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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CONTENTS

(Parts 1, 2, 3, 4, 5)

ADMINISTRATION WITNESSES

Page

Blumenthal, Hon. W. Michael, Secretary of the Treasury 130
Lubick, Hon. David C., Assistant Secretary of the Treasury for Tax Policy, accompanied by John M. Samuels, Deputy to the Legislative Counsel, and Benjamin J. Cohen, attorney 948
Miller, Hon. G. William, Chairman, Board of Governors, Federal Reserve System 1173

PUBLIC WITNESSES

Ad Hoc Committee for an Effective Investment Tax Credit, James Morrison 557
Allen, Jack, president, Independent Petroleum Association of America 910
American Automobile Association, John Archer, director of legislative affairs 919
American Federation of Labor and Congress of Industrial Organizations, Andrew J. Biemiller, director, department of legislation 427
American Gas Association, George H. Lawrence, president 393
American Greetings Corp., Paul Ozan, assistant general counsel 890
American Hotel & Motel Association, Albert L. McDermott, Washington representative 509
American Industrial Development Council, Thomas E. Bundy, treasurer 893
American Paper Institute, Edwin J. Spiegel, Jr., chairman of the board of the Alton Box Board Co 272
American Stock Exchange, Arthur Levitt, chairman 651
American Textile Institute, Louis Jenkins, vice president and controller, Cannon Mills, Inc 274
Americans for Democratic Action, Leon Shull 499
Archer, John, assistant director of legislative affairs, American Automobile Association 919
Assembly of Governmental Employees, James F. Marshall, executive director 1160
Association of American Railroads, Carl V. Lyon, senior vice president 720
Biemiller, Andrew J., director, department of legislation, American Federation of Labor and Congress of Industrial Organizations 427
Bixler, Roland M., president, JBT Instruments, Inc., on behalf of the National Association of Manufacturers 207
Brandon, Robert M., director, Public Citizen's Tax Reform Research Group, accompanied by Robert S. McIntyre, staff attorney 754
Building Owners and Managers Association, International, Gardner S. McBride, executive vice president 1064
Bundy, Thomas E., treasurer, American Industrial Development Council 893
Carlson, Jack, vice president and chief economist, Chamber of Commerce of the United States 209
Chafee, Hon. John H., a U.S. Senator from the State of Rhode Island 551
Chamber of Commerce of the United States, Jack Carlson, vice president and chief economist 209
Chambers, Walter R., chairman, Public Securities Association, accompanied by Arthur J. Kalita, assistant director for regulation 1015
Christmas, Jack, Society of American Florists 726

Page
Clarfield, Wallace J., on behalf of the Tax Council ---- 208
Coalition for Low and Moderate Income Building, William J. Laugelier, chairman of the executive committee ---- 1100
Cohen, Edwin S., Esq., on behalf of:
Investment Company Institute, accompanied by Matthew P. Fink, Esq., general counsel, Investment Council Institute ---- 487
Irving Trust Co., accompanied by Herman C. Biegel, Esq., and Carroll J. Savage, Esq ---- 1130
Cohen, Herbert B., Esq., on behalf of Committee for Capital Formation Through Dividend Reinvestment, accompanied by Samuel M. Cohn, vice president, Robert Nathan Associates ---- 493
Committee for a Uniform Investment Tax Credit, Daniel K. O'Connell, chairman ---- 556
Committee for Capital Formation Through Dividend Reinvestment, Herbert B. Cohn, Esq., accompanied by Samuel M. Cohn, vice president, Robert Nathan Associates ---- 493
Corcoran, Thomas G., Esq ---- 474
Council of Jewish Federations, Norman A. Sugarman ---- 1121
Council of State Housing Agencies, Carl Payne, director ---- 1102
Council of Vietnam Veterans, Inc. Robert O. Muller, executive director ---- 927
Davidson, James Dale, chairman, National Taxpayers Union and Donald Baldwin assistant to the chairman and legislative director, National Taxpayers Union ---- 433
DeBolt, Don, chairman, Small Business Legislative Council ---- 646
Delmarva Poultry Industry, Inc., Edward H. Ralph ---- 728
Derr, Charles I., senior vice president, Machinery & Allied Products Institute ---- 554
Donley, Edward, chairman of the board of Air Products & Chemicals, Inc., on behalf of the Manufacturing Chemists Association ---- 271
Edison Electric Institute, William McCollam, Jr., president ---- 279
Eisner, Robert, William R. Kenan, professor of economics, Northwestern University ---- 704
Emergency Committee for American Trade, Robert L. McNeil ---- 286
Emerson Electric Co., Richard H. Siemsen, corporate tax director, accompanied by Ramsay D. Potts, counsel ---- 887
Equitable Savings & Loan Association of Portland, Oreg., James W. Scott ---- 1156
Feldstein Martin, president, National Bureau of Research and Economics, Harvard University ---- 687
Foodservice & Lodging Institute, Thomas W. Power, general counsel ---- 510
Fowler, Henry H., former Secretary of the Treasury ---- 446
Foy, Lewis W., chairman of the board of Bethlehem Steel Corp. on behalf of the Iron & Steel Institute ---- 269
Friday, Herschel, on behalf of the Marmon Group ---- 894
Garfield, David, on behalf of the Special Committee for U.S. Exports ---- 285
General Electric Co., Reginald H. Jones, chairman and chief executive officer ---- 736
Giberson, Jack, chief clerk, general land office, State of Texas ---- 1026
Gilbert Jacqueline, on behalf of Virginia Martin, executive director, Parents Without Partners ---- 805
Greenspan, Alan, former Chairman, Council of Economic Advisers ---- 255
Hance, Kenneth G., president, National Realty Committee ---- 1058
Hotel & Restaurant Employees and Bartenders International Union, Robert E. Juliano, legislative representative ---- 506
Independent Petroleum Association of America, Jack Allen, president ---- 910
International City Managers' Association, James F. Marshall, executive director, Assembly of Government Employees ---- 1160
International Council of Shopping Centers, Myles H. Tanenbaum ---- 1061
Investment Company Institute, Edwin S. Cohen, Esq., accompanied by Matthew P. Fink, Esq ---- 487
Iron & Steel Institute, Lewis W. Foy, chairman of the board of Bethlehem Steel Corp ---- 269
Irving Trust Co., Edwin S. Cohen, Esq., accompanied by Herman C. Biegel, Esq., and Carroll J. Savage, Esq ---- 1137
Jenkins, Louis, vice president and controller, Cannon Mills, Inc. on behalf of the American Textile Manufacturers Institute ---- 274

Page

Jones Reginald H., chairman and chief executive officer, General Electric Co — 735
Juliano, Robert E., legislative representative, Hotel & Restaurant Employees and Bartenders International Union — 506
Klineman, Kent M., Klineman Associates, accompanied by Edward Merrigan — 921
Lane, Bruce, on behalf of A. Carleton Dukess, president, National Housing Rehabilitation Association — 1103
Langelier, William J., chairman of the executive committee, Coalition for Low and Moderate Income Building — 1100
Lawrence, George H., president, American Gas Association — 393
Levitt, Arthur, chairman, American Stock Exchange — 651
Lyon, Carl V., senior vice president, Association of American Railroads — 720
McBride, Gardner S., executive vice president, Building Owners and Managers Association International — 1064
McCamant, William C., executive vice president, National Association of Wholesaler-Distributors — 654
McCollam, William, Jr., president, Edison Electric Institute — 279
McDermott, Albert L., Washington representative, American Hotel & Motel Association — 509
McKevitt, James D., National Federation of Independent Businessmen — 649
McNeill, Robert L., on behalf of the Emergency Committee for American Trade — 286
Machinery & Allied Products Institute, Charles I. Derr, senior vice president — 554
Manufacturing Chemists Association, Edward Donley, chairman of the board of Air Products & Chemicals, Inc — 271
Marlan, Duane, administrator, State of Michigan Deferred Compensation Plan and chairman, Ad Hoc Committee of Administrators of State and Local Plans, on behalf of the State of Michigan and the Ad Hoc Committee on Administrators — 1163
Marmon Group, Herschel Friday — 894
Marshall, James F., executive director, Assembly of Governmental Employees — 1160
Monroney, Michael, vice president and director of government relations, TRW, Inc — 1146
Morrison, James, Ad Hoc Committee for an Effective Investment Tax Credit — 557
Moskowitz, Jack, vice president, government relations, United Way of America — 1114
Muller, Robert O., executive director, Council of Vietnam Veterans, Inc — 927
Municipal Finance Officers Association, Carl L. White, finance director of San Antonio, Tex., accompanied by Robert W. Doty, general counsel — 962
Murdoch, Converse, Esq — 1147
Musser, Leon B., National Machine Tool Builders Association — 558
National Association of Counties, James F. Marshall, executive director, Assembly of Governmental Employees — 1160
National Association of Home Builders, James H. Shimberg — 1057
National Association of Manufacturers, Roland M. Bixler, president of JBT Instruments, Inc — 207
National Association of Realtors, Wallace R. Woodbury — 1055
National Association of Wholesaler-Distributors, William C. McCamant, executive vice president — 654
National Conference of State Legislators, James F. Marshall, executive director, Assembly of Governmental Employees — 1160
National Federation of Independent Businessmen, James D. McKevitt — 649
National Food Brokers' Association, Mark M. Singer, president — 653
National Governors' Association, James F. Marshall, executive director, Assembly of Governmental Employees — 1160
National Housing Association, A. Carleton Dukess, president, presented by Bruce Lane — 1103
National League of Cities:
- Mayor David Vann, of Birmingham, Ala., accompanied by Jim White, fiscal adviser to the city of Birmingham — 975
- James F. Marshall, executive director, Assembly of Governmental Employees — 1160

Page

National Machine Tool Builders Association, Leon B. Musser 558
National Oil Jobbers Council, Deane Stewart 648
National Realty Committee, Kenneth G. Hance, president 1058
National Restaurant Association, Robert Neville, Washington counsel, accompanied by Douglas Bennett, special tax counsel 507
National Retail Merchants Association, Donald V. Seibert, chairman 717
National Taxpayers Union, James Dale Davidson, chairman, and Donald Baldwin, assistant to the chairman 433
Neville, Robert, Washington counsel, National Restaurant Association, accompanied by Douglas Bennett, special tax counsel 507
Nordberg, Carl A., Jr., Esq 289
O'Brien, Edward I., president, Securities Industry Association, accompanied by George L. Ball, chairman, tax policy committee, SIA, and president, E. F. Hutton & Co., Inc 823
O'Connell, Daniel K., chairman, Committee for a Uniform Investment Tax Credit 556
Ozan, Paul, assistant general counsel, American Greetings Corp 890
Parents Without Partners, Jacqueline Gilbert, on behalf of Virginia Martin, executive director 807
Payne, Carl, director, Council of State Housing Agencies 1102
Power, Thomas W., general counsel, the Foodservice & Lodging Institute 510
Public Citizen's Tax Refund Research Group, Robert M. Brandon, director, accompanied by Robert McIntyre, staff attorney 752
Public Securities Association, Walter R. Chambers, chairman, accompanied by Arthur J. Kalita, assistant director for regulation 1015
Ralph, Edward H., Delmarva Poultry Industry, Inc 728
Ritter, C. Willis, Esq., Haynes & Miller, Washington, D.C., accompanied by Bruce Coleman, associate, and Karen Ellis, law clerk 982
Scott, James W., on behalf of the Equitable Savings and Loan Association Portland, Oreg 1156
Securities Industry Association, Edward I. O'Brien, president, Accompanied by George L. Ball, chairman, tax policy committee, SIA, and president, E. F. Hutton & Co., Inc 823
Seibert, Donald V., chairman, National Retail Merchants Association 717
Shimberg, James H., on behalf of the National Association of Home Builders 1057
Shull, Leon, on behalf of Americans for Democratic Action 499
Siemsen, Richard H., corporate tax director, Emerson Electric Co., accompanied by Ramsay D. Potts, counsel 887
Singer, Mark M., president, National Food Brokers' Association 653
Small Business Legislative Council, Don DeBolt, chairman 646
Smith, L. G. Skip, office of the State of Texas Comptroller of Public Accounts, on behalf of State of Texas Deferred Compensation Plans 1162
Society of American Florists, Jack Christmas 726
Southwire Co., James Stone, manager of planning and venture analysis 891
Special Committee for U.S. Exports, David Garfield 285
Spiegel, Edward J., Jr., chairman of the board of the Alton Box Board Co., on behalf of the American Paper Institute 272
Stewart, Deane, National Oil Jobbers Council 648
Stone, James, manager of planning and venture analysis, Southwire Co 891
Sugarman, Norman A., Esq., representing the Council of Jewish Federations 1121
Tanenbaum, Myles H., on behalf of the International Council of Shopping Centers 1061
Tax Council, Wallace J. Clarfield 208
Teitell, Conrad, Esq 1113
TRW, Inc., Michael Monroney, vice president and director of government relations 1146
United Way of America, Jack Moskowitz, vice president, government relations 1114
Urie, John M., financial director, city of Kansas City, Mo 1029
U.S. Conference of Mayors, Mayor David Vann, of Birmingham, Ala., accompanied by Jim White, fiscal adviser to the city of Birmingham 975

	Page
Vann, Mayor David, of Birmingham, Ala., on behalf of the National League of Cities and the U.S. Conference of Mayors, accompanied by Jim White, fiscal adviser to the city of Birmingham	975
Weicker, Hon. Lowell P., Jr., a U.S. Senator from the State of Connecticut	635
Weidenbaum, Murray, director, Center for the Study of American Business, Washington University	809
White, Carl L., finance director of San Antonio, Tex., on behalf of the Municipal Finance Officers Association, accompanied by Robert W. Doty, general counsel	962
Woodbury, Wallace R., on behalf of the National Association of Realtors	1055

ADDITIONAL INFORMATION

Committee press releases announcing these hearings	1
Text of the bill H.R. 13511	8
Comparison of changes in the combined income and social security taxes resulting from H.R. 13511 and the alternative compared with 1977 law taxes (table)	145
Statement of Hon. Laurence N. Woodworth, June 15, 1977	158
Chamber tax relief compared with other tax relief (chart)	240
Table submitted by Mr. Fowler:	
Taxation of long-term capital gains under various alternatives (without reference to minimum and maximum tax provisions) on a $5,000 capital gain of a married couple filing jointly	450
Statement on Business Meals, by Senator Paul Laxalt	456
Articles:	
Labor Department Asks Jobs for 200,000 Viet Veterans, by Austin Scott	963
Promises of Jobs Unfilled, Vietnam Veterans Assert, by William Greider	937
Frank Greve—A Legacy of "Lost" Veterans	938
Coleman McCarthy's—Vietnam Vets: Does Congress Finally Understand?	940
Text of the bill, S. 3770	944
Material submitted by Senator Packwood	1168

APPENDIXES

Article: Capital Gains and Carter's Economics by Eugene J. McCarthy	203
Letter from National Association of Manufacturers to Senator Ribicoff with their comments	549
Material submitted by Murray L. Weidenbaum	1033

REVENUE ACT OF 1978

FRIDAY, AUGUST 25, 1978

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

The committee met, pursuant to recess, at 9 a.m. in room 2221, Dirksen Senate Office Building, Hon. Herman Talmadge presiding.

Present: Senators Talmadge, Bentsen, Moynihan, Curtis, Hansen, Dole, and Packwood.

Senator TALMADGE. This hearing will come to order.

This morning we have a panel consisting of Mr. Wallace R. Woodbury, on behalf of the National Association of Realtors; Mr. James H. Shimberg, on behalf of the National Association of Home Builders; Mr. Kenneth G. Hance, Jr., president of the National Realty Committee; Mr. Miles H. Tanenbaum, on behalf of the International Council of Shopping Centers; and Mr. Gardner S. McBride, executive vice president, Building Owners and Managers Association International.

Unfortunately, we will have to limit each witness to 5 minutes of oral testimony, or a total of 25 minutes for this panel. If you desire, you can insert your full statement in the record and summarize it, but not in excess of 5 minutes.

Mr. Woodbury?

STATEMENT OF WALLACE R. WOODBURY ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS

Mr. WOODBURY. Thank you, Mr. Chairman and members of the committee. My name is Wallace R. Woodbury. I am a realtor and attorney from Salt Lake City, Utah, and I am now, and for many years have been, chairman of the Federal Taxation Subcommittee of the National Association of Realtors.

Accompanying me today is Gil Thurm, staff legislative counsel and director of tax programs for the National Association of Realtors. We have filed a written statement for your consideration and appreciate this opportunity to emphasize a few of our major concerns regarding some aspects of the Revenue Act of 1978, H.R. 13511.

One of the better provisions of the House bill is the once-in-a-lifetime election of any taxpayer, regardless of age, to exclude from income up to $100,000 of gain realized upon the sale of his principal residence, if owned and occupied by him for at least 2 of the past 3 years. Such an exclusion would provide sorely-needed relief for middle-income homeowners who need funds during retirement, or for reinvestment in another home. However, the exclusion can be greatly

improved by allowing a homeowner to aggregate such lifetime exclusion of $100,000 among successive principal residences meeting the test. Otherwise, homeowners would have to gamble as to when it would be best to elect this one-shot exclusion.

The House bill also amends IRC 1034(d) to permit a homeowner, who because of a job transfer must move within 18 months of purchasing a new replacement home, to benefit by a tax-deferred rollover of his equity into the ultimate home. We heartily endorse this worthwhile provision.

The National Association of Realtors recognizes the urgent need for lower capital gains taxes to stimulate the economy and increase employment. We are confident that the increased turnover of properties and economic stimulus resulting from such tax rate reductions will prevent any revenue loss. We therefore enthusiastically support proposals to index for inflation the basis of properties in determining taxable gain and proposals to tax only 30 percent of the capital gains, or the Hansen-Steiger proposal to impose a 25-percent maximum tax rate on long-term capital gains.

The House bill takes a step in the right direction by eliminating capital gains from the tax preference items subject to the present minimum tax and providing for indexing of the basis of most capital assets beginning in 1980 to more nearly reflect real gain after adjusting for post-1979 inflation.

On the other hand, the House bill would eliminate the 25-percent alternative capital gains option on the first $50,000 of gain and would impose a new, alternative minimum tax, which would be a true alternative tax and not a surtax, as under the present law. Thus, the House bill falls short of the necessary objectives while acknowledging the need for relief.

Our association favors repeal of the present minimum tax on tax preferences in favor of the type of alternative minimum tax proposed by the House, but expanded to include the other tax preferences. We oppose the House concept of two separate minimum tax rules.

The National Association of Realtors urges Congress to repeal the limitation on investment interest deductions which discriminates unfairly against noncorporate middle-income entrepreneurs and discourages investment. Under the existing rule, coupled with the individual construction interest limitations, the noncorporate taxpayer may not compete with a corporation in terms of rental rates or construction costs or identical new properties.

Moreover, the investment interest limitation is less likely to impact the wealthy who have other investment income to shelter investment interest. The result is particularly devastating in the case of marginal or unsuccessful projects.

With regard to the partnership audit rules, our association opposes linking SEC registration requirements with the extension of the statute of limitations for such audits for an extra year. The question of who is or who is not required to report or register with the SEC would inject a vague, unclear standard into the Tax Code.

We favor other provisions, Mr. Chairman, including an additional new provision. Our association recognizes thrift institutions as major sources for residential mortgage money. To encourage availability of such funds, we again urge Congress to provide an income tax exclusion

for savers for some portion of the interest earned on savings deposits in thrift institutions.

Finally, we urge that the bad debt reserve deductions of such institutions which invest primarily in residential mortgages be eliminated from the list of tax preferences subject to the minimum tax.

Senator TALMADGE. Thank you for a very fine statement.

Senator Packwood?

Senator PACKWOOD. No questions.

Senator TALMADGE. Thank you very much.

Mr. Shimberg?

STATEMENT OF JAMES H. SHIMBERG ON BEHALF OF THE NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. SHIMBERG. Mr. Chairman and members of the committee, my name is James H. Shimberg, and I am a homebuilder from Tampa, Fla. I am testifying today on behalf of the more than 104,000 members of the National Association of Home Builders. Accompanying me are Mr. Robert Bannister, senior staff vice president of NAHB, and Arthur Schreiber of Silverstein & Mullens, NAHB's tax counsel.

We appreciate this opportunity to present our views on H.R. 13511, the Revenue Act of 1978. I will summarize my statement and ask that the full text be entered into the record.

Senator TALMADGE. Without objection, it will be entered into the record.

Mr. SHIMBERG. I would like to stress the importance of this proposal, not only to the Nation's homebuilders, but to that segment of the American public urgently needing housing. It has been stated by some that a reduction and restructuring of the capital gains tax is only of interest and benefit to the very rich. Our appearance here today in support of H.R. 13511 proves to the contrary.

The homebuilding industry is composed of thousands of small businessmen. We cannot be accused of representing the interests, selfish or otherwise, of big business, because we are not big business. NAHB is the representative of over 104,000 small businessmen—yes, sir, we favor a reduction in the rate and method of capital gains tax, primarily because it will help to stem the raging inflation in the cost of housing.

We believe that there is a direct relationship between the capital gains tax and the cost of housing. Ten years ago, raw land comprised no more than 2 to 3 percent of the cost of a new home. Today, with the restricted supply of land, caused, in part, by the unwillingness on the part of owners to sell and pay today's rate of capital gains taxation, raw land has risen to where it represents over 10 percent of the cost of a new home.

I have experienced myself, several times since 1976, the refusal of people to sell land because of not wanting to pay over 40 percent capital gains tax. Nowhere does the lock-in effect produced by the current capital gains tax have a greater impact on the average American than in the relationship between the cost of raw land and the price of a new home.

Some would argue that a reduction in the capital gains tax on the sale of land would not reduce my cost as a builder, but would merely in-

crease the aftertax dollars in the pockets of the landowner. Personally, I do not believe this, because I know that the more tracts of land from which I can choose, the greater the supply, the better my bargaining position, and the lower the price.

In addition to the housing cost-spiral problem, there is an equally severe crisis regarding multifamily housing. The scarcity of new multifamily productions is due to the absence of incentives for the private investor to make a low-yield, high-risk investment.

The Tax Reform Act of 1976 eliminated many of the incentives for real estate investment. While the legislation under consideration here today would not reverse the limits placed on tax incentives by the 1976 act, there are provisions which will encourage housing production. Among the provisions contained in H.R. 13511 which would be beneficial to the homebuilding industry are the reduction of the capital gains rates, the indexing of the basis of certain capital assets, corporate tax rate reductions, the extension of section 167(k), and certain small business tax revisions.

The graduated corporate tax rate would eliminate the inequities facing many of our members operating in corporate form. In addition, the NAHB supports the one-time $100,000 exclusion from capital gains tax of the gain realized from the sale of a home.

We would urge this committee, however, to go beyond the capital gains tax provision in H.R. 13511 as approved by the House. We support the Hansen amendment to reduce the basic capital gains tax to a maximum of 25 percent and, alternatively, we would support the efforts of Chairman Long to reduce the capital gains tax rate to a maximum of 19.5 percent by reducing the taxable portion of the gain from 50 percent to 30 percent.

Before closing, Mr. Chairman, I would like to briefly mention two very important tax issues of concern to NAHB which we hope will be included by the Senate in this bill.

First, we would heartily recommend Senator Harry Byrd's amendment to postpone the application of the carryover basis until December 31, 1979. We were among the people who did not get a totally fresh start on December 31, 1976.

We would also urge the bill introduced by Senator Laxalt, S. 3176, to give the same treatment to gas and electric utilities as to other utility companies in the case of contributions in aid of construction.

Thank you very much for this opportunity to present our views on this vitally important matter.

Senator TALMADGE. Thank you for a very fine statement.

Any questions, Senator Packwood?

Senator PACKWOOD. No questions.

Senator TALMADGE. The next witness is Mr. Kenneth G. Hance, Jr., president, National Realty Committee.

STATEMENT OF KENNETH G. HANCE, JR., PRESIDENT, NATIONAL REALTY COMMITTEE

Mr. HANCE. Thank you, Mr. Chairman and Senator Packwood. My name is Kenneth G. Hance, Jr. I am appearing before the committee today as president of the National Realty Committee, a nonprofit business league whose membership includes owners, operators and

developers of all types of residential, commercial and industrial real estate throughout the United States.

I am accompanied by Bartley F. Fisher of the New York law firm of Robinson, Silverman, Pearce, Aronsohn and Berman, which is tax counsel for the National Realty Committee and by Dr. Norman B. Ture of Washington, D.C., economic consultant to NRC.

Two preliminary matters. First, I request leave of the committee to file a written statement, copies of which have been delivered to the committee, which statement extends our oral testimony.

Senator TALMADGE. It will be inserted in full.

Mr. HANCE. Thank you, Mr. Chairman.

Second, as we have not yet completed our detailed technical and drafting analysis of H.R. 13511, I also request leave of the committee to supply our technical recommendations in a supplementary written statement to be filed within a deadline established by the Committee.[1]

The National Realty Committee is in full agreement with the clear, expressed priorities of the Congress and the administration: The strengthening of the American economy, the stimulation of business investment, and the revitalization of our cities. We applaud the Members of the House of Representatives and of the House Ways and Means Committee for their favorable action on H.R. 13511, as we believe this to be a major positive step in creating a climate conducive to increased business investment and capital formation.

Prospects for continuing vigorous economic expansion are far from certain, however, Inflationary pressures resulting, in part, from the high rate of expansion of the money supply, persistent unemployment and relatively low projected levels of plant and equipment outlays, all imply damped growth in both consumption and saving.

We urge that this economic outlook calls for public policies to reduce impediments to employment and capital formation.

The prospects of rising interest rates and slow growth in real per capita incomes, while adverse for the economy as a whole, are particularly ominous for real estate. Other factors discussed in our written statement suggest that the outlook for America's real estate industry is even cloudier.

We urge this committee to concentrate on those actions which will help achieve the Nation's priority goal of economic growth by building on the strong base afforded by H.R. 13511.

In our written statement filed with the committee, we offer comments on a number of provisions of this bill.

NRC specifically endorses, as of particular importance to the economy, the stimulation of business investment and the revitalization of our Nation's cities, those aspects of H.R. 13511 providing for: Individual and corporate income tax reductions; capital gains tax changes, including the concept of indexing for inflation; continuation and expansion of the investment tax credit; extension of section 167(k) and small business tax revisions.

NRC's policy recommendations for improvement in H.R. 13511 focus on the taxation of capital gains and individual income tax rates. We believe that this committee can, and should, move forward from the base of 13511 to even more effectively help achieve the Nation's priority goals of economic growth, and that this can be accomplished

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[1] Supplementary statement by Mr. Hance appears in part 6.

in a manner which will produce, in fact, increased Federal tax revenues by stimulating business investment.

NRC is on record with this committee as endorsing and supporting the Hansen-Steiger proposal to reduce the present tax burden on capital gains.

We wish to take this opportunity to again express our appreciation to Senator Hansen, together with his colleagues on this committee and in the full Senate and Congressman Steiger and his House colleagues for the initiative in putting forth this sound and constructive proposal.

In recent weeks, Chairman Long of this committee has advocated publicly a number of the concepts which were contained in President John Kennedy's 1963 tax message to the Congress. We believe this approach also has exceptional merit, and would provide a needed stimulus for savings and investment.

As the members of this committee are aware, NRC makes use of an econometric real estate tax impact model developed for use by the respected economist, Dr. Norman Ture. Presented in our written statement, and in the appendix to that statement, are the economic and Federal revenue effects on the real estate sector of the economy, of three alternative proposals, estimated through the use of the real estate tax impact model. In each case, the model evaluates the effect of the proposal on real estate investment, GNP originating in real estate, real estate related employment, and Federal tax revenues originating in real estate.

The three alternative proposals are: H.R. 13511 as passed; H.R. 13511 modified to include the Hansen-Steiger capital gains approach; and H.R. 13511 as passed, modified to provide that 30 percent of net capital gains be included in taxable income with the excluded 70 percent subject to the alternative minimum tax on capital gains at a tax rate of 10 percent and a reduction of individual marginal rates to 65 percent from the present 70 percent.

As is evident from this analysis, each of these alternatives would have significant positive effects on real estate investment, the creation of jobs and GNP originating in real estate. Most importantly, each of these proposals would cause an increase in Federal tax revenues originating in real estate.

The analysis indicates that the third proposal, identified as the modified Kennedy proposal, would produce the largest stimulus to real estate investment and the economy generally—in the first year alone, increasing real estate investment by $26.7 billion, GNP originatnig in real estate by $32.2 billion, real estate related employment by 754,000 jobs, and tax revenues originating in real estate by $3.2 billion.

In summary, Mr. Chairman, we urge that this committee act favorably on H.R. 13511 as passed by the House, modified to include the concepts of the so-called modified Kennedy proposal: that 30 percent of gain be included in taxable income with the excluded 70 percent subject to the alternative minimum tax on capital gains at a tax rate of 10 percent as provided in H.R. 13511, and a reduction in the marginal tax rates.

Adoption of this recommendation would not only extend needed relief from the heavy burden of capital gains taxation to taxpayers across a broad income spectrum, but also would produce positive

economic and revenue effects on real estate investment and, through it, the Nation's economy.

Thank you, Mr. Chairman.

Senator TALMADGE. I hate to call time on you, but as you know, we are limited.

I notice in your tables that real estate represents 12 to 13 percent of the total GNP of the country. Is that right?

Mr. HANCE. The figures for 1976, the most recent available as set forth in our statement, are that it is approximately 12 percent, yes, sir.

Senator TALMADGE. I beg your pardon?

Mr. HANCE. The——

Senator TALMADGE. I am looking at table A where you say that real estate represents about 12.2 percent of the total GNP.

Mr. HANCE. Yes. That is correct, Mr. Chairman.

Senator TALMADGE. Thank you.

Senator Packwood?

Senator PACKWOOD. No questions.

Senator TALMADGE. Senator Dole?

Senator DOLE. No questions.

Senator TALMADGE. Thank you very much for a very fine statement.

The next witness is Mr. Miles H. Tanenbaum on behalf of the International Council of Shopping Centers. Your entire statement will be be inserted in the record, Mr. Tanenbaum, and please summarize it in 5 minutes or less.

Mr. TANENBAUM. Yes. Thank you, sir.

STATEMENT OF MYLES H. TANENBAUM ON BEHALF OF INTERNATIONAL COUNCIL OF SHOPPING CENTERS

Mr. TANENBAUM. Mr. Chairman and members of the committee, my name is Miles Tanenbaum. I am executive vice president of Krafco, Inc., King of Prussia, Pa., a developer and manager of shopping centers. With me is Edward C. Maeder, of the law firm of Winston and Strawn.

The message I deliver this morning concerns this Nation's recent participation in an experiment in basic economics. It began in 1969 or earlier with a series of tax law changes that altered the Nation's economic balance, At that time, the United States had the most vibrant economy in the world. The dollar was sound the world around and there was excellent growth in our gross national product and employment.

While there were concerns about inflation and high interest rates, we did not realize then how well off we were.

Our tax law changes, not surprising, were motivated by laudable intentions. We wanted to help those less well off. What we failed to realize, however, was that it was the size of the economic pie and not the dimension of the slice which bears most importantly on the well-being of everyone in the economy and that this well-motivated legislation reduced the size of the pie for everyone.

How? Well, it goes back to basic economics. Take, for example, the 1969 increase in the maximum effective capital gains rate to over

40 percent, which was an overnight tax increase of over 60 percent. Subsequent legislation raised the maximum rate to over 49 percent, a virtual doubling of that rate since 1969.

An investor with a 35-percent tax rate having a $1,000 gain would pay $350 in cash to convert his remaining $650 into a new venture. If the new venture were successful to the point of providing a 60-percent yield, the resultant $1,030 would represent a mere $30 increase in his capital pool as a reward for the new venture risk.

Obviously, many potential investors have made this calculation and responded by saying "no way." They are unwilling to pay an unreasonably high capital gains tax to divert capital from an existing investment to a new venture, particularly where the reward—if, indeed, the new venture risk is rewarded—would be subjected to high taxation.

Investors having freedom of choice have judged the aftertax reward for success not worth the risk of loss in the tax erosion of their capital. Investors are simultaneously locked in and locked out and new enterprise is the loser.

So, our economy has grown slower. Manpower productivity, lacking new investment, has trailed other nations, and we have suffered inflation, higher unemployment, a weakened dollar and a crisis mentality in regard to our economy.

When other changes in the tax law are considered, the problem is compounded, as is the case in the shopping center industry. Tax legislation since 1963 has resulted in a serious capital drain for developers.

They no longer have double declining balance for depreciation. Construction period interest and taxes are now written off over a lengthy period of years. Gains are taxed as ordinary income to the extent of previously claimed accelerated depreciation. Capital gains rates have virtually doubled. The 15-percent minimum tax is now levied on so-called tax preferences and deductions for ordinary mortgage interest have been severely curtailed. Only the Treasury knows the amount of capital drain, but surely it is well over $1 billion annually, and is it any wonder why this once robust industry has a severe capital shortage?

Perhaps of greatest concern are the implications for the future of private enterprise. The real estate developer exemplified the American entrepreneur, historically. People of little means were able to enter this industry. They conducted their business affairs out of their homes, skillfully employed borrowed capital and pyramided their early success into expanded development.

They prospered, as did the Nation. They provided employment. They developed property, which became the foundation of local taxation, and they created the structures in which commerce and industry is conducted and our Nation's families are housed.

Real estate became the Nation's third largest industry.

What lies ahead? From the standpoint of the carrot, it is obvious that the aftertax reward is not what it was. More important from the standpoint of one's ability to get started, inflation and high tax rates have combined to increase the initial risk capital required.

Looking ahead, those in business will face less competition from new arrivals. The real estate industry will be converted from one having a large number of small units to one having a small number of

large units, and from the standpoint of the economic and political well-being of this Nation, that is not healthy.

The question, therefore, is why persist in such a course? The unfortunate steps begun in the sixties have created a malaise described as a shortage of investment capital, and now this Nation's leadership is focusing on capital formation as a major problem to be solved.

Well, there is no shortage. It is all there, but it is locked up tightly, and no one is going to unlock it. Is it not simply time to recognize that the problem can be solved by erasing the legislation which caused it? We call on Congress to recognize the need for a substantially lower tax on capital gains, to provide investment credit for real estate development, to liberalize depreciation deductions and to permit a full current deduction for investment interest and construction period interest.

Senator TALMADGE. Thank you, Mr. Tanenbaum.

Any questions, Senator Bentsen?

Senator BENTSEN. No questions.

Senator TALMADGE. Any questions, Senator Packwood?

Senator PACKWOOD. No questions.

Senator TALMADGE. Senator Dole?

Senator DOLE. I was going to ask what you would suggest?

Mr. TANENBAUM. Right.

Senator DOLE. Are there others than the three you just mentioned?

Mr. TANENBAUM. Well, there are four, sir. The most basic, from the standpoint of the larger impact, is the capital gains tax. Projects and money are tied up. We have difficulty, in our company and others in our industry, in acquiring the kind of capital that is needed for these projects because people are concerned about the cost of getting out of existing investments. The penalty is too high.

Construction period interest is an important factor, but there is something that is in the tax law that has most people confused. It is the investor interest concept that is creating larger and larger taxes on people holding property where their tax actually is on income that they are not realizing in cash. They are denied deductions of interest that is actually spent, laid out.

Those are the primary areas of our concern.

Senator DOLE. Thank you. I have no other questions.

Senator TALMADGE. Senator Bentsen?

Senator BENTSEN. You touched an open nerve when you started talking about the deductibility of interest. It is a matter of concern to me to what is happening in this country.

Generally, when they talk about limiting interest deductions, they really do not bother the fellow who has substantial income coming in. That is not the person they strike. But the person they strike is that one that is trying to bootstrap his way up. That is willing to incur the obligations, borrow to the hilt, take the gamble, take the risk, and build whatever enterpreneurial project your are talking about.

So if that was the tenor of your testimony—and I am sorry I was in Public Works Committee earlier and did not have a chance to hear it—but I am very sympathetic to that particular problem and want to see what we can accomplish in trying to alleviate it some.

Mr. TANENBAUM. Thank you, Senator.

Senator TALMADGE. The next witness on this panel is Mr. Gardner S. McBride, executive vice president, Building Owners and Managers Association International.

Mr. McBride, you may insert your full statement in the record and summarize it in the 5 minutes that is left.

STATEMENT OF GARDNER S. McBRIDE, EXECUTIVE VICE PRESIDENT, BUILDING OWNERS AND MANAGERS ASSOCIATION INTERNATIONAL

Mr. McBRIDE. Thank you very much, Senator Talmadge, Senator Bentsen, Senator Packwood, Senator Dole. I appreciate very much this opportunity to appear before you.

I am the executive vice president of the Building Owners and Managers Association. Our association represents about one-half billion square feet of commercial office space, the majority of the prime office space in America. About 70 percent of it is located in cities. It is the key space for expansion of the service sector of the economy, and our office space has been going through some difficult times in the last 6 years.

Since World War II and beginning in about 1947, you had the development of the first modern office building, from 1947 until the last 6 years, vacancy rates never got above 10 percent. In other words, you had 90 percent occupancy or more.

In the last 6 years, we have gotten as low as 86 percent occupancy, and this has caused real problems for people investing in office buildings.

Now, additional problems have hit us as well. Among them, rising utility rates have put more burden on the office building. There has been the imposition of differential tax rates. The cities, in trying to survive, have put a pressure on the office buildings to pay a little more than the average resident.

All of these things have combined to create some real difficulties for our industry, and we are just beginning to get out of it. The office staff cutbacks that took place after the OPEC oil embargo are just beginning to be overcome by the expansion of the economy and people are expanding their office forces. We are finding occupany rising again, but we also find that we have historically low margins and depressed rents.

And so there are two portions of the House bill that we feel are very, very important if we are going to see real investment dollars flow to the office building industry. First is the investment credit area, and second is the capital gains area.

In the investment credit area we find that the 10 percent investment credit being offered for renovation is terrifically helpful, but that its impact is going to be kind of artificial.

What we really need is to have the 10-percent investment credit extended to all construction. The credit should be given for construction activity whether it is renovation or not—both new and old construction—so we get away from the artificial kinds of questions such as whether or not replacement of 75 percent of a wall represents new construction or not. We need to really extend the investment tax credit

wholeheartedly to all construction if we are going to have orderly progress in office building construction, This is particularly true if we are going to avoid having the older cities lose new construction. Otherwise all of their investment dollars could end up in renovation and with none of their investment dollars going for the modern, efficient, and clean office space with wide bays that is in demand in the office building industry today.

Currently, we find that there are a terrific number of code changes and new codes that are impacting us right now. Thousands, even millions, of dollars are required by such code provisions in some properties. An example is New York City's fire law 5. Another example is the demand for the changes under the handicap codes where you have to take away from rentable square feet in order to put in an extra toilet or do other things to benefit the handicapped. Certainly this is something that is in the public interest, and we agree. However, such changes take away rentable square feet and cut your margin. In consequence, it is difficult to make buildings meet these standards while maintaining economic viability.

To encourage building owners to meet these code requirements we recommend that you grant an additional investment credit for mandated code changes; that is, where building owners have no choice but to make the investment, but where there is no way to get the investment back.

It would seem fair to give the additional investment credit for mandated code changes such as the fire law, handicap and life safety areas that are hitting us pretty hard.

The second area we are concerned with is capital gains. Here BOMA International would like to see the Hansen proposal added.

We also feel rather strongly about one other thing, and that is that the small investor should still get a chance to have a little piece of the pie through the alternative tax of 25 percent on the first $50,000 of capital gain that is taken away from him by the bill.

We are not anxious to see the office building industry fall into the hands of just a few developers. We would like to see the office building industry be able to attract investment from many sources. And if you are not going to lower capital gains effectively to 25 percent for everybody, please leave in the 25-percent limit for the small investor. We do not really think it is fair to take away that slice of the pie from him just when he is getting to the point where he recognizes office buildings as a good investment.

I appreciate very much the opportunity to testify before your committee. Our written statement contains many other points, but these are very important to us.

Thank you, gentlemen.

Senator TALMADGE. Thank you, Mr. McBride.

Senator Bentsen, any questions?

Senator BENTSEN. No questions.

Senator TALMADGE. Senator Dole?

Senator DOLE. There is a current provision in the law for a deduction providing certain building improvements for the handicapped?

Mr. McBRIDE. Yes; there is some help, and we have published the full IRS regulations in our newsletter recently just so everybody would know what they had to do and what they did not have to do.

They are a little more difficult to comply with. I direct your attention, Senator Dole, to the fact that the General Services Administration found it necessary to ask for exceptions to the promulgated standards because they could not figure out ways to meet them at times, and so we miss a lot of those deductions, simply because they are not practical.

They may be laudatory, but they do not work. And so the incentive really is kind of illusionary. It does not come to everybody.

Senator DOLE. Accessibility is important if you are in a wheelchair.

Mr. MCBRIDE. One of the past presidents, two terms ago, of our association is in a wheelchair—Donald Sheridan of Chicago, Ill. You may have met him, may know him. Donald Sheridan is among those that says we have to take care of people in wheelchairs.

My goodness, when he goes to visit another office building, he is in a wheelchair. We agree with him that the handicapped have to be taken care of.

What we are asking for is some assistance since we get no offsetting income for the investment we have to make to meet these code standards. It is tough enough to come up with at-risk dollars, and when you take away rentable square feet, which is our only source of getting capital, and you do not give us any offsetting income whatsoever, we need some sort of help.

Senator DOLE. We are having trouble with our office building, too.

Senator TALMADGE. Thank you, gentlemen, for a very fine presentation.

[The prepared statements of the preceding panel follow:]

STATEMENT OF WALLACE R. WOODBURY, CHAIRMAN OF THE REALTORS FEDERAL TAXATION SUBCOMMITTEE, ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS

Mr. Chairman and members of the Committee; my name is Wallace R. Woodbury. I am a Realtor from Salt Lake City, Utah and I am now, and for a number of years have been, Chairman of the Federal Taxation Subcommittee of the National Association of Realtors . Accompanying me today is Gil Thurm, Staff Legislative Counsel and Director of Tax Programs for the National Association of Realtors. We welcome and appreciate this opportunity to present the following statement concerning the Revenue Act of 1978, H.R. 13511.

The National Association of Realtors is comprised of 50 state Associations, and more than 1,720 local boards of Realtors located in every state of the Union, the District of Columbia, and Puerto Rico. Combined membership of these boards is in excess of 600,000 persons actively engaged in sales, brokerage, management, counseling, and appraisal of residential, commercial, industrial, recreational, and farm real estate. The activities of the Association's membership involve all aspects of the real estate industry, such as mortgage banking, home building, and commercial and residential real estate development, including development, construction, and sales of condominiums. The Association has the largest membership of any association in the United States concerned with all facets of the real estate industry.

I. TAX RELIEF FOR HOMEOWNERS

One of the major provisions in the House bill is the expansion of Section 121 of the Internal Revenue Code ("the Code") to permit any taxpayer regardless of age to elect once in his or her lifetime to exclude from income up to $100,000 of gain upon the sale of a principal residence.

Presently, Section 121 of the Code alows an exclusion for an individual, age 65 or older, of any gain attributable to the first $35,000 of sales price realized on the sale of a residence. In order to qualify for the exclusion, the individual must own and use the property sold as his or her principal residence for at least five years during the eight-year period preceding the sale. This provision was intended to help homeowners of retirement age who no longer had their children with them

and who wished to move to a smaller home or rental apartment. In many cases such homeowners were discouraged from moving because of the taxable gain (largely resulting from inflation) which would be realized upon the sale of their present residence.

While the purpose of the present Section 121 of the Code is laudable, the changes made by the House bill are needed to make the relief provided truly effective. The House bill expands the amount of excludible gain to $100,000 in recognition of present high real estate prices which reflect inflation and not any real gain. The House bill also reduces the residency requirement to ownership and occupancy for at least two years out of the three-year period preceding the sale. This lower residency requirement should enable more taxpayers in our mobile society to qualify for the exclusion.

Finally the House bill removes the age requirement of present Section 121. This change is desirable for three reasons: first, many people are retiring prior to age 65; second, children often move out several years before their parents' retirement and hence their parents have no need to wait until retirement before selling their present large home; and third, because of some technicalities an individual is sometimes not able to take advantage of the provisions for a tax-free rollover of his home (Section 1034 of the Code), and such an individual should be provided some alternative method to protect his investment in a home from being eaten up by income taxes.

The National Association of Realtors enthusiastically supports the proposed $100,000 exclusion for the gain on the sale of a home. It would provide sorely needed relief to middle-income taxpayers by allowing a homeowner to free funds needed for retirement or to protect funds needed for a reinvestment in a home when the rollover provision can not be used. Further, the House provision can and should be improved to provide needed relief to the owners of our Nation's 48 million owner-occupied homes. In some cases a homeowner who cannot qualify under the rollover provision but who intends to acquire a new home later will be faced with a hard decision—whether to elect to exclude a small gain now or wait until a later sale when the gain could be larger. For example, a homeowner may not be able to replace immediately a home sold for a $20,000 gain. In effect under the House bill the homeowner must gamble on whether the immediate use of the exclusion on $20,000 would provide a greater benefit than a later use in view of the uncertainty as to the size and even as to the realization of any later gain.

The House provision can be amended to remove the necessity of gambling with money needed to acquire a new home. For instance, a homeowner could be allowed a lifetime exclusion of $100,000 which could be taken with respect to one or more sales to the extent that the rollover provision was not applicable. Thus, in the example above the owner could safely use $20,000 of his life time exclusion knowing that he would not forfeit the later use of the remaining $80,000 of the exclusion.

The National Association of Realtors® strongly supports the proposed $100,000 exclusion but believes that the provision could be rendered even more effective, if the $100,000 lifetime exclusion could be used cumulatively with respect to more than one sale.

II. REVISION OF ROLLOVER PROVISION

One of the many overly technical requirements in the provision allowing a tax-free rollover of homes (Section 1034 of the Code) would be ameliorated by the House bill. Presently if a taxpayer sells his principal residence twice within a 18-month period, he must pay taxes on any gain realized upon the second sale. (In such situations the taxpayer is treated as rolling over his investment in his first home directly into the home bought to replace the second home.) The House provision would allow such a taxpayer to roll over tax-free more than one home in an 18-month period *if* the later home sale was made in connection with a job relocation. Homeowners who must move because of a job transfer or the acceptance of a new job in a different city should not be penalized because they could not live in the same house for 18 months.

The National Association of Realtors® supports the revision proposed by the House in the rollover provisions.

III. OTHER CAPITAL GAINS PROVISIONS

There is a growing conviction throughout this Nation that lower capital gains taxes are necessary to return our economy to a prosperous state. Contrary to the

Treasury Department's predictions of revenue loss, our Association firmly believes that lower capital gainst taxes will increase the number of taxable transactions, encourage capital formation and employment, and result ultimately in greater prosperity and revenue gain.

Several different proposals have been made this year regarding ways to reduce the present maximum effective tax rate of 49.1 percent on capital gains. We urge enactment of the Hansen proposal (S. 3065 joined in by 60 other Senators) similar to Congressman Steiger's proposal which would set a maximum long-term capital gains rate of 25 percent and exclude capital gains from any minimum tax. We would also favor the approach of taxing only 30 percent of long-term capital gains combined with indexing of inflation impact and exclusion for any minimum tax and related provisions.

The House bill (H.R. 13511) takes a step in the right direction by eliminating capital gains from the tax preference items subject to the present minimum tax, and providing for indexing of the basis of most capital assets (beginning in 1980) to more nearly reflect "real gain" after adjusting for post-1979 inflation. On the other hand, the House bill would eliminate the 25 percent alternative capital gains option on first $50,000 of gain, and would impose a new alternative minimum tax which would be a true alternative tax and not a surtax as under the present law.

The National Association of Realtors® urges the Congress to retain the indexing provision passed by the House but to enact much more significant capital gains tax cuts along the lines proposed by S. 3065 or by limiting taxable gain to 30 percent of total long-term capital gain. At the very least, if the maximum effective rate of tax is set above 25 percent, it is crucial that the existing 25 percent alternative tax be preserved in order to prevent an unjustified increase in taxes on many small investors. It would also seem wise to eliminate the complication of a second minimum tax rule by applying only the new *"alternative* minimum tax" to all items of tax preference.

IV. INVESTMENT INTEREST DEDUCTION LIMITATION

The Tax Reform Act of 1976 imposed a strict limitation against the individual taxpayer's deduction of investment interest over $10,000 plus the amount of the taxpayer's net investment income. This provision has discouraged equity investments in risk enterprises. The House bill unfortunately does not address the problems caused by the interest deduction limitation even though it generally recognizes the need to encourage risk taking by lowering capital gains taxes on successful ventures. Removing tax penalties placed on unsuccessful ventures is merely the other side of the same coin.

The investment interest deduction limitation was intended to curb so-called "tax shelter" arrangements set up to produce losses. However, it also adversely affects legitimate investments which have turned bad contrary to the investors' expectation. The effect of the provision on such investors (if they have other income) is to require them to pay taxes on their real losses. Interest is not a paper deduction; it is a cash expense and the rule applies not only to investment interest but to interest on many "business income" properties. Requiring an investor to pay taxes on unrecovered cash expenses merely increases the size of the loss suffered. And, of course, increasing the size of a possible loss discourages investment and risk taking.

The individual investment interest deduction limitation coupled with other 1976 changes such as the noncorporate construction period interest rules discriminates unfairly against noncorporate real estate developers and investors. Moreover, the limitation of $10,000 plus net investment income discriminates primarily against small investors who do not have other investment income. The wealthy investor, on the other hand, may have virtually no such deduction limitation since he can offset all his investment interest expenses against income from his other investments. Hence, this provision discriminates against the small and middle-income investor and in favor of the wealthy.

The Natonal Association of Realtors® urges Congress to repeal the discriminatory limitation on investment interest deductions by non-corporate taxpayers, so as to apply a uniform rule to all taxpayers in regard to interest deductibility.

V. PARTNERSHIP PROVISIONS

The Carter Administration initially advocated many so-called "tax reform" proposals aimed at business, which in general took a meat six approach to needed investment incentives. The House Ways and Means Committee wisely rejected

as unsound substantive proposals which would discourage investment at a time when the economy demands more capital formation to solve problems of unemployment and low productivity. The Ways and Means Committee did however approve a provision affecting the procedural aspects of partnership taxation. This provision in its present form is unclear and unfair and should not be approved.

The House bill amends the Code to allow the IRS an extra year (4 years in all after a return is filed) to assess a deficiency attributable to partnership items. This extension of the statute of limitations would apply only to partnership items attributable to a "federally registered partnership", *that is a partnership required to report annually to the Securities and Exchange Commission (SEC) or required to register an offering of partnership interests with the SEC.*

The partnership provision is unclear because it applies not only to partnerships registering and reporting with the SEC but partnerships which should register and report. The SEC rules on this matter are often not clear even to an experienced securities attorney, and the use of vague standards will increase the legal problems and costs particularly for small partnership which resolves a doubtful question of securities law in favor of registration or reporting will clearly be subject to the longer statute of limitations. The partnership which decides against registration or reporting can still argue that the longer statute of limitations does not apply to it. The aim of the securities law is full disclosure, but this goal will be frustrated by adding greater exposure to tax liability to the already onerous financial burden of registering and reporting. Our Association joins the Treasury Department in objecting to a tie-in between the statute of limitations extension and SEC registration and reporting requirements.

During the first round of mark-up sessions, the Ways and Means Committee approved a similar extension of the statute of limitations which would apply only to partnerships with 100 or more partners (including by attribution partners in partnerships holding an interest in the original partnership). The 100 partners rule is far more simple and objective than the SEC registration rule, and it would insure that the extension of the statute of limitations would only apply to those large partnerships which the IRS claims that it has difficulty in auditing.

The SEC registration rule was substituted for the originally approved version after only cursory consideration by the Ways and Means Committee. It was apparently believed that the 100 partner rule would affect large legal and accounting firms although the original intent was to affect only investment partnerships. If necessary, the 100 partner rule could be amended specifically to exclude partnerships in which the personal services of the partners are a material income-producing factor (a standard used elsehwere in the Code). This approach unlike the version in the House bill would establish a clear-cut standard familiar to tax practitioners and the Internal Revenue Service.

The Carter Administration is apparently not satisfied with the partnership provisions approved by the House and has asked this Committee to adopt a provision similar to its original proposal. This original proposal contained provisions for determining an indvidual partner's tax liability through administrative and judicial proceedings conducted at the partnership level. Although each individual partner could theoretically "participate" in the proceedings, the proposal was unclear and seemed to indicate that an individual partner would be bound by the actions of the general partner or other partners even though he may disagree. Thus a partner could be prohibited from protecting his own individual interest in the manner he thinks to be best.

The National Association of Realtors® opposes the proposal linking the extension of the statute limitations with SEC registration and reporting. Our Association also opposes the Administration's original proposal which unduly infringed on the rights of individual partners to act in their own interest.

VI. POLITICAL CONTRIBUTIONS DEDUCTION

Another one of the unsound "reforms" accepted by the House as part of its bill is the proposed elimination of the deduction (but not the tax credit) for political contributions. Under present law, an individual may either deduct political contributions up to $100 ($200 on a joint return) or take an income tax credit of one-half of such contributions up to $25 ($50 on a joint return). Elimination of the deduction would discourage the participation of taxpayers in the political process. This is precisely the opposite result of what is desired. Congress and the public have been focusing on the need for more participation by

the general public in the election process. Encouraging more individual contributions is a vital part of this effort.

The National Association of Realtors® urges Congress to retain the deduction for political contributions.

VII. INVESTMENT TAX CREDIT FOR REHABILITATION

The National Association of Realtors® supports the provision approved by the House allowing an investment tax credit for expenses incurred in rehabilitating nonresidential structures such as factories, office buildings and stores. This extension of the investment tax credit is necessary to reverse the declining usefulness of existing older buildings in central cities and older neighborhoods of all communities. The credit should promote greater stability in older areas by encouraging urban revitalization.

VIII. AMORTIZATION OF LOW INCOME HOUSING

The National Association of Realtors® supports the extension through 1981 of the special 5-year amortization rule, Section 167(k), for expenditures to rehabilitate low-income rental housing. This provision has encouraged significant rehabilitation of rental units, but the extension is necessary to encourage further upgrading of deteriorating neighborhoods and difficult-to-finance housing units available to low-income families.

IX. SMALL BUSINESS PROVISIONS

The House bill contains several provisions intended to benefit small businesses by increasing to 15 the permissible number of shareholders in a Subchapter S corporation, by simplifying the Subchapter S election, by increasing first-year depreciation for small businesses, and by increasing the amount of ordinary loss which can be claimed with respect to stock in a small business. The National Association of Realtors® supports these proposals. In addition, the Association urges Congress further to simplify Subchapter S by eliminating the passive income test. The existing test unfairly discriminates against small real estate businesses by prohibiting the use of the Subchapter S corporation as an investment vehicle.

X. SAVINGS EXCLUSION AND THRIFT INSTITUTIONS

The National Association of Realtors® has previously proposed an income tax exclusion of some portion of interest earned on savings deposits in thrift institutions. Our Association urges that this proposal should be a part of any tax bill passed this year. Such an exclusion would protect the integrity of saving deposits by not taxing fully higher interest rates reflecting inflation. Further. an exclusion would encourage savings in thrift institutions. The increased flow of funds into such institutions and hence into home mortgages could reduce interest rates on home mortgages.

Similarly we urge that bad debt reserve deductions of thrift institutions be excluded from the impact of the tax perference surtax.

Thank you for the opportunity to present our views. We will be pleased to respond to any questions the Committee may have.

STATEMENT OF THE NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. Chairman and Members of the Committee:

My name is James H. Shimberg and I am a home builder from Tampa, Florida. I am testifying today on behalf of the more than 103,000 members of the National Association of Home Builders (NAHB) a trade association of the nation's home building industry. Accompanying me today are Robert D Bannister, Senior Staff Vice President, and Arthur Schreiber, of Silverstein and Mullens, NAHB's tax counsel.

We appreciate this opportunity to present our views on various provisions contained in H.R. 13511 and to bring to your attention additional matters that are of particular interest to the nation's home builders.

The principal concern of home builders is the maintenance of an adequate level of housing production, including rental housing, to meet the national housing goal reaffirmed by Congress in 1969 of "a decent home and suitable

living environment for every American family." We have fallen far short of the production necessary to meet the target envisioned by Congress of 26 million new or substantially rehabilitated housing units by the end of 1978. The principal factor in our failure to achieve that goal is the recurring cycle of inflation, recession and high interest rates.

Inflation impacts the home building industry more than it does all other industries. The housing industry is always the first to suffer the effects of government actions to control inflation by tightening of the money supply.

A major stumbling block in providing adequate housing for all Americans is the housing cost spiral. The median sales price of a new single family home has increased from $32,000 in 1973 to $57,300 in June 1978. Between April and June alone the median price increased $4,200. These unprecedented increases will eliminate large numbers of families, particularly first-time buyers, from the home buying marketplace.

A recent study commissioned by the California Building Industry Association (CBIA) concluded that almost one-half (48.5%) of all California families cannot afford to buy a new home without substantial sacrifice. The study established that for every $1,000 increase in the price of the least expensive houses ($37,500) approximately 100,000 families are effectively priced out of the market.

Even though personal income is at an all time high, the cost of housing continues to outstrip any gains that the individual realizes in income. This cannot be allowed to continue. One provision of H.R. 13511 that could help is the cut in capital gains rates. I will, later in my testimony, fully discuss this topic, but I would like to briefly show how a cut could aid in slowing the rising cost of housing.

Since the average price for ¼ acre lots for new homes is currently above $13,000, it is not hard to see how even smaller land transactions can produce enough capital gains to subject land owners to the minimum tax. If a land owner is in a high tax bracket to begin with, his effective capital gains tax rate could be nearly 50 percent. By amending the law in the way proposed in H.R. 13511, NAHB believes that investors will be spurred to put more undeveloped land on the market, thus moderating price increases by expanding the supply of land. Since land is a basic element of housing costs, actions that are taken to moderate land price increases will benefit all Americans seeking to buy a new home.

Another issue of grave concern to NAHB is capital formation because it is one of the greatest problems facing American business and industry. There is simply not enough money available for investment, which has prevented American industry from modernizing its plants and equipment, has resulted in a high unemployment rate in several basic industries, and its ripple effect has caused deterioration of many cities and towns plagued by abandoned or partially used plants.

We urge this Committee to consider, that in order to stimulate economic growth, tax policies must be structured in such a way as to stimulate capital formation. A cut in the capital gains rate is very definitely a step in the right direction in that more capital would be available for investment in plants and equipment. While the primary beneficiaries of capital formation would be business and industry, the housing industry would also benefit because its success is directly related to increased productivity and employment, which, in turn, creates greater housing demand.

Housing also suffers because of the lack of funds available, especially in the area of multi-family construction. The multi-family housing sector relies heavily on outside investors. NAHB realizes that this is not a focus of these hearings but we would like to see the tax incentives for multi-family housing eliminated by the Tax Reform Act of 1976 reenacted. Tax law through 1976 encouraged the production of housing, particularly multi-family housing, by providing tax incentives for those willing to make a low yield, high risk investment.

The Tax Reform Act of 1976 eliminated virtually all incentives for real estate investment. One result of the changes in the tax law has been an increase in the conversion of multi-family rental projects to condominium and cooperative ownership projects, often priced beyond the means of moderate income families. In many cities this has caused a drastic decrease in the availability of rental housing. While multi-family starts are currently high, they have not reached levels sufficient to provide needed rental housing which was not built between 1974 and 1976.

While the legislation under consideration would not reverse the limits placed on tax incentives by the 1976 Act, there are other provisions which will en-

courage housing production and the general economy. Among the provisions contained in H.R. 13511 which would be beneficial to home builders are the reduction in capital gains rates, the indexing of the basis of certain capital assets, corporate tax rate reductions, the extension of section 167(k) providing for a five-year amortization of rehabilitation expenditures for low income housing and small business tax revisions. In addition, NAHB supports the one-time exclusion from capital gains tax rates the gain realized from the sale of a home.

I would now like to comment upon several of the specific provisions of H.R. 13511 which would affect the home building industry. Such provisions are as follows:

1. *Reduction in Capital Gains Rate*—We strongly support the concept underlying the proposed reduction in the maximum capital gains rate provided by the Bill through eliminating capital gains from the existing 15 percent minimum tax. The home building industry has been adversely affected by the high capital gains rate under existing law.

We believe that the present capital gains tax encourages land owners to hold their land off the market until they can obtain a better price in order to compensate for the high capital gains tax they will have to pay on a sale of such land. Thus, the "lock-in" effect produced by the existing tax on capital gains has directly contributed to the tremendous increase in land prices which in turn has contributed to the skyrocketing cost of new housing.

In view of this, we urge the Committee to go beyond the provision in H.R. 13511 approved by the House and also reduce the basic capital gains tax rate. We have supported the approach embodied in H.R. 12111 and S. 3065, the Steiger-Hansen Amendment, to reduce the basic capital gains tax rate to a maximum 25 percent (as well as elimination of capital gains as an item of tax preference subject to the minimum tax, which is the approach embodied in H.R. 13511.) Alternatively, we would support the efforts of Chairman Long to reduce the capital gains tax rate to a maximum of 19.5 percent by reducing the taxable portion of capital gains from 50 percent to 30 percent. We believe that such reduction in the maximum capital gains tax rate is necessary in order to moderate the sharp increases in housing prices that our industry has experienced in this decade. Such reduction would encourage investors to place more undeveloped land on the market, thereby expanding the supply of land for construction and in turn bring down the cost of such land to our members. Thus, since land cost is a major element in determining the cost of new housing, a reduction in the maximum capital gains tax rate would, by making available more land and moderating increases in the price thereof, benefit all Americans seeking to purchase a new home at more affordable prices. Moreover, the increased housing production resulting from an expanded supply will have a positive impact upon our nation's economy and should increase federal income tax revenues.

Accordingly, NAHB strongly recommends that this Committee amend H.R. 13511 to add a reduction in the maximum gains tax rate to either 25 percent as provided in S. 3065 or 19.5 percent as suggested by Chairman Long.

2. *Indexing of Basis of Certain Capital Assets*—NAHB strongly supports enactment of the provision for an inflation adjustment (or indexing) to the basis of real estate constituting capital assets used in a trade or business and held for more than one year, for purposes of determining gain or loss on the sale of such assets. NAHB has on numerous occasions testified before this Committee that a substantial portion of the purported "gain" on the disposition of real estate, including multi-family rental real estate, is not true gain, but in fact, represents mere changes in price levels resulting from inflation. Imposition of the current high capital gains tax rate on the sale of such property is inequitable and effectively deters the transfer of real estate, thereby creating the "lock-in" effect described above. Since the real value of the property (adjusted for inflation) has not increased, the seller should not be taxed upon the effect of inflation.

We, therefore, submit that that proposed basis adjustment to reflect increases in the consumer price index during the period after 1979 in which the property is held by the taxpayer will encourage sales of real estate, thereby increasing the supply of land for construction of housing and stimulate new investment. Accordingly, we recommend the enactment of such provision.

3. *Exclusion of Gain on Sale of Residences*—NAHB supports enactment of the provision to permit an individual to elect to exclude from gross income up to $100,000 of any gain realized on the sale or exchange of his principal residence. Homeowners who presently desire to sell their residences are deterred from doing so because of the substantial capital gains tax which would result by reason

of inflation. While section 1034 offers a deferral if the proceeds are reinvested in another residence, full deferral would result only if the cost of the replacement residence at least equals the sales price of the old. Many homeowners, however, are financially unable to meet the monthly cost of operation of a replacement residence of such cost. In addition, homeowners who are retired may well desire to rent rather than purchase replacement residence.

NAHB believes that the homeowners in such situations should be provided with a one-time exemption of $100,000 so as to permit the disposition of their residences. This, in turn, would free up and make available residential units for purchase by younger families.

4. *Rollover of Gain on Sales of Residence*—We support the provision to extend the rollover provisions of section 1034 of the code to 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. Non-recognilton of gain on such multiple sales would eliminate the hardship currently facing homeowners who as employees or as self-employed individuals may be required to change employment locations more than once during the 18-month reinvestment period.

5. *Corporate Rate Reductions*—We strongly support the provision in H.R. 13511 for a reduction in corporate tax rates and a 5-step tax rate structure for corporations in place of the existing surtax exemption. The reduction in corporate tax rates will stimulate economic development which is particularly important to the home building industry because of multiplier effect upon our economy. The application of graduated rates will encourage small business, including home building corporations, and eliminate the inequity created by the existing $50,000 surtax exemption. Such surtax exemption provided under existing law is unrealistic in light of current economic conditions. We have strongly supported an increase to $100,000 for the amount of taxable income subject to the full corporate tax rate. The proposed 5-step tax rate structure would retain the small business nature of a corporation which qualifies for the lower tax rates while eliminating the serious impact upon many small corporations, including home building corporations, which currently results from their payment of the full tax rate on taxable income between $50,000 and $100,000. The graduated tax rates of 30 percent for taxable income between $50,000 and $75,000, 40 percent for taxable income between $75,000 and $100,000, and 46 percent for taxable income over $100,000 meet this concern and would alleviate the tax burden presently existing for corporations which are truly small business.

6. *Amortization for Low-Income Rental Housing*—We strongly support the proposed three-year extension of the application of section 167(k), which provides for a five-year amortization of rehabilitation expenditures with respect to low-income rental housing. Section 167(k), which was enacted in 1969 and has been extended several times by Congress, has been an incentive for the stimulation and encouragement of rehabilitation of many buildings for low-income rental housing. The extension of section 167(k) to cover rehabilitation expenditures incurred either before January 1, 1982 or pursuant to binding contracts entered into before such date would clearly have the effect of encouraging continued rehabilitation activity so as to provide a greater supply of housing for families of low and moderate income.

7. *Small Business Tax Revisions*—We fully support the provisions of H.R. 13511 with respect to small business. The reduction in the corporate tax rates, together with the liberalization of the rules respecting the qualification for an application of Subchapter S, the allowance of additional depreciation for small business and expansion of small business stock treatment under section 1244, represent desirable tax incentives to the formation and operation of small businesses. A substantial number of our members conduct their home building activities in corporations which would otherwise qualify as small business corporations, so that the availability of such incentives would enhance their ability to expand such activities.

However, we recommend adoption of an amendment to the Subchapter S proposal in order to make such incentive for small business meaningful to our members. Our amendment would eliminate the present discrimination against small business corporations which own and operate rental real estate, including multi-family housing, as their active trade or business. Under existing law, Subchapter S treatment is not available to a corporation where more than 20 percent of its gross receipts constitutes passive investment income. Since the term "passive investment income" is defined to include "rental income", a corporation

primarily realizing rental income is denied Subchapter S treatment, even though such income is realized in the *active* conduct of the business of renting real estate.

While we believe that Subchapter S treatment was not intended to be available to a corporation realizing substantial rental income as passive investment income, we clearly believe that a corporation whose principal business activity is the rental of real property should not be denied Subchapter S treatment. Such corporation is actively engaged in the conduct of its trade or business which gives rise to the rental income so that such income should not be deemed to constitute "passive investment income." We believe that such amendment is necessary in order to make available to members of the home building industry engaged in the active rental of real estate, including multi-family housing, the benefit of the provisions of Subchapter S, which would be expanded under the Bill.

8. *Deduction for Political Contributions*—NAHB opposes the proposed elimination of the deduction for political contributinos by individuals. Many of our membership who make political contributions also itemize their deductions on individual tax returns. Such political contributions are made by them in order to support election of officials who would be supportive of the interests of the home building industry. The proposed amendment would reduce the incentive to our members itemizing deductions to make political contributions.

In addition to the above, NAHB strongly recommends the addition to H.R. 13511 of two amendments to eliminate problems of major importance to the home building industry. The amendments are as follows:

1. *Carryover Basis of Property Transferred on Death*—NAHB strongly urges that H.R. 13511 be amended to add a provision approved by this Committee earlier this year which deals with a problem of widespread significance created by the Tax Reform Act of 1976. The problem arises from enactment of the provision for carryover to the transferee of the decedent's basis for property at death, the heirs will have a low carryover basis for such property and will incur substantial income tax liability upon later sale.

While the Act, in order to modify part of the severe impact of this change, provides a "fresh start" adjustment to reflect the value of property held by the decedent on December 31, 1976, the provisions for determining such value are extremely complex. For example, assets such as commercial buildings, apartment buildings, and land are to be valued under a complex formula which prorates the difference between the property's estate tax value at the owner's death and his historic, original tax basis (usually cost) on a straight line basis over the entire period the property was held based on the period of holding before December 31, 1976, and the period thereafter through the date of death. However, this assumes that the appreciation in value of such property occurs ratably over the period during which it was held, which clearly is incorrect with respect to real estate.

The carryover basis rule will have a serious adverse impact upon the members of the home building industry. The substantial income and minimum taxes which result under such rules upon the sale of assets required in order to provide funds to pay the estate tax (because of the lack of liquidity typical in this industry) will substantially reduce the builder's assets available for his heirs after payment of such taxes. In addition, complexities and restrictions involved in the "fresh start" adjustment will cause great confusion in the home building industry and among other small businesses. The carryover basis rules were inadequately scrutinized before their enactment in 1976 and their operation will create a number of significant problems.

We therefore urge the addition to H.R. 13511 of the provision sponsored by Senator Byrd and approved by the Committee as an amendment to H.R. 6715 to postpone until December 31, 1979, application of the carryover basis rules enacted by the Tax Reform Act of 1976. Enactment of such provision would provide the Congress with more than a year in which to develop more equitable and understandable rules. In view of the potential adverse impact which application of the carryover basis rules would have upon the home building industry, we believe that such postponement is essential.

2. *Contributions in Aid of Construction*—We strongly recommend the addition to H.R. 13511 of the provisions of S. 3176, introduced by Senator Laxalt, to extend section 118(b) of the Code to cover contributions in aid of construction received by gas and electric utlities. Under section 118(b), added by Congress in the Tax Reform Act of 1976, non-taxable contribution to capital treatment was provided for certain amounts (other than customer connection fees) received by a regulated public utility which provides water or sewerage disposal services for construction of certain facilities. However, section 118(b) is not applicable to contributions in aid of construction received by a regulated public utility which provides electric energy or gas (through a local distribution system or transportation by pipeline.)

The failure to extend section 118(b) to gas and electric utilities has created a serious problem for members of the home building industry. Imposition of income tax liability upon gas and electric utilities for contributions in aid of construction paid by builders will result in an increase in the amount of contributions which such utilities charge such builders. Such increased cost to the builders will, in turn, be passed on to new home purchasers, thereby increasing the already skyrocketing cost of new housing and further intensifying the difficulty of young families in affording reasonable single-family housing.

We see no policy reason for distinguishing between contributions in aid of construction received by water and sewer utilities on one hand and gas and electric utilities on the other. We therefore urge that the provisions of S. 1376 which would eliminate such distinction be added to H.R. 13511 in order to prevent a further increase in the cost of new housing.

Thank you for the opportunity to present my views before you today. I stand ready to answer any questions which you may have with respect to my oral remarks or the more detailed statement which was submitted to you and which I have summarized.

Statement of the National Realty Committee

The National Realty Committee, a non-profit business league whose membership includes owners, operators and developers of all types of residential, commercial and industrial real estate throughout the United States, offers the following statement concerning aspects of the proposed Revenue Act of 1978 (H.R. 13511), for consideration and action by the Committee on Finance of the United States Senate.

Included in this statement are certain Tables relating to points made in the body of the statement, and filed with this statement is an Appendix containing additional materials which are identified and referred to in the body of this statement. In addition, we hereby request leave of the Committee to file a supplementary written statement prior to the deadline established by the Committee, especially with regard to certain technical recommendations which may result from our detailed review of H.R. 13511.

GENERAL COMMENTS ON TAX POLICY AND THE ECONOMY

The strengthening of our nation's economy, the stimulation of business investment and the revitalization of our cities are clear, expressed priorities of the Congress and the Administration. The National Realty Committee ("NRC") is in full agreement with these priorities.

We applaud the members of the House of Representatives and of the House Ways and Means Committee for their favorable action on H.R. 13511, as we believe this to be a major positive step in creating a climate conducive to increased business investment and capital formation.

Prospects for continuing vigorous economic expansion are far from certain. The very high rate of expension of the money stock portends strong inflationary pressures. This is reflected in the strong upward movement of interest rate and yields on short, intermediate, and long-term debt instruments, and in the con-

tinuing decline of the dollar in international exchange. Unemployment persists at an unacceptably high rate, despite the remarkable gains in total jobs last year and so far this year. Projected plant and equipment outlays show little gain in real terms over 1977, too little to support the strong advances in labor's productivity upon which major gains in employment and real wage rates will depend. With a projected inflation rate of over 7 percent, the prospects for significant increase in per capital real income are dim; in turn, this implies damped growth in both consumption and saving.

We urge that the economic outlook calls for public policies to reduce impediment to employment and capital formation. We believe that H.R. 13511 provides a sound base upon which to build in achieving this goal, and we will offer in this statement a limited number of recommendations which we believe will strengthen the proposed Revenue Act of 1978.

The outlook for real estate is cloudier than that for the economy as whole. America's real estate industry has lagged behind the pace of general economic recovery. Current unemployment rates remain at extremely high levels in construction—recent figures show unemployment in the building trades nationally to be approximately 16%, and in certain areas unemployment in this industry is as high as 60%.

With the exception of single family home construction, real estate investment and development remains well below previous levels. Data contained in the study *Real Estate in the U.S. Economy* (conducted by the independent economic research firm of Norman B'. Ture, Inc. for NRC), indicates that the real estate industry grew much less rapidly than other private business during the period from 1971 through 1976—1.99 percent per year compared to 3.02 percent per year for the total private sector. (See Table A). Real growth between 1971 and 1976 showed the industry subsectors of real estate services and finance and insurance services both up about 16 percent, but the private contract construction sector of the industry—responsible for the bulk of the industry's jobs—showed no growth during the period, and in fact a decline of 4 percent from the peak year of 1972. (See Table B) And even these results must be viewed in the light of the concentration of activity in the last two years in single family home construction.

TABLE A.—TABLE 1-A. PRIVATE BUSINESS SECTOR GNP IN CONSTANT DOLLARS ORIGINATING IN REAL ESTATE 1947-76

[Dollar amounts in billions of 1973 dollars]

Year	Total private sector	Real estate	Real estate as percent of total private sector
1947	$365.9	$44.1	12.9
1948	383.0	49.3	12.8
1949	379.3	48.7	12.8
1950	417.1	53.3	12.8
1951	444.1	54.7	12.3
1952	456.9	56.0	12.3
1953	477.5	57.3	12.0
1954	468.1	59.0	12.6
1955	504.9	63.5	12.6
1956	513.8	66.4	12.9
1957	520.6	67.2	12.9
1958	514.7	68.7	13.3
1959	550.1	74.1	13.5
1960	558.6	75.2	13.5
1961	569.9	76.6	13.4
1962	605.3	81.8	13.5
1963	631.4	83.8	13.3
1964	666.8	88.5	13.3
1965	709.4	94.3	13.3
1966	751.7	96.2	13.8
1967	766.1	97.2	12.7
1968	802.6	102.5	12.8
1969	822.7	104.9	18.8
1970	818.4	103.0	12.6
1971	843.3	108.3	12.8
1972	901.5	112.5	12.5
1973	958.1	115.3	12.0
1974	936.1	114.8	12.3
1975	916.5	109.3	11.2
1976	978.4	119.5	12.9

Source: Norman B. Ture, Inc., Real Estate in the U.S. Economy (Washington, D.C.; National Realty Committee, 1977).

TABLE B.—TABLE 3-A. GNP IN CONSTANT DOLLARS ORIGINATING IN REAL ESTATE BY SUBSECTOR, 1947-76

[In billions of 1972 dollars]

Year	Private contract construction				Real estate services	Finance and insurance	Total real estate gross national product
	Residential	Industrial	Commercial	Other			
1947	$9.9	$1.8	$1.0	$5.3	$23.8	$2.4	$44.1
1948	12.7	1.4	1.4	6.4	24.9	2.7	49.3
1949	11.5	1.0	1.2	6.4	25.6	3.0	48.7
1950	14.3	1.0	1.3	6.0	27.2	3.5	53.3
1951	13.5	1.9	1.4	6.9	27.1	3.9	54.7
1952	13.3	2.1	1.1	7.2	28.0	4.2	56.0
1953	13.5	2.0	1.6	7.5	28.0	4.7	57.3
1954	14.2	1.8	1.9	7.4	28.5	5.2	59.0
1955	16.1	1.9	2.5	7.3	29.7	6.0	63.5
1956	13.5	2.3	2.7	7.0	30.2	6.6	66.4
1957	14.7	2.9	2.9	8.4	31.3	7.1	67.2
1958	15.2	2.0	3.0	8.4	33.0	7.2	68.7
1959	18.5	1.7	3.3	8.2	34.9	7.5	74.1
1960	17.5	2.4	3.5	8.7	35.2	7.9	75.2
1961	17.2	2.3	3.9	8.4	36.6	8.2	76.6
1962	18.3	2.3	4.1	8.5	38.9	9.6	81.8
1963	20.0	2.2	3.8	8.4	40.2	9.1	83.8
1964	21.0	2.8	4.2	9.2	42.1	9.2	88.5
1965	20.5	4.3	4.9	10.0	44.5	10.1	94.3
1966	19.0	5.4	4.9	11.0	45.6	10.3	96.2
1967	18.8	4.9	4.9	11.5	46.8	10.4	97.2
1968	21.2	4.2	5.4	11.8	49.2	10.7	102.5
1969	20.9	4.2	5.8	11.8	50.6	11.6	104.9
1970	19.2	3.6	5.4	11.8	51.2	11.8	103.0
1971	22.8	2.5	5.6	10.5	55.2	11.7	108.3
1972	25.5	2.0	5.7	10.1	57.1	12.1	112.5
1973	25.1	2.5	6.2	10.8	58.2	12.4	115.3
1974	20.8	2.9	6.0	11.2	60.1	13.8	114.8
1975	18.4	2.7	4.5	10.5	59.6	13.6	109.3
1976	23.3	3.0	4.6	10.8	64.0	13.6	119.5

Note: Details may not sum to totals due to rounding.

Source: Norman B. Ture, Inc., Real Estate in the U.S. Economy (Washington, D.C.; National Realty Committee, 1977).

The prospects of rising interest rates and slow growth in real per capital incomes, while adverse for the economy as a whole, are particularly ominous for real estate.

We urge this Committee and the Senate as a whole to concentrate on those actions that will help achieve the nation's priority goal of economic growth, by building on the strong base afforded by H.R. 13511.

AMERICA'S REAL ESTATE INDUSTRY: ITS ECONOMIC ROLE AND THE NEED FOR BALANCED DEVELOPMENT

America's real estate industry is a major contributing force to the nation's economy, particularly in the creation of jobs. As analyzed in the new edition of *Real Estate in the U.S. Economy* referred to above, the $150.7 billion real estate industry ranks third in size among all U.S. industries. It directly or indirectly generates over six million jobs—one of every ten jobs in the private sector—and one-eighth of all income in the private sector. Tax revenues generated by the real estate industry play a vital role in financing state and local governments. Taxes on real estate income and property provide $54 billion annually, or nearly 36 per cent of all tax revenues collected by state and local governments. Real estate also provides 7.6 per cent of all federal tax revenues. The following profile of America's real estate industry emerges from this study:

Size: Real estate produced $150.7 billion in goods and services in 1976, constituting 11.5 per cent of the nation's private sector Gross National Product. (See Table C)

Industry Makeup: Real estate is composed almost totally of small firms. Sixty per cent of all construction firms and 80 per cent of all real estate service firms have four or fewer employees. (See Table D)

Employment: The national income generated by the real estate industry and other industries in meeting real estate needs amounts to $165 billion—about one-eighth of the U.S. national income. (See Table E)

Capital Growth Rate: The physical structures which are the real estate industry's principal final products constitute a major part of the total stock of real

capital in the United States. In 1976, the value of privately owned structures was more than $1.5 trillion constant 1972 dollars. The amount of this capital has increased at an average rate of 3.6 per cent a year since 1947, but has grown at a much slower rate of 2.8 per cent a year since 1969. (See Tables G and H)

TABLE C.– TABLE 1. PRIVATE BUSINESS SECTOR GNP ORIGINATING IN REAL ESTATE, 1947-76

[Dollar amounts in billions]

Year	Total private sector	Real estate	Real estates as percent of total private sector
1947	$198.5	$20.0	10.1
1948	222.3	23.2	10.4
1949	218.0	23.2	10.6
1950	242.9	26.4	10.9
1951	277.6	28.6	10.3
1952	288.0	30.1	10.5
1953	303.6	31.9	10.5
1954	300.8	33.2	11.1
1955	329.6	36.3	11.0
1956	346.3	38.8	11.2
1957	362.5	40.6	11.2
1958	362.6	41.5	11.5
1959	394.3	45.5	11.5
1960	406.5	47.0	11.6
1961	417.5	48.3	11.6
1962	449.6	52.2	11.6
1963	472.6	55.6	11.8
1964	503.8	59.6	11.8
1965	546.3	64.7	11.8
1966	597.0	69.1	11.6
1967	624.1	72.2	11.6
1968	679.0	79.2	11.7
1969	729.5	87.0	11.9
1970	757.8	91.7	12.1
1971	816.0	102.4	12.5
1972	901.5	112.5	12.5
1973	1,012.6	123.2	12.2
1974	1,086.7	129.6	11.9
1975	1,171.3	134.5	11.5
1976	1,311.6	150.7	11.5

Note: Percentages computed using unrounded data.

Source: Norman B. Ture, Inc., Real Estate in the U.S. Economy (Washington, D.C.; National Realty Committee, 1977).

TABLE D.—TABLE 25. ESTABLISHMENTS. EMPLOYEES, AND PAYROLL IN CONTRACT CONSTRUCTION AND REAL ESTATE SERVICES, BY NUMBER OF EMPLOYEES, 1974

	Total	Employment size class					
		1-4	5-9	10-19	20-49	50-99	100+
Construction contract:							
Number of establishments	371,776	229,262	65,464	40,268	25,111	7,447	4,224
Number of employees	3,944,099	431,019	481,720	586,092	796,463	524,420	1,124,385
Payroll (thousands of dollars)	45,415,035	4,585,534	4,279,020	6,054,505	9,188,746	6,443,888	14,863,343
Real estate services:							
Number of establishments	162,986	130,186	18,019	8,527	4,314	1,230	710
Number of employees	848,206	216,414	124,348	120,049	133,515	86,236	167,644
Payroll (thousands of dollars)	6,204,694	1,437,165	858,108	878,181	1,010,368	689,732	1,331,140

Source: Norman B. Ture, Inc., Real Estate in the U.S. Economy (Washington, D.C.; National Realty Committee, 1977).

TABLE E.—TABLE 11. DIRECT AND INDIRECT REAL ESTATE NATIONAL INCOME AND EMPLOYMENT, 1973-76

[In billions of dollars and thousands of employees]

Year	National income			Employment		
	Total	Direct	Indirect	Total	Direct	Indirect
1973	$129.4	$100.9	$28.5	6,655	4,670	1,985
1974	139.0	108.0	31.0	6,528	4,506	2,022
1975	145.2	112.5	32.7	6,004	4,070	1,934
1976	164.6	127.3	37.3	6,259	4,258	2,001

Source: Norman B. Ture, Inc., Real Estate in the U.S. Economy (Washington, D.C.; National Realty Committee, 1977).

TABLE F.—TABLE 12. INDIRECT REAL ESTATE NATIONAL INCOME AND EMPLOYMENT BY INDUSTRY, 1976

Industry	National income (billions of dollars)	Employment (thousands)
Total	37.3	2,001
Agriculture, forestry, and fisheries	1.4	57
Mining	1.2	51
Manufacturing	15.3	752
Nondurable goods	4.6	191
Durable goods	10.7	561
Lumber and wood products	1.7	94
Stone, clay, and glass products	1.8	96
Primary metals	2.0	87
Fabricated metal products	2.2	119
Machinery, except electrical	1.4	68
Electrical equipment and supplies	1.0	56
Other durables	.6	41
Transportation and warehousing	2.6	133
Communication and utilities	2.0	67
Wholesale and retail trade	5.7	395
Finance and insurance (except real estate)	1.7	122
Services	5.9	330
Business services	4.7	243
All other services	1.2	87
Government enterprises	1.5	94

Source: Norman B. Ture, Inc., Real Estate in the U.S. Economy (Washington, D.C.; National Realty Committee, 1977).

TABLE G.—TABLE 18-A. NET STOCKS OF PRIVATE RESIDENTIAL STRUCTURES IN CONSTANT DOLLARS BY TYPE OF OWNER, 1947-76

[In billions of 1972 dollars]

Year	Total	Corporate		Noncorporate	
		Total	Nonfinancial	Total	Owner and institutional occupied and individually owned rental property
1947	$348.5	$9.3	$8.8	$339.2	$305.9
1948	365.6	9.3	8.8	356.3	322.3
1949	379.6	9.3	8.9	370.3	335.6
1950	402.4	9.4	8.9	393.0	357.6
1951	419.6	9.4	8.9	410.2	374.6
1952	435.0	9.3	8.8	425.7	390.1
1953	451.1	9.3	8.8	441.8	406.2
1954	469.1	9.4	8.8	459.1	424.1
1955	491.6	9.5	8.9	482.1	446.7
1956	510.5	9.6	9.1	500.9	465.6
1957	527.2	9.9	9.3	517.3	482.0
1958	544.4	10.3	9.8	534.1	498.6
1959	567.8	11.0	10.5	556.8	520.9
1960	587.6	11.9	11.3	575.7	538.4
1961	606.9	13.2	12.6	593.7	556.4
1962	628.7	14.9	14.2	613.8	574.7
1963	653.9	16.9	16.2	637.0	595.1
1964	679.3	19.0	18.2	660.3	615.3
1965	703.9	21.0	20.1	682.9	634.6
1966	723.4	22.6	21.7	700.8	649.6
1967	741.1	24.0	23.1	717.1	663.2
1968	763.9	25.8	24.8	738.1	680.0
1969	786.5	28.0	26.9	758.5	694.7
1970	805.5	29.9	28.7	775.7	706.3
1971	835.0	31.7	30.6	803.3	727.8
1972	872.4	34.2	32.9	838.3	755.5
1973	906.9	36.8	35.5	870.1	780.2
1974	924.4	37.8	36.5	886.6	793.8
1975	934.8	38.0	36.7	896.8	803.5
1976	953.5	38.0	36.3	915.5	820.5

Note: Details may not sum to totals due to rounding.

Source: Norman B. Ture, Inc., Real Estate in the U.S. Economy (Washington, D.C., National Realty Committee, 1977).

TABLE H.—TABLE 19-A. NET STOCKS OF PRIVATE NONRESIDENTIAL STRUCTURES IN CONSTANT DOLLARS, 1947-76

[In billions of 1972 dollars]

Year	Total	By industry			By type of owner	
		Farm	Manufacturing	Nonfarm nonmanufacturing	Corporate	Noncorporate
1947	$185.3	$12.1	$50.8	$122.4	$138.8	$46.5
1948	192.6	13.1	53.3	126.2	144.0	48.6
1949	198.5	13.9	54.2	130.4	147.7	50.9
1950	205.4	14.8	54.5	136.1	151.0	54.4
1951	213.2	15.5	55.9	141.8	155.5	57.7
1952	220.5	16.4	57.0	147.2	160.0	60.6
1953	229.2	17.0	58.1	154.2	165.4	63.8
1954	238.5	17.6	59.0	162.0	170.6	67.9
1955	249.6	18.1	60.4	171.1	176.7	72.9
1956	262.8	18.6	62.3	181.9	184.6	78.3
1957	275.3	19.0	64.3	192.1	191.8	83.5
1958	285.3	19.3	65.6	200.4	197.0	88.4
1959	295.4	20.1	65.6	209.7	201.4	94.1
1960	307.1	20.6	66.2	220.3	206.9	100.2
1961	318.7	21.2	66.7	230.8	212.5	106.2
1962	331.4	21.8	67.0	242.6	218.9	112.6
1963	343.3	22.4	67.5	253.4	224.8	118.4
1964	357.1	23.0	68.2	266.0	232.2	124.8
1965	376.2	23.6	70.1	282.6	243.6	132.6
1966	397.1	24.2	73.1	299.8	256.8	140.3
1967	415.5	25.0	76.3	314.2	268.8	146.7
1968	433.8	25.5	78.4	329.8	280.8	153.0
1969	452.6	26.0	80.4	346.2	293.2	159.3
1970	469.3	26.5	81.5	361.3	304.5	164.8
1971	484.1	27.0	81.6	375.5	314.5	169.6
1972	499.4	27.2	81.2	391.0	325.0	174.4
1973	515.5	27.8	81.4	406.3	336.3	179.2
1974	532.0	28.8	82.2	420.9	348.4	183.5
1975	540.0	29.0	82.1	428.8	355.4	184.6
1976	547.7	29.3	81.5	436.9	360.7	187.0

Note: Net stocks equal cumulative investment less depreciation. Details may not sum to totals due to rounding.

Source: Norman B. Ture, Inc., Real Estate in the U.S. Economy (Washington, D.C.; National Realty Committee, 1977).

The revitalization of our cities is a subject that has engendered much discussion and some action in recent months—including the announcement by President Carter of his Administration's urban policy. As you know, the primary emphasis of this policy is on *private* investment, with the role of government primarily that of stimulating such private investment.

NRC submits that private *real estate* investment and development is an essential element in balanced urban and regional growth and revitalization. We believe that the record of recent history makes it clear that urban revitalization cannot be achieved if private real estate investment is limited to low and moderate income housing, or even to assisted housing and industrial plant alone. Commercial investment and development is essential to the provision of services vital to the stability and growth of communities and neighborhoods—office facilites, shopping and community facilities. Of equal importance are the jobs and personal income created by commercial real property investments, both in the con-

struction of the facilities and in their occupancy and operation. We suggest that the need for such private commercial real estate investment is particularly great today, since the portion of the nation's business devoted to the provision of services is constantly increasing. While there has been a trend in recent years toward the location of manufacturing facilities outside of central city areas, service-related businesses do seek urban locations for their facilities. We submit that there is ample evidence that the development of office and other commercial facilities in a city has a major beneficial impact on the economy of that city and the surrounding area.

In light of the clear need for private real estate investment in and development of commercial and service facilities, the priority attention being directed toward creating jobs and revitalizing urban areas and the primary role that private investment must have in these efforts, we are pleased with the emphasis in H.R. 13511 on encouraging both rehabilitation of existing structures and the capital formation essential to expand private real estate investment and development.

THE IMPACT OF TAX POLICY ON REAL ESTATE

As noted earlier in our statement, America's real estate industry is lagging behind the general economic recovery. Due to the relative size of the real estate sector, factors which obstruct the industry's progress toward full economic recovery also will create a drag on the entire U.S. economy.

We have shown that America's real estate industry consists predominantly of a very large number of small enterprises. Small size is characteristic, not only of real estate service firms, but also of enterprises in the construction sector which in the aggregate provide a significant number of jobs. This characteristic of small firm size, coupled with the fact that real estate investment is largely a discretionary activity, highly sensitive to net rate of return considerations, causes real estate investment decisions to be unusually sensitive to tax policy changes that affect return on capital.

Tax policies which suppress net return on capital investment have an adverse effect on real estate investment by increasing the difficulty of obtaining the necessary capital, whether those policies apply to the economy generally or are aimed specifically at real estate. One of the primary determinants of real estate investment is the atmosphere for growth in all sectors of the economy which, in turn, establishes demand for industrial, commercial and residential structures. The extent to which this demand results in new real estate investment depends in large part upon the attractiveness of real estate as an investment alternative.

The primary impact of tax policies which discourage real estate investment is followed by secondary effects with repercussions throughout the economy. Unsatisfied demand for real estate has an inflationary effect on the rental costs of existing structures, and diminished real estate investment—from whatever cause—reduces jobs and income in the real estate industry and in related industries, and the source of revenues available to state and local governments to finance needed public services.

Conversely, tax policies oriented toward the goal of increasing economic growth and stability will stimulate both demand for and the availability of the capital, in the form of both equity investment and mortgage debt financing, that is essential to capital-intensive real estate development. The really significant effects of such tax policies will be the larger stock of housing and other real property and the increased flow of services generated by this enlarged body of capital.

COMMENTS AND RECOMMENDATIONS AS TO H.R. 13511

Comments

As we have noted previously in this statement, NRC is pleased with the action taken by the House of Representatives in passing H.R. 13511, as we believe this Bill to be in general an important positive step toward the goal of economic growth and stability. Therefore, we endorse H.R. 13511 and urge this Committee's favorable action on it, subject to the recommendations set forth in the next sections of this statement.

We wish to take this opporunity to comment on several specific portions of H.R. 13511 which we believe to be of particular importance to the economy, the stimulation of business investment and the revitalization of our nation's cities.

1. *Individual and corporate income tax reductions:* NRC endorses the need for income tax reductions at this time for the purposes of providing needed stimulus to the economy. These reductions will offset somewhat the burden on in-

dividuals of increases in social security taxes and the impact of inflation on income tax liability and, particularly in the case of corporations, provide an incentive for increased business investment. We believe that the methods employed in H.R. 13511 to achieve these purposes are generally appropriate, and we endorse the portions of H.R. 13511 relating to tax reductions, subject to our specific recommendation set forth below concerning individual income tax rates.

2. *Capital gains tax changes:* NRC strongly endorses the concept embodied in H.R. 13511 of reducing the present heavy tax burden on capital gains, with its inhibiting effect on capital formation, business investment and, in particular, the availability of needed capital for expanded real estate investment and development. We believe this to be an enormously important expression of positive tax policy and a major step toward achieving the goal of economic growth. NRC also believes that the inclusion in H.R. 13511 of an inflation adjustment (or indexing) to the basis of certain assets for purposes of computing taxable gain or loss upon sale is timely and appropriate, and we endorse this provision. The rapid inflation of recent years has had a significant impact on investment assets and assets used in business, including real estate, held for extended periods of time. The result has been to impose a tax on "gain" which is inflation-induced, and which does not reflect an increase in the real value of the asset. This situation is inherently inequitable, and we believe that the concept of indexing for inflation is a proper remedy.

NRC has certain other recommendations concerning the taxation of capital gains which are described and discussed in the next sections of this statement.

3. *Investment tax credit:* NRC supports the provisions of H.R. 13511 making the present investment tax credit permanent at the rate of 10% and increasing to 90% over a four-year period the present annual 50% limitation on the amount of tax liability in excess of $25,000 that can be offset by the investment credit.

In addition, NRC strongly supports the inclusion in H.R. 13511 of a provision extending the availability of the investment credit to rehabilitation expenses for existing buildings used in most types of business and investment activities. We believe this to be an important and constructive extension of the policy objective of the investment credit. It certainly will provide an appropriate stimulus to the rehabilitation and modernization of existing commercial structures in central cities and older neighborhoods of all communities. It is consistent with, and supportive of, the important national goals of urban revitalization and economic growth and stability.

NRC endorses the provisions of H.R. 13511 relating to the investment tax credit, and urges this Committee's favorable action on these provisions.

4. *Five-year amortization for low-income rental housing—Code Section 167(k):* NRC supports the inclusion in H.R. 13511 of a provision extending for three years the present special depreciation rules of Section 167(k), providing five-year amortization for expenditures to rehabilitate low-income rental housing. We believe that the depreciation treatment afforded under Section 167(k) is essential to the investment of equity capital in the rehabilitation of such housing, and that the three year extension of these depreciation rules is an important step toward meeting the national goals of urban revitalization and improved housing conditions and opportunities for families and individuals of low or moderate income.

NRC endorses the provision of H.R. 13511 providing a three year extension of Section 167(k), and urges this Committee's favorable action on this provision.

5. *Small business tax revisions:* NRC endorses and urges this Committee's favorable action on the provisions of H.R. 13511 relating to small businesses. In particular, we believe that the proposed liberalization of certain of the criteria and rules for the use of Subchapter S corporations will accomplish the objective of making this form of organization more readily usable by small businesses, and that the proposed changes applicable to Section 1244 stock will be an important stimulus to increased equity investment in small business ventures—a result which we support and believe to be consistent with our nation's goals and needs.

* * *

Technical Recommendations

NRC has not as yet completed its detailed technical and drafting analysis of H.R. 13511. Therefore, we are limiting this statement to general policy recommendations concerning provisions of the Bill. We will supply our technical recommendations in a supplementary statement to be filed within the deadline established by the Committee.

* * *

Recommendations and Discussion

NRC's policy recommendations for improvement in H.R. 13511 focus on the taxation of capital gains and individual income tax rates. As we have noted elsewhere in this statement, we believe that H.R. 13511 as passed by the House of Representatives represents an important step in the direction of providing a climate more conducive to increased business investment and capital formation.

However, we also believe strongly that this Committee and the Senate as a whole can and should move forward from the positive base of H.R. 13511 to even more effectively help achieve the nation's priority goals of economic growth and stability, and that this *can* be accomplished in a manner which will produce *increased* federal tax revenues as a result of its stimulus to business investment.

NRC is on record with this Committee as endorsing and supporting the Hansen-Steiger proposal to reduce the present heavy tax burden on capital gains and alleviate the dampening effect on capital formation resulting from this heavy burden of taxation. We wish to take this opportunity to again express our appreciation to Senator Clifford P. Hansen, together with his many colleagues on this Committee and in the full Senate and Congressman William Steiger and his House colleagues, for his initiative in putting forth this sound and constructive proposal. We have filed with Senator Byrd's Subcommittee on Taxation and Debt Management of this Committee a statement illustrating that the Hansen-Steiger proposal alone with not only increase real estate investment, and employment and Gross National Product in real estate, but also would increase federal tax revenues originating in the real estate sector of the economy.

In recent weeks, Finance Committee Chairman Russell Long and others have advocated publicly a number of the concepts which were contained in President John F. Kennedy's 1963 Tax Message to the Congress. NRC has reviewed and analyzed these policies, particularly the proposals to include only 30% of net long-term capital gain in taxable income, in place of the present 50%, and to reduce the maximum individual marginal income tax rate to 65% from the present 70%. We believe that this approach also has exceptional merit in providing a needed stimulus to capital formation and business investment.

As members of this Committee are aware, NRC makes use of an econometric Real Estate Tax Impact Model, developed for us by the respected economist Dr. Norman B. Ture. Presented in the Appendix to this statement are the effects on the real estate sector of the economy of three alternative proposals, estimated through the use of the Real Estate Tax Impact Model. In each case, the Model evaluates the effect of a proposal on real estate investment, Gross National Product originating in real estate, real estate-related employment and federal tax revenues originating in real estate. The three alternative proposals to which the Model has been applied are:

1. H.R. 13511 as passed by the House of Representatives;
2. H.R. 13511 as passed by the House of Representatives, modified by the inclusion of the Hansen-Steiger proposal providing for a maximum tax rate on capital gains of 25%; and
3. H.R. 13511 as passed by the House of Representatives, modified to provide that: (i) 30% of net long-term capital gains will be included in taxable income, (ii) the maximum individual marginal income rate will be 65% (achieved by reducing the marginal tax rates in the range from 50% to 70% as contained in H.R. 13511 proportionately to arrive at a new recommended range of 50% to 65%), and (iii) the alternative minimum tax on capital gains, with a tax rate of 10%, would remain unchanged from that contained in H.R. 13511 and would apply to the excluded portion of capital gains, which now would be 70% of net long-term capital gains.

In summary, these three alternative proposals, evaluated through the use of the econometric Real Estate Tax Impact Model, would result in the following estimated economic and federal revenue effects on real estate (dollar amounts in billions of 1977 dollars):

[Dollar amounts in billions of 1977 dollars]

	Investment	GNP	Employment (thousands of FTEE)	Federal revenues
1. H.R. 13511:				
1st year	+$19.9	+$24.9	+529	+$1.8
10th year	26.1	37.1	442	1.6
2. H.R. 13511, with Hansen-Steiger capital gains provisions:				
1st year	+20.6	+25.8	+549	+1.9
10th year	27.3	38.7	462	1.7
3. H.R. 13511, with modified Kennedy proposal:				
1st year	+26.6	+32.2	+754	+3.2
10th year	33.1	46.3	602	3.3

As is evident from this analysis each of the three alternative proposals which we have evaluated would have significant positive effects on real estate investment, the creation of real estate-related jobs and GNP originating in real estate. Importantly, each of these proposals would cause an *increase* in federal tax revenues originating in real estate, both in the first year that such tax changes were in place and over time.

This Committee has heard other testimony recommending the addition to H.R. 13511 of several of the concepts contained in President Kennedy's 1963 Tax Message, notably that of former Secretary of the Treasury Henry Fowler. Secretary Fowler's testimony emphasized that the key elements of President Kennedy's programs—those identified and evaluated as our third alternative proposal above—would serve to encourage saving, and investment of savings as risk capital, among taxpayers across a broad spectrum of the income scale, including particularly the many taxpayers whose capital gains are not significantly affected by the minimum and maximum taxes.

NRC believes that this effect of reducing the heavy burden of capital gains taxation for a wide spectrum of taxpayers and providing major encouragement for saving and investment is, by itself, a valid and significant policy foundation upon which this Committee should base its adoption of this recommendation.

When coupled with the positive economic and revenue effects which this recommendation would have on real estate investment and, through it, the nation's economy—in the first year alone *increasing* real estate investment by *$26 billion*, GNP originating in real estate by *$32.2 billion*, real estate-related employment by *754,000 jobs* and federal tax revenues originating in real estate by *$3.2 billion*—we believe the conclusion to be clear: this proposal should be adopted by this Committee as the most effective means of equitably and productively achieving the primary national goal of economic growth and stability.

NRC therefore urgently recommends that this Committee act favorably on H.R. 13511 as passed by the House of Representatives, modified to provide that 30 percent of net long-term capital gains be included in taxable income with the excluded 70 percent of such gains subject to the alternative minimum tax on capital gains at a tax rate of 10 percent as provided in H.R. 13511, and that the maximum individual marginal income tax rate be reduced to 65 percent from the present 70 percent.

CONCLUSION

The National Realty Committee submits that this Committee should concentrate on those tax policy actions that will help achieve the nation's priority goal of economic growth, in light of the uncertain prospects for continuing vigorous expansion in the economy as a whole and particularly in America's real estate industry.

We believe that the adoption of H.R. 13511 by the House of Representatives is a major positive step in creating a climate conductive to increased business in-

vestment and capital formation, and that H.R. 13511 provides a sound base upon which to build. NRC specifically endorses, as of particular importance to the economy, the stimulation of business investment and the revitalization of our nation's cities, those aspects of H.R. 13511 providing for: individual and corporate income tax reductions, capital gains tax changes, extension and improvement of the investment tax credit, extension of Section 167(k) and small business tax revisions.

In order to most effectively achieve the primary national goal of economic growth and stability, NRC recommends that this Committee act favorably on H.R. 13511 as passed by the House of Representatives, modified to provide that 30 percent of net long-term capital gains be included in taxable income with the excluded 70 percent of such gains subject to the alternative minimum tax on capital gains at a tax rate of 10 percent as provided in H.R. 13511, and that the maximum individual marginal income tax rate be reduced to 65 percent from the present 70 percent. Adoption of this recommendation would not only extend needed relief from the heavy burden of capital gains taxation to taxpayers across a broad income spectrum, but also would produce positive economic and revenue effects on real estate investment and, through it, the nation's economy—in the first year alone increasing real estate investment by $26.7 billion, GNP originating in real estate by $32.2 billion, real estate-related employment by 754,000 jobs and federal tax revenues originating in real estate by $3.2 billion.

APPENDIX

ECONOMIC AND FEDERAL REVENUE EFFECTS ON THE REAL ESTATE SECTOR

[Dollar amounts in billions of 1977 dollars]

	Investment	GNP	Employment (thousands of FTEE)	Federal revenues
1. H.R. 13511, as passed by House of Representatives:				
1st year	$19.9	$24.9	529	$1.8
3d year	23.0	29.2	548	2.2
5th year	33.0	39.8	773	3.8
10th year	26.1	37.1	442	1.6
2. H.R. 13511, with Hansen-Steiger capital gains provisions:[1]				
1st year	20.6	25.8	549	1.9
3d year	23.5	30.0	556	2.3
5th year	34.7	41.7	823	4.0
10th year	27.3	38.7	462	1.7
3. H.R. 13511, with Modified Kennedy proposal:[2]				
1st year	26.7	32.2	754	3.2
3d year	30.8	37.9	786	3.9
5th year	36.9	45.2	880	4.8
10th year	33.1	46.3	602	3.3

[1] In lieu of the provisions in H.R. 13511 which would exclude capital gains from minimum tax on preference items, subject gains to a 10 percent alternative minimum tax and eliminate the alternative tax on the first $50,000 of gains, the tax treatment of capital gains would revert to that prevailing before enactment of the Tax Reform Act of 1969.

[2] In lieu of present 50 percent, 70 percent of net long-term capital gains would be excluded from income. Individual income tax rates would be those in H.R. 13511 but would top at 65 percent instead of 70 percent. Excluded capital gains would not be subject to the present minimum tax on preference items, but to an alternative minimum tax at 10 percent, as provided in H.R. 13511.

Statement of Myles H. Tanenbaum Esq. for the International Council of Shopping Centers

Summary of Comments

I. NEED FOR INVESTMENT CAPITAL

The real estate industry in general and the commercial segment of this industry in particular unquestionably are faced with a serious shortage of investment capital. As a result, the growth rate of all areas of real estate has decreased over the past five years. Commercial construction has grown even more slowly during this period than private residential and industrial construction.

II. THE CAPITAL DRAIN RESULTING FROM PAST TAX LEGISLATION

The effect of numerous changes in the tax laws over the past 15 years on the supply of investment capital in the commercial real estate industry cannot be overestimated. Fifteen years ago a commercial developer could currently deduct construction period interest and real estate taxes and continue to deduct all interest upon completion of the project. The project could be depreciated on the double declining balance method. Upon the sale of the project, all gain was taxable at capital gains rates which, under the alternative tax, could not exceed 25 percent.

These provisions, which significantly contributed to the strength of the commercial real estate industry, have, over the years, been eliminated or substantially eroded. In addition, new provisions have been enacted which have in-

creased the drain on investment capital even more. It is extremely important to recognize that the prospects for growth in our segment of the industry will be significantly hampered as the provisions of the Tax Reform Act of 1976 become fully phased in.

III. COMMENTS AND RECOMMENDATIONS ON SPECIFIC PROPOSALS

While we could recommend a number of changes in the tax laws that would improve the health of the real estate industry, and the nation as a whole, including repeal of changes made in the tax laws beginning in 1969, our comments and recommendations are limited to the specific areas covered by H.R. 13511.

1. Capital gains

A. *Maximum tax rate.*—H.R. 13511 would reduce the maximum effective tax rate on capital gains from over 49 percent to 35 percent. While this is a step in the right direction, H.R. 13511 does not go far enough to restore capital gain rates to levels that would once again attract significant capital for investment. High tax rates on capital gains artificially adjust the risk/reward ratio of many development opportunities by substantially reducing the potential after-tax reward below yields which are acceptable in light of potential risk, and high tax rates also restrict the movement of capital. If there were a substantial reduction in the tax rate on capital gains, much of the existing "locked-in" capital gains would likely be realized, resulting in the movement of capital to new enterprises, as well as the generation of added tax revenues.

We recommend restoration of a maximum tax rate not in excess of 25 percent, as had been the case prior to the 1969 tax law changes, or such other proposals as are designed to significantly reduce the maximum effective rate on capital gains. One such proposal, first recommended by President John F. Kennedy in 1963, would reduce the taxable portion of a capital gain from 50 percent to 30 percent. Significant reduction in capital gains rates would result in substantial increases in capital investment, GNP, federal tax revenues, and employment.

B. *Indexing of basis of capital assets.*—We support the provisions of H.R. 13511 which make an inflation adjustment to the basis of certain assets for the purpose of determining the capital gain on their sale. Such an inflation adjustment, based on the level of the Consumer Price Index, would prevent a taxpayer from suffering a reduction in available reinvestment dollars when converting a capital asset that in real terms did not result in economic gain. Such an enactment would reduce the disinclination to convert assets having unrealized capital gain, and thereby improve the flow of capital to new ventures.

C. *Alternative minimum tax.*—We support converting the existing minimum tax into a true or alternative minimum tax which would be imposed only if it exceeds the taxpayer's regular tax liability. However, if that is done, the Administration's proposed alternative minimum tax should be rejected and the alternative minimum tax in the House bill should be improved.

Thus, we recommend that any alternative minimum tax be imposed only where it taxes those items which actually produce a tax reduction or benefit for the taxpayer. Such a tax benefit rule is part of the present minimum tax, but H.R. 13511 eliminates this rule with respect to capital gains, and we urge inclusion of a tax benefit rule so as to prevent taxing a deduction which in fact did not reduce a taxpayer's tax liability.

2. Investment credit

We support the provisions of H.R. 13511 which extend the investment credit to rehabilitation expenditures incurred in connection with buildings not to be used for residential purposes which are held for the production or rent or used in business. But we also urge recognition of the broader need for tax relief to further stimulate the flow of investment towards all real estate development. By providing investment credit for the development of new structures, as well as rehabilitation of existing buildings, the tax laws would remain neutral in regard to the direction of development activity, permitting the requirements of the marketplace to determine whether a structure should be rehabilitated or replaced, or whether it should be relocated elsewhere. Moreover, such a broad rule would prevent fine-line legal issues from being raised, which inquiries will further complicate the tax laws and regulations, and adversely impact on taxpayer compliance and IRS administration.

I. Introduction

My name is Myles H. Tanenbaum of Kravco, Inc., King of Prussia, Pennsylvania. I am a member of the Tax Subcommittee of the Government Affairs Committee of the International Council of Shopping Centers (ICSC), and I appear today on behalf of the members of the International Council of Shopping Centers ("ICSC").

The ICSC is a business association of more than 6,500 members consisting of shopping center developers, owners, operators, tenants, lenders and related enterprises. ICSC represents a majority of the estimated 18,500 shopping centers in the United States.

Shopping center development in the United States involves an annual investment of almost $7 billion for structures, fixtures, and equipment. It is estimated that more than 5 million people are regularly employed in shopping centers and that several hundred thousand more are annually engaged in new construction. The employment in related businesses, including display and the manufacture of goods sold in the centers, is considerable.

At one time, retail trade in the United States was concentrated in individual stores and central businesses districts. By 1977, however, 37.79 percent of all retail trade in the United States—amounting to $242 billion—was conducted in the nation's shopping centers. In addition, it is estimated that, in the 1977–78 period, 80 percent of new retail square footage (including 88 percent of new department store square footage) will be constructed in shopping centers.

In short, the shopping center industry has a significant influence on the total United States economy.

II. NEED FOR INVESTMENT CAPITAL

The real estate industry in general and the commercial segment of this industry in particular unquestionably are faced with a serious shortage in investment capital. As a result, the growth rate of all areas of real estate has decreased over the past five years. Measured in constant 1972 dollars, the rate of growth of real estate and the total private business sector since 1947 has been very nearly the same—about 3.5 percent a year, on the average.[1] Since 1971, however, real growth in the real estate industry averaged only 1.9 percent a year, a third less than that for the private business sector as whole.[2] Private residential and industrial construction from 1947 through 1970 grew more slowly than commercial construction.[3] For the period 1971 to 1976, however, this pattern has been reversed: commercial construction during this period grew more slowly than both private residential and industrial construction.[4]

III. THE CAPITAL DRAIN RESULTING FROM PAST TAX LEGISLATION

The effect of numerous changes in the tax laws enacted over the past decade on the supply of investment capital in the commercial real estate industry cannot be overestimated. A comparison of the tax provisions in effect 15 years ago with the provisions presently in effect will, we believe, dramatically indicate how the tax laws have both reduced the supply of and increased the demand for investment capital in commercial real estate.

A. Tax Laws 15 Years Ago

Fifteen years ago a commercial developer operated under the following rules: Construction period interest and real estate taxes were currently deductible in their entirety. Upon completion of the project, all interest and taxes continued to be currently deductible. Moreover, a variety of accelerated methods of depreciation were available including the double declining balance method. Upon the sale of the project, all gain was taxable at capital gains rates which, under the alternative tax, could not exceed 25 percent. A combination of these provisions gave developers a positive incentive to construct commerial real estate by reducing the amount of investment capital required and increasing the ability to attract this capital.

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[1] Norman B. Ture, Inc. "Real Estate in the U.S. Economy," table 1–A citing, U.S. Department of Commerce, Bureau of Economic Analysis, "The National Income and Product Accounts of the United States," 1929–74 ("NIPA") tables 1.8, 5.5, 6.6, 6.2, 7.3, 7.5, and 8.3, Federal Reserve System, "Flow of Funds Accounts," 1946–1975, December, 1976; and unpublished Federal Reserve data.

[2] Id.

[3] Id. Table 3–A citing NIPA tables 5.5 and 6.2.

[4] Id.

These provisions, which significantly contributed to the strength of the commercial real estate industry, have, over the years, been eliminated or substantially eroded. In addition, new provisions have been enacted which have increased the drain on investment capital even more.

B. Tax Laws Today

In stark contrast to the tax provisions described above, the commercial real estate industry is now faced with the following rules: construction period interest and taxes are no longer deductible; rather, construction period interest and taxes must be capitalized and amortized over a prescribed number of years. In addition, many shopping centers have substantial limitations on the amount of mortgage interest that may be currently deducted once the project is placed in service. Although accelerated depreciation has not been entirely eliminated, present rules limit the maximum rate to the 150 percent declining balance method. Depreciation deductions in excess of straight-line are taxable upon the sale of the project at ordinary income rates to the extent of gain, regardless of the holding period. Moreover, the rules regarding the taxation of capital gains have undergone substantial change significantly increasing the effective tax rate.

It does not require a great deal of imagination or detailed analysis to see that the tax laws have drained capital from the commercial real estate industry. At the same time, however, exactly the opposite trend has taken place in other segments of the economy. For example, the investment credit and the asset depreciation range system were instituted to encourage formation in the manufacturing section. Thus, it would appear that what has been real estate's loss essentially has inured to the benefit of other capital intensive areas.

C. Specific examples

We would like to explain two of the tax changes affecting the real estate industry in more detail to show how the industry has been affected and to indicate the extent of the capital drain which has resulted.

1. Capitalization of real property construction period interest and taxes

The Tax Reform Act of 1976 requires that real property construction period interest and taxes be capitalized (for taxpayers other than a corporation which is not a subchapter S corporation or a personal holding company). The amount capitalized may be amortized over a period which began with 4 years in 1976 and will be extended to 10 years when the provision is fully phased in. Since the amortization is phased in over a 7-year period, the full 10-year amortization period will not be effective in the case of commercial real estate until 1982. Thus, although this provision has already had an adverse effect upon the shopping center industry, the full impact of the provision will not be felt for some time.

In 1976 the Treasury estimated it would raise $102 million in 1977 by limiting deductions for construction period interest and taxes related to commercial real estate.[5] If $102 million in fact was drained from the capital pool for commercial real estate development, the resultant reduction in projects would have totalled more than a billion dollars. In addition, this would have resulted in about 40,000 fewer jobs in the construction industry, plus job losses in manufacturing plants furnishing building materials.

2. Deductibility of investment interest

The Tax Reform Act of 1969 added Section 163(d) to the Internal Revenue Code which provided an exception to the general rule that a taxpayer itemizing his deductions may deduct all interest paid or accrued within the taxable year on his indebtedness. Section 163(d), as amended, imposes significant limitations on the deductibility of interest on investment indebtedness.

Section 163(d) works most harshly in the case of shopping centers since they are one of the few properties as to which the rather contorted rule operated to deny a deduction for a cash outlay for an unquestionably bona fide business expense, i.e., interest. Application of this rule, therefore, produces a "paper gain" which is taxed. Although no one really foresaw the effect that the enactment of this Section would have on shopping centers, the fact remains that shopping centers have borne its brunt. This is one example of how tax legislation, regardless of intended effect, produces a drain on capital in our industry.

The effects of deferring deductions for construction period interest and taxes and other provisions of the Tax Reform Act of 1976 and prior legislation are just

[5] Joint Committee on Taxation, "General Explanation of the Tax Reform Act of 1976," 1976-3 Cumulative Bulletin 29.

now beginning to be felt. When their full impact is realized, the after tax yield on high risk commercial real estate development will be so poor that the prospects for maintaining even the currently reduced rate of development of shopping centers will be significantly dimmed. Under these circumstances, we believe it is now time for Congress to enact changes in the tax law that would attract the capital so essential to the vitality of the commercial real estate industry.

IV. COMMENTS AND RECOMMENDATIONS REGARDING SPECIFIC PROPOSALS

There are a number of proposals which we could recommend to improve the health of our industry and the nation as a whole. Repeal of some of the provisions which have been particularly onerous to our industry, such as the investment interest limitation and the deferred deduction of construction period interest and taxes, would form the basis of a sound approach to the problem. Because of the strictures on our time we will not discuss those proposals any further, but we do urge the members of this Committee to review these provisions in the consideration of the proposed changes in the tax code. Henceforth, we will limit our comments and recommendations to the specific areas covered by H.R. 13511.

A. Capital Gains

1. *Maximum tax rate.*—H.R. 13511 contains provisions which would reduce the maximum effective tax rate on capital gains from over 49% under current law to 35 percent. This is accomplished by removing capital gains from items of tax preference for purposes of both the minimum and maximum tax, and is further supplemented by the "indexation" mentioned below. Although we believe that this reduction is a step in the right direction, H.R. 13511 does not go far enough to restore capital gain rates to levels that would once again attract significant capital for investment. In fact, by eliminating the alternative tax on the first $50,000 of capital gains, H.R. 13511 raises the effective rate on capital gains for many taxpayers.

The tax rates on capital gains, even with the changes proposed, will act as a deterrent to capital investment for several reasons. One reason is that high tax rates on capital gains artificially adjust the risk/reward ratio of many development opportunities by substantially reducing the potential reward below a yield sufficient to overcome the concern of downside risk.

Another reason is that high tax rates on capital gains restrict the movement of capital. An investor who would be inclined to convert his capital from an existing asset having a large unrealized capital gain to a new investment frequently feels precluded by reason of the capital erosion attributable to the tax on the sale. Not only would the tax payments reduce his capital pool, they also would reduce the income that could be generated from reinvestment unless the subsequent investment has a considerably higher yield than the asset sold. If there were a substantial reduction in the tax rates on capital gains, much of the nation's existing "locked-in" capital gains would likely be realized—resulting in the movement of capital to new enterprises, as well as the generation of added tax revenues.

The "experiment" initiated in 1969 of substantially increasing the effective tax rates on capital gains has simply not been a success; in fact, it has not generated added tax revenue and it has slowed the movement of investment capital so vital for the economic well-being of the nation. We believe that the Hansen-Steiger Bill (S. 3065), which would once again provide for a maximum tax rate on capital gains of 25%, the maximum rate before the tax laws were changed in 1969, will restore the flow of significant investment capital to the real estate industry and to the rest of the economy.

We also endorse a frequently mentioned proposal which would reduce the effective tax rate on capital gains by reducing the percentage of the gain includable in income. That proposal, first recommended by President John F. Kennedy in 1963, would reduce the taxable portion of a capital gain from 50 percent to 30 percent. Such an approach has the advantage of providing capital gains tax relief to all taxpayers having capital gains and, if the relief is not otherwise penalized, it would "unlock" much existing unrealized capital gain to flow to new ventures.

The real estate econometric model developed by Norman B. Ture[8] shows that the impact of the passage of S. 3065 during the first year would generate

[8] Developed by Norman B. Ture, Inc. for the National Realty Committee.

increases (in 1977 dollars) of 2.8 billion dollars in investment, 3.2 billion dollars in GNP, 0.9 billion dollars in federal revenues, and 27,000 jobs. By the fifth year there would be increases (in 1977 dollars) of 5.8 billion dollars in investment, 6.8 billion dollars in GNP, 1.5 billion dollars in federal revenues and 64,000 jobs (see Exhibit I).

For the foregoing reasons, the members of the ICSC strongly endorse S. 3065 or some comparable capital gains tax relief.

2. *Indexing of basis of capital assets.*—H.R. 13511 provides for an inflation adjustment—indexing—to the basis of certain assets for the purpose of determining the capital gain on their sale. The inflation adjustment is based on the level of the Consumer Price Index and, in a rather forthright manner, the amendment to the Internal Revenue Code simply provides that the percentage change in the price index is to be multiplied by the adjusted basis of the property involved.

The Report of the Ways and Means Committee on H.R. 13511 takes note of the fact that by reason of the substantial inflation we have already experienced, a taxpayer can have substantial gains for tax purposes even though the real value of the asset, adjusted for inflation, has not increased. As a consequence, an individual realizing a capital gain and reinvesting after-tax dollars in a new investment will be suffering a reduction in available dollars to reinvest without having any economic gain to show for it. This circumstance results in a disinclination to convert assets having unrealized capital gain, with the consequent "lock-in" effect and the resultant slowing of capital into new ventures.

That proposal is both fair and equitable, and indeed is long overdue.

3. *Alternative Minimum Tax.*—Under present law, a minimum tax of 15% is imposed on the amount of items of tax preference in excess of the greater of $10,000 or one-half of the taxpayer's regular tax liability. While called a minimum tax, that levy is not a true minimum tax but rather a surtax levied against taxpayers who have responded to the tax preferences enacted by Congress.

There have been a number of proposals to convert the existing minimum tax into a true minimum tax, sometimes referred to as an alternative minimum tax, which would be imposed only if it exceeds the taxpayer's regular tax liability and not as an add-on. This concept is an improvement on the existing so-called minimum tax. If the concept of a minimum tax is to be retained within the fabric of the tax laws, we would urge that it be in the form of a true or alternative minimum tax.

H.R. 13511 provides for an alternative minimum tax of 10 percent on the 50 percent capital gain deduction. Obviously, such a tax is intended to prevent some few taxpayers from otherwse avoiding tax by reason of the combination of the capital gain deduction and other permissible deductions. The modest revenue estimates attest to the fact that only a few taxpayers would be involved, and that circumstance should bring into question the fundamental issue of whether the insignificant revenue and social goals provided by such a tax are really worth the serious burden of adding further to the complexity of the tax law, to the problems of taxpayer compliance and to the cost of IRS administration. We think not.

If the "experiment" of a minimum tax, also begun in 1969, is to be continued, the current add-on minimum tax should be rolled into a true or alternative minimum tax. However, if that is done, the Administration's proposed alternative minimum tax should be rejected, and the alternative minimum tax in the House bill should be improved.

Thus, we recommend that any alternative minimum tax be imposed only where the includible items—designated tax preference deductions—actually produce a tax reduction or benefit for the taxpayer. That is, a taxpayer should not incur a tax for claiming a deduction which did not benefit him, i.e., result in a tax saving for him. This sort of tax benefit rule is part of the present minimum tax, but H.R. 13511 eliminates this rule with respect to capital gains. The following example will illustrate our concern: If a taxpayer in a given year has $100,000 of business losses and $100,000 of capital gains, he would under H.R. 13511, have to pay a minimum tax even though he does not have any economic income for the year and does not derive any advantage from the 50% deduction for capital gains. We believe it would be anomalous to apply the alternative minimum tax to a situation where the so-called "preference item" has not resulted in any tax benefit to the taxpayer.

B. Investment Credit

H.R. 13511 extends the investment credit to rehabilitation expenditures incurred in connection with existing buildings held for the production or rent or

used in business which are not to be used for residential purposes. The report of the Ways and Means Committee takes note of the fact that such structures have declining usefulness, unless rehabilitated, and the purpose of extending the investment credit to such activity is to permit the tax laws to act as a stimulant.

We support this extension of the investment credit and the recognition given to the impact of tax relief in furthering economic activity. But we also urge recognition of the broader need for tax relief to further stimulate the flow of investment towards real estate development. It is our recommendation that the 10 percent investment credit be extended to all buildings, whether new or existing, which are used in business or productive activities. By providing investment credit for the development of new and existing structures, the tax laws would remain neutral in regard to the direction of development activity, permitting the requirements of the marketplace to determine whether a structure should be rehabilitated or replaced, or for that matter whether it would be more consistent with contemporary facts to relocate elsewhere without being bound to the judgments of the past. Moreover, the "fine line" issues raised by the House Bill in determining whether there is a rehabilitation (e.g., whether "75 percent or more of the external walls . . . are retained in place as external walls") will further complicate and clutter the tax laws and regulations, and adversely impact on taxpayer compliance and IRS administration.

We applaud the recognition of the need to extend investment credit to real estate structures, but we urge that it be extended across the board to include new, as well as rehabilitated, buildings.

Thank you for the opportunity of appearing before the Committee on this important matter.

EXHIBIT I

ECONOMIC AND FEDERAL REVENUE EFFECTS OF S. 3065;[1] EFFECTS ON REAL ESTATE

[Dollar amounts in billions of 1977 dollars]

	Investment	GNP	Employment (thousands of FTEE)	Federal revenues
1st year	2.8	3.2	27	0.9
3d year	3.6	4.2	35	.7
5th year	5.8	6.8	64	1.5
10th year	3.6	4.2	14	.5

[1] Developed by Norman B. Ture, Inc. for the National Realty Committee.

STATEMENT OF THE BUILDING OWNERS AND MANAGERS ASSOCIATION INTERNATIONAL

SUMMARY

BOMA believes that the Revenue Act of 1978 (H.R. 13511) as passed by the House provides a good beginning for writing the kind of tax bill that the people of this country need and deserve.

As the House Ways and Means Committee Report indicates, a major concern of the Committee was "the inadequate level of investment" in the economy, and for that reason the Committee took several steps in the bill to improve the effect of the tax system on economic incentives. However, further steps need to be taken in order to help attract capital to the real estate industry, sustain the pace of recovery from a period of record inflation and recession, and encourage both new construction and needed replacement investment in office buildings.

The office building industry has suffered the consequences of rising operating costs coupled with depressed demand for office space. We have sustained vacancy rates in excess of twelve percent for the last several years. Now the industry is recovering. Downtown office structures are filling, providing space for office workers and needed vitality for our urban cores.

With about 70 percent of office space in the United States concentrated in central cities, office buildings play a crucial role in the health and vitality of downtown areas, providing places of employment for central city residents as well as suburbanites. Financially viable office buildings in downtown areas provide cities with needed tax revenues to finance essential municipal services.

BOMA makes the following comments regarding the proposals before this Committee:

Investment tax credit

BOMA believes that the availability of the investment tax credit should be extended beyond the rehabilitation of existing commercial and industrial structures to the new construction of such facilities. To make a distinction between existing and new construction places new commercial and other types of real estate at a disadvantage in attracting capital.

In addition, this Commitee should consider extending the investment tax credit beyond 10 percent for the rehabilitation of older buildings. Older buildings, and new ones as well, must comply with increasingly stringent codes that are being imposed on office buildings. While new buildings can be designed to incorporate most of these mandated changes, the older building, originally designed to a much different code, must undergo extensive and costly renovations to comply.

BOMA feels strongly that additional tax incentives are required to assist the office building industry in serving the public's needs by providing for the needs of special user groups and for the general health and safety of the office using public through the installation of new life safety and fire safety equipment and compliance with handicap codes.

Capital gains

BOMA recommends that the Committee adopt the provisions contained in the bill introduced by Senator Hansen (S. 3065) that would return the tax law to the pre-1969 treatment of capital gains. This bill would eliminate capital gains as a preference item for the purposes of computing the minimum and maximum tax, and would have the effect of reducing the maximum rate on all capital gains (individual and corporate) to 25 percent.

Unless the effective rate of tax on capital gains is reduced to or below the 25 percent level, BOMA opposes the elimination of the alternative capital gains tax which allows individuals to have the first $50,000 of long term capital gains taxed at a rate of 25 percent. Without the reduction of the maximum rate to 25 percent, the repeal of the alternative tax will have the effect of increasing the rate on capital gains for smaller taxpayers, and will discourage the capital formation that is one of the purposes of the legislation.

Corporate and individual rate reductions

BOMA urges the Committee to increase the amount of tax relief granted to individuals and corporations under the Revenue Act of 1978. For many taxpayers, these reductions will fall short of the amount necessary to offset the social security tax increases scheduled and anticipated in 1979. With these increases many taxpayers would pay more taxes, not less, in 1979 despite the passage of H.R. 13511.

My name is Gardner McBride; I am Executive Vice President of the Building Owners and Managers Association International (BOMA). BOMA is an association of owners and managers of commercial office buildings, comprising nearly 500 million square feet of space. In addition, our members own or manage residential as well as other types of nonresidential real estate.

I welcome the opportunity to appear before you today to testify on the Revenue Act of 1978 (H.R. 13511) and the other proposals before this Committee.

The United States is experiencing a slow but steady recovery from a period of record inflation and recession. The office building industry in particular has suffered the consequences of rising operating costs coupled with depressed demand for office space. Due to the recession and the OPEC oil boycott, this country's office building industry has sustained vacancy rates in excess of twelve percent for the last several years. Now the industry is recovering. Vacancy rates are falling in new and old buildings. Downtown office structures are filling, providing space for office workers and needed vitality for our urban cores.

I should note that about seventy percent of office space in the United States is concentrated in central cities.[1] Office buildings therefore play a crucial role in the health and vitality of downtown areas, providing places of employment for central city residents as well as suburbanites.

Over the last twenty years, while employment in manufacturing industries in central cities remained relatively constant, employment in the government and

[1] Bennett Harrison. "Urban Economic Development." Washington, D.C.: Urban Institute. 1974; p. 13.

service sectors increased dramatically. Government and service workers are office space oriented. Employment growth in the government and service sectors is a major determinant of office building construction. It has also been largely responsible for the total growth of new jobs in central cities.[2]

It is well known that office buildings already pay a disproportionately large share of local property tax in many cities. The effective tax rate for office buildings often exceeds rates for most other real estate property types.

We project that in the next three to four years, there will be a continuing increase in employment in these sectors, and that unless adequate new office building construction is started soon, there will be a lack of adequate office space to accomodate these new jobs.

BOMA believes that H.R. 13511 as passed by the House is a good beginning on which to write the kind of tax bill that the people of this country need and deserve. As the House Ways and Means Committee Report indicates, a major concern of the Committee was "the inadequate level of investment" in the economy and for that reason the Committee took several steps in the bill to improve the effect of the tax system on economic incentives.

The bill certainly is a great improvement in concept and direction over the Administration's original proposals to the Congress. Those proposals would have perpetuated and continued the type of changes in the tax laws as they relate to real estate that over the years have had a depressing effect on investment in real estate. These recommendations would have drained capital from the real estate industry, retarded the pace of recovery and depressed both new construction and needed replacement in office buildings. In particular, BOMA is gratified that the House Ways and Means Committee rejected the Administration's misinformed and short-sighted recommendations regarding real estate depreciation.[3] The Administration based their recommendations regarding depreciation on a study by Paul Taubman and Robert Rasche that purportedly shows that allowable tax depreciation on real estate, based either on straight line or accelerated methods, greatly exceeds actual economic depreciation. This study was based on BOMA statistics, and was thoroughly discredited by the testimony of Professor Randall Craig Zisler of Princeton University, presented on behalf of BOMA to the House Ways and Means Committee (a copy of this testimony is attached).

BOMA believes that H.R. 13511 is an improvement over the original Administration proposal not only because of what has been left out, but because of what has been included in the bill. The extension of the Investment Tax Credit to the rehabilitation of existing structures such as commercial buildings, the reduction

[2] Edwin Mills. "Studies in the Structure of the Urban Economy." Baltimore: Johns Hopkins Press. 1972; pages 28–29. For the period 1947–63, service employment was the only sector with a positive growth rate in central cities; +1.4 percent per year compared with −0.8 percent for manufacturing, and −1.1 percent for retailing. Population declined in central cities at a rate of 0.1 percent. At the SMSA level, service employment grew at 3.7 percent compared with 1.6 percent for wholesale, 1.3 percent for retail, and 3.1 percent for population.

[3] Depreciation:

Present law.—In the case of new non-residential property, depreciation under the declining balance method is limited to a rate which does not exceed 150 percent of the rate determined under the straight-line method. With respect to used non-residential real property, no accelerated method of depreciation is allowable. Additionally, the estimated useful lives of depreciable real property is based upon a facts and circumstances test.

Administration proposal.—Under the Administration proposal, with exceptions for low-income housing and new multi-family housing, depreciation of all realty would be based on the straight-line method.

The estimated useful lives of depreciable realty would be based upon surveys conducted by the Department of the Treasury of lives actually used by taxpayers. A limited facts and circumstances test would be provided.

Taxpayers will be permitted to depreciate buildings on the basis of zero salvage values and the average lives now in use as determined by the Treasury study requested by Congress in 1971.

Taxpayers who make this election will be required to use the straight-line method of depreciation for their buildings, including buildings depreciated under the ADR system of depreciation. Although taxpayers will be able to use lives longer than the guideline lives, except under the facts and circumstances option described below, there will be no allowance of lives shorter than the guideline lives. For the few buildings for which ADR classes are established, the ADR life will be used.

As an alternative to using the average useful lives and straight-line method, a taxpayer will be able to elect on his tax return to use a facts and circumstances test that will permit a depreciation deduction in any year sufficient to decrease the basis of the building to its fair market value as of the end of the year.

Once the facts and circumstances test is elected for a structure a taxpayer has constructed or acquired, the taxpayer will not be permitted to change to the guideline system.

The component method of depreciation will not be permitted for new or used buildings. Prescribed guideline lives will be required for components placed in service after the original construction or acquisition of a building by a taxpayer.

in the excessive taxation of capital gains, the replacement (at least for capital gains) of the current-add-on minimum tax with a true and reasonable alternative minimum tax, and the reduction in the tax rates for corporations and individuals all are positive steps. However, BOMA believes that each of these provisions of H.R. 13511 are only the beginnings of a good tax bill and that the Finance Committee should go beyond them. Our recommendations regarding these areas follows:

I. Investment Tax Credit

Under the provisions of the House Bill, the investment tax credit was:

A. Made permanent; increased in limitation.—The present 10 percent investment credit and the $100,000 used property limitation scheduled to expire at the end of 1980 would be made permanent. In addition, the 50 percent limitation on the amount of investment credit that can be used to reduce tax liability in excess of $25,000 for any taxable year would be increased to 90 percent, phased in at an additional ten percent per year.

B. Extended to the rehabilitation of existing commercial structures.—Eligible property for purposes of investment tax credit would be expanded to include rehabilitation expenditures with respect to existing industrial and commercial buildings (including retail structures and warehouses). It would not apply to residential property. The credit would be available for eligible rehabilitation expenditures incurred after December 31, 1978.

C. Allowed for pollution controls.—The full investment credit would be allowed for pollution control facilities which are eligible for an election to use five-year amortization, except to the extent the facility has been financed with tax-exempt industrial development bonds. Under present law, the investment credit on pollution control facilities for which the taxpayer elects five-year amortization is limited to one-half of the credit that otherwise would be available. In general, this provision would apply to property acquired by the taxpayer after December 31, 1978.

BOMA recommendations

BOMA believes that the availability of the investment tax credit should be extended beyond the rehabilitation of existing commercial and industrial structures to the new construction of such facilities.

If the investment tax credit it to be used at all, it must be extended to all such real estate. To make a distinction between existing structure and new construction places new commercial and other types of real estate at a disadvantage in attracting capital. Also, by extending the investment tax credit to new construction, some of the problems that we see with the definition of rehabilitation that is included in the House provision can be avoided.

In addition, this Committee should consider adding an additional investment tax credit beyond 10 percent for the mandated rehabilitation of older buildings. Older buildings, and new ones as well, must comply with the increasingly stringent building and operating codes that are now being imposed on office buildings. While new buildings can be designed to incorporate most of these mandated changes, the older buildings, originally designed for a much different building code, must undergo extensive and costly renovations to comply. Society has seen fit to require that office buildings provide for the needs of special user groups and for the general health and safety of the office using public through the imposition of new life safety and fire safety equipment and handicap codes. BOMA feels strongly that additional compensating tax incentives are required to assist the office building industry in meeting mandated codes that serve the public's need.

II. Capital gains

H.R. 13511 includes the following provisions regarding capital gains.

A. Alternative capital gains tax.—The election for individuals to have the first $50,000 of long-term capital gains taxed at an alternative rate of 25 percent would be repealed, effective for taxable years beginning after December 31, 1978.

B. Minimum and maximum tax.—Capital gains would be removed from the list of tax preferences for individuals, corporations, estates and trusts under both the minimum and maximum taxes, effective for taxable years beginning after December 31, 1978. This change would reduce the maximum rate of tax on capital gains to 35 percent.

C. Alternative minimum tax on capital gains.—An alternative minimum tax would be provided at the rate of ten percent on the excluded one-half of an indi-

viduals's long-term capital gains, reduced by a $10,000 exemption. This alternative minimum tax would be imposed only to the extent this tax exceeds the individual's regular tax liability. The alternative minimum tax base excludes any capital gain realized on the sale or exchange of an individual's principal residence.

D. Inflation adjustment.—Taxpayers would be allowed to adjust the basis of certain capital assets upward by the rate of inflation. For eligible assets sold after December 31, 1979, the basis adjustment would reflect the rate of inflation indicated by the consumer price index for the holding period of the asset. However, the adjustment would be made only with respect to increases in the consumer price index occurring after December 31, 1979. In general assets eligible for the basis adjustment would be corporate stock, real estate, and tangible personal property.

E. Capital gains tax study.—The Treasury Department would be required to prepare, and submit to Congress, by September 30, 1981, a report on the effectiveness of the reductions of both the individual and the corporate capital gains tax rates in stimulating investment and increasing the rate of economic growth. The report also is to include a study of the effects of these reductions on the growth of employment and on income tax revenues.

BOMA recommendations

BOMA believes that the reduction of the excessive tax on capital gains is a step in the right direction, but that the House did not go far enough. BOMA recommends that the Committee adopt the provisions contained in the bill introduced by Senator Hansen (S. 3065) that would return the tax law to the pre-1969 treatment of capital gains. This bill would eliminate capital gains as a preference item for the purposes of computing the minimum and maximum tax and would have the effect of reducing the maximum rate on all capital gains (individual and corporate) to 25 percent. We do suggest that these provisions be made effective prior to January 1, 1980, as called for in S. 3065, to avoid locking in capital gains. The impact on Federal revenues as shown by econometric studies by Norman B. Ture and Chase Econometrics Associates Inc. will be positive not negative.

Unless the effective rate of tax on capital gains is reduced to or below the 25 percent level. BOMA opposes the elimination of the alternative capital gains tax which allows individuals to have the first $50,000 of long term capital gains taxed at a rate of 25 percent. Without the reduction of the maximum rate of 25 percent the repeal of the alternative tax will have the effect of increasing the rate on capital gains for the smaller taxpayers, and will discourage the capital formation that is one of the purposes of the legislation.

The provision of the House bill that "indexes" capital gains is a recognition of the fact that much of the capital gains that is taxed is not gain at all, but is the result of inflation. In fact, according to a study by Joël Slemrod and Martin Feldstein published by the National Bureau of Eeconomic Research, the nominal gain created by inflation may be a real capital loss.[4]

The Tax Reform Act of 1976 began the process of converting the minimum tax from a safety net, which would catch those who paid no tax at all, to a penalty or a surtax on taxpayers who receive certain types of income. The 1976 Act did this by limiting the deduction for taxes to one-half of the total amount paid. The House bill reverses this process for capital gains by eliminating capital gains as a tax preference item under the current add-on minimum tax and creating a true alternative minimum tax for capital gains.

If the Committee wishes to retain the minimum tax concept in the law for capital gains, BOMA favors a true alternative minimum tax such as that included in the House bill and opposes the Administration's proposed change of the minimum tax law.

III. Corporate and individual rate reductions

The House bill reduces individual tax rate by $11.9 billion and corporate income tax rates by $5.1 billion.

While these reductions will no doubt be welcomed, for many taxpayers they will fall short of the amount necessary to offset the social security tax increases and the inflation-induced income tax increases scheduled and anticipated in 1979.

[4] Slemrod and Feldstein, using information from 1973 Federal income tax returns and considering only corporate stock, demonstrated that when adjusted for increases in the consumer price level, $4.5 billion in nominal gain became $1 billion in real capital loss.

Therefore, many taxpayers will pay more taxes, not less, in 1979, despite the passage of H.R. 13511.

Because of this fact, BOMA urges the committee to increase the amount of tax relief granted. To avoid being inflationary Congress must, at the same time, act to reduce Federal spending.

CONCLUSION

H.R. 13511 begins to address the problems of capital formation, inflation induced increases in taxation, and the impact of the increases in the social security taxes, but it does not go far enough. BOMA urges the Committee to build on the provisions of the House bill and to produce a tax bill that brings adequate relief to taxpayers at all levels and restores the economic incentives that will create growth and capital formation.

Thank you for allowing us to appear before this Committee.

Addendum

TESTIMONY OF RANDALL CRAIG ZISLER, ASSISTANT PROFESSOR, PRINCETON UNIVERSITY AND ECONOMIST, BUILDING OWNERS AND MANAGERS ASSOCIATION INTERNATIONAL ON THE TAUBMAN AND RASCHE STUDY OF ECONOMIC AND TAX DEPRECIATION

The U.S. Treasury has used a 1970 study conducted by Paul Taubman and Robert Rasche to show that allowable tax depreciation, based either on straight-line or accelerated methods, greatly exceeds actual economic depreciation. A closely related study by Taubman and Rasche appeared in the *National Tax Journal*, September, 1969. It was titled "Economic and Tax Depreciation of Office Building." The Taubman and Rasche study is so seriously flawed that its conclusions cannot be trusted.

I have been actively involved at Princeton University in research on investment and capacity utilization in the office building industry. I work extensively with individual office building data collected by the building Owners and Managers Association International (BOMA).

I will demonstrate that certain data deficiencies and faulty assumptions lead Taubman and Rasche to overestimate the useful life of an office building and underestimate its true rate of economic depreciation. Taubman and Rasche (TR) use cross-sectional rental income and expenditure data collected by BOMA to calculate economic depreciation. The data is highly aggregate, covering the years from 1951 to 1963. TR attempt to construct a time series of depreciation and building market values from thirteen cross-sections of U.S. national data. The data were published in BOMA's Experience Exchange Report. In addition, TR use the data as it is divided into four age classes: (1) less than 10 years old, (2) 10 to 25 years old, (3) 25 to 40 years old, and (4) over 40 years old. Based on data in these age classifications, TR construct a profile of net rental income for buildings of different ages within a given year's cross-section. In order to construct a net rental income profile, TR make certain explicit and implicit assumptions about income and costs which are not true.

TR use the cross-section profiles to construct a time-series of present discounted values (PDV) of sales revenue minus the sum of direct costs, repair costs and property taxes. Depreciation is then measured by the change in PDV, while the rate of depreciation is measured by the percentage change in PDV from one year to the next.

The net income data, which TR calculated from BOMA data for total operating income and total reported building expenditures, are perhaps the easiest to fault. Moreover, the net rental income data are the cornerstone of the TR study, for it is from these data that the depreciation calculations and eventually the TR conclusions follow.

The rental income data are biased downward. Many, if not most of the buildings reporting during the 1951–1963 period were partially or completely owner occupied. The likelihood of a building being owner occupied decreases with building age. Newer buildings, with wide bays and moren features, are always entering the market. These new buildings tend to attract owner-occupants of older buildings. It has been the practice of many building owner-occupants not to charge themselves rent. Therefore, it is most likely that the reported total operating income figures understate true income. I also suspect that this bias is more important in the earlier years of the 1951–1963 period. If a smaller per-

centage of the sample were owner-occupied in the latter years of the study period, then the stream of current dollar total rental income would seem flatter over time than it really is. In other words, I believe that true rents decrease much faster for a building over time than TR realize in their study. Deficiencies in the data base, which TR were not in a position to detect using aggregate national data, would seem to support by observations. If rents decline faster than TR report in their study, then they overestimate the true useful life of an office building.

TR are led to cost assumptions which are neither supported by industry experience nor by individual building data. For example, TR claim that "As long as future technical changes can not be introduced into existing buildings, present costs are good indicators of costs to be incurred as the building ages." This assumption is wrong. First, building codes, safety regulations, and occupancy standards are constantly in flux. Many of these codes apply to old as well as new buildings. Aside from changing market condiitons, code changes tend to induce replacement investment in older buildings. Repairs and alterations embody the latest cost-reducing technologies. In many instances, these repairs or alterations are more costly to implement in an older building than in a new building of the same size. Second, BOMA repair data are poor for the 1951–1963 period. Many buildings simply do not report repairs. Buildings that may report cleaning expenditures, for example, may not in practice report rental income or repairs and alterations. The aggregate data give the casual observer the false impression that the income data match the expenditure data on a building by building basis. Third, the reporting problem might not be so important were it not for the small sample properties of the aggregate data. Only a few buildings per city are included in the early BOMA reports. The buildings which do submit survey forms do so on a voluntary basis. The aggregate published data are not weighted to correct for nonrandomness in the survey method. Since the sample is not randomly drawn, it is difficult to make correct statistical inferences about the true underlying population of U.S. office buildings. Given small nonrandom samples, comparisons between years are seriously biased because these comparisons are not made between identical sets of buildings. As a result, it is most difficult to make reliable comparisons from year to year. If TR had used individual building data, which were not available for the 1951–1963 period, they could have used multiple regression to correct for changes in the location and characteristics of buildings constituting each year sample. However, without individual building data, it is difficult, if not impossible, to correct for some of these data problems.

There are various factors, other than depreciation, which affect nominal and real rental income. These factors can be regional or urban, or they can be specific to a particular neighborhood. The TR study does not separate out the non-depreciation related factors affecting rental income. Office space services are produced with inputs of office space as well as other inputs. Office building occupants buy space services, not simply office space. The quality attributes of office space services, and hence their market value, have changed over the years. These changes have been due in part to technological change. The timing of technological change and its incorporation into the modern office building, have been complex. The TR study does not propertly recognize the process by which office space services are produced. TR also oversimplify the pattern of replacement investment. In fact, TR overstate the true fixity of office building physical capital.

In conclusion, the TR study is handicapped by its data. In addition, the authors, who, in all likelihood, are unacquainted with the structure and function of the office building industry, make unsupported assumptions about costs and replacement investment. Although I cannot provide another study of depreciation which directly refutes their study, I do believe that the inherent biases in the data and their assumptions imply much shorter useful lives and faster rates of depreciation. These biases are serious enough to discredit the TR conclusions and tax policy recommendations.

Senator TALMADGE. The next group of witnesses will consist of a panel of: Mr. William L. Johnston, president, Council of State Housing Agencies; Mr. A. Carleton Dukess, president, National Housing Rehabilitation Association; Mr. William J. Langelier, chairman of the Executive Committee, Coalition for Low and Moderate Income Housing.

Gentlemen, you may come around. Your entire statements will be inserted in the record. Please summarize your statements not in excess of 5 minutes.

The first witness is Mr. William L. Johnston.

Mr. LANE. Senator, if I may, we would like to vary slightly the order of the witnesses.

Senator TALMADGE. All right. Who do you want to go first?

Mr. LANE. Mr. Langelier would go first.

Senator TALMADGE. Mr. Langelier, you are recognized, sir.

Mr. LANGELIER. Thank you, Senator.

STATEMENT OF WILLIAM J. LANGELIER, CHAIRMAN OF THE EXECUTIVE COMMITTEE, COALITION FOR LOW AND MODERATE INCOME BUILDING

Mr. LANGELIER. Thank you, Senator.

My name is William J. Langelier. I am appearing in my capacity as chairman of the executive committee of the Coalition for Low and Moderate Income Housing. I am accompanied today by the coalition's counsel, Bruce S. Lane of Lane & Edson, P.C., Washington, D.C.

To conserve the committee's time, I am also speaking on behalf of the National Leased Housing Association, a member of the coalition. In its own right, NLHA is a 600-member organization devoted to the production of new and rehabilitated housing under the section 8 leased housing program.

The Coalition for Low and Moderate Income Housing is organized to bring together into a single coalition all associations, trade groups, business organizations, and individuals as well as associated professionals involved in the private financing, production, rehabilitation, and operation of Government-assisted low- and moderate-income housing for the purpose of making known their views with respect to tax, securities, and similiar matters of common interest.

We now appear before you to state our views with respect to H.R. 13511, the Revenue Act of 1978, insofar as it affects low- and moderate-income housing.

As the committee well knows, the production of low-and moderate-income housing is an important part of the national housing goals established by Congress and supported by the administration. Since 1970, the construction and rehabilitation of more than 600,000 units of Government-assisted multifamily low- and moderate-income housing has been started or completed as a result of the combined incentives provided by the Internal Revenue Code and the Nation's housing laws. Incidentally, nearly two-thirds of these starts occurred in the peak years of 1970 to 1972, before the Nixon moratorium on subsidized housing construction, and we are still struggling to return to the levels of those years. For fiscal year 1978, the Secretary of Housing and Urban Development estimates that there will be 125,000 units of new and rehabilitated construction begun under the section 8 housing program which was enacted by Congress in 1974. The stated goal of the administration is 200,000 units for fiscal 1979, greater than the production of

any prior single year. All of this production depends heavily on the tax incentives of the Internal Revenue Code.

The 1976 Tax Reform Act served to eliminate many of the questionable practices—for example, the retroactive allocation of losses—in the area of tax shelters. Recently, the Internal Revenue Service's ruling policy, a more vigorous audit program, and various court decisions have reinforced the beneficial effects of the 1976 act and, in our opinion, give the Internal Revenue Service all the tools that it needs to prevent abuses in this tax shelter area.

Therefore, we applaud the decision of the Ways and Means Committee and the House of Representatives not to adopt further changes recommended by the administration and, in so far as low- and moderate-income housing is particularly concerned, to leave the law as it presently is.

The House also has taken several constructive steps on its own to insure the continuing viability of the incentives for investment in, and the production of, low-income housing. Most importantly, we support the decision of the House after several previous 1-year extensions by the Congress to extend through 1981 the rapid writeoff permitted by section 167(k) for rehabilitation expenditures related to low-income housing. This will relieve the rehabilitation industry from its annual "sword of Damocles" problem.

We also endorse the action of the House to eliminate the tax preference item for both the minimum and the maximum tax, to exclude half of the capital gains, and to reduce the capital gains tax to a maximum 35 percent rate. Indeed, we recommend that the Congress restore the 25-percent alternative tax for the first $50,000 of long-term capital gain; this has been eliminated by the House. We are not disturbed by the new 10-percent minimum tax on capital gains proposed by the House and we believe that the indexing concept, adopted by the House, is an idea whose time has come.

We support the action of the House in extending the at-risk rule to substantially all investments except for the real estate, but we point out that the language, as drafted, has several technical flaws in it, which will be addressed by the National Realty Committee, and others, in later tetimony.

We also concur in the decision of the House to extend the statute of limitations with respect to audits involving partners of large, syndicated partnerships which are subject to the registration or reporting requirements of the Securities and Exchange Commission.

Senator TALMADGE. I am sorry to have to call time on you, but we are under limited time constraints.

Who do you wish to testify next?

Mr. PAYNE. Senator, I will testify next.

Senator TALMADGE. You are Mr. Dukess?

Mr. PAYNE. My name is Carl Payne.

Senator TALMADGE. Payne?

Mr. PAYNE. Payne. P-a-y-n-e.

Senator TALMADGE. All right. You are recognized for 5 minutes, Mr. Payne, and your full statement will be inserted in the record.

Mr. PAYNE. I am substituting for Mr. William Johnston.

Senator TALMADGE. All right.

STATEMENT OF CARL PAYNE, DIRECTOR, COUNCIL OF STATE HOUSING AGENCIES

Mr. PAYNE. I submit this statement in my capacity as a director of the Council of State Housing Agencies. The Council of State Housing Agencies is an association representing the State housing agencies of virtually all of the approximately 40 States that have enacted such a program. Each State housing agency is an arm of the State Government that has created it. We have previously submitted to the committee a list of our membership.

I am the executive director of the Pennsylvania Housing Finance Agency, a political subdivision of the Commonwealth of Pennsylvania, and one of the more active State housing agencies in the Nation, responsible for the financing and development of low- and moderate-income housing.

Mr. Chairman, I want to support the statement made by the previous speaker and the speaker who is to follow me. However, I want to emphasize a few key points.

One, the construction of low- and moderate-income housing requires two major elements, mortgage financing and equity capital. Without those two elements, no housing can be produced. The State housing agencies make available the mortgage financing by issuing tax-exempt bonds, but the housing does not get constructed until the private sector produces the equity capital. It is that equity capital which the present tax incentives provide.

Whenever a private investor is making a decision with respect to the investment of capital, he considers alternate investments. There are many available to him, ranging from essentially risk-free tax-exempt municipal bonds to highly speculative ventures. The greater the risk, the higher the potential rate of return. In the area of equity investment in housing, the rate of return is composed of cash flow and tax benefits. In the case of low-income housing, cash flow is usually limited either by the Federal Government or by the State agency involved, and, in any event, it is problematical whether any such cash flow will be realized because of the character of the investment. Thus, the principal return on an investment in low- and moderate-income housing is provided through tax benefits. This has recently been carefully documented by the study done by the Congressional Budget Office, entitled "Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives," which was published in May 1977, and with which I believe your committee is familiar. That study points out that seemingly small changes in the tax law would collapse the entire structure, especially in the areas of low- and moderate-income housing.

The 1976 Tax Reform Act served to eliminate many abusive practices. More recently, the Internal Revenue Service's rulings policy, a vigorous audit program and certain court decisions have reinforced the beneficial effect of the 1976 act. Therefore, we were delighted that the House of Representatives saw fit not to modify any further the tax law as it affects low- and moderate-income housing. In addition, we believe that the decisions of the House with respect to capital gains are sound and will further encourage investment in low-income housing. We would urge, however, that the Senate restore the 25 percent "alternative tax" for the first $50,000 of capital gains.

Second, we would like to echo loudly the request of my fellow panelists that the cutoff dates in section 189 affecting low-income housing and the section 167(k) cutoff date both be removed. It makes no sense for these dates to continue, since they will begin to affect the pipeline of housing well before 1981—as early as 1979.

Senator MOYNIHAN. We will get back to you, Mr. Payne, in the course of the questioning.

Do I understand Mr. Dukess is next?

Mr. LANE. My name is Bruce Lane, and I am substituting for Mr. Carl Dukess, who is the president of the National Housing Rehabilitation Association.

Senator MOYNIHAN. Mr. Lane, we welcome you. Go right ahead.

STATEMENT OF BRUCE LANE ON BEHALF OF A. CARLETON DUKESS, PRESIDENT, NATIONAL HOUSING REHABILITATION ASSOCIATION

Mr. LANE. Senator, I would like to summarize, on behalf of all three of the panelists, the basic position of the low- and moderate-income housing industry with respect to H.R. 13511 and also to make one particular point on behalf of the rehabilitation association involving the area of tax preferences.

First of all, the basic position of all three of the witnesses on this panel is support for the extension of 167(k) for an additional 3 years. Further, we suggest that any cutoff dates relating to section 167(k), and those pertaining to section 189 insofar as they involve low-income housing, be eliminated.

The reason for these cutoff dates was to encourage the Congress and the administration to study alternative means, other than through tax expenditures, to subsidize low-income housing. Frankly, we do not believe that between now and the end of 1981 any such alternatives will be studied and put in place. In addition, we believe that the existence of those cutoff dates will, as early as 1979, start to discourage production because of the long leadtime that is involved in the production of housing.

So we urge that all such cutoff dates be removed; we also believe that a study of alternatives still be mandated by Congress. We are looking for alternative methods, and when an alternate method has been established and tested, Congress is, of course, free to come along and change the law with regards to tax incentives. But meanwhile, remove the "sword of Damocles" that exists at the moment.

Second, the NHRA supports the various actions taken by the House, as have other speakers, with regard to the capital gains tax but we would like to see the 25-percent alternative tax restored for the first $50,000 of capital gains in order to continue to encourage smaller investors to invest in low income housing.

We have, in our prepared testimony, a couple of technical amendments which we think are very important and which we have addressed with this committee, the Ways and Means Committee, and the staff before, and we believe that this would be an appropriate time to handle them.

First, of all, with regard to the definition of low-income housing, we believe that one of two things should be done. Either a more generic definition of low-income housing should be put into the Code, one that does not turn constantly on references to various sections of the housing

law, which are constantly changing. So every time the housing law changes, for example, from the section 236 program to the section 8 program, we do not have to come up and amend the Internal Revenue Code.

We have suggested some language for that.

If you do not see fit to go that far in this particular legislation, there is one special program that involves State housing finance agencies reference to the State agency housing programs as they relate to the Federal housing program. In two places the language is really very ambiguous and we have suggested language in attached exhibits which would remove this ambiguity and provide certainty to everybody when we are dealing with the State housing programs that we are dealing with low-income housing programs as defined in the Internal Revenue Code. There is no intent on our part to change the existing law in this regard, but simply to remove the ambiguity.

Last, we would like to see the section 1039 rollover provision extended to State housing agency financed low-income housing, to which it does not apply at the moment, as well as to Federal low-income housing. We would also like to see the inequity that exists between the tax preference items which are created by rehabilitation and those created by new housing eliminated.

We do not feel that rehabilitated housing should give rise to a greater tax preference for purposes of the minimum and maximum tax than new construction does. By a quirk of the laws now, if you rehabilitate, you are faced with greater tax preferences than if you get involved in new construction, which discourages rehabilitation for inner cities.

Therefore, we suggest that the——

Senator MOYNIHAN. Would you mind saying that again?

Mr. LANE. Under the present law, all depreciation in excess of straight line depreciation is treated as a tax preference item. Rehabilitated housing is entitled to a fast 5-year writeoff.

Senator MOYNIHAN. Right. That is 167(k)?

Mr. LANE. Exactly. The amount of depreciation in excess of depreciation in that case over that 5-year period is much larger than the amount of depreciation in excess of straight line in the case of new construction, even if you are using 200 percent depreciation for the new construction, so that there is a gap. If the straight line is here, the gap above it for rehabilitation is like this and for new construction, even at the most rapid rate, is like that. We are suggesting they be made equal by saying the tax preference created by rehabilitation not be any greater than the largest tax preference related to new construction.

Senator MOYNIHAN. I thought you said—and I am probably wrong—that the preference was to new construction?

Mr. LANE. Both of them give rise to a preference. We want the preference to be no greater or less than the maximum for new construction, so people will not favor new over rehabilitation.

Senator MOYNIHAN. So they will not favor new?

Mr. LANE. So they will be neutral in terms of an investment decision. As it is now, they would favor new over rehabilitation.

The more favorable situation——

Senator MOYNIHAN. I thought it was the other way around, but let's let Senator Hansen pursue the matter. I am confused enough already.

Senator HANSEN. I thought the witness was saying that presently there would be a faster write-off of depreciation for rehabilitated construction than for new construction?

Senator MOYNIHAN. That is what I thought.

Mr. LANE. That is exactly right. On the one hand, the code provides a faster writeoff which is beneficial from a tax incentive viewpoint for rehabilitation than new construction. On the other hand, a greater amount of that writeoff is treated as a tax preference item than would be the case for new construction. So you give with one hand and take it away, with the minimum and maximum tax, with the other. So you do not have a neutral situation.

I hope that helps to clarify it.

Senator MOYNIHAN. It is very clear to me that you understand it and I do not. Somebody on this committee should.

Mr. LANE. I hope the staff could be of help on this. I have talked to them about this in the past.

Senator MOYNIHAN. Senator Hansen?

Senator HANSEN. I will ask no more questions.

Senator MOYNIHAN. Gentlemen, you have made some very important points. For example, with regard to the unanticipated consequences of different sections of the code here, I was comfortable with the notion that rehabilitation was receiving a certain stimulus as against new construction in our tax code, but I find the opposite. That is what persons such as yourself are for.

I would like to make the general point that I thought the testimony of each of you, Mr. Payne, Mr. Langelier and yourself, sir, were remarkably convergent with much other testimony we have had this last week. Although you represent a governmental sector, you represent an aspect of it in which people invest or do not as they can make profits from it.

You have been talking about capital gains very much in the same terms of the great captains of industry and others who have been coming here all week have as well. It is rather interesting and perhaps reassuring, because, I think we are moving in the direction of the Hansen-Steiger amendment, even though it may or may not be known as that by the time it emerges from this committee.

Mr. LANE. If I could comment on that briefly, I think that is an interesting perspective. I think that it is because there has been a decision made by the Congress some time ago that the private sector, working in conjunction with State housing agencies and similar entities, is to produce low- and moderate-income housing and they must turn to the private sector for the equity portion of the money that goes into that housing.

When they turn to that sector, they are involved in the private market and competing for capital, frankly, in the same way that General Motors, or somebody else, is competing for capital, and we have the same problems of what the capital gains tax will be, and so on.

Senator MOYNIHAN. Some persons have not been as supportive of Senator Hansen's proposal as most of his fellow Senators have been and I count myself as one of them. Would you agree that when we think about the proposal, public housing is not the first thing that comes to mind, and yet public housing is very much involved. The provision of low and moderate housing is very much involved with the rates of return on capital and you are asking us to reduce capital gains taxes on low and moderate housing.

Mr. LANE. We stress the preservation of the alternative 25 percent rate because so often the investment in low-income housing is made by a number of small people, each buying units of a project. They will benefit greatly by that.

Senator MOYNIHAN. When you touch the Tax Code, you touch everything. We have more in mind here than just add to the resources of Chase Manhattan. We are trying to build things, and that includes low-income housing.

Are you having a fairly good year right now, Mr. Payne?

Mr. PAYNE. The State housing agencies, Senator, so far, since the section 8 program has been in existence, which is about 3 years, have produced about 52 percent of the construction starts through the financing mechanism that we are talking about here today. So I would say we hope that we have been pretty successful in producing and carrying out various missions.

Senator MOYNIHAN. We hope so, too.

The question is, Do we want to have an even choice as to between new construction and rehabilitation? That is the policy decision.

You think it ought to be, that we not prefer one to the other?

Mr. LANE. That is basically what we are suggesting. In the area of tax preferences, the decision should be neutral.

Senator MOYNIHAN. The decision should be neutral.

Mr. LANGELIER. If I could comment, in the 1976 Tax Reform Act the amount of available writeoffs under rehabilitation that you could write-off rapidly was increased by approximately 33 percent.

On the other hand, as Mr. Lane pointed out, the amount of minimum tax as a result of those writeoffs was a severe deterrent to an investor to invest in a rehabilitation development.

So with Congress as well as HUD emphasizing rehabilitation on the one hand, the effects of the 1976 act are causing a tremendous deterrent on the other hand in terms of investor attraction.

I think that Mr. Lane's suggestion of bringing it to parity with new construction is very equitable.

Senator MOYNIHAN. This is a decision. We are making housing policy and neighborhood policy besides tax policy. We will attend to this matter with great detail.

Senator Packwood?

Senator PACKWOOD. No questions.

Mr. LANE. One last comment.

If we could have your thoughts on one other point we made, which we believe is technical, removing this ambiguity in the definition of lower-income housing, with regards to State housing. If we could address that with the staff? It is strictly a technical point, but it is very important to be able to proceed with certainty.

Senator MOYNIHAN. I see Mr. Cohen in the audience. He would agree that ambiguity is the essence of the tax code.

If we start removing ambiguity—Mr. Cohen has a remark.

Mr. COHEN. I was going to say, Mr. Chairman, it is only the elimination of ambiguity that is the essence of the tax code.

Senator MOYNIHAN. We thank you for a very useful testimony in bringing to our attention, and to that of our guests, the wide range of implications of some of these matters in two areas that are not generally thought of as being involved.

We appreciate very much what you have brought to us.

[The prepared statements of the preceding panel follows:]

STATEMENT OF WILLIAM J. LANGELIER, PRESIDENT, COALITION FOR LOW AND MODERATE INCOME HOUSING

Mr. Chairman and members of the committee: My name is William J. Langelier. I am appearing in my capacity as Chairman of the Executive Committee of the Coalition for Low and Moderate Income Housing. I am accompanied today by the Coalition's counsel, Mr. Bruce S. Lane, of Lane and Edson, P.C., Washington, D.C.

To conserve the Committee's time, I am also speaking on behalf of the National Leased Housing Association, a member of the Coalition. In its own right, NLHA is a 600-member organization devoted to the production of new and rehabilitated housing under the Section 8 leased housing program.

The Coalition for Low and Moderate Income Housing is organized to bring together into a single coalition all associations, trade groups, business organizations and individuals, as well as associated professionals, involved in the private financing, production, rehabilitation and operation of government-assisted low and moderate income housing, for the purpose of making known their views with respect to tax, securities, and similar matters of common interest. During consideration of the Tax Reform Act of 1976, the Coalition worked actively with the Administration, this Committee, and the other committees and members of Congress with respect to the provisions of that act which affect low and moderate income housing.

Now we appear before you to state our views with respect to H.R. 13511, The Revenue Act of 1978, insofar as it affects low income housing.

As the Committee well knows, the production of low and moderate income housing is an important part of the national housing goals established by Congress and supported by the Administration. Since 1970, the construction or rehabilitation of more than 600,000 units of government-assisted multifamily low and moderate income housing has been started or completed as a result of the combined incentives provided by the Internal Revenue Code and the nation's housing laws. Incidentally nearly two-thirds of those starts occurred in the peak years of 1970–1972, before the Nixon moratorium on subsidized housing production, and we are still struggling to return to the levels of those years. For fiscal year 1978, the Secretary of Housing and Urban Development estimates that there will be 125,000 units of new and rehabilitated construction begun under the Section 8 housing program which was enacted by Congress in 1974. The stated goal of the Administration is 200,000 units for fiscal year 1979—greater than the production of any single prior year. All of this production depends heavily on the tax incentives of the Internal Revenue Code.

The 1976 Tax Reform Act served to eliminate many questionable practices, for example, the retroactive allocation of losses, in this area of tax shelters. Recently the Internal Revenue Service's rulings policy, a more vigorous audit program, and various court decisions have reinforced the beneficial effects of the 1976 Act and, in our opinion, give the Internal Revenue Service all of the tools that it needs to prevent abuses in this tax shelter area. Therefore, we applaud the decision of the Ways and Means Committee and of the House of Representatives not to adopt further changes recommended by the Administration and, insofar as low and moderate income housing is particularly concerned, to leave the law as it presently is.

The House has also taken several constructive steps on its own to ensure the continuing viability of the incentives for investment in, and the production of, low income housing. Most importantly, we support the decision of the House, after several previous one-year extensions by Congress, to extend through 1981 the rapid write-off permitted by Section 167(k) for rehabilitation expenditures related to low income housing. This will relieve the rehabilitation industry from its annual "sword of Damocles" problem.

We also endorse the action of the House in eliminating as a tax preference item, for purposes of both the minimum and the maximum tax, the excluded half of capital gains, and the reduction of the capital gains tax to a maximum 35 percent rate. Indeed, we recommend that the Senate restore the 25 percent "alternative tax" for the first $50,000 of long term capital gain, which alternative tax has been eliminated by the House. We are not disturbed by the new 10 percent minimum tax on capital gains proposed by the House, and we believe that the "indexing" concept adopted by the House is an idea whose time has come.

We support the action of the House in extending the "at risk" rule to substantially all investments except for real estate, but we point out that the language as drafted has several technical flaws in it. We understand that these will be addressed by the National Realty Committee and others, and we support their technical comments in that regard.

We also concur in the decision of the House to extend the statute of limitations with respect to audits involving partners of large syndicated partnerships which are subject to the registration or reporting requirements of the Securities and Exchange Commission.

I would like to address the balance of my comments to a problem that we see arising on the horizon and to several suggestions not contained in H.R. 13511.

At the end of 1981, certain of the incentives for low and moderate income housing, particularly the ability under Section 189 to deduct currently construction period interest and taxes and, if H.R. 13511 is passed in its present form, the ability to write off rehabilitation expenditures over a five-year period, will expire. The though behind those "cut-off" dates is to compel a study of methods, other than tax expenditures, which might serve equally well to encourage the construction and/or rehabilitation of low income housing. We favor such a study—indeed, we urge that Congress should mandate it and that it should further mandate that the study be conducted jointly by the government and the private sector through the use of a commission or task force such as the Kaiser and the Douglas Commissions, which so effectively studied housing in the past.

But, once a study is completed, if a potentially more effective alternative is proposed, it must be enacted, tested, and placed in operation before the present tax incentives can be replaced. Given the other priorities of the Administration and the Congress, it is unlikely that all of this will happen before the end of 1981. In the meantime, you cannot play brinkmanship with an industry in which the lead time between conception and production is at least three years—sometimes more. To write in a 1981 deadline is to begin to cause production to gear down as early as the beginning of 1979, because it is at that time that land is first acquired, plans and specifications are drawn, zoning applications are filed and building permits obtained. The housing itself results two or three years later. Producers will stop the planning process long before the end of 1981. There is no merit to a deadline. Congress has the authority at any time to modify or terminate any provision of the Internal Revenue Code. The exceptions in Section 189 of the Code for low and moderate income housing and Section 167(k) should be continued without change or deadline until such time, after a study has been completed, that an alternate program has been enacted and is operational. Should the Congress feel that it is imperative to have some deadline in the Code, we recommend that it be at least December 31, 1984.

We also wish to urge upon this Committee certain other modifications to the Internal Revenue Code, which we have already discussed with the Joint Committee staff and the Treasury Department. Briefly, we recommend that:

The definition of preference items be modified to provide that the additional depreciation permitted for rehabilitation projects shall be treated as a preference item only to the extent of the depreciation deductions allowable if the deduction were computed under the most accelerated rate applicable to new housing with the same useful life as the rehabilitated housing;

A generic definition of low-income housing be adopted so that it will not be necessary to amend the Code each time that a new federal housing program is implemented (see Exhibit A);

If the present definition is retained, that certain language in Section 1250 (a)(1)(B) be clarified (see Exhibit B): and

Section 1039 be amended to permit the tax-free "roll-over" of *all* low-income housing, not only certain *federally* assisted low income housing.

Other speakers will address these latter points more fully than I. Thank you, Mr. Chairman.

EXHIBIT A

A Proposed Definition of Low-Income Housing

Low-income housing shall mean a housing project providing rental or cooperative housing—

(A) with respect to which:

(i) a mortgage is insured under section 221(d)(3) or 236 of the National Housing Act, or

(ii) financing or assistance is provided by a state or local government, or an agency thereof, by loan or tax abatement, or

(iii) there exists a housing assistance payment contract, or an agreement to enter into such a contract, between the Department of Housing and Urban Development or a state or local public housing agency and the owner with respect to 50% or more of the dwelling units, or

(iv) other financing, assistance, or subsidy is provided by the United States or an agency thereof and the housing is occupied, or held for occupancy by, families of low or moderate income, and

(B) with respect to which the owner is by the law under which such housing is operated, or regulations thereunder:

(i) limited as to rentals or occupancy charges for the assisted units in the project, and

(ii) in the case described in Section (A)(ii) above, limited as to the rate of return on his investment in the project.

Exhibit B

Proposed Clarifying Amendment to Section 1250(a)(1)(B) (i) and (ii)

(B) *Applicable percentage.*—For purposes of subparagraph (A), the term "applicable percentage" means—

(i) in the case of section 1250 property with respect to which a mortgage is insured under section 221(d)(3) or 236 of the National Housing Act, or housing financed or assisted by direct loan or tax abatement under provisions of State or local laws intended primarily to finance or assist housing for families or individuals of low or moderate income and with respect to which the owner is subject to the restrictions described in section 1039(b)(1)(B), 100 percent minus 1 percentage point for each full month the property was held after the property was held 100 full months;

(ii) in the case of dwelling units which, on the average were held for occupancy by families or individuals eligible to receive subsidies under section 8 of the United States Housing Act of 1937, as amended, or under the provisions of State or local law, providing for subsidies of a similar nature for low or moderate income families and individuals, 100 percent minus 1 percentage point for each full month the property was held after the date the property was held 100 full months; * * *

[Also, in Section 1250(a)(2)(B)(ii) an amendment should be made identical to that recommended above for Section 1250(a)(1)(B)(i)].

STATEMENT OF CARL PAYNE, DIRECTOR, COUNCIL OF STATE HOUSING AGENCIES

Mr. Chairman and Members of the Committee: My name is Carl Payne. I submit this statement in my capacity as a director of the Council of State Housing Agencies. I am accompanied today by the Council's general counsel, Bruce S. Lane, Esq., of Lane and Edson, P.C., Washington, D.C.

The Council of State Housing Agencies is an association representing the state housing agencies of virtually all of the approximately 40 states that have enacted such a program. Each state housing agency is an arm of the state government that has created it. We have previously submitted to the Committee a list of our membership.

I am the Executive Director of the Pennsylvania Housing Finance Agency, a political subdivision of the Commonwealth of Pennsylvania and one of the more active state agencies in the nation responsible for the financing and development of low and moderate income housing.

State housing programs have become an important element in the field of government-assisted housing. To date their programs have assisted the development of over 200,000 units of multifamily low and moderate income housing, representing an aggregate investment of over seven billion dollars. The bulk of this housing was developed in conjunction with the interest subsidies provided by the federal Section 236 program and, more recently, with the rental subsidies provided through the Section 8 housing program. Since the start of the Section 8 housing program in 1974, 52 percent of all housing begun under that program has been developed in conjunction with financing provided by state housing finance agencies, and for the 1978 fiscal year, we project that 48,000 units of such housing will be reserved.

Mr. Chairman, I want to support the statements of the Coalition for Low and Moderate Income Housing and the National Housing Rehabilitation Association, who share this panel with me. I will not repeat here all of those points, but I do want to briefly emphasize a few key issues.

The construction of low and moderate income housing requires two major elements, mortgage financing and equity capital. Without those two elements, no housing can be produced. The state housing agencies make available the mortgage financing by issuing tax-exempt bonds, but the housing doesn't get built until the private sector produces the equity capital. It is that equity capital which the present tax incentives provide.

Whenever a private investor is making a decision with respect to the investment of capital, he considers alternate investments. There are many available to him, ranging from essentially risk-free tax-exempt municipal bonds to highly speculative ventures. The greater the risk, the higher the rate of return. In the area of equity investment in housing, rate of return is composed of cash flow and tax benefits. In the case of low-income housing, cash flow is usually limited either by the federal government or by the state government involved, and, in any event, it is problematical whether any such cash flow will be realized because of the character of the investment. Thus, the principal return on an investment in low and moderate income housing is provided through tax benefits. This has recently been carefully documented by the study done by the Congressional Budget Office entitled "Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives," which was published in May, 1977 and with which I believe your Committee is familiar. That study points out that seemingly small changes in the tax laws could collapse the entire structure, especially in the areas of low and moderate income housing.

The 1976 Tax Reform Act served to eleminate many abusive practices. More recently, the Internal Revenue Service's rulings policy, a vigorous audit program, and certain court decisions have reinforced the beneficial effect of the 1976 Act. Therefore, we were delighted that the House of Representatives saw fit not to modify any further the tax law as it affects low and moderate income housing. In addition, we believe that the decisions of the House with respect to capital gains are sound and will further encourage investment in low income housing. We would urge, however, that the Senate restore the 25 percent "alternative tax" for the first $50,000 of capital gains.

Next, we would like to echo loudly the request of my fellow panelist that the "cut-off" dates in Section 189 affecting low income housing and the Section 167 (k) cut-off date both be removed. It makes no sense for these dates to continue since they will begin to affect the pipeline of housing well before 1981—as early as 1979. When and if alternatives to tax expenditures as incentives are found and are in place Congress can amend the Code to eliminate the favorable treatment accorded low income housing. Until then, let us continue our good work.

In addition, we ask you to remedy two technical problems which we have brought frequently to the attention of the House and the Joint Committee Staff. (1) The present definition of low income housing, set forth in Section 1250(a) (1) (B) if it is retained, needs to be clarified in the manner set forth in Exhibit A. The word "similar" is simply inappropriate and gives rise to many ambiguities and uncertainties. (2) Section 1039 should be amended to permit the tax-free "rollover" of *all* low-income housing, not only *certain federally* assisted low income housing.

Lastly, I wish to alert the Committee to an increasingly difficult problem facing state assisted housing. As I indicated a moment ago, state housing agencies make mortgage financing available by issuing tax exempt bonds. Those bonds derive their tax exempt status from Section 103 of the Code. Over the past several years, and especially in the last nine months, the Treasury Department has issued a barrage of Temporary and Proposed Regulations seeking to regulate arbitrage bonds in general and advance refunding bonds in particular. Many of these regulations are attempts by the Treasury to eliminate what they perceive to be abusive practices, almost all of which occur in connection with the advance refunding of industrial development bonds. Both because housing bonds are technically industrial development bonds and because the regulations often go well beyond the intended targets, housing bonds are often seriously affected by these regulations. There have been several instances during recent years

when the state housing programs have been seriously hampered by the sudden and sweeping nature of these proposed Treasury Regulations. New money for new projects has been materially delayed and legitimate advance refundings have been greatly handicapped.

The Treasury Department is aware of our problems and, in fairness, has always been most sensitive to them. (We are not the issuers that they are out to get.) Indeed, when the December 1, 1977 proposed regulations were issued Treasury stated publicly that it would ask Congress to amend the Code to avoid hardships to state and local governments. Unfortunately, that legislation has not yet been proposed. Our dialogue with Treasury continues; we continue to find Treasury sympathetic; and we hope that our problems can be resolved by some combination of legislation and regulation.

However, we know that through the so-called Bentsen bill (S. 3370) this Committee is already aware of, and is considering, the views of others regarding the recent Treasury regulations. We want this Committee to know that we too have a problem and that if Treasury is not ultimately able to resolve it, we may be back on our own, seeking legislative relief or supporting the others who are already before you.

Thank you for your attention.

Exhibit A

Proposed Clarifying Amendment to Section 1250(a) (1) (B) (i) and (ii)

(B) *Applicable percentage.*—For purposes of subparagraph (A), the term "applicable percentage" means—

(i) in the case of section 1250 property with respect to which a mortgage is insured under section 221(d)(3) or 236 of the National Housing Act, or housing financed or assisted by direct loan or tax abatement under similar provisions of State or local laws intended primarily to finance or assist housing for families or individuals of low or moderate income and with respect to which the owner is subject to the restrictions described in section 1039(b)(1)(B), 100 percent minus 1 percentage point for each full month the property was held after the property was held 100 full months;

(ii) in the case of dwelling units which, on the average were held for occupancy by families or individuals eligible to receive subsidies under section 8 of the United States Housing Act of 1937, as amended, or under the provisions of State or local law authorizing similar levels of subsidy for lower-income families, providing for subsidies of a similar nature for low or moderate income families and individuals, 100 percent minus 1 percentage point for each full month the property was held after the date the property was held 100 full months; * * *

[*Also, in Section 1250(a) (2) (B) (ii) an amendment should be made identical to that recommended above for Section 1250(a) (1) (B) (i)*].

STATEMENT OF CARLETON DUKESS, PRESIDENT, NATIONAL HOUSING REHABILITATION ASSOCIATION

Mr. Chairman and Members of the Committee:

My name is A. Carleton Dukess. I am the President of the National Housing Rehabilitation Association. I am accompanied by Mr. Bruce Lane of Lane and Edson, P.C., counsel to the Association.

Our Association subscribes fully to the positions of the Coalition for Low and Moderate Income Housing and the Council of State Housing Agenies, both of which are testifying on this panel. I will restrict my remarks to the rehabilitation of housing for low and moderate income families.

The National Housing Rehabilitation Association is an organization composed of approximately 125 persons and organizations active in the business of rehabilitating housing for low and moderate income families. Members of the Association include developers, builders, contractors, management firms, suppliers, and associated professionals. The members of the Association include some of the most active organizations in the field of government-assisted rehabilitation, and account for a significant proportion of the multifamily rehabilitation projects undertaken with HUD or state assistance.

We have previously testified at length before this Committee. The key point that we have made previously is the pressing need for rehabilitation—preservation, restoration, call it what you will—of our nation's older housing inventory. The importance of this process to stabilizing and upgrading neighborhoods and preserving cities is so obvious (especially when viewed in light of the obstacles being put in the path of a new development) and so well-known to the Committee that I will not dwell on it at length.

In recognition of this, a major national commitment recently has been made to rehabilitation, preservation and restoration of the nation's existing housing stock. That commitment has been expressed by the President, by HUD Secretary Harris, and by Senator Proxmire and Congressman Ashley, chairmen respectively of the Senate Committee and the House Sub-committee responsible for urban affairs.

On March 2, 1978, Secretary Harris spoke to the Annual Meeting of our Association and stated: "You're where the action's at. We [HUD] want to work with you on stimulating and streamlining the production of multifamily rehabilitated housing." She pointed to several components of her department's budget for fiscal year 1979 which reflect its sharply increased interest in rehab: a 50% increase in Section 312 loan funds; 70,000 units proposed for Section 8 rental assistance for substantial rehab; and a new "moderate rehabilitation" program within Section 8, an additional 39,000 units. She also mentioned HUD's new Neighborhood Strategy Areas program for rehab; its proposed coinsurance program; and the Targeted Tandem assistance to be made available with Section 221(d)(4) multifamily projects.

The ability of the private sector to respond to this challenge often has been questioned. The principal incentive for private sector involvement has been Section 167(k), which was added to the Internal Revenue Code by the Tax Reform Act of 1969. This is the five-year writeoff of rehabilitation expenditures for housing of families of low and moderate income. As you know, when Section 167(k) was enacted in 1969, it was for a trial period of five years. On three separate occasions now, Congress has extended 167(k), each time for only one year and then only after frantic last-minute efforts on the part of HUD and the private sector. As presently written, Section 167(k) will essentially expire at the end of this year, 1978. We are delighted that H.R. 13511, as passed by the House, at last recognizes our "sword of Damocles" problem and extends Section 167(k) for three years through December 31, 1981. That action has the full support of the Administration (see Exhibit A) and we urge this Committee to at least preserve the good work done by the House. Indeed, as the Coalition for Law and Moderate Income Housing has pointed out, we believe that the deadline should be removed entirely, since Congress can amend the law at any time, and we urge you to consider that proposal seriously.

In addition, I want to ask this Committee to correct an inequity imposed on rehabilitation expenditures as a result of the Tax Reform Act of 1976. As you know, the Tax Reform Act of 1976 increased the rate of the minimum tax on tax preference items and reduced the exemption. Further, it eliminated entirely the $30,000 "maxi-tax" exemption.

Under present law, depreciation in excess of straight-line depreciation is treated as a tax preference item for purposes of both the minimum and the maximum tax. Subject to a modest exemption, the minimum tax imposes an additional tax of 15% on such excess depreciation. In the case of the maximum tax, each dollar of excess depreciation reduces the amount of an investor's earned income which is subject to the maximum tax rate of 50% and subjects that income to a higher rate of tax, which could be as high as 70%.

Rehabilitation expenditures are struck particularly hard by these provisions of the Internal Revenue Code, more so than new construction because the amount of excess depreciation during the five years permitted by the election is much greater than that permitted under even the most accelerated rate of depreciation available for new construction. This treatment is sort of a schizophrenic approach which says on the one hand "a five-year writeoff is necessary in order to meet the nation's needs" while on the other hand stating "those who avail themselves of such a writeoff will be punished."

Therefore, we recommend that for purposes of both the minimum and the maximum tax, the amount of the Section 167(k) depreciation treated as a preferance item be limited to the amount which would be a preference item if the depreciation deduction were computed by using the most accelerated rate of depreciation permitted for new construction with the same useful life as the

entire rehabilitated structure. This proposal would equalize tax treatment of rehabilitation projects with that of new construction and would encourage the restoration of the inner cities, which is an avowed policy of the present Administration.

I will be glad to answer any questions. Thank you for your attention.

Exhibit A

DEPARTMENT OF THE TREASURY,
Washington, D.C., April 5, 1978.

Hon. AL ULLMAN,
Chairman, Committee on Ways and Means,
House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: In testimony before your Committee regarding the Presidents tax proposals on real estate depreciation, several witnesses stated that section 167(k) of the Internal Revenue Code, which permits 5-year amortization for rehabilitation expenses, should be extended through 1982.

This extension is provided for in the Administration's budget, and the Administration does not object to continuing this provision through 1982. I would like to emphasize that there are several other tax subsidies for low- and moderate-income housing which the President has proposed be extended through 1982. By that time, the Administration will have completed an analysis of tax and alternative subsidies for housing and will have made recommendations to the Congress for a coherent and coordinated pattern of housing subsidies. Because of this study and because we are proposing that other subsidies be continued through 1982, we do not object to the extension of section 167(k) during that same period.

Sincerely,

DONALD C. LUBICK,
Acting Assistant Secretary, (Tax Policy).

Senator MOYNIHAN. Now we have another panel appearing, again in a related area of public policy that we would not immediately associate with the Tax Code the area of private giving. We have Mr. Conrad Teitell—good morning to you—Mr. Moskowitz, vice president, Government Relations of the United Way; and Mr. Norman Sugarman, representing the Council of Jewish Federations.

We welcome you, gentlemen, and Mr. Teitell, will you begin?

STATEMENT OF CONRAD TEITELL, ESQ.

Mr. TEITELL. Mr. Chairman, members of the Committee, I am Conrad Teitell, a member of the New York City Law Firm of Prerau and Teitell and appear as Special Council to the American Association of Presidents of Independent Colleges and Universities, the Mayo Clinic, 48 New York colleges and universities and 36 other charitable organizations, many of them national umbrella organizations whose names appear on the written statement submitted to the Committee.

The organizations on whose behalf I appear have the same general interest and have consolidated their testimony so as to conserve the Committee's time.

I request that our prepared statement be inserted into the record.

Senator MOYNIHAN. We would be very happy to do that.

Mr. TEITELL. Thank you.

We ask that the charitable deductions be available to all taxpayers, including those who take the standard deduction. Matyas Rakosi, Hungarian Communist Party general secretary once said, "When you want to get hold of a salami which your opponents are strenuously defending, you must not grab at it. You must start carving for yourself

a very thin slice. Then the owner of the salami will hardly notice it, or at least he will not mind very much. The next day you will carve another slice, and then another, and so little by little, the whole salami will pass into your possession.

In 1970, 50 percent of the taxpayers itemized their deductions and thus had tax incentives to make charitable gifts.

Today only 24 percent of the taxpayers itemize their deductions.

H.R. 13511 would reduce even further the percentage and number of taxpayers who itemize their charitable deductions. There has been a steady slicing away at the tax incentives to those who wish to support charitable organizations.

This decrease in tax incentives has not come about because Congress wished to decrease tax incentives for charitable giving, but happened rather almost accidentally as a result of other tax law changes.

There is a solution. Charitable deductions should be deductible from gross income rather than adjusted gross income. This is not blazing a new Internal Revenue Code trail. The Code already allows some deductions for all taxpayers whether or not they itemize, for example, moving expenses and alimony are allowed as deductions from gross income.

Therefore, we urge passage of the Moynihan-Packwood bill, Senate bill 3111, which would allow charitable deductions to all taxpayers.

Reasonable men and women can differ with the President's statement that parts of H.R. 13511 would provide huge tax windfalls for millionaires and two bits for the average American. However, we hope that you agree that passage of the Moynihan-Packwood bill would provide tax benefits for the average American. Millionaires already itemize their charitable deductions.

Passage of the Moynihan-Packwood bill would benefit the Nation by providing additional support for charitable institutions which serve the average American.

Mr. Chairman, members of the committee, thank you for this opportunity to be here to present our views.

Senator MOYNIHAN. Are you aware that you have not used up your time? This is an event that should be reported.

We will get back to you in more detail.

Mr. TEITELL. I yield it to my colleagues.

Senator MOYNIHAN. Who is next?

Mr. MOSKOWITZ. I believe I am next, but Mr. Teitell has covered the subject very well. If I could have my statement inserted into the record——

Senator MOYNIHAN. We would be happy to do that.

JACK MOSKOWITZ, VICE PRESIDENT, GOVERNMENT RELATIONS, UNITED WAY OF AMERICA

Mr. MOSKOWITZ. As a supporter of public radio and television, I listened with sympathy recently to my local station's appeal for funds. After each appeal, the announcer stated that the contribution was tax deductible.

I realize now that this statement is misleading. To be accurate and not deceptive, the statement should be followed by a disclaimer that the deduction is available to only one-quarter of all taxpayers—those in the highest income brackets who itemize their deductions.

If H.R. 13511 becomes law, the deduction will become available to only one out of five taxpayers, and that one will likely be in the highest income bracket.

The announcer's statement would be accurate if the Tax Code were amended to allow all taxpayers to take a deduction for their charitable gifts whether they itemize or not. Approval of the Moynihan-Packwood bill, S. 3111 as an amendment to H.R. 13511 will make this a reality and assure that every taxpayer is encouraged to support charitable, educational, and artistic endeavors.

The United Way of America endorses this change in our tax law and deems passage essential to maintaining a strong, independent, and voluntary sector.

The Moynihan-Packwood bill would accomplish two beneficial purposes. It reduces taxes for those who need it most—moderate-income Americans. Second, charitable giving to institutions supported by these Americans is increased by an amount larger than the tax revenue losses.

I will not repeat Mr. Teitell's statistics that the number of nonitemizers has now gone from 50 percent in 1970 to 77 percent and if H.R. 13511 passes will go to almost 80 percent.

Senator MOYNIHAN. Why do you not repeat them anyway? Rarely have we seen such a pronounced change in behavior as a result of a small change in the Tax Code.

Mr. MOSKOWITZ. Presently, 77 percent of American taxpayers do not itemize their deductions. This is compared to about 50 percent in 1970.

H.R. 13511 will increase the number of taxpayers who take the standard deduction by an additional 2.5 million. Like increases in the past, this additional increase in the use of the standard deduction simplified tax filing for many. At the same time, however, it has negative consequences for charity.

These efforts to simplify the Tax Code inadvertently create disincentives to charitable giving by low- and moderate-income families.

Harvard professor Martin Feldstein estimates that charities have lost about $5 billion in contributions since 1970. Recent studies by Professor Feldstein and Michael J. Boskin found that households with incomes under $30,000 are very sensitive to tax induced variations in the cost of giving. The estimated price elasticities generally exceed two.

That means if the Moynihan-Packwood bill is approved and the deduction of charitable gifts is available to all taxpayers, for every dollar lost to the Treasury, charities will gain $2 from families with incomes of $30,000 or less.

Professor Feldstein's study makes it clear that the charitable deduction is efficient, and that extending it to all taxpayers, as contemplated in the Moynihan-Packwood bill would induce a substantial flow of funds to charitable organizations from low- and middle-income households.

Failure to pass the Moynihan-Packwood proposal would force the charities to look to the rich for support. This trend is dangerous for several reasons. Without broad support, public charities will lose their viability and democratic base. Worthy causes not in fashion and without high visibility are the most likely to lose support, and without a broader giving base, it will be impossible for public charities to keep up with the demand for services in an era of increasing costs and high inflation.

If Congress does not accept the Moynihan-Packwood proposal, United Way may not flourish, but it will survive. The large universities, museums and other longstanding institutions will survive also. But all of those financially fragile entities so important to American life, such as local community centers, small colleges, day care centers, halfway houses, co-ops, little theaters, will surely go under.

In the last 25 years, we have seen a recognition of Government policy of the importance of maintaining and enhancing a voluntary sector by supporting private philanthropies. In recent years, however, there has been an increasing erosion of this support. Legislative bodies, courts, State regulators and Federal agencies are increasingly seeking to inhibit charitable fundraising.

If Congress does not act soon to encourage support, philanthropic endeavors and this unwelcome trend will continue. As a consequence, the United States might be on the same road as Western nations that frown on philanthropy.

In closing, Mr. Chairman, I have in my testimony the New York Times article that talks about——

Senator MOYNIHAN. On private charity going out of style in West Europe's welfare states.

Mr. MOSKOWITZ. And I would like permission to enclose a review of Professors Boskin and Feldstein's study from the Review of Economic Statistics.

Senator MOYNIHAN. We would be very happy to do that, Mr. Moskowitz.

[The material referred to follows:]

EFFECTS OF THE CHARITABLE DEDUCTION ON CONTRIBUTIONS BY LOW INCOME AND MIDDLE INCOME HOUSEHOLDS: EVIDENCE FROM THE NATIONAL SURVEY OF PHILANTHROPY

Michael J. Boskin and Martin Feldstein*

Economists and tax lawyers have long debated the efficacy and propriety of the income tax deduction for charitable contributions.[1] The effect of the deduction is to lower the individual's net cost of giving if he itemizes his deductions. More specifically, the net cost to the donor per dollar received by the charitable donee is equal to one minus the individual's marginal tax rate.[2] If the elasticity of total giving with respect to this price (or net cost) is absolutely greater than one, the charitable deduction causes donees to receive more in additional gifts than the Treasury forgoes in revenue. Alternatively, if the price elasticity is absolutely less than one, the deduction is less than fully efficient in this sense.

In a series of recent papers, Feldstein and his collaborators (1975a; 1975b; Feldstein and Clotfelter, 1976; Feldstein and Taylor, 1976) obtained estimates of the price elasticity that cluster around −1.2 from a variety of different data sources. All but one of these studies (Feldstein and Clotfelter, 1976) are based on the gifts of only those taxpayers who itemize their deductions. Since substantially more than half of the households either do not itemize deductions or do not file any tax return, the estimated price elasticities have been obtained primarily from the top half of the income distribution. While this part of the population accounts for a disproportionate share of charitable contributions, extrapolation to the entire population may not be warranted. A variety of policy proposals that are currently being considered, e.g., a tax credit for all taxpayers for charitable gifts or extension of the charitable deduction to non-itemizers, would alter the price of giving for households that do not now itemize. An accurate estimate of the price elasticity for this income group is required to predict the effects of such policies. The results presented in the current paper indicate that *households with income under $30,000 are very sensitive to tax-induced variations in the cost of giving; the estimated price elasticities generally exceed two.*

I. The Data

The data for this study were collected by the 1974 National Study of Philanthropy, a special household survey conducted by the Survey Research Center of the University of Michigan (Morgan et al., 1975). Because our focus is on the behavior of low and middle income households, data for households with incomes over $30,000 were deleted. We have also deleted all households that reported incomes below $1,000. The key variables used in the analysis will now be described.

Charitable Contributions: The dependent variable of our study is the household's gifts to charity in 1973 in the form of both cash and property. Because we will estimate a loglinear equation to obtain constant price and income elasticities, the small fraction of households that report no contribution poses a problem. We believe that most of those who report no giving actually did give a small amount which has since been forgotten or was regarded as too small to mention. Three alternative modifications of the reported giving have therefore been examined. First, we assigned a gift of $1 to all those who reported no giving; if reported giving is denoted G, this estimate is $G1 = G$ if $G > 0$ and $G1 = 1$ if $G = 0$. The second alternative assigns $10 instead: $G10 = G$ if $G > 0$ and $G10 = 10$ if $G = 0$. Finally, we try adding $10 to everyone's reported giving; this variable is denoted $G+10$. We also estimated equations using a regression specification that directly accounts for the non-negativity and

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*We are grateful to James Morgan for the survey data used in this paper; to Joseph Pechman for insisting on the importance of obtaining estimates for these income groups; to William Barsky and Henry Moore for programming assistance; and to the Commission on Private Philanthropy and Public Needs for financial support. A more detailed analysis of this data is presented in an earlier version presented as Harvard Institute of Economic Research Discussion Paper No. 427 and Stanford University Center for Research in Economic Growth Research Memoranda Series No. 150.

[1] See, e.g., Aaron (1972), Andrews (1972), Bittker (1972), Kahn (1960), McDaniel (1972), Surrey (1972), Taussig (1967), and Vickrey (1962).

[2] This refers to gifts of cash or of depreciated property. Gifts of appreciated property have a lower net cost because no tax is paid on the appreciation.

piling up at zero of charitable contributions. The results of this procedure (which are available upon request) are quite similar to our basic results.

Price: For households that itemize their deductions, the price of a $1 charitable gift is $1-m$, where m is the household's marginal tax rate. For those households that do not itemize, the price is simply 1. Because charitable deductions are almost always a small part of a taxpayer's itemized deduction, we assume that the decision to itemize is exogenous.[3] Two different definitions of the marginal tax rate have been studied. $P1$ was the estimated marginal tax rate that the individual would face if he made no charitable gift, i.e., $P1$ is the price for the first dollar of charitable giving. Alternatively, $P2$ uses the estimated marginal tax rate that the individual would face if he made the average charitable contribution in his income class. Both measures assure that the individual's price measure is exogenous, i.e., not a function of his own amount of charitable giving.

The relevant marginal rate was estimated for each taxpayer on the basis of his reported total income, the number of his dependents, marital status, and either the relevant standard deduction for nonitemizers or an estimate of the amount of noncharitable deductions based on Internal Revenue Service averages for homeowners and others by income class (U.S. Treasury, 1974).

Income: The survey collected information on the respondent's income bracket but not his exact income; we have used the midpoint of each narrow bracket to measure gross income.[4] The net income variable, Y, is defined as gross income minus the federal income tax liability that would have been paid had no charitable contribution been made.[5]

Age: The fraction of income contributed to charity increases with age. The current study therefore includes three age dummy variables to measure proportional shifts in giving: $A3554=1$ if the head of the family is aged between 35 and 54 and equal to zero otherwise, $A5564=1$ if the head is 55 to 64, and $A65+=1$ if the head is over 64. The omitted category is households with heads under age 35. Separate estimates were also made with the sample limited to households containing a married couple with the head between the ages of 35 and 54. This should eliminate the special problems of transitory income associated with young households, the aged, widows, etc.

II. The Basic Results

Equation (1) presents the basic estimate of the price and income elasticities for the sample of households with incomes between $1,000 and $30,000:

$$\ln(G+10) = \underset{(0.28)}{-2.54}\ln P1 + \underset{(0.06)}{0.69}\ln Y + \underset{(0.07)}{0.46}\,AGE3554 + \underset{(0.09)}{0.75}\,AGE5564 + \underset{(0.09)}{0.86}\,AGE65+ - \underset{(0.49)}{2.17} \quad (1)$$

$$N=1621, \quad R^2=0.30, \quad SSR=2125.75.$$

Note first that the estimated price elasticity (-2.54) is very large and significantly greater numerically than 1. The elasticities and age effects are all estimated quite precisely.

The estimated price elasticity is quite consistent with the much less precise results obtained for low and middle income groups in the previous studies (Feldstein and Clotfelter, 1976, and Feldstein and Taylor, 1976).[6] The estimated price elasticity for low and middle income households in thus substantially larger than the corresponding elasticity for higher income groups. The previous studies for the entire population found overall price elasticities that clustered around -1.2 (Feldstein, 1975a, Feldstein and Clotfelter, 1976, and Feldstein and Taylor, 1976).

The estimated price elasticity of -2.54 implies

[3] No adjustment is made for the special tax treatment of appreciated property since such gifts are very unimportant in the income range that we are concerned with in this paper. In 1970, the last year for which data are currently available, only 4% of charitable gifts were not in the form of cash for taxpayers with incomes below $30,000.

[4] The bracket intervals correspond to units of 1-2, 2-4, 4-8, 8-10, 10-15, 15-20 and 20-30 thousand dollars.

[5] Feldstein and Taylor (1976) show that collinearity between price and income need not be a serious problem; the inclusion of both nonitemizers and itemizers in the current study further reduces the correlation. The survey collected some data on wealth but did not obtain any information on debts or the value of pension rights; we have therefore not explored the implications of wealth here. Feldstein and Clotfelter (1976) found that higher net worth did increase charitable giving (for fixed levels of income and price) but that the inclusion of a net worth variable did not alter the estimated price elasticity.

[6] For these studies the data, income classes, and estimated price elasticities are as follows: 1962 Federal Reserve Board Survey, $1,721-$3,000, -2.50 (S.E. 0.91); 1962 Treasury Tax File, $4,000-$20,000, -3.67 (S.E. 0.45); 1970 Treasury Tax File, $4,000-$20,000, -0.35 (S.E. 0.52). Feldstein and Taylor (1976, section 4) explain that the data for 1970 itemized tax returns contain too little independent variation in price and income to permit estimation of separate price and income elasticities for this group. Using a single equation for all 1970 Tax File observations but allowing separate price elasticities by income class indicates a price elasticity of -2.10 (S.E. 0.40) for $4,000-$10,000 and -1.59 (S.E. 0.23) for $10,000-$20,000.

that contributions are very sensitive to their tax treatment. The current deductibility of contributions substantially increases the total value of gifts by these lower and middle income households. For each dollar of revenue that the Treasury forgoes because of the charitable deduction, donees receive an additional $2.54.

As we noted above, several alternative adjustments were made to deal with households that reported no gift to charity. Replacing these zero reports by $10 (instead of adding $10 to *all* reported gifts) slightly increases the estimated price elasticity to −2.65 (S.E. 0.28). Since the logarithmic transformation becomes quite steep as we approach zero, the adjustment that adds only $1 to the 0 reported by some households yields a high price elasticity that may overstate the difference in giving for small price differences: −2.99 (S.E. 0.39).

The age coefficients of equation (1) confirm the importance of age as a separate determinant of giving. For example, the basic estimates of equation (1) imply that those aged 35 to 54 give 58% more than those less than 35, that those 55 to 64 give 34% more than those age 35 to 54, and that those over 64 give 49% more than those aged 35 to 54. To show that this effect is basically a proportional shift and does not involve a changing price elasticity, we present a reestimate of equation (1) with the sample limited to households headed by a male between the ages of 35 and 54; the price elasticity is −2.76 (S.E. 0.53).

Finally, we can report that the substitution of $P2$ (the price based on average gift) for $P1$ (the price based on the first dollar of giving) has essentially no effect on the estimated parameters. The price elasticity is −2.51 (S.E. 0.36).

All of our basic results thus indicate that the price elasticity of charitable giving is numerically somewhat larger than −2 for those households with incomes between $1,000 and $30,000. We turn next to the question of whether the price elasticity varies within this income range. When equation (1) is reestimated for households with incomes between $1,000 and $20,000, the price elasticity is −2.36 (S.E. 0.31) and the income elasticity is 0.69 (S.E. 0.06). More refined tests indicate no difference in price elasticity between those with incomes below $10,000 and those with incomes between $10,000 and $20,000. Since the current tax law lowers the price of giving to charity only for those who itemize their deductions and since a substantial percentage of low income and middle income households use the standard deduction instead of itemizing, the question arises as to whether the difference in charitable contributions across households which we attribute to price really reflects an effect of itemization itself. To this we now turn.

III. Is There an Itemization Effect?

To test for the presence of a pure "itemization effect" in addition to a price effect, we consider two alternate approaches. First, we use the sample of non-itemizers, all of whom face a price of 1, to estimate the income elasticity of charitable giving. This estimate is clearly not "contaminated" by either collinearity or any possible itemization effect. This income elasticity is then used as "prior information" which is imposed as a constraint on the itemizers in the sample to estimate the price elasticity. Since this price elasticity is based on data for itemizers only, there is again no itemization component in the estimated price elasticity.

Equation (2) shows that the income elasticity for non-itemizers is 0.63:

$$\ln(G+10) = \underset{(0.06)}{0.63}\ln Y + \underset{(0.11)}{0.31}\,AGE\,3554 + \underset{(0.13)}{0.86}\,AGE\,5564 + \underset{(0.12)}{0.71}\,AGE\,65+ - \underset{(0.66)}{1.60} \qquad (2)$$

(non-itemizers only) $N = 724$, $R^2 = 0.16$, SSR = 890.19.

Using this as an extraneous estimate of the income elasticity for the itemizers, we find a price elasticity of −2.3:

$$\ln(G+10) - 0.63\ln Y = \underset{(0.60)}{2.32}\ln P1 + \underset{(0.09)}{0.55}\,AGE\,3554 + \underset{(0.12)}{0.67}\,AGE\,5564 + \underset{(0.16)}{1.07}\,AGE\,65+ - \underset{(0.16)}{1.54} \qquad (3)$$

(itemizers only) $N = 897$, $R^2 = 0.08$, SSR = 12[illegible]8.

Similarly, imposing this income elasticity on the full sample yields a price elasticity of −2.7. The estimated price elasticity therefore reflects a genuine price effect and not the effect of itemization per se.

A more direct test of the itemization effect is obtained by estimating separate constant terms for itemizers and non-itemizers. Any itemization effect would show up in different constant terms. This is formally equivalent to estimating two separate equations for the two groups subject to the constraint that the income elasticity and proportional age effects are the same for the two groups. For our basic specification, this yields the equation (4) where item = 1 for itemizers (and 0 otherwise)

and non-item = 1 for non-itemizers (and 0 otherwise).

$$\begin{aligned}\ln(G+10) = &\underset{(0.50)}{-2.14}\ \text{item} \underset{(0.52)}{-2.44}\ \text{non-item}\\ &\underset{(0.64)}{-1.38}\ \ln P1 + \underset{(0.06)}{0.72}\ \ln Y\\ &+ \underset{(0.07)}{0.45}\ AGE\,3554 + \underset{(0.09)}{0.75}\ AGE\,5564\\ &+ \underset{(0.09)}{0.86}\ AGE\,65+ \end{aligned} \tag{4}$$

$N = 1621$, $R^2 = 0.30$, SSR = 2120.95.

The two constant terms are similar in magnitude and not significantly different. Comparing equation (4) with equation (1), we may use the sum of squared residuals from each to construct an F-statistic to test the hypothesis that the coefficients of the itemizer and non-itemizer dummy variables are equal. This yields an $F(1,1617) = 3.58$; the difference between the constants is insignificant. In any case, the difference between −2.14 and −2.44 is so small that the estimates clearly imply no economically significant effect of itemization.

IV. Conclusion

We have examined a new and rich body of data on philanthropic activity by households with incomes below $30,000. Using a variety of estimating equations and subsamples of the population, we find that in each case charitable contributions are quite price elastic throughout this range of income. Almost all of the evidence indicates a price elasticity that is absolutely greater than 2.

Our experience in discussing this work has taught us that some economists are at first surprised and skeptical about the high price elasticity because it seems "contrary to intuition and common observation." We do not agree with this view. Among families with adjusted gross incomes between $10,000 and $15,000 who itemize their deductions, the average price of giving is about 0.80 and the average annual giving is about $300. Eliminating the deduction would raise the price to 1, an increase of 25%. Would eliminating the deduction reduce average giving in this group by $100? If so, the elasticity is approximately −2. We doubt that intuition and common observation are capable of answering this question. We therefore do not find that the statistical estimates are in conflict with our informal judgment about the behavior of individuals in this group.

This discussion does imply an important caution in interpreting high price elasticities for low income families. An elasticity of −2 may not be appropriate for very large decreases in price faced by this group. For example, a 50% credit would lower the price from 0.80 to 0.50, a reduction of 37%. A price elasticity of −2 would imply an increase in giving from $300 to $768, i.e., from a net cost of $240 to a net cost of $384. While this cannot be excluded as impossible, it may be larger than is likely. It is not possible to learn how the elasticity might change outside the range of current and past experience for this group.

Fortunately, however, the current estimates are appropriate for the analysis of the policies that are more likely. The extension of the charitable deduction to non-itemizers, or the availability of an optional credit at 25% or 30%, are well within the range of experience that we have studied. The current estimates therefore have important policy implications: Tax incentives to encourage giving by low and middle income households would induce a substantial increase in the flow of funds to charitable organizations.

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Senator MOYNIHAN. May I point out to the panel that while Senator Packwood and I perhaps initiated this matter, our esteemed colleagues, Senator Curtis, who is the ranking minority member and Senator Gravel are also cosponsors of this legislation.

And now, Mr. Sugarman.

Senator HANSEN. Mr. Chairman, if I could interrupt for just a moment, let me say that I would like to join with you in complimenting the distinguished panel we have before us. It has been my privilege to be actively engaged with the management of a private hospital for a long time in Jackson, Wyo., and to be associated as well with the University of Wyoming. You pointed out quite accurately that the larger institutions are going to survive because, without exception, they are tax supported and also supported by the generous giving of people.

But an important extension of their effectiveness invariably is achieved through the opportunity that a sensible tax code provides individuals to make bequests.

A friend of mine who lived in New York died recently, leaving his $3.4 million estate to three great universities, Harvard, Yale and the University of Wyoming. I fully support this Packwood-Moynihan bill.

It is a great concept, and I compliment you.

Senator MOYNIHAN. Well, we thank you, sir. These are striking figures.

I wonder, before we go on to Mr. Sugarman, if Mr. Moskowitz, you have any idea what proportion of taxpayers are likely to be taking the standard deduction if the new House bill goes through?

Mr. MOSKOWITZ. It will be close to 80 percent.

Senator MOYNIHAN. Close to 80 percent.

Mr. MOSKOWITZ. The House report talks about an additional 2.5 million. They did not give a percentage, but I just applied it, and I am looking at Mr. Shapiro, and I think that would be—the next additional 2.5 million would be close to 80 percent, if I am correct.

Senator MOYNIHAN. Mr. Shapiro seems to think that is the proper area.

Mr. MOSKOWITZ. I respect Mr. Shapiro's opinion.

Senator MOYNIHAN. As does this committee.

Mr. Sugarman?

Mr. SUGARMAN. Thank you, Mr. Chairman.

We have filed a written statement which we request be included in the record, Mr. Chairman.

Senator MOYNIHAN. We would be happy to do that.

STATEMENT OF NORMAN A. SUGARMAN, ESQ. REPRESENTING THE COUNCIL OF JEWISH FEDERATIONS

Mr. SUGARMAN. At this point, I would like to highlight our views on the deduction for the charitable contributions.

The Council of Jewish Federations is concerned about the trend in our tax laws away from charitable institutions. We see this trend as undermining community and individual responsibility.

The council is an association of central community Jewish organizations located in almost every major city in the United States. These

organizations obtain gifts to provide a wide variety of humanitarian services to over 800 hospitals and clinics, institutions, and agencies for the care of the aged, agencies providing family and child welfare, youth and community centers; centers for college youth on campuses; vocational guidance and rehabilitation services; and other forms of assistance.

The expenditures for these services total over $2.8 billion annually and are substantially dependent on voluntary gifts. Thus, contributed dollars have a multiplier effect because the services they finance generate additional support.

Mr. Chairman, I do not want merely to repeat what the prior witnesses have already said, but it cannot be overemphasized that the tax law changes in recent years have had the effect of reducing incentives for charitable giving. This can set off a reaction in which much more could be lost than the level of charitable support in terms of dollars.

Agencies services to individuals and voluntary services to charities can be adversely affected.

Already, the growth of the standard deduction has led to a diminution of tax incentives for contributions among the middle and lower income contributors. Under the House bill, there is a further shift, and we agree with the estimate that has been made, although I have heard even higher ones, that the percentage that would be using the standard deduction and have no incentive for charitable giving would be at least 80 percent or more.

As these changes occur, two results follow. One, support of charities is reduced, lessening their capacity to aid those requiring their services. In the long run, the effect is to hurt needy people by depriving them of assistance and, as a result, to impair the well-being of society.

Two, reduced private support of charitable services inevitably results in pressures for Government to make up lost funds in order to continue needed services.

The solution to these problems is to return to the relationship between charity and Government which existed for the first half of our national life under the income tax system. That is the allowance of charitable deductions for all taxpayers.

We desire to associate ourselves with those Members of the Congress and those organizations which are supporting the allowance of the charitable deduction as a deduction from gross income, that is, in computing adjusted gross income.

This change would make the charitable deduction a so-called above-the-line deduction rather than an itemized deduction. Precedents for this type of change have already been cited.

I cannot help but refer to the most recent precedent, that in 1976 relating to alimony, when that was moved from an itemized deduction to a deduction in computing adjusted gross income.

Certainly, in pursuit of our national ideals, charity should be given at least as much, if not more, recognition than alimony.

The reasons for advocating this change can be summarized, I believe, as follows.

First, the charitable deduction is distinguishable from other itemized deductions. When a person contributes to a charity, whatever the tax abatement, he reduces his own net income voluntarily. The donor

does not benefit from the charitable gift; the benefit derived is realized by the beneficiaries of the charitable gift, the persons in need who are served and assisted by a charitable agency.

Thus, charitable contributions should be treated separately as a subtraction from adjusted gross income because this conforms to the reality of the contributors' option to reduce his net income.

Second, the change would protect the charitable deduction from further erosion and would also extend the charitable deduction to the full spectrum of income classes. It would mean that charities would look increasingly to support from persons of moderate income, as well as the generous gifts from the upper income taxpayers. This would also extend the democratization of philanthropic support, a desirable objective independent of the magnitude of the dollars involved.

Third, in this period when we are recognizing the importance to the economy of tax reduction, we should seek to channel tax savings to purposes which are important to society, as well as to the economy. This change would be consistent with the objective to provide tax relief to middle and lower income taxpayers and would be done in a way which could also be helpful to the people with the greatest need.

This cut would be particularly beneficial, because it would be a reward for generosity in the public interest.

Fourth, this tax cut will be doubly beneficial because it also reduces burdens on government. The effect of the tax deduction as an incentive for charitable gifts has been substantiated in the figures presented before this committee, based on Professor Feldstein's studies. These studies have emphasized that the total funds contributed to the charities are greater than the revenue loss to the Government.

Thus, the cost to the Government in revenue would be approximated or exceeded by private funds provided for charity.

There are, therefore, compelling reasons in the national interest for permitting charitable contributions to be deducted from gross income.

We urge the committee to approve this change.

Senator MOYNIHAN. We thank you, Mr. Sugarman.

Before returning to my colleagues, let me say I have a statement I would like to put in the record, and say to Mr. Teitell that he invoked Rakosi on salami tactics. In my statement, I invoke Schumpeter.

Mr. TEITELL. I hope you agree my statement on salami tactics, Senator, is not so much baloney.

Senator MOYNIHAN. Oh, wow. All right.

It was years ago that Schumpeter argued that the demise of liberal society as it emerged in the late 18th and 19th century would come by conquest of the private sector by the public sector, and I do not suppose there would be any point where this would be more in evidence than as the government assumes the provision of care and education and concern, those objects which we associate with things that are attractive in the society and the mark of an advanced culture and ethic of mutual provision, as these become something the government gives you, and not your neighbor.

And how intentionally this has been going on as, for example, in the tax code, I do not know. I did not go to CCNY for nothing. It is no accident that, step by step, the private sector is being eliminated by government here. It is what the 20th century is all about, and I do not like it one damn bit.

Senator Packwood?

Senator PACKWOOD. Well, it has been eliminated partially by negligence and partially by malice, by those who want to eliminate it.

I am looking at the revised form for 1978 and I notice under adjustments to income we have moving expenses, employee business expenses, payments to an IRA, payments to a Keogh plan, interest penalty due to early withdrawal on savings, alimony—all of those have the status that you are simply asking to be given an equal rank with and it seems to me that contributions to charities would rank, in my mind, among the highest, if not the highest, in priority.

Senator MOYNIHAN. Did you say moving expenses?

Senator PACKWOOD. Yes, moving expenses—moving expenses.

Senator BENTSON. There are some 13 of those items.

Senator PACKWOOD. Yes. And contributions to charity and the value we receive from the money given, in my mind, occupies as important a priority as these.

Second, this argument about simplification of the tax form has never struck me as one that had any overwhelming public support. There are two ways to judge that.

Most of us who are in politics go back home and campaign or mend fences and you know what people are thinking about by the questions that they ask you. I do not care if I am in a lumber mill with an average wage of $11,000 or at a Rotary with an average wage of $25,000, the question of simplification seldom comes up.

This was confirmed the other day when Mr. Roper was here, going through his list of income tax and taxation questions, and he said the public is very irate about tax reform, about what they regard as unfairness. But on the issue of simplification, it almost fell off the bottom of his chart, in terms of public demand.

That demand comes from Stanley Surrey, the Internal Revenue Service, and the Treasury Department in the desire to make their workload easier. It does not come from many taxpayers that I know.

Second, simplification is a two-way street. You can simplify the Tax Code all right. You can go a straight gross income. If you make $10,000, pay a straight 10 percent and you would have a two-line form.

But the other side is that the Federal Government gets into a support of a variety of activities and we would not be long before we set up a Federal charities commission, and we would decide how we would give the money out—kind of a gigantic United Way run by the Federal Government.

Of course, we would run into the religious problems of whether we could give any money to any charity that had any religious connection, and we would give it out, if we ever went to that kind of a system, with forms infinitely more complex and regulations infinitely more arcane than any income tax form that has never been devised to date.

I have no questions.

Senator MOYNIHAN. Senator, that is exactly right. Simplifying the techniques by which the Government scoops up this money is only the beginning of the process that become ever more Byzantine as it begins to dispense it.

Gentlemen, we are obviously very much impressed by your testimony as you would expect us to be. But still, what we are trying to make

clear here is that there are ways in which the Tax Code reflects the priority of a society in the most fundamental, impecable way. We have just heard testimony on the importance of the Tax Code in low and moderate income housing. If you want to know what a place is about, look at its Tax Code, and yet there are situations where there are unintended consequences.

Senator Packwood and I have reason to say that many seemingly unintended acts that discourage the private sector are not unintended at all. They are fully conscious acts by the bureaucracy, and there is something about this Government that commences to fear those things which compete with it in the provision of health and education and welfare generally.

And it comes out in this code. And if we are going to collaborate in destroying this third sector in our economy as it has been rather nicely called, and if we end up altogether dependent upon what the Government would provide, let it at least be understood that we made that decision. What we are going to try to get this committee and the Congress to understand that if you go in the direction in which you are going, you are deciding to destroy those Jewish hospitals—to close them. You are deciding to close down those small colleges in western Massachusetts. You are making a decision that the United Way will have very little influence in a community and will not, in fact, express a community concern.

That is what you are deciding. If you want that, do it. Then you are getting what you want.

If you do not want that, then be aware that this is the consequence of the tax code.

We thank you very much and wish us luck.

Mr. TEITELL. We thank you.

[The prepared statement of Senator Moynihan and the prepared statements of the preceding panel follow:]

STATEMENT OF SENATOR DANIEL PATRICK MOYNIHAN ON S. 3111, THE MOYNIHAN-PACKWOOD CHARITABLE CONTRIBUTIONS BILL

Mr. Chairman, we will today hear testimony from groups that are unique to these deliberations in two respects. First, they are not regular visitors to these chambers, unlike others who appear at tax hearings on almost every occasion. Second, and more important, they are not asking for any conceptual change in the law. They are merely requesting that all citizens again be afforded the treatment that Congress intended when it enacted a particular provision of the tax code over 60 years ago.

Since 1917, that code has embodied the principle that income given to charitable causes ought not to be taxed. The reasons for this deduction are straightforward and wise: to encourage support of the private philanthropic and voluntary organizations that comprise such an important part of this society, and to avoid taxing income that is given away rather than consumed.

The concept remains today, but the gradual enlargement of the "standard deduction," and the tendency of an ever larger fraction of the taxpaying population to take that deduction rather than to "itemize," has resulted in severe erosion of private philanthropy and has undercut the basic notion: that public policy should provide an explicit incentive for charitable giving. I cite an editorial from the Washington Post of August 25, 1917, at the time the charitable deduction was first under consideration in the Senate:

"If the Government takes all, or nearly all, of one's disposable or surplus income, it must undertake the responsibility for spending it, and it must then support all those works of charity and mercy and all the educational and religious

works which in this country have heretofore been supported by private benevolence.

"It would be a mistake to change abruptly the traditional policy under the stress of war conditions. This country cannot abandon or impoverish the great structure of private charity and education that has been one of the most notable achievements of American civilization. Therefore with every additional dollar the Government finds it necessary to take in taxation it becomes increasingly necessary to accept the principle of the pending amendment and leave untaxed that part of every citizen's income which he may give voluntarily to the public good."

Studies by my good friend and former colleague, Professor Martin Feldstein, have concluded that our proposal—to make charitable contributions deductible by all taxpayers—would indeed stimulate additional giving, perhaps as much as $2 for every dollar in tax saved.

Decades ago, Joseph Schumpeter warned that the demise of liberal society as we know it would be associated with the conquest of the private sector by the public. The measure that Senator Packwood and I have sponsored—with the cosponsorship from this committee of Senators Curtis and Gravel—seeks to reduce that possibility by crafting a public policy intended to buttress worthwhile activities in what is sometimes termed the "third sector," the sphere of private nonprofit organizations and those who support them. Philanthropic organizations have immeasurably enhanced our national life and character, and their voluntary nature has been the cornerstone of their strength. In this early age of mounting direct involvement by government in so many aspects of our lives, retention of a vibrant voluntary sector seems important indeed.

STATEMENT OF CONRAD TEITELL, MEMBER, PRERAU & TEITELL, NEW YORK CITY

Mr. Chairman and Members of the Committee, I am Conrad Teitell, a member of the New York City law firm of Prerau & Teitell, and appear as special counsel to a number of charitable organizations which have the same general interests and have consolidated their testimony so as to conserve the Committee's time. The organizations on whose behalf I appear are:

American Association of Presidents of Independent Colleges and Universities; 48 New York colleges and universities; Mayo Foundation; National Association for Hospital Development; The Christian and Missionary Alliance; The Church of the Nazarene; Baptist Foundation of Alabama; The Conservative Baptist Foreign Mission Society; General Council of the Assemblies of God; Association of Baptist Foundation Executives; Beloit College; Bradley University; Carleton College: Choate Rosemary Hall; The Church of God; Clark University; College of the Holy Cross; Deerfield Academy; Doane College; Drexel University; General Conference of Seventh-day Advantists; Hendrix College; Holy Cross Hopsital; Knox College; Lafayette College; LeTourneau College; Middlebury College; Millikin University; Mount Olive College; Mount Holyoke College; The Mount Sinai Medical Center; Northfield Mount Hermon School; Northwood Institute; Ohio Northern University; University of Notre Dame; Smith College; The Society for the Propagation of the Faith; Worcester Polytechnic Institute; and World Literature Crusade.

Thank you for this opportunity to present our views. We support your efforts to make our tax laws more equitable.

I. A charitable deduction should be allowed to all taxpayers whether or not they itemize their personal deductions. This would further democratize the charitable deduction and increase charitable giving. We urge passage of the Moynihan-Packwood Bill (S. 3111).

The House bill (H.R. 13511) which would increase the standard deduction and eliminate the deduction for gasoline taxes, would reduce by millions the number of taxpayers who itemize their deductions. The taxpayers who would switch to the standard deduction and those now claiming the standard deduction under current law have no tax incentives to make charitable gifts. Accordingly, we urge Congress to allow a charitable deduction for all taxpayers—those who take the standard deduction and those who itemize. Charitable gifts should be deductible from gross income—rather than adjusted gross income. This is not blazing a new Internal Revenue Code trail. The Code already allows some deductions to all taxpayers whether or not they itemize. For example, moving expenses and

alimony are allowed as deductions from gross income. Therefore, this would not be a special rule for charitable contributions.

The increases in the standard deduction this decade have brought about a marked decrease in the percentage of taxpayers who itemize their deductions and thus have tax incentives to make charitable gifts. Making the charitable deduction available to all taxpayers would increase charitable giving, according to econometric projections made by Harvard University Professor Martin Feldstein for the Commission on Private Philanthropy and Public Needs. Allowing the charitable deduction to all taxpayers would in 1976, for example, have increased charitable contributions by $1.9 billion, according to Professor Feldstein.

The case for allowing the charitable deduction for those who take the standard deduction (as well as those who itemize) is based on the charitable deduction being different from all other deductions—and thus entitled to special treatment.

Common rationales for tax deductions are (1) to alleviate the impact of extraordinary unanticipated expenses, and (2) to encourage particular activities. Among deductions enacted for the first reason are those for extraordinary medical expenses and casualty losses. A deduction for the latter reason is interest on home mortages, designed to promote home ownership. Both types of deductions involve expenditures to satisfy a taxpayer's personal needs.

The charitable deduction, however, provides an incentive for an expenditure which benefits the public. Unlike other deductions, such as the deduction for state taxes, the charitable deduction is entirely vountary. Of all the deductions, it is the only deduction for public purposes that each individual decides on his own whether or not to make.

II. Now is the time to increase, not decrease tax incentives to those who support schools, hospitals, churches, health, and other publicly supported charities.

Current news abounds with articles concerning the inadequacy of the finencial resources of all types of charitable organizations. Never in our history have charitable organizations found themselves in comparable circumstances—in which they are unable to carry on assigned roles without using the depleting endowment ment and obtaining additional current contributions.

It is no answer to suggest that direct government funding will substitute for funds lost through reduction of tax incentives. Funds syphoned off in general revenues reach the public through the charitable stream in the most remote way, if at all. Reducing current tax incentives would reverse the objective of less, rather than more, government intervention.

Schools, hospitals, churches, health, and other publicly supported charitable organizations perform a vital role in our nation. If the services rendered to the general public by charitable institutions were to be diminished because of reduced private support, the public would suffer immeasurably.

In no country is private philanthropy as important a part of the national character as in the United States. The inception early this century of our federal tax laws encouraged rather than curbed the generosity of Americans. Since 1917, the government has stimulated private voluntary support by granting tax deductions to those who give to charitable organizations.

Congress has continually increased the tax incentives for charitable giving, starting out with a 15 percent ceiling on the charitable deduction and increasing it over the years to the present 50 percent of adjusted gross income ceiling—with a 5 year carryover for any "excess."

The government has practical reasons for encouraging voluntary financial support. We need the services provided by schools, churches, hospitals, health organizations and other charities. If support for their work does not come from private sources, from where will it come?

Charitable contributions by concerned citizens have enabled educational institutions to maintain freedom of academic inquiry. They have insured separation of church and state. Voluntary charitable contributions have offered the means of maintaining the historical balance between government services and voluntary initiatives, the antithesis of a totalitarian society. The charitable contribution deduction enables our citizens to participate in making decisions, rather than concentrating further power in the hands of government.

The increased tax incentives for charitable gifts over the years has resulted in expansion and development of charitable organizations which now more than ever depend upon private philanthropic support.

A vast corps of volunteers give not only their money, but also their time to charitable organizations. If our private institutions become government institutions, much of this volunteer time is likely to be lost.

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The Congress has stated on many occasions that the government is compensated for any loss of revenue by its relief from financial burdens which otherwise would have to be made by appropriations from public funds and by the benefits resulting from promotion of the general welfare.

Mr. Chairman and members of the committee, thank you for this opportunity to present our views. We ask that any new tax law continue the long established and essential tax incentives to charitable giving which undergird our nation's educational, religious, hospital, health, and other charitable organizations.

If the Committee wishes amplification on any point, we should appreciate the opportunity of submitting a supplemental statement.

STATEMENT OF JACK MOSKOWITZ, VICE PRESIDENT FOR GOVERNMENT RELATIONS, UNITED WAY OF AMERICA

As a supporter of public radio and television, I listened with sympathy recently to our local stations' appeal for funds. After each appeal the announcer stated that the contribution was "tax deductible." I realize now that this statement is misleading. To be accurate and not deceptive, the statement should be followed by a disclaimer that the deduction is available to only one quarter of all taxpayers, those in the highest income brackets who itemize their deductions. If H.R. 13511 becomes law, the deduction will be available to only one out of five taxpayers and that one will likely be in the highest income bracket.

The announcer's statement would be accurate if the tax code were amended to allow all taxpayers to take a deduction for their charitable gifts whether they itemize or not. Approval of the Moynihan-Packwood bill (S. 3111) as an amendment to the Revenue Act of 1978 (H.R. 13511) will make this a reality and assure that every taxpayer is encouraged to support charitable, educational and artistic endeavors.

United Way of America endorses this change in our tax laws and deems passage essential to maintaining a strong independent voluntary sector. The Moynihan-Packwood bill accomplishes two beneficial purposes. It reduces taxes for those who need it most—moderate income Americans. (Almost 60 percent of the benefits go to families with incomes of less than $20,000.) Secondly, charitable giving to institutions supported by these Americans is increased by an amount larger than the tax revenue losses.

For these reasons, we believe the Moynihan-Packwood bill is sound public policy. It provides a much needed tax reduction for middle income Americans and enhances institutions and social welfare programs in their own communities.

Approval now of the Moynihan-Packwood bill is more critical than ever. This is because of the increase in the standard deduction and the changes in the itemized deduction in the Revenue Act of 1978 (H.R. 13511) as passed by the House of Representatives. Presently 77 percent of American taxpayers do not itemize their deductions. This is compared to about 50 percent in 1970. H.R. 13511 will increase the number of taxpayers who take the standard deduction by an additional 2.5 million. Like the increases in the past, this additional increase in the use of the standard deduction simplifies tax filing for many. At the same time, however, it has negative consequences for charities. These efforts to simplify the tax code inadvertently create disincentives to charitable giving by low and moderate income families. Harvard Professor Martin Feldstein estimates that charities have lost about $5 billion in contributions since 1970. In 1977 alone the loss was approximately $1.3 billion.

Recent studies by Professors Feldstein and Michael J. Boskin found that "households with incomes under $30,000 are very sensitive to tax-induced variations in the cost of giving; the estimated price elasticities generally exceed two." This means that to the extent tax law changes—such as the repeal of the gasoline tax deduction—increase the next cost of a charitable gift, charitable giving declines by $2.00 for every $1.00 in additional Federal taxes. The charitable contributors among the additional 2.5 million taxpayers who will switch to the standard deduction under H.R. 13511 can be expected to reduce their gifts by this 1 to 2 ratio. The net cost of their gifts will increase because they will have no deduction.

Conversely, if the Moynihan-Packwood bill is approved and a deduction for charitable gifts is available to all taxpayers, for every dollar lost to the Treasury, charities will gain $2 from families with incomes of $30,000 or less. Professor Feldstein's studies make it clear that the charitable deduction is efficient and

that extending it to all taxpayers, as contemplated in the Moynihan-Packwood bill, would induce a substantial flow of funds to charitable organizations from low and middle income households.

Failure to pass the Moynihan-Packwood proposal will result in forcing the charities to look for the rich for support. This trend is dangerous for several reasons:

1. Without broad support, public charities will loss their viability and democratic base.
2. Worthy causes, not in fashion and without high visibility, are the most likely to lose support, and
3. Without a broader giving base, it will be impossible for public charities to keep up with the demand for services in an era of increasing costs and high inflation.

If Congress does not accept the Moynihan-Packwood proposal, United Way of America may not flourish, but will survive. The large universities, museums and other long-standing institutions will survive also; but all those financially fragile entities so important to American life, such as local community centers, small colleges, day care centers, half-way houses, co-ops, little theaters, etc., will surely go under.

In the last 25 years we have seen a recognition by government policy of the importance of maintaining and enhancing a viable volunteer sector by supporting private philanthropy. In recent years, however, there has been an increasing erosion of this support. Legislative bodies, courts, state regulators and federal agencies are increasingly seeking to inhibit charitable fund raising. If Congress does not act soon to encourage support of philanthropic endeavors, this unwelcome trend will continue. As a consequence, the U.S. might be on the same road as Western European nations that frown on philanthropy. (See July 2, 1978, New York Times "Private Charity Going Out of Style in West Europe's Welfare States.")

United Way of Ameria is the national organization for local United Ways. There are over 2,000 United Ways throughout the United States. Founded in 1887, the United Way movement is the largest community-wide fund-raising, planning and allocations organization in the world. In 1976, for the first time, United Ways passed the billion dollar mark in fund-raising with total contributions of more than $1.1 billion. Our 1977 tally was $1.2 billion.

United Ways are not service delivery agencies. The money collected by United Way campaigns is allocated to member agencies skilled in providing needed assistance to members of their communities. Each local United Way has a volunteer board composed of men and women from labor, business, minority groups, public interest organizations and other concerns who work together with United Way professionals to assess community social welfare and health needs and determine the most effective means of meeting them. Funds are allocated to those agencies most capable of providing basic human needs such as, services to the elderly and handicapped, job and skill training, education, child services including day care, foster care, adoption services and recreation, and services geared toward community improvement such as consumer protection, safety and environmental protection. The United Way family consists of many familiar agencies—the Red Cross, Salvation Army, Family Services, YMCA and YWCA, the Council of Jewish Federations and Welfare Funds, National Catholic Charities, Girl Scouts, Boy Scouts and others (a complete list is attached). Some agencies—neighborhood centers, day care programs and senior citizen centers—are not familiar nationally, but are well known in the communities they serve. Hundreds of smaller service organizations, not affiliated with any national association, depend on United Ways for support so that their scarce dollars need not be spent on conflicting and competitive fund-raising campaigns.

I realize that to most people a billion dollars sounds like a great deal of money. But the members of this Committee and those who work in the voluntary sector are well aware of how inadequate that figure is when we talk about meeting the basic human needs of people who have nowhere else to turn. The poor, the victims of catastrophe, children, families in crisis, the elderly, handicapped and many others are our clientele. It is difficult to imagine how these citizens would receive assistance were it not for the programs offered by the voluntary sector.

All of our agencies can use more dollars than we can provide or they can raise. Though each year United Way goals are higher, they have not been able to keep up with the increasing need, much less increased costs and inflation. At the same time the raised dollar is shrinking in value, the costs of food, medicine, other serv-

ice supplies, salaries and operational expenses go up constantly. Since we cannot pass our rising costs on to the consumers of our services, charities must absorb the increases themselves. This means even fewer dollars to expend for care.

The only way to overcome this twin problem of escalating need and increased costs is to raise more money. Unfortunately, no matter how hard we tried or how desperate our appeals, charitable giving has not kept up. In 1969, Americans gave 1.98 percent of the gross national product to non-profit organizations. By 1974 that had fallen to 1.80 percent of GNP.

If the increase in the standard deduction and the changes in itemized deductions of the Revenue Act of 1978 become law, there will be a further unintentional fallout that will adversely affect charitable giving. Taxes will increase for the 2½ million middle income taxpayers who would switch to the standard deduction. The result is that the taxpayers would not only lose their tax incentive to make a charitable gift, but would also have less after tax income available to donate to charities.

Such a situation threatens the survival of the nonprofit sector for two basic reasons. First, the foundation of philanthropy—the private, voluntary giving of time, money and labor—is being eroded by a tax policy that denies many millions of Americans encouragement to participate at the most elementary level of voluntary activity. In effect, this shifts support for charities to the better off minority of taxpayers.

Historically, the bulk of giving in this country has come from households with incomes below $20,000. Yet it is in the income range of $10,000 to $25,000 that giving has fallen off most sharply. And with a decline in giving comes an equivalent decline in volunteer hours.

There is a real danger that charitable giving may become the province of the wealthy elite instead of the open, shared expression of concern for others that has maintained our pluralistic way of life for 200 years.

Secondly, if charitable contributions continue to decline, the government will feel increasing pressure to take over services the voluntary sector can no longer afford to provide. Surely there is a need for government involvement in social services, but experience has shown that government works best in partnership with a strong, independent private sector. There is no way that a huge federal agency like Health, Education and Welfare can make judgments that are right for local communities. Local leaders must make those judgments. Perhaps the greatest value of the voluntary agencies is that they exist in and for the communities they serve. The needs of the citizens are assessed by the citizens, and what is right for one neighborhood can be determined apart from what is right for another.

Not only do charities provide for local determination of services, but they have been doing so for many years. They have watched the neighborhoods change and grow and in some cases decay. They have experienced the valuable knowledge acquired through the history of service delivery and needs assessments. For the government to duplicate the efficiency of the volunteer agencies, it would first have to duplicate their experience. That would take years of experimenting, succeeding and failing with programs that have already been tested.

The United Way of Metropolitan Chicago, for example, did a neighborhood by neighborhood needs assessment for its own reference and allocation purposes. Their past experiences with doing such assessments had taught them well. Their directory was used by the federal government, the Illinois state government, the city government and the business community in Chicago for their own programs. This is the type of partnership we need: the talent, experience and resources of the private sector working with governments at all levels to provide continually improving service.

United Way voluntary agencies have been working in partnership with government for several years. Currently, over twenty percent of our agencies' income is derived from government sources. Some of the services provided by these voluntary organizations are partially funded by the Title XX program, the Law Enforcement Assistance Administration, the Juvenile Justice program and others. Agencies have provided skills training under the Comprehensive Employment and Training Act. CETA has also enabled nonprofits to productively utilize workers they otherwise could not afford to employ.

But more than service delivery, the voluntary sector brings local input to federal programs. Through monitoring and evaluation, local organizations can tailor massive programs to individual needs. That role is vital to the success of any national program.

Most government grants require the local incentive of matching funds. Each dollar raised by charities, therefore, can become three or four dollars worth of service when used in partnership with government. Conversely, each dollar lost to charities reduces by three or four dollars their overall income and inevitably, the amount of service provided.

This brings us back to the beginning. In order to have a successful partnership between the voluntary sector and government, both must be viable and strong. If the voluntary sector falters, government will too.

The only way to insure the viability of the nonprofit sector is to increase the giving base by amending the tax code to allow all taxpayers to take a deduction for their charitable gifts whether they itemize or not. This proposal was a primary recommendation of the Commission on Private Philanthropy and Public Needs, the Filer Commission. There are several reasons for supporting this change. The basic one is the continuing belief that the money a person gives away simply ought not be considered as income for purposes of determining the federal tax due. Also, it is a way of channeling money into socially desirable paths and encouraging people to participate in voluntarism.

The charitable deduction is a proven, effective mechanism to stimulate giving. It is simple to administer and highly efficient. For each dollar of taxes lost by virtue of the deduction, charitable organizations receive up to $2.00. Most importantly, these monies are immediately transferred to citizen supported institutions to provide services and are insulated from political and bureaucratic manipulation.

Almost since the inception of the Income Tax Code, government, recognizing the efficiency of the charitable deduction, has not taxed income given away to charitable causes. The worthiness of the cause, the absence of personal gain for the donor and the natural overlap of function between the charity and general government have led policymakers to continue to recognize the uniqueness of the charitable deduction. Now, that principle remains only in policy, not in fact.

Enactment of such tax code changes will reaffirm this country's longstanding commitment to a public policy that assists the private sector, thus preserving our pluralistic society.

[From the New York Times, July 2, 1978]

PRIVATE CHARITY GOING OUT OF STYLE IN WEST EUROPE'S WELFARE STATES

(By Jonathan Kandell)

STOCKHOLM, June 29.—A few years ago, toward the end of his life, King Gustaf VI Adolf decided to make a final bequest from the royal coffers to his Swedish subjects. He would contribute a sizable amount, running into the hundreds of thousands of dollars, to a national association for the handicapped.

The donation was never accepted. And, in fact, the would-be recipients admonished the King for even attempting as a private individual to fulfill what was considered in modern-day Sweden a function of the government.

Increasingly in Western Europe, philanthropy is acquiring a bad name. Leftists assert it delays the expansion of government-controlled social benefits and softens popular attitudes toward private wealth.

Even moderates are voicing disapproval of what they call the elitism of philanthropists' and their foundations' dispensing large amounts of money and patronage without the controls of electroalmn dates or the accountability of government bureaucrats.

CHARITABLE GROUPS ARE NUMEROUS

In sheer numbers, West European charitable associations seem impressive enough. There are 120,000 in Britain, 32,000 in the Netherlands, 19,500 in Switzerland, 15,000 in Sweden and 4,000 in West Germany. But most of them are small and exist in name only. Fewer than 5 percent still make sizable donations. Public sentiment that philanthropy should be the responsibility of government has forced thousands of small charities to depend increasingly on funds from state and local authorities.

The refusal of West European governments to allow tax deductions for large individual donations has reduced the number of tycoon-philanthropists of the sort that achieved fame before World War II. Even those wealthy persons who continue to contribute often find that the publicity surrounding their donations can boomerang.

Last March, for example, Marcel Dassault, the aircraft manufacturer and reputedly one of the richest men in France, decided to finance an indoor swimming pool for his constituents in Beauvais, a district he represents as a conservative Gaullist legislator in the National Assembly.

The mayor, Walter Amsallem, a Socialist, inaugurated the pool with some acid comments as the 86-year-old Mr. Dassault stood by.

"To give ourselves over to patronage, consigning our fates to the powerful and the rich, seems to us contrary to the spirit of the republic and of democracy," said the mayor. "We should have preferred action by the nation, the fruits of efforts by the whole community, eliminating charitable practices that degrade those who benefit from them."

It is doubtful that Mr. Dassault even heard the rebuke. He was caught up in a shouting match with some Communist councilors, hurling abuse at him from across the pool. "My workers are the best paid in France," Mr. Dassault yelled. "And I also was once poor before I was successful."

Less raucous, but no less controversial, has been the case of Pierre Guerlain, 72, the perfume manufacturer, whose offer to donate 10,000 acres of lake and land for a wildlife reserve was approved after four years of negotiations with the French Government.

His credentials as a nature lover were never questioned—he was once administrator of the World Wildlife Fund. But bureaucrats reportedly held up the bequest for fear that it would give Mr. Guerlain a windfall of publicity or set off rumors that he had been given a tax break. Mayors in some of the communities bordering the preserve felt that the Government should reserve the option of eventually using the land for housing.

In Sweden, where popular feeling against private philanthropy probably runs highest, there have been few recent cases of large private donations.

"I would say that sort of philanthropy is suspect nowadays," said Lar Bergstig, information secretary in the Budget Ministry. "Even among wealthy people, there is a feeling that you don't become popular by giving away money, by establishing a grant or foundation in your name."

SWEDEN ALLOWS NO TAX DEDUCTION

Nor would a philanthropist in Sweden be allowed a deduction from his taxable income for a charitable donation.

"In the past, philanthropy was an important substitute for social benefits for the poor," said Mr. Bergstig. "But we've had such a fast buildup of public welfare services since the end of the war. All political parties now believe that philanthropy should be the function of the state and local communities. And the mentality of Swedes today is that if you need money for disease research or support for the arts, you go straight to the Government. After all, isn't that why we pay all those taxes?"

According to Mr. Bergstig, many of the thousands of small charitable trusts that still exist can no longer fulfill their original aims.

"There are five to ten small trusts in Stockholm alone that specify that their money should be spent for the moral improvement of wayward women," he recalled. "Can you really imagine giving away money for that in Sweden today? Then we have old charitable funds to make it possible for young people to go to a university or study abroad. Well, the Government more than takes care of that nowadays.

"The trouble is that even if there are no longer recipients who qualify for many of the old charitable funds, no new legislation has been passed to alter their provisions. It just would not be worth the controversy."

TAX EXEMPTIONS EXIST IN BRITAIN

In Britain, charities are exempted from income tax, corporation tax and capital gains. But individual donors are not. And in recent years, most of the charities have had trouble raising money or maintaining their endowments.

"Operating and administrative costs continued to rise and inflation persisted in eroding the value of capital," stated a report last year by the charity commissioners for England and Wales. "These trends impinged adversely on the ability of charities to sustain existing programs and to start new ones, from their own resources and also on the ability of the public to subscribe fresh funds."

Increasingly, British charities depend on government financing. Earlier this year, a survey by the Charities Aid Foundation, an umbrella group for many voluntary organizations, disclosed that only 40 percent of donations to British charities came from individuals, wills, trust funds and corporations. Government grants covered most of the rest.

TREND TOWARD STATUTORY FUNDING

"It would be naive to suppose that charities which are effectively dependent on statutory funding will be left with the freedom of initiative any longer than it suits and convenience of the state," said Redmond Mullin, assistant director of the Charities Aid Foundation.

This view was also put forward in a report last year on philanthropy by the National Westminster Bank, but with a slightly different perspective:

"In recent years there has been increasing political interest in charities, and their attractive, tax-sheltered status must have played a role in this. Some charities such as private schools or hospitals are seen as havens of wealthy privilege that enable the rich to buy certain services at a cut price; others are attacked on the ground that they launch political propaganda under the guise of charitable activity."

STATE'S ROLE DOES NOT RESOLVE ISSUE

But a government monopoly of philanthropy, as has occurred in the patronage of the arts in Britain, has not put an end to the controversy.

In the United States, businesses are allowed to give away up to 5 percent of their income, free of tax. In Britain, business gifts to the arts are free of tax only if the Government determines that they are part of actual business or advertising expenses. As a result, private donations account for only $1.8 million a year, or less than 1 percent of total patronage for the arts.

But the Government, particularly at the local level, tends to donate its money to the more conventional artistic activities that are free from public controversy, according to advocates of private philanthropy.

The stringent tax laws against potential private art patrons have also been blamed for the large-scale outflow of works of art abroad. Neither the museums nor the Government are able to match offers by foreign collectors for paintings put up for sale by their British owners.

A PARTIAL LIST OF AGENCIES AND SERVICES RECEIVING UNITED WAY ALLOCATIONS

American Diabetes Association
American National Red Cross
American Social Health Association
Arthritis Foundation
Big Brothers
Big Sisters
Boys Clubs
Boy Scouts
Camp Fire Girls
Catholic Charities
Child Adoption Services
Child Guidance Clinics
Day Care Centers
Epilepsy Foundation of America
Family Counseling Services
Foster Care of Children
Girls Clubs
Girl Scouts
Homemaker—Home Health Aide Service
Homes for Dependent and Neglected Children
Hospitals
Information and Referral Services
Inner City Projects
Legal Aid Services
Leukemia Society of America
Mental Health Services
Medical Clinics
National Association for Mental Health
National Association for Retarded Citizens
National Association of Hearing and Speech Action
National Council on Alcoholism
National Council on Crime and Delinquency
National Cystic Fibrosis Research Foundation
National Easter Seal Society for Crippled Children and Adults
National Hemophelia Foundation
National Kidney Foundation
National Multiple Sclerosis Society
National Recreation and Park Association
Neighborhood Centers and Settlements
Planned Parenthood Services
Residential Treatment Centers for Children
Salvation Army
Services for the Aging
Services for the Handicapped
Services for Unwed Mothers
Summer Camps
Temporary Shelters for Children

Travelers Aid
United Cancer Council, Inc.
United Cerebral Palsy Association
United Seamen's Service
United Service Organizations (USO)
United Way Planning Organizations
Urban League
Visiting Nurse Services
Volunteer Bureaus and Voluntary Action Centers
Volunteers of America
YMCA
YWCA
YMHA
YWHA

STATEMENT OF THE COUNCIL OF JEWISH FEDERATIONS, INC., BY NORMAN A. SUGARMAN, COUNSEL

The Revenue Act of 1978 (H.R. 13511), as passed by the House of Representatives, includes proposals which would result in reducing incentives for charitable contributions for several million taxpayers, mainly in the middle income bracket.

The House Bill creates this adverse effect by eliminating certain itemized deductions and by increasing the application of the "zero bracket amount" (formerly the standard deduction) to substantially more taxpayers.

The effect of the Bill is to eliminate more taxpayers from the category of those who itemize deductions, and thereby to eliminate or sharply reduce the tax incentives for charitable contributions.

To put the matter in perspective, there has been concern for some years over the erosion of the base for charitable contributions by the withdrawal under the tax system of the charitable deduction from use by more and more taxpayers.

When the standard deduction was first presented as an alternative to itemized deductions, including the charitable deduction, it was described as a method of simplification for low bracket taxpayers. Over the years the standard deduction has been increased so as to be used by more and more taxpayers and this trend has culminated in those recommendations of the Administration which are included in the House Bill and which have the effect of extending the standard deduction to all but a small fraction of taxpayers.

The standard deduction came into the law in 1944. It is our understanding that as recently as the late 1960's less than half of the taxpayers used the standard deduction. By 1970 changes in the law increased this percentage to 52 percent. Successively the statute has been changed to provide or require more and more taxpayers to forego the itemization of deductions and to use the standard deduction, so that by 1972 the percentage was 65 percent and by 1977 the figure had risen to 77 percent. The tax proposals adopted by the House would, if enacted, increase the percentage of taxpayers using the standard deduction (or equivalent) to over 80 percent.

This results from the proposed increase of $200 in the zero bracket amount and the disallowance of $150 for medical insurance, and disallowance of deductions for the gasoline tax.

While we do not at all disagree with the objective of seeking simplification in our tax system, the method employed for obtaining simplification should not be such as to run roughshod over other basic principles, namely, the policy to encourage the active participation and support of all taxpayers in meeting charitable and social welfare needs.

It is time to recognize that the changes in the tax laws that have occurred over the past several years have drastically altered the emphasis previously placed on the obligation of citizens to support charitable institutions. Now a substantial standard deduction is allowed, purportedly to take into account charitable contributions and other deductions by the taxpayer, but in fact allowed to the taxpayer even though he makes little or no charitable contributions whatsoever.

The House proposals would switch over three million Americans to the standard deduction, thereby rewarding them for deemed contributions even though in fact they may make very small or no contributions.

We ask the Committee to recognize that there is a significant and basic policy issue here which cannot be resolved only on the grounds of "simplification;" it should be recognized that the tax system is moving in the direction of widening inducements for citizens to shirk their community responsibilities!

The adverse effect of these changes in the tax laws are real, as has been substantiated by a study conducted by the Michigan Survey Research Center (one

of the Filer Commission's studies published by the Treasury). This study indicates that the level of contributions by nonitemizers in income classes between $10,000 and $20,000 is about half the level of contributions by itemizers in the same income classes.

Support of the poor, the aged, the ill and others in distress, as well as dedication to community rehabilitation, safety and health, have all been essential elements in the responsible growth of our communities. Until recent years, this responsibility was fully recognized in our tax system, with the view that the government in enacting taxes—at an ever increasing higher rate—did not want to deprive communities and social welfare institutions of their traditional support. But now we are faced with a proposed governmental policy to reduce the incentive to charitable giving to encompass less than 20 percent of all taxpayers.

The Council of Jewish Federations is concerned about the trend in our tax laws away from support of charitable institutions because we see this trend undermining community and individual responsibility. The Council is an association of central community Jewish organizations located in almost every major city in the United States.

These organizations obtain gifts to provide a wide variety of humanitarian services through over 800 hospitals and clinics, institutions and agencies for care of the aged, agencies providing family and child welfare, youth and community centers, centers for college youth on campuses, vocational guidance, placement and rehabilitation services, and other forms of assistance.

A minimum estimate of persons individually served annually is over 1,200,000. Many are served without regard to race or creed, particularly in Jewish hospitals where over 65 percent of those served are other than Jewish.

The expenditures for these services total over $2.8 billion annually and are substantially dependent on voluntary gifts. Thus, contributed dollars have a multiplier effect because the services they finance generate additional support.

Any proposal which would have the effect of reducing charitable support could set off a reaction in which much more could be lost than the level of charitable support in terms of dollars; agencies' services to individuals and volunteer services to charities would be adversely affected. Already, the growth of the standard deduction has led to a diminution of tax incentives for contributions among middle and lower income contributors.

Another shift as under the House Bill, further removes tax incentives for contributions. As these changes occur, more donors may choose not to make gifts at all. That would reduce the support of charities, reducing their capacity to aid those requiring their services. In the long run the effect is to hurt needy people by depriving them of assistance and, as a result, to impair the well-being of society.

A reduction in charitable gifts resulting from tax changes, and consequent reduced support of charitable services, inevitably results in pressure for government to make up lost funds in order to continue needed services.

Recent reports involving philanthropy in Western Europe indicate some sentiment for turning over charitable responsibilities completely to government. This would be of no benefit in terms of public expenditures or services; but unfortunately it is the direction we would continue to be moving in this country if the provisions in the House Bill are finally enacted.

The solution to the problem that is accentuated by the House proposals is to return to the relationship between charity and government which existed for the first half of our national life under the income tax system, that is, the allowance of the charitable deduction for all taxpayers.

We desire to associate ourselves with those members of the Congress and those organizations which are supporting the allowance of the charitable deduction as a deduction in computing adjusted gross income.

This change would make the charitable deduction a so-called "above the line" deduction, rather than an itemized deduction to be allowed only in computing taxable income for those who itemized deductions. There is precedent for this approach since the Congress has on other occasions moved deductions from the category of below the line itemized deductions to above the line deductions in computing adjusted gross income.

The most recent additional example was the 1976 change, moving the deduction for alimony from an itemized deduction to a deduction in computing adjusted gross income. Certainly, in pursuit of our national ideals, charity should be given at least as much if not more recognition than alimony!

The charitable deduction is distinguishable from other itemized deductions. When a person contributes to a charity, whatever the tax abatement, he reduces his own net income voluntarily. The donor does not benefit from the charitable gift; the benefit derived is realized by the beneficiaries of the charitable gift, the persons in need who are served and assisted by charitable agencies. Thus, charitable contributions should be treated separately as a subtraction from adjusted gross income because this conforms to the reality of the contributor's option to reduce his net income.

This change would protect the charitable deduction from further erosion and would also extend the charitable deduction to the full spectrum of income classes. It would mean that charities could look increasingly for support from persons of moderate income as well as the generous gifts from upper income taxpayers. This would also extend the democratization of philanthropic support, a desirable objective independent of the magnitude of the dollars involved.

Moreover, in this period when we are recognizing the importance to the economy of tax reduction, we should seek to channel tax savings to purposes which are important to society as well as to the economy. A tax cut is particularly beneficial when it is a reward for generosity in the public interest. It is doubly beneficial when it also reduces burdens on the government.

The effectiveness of the tax deduction as an incentive to charitable gifts has been substantiated in the studies made by the Commission on Private Philanthropy and Public Needs. These studies have emphasized that the total sums contributed to the charities are greater than the revenue loss to government.

Thus the cost of government in revenue would be approximated or exceeded by the benefits to philanthropy. This would be consistent with the objective to provide tax relief for middle and lower income taxpayers—and it would be done in a way in which it could also be helpful to philanthropy, particularly to people with the greatest need.

There are, therefore, two compelling reasons—tax relief and aid to philanthropy—for permitting the charitable contribution as a deduction from gross income.

As to the matter of simplification, extending the charitable deduction would not complicate the tax form. It would be welcomed by taxpayers.

Simplification for the individual taxpayer should not be confused with simplifying the work of IRS. Philanthropy should not be penalized because our tax laws are complex—nor should philanthropy do without the resources required to provide essential human services because an additional number would appear on the tax form.

The Congressional encouragement of publicly supported charities evidences one of the proudest attributes of the American people: The impulse toward voluntary association to meet human needs. People are better people if they give. Giving patterns affect the quality of the community. The time has come to renew the encouragement to all taxpayers for charitable giving by allowing the charitable deduction as a deduction in computing adjusted gross income.

Senator MOYNIHAN. And now we have the pleasant prospect of a panel consisting of Mr. Herman C. Biegel, Mr. Carroll J. Savage, and our old and good friend, the Honorable Edward S. Cohen.

Goor morning to you all.

STATEMENT OF EDWIN S. COHEN, ESQ., IN BEHALF OF THE IRVING TRUST CO., ACCOMPANIED BY HERMAN C. BIEGEL, ESQ., AND CARROLL J. SAVAGE, ESQ.

Mr. COHEN. Thank you, Mr. Chairman.

The three of us appear before you today in connection with section 125 of the tax bill, H.R. 13511, a provision which accomplishes substantially the same result as the bill, S. 2148, which you, Mr. Chairman, introduced last September with respect to so-called cash or deferred profit-sharing plans.

Each of us has submitted a written statement which I trust will be incorporated in the record.

Senator MOYNIHAN. That will be done.

Mr. COHEN. We have agreed to save the time of the committee that we would coordinate our testimony and that I would make a brief statement explaining the matter on behalf of the three of us. I may identify myself as Edwin S. Cohen and say that I appear before the committee today on behalf of the Irving Trust Co. of New York and its 6,000 employees for whom one of these plans has been in existence for many years.

I will ask Mr. Biegel and Mr. Savage to identify themselves and their clients.

Mr. BIEGEL. My name is Herman C. Biegel. I am with the law firm of Lee, Toomey & Kent in Washington. I am appearing on behalf of the Profit-Sharing Council of America, which is a nonprofit association of approximately 1,400 large and small employers who have profit-sharing plans, and their members cover approximately 1,750,000 employees.

I have filed a statement, and I trust it will be incorporated into the record.

Senator MOYNIHAN. It will be, of course.

Mr. SAVAGE. Mr. Chairman, my name is Carroll Savage of the Washington, D.C., law firm of Ivins, Phillips & Barker, and I am appearing on behalf of Eastman Kodak Co. and Xerox Corp., both of whom maintain longstanding profit-sharing plans which, combined, cover over 100,000 employees, which would be affected by this legislation.

Senator MOYNIHAN. Mr. Cohen?

Mr. COHEN. Mr. Chairman, I should add, perhaps, that I am a member of the law firm of Covington & Burling and, in that connection, appear on behalf of the Irving Trust Co.

Since 1953, the Irving Trust Co. has maintained not only a retirement plan, but a profit-sharing plan for its employees of the type to which we are now referring. This profit-sharing plan sets aside for employees a portion of the profits of the company for the year which is not in excess of 15 percent of the compensation of the employees.

Every employee eligible to participate in the plan—and that means every employee who has had more than 3 years of service with the company—may, before the end of September of each year, elect whether or not to receive his share of the profits for the year in cash after the end of the year, or to have them transferred to the profit-sharing trust to be held for his benefit until he retires, dies, is disabled, severs employment or encounters a hardship.

Substantially similar plans have been adopted by a number of companies throughout the country and we estimate that more than 200,000 employees around the country are covered by these plans.

I have been counsel to the Irving Trust Co., in connection with its plan for 25 years, except for my period of Government service, and in 1956, shortly after the plan was installed, I obtained a ruling from the national office of the Internal Revenue Service that the plan qualified as nondiscriminatory under the requirements of the Internal Revenue Code.

The Internal Revenue Service, at that time, published a ruling that plans of this type would be considered nondiscriminatory if a majority of the employees who elected to defer their profit shares and have them

transferred into these trusts, came from the lower two-thirds of the payroll.

Senator MOYNIHAN. Can I ask you to help me? As you know, I am new on the committee. The term "nondiscriminatory" that suggests what?

Mr. COHEN. Section 401 of the code provides certain tax benefits to encourage retirement plans and profit-sharing plans, and it provides these benefits only if the plans meet certain tests of nondiscrimination in the sense that the plans must not discriminate in favor of the highly compensated or of shareholders of the company. So we use the term nondiscriminatory——

Senator MOYNIHAN. That is companywide, as it were.

Mr. COHEN. That is right.

And a special test has been devised for these plans because they permit the employee either to elect to take his share of the profits in cash, or to have them deferred. The Service has devised this test so that it will be assured that a majority of those who elect to have the amounts transferred into the trust, to be held in the trust for their benefit, come from the lower two-thirds of the payroll.

Senator MOYNIHAN. Right.

Mr. COHEN. Less than a majority may come from the upper third.

And that test has existed since 1956.

Again, in the early 1960's the matter was thoroughly reviewed, and Mr. Biegel and I and Mr. Barker of Mr. Savage's firm argued the case before the then Commissioner of Internal Revenue, Mortimer Caplin, and the then Assistant Secretary of the Treasury for Tax Policy, Stanley Surrey, and the rulings were again reaffirmed.

Subsequently, in 1972, a proposed regulation that has since been withdrawn was issued with respect to so-called salary reduction plans, and those regulations when they were proposed seemed to raise some question as to the future status of these cash and deferred profit-sharing plans.

A provision was inserted in the ERISA legislation when it passed in 1974 that assured the continued qualification of all the plans of this type that were then in existence, but provided that no further plans could be instituted pending a further study by the Congress. This freeze, so-called, was to continue under the ERISA bill until the end of 1976.

Subsequently, that date was extended to 1977 and by the Tax Treatment Extension Act, which has now passed both Houses of Congress, the date would be extended until the end of 1979.

The freeze was adopted to give the Congress and the staffs time to study the matter further. Four years have now elapsed and you, Mr. Chairman, have introduced S. 2148 in the Senate and Congressmen Conable and Rangel have introduced similar legislation in the House to end the freeze and to provide that the tests that have been applied in the published rulings all of these years since 1956 shall continue to be applied.

Section 125 of the pending bill, H.R. 13511, accomplishes that result in somewhat different language. It simply provides that the IRS rulings announced in 1956 shall continue in effect, that the plans that

conform to these rules will continue to be qualified under the code and viewed as nondiscriminatory, and that new plans that meet these tests will also qualify.

When Secretary Blumenthal appeared before the committee on August 17, he referred to this matter, and said that the Treasury is working on a detailed proposal in this area. We have been attempting, for some time, to work with the Treasury Department staff to develop a code amendment that would be acceptable to all, and we shall continue to do so.

But unless an agreement can be developed before the committee concludes its consideration of the pending bill, we strongly urge that 4 years after the ERISA legislation, the time has come to remove the temporary freeze and to enact section 125 to make permanent the rules that have been in effect since 1956.

Thank you, sir.

Senator MOYNIHAN. Well, that could not be more explicit.

Section 125 is somewhat different from the legislation which Mr. Conable and Mr. Rangel and I have introduced, but it suits your purposes?

Mr. COHEN. Yes, sir.

Senator MOYNIHAN. It obtains the objective.

Mr. Savage, sir?

Mr. SAVAGE. Yes; it does.

Senator MOYNIHAN. It does. What you want us to do is to keep section 125 in this bill. I think you are right. Unhappily, I do not have anybody here to agree with me.

Let me turn if I may and consult with staff a moment.

I just wanted to say to you that as far as I know, this is the disposition of our committee, that there is no contrary disposition; that is what I wanted to establish.

And, without making any commitment—which obviously I cannot make—let me say to you that we appreciate your testimony, we take your point. Four years is long enough.

The fact that the Treasury is working on a detailed proposal fills me with profound alarm, but also with the certain knowledge that it will not be forthcoming soon, as you would agree, Mr. Chairman, from your long experience.

I think this is in good shape, and we appreciate very much your coming to help us with it?

Did you have something else you wanted to say?

Mr. COHEN. No, sir.

Senator MOYNIHAN. I think it is in good shape and you make a clear case. Again, the Government ought not to be discouraging private efforts of this kind. This is not the purpose of the Tax Code. The purpose of the Tax Code is to raise money to keep the Government going and not to change the society. What have I said? That is obviously nonsense. The purpose of the Tax Code is to shape the society but we ought to know which way we are shaping it, and do so intentionally.

Thank you very much, gentlemen.

Mr. COHEN. Thank you, Mr. Chairman.

[The prepared statements of the preceding panel follow:]

STATEMENT OF CARROLL J. SAVAGE, ESQ., IVINS, PHILLIPS & BARKER, WASHINGTON, D.C., ON BEHALF OF EASTMAN KODAK CO. AND XEROX CORP.

This state is being submitted by Carroll J. Savage of the firm of Ivins, Phillips & Barker, Washington, D.C., on behalf of Eastman Kodak Company, with headquarters in Rochester, New York, and Xerox Corporation, with headquarters in Stamford, Connecticut.

Eastman Kodak and Xerox both maintain profit sharing plans which have been in operation for over 20 years. These plans combined cover over 100,000 employees in locations throughout the United States. They are qualified plans which meet all of the requirements of section 401(a) of the Code. Both the Eastman Kodak and Xerox plans grant to employees a "cash or deferred" option which brings the plans within the provisions of section 125 of H.R. 13511 as passed by the House of Representatives.

Eastman Kodak and Xerox also maintain defined benefit pension plans designed to insure retirement benefits for their employees. While the profit sharing plans serve as an important supplemental source of retirement income, the amounts contributed under the profit sharing plans which are subject to employee elections had their genesis in profit sharing bonuses which also have traditionally served other important purposes. Over the years these plans have provided a significant source of funds for investment in securities of the employer. In addition, some employees from time to time in their careers have current cash needs which are undeniably more important to their welfare and that of their families than additional retirement benefits. Such cash needs may occur during times of heavy family expenses such as education of children or purchase of a home. An employee may justifiably conclude that his retirement needs are well taken care of through the company's pension plan, past deferrals under the profit sharing plan, the retirement benefits of the employee's spouse, the employee's own savings, or a combination of these sources.

Employees who elect to receive their profit sharing bonuses in cash are currently taxable on such bonuses. Under the law as it has been administered since 1956, an employee who makes a timely election not to receive his bonus in cash, but rather to have it contributed to a qualified plan on his behalf, is not taxable until amounts set aside under the plan are ultimately distributed to him, as in the case of any other qualified retirement plan. In either case, the contributing employer receives a deduction for the amount paid to the employees or to the exempt trust. Accordingly, there are no tax ramifications for the employing company as a result of the employees' elections under a cash or deferred plan, nor would any of the legislative proposals which have been made affect the tax treatment of the employers. This is purely an issue affecting the tax treatment of the employees. If the Internal Revenue Service or Congress were to take the position that an employee will be taxed currently whether or not he elects to defer his profit sharing bonus, or if the law were to provide that a plan cannot be qualified where contributions are based on an employee election, in order to protect employees from adverse tax consequences the plan sponsors would be faced with the necessity of abandoning these long-standing plans and paying all profit sharing bonuses to employees in cash, thereby depriving those employees who wish to enhance their retirement income of the opportunity to do so, contrary to the national policy qualifications reflected in ERISA and other legislation. As a practical matter, it is not feasible to amend the plans to provide that all profit sharing bonuses would be deferred on a mandatory basis to provide additional retirement benefits because some employees are dependent upon this bonus to supply ongoing cash needs at this point in their career.

In recent statements the Treasury Department has indicated that it has no objection to the continuation of cash option profit sharing plans on a basis which insures a wide-range of nondiscriminatory participation. Accordingly, the sole issue surrounding cash option profit sharing plans at this time appears to be the question of whether the nondiscrimination rules presently applicable to these plans protect adequately against discrimination in favor of highly compensated employees.

Present Internal Revenue Service rules which have been applied since 1956 hold that cash option profit sharing plans are nondiscriminatory if the group eligible for the plan otherwise meets the coverage requirements of the Code and if more than one-half of the eligible employees come from the lower-paid two-thirds of the eligible group.

Eastman Kodak and Xerox believe that the present rule adequately insures a wide-range of participation. However, we are not opposed in principal to

alternatives which have been proposed by the Treasury Department in recent weeks provided these alternatives do not introduce restrictive requirements which would discourage or prevent participation and thereby undermine the purposes and advantages of these plans. Some of the approaches which have been suggested by the Treasury would, we believe, have the practical effect of discouraging participation by lower-paid employees and would actually be counterproductive to the Treasury's declared objective of fostering increased retirement security.

The Statements filed today on behalf of the Profit Sharing Council of America and Irving Trust Company, which we endorse, provide the legislative background in the context of which the House of Representatives passed section 125 of H.R. 13511. Section 2006 of ERISA imposed a freeze on the adoption of new cash or deferred profit sharing plans pending a study of such plans. Since the enactment of section 2006, the status of cash or deferred profit sharing plans has been one of continuing uncertainty. In view of the extended period of time which has elapsed without development of a permanent set of rules governing this type of arrangement, the approach taken by the House of Representatives in section 125 of H.R. 13511 was to act to eliminate this uncertainty without foreclosing the possibility of enactment of a permanent rule at a future date.

We are continuing to work actively with the Treasury Department staff to develop a Code amendment which will represent a sound approach to cash and deferred profit sharing plans. We are optimistic that such an amendment can be developed which will satisfy all of the Treasury's policy objectives while permitting a continuation of these desirable programs. If development of an appropriate rule has not been achieved before this Committee acts on H.R. 13511, however, we strongly urge the adoption of section 125 in its present form, for the reasons stated in H.R. Report No. 95-1445 at page 66, the Ways and Means Committee Report accompanying H.R. 13511:

"Since the enactment of ERISA, the freeze of the status quo treatment of cash or deferred profit-sharing plans has prevented employers from setting up new plans of this type for their employees. Originally, it was thought that a relatively short period of time would be needed for Congressional study and that a permanent solution would be in place by January 1, 1977. The committee believes that the uncertainty caused by the present state of the law has created the need for an interim solution which permits employers to establish new cash or deferred profit-sharing plans pending the adoption of a permanent solution in this area. Also, the committee believes that present law discriminates against employers who had not established cash or deferred profit-sharing plans by June 27, 1974."

Statement of Herman C. Biegel, Esq., Lee, Toomey & Kent, Washington, D.C.

This statement is being submitted by Herman C. Biegel of the law firm of Lee, Toomey & Kent, Washington, D.C., on behalf of the Profit Sharing Council of America (the "PSCA"), 20 North Wacker Drive, Chicago, Illinois 60606. The PSCA is a non-profit association of approximately 1,400 large and small employers who have profit sharing plans. Their members cover approximately 1,750,000 employees. Council members are located throughout the United States and are engaged in practically all areas of economic activity.

The PSCA wishes to submit its views in favor of the tax treatment of cash or deferred profit sharing plans as incorporated in Section 125 of H.R. 13511. That section provides as follows:

"Sec. 125. Administration of 1954 Code in the Case of Certain Cash or Deferred Arrangements

(a) General Rule.—In the case of any qualified cash or deferred arrangement under a profit-sharing plan, the Internal Revenue Code of 1954 shall be administered in a manner consistent with—

(1) Revenue Ruling 56-497 (1956-2 C.B. 284),

(2) Revenue Ruling 63-180 (1963-2 C.B. 189), and

(3) Revenue Ruling 68-89 (1968-1 C.B. 402).

(b) Qualified Cash or Deferred Arrangement Defined.—For purposes of this section—

(1) In General.—The term 'qualified cash or deferred arrangement' means any arrangement under which a contribution is made by an em-

ployer to a trust on behalf of an employee only if the employee elects not to receive such contribution from the employer in cash.

(2) EXCEPTION.—The term 'qualified cash or deferred arrangement' does not include an arrangement under which the contribution by the employer to the trust is made in return for a reduction in the basic or regular compensation of the employee or in lieu of an increase in such compensation.

(c) PROFIT-SHARING PLAN DEFINED.—For purposes of this section, the term 'profit-sharing plan' includes a stock bonus plan.

(d) EFFECTIVE DATE.—This section shall apply to taxable years beginning after December 31, 1977."

I. HISTORY

Cash or deferred profit sharing plans are trusted profit sharing arrangements which provide each employee with an individual advance election, usually made on an annual basis, as to whether all or a specified portion of the profit sharing contribution to be made by the employer will be paid into a qualified deferred profit sharing trust. Under the sanction of a series of Internal Revenue Service published rulings dating from the mid-1950's, amounts elected to be deferred are not taxed to the employee until actual distribution from the qualified plan. (See Rev. Rul. 56-497, 1956-2 C.B. 284; Rev. Rul. 63-180, 1963-2 C.B. 189; and Rev. Rul. 68-89, 1968-1 C.B. 402.) Over 100,000 employees of more than 100 companies throughout the country are covered by such plans.

Cash or deferred plans are required to meet all of the applicable qualification requirements of Section 401(a) of the Code, including the rules dealing with non-discrimination in favor of the highly-paid. The non-discrimination requirement generally has meant that at least 50% of all employees electing to defer receipt of their allocable share of profits must have compensation which places them among the lower two-thirds of the employer's payroll. See Rev. Rul. 56-497, supra.

On December 6, 1972, the IRS issued proposed regulations which would have changed the tax treatment of employees covered under certain so-called "salary reduction" plans. A salary reduction plan gives employees the option of taking a decrease in basic or regular compensation, or forgoing an increase in such compensation, in return for a contribution by the employer in an equal amount to a plan qualified under Section 401(a) of the Code. Under the proposed regulations, employees would have been taxed currently on amounts contributed to the plan. See Prop. Regs. § 1.402(a)-1(a). The regulations specifically would not have applied to cash or deferred profit sharing plans which relate only to an employee's share of profits and do not relate to his basic or regular compensation.

In Section 2006 of ERISA, Congress provided that the tax treatment proposed by the Treasury in its 1972 regulations with respect to salary reduction plans would be applicable to all new plans, but only until January 1, 1977. However, arrangements existing on June 27, 1974, would continue to be governed under prior law for the duration of a Congressional study regarding the entire area surrounding individual employee elections under employee benefit plans. Section 2006 of ERISA was extended to cover all types of elective plans, including cash or deferred profit sharing plans and so-called cafeteria plans (under which employees customarily are provided a choice between various non-taxable employee benefits and cash) as well as salary reduction plans.[1]

The study period, which was extended for one year by the Tax Reform Act of 1976, expired December 31, 1977. H.R. 9251, the Tax Treatment Extension Act of 1978, passed by both the House of Representatives and the Senate, further extends the freeze until December 31, 1979.[2]

II. OUR POSITION

It is our position that the treatment of cash and deferred plans as in effect prior to the 1972 proposed regulations should be retained. For this reason, we support the enactment of Section 125 of H.R. 13511, which does precisely that. It states that in the case of any cash or deferred arrangement under a profit sharing plan the Internal Revenue Code shall be administered in a manner consistent with Rev. Rul. 56-497, Rev. Rul. 63-180, and Rev. Rul. 68-89, all supra.

[1] On July 13, 1978, the Internal Revenue Service withdrew the proposed regulations dealing with salary reduction plans. (See the Federal Register of July 14, 1978, 43 FR 30308.)

[2] This Bill has not as yet gone to Conference.

Salary reduction plans are expressly excluded from the applicable scope of Section 125. That section is made applicable to taxable years beginning after December 31, 1977. Thus, it is correlated with the current expiration date of Section 2006 of ERISA.

Cash or deferred plans frequently represent the only qualified deferred compensation plan maintained by an employer. Smaller employers, particularly, often cannot afford to maintain more than one plan, benefiting different groups of employees. They cannot afford both a pension and a profit sharing plan, or both a cash and a deferred profit sharing plan, or any other sophisticated employee plan such as a stock option, stock appreciation, or performance share plan.

Accordingly, the one plan which they offer must satisfy the needs of some employees for cash and the desires of other employees for deferral. The cash and deferred plan under consideration in these hearings provides such flexibility in order to meet the needs of all employees. In this connection, a common misconception of cash or deferred plans is that they are a tax shelter for the highly-paid in that only they can afford to defer the employer's contribution and thus avoid being taxed currently.[8] It should be emphasized that the IRS presently requires that at least half of the participants deferring be among the lower paid two-thirds of a nondiscriminatory eligible group. Further, as a practical matter, the consideration as to whether to defer the employer's contribution or take it in cash is often unrelated to whether the employee is highly paid. For example, a young, rank and file employee with no family to support or a second wage earner in the family may opt for maximum deferral. On the other hand, an executive whose children are about to enter college may opt for an immediate cash payment. In other words, there is no necessary correlation between the choice of cash or deferred and the salary bracket of the employees covered by the plan.

In view of the fact that cash or deferred plans do provide so much flexibility, but still must meet the requirements under Section 401(a) of the Code prohibiting discrimination in favor of highly paid employees just as a deferred only plan must do, we believe that their continued existence under the rules in effect prior to the issuance of the Treasury's proposed regulations in 1972 should be permitted.

We understand that the Treasury Department does not support Section 125 of H.R. 13511 in its present form. We have been attempting for some time work with the Treasury Department staff to develop a Code amendment that would be acceptable to all, and we shall continue to do so.

Unless such an agreement can be developed before the Committee concludes its consideration of this Bill, we strongly urge the Committee to approve Section 125 in its present form rather than continuing the freeze adopted in Section 2006 of ERISA. As stated by the Committee on Ways and Means:

"Since the enactment of ERISA, the freeze of the status quo treatment of cash or deferred profit-sharing plans has prevented employers from setting up new plans of this type for their employees. Originally, it was thought that a relatively short period of time would be needed for Congressional study and that a permanent solution would be in place by January 1, 1977. The committee believes that the uncertainty caused by the present state of the law has created the need for an interim solution which permits employers to establish new cash or deferred profit-sharing plans pending the adoption of a permanent solution in this area. Also, the committee believes that present law discriminates against employers who had not established cash or deferred profit-sharing plans by June 27, 1974." [H.R. Rept. No. 95-1445, p. 66]

We agree whole-heartedly with the statement of the Committee on Ways and Means and, for the reasons stated in that Report, urge this Committee to approve Section 125 of H.R. 13511.

STATEMENT OF EDWIN S. COHEN ON BEHALF OF IRVING TRUST CO.

My name is Edwin S. Cohen. I am a partner in the law firm of Covington & Burling, Washington, D.C. I appreciate the opportunity to appear before the Committee on Finance on behalf of the employees of the Irving Trust Company, New York City, with respect to its profit sharing plan.

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[8] It is significant that in the period during which cash or deferred profit sharing plans have been under study, not one case has "surfaced" which indicated that there has been any abuse in this area.

Irving Trust Company employs some 6,000 people in New York City. Its profit sharing plan has been in existence since 1953 and the plan for many years has been ruled by the Internal Revenue Service to qualify under Section 401 of the Internal Revenue Code. For some 25 years, except for my period of government service, I have been counsel to the Irving Trust Company and its employees with respect to the plan.

Section 125 of the pending bill, H.R. 13511, would preserve the continued qualification of the plan and similar plans in accordance with long-established rulings and regulations of the Internal Revenue Service. A question as to the future status of these plans was raised as a result of a proposed regulation which was issued by the Service in 1972 and which was recently withdrawn, and by a provision in the ERISA legislation enacted in 1974. Section 125 of the pending bill would simply insure the continued qualification of the plans.

The Irving Trust Company plan works essentially as follows:

The bank, each year, sets aside for employees a portion of its profits for the year based on a formula, but the amount set aside cannot exceed 15 percent of employee wages;

Every employee eligible to participate in the plan (and that means every employee with three or more years of service) may, before the end of September in each year, elect to receive in cash after the close of the year his or her share of the year's profits set aside for employees;

If an employee does not elect to receive cash, an amount equal to his or her share of the year's profits is transferred to a profit sharing trust for his or her vested benefit;

An employee may instead elect to receive 50 percent in cash, in which case the remaining 50 percent is transferred to the trust for his or her vested benefit;

The amount transferred to the trust is not available to the employee until retirement, death, severance of employment or hardship, and is not taxed until received.

Prior to 1953, Irving provided a cash bonus to its employees at the end of each year. In 1953 Irving established its present profit sharing plan in lieu of the previous cash bonus system at the same time that two other New York City banks established similar plans. Thereafter, at least seven other New York City banks installed similar plans, as did numerous banks in other cities throughout the country, as well as many other business corporations. We estimate that more than 50,000 employees of ten New York City banks and more than 200,000 employees throughout the country are covered by plans of this type. Most of these plans have been existence for more than 15 years and in Irving's case for 25 years. The plans are sometimes referred to as "cash or deferred profit sharing plans."

In addition to its profit sharing plan, Irving Trust Company has a retirement plan for its employees. Those employees who participate in the deferred profit sharing trust will through that trust receive supplementary retirement benefits. Whether an employee wishes to receive his share of profits in cash for immediate use or have it deferred to increased retirement benefits depends upon a variety of personal and family considerations that vary from employee to employee. Some may have immediate needs for family illness, support of elderly parents, education of children, or purchase of homes; others may have no such current demands and should be encouraged to provide for supplemental retirement benefits. This variation in need occurs among employees at any level of compensation. An executive may be saddled with current family obligations while a junior employee may be free of them. The Irving plan offers each employee his choice according to his own need.

If the income tax law were changed to disqualify profit sharing plans that provide each employee with an option to receive cash, the directors of Irving would be faced with a serious dilemma: they would have to decide whether

(1) to eliminate the option of employees to take cash, in which event every employee would be required to defer his profit sharing to supplement his retirement income, even though he may have urgent current cash needs; or

(2) to pay out all profit sharing in cash, even though many employees throughout the salary scale do not have such needs and should be encouraged to save for retirement.

The Irving Trust Company sincerely trusts that it will not be faced with such an unfortunate dilemma.

Since 1942 the Internal Revenue Code has provided that trusteed pension and profit sharing plans must not discriminate in favor of officers, shareholders or highly compensated employees. The Irving plan was approved by the Internal Revenue Service when it was established.

After the initial approval of the plan in 1953, there was an extensive review of the matter in the National Office of the Internal Revenue Service and the Treasury Department. There was concern that plans of this type might automatically discriminate in favor of highly compensated employees because of the possibility that the highly compensated employees might elect to defer and other employees take cash. After some months of discussion with the Service, the three companies whose plans were then under review provided me information about their entire payrolls, with data as to which employees elected to receive cash and which did not. From this data it was clear that many highly compensated employees elected cash and many rank-and-file employees preferred to have their share of profits paid into the trust to provide increased retirement benefits.

I then proposed to the Service a rule to require a minimum participation in the deferred trust by employees not highly compensated and a maximum participation by those who were highly compensated. After some months of deliberation, the Service published a ruling, Rev. Rul. 56-497, 1956-2 C.B. 284, to the same general effect but with certain different particulars. That rule requires in general that for the plan to satisfy the statutory rule of nondiscrimination, a majority of those employees electing to defer must be in the lower two-thirds of the pay scale of the employer. Irving's employees have more than met this test in every one of the past 25 years.

In 1962 and 1963 the matter was re-examined once again at a hearing before Commissioner of International Revenue Mortimer M. Caplin and Assistant Secretary for Tax Policy Stanley S. Surrey, not only on the issue of nondiscrimination but also on the issue whether each employee should be deemed in constructive receipt of income even if he did not elect to receive cash. Again, after extensive consideration, Rev. Rul. 63-180, 1963-2 C.B. 189, held that there was no constructive receipt and the 1956 ruling was reaffirmed. This was again reaffirmed in 1968 in Rev. Rul. 68-89, 1968-1 C.B. 402.

On December 6, 1972, the IRS issued proposed regulations which would have changed the tax treatment of employees covered under certain so-called "salary reduction" plans. A salary reduction plan gives employees the option of taking a decrease in basic or regular compensation, or foregoing an increase in such compensation, in return for a contribution by the employer in an equal amount to a plan qualified under Section 401(a) of the Code. Under the proposed regulations, employees would have been taxed currently on amounts contributed to the plan. See Prop. Regs. § 1.402(a)-1(2). The regulation specifically would not have applied to plans such as that the Irving Trust Company which relate only to an employee's share of profits and do not relate to his basic or regular compensation. The proposed regulation was withdrawn by the Service on July 13, 1978 (43 Fed. Reg. 30308).

In 1973, during early consideration of the legislation that was later enacted as the Employee Retirement Income Security Act of 1974 (ERISA), without any hearing on the subject, a provision was inserted that would have required all employees to treat as current income amounts deferred under cash or deferred profit sharing plans as well as salary reduction plans. Section 2006 of ERISA, as enacted, permitted these plans that were in existence on June 27, 1974, to continue until December 31, 1976, pending further study of the matter by the Congress. In 1976 this period was extended to December 31, 1977: and by Section 5 of H.R. 9251, the Tax Treatment Extension Act of 1975, which has now passed both the House and the Senate, this period would be extended further to December 31, 1979.

S. 2148, introduced September 27, 1977 by Senator Moynihan, and a similar bill (H.R. 12115) in the House, introduced by Representatives Conable and Rangel, would provide that the cash or deferred profit sharing plans would be permitted to continue on a nondiscriminatory basis under the rules heretofore applied by the Internal Revenue Service.

Section 125 of H.R. 13511 similarly preserves these plans under the same rules for nondiscrimination that have been applied for so many years. In his statement on H.R. 13511 before the Committee on Finance, Secretary Blumenthal, in referring to Section 125 of the bill, stated that "The Treasury Department is working on a detailed proposal in this area." We have been attempting for some time to work with the Treasury Department staff to develop a Code amendment that would be acceptable to all and we shall continue to do so. Unless such an agreement can be developed before the Committee concludes its consideration of H.R. 13511, we strongly urge the Committee to approve Section 125 in its present form

as passed by the House rather than continue the freeze adopted in Section 2006 of ERISA.

Senator MOYNIHAN. Now we have a panel that consists of Mr. Michael Monroney who is the vice president and director of government relations for TRW and Mr. Converse Murdoch.

Mr. Monroney, we welcome you and are very happy to see you here again, and Mr. Murdoch. Why do you not proceed as you wish?

STATEMENT OF MICHAEL MONRONEY, VICE PRESIDENT AND DIRECTOR OF GOVERNMENT RELATIONS, TRW, INC.

Mr. MONRONEY. Thank you, Mr. Chairman. I am Michael Monroney, vice president and director of government relations for TRW. I am here to express TRW's strong support for section 124 of the bill now pending before this Committee.

It relates to cafeteria plans, and I will elaborate on that, if my statement can be submitted for the record.

Senator MOYNIHAN. Please, we will have your statement in the record, yes.

Mr. MONRONEY. TRW, several years ago, initiated and established a very innovative and unique fringe benefit plan, a flexible benefit plan, which we refer to as a cafeteria plan. In describing that, I could tell you that what we have done is to set a dollar value on the fringe benefit package for each employee, then allow the employee to design his or her own benefit program within the parameters of that dollar value to meet his or her own family or individual needs.

Now, the advantages of this program are strictly for the employee.

It would permit, for example, an employee whose spouse worked for another company and who was covered by health insurance by his spouse's employer to cut down on his health benefit programs within TRW and perhaps increase his life insurance or accidental death coverage.

He can, in effect, pick and choose, and that is the origin of the word "cafeteria." He can pick and choose what he wants and, within the parameters of the dollar value of the benefit package design a benefit package that meets his own personal needs.

Now, we did this 4 or 5 years ago and established it in a small unit in Ohio and one large unit in California, but there are many other parts of TRW where we have not been able to expand the program, including our more than 3000 employees in the state of New York because of the possibility of an adverse IRS ruling which would have a bad effect on the employees with respect to their taxes.

There is the possibility the IRS may rule that—because we have assigned this dollar value to the benefit package and allowed the employee to design it within the framework of that dollar value—it is comparable to giving the employee the dollars and letting him buy back the benefits, and thus, he should be taxed on the cost of the total benefit package.

We have argued that we would assume he or she would be taxed on the benefits that are normally considered taxable, but not taxed on those which are normally considered nontaxable.

Senator MOYNIHAN. As, for example, the health plan.

Mr. MONRONEY. That is correct. The health plan, accidental death, life insurance, and so on.

We have worked for about 4 years in the Congress to get relief for this and I assume there are other companies who are watching our progress to see if they could establish similar cafeteria plans comparable to ours.

I might add that there are no pension benefits involved in this program. It is a nondiscriminatory program. There are no tax or financial advantages to the employer whatsoever.

My fellow panelist, Mr. Converse Murdoch, gave me the courtesy yesterday of calling me to tell me what his reservations were about section 124, and I might add that, in discussing them with him, I believe that, subject to the committee's agreement, we could probably work out the problems he sees in the legislation in the committee report.

Mr. Savage, who was on the previous panel, is also outside tax counsel to TRW and would be glad to sit down with the Treasury Department and the committee staff to work out language that might resolve Mr. Murdoch's reservations.

In concluding my statement, I can only say that the House has approved this section 124 and we have worked out agreements with the Treasury Department and made certain modifications at their suggestion, and I think it is a noncontroversial matter. It certainly is one in which we are concerned with the welfare of our employees and I mentioned earlier, it has no tax or financial advantages to TRW.

Thank you.

Senator MOYNIHAN. Let me say, I need not say how welcome you are always before this committee, sir, and that you obviously understand our purposes.

Did Mr. Murdoch want to state his reservations so we will have this as a matter of record, and we can then work them out?

STATEMENT OF CONVERSE MURDOCH, ESQ.

Mr. MURDOCH. Yes, sir.

My name is Converse Murdoch. I am an attorney in private practices in Wilmington, Del. Most of my clients are small business people. I hasten to add that I did not plan it that way; that is just the way the ball bounced. We have no rule excluding large businesses, we just do not represent them.

I am in the somewhat anomalous position of agreeing with everything Mr. Monroney says except that I do not agree that section 124, as it came out of the House, should be kept in the bill.

In the first place, the definition of cafeteria plans in the section which I oppose, section 124, is very vague. Most of our clients in the small business area do not even know what you are talking about when you tell them that they may have a cafeteria plan. They do not know what that term means.

And it is quite possible that many small businesses, particularly, will be maintaining cafeteria plans without even knowing it.

For example, it is usual in a small business where you have a limited number of employees, that in interviewing people for a few jobs, you will run into a situation such as in the following. In Dover, Del., a woman will apply for a job as a secretary or a clerk and the boss, in interviewing her, will tell her that they have a wonderful Blue Cross

plan. She will say: "That is interesting, but my husband is an airman out at the airbase and all of our medical expenses are taken care of out there. We do not need it."

The boss says: "Fine, we will not give you Blue Cross coverage."

She may say: "However, I would like some disability insurance because if I got ill, that would hurt our family." The boss will say: "Fine, if it is the same cost, it is all right with me."

Now, that man, I think, under section 124 as it came out of the House is probably maintaining a cafeteria plan and he does not even know it. And there are bad results from having a cafeteria plan if they flunk these tests of nondiscrimination.

Mr. Cohen a few minutes ago explained to the committee the meaning of nondiscrimination in the pension area, and that is a concept which is workable in the pension area for a number of reasons.

One, it has been in the law for 36 years, at least, and people establish pension plans knowingly, and usually with professional advice. Small business employers generally do not get professional advice when they establish a welfare plan. They drift into it.

They start a life insurance plan and then they will add Blue Cross and then they will add medical reimbursement. No salesman sits down and says this is what you are buying, and you must comply with section 124.

The antidiscrimination rules of the pension area just cannot be made to work in the welfare plan area, particularly in the small business segment. The reason is because everybody is insurable for a pension. There is not an insurance company in the world that will refuse to sell anybody in the world an annuity contract. The worse shape you are in, the more they love you.

But that is not true when it comes to medical expense and life insurance. As to those, many people are uninsurable.

And therefore, in the small business area, even though the employer does not intend his plan to be discriminatory, he may have one just because the insurance company will not sell certain coverages to certain of the lower paid people.

Thank you, Mr. Chairman.

Senator MOYNIHAN. Well, thank you, sir, but do I understand that you believe that you can resolve these ambiguities. Well, they are ambiguities in a way, are they not?

Mr. MONRONEY. I feel that would be very easy to do, Mr. Chairman.

Senator MOYNIHAN. Well, I think if you did, that would be in the public interest, would it not? We want this kind of creativity in the private sector, and even those people who are creative and do not know it should be encouraged to be.

Is it your thought that you could get some language to us in report that would resolve this?

Mr. MURDOCH. Mr. Chairman, I would be glad to work with anyone on this matter. The only reservation I have, I do not believe that I could devise an antidiscrimination rule for welfare plans, including cafeteria plans, which would be workable.

If what Mr. Monroney has in mind is dropping the antidiscrimination rules, then there would be no problem, and I could work with Mr. Monroney on that.

Mr. MONRONEY. I might add, Mr. Chairman, that we would have no objection to dropping the nondiscriminatory rule. Our plan will be

nondiscriminatory in any event, but we have no objection to dropping that provision from section 124.

Senator MOYNIHAN. Well, there you are.

Senator Packwood?

Senator PACKWOOD. No questions. Good presentation.

Senator MOYNIHAN. Senator Curtis?

Senator CURTIS. Mr. Chairman, I did not get here for all the testimony. I am familiar with TRW and they have a couple of fine plants in Nebraska.

It has been my observation that this cafeteria plan of fitting fringe benefits to the particular needs of an employee is quite popular with employees. Am I correct in assuming that?

Mr. MONRONEY. Yes, Senator, that is true. The actuaries in the insurance industry were very, very skeptical that there would be a wide variety of choice by our employees, but we find that they study very carefully the options available to them under the cafeteria plan. There is a wide variety of selections made, and it is very popular; yes, sir.

Senator CURTIS. In other words, it meets the needs of the employees without unnecessarily increasing the cost to the consumer; is that correct?

Mr. MONRONEY. That is correct.

Senator CURTIS. That is all, Mr. Chairman.

Senator MOYNIHAN. Well, this has been very clear and very straightforward. I have spoken to Mr. Shapiro, who feels that this can be worked out, and we thank you for bringing the matter to us and for your cooperative attitude and, with any luck, we will let you go on and continue to manage your own affairs, as you are obviously doing very well.

And if I see anybody from Du Pont, I will tell them that you were here, sir.

[The prepared statements of the preceding panel follow:]

STATEMENT OF MICHAEL MONRONEY ON BEHALF OF TRW INC.

My name is Michael Monroney. I am Vice President of Government Relations for TRW Inc. With me is Carroll J. Savage, of the Washington law firm of Ivins, Phillips & Barker, tax counsel to TRW.

TRW is a diversified manufacturer specializing in products, systems and services for electronic, space, aircraft, defense, automotive and other industrial and commercial markets. TRW and its subsidiaries and affiliates employ approximately 90,000 employees.

I am here today to express TRW's strong endorsement and support for section 124 of H.R. 13511 relating to Cafeteria Plans or, as they are called at TRW, flexible benefits programs.

BACKGROUND

Flexible benefit programs are a relatively new innovation for which TRW has been one of the principal pioneers. The distinctive characteristic of these plans is that they give each employee an individual choice in the amounts and kinds of fringe benefits which are made available at the expense of his employer. Such programs typically cover nonqualified fringe benefits of the welfare plan variety such as group hospitalization, life insurance, accident, sickness and vacation. Under a flexible benefits program, the employer, either unilaterally or through collective bargaining with the union representatives of the covered employees, decides on the level of employer expense which will be assigned to fringe benefits covered under such a plan, and the individual employees are given choices among benefits within the defined package. The idea of flexible benefits originated at TRW in 1969 in contract negotiations with a union group in Ohio. Other unions have asked for similar kinds of programs, and in 1974

the company extended such a program on a completely nondiscriminatory basis to a large segment of its employees (Systems and Energy Group).

The plan which has been developed and installed at TRW's Systems and Energy Group is based on the principle that the Company cannot design a single package of benefits that will meet the needs of all employees and that, within limits, employees should be given the opportunity to tailor individualized benefit packages that meet their specific needs. A brief description of the plan presently in effect for TRW's Systems and Energy Groups is contained in an appendix to this statement.

Under a flexible benefits program, each employee may be given a choice among levels and types of benefits available within the defined package. If, for instance, an employee does not have any dependents, he may wish to reduce life insurance coverage in favor of additional long-term disability or medical coverage, or he may wish to obtain the benefits of a dental care plan in lieu of accidental death or survivor benefit insurance. Another employee with a large family may want to put greater stress on life insurance coverage and might also wish to reduce other benefits or cash compensation in order to obtain an additional week of vacation. An employee may wish to select the minimum fringe benefit levels permitted under the company program and thereby maximize his or her take-home pay during a period of heavy cash needs or to avoid duplication when adequate family benefit coverage is provided for a working spouse by another employer.

It is important to stress that this kind of program contains no tax or other monetary benefits for the sponsoring employer. The amount expended by the employer on benefits of this kind is deductible under section 162 of the Code whether paid in cash or contributed to an insurance or other welfare plan.

On the other hand, the kind of program described contains many desirable advantages for employees covered because they are no longer required to accept the package of employer-paid benefits designed for the hypothetical average employee but can obtain benefits which are of maximum value to each employee in a particular situation at any time in his or her career. The employer reaps only the incidental benefits of having better satisfied and motivated employees.

Despite all of these advantages, employers have been prevented from establishing or expanding flexible benefit plans in recent years because of uncertainty which has developed concerning the tax treatment of employees covered by such plans. This uncertainty arises from the fact that some of the benefits available under Cafeteria Plans are of a kind which, by reason of section 106 or section 79 of the Code, are nontaxable to the employee at the time contributions are made under the plan by the employer, whereas other benefits under these plans, such as group life insurance at levels above $50,000 are taxed to the employee for the year in which contributions are made by the employer on his behalf. Also, an employee who elects a benefit package which adds up to less than the overall cost of the standard company package would receive additional taxable cash compensation representing the reduced cost of his benefit coverage. Of course, if all available benefits are nontaxable under the Code, the existence of an employee choice among these nontaxable benefits would not produce any adverse tax consequences under present law.

The uncertainty which has faced employees covered by these plans in recent years arises from a potential Internal Revenue Service position that, where the plan provides both taxable and nontaxable benefits at the employer's expense, each employee who is given a choice might be taxed if he had made the election under the plan which would have resulted in the highest amount of taxable income, regardless of his actual choice. This would produce an intolerable result since, merely by reason of establishment of the plan by the employer, each employee's taxable wages would increase to the highest possible level under the plan, and employees electing nontaxable coverages such as hospitalization insurance would in effect be taxed on the amounts contributed by the employers to such coverage notwithstanding the exclusions presently contained in the Code.

Although there is no requirement under present law that this kind of program be installed on a broadly based nondiscriminatory basis, TRW's flexible benefit program is completely nondiscriminatory in coverage and benefits, and we believe it is reasonable for Congress to encourage the extension of such programs to rank and file employees by imposing a workable nondiscrimination requirement on plans which offer individual employee choice.

The Treasury Department has made an extensive study of flexible benefit plans and the President included in his proposal for tax reform sent to Congress earlier this year a provision which would clear the way for flexible benefit plans which

are installed and administered on a nondiscriminatory basis. The House of Representatives adopted the substance of the Treasury's proposal in section 124 of H.R. 13511 and last week Secretary Blumenthal, in his testimony before this Committee, urged that the Senate retain this provision.

TRW believes that for the most part the rules are acceptable. We have made some minor suggestions for modification of the wording of some of the technical rules which, on the basis of our experience, will enhance their workability, and it is our expectation that the Treasury and your staff will be receptive to these minor modifications.

We are aware that there has been some uneasiness among some employers and practitioners that section 124 of the House bill might be construed somehow to require the application of nondiscrimination rules to welfare plans which do not provide employees with choices between taxable and nontaxable employer financed benefits, or to welfare benefits which are not based on a clear employee election. We do not believe that these concerns are well-founded. TRW shares the concern of many that the administrative burden and complexities of applying nondiscrimination rules to all types of welfare programs would be overwhelming. If there is concern that the present proposal with respect to Cafeteria Plans can be construed as applying beyond the limited area for which it was intended, the Committee may wish to make minor modifications in the language of the House bill to clarify this limited application.

TRW is pleased to support section 124 of H.R. 13511 and with enthusiasm. We only hope that the Committee will retain this provision in the bill.

Appendix to Statement of Michael Monroney, Description of Present TRW Flexible Benefits Plan

The plan for flexible benefits ("cafeteria" approach) installed at TRW (Systems and Energy Group) evolved from a study on the feasibility of employee choices in the way they receive compensation. The plan developed is based on the principle that the Company cannot design a single package of benefits that will meet the needs of all employees and that, within limits, employees should be given the opportunity to tailor a benefit package that meets their specific needs. The plan developed by TRW does not result in any financial or tax advantages to the Company, as tax deductions are permitted for the cost of all benefits and cash compensation. Under the plan employees are permitted to trade-off between certain defined non-qualified benefit programs.

The basic principles underlying the plan are:

The benefits in effect at the time of implementation will be considered the Company standard.

Benefit programs that are better (more costly) than the Company standard will also be available.

Benefit programs that provide less coverage (less costly) than Company standard will be included to give an employee credit towards other benefits.

If the cost of the benefits chosen by the employee does not equal the cost of the Company standard benefit package, the difference will be paid to the employee in cash.

The Company will pay for all administrative costs of the plan.

Company standard benefits will be reviewed annually and maintained at a competitive level.

Additional choices will be added as new elements of the total compensation package can be defined on a choice basis; additional possibilities include long-term disability insurance, dental care plan, and additional paid vacation.

Employees at all levels are eligible immediately upon employment. There is no waiting period.

While many variations are possible under this kind of program, the choices currently available to employees at TRW are:

Hospital medical insurance.—Standard plan, improved plan, less costly major medical, four prepaid HMO health care plans.

Life insurance.—Level term in increments of ½, 1¼, 2½, 3¾ or 5 times annual salary with 1¼ being the Company standard level, or a monthly survivor income annuity which is the actuarial equivalent of insurance at 1½, 2½ or 3¾ times annual salary.

Supplemental accidental death and dismemberment insurance.—Coverage at 1¼ or 2½ times annual salary.

Dependent life insurance.—One plan which provides $1,500 for spouse, $1,500 for children age six months to 21 years and $100 for children age 14 days to six months.

Benefit levels are elected in the year prior to the year they become effective. Benefit levels cannot be changed during the plan year, except in narrowly defined situations such as transfer to a different geographical area or other unforeseen circumstances.

When a higher level of benefits is elected, satisfactory evidence of good health must be shown before participation is permitted.

If the net cost of the benefit package elected is more costly than the Company standard package, the additional cost is deducted from the employee's pay prior to the computation of payroll taxes. If the net cost of the benefits elected is less costly, the resulting cash breakage is included in the employee's pay prior to the computation of payroll taxes.

Employees are very positive about the plan. The opportunity to tailor their own benefit package is viewed by employees in itself as a benefit.

Statement of Converse Murdoch, Esq., Wilmington, Delaware

This statement is submitted to the Senate Finance Committee in connection with its consideration of H.R. 13511 and specifically with respect to section 124 of the bill having to do with tax treatment of cafeteria plans.

I am an attorney in private practice in Wilmington, Delaware. I have been an attorney for over thirty years. Most of my clients are closely held businesses. I am also presently the head of an organization known as "The Group." That organization consists of approximately 100 individuals (most of them practicing attorneys) who are engaged in counselling small and closely-held businesses with respect to various matters, including employer-sponsored pension, profit sharing and welfare plans. The Group is not a position-taking organization. Accordingly, my statement should not be considered as an official statement on behalf of The Group. However, my statement does reflect the comments of many members of The Group and these, in turn, reflect the attitudes of the owners of many thousands of small and closely-held businesses.

THE BACKGROUND OF SECTION 124 OF THE BILL

The Treasury's Tax Reform proposals which were submitted in January 1978, included proposals to apply the so-called "anti-discrimination" rules of the pension plan area to welfare plans.

For this purpose, welfare plans means employer-sponsored plans to provide death, medical, disability and similar benefits.

The Ways and Means Committee held public hearings with respect to the Administration's proposals regarding welfare plans. A great number of people knowledgeable in the area submitted written comments to the Ways and Means Committee. Most of these comments were to the effect that the Administration's proposal regarding closely-held businesses constituted an unfair discrimination against small business and would result in most small businesses dropping employer-sponsored welfare plans. The comments to the Ways and Means Committee also pointed out that the Administration proposals in these areas would lead to absurd results in many cases. This is because the so-called anti-discrimination rules in the pension plan area simply don't fit in the welfare plan area.

The Ways and Means Committee wisely decided to not adopt the Administration proposals regarding welfare plans. However, at the last minute, during the Ways and Means Committee consideration of H.R. 13511, there was inserted in the bill section 124 having to do with so-called "cafeteria plans." That term has not been (and still is not) well defined. In popular parlance, it has been used to describe a great many fringe benefit programs maintained by employers. The Ways and Means Committee report[1] describes a cafeteria plan as a plan under which "* * * an employee may choose from a package of employer-provided fringe benefits; some of which may be taxable (e.g. group term life insurance in excess of $50,000) and some of which may be non-taxable (e.g. health and accident insurance)."

Section 124 of the bill[2] sets forth a general rule that under a cafeteria plan, employees will not be subjected to income tax merely because one of their options under the plan is to take benefits in a form which would otherwise be taxable except to the extent that the employee elects a taxable form of benefit.

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[1] H.R. Rep. 95-1445, 95th Cong., 2d Sess. p. 98.

[2] Section 124 of the bill adds a new section 124 to the Internal Revenue Code. Hereafter references to section 124 are references to the proposed new Code section.

While I am not urging the adoption of the just stated general rule, neither am I opposing it. There is much to be said in favor of the general rule. Most importantly, it permits needed flexibility in establishment of employer-sponsored welfare plans—giving each employee the flexibility to choose the mix of benefits most needed because of the particular employee's family or financial status. That is all to the good.

However, section 124 of the bill goes beyond the stated general rule and attempts to introduce into the law some of the unworkable concepts originally proposed by the Administration for all employer-sponsored welfare plans. This feature of section 124 I strongly oppose.

STATUTORY DEFINITION OF CAFETERIA PLAN

Sub-section (d) of section 124 defines a cafeteria plan as one under which:

"(A) All participants are employees; and

"(B) The participants may choose among two or more benefits."

The referenced sub-section goes on to provide that the term, "does not include any plan which provides for deferred compensation." This definition is so loosely drawn that it will be nearly impossible for most employers to determine whether or not a particular welfare plan they are sponsoring is or is not covered by the term "cafeteria plan." The effect of this will be to convert what was clearly meant as a special relief provision into a trap for the unwary.

There will undoubtedly be many employers (particularly in the small business area) who will not be aware that their plan for supplying welfare benefits for employees constitutes a cafeteria plan for purposes of Code section 124. For example, it is not unusual for an employer to provide that if his employees choose to contribute some small part of the cost, the employer will pay the balance of the cost of group life insurance, group medical expenses insurance, and group disability insurance. Does the fact that employees to get such coverage must be willing to contribute a part of the cost mean that "the paricipants may choose among two or more benefits?"

Throughout proposed Code section 124, the word "plan" is repeatedly used with critical and far reaching significance. This is a word which in a tax context is very elastic.[2] Yet, proposed section 124 could create tax havoc for employer-sponsored welfare benefit programs depending on decisions (initially by IRS personnel and ultimately by judges) as to whether a combination of programs constituted a simply plan or multiple plans.

For example, assume an employer who one day announces that he is going to institute a program of supplying group term life insurance for his employees. The employer at the time of that announcement has an informal arrangement about continuing salaries while an employee is ill. Stopping to analyze the situation at that point, there will be a serious question as to whether the wage continuation arrangement and the announced program of purchasing life insurance for employees together are a single plan or if each is a separate plan. Assume a determination that the hypothetical employer has established a single plan involving a wage continuation program and a life insurance program. The next question is whether the employees have a choice among benefits, if the employer, as part of his life insurance program, requires employees to contribute some small part of the cost of the program in order to participate. Absent an employee contribution, the employee will not qualify for life insurance coverage. Does this voluntary contribution feature mean that the life insurance program is one that the employee may "choose," thereby bringing into effect section 124? These are not fanciful situations. It must be remembered that legislation in such an important field as employer-sponsored health and welfare plans is not limited in its coverage to large employers with sophisticated knowledge of the law, employee benefit programs, and tax matters. There are many small businesses which cannot afford either in-house or outside professional guidance to lead them through the mine fields of complicated tax laws with respect to their welfare programs for employees.

If such employers become convinced that "somewhere out there" is a booby trap associated with the establishment of welfare plans for employees and that the only way they can avoid the booby trap is to hire high-priced tax lawyers and accountants—the employer is going to forego the establishment of a welfare plan with its normal expenses, rather than pay the substantial added cost of seeking advice as to how to avoid the booby traps.

[2] E.g. see Treasury Regs. 1.401–1 (discussing pension and profit sharing "plans" and Treasury Regs. 1.368–2(g) discussing a "plan of reorganization.")

If section 124 in anything even closely resembling its present form is included in the Internal Revenue Code, there will be a chilling effect on employer-sponsored welfare plans. This is obviously not the right time (if there will ever be a right time) for the Government to take any action which will inhibit the spread of employer-sponsored plans to assist employees in meeting the financial crises occasioned by medical problems or death.

THE ANTIDISCRIMINATION RULE FEATURES OF SECTION 124

Up to this point, I have been attempting to demonstrate that section 124 is inadvisable until the draftsmen can be "sent back to the drawing board" to fashion a more precisely honed instrument to accomplish the purposes of the sponsors of section 124.

I next want to focus on one particular feature of section 124—the rule set forth in section 124(b) having to do with discrimination in favor of highly compensated employees.

There is a surface appeal to the idea of enacting a rule which says that to gain favorable tax results, an employer-sponsored welfare plan must not discriminate in favor of highly compensated employees.

However, the implementation of the idea leads into a morass of problems which wll discourage many employers (particularly those in the small business area) from becoming involved in or continuing employer-sponsored welfare plans.

The design and enforcement of anti-discrimination rules in connection with pension and profit sharing plans has resulted in much controversy, audit disputes and litigation. These rules, which have been applied in the pension and profit sharing plan areas for thirty-six (36) years, are still the subject of extensive comment and controversey.

Pension and profit sharing plans tend to fall into a limited number of categories. Despite that, it has been difficult for the Internal Revenue Service and taxpayers to fully understand the application of the anti-discrimination rules to the limited categories of pension and profit sharing plans.

The varieties and combinations of welfare plans are almost infinite. It is a practical impossibility to catalog employer-sponsored welfare plans. Such plans run the gamut from a simple oral statement at a hiring interview that the employer will pay wages for limited periods while an employee is absent due to illness, all the way to highly developed, well articulated, printed plans of large corporations involving literally scores of fringe benefit programs.

There seems to be no quarrel about the proposition that it is in the public interest that employers be encouraged to adopt and expand plans under which, at employer expense, employees be given protection against financial losses occasioned by death, accident or illness. However, except in very limited circumstances, there is no law which requires an employer to adopt or expand welfare plans. Anything which makes the adoption or expansion of such plans more expensive or anything which even adds to the "hassle factor" is bound to discourage the spread of such plans.

The adoption of section 124's special rules about non-discrimination for cafeteria plans is certain to inhibit the spread of welfare plans. If for no other reason, the vagueness as to the applicability of section 124, will discourage employers from embarking on or expanding such plans. Most businessmen are prepared to take calculated business risks as a part of many business transactions. However, when it comes to establishing or expanding welfare plans for employees, most businessmen are not willing to proceed and incur the cost involved if their advisors tell them that the law is in a state of flux, and that the tax results are uncertain. Businessmen are badly turned off when they learn that the establishment of such plans will likely subject then at best, to substantial professional fees in establishing the plans and securing IRS approval for them and, at worst, will cost them additional fees for audit and litigation aspects and could very well result in a substantial tax deficiency for the employer. Faced with that sort of gamble, the ordinary businessman will opt to merely give his employees benefits in a form with respect to which the results are certain.

The adoption of the anti-discrimination rules set forth in section 124 will undoubtedly discourage the spread of employer-sponsored welfare plans. The proposed antidiscrimination rules in section 124 are very complex and undoubtedly will lead to confusion and bizarre results for those who attempt to comply with them.

One has only to look at the simplest type of welfare plan to realize the inappropriateness of anti-discrimination rules in the welfare plan area. One of the

oldest forms of employer-sponsored welfare plans is a group life insurance program. Typically, in such a plan the employer pays all or most of the premium costs. The insurance provides death benefits roughly geared to compensation levels. A fairly typical group life insurance plan would provide that all employees over age 25 who are willing to contribute $1.00 per month will be given employer-sponsored group life insurance protection. Those earning more than $25,000 get $50,000 coverage, those earning between $15,000–$25,000 get $25,000 coverage, and those earning less than $15,000 get $15,000 in coverage. If in the unlikely event that such was the only plan maintained by the employer—section 124 would probably not be applicable. However, one should assume the likely possibility that the same employer will at some point adopt a medical expense insurance program and a program for direct reimbursement by the employer of uninsured medical costs up to some annual limitation—usually a percentage of cash compensation. Such medical expense programs may require a small employee contribution as a condition for participation.

It seems clear in the hypothetical situation just posed (which is far from fanciful) that the employer (whether it knows it or not) is maintaining a cafeteria plan subjected to all the complexities of section 124. Because of the contributory feature, it is a near certainty that the Internal Revenue Service will contend that the plans give the employees a choice between benefits.

Assuming that the IRS decides that the described plan is subject to the provisions of section 124, the next question which must be asked is: Does the plan violate the anti-dicrimination rules?

It's frequently the case that a young married employee will elect not to be covered under the group life insurance plan but may, instead, arrange with the employer to have some sort of supplemental disability insurance coverage. Assume that enough young lower-compensated employees opt out of the life insurance program, leaving the bulk of the life insurance coverage applicable only to the older, married and highly compensated employees. Does this mean that there is resulting discrimination in favor of the highly compensated employees?

In the same hypothetical employee group, there will likely be some employees whose spouses are employed elsewhere and have full family coverage under medical expense insurance plans and who, therefore, opt to not participate in the medical expense insurance program. Under the proposed statute, will this result in the plan becoming discriminatory if the employees who opt out happen to be in the lower levels of compensation, leaving a disproportionate number of covered employees among the highly compensated?

Many employer-sponsored welfare plans involve what amounts to self-insurance for certain types of medical expense and death benefits. The proposed statute speaks in terms of prohibited discrimination with respect to "contributions or benefits." It's unclear how these non-discrimination rules will be applied in such a self-insured plan. If the employee group has only two members and one of them is highly compensated and the other is not—it will be nearly impossible to ever be certain during any point in a year whether the plan is going to end up being discriminatory or non-discriminatory. For example, if there is a self-insured medical expense reimbursement plan and the highly compensated employee has substantial expenses at the end of the year in which the lower compensated employee is fortunate and has no such expenses, presumably the plan for that year would be deemed to be discriminatory. Such a result is dependent upon blind luck. Surely, such drastic differences in tax results should not be made to turn on blind luck.

These problems are not stated here as an exhaustive list of all of the problems posed by section 124. They are merely mentioned as examples which quickly occurred to me in attempting to understand how section 124 will work.

In the time available to this Committee, I don't believe that all of the brains which the Committee can bring to bear on the problem could even scratch the surface in finding the problems posed by section 124. If all of these problems could be discovered and all of them could be solved by redrafting section 124, it might be worth the effort to do so. However, to hope for such a result is not realistic.

Unless the Committee can be assured that all problems in this area have been identified and solved, it will be a serious mistake for the Committee to approve section 124. For the Committee to approve section 124 with many of the problems not even identified (much less solved) is bound to have a chilling effect on establishment and explansion of employer-sponsored welfare plans.

I respectfully urge that the Committee not act precipitously in this area when to do so runs the risk of causing irreparable damage in an area which is so important to American working people.

Section 124 was a hastily devised provision inserted into the bill immediately prior to the Ways and Means Committee reporting it to the House. Something which affects so many million of employers and employees should not be rushed through in this fashion. Rather, it should be the subject of extensive exposure with a view to the Congress knowing all of the problems associated with the provision before it is voted up or down.

CONCLUSION

I respectfully request that the Committee eliminate section 124 from the bill pending further study of the problems posed by it.

Senator MOYNIHAN. And now, I believe this is the concluding panel this morning. We are going to hear from a wide range of interests and regions.

Let me just take the liberty of reading off your names, and perhaps you would have the kindness to identify yourselves, as I have not had the pleasure of meeting you.

Mr. James W. Scott, who appears on behalf of the Equitable Savings and Loan Association of Portland, Oreg.

Mr. Scott? We welcome you, sir.

Mr. L. G. "Skip" Smith, who is from the Office of the State of Texas, Comptroller of Public Accounts.

Mr. Smith, good morning to you, sir.

Mr. James F. Marshall, who is the executive director of the Assembly of Governmental Employees, on behalf of the Conference of Mayors, the League of Cities, the City Managers' Association, and associations too numerous to state.

Mr. Marshall, nice to see you again.

And Mr. Duane Marlan, administrator, State of Michigan Deferred Compensation Plan and chairman of the Ad Hoc Committee of Administrators of State and Local Plans, on behalf of that State and that committee.

We welcome you.

Mr. Scott is first on our list, and so we ask you to begin, if you would do so.

STATEMENT OF JAMES W. SCOTT, ON BEHALF OF THE EQUITABLE SAVINGS AND LOAN ASSOCIATION OF PORTLAND, OREG.

Mr. SCOTT. Good morning, Mr. Chairman.

My name is Jim Scott, and I am employed by Equitable Savings and Loan Association, headquarters in Portland, Oreg.

Section 121 of the Revenue Act of 1978 recently passed by the House requires employees of State and local governments to choose whether or not to participate in a deferred compensation plan in the year preceding a year in which the deferral would actually start.

We understand that Senator Packwood will offer an amendment to give these employees a choice of whether or not to participate in the month preceding the month for which the deferral would actually begin. I am here to speak in favor of his amendment.

Equitable Savings is presently serving in excess of 150 public agencies. These range in size from very small institutions, such as fire and water districts, to larger cities and counties, all having deferred compensation programs.

We have approximately 3,000 individuals participating in these programs.

Treasury's proposed regulations banning deferred compensation obviously caused us considerable concern. We were delighted to see section 121 of the House bill offering congressional support for the continuation of these plans. We believe that Senator Packwood's amendment meets the intent of Congress in that deferred compensation programs should continue without undue hindrance or operational difficulty.

The present language of the bill requires that employees who choose to participate must execute the deferred compensation agreement in the year prior to the year the payroll deduction actually takes place. In other words, if an employer with a deferred compensation program wished to add an employee to the plan, the employer and the employee could sign the agreements at any time during the year but could not make the payroll deduction for these commitments until the following year.

In practical terms, for a State or local employer who is operating on a monthly or bimonthly payroll, this means that all deferred compensation agreements would have to be started in January of the following year.

We believe that this provides a substantial obstacle to orderly and efficient operation of a program by an employer operating on a monthly payroll.

It will restrict and inhibit the smaller agencies, and many of the larger ones, which do not have the staff to cope with this logjam of payroll activity dumped into January of each year. These agencies usually operate on something other than a calendar year.

Their problem is further complicated by ongoing collective bargaining agreements which cause these or other changes in payroll and benefits at various times throughout the year.

The smaller agency may not be able to afford the kind of support necessary under this kind of provision to consider having the program at all.

We also feel that the smaller wage earner will be impacted more heavily than the individual earning a larger wage. The day-to-day financial problems of a low-paid person such as a janitor or a secretary attempting to estimate as much as a year in advance whether they will be able to live with a $20 or $30 a month deferral make it very improbable that they would choose to participate in this kind of a plan at all.

This potential for a long wait between the time the individual signed to participate in the program and the time they had the opportunity to see the results of their commitment, would surely leave the plan the primary tool of the highly-paid employees.

We believe this to be the result not only in view of our considerable experience with publicly-deferred employee compensation programs, but with many other forms of monthly savings transactions that our industry has historically offered.

We feel that it is particularly important for the small wage earner to be given evidence of his activity, accumulations of his account and so forth, as quickly as possible in order to maintain his or her commitment to participate.

We believe that it would be quite inconsistent with the spirit of this legislation to have a rule which would assure participation, mostly by those in the higher income brackets.

We believe that Senator Packwood's amendment provides the safeguards that Treasury seems to be seeking, in that it requires any deferral agreements must be executed prior to the performance of service by the participant. Therefore, if an individual did sign an agreement in September, only wages earned for pay periods beginning after the signing of the agreement could be deferred.

It would prevent a contractor who had negotiated a contract and performed services for a municipal agency from entering into a deferred agreement after the completion of the services.

The bill limits the amounts an employee can defer by specific percentage and dollar limits. We believe that this adequately protects the Treasury from any abuses that might take place.

In conclusion we believe that the Packwood amendment assumes that the operational rules applied to these programs will allow them to be run with a minimum of administrative overhead and give every assurance of participation throughout the public employee sector, not just the highly paid.

Senator MOYNIHAN. We thank you very much, Mr. Scott. That was beautifully timed.

Senator PACKWOOD. I wanted to interrupt for just a moment. The city of Portland and the city of Eugene, which are the two biggest cities in Oregon, wrote me about the problem to which Mr. Scott made reference, and I asked them who knew this subject well and they suggested Mr. Scott, who works for a savings and loan that is involved in managing these plans.

And what I discovered from the city of Portland and the city of Eugene is that, indeed, if you are talking about somebody making $8,000, $9,000 or $10,000 a year and then try to sell them a plan in February for which the deductions will start the following January, you might as well not talk about selling them a plan. They just do not think that far ahead.

Now, if you are making $35,000 or $40,000 as the city manager, you might think that far ahead and would do it.

We also have to start with the realization that Treasury does not like any deferred compensation plans at all. Therefore, if they could have regulations that would say that you have to make this decision almost a year ahead of time, that will certainly deter at least a good many people from participating in these plans and achieve half of what Treasury wants.

So the amendment I have designed is in response to the cities and the municipal associations. They prefer it because otherwise they have to wait to do all of their bookkeeping in January, and then it comes in a lump sum, instead of being written out through the year.

I know of no opposition to the amendment, short of Treasury, which, of course, opposes the whole concept anyway.

Senator MOYNIHAN. Is there anything the Treasury is for this year? Does anybody have a guess at something that Treasury is in favor of?

Senator PACKWOOD. You do not even have to add this year.

Senator DOLE. I think they are for Congress going home.

Senator MOYNIHAN. Well, sir, that we may have reached an agreement on.

Senator Curtis, while Mr. Scott's matter is before us, did you want to comment?

Senator CURTIS. This is a very elementary question, but I think in addition to educating the Senator from Nebraska, it might be well to have it in the record.

How does this deferred compensation work with State and municipal employees? Give me an example of someone in a certain wage level. What does he do, and how is it handled?

Mr. SCOTT. Well, Senator, deferred compensation, by definition, is simply a bilateral agreement between two parties who have the right to contract and the right to property. In the case that we are discussing here, it involves a person that is a corporate entity that happens to be a municipal agency, agreeing with a human being in writing that the human being will work for the agency, but not be paid, until some time in the future.

In other words, the wage earner and the employee agree that the wage earner will continue to be employed but simply not receive the income due the wage earner.

Senator CURTIS. I understand the legal requirements of deferred compensation, but give me an illustration of say a $15,000 a year State employee. How is it handled? When do they take it out and when does he get it? What is a typical case?

Mr. SCOTT. Very simply, sir, the individual would indicate his desire to participate to the employer and be given the enrollment procedure. It would involve the signing away of a portion of the income normally due him to be retained as a general asset of the employer, subject to the general claims of the employer.

At such time as the individual severed service with the employer, either through retirement, death or disability, these funds then could be made available to him from the employer, and paid back either in a lump sum or over a period of time.

The taxation on this would result when the individual eventually receives the money.

Senator CURTIS. Well, now give me an illustration, dollarwise, of a $15,000 a year employee. What would be a typical amount deferred.

Mr. MARSHALL. I have specifics on that, Senator, if I may.

Senator MOYNIHAN. Please do.

Mr. MARSHALL. I am James F. Marshall. I want to do my testimony later, but in specific response to the issue raised by Senator Curtis, we have studies throughout the country of various plans, and I have in my testimony which is prepared and somewhere up on the desk, an example of the average State employee that participates in the plan.

If he makes less than $15,000 a year, he sets aside or signs an agreement with his employer to withhold somewhere between $50 to $100 a month from his income—he does not have constructive receipt of it.

Senator CURTIS. And up until now he is not taxed on that deferral.

Mr. MARSHALL. No; he is not taxed until he receives it. The design is purely for a retirement supplement.

Senator CURTIS. Now, who holds that $50, assuming that he sets aside $50 a month deferred? Who has possession of that?

Mr. MARSHALL. The employer.

Senator CURTIS. The employer.

Does the employer sometimes escrow it or put it in a trust?

Mr. MARSHALL. Yes. There are several plans. Some have programs in which the employee can sign, say, that I would like to have received my money as though it had been in this annuity program for all of those years. And the employer can retain it or, in fact, put it in that annuity program. As a practical matter, many times they do, or in the case of some other States, and we have some experts here that can talk about their own States and how they do it, in some States the States actually invest the money and set up a return but they are the legal owners and the employee has only the rights of a general creditor in the issue.

Senator CURTIS. Are there some States or municipalities that permit the individual to defer, but do not segregate the money in any way, just let it remain as an unfunded obligation?

Mr. MARSHALL. Well, it is officially part of the general funds of the jurisdiction that runs the program.

Senator CURTIS. I know it would be an obligation on them, but my question is this—and all I want to know is just what is the pattern of operation—do they always earmark it and segregate it, either in a fund managed by themselves or with a trustee, or do they sometimes do nothing, just let it remain as a claim to be presented at a later time?

Mr. MARSHALL. I think some of the other panelists might know, but in my experience in the many cases which we are involved in around the country, I know of no case where they just let them sit.

Senator CURTIS. I do not see anything wrong with it, but what I am trying to find out is how these plans work.

Mr. SMITH. I am not aware of any plans where the funds are not set aside.

Mr. MARSHALL. I think in other testimony you will see some examples of specific plans or percentage payout, how they are used and so forth, as the panel goes on.

Mr. SCOTT. Yes, I am aware of funds held by the municipality, but they are accounted for, establishing an accounting or an audit trail to identify that element of the overall portfolio.

Senator CURTIS. In other words, they are recorded in their books as obligation that they must meet, but they are not funded.

Mr. SCOTT. Yes, sir.

Senator CURTIS. That answers my question. Thank you very much.

Senator MOYNIHAN. Well, Mr. Marshall, since you are speaking why do you not continue?

STATEMENT OF JAMES F. MARSHALL, EXECUTIVE DIRECTOR, ASSEMBLY OF GOVERNMENTAL EMPLOYEES, ON BEHALF OF ASSEMBLY OF GOVERNMENTAL EMPLOYEES, ET AL.

Mr. MARSHALL. Thank you, Mr. Chairman.

My name is James F. Marshall—not 'G." as is on the agenda—and I am the executive director of the Assembly of Governmental Employees.

And not only today am I representing our 600,000 State and local public employees, but I have the great opportunity to represent the National Governors' Association, the National League of Cities, the U.S. Conference of Mayors, the National Conference of State Legislators, the National Association of Counties, and the International City Managers' Association.

Now, I stated all of those elements I represent not because I expect 5 minutes for each representation, but I think it is indeed a unique time in history when labor and management in the public sector are able to work in tandem on an issue.

We have been working with each of these national organizations representing public employees for a year now, in efforts to try to retain the opportunity for deferred compensation of public employees. And I think it speaks well for labor-management cooperation in this area, and it also speaks to the importance of the issue that all administrators and all elected officials in State and local government, as well as the employees view this deferred compensation proposal.

We are here to support the section in H.R. 13511 dealing with the deferred compensation for public employees. I want to make it also clear that this panel speaks about public employee deferred compensation, unlike the previous panels who were more specifically dealing with private sector plans.

I also want to make it clear at the outset—first of all I would appreciate my written statement being inserted into the record——

Senator MOYNAHAN. We would be happy to have that done.

Mr. MARSHALL. [continuing]. And I will make only brief comments in that regard.

We are very, very grateful that the U.S. Senate we have 40 Senators who are cosponsoring legislation in this area. That is a clear indication of an interest on behalf of the Senate to make sure that the public employees have the right to retain the deferred compensation programs that now many, many enjoy.

I would like to talk a little bit about the people involved, because I think that is what is important.

The Treasury Department, in previous testimony, talked about some considered abuses, and in my statement I reiterate that two or their abuses were the doctor who deferred 94 percent and all of these kinds of things.

I however, am concerned about the 12.5 million State and local employees, and we are all anxious to make sure that opportunities for abuses for the deferral plan are considered, but I think it is important for you to know that, in our research, we do not have a plan-by-plan description of the makeup, but we have been researching for some time.

The average employee in the public sector is an employee of low or middle income who puts $50 to $100 a month away and works on less than a $15,000 annual salary.

Now, the idea is to encourage public employees to prepare themselves for retirement in addition to what they already have. In fact, our research has shown, and we have all State plans in the country, that the average public employee, after 30 years of service, retires at 52 percent of his final 3- to 5-year average salary. Now, that is not that much money, and that assumes he has been there all that time.

We have over a 20-percent turnover in State and local government, even in these times of employment problems. We have over 20 percent turnover. So those people are in and out of the plan all the time. They do not have time to get vested in any retirement program. They do not have portability from jurisdiction to jurisdiction; they need to find a way for themselves to help augment the retirement that they are going to get, because most of them are not going to get that amount.

And I think it is very important that you understand their needs We are very anxious to have all the flexibility we can in a plan to encourage public sector employees throughout to participate in this program. It is on the increase. It needs your immediate support.

We are very anxious to insure that this legislation be adopted this year, because there are many, many thousands of employees waiting for plans who have not been approved by IRS. They stopped approving plans in May of 1977, and there are a lot of employees that could ease the welfare rolls, that could improve their own retirement situation, but they cannot do it until the Congress acts.

So on behalf of all of these interests that I represent, let me finally say that we totally support the concept of H.R. 13511. We urge your quick adoption, and I will be happy to try to answer any questions you might have.

Senator MOYNIHAN. Thank you, Mr. Marshall, and I think we will go right ahead—please, Senator Packwood.

Senator PACKWOOD. I wanted to ask him on the same amendment that the city of Portland and the city of Eugene want, and I also have letters from the Portland school district in the State of Oregon, requesting the same 1-month instead of 1-year delay.

In your experience, if you have a 1-year delay, at least for low- and middle-income employees, is that going to deter them from making an option for deferred compensation?

Mr. MARSHALL. I say in my statement that we are anxious for as much flexibility as possible. Our experience—we have not really delved in to that particular problem precisely. I can certainly see some administrative problems of the continue to work, but I also see a greater need to encourage that employee whenever he is ready. It is normally not a full year; it is just a 3-, 4-, 5-, 6-month delay.

But I am anxious to get them on the books as soon as they are ready to get on the books, and we would support that kind of action.

Senator MOYNIHAN. Senator Curtis?

Senator CURTIS. I have no questions.

Then, Mr. Smith?

STATEMENT OF L. G. SKIP SMITH, OFFICE OF THE STATE OF TEXAS COMPTROLLER OF PUBLIC ACCOUNTS, ON BEHALF OF STATE OF TEXAS DEFERRED COMPENSATION PLANS

Mr. SMITH. Mr. Chairman and distinguished committee members, my name is Skip Smith and I represent the Honorable Bob Bullock. Comptroller of Public Accounts and Administrator of the State of Texas Deferred Compensation Plan.

The section on public employee deferred compensation plans was included in the House bill in direct response to a proposed Treasury regulation filed in January of this year that would have eliminated such plans.

The administrators of the 37 States that have existing deferred compensation plans and thousands of participating employees realize that this regulation would put their retirement plans in limbo while the validity of the regulation was being contested in the courts.

Victory in the courts is a near certainty, since there is virtually no legal basis for the regulation. But the threat of an unnecessary disruption caused us to look to Congress for a legislative solution.

So turning to the bill itself, subsection (a) is merely a specific statutory restatement of existing law. It tells us that an individual, using the tax method of accounting for income, may elect to surrender all rights to a portion of his paycheck until he or she retires, quits, dies, or retires, and that income tax on those amounts will therefore not be due until such time.

The only change in the law appears in subsection (b) of the House bill—and I would like to note that this is a tax reform rather than tax reduction type of change. It places a ceiling on how much can be deferred.

Under existing law, any amount from 1 percent to 100 percent of total pay may be deferred. Under subsection (b), only 25 percent of gross pay or $7,500 is allowed, whichever is less.

I believe the ceiling is considered necessary to prevent the possibility of someone deferring their whole paycheck, since Treasury has pointed that out as an abuse that could occur presently.

I think that a flat 25-percent limit would solve that problem. The additional dollar limitation in the House bill seems unnecessary and unwieldy, since, in all likelihood, it would have to be increased in the future due to inflation.

My only other comment on the provisions of the House bill concerns the absence of the nondiscrimination provision. I concur with Senator Bentsen's view that participation should be open to all employees in any State that has a plan, not just a select few.

This could be accomplished by substituting the word "all" for the word "only" in subsection (b), paragraph (1).

Senator MOYNIHAN. Substitute the word "all" for the word "only"? Does Senator Bentsen know about that? That is important.

Mr. SMITH. However, I am very opposed to a percentage test, proposed by Treasury which, in effect, would require equal participation among employees at all income levels. This would be a forced participation requirement, rather than a nondiscrimination requirement, and would be totally foreign to all deferred compensation plans since they are optional retirement plans that had no elements of forced or guaranteed participation.

Mr. SMITH. In addition, this formula would give all plan administrators an annual headache in trying to figure it out.

In summary, I strongly endorse the deferred compensation section of the House bill and the amendment proposed by Senator Packwood. It would remove the Treasury cloud of uncertainty that has hung over all public employee plans since May of 1977.

Senator MOYNIHAN. We thank you, Mr. Smith.

And now, to finish the panel discussion, Mr. Marlan.

STATEMENT OF DUANE MARLAN, ADMINISTRATOR, STATE OF MICHIGAN DEFERRED COMPENSATION PLAN AND CHAIRMAN, AD HOC COMMITTEE OF ADMINISTRATORS OF STATE AND LOCAL PLANS, ON BEHALF OF THE STATE OF MICHIGAN AND THE AD HOC COMMITTEE ON ADMINISTRATORS

Mr. MARLAN. Thank you. I am Duane Marlan, administrator for the State of Michigan Deferred Compensation Plan and chairman of the Ad Hoc Committee of Plan Administrators, representing other State plans, city plans, and county plans throughout the country.

Twenty-two States have deferred compensation plans in this country, plus 15 more States have enabling legislation and are awaiting the passage of House bill 13511 before they proceed.

The deferred compensation section of H.R. 13511, section 121, offers very simple, easy-to-administer solutions to a problem created by the concern of the Internal Revenue Service of abuses to the old system prior to February 3, 1978.

It checks the abuses by putting 25 percent of gross income, or $7,500, whichever is less, as a limit that the employee can defer. The 33⅓ percent to excludible income in the law translate to 25 percent of gross income, because includible income is income after the deferred compensation has been deducted.

It provides for a reasonable 3-year retirement catch-up provision for employees who have been unable to be very active in deferred compensation, because of college commitments to their children, debt retirement, and things like that.

Just to give you a little idea about the State of Michigan plan, the State of Michigan plan is a solely self-administered plan. We conduct all our enrollments and we conduct the investment in our plan and disbursement of its monys to the participants when they retire or separate from State service.

You might be interested to know that 42 percent of our participants make less than $15,000; 31 percent make between $15,000 and $20,000; 17 percent make between $20,000 and $25,000; and 9 percent make more than $25,000.

If the Internal Revenue Service does not attach too many regulations on this law when it becomes law, we foresee no problems at all in the administration of this law. My only suggestion for improvement is what Skip Smith just told you about the $7,500.

In the State of Michigan, State employees' income has doubled in the last 12 years. So with inflation and things like that, we would assume that 12 years from now, that $7,500 would have to be $15,000 to be equitable for the people to participate then, as they do now.

All the other provisions track very well to the Michigan plan. As to the enrollment periods for the Michigan plan—and Senator Packwood was concerned about this—we enroll new employees. When they come in as a new employee, they are eligible to enroll during the first 60 days that they are an employee, and deductions begin on the first pay period after the 60-day enrollment period is gone.

All existing employees must enroll by December 1 of the year preceding the year that they are going to defer their income. So we begin conducting an enrollment period right now that runs through the months of September, October, and November, and employees must elect to defer by December 1 for income they are going to defer for the next calendar year.

It has worked very well, although there are some problems when they are all put on in the same pay period. You know, we have 2,000 people—the changes going on. But we have 65 personnel agencies throughout the State of Michigan and they all do this payroll transaction work on the computer.

I know there may be some disagreements on some of this House bill, H.R. 13511, but we pray that you continue the deferred compensation section, section 121, as it is, with some of the modifications that

I have suggested here. We pray that that will continue and it will solve the problem that is troubling IRS by dealing with the excesses, and it is fairly simple to administer.

Thank you.

Senator MOYNIHAN. Well, thank you, sir. That was very straightforward, very sensible testimony.

Senator Packwood?

Senator PACKWOOD. No questions.

Senator MOYNIHAN. Senator Curtis?

Senator CURTIS. Among those plans that are funded, who gets the interest?

Mr. MARLAN. The employee gets the interest, after any administrative costs have been subtracted.

Senator CURTIS. When does he get the interest?

Mr. MARLAN. We apply our interest on a quarterly basis.

Senator CURTIS. When do you pay it?

Mr. MARLAN. We do not pay it to him, we apply it to his account. We set up an accounting system where each employee——

Senator CURTIS. He gets the interest, then, when he gets the corpus?

Mr. MARLAN. That is right.

Mr. MARSHALL. In other plans, Senator, he is able to take advantage of a mutual fund, or a savings and loan or an annuity and the interest accumulates there, and at the time of payout there is a formula, just like a lot of other programs, where that pay-out, including the interest, is given to him at that time.

Senator CURTIS. Now, if it is nonfunded, is there an interest factor when the State or municipality eventually pays him?

Mr. SCOTT. There could be, Senator. There is no requirement that there be.

Senator CURTIS. What is the general practice?

Mr. SCOTT. The general practice is yes.

Senator CURTIS. That is all I have.

Mr. MARSHALL. Mr. Chairman, I would like to make one reminder to Senator Packwood, if I might.

Senator MOYNIHAN. You are very welcome to, Mr. Marshall.

Mr. MARSHALL. We mentioned 2 or 3 times about plans being frozen and not activated, and I wanted to remind Senator Packwood that in his own glorious State of Oregon, their State plan has been frozen since May of 1977 and maybe this year we can clear it up, Senator.

Senator PACKWOOD. I am well aware of that, and that is one of the reasons I have more than a passing interest in this legislation.

Mr. MARSHALL. And I thank you for that.

[The prepared statement of Mr. Marshall follows:]

STATEMENT OF JAMES F. MARSHALL, EXECUTIVE DIRECTOR, ASSEMBLY OF GOVERNMENTAL EMPLOYEES

Mr. Chairman and Members; I appreciate this opportunity to appear on behalf of state and local public employees on a matter of grave concern to all of us. For over 25 years, the Assembly of Governmental Employees has been a federation of independent public employee organizations representing state and local employees throughout the United States. Some of our affiliate organizations have been representing public employees for more than 50 years. They include 46 affiliate organizations in 35 states, including 34 state employee organizations.

Membership in our affiliate organizations is the free choice of the public employee, and our affiliate organizations join AGE on a voluntary and non-con-

tractual basis. Consequently, we know that our policies reflect the judgment of the men and women engaged in a wide cross section of public sector employment as expressed through their state and local organizations to AGE.

Deferred compensation plans for the benefit of state and local public employees (excepting educational employees who are covered by special provisions in the Code) developed on what we believed was the soundest possible basis. Public sector deferred compensation plans are designed, with the cooperation of the state or local jurisdiction, to put the public employee in a position of compliance with established legal principles determining receipt of income.

The legal basis for public employee deferred plans is identical with that of the corporate president, the professional athlete or other highly paid individuals. They have been developed in compliance with the statutes of the United States as interpreted by the courts of the United States, interpretations concurred in for many years by the Treasury Department.

Based upon these precedents and recognizing the frequently declared public policy of the United States—as expressed by Congress in providing special deferral programs for many other segments of our society—hundreds of thousands of state and local government employees participate in public employee deferred compensation plans established in 30 states and hundreds of local governments.

Recognizing that these plans provide a useful opportunity for the average state and local public employee to make a more secure provision for retirement, our organization has encouraged and assisted our affiliate organizations and state and local government units in establishing these commendable plans.

The turnover rate of public employees at the state and local level is in excess of 20 percent annually. Lack of portability, delays in vesting and, in some instances, problems of funding public sector pension plans, encourage our members to improve their long-range financial security by their own initiative.

Although comprehensive data on participation in these plans are not currently available, a broad sampling of pay grade and average contributions has established that the typical participant is a low to medium income employee of state or local government, with gross annual pay of less than $15,000, who defers between $50 and $100 a month in such a program, sacrificing now to provide a more secure future for himself and his family. We believe this is prudent of him and good for our country.

Our member does not have the capital, the access to information or the financial flexibility to use the variety of tax shelters and investment programs that some people utilize. But he does not enter into these programs casually or without considerable soul searching. The fact that these programs are endorsed by his own organization, by his jurisdictional legislative body, by his chief executive officer and approved in writing by the federal government gives him confidence that he's getting a fair shake, the benefit of the lowest possible costs, some tax advantages and security. Life being what it is, he probably would not act on the single assurance of any one of these groups but, when they all concur, most employees feel that they can confidently make the difficult decision of putting a portion of their income, for practical purposes, beyond their reach until retirement time.

As a result, many thousands of state and local employees are participating in these plans. That is why the February 3rd proposed regulation (1.61-16) published by the Treasury Department was such a shock to employees and officials at all levels of state and local government. This regulation, specifically directed to public sector plans, would effectively destroy them by, in effect, repealing existing law by regulation as to the deferral aspects of the program.

It was inconceivable to us that the Treasury Department could or would reverse a legal policy of such long standing to the detriment of state and local governments and their employees throughout the United States without congressional direction. As a matter of public policy, the action of the Treasury Department in attempting to destroy these public sector deferral plans is no different in magnitude or concept than if they proposed regulations to wipe out the Keogh plans, the IRA plans, or the education employees annuity programs.

Faced with the disastrous implications of the proposed regulations, AGE and its affiliates, and to to our knowledge most state and local government organizations, have asked for relief by the Congress of the United States.

Concerned state and local public employees are deeply grateful to the Congress of the United States for its action in securing a delay in the issuance of the proposed regulation, pending subsequent congressional consideration. We are particularly indebted to the 40 members of the United States Senate and the more

than 100 members of the House of Representatives who have introduced legislation to enable these programs to continue.

I was honored on March 15, 1978 to have the opportunity to appear before Senator Bentsen's subcommittee to testify on this subject matter.

In his testimony on March 15th, Mr. Halprin of the Treasury Department cited the cases of a physician who worked for a tax exempt organization deferring 90 percent of his compensation, and of a group of physicians working with a tax exempt organization who deferred more than $1.5 million in 1974.

In response to a question from Senator Bentsen, I made it clear to the subcommittee that these figures have no correlation to public employment as I know it. AGE and its affiliates recognize the need for a reasonable ceiling on deferments, comparable to other statutory deferral programs.

The excesses referred to by previous Treasury Department testimony appears to be a problem with A.M.A. and not with AGE or the millions of public employees who need this program.

We believe that the formula adopted by the House of Representatives in HR 13511, which places a ceiling of the lesser of 33 and ⅓ percent of includible compensation (25 percent of gross income) or $7,500 on deferrals and allows a limited "catch-up" prior to retirement, is a reasonable alternative to the Treasury Department's basic objection to the effect of previous Treasury Department rulings and is fair and equitable to the public employee.

We believe there is a need to define clearly by statute maximum flexibility for employees to enter the program, have reasonable choice of investment medium and to elect at the time of distribution the manner in which the deferred amount is to be paid.

The Treasury Department has referred to the need for nondiscrimination provisions in a deferral plan. With regard to program availability to all employees we certainly agree, but we have not encountered this problem in the 46 jurisdictions we represent. If there is such a problem, we, of course, would support a requirement that the programs be made available to all employees of the public entity involved.

However, when the Treasury Department refers to discrimination in the sense of "the group of employees who actually participate" in any given year, we understand the words but not the concept. Non-discrimination provisions that in practice would make an employee's right to use the program dependent upon the decision of other employees to participate makes no sense to us. This is a voluntary program which must be made available to all to the extent they want to participate.

Our members use this program as a means of enhancing their retirement income as much as possible. Since the average state retirement plan as of 1977 provided approximately 52 percent of the average of the last three to five years of pay prior to retirement (assuming an employee has worked for 30 years), I know you can understand their concern. The extent of their ability to participate at any particular time is dependent on their family situation. ages of their children, whether their spouses work and all the other facets of economic life, including their willingness to forego current luxuries for future security.

Public sector plans existing over the past seven years have evolved to the satisfaction of the state or local jurisdiction and their employees. The administrative and distributive mechanisms have been worked out and are functioning. They have been tailored to the realities of public employer-employee relationships which are distinct from those of the private sector.

They are consistent with the public policy of encouraging savings and, with the ceilings adopted by the House of Representatives in HR 13511, are fair and equitable in comparison to other programs heretofore made available to many segments of American workers and taxpayers.

For over six months, hundreds of thousands of current participants have been seriously concerned as to the continuity of their deferral plans. For over 16 months, many jurisdictions have been in limbo, having adopted legislation but not activiated their programs because of the IRS freeze.

The Assembly of Governmental Employees urges early and favorable action by Congress to clarify the present and future status of state and local public employee deferred compensation programs.

I am confident that I speak for all state and local governments and their employees when I urge Congress to act as its judgment dictates, but to spell out that judgment comprehensively, leaving as little as is technically possible open to administrative interpretation.

Again, speaking for a major portion of public sector employment, we appreciate this opportunity to be heard and the courtesy extended to us on this issue.

Senator MOYNIHAN. Gentlemen, we thank you for a most helpful and informative presentation.

Senator PACKWOOD. Mr. Chairman, I would like to put into the record letters from the State of Oregon, city of Portland, and Portland City School Board supporting not only the amendement that I offered but the entire slate of changes.

Senator MOYNIHAN. Without objection, we will include those letters.

[The material referred to follows:]

THE CITY OF PORTLAND OREGON,
OFFICE OF THE MAYOR,
Portland, Oreg., August 18, 1978.

Hon. ROBERT PACKWOOD,
1317 Dirksen Building,
Washington, D.C.

DEAR SENATOR PACKWOOD: The City of Portland began offering deferred compensation to a limited number of its employees in January, 1977.

We have followed with considerable interest the Revenue Service's attempt to stop deferred compensation with regulation and the Congressional response in the form of Subtitle C of the tax package recently passed by the House.

One provision, however, that we believe may have escaped proper scrutiny, deals with the timing on the execution of the deferral agreements and the actuation of the payroll deduction.

The present language of the bill commits all deferred compensation transactions to take place in the year following the actual execution of the deferred compensation agreement. In practical terms, then, this means the City of Portland must store all deferral agreements, to be executed only in the January following their actual execution.

The great delay between making a commitment to defer a modest sum from an employee's salary, and actual evidence of that deposit growing and earning interest for the employee, surely will cause the participation by our lower paid employees to drop. This provision will also cause the City to endure a great administrative burden.

We seek your support in amending the language of the present bill to ensure that municipalities are able to offer these programs in a fashion that allows reasonable periods of enrollment and change throughout the calendar year, and not just in January. This is an important program to municipal employees. We deeply appreciate your efforts in keeping it alive and well.

Best regards,

NEIL GOLDSCHMIDT, *Mayor.*

CITY OF EUGENE,
August 16, 1978.

Attention: Terry Kay,
Senator ROBERT PACKWOOD,
1002 Northeast Holladay,
Portland, Oreg.

DEAR BOB: I would like to urge that you attempt to amend the tax law (HR 13511) presently in the Senate Finance Committee in the new provisions (Section 121(b)(4) authorizing deferred compensation for local government employees.

The City of Eugene has had an Internal Revenue Service approved deferred compenstion plan for several years as a supplemental retirement program for our employees. One of the key issues that the City and IRS were initially at odds over was the sign up or open enrollment period for employees to indicate their amount of deferred salary for the coming year. IRS wanted the City to use a calendar year. The City wished to use the inception of the fiscal year (July to June) since this is the normal budget and salary adjustment period. For an employee to determine the amount of deferred compensation it is extremely important to know his or her scheduled earnings in the upcoming year.

I would urge that you amend the language in the current version of the bill by deleting the phrase ". . . for any taxable year . . ." and substituting language which would allow for four open enrollment periods during the year. If this

alternative is unpalatable to the Senate Finance Committee, I would hope that you can at least amend the current provision by permitting employers the flexibility to determine in their deferred compensation plans an open enrollment period which is consistent with their fiscal year, whether that be a calendar year, a July to June period or an October to September year.

Again, I remind you that the IRS has approved our plan in Eugene with a fiscal year period and I know of no problems in this arrangement.

Thank you very much for your attention to this matter.

Sincerely,

R. A. GUS KELLER, *Mayor.*

OREGON EMPLOYER GROUPS PARTICIPATING IN EQUITABLE SAVINGS' DEFERRED COMPENSATION PLAN IN CONGRESSIONAL DISTRICT NO. 1 (REPRESENTATIVE LES AUCOIN)

Employer	Number of participants	Total amount on deposit
Administrative School District 47J	2	$1,480
City of Newberg	10	4,394
Clatsop County IED	7	39,919
County of Tillamook	10	2,020
Farmington View School District	1	502
Lincoln County School District	18	56,125
Neah-Kah-Nie School District 56	28	87,921
Newberg School District 29J	13	9,884
North Clackamas School District	86	241,791
Northwest District Lutheran Church	3	7,113
Philomath School District 17J	4	11,301
Scappoose School District 1J	10	30,459
Tigard School District 23J	35	231,361
Tillamook PUD	8	2,856
Warrenton-Hammond School District	7	29,145
West Linn School District 3J	158	412,379
West Slope Water District	4	1,946
Total (17 employers)	404	1,170,596

OREGON EMPLOYER GROUPS PARTICIPATING IN EQUITABLE SAVINGS' DEFERRED COMPENSATION PLAN IN CONGRESSIONAL DISTRICT NO. 2 (REPRESENTATIVE AL ULLMAN)

Employer	Number of participants	Total amount on deposit
Boring School District 44	2	$922
Canby School District 86C	4	1,502
Central Linn School District 552C	2	1,200
Central Oregon Community College	12	37,719
Chenowith Irrigation Cooperative, Inc	1	2,355
City of Canby	6	2,172
City of Estacada	3	922
City of Hubbard	2	2,013
City of Wilsonville	5	2,039
Clackamas Intermediate Education District	4	2,012
Clarkes School District 32	8	5,509
Colton School District 53	1	662
County of Clackamas	18	3,541
County of Deschutes	23	28,649
County of Gilliam	14	6,160
County of Sherman	8	4,202
County of Wheeler	2	1,208
Democrat Herald Publishing Co	2	10,560
Dufur School District 29	19	21,554
First United Methodist Church, Bend	4	9,187
Gervais, Elementary School District	4	5,923
Gervais Union High School District	2	606
Gladstone School District 115	25	89,715
Grand Prairie School District 14	19	10,482
Grant County School District 4	4	12,637
Grass Valley School District 23	2	1,350
Hood River County School District	20	24,606
Hood River Electric Cooperative	3	4,372
Imbler School District 11	4	8,118
Klamath Falls School District 1	17	82,354
Knox Butte School District 19	4	2,272
Maupin Grade School District 84	4	1,056
McFarland School District 25	4	2,033
Morrow School District 1	6	2,110
North Clackamas School District 12	86	241,791
North Powder School District 8J	13	29,323
Pendleton School District 1	15	15,640
Port of Hood River Commission	3	1,050
Redland Administration School District	45	35,612
Riverside School District 24	4	1,577

OREGON EMPLOYER GROUPS PARTICIPATING IN EQUITABLE SAVINGS' DEFERRED COMPENSATION PLAN IN CONGRESSIONAL DISTRICT NO. 2 (REPRESENTATIVE AL ULLMAN)—Continued

Employer	Number of participants	Total amount on deposit
Salem School District 24J	16	2,760
Sandy Union High School District 2	11	20,638
Sherman Union High School District	8	10,021
Suburban East Salem Water District	2	1,214
Treasure Valley Community College	1	1,026
Umatilla County School District 2R	8	34,734
Union High School District 2 (K-Falls)	9	33,584
Wasco Intermediate Education District	4	4,955
Wasco County School District 40	6	683
Total (49 employers)	489	792,746

OREGON EMPLOYER GROUPS PARTICIPATING IN EQUITABLE SAVINGS' DEFERRED COMPENSATION PLAN IN CONGRESSIONAL DISTRICT NO. 3 (REPRESENTATIVE ROBERT B. DUNCAN)

Employer	Number of participants	Total amount on deposit
Catlin Gable School	1	$2,057
Centennial School District 28JT	19	2,274
City of Portland	262	919,069
City of Rockaway	4	5,961
City of Scappoose	3	3,016
Gresham Grade School District 4	17	53,876
Mount Hood Community College	9	5,108
Multnomah County Fire District 10	4	540
North Clackamas School District 12	86	241,791
Orient School District 3J	13	32,961
Portland School District 1	354	1,186,412
Port of Portland	59	54,706
Reynolds School District 7	20	10,166
Rockwood Water District	4	12,144
United Church of Christ, Central Pacific	2	150
U.S. Hop Administrative Committee	6	30,526
West Slope Water District	4	1,946
Total (17 employers)	867	2,562,703

OREGON EMPLOYER GROUPS PARTICIPATING IN EQUITABLE SAVINGS' DEFERRED COMPENSATION PLAN IN CONGRESSIONAL DISTRICT NO. 4 (REPRESENTATIVE JAMES WEAVER)

Employer	Number of participants	Total amount on deposit
Ashland Community Hospital	4	3,510
Ashland School District 5	29	198,137
Coos County Intermediate Education District	8	4,578
County of Douglas	50	135,941
County of Douglas, Fair Board	4	1,508
Crow-Applegate School District	21	90,105
Curry County School District 3C	10	8,824
Curry County School District UH-1	4	3,394
Curry County Intermediate Education District	6	948
Douglas County Intermediate Education District	8	48,500
Douglas County School District 4	55	172,447
Douglas County School District 21	4	15,203
Douglas County School District 70	4	250
Fern Ridge School District 28J	6	8,107
Harrisburg Elementary School District	6	3,950
Harrisburg Union High School District	12	40,317
Jackson County School District 4	12	50,643
Jackson County School District 6	28	158,159
Jackson County School District 9	12	29,948
Jackson County Intermediate Education District	4	4,381
Josephine County School District	20	79,966
Lane Community College	41	170,934
Lane County School District 52	32	177,149
Lane Electric Cooperative	4	31,072
Lane Intermediate Education District	8	11,437
Medford School District 549-C	96	539,892
Oregon Shakespearean Festival Association	8	9,605
Pleasant Hill School District 4	4	8,037
Rogue Community College	8	29,933
Rogue Valley Manor, Inc	16	44,374
South Lane School District 45J	24	148,040
Talent Irrigation District	4	4,802
U-Lane-O Federal Credit Union	11	21,972
Winston-Dillard School District 116	15	20,727
Wyatt School District 63CJ	4	1,497
Total (35 employers)	582	2,278,377

GRAND TOTAL—EMPLOYER GROUPS PARTICIPATING IN EQUITABLE SAVINGS' DEFERRED COMPENSATION PLAN

	Employers	Participants	Amount
Congressional District No. 1	17	404	$1,170,596
Congressional District No. 2	49	489	792,746
Congressional District No. 3	17	867	2,562,703
Congressional District No. 4	35	582	2,278,377
Total	118	2,342	6,804,422

PORTLAND PUBLIC SCHOOLS,
Portland, Oreg., August 15, 1978.

U.S. Senator BOB PACKWOOD,
1317 Dirksen Building,
Washington, D.C.

DEAR SENATOR PACKWOOD: Portland Public Schools presently makes available to its employees, a program of non-qualified, unfunded deferred compensation.

We are delighted to see the recent Congressional intent expressed in the House-passed tax bill which supports the continuation of such programs.

We are concerned, however, about the language in the bill which requires that all deferral agreements must be entered into prior to the taxable year of deferral accomplished by payroll deduction. Such a restriction can only serve to reduce the accessibility of a deferred compensation program for people who are paid on a monthly basis.

We ask your strong support for amendments which will surely be offered, to allow municipal employers to establish reasonable enrollment periods for future compensation that are more coincident with fiscal and employment year considerations as well as calendar year periods.

Thank you for your attention.

Best regards,

HAROLD A. KLEINER,
Deputy Superintendent.

OFFICE OF THE STATE TREASURER,
Salem, Oreg., August 15, 1978.

Hon. BOB. PACKWOOD,
U.S. Senator,
1317 Dirksen Building, Washington, D.C.

DEAR BOB: As you know, the 1977 Oregon Legislature authorized the Treasurer to develop and implement by July 1, 1978, a deferred compensation plan. (Copy of SB 167 enclosed. The Oregon bill, incidently, restricts amounts deferred to 15% of salary).

Because the U.S. Treasury proposed rules negating these benefits for state employes, we have supported Congressional action.

The deferred compensation section—subtitle C—in the Revenue Act of 1978 merits your support. However, we urge amendment to section 457(b)(4) lines 24–25 of page 21 and lines 1, 2, 3 of page 22, wherein it presently requires public employes to make their election to participate in the tax year prior to the year earnings are deferred.

This condition appears to discriminate against public employes, and unduly encumbers plan administration without any offsetting public policy considerations. It should be amended to permit an election one month prior to an employe's participation.

Cordially,

TUCK WILSON,
Deputy State Treasurer.

Senator MOYNIHAN. We thank you, each and everyone.

This morning's hearings are concluded.

[Thereupon, at 11:25 a.m., the hearings in the above-entitled matter were recessed, to reconvene at the call of the Chair.]

REVENUE ACT OF 1978

WEDNESDAY, SEPTEMBER 6, 1978

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

The committee met, pursuant to notice, at 10:05 a.m. in room 2221, Dirksen Senate Office Building, Hon. Russell B. Long, chairman of the committee, presiding.

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

The CHAIRMAN. The committee will come to order.

We are very pleased to have with us this morning Hon. G. William Miller, Chairman of the Board of Governors of the Federal Reserve System.

Mr. Miller, we are delighted to have you before the committee. You may proceed in whichever fashion you may prefer. You may either read your prepared statement, or if you would like to, you may summarize it.

Mr. MILLER. Mr. Chairman, with your permission, I would suggest that the prepared testimony might be inserted in the record and perhaps I could hit the high spots, so that we could proceed to the questions, if that would be satisfactory.

The CHAIRMAN. That would be fine.

STATEMENT OF HON. G. WILLIAM MILLER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. MILLER. I certainly appreciate the opportunity to be here this morning. I know that taxes are not the usual preserve of the Federal Reserve, but they influence the entire economy and are very important in the coordination of monetary and fiscal policy, so I welcome the opportunity to give my thoughts on this subject.

All of you are familiar with recent economic conditions, but the Board's staff has prepared some charts that you might want to glance at, just as a reminder of where we are. We have had substantial recovery from the recession of 1974–75, with an 18-percent growth in real GNP since the trough and 10.5 million jobs added to the payrolls since that time.

While the unemployment rate is still much higher than we would like, we do have the highest percentage of Americans employed that we have ever had. So there have been some real improvements.

The problem on the job front, of course, is that much of the remaining difficulty with unemployment is structural in nature and falls par-

ticularly heavily on young people and blacks. The problem deserves careful consideration.

But the main theme, I think, in looking at the economic situation generally is that we need to maintain upward momentum. Even though we have had a 3½-year period of growth—and that is a long upswing by historical standards—conditions in this Nation are such that we need to continue to grow at a moderate pace that will allow us to add to output and the utilization of labor and capacity, at the same time, to counter the inflationary pressures that have hit us so dramatically.

We cannot afford to risk the mistakes of the past of overshooting by trying either to slow the economy down too rapidly and falling into recession, or trying to grow at a pace that will add to inflation pressures and cause difficulties later.

Inflation is our most important economic concern today. The advance in prices, which you can see in chart 2, has been worrisome. We have had an almost 10-percent annual rate of growth in consumer prices in the first half of the year. Food prices have accelerated very sharply.

If you look at chart 2, you can see that in July, while there was a considerable improvement in the CPI, the middle panel shows that if we take out food, we still have a very unacceptable rate of increase in prices.

The depreciation of the dollar, of course, is one of the factors that has both influenced inflation and has been a very troublesome matter to us, and one that deserves continued close consideration.

Well, under all of these circumstances, it would seem that Congress should weigh with great care the size and the composition of its tax program. A tax cut certainly should provide no more stimulus than is necessary to sustain moderate economic expansion. Anything beyond that would jeopardize our chances for restraining inflation.

It also seems to me that the structure of tax cuts should be programed to provide incentives for work and for capital formation. Such incentives are essential to overcome the forces of inflation. Congress can take a significant step by paying greater attention to the supply-side effects, and I would like to discuss some of those aspects here today.

In my personal judgment, a tax reduction in the vicinity of the $15 billion, effective January 1, that is being discussed in Congress is appropriate. Despite some bumpiness in recent economic activity, the economy is quite well balanced. Yet, we do need to provides some further adjustment in private demand if we are going to sustain the growth.

If we look at chart 3, we see that there is a continuing, fairly satisfactory level of consumer attitudes about buying, but there is already a fairly low rate of saving and a very high, historically high, burden of debt repayments. Household debt is now at the point where about 20.5 percent of disposable personal income is required to service that debt.

So, we have to look at disposable income and means of maintaining it to be sure that we do not create an undue burden on consumers.

Chart 4 shows private housing starts. This also is an area that, with some of the steps taken this spring to avoid disintermediation, has continued at a fairly good level, but with the maturity of the cycle

and with the present level interest rates and available resources, we could expect that housing activity would be tapering off.

Chart 5 shows that there has been, as is typical in recoveries from recessions, a growth in business-fixed investment, but it has been rather sluggish by historical standards and only recently has reached the peak of the prior cycle. In a historical sense, it is really lagging.

Against this backdrop, a reduction in Federal taxes next year would provide timely support to spendable income, and without a tax cut, individuals will actually be facing substantial tax increases in 1979. You will remember that mandated social security increases will boost Federal revenues next year by $8 billion. I would like to point out that about half of that—about $4 billion—will be in the form of increased taxes on individuals. In fact, without some tax relief, we not only have a $4 billion increase in payroll taxes, but we also have another $8 billion that will impact individuals because of the interaction of inflation and the progressive income tax structure.

It is also important to consider the expenditure side of the budget ledger in deciding what size the tax cut should be and what can be afforded. Inflationary pressures are such that it is imperative that the budget deficit be reduced substantially below the $50 billion of the current fiscal year. It is encouraging to see the action that has already been taken by Congress to narrow that deficit to perhaps the $40 billion area.

As a side note, I mentioned that the original plan for fiscal year 1979 contemplated a budget deficit of $60.5 billion, so reducing that to around the $40 billion level is a really outstanding accomplishment. I think Congress deserves a lot of credit for taking that initiative in the face of inflationary difficulties.

Well, if a tax cut is desirable and if the amount of it is on the order of magnitude that we have been discussing, then the question is how to structure it. We need to structure it to make maximum contributions toward achieving our basic economic goals of full employment, price stability, and a sound dollar.

It is obvious that substantial, contemporaneous tax increases for individuals suggest that a lot of the tax cut be allocated to this group in order to provide equity. Distribution of the tax cuts between the household and corporate sectors implied in the House bill appears to me to be reasonable. However, I would like to express just a few doubts as to the particular devices employed, not as to the amounts.

A significant portion of the tax cuts for individuals, of course, would only offset the built-in impacts I have mentioned. It therefore might be asked whether it would be more desirable simply to defer the 1979 social security tax change, and in that way accomplish two things—to provide part of the tax reduction for individuals in that way, but at the same time to reduce the inflationary impact of increased payroll taxes. The Board's staff has estimated that the scheduled increase in employer contributions to social security would add about one-half percent to inflation next year—and one-half is a large number. Anything that could be done to eliminate that amount of inflation should be given careful consideration.

A 1-year deferral of the social security increase due to take effect next January 1 would not place an undue strain on the resources of the trust funds. Nonetheless, a deferral should be considered only if

33-058—78——9

there was an explicit commitment for action to deal realistically with the remaining long-range problems of funding the social security system. Last year's legislation did insure financial viability for social security, but with the people of this country facing a rapidly growing financial burden and a social security tax that is both inflationary and regressive, it is certainly worthwhile to consider whether a deferral might not be coupled with an undertaking by Congress for a comprehensive study to reduce the funding requirements and therefore to make a permanent change in the level of taxation in this area.

I would be happy later, during the questions, to discuss some of the ways that this might be accomplished, because I am not suggesting for a moment that social security taxes be deferred or reduced in a way that would impair the long-term financial integrity of the social security system; but, rather, that we look at means for improving the funding.

In considering the corporate and capital gains provisions of the House bill, I also want to focus attention today on how the proposed cuts woulr contribute, if at all, to enhancement of business-fixed investment. The performance of capital spending in this economic expansion has not been satisfactory. Real business-fixed investment has recovered much later than was the case in prior cycles. Moreover, the growth of the Nation's capital stock has not kept pace with the increases in its work force.

I would call particular attention to chart 6. It is the most important chart that I have submitted to this committee this morning. The chart shows that throughout the 1970's, the ratio of capital stock to labor has fallen ever shorter of its earlier growth trend line, and this, undoubtedly, has been a significant factor in the slower growth of productivity that we have experienced over this period.

The upper panel shows the rather remarkable decline in the ratio of capital to labor, the lower panel shows the tremendous dropoff in productivity gain. To my mind, increased productivity is one of the keys to achieving an answer to our inflation problem. The only way I know that we are going to break the cycle of wages chasing prices and prices chasing wages is to begin to realize productivity gains so that prices do not have to go up in order to maintain profitability.

Capital accumulation is a critical ingredient in the long-range growth of labor productivity and the raising of living standards. To compensate for the neglect of recent years, as well as to accommodate to the reality of scarcer and more expensive energy, a larger share of GNP must now be devoted to the expansion and modernization of the Nation's capital stock. It will not be enough simply to reach the investment proportion of 10.5 to 11 percent of GNP that has been characteristic of past periods of prosperity and low unemployment. In my opinion, the Nation must set an ambitious goal of 12 percent of GNP for an extended period—say, over 10 years—a level that would foster more rapid improvement in productivity and faster economic growth.

The capital gains and corporate income tax cuts in the House bill would provide some impetus to business capital formation and would certainly be a move in the right direction. The question is, are these the most effective measures that might be taken at this time? I have some reservations.

There is considerable controversy, for example, about the effects of cuts in capital gains taxes on investment and on Federal revenues. This is not surprising. A change in capital gains treatment would work its influence through a complex and uncertain set of channels.

In assessing the impact of business capital formation, one must contend with the fact that the tax change would affect investment by both households and businesses in all sorts of assets and, therefore, in all sorts of ways. How much effect the tax cut would have on the price of corporate stock and thus on the cost and availability of equity capital is still unclear, and how this would translate into acquisition of new plant and equipment is a further uncertainty.

Yet, I would say the reduction in capital gains tax does have its advantages and its attractions. It would, for example, bring some relief to those who have been confronted with very high, real tax rates, often exceeding 100 percent because their cost basis, in calculating capital gains, does not reflect the impact of inflation. It would also benefit young, emerging companies which have little income and thus are not in a position to benefit from other changes in business taxes. Lower capital gains taxes would encourage equity investment in such enterprises.

I would conclude that some cut in capital gains taxes would be appropriate, but I would not assign a high priority at this time to this particular tax initiative. I believe that it might have higher priority at some later time.

My reservation about the capital gains provision in the House bill extends to the corporate tax changes as well. Insofar as incentives for business investment are cocnrened, the bill seems to use a shotgun approach rather than a rifle. It does provide for a phased liberalization of the investment tax credit, but the bulk of the corporate tax reduction occurs through a lowering of the rate structure.

Although lower tax rates would improve after-tax profits, the linkage between this improvement in cash flow and spending on new plant and equipment is a loose one. The additional cash might be channeled into any of a number of uses, including the acquisition of other firms, the purchase of securities, or an increase in dividends. It is quite likely that a smaller gain in real investment would be achieved for a given dollar of tax revenue loss than would be the case with tax reductions that are linked directly to capital expenditures.

While some cut in corporate tax rates is desirable, I believe greater emphasis should be placed on other, more efficient tax incentives for investment.

Accelerated depreciation is a very efficient way to encourage investment. The tax benefits of faster depreciation accrue to a firm only after new plant and equipment has been put in place. In addition, enlarged depreciation allowances would redress the serious drag on real corporate profitability that has occurred in recent years as inflation has caused replacement costs to exceed depreciation deductions by a wide margin.

Larger investment tax credits also provide direct incentives to capital formation and, therefore, are more efficient in stimulation investment than are corporate tax rate cuts. There are, however, likely to be differences in the cost effectiveness of accelerated depreciation and in-

vestment credits, that is, the degree of investment stimulus that is achieved per dollar or tax relief. These differences will hinge on some rather technical factors, among the most critical of which is the importance that business attaches to the time pattern of income. In my experience, as businesses are increasingly paying attention to discounted cash flow in making investment decisions, there is more bang for the buck through accelerated depreciation than through the investment tax credit.

I hope that these comments have been helpful for the committee to set the stage for the questioning. I would just add that it seems to me that our Nation's economic problems are very serious. They have developed over a dozen years. They start with our involvement in Vietnam, both as a divisive activity and one in which we did not elect to pay our way. This sowed the seeds of inflation. It led to higher inflation and to the experiment with wage and price controls which proved ineffective. Our inflation contributed significantly to the breakdown of the international monetary system.

We had the experience of double-digit inflation and double-digit interest rates. We had the oil embargo. We had the great recession of 1974–75 and, for a dozen years, we have misdirected, perhaps seriously, our efforts to strengthen our economy and achieve the productivity that it needs for the long term.

Perhaps it is time now for all of us to give up some of our individual preferences and see if we can take the resources that are available for a sound economic plan and use them as directly as possible to achieve the important results of fighting inflation, achieving productivity gains, and creating a sense of equity and fairness in our tax structure that will, in the long term, best benefit our Nation.

Thank you very much.

The CHAIRMAN. Thank you very much, Mr. Chairman.

We proceed under the early bird rule here. Senator Talmadge was the first, but he has stepped out momentarily. I will call on Senator Ribicoff.

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

Mr. Miller, I know that all of us are grateful for your coming here. It would seem to me that the only one in this Government who is in a position of being completely independent in their thinking on the American economy is yourself.

You are in an independent position. I believe that the financial community, and those who think about economics, rely on you more than any other individual in our Government. Therefore, what you have to say is very cogent and very important.

I would gather from your testimony that you tie together the problems of fighting inflation, increased productivity, the depreciation in the value of the dollar, and what should we do to increase our exports—all of them are inextricably bound together, if we are going to mount a real challenge to our economic problems.

I think this committee has a grave responsibility here to try to fashion out of this tax bill whatever we can to address those basic problems.

I gather from your testimony that you feel that what should be left out of this bill, or put into this bill, above all others, is the question of deferral of the social security tax for a year and also to

substitute accelerated depreciation for other means of tax reduction, and the House bill has done very little to that end.

Does that represent a proper summation of your testimony, or are there other elements that you would give a priority to?

Mr. MILLER. Senator Ribicoff, you have summarized well. Let me put it in a little bit broader context. I should have perhaps reduced my presentation to the few words, and said what I have on my mind.

The first question is, simply, how much can we afford to apply to a tax cut at this time, given the fiscal disciplines we need to balance with monetary policy to fight inflation? We could argue about the size of the tax reduction a few billion one way or the other, but we are in agreement on its range. Given that, how should we best allocate it?

My view is what you just summarized. The best way to allocate it for individuals is to couple an income tax cut with a deferral of the social security increase, because we then can reduce inflation by about a half percent next year. It is of critical importance to start such deceleration of inflation. At the same time, the preferred use for the business side of the tax cut is for stimulation of investment that is essential to achieving productivity gains, which in turn are essential to fight inflation—not only short term, but long term.

So I think you have summarized my views very well. I can round out by saying, yes, we need to look at the capital gains situation. I do not disagree that that question needs to be addressed. But I am trying to give the issue of fostering investment as high a priority as possible with as much of a rifle shot or concentrated approach as possible.

Senator RIBICOFF. Let me ask you, why do you feel that there is such little talk from those who have the responsibility to fight inflation concerning the role that productivity has on inflation? I mean, we know that the Japanese and the West Germans are running us all off the competitive lot. The Japanese annual increase of productivity is about 8 percent; the West Germans are about 6 percent, and we are down to about 0 productivity. And, as you say, we are never going to lick this problem of inflation unless we increase the productivity.

As you point out—your chart number 6 is the most important chart of all.

And yet, there is so little said about the role of productivity in fighting inflation. Of course, you step on a lot of toes. It is a question—you step on a lot of toes of management, you step on a lot of toes of labor, but are we going to be able to solve this unless we increase productivity, and what should we do to increase productivity in America?

Mr. MILLER. Senator, I cannot explain why there has not been more focus on productivity. It seems obvious, in looking at all the options we have in fighting inflation, that we have a series of legislative or administrative actions that can be taken that would help, but long term there is nothing more important than renewing vitality in productivity, plant modernization and technology—regaining our leadership as a producing Nation.

The Japanese spend over 20 percent of their GNP in capital investment, the Germans 15 percent. Now, we have been spending 8 or 9 percent, and over time, the cumulative impact of their spending so much, and our spending less, gives them a tremendous advantage. And it just

seems to me that the time has come for us to face the fact that there is no free lunch. Unless we are willing to shift our economic policies from demand management and put more emphasis on investment management, we are just not going to get there.

I have always used the example—and you have heard me use it—of hyperinflation in 16th century Spain, where the discovery of the New World gave Spain access to large amounts of gold and silver. These metals introduced unearned purchasing power into Spain, allowed the nation to build the most elegant society that Europe had even seen up to that time. But they spent it all on consumption. When they had exhausted the gold and silver, they had nothing left for investment and, in the 17th century, they were, economically speaking, barefoot.

For a long time, in this country, we have been emphasizing consumption and we have not been putting anything back—or not enough back—for the future. And unless we are willing to take something out of our day-to-day enjoyment and put something back for the future, I think our heirs are going to have very, very thin soles on their shoes, if they are not barefoot.

Senator RIBICOFF. Thank you very much, Mr. Miller.

The CHAIRMAN. As you notice, Mr. Secretary, we are operating under a 5-minute rule in the first round of questions.

Mr. MILLER. Does that include the answers, or just the questions, Mr. Chairman?

The CHAIRMAN. Well, you have the privilege of fibibustering, but the Senators do not.

Senator Byrd?

Senator BYRD. Thank you.

Mr. Chairman, you seem to put great emphasis on accelerated depreciation. You say on page 10 that it is a very efficient way to encourage investment and then on page 11, you say, "Faster depreciation is likely to yield the greatest addition to investment per dollar of tax reduction."

It seems to me that what you say is very logical and sound. It certainly coincides with my view.

Do you propose this in lieu of the reduction in corporate tax rates, or along with a reduction in corporate tax rates?

Mr. MILLER. Well, if I had my preference, I would use it in lieu of, because if we have $5 billion or $6 billion that might be allocated to corporate tax reductions, if that is the right balance, then I would prefer to use all of that to obtain productivity gains through expanded investment.

Now, ideally, I would like to see us work over a number of years to a point where the depreciation life for machinery and equipment would be 5 years. Perhaps a 1-year writeoff could be allowed for mandated pollution control equipment, but a 5-year writeoff for production equipment, and a 10-year writeoff for structures.

These schedules would be too expensive at this point. They would cost too much in lost revenue.

But if we reduced the useful lives for depreciation by 20 percent and if we allowed a 1-year writeoff of all mandated environmental equipment, then the annual revenue cost would be about $5 billion. But every dollar of that revenue loss would be related to an investment.

There would be no leakage. There would only be a revenue loss if there were an investment.

I recognize that some service industries do not have capital requirements, and it might be argued that they deserve some rate reductions. However, those service industries benefit when this Nation is strong and is moving ahead on a capital program and when their business activities expand in order to support the productive side. So, I think they would benefit from the stimulus to investment.

Senator BYRD. I think it is important to do something about accelerated depreciation.

Now, you also seem to lay great stress on the larger investment tax credits. You do not propose to go beyond 10 percent, do you?

Mr. MILLER. No. My point is that the way a business calculates the risk-reward ratio on a new capital project is to look at discounted cash flow, and an increase in the investment tax credit does not change that formula too much, while accelerated depreciation does change it much more favorably. Therefore, I would not increase the investment tax credit; I would leave it at its present 10 percent, and I would use all of my available $5 or $6 billion of corporate tax cuts for the accelerated depreciation.

Senator BYRD. The accelerated depreciation, as I visualize it, would be more advantageous to more companies than would the investment tax credit.

Mr. MILLER. That is correct.

Senator BYRD. Senator Ribicoff mentioned the social security. As I read your statement on page 6, at the top of the page, you seem to advocate a deferral of the 1979 social security tax changes but at the bottom of the page, you say, "I would recommend that Congress undertake a comprehensive study of the social security system so that needed legislation could be enacted next year."

I am not clear as to just what is your position on that.

Mr. Miller. Yes; let me explain that. The deferral for 1 year would have a revenue cost of $8 billion divided between individual taxes and corporate taxes. Since social security taxes have become part of corporate costs and are passed on in prices, it would also have a very favorable impact on reducing inflation next year.

But I fear for the financial integrity of the social security system, so when I suggest deferral for a year, it seems to me that that year should be used to study how we can, in subsequent years, fund social security with financial integrity but at a lower cost level. And let me suggest some of the things that could be done.

Congress could look at such things as taxing social security benefits at certain income levels. I take my own example. When I retire, I think I could afford to pay taxes on my social security income and feed it back to the social security system to help fund it. People who have less income in retirement could not do that, but there could be a phase-in of income tax. That would reduce the cost of social security over a life cycle and therefore would reduce the need for higher payroll taxes.

Deferring the retirement age by 1 or 2 years also has an enormous cost-reduction impact.

Social security is indexed for inflation on an aftertax basis. All of the other indexing I know is on a pretax basis. If we had less indexing,

or indexing only for the bottom layer of social security, for people who have more immediate needs, it also would reduce costs.

Now, I do not know which of these courses, or others, would be acceptable, but there are ways that Congress could reform social security, without changing its social purpose of protecting the needy aged, and at the same time could reduce its costs.

And if its costs were reduced permanently by a reform of the benefit structure, then, of course, we would have a permanent opportunity to lessen the payroll taxes and their inflationary impact.

Senator BYRD. Thank you.

The CHAIRMAN. Mr. Chairman, I believe we will have something of a debate about the revenue estimates that relate to the actions of this committee. I, for one, am very concerned about the failure of some of these estimates to reflect the fact that this is a living country, that it is a moving country, a dynamic country—things move, and things change.

We pass tax laws for the purpose of bringing about some of these changes, and we ought to be willing to assume that those laws are going to do some of the things that we have in mind.

In 1976, when we changed the law with regard to inheritance taxes and gift taxes, Treasury's estimate proved to be very far off in the effects of that change. A tremendous number of people saw what we were doing about the carryforward basis, and they rushed to make gifts to their children, with the result that Treasury collected a great deal of money that it was not anticipating.

Likewise, if we do something about capital gains, Treasury wants to make their estimates based on pulling someone's tax return from last year and assuming that the same person would do the same thing next year that he did the previous year, even though the rate had been changed.

We were concerned some years ago that we thought the investment tax credit was heating up the economy, so we repealed it, and we thought we were going to pick up about $9 billion by repealing the investment tax credit. What we did was to cause businesses to cancel orders and decline to place new orders and the result was that by the middle of the year, the country was in a recession and by the month of August, the President was calling us back frantically to urge us to restore the investment tax credit.

What is your view about these estimates? Do you think we ought to try to work out an estimate that is going to take into account how people are likely to react to a tax change, or do you think we ought to try to do it assuming that everything will be just exactly the same as it would have been if you had not changed the tax law?

Mr. MILLER. Mr. Chairman, I agree we have to look at the dynamics. In fact, I suppose we could coin a phrase and say that we need to understand behavioral economics, because we do have a dynamic system.

I mentioned my pet theory of accelerated depreciation, and it is dynamic, too, because the cuts I have mentioned would, themselves, create jobs and increase the production of goods and profits and taxes. We make our estimates, but we are not very skilled as yet in seeing how the dynamics work through the economy.

In particular, when we do our macroeconomic analysis for the economy, we make the analysis for the whole economy, but we do not know how to do it very well for these individual items, and I think we have to learn how to do better.

I agree with you. I think the right solution is to perfect our ability to understand dynamics and, as we do so, we probably should start on the conservative side, making sure that we do not kid ourselves into thinking that everything is going to happen favorably. We should probably find some middle ground of estimating and probably do more studies and more tracking so that we can become better at it.

The CHAIRMAN. Well, if you pass a law seeking to bring about a result, you ought to have enough confidence in what you are doing to assume that it might do what you are proposing that it do. If you cannot do that, you should not pass it at all.

Mr. MILLER. That is right.

The CHAIRMAN. For example, if we do what you are suggesting with regard to accelerated depreciation, we ought to be willing to assume that this is going to cause people to make decisions somewhat different than they would do otherwise, and I would think that the same thing would be true about changing the capital gains rates.

Back in 1963, we had the Secretary of Treasury, accompanied by two men who subsequently served under him as Secretary of Treasury, who came to the Congress recommending a change in capital gains taxes and also a provision for a capital gains tax at death, which he estimated was going to bring about an increase in revenues to the Government.

Now, if you estimated the way the Treasury wants to do today, you would have to assume that this would have lost money. In fact, at that time the Secretary was estimating a substantial increase in revenues.

I would hope that you would get well enough acquainted with those people you have working under you down there in the Federal Reserve, that your people and your economists could cooperate with us in trying to estimate what is going to happen with these tax proposals based on the dynamics of the situation, rather than just based on the static part of it. It obviously has to be incorrect, let us say, if a person last year sold the only home he ever owned, or the only business he ever had, and what he received was then put into, let's say, tax exempt bonds—it would be absurd to estimate that that person is going to do the same thing again the following year; one, because he does not have the home or the asset; and two, because he holds a different type of security and he does not have the same base.

I would hope that you will do what you can on your end and I will try to do what I can on my end to try to see that these tax changes which propose to bring about a stimulative effect to the economy will actually do some stimulating, and if they do, there is going to be a lot of feedback in there.

I think you are right, and I am sure there are combinations of techniques that would accomplish some substantial improvements in our whole tax structure which is—I think tax reform in this country is really understood to be, one, lower taxes, and two, simpler taxes.

The lower taxes can come about when we get the discipline in to control expenditures and the simpler taxes can come in. I think, as we learn better these interactions and learn to simplify.

The CHAIRMAN. Senator Danforth?

Senator DANFORTH. Mr. Miller, thank you very much for being with us today. We have had a number of economists testify before the Finance Committee in the last couple of weeks. They all have taken the position that capital formation and productivity is the name of the game, and that is your message again today.

As I understand your point, it is that a reduction in the capital gains taxes, while it might be a good idea in itself, will not provide the kind of incentive for capital formation and increased productivity that we need, and that we also have to address the question of corporate taxes.

In talking to economists, I have found that they all agree up to that point, and then you ask them, well, what would you like to do about corporate taxes, and that is where the difference of opinion develops.

About half of them say that they would prefer reduction in the corporate tax rate. The other half say that they would prefer a more capital-intensive type of approach, either by increasing the investment tax credit or, as you propose, increase the asset depreciation range.

Now, those who are, argue on behalf of a reduction in the corporate tax make the following argument. They do not argue so much in terms of retained earnings. Rather, they say that business investment decisions are made in accordance with the projections for rate of return in the future. And that would be an after tax rate of return.

And therefore, what they say is that it does not matter so much what reduction takes place this year or next year in the corporate tax rate, but if you could have a corporate tax rate with a phased reduction so that 5 years down the road, business people who are making the decisions now on plant and equipment could predict with some certainty a corporate tax rate which would be substantially lower than what we have today, that would increase business investment.

Do you have any comments on that?

Mr. MILLER. Senator Danforth, let me just run through a little analysis for a moment.

There are a number of ways, and theories, for stimulating investment through tax policy. The ones that are most mentioned are the reduction of tax rates; subsidized interest rates—revenue bonds, that sort of thing; accelerated depreciation; and investment tax credits. Perhaps there are some others more esoteric, but those are the main ones that are available.

If you do a survey of businesses, you will find that business people prefer a reduction of tax rates. My opinion is that they prefer a reduction of rate because it would give them the most flexibility to use the money in whatever ways they want, perhaps to increase dividends, perhaps to retire debt, or just to retain earnings. And yet, there is no doubt that some place along the calculations there would be some use of the improved cash flow that would also get into investment.

But the linkage is somewhat remote, less probable, and rate cuts apply in industries that do not have capital investments to make. Therefore, rate reductions have less impact on investment than other tax policies, in my opinion.

Subsidized interest rates, for all kinds of reasons, are a move in the wrong direction. Congress some time ago made a decision that that was not going to be the main way of stimulating capital investment. They reduced the degree to which the revenue bond technique could be used, and I think that is correct, so I do not see a need to resurrect this alternative.

That leaves us with the more direct methods, to choose between the investment tax credit and accelerated depreciation.

I can go through my analysis again, but my view is the same as yours. In my former business, we calculated rates of return and discounted cash flow in order to determine that an investment was worthwhile, was worth the risk, when markets are uncertain and profits are uncertain.

The faster the writeoff of the asset, the faster the cash flow and, therefore, the more impact on the formula for return on investment than in the case of say, a 2-percent reduction in the tax rate. It takes a long time for 2 percent per year to show up as much real change in the discounted cash flow.

I guess it was Keynes who said, when asked about the long term, that in the long term, we are all dead. Well, in the long term, I hope we are not dead in this Nation. But I hope we do not have a tax theory that will work only if we all live 50 more years. I think we need one that gives action now, and I think accelerated depreciation is the type that does.

The CHAIRMAN. Senator Hansen?

Senator HANSEN. Mr. Chairman, Thank you very much for your appearance here today. I note that you state that a tax cut in the magnitude of $15 billion is indicated. You underscore the importance of increasing productivity in this country, and you call attention to the fact that the Japanese have been reinvesting about 20 percent of their GNP, about 15 percent in West Germany, whereas we have been reinvesting about 8 or 9 percent.

I, too, share your concern with these facts.

You, as has been pointed out, stress the advantages of depreciation as a way of getting the capital formation necessary together.

In this morning's Washington Post is a story on what France is doing. I have not always opted to try to do the things that Europe has done; for a long time, I think they have been down the wrong trail. But I must say that France's new direction indicates a fresh look at things, and I think there is considerable merit in it.

They propose to give each French taxpayer an opportunity to write off a 5,000-franc investment of taxable income if it is invested in the stock market. We have had a number of knowledgeable witnesses here who speak for the stock market. All of them say cutting capital gains taxes would stimulate the capital formation in this country.

Second, they point to the advantages of changing the rates of corporate taxes as a way in which we could stimulate capital formation.

I would invite your comment on the view as expressed by those people wwho are students and active participants in the stock market.

Mr. MILLER. Senator Hansen, the term "capital formation" is a very broad term. It is something like an engineer talking about mechanics or electronics. It covers the whole waterfront. And certainly, capital is formed when corporate rates are lower and cash accumulates in a

corporation. Certainly capital formation may be generated through the interaction of security investments, but, of course, we all know that you and I, buying securities from each other, do nothing to put more cash into an operating business. It merely changes the values, perhaps, of the securities we traded. It may affect our accumulation of personal capital, which we may then invest in some way. Therefore, it is linked remotely to short-term action in business-fixed investment.

The point I have been stressing this morning is that I do not disagree that capital, in the broad sense—private capital, corporate capital, Government capital—can be formed in many, many ways. But when you have limited resources to use through your tax policy, my suggestion is that you home it in to the capital formation that is linked to the result we most need—productivity gains—calling for direct investment, not indirect generation of wealth.

Having said that, I will certainly concur that there is a time and place, and the desirability of relief respecting capital gains taxes. For instance, we need such relief in order to provide, once again, the entrepreneurial spirit that this country needs, if we are going to be a really vital, active country where people take the risk of forming new businesses with new ideas because they can see a reward.

Recently, we have weakened the reward a great deal. Consider the scientist who worked at Lincoln Labs and started Digital Equipment Corp. and had $100,000 to do it. It is now a billion-dollar company. But such people do not leave Lincoln Labs so much anymore, because they do not retain enough if the project succeeeds, while, if they lose, their families are in trouble. The alternative of staying in a safe job is to incur a maximum tax of 50 percent. You know, we have taken much of the entrepreneurial reward away.

So we need to do a number of things.

My theme is, let's do them consciously, to home in with really important shots at what we are trying to accomplish and not piddle away our actions in little drabs and dribs.

Now, as for the idea of writing off an investment in the stock market, I am not sure that is timely. I think we have other techniques.

In my former company, thanks to the tax laws that you have already provided, we had a stock investment program for our employees. Over time, they acquired about 20-percent interest in a very large company. It was tremendous incentive for the employees to own a part of their company. The tax benefits of the company's matching employee contributions and helping employees to build up their equity is substantial. I think we already have those techniques in place in this country for those who want to use them—and the recent plans that you all have promoted have aided that a great deal.

So I think we are in pretty good shape as among priorities right now, as concerns employee ownership. As for the general stock market, I think that it would be a better way to go—at the appropriate time, when you feel the costs can be borne within fiscal plans—to adopt a liberalized capital gains treatment of some sort.

Senator HANSEN. We will have another chance later.

The CHAIRMAN. I believe he wanted an answer from you, though, with regards to capital gains.

Senator HANSEN. Thank you very much, Mr. Chairman. Yes, I do, indeed.

Most of the witnesses have testified that reducing the rate on capital gains would not constitute a drain on Treasury at all, but would have precisely the opposite effect. Now, you talked about the $15 billion overall limit for a tax cut, and the testimony we have had would indicate that jobs would increase, that there would be accelerated capital formation and that it would not cost the Treasury anything.

Do you agree or disagree with most of the economists?

Mr. MILLER. Well, let me say that depending on the tax cut, I think the dynamics could work in the direction in the first year. The studies I have seen at the Board would indicate that with certain capital gains tax reductions, you would unlock certain of the gains that are unrealized and you would have a turnover and you would, perhaps, in the first year have no revenue loss. But these studies also indicate that, as those funds are reinvested, that phenomenon does not continue. If you unlock unrealized capital gains accumulated over the present average holding period of 9 years—in order to continue to have no revenue loss—it would be necessary to greatly shorten the holding period to keep the situation stable for the future years.

I am not sure whether you can shorten the holding period enough to avoid revenue losses in later years, given the dynamics here, because, you know, once we have all turned our assets over to take advantage of the window—just as the chairman was pointing out the window in the gift tax; there might be considered to be a window here—people would fear that next year Congress might change its mind. Once you have turned the assets over, you do not build back those unrealized profits again very quickly. So you have to be careful in your analysis.

I suspect that the people who testified are correct, that what you have proposed to them would probably have minimal first year impacts on the Treasury, but, later on, I suspect you would lose revenue.

Senator HANSEN. Mr. Chairman, if you would forgive me for one additional comment, I just make the point, that we have to keep clearly in mind the difference between the present encouragement to spend money on consumptive activities as contrasted with investment activities, I do not think that your analogy quite holds up on that point.

Mr. MILLER. But you see, buying existing stock does not necessarily create jobs, and a lot of the people who——

Senator HANSEN. It would start a lot of little companies that have to go to Japan and West Germany now for their financing.

Mr. MILLER. Yes. You can help form new enterprises if you have the reward that I mentioned. But a lot of the money you are talking about—you know, in the terms of how much liberalization you have to create in order to create that wedge—is a tradeoff that you have to look at very carefully, because a lot of what results is just trading in the New York Stock Exchange, and that does not put one dollar into a corporation.

I might divert for a second—well, I will not take the time.

Senator HANSEN. I will forgo my next turn, Mr. Chairman. You have been very patient.

Mr. MILLER. I would like to comment at some point, if the chairman permits, on the general theory of taxes and the kind of direction we

might want to go in this country to create more equity and more of these incentives, looking at it as a phase situation. My concern is not with what your objective is. My concern is, how much money do we have now, how should we spend it now in tax reductions, and how should we phase in the other very desirable tax improvements. That is what I would like to address at some point.

The CHAIRMAN. Senator Bentsen?

Senator BENTSEN. Mr. Chairman, it is surely good to have you here this morning and I think you pointed out very well the direct correlation between accelerated depreciation and how that can help improve the manufacturing capacity of this country.

I would like to speak to you about another concern of mine, and that is the decline of the dollar, and what we have seen over many months now, and some of the actions that the Federal Reserve has tried to take in stabilizing the dollar, and what you see forthcoming in the way of a further decline in that dollar, or stabilization of that dollar, in the next several months.

Now, since I have a 5-minute rule, I want to get the second part of my question in. Do you think, up to now, that that has worked to the net advantage or disadvantage of the United States, the decline in the dollar?

I can recall President Nixon talking about it being a great economic coup when they devalued the dollar, that it was a good thing, and what I am trying to find out now is whether we have had enough of a good thing.

Mr. MILLER. Senator Bentsen, I can answer you very categorically. I think the decline of the dollar is bad for America.

It is bad because it introduces an unneeded, unwanted, and undesirable dose of inflation just at a time when we do not need it. It brings in inflation because: first, it increases the cost of essential imported commodities and material for which we have no immediate alternate sources; and second, it reduces the competitive pressures of other goods that come in and compete with domestically produced goods.

Both of those effects are very significant. The decline of the dollar in the last 12 months will result in increasing inflation by 1 percent, and that is a very large tax on every American. I think it is very, very disadvantageous to our Nation.

Second, the decline in the dollar itself is disruptive to international trade, and we live in an interdependent world, and once we begin to disrupt trade, and once we begin to disrupt capital flows, we run the risk of economic dislocations, recessions worldwide, that could be extremely undesirable. That risk is one that I think we have gone too far on in allowing the dollar to decline.

Another factor in the decline of the dollar is that, like it or not, we have become overdependent on imported petroleum. In 1973, $8 billion of imported petroleum; this year, $45 billion; next year, $50 billion. And, if those who price their petroleum in dollars become concerned about the value of the dollar, they may react in one of two ways—they may put in higher price increases to make up for the decline of the dollar, or they may try to price oil in some other currency, or basket of currencies. So far, that has been staved off, but it becomes a bigger threat the more that the dollar is weakened.

And finally—and all of those are disadvantageous to the United States—finally, the United States is the issuer of the U.S. dollar, which is the primary reserve asset in the world, and we have an obligation as the bank for that reserve asset to do our best to make it a stable asset so that we meet our responsibilities in the world and enhance our quality of leadership that is essential to security throughout the world.

Senator BENTSEN. What do you think is going to happen in the next 20 months?

Mr. MILLER. I think that it depends now upon our taking some fundamental action. The fundamental actions that affect the dollar are inflation and the current account deficit, which is related also to the inportation of energy, or petroleum.

If the Congress and the administration can show action on inflation and begin to bring the inflation rate down, and if action can be taken on the energy package to show that we are going to come to grips with our energy plan and put in place a baseline from which we can operate and improve, as necessary—if we do those things and begin to put on a drive for exports, which we should, and begin to turn our current account deficit in the right direction, then the dollar will be stable.

And I think it is within our own choice in the next 60 days whether we show that ability. If we do show it, we will have stabilized the dollar. If we do not, I think we are going to continue to have problems.

Senator BENTSEN. Thank you.

The CHAIRMAN. Senator Dole?

Senator DOLE. This might not be a fair question, but you are not suggesting that we act favorably on the gas pricing bill?

Mr. MILLER. Senator Dole, I am not really an expert on that bill. My judgment, based on what I have seen of it, is that it would be desirable to enact it.

The reason I think so is that it accomplishes several positive things, even though it may not be perfect, because it does represent a compromise between producers and consumers and that is perhaps the most hotly contested kind of issue that you can have. You know, the debate on this issue has been going on for a quarter of a century.

But the compromise natural gas bill does, it seems to me, create a national market for natural gas and gets away from the unhealthy dual market system of interstate, intrastate. I tbegins a phased deregulation and returns, in time, more of the reaction to market forces. I think that is desirable—to let market forces work on incentivizing production and distribution of natural gas.

I think those, and other components of the bill, are factors in favor of enacting it. I do believe that whatever energy bill is enacted this year by Congress, if any, should not be the last, because we should take it as a base line and if it is not working as predicted, we should have the courage to change it; but I think we need a base line, so we can all move forward from a known position, instead of the uncertainty we have now.

Senator DOLE. As I read your statement, you suggest we defer the increase in the social security tax for 1 year. Have you given any thought to the minimum wage increases? Do you think we ought to defer any increase in minimum wage, say next year or in 1980?

Mr. MILLER. Senator Dole, I would encourage the Congress to defer the minimum wage increase due to take effect on January 1 for 1 year.

That would reduce inflation next year by one-half of 1 percent. If the social security were deferred for a year, that is another half percent. And there are very few things we can do that will take 1 percent out of our inflation rate. And if we should stabilize the dollar and improve it so that these actions show that we are now getting control of our inflation, that could also add to reducing our inflationary pressures.

So I think that these are powerful moves. They are not things that have to wait for productivity gains or investment. They can be done by a vote of the Congress and a signature by the President.

So I very much think that they should be done.

Senator Dole. I think you probably have covered it. I think you have indicated, you mention an $8 billion in inflation tax increased and $8 billion in increased social security taxes, and a $15 billion tax cut. That does not seem to come out to a tax cut.

Mr. Miller. It is a standoff.

Senator Dole. But you still think the $15 billion is the proper range cut?

Mr. Miller. Senator, I do think so. I would note that we are in the fourth year of an expansion and that when fiscal year 1979 is underway we will be moving into the fifth year of expansion. To do so at a time when we have such a large deficit is bound to come back to haunt us in terms of inflation.

So I think we need the discipline of maintaining a moderate growth, but keeping the stimulus to such a tradeoff and not trying to increase it.

I might add that——

Senator Dole. How do you eliminate the effects of inflation on capital formation? Would you support indexing in any fashion? The Archer amendment on the House side, for example?

Mr. Miller. No, I am generally an opponent of indexing. It is a philosophical opposition. My opposition is due to the fact that I believe if there is no pain or suffering from inflation, we lose inflation fighters and we tend to accept it. As soon as we insulate ourselves, or think we do, from inflation, we tend to not make the hard decisions to combat it, and we delude ourselves into believing that we are secure.

I do not believe there is a security for this Nation if it adopts the philosophy that inflation can be tolerated.

The Chairman. Senator Nelson?

Senator Nelson. Mr. Miller, a number of witnesses, including yourself, commented on the importance of reducing the impact of the social security increase. You suggested deferral, which would cost about $7-plus billion, but that would be a heavy drawdown on the reserve in the fund, and would have to be replaced.

Over on the House side, the suggestion was made for a 5-percent tax credit. How would you evaluate that? In other words, a tax credit of 5 percent, employer and employee. That would cost $5 billion.

Mr. Miller. It seems to me what you are doing then is shifting social security funding to general revenues, and I do not think that is wise. My suggested deferral for 1 year was coupled with an undertaking by Congress to look at the funadmental costs of social security and make some changes that would get that $8 billion or $7.5 billion back by looking at techniques for reducing overall costs.

Now, one of the techniques I mentioned before was the phased-in taxing of social security benefits when received at retirement, so that those who have other income and are not, therefore, in need of the sustaining effect of the social security would pay back something into social security.

Another way would be to defer the retirement age. Another way would be to look at indexing. Another way would be to look at the actuarial aspects.

And it would be possible to look at the nonretirement features of social security, such as medicare, as to whether they should be funded from general revenues.

But I think making a shift to a tax credit, to general revenues, is a disguised way of solving the problem. I would rather see it solved on top of the table.

Senator NELSON. Since time is short, I will skip on to something else.

The administration has recommended that we eliminate the Domestic and International Sales Corporation—DISC. That would save $1 billion, by their estimates. Would you agree with that?

Mr. MILLER. Well, one of our great needs in solving our dollar problem is a very high visibility, high profile, powerful promotion of exports. A few months ago I probably would have favored phasing out DISC, but at the moment I would tend to leave it on the theory that, at this time, we ought to get our export program very clear and in focus before we dismantle anything that does create an improved cash flow from export activities.

Senator NELSON. But if you look at the large exporters who have been in the business for years, DISC did not do anything to expand their exports, so far as the best figures we can look at. They were exporting already.

And so, you gave them a tax break on something that did not really increase exports.

Mr. MILLER. I think you are probably correct. As I say, I would have thought a few months ago that it should have been phased out and I do not have a strong position on it now. I would just say that if we are going to get a new export policy in place, I probably would want to know what it is before I started dismantling pieces of it. But I do not have a strong feeling. I think you are right, philosophically.

Senator NELSON. You commented on the importance of depreciation. One of the things that concerns many people is depreciation and the benefits from the current proposals to small businesses which, under the SBA definition, represent about 50 percent of the employment in the country and about 40 percent of the gross national product.

There was on the House side, and there is pending here, a proposal for a 3-year straight-line writeoff on the first $100,000 of capital investment, so that small businesses get away from all the complications of several schedules. In addition, the full investment tax credit would also be applied.

Small businesses strongly support that. What is your view?

Mr. MILLER. I would support that sort of approach.

Senator NLESON. Thank you, Mr. Chairman.

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The CHAIRMAN. Senator Hathaway?

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

Mr. Miller, I am very happy to hear you say that you were opposed to indexing and for the good reasons that you gave. Let me ask you some questions with regard to inflation. I think you suggested that we should not go through with the next increase in the minimum wage. I hate to put the burden of curbing inflation upon the lowest paid workers of the country.

I recognize, and I think you do, too, that there are many other causes for inflation, and I wonder if you had any study of, or could just tell us off the top of your head, what you think are the major causes, such as the increase in the deficit, and the increase in energy prices which we have had. But no one seems to mention the fact that we have, according to FDC estimates, about 200 industries in this country that are essentially noncompetitive and, consequently, keep their prices up pretty high.

And, of course, the actions of your board with regard to inflation. How do you weigh all of those factors?

Mr. MILLER. Senator Hathaway, the kind of inflation we have been suffering from recently has been cost-push inflation that, of course, is the aftermath of the demand-pull-stimulated inflation of prior years. Once you get on the treadmill, it is very hard to get off, because our whole economic pattern for 40 or 50 years has been toward a stimulus in a time when we were coming back from a major world deflation and building floors under things.

We have not learned any techniques of building ceilings, and so the consequence is that we have pushed up and pushed up. Thus, the minimum wage is an aftermath of the 1930's, in which we feared that, without a floor, labor would sell itself for any price because people were so desperate for jobs.

Well, that is no longer true, but I do not want to hurt the people at the lower threshold, either. I think you hurt them by increasing the minimum wage when the result of that is no doubt to continue to put pressure on unemployment of teenagers, youngsters who live at home, who need the job experience, who need the minimum kind of a job to learn, and so on. And in the converse, when you do add a minimum wage increase at this time, you put a tax of a half-percent on GNP on all Americans. That is a pretty bad tradeoff, in my view.

But when you come to the cost-push inflation that we have been suffering and how we dismantle it, the road is very hard and very tortuous. I have listed 8 or 10 points that I think we need to follow over 5 or 7 years in this country to solve the problem. I have no illusions that it can be done quickly.

One, of course, is to bring the budget into balance by 1982 with full employment. Another is to reduce the amount of GNP spent by the Federal Government from 22 percent down to 20 percent, over time. Another is to increase capital expenditures, up to 12 percent of GNP. Another is to increase exports, up to 10 percent of GNP, and so forth.

There is a whole pattern of things that we need to do, but we need to start them. And, you know, this is one place, today in this committee, where we can make a start, by stimulating the investment side and creating a major thrust toward achieving the productivity gains that

break the vicious cycle of wages chasing prices and prices chasing wages.

Senator HATHAWAY. Well, when you say stimulating investment, are you talking about simply the first investment, or the money that is saved as a result of the tax break that we give them? The first investment—accelerated depreciation or a 10-percent investment tax credit—encourages the business to invest because they are going to save so much money. Now, are you talking about the capital formation that resulted from the savings of that money as a result of the accelerated depreciation or the 10-percent investment tax credit and, if so, how do we have any control over that? They can pass that out in dividends or do something else with it other than invest it, and there is nothing we can do about it.

Mr. MILLER. The accelerated depreciation proposal we have been discussing has the merit that the reduction of revenue to the Federal Government takes place only if there is a new investment.

Senator HATHAWAY. Right; I agree with you there. But they also save some taxes that way and that means that they have some more money to invest. Are you saying that is another reason that we should have accelerated depreciation?

Mr. MILLER. The recapture of the capital investment, which is the speeding up of the cash flow, occurs because of the accelerated depreciation. The tax is deferred, in effect, and that is one of the other advantages of accelerated depreciation over the investment tax credit. The credit is a forever forgiveness of taxes, while accelerated depreciation is a deferral.

As soon as you have depreciated 100 percent, then, as you say, income would go up, taxes would go up, and the cash flow stream that would come from the new investment would continue, which would enhance the capital base of the enterprise and give it the resources to either continue to invest money, without borrowing, in new investment that would also get accelerated depreciation, or to put the money into improving its payout, or building inventories, improving working capital or whatever.

Senator HATHAWAY. Thank you. My time has run out; I would like to follow that up the next time around.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. Chairman Miller, you recommend that we defer the social security tax increase. The figure that has been mentioned here, that that would cost $7 billion in revenue; is that correct?

Mr. MILLER. Yes, sir.

Senator CURTIS. How much of that $7 billion would go into production, accumulation of capital, and to do the things that you say are the first priority?

Mr. MILLER. Senator Curtis, the reason for deferral of social security tax is related to inflation rather than capital formation. Of the roughly $8 billion that is involved in deferral for 1 year, about $4 billion would be to individuals to reduce their taxes, and would be taken account, in my thinking, in the package given to individuals. That would be $4 billion of any tax reduction.

For businesses, there would also be a $4 billion tax reduction, but that payroll tax in business has, in the past, shown up in prices and

has merely meant that the corporation became the collector of the tax. And so it created no new capital of any kind.

So the reason for deferring it is not for the purpose of getting capital formation or investment. It is to reduce the price increase pressure that has a multiplier effect that results in about one-half of 1 percent inflation next year, and if we could eliminate that one-half percent, we would go a long way toward reducing inflation.

So that particular proposal is related to packaging up the relief from taxes for individuals coincident with our desire to reduce inflation. The alternate proposal, or the parallel proposal, of depreciation is the one that is designed to create the investment, not the social security tax.

Senator CURTIS. You do not contend that $7 billion is an unneeded surplus?

Mr. MILLER. In terms of the Federal deficit, if there is a deferral of the social security tax increase, then $4 billion of that—assuming that this committee desired to create a $10 billion tax reduction for individuals, then $4 billion of it would come from social security and $6 billion of it would come from rate structure changes that you would want to make.

So that is how you would handle that.

In terms of the—if you mean the social security fund itself, a deferral of 1 year does impact the fund by about $8 billion, and I would be in favor of that only if Congress undertook, during the year's deferral, to look at means and ways of reducing the fundamental, actuarial costs of social security, through looking at benefits, or payouts, or taxing of benefits, and thereby returning integrity to the fund.

Senator CURTIS. Well, that is a hopeful situation. Congress has taken a long, long look at social security financing and turned and ran. The only proposal that seemed to get any support was to take it out of general funds. Then there was a movement to borrow from the general fund. Then there was a proposal to abandon the 50–50 arrangement—half of it on employees and half of it on employers.

So that is not a very hopeful situation.

One of the things that sold me on the idea of the desperate need for a capital gains tax reduction was a young man from my State whose father is a professor and this young man excelled in electronics engineering. He went to the west coast. He established a factory that is going well. He employs between 200 and 300 employees; he needed capital.

He tramped the streets and pursued many avenues in attempting to find additional capital and could not find it because of the high capital gains tax rates. He turned to Japanese investors. They provided the money. They have no capital gains tax there.

Now, do you think that the benefits that would have resulted from being able to get this capital in the United States would have been confined to millionaires?

Mr. MILLER. Well, in previous company, we had a division that engaged in venture capital and we would have hoped that young man would have come to see us, because we would have been delighted to put money into his business as we did with many others, because we believed that it was to our advantage to help young companies start up and develop new technologies.

I cannot, of course, answer a broad, public question on the experience of one individual. I think we do need, very, very badly in this country, a renewal—as I said to Senator Hansen—of the mechanism that does provide new incentive to the entrepreneurial spirit and for the freshness and vitality and youthful spirit of building that is almost the credo of the American enterprise system, which we need to reinstate.

So I have no opposition to what you are suggesting.

Senator CURTIS. You do not believe, then, that a reduction in the capital gains taxes would only help millionaires?

Mr. MILLER. No, I do not believe that it only helps millionaires. It may help make millionaires, but that is not so bad.

Senator CURTIS. That is a good idea.

If I may have 20 seconds, the trouble of this marxist tax policy that we have in this country—and we have it—is that it holds down the have-nots. It prevents the bright boys who have what it takes to go to the top, give some competition to the giants. They cannot compete, and that is the evil of the tax policy that we have.

The CHAIRMAN. Senator Ribicoff?

Senator RIBICOFF. Mr. Miller, now you and Secretary Blumenthal have been given the responsibility to try to buttress our sinking dollar. Is that not correct?

Mr. MILLER. Yes, sir.

Senator RIBICOFF. Do you have a similar role in the group trying to do something about inflation? What role do you have in coming up with an anti-inflation program?

Mr. MILLER. I have no formal role, Senator Ribicoff, but I have been in contact. I do meet frequently, as you know, with the Secretary of the Treasury and with Charles Schultze, the Chairman of the Council of Economic Advisers, and we have been spending considerable time in recent meetings discussing the wide range of anti-inflation policies.

And so, in that sense, I have informally been involved. I have no formal role in that regard.

It is a very high priority and one in which the Federal Reserve cannot be an idle bystander, because it is so critical to monetary policy that we control inflation. Otherwise, our task just becomes impossible.

Senator RIBICOFF. You touched upon the beleagured gas bill that will be before the Senate within the week. Now, here is a bill that the producers say is no good, the consumers say it is no good, and yet, worldwide, it has become the symbol of America's intention of doing something about energy. Our imported energy bill is probably the biggest cause of our present high inflation rate.

As you go around the world talking to your fellow bankers, those who are responsible for making policy and determining the value of the dollar, please explain why that gas bill has become the symbol of America's intention to do something about inflation and, if I may be so bold and ask you to comment, do you think that the Congress of the United States has abdicated its responsibility in this field to do something about inflation?

Mr. MILLER. Senator Ribicoff, the world, for whatever reason, has built up the question of the energy bill as an almost the essential ele-

ment in our determination to cope with our problem of inflation and the problem of the dollar, particularly the problem of the dollar.

I cannot say it is logical. It perhaps is a result of our own actions that have possibly raised expectations thus creating the impression ourselves. But more than that, it has been a dramatic element in all of the international conferences I have attended or heard about in terms of the viewpoints and perception of foreigners, and I am sure it has a great influence on the foreign exchange markets.

I suppose it reduces simply not to the merits of the bill, but to whether or not the world views the United States and the combination of its Chief Executive and its Congress as being impotent to deal with the major issue. I think that that is probably it.

So, perhaps through historical events, we come to the end of a congressional session in which almost 18 months, or 16 months, have been spent hammering out a compromise and in which the world views it as a compromise performed in the Government of the United States and if it cannot survive and be passed it will be viewed as a sign of inability to come to grips with the problem, and I think we will have adverse consequences.

Senator RIBICOFF. Let me ask you, if that gas bill either passes or fails, what impact would passage or failure have upon the standing of the American dollar?

Mr. MILLER. If it fails, it will have an adverse impact.

Senator RIBICOFF. If it fails, it will have an adverse impact.

Mr. MILLER. If it passes, I believe it will have a very positive impact.

Senator RIBICOFF. Thank you very much.

The CHAIRMAN. Mr. Chairman, I did not think we were going to be debating the gas bill before this particular committee.

Mr. MILLER. I did not come prepared either, Mr. Chairman.

The CHAIRMAN. But let me just say this: For a long time we were told that we had to pass a crude oil equalization tax because that was going to be perceived as a question of whether America was serious about its energy crisis or not. Now it looks like we are going to be told we have got to pass this so-called gas bill for the same reason.

My objection to the gas bill is that it means a big increase in the price of natural gas without any commensurate increase in the supply. I find myself joining forces with those on the consumer side of the issue who are against the increase that the consumers would have to pay, because it looks to me as though what they have in that bill is going to be a big administrative nightmare.

I thought—and I think that most of us thought—that decontrol, or the free market, would be the answer. And then we are told here that oh, no, no, the answer is more regulation. Anything that they do not have under Federal control, get their hooks in it and see if you cannot put that under Federal control.

From what I am hearing from producers, it is not the price they are complaining about, it is this monstrous increase in regulatory activity that would dismay them and would discourage them from producing more energy.

Now some of us who are opposing this conference report are offering what we think is a fair compromise—just say that anyone who wants to can put more gas in those pipelines without its going necessarily

into Federal regulation by doing so, if it is delivered within a State, and also saying that the gas can be delivered within the State.

But what is the effect going to be when our foreign friends find out that all this is just conversation about what this bill is going to do, that it does not mean any increase in production, all it means is an increase in the price?

Mr. MILLER. Rightly or wrongly, Senator Long, the issue has been drawn, and I think the dollar will be influenced whether it is passed or not, regardless of the merits of the legislation.

On the question of whether there will be more gas produced, if the enactment of this bill does not create incentives for more production, then certainly we are on the wrong track. I believe that the process of getting rid of regulation over time is the ultimate answer to production since it will result in more market freedom. If that does not take place, then we have a problem.

I suppose my viewpoint is that if we have a perception by some that we are not going to have more production, and a perception by others that we are, it might be well to lay down the base line of this bill and be prepared to make changes in it if, in fact, the reaction is different than is being expected.

That is one fair way to look at it. I do not know if it is feasible or not.

The CHAIRMAN. Well, up until now, I have been led to believe that the big thing about the whole energy package is the crude oil equalization tax—that is what is going to do the job. We are going to tell everybody we have moved our prices ahead to world prices of oil.

Now, I regret to say it, Mr. Chairman, but although I have been trying to cooperate with the administration, I do not see any prospect; as it stands right now, of passing that crude oil equalization tax. When the word goes out that that is not going to pass, what is that going to do to the same psychology of those who, for the moment, might want to proceed to go out and buy more dollars?

Mr. MILLER. The perception, as you know, around the world was created that we have a five-unit program and for a considerable time it was very much viewed as essential that all five units be passed. Part of the decline in the dollar, I think, was the delay in bringing that about.

Now I believe that the world has already discounted any enactment of COET this session, so I think we are down to a narrow issue at this point. I think that the possibility of COET being tabled has already had its impact on the dollar.

The CHAIRMAN. Well, you are saying, Mr. Chairman, that the people overseas are a lot more sophisticated than those down at the White House if you are saying that the people around the country have given up on COET. I was under the impression that the administration is still counting on it and that they think that somehow or other we might manage to put Humpty Dumpty back together again and pass that COET tax.

I must say, for my part, the potential for that tax has become increasingly discouraging, and I think I find myself more and more agreeing with those sophisticated people overseas. Now, if they are smart enough to see that the COET tax is not going to pass, how long

do you think we are going to fool them with a gas bill that says we are going to do a lot about gas, only to find out that very little is going to happen?

Mr. MILLER. I do not think we can fool anybody very long. If we do not get production, the decision to pass the gas bill will not have accomplished its purpose; then it will be necessary to pass another gas bill.

Senator DOLE. You had it right there.

Mr. MILLER. I am not sure if the tempers of the Congress can stand another gas bill if this one fails. I have never seen anything so emotional. As I have gone around Congress, it has been amazing. It is understandable, because there are these different perceptions.

We are not a homogeneous country. We are a hetereogeneous country. In my early years, I lived in the Southwest in an area that produced oil and gas. Then in recent years I have lived in New England, which is just the opposite. So I have seen both viewpoints and appreciate both viewpoints. I know that the Northwest for a long time has been more dependent on hydropower, the Southwest on indigenous produced energy, the Midwest on coal, and the Northeast on residual oil. Yes, somehow, the problems are closing in on us and we may have to take some risks in laying some baselines and being willing to make midcourse corrections in this process where everybody is trying to guess what will happen and nobody is willing to give in on either side.

I think we may have to take some of those risks.

The CHAIRMAN. Senator Danforth?

Senator DANFORTH. You indicated during the first round, I think, to Senator Hansen, that you hoped to get to a point that you wanted to make—I think it had to do with longrange tax policy and how we should handle it over a period of years. I would appreciate it if you would do that.

Mr. MILLER. Well, thank you, Senator. It just seemed appropriate at that time, because we were getting to the philosophy of taxes.

I do say seriously that I believe the American people view tax reform as lower taxes and simpler taxes, and my point was that lower taxes depend upon reducing once again the level of Federal Government expenditures rather than reducing taxes and having larger deficits.

We have had Federal expenditures as a percent of GNP well below 20 percent through the decade of the 1960's. It has crept up to 22 percent now. There is no reason that we cannot return it to a relative level in our economic model that it held just a few years ago.

If the Americans in their wisdom—and I think they are basically wise—think that lower taxes and simpler taxes are the answer, they also are thinking, in my view, that assurance of equity and fairness in taxing is very important. I do not think Americans are as turned off by paying taxes as they are by the complexities and the sense of inequity in that some people get benefits and others do not, and the feeling that it is complex and confused.

Therefore, it seems to me that, in the long run, we might well go to a combination of the present graduated income tax structure for individuals plus a graduated minimum tax structure on adjusted gross income and, over a period of years, phase out all forms of deductions and end up with a lower graduated tax on adjusted gross income. This would

enormously simplify the whole tax structure, and get away from many of the distinctions in types of income that are so troubling.

I think it takes a phase-in to do that, because it would take a period of time to adjust, make the transition, and experiment with the kinds of minimum levels that are necessary in order to spread the same aggregate tax requirements more equitably and justly over the whole system.

Senator DANFORTH. One thing that concerns me in this particular bill is that we have a great opportunity to do something for the economy and a limited number of dollars to work with, and there is always a temptation in a tax bill to create a Christmas tree, for everybody to be pushing for some little tax incentive that he might want. And therefore, in this bill, while the chances are zero for this bill to be a major tax reform, at least we can keep it simple in this bill. At least we can approach the basics of tax policy.

Mr. MILLER. Senator Danforth, we are being tested right now in our own wills and disciplines, and I agree with what you are saying. I would just add that we are going to have to face a period of some austerity, some giving up of business as usual if we want to work our way out of the box we are in. Part of that starts with the mental discipline to be willing to give up the Christmas tree with all the fun presents and take, instead, the barebones, simple, direct, well-understood actions that speak very loudly for our control of our own destiny and our determination to structure our system to solve the problems.

Senator DANFORTH. Now, you have said this at least four times, but I do not want it to be lost, with respect to social security taxes.

The tendency of anybody in our business—namely, politics—is to hear the popular thing you are saying and to ignore the unpopular thing you are saying. Any reform in social security taxes, any structural reform, is going to be very unpopular. Any change in the indexing formula, for example, is going to be very, very unpopular.

As I understand what you were saying, you would favor a 1-year deferral in the increase in social security taxes, which is popular, only if the Congress commits itself to facing up to those structural aspects of social security—including benefits—and when we do that, that would be very unpopular.

Mr. MILLER. You have stated it absolutely correctly. There is no free lunch. A deferral of 1 year should be with the commitment to undertake some reforms that would reduce the fundamental costs of social security, and therefore, the fundamental burdens. This would enhance the best social purpose of social security, which is to take care of those who are needy and not just take care of everyone.

The CHAIRMAN. Senator Hansen?

Senator HANSEN. I will pass this time. I took my full 10 minutes before, Mr. Chairman.

The CHAIRMAN. Senator Dole?

Senator DOLE. In line with Senator Danforth's question, if you are going to defer the increase for 1 year, then you would be in a rather critical year of 1980. Maybe you had better go for 2 years, if you talk about the politics.

Mr. MILLER. Is this a declaration of candidacy?

Senator DOLE. No; I am just thinking about others.

It is like the three-martini lunch, most businessmen were not even thinking about it until President Carter was elected. But, in any event,

if we are going to defer the minimum wage, and social security, it gets back to the gas bill. It seems to me that if it is going to have an impact on the dollar, it is going to be very short term. It is more psychological than real. Would you agree to that?

Once they discover what may be in the bill?

Mr. MILLER. Well, the first impact will be psychological, but if it is combined with other actions to show that we are determined to do something about inflation and follow up the gas bill with whatever else we have to do in returning more market influence to oil—we are talking gas now, but we need to deal with oil——

Senator DOLE. Right.

Mr. MILLER [continuing]. And if we are going to follow up and not let the gas bill be put on the shelf but make it a living project whereby we are going to change it if it is not working then, I think there will be a perception that we are beginning to get hold of our problems. Then I think there will be a lasting impact; but if we just pass it and put it on the shelf and say, "Well, if it does not work, too bad!" then I think we will have a negative reaction in 3 or 4 months.

If we have the attitude that we are going to put a gas bill in place, monitor it, and see how it is working, we will see if there is going to be any more production. If there is not, we will change it. I think that the Nation needs the additional production. There is no debate about that between consumers or producers; it is the pricing and availability of gas which are the tough issues.

Senator DOLE. Senator Roth is not here, but I would not want a hearing to go by without asking about the Roth-Kemp bill. It has been widely discussed in Congress. I think everybody is generally aware that it would provide a 33-percent, across-the-board tax cut. Have you given any thought to what kind of impact that kind of a cut might have on interest rates?

Mr. MILLER. I believe such a tax program would be highly inflationary because I believe that experience shows that it is very easy to vote tax cut and very hard to reduce the expenditures that must go with that if we are going to have a sound fiscal program. I fear that what we would see is very much larger Federal deficits as the initial reaction, followed by much more severe financing problems, higher interest rates, and more inflationary pressures.

We all want to see lower taxes. I want Federal expenditures down to 20 percent of GNP so we can reduce taxes and return those funds—about $50 to $75 billion to individuals and businesses for private decisions. But I think we have to reduce the expenditures coincident with reducing the taxes, rather than reducing the taxes and hoping we will reduce the expenditures later.

Senator DOLE. I think that is the same reservation that many of us have with reference to the Roth-Kemp proposal, because you cannot address the revenue side without addressing the spending side.

Mr. MILLER. Right.

Senator DOLE. But we will probably go for it.

Mr. MILLER. Well, with the new computer system—do you have computer voting in the Senate, yet?

Senator DOLE. No.

Mr. MILLER. You could run out the odds.

Senator DOLE. We are not required to understand what we vote on, but that may be a little different than computer voting.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. Mr. Chairman, what do you think will be the affect on our economy if we reduce capital gains taxes?

Mr. MILLER. I think the effect will be very minimal at the beginning. There will be an immediate favorable reaction of the stock markets, but that does not itself create jobs or investments; and I think the improved opportunity for risk taking for investment will, over a period of years, contribute to more entrepreneurship and vitality in our economic system.

I do not know that I could measure it because I do not know the level of cuts you are talking about.

Senator CURTIS. I am talking about going back to at least a minimum of a 25-percent top rate and taking it out of the minimum tax.

Mr. MILLER. And then taking it out with the minimum tax?

Senator CURTIS. Taking it out of the minimum tax.

Mr. MILLER. I do not think there will be an immediate impact on economic activity. I think there will be an immediately favorable stock market reaction and, over time, a favorable input to economic activity.

Senator CURTIS. I would think so. There are a great many individuals in the country that believe that lowering capital gains rates would be a very important factor in promoting increased economic activity which, after all, result in jobs.

Do you agree with that?

Mr. MILLER. I think over time, yes, but I have to repeat that if we take the bucks that are available and try to prioritize them, there will be more immediate reactions from tax policies that are directly linked to investment rather than ones that are indirectly linked.

Senator CURTIS. But you have just recommended $7 billion or $8 billion tax relief in social security that would have practically no effect on investment and productivity.

Mr. MILLER. I recommend that for a twofold reason, Senator Curtis. One is that it would be encompassed in the tax reduction for individuals to merely trade off the tax increases they will otherwise suffer. So I am not making any new initiative; it is a tradeoff.

And the other reason for recommending it is to reduce, by one-half percent next year, the inflation rate that affects all Americans, their jobs, and almost everything else in our economy. I am not advocating the social security deferral as a policy directed toward investment, but rather as a relief for individuals to restore real purchasing power on the one hand, and a relief from inflation on the other.

Senator CURTIS. Now, on the subject of inflation, is it not true that you increase the overall deficit by the same $7 billion?

Mr. MILLER. You would not increase the deficit if your $4 billion reduction of individual social security taxes is part of the $10 billion reduction that you have in mind. It is just a different kind of dollars, but it would be the same $10 billion.

Senator CURTIS. Well, in the unified budget that we have, would it lessen or increase the deficit.

Mr. MILLER. It would not do so. If we are contemplating a $15 billion tax cut starting January 1 and part of the social security tax

were deferred, it would be part of that $15 billion and it would not be in addition to it. So it would not change the deficit from the $40 billion range that we were contemplating if we had a $15 billion tax cut.

Senator CURTIS. But you think—now, I think in addition to revenue, we have got to take into account whether a tax is just. Do you think the present capital gains tax is just?

Mr. MILLER. Well, I think there are many unjust taxes, and I think when you say, for example, that social security taxes are unjust——

Senator CURTIS. No; it was the capital gains tax.

Mr. MILLER. The capital gains tax. I could say yes, but then I would have to say a lot of other things.

For example, there are those who favor indexing the base for capital gains calculation. I am not sure why an individual should be protected as to the tax on his capital assets if he is not protected on the income from his savings account which is, as you know, not protected. All the interest you draw down at the bank—5 percent, let us say—is taxed, and yet inflation is chewing up 7 percent of it, so you are actually losing 2 percent and paying tax on 5 percent. So that is unjust.

So I think we have to be careful with the broadcasting of something as unjust without looking at everything, because, in a sense, there are many unjust things when we are burdened so heavily with inflation, and if we try to correct it in one place and do not correct it in another, we create more injustice, in my opinion.

I do not think it is just for the person who has a capital asset, who is usually more affluent than the one that does not, to get relief on inflation while the one who has savings down at the savings and loan is not getting similar treatment. I think neither should get the treatment because if you index them, you begin to create this attitude that inflatton does not matter and you lull everyone to sleep and invariably the nation ends up in terrible shape.

Senator CURTIS. A Nebraska constituent, a small businessman, owned one filling station. He reached retirement in the fall of 1976. He sold his business in September. He asked his lawyer and accountant what the tax consequences would be and they gave him a figure.

In November or December, the Congress changed the rules and put capital gains into the minimum tax retroactively to the 1st of January 1976. This retired man is faced with an unexpected tax bill of $17,000.

Now, we have talked here about inflation. When people sell their property, a considerable portion of the selling price is inflation. Yet we tax it as though it was a real gain.

Now, I think that, in addition to the high capital gains taxes retarding our economy that we are perpetuating a grave injustice. I am very disappointed that the administration witnesses do not support such a move.

The businessmen I talk to say this is one of the real priorities. Now, we can theorize all we want to, but to increase the rates on capital gains, which is what Congress has done in the last few years, does not do the very thing you have been pleading for this morning, and that is to plow back something into industry for capital formation. It is just the reverse.

And I was not just careless with words when I referred to our tax system as a Marxist system. I think we put into the tax law everything that Eugene Debbs and all the rest of the Socialists have recommended down through the years.

Mr. MILLER. Well, the fairest tax structure is achieved, no doubt, when we have a confluence of our individual interests with the public interest, and I think we can accomplish that in a number of places.

Senator DANFORTH. I just want to try out an idea on you, and get your reaction to it. In connection with trying to hold down Federal spending increases and to reduce the percent of gross national product consumed by the Government, suppose that, in connection with this tax bill, which will be a major reduction in taxes, suppose that in connection with this bill we set as the target an increase each year in Federal spending of no more than 2 percent, plus inflation.

And, if Federal spending exceeded that amount, there would be a surcharge on the income tax to pick up the overage. And further provide that that would kick out in times of high unemployment, so that you would retain the possibility of countercyclical deficits.

If we were to do this, assuming that gross national product increases at a rate higher than 2 percent a year, over a period of about 5 years the percent of gross national product consumed by the Government would be reduced to about 20 percent, maybe a little under. It would seem to me that this kind of approach, rather than going to the constitutional amendment process that seems one, so time consuming to accomplish and two, so rigid in the way it operates, that this would be a very phased, relatively easy way to accomplish an objective.

It would not absolutely tie the hands of Congress to increase, spending over a real increase of 2 percent a year, but it would simply say that if we were to do that, we would be on a partial pay-as-you-go basis and we would have the political disincentive that the people in our shoes would have to go back to their constituents and explain why it is that there would be this separate item on their tax return to cover the overage.

Does that seem to you to be a reasonably sound idea?

Mr. MILLER. Senator Danforth, I have generally disfavored rigid formulas, even though I want to get to 20 percent of GNP, because I know the world changes. A constitutional amendment worries me because you never can predict circumstances where the Nation's interests may change significantly. You know, for $1 you might be violating the Constitution, so to speak.

So anything that could be done in the legislative arena in the way of a guideline or a policy commitment, I think, would be preferable. I had not thought about linking it to a precommitment for a surtax. My offhand reaction to that is that it is quite an ingeneous idea, because it has obviously political implications that introduces some discipline, and it may well be worth exploring.

As you have already pointed out, it needs some flexibility so that it would not completely tie Congress' hands, which I think would be unwise, because there can be conditions of famine or problems in the world that we cannot anticipate, or domestic problems that would require other actions.

But I think you have the germ of a good idea there.

Senator DANFORTH. What rate of unemployment should be the out? I was thinking in terms of 7.5 percent. Would that be about right?

Mr. MILLER. Well, I think when you get to 7.5 percent in today's economy there is considerable distress, so you should be willing to take countercyclical action. I would say that that number itself has to be flexible because, as you know, in the 1960's, that would have been a lower number. We must work through the recent bulge and change in the labor force that we have had because of demographics and because of the entry of women into full careers. There are some predictions that by 1990 we may have a shortage of labor in this country.

So I think you would not want to lock in figures for too long a time, but retain some flexibility.

Senator HANSEN. Mr. Chairman, at the risk of being redundant, in response to questions on the gas bill, you stated that there was a real need for market freedom in this country. You also said that you thought we should take some action and then improve on it. You did not say take some action even if it is wrong and then improve on it, but I suspect that there are some besides me who may feel that this gas bill before us would be a wrong action.

We need more market freedom. The only part of the gas industry that is not now controlled is the intrastate market, and this bill would impose Federal control on the intrastate market. And, if you have in mind also the statement by Sheila Hollis, he enforcement devision head for FERC, that this bill would be an administrative nightmare, incapable of being administered, how do you think Europe and the rest of the world would perceive our actions? Would they be wise and timely, or would they be counterproductive?

Mr. MILLER. Well, again we are dealing in an area of considerable opinion.

Senator HANSEN. Well, I was asking your opinion.

Mr. MILLER. My view of the bill is not nearly as complete as yours, Senator Hansen, so it would be rather presumptuous of me to suggest that I know the ins and outs and pitfalls. The thing that appealed to me about the bill was that while we currently have market freedom for intrastate gas, but we have regulated interstate gas, and it seems to me that the abundance of supply and availability of intrastate gas almost proves that freedom from restraint does bring in production.

Senator HANSEN. I agree with you.

Mr. MILLER. And therefore if, in the debate between consumers and producers, the compromise has been to bring in a national market and a national regulation at a higher price in order to cushion the effect to existing interstate customers and then phase it out over time so we trade off a period of 7 years of regulation at a higher level for freedom ~~from regulation~~ beyond that, I think it may be a reasonable proposition that that tradeoff will work toward the market freedom that I think we need.

Now, before joining the Government I was a participant in the Coalition of Northeastern Governors—that included New York, Pennsylvania, New Jersey, and most of the New England States. We held a conference in Saratoga, New York, in November 1976 and the Governors of those States unanimously supported a policy of phased deregulation of natural gas even though, until that point, the Northeast had always insisted on regulation to hold the price down. The

basis for the new position was that if we could bring deregulation in over time and therefore cushion the impact, we would all be better off to be assured that we would have gas at a price we had adjusted to, rather than to continue to delude ourselves that we were going to have gas at a lower price when in fact we would have less, or none at all, as well as inadequate supplies.

So I know these are issues on which people have widely different opinions, but I am so sure that we need to get to more freedom that I guess I would make the tradeoff.

Senator HANSEN. Well, if I could interrupt for just one moment, let me say that you are saying that we should have more freedom and that you would be willing to want to wait 7 years to have that freedom but in the meantime with 40 percent of the market still free, the intrastate market, you think that it is a reasonable tradeoff to impose controls on that 40 percent of the market that is still today free in order to get the hoped-for freedom of all of it 7 years from now. Is that what you are saying?

Mr. MILLER. Senator Hansen, if I understand the basis in the indexing of the ceiling prices that would be applicable, yes. I guess my judgment would be that, while it is not perfect, it is an acceptable compromise to get where we need to go.

Senator HANSEN. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Hathaway?

Senator HATHAWAY. Let me pursue what I was asking you before with regard to capital formation, which do you advocate, continuation of the 10-percent investment tax credit.

Mr. MILLER. Yes.

Senator HATHAWAY. Would you like to see it made refundable, or do you think that is going too far?

Mr. MILLER. The recent liberalization allowed the credit to offset higher levels of income tax, as I recall. It was originally limited to 50, now it is 90. However, I have not done what we call the footings, to see what the value is, but in principle I would not object to refunding.

Senator HATHAWAY. Over any length of time?

Mr. MILLER. Well, I have not studied it carefully, but I think the point is that I can see that businesses that are not making a current profit but need to make investment to modernize need the cash, and that is what you are talking about.

Senator HATHAWAY. That is right.

Mr. MILLER. And concerning the timetable of refunding, I believe the credit is available to taxpayers in a single year. I suppose the refund should be available to a business in a loss position in a single year to make it parallel. But I do not know the numbers, and I do not know whether it would fit into the——

Senator HATHAWAY. Right.

You noted previously the differences between the two, the 10-percent investment tax credit and the accelerated depreciation is in the latter case the business is simply postponing its tax and in the former it is saving it forever.

Now, in a situation where it is saving it forever, is that not a better way for capital formation, assuming that the company reinvests that money?

Does that not provide more of an incentive for investment?

Mr. MILLER. If you look at the capital asset, suppose it cost $1 million, and if there is a 10-percent tax credit to a taxpaying corporation, then there is a $900,000 cash requirement to make the $1 million investment. And if the $1 million is depreciated over 12 years, you have to calculate, of course, the cash return and discount it back to see how the formula works out.

If you shorten that 12 years to 7 or 8 years, you would be surprised how much more valuable that is than a 2-percent increase in the investment tax credit. And yet, from the Government's point of view, the Government is going to collect the money sometime, so it has the discounted cash view also. The Government is going to get the cash later, and therefore, the Treasury has some value in the bank.

So it works, I think. My view is that you would have to go very high in an investment tax credit to get the same wallop that you can get by shortening depreciation lives.

Senator HATHAWAY. When you are considering the wallop, you are really just considering initial investment. We are not really that much concerned with the savings.

Mr. MILLER. The savings will be achieved by the capital improvement, in any case.

Senator HATHAWAY. Well, whether the tax saving is actually in-

Mr. MILLER. If the capital improvement reduces the cost of producing the product by 20 percent, it will do it whether you give the cash back to the——

Senator HATHAWAY. Well, whether the tax saving is actually invested again or not, we are not concerned about that. Or should we be?

Mr. MILLER. We are concerned in the sense that history shows that when you have businesses that are able to invest, modernize, build markets, they tend inevitably to plow back x percent of their retained earnings in new investment.

Senator HATHAWAY. I see.

Mr. MILLER. And so what you expect is that rollover to continue and to be slightly enhanced, because now, as compared with other uses of funds, a new investment that reduces costs and recaptures the invested money sooner becomes even more attractive. So there actually is a little speed up, even in the rate of reinvestment.

Senator HATHAWAY. Now, I assume from your testimony that you would be opposed to the Kemp-Roth proposal?

Mr. MILLER. Yes, sir.

Senator HATHAWAY. And could you tell me—maybe you have answered this for other people, because I was not in the room all the time—how you arrived at the $15 billion figure for a tax cut? You mentioned that on one page of your testimony.

Mr. MILLER. Yes. I have arrived at that—I guess I started arriving at it back in March or April. At the time, it was very apparent that inflation was becoming much more virulent and difficult than had been anticipated and that, under those conditions, we were facing a Federal deficit for fiscal year 1979 that was increasing at a time when the economy was nearing a mature cycle stage, which was a very unhealthy direction to go.

And so the choices to reduce the deficit were one of two: either to reduce Federal spending or to collect more taxes. And what has been

appropriate is to try to do both, reducing the projected Federal spending of $500 billion to about $490 billion, and reducing the projected tax cut of $25 billion on October 1 to $15 billion or so on January 1.

The result of the combination of those, coming out to a $40 billion deficit instead of a $60 billion deficit, thereby reduces the unwanted stimulus that is inflationary and creates credit demands that greatly trouble our monetary policy.

And so we worked backwards in trying to scale down on a reasonable basis the deficit to a level that is appropriate at this time. I would like to see the deficit for fiscal year 1980 well below $30 billion; at $15 billion in fiscal year 1981; and a balanced budget in 1982.

I think that a gradual reduction in the deficit at the same time that we keep a moderate growth in the economy would be a sound economic plan.

Senator HATHAWAY. Senator Curtis?

Senator CURTIS. Mr. Chairman, we have been here a long time, and so the question I am going to ask can be supplied for the record.

I would like to have a list of the industrialized countries which: (a) import a greater portion of their petroleum than the United States; (b) the rate of inflation in each of those countries, and; (c) the trade balances of those countries.

Mr. MILLER. I would be very glad to, Senator Curtis.

[The following was subsequently supplied for the record:]

OIL DEPENDENCE, INFLATION, AND TRADE BALANCES IN MAJOR INDUSTRIAL COUNTRIES

Country	1977 net oil imports as percent of oil consumption	Consumer price inflation (percentage change from previous year)					Trade balance (billions of dollars)				
		1973	1974	1975	1976	1977	1973	1974	1975	1976	1977
Japan	100.0	11.7	22.6	12.1	9.7	8.3	3.7	1.4	5.0	9.9	17.5
Italy	100.0	10.8	19.1	16.9	16.8	18.4	−5.6	−10.7	−3.4	−6.5	−2.5
Germany	96.3	6.9	7.0	5.9	4.6	3.9	12.7	19.7	15.3	13.5	16.4
France	95.7	7.3	13.7	11.7	9.6	9.5	1.4	−3.4	1.5	−4.2	−2.3
United Kingdom	57.9	9.1	16.0	24.2	16.6	15.8	−5.6	−12.3	−7.1	−6.3	−2.9
United States	47.8	6.2	11.0	9.1	5.7	6.5	.9	−5.3	9.0	−9.4	−31.1
Canada	[1] 12.6	7.6	10.8	10.8	7.5	8.0	2.1	1.7	−.6	1.2	2.2

[1] Estimated.

Source: Prepared in World Payments and Economic Activity Section, International Finance Division.

May I say one thing before you leave, because one of the things that you will find is that there is no correlation between dependence on foreign oil and inflation. Many countries do better than the United States.

Before we criticize ourselves too much as a nation, we should remember that we have had the great benefit of having a boundless continent that we all grew up in that seemed to have unlimited resoures. We always had abundant and inexpensive energy; we built up our entire industrial and transportation base; and we learned to love our personal automobiles because we had that blessing. When that blessing began to come to an end, we had not prepared ourselves well to rebuild our capital stock and our transportation stock.

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Other nations did not have the blessing, so they never built the mode or standard of living that we did. Therefore, we must not be too self-critical. We must now work hard for 10 years to get ourselves on an energy-efficient basis.

Senator CURTIS. But it does provide excuses for a lot of our sins.

Mr. MILLER. Well, we should not use it as an excuse, but we should not have a sense of guilt because that will cause us to make unwise decisions. We should be mature about it, recognize why it happened, and go about solving it.

Senator HATHAWAY. Just another question or so, Mr. Miller.

When you came to the conclusion that there should be a $15 billion or so cut, that was unstructured. Just any kind of a cut of $15 billion?

Mr. MILLER. Well, that is the appropriate amount. Then as to the structure, the view was that about two-thirds of that cut should go to individuals to offset the dual effect of social security tax increases and inflation that works in progressive income tax to reduce real income. There is about an $11 billion or $12 billion impact on individuals next year, and about $10 billion in tax cuts offset that.

That left the balance to direct toward business. First, I discussed an amount in terms of the fiscal plan, and second I discussed structure from the point of view of equity to individuals in maintaining income and then a targeted program to incentivize investments for businesses.

Senator HATHAWAY. Now, just one last question in regard to the value of the dollar. You answered Senator Bentsen, I believe it was, and made certain recommendations, but is it not true that it really is not so much that the value of the dollar is going down, as it is the yen increasing and the reason for the yen increasing is that the Japanese simply cannot afford to buy a lot of the things that we would like to sell them, and that the dollar, really, relative to other currencies in the world is fairly stable? And that we should not be—sure, we should be concerned about the dollar, but we should be reminiscent of the fact that Portugal, at one time, had the strongest currency in the world, and yet 90 percent of the people were poor.

Is it not a question, the real question, is to get the Japanese to import more from us, to strengthen the dollar vis a vis the yen?

Mr. MILLER. Senator Hathaway, there certainly are two sides to it. In the case of the dollar, over 1 year on a trade-weighted basis there has been a decline against most currencies except the Canadian dollar, but there has been a very substantial change in relation to the deutsche mark, to the Japanese yen, the Swiss franc, and to those currencies which are tied to the D-mark.

And we had, in July, a breakout of the yen where it was truly no depreciation of the dollar, but just an increase in the yen. But that ended, and already in August we began to have all currencies changing in relation to the dollar. So I think we have to admit that the dollar has been weak against many major currencies.

However, that does not lessen your point which is well taken. The way you correct it is to correct the imbalances. The Japanese have accumulated large surpluses and we have accumulated large deficits. And that is why we must have an export drive, get Japan to be more open in its markets to American goods, and why we must make the adjustment in the world to get us back in equilibrium for everybody's

good—for the Japanese, too. They consider their surplus a problem; we consider our deficit a problem.

They each work to keep the status quo going. Their strong yen means everything they buy—oil, for example—is down in price. Therefore, their inflation is down, because the oil is sold to them in dollars. It now takes 30 percent less yen to buy a dollar than it did a year ago. So if you can buy a barrel of oil with the same dollars, you spend 30 percent less yen.

Now, that means their prices go down and their inflation is less. On the other hand, that means that our inflation is more and each of them continue—in one case it makes the yen stronger and in the other case it makes the dollar weaker.

So it is a very difficult problem, which we are going to be working with and I feel very strongly that we are going to correct it. That is why we need an energy bill in place and anti-inflation programs that are strong; it is also why we need to take unpopular actions to do some things like deferring minimum wage and reforming social security. They are unpopular things, but they are the medicines that go with correcting fundamentals that have, for 12 years, been allowed to go in the wrong direction.

Senator HATHAWAY. Mr. Miller, thank you very much for your excellent testimony and your excellent answers to our questions.

Mr. MILLER. Thank you.

Senator HATHAWAY. It was nice to have you with us.

Mr. MILLER. I am delighted to be here, Senator.

[The prepared statement of Mr. Miller follows:]

STATEMENT OF G. WILLIAM MILLER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. Chairman, I am pleased to participate in the Finance Committee's hearings on tax legislation. While decisions regarding taxation fall outside the province of the Federal Reserve, the System is certainly not a disinterested observer. I hope that my appearance today will contribute to the development of a coherent set of public policies to deal equitably and effectively with the economic problems confronting the nation.

ECONOMIC ACHIEVEMENTS AND CONCERNS

The past 3½ years of economic expansion have brought substantial gains in production and employment. This may be seen in the first of the attached charts. Real gross national product has increased more than 18 percent, and total employment has risen by almost 10½ million. A larger proportion of our people have jobs today than at any time in the nation's history.

Even so, unemployment remains unacceptably high among some segments of the population—especially certain minority groups and youth. And there are areas of the country that, owing to their particular industrial mixes or to other factors, have lagged noticeably in economic recovery. We must make certain that all of our people have an opportunity to achieve a greater measure of prosperity. But in setting monetary and fiscal policy we must also recognize that many of these lingering elements of weakness in the economy reflect structural problems that will not be solved through rising levels of aggregate demand alone.

Indeed, while there is a clear need to maintain the upward momentum of economic activity, we must be increasingly alert to the need to avoid excessively rapid growth. It is desirable that the pace of expansion moderate as a business cycle upswing matures and the economy approaches high levels of utilization of labor and industrial capacity. At times in the past aggregate demand overshot the level at which these resource constraints became significant, and inflationary pressures mounted dramatically. We cannot run the risk of repeating that mistake.

Inflation is the preeminent economic concern of our people today, and the greatest threat to the vitality of the current expansion. The advance in prices has accelerated sharply this year, averaging almost 10 percent, at an annual rate, at the consumer level. Food prices have been a major element in this step-up in inflation. While there have been signs recently of improvement in that sector, other prices are continuing to rise briskly, as may be seen in Chart 2. Across the economy, cost pressures have remained intense, reflecting in part the effects of a rise in the minimum wage and of increased employer contributions for social security and unemployment insurance. At the same time, the depreciation of the dollar in international exchange markets has raised import prices and reduced the competitive pressures on prices of domestically produced goods.

SETTING THE DIMENSIONS OF THE TAX CUT

Under the circumstances, Congress must weigh with great care the size and composition of its tax program. A tax cut certainly should provide no more stimulus than is necessary to sustain moderate economic expansion; anything more could jeopardize our chances of restraining inflation. It should also be structured in a way that recognizes that our tax system exerts a powerful influence on our economy through the incentives it provides for work and for capital formation. The Congress can take a significant step toward the enhancement of our nation's economic welfare by paying heed to these "supply-side" effects. In the remainder of my statement, I want to discuss briefly both the size and shape of a desirable tax cut today.

It is my judgment that a tax reduction in the vicinity of $15 billion being discussed by Congress would be appropriate for the coming calendar year. Despite some bumpiness related to strikes and weather this past winter, the recent pace of economic expansion has on balance been satisfactory. However, available indicators of future economic trends suggest that, in the absence of some fiscal adjustment, private demands might well prove insufficient to sustain growth that is strong enough to prevent the unemployment rate from rising in the next year.

As illustrated in Chart 3, consumer buying sentiment remains generally favorable, but the savings rate is already at a fairly low level and debt repayment burdens are at a record high. Consequently, consumption expenditures, which up to now have been a dynamic factor in the expansion, are likely to provide little impetus to activity. Housing starts (shown in Chart 4) have remained at a high level thus far this year; given the tighter conditions that have developed in the mortgage market, however, it is probable that residential construction activity will begin to taper off in upcoming months. Businessmen meanwhile remain hesitant about undertaking major capacity-expanding outlays for plant and equipment. Recent data on orders for machinery and other capital goods have been on the weak side, as may be seen in Chart 5, and these suggest that real business fixed investment may grow rather sluggishly over the next few quarters.

Against this backdrop, a reduction in Federal taxes next year would provide timely support to spendable income. It must be remembered that without a tax cut we would actually be facing a substantial tax increase in 1979. Mandated social security tax increases alone will boost Federal revenues by about $8 billion; in addition, taxes for individuals will be increased another $8 billion or more by the interaction of inflation and the progressive income tax structure. As a result, a tax cut on the order of that embodied in the House-passed bill would serve only to neutralize the impact of these other revenue changes already in train.

Of course, it is also essential to consider the expenditure side of the budget ledger when determining the size of tax cut that can be afforded. If we are to have any real hope of containing inflationary pressures, it is imperative that the budget deficit be reduced from the $50 billion level projected for the current fiscal year. Spending cuts of the dimension recommended recently by the Administration would permit reasonable progress toward the longer range objective of restoring budgetary balance—even with a tax cut. A narrowing of the deficit to the $40 billion area also would be consistent with sustained economic expansion and further sizable gains in employment.

PROVIDING TAX RELIEF TO THE HOUSEHOLD SECTOR

The next question is how a tax cut of the proper over-all size should be structured in order to make the maximum contribution to the achievement of the goals of full employment, price stability, and a sound dollar. The fact that there will

be substantial contemporaneous increases in taxes on individuals suggests the desirability of allotting to this group a large share of the tax reduction. Rising prices of food and other necessities have strained the budgets of many households, and these hardships should not be intensified. In this respect, the distribution of the tax cuts between the household and corporate sectors implied by H.R. 13511 appears reasonable. However, I have some doubts regarding the particular devices employed in delivering this tax relief.

As I noted earlier, a significant portion of the tax cuts would serve only to offset the revenue impacts of scheduled social security tax increases. It might reasonably be asked, I think, whether it would not be more desirable simply to defer the 1979 social security tax changes. This course of action would have some significant advantages. Besides bolstering disposable personal income, it would avert another inflationary impulse to the structure of labor costs. The Board's staff has estimated that the scheduled increase in employer contributions to social security would add roughly one-half percentage point to inflation next year.

A one-year deferral of the further tax increases dictated by the Social Security Amendments of 1977 would not place undue strain on the resources of the trust funds. Nevertheless, a deferral should be enacted only with an explicit and urgent commitment to action that deals realistically with the remaining long-range problems of the Social Security System. Last year's legislation did ensure the System's financial viability by making much needed corrections of the benefit computation formula and by increasing contributions. But the people of this country are faced with the prospect of a rapidly growing financial burden, and a social security tax that is both inflationary and regressive. I would recommend that Congress undertake a comprehensive study of the Social Security System so that needed legislation could be enacted next year.

THE NEED TO INCREASE BUSINESS INVESTMENT

In considering the corporate and capital gains tax provisions of H.R. 13511, I would hope that this Committee would focus its attention particularly on how the proposed cuts would contribute to the enhancement of business fixed investment. The performance of capital spending in this economic expansion has been most unsatisfactory. Real business fixed investment reattained its previous peak level only in the second quarter of this year—much later than has been the case in other cyclical upswings. Furthermore, the growth of the nation's capital stock has not kept pace with the increases in its work force. Indeed, as may be seen in Chart 6, throughout the 1970s the ratio of capital stock to labor has fallen ever shorter of its earlier growth trend line, and this undoubtedly has been a significant factor in the slow growth of productivity we have experienced over this period.

Capital accumulation is a critical ingredient in the long-range growth of labor productivity and the raising of living standards. To compensate for the neglect of recent years, as well as to accommodate to the reality of scarcer and more expensive energy, a larger share of GNP must now be devoted to the expansion and modernization of the nation's capital stock. It will not be enough simply to reach the investment proportion of 10½ to 11 percent that has been characteristic of past periods of prosperity and low unemployment. In my opinion, the nation must set an ambitious goal of, say, 12 percent of GNP for an extended period—a level that would foster more rapid improvement in productivity and faster economic growth.

SOME SHORTCOMINGS OF THE CAPITAL GAINS AND CORPORATE INCOME TAX CUTS

The capital gains and corporate income tax cuts in the House bill should provide some impetus to business capital formation and represent moves in the right direction. What must be considered is whether they are the most effective measures that might be taken at this time. I have some reservations on this score.

There is, as you know, considerable controversy about the effects of a capital gains tax cut on investment and on Federal revenues. This is not surprising. A change in capital gains treatment would work its influence through a complex and uncertain set of channels. In assessing the impact on business capital formation, one must contend with the fact that the tax change would affect investment by both households and businesses in all sorts of assets, ranging from diamonds to real estate. How much effect that tax cut would have on the price of corporate stock and thus on the cost and availability of equity capital is unclear; and

how this would translate into acquisition of new plant and equipment is a further uncertainty.

Still, a reduction in capital gains taxes does have its attractions. It would, for example, bring some relief to investors who are confronted with very high effective real tax rates—ofttimes exceeding 100 percent—because their cost bases in calculating capital gains do not rise to reflect inflation. It would also benefit young, emerging firms which have little current income and thus are not in a position to benefit from other changes in business taxes; lower capital gains taxes would encourage equity investment in such enterprises. All things considered, I would conclude that some cut in capital gains taxes would be appropriate, but I would not assign it as high a priority as other tax actions whose impacts on investment are more direct.

My reservation about the capital gains provisions of the House bill extends to the corporate tax changes as well. Again, insofar as incentives for business investment are concerned, the bill uses a shotgun approach rather than a rifle. It does provide for a phased liberalization of the investment tax credit, with an estimated first year impact of $500 million, but the bulk of the corporate tax reduction occurs through a lowering of the rate structure. Although lower tax rates would improve after-tax profits, the linkage between this improvement in cash flow and spending on new plant and equipment is a loose one. The additional cash might be channeled into any of a number of uses—including the acquisition of other firms, the purchase of securities, or an increase in dividends. It thus seems quite likely that a smaller gain in real investment would be achieved for a given dollar of tax revenue loss that would be the case with tax reductions that are linked directly to capital expenditures. While some cut in corporate tax rates is desirable—in part to enhance the profitability of businesses in less capital-intensive sectors such as services and finance—greater emphasis should be placed on other, more efficient, tax incentives for investment.

THE ADVANTAGES OF MORE DIRECT TAX INCENTIVES FOR INVESTMENT

Accelerated depreciation is a very efficient way to encourage investment. The tax benefits of faster depreciation accrue to a firm only after new plant and equipment has been put in place. In addition, enlarged depreciation allowances would redress—if in an indirect way—the serious drag on real corporate profitability that has occurred in recent years as inflation has caused replacement costs to exceed depreciation deductions by a wide margin.

Larger investment tax credits also provide direct incentives to capital formation and therefore are more efficient in stimulating investment than are corporate tax rate cuts. As with accelerated depreciation, a firm only receives a tax benefit if it acquires—or, under the current proposal, rehabilitates—a capital good. There are, however, likely to be differences in the cost-effectiveness of accelerated depreciation and investment credits—that is, in the degree of investment stimulus per dollar of tax relief. These differences will hinge on some rather technical factors, among the most critical of which is the importance that businesses attach to the time-pattern of their income. When firms require very short pay-off periods for investment, accelerated depreciation will tend to be more cost-effective than tax credits in stimulating capital outlays. There unfortunately is no simple, direct way to measure the relevant variables; however, it is my judgment that at the present time, when changes affecting the environment in which firms operate seem to occur rapidly nad unpredictably and businessmen are highly risk-averse, faster depreciation is likely to yield the greatest addition to investment per dollar of tax reduction.

A NEW CHALLENGE FOR FISCAL POLICYMAKERS

I hope that the Committee will find the foregoing remarks helpful in its deliberations on the tax bill. The issues that it must address are many and complex. The Congress has made notable progress in the past few years in bringing better order to the nation's finances. The Congressional Budget Act has accomplished a great deal in providing for a more effective means for setting the over-all levels of revenues and expenditures consistent with the prospective strength of aggregate demand. But traditional demand management policies are not sufficient to solve many of the basic problems of the economy. Thus the Congress now faces a further challenge—to structure its fiscal actions so as simultaneously to satisfy the criterion of equity, to minimize inflationary pressures, and to provide adequate incentive for growth and productivity enhancing capital formation. This is no small order, but conditions in the domestic and international economy demand that you aim for no less.

Chart 1

OUTPUT, EMPLOYMENT, AND UNEMPLOYMENT

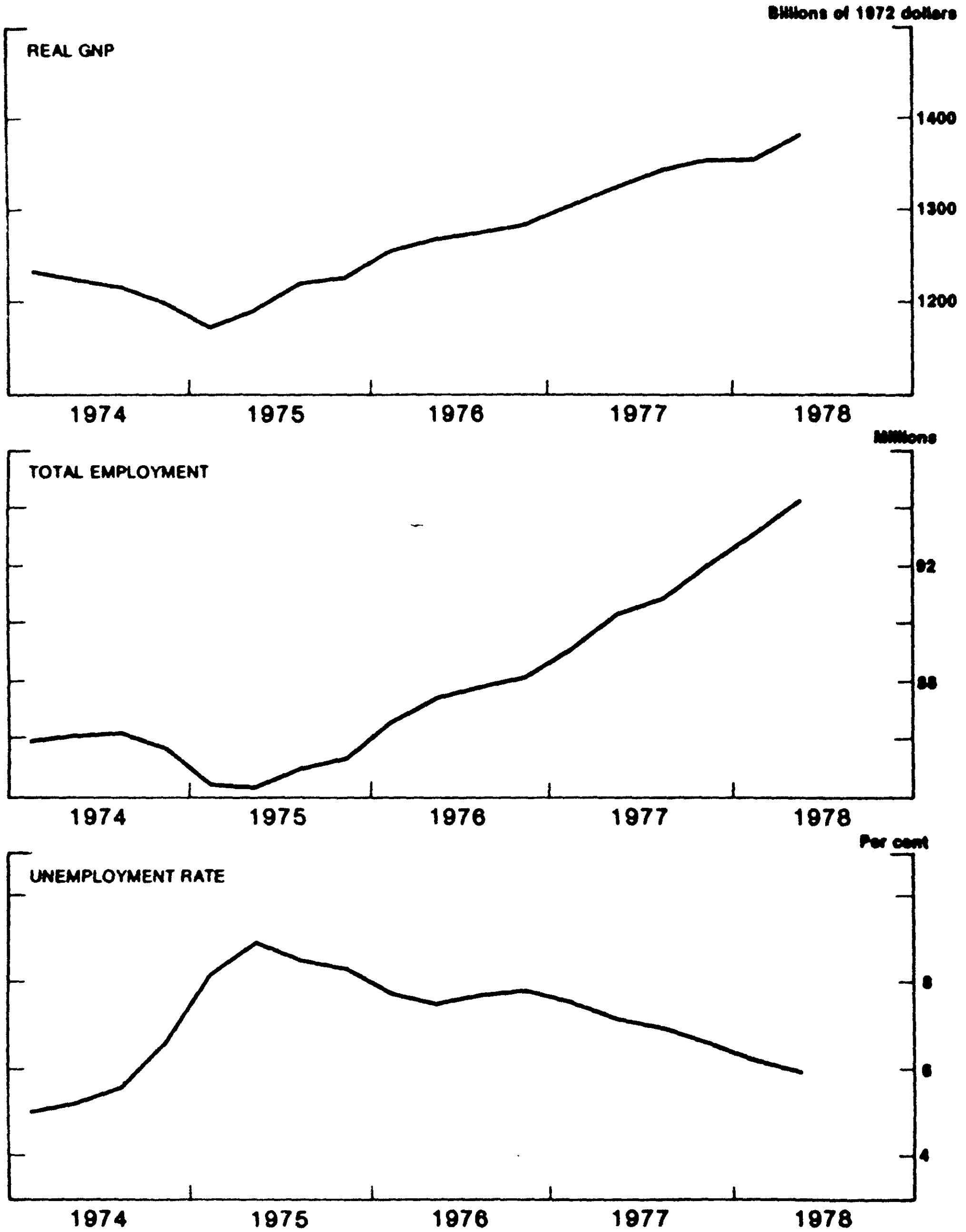


Chart 2

MEASURES OF PRICES AND LABOR COSTS

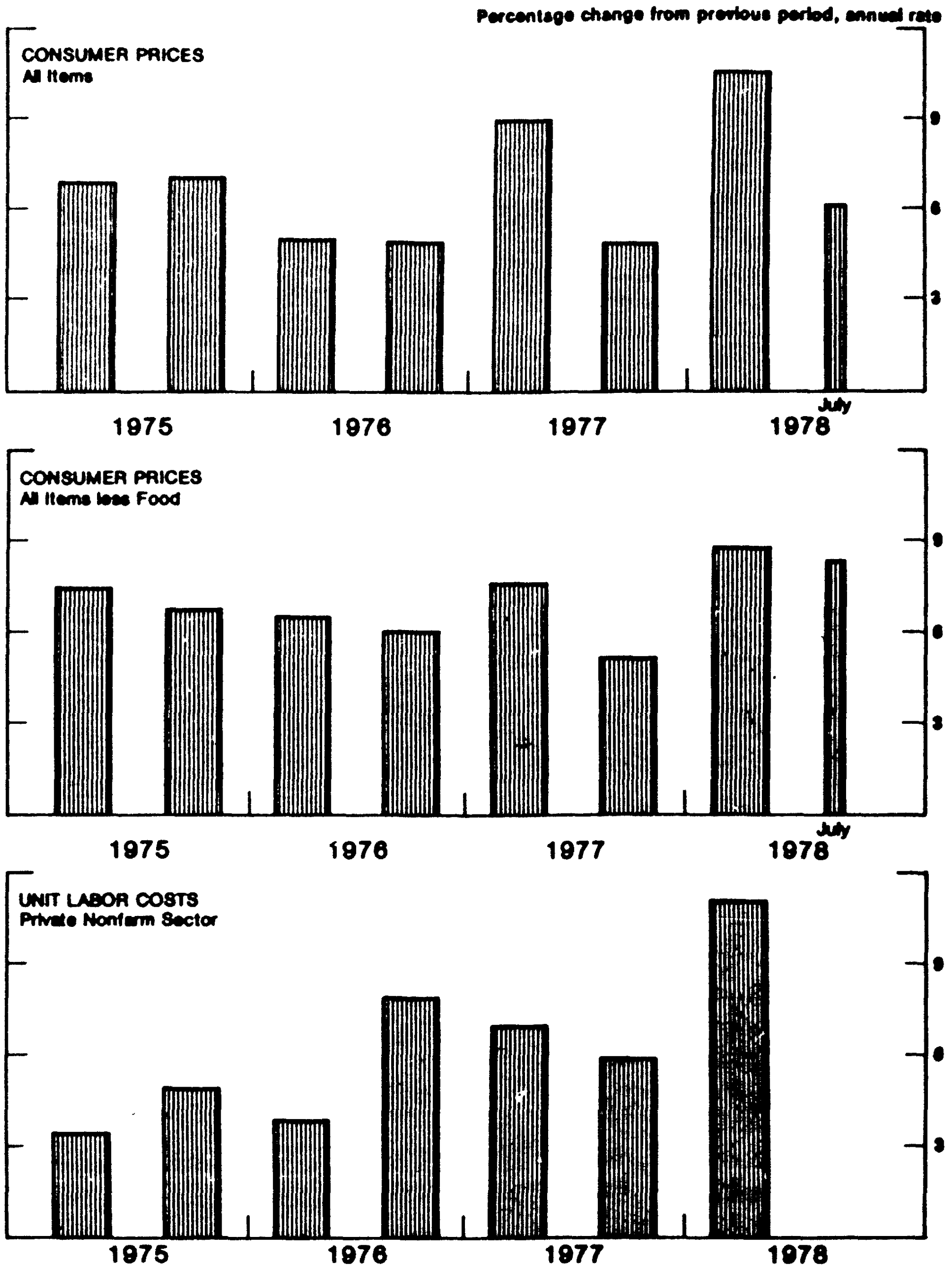
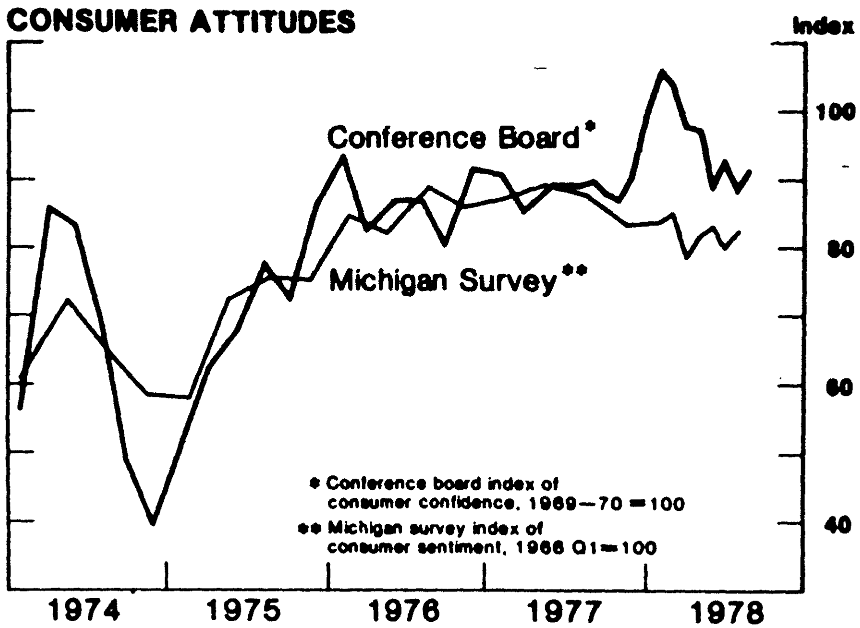
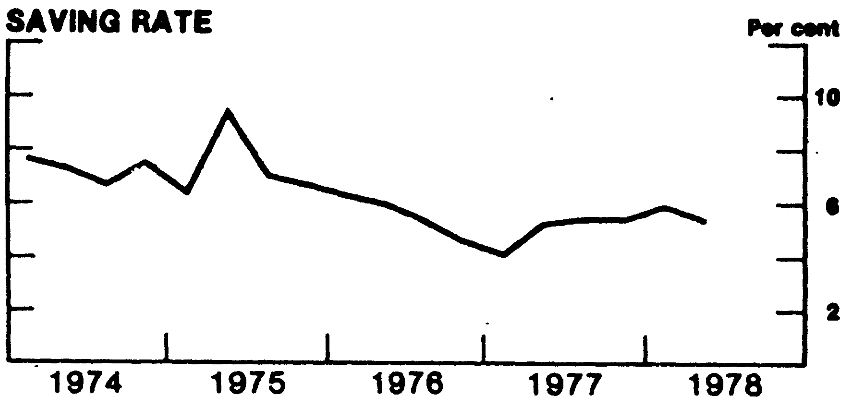


Chart 3





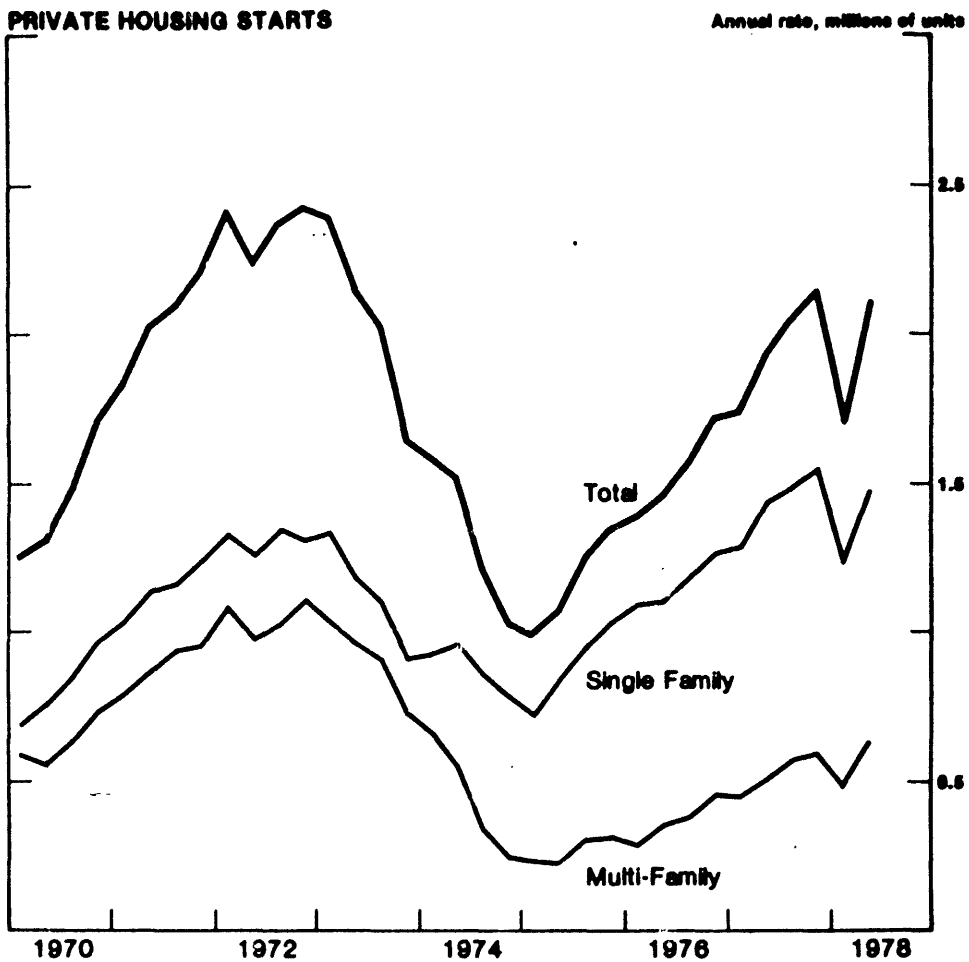
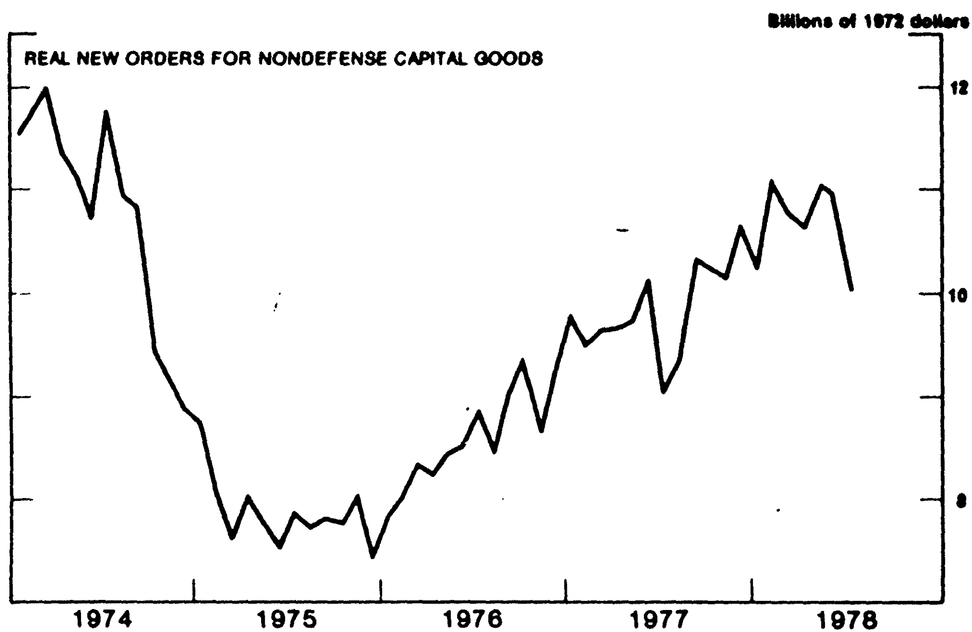


Chart 4
PRIVATE HOUSING STARTS
Annual rate, millions of units
2.5
1.5
0.5
Total
Single Family
Multi-Family
1970
1972
1974
1976
1978

Chart 6

BUSINESS CAPITAL SPENDING ACTIVITY



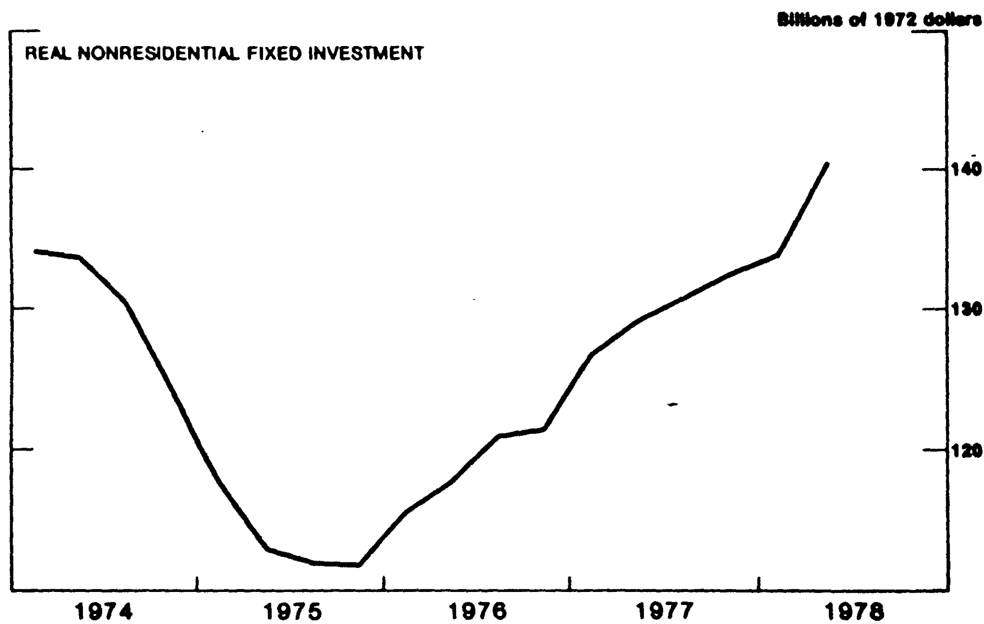
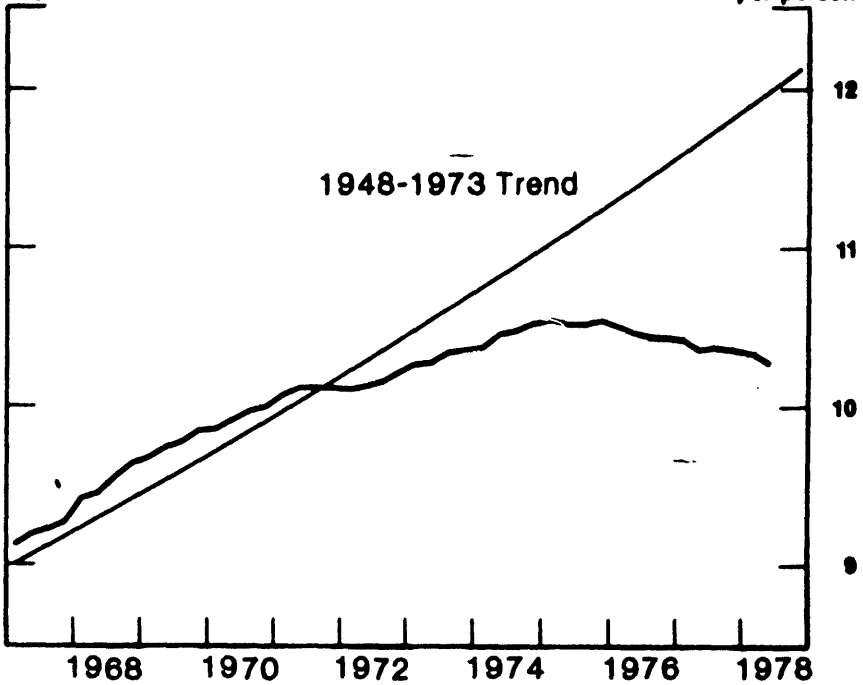


Chart 8



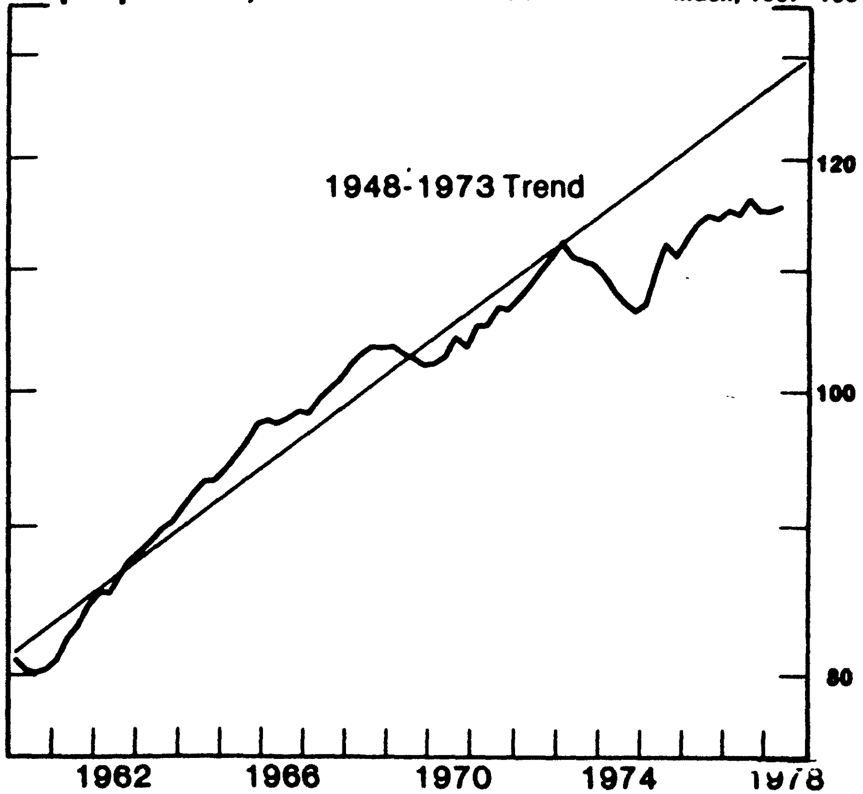
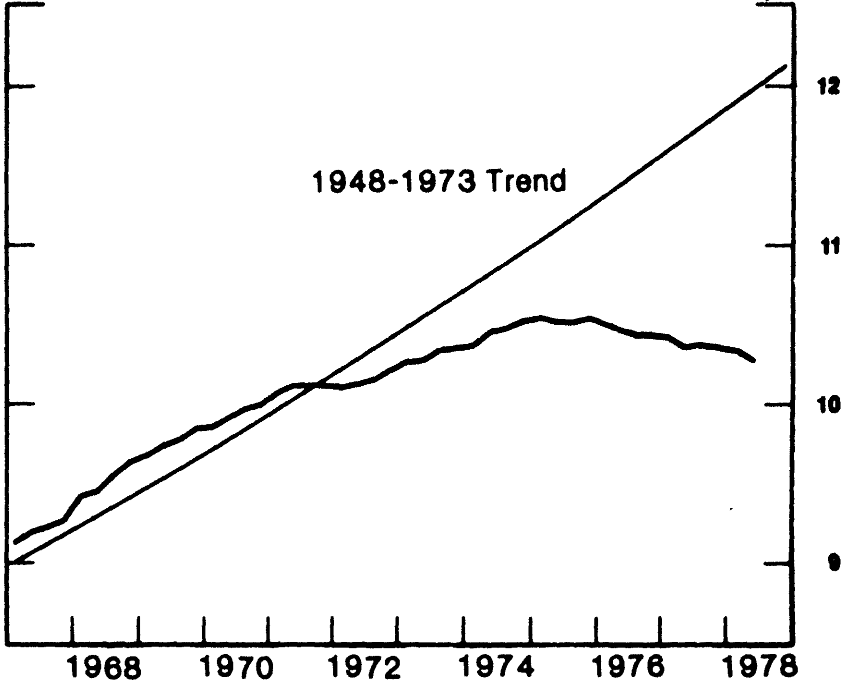
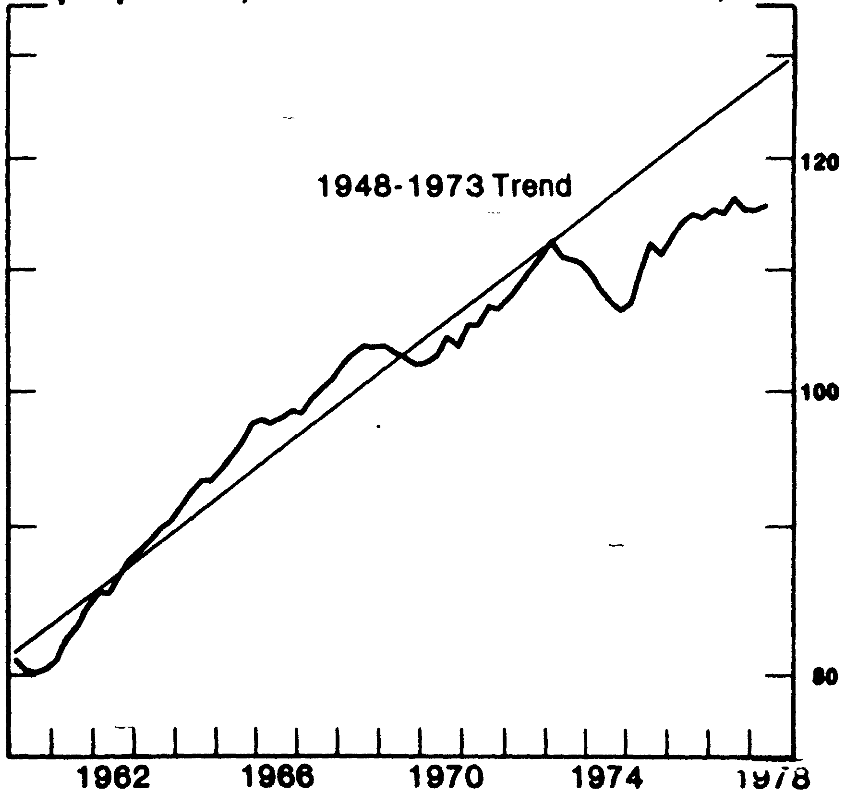


Chart 6





[Thereupon, at 12:30 p.m., the committee recessed, to reconvene at the call of the Chair.]

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