit to $100,000 with no provision for carry-back or carry-forward of the Credit. This limit impacts severly on small business and the unavailability of the carryover is a particular penalty to the new business in a start-up position. We propose the current limit on used property eligible for the Credit be removed entirely and that the carryover provisions which apply to new property be made applicable to used property.

Carryover provisions of the Investment Tax Credit are logical and proper because during a year a firm acquires equipment it may well have a small tax liability. Small businesses that buy used equipment, and who cannot now apply all of their allowable Credit during the year the equipment is purchased, lose their remaining Credit because carryover provisions for used equipment are now excluded.

The heart of all SBLC recommendations is catch-up growth for small business which, in practical terms, is an increased share of the market—industry by industry. An essential force to accomplish that goal is a restructured Tax Code which in effect is two-tier in application.

For that reason we applaud the recognition by the House of small business problems in limiting a "bonus" depreciation to smaller firms only—that is, with less than $1 million in assets. H.R. 13511 increases the extra depreciation deduction during the first year that equipment is purchased from $2,000 to a maximum $5,000 for smaller firms. We support this provision of the House-passed bill but we encourage this Committee to accommodate, insofar as possible, the purposes of S. 2742, sponsored by Senator Nelson, to simplify the depreciation law and 100 pages of regulations.

Another good step taken by the House in H.R. 13511 is inclusion of retail establishments in those categories eligible for a credit for the rehabilitation of structures.

A total of 91 associations (see Attachment A) share the SBLC position calling for a graduated Investment Tax Credit.

RECOMMENDATION NO. 5—THE SMALL BUSINESS LEGISLATIVE COUNCIL SUPPORTS A GRADUATED CAPITAL GAINS TAX

SBLC continues its support of a roll-over provision which would amend the Tax Code to provide that the proceeds of sales of interests in qualified small businesses be exempt from the capital gains tax if the proceeds are reinvested in another small business within a two-year period.

In view of the House treatment of the capital gains tax, we stress that, from the small business point of view, the capital gains tax rate should be two-tiered by relating it to the time an asset is held.

Thus, for an asset held only one year, a gain would be taxed at a maximum rate, but an asset held for 20 years would be taxed at a much lower rate.

It is argued that the House accomplishes the same result by indexing. However, tying the capital gains or any rate to inflation tends to weaken psychologically the battle against inflation itself. In effect, no one would join the war against inflation if he will be made whole by indexing. The capital gains rate should not be founded on whether there is high or low inflation.

The sounder approach from both a logical and equitable point of view is to two-tier the capital gains rate by basing it on the length of time the asset has been held.

The SBLC position calling for a graduated capital gains tax is shared by 91 associations (see Attachment A).

Mr. Chairman, we anticipate that additional associations will support the SBLC positions contained in this statement. We request permission to supply the Committee revised attachments to this statement

On behalf of the entire membership of the Small Business Legislative Council, we appreciate the opoprtunity to appear before this distinguished Committee.

SMALL BUSINESS LEGISLATIVE COUNCIL (OF THE NATIONAL SMALL BUSINESS ASSOCIATION)

ATTACHMENT A

Ninety-six organizations support in principle the Small Business Legislative Council policy supporting a simplified and graduated business tax system. These are:

American Association of Nurserymen, Washington, D.C.
American Gear Manufacturers Association, Washington, D.C.
American Pipe Fittings Association, Stamford, Conn.
American Pulpwood Association, Washington, D.C.
American Road Builders Association, Washington, D.C.
Appalachian Hardwood Manufacturers Association, High Point, N.C.
Associated Master Barbers & Beauticians of America, Charlotte, N.C.
Associated Retail Bakers of America, Annapolis, Md.
Association of Diesel Specialists, Kansas City, Mo.
Association of Steel Distributors, Cleveland, Ohio.
Automotive Parts & Accesories Association, Washington, D.C.
Boat Manufacturers Association, Chicago, Ill.
Building Service Contractors Association, McLean, Va.
Casket Manufacturers Association of America, Evanston, Ill.
Christian Booksellers Association, Colorado Springs, Colo.
Colorado Organic Growers' and Marketers' Association. Denver, Colo.
Computer & Communications Industry, Association, Rosslyn, Va.
Connecticut Small Business Federation, Hartford, Conn.
Delaware Retail Association, Wilmington, Del.
Direct Selling Association, Washington, D.C.
Electrical Generating Systems Marketing Association, Chicago, Ill.
Electronic Representatives Association, Chicago, Ill.
Engraved Stationery Manufacturers Association, Chicago, Ill.
Farmers Elevator Association of Minnesota, Minneapolis, Minn.
Greater Washington Business Center, Washington, D.C.
Idaho Feed & Grain Association, Caldwell, Idaho.
Independent Bakers Association, Washington, D.C.
Independent Media Producers Association, Washington, D.C.
Independent Sewing Machine Dealers Association, Hilliard, Ohio.
International Franchise Association, Washington, D.C.
International Repro Graphic Blueprint Association, Franklin Park, Ill.
Machinery Dealers National Association, Silver Spring, Md.
Manufacturers Agents National Association, Irvine, Calif.
Menswear Retailers of America, Washington, D.C.
Metal Treating Institute, Phoenix, Ariz.
Metropolitan Contractors Association, Washington, D.C.
Minnesota Motorcycle Dealers Association, Minneapolis, Minn.
Motorcycle Trades Association, Alexandria, Va.
Narrow Fabrics Institute, New Rochelle, N.Y.
National Appliance Service Association, Kansas City, Mo.
National Association for Child Development and Education, Washington, D.C.
National Association of Black Manufacturers, Washington, D.C.
National Association of Brick Distributors, McLean, Va.
National Association of Business & Educational Radio, Washington, D.C.
National Association of Catalog Showroom Merchandisers, New York, N.Y.
National Association of Floor Covering Distributors, Chicago, Ill.
National Association of Furniture Manufacturers, Washington, D.C.
National Association of Glove Manufacturers, Gloversville, N.Y.
National Association of Home Manufacturers, Washington, D.C.

National Association of Independent Lumbermen, Washington, D.C.
National Association of Installment Companies, New York, N.Y.
National Association of Men's & Boys 'Apparel Clubs, Atlanta, Ga.
National Association of Plastics Distributors, Devon, Pa.
National Association of Plumbing-Heating-Cooling Contractors, Washington, D.C.
National Association of Printing Ink Manuafcturers, Harrison, N.Y.
National Association of Retail Druggists, Washington, D.C.
National Beer Wholesalers of America, Chicago, Ill.
National Bicycle Dealers Association, Wickliffe, Ohio.
National Building Material Distributors Association, Chicago, Ill.
National Campground Owners Association, Martinsville, Ill.
National Candy Wholesalers Association, Washington, D.C.
National Commercial Refrigeration Sales Association, Philadelphia, Pa.
National Concrete Masonry Association, McLean, Va.
National Electronic Service Dealers Association, Indianapolis, Ind.
National Environmental Systems Contractors Association, Arlington, Va.
National Family Business Council, Westville, N.J.
National Glass Dealers Association, Washington, D.C.
National Home Furnishings Association ,Washington, D.C.
National Home Improvement Council, New York, N.Y.
National Independent Dairies Association, Washington, D.C.
National Insulation Contractors Association, Washington, D.C.
National Liquor Stores Association, Washington, D.C.
National Lumber & Building Material Dealers Association, Washington, D.C.
National Office Machine Dealers Association, Hackensack, N.J.
National Office Products Association, Alexandria, Va.
National Paper Trade Association, New York, N.Y.
National Parking Association, Washington, D.C.
National Patent Council, Arlington, Va.
National Peach Council, Martinsburg, W. Va.
National Pest Control Association, Vienna, Va.
National Precast Concrete Association, Indianapolis, Ind.
National Roofing Contractors Association, Oak Park, Ill.
National School Supply & Equipment Association, Arlington, Va.
National Screw Machine Products Association, Cleveland, Ohio.
National Selected Morticians, Evanston, Ill.
National Small Business Association, Washington, D.C.
National Utility Contractors Association, Washington, D.C.
National Woodwork Manufacturers Association., Chicago, Ill.
New York State Council of Retail Merchants, Albany, N.Y.
Northeastern Lumber Manufacturers Association, Glen Falls, N.Y.
Oregon Feed, Seed & Suppliers Association, Portland, Oreg.
Small Business Service Contractors Association, Washington, D.C.
Society of American Florists and Ornamental Horticulturists, Alexandria, Va.
South Dakota Retailers Association, Pierre, S. Dak.
Truck Body and Equipment Association, Washington, D.C.
Truck Equipment & Body Distributors Association, Cincinnati, Ohio.

ATTACHMENT B

The following 98 organizations have advised the Small Business Legislative Council they agree in principle that in elimination of current high unemployment, the small business sector should be the employer of first resort, with the incentive being provided by a job creation tax credit.

American Association of Minority Enterprise Small Business Investment Companies, Washington, D.C.
American Association of Nurserymen, Washington, D.C.
American Gear Manufacturers Association, Washington, D.C.
American Pipe Fittings Association, Stamford, Conn.
American Pulpwood Association, Washington, D.C.
American Road Builders Association, Washington, D.C.
Appalachian Hardwood Manufacturers, Inc., High Point, N.C.
Associated Master Barbers and Beauticians of America, Charlotte, N.C.
Associated Retail Bakers of America, Annapolis, Md.
Association of Diesel Specialists, Kansas City, Mo.
Automotive Engine Rebuilders Association, Glenview, Ill.
Automotive Parts and Accessories Association, Washington, D.C.
Automotive Warehouse Distributors Association, Kansas City, Mo.
Automotive Warehouse Distributors Association, Inc., Kansas City, Mo.
Boat Manufacturers Association, Chicago, Ill.

Building Service Contractors Association, McLean, Va.
Casket Manufacturers Association of America, Evanston, Ill.
Christian Booksellers Association, Colorado Springs, Colo.
Colorado Organic Growers and Marketers Association, Denver, Colo.
Computer and Communications Industry Association, Rosslyn, Va.
Connecticut Small Business Federal, Inc., Hartford, Conn.
Cutting Tool Manufacturers Association, Birmingham, Mich.
Delaware Retail Association, Wilmington, Del.
Electrical Generating Systems Marketing Association, Chicago, Ill.
Electronic Representatives Association, Chicago, Ill.
Engraved Stationary Manufacturers Association, Chicago, Ill.
Farmers Elevator Association of Minnesota, Minneapolis, Minn.
Food Merchandisers of America, Inc., Washington, D.C.
Greater Washington Business Center, Inc., Washington, D.C.
Idaho Feed and Grain Association, Caldwell, Idaho
Independent Bakers Association, Washington, D.C.
Independent Media Producers Association, Washington, D.C.
Independent Retail Businessmen's Association, Inc., Burlington, Vt.
Independent Sewing Machine Dealers of America, Inc., Hilliard, Ohio.
International Franchise Association, Washington, D.C.
International Repro Graphic Blueprint Association, Franklin Park, Ill.
Machinery Dealers National Association, Silver Spring, Md.
Manufacturers Agents National Association, Irvine, Calif.
Menswear Retailers of America, Washington, D.C.
Metal Treating Institute, Phoenix, Ariz.
Metropolitan Contractors Association, Washington, D.C.
Minnesota Motorcycle Dealers Association, Minneapolis, Minn.
Motorcycle Trades Association, Inc., Alexandria, Va.
National Appliance Service Association, Kansas City, Mo.
National Association for Child Development & Education, Washington, D.C.
National Association of Black Manufacturers, Washington, D.C.
National Association of Brick Distributors, McLean, Va.
National Association of Floor Covering Distributors, Chicago, Ill.
National Association of Furniture Manufacturers, Washington, D.C.
National Association of Glove Manufacturers Inc., Gloversville, N.Y.
National Association of Independent Lumbermen, Washington, D.C.
National Association of Men's & Boys' Apparel Clubs, Atlanta, Ga.
National Association of Plastics Distributors, Devon, Pa.
National Association of Plumbing-Heating-Cooling Contractors, Washington, D.C.
National Association of Retail Druggists, Washington, D.C.
National Bicycle Dealers Association Inc., Wickliffe, Ohio.
National Building Material Distributors Association, Chicago, Ill.
National Campground Owners Association, Martinsville, Ill.
National Candy Wholesalers Association, Washington, D.C.
National Coffee Service Association, Chicago, Ill.
National Concrete Masonry Association, McLean, Va.
National Electrical Contractors Association, Inc., Bethesda, Md.
National Electronic Service Dealers Association, Indianapolis, Ind.
National Family Business Council, West Bloomfield, Mich.
National Glass Dealers Association, Washington, D.C.
National Home Furnishings Association, Washington, D.C.
National Home Improvement Council, New York, N.Y.
National Independent Dairies Association, Washington, D.C.
National Independent Meat Packers Association, Washington, D.C.
National Insulation Contractors Association, Washington, D.C.
National Liquor Stores Association, Washington, D.C.
National Lumber and Building Material Dealers Association, Washington, D.C.
National Office Products Association, Alexandria, Va.
National Office Machine Dealers Association, Inc., Hackensack, N.J.
National Paper Trade Association, Inc., New York, N.Y.
National Patent Council, Inc., Arlington, Va.
National Peach Council, Martinsburg, W. Va.
National Pest Control Association, Vienna, Va.
National Precast Concrete Association, Indianapolis, Ind.
National Ready Mixed Concrete Association, Silver Spring, Md.
National School Supply and Equipment Association, Arlington, Va.
National Sand and Gravel Association, Silver Spring, Md.

National Screw Machine Products Association, Cleveland, Ohio.
National Selected Morticians, Evanston, Ill.
National Small Business Association, Washington, D.C.
National Society of Public Accountants, Washington, D.C.
National Utility Contractors Association, Washington, D.C.
National Water Well Association, Worthington, Ohio.
National Woodwork Manufacturers Association, Chicago, Ill.
New York State Council of Retail Merchants, Albany, N.Y.
Northeastern Lumber Manufacturers Association, Glens Falls, N.Y.
Oregon Feed, Seed and Suppliers Association, Portland, Oreg.
Rocky Mountain Food Dealers Association, Denver, Colo.
Small Business Service Contractors Association, Washington, D.C.
Society of American Florists and Ornamental Horticulturists, Alexandria, Va.
South Dakota Retailers Association, Pierre, S. Dak.
Truck Body and Equipment Association, Inc., Washington, D.C.
Truck Equipment and Body Distributors Association, Cincinnati, Ohio.

ATTACHMENT C

Forty-four associations support the PLITE bill, H.R. 7711. These associations believe that small business needs immediate relief if it is to survive the current product liability crisis. The PLITE bill helps provide that relief, without foreclosing more substantive reforms in the law at the federal and state levels. These associations are:

American Association of Nurserymen, Washington, D.C.
Association of Diesel Specialists, Kansas City, Mo.
Association of Steel Distributors, Cleveland, Ohio.
Automotive Warehouse Distributors, Association, Inc., Kansas City, Mo.
Building Service Contractors Association International, McLean, Va.
Christian Booksellers Association, Colorado Springs, Colo.
Direct Selling Association, Washington, D.C.
Electronic Representatives Association, Chicago, Ill.
Food Merchandisers of America, Inc., Washington, D.C.
Independent Bakers Association, Washington, D.C.
Independent Sewing Machine Dealers of America, Inc., Hilliard, Ohio.
International Franchise Association, Washington, D.C.
Local and Short Haul Carriers National Conference, Washington, D.C.
Machinery Dealers National Association, Silver Spring, Md.
Manufacturers Agents National Association, Irvine, Calif.
Marking Device Association, Evanston, Ill.
Menswear Retailers of America, Washington, D.C.
Narrow Fabrics Institute, Inc., New Rochelle, N.Y.
National Association for Child Development & Education, Washington, D.C.
National Association of Black Manufacturers, Washington, D.C.
National Association of Brick Distributors, McLean, Va.
National Association of Catalog Showroom Merchandisers, New York, N.Y.
National Association of Home Manufacturers, Washington, D.C.
National Association of Independent Lumbermen, Washington, D.C.
National Association of Plumbing/Heating/Cooling Contractors, Washington D.C.
National Association of Realtors, Chicago, Ill.
National Association of Retail Druggists, Washington, D.C.
National Beer Wholesaler of America, Inc., Chicago, Ill.
National Building Material Distributors Association, Chicago, Ill.
National Electrical Contractors Association, Inc., Bethesda, Md.
National Family Business Council, Westville, N.J.
National Independent Dairies Association, Washington, D.C.
National Independent Meat Packers Association, Washington, D.C.
National Insulation Contractors Association, Washington, D.C.
National Office Machine Dealers Association Inc., Hackensack, N.J.
National Office Products Association, Alexandria, Va.
National Paper Trade Association, Inc., New York, N.Y.
National Patent Council, Inc., Arlington, Va.
National Pest Control Association, Vienna, Va.
National Precast Concrete Association, Indianapolis, Ind.
National Small Business Association, Washington, D.C.
National Society of Public Accountants, Washington, D.C.
Small Business Service Contractors Association, Washington, D.C.

STATEMENT OF DEANE STEWART, PRESIDENT OF STEWART OIL CO., ON BEHALF OF THE NATIONAL OIL JOBBERS COUNCIL

Good morning Mr. Chairman and members of the committee. My name is Deane Stewart and I am the President of Stewart Oil Company in Urbana, Illinois. I am also the Chairman of the National Oil Jobbers Council's (NOJC) Blue Ribbon Ad Hoc Tax Committee. This committee was created specifically to examine President Carter's tax proposals and make appropriate recommendations to your and other congressional committees. I thank you for the invitation to appear this morning and present the views of NOJC.

The National Oil Jobbers Council is a federation of 43 state and regional associations representing over 12,000 independent, small business marketers of petroleum products. Attachment I provides a list of NOJC's federated associations.

The individual members of these associations include gasoline and diesel fuel wholesalers, commissioned distributors of gasoline, gasoline resellers-retailers, and a large number of retail fuel oil dealers. Our members also market many other petroleum products, including kerosene, LP gas, aviation fuel and motor oils as well as residual fuel oil. Together our members market 75 percent of the home heating oils and 25 percent of the gasoline sold in America under either their own private brand or the trademark of their supplier.

The key adjectives that describe the vast majority of our members are "small" and "independent." Over 95 percent of our members qualify under the Small Business Administration's loan size standard for wholesale petroleum marketers. Over half of our members would qualify under retail SBA standards as well.

Consequently, our perspective today will be that of the small businessman in the petroleum industry. And, like all small businessmen, independent marketers are threatened by a confluence of forces including competition from our huge refiner suppliers and benign neglect by a government that refuses to recognize that there is a difference between a small distributor like myself and a multinational oil company. This neglect results in the cruelest tax of all being imposed on small business, i.e. government red tape and paperwork.

For example, marketers are currently faced with the dilemma of whether to pay the federal excise tax on gasoline when they purchase it from their supplier, thus paying taxes on gallons they will loose through shrinkage and other ways, or to pay taxes after they sell it under an unrealistic payment schedule which requires that the taxes be remitted within 9 days of the semimonthly period. This means that a marketer must make payment on September 9 for gasoline sold September 1.

There are two major objections to this schedule. First, as a practical matter, it is impossible for many marketers to know how much gasoline they sold during the payment period in only nine days. Last September, for example, the first fell on a Thursday. If a marketer's dealers sent their sales through the mail the marketer would not have received them until Tuesday, the 6th, since Monday was Labor Day. The jobber's accountant, who doubles in many cases as his wife, his receptionist and his secretary must be able to collate all of this data from all the marketer's stations and make the necessary deposits within three days. If the data is not tabulated properly the marketer can estimate his gallonage but faces a 10 percent penalty if he underestimates his gallonage by 10 percent or more.

The second problem with this schedule is that no distinction is made between "sales" and "accounts receivable." Most independent marketers operate in rural areas and supply the energy needs of small consumer accounts, such as local bakeries, as well as nearly 90 percent ? the petroleum needs of America's small farms.

Many times, espcially in the case of small farms, the marketer will sell the gasoline and not be paid for an entire year and be paid only when crops are harvested. The marketer must pay the Federal excise tax, however, when the product is sold—not when it's paid for.

NOJC recommends that the payment schedule be mod'fied and that marketers be givn at least 20 days after the payment period to remit the Federal tax. Such a schedule would reduce the necessity of marketers estimating the number of gallons sold during a payment period and would better reflect the problems most marketers have with their accounts receivable.

Accounts receivable are part of a major problem not only for marketers but for most small businessmen. An even greater problem, however, is capital formation. We can echo Senator Nelson's statement last March when he introduced S2669, the Small Business Tax Reduction and Stimulation Act ". . . This much is cer-

tain. In these troubled times of inflation, recession, and energy shortage, smaller businesses are desperate in their need for capital—not only to grow and expand, but simply to stay afloat."

Senator Nelson added, "For the small business that cannot reach the stock market, the most equitable and efficient way for government to help is to permit such firms to retain more of the dollars which they have earned in the competitive marketplace." The tax code is a vital tool for insuring that adequate capital is available to help finance the growth of small business.

President Carter had an excellent chance to aid small business in his Tax Reduction and Tax Reform proposals but unfortunately skewed most of the benefits to the large corporate end of the tax scale. The House of Representatives obviously recognized this inequity and made several changes which could improve the livelihood of small businessmen now and in the future. I would like to discuss several of provisions of the House bill this morning and make recommendations for action by this Committee and the full Senate.

INDIVIDUAL RATE REDUCTIONS

Nearly 90 percent of all businesses in the United States are conducted as sole proprietorships, partnerships, or Subchapter 5 corporations. The vast majority of these unincorporated businesses are small. Consequently, when one advocates assistance for the small businessman, he is concerned with more than just restructuring the corporate tax tables.

The House bill proposes an $11.9 billion individual income tax reduction. This reduction is accomplished through four changes. First, the general $35 tax credit per personal exemption is replaced by an increase in the personal exemption from $750 to $1,000. Second, the floor for itemized deductions is raised from $2,200 to $2,300 for individuals and from $3,200 to $3,400 for married couples. Third, individual income tax brackets are widened by 6%. (For example, for married couples in the 14% bracket, the range will be changed from $3,400–$4,400 to $3,400–$4,460. The 15% bracket will then be $4,460 to $5,520 . . .). Finally, the bill provides individual rate cuts in the following income brackets: The 19 percent ($7,640–$11,880), the 22 percent ($11,880–$16,120) and the 25 percent ($16,120–$20,360) brackets are reduced to 18, 21 and 24 percent, respectively.

Though these reductions are certainly of some assistance, they do not go far enough. Most tax analysts agree that even with these cuts, individuals will be paying more taxes in 1979 due to scheduled Social Security hikes. NOJC feels strongly that the minimum individual rate reduction must fully compensate for incerases in Social Security taxes. It is not really a tax reduction to take more money out of one pocket than you intend to put back in the other.

Nor is it a tax reduction to enact a decrease which is almost immediately eaten up by inflation. Despite tax reductions enacted in the past three years, millions of Americans are finding they must pay more, not less, taxes even though real income (adjusted for inflation) has not changed.

To deal with this inflation problem several members of Congress have recommended various indexing systems which in fact would adjust tax brackets automatically to keep pace with inflation. The Ways ad Means Committee, and subsequently, the full House of Representatives approved an indexing formula for capital gains tax to take effect in 1980.

Though the proposal looks very attractive on the surface, I am concerned with the problems small businessmen may have implementing it in the real world. Consider a small gasoline distributor who wishes to sell a service station. As I understand the House proposal, this small distributor would be forced to not only index the station as a whole but every piece of equipment (pumps, tanks, hydraulic lifts, etc.) that is a part of the station. Few petroleum marketers have the accounting capability to index every piece of equipment which they may sell as part of a package deal. Thus, the capital gains indexing proposal approved by the House may be too complicated to be meaningful for most small businesses and would in fact serve to assist larger operations who are in direct competition with the small businessman.

The NOTC does not feel, however, that all indexing proposals must be this complicated. Senator Gary Hart has introduced legislation (S3138) which would index only the tax brackets and the standard deduction in proportion to the rate of inflation. This would be an excellent first step toward the concept of indexing and would provide a framework to study the possibility of extending indexing to other aspects of the tax code. The Hart bill would also require the Council on Wage and Price Stability to conduct a study of the impact of such limited indexing and report to the President and Congress by July 1, 1982.

Individual taxpayers and small businessmen cannot continue to survive, prosper and invest unless some mechanism is included in the tax code to ameliorate the hidden tax burden created by inflation.

CORPORATE RATE REDUCTIONS

The House took a dramatic step when it approved the graduated corporate income tax for corporations with taxable income of less than $100,000. For nearly 37 years prior to the Tax Reduction Act of 1975, the corporate dividing line between large and small business was $25,000. During this 37 year period prices climbed 358.9 percent.

Finally, a small step was taken in the 1975 legislation when several members of this Committee succeeded in increasing the dividing line to $50,000. But this still does not fully provide an equitable corporate rate which clearly distinguishes between the various sizes of businesses.

The House bill, which created two new brackets ($50–$75,000 and $75–$100,000), demonstrates that body's concern with small business but it could have and should have gone much further. The bill I cited earlier, sponsored by Senator Nelson (S2669), would also create two new brackets, $50,–$100,000 and $100–$150,000, to be taxed at a rate of 30 and 40 percent, respectively. These brackets are obviously wider and would provide greater assistance to small businessmen in capital formation efforts. The Nelson bill would save a corporation, with taxable income of $150,000, six thousand more dollars than the House bill and almost $15,000 more than under current law. This is especially attractive since it can be accomplished with no more revenue loss than the Administration's original proposal. The bill lowers the rate for corporatons with income in excess of $150,000 to 45 percent rather than the 44 percent recommended by the President. We urge enactment of the Nelson bill as the minimum step to assist small businessmen.

INVESTMENT TAX CREDITS

Though many small businesses do not take advantage of the investment tax credit, independent petroleum marketers support the House's action on the ITC, particularly the provision allowing both the 5 year amortization and the full 10% ITC for pollution control equipment. This is especially critical to marketers in those areas where vapor recovery is now required.

In addition, NOJC strongly supports the House provisions making the 10 percent credit permanent and the phase in over four years of a provision which will allow businesses to write off up to 90% of their taxes with ITC's. Under existing law, a taxpayer can wirte-off all of the first $25,000 of income but only 50 percent of any income in excess of $25,000.

But, marketers feel that clarification needs to be made on precisely what equipment qualifies for investment tax credits. With the current consumer demand for self service gasoline, many station operators are using free standing canopies over the pumps to protect consumers from inclement weather. These canopies are usually not connected to the service station, rather they are merely bolted into the ground and are easily movable from one site to another.

Yet, Treasury argues that the law prohibits them from allowing an investment tax credit for canopies. We hope this point can be clarified as a part of this legislation.

We also hope the committee will examine a system of ITC's or accelerated depreciation for certain capital expenditures resulting from government regulations. For example, over the next few years most marketers will have to convert their existing gasoline pumps to the metric system. Rapid write off of these new pumps should be permitted.

Without some available tax relief, most small businessmen are staggered by the expense of many of the requirements of Federal agencies such as OSHA and EPA.

SMALL BUSINESS REFORMS

The House bill essentially retained the recommendations made by President Carter to liberalize Subchapter S requirements and to double the amount of stock invested in a small business which can be deducted as an ordinary loss. In addition, the bill sets up a special first year depreciation allowance which increases the existing allowance (20 percent of the first $10,000 in property) to 25 percent

of the first $25,000. This provision is limited to firms with less than one million dollars in depreciable assets.

NOJC endorses these reforms and urges the Senate to enact these or similar provisions.

CAPITAL GAINS

Independent marketers endorse the House's action of reducing the effective rate on non-corporate capital gains from 49.1 percent to 35 percent. We understand that several proposals are currently pending, including the Steiger-Hansen proposal, to slash capital gains taxes even more. We urge you to consider fully those proposals in light of the increased need for investment throughout the country.

JOBS TAX CREDIT

Many marketers have taken full advantage of the jobs tax credit program which was originally enacted in 1977 as part of the Tax Reduction and Simplification Act. Because most small businesses are labor intensive, the jobs tax credit is yet another example of a program that can significantly aid small businesses.

In our testimony before the House Ways and Means Committee NOJC urged a five year extension of the existing credit. The House elected to modify the credit, however, and target it to seven specific groups: WIN registrants, vocational rehabilitation referrals, food stamp youths, Vietnam veterans on food stamps, supplemental security income recipients and cooperative education students.

Though we recognize that unemployment may run higher in these groups than others, we think it is regrettable that the credit must be limited to any categories. We urge the Finance Committee to re-enact the original jobs credit in lieu of the House passed bill.

INDEPENDENT CONTRACTOR STATUS

I would like to take the opportunity to discuss two more issues of critical concern to small petroleum marketers. The first deals with the IRS's handling of cases involving the status of an individual as an employee or an independent contractor for employment tax purposes. Marketers supplying service stations with petroleum products are particularly sensitive to IRS's efforts in this area and to the uncertainty surrounding the standards involved. Unfortunately, our efforts to obtain administrative relief through reasonable guidelines have met with little success. We consequently join with the General Accounting Office and others in recommending legislative action in this area.

We strongly support the amendment offered by Senator Dole nad recently approved by this Committee which would not only prohibit IRS from applying a new or changed position inconsistent with a position taken in January 1, 1976, but would also recognize the independent contractor status of individuals who have been treated consistently and in good faith as independent contractors in reliance on rulings, cases, past IRS audit practices, industry practices, or the taxpayer's own long standing practices. We urge the committee to include this amendment as part of the tax reduction legislation.

Small jobbers should not be forced to remain vulnerable to arbitrary IRS rulings that could force the jobber to pay three years back taxes and Social Security for a dealer (and the dealer's employees) that has been treated consistently both under the taxpayer's own practices and general industry practices as an independent entrepreneur.

ENERGY CONSERVATION TAX CREDITS

The final issue I wish to discuss this morning deals with the issue of tax credits for Energy Conservation devices. Final rites have been pronounced over the beleagured crude oil equalization tax for some time. Even Energy Secretary James Schlesinger has reportedly accepted that the centerpiece of the President's National Energy Act will not be approved this year.

Therefore, it is incumbent on this committee to remove from the energy tax bill those sections which are most critical to the interests of consumers—the tax credits for solar and other energy conservation devices. Many consumers have acted to insulate their home over the past 16 months on the assumption that a tax credit would be approved as part of the National Energy Act. Now they are faced with the prospect of receiving no credit.

NOJC recommends that this committee approve, as part of the tax reduction bill, a 20 percent tax credit for all the solar and other energy conservation devices made eligible under the Senate passed energy tax bill. We are especially concerned that replacement boilers and furnaces remain on the list since the energy conservation potential of such devices is enormous.

Approximately one-third of the home heating systems utilizing oil as an energy source are over 12 years old. In most cases, replacing old equipment with a modern system would result in fuel savings of up to 40 percent. Installation of a new efficient oil burner can save $200 in annual fuel costs at a one time expense of approximately $250.

SUMMARY

Mr. Chairman, I have touched on numerous subjects this morning and I will just summarize by saying that we hope the Congress will view the tax code as a tool to encourage innovation in the marketplace and to aid capital formation especially among small businesses. We hope this committee will strive to reduce the complexities of the code to the extent that the economic community designated to benefit from program can in fact understand the program and participate.

I appreciate the opportunity to appear before the committee and will be happy to answer any questions you may have.

ATTACHMENT I

The National Oil Jobbers Council is a federation of 43 state and regional trade associations representing thousands of independent small business petroleum marketers. Members include gasoline and diesel fuel wholesalers, commissioned distributors of gasoline, gasoline reseller-retailers and a large number of retail fuel oil dealers. Members also wholesale or retail many other petroleum products, including kerosene, LP gas, aviation fuels and motor oils as well as residual fuel oil. Together our members market approximately 75 percent of the home heating oils and 25 percent of the gasoline sold in America under either their own private brand or the trademark of their supplier.

MEMBER ASSOCIATIONS OF THE NATIONAL OIL JOBBERS

Alabama Petroleum Marketers Association, Inc.
Arizona Oil Marketers Association
Arkansas Oil Marketers Association, Inc.
California Independent Oil Marketers Association
Colorado Petroleum Marketers Association
Independent Connecticut Petroleum Association
Petroleum Association of Delaware
Oil Heat Association of Greater Washington
Florida Petroleum Marketers Association, Inc.
Georgia Oilmen's Association
Illinois Petroleum Marketers Association
Indiana Oil Marketers Association, Inc.
Intermountain Oil Marketers Association
Iowa Independent Oil Jobbers Association
Kansas Oil Marketers Association
Kentucky Petroleum Marketers Association
Louisiana Oil Marketers Association
Maine Oil Dealers Association
Maryland Oil Jobbers Council
Michigan Petroleum Association
Mississippi Petroleum Marketers Association
Missouri Oil Jobbers Association
Nebraska Petroleum Marketers Association, Inc.
Independent Oil Men's Association of New England
New England Fuel Institute
Better Home Heat Council of New Hampshire
Fuel Merchants Association of New Jersey
New Mexico Petroleum Marketers Association
Empire State Petroleum Association, Inc.
North Carolina Oil Jobbers Association
Northwest Petroleum Association

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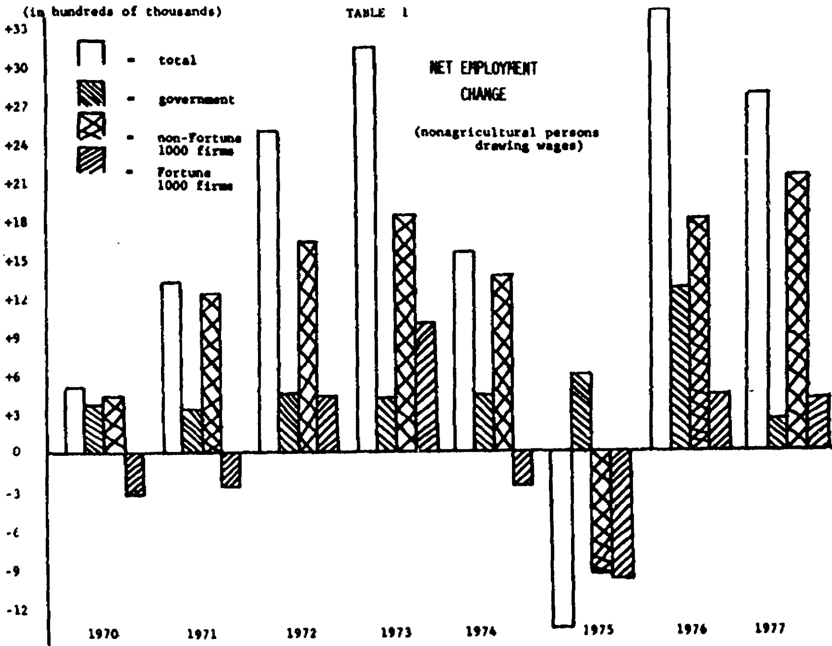
Ohio Petroleum Marketers Association
Oklahoma Oil Marketers Association
Oregon Oil Jobbers
Pennsylvania Petroleum Association, Inc.
South Carolina Oil Jobbers Association
Tennessee Oil Marketers Association
Texas Oil Marketers Association
Virginia Petroleum Jobbers Association
Washington Petroleum Marketers
West Virginia Oil Jobbers-Distributors Association
Oil Jobbers of Wisconsin
Wyoming Petroleum Marketers Association

STATEMENT OF JAMES D. "MIKE" MCKEVITT, WASHINGTON COUNSEL, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. Chairman, I am James D. "Mike" McKevitt, Washington Counsel for the National Federation of Independent Business (NFIB). On behalf of NFIB and its 540,000 small and independent member firms, I am pleased to have this opportunity to express our views on federal tax changes needed by the nation's small businesses. While this testimony does not exhaust the list of possible changes,[1] I have attempted to cover the major points being actively considered.

Two significant facts must be recognized at the outset. First, despite 1975, there has been an enormous growth in the total number of people employed in this decade. Since 1970, 12 million more Americans have found jobs. Principally responsible for this growth has been the small business sector of our economy. (See Table 1.) With little recognition, until recently, and minimal assistance, small business has provided and is providing the new jobs demanded by our ever expanding labor force.



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[1] The principal omission is payroll taxes. NFIB surveys reveal that more 50 percent of all small firms pay a greater amount in payroll taxes than in either income or property/inventory tax. The "breakpoint" at which income tax becomes the most expensive tax for a majority of small firms is approximately $3,000,000 in annual gross.

Second, the Federal tax policy has tacitly discriminated against small firms:

The Code's complexity makes it difficult for small businesses to understand, and to use it to their advantage, and,

The Code's slant toward capital intensive firms favors them over others.

Let me elaborate on this latter point. Supporters of the present business tax system, and indeed some of its bitterest opponents, would argue that Federal tax policy does not discriminate against small firms because the incentives it offers are available to all businesses. These preferences are there to be used by large and small businesses alike. In theory this argument may be valid, but the difference between theory and practice is enormous.

Small firms simply do not have the resources to make the Code work for them. They cannot afford to employ the battery of accountants, attorneys, and tax consultants used by their larger competitors to take full advantage of what is available. ADR (Asset Depreciation Range), a capital recovery method used almost exclusively by large firms, is a perfect example. It is so complex that most small firms avoid it like the plague. Only 2 percent of the businesses with assets between $500,000 and 1 million dollars make use of it, while 63 percent of those with assets of over 1 billion dollars use it. And just nine-tenths of 1 percent of the smallest firms, those with assets under $500,000, employ ADR.

Similarly, the complexity of some of the mandatory regulations cost certain small firms dearly. One such provision requires that all firms, whose operations depend on inventories of goods or raw materials, must use the accural accounting system. This method allows the government to tax the increased value of inventories, but during inflationary periods it places a hardship on most firms. IRS has recognized this and allows firms to compensate for its effect by using LIFO (last-in-first-out) accounting. But LIFO is so complex that only big, corporate merchandisers can use it. Smaller merchants lack the facilities, personnel and expertise needed to take advantage of LIFO. The result is that the firms that can least afford it end up paying a proportionally larger share of their paper profits in taxes.

There has been a great deal of discussion about lagging capital investment and the need to stimulate this activity. NFIB does not disagree. But I would note, the Code already contains significant incentives for capital intensive firms. ADR, which I singled out earlier because of its complexity, is one of the two most important capital related incentives in the Code. It allows large firms that have the resources to use it to recover their investments more quickly than businesses using more traditional depreciation methods. The other capital incentive provided by the Code is the Investment Tax Credit, and neither of these are more than marginally beneficial to small firms. Like ADR, the benefits of ITC accrue mainly to our largest firms. The latest Internal Revenue statistics (for 1974) show that 66 percent of the dollars recovered through ITC went to 1,300 firms[3]—less than one-tenth of one percent of our corporations. And remember, corporations account for less than 50 percent of the employers in the United States.

In contrast, small firms tend to be labor-intensive. Recent years have seen a dramatic shift away from income taxes and toward payroll taxes as a means of financing federal and state programs. Thus, we find an increasing disparity of taxes on labor and capital, sic. taxes on small and large firms.

NFIB's surveys clearly show that most small firms want to grow. Nearly 60 percent of the NFIB members answering a 1977 questionnaire indicated that they wished to expand their businesses, but they and their fellow small businessmen are hampered in pursuing this goal by a lack of capital.

Methods of financing small business growth are limited. One choice, equity financing, is virtually non-existent for small firms. A second, debt financing, can be prohibitively expensive, particularly in a period of high interest rates into which we now appear heading. That leaves retained earnings or recovered investment as the only feasible methods of financing small business growth.

In our judgment the House passed Revenue Act of 1978, H.R. 13511, is a significant attempt to provide increased stimulation and greater equity to the small business community. In particular, it would:

1. Increase and graduate the corporate surtax exemption up to $100,000, with rates starting at 17 percent on the first $25,000 in taxable income and topping out at 46 percent on everything over $100,000. This would allow small corporations to logically plan their growth and give them additional retained earnings to execute their plans,

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[3] By asset size if taxable income were used the percent of ITC going to those firms would be even higher.

2. More than double allowable first year depreciation from $2,000 and $4,000, for joint returns, to $5,000 and $10,000 respectively. This will help close the gap in the rate at which large firms that use ADR and small firms can recover invested capital,

3. Cut individual taxes $10.5 billion with 63 percent of this reduction aimed at taxpayers with incomes between $20,000 and $50,000 a year. This would help ease the impact of rising social security taxes for businesses that are taxed as individuals, namely proprietorships and partnerships,

4. Cut capital gains taxes which would hopefully make investment in smaller businesses more attractive, and,

5. Liberalize the rules for Subchapter S corporations and those governing ordinary loss limitations on small business stock (1244 stock).

On the negative side the House bill kills what all evidence suggests is one of the most successful incentives enacted in recent years, the general Jobs Tax Credit. In recent testimony before a joint Finance-Select Small Business Committee hearing chaired by Senator Haskell, NFIB estimated the credit had directly caused the creation of 300,000 jobs; ours was the low estimate. Despite this, the House would target the credit. But targeting the credit, as NFIB explained in some detail at the Haskell hearings, does not fit small business; it runs counter to their means and methods of hiring. I, therefore, see little or no possibility the targeted program will work.

It is not an easy task to construct an all-encompassing and equitable small business tax policy because the constituency is heterogeneous and diverse. Small firms do business as corporations, partnerships and sole proprietorships; many are capital-intensive but more are labor-intensive; and some are exporters but most focus exclusively on our domestic market. Still, H.R. 13511 contains the germs of the most comprehensive and most beneficial small business tax bill ever written. All it needs is some polishing and fine tuning and it will go down as the finest small business tax bill in history.

Specifically, NFIB would recommend and urge the inclusion of the following:

A $150,000 graduated corporate surtax exemption with rates starting at 15 percent on the first $25,000 and topping out at 45 percent on all income over $150,000 (as proposed by Senator Nelson). This would provide significant tax relief to small corporations allowing them to retain enough of their earnings to fuel their own growth. In addition, if an inflation factor were applied to the surtax exemption from the time it was set at $25,000 to the present, it would cost over $125,000 to replace it in current dollars.

A new three-year straight-line depreciation proposal fo rsmall capital intensive firms with $100,000 or less in depreciable asset acquisitions a year. While the depreciation provision in H.R. 13511 is beneficial to small business and closes the gap in the rate at which it can recover invested capital vis-a-vis ADR users, it does not address the problem of complexity in depreciation rules, which IRS states is the number one compliance problem for small firms. This proposal on the other hand would do both—equalize the rate of return and damatically simplify depreciation rules and regulations.

A simplified version of the general Jobs Tax Credit coupled with or as an option to a targeted jobs tax credit along the lines proposed by the Administration. The record shows that the Jobs Tax Credit is the most successful general incentive enacted in recent history, yet the Administration remains opposed and wants to kill it. If the Administration is successful, it will eliminate $2.2 to $2.5 billion in hiring incentives on the very same day it increases the minimum wage and raises social security taxes. The facts merit the retention of at least a modified version of the general Jobs Tax Credit; the credit has already influenced the creation of a substantial number of new jobs; it is expected new entrants into the labor force will continue at high rates; "tax" increases on labor, e.g. Social Security and minimum wage, are programmed to rise over the next few years; and, the targeted credit will influence few small firms to hire because it adds complexity, confuses small employers as to eligible employees, and generally runs counter to hiring practices, e.g. many small firms hire "right off the street" while relatively few use public employment services. We are not opposed to the Administration's desire to experiment with a targeted credit aimed at the hard core unemployed. But we do not believe that the former should be sacrificed to obtain the latter.

A provision allowing retailers and wholesalers under one million dollars in gross sales to use the cash method of accounting. Under present IRS rules any business in which inventory is an income producing factor must use the accrual accounting method. Accrual accounting creates serious problems for small retail-

ers, especially newer ones, because it requires professional assistance and allows the business to be taxed on inflation generated paper profits. IRS acknowledges that accrual accounting is a problem for small firms and has testified that it is the main reason why audited retailers are found in noncompliance. It has also recognized the impact of inflation on inventory sensitive businesses by allowing the use of LIFO, but LIFO is even more complicated than accrual for the small retailer and is of little or no use. The cost of allowing this change for all present inventory would be prohibitive (over $5 billion), but if it were applied to only new inventory purchased after a certain date the cost could be cut by 90%. The tax code provides a number of effective preferences for capital intensive firms, but few that would substantially benefit inventory sensitive, labor intensive businesses that are for the most part partnerships and sole proprietorships. Cash accounting would benefit these types of firms.

To conclude, NFIB believes that H.R. 13511 as passed by the House is a step in the direction of dealing with the tax related problems of small business, but the ultimate repeal of the general Jobs Tax Credit would drastically change this assessment. We also believe that the Senate Finance Committee is in the unique position of being able to improve the bill even further so that it would provide substantial tax relief to hard pressed small firms and enough stimulation so the country could begin to take advantage of its small business community.

Statement of Arthur Levitt, Jr., of the American Stock Exchange

Summary

1. The equity markets have not been performing their function of raising capital for American industry, particularly for smaller companies whose debt-to-equity ratios have become uncomfortably high.
2. There has been a sharp decline in the participation of the average American citizen in equity investments in American enterprises, which can be expected to continue unless effective measures are taken to make equity investment more attractive.
3. In view of these considerations, the limited capital gains tax relief in H.R. 13511, while moving in the right direction, will not provide the stimulus to capital formation which our economy desperately needs.
4. Furthermore, H.R. 13511 fails to provide specific incentives to investment in smaller corporations or to attracting individual investors back to the equity markets.
5. S. 3320, introduced by Senators Hathaway and Weicker, is designed to accomplish those goals through a credit for individuals against their tax liability of 10% of their investment in new issues of common and preferred stock of small to medium-sized corporations.
6. S. 3320's credit-for-investment cuts across traditional political lines with a basic appeal not only to smaller corporations and individual investors, but also to labor unions, minority groups, urban leaders, and others who are interested in innovation, jobs and economic growth.

Statement

Mr. Chairman and members of the Committee. My name is Arthur Levitt, Jr. I am grateful for this opportunity to testify as to the crucial importance to the American economy of restoring the tax on capital gains to a historically acceptable level and of providing a vital stimulus for equity investment.

In particular, I am here to ask the Committee to support the adoption of S. 3320, introduced last month by Senators Hathaway and Weicker, which would provide tax incentives to individual investors for investment in new equity issues of small and medium-sized businesses.

I am Chairman of the American Stock Exchange. We at the Amex think that it plays a special role in the capital formation process. More than one-half of our trading is done by individual investors. We provide a market for the securities of 1,100 small and medium-sized businesses.

The auction market which the Amex provides has the effect of seasoning the securities of small and medium-sized companies, some of which eventually transfer to the NYSE. An indication of how successful this process has been is the fact that more than 50% of NYSE listed companies were once traded on the Amex.

These include such companies as Xerox, the Standard Oils of Ohio, Indiana and California, A & P, Alcoa and virtually every airline and aircraft manufacturer.

In general, securities are sold to the public by underwriting syndicates, not through the use of stock exchanges. Nevertheless, the exchanges play a most important role in capital formation by providing a liquid market and a pricing mechanism which enables securities that have been bought in an underwriting to be re-sold quickly and efficiently. Without the assurance of such a secondary market the flow of new investment to businesses would be halted or slowed.

In recent years, the equity markets have not been performing their function of raising capital for American industry. 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.

Public offerings of equity securities by industrial firms fell 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, this had decreased to $918 million in 418 stock offerings, and 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. Under the small issue exemption provided by Regulation A, in 1972 650 companies raised a total of $256 million; in 1977, only 124 companies used Regulation A, raising a total of a mere $46 million.

I am also greatly disturbed by the sharp decline in the participation of the average American citizen in equity investments in American enterprises since 1970. By 1975, the United States shareholder population had dropped from 30 to 25 million individuals, a decline of more than 18%. The percentage of shareholders with total investments of under $10,000 fell from 62% to less than 50%; those with total investments of under $5,000 fell from 41% to less than one-third.

A recent survey indicates that there will be relatively few new American stockholders in the immediate future. Only 2% of those interviewed who had never owned stock thought they might acquire stock this year. The average age of American sharholders increased from 48 to 53 between 1970 and 1975, 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.

In view of these considerations, Mr. Chairman, it is clear to me that the limited capital gains tax relief in H.R. 13511, while moving in the right direction, will not provide the stimulus to capital formation which our economy desperately needs. In fact, the Bill's elimination of the 25% maximum rate on the first $50,000 of long-term captial gain may actually increase the tax bite on investors who have not been subject to the minimum tax and do not benefit from the maximum tax.

I continue to strongly support Senator Hansen's bill, S. 3065, which would restore the tax on capital gains to the 25 percent maximum rate 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 since 1969 has indicated that taxing capital gains at rates in excess of 25 percent may be a significant factor in curtailing equity investments to the deteriment of the entire economy.

I think, Mr. Chairman, that your suggestion of increasing the deduction for long term capital gains from 50% to 70% also has merit, but I am concerned,

frankly, that unless the proponents of a reduction in capital gains taxes get together behind a single good proposal, there will be no reduction at all enacted this year.

I am also deeply concerned that H.R. 13511's capital gains provisions fail to provide significant incentives to investment in smaller corporations or to attracting individual investors back to the equity markets. In my testimony before the House Ways and Means Committee on March 7th of this year, and again before a Subcommittee of this Committee in June, I suggested a proposal which was designed to accomplish precisely those goals.

I proposed that a credit be allowed to individuals against their tax liability of 10% of their investment during the year in new issues of common and preferred stock of small to medium-sized corporations. I am extremely gratified that this proposal is now substantially embodied in a bill, S. 3320, the Small Business Investment Incentive Act of 1978, introduced on July 19th by Senators Hathaway and Weicker. (Senator Hathaway has also substantially incorporated this proposal as section 223 of his tax bill, S. 3420.)

Under S. 3320 the credit-for-investment is limited to $750, $1500 for a joint return. The benefits will flow to small and medium-sized businesses, where they are most needed, since the credit will be allowed only in the case of new issues by corporations with net equity of $25,000,000 or less. Utilizing a credit, rather than a deduction, and limiting the credit to a specific dollar amount, will assure that the benefits will flow primarily to the intended recipients, middle income taxpayers.

In essence, S. 3320 amounts to a tax credit for investors, a concept that the tax law has recognized as critical to stimulate investment in other areas. The urgent need for such an incentive, has been amply demonstrated. The fact that this proposal is targeted to benefit middle income taxpayers and small corporations should add greatly to the political appeal of the overall tax package of which it is a part. In all the swirling debate over the taxation of capital gains, virtually no one has challenged the need for incentives and relief targeted to these two groups.

It is clear to me that this credit-for-investment proposal cuts across traditional political lines with a basic appeal not only to smaller corporations and individual investors, but also to 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, have actively supported our proposal, as have 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 support for the "grass roots" of the American economy.

We are talking about the hopes and dreams of energetic and innovative young people aspiring to establish businesses in vitrtually every town and hamlet across the country. We are talking about raising equity capital for these businesses through the participation in our economic system of the average citizen. In short, we are talking about bringing Main Street back to Wall Street.

I wish to thank the Committee for its time and patience. I sincerely hope that my testimony has been of some assistance.

Statement of Mark M. Singer, President, National Food Brokers Association

Mr. Chairman and members of the Committee, my name is Mark M. Singer. I am President of the National Food Brokers Association which is a national non-profit trade association representing over 2,400 member firms. Our Association is one of the oldest in the food industry, having been founded in 1904.

Food brokers are small business firms serving as independent sales agents for manufacturers of processed food, grocery, and related products, selling on terms set by their principals. They sell to all wholesale buyers, wholesalers and supermarket firms, both chain and independent.

Our members are located throughout this nation and are responsible for the sales and merchandising of the majority of the food sold in this nation. They have served the nation and the food industry well. On an average, one of our member firms represents 23 grocery manufacturers and processors, providing economic and efficient sales service to each. Many of our member firms have represented the same food processors for over a period of fifty years. This is a tribute to their stability and the quality of their service.

SUMMARY OF POSITION

National Food Brokers Association (NFBA) has always directed its efforts toward the improvement of food broker business efficiency and continuity in a rapidly changing economic climate. We have observed that business operating costs have been adversely affected in this decade by two major factors. First, is the rate of inflation. The second is the restrictive federal tax measures. Therefore, NFBA recommends that substantial individual and business tax reductions be made for 1978 to relieve the effects of inflation and to contribute to economic growth.

The National Food Brokers Association urges:

1. The income tax burden on all individual taxpayers, but especially middle income taxpayers, be reduced by lowering the rates on taxable income and by widening individual income tax brackets.
2. Provide employees, self-employed persons, and employers a refundable five percent social security income tax credit.
3. The inflationary impact on small business be relieved by raising the corporate surtax exemption from $50,000 to $100.000 and taxing corporate income above $100,000 at 44 percent. The first $50,000 of corporate income should be taxed at 16 percent and the next $50.000 at 18 percent to give substantial relief to the small businesses most in need of capital resources.
4. The maximum additional first-year depreciation allowance in dollars be raised from $2,000 to $10,000.
5. The accumulated earnings limit be raised from the current $150,000 to $200,000.
6. Rules for deductible expenses that meet the ordinary and necessary needs of conducting business should remain unchanged. This includes the so-called business lunch.
7. Reform of the new "carryover tax basis" that adversely affects owners and heirs of closely-held corporations is needed.

NFBA cannot urge strongly enough that substantial tax reduction to offset the ravishing effects of inflation and social security tax increases is necessary not only to help small business, but also to stimulate consumer confidence and foster an active growing economy. The American public has grown exceptionally sensitive to the effects of inflation and increased federal, state, and local taxes. The time is right to reverse the growing federal income tax burden.

DETAILED ANALYSIS

It is generally recognized that small firms are starved for capital in this country. The present tax laws have the harmful effect of aggravating this situation.

It is well recognized that access to the capital market is open only to relatively few companies. Small concerns are not able to raise outside capital in the public market, whether in the form of equity or debt. The result is that growth of small concerns is made more difficult and much slower. This affects not only the owners, managers and employees of small business, but the nation as well.

To compound this problem, current federal tax policy creates a substantial barrier to the growth and development of small business in the United States. It does this in many ways, such as, imposing excessive taxes on both individual and corporate earnings, by adopting undue restrictions on deductions for such items as depreciation, by over-taxation of accumulated earnings, by failing to make due allowance for the effects of inflation, and by erecting an estate and gift tax system penalizing owners of successful small business.

Action is doubly important now because the social security law and proposed energy legislation will raise taxes substantially. Some experts predict an increase in federal tax collections as a result of higher payroll and energy taxes will reach $50 billion through 1981. Higher taxes of this magnitude are not only a drag on economic activity, but a severe burden on small business which is already over taxed. The increased diversion of resources to the federal government from small concerns constitutes a serious national problem.

SOCIAL SECURITY TAXES

Another round of Social Security tax increases will take effect in 1979. A $20,000 wage earner and employer will each pay $1,226 in social security taxes next year, an increase of $155 over the amount each will pay this year. Higher increases are scheduled to take effect in later years. Relief from steadily increasing Social Security taxes is needed to help individuals and to strengthen the economy. A five percent refundable Social Security income tax credit would provide modest but essential relief.

CORPORATE TAX REDUCTIONS

For small corporations, substantial tax reduction is an urgent need. The corporate surtax exemption should be increased from the present $50,000 to $100,000. Under current law, corporate profits above $50,000 are subject to 48 percent tax. This top rate should be reduced to no more than 44 percent.

Of equal importance is a permanent substantial reduction in the normal corporate tax rate. The first $25,000 of corporate income is now taxed at 20 percent. This is much too high. A reduction to 16 percent or less is needed. The rate on the second $25,000 of corporate income is presently 22 percent. A four point reduction is also needed here. The 16 and 18 percent rates should apply to the first and second $50,000 of corporate income respectively.

INDIVIDUAL TAX REDUCTIONS

Another step to stimulate small business is a major reduction in individual rates on taxable income, especially for persons in the middle income brackets. The present 14 to 70 percent range for individual income tax rates should be lowered. A tax cut for middle income individuals of at least four points would do much to help small business create more jobs and add to the gross national product.

In 1976 taxpayers earning over $15,000 comprised 29.9 percent of the tax returns but paid 80 percent of the nation's personal tax liability. Those earning between $15,000 and $50,000 filed 28.4 percent of the returns and paid 57.5 percent of the nation's tax liability. There is no material tax reduction for them. A substantial reduction in taxes for those taxpayers carrying the financial load is necessary in order to encourage consumer spending and restore taxpayer confidence in the tax system and our government.

ORDINARY AND NECESSARY BUSINESS EXPENSES

No discussion of tax reform today would be complete without reference to the proposal to disallow a deduction for all or part of so-called "business lunch" expenses. This proposal is most unrealistic. The harmful consequences of this are particularly obvious to the food-service industry. But the effects would be even more widespread. It would reach every business field, and to the detriment of most.

Businessmen, whether small or large, are in the business to make a profit. They are always concerned with cutting costs in order to remain competitive. They are the best judges of the value to their business operations of luncheon meetings as well as various forms of business entertainment and promotions. There should be no change made in any legitimate expenses which meet the ordinary and necessary needs of conducting business and promoting favorable relationships and good will.

OTHER RECOMMENDATIONS

Another step that would help us to allow small business to claim additional first-year depreciation by raising maximum allowance in dollars from $2,000 to $10,000. This change would increase the cash flow of small business and generate more internal capital for expansion. Also helpful, particularly to processors and distributors, would be a provision to make building structures eligible for reinvestment tax credit along with equipment.

Another recommendation we make is to increase the minimum earnings credit from $150,000 to $200,000. We recognize that this recently was increased from $100,000 to $150,000. However, we believe it should be further increased because of the continuing and unceasing ravishing effects of inflation. Small concerns are affected by this credit because of their need to accumulate capital out of retained earnings. The accumulated earnings tax impedes the growth of small corporations especially during periods of inflation. Some tax policy makers in government fail to recognize that inflation is a hidden tax on profits.

Another area of needed reform comes from the effect of the new so-called "carryover tax basis" which hits owners of small enterprises under the federal estate tax. The impact from the new capital gains tax on property held by owners of closely-held corporations is severe on their estates, heirs, and beneficiaries. Much of the assumed increase in value taxed as capital gain on the deceased's property is the result of inflation. The new federal estate and gift tax law is a burden on owners of successful small enterprises.

CONCLUSION

In making these proposals we emphasize again the importance to the economy of the nation's small business firms. We shall not burden this committee with statistics and rhetoric on the importance of such firms. We know that the Congress is supportive of small business and is aware of its essential role. The country's economy requires major reversal in the rise of taxes affecting business, particularly small business. The alternative is economic stagnation, compounded by continued high inflation and a lower standard of living for everyone. Tax decreases are needed now, to stimulate production and growth and we urge your support for these measures.

STATEMENT OF WILLIAM C. McCAMANT, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

I am William C. McCamant, Executive Vice President of the National Association of Wholesaler-Distributors (NAW). NAW is a federation of 109 national commodity line associations composed of over 40,000 merchant wholesaler-distributor establishments located throughout the 50 states. Wholesaler-distributors are responsible for a large share of our nation's economic activity. Their sales are estimated by the Commerce Department to have totalled $532 billion in 1977 and may reach $700 billion in 1978. The firms represented by NAW account for approximately sixty percent of total industry sales, and sixty percent of the 3.5 million individuals employed in wholesale trade. As is detailed in the attachment to this testimony, our industry is preponderantly composed of small-to-medium businesses, is highly competitive, and operates on a very slim profit margin, averaging three percent before taxes.

We welcome and appreciate this opportunity to present the views of our industry on tax proposals pending before the Committee. While our industry has many wide-ranging interests in inflation, capital formation and taxation, our presentation will be cast with special reference to the House-passed bill, H.R. 13511, and the statement of Secretary of the Treasury Blumenthal who testified before this Committee last week. We are not unmindful, however, of the many excellent proposals made by members of the Senate and of this Committee to achieve a tax structure that will restrain inflation, aid in capital formation, increase employment and promote orderly and sustained economic growth.

We welcome the recognition in both H.R. 13511 and the Administration's position that the rate of capital formation in this country has been inadequate in recent years. This is in large measure, attributable to existing tax policy. Failure to effectively deal with our growing capital formation shortfall will have profound implications for the economy as a whole. Our nation's economic strength derives from our productivity and competitiveness. These, in turn, depend on our generation and reinvestment of capital.

While the role of capital is not fully understood by the public, the public does suffer the effects of inadequate capital formation: inflation, eroded real purchasing power and unemployment. To successfully cope with these symptoms of economic malaise, there is a need to greatly increase the amount of capital generated and retained by the private sector. I know of no other successful approach to maintaining, let alone increasing, our productivity and standard of living and do not believe that one exists.

CORPORATE TAX RATE REDUCTION

H.R. 13511 would establish a corporate rate structure of 17 percent on the first $25,000 of income; 20 percent on the second $25,000; 30 percent on the third $25,000; 40 percent on the fourth $25,000; and 46 percent on income exceeding $100,000. Mr. Blumenthal indicated the Administration is of the opinion that this is too much tax relief for smaller business enterprises. We do not think it is enough.

In 1938, Congress made a distinction in the income tax rate between the first $25,000 of corporate taxable income and income that exceeded that amount. In more recent years, what is referred to as the "normal tax" on the first $25,000 was at the 22 percent rate and the surtax rate was 26 percent. It was not until the tax reduction act of 1975 that Congress increased the surtax exemption to $50,000. That provision is now in effect, with the first $25,000 being taxed at a 20 percent and the earnings between $25,000 and $50,000 at 22 percent.

Corporate tax rates as they affect smaller business enterprises have been the subject of intensive examination by the Senate Small Business Committee. In a report issued April 17, 1978, the Committee concluded that if the exemption from the surtax which was first established by Congress in 1938 were to be adjusted for inflation as measured by the GNP deflator, the break point between the lower rate and the surcharge rate would be $124,000. We believe the Congress should consider this as a minimum distinction between corporations limited to the normal tax and the larger corporations, whose earnings would be subjected to the surtax.

In considering at what point this break should be made, there is apparently no conflict between smaller businesses and larger businesses. The record of the Ways and Means Committee on hearings held this spring was replete with recommendations from the larger corporations to increase the surtax exemption to at least $100,000.

We believe the Congress should make a distinction between those corporations which have access to the equity capital markets and those which do not. In the Senate Small Business Committee report, the committee stated that "when a company achieves access to national stock, bond and commercial paper markets and multiple lines of bank credit . . . it might safely be classified as a large business." These smaller business enterprises have limited borrowing capacity and always on shorter terms at higher interest rates. Therefore, they are more dependent upon retained earnings for their modernization and expansion than are their larger competitors.

We would also prefer to see a more simplified structure, with one tax rate for the smaller corporations and the larger corporations being subject to the surtax. A multicplicity of brackets does not have sound economic justification. Certainly, in our industry, a company in the profit range of $50,000 to $75,000 finds it just as difficult to raise equity capital as a smaller corporation and borrows money at the same rate of interest.

There is a need to provide all business enterprises—small and medium, as well as large—with substantive tax relief. An objective perspective recognizes that small and medium sized businesses provide over half of the employment in the private sector, and that almost all the new jobs in the past five years have come in sectors of the economy which tend to be dominated by small to medium sized enterprises, as Table 1 clearly demonstrates.

TABLE 1.—GROWTH IN EMPLOYMENT, 1970–76 BY SECTOR

[Number of employees in millions]

	1970		1976		Gain	
	Number	Percent	Number	Percent	Number	Percent
Total employment	78.6	100	87.5	100	8.9	0
Manufacturing, etc.[1]	34.9	44	35.1	40	.2	+1
Balance of economy	43.7	56	52.4	60	8.7	+20

[1] Includes agriculture, forestry, fisheries, mining, construction, transportation, communications, and other public utilities.

Source: Bureau of Labor Statistics, Employment and Earnings Statistics, March 1977.

Wholesale trade employment alone rose from 2,670,000 to 3,462,000 during this period, an increase of 792,000 jobs—almost four times the number created in manufacturing and the other industries included in this grouping. By 1976, employment in our industry represented 4.0 percent of total employment, up from 3.4 percent of total employment in 1970—a gain of 18 percent.

Sustaining the rate of new job creation in wholesale distribution and other smaller business-dominated sectors of the economy requires greater real retained earnings. An adjustment in the surcharge exemption to $150,000 is the simplest and most effective way to accomplish this. The Administration's proposal would increase the retained earnings of a corporation with $50,000 in pre-tax earnings by only $1,000, a small fraction of the capital necessary to create a single job.

We recognize that this Committee and the Congress need hard, factual analyses in order to evaluate tax proposals and to reach decisions about appropriate changes in the tax law.

In an effort to provide such analyses, in hearings before the House Ways and Means Committee in July, 1975, Dr. Norman B. Ture, a recognized expert on capital formation and tax policy, presented that Committee with a comprehensive and detailed analysis of the capital formation process within wholesale distribution and the role played by tax policy in this process. Dr. Ture concluded that, in light of the dependence of merchant wholesaler-distributors on retained earnings to finance their increased capital requirements and the estimated inadequacy of the growth of our industry's retained earnings, wholesale distribution would experience a severe capital short-fall without significant corporation rate reduction. His study determined that an increase in the corporate surtax exemption to $100,000 would most effectively solve this capital shortfall.

Dr. Ture's study also examined the revenue and overall economic impact of such an increase in the corporate surtax exemption. It is important to note that among his findings was that increases in output, employment, and income deriving from an increase in the exemption would result, after a lag of some two-to-three years, in additional federal revenues which more than offset the "initial impact revenue loss." The conclusions reached by Dr. Ture remained valid today, save that since completion of his study the rampant inflation we have experienced requires an even higher surtax exemption than indicated at that time. In our view, a $150,000 figure is justified today, utilizing the same criteria.

We wish to make the point that by not adequately increasing the surtax exemption, Congress has effectively increased the taxes on smaller business enterprises because the value of the exemption has been seriously eroded. Smaller business owners do not have the options often imagined as to whether they will pay out dividends or retain them in the business. For the wholesaler-distributor, the largest single investment is in inventory. When produces raise their prices as is reported monthly in the Producers Price Index, wholesalers must pay more for inventory replacement costs. These increases are running at the rate of 10% per year.

To maintain the same amount of stock in inventory, the businessman is forced to increase his investment with after-tax earnings. Let me present a simple example. If a wholesaler-distributor carries an inventory of $100,000 during a period with a 10 percent rate of inflation, he must increase his investment in inventory by $10,000 to carry the same level of inventory. If he averages a net profit of 3 percent before taxes, and turns the inventory over four times in the year, he would have a net profit before taxes of $12,000. If this were to be taxed at the rate of 20 percent, he would have after tax profits of $9,600. When this profit is measured against the need to invest in additional $10,000 to maintain the same level of inventory, it is apparent he has no option but to leave the profit in the business.

Increasing the surtax exemption will assist those coporations who do not have access to the equity capital markets to retain this capital in the business. If retained capital is increased, then the wholesaler can borrow a slightly larger amount than formerly. Banks generally will not increase a line of credit unless there is more equity capital also added to the business. Even with this assistance, the smaller business will pay more for its borrowed money than its larger competitors. For these reasons we recommend the Congress increase the surtax exemption to $150,000.

INVESTMENT TAX CREDIT

We support the provision of H.R. 13511 which makes permanent the investment tax credit at the 10 percent rate. While we are pleased the amount of ex-

penditure for used equipment eligible for the investment tax credit was increased by the House from $100,000 to $200,000, we question the economic justification for the limitation. To the small businessman, used equipment often represents his most viable option to modernize machiney and equipment. Although such equipment is used, it nonetheless is "new" to the purchaser and is purchased for the same purposes as is new equipment, namely to increase efficiency and productivity. Therefore, we recommend the limitation be deleted.

We also believe the extension of the investment tax credit to the rehabilitation of industrial and commercial buildings will be of considerable assistance in helping business, including wholesale distribution, to modernize its facilities. When the Administration, early this year, recommended investment credit be extended to buildings, the proposal limited the eligibility to structures essentially used by manufacturers and utilities. By eliminating the discrimination against buildings used in distribution, the Ways and Means Committee recognized that the economy as a whole is as dependent on non-manufacturing activities as it is on manufacturing activities and on utilities. By stimulating the modernization of facilities through the investment tax credit device, improved productivity may be enhanced in wholesale distribution, as well as in other lines of business enterprise. The 1972 Census of Business indicates the wholesale trade uses 3.1 billion square feet of warehouse space. Many of these facilities need extensive rehabilitation, which will be encouraged by this provision in H.R. 13511.

We oppose, however, the suggestion by Secretary Blumenthal that the Congress reduce the eligibility of the investment credit to no more than 90 percent of the first $25,000 of tax liability. The 100 percent provision in the House bill will make the provision meaningful to those businesses with low taxable income which need rehabilitation of facilities to become more productive and improve earnings.

TARGETED JOBS CREDIT

We note the jobs tax credit, a provision enacted last year to encourage employers to hire disadvantaged youth and handicapped individuals, has been extended with considerable modification. First, we would like to endorse the provision which relieves an employer of the responsibility for determining whether the new employee is in the class which would make the employer eligible for a job tax credit. By reliance on a certificate issued by the Secretary of Labor, uncertainty as to whether the IRS will allow a tax credit has been removed. We appreciate the reasons why the Ways and Means Committee wished to target in on the specific classes of the unemployed as set forth in H.R. 13511. We do urge the Congress keep these special tax provisions unchanged for longer periods of time. Most employers have not had enough time with the current jobs credit provisions to utilize them fully. They provide only limited tax relief and to obtain the tax relief, the employer must look to sources of employees he has not normally used, as well as study the tax provisions which he must carefully follow in order to obtain the benefits of the credit. Therefore, we endorse the concept of the jobs credit provisions, but urge the Congress not to change the provisions too frequently.

CAPITAL GAINS TAXATION

In the House-passed bill, a major step has been taken to assist in capital formation. Under current law, in certain cases the capital gains rate could go as high as 50 percent. Under H.R. 13511, capital gains would be deleted from the list of tax preference items for individuals, corporations, estates, and trusts under both the minimum and maximum provisions. This would make the maximum capital gains tax rate for corporations at 30 percent and the maximum rate for individuals at 35 percent.

The enactment of the House changes will provide additional investment funds needed for small businesses and for larger entities as well.

This Committee, we believe, should look to the advisability of reducing capital gains taxes even further. There is considerable evidence that reduction in these taxes do have a feedback effect on Treasury receipts. With the current high need for investment capital, the maximum impact of encouraging investment may be achieved with the least loss of revenue in the short run. In the longer run, there is considerable evidence such a reduction would increase Treasury revenues. Therefore, we urge the Committee to make further reductions in capital gains taxes.

INDEXATION OF CAPITAL GAINS TAXES

While many portions of the House bill were aimed at reducing inflation, the indexation of capital gains realized after December 31, 1979, is the most significant. We do believe the Congress should periodically review the effect of inflation on tax provisions. For example, we have asked for an increase in the corporate surtax exemption because inflation has eroded the value of the exemption. Therefore, the House-passed provision has great appeal. Indeed, a first review brings a favorable evaluation. It is necessary to view this new approach to mitigate the ravishes of inflation with some caution. There are reports of its use in other countries. While we have limited information on this, some of those reports do not indicate that it has aided in reducing inflation. Would enactment of indexation contribute to curbing inflation? There is no complete study to support that it would. Many who support indexation have expressed the opinion that it would reduce Federal revenues, thereby forcing the Federal government to reduce expenditures. The Congress has other, more direct ways to reduce Federal expenditures, and the results are more predictable.

We also believe that once indexation is provided for capital gains, there would be immediate demands for it to be extended for other taxable income. When the minimum wage legislation was pending in the Congress last year, we opposed indexation of the minimum wage to the Consumer Price Index. The Congress did not tie the minimum wage increase to the CPI, but did provide for four years of increases. We believe the multiple steps in minimum wages have created in the minds of many people the concept that inflation is here to stay, that it is a way of life and cannot be curtailed. The measure institutionalized wage increases and thereby has institutionalized increased business operating costs.

We share with the Secretary of the Treasury his observation that indexation would create numerous distortions, many of which cannot be predicted. For example, we note that stock in subchapter S corporations is excluded from eligibility for indexing. Many small businesses which are not now subchapter S, but may wish to become so, would lose the benefit if they were to select this option. Most of all, the provision carries a possible affirmation that inflation can be controlled by indexation or that the harm caused by inflation will be mitigated. While we fully support reducing the taxes on capital gains, we urge caution on a tax provision that signals an acceptance of inflation, an accommodation to inflation, or a surrender to inflation.

With persistent inflation, the dire need for business for additional capital and the requirements for revenues, restructuring the tax system is very difficult. We appreciate this opportunity to express the views of the wholesale distribution industry while this Committee is engaged in this most challenging task.

APPENDIX A

STRUCTURE AND ECONOMIC SIGNIFICANCE OF THE WHOLESALE DISTRIBUTION INDUSTRY

The wholesale distribution industry, in contrast to the manufacturing sector of the economy, continues to be dominated by small-to-medium size closely-held, family-owned businesses. Of the 202,000 merchant wholesaler-distributor corporations filing tax returns in 1973, 99 percent had assets of less than $10 million. These smaller firms accounted for about 65 percent of the industry's sales volume. In contrast, in the manufacturing sector, approximately 2 percent of the firms controlled about 88 percent of the assets and accounted for approximately 80 percent of sales.

The wholesale distribution industry provides year-round employment for 3.5 million individuals. In 1977, average hourly earnings ($6.78) in wholesale trade exceeded those for all private industry ($5.14), while average weekly earnings ($212) were 15 percent above those for all private industry ($185). In short, the wholesale distribution industry provides dependable, well-paying jobs throughout the U.S. economy.

Industry sales in 1977 totalled $432 billion and are expected to reach approximately $665 billion in constant dollars in 1982, according to Commerce Department estimates.

Merchant wholesaler-distributors perform an essential economic function. They make goods and commodities of every description available at the place of need, at the time of need. Wholesaler-distributors purchase goods from producers, inventory these goods, break bulk, sell, deliver, and extend credit to retailers and industrial, commercial, institutional, governmental and contractors business users.

Wholesaler-distributors are essential to the efficient satisfaction of consumer and business needs. Further, by the market coverage which they offer smaller suppliers and the support which they provide to their customers, wholesaler-distributors preserve and enhance competition, the critical safeguard of our economic system. According to a recent NAW survey, the typical wholesaler-distributor establishes the market connection between 133 manufacturers and 533 business customers. Many of thesse manufacturers are themselves small businessmen who must rely on wholesaler-distributors to establish, maintain, and nurture markets for their products. The majority of customers are small businessmen also, who look to the merchant wholesaler-distributor to provide merchandise availability, credit, and other critical services.

Senator MOYNIHAN. Now the Chair has a special pleasure to call to the witness stand Prof. Martin Feldstein. Professor Feldstein is well known as the president of the National Bureau of Economic Research, and is a professor of economics at Harvard University. He appears in his own right, of course, and you are most welcome to the Finance Committee, sir.

STATEMENT OF MARTIN FELDSTEIN, PRESIDENT OF NATIONAL BUREAU OF RESEARCH AND ECONOMICS, HARVARD UNIVERSITY

Mr. FELDSTEIN. Thank you, sir.

I am pleased to be here this morning. During the past 3 years, I have been doing research on aspects of taxation that bear directly on the proposals that you are considering. This morning, I am going to summarize briefly the results of those studies. I will talk first about the taxation of capital gains, and then about the corporate income tax.

Although there has long been speculation about the extent to which

high tax rates on capital gains deter individuals from selling stock and other assets, there has been little hard evidence on the subject. In collaboration with two colleagues, I recently completed a study that indicates that the realization of capital gains is so sensitive to tax rates that reducing the tax rate on capital gains would actually increase tax revenue from this source.

Let me emphasize that this estimate of extra revenue does not depend on any assumed increase in share in share prices, in investment or in economic activity. The extra revenue results directly and immediately from the "unlocking" of gains that would not otherwise be realized. A favorable impact on share prices and total economic activity would, of course, increase revenue further. But even without such stimulating effects, the evidence indicates that reducing the tax rate on capital gains would increase both total tax revenue and the taxes paid by high income individuals.

The key evidence in this study is an analysis of the Treasury Department's sample of individual tax returns for 1973. The sample consists of over 30,000 individuals with more than 230,000 stock sales. 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. With this data, we found that the realization of capital gains on corporate stock is extremely sensitive to the tax rate.

We calculated that limiting the top capital gains rate to 25 percent would have caused an almost threefold 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.

This study was restricted to gains on corporate stock. To study the tax sensitivity of all types of capital gains, we examined the Treasury's published data on capital gains before and since the 1969 Tax Reform Act. The historic record shows that all gains as a whole are sensitive to higher tax rates. We have compared the 2 years before the 1969 Tax Reform Act with the 2 most recent years for which data are available. Over this period, taxpayers with adjusted gross incomes below $100,000 increased their realized gains by 18 percent. In contrast, realized gains fell by 35 percent for the very high income taxpayers—with AGI over $500,000—who were most affected by the 1969 changes. These data indicate that the gains of this high-income group would have been about twice as high today if they had not been depressed by the 1969 tax changes.

In short, the Treasury's calculation that cutting the top capital gains tax rate to 25 percent would cost $2 billion is totally misleading. They arrive at this figure because they ignore the unlocking of gains that would result from the lower tax rate. Reducing the top tax rates on capital gains would actually increase tax revenues. A capital gains tax cut should therefore not be evaluated as an alternative to other ways of stimulating capital formation because a capital gains tax cut has no real revenue cost.

With this as background, I want to talk briefly about two aspects of the bill recently passed by the House: The Archer amendment to ad-

just capital gains for inflation and the elimination of the alternative tax.

I think the Archer amendment is a very desirable feature of the bill and should be retained. 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 30,000 individual tax returns for 1973 that I mentioned a few minutes ago.

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.

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. 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 nominal and real gains and corresponding tax liabilities are compared in exhibit 1; I will not comment further on these figures now.

The proposal in the House-passed bill to adjust taxable gains for the effects of inflation would eliminate this unfair treatment and would provide a more equitable and predictable taxation of capital gains. It is important to realize that, based on the 1973 experience, two-thirds of the tax reduction on corporate stock gains that would result from this inflation correction would go to taxpayers with AGI's below $100,000 even though they only paid less than one-fourth of the capital gains tax on corporate stock. The inflation correction would thus be a major benefit to middle-income investors.

Let me turn now to the proposal to eliminate the alternative tax that is contained in the bill passed by the House. I think this would be a very serious mistake. For many individuals, the adverse effect of eliminating the alternative tax would outweigh the favorable effect of taking the untaxed half of capital gains out of preference income.

It is easy to see how this can happen. A high income executive or professional with little or no so-called preference income would not benefit from the provision that takes capital gains out of preference

income. He would, however, find that eliminating the alternative tax would raise his tax rate on capital gains.

This type of situation should not be considered a rare anomaly. It is actually the typical result of the House-passed bill.

The most important thing I will say in this testimony is this important fact. Among taxpayers, with 1978 adjusted gross incomes over $100,000, the combination of eliminating the alternative tax method and taking capital gains out of preference income would actually cause more tax rate increases than tax rate decreases.

More specifically, to study this question, I used the 1973 Treasury data on individual sales and gains projected to 1978 levels. I found that, with these sales and gains, eliminating the alternative tax and taking capital gains out of preference income would raise the capital gains tax for 99,000 individuals with AGI's over $100,000. Only 79,000 such individuals would pay lower capital gains taxes.

Of course, since the taxpayers with reduced tax rates are also the investors with the largest gains, this combination of policies results in a net reduction in the total tax liability on the initial level of gains. But this does not change the fact that, aside from the indexing proposal, the plan passed by the House would actually cause more capital gains tax increases than decreases.

The effect of this would be to discourage investment by the very individuals whom the current tax reform sought to bring back into greater equity investment. I am confident that the magnitude of this perverse effect was not anticipated by those who drafted the House bill. I hope that in light of this new evidence you will reconsider the reverse the decision to eliminate the alternative tax. Let me remind you that doing so would not only stimulate personal investment but would also increase Treasury revenues.

For the very brief time that remains, let me turn to the corporate income tax. For the long run, I think the thing that must be done is reconsider depreciation, and go from a historic cost basis to something that more accurately reflects changes in the price level.

Now, I would like to suggest that you consider a simpler idea—a substantial cut in the corporate tax rate, 40 percent in example, voted now, but only becoming effective in 1981. If such a tax cut were promised now, it would cause a significant increase in investment even before the lower tax rate takes effect.

The prospect of a lower tax rate on future profits would stimulate investment, even before the tax rate fell. Indeed, firms would rush to make investments in order to get the depreciation at the higher tax rate.

A substantial tax cut explicitly legislated for the future would thus stimulate capital formation now without any concurrent increase in the deficit.

I hope that the committee will give this simple idea serious consideration.

Thank you.

The CHAIRMAN. You made a very fine statement here. I read your statement before you came here to testify, Mr. Feldstein, and the several points that you are making I hope will not escape the attention of every member of this committee.

The capital gains tax is so high that it is costing us money. It is a counterproductive tax. It would be just as though you had a tax of 120 percent on somebody's income. The man would not dare go to work.

If we fix it so a person sees a lower tax rate, he then goes to work and makes money for the Government. Yet there are some people who want to say we are giving him something. We are not giving him anything. We are just making it so a fellow can go back to work.

You have discussed here billions of dollars of so-called capital gains where the person did not make anything. In real terms, he lost money. This was a penalty assessed on the citizen because the Government failed to maintain the purchasing power of its money.

That is almost like a criminal fine on somebody who is actually blameless, to be assessed on him for engaging in what we were thinking was actually a desirable course of conduct.

Henry Fowler, former Secretary of Treasury, was here testifying to the same thing you were saying. He said that when he was Secretary of Treasury and Under Secretary, they had before us a proposal to drastically reduce the tax on capital gains and they were estimating, in the Treasury under John Kennedy, that they were going to make money with that proposal.

We are not giving somebody something when we take a counterproductive tax schedule and make it productive. That is nothing more than simply advancing the public interest. A lot of people just miss that point. I hope that we can get the Treasury and get the President and his advisors to see what is apparent to many of us. If our Treasury people can just make enough progress to move ahead and surge forward to where they were back in 1963, we can do great things for this country.

You have made a fine statement that moves us in that direction. I want to thank you for what you said here today.

Mr. Danforth?

Senator DANFORTH. Professor Feinstein, you have made a reputation for being a real expert on tax policy in general and the question of capital formation in particular. It seems to me devise a tax program and we write a tax bill, that we should not just be interested in well, how can we do something popular because we are politicians. We should be interested in the effects of what we are doing on the economy.

It is my understanding that the issue of capital formation is a very important economic question, that it is of great moment in the year 1978. It is my further understanding that part of the picture in addressing this problem has to be to do something about the capital gains tax.

But it is my further understanding that we also have to address ourselves to the question of capital formation in so far as it pertains to businesses, in so far as it pertains to corporate rates or investment credit, or accelerated depreciation.

What I want to ask you, am I wrong in those assumptions, and could you elaborate for the committee and for the record the significance of the issue of capital formation and particularly address yourself to the question of business taxes as a part of the total picture.

Mr. FELDSTEIN. I do not think you are wrong at all. I think you are absolutely right.

The sluggish growth in this country in the last 10 years has caught public attention recently, but it is even worse than that if you look at a longer period of time. We have had a lower rate of capital formation, therefore a lower rate of growth in this country than in other major industrial countries.

Why do we have a lower rate of capital formation? Certainly a major reason for that is the low rate of return after tax that is available on investment in this country. I emphasize after-tax because the before-tax rate returns remain high, but the reward to the individual investor has gone down.

In the last 10 years, the effective rate of tax on real corporate income has risen from 41 percent to 52 percent, despite the apparent best efforts of the Congress to reduce the tax burden on corporate income through accelerated depreciation and other provisions.

The impact of inflation has been to raise effective tax rates, and therefore to lower the return of investment.

The capital gains tax rate, because it has become a tax, in large part, on inflation has further reduced the after-tax return to investment. We have discouraged, very substantially, real investment in our economy, and if we can provide that incentive again by reducing some of the high tax burden, I think that we will see an increased rate of capital formation, a higher rate of productivity growth, and a possibility of reaching full employment without such a large deficit, because private investment will take its place.

Senator DANFORTH. Could you explain to the committee how the corporate tax rate relates to the health of the economy?

Mr. FELDSTEIN. Can I do it quickly is the question.

The willingness of individuals and firms to commit money to make long-term investment has to depend on the after-tax rate of return that they are able to get.

What we have been doing, because of inflation, is to substantially decrease the after-tax rate of return, because we have increased effective tax rates, effective corporate tax rates.

If we want to revitalize investment, corporate investment in plant and equipment, we have to do something to reduce that rate of tax so that corporate investment becomes an attractive alternative again relative to holding cash, going into other types of securities, government bonds, land, gold.

That is the basic, simple reason: The net rate of return to investors has been substantially curtailed by giving them 50 cents on the dollar when 10 years ago they were getting 60 cents on the dollar.

Senator DANFORTH. Thank you.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. I notice that you are president of the National Bureau of Economic Research. What is that, exactly?

Mr. FELDSTEIN. The National Bureau of Economic Research is a nonprofit, private, essentially academic research organization that does studies of the national economy. It has been around for 50 years, 60 years, doing research, quantitative studies of different aspects.

Senator PACKWOOD. Is it funded basically by contract to do research?

Mr. FELDSTEIN. We do almost no contract work.

Senator MOYNIHAN. Professor Feldstein, if you tell them Arthur Burns was one of your predecessors, they would all feel better over there.

Mr. FELDSTEIN. Arthur Burns was the president of the bureau for 20 years. We are funded by a combination of grants. The National Science Foundation, contributions from corporations, labor unions, foundations.

Senator PACKWOOD. You presume an increase in revenue because of the increase in the quantity of transactions, if we lower the capital gains tax. I understand that for the first year.

Can you presume that there will be a perpetually increasing cycle of unlocking and there will always be revenue increases from this fact alone?

Mr. FELDSTEIN. I think so. I think what we have here is basically an estimate of what will happen year after year, not merely the first year. I am glad you asked the question, because I do not think that was clear in my statement, but basically the way we have made this estimate is by looking at a cross-section of individuals. We have not looked before and after when we have looked at our corporate gains study, but we have looked at individuals who tend to be in the same brackets year after year, but what we find is that the high income individual sits on his gains, postpones them indefinitely, while the lower income individual, lower tax rate individual, turns those gains much more frequently.

I think that we would see a continuing increase and turnover and therefore, in capital gains tax, if we lowered it.

Senator PACKWOOD. You would not have any first-year bulge?

Mr. FELDSTEIN. There would be a first-year bulge. I think, if anything, this underestimated the first year, or first couple of years, effect, and overestimated, slightly the permanent thing.

But for technical, statistical reasons on how the estimates were made, basically this is an estimate of what will happen when the dust settles down and we keep repeating year after year.

Senator PACKWOOD. Within reason, what you are saying on the corporate tax is that we could leave it at the present rate for 2 or 3 years, but if we see in 1981 it is going to drop precipitously, I do not believe that in a bad sense, but from 48 to 50 percent 4 years hence, that would immediately generate investment right now, so long as they know they could count on it 3 to 4 years hence.

Mr. FELDSTEIN. It would increase investment now more than if you cut the corporate tax rate now because of higher depreciation, the higher tax rates against which depreciation could be charged in the early years.

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

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. Thank you.

I would like to depart a little bit from Professor Feldstein's testimony and ask him about a matter that Senator Packwood and I are interested in, which is another one of the effects of recent tax legislation. There has been a sharp decline in gifts to charity among the American people, a real change in almost our mores as people. Senator Packwood and I have proposed that the deductions be made available to all taxpayers including those who take the standard deduction by moving it along the line. The Treasury, rather wearily and predictably said no, you cannot do that.

But you have done some rather remarkable studies on what you call the price elasticity of giving. And I think you have found elasticity of at least 1.2 percent, possibly much higher for middle income persons.

Could you speak to this question for a moment?

Mr. FELDSTEIN. Everything you said is quite correct about what we have done. We did studies, starting about 5 years ago, I suppose, on the effects of the tax rates on charitable giving, the effective tax deductible for charitable giving. It is like the capital gains story, people are very sensitive.

This is something you have a great deal of discretion over. We find when the cost to the taxpayer for giving is reduced because of deductibility, he gives significantly more. For every 10 percent reduction in the cost, the out-of-pocket cost to him delivering funds to a charity, he gives roughly 12 percent more, and that ratio of 12 to 10 is the 1.2 percent you mentioned.

What that means, if we extended deductions for charitable giving for those who are currently nonitemizers, is that there would be a greater increase in giving than there would be a loss of revenue to the Treasury. Charities would get more dollars.

These studies have all been based upon the official IRS logs, except for one which looked at survey data collected by the University of Michigan and used that to study the lower income, nonitemizing population relative to the comparable income group who do itemize—people with incomes under $30,000.

This is where we had an indication of a higher sensitivity which would suggest that the revenue cost would be slightly greater, but per dollar of revenue cost, the gain to the charity would be that much larger.

Senator MOYNIHAN. Would you agree that there is an issue of social policy as well as economic policy here? To the degree government tax policy squeezes out the traditional private charitable enterprises, government tends to fill the vacuum and you get an increase of stateism?

Mr. FELDSTEIN. Yes, and to a certain extent, it cannot begin to fill it. If you look at where the dollars go for the people we are talking about here, the people who are currently nonitemizers, it is the church, it is the United Way, it is the community action groups. It is very hard to see how the government is going to step into that role.

Senator MOYNIHAN. We thank you. I hope the chairman has listened to you as attentively on this matter as he did on the question of how to shoot ducks.

The CHAIRMAN. Senator Hathaway?

Senator HATHAWAY. Thank you, Mr. Chairman.

Doctor, are you advocating indexing of capital gains?

Mr. FELDSTEIN. Yes. I would recommend the Archer amendment as passed by the House.

Senator HATHAWAY. Will that not, in and of itself, have some inflationary effect, just as cost of living escalaters have?

Mr. FELDSTEIN. I think it is very different. It is not a cost of living escalater in any sense. It is not a price that will automatically go up.

Actually, it is a tax that will automatically go down because there is a greater willingness of people to supply capital in times of inflation because they know they will not be penalized because of that inflation

and, if anything, that will eliminate some of the bottlenecks that can cause inflation.

Senator HATHAWAY. Are you advocating that we also index the complete tax structure?

Mr. FELDSTEIN. If I had my druthers, I would index generally—the levels at which bracket rates change, the tax treatment of depreciation, and the tax treatment of interest—but I do not think that we are going to see all of that this year, and this is an important place to begin, because it is the place that is crucially affected by inflation, as the chairman pointed out.

Senator HATHAWAY. Will it not cause some distortion? The person who puts his money in a savings bank, he will not have indexing.

Mr. FELDSTEIN. It will induce people to move more into the market and into other kinds of real investments relative to government bonds or municipal bonds or savings accounts.

Senator HATHAWAY. If we had indexing generally, as you would advocate if you had your druthers, would that not mean less money coming into the Federal Treasury, so the deficit would be increased if the level of spending stays at the same rate?

Mr. FELDSTEIN. I assume, year after year, Congress will adjust its overall tax rates to bring in the amount of money that it would need. I do not think that it would increase the deficit as such.

Senator HATHAWAY. If it does that, what is the sense of having the indexing in the first place? If Congress, you think, is going to adjust to the same amount of revenue, why have the indexing in the first place?

Mr. FELDSTEIN. The adjustment that would come from adjusting ordinary tax rates would not undo the very substantial effects of inflation on capital gains, on depreciation, and on interest. There is a real interest between the bracket rate adjustment for the regular income tax schedule and the adjustment for the taxation of capital income, particularly capital gains and depreciation.

I think the usual kinds of year to year adjustments that the Congress continually makes to keep the revenue level at what it wants does not deal at all with excess taxation of capital gains or corporate source income that comes about because of inflation.

Senator HATHAWAY. If you have indexing across the board, you are adding an inflationary cushion to what many employees already get with the cost-of-living escalator built into their contracts.

Mr. FELDSTEIN. It goes the other way now because of the progressive structure of the income tax and the fact that it is not indexed, employees have to get an increase greater than the price level increase just to stand still because we have not indexed the income tax. We have built in this extra inflationary pressure.

If I am an employee making $15,000 now and there is a 6 percent inflation, I do not have to get $900 to stand still; I have to get $1,200 or $1,000 because of the extra tax I am going to have to pay.

So we build in an extra kick into the inflation in each range because of the fact that the brackets are not indexed. I think that we would actually reduce wage pressures if people knew that there was not going to be an extra increase on the cost of living on the tax side.

Senator HATHAWAY. Then you say the Congress will adjust to get the amount of revenue so you are going to be back where you started, are you not?

Mr. FELDSTEIN. In part it is the certainty and in part how it is distributed over brackets as far as the individual side goes. As far as the income side, yes.

Senator HATHAWAY. Across the board it seems to have some difficulty?

Mr. FELDSTEIN. The difference is essentially one of predictability and distribution.

Senator HATHAWAY. Let me ask one more question. The Sunday Washington Post indicated that this capital gains change will raise the price of real estate substantially. Could that have a chain reaction for our HUD programs?

Mr. FELDSTEIN. I have thought about that a bit. I do not have a clear conviction in my own mind. One of the reasons that real estate has gone up so much in the last few years is that the stock market, because of inflation, is a bad investment. You do not pay taxes, really, on real estate capital gains if you are an individual. You keep rolling them forward.

So, if anything, this ought to make the stock market more attractive relative to real estate, or gold, or pure land as an investment. I would think, if there is a relative price change, it is that the stock market will rise more than the price of housing or gold.

Senator HATHAWAY. Even if the capital gains would be available?

Mr. FELDSTEIN. Even if the capital gains were available for everything. Essentially, they are available for housing through the rollover provision.

Senator HATHAWAY. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Nelson?

Senator NELSON. I have a question for the chairman. I was wondering why you gave that eloquent speech on cutting capital gains to Evans and Novack before you gave it to the Finance Committee?

The CHAIRMAN. I gave it to the Treausry first. It was a waste of time.

Senator NELSON. I have no questions.

The CHAIRMAN. Senator Ribicoff?

Senator RIBICOFF. Mr. Chairman, it would be unfair to ask a question because I did not hear the testimony. However, I have read, from time to time, various articles written by Professor Feldstein and I was always deeply impressed by the points you have made. I will read your testimony very carefully. I think it is good to have a man like you testifying.

Mr. FELDSTEIN. Thank you. Let me call your attention to one point in particular, and that is the third point on that key points list. I think it is the least understood of the things that I talked about before—the fact that the alternative tax elimination in the House-passed bill would actually hurt so many of the middle and low end taxpayers, that more people would be penalized by the House-passed bill, aside from the Archer amendment, than would actually gain.

Senator RIBICOFF. I am curious about this whole question of how experts arrive at their conclusions. How do you explain the difference between your conclusions and those of the Treasury Department?

Mr. FELDSTEIN. Well, Treasury's revenue estimate are a certain stylized art form and they have to be seen as a stylized art form. They are not a picture of reality, but a stylized art form. I do not think they would object to that characterization. They specifically assume no change in behavior.

Everybody agrees there would be some change in behavior if you lower capital gains tax rates. The only thing is how large the change is going to be. The Treasury supplied some statistical estimates of that, which we used in our estimates. But in general, when the committee gets revenue estimates from the Joint Committee staff or from the Treasury, they are this particular art form that assumes no change in the behavior of the individuals that are taxed.

Senator RIBICOFF. Do you think that it is possible that the so-called experts are looking for the ultimate objective that they want to achieve and then adjust their figures to justify that objective?

Mr. FELDSTEIN. Some kind of studies are more vulnerable to that than others. What we have done here is reproducible. There is no question about the methods that have been used. The simple statistic of looking at what has happened to realized capital gains by income class since 1969 is something that anybody with the Treasury's statistics of income can do in an hour, and it is very clear from those figures that what has happened has been that high-income individuals have cut their real gains substantially while low income individuals are realizing more gains.

There is only one possible explanation of that, and that is the tax changes in the 1969 act.

Senator RIBICOFF. I know what a professor of economics at Harvard is. I do not know what the National Bureau of Economic Research is.

Mr. FELDSTEIN. This is a nonprofit, private organization that does basic, economic research on the American economy. We were founded by Wesley Mitchell who was a Columbia professor in the 1920's, and as Senator Moynihan pointed out when this question came up a little while ago, Arthur Burns was the president of the National Bureau for some years in the 1940's and 1950's.

Senator MOYNIHAN. As a matter of fact, no recession is official until the NBER declares it so—2 years after the event.

Senator RIBICOFF. This committee has a grave responsibility for making decisions affecting the future economy of our country which will impact on the economic well-being of 230 million Americans. We depend on the advice that we get. Economics is a very, very puzzling discipline. The inconsistencies in economic conclusions and economic advice is probably as widespread as in any phase of our learning.

How should a group of men, such as ourselves, reach our conclusions? Do we take it out of our viscera instead of your intelligence?

Mr. FELDSTEIN. I do not have a good rule for sorting out the good evidence from the bad evidence.

Senator RIBICOFF. Thank you very much.

The CHAIRMAN. Senator Hansen?

Senator HANSEN. Dr. Feldstein, I am sorry I was not here to hear your testimony. I have been an admirer of yours, as I continue to be, for the excellence of your research.

When Secretary Blumenthal was testifying before this committee, we confronted him with some of the conclusions you reached. As I recall, he criticized your methodology.

I am curious, because I was under the impression that your work was, indeed, authorized and paid for by Treasury. What about the criticism he makes of the conclusions you reached based upon the methodology?

Mr. FELDSTEIN. I heard he said that. I do not know exactly what he has in mind. You are correct that the Treasury commissioned and financed the study. They provided the data. We discussed with the Office of Tax Analysis the specific design of the research and what we would do.

We presented results at an intermediate stage, and then before I testified before your subcommittee, I presented them at the Treasury.

The only objection that was raised at the time was that this was just about corporate stock, capital gains. That is why my colleague and I looked at the total capital gains history from before the 1969 act to the present.

That is not the kind of fine-tuned analysis that the corporate stock study was. There is no way to use the cross-sectioned household income tax records to study other kinds of capital gains. It seems to me that the time series record supports what we found from the individual tax returns.

Senator HANSEN. Do I understand you to be saying that you apprised Treasury, and they were aware of your methodology, to examine data and to reach conclusions?

Mr. FELDSTEIN. That is correct.

Senator HANSEN. I have no further questions, Mr. Chairman.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. I want to commend you on your testimony. I think the case has been pretty well-established. I will not take time for any more questions.

Thank you very much,

The CHAIRMAN. Senator Dole?

Senator DOLE. I just have one question. Indexing, Senator Hathaway mentioned, is an idea that is getting a considerable amount of support around the country, even in State legislatures. They are addressing the problem in Colorado and Arizona. Tax indexing is going to happen one of these days. It is probably going to happen in this committee, hopefully this year. If not, we will try indexing on the floor.

With reference to capital gains and tax reduction, there is the House approach, and the approach suggested by some of our colleagues on the Senate side, that there be a dollar amount exemption from capital gains tax. Have you made an analysis of this latter suggestion? What impact it might have?

Mr. FELDSTEIN. I looked at that a bit, the proposal that Senator Nelson made.

To my way of thinking, there are two issues. One is the incentive effects and the other is the equity with respect to taxing people on real rather than nominal gains. Of course, that does not address the issue of indexation or real gains.

With respect to the incentive effect, what matters is what happens to the tax rate on another dollar of capital gains, on a marginal dollar of capital gains, for somebody who is already realizing more than

$3,000 of capital gains then the exclusion will do nothing to the tax rate they will face on another dollar of gains.

So while it would benefit all of those individuals, it would only have an effect on the behavior, it would only help to unlock gains and to increase the fluidity of the market, for those gains that were above the $3,000 limit or $1,500 for individuals.

My calculations indicate that 95 percent, roughly, of all gains are above the $3,000 limit, or $1,500 per individual, so 95 percent of the gains would be unaffected by that. Or another way of saying the same thing, the tax cut that goes to individuals that are already realizing gains in excess of that limit is, in effect, wasted in respect to incentive effects. And on that basis, roughly 75 percent of the tax cut in that proposal is wasted, and only 25 percent of it goes to stimulating additional realization.

So I do not think that really deals with what I think is the key equity issue—inflation. I do not think it has the kind of favorable incentive effects that either the Steiger-Hansen proposal has, or the House-passed proposal.

There, I have my reservations because of the alternative tax provision, or the chairman's proposal.

Senator DOLE. Thank you.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Feldstein follows:]

STATEMENT OF MARTIN FELDSTEIN,* PRESIDENT, NATIONAL BUREAU OF ECONOMIC RESEARCH AND PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

I am very pleased to be here this morning and to appear before this distinguished committee. During the past three years, I have been doing research on aspects of taxation that bear directly on the proposals that you are considering. This morning, I will talk first about the taxation of capital gains and then about the corporate income tax.

THE TAXATION OF CAPITAL GAINS

Although there has long been speculation about the extent to which high tax rates on capital gains deter individuals from selling stock and other assets, there has been little hard evidence on the subject. In collaboration with two colleagues, I recently completed a study that indicates that the realization of capital gains is so sensitive to tax rates that reducing the tax rate on capital gains would actually increase tax revenue from this source.

Let me emphasize that this estimate of extra revenue does not depend on any assumed increase in share prices, in investment or in economic activity. The extra revenue results directly and immediately from the "unlocking" of gains that would not otherwise be realized. A favorable impact on share prices and total economic activity would, of course, increase revenue further. But even without such stimulating effects, the evidence indicates that reducing the tax rate on capital gains would increase both total tax revenue and the taxes paid by high income individuals.

The key evidence in this study [1] is an analysis of the Treasury Department's sample of individual tax returns for 1973. The sample consists of over 30,000 individuals with more than 230,000 stock sales. 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. With this data, we found that the realization of capital gains on corporate stock is extremely sensitive to the tax rate. We calculated that limiting the top capital gains rate to 25 percent

*President, National Bureau of Economic Research, and professor of economics, Harvard University. The views expressed here are my own and not necessarily those of either the NBER or Harvard.

[1] 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 Working Paper No. 250, 1978.

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.

This study was restricted to gains on corporate stock. To study the tax sensitivity of all types of capital gains, we examined the Treasury's published data on capital gains before and since the 1969 Tax Reform Act.[8] The historic record shows that all gains as a whole are sensitive to higher tax rates. We have compared the two years before the 1969 Tax Reform Act with the two most recent years for which data are available. Over this period, taxpayers with adjusted gross incomes below $100,000 increased their realized gains by 18 percent. In contrast, realized gains fell by 85 percent for the very high income taxpayers (with AGI over $500,000) who were most effected by the 1969 changes. These data indicate that the gains of this high income group would have been about twice as high today if they had not been depressed by the 1969 tax changes.

In short, the Treasury's calculation that cutting the top capital gains tax rate to 25 percent would cost $2 billion is totally misleading. They arrive at this figure because they ignore the unlocking of gains that would result from the lower tax rate. Reducing the top tax rates on capital gains would actually increase tax revenues. A capital gains tax cut should therefore not be evaluated as an alternative to other ways of stimulating capital formation because a capital gains tax cut has no real revenue cost.

With this background, I want to talk briefly about two aspects of the bill recently passed by the House: the Archer Amendment to adjust capital gains for inflation and the elimination of the alternative tax.

Inflation and the taxation of capital gains

I think the Archer amendment is a very desirable feature of the bill and should be retained. 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,[9] 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 30,000 individual tax returns for 1973 that I mentioned a few minutes ago.

We found that in 1973 individuals paid capital gains tax on $4.6 billion of nominal capital gains or corporate stock. When the cost 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.

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. 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 nominal and real gains and corresponding tax liabilities are compared in Exhibit 1; I will not comment further on these figures now.)

The proposal in the House passed bill to adjust taxable gains for the effects of inflation would eliminate this unfair treatment and would provide a more equi-

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[8] This study is reported in J. Slemrod and M. Feldstein, "The Lock-in Effect of the Capital Gains Tax: Some Time Series Evidence", National Bureau of Economic Research Working Paper No. 257, 1978.

[9] This study is reported in M. Feldstein and J. Slemrod, "Inflation and the Excess Taxation of Capital Gains", NBER Working Paper No. 234, 1978 (published in the National Tax Journal, June 1978).

table and predictable taxation of capital gains. It is important to realize that, based on the 1973 experience, two-thirds of the tax reduction on corporate stock gains that would result from this inflation correction would go to taxpayers with AGI's below $100,000 even though they only paid less than one-fourth of the capital gains tax on corporate stock. The inflation correction would thus be a major benefit to middle income investors.

The alternative tax

Let me turn now to the proposal to eliminate the alternative tax that is contained in the bill passed by the House. I think this would be a very serious mistake. For many individuals, the adverse effect of eliminating the alternative tax would outweigh the favorable effect of taking the untaked half of capital gains out of preference income.

It is easy to see how this can happen. A high income executive or professional with little or no so-called preference income would not benefit from the provision that takes capital gains out of preference income. He would however find that eliminating the alternative tax would raise his tax rate on capital gains.

This type of situation should not be considered a rare anomaly. It is actually the typical result of the House-passed bill. Among taxpayers with 1978 adjusted gross incomes over $100,000, the combination of eliminating the alternative tax method and taking capital gains out of preference income would actually cause more tax increases than tax rate decreases.

More specifically, to study this question I used the 1973 Treasury data on individual sales and gains projected to 1978 levels. I found that, with these sales and gains, eliminating the alternative tax and taking capital gains out of preference income would raise the capital gains tax for 99,000 individuals with AGI's over $100,000. Only 79,000 such individuals would pay lower capital gains taxes. Of course, since the taxpayers with reduced tax rates are also the investors with the largest gains, this combination of policies results in a net reduction in the total tax liability on the initial level of gains. But this does not change the fact that (aside from the indexing proposal) the plan passed by the House would actually cause more capital gains tax increases than decreases.

The effect of this would be to discourage investment by the very individuals whom the current tax reform sought to bring back into greater equity investment. I am confident that the magnitude of this perverse effect was not anticipated by those who drafted the House bill. I hope that in light of this new evidence you will reconsider and reverse the decision to eliminate the alternative tax. Let me remind you that doing so would not only stimulate personal investment but would also increase Treasury revenue.

Corporate Tax Reduction

For the very brief time that remains, let me turn to the corporate income tax. The sluggish performance of the economy over the past decade is due in significant measure to our low rate of capital formation. Moreover, if investment were stronger, it would be possible to reduce the government deficit without fear of inadequate demand. And the added investment would increase capacity and thereby avoid the potential bottlenecks that threaten to increase the rate of inflation.

A key reason for the low rate of corporate investment has been the sharp fall in the after-tax profitability of investment. The primary cause of this low profitability has been the great increase in the effective rate of corporate income tax. Because inflation causes taxable profits to overstate real profits, the true corporate tax rate on real profits has increased from 41 percent in 1967 to 52 percent in 1977 despite the changes in statutory rules intended to stimulate investment.

Two remedies are called for. First, depreciation rules should be based on inflation-adjusted costs not the original "historic" costs used in the current tax law. This would not only reduce the total tax rate but would eliminate a major and unnecessary source of uncertainty that hangs over current investment decisions.

The second change is to reduce the statutory corporate tax rate itself from the current 48 percent level. The House bill makes a small step in this direction with a two percent cut. I want to conclude my remarks this morning by suggesting a more dramatic change.

Consider the idea of a substantial cut in the corporate tax rate—to 40 percent, for example—voted now becoming effective only in 1981. If such a tax cut

were irrevocably promised, it would cause a significant increase in investment even before the lower tax rate takes effect. The prospect of a lower tax rate on future profits would stimulate investment even before the tax rate fell. Indeed, firms would rush to make the investments in order to get the depreciation at the higher tax rate. A substantial tax cut explicitly legislated for the future would thus stimulate capital formation now without any concurrent increase in the deficit. I hope that you will give this simple idea your serious consideration.

EXHIBIT 1.—CAPITAL GAINS AND ASSOCIATED TAX LIABILITIES

[In 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

The CHAIRMAN. Next, we will call Prof. Robert Eisner, Northwestern University.

STATEMENT OF ROBERT EISNER, WILLIAM R. KENAN PROFESSOR OF ECONOMICS, NORTHWESTERN UNIVERSITY

Mr. EISNER. Thank you very much, Mr. Chairman. I am very glad to be here. I am very glad to follow Professor Feldstein. We have been, I think, something of a road show together in terms of getting into debate situations on this subject.

I should add I am affiliated with the National Bureau of Economic Research as a senior research associate and I have some substantial research work which fits very closely to the subject under discussion here.

I have devoted much of my career to the studies of determination of business investment. I have a very substantial research paper on capital gains prepared for the national bureau, and I will quote from some of those findings.

I do have a prepared statement for the record but, in view of the time, I will try to be brief and come quickly to the point.

It is interesting to reflect on Senator Ribicoff's question of where to turn for expertise. I highly respect Professor Feldstein in terms of his objective data and findings. I agree and support most of them, but I come frequently, in this case, to some diametrically opposed conclusions. I hope I can persuade you of some of them, as you keep your minds open, as you weigh the evidence.

First, on business investment, on capital formation, it is somehow not generally recognized that business investment, as conventionally measured, includes no more than about 20 percent of total capital formation in the United States.

Capital formation, to the economist or any one who thinks about it, is current economic activity which is devoted to the future, providing capacity for future production. That does not only include business acquisition of plant and equipment. It includes business expenditures for research and development. It includes Government expenditure for plant and equipment and research and development, and nonprofit expenditures. It includes households; it includes investment in education and human capital, job training experience. All of these things are major.

Very distinguished researchers—Edward Denison, for example—have found that business plant and equipment investment contributes, in the United States, to no more than 25 percent of productivity growth. Denison finds those results duplicated in growing economies throughout the world, and that has to be kept clearly in mind.

Secondly, I will question very seriously the notion that the capital gains tax reduction being proposed will do anything for capital formation of any kind. I think that there are strong arguments to suggest it is going to move resources away, even from business capital formation, and into speculation in land, looking for tax shelters, into the places where most capital gains are being realized.

Now, third, I would add that if we are interested not only in capital formation but in growth, that the direction to pursue is the one that Senator Dole alluded to. I know Senator Long and a number of the

rest of you have been quite interested in it, Senator Nelson, Senator Haskell—investment in human capital.

The new jobs credit should be expanded and extended. The administration proposal, at least as adopted by the House, is frankly awful. It emasculates it. It targets it, not to the unemployed, but to people from poor families, in such a way as to be like the aid to families with dependent children, which Senator Moynihan has so well criticized in the past. It will have the effect of driving adult wage earners out of the family so that youths between 18 and 24 can get certificates saying they are from a poor family and then perhaps can get an employer eligible for a job credit.

I should add on the matter of the effect of capital gains tax reduction on revenues from taxation and from the stock market, hence on capital formation, you cannot have it both ways. Let us think quickly.

If Professor Feldstein is right and there will be a major unlocking effect—that is, people will now decide to sell their assets, sell their stock, because the capital gains rate has been reduced—who is going to buy? You are going to have a big wave of selling.

Are all of you gentlemen ready to assume that every person who sells the stock on January 1, 1979, or thereafter, will take the proceeds and immediately, simultaneously put the same amount in additional stock? There is no economist, there is no econometric model, that can demonstrate that to you, and I work a bit with these models. There is a substantial likelihood that a lot of these investors may sell out. If they do so, Treasury may get more revenues, I concede that. I am not objecting to Professor Feldstein's objective data.

What is going to happen, though, is that some will take the money and run, as we say. Some will take the proceeds and go into land, into real estate, into very many of the tax dodges and tax shelters that exist, and you may very well have a stock market decline. I will not predict it. I do not think you can predict the stock market very well. But it is just as likely you will have a startling collapse in the stock market, at least temporarily, as people try to sell and move their proceeds elsewhere. That is not going to help equity capital, not going to help business capital formation.

Of the proposals that are before you, most of them—and you really have to concentrate on the figures—there are always qualifications. You can take figures that have been provided by the Joint Committee on Taxation and you find, for example, the House bill—I have taken their figures and worked it out—amounts to a tax gain for 21,500 taxpayers. According to recent, past data 21,500 taxpayers of the $200,000 and over group will enjoy a tax gain of an average of $25,000 a year. That is where 56 percent of the benefits are going to go on the House bill, and while I do not have the figures on Steiger-Hansen and some of the other proposals, I have to tell you they are going to turn out roughly in the same ball park. The only one of the proposals in terms of equity that comes near helping even the small minority of the 90 million taxpayers that had capital gains, is Senator Nelson's proposal, and there are other Senators, I believe, also supporting that.

That proposal, at least, will have the benefit of going roughly to all of the 4 million taxpayers who report capital gains. By getting an exclusion of up to $3,000 on joint returns, there will be an average benefit to to those taxpayers of $300 a year.

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In my work on capital gains, I would like to point quickly to some numbers which I think people miss, which are very relevant to the indexing Professor Feldstein reported, and should be very relevant to this committee.

In my paper, I point out total capital gains in this country for households, from 1946 to 1975. These were accrued gains, not merely those realized. And I think that you have to look at the accrued capital gains. The realized ones are the tip of the iceberg.

The accrued capital gains for households are by preliminary estimates, and these are subject to change with later data from the Federal Reserve, $2,664 billion or more than $2.5 trillion of capital gains over a 30-year period.

Now, you quickly point out—and I will—that most of them were illusory. They were related to inflation. When you take out the inflation effect, the net capital gains were not $2.5 trillion, but $86 billion over a 30-year period.

Does that mean that you should come to the conclusion that you want to lower rates on the capital gains which are realized? How did that net figure of $86 billion after adjustment for inflation come about?

By my figures, there were $26 billion in gains after inflation on stock, on corporate equity. There were $217 billion in gains on land. That is where the capital gains come.

There were $249 billions of gains on mortgages because people owed less in real terms. There were $472 billion of losses by the mass of the American people, in their savings accounts, their demand deposits, their money, their pension funds, their life insurance.

There were $102 billion of loss in Government securities. All of these losses were due to inflation. Is the Congress going to consider adjusting for them, or is it just going to adjust and offer capital gains tax relief for those who have been unfortunate to have gains on land, on shelters, on stock, which partially or more than partially compensate for the losses due to inflation?

Now, as I have indicated, the unlocking is likely to lower stock market prices. You cannot say there is going to be an increase in sales, a big increase in Treasury revenues, and these sales will not depress the market.

I see my time is up. I will be happy to elaborate as questions may come up.

The CHAIRMAN. Senator Danforth?

Senator DANFORTH. I have no questions.

The CHAIRMAN. Senator Packwood?

Senator PACKWOOD. Professor, will indeed the market unlock and there will be an immense selling of stocks if we lower the capital gains?

Mr. EISNER. I am not prepared to say there will be an immense selling of stock, but the arguments have been made and Professor Feldstein made it, that revenues will be increased. What I am saying is that there is a contradiction here. If you really believe that Treasury revenues increase because people will sell more stock, then you have to ask who is going to buy the stock.

The same people who sell also buy the same amount of stock, your argument is over, but you cannot insist on that. People will be buying all kinds of assets. My guess is that since the stock market has not

proven to be such a good investment over the years, while land has been a very good investment, there is every likelihood that people faced with the new law will say, "Great! This is a real chance to unload the stock and go into something that is really booming, that is land." If that is right, then stock prices will go down.

Senator PACKWOOD. Is there any possibility that if we lower the capital gains tax that roughly the 6 million people who have left the stock market in the last 8 years might think to themselves that this is a good time to come back in? All the stock is being sold; all the prices are going down. I will buy.

Mr. EISNER. That is a possibility, Senator, but I would suggest that there are too many reasons that the little guy has left the stock market, probably because of tax treatment. It pays to have him put his money in the pension fund and let the pension buy the stock and not buy it individually out of his after-tax income.

The second reason the little guy has left the stock market is because the stock market has not done so well. He has been burned, and I doubt the changed tax treatment will have much to do with it, although it may have some.

Senator PACKWOOD. If there is no other reason for changing the capital gains tax, no other reason than increased revenue, then is that is that an adequate reason?

Mr. EISNER. No; I would say, Senator Packwood, that that is not a good reason at all. I do not think you want to raise tax revenues to the Treasury. If you are raising taxes, in a sense you are hurting the economy.

I have testified elsewhere, and would again, that you should be cutting taxes, you should be cutting income taxes, you should be cutting every tax you can think of—capital gains relief is the last tax that I would see cut.

Senator PACKWOOD. Do you think the revenues will increase if we cut the capital gains?

Mr. EISNER. Yes.

Senator PACKWOOD. No other questions.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. No questions.

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. I would like to thank Professor Eisner for a good, stimulating presentation. We now have equal and opposite views. That is just the way we like to get it at the end of a long morning.

I would like to press you on just one point. You speak of Denison's work on human capital formation. We have all learned a lot of his work in the last 15 years.

It strikes me that to suggest that plant and equipment is only 20 percent of capital formation is incomplete. What percent represents what it is in public tax policy? To what degree is there formation through education? That is a long and slow process and not particularly responsive to tax policy in terms of what we have that we can get our hands on.

Is not the kind of capital reflected in capital gains a measure of target of opportunity?

Mr. EISNER. Of course, I question whether lowering of capital gains taxes will do anything for capital formation anyway. But there

is something that I think the Congress has to watch—and I am really, frankly, rather surprised that many members who are most concerned about intervention in the market do not recognize this. You should be very wary of second-guessing a relatively free market, or telling a businessman that you know better than he.

If he has decided that additional plant and equipment is not the most profitable way to proceed, but you want to give him some kind of tax break that will accomplish it——

Senator MOYNIHAN. Surely, his judgment of profit has to do with the rate of tax?

Mr. EISNER. There is the whole tax structure. The tax structure, in many ways, favors or discriminates against different kinds of activity—your payroll taxes, your Social Security taxes, discourage employment of labor. You have actually already an investment tax credit. You have a situation where interest, which is the main cost of financing or borrowing is tax deductible. You have capital gains excluded from taxation until they are realized, and then you pay only on the portion that is realized. There is an already imbalanced tax structure that it does not clearly discourage plant and equipment expenditures.

Senator MOYNIHAN. May I just say that I respect very much what you have said. I have commented several times in these hearings that we have seized ourselves on the issue of capital formation, and we would not want too rationalist a model. This is a problem which we have which may persist beyond us dealing with marginal rates of taxation, but we are seized of this issue of capital formation. We do not know why it has been so sluggish, and we want to respond.

Mr. EISNER. If you believe in the free market, it may be sluggish because businesses do not find the demand for their product, the opportunities for advance with new plant and equipment sufficient. I can point to examples.

Take the Indian economy, which you must know much better than I. They have accumulated. They have steel mills that they do not know how to use.

It is not axiomatic that simply furnishing whole cartloads of equipment and machinery paid for by a government out of the taxpayers' money is going to add to productivity. It will add to productivity if the businessman believes it will and he calculates correctly.

It will not add to productivity if we tell him go ahead and do it, or here is the taxpayers' money and go ahead and do it.

Senator MOYNIHAN. Sir, you are cautioning us in the best way, but Senator Ribicoff and others on this committee are just as committed and see an issue of national policy having to do with the resilience of this economy in the world markets. It just commands the attention of this committee, and we have learned from you and I thank you for it.

The CHAIRMAN. Senator Hathaway?

Senator HATHAWAY. Thank you, Mr. Chairman.

Professor, you are saying, Leave the capital gains structure the way it is, no indexing, no rate reduction?

Mr. EISNER. Actually, indexing attracts me in principle. I think it is inappropriate to tax nominal capital gains unless you really want to tax capital.

The problem with indexing, as I see it, relates to what I tried to give you in the way of these figures and what has really happened.

To index capital gains means to give a break to those few who have managed to beat the rap on inflation while still leaving unhelped and unaided the masses of people who have lost terribly because of inflation.

The guy with his money in the savings account getting 8-percent interest finds with inflation that he is only getting 5 percent in his return, perhaps after taxes losing 10 percent per year on real values. He comes with a return of 5 percent.

The trouble with the indexing is that you are not helping the masses of people. You are hurting most investors. Given the choice, I should say, we should take a hard and long look at the whole thing and, for the moment, leave it alone.

Senator HATHAWAY. It seems to me there is not a problem with respect to indexing. If you compute in the gain that is made on the sale of the asset as a part of the inflation, which I suppose you have to do and if the rise in prices in the houses is the same as the general index, then the person who sells the house will obtain nothing. If it works out as it should, with the indexing, he has no gain, right?

Mr. EISNER. That is correct.

Senator HATHAWAY. It is only in the cases where the inflation on the price of houses was higher on the average, that you would have to pay a tax on the gain.

Mr. EISNER. If it were calculated appropriately, many homeowners or asset owners who have borrowed and even if the house has gone up in price no more than the Consumer Price Index, his equity has gone up much more. He still would have a gain to report after inflation.

Essentially, your argument is correct.

Senator HATHAWAY. Thank you.

The CHAIRMAN. Senator Nelson?

Senator NELSON. Professor Eisner, I think you have made a very compelling argument on the issue of special treatment for capital gains, which ignores the great, large numbers of people who have been seriously damaged by inflation.

There was a provision proposed on the House side and will, I suppose, be proposed over here, respecting the social security tax.

It was necessary to increase it. Nonetheless, as the experts and their economists in their testimony pointed out, when you add the tax on the employer, it is inflationary since it has to go into the cost of the product.

In the whole tax mix that is being considered, which is the reduction of income taxes, a reduction of corporation taxes, a reduction of capital gains taxes, as well as individual, where would you place—what importance would you give in this whole mix—a proposal to reduce the social security tax by the device, or any other device than this broader device, of giving a 5-percent tax credit to the employer and employee which, I understand, would amount to something over $5 billion in reduction of the social security individual tax, which I believe goes up next year by a total of $7 billion?

Mr. EISNER. I would place a very high priority on that. That is exactly the first tax I would cut by the House device, or any other

that you suggest, because the payroll taxes are the most obnoxious taxes you can have in the current situation.

We talk about the need to combat inflation and unemployment. The increase in the payroll tax has the most remarkable quality of going the wrong way on both.

The higher the payroll taxes, the more increased are labor costs which are the major element of prices, but at the same time tend to discourage employment. Any move by the Congress to, in any way, credit or reduce payroll taxes would be where you could very wisely spend tax revenues, both to reduce unemployment and to reduce the rate of inflation.

Senator NELSON. Thank you.

The CHAIRMAN. Senator Ribicoff?

Senator RIBICOFF. Your testimony has been very interesting and provocative. I would like your reaction to the House provision providing a one-time $100,000 exemption on any capital gains tax on the sale of a house.

Is there not a sense of unfairness there in which the people in the higher income levels sell a house in which they are apt to have $100,000 profit, or capital gains, as against people in the lower income brackets or younger people on their way up who may sell a house and get $20,000 or $25,000 and they have a much lower break than the people in higher incomes.

If you are going to do that, should there not be a lifetime exemption on the sale of residences, legitimate residences, up to $100,000?

Mr. EISNER. The whole question of the exemption on housing is one that I guess I can only comment on by perhaps reducing my popularity to zero, but homeowners, in a way, are those who have most beaten the rap against inflation. I can speak from my own experiences, or anybody else's. My best investment for all my life was in a home. I have had a huge capital gain on that, at this point, that I have not chosen to realize. Even on the tax I would pay, I would come out way ahead.

I would say, I guess, that the one equitable thing that might be done for homeowners is to prevent them from having to pay a huge tax the year they sell. That is sort of unfair. It should be evened out.

You could even look for an inflation adjustment.

I must say that this notion of a $100,000 exemption under any condition rather bothers me. Homeowners have been gainers under the tax structure on the interest deductibility of their mortgage payments, on the fact that they are not charged for the rent they would otherwise have to pay out of aftertax income if they were renters, and again, what the Congress is being asked to do, what the House is doing, is to give a tax benefit to those elements of the population, in the main, that have not only suffered least, but have actually gained.

And I do not know—perhaps over 50 percent of the American people are holding homes—just what the Congress can come up with that will not offend a lot of people. I do not like what the House has done. I am not sure I have really followed the details of the difference you are asking about.

Senator RIBICOFF. In other words, you have the men around the circle here. We have had a house for many years, and we sold it and

made $100,000 so we get a $100,000 exemption and we pay no taxes. But take the case of the staff members who work for us. They are 30 years, or 32 years of age. They have bought a house and it is a more modest home, and they leave the employ of this committee and they get a job in a bank or a law firm in Chicago and they sell the house and they get $20,000. They do not know how long they are going to stay in Chicago, so they rent an apartment. Then they decide, well, maybe I have a better job in San Francisco or New York. They occupy their home for 2 years and it is really a residence.

And then they sell it, and they are 38 now. They are still on their way up.

The people in the higher income groups have held it longer. They get a $100,000 break. But the younger people, lower income groups, get a smaller break.

I am just looking, if we are going to do it, how do we have a sense of equity to everyone, to give them the same opportunities?

Mr. EISNER. I follow you now, sir, and your point is very well taken. Indeed, there is an added objection to what the House has done and what you might think about, that puts each taxpayer in kind of a guessing game. Now should I take my gain now, take my exemption now on the $25,000 on this house, or should I wait?

It is a very curious kind of procedure. I wonder if the House has thoroughly thought through what it involves.

So that I would think that one would do better with some kind of a lifetime exemption, if you went that route, which you could use up over your lifetime rather than having to make a guess whether to take it on this asset I am selling now or wait.

Senator RIBICOFF. Thank you.

The CHAIRMAN. Senator Danforth?

Senator DANFORTH. May I ask one more question?

The CHAIRMAN. Yes.

Senator DANFORTH. Do you favor a reduction in the corporate tax rates?

Mr. EISNER. Yes, I do. I would eliminate the corporate income tax entirely. I would eliminate it, and would have individuals charged for their share of corporate earnings, but the corporate income tax is an inappropriate tax.

By the way, Professor Feldstein had an excellent proposal on the corporate tax, of planning to reduce it later. I say it is excellent, because I have made the same proposal.

It is something that I wish you would still think of. If you couple that with a greater proposed reduction in the future with announcement that the investment tax credit instead of being made permanent will go back to 7 percent, let's say, in 1980, that would mean a double stimulus to investment because businesses would invest then because they are getting the 10 percent credit now and they know that they will later get only 7 percent. And for that investment, as Professor Feldstein and I have pointed out, they have a still greater incentive with depreciation and other deductions at a higher current rate with greater profits in the future.

It may sound tricky but I assure you, all the logic is in favor of it.

The CHAIRMAN. We could wait until that time came, and then do it all over again.

Thank you very much.
[The prepared statement of Mr. Eisner follows:]

STATEMENT OF ROBERT EISNER[1]

A reduction in tax burdens will generally be good for the United States economy. What kind of tax reduction can make enormous differences, for the economy as a whole and for the various elements of our population.

Some forms of tax reduction may be particularly helpful in winning the battle for truly full employment. Some forms of tax reduction may critically reduce the rate of inflation. But other forms of tax reduction may conceivably discourage employment and other forms may well increase inflation.

Some kinds of tax reduction will aid particular groups who earn their income in particular ways while leaving unaffected or indirectly injuring all those who earn their incomes in other ways. Some forms of tax reduction may hence be very uneven in their effects on different individuals or households of the same incomes, violating the principle of horizontal equity. And some forms of tax reduction may violate seriously the principle of vertical equity by giving "relief" to those who, because of already very high incomes, least need it.

Much of the American voting public is apparently clamoring for tax relief. But as we here all know, taxes are a complicated matter. It would be a terrible pity and indeed a deception to offer the people tax reductions which go overwhelmingly to a relative few who are already benefiting generously from special tax privileges. It would be all the more pity if such tax reductions disturb the economy, aggravate inflation, unsettle capital markets and in the process do real economic injury to most of our people and the Nation as a whole.

I must express at the outset my views that the loud clamor for reduction in the rate of taxation of capital gains has relatively little merit. Employment taxes, now running some 12 and 15 percent on the bulk of salaries and wages, are a direct discouragement of employment and contribution to higher labor costs and prices. Sales and excise taxes throughout the Nation contribute as well to higher costs and prices and reduction in the real purchasing power necessary to sustain a prosperous economy. Personal income taxes, repeatedly raised by inflation, take painful bites from the incomes of all of us without special tax shelters, whether we earn our living on wages, salaries, commissions, interest and dividends, rents, or profits of individual enterprises and partnerships. The corporate income tax encourages extravagance in business expenses and costs which are tax deductible and adds heavily to the ultimate costs of the products of most of American industry.

We should strive to decrease all of these forms of taxation and decrease them generally in manners that would involve the broadest possible distribution of benefits. We should be guided by likely effects upon the economy as a whole and by the special needs of those in real hardship.

It should be clear, despite the loud voices of special pleaders and the apparently still gathering momentum in the Congress, that capital gains must come last on any list of claimants for tax relief, if they should appear at all. Indeed, the only legitimate arguments that I can see for further reduction in the rate of taxation of realized capital gains is that inflation has made many of the "gains" nominal rather than real, so that taxes are actually being levied on capital rather than income. If we choose to act on this concern, however, we must recognize that inflation has caused huge capital losses to the great majority of Americans who have seen their cash, their savings accounts, their pensions and their life insurance eaten away by the ravages of inflation. It is very difficult to see the justification for additional tax relief to those who have been fortunate enough to have nominal capital gains which have at least partially—but in some cases much more than partially—balanced their losses from inflation, while offering no corresponding tax relief to those who have had no such gains.

It is important to understand both the nature and the amount of capital gains and losses and the implications of current tax laws as well as prospective changes relating to these gains and loses. We are found of repeating that with half of realized capital gains generally excludable from taxable income, the maximum tax on capital gains was until relatively recently 35 percent. With legislation regarding preference items and minimum taxes, the maximum rate of taxation on relaized gains was conceivably as high as some 49 percent, although the fact is that relatively very few people paid taxes at this maximum rate.

[1] William R. Kenan Professor of Economics, Northwestern University.

What is generally ignored, however, is that "realized" capital gains are literally the tip of the iceberg. The great bulk of capital gains, partly because of the tax laws, are unrealized. That they are technically unrealized does not mean that individuals do not benefit from them. First, of course, we are better off if our land, or stock, or house, or painting or gold rises in value, even if we make no attempt to realize the gains. Most of us go through most of our lives saving, presumably for retirement or in order to have an estate. The more that our assets or net worth rise because of capital gains, the less we need to save or abstain from current consumption in order to meet our future expenditure, retirement or bequest goals.

But further, as millions of Americans have learned in recent years, one need only go to a bank or other lender and refinance or borrow against one's house or land or stocks in order to get funds for current expenditures without technically "realizing" the gains and paying any taxes on them. Or, we can realize our gains and pay only a very small tax because taxes are paid only on the portion of assets that are sold and not on the total gain. Thus, for example, if we have property or securities which rise in value by say 10 percent, from $100,000 to $110,000 and choose to sell off the $10,000 gain, we pay a tax only on the gain on the $10,000 of assets that we sell. This would be a tax then on roughly 10 percent of the $10,000 or more precisely on the product of the ratio of 10/110 and $10,000, or some $909. Even at the old maximum rate of 35 percent, this would be a tax then of $318 on a gain of $10,000. The rate of taxation for the realization was thus less than 3.2 percent, nowhere near the presumed 35 percent maximum. And of course capital gains taxation has essentially been avoided entirely in bequests. Taking into account the lack of taxation in gifts and bequests and the time at which accrued capital gains are eventually realized, one careful economist, Martin Bailey, in 1969 estimated the effective rate of taxation of capital gains at 8 or 9 percent. It is doubtful that it is much higher now.

In a lengthy preliminary research paper presented to the Conference on Research in Income and Wealth of the National Bureau of Economic Research, I recently estimated capital gains, or gross revaluations of capital and revaluations net of inflation, in the United States from 1946 to 1975. These were accrued, not "realized" capital gains and losses, and they were estimated for the economy as a whole and for the household, noncorporate, corporate nonfinancial, financial, and government sectors separately. I am currently revising all of the estimates on the basis of new and improved data but consideration of my preliminary figures and their composition by type of asset and liability will prove revealing.

Over the period from 1946 to 1975, these preliminary estimates indicated gross revaluations or capital gains in households of the United States totalling $2,664 billion or over 2 and one-half trillion dollars. This came to a mean of almost $90 billion per year. After adjustment for inflation, however, the net revaluations totalled only $86 billion or about $3 billion per year. Positive capital gains net of inflation occurred through most of the period but were almost completely wiped out by the major losses, due to both inflation and falling bond and stock prices, of $258 billion in 1973 and $418 billion in 1974.

What is most revealing, though, is the distribution of the gains and losses in households by type of asset. Dealing now with net revaluations after adjusting for the effects of the depreciating value of the dollar or inflation, we find that over the 30 years American households had a total gain of $26 billion in the stock market. There were very large gains by households on their equity in unincorporated business, almost $500 billion, although this may have been considerably the result of human labor in building up unincorporated business rather than pure capital gains. But households lost $35 billion on their holdings of mortgages and $287 billion on life insurance and penson funds, after adjustment for inflation. They also lost $472 billion in the depreciation of the money they held in currency, demand deposits and time deposits. They lost $102 billion on U.S. government securities and $35 billion on state and local obligations. They also lost $32 billion on corporate and foreign bonds.

On the other hand, households fortunate enough to have mortgage debts gained $249 billion as the real value of their debt declined with rising prices. Households also gained $128 billion on other outstanding loans and credit obligations.

It thus becomes clear that while on balance households may have benefitted slightly from capital gains over this period, even after adjustment for inflation, the gains were concentrated among those who had invested in the stock market and those, mainly home owners, with large mortgage debts. On the other hand, great masses of households lost heavily on their assets and savings in the form of money, government and corporate bonds and life insurance and pension funds.

Nonfinancial corporations showed gains, after adjustment for inflation, of $333 billion, just about one-third of a trillion dollars over the 1946–75 period, averaging some $11 billion per year. But again the totals were an aggregate of substantial gains in some areas, particularly land and plant and equipment and financial liabilities, with major losses on financial assets.

All of this indicates clearly that capital gains—and losses—have been a very large and major element in the American economy. It should suggest extreme caution, however, in offering additional special tax relief to those who have made substantial capital gains, over and above inflation, while allowing the tax structure to bear all the more heavily on the masses of Americans, fortunate enough to have some assets, who have actually lost heavily. It is important to see the relatively preferential treatment of the person with, say, $100,000 in the stock market, who receives a relatively small taxable dividend but sees his stock go up by 10 percent so that his wealth at the end of the year, aside from the dividend, has gone to $110,000. None of this will be taxed if he does not choose to sell and only a small portion will be taxed, as we have pointed out earlier, if he chooses to "realize" the $10,000 gain. By contrast, the person with $10,000 in savings in a bank or savings and loan association, receiving 8 percent in interest, finds that he must pay a tax, depending upon his tax bracket, of perhaps $200 to $560. If there is a 10 percent rate of inflation during the period, as in the last quarter for which we have data in the current year, the person with the savings account finds that, far from a return of 8 percent, his yield, after considering inflation and taxes, is in the range of minus 4 to minus 7 percent! For the real value of his $10,000 in savings declines to approximately $9,100 and his interest return after taxes is in the range of $240 to $600. What tax relief does the Congress have in mind for the millions of small savers who have no capital gains to report on stocks, or land or tax shelters, but very probably losses in real terms on their life savings, whether in banks, insurance, pension funds or other non-appreciating assets?

With effective rates of taxation of capital gains perhaps in the area of 10 percent, what is the argument for new reductions in the rate of capital gains taxation? What we seem to hear most from their proponents is not that we must raise after-tax incomes of the tiny minority of Americans who have enjoyed large capital gains but rather that it is somehow good for the economy to cut capital gains taxes. The argument then runs that we "need" more capital formation, and lowering the rate of taxation on capital gains will provide this.

It is necessary first to raise a fundamental question as to our view of a relatively free, market economy. In such an economy, the rate of capital formation is presumably the resultant of people's desire to save, that is to put off current consumption in the interest of adding to wealth and/or consuming more in the future, and the opportunities for profitable capital formation seen by producers. To have more capital formation is to save, and invest, more. But why should it be the role of government to tell us to save and invest more? To save more is to have less now and hopefully more in the future. Is it for government—either the Congress or the President—to tell us to have less now so that our children or grandchildren or great grandchildren should have more? Or should that be left to the individual decisions of all of us, with the economy as a whole growing more or less rapidly as a result of the sum total of all of our free, individual decisions?

But what is more, if we are to save, is it to the government, regardless of basic economic forces and considerations of efficiency, to dictate the form of our saving and capital accumulation? In another study, on "Total Incomes in the United States, 1959 and 1969," I have found that business investment, as usually defined, is no more than one-fifth of total capital formation in the United States. The great bulk of capital formation takes place not in the form of traditional business investment but in expenditures for research and development by business, nonprofit institutions, and government, in the accumulation of human capital in the form of education, training, skills and job experience and management knowhow, and in the further investment by government, nonprofit institutions and households, in addition to business, in durable goods in the form of homes and other structures, roads and other transportation facilities, schools, household appliances and the like. Can the Congress or government be so sure that growth and productivity will be enhanced by further encouragement of business investment rather than other much broader and massive components of capital formation? Indeed careful research on the sources of economic growth by Edward Denison has collaborated and extended findings of others that business investment accounts for a relatively quite minor share of total growth in the United States, and in growing economies throughout the world.

But even if we were determined to stimulate business capital formation, is a reduction in the rate of capital gains taxation an efficient way to do so? Here again, one can find little objective evidence to support an affirmative answer. The main determinant of business investment is its expected profitability. My own research, and that of many others, has demonstrated that this is overwhelmingly related to the demand that businesses can see for their product.

If demand is high and business is good, pressure on existing capacity will be great and the opportunities for profitable investment will seem attractive and decisive. If demand and business activity decline, business investment collapses. Indeed we have an outstanding recent example. In the 1974–1975 recession, real nonresidential business fixed investment fell 17.5 percent. It is only just now reaching its previous peak of the first quarter of 1974. An interruption or even serious slowing of the rate of growth of the economy is the great danger to business investment, not our current rate of taxation of capital gains.

Proponents of reduced taxation of capital gains have in a number of instances come up with the remarkable argument that lower capital gains tax rates will cause the stock market to boom and hence stimulate the economy, actually adding to total tax revenues as a consequence. Most prudent economists, and others, would make no pretense to being able to forecast the path of the stock market. I might suggest one specific caution, however. If lower rates of taxation on realized capital gains do in fact lead to substantially increased sales of securities, would this not be likely to cause at least a temporary sharp drop in stock prices? Unless we can assume that every investor who sells stocks, taking advantage of the lower capital gains tax rate, simultaneously seeks to buy other stocks of equal value, the wave of selling might well drive the market down. After all, some investors might take the money and run. And they might decide to invest the proceeds in other assets—land and tax shelters, for example—driving their value up while stock prices decline. As I and others have pointed out, most capital gains (and losses) have been in areas other than corporate equity. Before one could safely predict the consequences of lower capital gains tax rates on the stock market, one would have to know how they would affect the relative demands and supplies for all of the various possible assets that individuals and businesses might hold. I can only conclude that for those who see a stock market boom stemming from lower capital gains tax rates, the wish is the father to the thought. In fact, a generally lower rate of capital gains taxation might well move financial resources out of the stock market and away from productive business and into investment and speculation in land and other assets where capital gains have been exceptionally large. And as Secretary Blumenthal and others have pointed out, capital gains tax relief would go in much larger proportion to investors in these other assets than to investors in the stock market.

Where are we left then in our relation to the legislation on captal gains that has passed the House of Representatives and to the various proposals recommended and sponsored in the Senate? First, I must insist that ideally there should be no general reduction in capital gains tax rates along any of the lines indicated. The economy is in need of tax cuts which will both reduce business costs, thus reducing the rate of inflation, and increase real purchasing power and employment, thus increasing total output and economic well being. In a recent previous appearance before the Senate Finance Committee, Subcommittee on Administration of Internal Revenue Code, and the Senate Select Committee on Small Business, I have particularly urged extension and expansion of employment tax credits. I have urged that these be focused on the unemployed and on youths, with elimination of payroll taxes for the latter. Unfortunately the House-adopted Administration substitute for the temporary New Jobs Tax Credit is a major step backward, likely to do more harm than good.

On revision of taxation in the area of capital gains, the ideal way to move would be in the direction of a thorough overhaul of all the treatment and nontreatment of capital gains and losses. To an economist as well as to any other individual who gives it a moment's careful thought, income is what we can spend without dipping into our wealth or savings. In that sense real capital gains after adjusting for inflation are a part of income and real capital losses must be subtracted to arrive at a proper measure of income. Ideally, both should be taken into account, on an accrual basis with appropriate provision for averaging and flexibility in timing of payments, in devising tax policy. With such a comprehensive treatment, and allowance for inflation against both gains and losses, there would be no reason for any special treatment of capital gains, which should then be taxed as ordinary income.

Since the Congress is clearly not prepared to undertake such fundamental revision of the treatment of capital gains and losses at this time, it would be best to leave the whole matter alone. From the standpoint of efficiency of the economy and equity, all of the proposed changes will do more harm than good.

If the clamor for capital gains tax "relief" seems irresistible, which of the various proposals is least objectionable? The House bill would repeal the alternative tax on capital gains of individuals and no longer count capital gains among preference items for purposes of applying the minimum tax. Thus the rate of tax on capital gains would be reduced from the maximum of some 49 percent to 35 percent. Of course any capital gains tax relief will be of no help at all to the vast majority of taxpayers, perhaps 95 percent of the total, who have no capital gains to report on their tax returns.

The House bill, remarkably, will offer tax reductions to less than 10 percent of those currently paying taxes on capital gains. It will clearly be a benefit only to those in very high tax brackets and/or those enjoying very large capital gains.

Senate Bill 3065, sponsored by a large number of senators, would benefit only those taxpayers in high income tax brackets and/or enjoying very large capital gains. I cannot vouch personally for the figures, but I find entirely plausible the estimate presented by Senator Nelson that, under both the House and Senate bills, over 90 percent of the tax relief benefits would go to taxpayers with adjusted gross incomes of over $50,000, a group that comprises less than 2 percent of the total number of taxpayers. And those enjoying tax savings from either the House or Senate versions would be a much smaller proportion of all taxpayers, probably well under half of one percent of all taxpayers.

If for reasons which must be beyond the scope of my statement, the Senate chooses to enact some reduction in capital gains taxation, the proposal by Senator Nelson is by far the least objectionable. His proposal would exclude the first $1500 of capital gains from taxable income; the first $3000 would be excluded on a joint return. The effect would be to distribute capital gains tax reductions much more broadly among the still small proportion of taxpayers who enjoy capital gains. But at least under Senator Nelson's proposal all of the some 4 million taxpayers with capital gains to report would enjoy some tax savings. The tax savings would be higher in amount for taxpayers in higher tax brackets, less in amount for those in lower tax brackets but there would be no bonanzas for the rich and super-rich. The maximum reduction in taxes for any single taxpayer would be approximately $1500. The average reduction in taxes for the 4 million odd taxpayers affected by Senator Nelson's proposal would be in the neighborhood of $200. By contrast, the House bill and Senate Bill 3065 would offer huge benefits to some very few taxpayers and no benefits to even the bulk of taxpayers currently paying taxes on capital gains. Again, I cannot vouch personally for the particular numbers, but on the basis of the estimates presented by Senator Nelson, which seem most reasonable to me, the average benefit per taxpayer affected in the House bill would be some $3000, with well over half of the benefits going to those with adjusted gross incomes over $200,000. The average tax "relief" to these 21,500 taxpayers estimated to receive 56.5 percent of total benefits would be, in 1978 alone, $25,000! And the tax relief or benefits in the House bill are estimated to rise some 50 percent in 1979.

In terms of effects upon the economy, the Nelson proposal would offer some benefit by modestly increasing after-tax income and purchasing power of 4 million, chiefly upper-income taxpayers, without adding outrageous new tax loopholes for the very richest among us. The Nelson proposal would therefore tend to compensate, in the economy as a whole, for the losses in purchasing power resulting from increases in social security taxes and the general effect of inflation in pushing people into higher tax brackets,

In conclusion, therefore, I can state simply that if reductions in capital gains taxes are to be legislated, the Nelson proposal of a flat exclusion of up to $3000 of capital gains is the most equitable and least damaging of the proposals under consideration. My own preference, however, would be that the Senate junk the whole matter and stand by its guns in the face of the House bill until a thorough and judicious review of the role of capital gains and losses in taxable income can be accomplished. And I confess that if I were advising the Administration, I would urge the President to veto any tax legislation which significantly enlarges special treatment of capital gains, which already account for more of the budget's tax expenditures than any other special provision or loophole in the tax code.

The CHAIRMAN. Next, we will call Mr. Donald V. Seibert, chairman of the National Retail Merchants Association.

STATEMENT OF DONALD V. SEIBERT, CHAIRMAN, NATIONAL RETAIL MERCHANTS ASSOCIATION

Mr. SEIBERT. Good morning. I am Donald V. Seibert and I am chairman of J. C. Penney Co., Inc. I am also chairman of the National Retail Merchants Association which represents over 35,000 retail and department stores throughout the Nation. In addition, my company is an active member of the American Retail Federation, a Washington-based organization representing retailers and their State retail associations.

Both these broad-based national organizations have formally adopted positions similar to the one I am urging today. This position is also supported by Dayton Hudson Corp., Federated Department Stores, K-Mart Corp., The May Co., and Sears, Roebuck & Co.

I appear before you today to urge extension of the investment tax credit to both new and rehabilitated retail structures. The House bill, H.R. 13511, would allow the credit for certain costs of rehabilitating older existing industrial, retail or other commercial structures. We applaud that important step forward. But we strongly believe that the credit should be extended to new, modern structures as well.

There are two reasons why the Congress should take this action.

First, there is a need to stimulate retail construction which has been lagging in recent years.

Second, investment in new, efficient retail structures, as well as rehabilitating older, less efficient stores, pays a high rate of return in terms of benefit to the national economy.

An efficient retail distribution system creates a market for goods and exerts a strong pull through effect on manufacturing. Increased retail efficiency exerts a downward pressure on price levels by delivering goods to consumers at the lowest possible final cost. Conversely, an inefficient retail system may offset the potential productivity gains from increased capital investment in the manufacturing sector alone.

Retailing is also associated with an unusually large number of jobs. Indeed, while we retailers account for about 10 percent of the gross national product, fully 20 percent of the new jobs since World War II have been created by retailers.

Retailing also requires large amounts of fixed capital investment—an unusually high proportion for structures which are a key to greater efficiency in the distribution sector. The capital needs of retailers are great and growing. Many older stores are becoming increasingly obsolete and in need of replacement.

Additional stores and support facilities are necessary to provide a distribution system of sufficient size and efficiency to serve the economy in the face of shifting population patterns, changing shopping habits and new consumer preferences. It is projected that the five largest retailers alone will, in 1978, spend about $1.5 billion on fixed capital investment. A large part of this will be for structures. In the aggregate, it is estimated that in 1977 the retail industry spent about $3.5 billion on structures. The percentage of their capital investment devoted to structures by retailers is more than twice that of the manufacturing sector, where most fixed capital investments are for machinery and equipment already eligible for the investment credit.

Yet, as I said in an absolute sense, investments are lagging despite the need for new capital expenditures. Measured in constant dollars, business investment in machinery for manufacturing has recovered from the recession in 1974 and is steadily increasing. In contrast, however, between 1973 and 1977, investment in commercial structures—other than office buildings—has actually declined by 28 percent, again when measured in constant dollars.

The dramatically escalating costs of structures have made needed expansion, replacement, and renovation programs increasingly difficult for retailers. From 1960 to 1976, the cost of commercial and factory buildings increased by 154 percent—much faster than the GNP deflator which increased only 95 percent.

Moreover, unlike many industries, retailers are required not only to make large capital investments to expand, but are required to make large capital investments merely to maintain their existing capacity.

Large capital expenditures for remodeling, renovation, or modernization will have to be made many times during the life of a retail structure. Others become obsolete and must be replaced because they are too old-fashioned in layout and design to efficiently serve the market and/or because of shifting population patterns and consumer preferences.

In addition, retailing pays the highest effective tax rate of any sector of the economy—40 percent or more. In part, that is because an unusually large portion of a retailer's capital expenditures are for investment in structures which are presently excluded from the investment tax credit. It should also be noted that ever since 1962, the maximum rate of depreciation on structures has steadily been reduced by a series of amendments to the tax law, thus providing a further disincentive to investment in retail structures.

We believe that the need and justification for extending the investment tax credit to structures, including retail buildings, is clear. As retailers we also see this extension of the credit as a start toward equalizing the tax treatment of the manufacturing and distribution sectors of the economy.

On the positive side, the benefits to the national economy would be substantial.

A recent study conducted at Northwestern University using input/output analysis indicates that $100 million of capital investment in new retail stores will involve 3,833 permanent jobs—more than three times the 1,198 permanent jobs associated with a like investment in manufacturing.

In 1977, 22 percent of the nonagricultural work force were employed in retail and wholesale trade—17 percent, or one out of six employees, in retail trade alone. The growth of employment in retailing has been accelerating. One out of every five jobs created in the 1970's has been in the retail sector.

When considering the benefits from increased capital investment in retail structures, it is important also to note where that investment occurs, as well as the location and nature of the large number of jobs associated with the retail sector. There are about 2 million retail establishments located nationwide—in every town and village, in the city, and in the suburbs.

The majority of the Penney Co.'s over 2,000 stores are located in the smaller towns in every State of the Union. Larger retail stores also play a major role in the economies of all large cities. This importance of retail stores—and their particular contribution to urban redevelopment—was recognized by a recent study prepared by the Congressional Budget Office. Some of the most recent and outstanding examples of retailing's contributions in this respect have occurred in New Orleans, Atlanta, Chicago, Brooklyn, Philadelphia, and Boston.

These are only major examples. The same thing, in lesser degrees, occurs all around the country almost daily.

The nature of many of the jobs provided by investment in the retail sector is also of special significance. Many retail employees are highly skilled and experienced. But a large percentage of retail jobs can be filled by less skilled, less experienced workers. Moreover, retailing employs a large percentage of part-time workers—women, students, and older persons who do not wish to work fulltime, but nevertheless need and seek employment.

Thus, both because of the location and accessibility of retail jobs, and their nature, retailing contributes substantially to providing jobs for those members of the work force who otherwise would be structurally unemployed—a result which could not be achieved simply by stimulating overall higher levels of economic activity.

Finally, as I mentioned at the outset, more efficient retail structures and more efficient distribution system produce important economic gains in an exactly similar manner as greater efficiency in manufacturing as a result of increased capital investment. A retail structure is the basic productive tool of the industry; and such structures have become increasingly specifically and scientifically designed facilities which hold down energy and operating costs and permit the introduction of new technologies in goods handling, storage, display, point of sale inventory control and accounting, optimum store size and the like.

It is no more true that one building is as efficient and productive as another, than it is true that all machines are alike. New store buildings of the 1970's, for example, typically devote a greater percentage of total space to selling, compared to older retail stores.

Because retailing is highly competitive, cost savings achieved through efficiency are passed on to the consumer. It is significant to note that over the 5-year period between 1972 and 1977, for example, retail prices of general merchandise have increased less than prices generally. Over the past 25 years, the Consumer Price Index rose 128.3 percent, while the department store inventory price index rose only 81.9 percent.

In concluding my testimony with respect to allowing the investment tax credit for retail stores, I would point out that the rationale for the investment tax credit is, withou question, equally applicable to structures and to equipment. The investment tax credit was originally proposed and designed to apply to both.

In addition to supporting the inclusion of new and rehabilitated structures in the investment tax credit, I would, on behalf of the J. C. Penney Co., Inc., like also to endorse the provision in the House bill to retain the 10 percent investment tax credit on a permanent basis after 1980, and the provision in the House bill to reduce the corporate

tax rate to 46 percent. We would also support the Administration's proposal to further reduce the corporate tax rate to 44 percent.

Moreover, we consider a reduction in individual and capital gains tax rates to be of major importance. We support S. 3241, the Expanded Employee Stock Ownership Act of 1978, which would make employee stock ownership plans much more attractive and useful mechanisms for the important purpose they are intended to serve.

The need for increased capital formation in this country has been well-documented and deservedly enjoys broad support. If we are to create the jobs necessary for a rapidly growing labor force and to provide goods and services at reasonable costs, we must encourage the development of new, more efficient plant and equipment of all types—including retail structures.

I thank the committee for its attention and will be pleased to answer any questions.

The CHAIRMAN. Thank you.

Senator Curtis?

Senator CURTIS. I just have a question or two. Your closing remark about the building of facilities for retail, what you are referring to is an extension of the investment credit into buildings?

Mr. SEIBERT. That is correct. We are talking about the retail end of the distribution sector, retail stores, warehousing facilities, the end of the line, so to speak, that begins with manufacturing.

Senator CURTIS. What does the House bill do in that regard?

Mr. SEIBERT. The House bill provides for the extension of the investment tax credit to the rehabilitation of existing retail structures. This is exactly as it sounds. It is the renovation and rehabilitation of existing buildings.

The House bill precludes even the opportunity to relocate the existing building, or rebuild it, which in many cases may be the more effective and efficient thing to do, to tear the old building down and put up a new one.

The House bill would simply provide for the renovation of an existing building.

Senator CURTIS. So that your position is that, while the House bill, in renovating buildings within a certain situation would be helpful, that it would not be helpful where for valid other reasons, it ought to be a new building?

Mr. SEIBERT. That is correct. We believe that that is the minimum fallback from our proposal to extend the credit to all new buildings. The Senate bill should at least permit the replacement or relocation of an existing building, which, we think, would be in the interest of a more efficient retail distribution system, and thus, would benefit the consumer.

Senator CURTIS. That is all, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Next, we will call Mr. Carl V. Lyon on behalf of the Association of American Railroads.

STATEMENT OF CARL V. LYON, SENIOR VICE-PRESIDENT, ASSOCIATION OF AMERICAN RAILROADS

Mr. LYON. Mr. Chairman and members of the committee, my name is Carl V. Lyon. I am accompanied by Mr. Robert J. Casey who repre-

sents theUnion Pacific Railroad and I believe two or three other members of our railroad tax policy committee are here.

If it should become necessary, we would like to call upon them to answer any questions.

I am sure I do not need to emphasize to you, Mr. Chairman, the serious condition of the railroad industry in financing its new facilities and equipment. You have heard the story a number of times, as have other members of the committee, but the railroad industry's capital needs are exceeding their investments by $1.5 billion each year.

While this is caused primarily by the inadequate level of our profits which are at the lowest level in our history, there are other contributing factors, and we are working on all of these at the same time. But we desperately need help in the area of capital formation.

In addition to our already severe problems with capital needs, there are two major challenges that face the industry today that relate to this problem. One is our challenge to transport the increased coal production which would mostly be transported by rail over the next 15 years. It presents us with not only a transportation challenge, but a major challenge in coming forward with the needed capital investment to get the track structures in shape and the added equipment.

The other challenge is to continue to improve, in a major way, our ability to perform transportation safely, particularly in light of the rapidly increasing volume of hazardous materials moving by rail.

We are very pleased with the House bill's general focus on the problem of capital formation. In general, we support the bill and we support the corporate tax rate reduction and the capital gains tax provisions. Senator Hansen's bill goes further in this regard, and we believe it would be advisable in the public interest, and certainly helpful to us.

We applaud the committee and the House for its approval of making the 10 percent credit permanent. There is a problem in the tax bill with respect to the investment tax credit as it relates to railroads—that is, that it would result, during at least 1 year, and probably 2 years, in decreasing the amount of offset that is available to the railroad industry under present law.

Under present law, we have 100-percent offset at the present time. It is going to be reduced to 90 percent in 1980. Uunder the House-passed bill it would be further reduced down to 80 percent and brought back to 90 percent, and we urge the committee to correct this deficiency and make it so that the available credit would not be reduced to the 80 percent offset as the House bill envisions.

Because of our peculiar needs and because of the challenges I have described, we would urge the committee to increase the investment tax credit available to the railroad industry to 20 percent investment in railroad rolling stock and track structure. We think this is important and we think that it is vital to the national interest and certainly vital to the well-being of the railroad industry.

Further, we urge that the investment tax credit for railroad rehabilitation be made refundable. As you well know, we have a number of companies who do not have an income tax status and therefore are not able to take any direct benefit from the credit and receive it to the extent they can only by indirect means.

We think that for this reason, primarily, that the tax credit ought to be made refundable.

In my prepared statement, which I would submit for the record, I have outlined several other proposals, some of which are technical in nature which we would commend to the committee's attention.

With that, Mr. Chairman, we invite any questions that you may have.

The CHAIRMAN. Thank you very much.

Senator Curtis?

Senator CURTIS. I have one question that is outside of your oral testimony here.

What has happened in the way of the building of grain cars? This committee has given considerable attention to that in the past. That was not in your testimony.

Are you prepared to give us a report?

Mr. LYON. Yes, sir, I think so, Senator Curtis.

At the present time, we have a large number of grain cars on order and new cars installed and placed in service are running at a high rate for the grain service. The number is about consistent, a little bit higher, than what it has been in the recent past.

I cannot cite that figure, but I would be happy to furnish it to you. As of August 1, 1978, there were 14,692 new covered hopper cars on order for use on the Nation's railroads. During the first 7 months of 1978 there were 6,620 new covered hopper cars placed in service. During the year 1977 there were 10,547 additional covered hoppers placed in service.

As you know, much of the movement of grain has been changed from the typical boxcar to the covered hopper. Over the past 10 years, we have installed large numbers of covered hopper cars with high capacity. In terms of capacity, we have pretty well kept our fleet in good shape for that purpose.

As you also know, we have had troubles this year with the grain harvest, and we have still had some serious shortages in meeting that grain movement. This results from a combination of factors, one of which was the bad weather and another of which, and very importantly, is because of the fluctuating market price for grain. This has placed us in a position of handling 2 year's crops in 1 year with 1 year's, of course, supply of boxcars and covered hoppers.

Senator CURTIS. Has there been any tax incentive for this boxcar situation?

Mr. LYON. Yes, indeed. I think the investment tax credit has been of a major help to us over the years, and our records show that it has stimulated the investment in grain cars and other cars.

Senator CURTIS. Do you build cars, or do you buy them in some other ways?

Mr. LYON. We do it both ways. There are a number of nonrailroad companies in the business of building cars, and railroads have their own shops that supplement this building program.

Senator CURTIS. The covered hopper car does have quite a few advantages. It holds a lot of grain. What can you use it for during periods of the year when they are not all needed for grain shipment?

Mr. LYON. There are a number of commodities that move in covered hoppers now. The cars we use for grain are used also for fertilizer and they are cleaned, of course, in between movements, but there are a number of covered hopper cars in the movement of aggregates and in

some plastic products. Virtually all of the grain products that are fungible are moved, primarily by covered hopper these days.

Senator CURTIS. How about coal?

Mr. LYON. I would say no coal moves in covered hoppers. Practically all moves in open cars.

Senator CURTIS. That is all, Mr. Chairman.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Lyon follows:]

STATEMENT OF CARL V. LYON, SENIOR VICE PRESIDENT, ASSOCIATION OF AMERICAN RAILROADS

My name is Carl V. Lyon. I am Senior Vice President of the Association of American Railroads, with headquarters in Washington, D.C. The railroads which are members of the Association operate 92 percent of the total line-haul mileage, employ 94 percent of the workers and produce 97 percent of the freight revenues of all railroads in the United States.

I appreciate the opportunity to appear before you today to present the views of the Association and its members on the House-passed tax legislation (H.R. 13511) and related proposals. The railroad industry is pleased that the pending legislation would provide for a reduction in the corporate tax rate and for liberalization of the investment tax credit so that it can be used for the rehabilitation and replacement of existing industrial and utility structures as well as depreciable tangible property.

The railroad industry has consistently advocated that the 10 percent credit be made permanent, and we applaud the fact that a provision to do so is included. All of these proposals should be of material value in expanding the capital supply that business and industry need to stimulate the economy and to provide essential jobs.

The bill also points in the right direction by gradually increasing to 90 percent the amount of tax liability which can be offset by the investment tax credit. Under present law the railroads are allowed to use their investment tax credits to offset 100 percent of tax liability for 1978 and 90 percent for 1979. However, unless an amendment is made to the bill as passed by the House to freeze the railroad offset at 90 percent, the railroads would have their offset reduced to 80 percent in 1980. Congress has already recognized the need for the railroads to offset at the 100 and 90 percent level and we strongly urge that it not be reduced below 90 percent so it can later be raised.

We in the railroad industry have a great deal of interest in the improvements in the capital gains tax provision contained in the House-passed bill. This bill, now before your Committee, recognizes that the tax burden on capital gains resulting from the 1969 Tax Reform Act has had an unintended and undesired effect on capital formation generally.

While pleased with the House action lowering the tax rates and improving the tax treatment of capital gains, we believe that return to the pre-1969 tax law relative to capital gains, as proposed by Senator Hansen (S. 3065; and by Congressman Steiger in H.R. 12111) should be approved by this Committee and the Senate and be included in the final tax legislation enacted into law this year. It would stimulate the nation's economy, benefit employers and employees, and result in a higher level of business activity which would help all American business including the railroads. As a highly capital intensive industry the railroads require large investments in equipment and plant, most of which has to come from internally generated funds. Although our support of liberalized tax treatment of capital gains as provided in Senator Hansen's bill and in the House-passed bill is based primarily on the benefit to the economy as a whole, we would certainly also hope to see these provisions result in improvement in the flow of capital funds to railroads from outside investment.

Today, the railroad industry continues to face the problem of obtaining the necessary capital by means of internally generated cash flow and borrowing capacity. Tax incentives are urgently needed to meet the requirements of the energy program, to improve railroad safety and to achieve the broader goals set forth in the President's 1978 Tax Program of modernizing our equipment and plants and creating permanent jobs for American workers. We have specific proposals which I will enumerate and discuss. However, before doing so I would like to review the railroad industry's capital needs.

The railroad industry, the Interstate Commerce Commission and the Department of Transportation have all concluded analyses of the railroad industry's capital needs which show them to be in the neighborhood of $4 billion per year. Actually capital expenditures have been running at little more than half that amount, about $2.5 to $2.6 billion per year in the past few years.

Even this level of capital expenditures have been burdening the industry severely. Capital outlays have exceeded internally generated funds—income plus depreciation—in each of the years 1963 through 1977 for which we have complete figures. The cumulative deficiency in the last three years alone amounts to $3.8 billion. The increase in recent years has been widening, and the $1.6 billion shortfall in 1977 is much higher than any other period in modern railroad history. This cannot continue if we are to have a viable, private-enterprise railroad system.

There is one cause for this problem—the inadequate level of profits which have been consistently low but most recently at the lowest levels in railroad history. Inability to generate internally the capital funds spent for capital improvements has resulted in the mounting debt just described. What makes this situation even more critical for the railroads in the case of needed capital investment in plant and facilities (such as yard and track improvements) is that they must be largely financed from internally generated funds since existing railroad mortgages preclude new debt financing for most road projects.

There are two current challenges facing the railroad industry which intensify the need for capital and which demonstrate the public interest in providing tax relief to the railroads. The first of these is to meet the nation's energy transportation needs over the next 10 to 15 years. Under both President Ford and President Carter a major thrust of the nation's program for conserving oil has been to promote conversion to coal wherever possible. It has been estimated that coal production over the next 10 years should double.

The railroads, which now carry about two-thirds of the nation's coal production to market, fully expect to be the major participant in hauling this increased coal production. This increase has already become evident on several railroads, and large commitments of capital have been made to provide the necessary equipment and facilities. Last year it was estimated that an investment of $4½ to $6 billion would be necessary over the next eight years in order for the railroads to meet the coal production goal of approximately 1.1 billion tons a year by 1985. The basic facilities and the ability to build essential new equipment is available, but it will take large infusions of capital investment. The railroad industry needs this new business, is anxious to perform the service, and is satisfied that it can do so. Moreover, the additional business will in time strengthen the specific carriers who will participate in the bulk of it.

The other major challenge facing the industry today which likewise calls for large amounts of additional investment is the continuing need to maintain and improve safety. A large portion of the nation's production of hazardous materials moves by railroad. While the railroad industry is proud of its safety record in the handling of hazardous materials, the potential for disaster inherent in accidents involving carloads of such materials makes it vital that every possible step be taken to improve safety performance. It is certainly preferable to handle such commodities by rail than to transport them over the nation's highway system which is crowded with heavy trucks and private automobiles and also runs through densely populated communities to a much greater extent than do the railroads. One definite means by which railroads safety can be maintained and improved is in the accelerated acquisition of new and better equipment and the improvement of rail track and bridge structures. As in the energy situation, the public interest is unquestionable and very high.

Our principal need at this time if for an immediate tax stimulus to acquire equipment and improve our track structure. The need for capital for railroad investment has never been more critical. Consequently, we urge the Committee to consider an increase in the investment tax credit to 20 percent for investment in rolling stock and expenditures with respect to the rack structure. We would estimate this to generate around $250 million per year in credits.

Over the years this Committee has properly recognized what an important tool investment credit can be in the railroad's effort to raise capital to acquire these badly needed investments. The credit has proven itself to be a necessary incentive and stimulus for modernization and expansion of plant, equipment and machinery. As a capital intensive industry with historic cash problems, the railroads have relied heavily on the credit as a source of cash needed for capital investment. Through leasing transactions marginal and loss railroads have been able to obtain a partial benefit from the credit in leasing needed equipment which they could

not afford to purchase. Although leasing has been beneficial, this highlights a serious defect in the operation of the investment tax credit under present law—no direct benefit is provided for those taxpayers who make qualified investments but who subsequently are unable to generate the profits and tax liabilities required to make use of the credit against tax. Thus, a number of the most needy railroads in our national system are unable to receive benefits from the investment tax credit other than indirectly through leasing since their earnings and consequent tax liabilities have been so small or non-existent. This problem could be resolved by providing for the refund to railroads of unused investment tax credits (a railroad rehabilitation credit).

Such a refundable railroad rehabilitation credit would, for the first time, provide railroads with the certainty that to the extent they invest in qualified property they will receive the benefit of the investment credit and enable them to take advantage of the favorable cost recovery methods previously enacted by Congress. Loss and marginal railroads would for the first time be able to benefit directly from this tax incentive and could increase their capital programs accordingly. In the railroad industry whose average rate of return on net investment is currently in the range of one to two percent, a large number of roads both large and small and particularly those engaged in marginal or loss operations would be able to benefit from such a refundable railroad rehabilitation credit provision. It is estimated that benefits from such a provision based upon a 10 percent credit could be as great as $160 million per year.

Because of poor earnings and inadequate cash, as mentioned above, railroads have resorted increasingly to the acquisition of equipment by means of leasing. This permits a railroad indirectly to utilize tax credits is could not otherwise use and has been important and helpful, particularly to low income or deficit roads, in financing desperately needed equipment. It does not work as it should, however, because among other problems the railroad lessee must share the benefit of the credit with the lessor and ends up receiving less benefit from the credit than had it been financially able to acquire the property by purchase rather than lease.

As with all other industries the railroads have encountered this practical problem as well as technical impediments to the full utilization of the investment tax credit. In order to ensure that the investment credit incentive will be more fully utilized, we propose that an election be made available whereby any party to any arrangement involving qualified railroad property would be entitled to the investment tax credit. There would be only a single investment credit and a single allowance for depreciation. The various parties to the transaction would determine which of them could claim the tax advantages to the exclusion of all others, and the various technicalities, distinctions and fine points in the IRS procedures and rulings which complicate and inhibit leasing would be eliminated. In the railroad industry it would permit a profitable railroad or a shipper to finance the acquisition of equipment and the upgrading of track to enjoy the tax benefits without being the owner. This type of election would apply to the acquisition of any Section 38 property and would remove the uncertainty generated by the current IRS procedures and rulings to cast transactions as leases. Further, it would eliminate the need for rulings in this type of transaction, saving expense to the taxpayer and the IRS.

The virtue of transferability of the investment credit and other tax benefits lies in the advantages it affords railroads that cannot use, for one reason or another, the particular benefits involved. By transferring them to the party who is financing the acquisition of the qualifying property, a railroad realizes the tax benefits in the form of reduced rents or interest. For example, extension of such tax benefits to any interested investor such as an interchange railroad or a shipper would permit an interchange railroad or shipper who has the needed capital to finance improvements to the track structure of a railroad which cannot do so on its own and receive the tax benefits regardless of the ownership of the property. Transferability will also free railroads from reliance on leasing which would eventually result in non-ownership of a large portion of their means of earning revenue.

There are other areas of tax relief and reform which would be of assistance to railroads. Among these we would list: (1) 60-month amortization of equipment and expenditures on the track structure without loss of the full investment tax credit and without imposition of minimum tax liability; (2) elimination of the percentage reduction of investment tax credit because useful life is three or more but less than seven years; (3) extension of the present tax benefits appli-

cable to pollution control expenditures (included in the House-passed bill) to similar costs incurred to comply with government safety and noise requirements; and (4) expansion of the categories of expenditures for which industrial development bonds may be issued to cover the acquisition of railroad rolling stock and track improvements. Also, for over 75 years the Interstate Commerce Commission has prescribed the Retirement-Replacement-Betterment method of accounting for the depreciation of railroad track, and the railroad industry has consistently followed it. It is a very conservative method of reporting operating results, and provides the industry with a greater cash flow than any ratable depreciation method because it reflects the current cost of replacing assets. The industry is gravely concerned because questions have been raised concerning the R-R-B method by the Interstate Commerce Commission and the Securities and Exchange Commission.

To avoid any problem should the Internal Revenue Service question its continued use, it is proposed to codify what has been the practice of the industry throughout the existence of the Federal income tax and which has been hitherto accepted by the I.C.C. and the I.R.S. There is no revenue loss involved.

In summary, the railroads, as the most energy efficient transportation system, welcome the opportunity presented by the increased need for coal and the need for the use of a more energy efficient means of transporting other products. We also acknowledge the challenge to enhance the safety of rail operations particulary for the safe movement of increasing amounts of hazardous materials. In our view these two highly important national and public goals fully justify the increased and refundable credit I have proposed. In order to achieve these important goals, we must bring our equipment and facilities up to the standards required to do the job. The tax proposals for which we seek your support are designed to assist in accomplishing those goals. The use of tax incentives will afford quicker relief than other government programs and will provide a workable system of channeling capital into badly needed improvement programs. The knowledge that an increased portion of earnings will be available for use in the business will be an incentive for railroads to further increase earnings through operating efficiency. We feel that the program we offer is a balanced one which will help all railroads, and we look forward to favorable action by this Committee and Congress with regard to our suggestions.

I shall be pleased to respond to any questions the Members of this Committee may wish to ask. Thank you.

The CHAIRMAN. We will now call the panel of Mr. Jack Christmas, Edward Ralph, and Latimer Turner.

Mr. COHEN. Senator, I am Edward S. Cohen of Covington & Burling, Washington. I am counsel for the poultry industry, for which Mr. Ralph will speak.

Mr. RALPH. I am Edward H. Ralph, executive secretary, Delmarva Poultry Industry, Inc.

Ms. TOMASULO. I am Virginia Tomasulo. I am here to accompany Mr. Jack Christmas who is going to testify on behalf of the Society of American Florists.

Mr. CHRISTMAS. I am Jack Christmas with the Society of American Florists and president of Oakdale, Inc., in Florida.

Mr. CAMPBELL. I am Lee Campbell with the Poultry and Egg Institute of America, appearing with Mr. Ralph.

Ms. MANARD. Marilyn Manard with the National Broiler Council, also with Mr. Ralph.

Mr. WALLS. I am Lou Walls, I am here with Mr. Gebhart. I am representing the National Turkey Federation.

STATEMENT OF JACK CHRISTMAS, SOCIETY OF AMERICAN FLORISTS

Mr. CHRISTMAS. Thank you, Mr. Chairman. I am Jack Christmas, president of Oakdale, Inc. in Florida, and I am here today represent-

ing over 850 commercial floriculture growers who produce approximately 90 percent of the flowers and foliage plants grown in the United States. The society's membership also includes 6,600 wholesalers and retailers who are small businesses receiving, distributing, and selling the products that we grow.

In total, over 93 percent of the floricultural industry is represented by the society through direct membership and affiliation.

I come to this committee to ask your favorable consideration on two issues which can help us all to enjoy flowers and plants in the coming years. The investment tax credit on greenhouses and tax accounting requirements.

The first issue concerns the application of the investment tax credit to greenhouse structures used to grow flowers and plants.

Since the enactment of the investment tax credit in 1962, it has not applied to buildings but has been applied to certain single-use structures. In 1971, the Senate Finance Committee commented on structural use qualifications for investment credit. The single and specialized use of greenhouses clearly fit the criteria.

In particular, there is very little difference between the hog-raising structure described by the committee as qualifying for the credit and a greenhouse used for raising flowers and plants. During the ensuing years, several other structures have been found by the courts to qualify for the investment credit because of the unique function they perform in the production of the product.

In 1974, the Ninth Circuit Court of Appeals and, on August 10, 1978, the Western District Court of Missouri, found greenhouses eligible for the same reason.

The Ninth Circuit Court said that the functional test rather than appearance test is the test, whether the structure constitutes a building. The court concluded that under the functional test, greenhouses do not function as a building as the term is employed in section 48, but greenhouses supply the controlled environment that is essential for the commercial production of more and finer flowers and plants.

The Western District Court in Missouri found, and I also quote:

> It is the second exception that prevents these greenhouse structures from being classified as buildings within the meaning of the statute. That is, these particular structures are so uniquely and specifically designed to provide the optimum atmoshperic conditions and specifically designed to provide the optimum atmospheric conditions conducive to the commercial growing of flowering plants and are so designed to meet the specific needs of horticulture, that the greenhouse in question are not buildings under section 48 by virtue of the functional test as contained in the regulation's second exception.
>
> The structures cease to be a greenhouse when the function of creating an environment is terminated.

Over the past few years, our industry has spent a great deal of time and money litigating this question. As a matter of fact, my own company has a court case pending in the U.S. Court of Claims on this issue of greenhouse eligibility for the investment tax credit and, I might add, that I am not here today saying anything about this case, but it is an industry case, and speaking strictly for the industry and hoping that something like this will not happen again.

It now appears that the internal Revenue Service will continue to reject claims for the investment credit for greenhouses despite the favorable court decisions that greenhouses are not buildings but special-purpose structures as described in the law.

The taxpayers like myself will continue to be harrassed by the Internal Revenue Service unless Congress further clarifies what it intended to include as special-purpose structures.

I feel strongly that the merits of our claim and the obvious inequities this issue presents requires your favorable consideration of S. 3433. We believe that the congressional intent in establishing the investment tax credit in 1962 and its reenactment in 1971 was that structures specifically designed and singular in function, such as these environmental growth chambers are eligible for the investment credit, so we are confident that if you make the comparison between the single intent and actual use of greenhouses with those structures that Internal Revenue presently considers eligible you will also understand the justification of our claim.

Thank you.

The CHAIRMAN. Now, Mr. Edward H. Ralph.

STATEMENT OF EDWARD H. RALPH, DELMARVA POULTRY INDUSTRY, INC.

Mr. RALPH. My name is Edward H. Ralph. I am executive secretary of Delmarva Poultry Industry, Inc. and I shall abbreviate my statement, if the full written statement may be included in the record, Mr. Chairman.

Because of the great importance we place upon this issue, we have Mr. Lee Campbell, Marilee Menard, Lew Watts and Mrs. Edwin Cohen accompanying me today, as were introduced earlier.

Our statement is on behalf of 30 national, regional, and State poultry and egg organizations from throughout the country and they are listed in the written statement.

All the organizations on behalf of whom I appear today urge that the committee amend section 314 of H.R. 13511 to include the provisions of S. 3289. The bill was introduced by Senator Roth.

This bill (S. 3289) would assure that the investment tax credit is available to farmers with respect to structures specifically designed and used solely for the housing, raising or feeding of poultry and for the equipment necessary for such purposes.

Two other bills, S. 3433 introduced by Senator Talmadge, and S. 3285 introduced by Senators Tower, Bentsen and seven other Senators, are similar. These would accomplish the same result for these poultry structures and certain other farm structures.

Congressmen Pickle and Jenkins have introduced in the House of Representatives a bill, H.R. 12846, which is identical to S. 3289, and hearings were held on that House bill before the Subcommittee on Miscellaneous Revenue Measures of the Committee on Ways and Means on August 11, 1978.

Congressman Evans has also introduced identical legislation, which is H.R. 13147.

When the investment credit was restored in the Revenue Act of 1971, the Senate Finance Committee in its report accompanying the 1971 act, stated their intention that the credit, under the reinstated investment credit, would be applicable to structures specifically designed and closely-related to the use of the equipment it houses.

The report used as example a unitary system for raising hogs. The text of the Committee's Report statement is attached as an appendix to our written statement. And yet, despite the striking similarities between the structures for raising of hogs and those for the production of poultry and eggs, the IRS has, on a number of occasions since the 1971 restoration of the credit, disallowed the credit for farmers who invested in such structures for the production of poultry and eggs.

The U.S. Tax Court held in the *Melvin Satrum* case in 1974 that the credit was available with respect to these special purpose poultry structures.

The Commissioner of Internal Revenue appealed the case to the Court of Appeals for the Ninth Circuit, but then dismissed the appeal

Just recently, on August 8, 1978, the Tax Court, following its own earlier decision in the *Melvin Satrum* case, again held that these poultry production process and do qualify for the investment tax credit.

This was the case of the Walter Sheffield Poultry Co.

Despite these decisions, the IRS has, on a number of audited returns, disallowed the credit. Such repetitive litigation is an un ecessary and expensive burden to the farmers in our industry. I would call your attention that some 90 percent of the broilers and most of the turkeys and eggs in this country are produced by small, independent farmers, not the large integrated broiler companies.

The bills that we have discussed would help clarify the existing law effective from the effective date of the restoration of the investment tax credit in 1971. We believe that this is appropriate in light of the Senate Finance Committee's statements in the 1971 report, and the favorable decisions of the Tax Court in 1974 and 1978.

We appreciate this opportunity to testify, and we respectfully request the committee to amend section 314 of H.R. 13511 to include the provisions of S. 3285, S. 3289, or S. 3433.

Thank you.

The CHAIRMAN. Thank you very much, gentlemen.

Senator Curtis?

Senator CURTIS. This problem involves this proposition, does it not? Equipment used in a trade or business is eligible for an investment credit, and buildings used in a trailer business are not, and the controversy is over whether something is equipment or whether it is a building.

Is that what it amounts to? Would you say that, Mr. Cohen? That is oversimplified, but is that the proposition?

Mr. COHEN. Yes.

That is the point, Senator Curtis; as these gentlemen have said, in the 1971 report of this committee, it was specifically said that these special-purpose structures should not be regarded as buildings, but should be eligible for the credit, and the report used as an illustration automatic hog-raising facilities. The point is, as Mr. Ralph was saying, that there is no difference between the hog-raising facilities and the poultry-raising facilities. They are essentially the same type, and still this litigation continues. As Mr. Ralph pointed out, the average amount of tax involved for a poultry facility is something less than $5,000 and the farmers are having great difficulty standing the expense of this con-

tinued litigation. A similar problem exists with respect to the greenhouses.

Senator CURTIS. You do not want the chickens to have a disadvantage over the hogs? I think I understand it.

Mr. RALPH. There is a saying what is fair for the goose is fair for the gander. We think what is fair for the hogs should also be fair for the chickens.

The CHAIRMAN. Thank you very much, ladies and gentlemen. We are happy to have you here today.

[The prepared statements of the preceding panel follow:]

STATEMENT OF JACK CHRISTMAS ON BEHALF OF THE SOCIETY OF AMERICAN FLORISTS

The Society of American Florists was organized in 1884. Its membership includes 850 floricultural growers producing approximately 90 percent of the flowers and plants grown in the United States and 6,600 wholesalers and retailers which are small businesses receiving, distributing, and selling floriculture products. In total, over 93 percent of the floriculture industry is represented by the Society through direct membership and affiliation.

The floricultural industry is engaged in the business of growing and marketing flowers and plants. These flowers and plants are grown for use in offices and homes, for decoration, esthetics, sentimental reasons, for special occasions and numerous other reasons.

Several factors are presently testing the industry's ability to stay in business. These factors include inflation, rising labor and energy costs, and increased foreign competition coupled with government action such as the rising minimum wage, dramatic increases in social security, and other payroll taxes and environmental controls by the EPA, OSHA and other government agencies which have, for example, paralyzed pesticide availability. These problems impact most heavily on small businesses, such as the membership of the Society, which are least able to cope with rising costs, foreign competition and increasing government controls.

Our industry shares the concerns of this Committee and those expressed by the House in H.R. 13511, that tax relief is required to offset the drain of higher taxes and inflation. It is essential that business investment be stimulated to expand and modernize production facilities, thereby increasing productivity and creating new jobs. Without stimulus, our industry will be particularly hard hit and many of its small businesses will fail. This is particularly true because of recent technological advances which require heavy capital investment and which are required to make the industry competitive with foreign growers who often have the advantage of more favorable climates and low labor costs.

Before commenting on the overall tax program, there are two issues of particular concern to our industry—the investment tax credit and tax accounting requirements.

I. INVESTMENT TAX CREDIT

A. In general

The House passed tax bill, H.R. 13511, proposes that the investment tax credit be made permanent at 10 percent. In addition, it would be expanded from its present application to include the rehabilitation of buildings. Also, the percentage limitation regarding the amount of the investment credit that may be applied against tax liability would be raised from 50 to 90 percent. Overall, these proposals would provide an incentive to capital investment and are supported by the Society. However, the following particular concerns of our industry should be resolved by any legislation adopted by Congress.

B. Treatment of greenhouses as special-purpose structures

1. Background

When the investment tax credit was enacted as a part of the Revenue Act of 1962, the credit was applicable to equipment and certain types of real property:

"The credit is available for investment in most tangible personal property. It is also available for limited types of real property, other than buildings." [1]

[1] House Rept. No. 1447, 87th Cong., 2d sess. (1962), at p. 9.

In order to clarify the types of real property eligible for the credit, the Senate Committee on Finance clarified Congress' intent when the investment tax credit was reinstated by the Revenue Act of 1971.[2]

"The Committee also desires to make it clear that the term 'building' is not intended to include a structure which houses property used as an integral part of a manufacturing or production activity (or other activity referred to in Section 48(a)(1)(b)(i)) if the use of the structure is so closely related to the use of the equipment it houses that the structure clearly can be expected to be replaced when the property it houses is replaced. Factors which would tend to indicate that a structure is closely related to the use of the equipment include the fact as to whether the structure has been specifically designed to provide for the stress and other demands of the equipment which the structure houses and the fact as to whether construction could not be economically used for other purposes."[3]

This report further clarified the meaning of "special purposes structures" by way of example:

"One example of a type of structure closely related to the product it houses which was called to the attention of the committee is a unitary system for raising hogs which includes automatic feed systems, special airflow units, slatted flooring, pens and partitions. The structure which can be added to, according to the number of hogs raised, is no more than a cover and way of tying together the specially designed pens, automatic feed systems, etc. There is no other practical use for the structure and it can, therefore, be expected to be used only so long as the equipment it houses is used. Such a structure would be eligible for an investment credit."[4]

Thus, the investment tax credit is applicable to a structure which is essentially an item of machinery or equipment, or an enclosure which is so closely combined with the machinery or equipment which it supports, houses, or serves, that it must be replaced, retired, or abandoned contemporaneously with the machinery or equipment. That a structure is a special purpose structure is indicated by its special design and by its inability to be utilized for other purposes.

Both the courts and the Internal Revenue Service through rulings have identified various types of structures, in addition to the hog raising structure identified by the Congress, which qualify for the credit as special purpose structures.

COURT CASES

Robert E. Catron, 50 T.C. 306 (1968), apple storage structure;

Central Citrus Co., 58 T.C. 365 (1972), orange juice structure;

Merchants Refrigerating Co. of California, 60 T.C. 856 (1973), refrigeration structure;

Melvin Satrum, 62 T.C. 413 (1974), chicken and egg raising structure;

Commissioner v. *Schuyler Grain Co., Inc.*, 411 F. 2d 649 (7th Cir. 1969) grain structure;

Brown and Williamson Tobacco Corp. v. *United States*, 369 F. Supp. 1283 W.D. Ky. 1973), tobacco structure;

Brown-Forman Distillers Corp. v. *United States*, 499 F.2d 1263 (Ct. Cl. 1974), liquor aging structure;

Thirup v. *Commissioner*, 508 F. 2d 915 (9th Cir. 1974), greenhouse; and

Stuppy Inc. v. *United States*, S. 2nd , 77-0659-CV-W-3, (W.D. MO. 1978), greenhouse.

REVENUE RULINGS

Rev. Rul. 66-89, 1966-1CB7, farm items—fences, paved barnyards and storage structures;

Rev. Rul. 68-132, 1968-1CB14, potato structure;

Rev. Rul. 68-347, 1968-2CB33, refinery structures;

Rev. Rul. 71-104, 1971-1CB5, cement kiln structure;

Rev. Rul. 71-359, 1971-2CB61, peanut structure; and

Rev. Rul. 71-489, 1971-2CB64, refrigeration structures.

In summary, there is no question that numerous kinds of structures, including greenhouses, have been held to be special purposes structures qualifying for the Investment Tax Credit.

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[2] It was repealed by the Tax Reform Act of 1969.
[3] Senate Rept. No. 92-437, 92d Cong., 1st sess. (1971) p. 29.
[4] Senate Rept. No. 92-437, 92d Cong., 1st sess. (1971), pp. 29 and 30.

2. Greenhouses

A greenhouse constitutes an essential and integral part of producing flowers and plants. Without its uniquely designed controlled environment, many flowers and plants could not be produced in adequate quantities or quality to be economic.

It is not a building in the normal sense which can be used for various purposes. The greenhouse itself, because of its translucent construction and the environmental watering, fertilizing, insect, and disease control equipment contained as a part of the structure's overall configuration, is a uniquely designed structure which is a required part of and can only serve the purpose of growing plants and flowers.

The qualifications of a greenhouse for the investment tax credit as a special purpose structure is justified on the following grounds:

(*a*) Consistent with the above quoted Committee Report, the structure is specifically designed to provide for the stress and other demands of the equipment it houses and it could not be economically used for other purposes.

(*b*) Like the cited eligible facilities, it is a unitary system for raising flowers or plants which includes equipment such as automatic fertilization, temperature control, light control, watering, disease and insect control, and raised benches for the most economic production of flowers and plants many of which could not otherwise be grown at the location. It is no more than a mechanism for tying together the environmental and other factors required to grow flowers. Finally, there is no other practical use for the structure.

(*c*) The structure itself constitutes a piece of production equipment whose sole, vital purpose is the production of plants and flowers that require a strictly controlled environment.

Thus, it is clear that Congress intended for this type of facility to qualify for the investment tax credit.

3. Internal Revenue Service position

In spite of this background and the unique nature of greenhouses, the Internal Revenue Service has taken the position that they do not qualify for the credit. This is true even though the U.S. Circuit Court and the Federal District Court For the Western District of Missouri have ruled on the question of their qualification held that greenhouses do qualify for the credit. See *Thirup* v. *Commissioner*, 508 F. 2d. 915 (9th Cir. 1974), and *Stuppy Inc.* v. *United States* S. 2nd, 77-0659-CV-W-3, (W.D. MO 1978). The Internal Revenue Service's position is stated in Rev. Rul. 77-363, 1977-41 IRB 8.

This position has led to numerous audit disputes and resulted in litigation across the country. These types of disputes are particularly damaging to industries consisting of small businesses such as the floricultural industry. The amounts in dispute are small and the costs of court action constitute a heavy burden. There are cases in various stages pending in at least Colorado, Kansas, Michigan, Mississippi, Ohio and Texas already and numerous other disputes which will reach the courts in the near future in virtually every state.

4. Society's position

The Society's position is that greenhouses are required to produce the quality and quantity of flowers and plants required by our economy. They constitute an essential and integral part of the production process clearly qualifying them for the investment tax credit.

It is difficult for the effected taxpayers to understand why an environmental growth chamber does not qualify for the credit in the Internal Revenue Service's view when other specially designed, single purpose structures do qualify. The inequity is not understood.

A greenhouse is clearly a unique structure which can only be used for the production of flowers and plants. Further, this production facility in addition to increasing this country's production capacity and creating jobs, allows us to compete with other nations with more favorable climates and cheap labor. Thus, it meets both the technical requirement that it is a special purpose structure and Congress' purpose of enacting the credit for increased production and jobs.

5. Action requested

The Society respectfully requests that the floricultural industry be permitted to participate in the tax incentives provided by the House passed, H.R. 13511, proposal on the investment tax credit. This will provide a badly needed stimulus to numerous small businesses. Therefore, any legislation enacted on the investment tax credit should make it clear that greenhouses qualify for the credit as

special purpose structures. Specifically, we support Sen. Talmadge's legislation, S. 3433, which recognizes that certain special purpose structures and enclosures, such as greenhouses, should be eligible for the investment tax credit. Also, we support Rep. Kelly's investment tax credit for greenhouses legislation, H.R. 12686, which is presently under consideration before a Ways and Means Subcommittee. It should also be made clear that Congress has always intended for this type of structure to qualify for the credit.

This action will allow the floricultural industry to participate fully in the nation's economic growth in keeping with the intent of the investment tax credit and to the benefit of the nation's economy. This action will also prevent the cost and time delays entailed in numerous court cases.

II. TAX ACCOUNTING REQUIREMENTS

A. Background

Early in 1976, the Internal Revenue Service published Revenue Ruling 76–242, 1976–1CB132. This ruling required accrual method taxpayers operating farms, nurseries and florist shops to inventory growing crops, trees, and plants. This ruling reversed the Internal Revenue Service's position for over 50 years that such taxpayers need not inventory their crops, trees and plants. See I.T. 1368, I–1CB72 (1922) and O.D. 995, 5CB63 (1921).

Later in 1976, the Congress added section 447 to the Internal Revenue Code of 1954 in the Tax Reform Act of 1976. This provision requires the inventorying of growing crops in certain cases.

As a result of the new legislation and beacuse it raises "questions concerning the intended treatment of some taxpayers," on February 25, 1977 the Internal Revenue Service issued Revenue Ruling 77–64, 1977–18 IRB 12. This ruling postpones the application of the new inventory rules until taxable years beginning after December 31, 1977.

B. Society's position

New section 447 requires certain corporations engaged in the trade or business of farming to inventory crops. Exceptions from the new rules were provided for small businesses (gross receipts under $1 million) and family owned corporations.

Of particular significance is the language of section 447(a) providing that section 447 shall not apply to: the trade or business of operating a nursery or to the raising or harvesting of trees (other than fruit and nut trees).

Because the term nursery has a broad definition in the agricultural community, we believe that Congress intended the term "nursery" to identify agricultural operations producing field and greenhouse grown flowers, plants and nursery stocks. The similarities of these activities was recognized by the Internal Revenue Service when it treated them the same under Rev. Rul. 76–242.

The exception of these industries from the requirments of section 447 was because they are not the subject of tax sheltering investments, but rather constitute small active businesses. This was recognized by Congress in the 1976 Act.

It is impossible to inventory floricultural crops in various stages of growth, with any degree of accuracy. The impossibility was recognized by the Internal Revenue Service for over 50 years. There are no new accounting concepts to change the original conclusion. As was the case 50 years ago, insects, disease, inclement weather, market demands and pressures, and numerous other unforeseeable factors make inventorying impossible.

Floriculture growers produce a great variety of crops each of which have different production, biological and market problems. Additionally, these crops do not have a market value until they are actually sold. These factors would make inventorying, even if possible with any degree of accuracy, prohibitively expensive for the small businesses involved.

C. Action requested

The Society respectfully requests that the floricultural industry be exempted from the onerous requirements of section 447 as a nursery industry and that the Senate adopt Section 342 of H.R. 13511 to clarify this issue. The Internal Revenue Service has recognized the inequity of Rev. Ruling 76–242 in its recently released Revenue Procedure 78–22. It "provides relief for farmers who would have elected the cash method of accounting at the time of filing their first Federal income tax return had they known the IRS would later require them to inventory growing crops, trees and plants." The revenue procedure permits farmers, nurserymen and florists a one time, one year opportunity "to change to

the cash receipts and disbursements method of accounting." It should be noted that 78–22 is only a partial solution to this problem. Further, to activate this procedure, the taxpayer must submit a detailed application for approval before the accounting change can be implemented. The House passed bill, H.R. 13511, Sec. 342, presents a more equitable approach to this issue and would present less of a paper work burden to the small businessman. The Society supports Sec. 342 because it would allow a farmer, nurseryman or florist to either continue his present method of accounting and not inventory growing crops or to change back to cash method of accounting before January 1, 1981. H.R. 13511 clearly addresses the problems of inventorying crops and proposes suitable alternatives to the affected taxpayers.

This would be a meaningful step assisting small busineses—one of the goals of the tax proposed and one often expressed by Congress. These actions would over time prevent an onerous accounting burden from being implemented without affecting Federal revenues because accrual and inventory accounting requirements are only concerned with the timing of deductions.

III. GENERAL COMMENTS

The Society agrees that the individual and corporate tax rates should be reduced to provide economic incentive and offset the increasing payroll taxes and the effects of inflation. The specific comments of the Society on the tax proposal are as follows:

Reduction in corporated tax rate

The Society supports the proposal to reduce the corporate tax rate. But, we feel the initial proposal did not go far enough in providing tax relief for small and medium-sized corporations.

The Society supports S. 2669, introduced by Senator Nelson, to help small enterprises (like the floricultural industry) "grow," "expand," and "stay afloat." Nelson said "this bill would help channel funds in their direction."

The Society supports the following distribution of tax rates:

Taxable income:	Proposed tax rate (percent)
$0 to $25,000	15
$25,000 to $50,000	20
$50,000 to $100,000	30
$100,000 to $150,000	40
Above $150,000	44

Expanded investment tax credit

The Society supports expanding the investment tax credit, as in H.R. 13511, to the rehabilitation of structures, including industrial office buildings, retail buildings and warehouses. This proposed expansion to include retail buildings is applauded by our industry of small retail businessmen.

Estate taxes

The new carryover basis at death rules of the Tax Reform Act of 1976 are particularly harsh on small businesses and should be repealed.

IV. CONCLUSION

The Society is encouraged by the House passed tax proposal H.R. 13511 to reduce the individual and corporate tax rates and provide incentives for business investment. However, we urge that the investment tax credit provisions be clarified to make it clear that greenhouses qualify for the credit as a special purpose structure. The other primary concern of our industry is that the small businesses engaged in floriculture not be subjected to costly and onerous tax accounting burdens.

STATEMENT OF EDWARD H. RALPH ON BEHALF OF VARIOUS POULTRY ORGANIZATIONS

My name is Edward H. Ralph. I am the Executive Secretary of the Delmarva Poultry Industry, Inc., the members of which are poultry and egg producers located in the Delmarva Peninsula of Delaware, Maryland and Virginia.

Accompanying me today are Lee Campbell, Executive Vice President of the Poultry and Egg Institute of America; George Watts, President of the National Broiler Council; Lew Walts, Executive Vice President of the National Turkey

Federation; and Edwin S. Cohen, of Covington & Burling, Counsel to Delmarva Poultry Industry, Inc.

The following poultry and egg organizations support this statement: Alabama Poultry and Egg Association; Arkansas Poultry Federation; Delmarva Poultry Industry, Inc.; Georgia Poultry Federation; Indiana State Poultry Association; Louisiana Poultry Industries Association; Maine Poultry Federation; Michigan Allied Poultry Industry, Inc.; Midwest Egg Producers Cooperative Association; Midwest Poultry Federation; Minnesota Poultry Industries Association; Mississippi Poultry Association; National Egg Company; National Broiler Council; National Turkey Federation; Nebraska Poultry Industries, Inc.; North Carolina Poultry Federation; Northeast Egg Marketing Association; Northwest Egg Producers Cooperative Association; Ohio Poultry Assoication; Pacific Egg and Poultry Association; Pennsylvania Poultry Federation; Poultry and Egg Institute of America; South Carolina Poultry Improvement Association; Southeastern Poultry and Egg Association; Southern California Egg Cooperative; Texas Poultry Federation; United Egg Producers; Virginia Poultry Federation; and Western Egg Company.

Section 314 of H.R. 13511 extends the investment credit provisions of the Internal Revenue Code to certain rehabilitated buildings. All of the organizations on behalf of whom I appear today urge that the Committee amend Section 314 of H.R. 13511 to include the provisions of S. 3289, introduced by Senator Roth, which would ensure that the investment tax credit is available to farmers with respect to structures specifically designed and used solely to provide for the housing, raising or feeding of poultry and for the equipment necessary for such purposes. Two other bills, S. 3433, introduced by Senator Talmadge, and S. 3285, introduced by Senators Tower, Bentsen, Lugar, Morgan, Clark, Hayakawa, Percy, Allen and Helms, would accomplish the same result for these structures and certain other farm structures. Congressmen Pickle and Jenkins have introduced in the House of Representatives a bill, H.R. 12846, which is identical to S. 3289, and hearings were held on H.R. 12846 before the Subcommittee on Miscellaneous Revenue Measures, Committee on Ways and Means, on August 11, 1978. Congressman Evans has also introduced identical legislation, H.R. 13147.

The Internal Revenue Code provides generally that the present 10% investment credit applies to tangible personal property and to other tangible property used as an integral part of production, but does not apply to a building. (Section 48(a)(1)(B).) The Code does not define the term "building," and this has resulted in a question being raised as to the availability of the credit with respect to these special structures that enclose and are an integrated unit with automated equipment for the production of poultry and eggs.

With respect to similar structures for the automatic raising of hogs, the Internal Revenue Service had ruled in 1966 that the investment credit was not available. When the investment credit was restored in the Revenue Act of 1971, after having been terminated in 1969, the Senate Finance Committee in its report accompanying the 1971 Act specifically referred to this matter and stated the intention of Congress that the credit under the reinstated investment credit would be applicable to structures specifically designed and closely related to the use of the equipment it houses. The report used as an example a unitary system for raising hogs. The text of this committee report statement is attached as an appendix.

Despite the striking similarity between the structures for the raising of hogs and those for the production of poultry and eggs, the Internal Revenue Service has on a number of occasions since the 1971 restoration of the credit disallowed the credit for farmers who have invested in such structures for the production of poultry and eggs. The United States Tax Court held in 1974 that the credit was available with respect to these special purpose poultry structures. *Melvin Satrum*, 62 T.C. 413. The Commissioner of Internal Revenue appealed the case to the Court of Appeals for the Ninth Circuit but then dismissed the appeal.

Despite this decision, the Internal Revenue Service has on audit of a number of returns disallowed the credit. We understand that the Service has dismissed some of the cases before trial but is bringing other cases to trial where appeals would lie to other courts of appeal. In one case in the Western District of Arkansas, the Federal District Court has denied the credit, relying upon language in an opinion in the Court of Appeals for its circuit (8th Circuit) in a case relating to freight loading docks. *Starr Farms, Inc.* v. *U.S.*, 447 F. Supp. 580 (1977).

On August 8, 1978, the Tax Court, following its own earlier decision in *Melvin Satrum*, again held that these poultry structures are an integral part of the poultry production process and qualify for the investment tax credit. *Walter Shef-*

field Poultry Co., Inc., T.C. Memo 1978–398, August 8, 1978. This repetitive litigation is an unnecessary and expensive burden to the farmers in our industry.

Some 90 percent of the broilers and most of the turkeys and eggs in this country are raised or produced by independent farmers. We believe these farmers should be entitled to know whether the investment credit is available when they undertake the investment in the construction of the new efficient automated poultry and egg producing facilities. The amount of credit in issue on any one facility is generally less than $5,000, an amount which does not warrant extensive litigation by farmers with the Internal Revenue Service in the courts. These farmers have understood, in the light of the specific statements in the Senate Finance Committee report in 1971, that the credit was intended to be available to them. They are grateful for the introduction of S. 3433, S. 3289 and S. 3285, which at long last would set this matter at rest and ensure that they are entitled to the credit without resort to further litigation.

These automated poultry and egg production facilities greatly increase the efficiency of poultry and egg production in this country. The facilities reduce the need for energy and produce significant savings in the cost of production and in the cost of poultry and eggs to the consumer. We believe their construction should be encouraged, and that they fulfill the basic purposes of the investment credit in improving the productive capacity of the nation.

The bills would make this clarification of existing law effective from the effective date of the restoration of the investment credit in 1971. We believe that this is appropriate in the light of the Senate Finance Committee statements in its 1971 report, the favorable decisions of the Tax Court in 1974 and 1978 and the desirability of putting an end to expensive and lengthy litigation. We understand that when a comparable problem existed with respect to the application of the investment credit to motion picture films and a favorable court decision existed, the clarification enacted in the Tax Reform Act of 1976 was retroactive.

We appreciate the opportunity to appear before the Committee, and respectfully request that the Committee amend Section 314 of H.R. 13511 to include the provisions of S. 3433, S. 3289 or S. 3285.

EXCERPT FROM SENATE FINANCE COMMITTEE REPORT[1] ACCOMPANYING THE REVENUE ACT OF 1971

The committee also desires to make it clear that the term "building" is not intended to include a structure which houses property used as an integral part of a manufacturing or production activity (or other activity referred to in sec. 48(a)(1)(B)(i)) if the use of the structure is so closely related to the use of the equipment it houses that the structure clearly can be expected to be replaced when the property it houses is replaced. Factors which would tend to indicate that a structure is closely related to the use of the equipment include the fact as to whether the structure has been specifically designed to provide for the stress and other demands of the equipment which the structure houses and the fact as to whether the structure could not be economically used for other purposes.

One example of a type of structure closely related to the product it houses which was called to the attention of the committee is a unitary system for raising hogs which includes automatic feed systems, special airflow units, slatted flooring, pens and partitions. The structure which can be added to, according to the number of hogs raised, is no more than a cover and way of tying together the specially designed pens, automatic feed systems, etc. There is no other practical use for the structure and it can, therefore, be expected to be used only so long as the equipment it houses is used. Such a structure would be eligible for an investment credit.

The CHAIRMAN. The committee will meet again at 9 o'clock tomorrow.

[Thereupon, at 12:30 p.m., the committee recessed, to reconvene at 9 a.m. on Thursday, August 24, 1978.]

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[1] (S. Rept. No. 92–437, p. 29 (92d Cong., 1st sess. (1971)), 1972–1 Cum. Bull. 575).

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