TAX CUT PROPOSALS

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SIXTH CONGRESS

SECOND SESSION

JULY 23, 24, 25, 28, 29, 30, AND 31, 1980

PART 1 OF 3 PARTS

ADMINISTRATION WITNESS
(JULY 23, 1980)
AND COMMUNICATIONS

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WEDNESDAY, JULY 23, 1980

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

The committee met, pursuant to call, at 10:05 a.m., in room 2115, Dirksen Senate Office Building, Hon. Russell B. Long (chairman of the committee) presiding.

Members present: Senators Long, Byrd, Nelson, Bentsen, Matsunaga, Moynihan, Baucus, Boren, Bradley, Dole, Packwood, Roth, Danforth, Chafee, Heinz, and Wallop.

[The press release announcing these hearings and the prepared statements of Senators Nelson and Wallop follow:]

Press Release #H-34

P R E S S   R E L E A S E

FOR IMMEDIATE RELEASE
June 30, 1980

UNITED STATES SENATE
COMMITTEE ON FINANCE
2227 Dirksen Senate Office Bldg.

FINANCE COMMITTEE ANNOUNCES HEARINGS ON TAX CUT PROPOSALS

The Honorable Russell B. Long (D., La.), Chairman, today announced that the Committee on Finance will hold hearings on various tax cut proposals beginning Wednesday, July 23. The hearings will begin at 10:00 a.m. each day in Room 2221 of the Dirksen Senate Office Building.

Senator Long noted that the overwhelming majority of Republicans in the Senate favor immediate enactment of a tax cut, while the overwhelming majority of Senate Democrats voted to table the Republican amendment, principally because they prefer to follow the orderly legislative process. The Senate Democrats have themselves called upon the Committee on Finance to report to the Senate "a responsible, targeted anti-inflationary tax cut to take effect in 1981." The hearings are intended to develop the information the Committee needs to fashion this kind of tax cut.

Witnesses who desire to testify at the hearings should submit a written request to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D. C. 20510 by no later than the close of business Friday, July 11, 1980.

Legislative Reorganization Act.--Senator Long stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify should comply with the following rules:

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

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

(3) The written statements must be typed on letter-size paper (not legal size) and at least 100 copies must be submitted by the close of business the day before the witness is scheduled to testify.

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

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

Written Testimony.--Senator Long stated that the Committee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length and mailed with five (5) copies by Friday, August 1, 1980, to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D. C. 20510.

U.S. Senator Gaylord (202) 224-5323

NELSON

WISCONSIN

NELSON SAYS ANY NEW TAX CUT MUST BE DESIGNED TO BOOST PRODUCTIVITY

WASHINGTON, D.C., July 23, 1980 -- Sen. Gaylord Nelson (D-Wis.) said Wednesday that any new tax cut must be designed to boost productivity, and he cautioned against "any purely political, election-year, irresponsible tax cut proposals which would simply fuel a new round of inflation."

In a statement released before the Senate Finance Committee, which this week opened seven days of hearings on various proposals for individual and business tax cuts, Nelson said that "any tax cut must be targeted to help the economy, improve productivity and reduce the tax burden on both individuals and businesses, without being inflationary."

Nelson said that individual tax cuts must be considered in light of the increased Social Security taxes scheduled to go into effect next January. Nelson said the Finance Committee "should carefully review all responsible proposals for reducing the tax burden on individuals and helping increase individual savings and investment." Individual savings, he said, are currently at their lowest level in 30 years. "Without savings," Nelson said, "there can be no money loaned for capital investment. Without investment, productivity declines, inflation increases and there aren't many new jobs created."

Nelson said business tax cuts must encourage investment to help modernize the nation's industrial plant, rebuild the economy, increase productivity, provide new jobs, fight inflation and enable the United States to become more competitive in world markets.

Nelson focused on the need to modernize the nation's industrial plant: "Our industrial plant is, on average, twice as old as those of our major international competitors," he said. "We cannot compete in world markets without a massive modernization program which will require enormous capital investment. The best source of this additional capital will come from changing our present depreciation system to allow accelerated depreciation for businesses so they can get the capital they need to modernize their plant and equipment and create new jobs."

Nelson said his proposals represent "a responsible approach to a productivity-related tax cut. In my judgment," Nelson said, "it would be totally irresponsible to rush into an election-year tax cut if the consequence were to be another round of inflation. The last thing we want to do is enact an irresponsible, politically-expedient tax cut at the expense of the nation's economy."

Statement of Senator Malcolm Wallop
Before the Senate Committee on Finance
July 23, 1980

Mr. Chairman, I want to thank you for holding these hearings on the state of the economy so that this committee and the Senate can act upon tax cut legislation at the earliest possible date. I am confident that these hearings will reconfirm the conclusion of many economists and Senators that immediate tax relief is needed for both individuals and business.

It is unfortunate that meaningful progress on tax legislation cannot go forward in a cooperative effort between this Administration and Congress. This Administration is trying to paint tax relief efforts in this session of Congress as inflationary, but it dangles the promise of some sort of nonspecific tax relief after the elections. In the meantime we are left with a prescription of the same economic policies that recently brought President Carter's self-styled misery index as high as 24 percent. The most recent figures for May 1980 put his misery index at 18.4 percent with a 10.6 percent inflation rate and unemployment at 7.8 percent.

The economic policies which have given us the Carter recession and double digit inflation will still provide increased revenues to the federal government despite the recession. During 1981 higher oil prices will boost crude oil tax revenues to around $27 billion, inflation induced bracket creep will increase income tax receipts by some $14-15 billion, and social security tax hikes will add $18 billion to the Treasury. The federal government will increase tax receipts by around $60 billion over the next year! With revenues increasing at this rate, one has to wonder why an administration could not balance the budget. Yet next year our budget will be in deficit by some $30 billion. By enacting a tax cut we will only slow the rate of increase in federal tax receipts. A $30 billion tax cut would still leave the federal government with $30 billion in increased revenues.

Clearly there is a need to moderate the economic drag that the Administration's inflation based tax system will have on our postponed recovery. We cannot allow the American taxpayer to be pilloried by these tax increases while the Administration plays politics with the economy. We will only extend the recession and delay real economic recovery to some time beyond the end of this year unless carefully structured tax cuts are enacted. The Department of Commerce recently reported that the nation's economic output contracted at 9.1 percent seasonally adjusted annual rate in the second quarter of this year. During this period the decline of real gross national product stood at 1.2 percent. The chief economist for the Commerce Department has called for tax cuts coupled with a continued battle on the inflation front to arrest the decline in after tax incomes.

Mr. Chairman, it is clear that tax relief is needed for individuals and business, both in terms of providing equity and establishing the basis for solid economic growth -- with price stability. The Republicans on this committee have endorsed one approach that gives needed tax relief for individuals and will induce productivity enhancing investments for industry.

This proposal has not come in the form of the traditional cut-and-paste Christmas tree tax bill we have seen so often in the past. I agree that a Christmas tree tax bill with insignificant adjustments in taxes is not in order. What we are calling for is an agenda of tax reductions for both individuals and business which will allow people to plan their savings and investments and allow some dynamic response to tax stimulus in the economy. It is especially important to provide some predictability to the private sector. One election year gimmick will not accomplish this. We must give business and individuals an opportunity to plan investments and purchases which alone will help bring us out of recession into real economic growth.

The allegation that Congress and the Administration cannot structure a sound tax cut in an election year implies that this election year is somehow politically different than 1976, 1978, or the other election years when Congress has enacted needed tax relief legislation. It is difficult to stave off pressures to enact special interest tax legislation that is inflationary. There is a need for, but no sign of, leadership on the part of the President to help guide sound tax legislation through Congress. When there is such a desperate need for tax relief and increased productivity, the American people should not be kept waiting until after the elections. If the leadership required to guide sound tax changes through this Congress is not at hand, then the American people will demand leadership that can do the job, and they will get it.

The CHAIRMAN. The committee will come to order.

The committee today will consider testimony relevant to a reduction of income taxes. In order to get on with the business, I am not going to make any opening statement. If others want to say something, I will be glad to call on them.

Senator DOLE. I would just like to submit a statement for the record, and indicate, as we have just a few minutes ago, that it is our hope, the hope of many Democrats and Republicans, we will have a tax cut next year. Nobody is advocating a cut for 1980. We are just suggesting that we ought to do something this year to make it effective next year, because we must reorganize the Congress, and there could be other changes. We could be in March, April, or May before anything might be done next year.

So I appreciate the distress that the Secretary finds himself in with the economy and other areas, but I would hope that we could agree that we could take some action that would be effective next year.

I will put my statement in the record.

[The prepared statement of Senator Dole follows:]

JULY 23, 1980

STATEMENT OF SENATOR DOLE ~~For Econ~~

ON THE NEED FOR A TAX CUT

Monday ~~YESTERDAY~~ PRESIDENT CARTER SENT THE CONGRESS HIS "MID-SESSION REVIEW" OF THE ECONOMY. THE DATA CONTAINED IN THE REPORT WERE WORSE THAN EXPECTED IN EVERY RESPECT. THE EXTENT TO WHICH WE ARE IN THE MIDST OF A SEVERE RECESSION BECOMES QUITE CLEAR. THE BUDGET DEFICIT FOR F.Y. 1980, WHICH WE ESTIMATED LAST MARCH AT $36 BILLION, HAS GROWN TO $61 BILLION. IT IS POSSIBLE THAT BY THE TIME THIS FISCAL YEAR IS OVER WE WILL HAVE THE BIGGEST DEFICIT IN OUR HISTORY. THE 1981 BUDGET, WHICH WE WERE TOLD WAS BALANCED JUST A FEW WEEKS AGO, IS NOW ESTIMATED TO BE $30 BILLION IN DEFICIT. SOME HAVE SUGGESTED THAT BY THIS TIME NEXT YEAR THAT $30 BILLION FIGURE MAY HAVE GROWN TO OVER $50 BILLION.

AS BAD AS THESE DEFICITS ARE, THEY ARE NOT THE WORST NEWS IN THE MID-YEAR REPORT. THE CARTER ADMINISTRATION PREDICTS THAT THE UNEMPLOYMENT RATE FOR THE FINAL QUARTER OF THIS YEAR WILL BE 8.5%. TO PUT THIS FIGURE IN REAL TERMS, WE ARE TALKING ABOUT OVER EIGHT MILLION MEN AND WOMEN OUT OF WORK. ON AN ANNUALIZED BASIS THIS IS AS HIGH AS ANY PERIOD SINCE WORLD WAR II.

THE BAD NEWS DOES NOT STOP HERE. THE ADMINISTRATION IS CURRENTLY FIGHTING INFLATION WITH UNEMPLOYMENT BUT IT APPEARS TO BE LOSING BOTH WAYS. THE PRESIDENT PREDICTS THAT CONSUMER PRICES IN THE LAST QUARTER OF THIS YEAR WILL BE 12% HIGHER THAT THE LAST QUARTER OF 1979. FOR NEXT YEAR HE PREDICTS 10% INFLATION. THIS IS INTOLERABLE AND TWICE WHAT IT WAS WHEN MR. CARTER WAS ELECTED.

LAST WEEK THERE WAS MORE ECONOMIC BAD NEWS THAT SHOULD RECEIVE MAJOR ATTENTION. THE COMMERCE DEPARTMENT REPORTED THAT THE "REAL" OUTPUT IN THIS COUNTRY FELL 9.1% DURING THE SECOND QUARTER OF THIS YEAR. THIS PERFORMANCE MATCHED THE WORST PERFORMANCE DURING THE LAST RECESSION.

FACED WITH THIS KIND OF ECONOMIC SITUATION, I FIND IT HARD TO BELIEVE THAT THERE IS ANY REAL RESISTANCE TO ENACTING A CAREFULLY CRAFTED PRODUCTIVITY TAX CUT RIGHT NOW.

THE REPUBLICAN TAX CUT PROPOSAL WAS DRAFTED AFTER NUMEROUS MEETING AMONG SENATORS AND REPRESENTATIVES AND RELIES ON HEARINGS

BEFORE BOTH THE FINANCE COMMITTEE AND THE JOINT ECONOMIC COMMITTEE. OUR PROPOSAL HAS TWO PARTS:

FIRST, A PERMANENT 10 PERCENT ACROSS-THE-BOARD TAX RATE REDUCTION FOR INDIVIDUALS. THIS IS THE FIRST ONE-THIRD OF THE ROTH-KEMP BILL.

SECOND, A PHASED-IN ACCELERATION AND SIMPLIFICATION OF DEPRECIATION TO ENCOURAGE CAPITAL INVESTMENT. THIS PART OF THE PROPOSAL IS THE WELL KNOWN 10-5-3 CAPITAL COST RECOVERY SCHEDULE. IT INCLUDES SOME LIBERALIZATION OF INVESTMENT TAX CREDITS.

THE SENATE HAS HAD TWO OPPORTUNITIES TO VOTE ON THIS PACKAGE. UNFORTUNATELY IT WAS DEFEATED BOTH TIMES ON AN ALMOST STRAIGHT PARTY LINE VOTE.

THE REPUBLICAN PROPOSAL IS NOT INFLATIONARY

SOME HAVE ASSERTED THAT THE REPUBLICAN PROPOSAL IS INFLATIONARY AND DESIGNED TO HELP THE RICH. NEITHER ACCUSATION IS ACCURATE. THE 10-5-3 PROVISION WILL DIRECTLY INCREASE INVESTMENT IN PLANT AND EQUIPMENT. SUCH INVESTMENT WILL INCREASE PRODUCTIVITY. I SERIOUSLY DOUBT THAT ANYONE BELIEVES THAT THIS PART OF THE PACKAGE IS INFLATIONARY.

THE 10% RATE CUT IS ALSO NOT INFLATIONARY. A ONE SHOT TAX CUT MAY BE. CARTER'S $50 REBATE, FOR EXAMPLE, WOULD HAVE INDUCED TAXPAYERS TO INCREASE DEMAND FOR CONSUMER GOODS. SUCH AN INCREASE IN DEMAND, WITH NO INCREASE IN SUPPLY IS INFLATIONARY. A RATE REDUCTION, BY CONTRAST, SHOULD INCREASE THE SUPPLY OF LABOR AND GOODS BECAUSE ALL TAXPAYERS WILL RECEIVE A HIGHER RETURN FOR THEIR EFFORTS. INCREASING SUPPLY IS ANTI INFLATIONARY.

THE ACCUSATION THAT OUR PROPOSAL IS DESIGNED FOR THE RICH IS EQUALLY FALACIOUS. ONCE AGAIN 10-5-3 IS NOT THE TARGET OF THIS CRITICISM.

THE 10% RATE CUT PART OF THE PACKAGE DOES NOT DISPROPORTIONATELY FAVOR THE RICH. IT IS A NEARLY PERFECTLY PROGRESSIVE TAX CUT. FOR EXAMPLE, THOSE WHO EARN BETWEEN $10,000 AND $30,000

PER YEAR PAY 48% OF ALL INDIVIDUAL INCOME TAXES. UNDER THE 10% RATE CUT, THEY WILL RECEIVE 51% OF THE TAX CUT BENEFITS. A FAMILY OF FOUR WITH $17,500 IN INCOME WOULD RECEIVE A $190 TAX REDUCTION. ANYONE WHO THINKS SUCH A FAMILY IS RICH HAS NOT BEEN TO THE STORE DURING THE CARTER ADMINISTRATION.

FURTHER, THE REPUBLICAN TAX CUT WILL HELP TO OFFSET THE LARGE INCREASE IN SOCIAL SECURITY TAXES THAT IS SCHEDULED FOR NEXT JANUARY. IT DOES SO WITHOUT AFFECTING THE INTEGRITY OF THE TRUST FUND OR RESORTING TO BACK DOOR GENERAL FUND FINANCING OF SOCIAL SECURITY.

A TAX CUT IS NEEDED NOW

IF WE DO NOT PASS A TAX CUT THIS YEAR, TAXES WILL INCREASE NEXT YEAR BY ALMOST $90 BILLION. THE REPUBLICAN PROPOSAL WILL NOT REDUCE REVENUES. IT WILL MERELY SLOW THE METEORIC INCREASE OF REVENUES SCHEDULED TO BEGIN IN 1981.

SOME HAVE SAID THAT WE SHOULD WAIT UNTIL NEXT YEAR TO ENACT A TAX CUT. "WE NEED MORE TIME TO STUDY THE ECONOMY; DON'T CONSIDER A TAX CUT DURING AN ELECTION YEAR," THEY COUNSEL. TO THE 8,000,000 MEN AND WOMEN OUT OF WORK IN THIS COUNTRY SUCH ADVICE MUST HAVE A HOLLOW RING. TO THOSE WHO ARE WORRIED ABOUT THE DROP IN OUR COMPETITIVENESS, SUCH ADVICE MUST SEEM TIMID. OUR ECONOMY IS IN DESPERATE SHAPE. WE MUST ACT NOW TO REVERSE IT. WE HAVE ALREADY STUDIED THE RECESSION TOO LONG. IF WE PASS A TAX CUT NOW, EVEN ONE WITH A JANUARY, 1981 EFFECTIVE DATE, THE EFFECT ON OUR ECONOMY WILL BE IMMEDIATELY FELT. THE ORDERS FOR NEW CAPITAL GOODS WOULD NORMALLY BE PLACED NOW.

TO THOSE WHO SAY, "WAIT UNTIL AFTER THE ELECTION," I RESPOND THAT CONGRESS ACTS MOST RESPONSIBLY BEFORE AN ELECTION. LET US PASS THE LAW NOW AND STAND BEFORE THE VOTERS TO EXPLAIN OUR ACTION. THIS TYPE OF ACCOUNTABILITY IS THE BASIS OF OUR

DEMOCRATIC PROCESS. SPECIAL INTEREST GROUPS ARE MORE LIKELY TO PERVERT A TAX CUT AFTER THE ELECTION THAN BEFORE IT. I WOULD LIKE TO REMIND EVERYONE THAT WE PASSED MAJOR TAX BILLS IN 1976 AND 1978.

FINALLY, I WOULD LIKE TO NOTE THAT WE REPUBLICANS ARE NOT WEDDED TO EVERY DETAIL OF OUR PROPOSAL. WE FAVOR SOME KIND OF ACROSS-THE-BOARD TAX RATE REDUCTION FOR INDIVIDUALS AND A SPEED UP IN DEPRECIATION FOR BUSINESS. THE DETAILS ARE ALL SUBJECT TO NEGOTIATION. WHAT IS IMPORTANT IS THAT WE PASS A TAX CUT AND THAT WE DO IT NOW.

The CHAIRMAN. Are there any further statements?

Senator ROTH. Mr. Chairman, I have a statement that I, too, would like to put in the record. I would just like to add a line or two to what Bob Dole has already said.

I don't think that time is on our side. I think that we have to take action now. I am concerned by the fact that we already have 8 million workers unemployed. I am concerned that the working people of this country are paying higher taxes than ever. The typical family is paying something like $2,000 in additional taxes as a result of the 4 Carter years.

The most important reason is that I think we have to take some steps now to give a signal to the private sector of what direction we are moving. We cannot afford to just wait and see, as has been the practice of this administration.

For 4 years now, every time we talk about a tax cut—we first proposed Roth-Kemp nearly 4 years ago—they say, let's wait and see. Earlier this year it was let's wait and see if we are going to balance the budget. We are not balancing the budget, so they say, let's wait and see beyond the election year.

I say that the time to act is now. We must give a clearcut signal to the private sector that we are going to give it a chance for real growth.

[The opening statement and attachment of Senator Roth follow:]

OPENING STATEMENT BY SENATOR BILL ROTH

Mr. Carter's economic policies have been disastrous.

For the past four years, the Carter Administration has presided over an enormous increase in Government spending and tax burdens, and has opposed every effort to reduce tax rates and restrain Federal spending.

The President's attempt to balance the budget through massive tax increases has crippled our economy, resulting in continued inflation, increasing unemployment, and massive budget deficits.

It is clear we need a change in economic policy—a long-term policy based on economic growth through lower tax rates. It is not only a question of tax cuts or no tax cuts. It is a question of growth or no growth.

The President says we cannot afford a tax cut. I believe we cannot afford not to have a tax cut.

The high tax rates imposed on the American people have brought the economy to a halt—reducing savings and productivity and pushing up inflation and unemployment.

The President says we don't need a tax cut because the American people are not "suffering severely yet."

What about the eight million people now out of work, and the millions more who are threatened by unemployment, inflation, high taxes and downward mobility?

The President says we are proposing a massive tax cut.

But he neglects to say that the Roth-Kemp tax cut is not even big enough to offset the massive tax increases facing the American people.

Over the next five years, total taxes will more than double—increasing by $562 billion to a level exceeding one trillion dollars a year.

Unless taxes are cut substantially, the tax burden on the economy will reach unprecedented levels.

The President says a tax cut would be inflationary.

But he doesn't think it would be inflationary for the Government to spend the massive tax increases being imposed on the working men and women of this country.

With savings and investment rates at dismally low levels, and with the capacity rates of our nation's factories at the lowest levels in years, the biggest myth today is that a tax cut would be inflationary.

Individual tax rate reductions are urgently needed to offset the projected tax increases, to increase savings and investment, and to increase the nation's production and output and create jobs.

As we open these hearings on the need for a tax cut, I expect the Administration to oppose the need for a tax cut and to urge us to study and delay.

But for the past four years, this Administration has studied and delayed while the economy has collapsed.

The time for action on a tax cut is now.

Republicans in the House and the Senate have proposed a responsible tax cut plan providing for a reduction in individual tax rates of 10 percent and accelerated depreciation to reindustrialize our nation's economy.

Our 10 percent tax cut is not an ill-conceived election-year gimmick. In fact, I first offered the 10 percent tax cut as an alternative to the Administration's $50 rebate scheme three and a half years ago.

In addition, our tax cut proposal is far superior to the proposal floating around to give an income tax credit for a portion of the increased Social Security taxes.

For the typical family of four earning $20,000, this scheme would provide a net tax cut of only $29—compared to a net tax cut of $124 under the Republican tax cut proposal.

Mr. Chairman, the Carter Administration's economic policies have pushed the economy into a recession and thrown millions of people out of work, resulting in more Federal spending, bigger budget deficits and continued inflation.

It is time to reject the Administration's no-growth policies and adopt an economic policy based on lower tax rates for higher economic growth.

Fact Sheet—Republican Tax Cut

The Republican Tax Cut provides for a permanent reduction in individual tax rates of 10 percent and accelerated depreciation to reindustrialize our nation's productive capacity.

Individual rate reductions

The bill reduces individual income tax rates by approximately 10 percent, reducing the present marginal tax rates ranging between 14 and 70 percent to rates ranging between 12 and 63 percent. Thus, the lowest tax rate is reduced by 14.3 percent while the highest tax rate is reduced by 10 percent. By reducing tax rates across-the-board, the bill provides tax relief to the people who pay taxes, with the benefits distributed in the same proportion as current law tax liability is distributed. According to the Joint Committee on Taxation, the bill would provide taxpayers with a tax cut averaging $409 in 1981.

Revenue impact

In calendar 1981, the Republican tax cut would reduce taxes by $36 billion—$31.8 billion for individuals and $4.2 billion for business. However, because it would be effective January 1, 1981—three months after the start of the fiscal year—the fiscal 1981 impact would be $22.3 billion—$19.8 billion for individuals and $2.5 billion for business. Of course, these are static revenue estimates which do not take into account the reflows from increased economic activity.

Tax cuts versus tax increases

Substantial tax cuts are needed to offset the massive tax increases facing the working men and women of this country. Under current tax laws, total Government taxes will more than double over the next five years—increasing by $562 billion. As the following table shows, the Republican tax cut does not even begin to offset the massive tax increases facing the economy.

	Fiscal year					
	1980	1981	1982	1983	1984	1985
Tax revenues under current law	$525.7	$613.8	$706.8	$814.1	$904.2	$1,087.7
Cumulative tax increase		88.1	181.1	288.4	414.5	562.0
Republican tax cut		22.3	42.4	57.7	77.3	100.2
Individual rate cuts		−19.8	−35.4	−41.7	−49.3	−58.2
Accelerated depreciation		−2.5	−7.0	−16.0	−28.0	−42.0

Even with the full Roth-Kemp tax cuts—which would reduce taxes by $174.6 billion over a five-year period—total Government tax revenues will still increase by an enormous amount. Thus, by combining tax rate reductions with firm restraints on the growht of non-defense spending and by increasing economic growth, taxes can be reduced, defense spending can be increased, and the budget can be balanced.

Senator HEINZ. Mr. Chairman.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you.

Essentially I would like to hear what the administration now proposes as an economic policy for the United States. It is one thing to be against things that are proposed. It is one thing for the administration to oppose what we, as Republicans, are proposing. I suppose mature individuals can differ. But I find great difficulty in accepting the proposition that more of what we have been doing, which is nothing, is a successful response to our economic problems.

The record shows to the contrary. Unemployment is rising. Most importantly, based on the numbers released this morning, and I direct the Secretary's attention to this, inflation is rising. It has risen nearly two points, to 12.4 percent, which is particularly distressing given the fact that that number benefited from a reduction in gasoline prices in June, and a reduction in mortgage costs, which means quite unfortunately that all the other elements in the CPI are going up much faster than 12.4 percent.

It is hard for me to accept the notion that a good economic policy is one which counternances rising unemployment, and accelerating inflation, and this is the situation that we now find ourselves in. I would like to hear a constructive proposal, if the administration is going to continue to oppose what we have proposed.

Thank you, Mr. Chairman.

Senator CHAFEE. Mr. Chairman.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Mr. Chairman, I think the important thing about getting on with the tax cut this year, to be effective next year, is so that people can make their plans.

Secondly, unemployment is predicted to be close to 9 percent from the administration's figures, and I think nothing would help to make the United States more competitive, as the Secretary has frequently testified, than more rapid depreciation; namely, the 10-5-3 plan which the Secretary has been enthusiastic about in the past.

I think this will make us more competitive, and help the job situation which is so important.

Thank you.

The CHAIRMAN. Mr. Secretary, I just want to say this with reference to what our colleagues have said here this morning.

You and I had occasion to meet at the White House yesterday. I always feel that it is not appropriate for me to quote what the President said at those morning meetings at which he invites people like you, and sometimes like me, to visit and talk about these matters. The last time we met, it sounded like I was in the minority, but I think on this committee, my view is on the majority, which is reflected by what has already been said, and I think will be reflected by what my Democratic colleagues will say when their turn comes in the course of interrogation.

The Democratic Caucus voted to oppose the tax reductions offered from the Republican side of the aisle only for the reason that they felt we ought to hold hearings on the matter. But their expression at that point was that there should be a tax cut voted this year, and they indicated that they feel that the effective date ought to be January 1, 1981.

Philosophically, on the question of whether there should be a tax cut or not, I believe that it is safe to say that on this side of the aisle the sentiment, certainly in this committee, and I think in the Senate, is favorable to a tax cut to be voted this year, notwithstanding the very eloquent statement that you are quoted as having made before the Ways and Means Committee yesterday.

Senator Byrd, did you want to be recognized?

Senator BYRD. Yes, Mr. Chairman. Thank you.

I want to say that I have a copy of the Secretary's statement. I read it last evening. It is 30 pages long. If it is read in full, it will be more than 1 hour. I would hope that we would have as much time as possible for questions because I think that is where we will get the more valuable information.

I myself have a great many questions that I would like to propound, so I would hope that the formal presentation would be as brief as possible.

The CHAIRMAN. I believe I speak for all of us, Mr. Secretary, when I say that we have the highest admiration for you as a talented, sincere, dedicated individual. I believe all of us feel that there is room for difference of opinion about some of these things, and we certainly will welcome your views expressed here today, and we will give them careful consideration. I know that we will on this side of the aisle.

You may proceed, sir.

STATEMENT OF HON. G. WILLIAM MILLER, SECRETARY OF THE TREASURY

Secretary MILLER. Thank you very much, Mr. Chairman.

It seems that the odds are very much loaded in your favor today, and so it may be, despite Senator Byrd's suggestion, that I will need a bit of time to counter the force that is arrayed against me. It may, in fact, be necessary for us to take as many days as possible just on my testimony if you believe, as you seem to believe, that this is an important matter for the Nation that should be looked at indepth, and should not be dealt with in some superficial and hasty way.

So with your permission, I do not want to read my entire prepared testimony. I would like it in the record. But I would like to hit parts of it, and I would like to walk the committee through a series of charts that I have prepared, which I think can demonstrate in a visual way some of the issues that we in the administration believe should be addressed.

The CHAIRMAN. Mr. Secretary, if your staff has brought some of those charts, we can provide some place for you to put them up so that the audience can see them, and we can look at them.

Secretary MILLER. I think we have copies that are perhaps available to the audience. I think there are copies for everyone.

The CHAIRMAN. Then I suggest that you simply refer to them by the words "exhibit number" with the number when you want to refer to them.

Secretary MILLER. Certainly.

Let me again express my appreciation for the opportunity to discuss this subject. The question of whether there should be a tax reduction program for next year, and I recognize that no one is suggesting that taxes be reduced in calendar year 1980. But these are complex issues that require careful study and deliberation. The timing and the magnitude of any tax reduction is particularly critical in view of the inflationary expectations and the budgetary realities, and the impact that these things have on domestic and international financial markets.

It is the considered judgment of the administration that Congress should not seek to enact tax cutting legislation prior to the national election. These hearings, and the hearings in the House, and hearings before other committees could lay the foundation, and do the homework, and make it possible to move quickly after the election, next year, if the circumstances, the facts and the basic issues were in favor of that direction.

I do not believe, therefore, it is inconsistent with what has been expressed this morning by a number of Senators for us to have the hearings, but to have also the patience to go about this process in a responsible way, and not create the impression in America that what we are trying to do is rush through a tax cut for election purposes.

I think that this is the way to make sound policy, and if we are seeking sound policy of a mutual bipartisan basis, we can do it just as well after the election, and still have the effective dates which are being sought by some proponents.

I, yet, am not prepared to say that the data require us to move in that particular way, although we are openminded and want to discuss the issues indepth.

During 1981, it may be that properly targeted tax cuts directed at strengthening the productive foundations of our economy will prove to be desirable. If those can be designed with care as part of an overall economic program, as Senator Heinz suggested, then the actions may well improve our economic performance over the next several years. But hasty tax cutting now could be counterproductive.

One of the causes of the current recession, certainly not the only cause but one of the causes, was the fever of inflationary expectations early this year which brought serious disarray into the financial markets and resulted in severe credit constraints on businesses, farmers, and families.

Following the strong initiatives taken by the administration last March after extensive consultation with Congress, both inflation rates and interest rates have come down dramatically. The new CPI numbers that are out today show a continuation of the pattern of lower rates from the first quarter, and do continue to reflect the unusual circumstances of adjusting downward mortgage rates.

The biggest factor in the increase in June was again housing costs, which will now come down as the new lower interest rates are reflected with a lag in the CPI numbers. So I hope that we don't mix this technical question up with the progress that we are making in showing much lower rates of inflation, and lower interest rates.

These trends have been aided by the responsible budgetary actions taken by the Congress, and that kind of action and these trends do lay the foundation for an economic recovery. But taking premature action, which might be perceived in the marketplace as undermining fiscal responsibility, could well interrupt or reverse those trends, and impair the recovery. I think that we should move with very great caution not to undo what we have accomplished, and to start us back on a new trend of inflationary expectations.

In addition, the brief legislative session that remains before elections is just not likely to provide the time or the climate for properly analyzing the kind of structural and well-focused tax and other economic measures which are essential to the long-term health of the economy. Our joint responsibility between the administration and the Congress is to secure a robust, noninflationary path of growth for the economy over the years ahead. This objective is not served by rushing forward at this time with large injections of purchasing power, or undigested plans for transforming the revenue side of our fiscal accounts.

Acting after the election rather than in haste over the coming weeks would also allow us to gain a much better understanding of the economy's evolution into recovery, a much better view of the trends and decisions on Federal spending which are now being made in the Congress, and a much firmer consensus on other economic measures, other than taxes, needed to improve the economy's performance over the new decade.

Nevertheless, the opportunity to examine indepth the important issues before this committee is greatly appreciated. In order to do so, I propose to review long- and short-term economic developments. I intend to suggest appropriate criteria against which we can measure and evaluate any future tax program. I propose to outline some of the major choices in establishing tax policy.

There is a natural tendency to place emphasis on short-term economic policy even though the underlying problems are long term in nature. The adverse trends in inflation and productivity which we are experiencing did not occur overnight. They have been developing for at least the last 15 years. Therefore, we need to give serious attention to the origin of these and other economic problems as a basis for dealing with them effectively.

The 1950's and the early 1960's were a period of strong U.S. economic performance in both domestic and international markets. This was a period of world reconstruction following the war. The economy acted to fill up the pent up needs deferred from the war, and to contribute to rebuilding the world's economy.

It has become a more difficult world during the 1970's and early 1980's. Inflation has become a clear and present danger. Energy prices have pushed up very sharply, over tenfold, by the actions of the oil exporting countries. The international financial system has been placed under great strain. International trade has become increasingly competitive, and domestic industries sometimes bear a heavy burden of adjustment.

We face a range of solutions, no easy ways out. These problems can be mastered; but only if we face them squarely and resolutely, eschewing easy answers based purely on hope or rhetoric.

Significant gains have been made in the last few years. There is an increasing realization throughout the country that many of our economic problems are structural in nature, and long standing in origin. The energy problem is being attacked now in a coordinated way for the first time. Fiscal and monetary policies are being formulated with greater discipline to bring inflation under control. New approaches are being explored to reinvigorate the industrial sector of our economy. Substantial progress has been made in reducing the burden of Government regulation on the private economy.

At present, it is understandable that a great deal of attention is being focused and properly focused on the economic downturn. But this current recession is not something that any of us deliberately sought. It is a deep concern to all of us, whatever our other views may be. It does cause real suffering, and we need to act together to mitigate that suffering.

The downturn, also, will result in some reduction in the rate of inflation, but recovery must be charted and it must proceed without reigniting inflationary forces, or even the suffering will have been in vain.

As we contemplate recovery over the coming year, economic policies should therefore be shaped in the interest of longer run stability in our economy. The economy needs to perform much more strongly in the future in the key areas of capital formation, productivity growth, and international competitiveness, so that employment gains which we can achieve will be sustained without generating new waves of inflation. That will not be accomplished by a hasty across-the-board tax cut. Any tax program to reinforce recovery should be carefully constructed to be consistent with overall economic objectives.

If our difficulties were simple or of recent origin, the straightforward countercyclical use of fiscal policy might meet the needs of the situation. But our problems are deep seated. They have developed over a long period of time. Simply pumping purchasing power into the economy will not raise the capital-labor ratio. It will not increase the rate of growth of potential output. It will not improve the competitive ability of the United States in foreign markets.

The range of policy options that we should have under active consideration can best be appreciated by reviewing the general trends of economic events that form the background to the current situation.

There have been three basic periods of economic development since World War II. The first was the postwar reconstruction period from 1945 to 1965. Then there was an era of transition to the new balance of economic reality in the world that took place between 1965 and 1976, which was impacted by some very important historical events. Then there is the recent period of reforming and redirecting our strategy toward the future that has taken place in the period since 1976.

Mr. Chairman and members of the committee, let me address these issues by referring to the exhibits. I might just start with exhibit 1.

This particular chart shows in the solid line that runs from left upward to the right the real growth in GNP for our economy. This is the growth in GNP in constant 1972 dollars. What we see is a continued upward trend. At the right upper corner we see a sharp break downward in the great recession of 1974–75. that is the biggest interruption in growth we have had in this whole postwar period.

The important thing is, if you look at the bar charts, the three bars at the bottom, you will see the first one shows what the average growth of real GNP has been from 1947 to 1965, the era of reconstruction. During that period, real growth per year was 3.9 percent. In this period of transition, the period 1965 to 1976, our growth rate dropped to 2.9 percent a year. In the period 1976-79, we have had a resurgence of real growth at an annual rate of 4 percent.

I will turn to exhibit 2. Let's us at the relation——

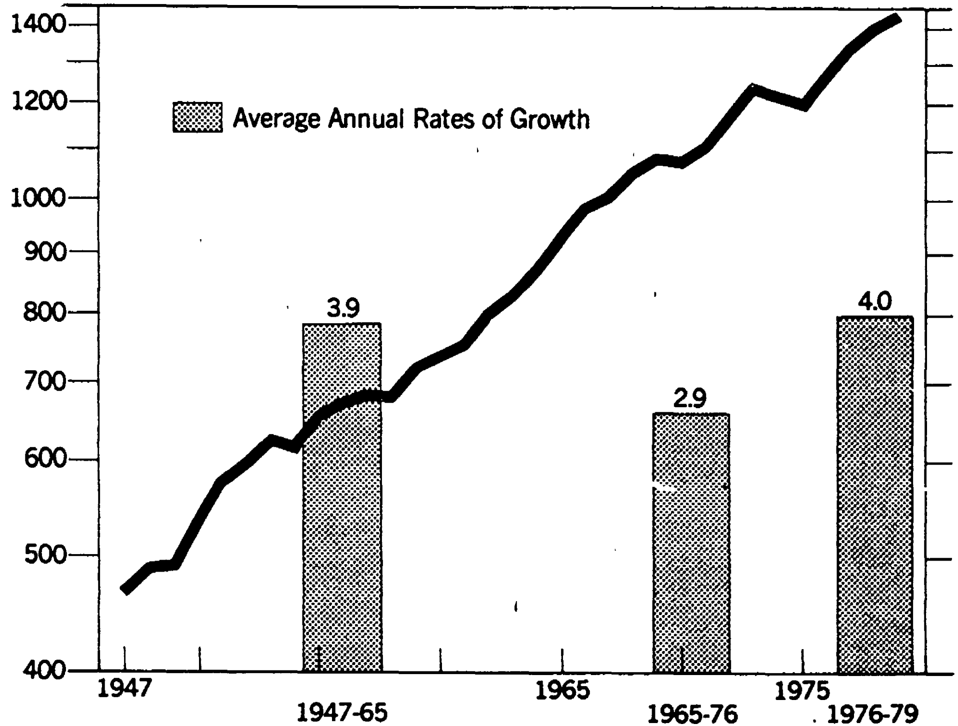
Senator HEINZ. Mr. Secretary, a question on the first exhibit. This is not, as I understanding a semilog scale, which is the way growth charts are usually presented. Could you supply us with what is known as a semilog scale. You know what I mean by that, I am sure.

Secretary MILLER. Yes; we will be pleased.

[The chart follows:]

Real GNP and Growth

Billions of 1972 $ (Log scale)



Senator HEINZ. So we will have a curve that reflects accurately what the growth rate is.

Thank you.

Secretary MILLER. The second exhibit displays the growth of the civilian labor force over these same periods. The black line that runs from left to right, again not a logarythmic scale, but on a straight arithmetic scale, shows that there has been a very substantial growth in our civilian labor force. You would expect this with a growing population and a growing participation in the labor force, which incidentally, has been a very important factor.

The bar charts show that from 1947 to 1965 the annual rate of growth of the civilian labor force was 1.2 percent per year. Notice how much more rapidly it has grown in the transition period of 1965 to 1976 at 2.2 percent a year, and more recently at 2.7 percent. We have had record growth in our labor force, both because of demographic factors and because we have had the highest percentage of adult workers in the labor force and actually employed that we have ever had in our history. So we have a greater participation rate.

The next exhibit, exhibit 3, presents our first major long-term problem in looking at our economy, and assessing all economic policies to address it. The first long-term economic problem is the question of productivity and inflation. The panel at the left shows the period 1947 to 1965. The first bar, the one with diagional lines, shows 5.1 percent annual increase in compensation per hour.

The center bar shows an annual increase of productivity of 3.2 percent. That is the total private economy. The result of higher productivity, even with the high compensation increase, meant in the third bar that we had unit labor cost going up at 1.8 percent a year, which was a fairly modest level of increase in unit cost.

Look at what happened in the transition period, 1965 to 1976. Inflation began to take hold. As I have said, it has been developing over a long period of time. Compensation per hour leaped up to an annual rate of 7.6 percent, but productivity fell to 1.9 percent. So there was an enormous increase in the unit labor costs, which fed on the very inflation which was contributing to the higher labor costs in the first instance.

This is carried on into the third panel, the period from 1976 to 1979, where we have had one more percentage point increase in compensations per hour as workers tried to keep up with inflation, but as productivity drops dramatically again, then unit labor costs go up, and we feed inflation in a geometric progression.

Let us go to the second major problem of our economy long-term, which is illustrated on exhibit 4. This is the real cost of oil per barrel in the postwar period, expressed in 1972 dollars. Look at the dramatic impact of the oil situation in the world from the period of 1947 through 1965, the period of reconstruction, the real price of oil actually went down.

My testimony goes into greater depth about the whole energy situation, but I think we can illustrate it best by oil, and I will not go into the details of all the others energy courses. Basically, we had inexpensive energy that allowed us to build our economy. It continued into the 1970's until the oil boycott and the dramatic shock of oil increases in 1973–74. This has created an inevitable shock to our whole economic system, exacerbating the inflation problem, and contributing to these long-term root causes of inflation which we just must address if we are going to turn this country in the right direction.

After the boycott, the shock on the world system was so heavy, and the worldwide recession that ensued was so deep, that oil prices did not increase in real terms until 1979, when the fall of the Government of Iran, and the drying up of the supply of oil from Iran, and the shortage of supply in relation to demand once again set up the stage for a dramatic shock, driving oil prices off the chart in real terms, and seeing us experience another dramatic setback in our efforts to address our fundamental problems.

In exhibit 5, we see something about the volume of imported oil, which is again a part of this second major problem we face. In the period when we had inexpensive domestic oil, we could build an economy based upon that energy source. As our economy grew, and our own capacity to produce was limited at the price that then existed, we encouraged imports. Imports began to move up. By 1970, we were importing about 3 million barrels a day, but as we came to the oil price shock of 1973-74, and were unwilling to recognize the real change of energy pricing and tried to contain it, and disguise it, we merely increased our appetite for imports, which shot up to a record level in 1977 of over 8.5 billion barrels per day.

But thanks to the work of Congress, and the administration, and this committee over the last few years, we have begun to form a basic, comprehensive national energy policy that addresses the total question, including conservation, greater production from domestic sources, greater production of synthetic sources, and the use of renewable energy.

We are already beginning to reap the benefits of a sharp decline in our demand for imported oil. This is not produced by the recession, because this dropoff in demand starts back before we have any recession. This year we are going to be down to something like 6.5 to 7 million barrels per day.

We are not there yet. As we know, we have a major economic program for the 1980's in energy, which will be greater than the Apollo program in terms of investment, greater than the Apollo program and the highway construction combined, to bring us down to where our demand for imports, even on a greater economic base will be 4 to 5 million barrels per day. We will break this dependence on foreign oil that is such a threat to our Nation.

Let's turn to exhibit 6 and look at the threat, not just in terms of volume and prices, but in terms of the outflow of wealth from this Nation that results from this dramatic problem that we face on both sides of the aisle, that we faced in Democratic and Republican administrations, and which we should tackle on a bipartisan basis.

In 1970 we paid $3 billion for imported oil. This year we will pay over $85 billion for imported oil. If we continue at that pace, in the next 10 years we will transfer to OPEC the total value of all American stocks listed on the New York Stock Exchange. This has to be a major problem we address, and it has to be taken in the context of long-term efforts to deal with it, and not some short-term, election oriented kind of tax program.

Let's turn to exhibit 7 and look at what this all comes down to. How do we reduce the linkage of economic growth to the demand for energy. We must make the growth of our economy less dependent on the use of energy, as we pledged to do at the Venice summit meeting.

You will notice that through the postwar period, up until the 1970's, there was a more or less sidewise, slightly drifting downward, ratio of the use of energy per unit of GNP. So that we were absorbing about the same amount of energy per unit of output. As the economy grew, we had to have more energy.

The CHAIRMAN. On the chart there, are those constant dollars?

Secretary MILLER. These are in constant dollars, in constant relation to GNP. So we have a real relationship between the use of Btu's with real units of output.

Senator HEINZ. Mr. Chairman, may I ask?

Do you have a break by industrial versus service components?

Secretary MILLER. We can break this down in components. I was trying to simplify this.

Senator HEINZ. I suspect that a lot of this is because of the shift of the economy in the last 10 years toward the different kinds of services.

Secretary MILLER. Look what happens from 1965 to 1976, when we were shifting toward services. Our demand went up dramatically, and our demand in industrial uses continued to be very high.

Senator HEINZ. There was a small additional use of energy, which was called war in Vietnam.

Secretary MILLER. I will get you those figures, but that is not basic to the thrust of the underlying use by industry, by transportation, by components. There are some major components that we can break down for you to show how this works.

From 1970 on, and particularly as we began to recognize the real price of energy, our economy has reacted very strongly. The 1973 boycott and the price increases led to, as a matter of self-interest, efforts to engineer out some of the rise in unit costs, and Congress began to act to require that energy use come out of automobiles, for example, by mandating standards.

So we began to react, and we are beginning to get a payoff. I really want to use this to show that we should not be so pessimistic in our outlook. We are making some progress. The point is to keep making that progress, and to keep our eye focused on the long-term trends.

My associate, Senator Heinz, has just passed me a note saying that when we get that data for you, it will show you that the industry use actually showed the highest gain in this period. We will get the data for you.

Senator HEINZ. Fine.

[The following was subsequently supplied for the record:]

Data problems prevent the presentation of energy usage to GNP ratios by the economic sectors requested by Senator Heinz. However, an examination of the energy/GNP ratio in the industrial sector leads to the conclusion that improvements in energy efficiency were roughly uniform in industrial and non-industrial economic sectors. The hypothesis that energy efficiency improvements were due to changes in economic structure was not substantiated. The pertinent data are shown on the attached table.

Between 1970 and 1979 the ratio of energy consumption to total GNP dropped from 62.2 thousand Btu per constant 1972 dollar of GNP to 55.1. That was an 11.4

percent drop over the whole period, for an average annual rate of 1.34 percent per year. During the same time interval, the ratio of industrial energy consumption to industry value added dropped from 70.5 thousand Btu per constant dollar to 62.2 thousand per constant dollar. That was a drop of 11.8 percent for an AAR of 1.38 percent per year. Thus, in percentage terms both ratios have decreased by approximately the same percentage.

Between 1970 and 1979, industry value added as used in these calculations ranged between 31.8 and 34.5 percent of GNP. In 1970 the contribution was 34.5 percent and in 1979, 33.5 percent. Thus, we do not see any evidence that the reported reduction in the energy-GNP ratio is due to a structural change in the economy.

RATIO OF ENERGY USE PER DOLLAR OF GNP FOR THE WHOLE ECONOMY AND FOR THE INDUSTRIAL SECTOR [1]

[Thousands of Btu's per 1972 dollar]

Year	Ratios		
	Total Energy/GNP	Industry energy/value added	Industry value added/GNP (percent)
1970	62.2	70.5	34.5
1971	61.6	69.4	33.9
1972	61.2	67.7	34.2
1973	60.4	66.9	34.5
1974	59.7	69.3	33.1
1975	58.8	67.3	31.8
1976	58.5	63.7	33.9
1977	57.0	64.4	32.9
1978	55.9	62.1	32.9
1979	55.1	62.2	33.5

[1] Industry consumption as defined by DOE. Value added is the sum of total manufacturing, construction, agriculture, forestry, fisheries, and mining sectors.

Secretary MILLER. We are beginning to come down.

Let's turn to the third major problem for our economy, exhibit 8, and that is inflation. Inflation has been fed by a number of things. It has been fed by the decline in productivity. It has certainly been fed in major ways by the oil price increases. There is just no question that our economy is brought to an enormous inflationary impasse each time there is this dramatic increase in energy costs, but there has also been periods of crop failures.

There have been many things that feed inflation, some of them cyclical, and some of them transitory. But underneath what has happened, unfortunately, is the fact that inflation has now become very deeply imbedded, and it cannot be addressed simply by cyclical response. It has got to be addressed by going at the root causes.

The index that is on here showing price performance over the period of the postwar is a solid line. Of course, once again I break it into three periods. In the period 1947 to 1975, the annual increase in prices was 2.3 percent. In the next period, 1965 to 1976, the transition period, the annual increase in prices was 5.5 percent. Incidentally, that period was affected very much by the oil price increases of 1973 and 1974.

The period since 1976 has been impacted by a number of things. Of course, the big oil price increases last year and this year have given the greatest impulse to inflation that we have seen through the whole period. Now we have been running in this period at the very, very unacceptable rate of 7.4 percent.

We have to make it a matter of complete national concern to turn that around. We must do it, as I say, by addressing the total long-term problem.

Turn to exhibit 9. While this shows the growth of potential output of GNP along with actual GNP, I would just like to pause for a moment to give you a view of the underlying concern that I am trying to illustrate with this exhibit.

The rate of potential output of GNP grew at a fairly rapid rate in the 1947–65 period. It slowed down in the 1965–76 period, and now has slowed down again. You can hardly see that in this trendline, but that is more or less what it has done. But the real lesson we must learn, and the real lesson if we are to deal with inflation, energy, and other problems long term, is that unless we improve and increase the potential GNP output, all the policies we adopt to stimulate the economy will merely jam us up against that potential, and we will not get more output. We will only get higher prices. That is a reality that we have got to face up to.

If you talk about the concern that you now have about this recession, just think beyond now, and who wants to be the President of the country in the next term has to be concerned about whether some short-term action will merely put us back into another high amplitude, upward movement of prices from which we will once again be facing the same sort of problems that last year so concerned us but which we seem to forget so easily.

As soon as we jam ourselves up against our potential output by stimulus, without increasing our potential output, we are just opening the inflationary throttle again, and inflation will come out in stronger form.

Our fourth important national economic problem is illustrated on exhibit 10. This relates to our international competitiveness. It is essential, as we deal with the other problems, and particularly with the fact that for the next 5 or 8 years we will continue to pay a high bill for imported oil, that we expand our exports to cover that, and keep our international accounts in order, as we have been doing, and that we keep the dollar strong. This is absolutely imperative.

You see here the import growth in the solid line and the dotted line of exports over this period. After the war there was an enormous increase in exports because we were just getting the world going again, and then the world came back to more normal relationships. But there has been a steady upward trend in our involvement in world trade, and this is part of the growing interdependence among nations.

Look at the bar charts. From 1947 to 1965, our exports represented 4.1 percent of GNP. Our imports represented 3 percent of GNP. We had a consistent and continuous surplus, which was the basis for us having the capacity to help other parts of the world with our surpluses as the other economies recovered.

Look at what happened in the period 1965–76. We maintained ourselves in balance. Our exports grew to 4.9 percent of GNP, and our imports stayed at 4.9 percent. We were in balance, but we no longer had the surplus to use in our economic objectives.

Now look at what has happened in the most recent period. Our imports have grown strongly. We should not forget that export performance has been outstanding not only in agricultural products, but in manufactured goods, and in nonagricultural products. We brought it up to 7 percent of GNP. But the sad news is that the oil bill racing up to $60, $80, $90 billion has gotten ahead of us, and so we have a major problem of improving our competitiveness so that we can export more, and improving our competitiveness so that we do not become the market for imports, but that we can produce in this country competitive goods that keep us a strong component in many of the major industries.

Now, having given you the main four problems, let me turn to exhibit 11, and just look at our performance over the last few years in comparison with the other big industrial nations, in comparison with Germany and Japan, the United Kingdom and France and Italy and Canada.

We see here simple bar charts. The left one shows that over those years, 1976–79, our real output grew 12.5 percent. That is not per year, that is the whole period of time. These other major countries grew at 12.3 percent.

In industrial production, the next bar chart, our industrial production expanded over 16 percent. Their industrial production went up 13 percent. Our real consumption went up almost 12 percent. Theirs went up 11 percent. But the most amazing performance of this economy is its ability to provide jobs. We have had an increase of 10.9 percent in our employment, and those countries have only had a 2.3-percent increase.

We have outperformed all the other nations in providing jobs, and we have marginally outproduced them in real output, production, and in real consumption. Now, our task is to address the four major problems, and continue to show strong performance relative to these other particular nations of the world.

The short-term results of the economy you all know, but exhibit 12 just reminds us, as we think of our current problems in the long term we should bear in mind what can happen when inflationary expectations and speculation run away.

As we know, earlier this year, as a result of the oil price shock, as a result of the invasion of Afghanistan which unleashed the impression that we were going to have a wild runaway in defense spending, the impression that we were going to have wage and price controls, which we are not going to have, but which was abroad in the land as an idea and caused businesses to run out and borrow money, and raise prices. All this speculative bubble of activity drove interest rates and inflation through the roof in the first part of the year.

We moved, after very extensive consultations with the Congress, and took some strong measures in March. As a result of this, we have seen dramatic drops in interest rates, and we have seen a dramatic drop in the Consumer Price Index which we believe will go on down as the lower mortgage rates begin to be reflected in the CPI in the coming months.

These are gains that we should not easily give away by some action that is perceived to be backing away from the commitment which the Nation expects of us, to show fiscal discipline, to show discipline in our other actions so that we do not once again unleash this inflation.

We are in a recession, as exhibit 13 tries to illustrate. In terms of earlier recessions, the present recession, by consensus, appears to be one that is more or less average, perhaps of a nature of the 1953-54, or the 1957-58 recession, but less than the one in 1974-75.

Exhibit 14 merely displays for you in a different way the comparison of the present models of many economists, and the consensus of business forecasters with the midsession economic path that is contemplated by the administration assuming no economic action.

The midsession review path on the bottom line there shows that the administration compared with other forecasters is more or less in line on the downside. It is a little less on the down, and a little less on the up, but in the 2 years they are very comparable. The unemployment rates are comparable. If anything, we look a little more pessimistic on the price side.

I think that this information has been available to the committee, and I am not going to dwell on it. I am going to call your attention to exhibit 15 where we indicate the updated budget. I believe you are familiar with these figures. The current estimate of a deficit of $61 billion in fiscal year 1981, and a current estimate of a deficit of $30 billion in fiscal year 1981.

Senator HEINZ. Mr. Chairman, before we get too far between exhibits 13 and 14, there is just one number that I would like to ask the Secretary about.

On exhibit 13 there is a consensus of 42 private forecasts as respects this recession we are in, which is noted to be the blue chip economic indicator for June, et cetera. On the next page, there is the so-called consensus of business forecasters, which is July. They provide an unemployment rate.

I am trying to find out, first of all, how different these two forecasts are, and what the minus 3.5 percent, which is the trough decline real GNP is premised on for an unemployment rate. You have the comparable number for that particular forecast, which as I read it is not necessarily the same as the consensus of business forecast in the next table?

Secretary MILLER. They are very, very similar. The reason we use a slightly different number on exhibit 14 is merely to get a July number, but they are basically the same. One of them was June, and we just took a more current number. That is the only difference.

Senator HEINZ. My recollection is that the people who were published in June were writing thinking in May, and in May, people were a lot more optimistic than they have since become. So I am just curious as to whether they really were premising this on an 8.8-unemployment rate back then. Perhaps we could get that number later, if that would be all right, Mr. Chairman. It would be helpful to view that.

[The following was subsequently supplied for the record:]

Senator Heinz is correct that the private consensus shifted somewhat during the period. The Blue Chip private consensus projected an 8.4 percent unemployment rate in June. This had increased to 8.8 percent by July as shown in Exhibit 14. The June issue was used for the cyclical comparison shown in Exhibit 13 because a set of special questions was asked of the private panel at that time as to the expected depth and duration of the current recession. The questions were not repeated in July. However, the quarterly GNP patten reported in the July issue would appear to imply a peak to trough GNP decline of roughly 3.7 percent, in contrast to 3.5 percent in June.

Secretary MILLER. We put the four leading models in because they are the ones that are done every month, and are pretty much followed.

I think that the purpose of exhibit 14 was so that we did not just give you a cold view of our forecast, but to relate it to what other people were thinking, so that you could see whether we were in any way in the ballpark.

I must say, and I should pause here to say it, we are not satisfied with this economic path, and I hope that no one will misunderstand my testimony today. Before the Congress went on recess, it was apparent and it has been apparent for a while that the recession is deeper than had been thought by even these same forecasters back earlier in the year.

We are not satisfied with this path. The midreview is a mechanical update of reestimating outlays, or reestimating revenues, reestimating our projection of the economy, and taking account of actual actions by the Congress since March.

It is our intention, and we have made a commitment to consult with Congress, and to look at what economic measures we should be taking so that we can come out with a reinforced recovery, with less unemployment, and a faster path of recovery, provided it can be done, again, without unleashing inflation.

Therefore, it is very important that we not ourselves rush in with some precipitous action, that we all think together how we can get the recovery reinforced in a way that contributes to dealing with the problem of productivity, that deals with the problem of energy, that deals with the problem of inflation, and deals with the problem of competitiveness in the world markets.

That is why we feel we should go about this not in a way to create delay, but in a way in which we use the best brains, the best information, and the best consulting, outside the atmosphere of an election process, so that we do the best good for the country over the longest period of time.

Now on exhibit 16, I must tell you that this is as important a chart as we have here, because it is an illustration of the new directions of economic policy that we have been forging together, and which we must continue to husband and to protect, and to reinforce. This chart says millions of words in terms of economic policy and direction.

The CHAIRMAN. Which chart are you on, Mr. Secretary?

Secretary MILLER. This is exhibit 16, and I would like to walk you through it carefully because it is the heart of what we have to talk about when we talk about taxes.

At the left we see three bars that show for the period 1947 to 1965. The first bar chart shows the total real growth in budget outlays per year. The annual rate of change of real outlays, 3.4 percent per year increase in real Government expenditures of which defense was running at 4.8 percent a year—that is the second bar—and nondefense at 2.7 percent. The defense and nondefense average out, when you plot them out, to the 3.4.

Now let's look at what happened in the period 1965 to 1976. Annually, in real terms, the Federal outlays went up 4 percent per year. Defense outlays went down. We actually had in real terms a decline in defense spending, and we had a dramatic increase of 6.2 percent per year in nondefense outlays.

Look at what happened from 1976 to 1981, including the budget now on the table. If we can stick with the budget now on the table, then we will have over this period annual increases in real terms of budget outlays of 1.7 percent, the lowest in the whole postwar era, showing for the first time that we are bending ourselves toward controlling Federal expenditures, which has been one of the continuing problems in terms of long-term inflation that we faced.

Notice also what has happened. We have begun to improve our military posture, and we have a growth of defense spending in real terms of 3.2 percent a year and a nondefense spending of 1.3 percent. Therein lies a strategic shift in administrative/congressional interaction and results that needs to be reinforced. Anything that backs away from that and shows that we are going to let down our guard and once again not show the discipline that we need will in my opinion reinflate inflationary expectations, and unwind all the good things that people are seeking through tax relief or any other economic measure.

Senator PACKWOOD. Mr. Secretary, when you say real growth, what is your standard? Is it above or below the Consumer Price Index, or the deflator index.

Secretary MILLER. This is based upon the GNP deflator, so it is tied to the actual performance of the economy.

Senator PACKWOOD. Let me ask you another question. If you were to take that figure for fiscal year 1981 only, couldn't that show that the total growth was actually negative?

I have no complaint on the budget. But the total growth and nondefense spending would be slightly below your index; only the defense spending would be substantially above it.

Secretary MILLER. I will get you the exact 1981 figures in a moment.

The CHAIRMAN. If that is correct, why don't you just say that it is.

Secretary MILLER. I believe it is. It is correct.

Senator PACKWOOD. Thank you.

Secretary MILLER. Now, having looked at the long-term problems, having looked at the progress the Congress has made in disciplining Federal spending, let us look also at another issue, and that is what is the state of the economy. Certainly after the tremendous problems in the first quarter with the runaway inflation psychology and speculation, we had an unusually sharp contraction because we brought down some forceful action. We have seen a historically sharp contraction.

There were people who for a while said that we were in a free-fall, but that was not true. That contraction was predictable in terms of a response to the overspeculation, and because of reduced interest rates, because of breaking the back of the inflationary expectation, we are forming a base for recovery. There are some signs of this as shown on exhibit 17.

I want to be careful to state this. I am not suggesting to you any Pollyanna view of the economy. Our forecast shows a recession continuing with negative growth through much of this year. But the point is that we are no longer on a steep decline. That kind of rapid contraction is behind us. Our rate of decline is slowing, and there are some signs of reforming for recovery.

June housing starts were up 30 percent. Permits were up 28 percent. The early July initial claims for insured unemployment fell quite sharply for 2 weeks. Two weeks does not mean that we have a complete answer, but I am just pointing out the continued sharp fall is not there.

In May there was actually a decline in business inventory holdings, so we don't have a buildup of overhang of inventory that will take the big kind of liquidation that we had in 1974 and 1975.

In early July, in the first 10 days, automobile sales were up sharply. At the end of today, we will get the next 10 days, and it may show that we have not really bounced back permanently, but at least the very low levels of a 5.2-million unit annual rate of production in May and June are now showing in July a pickup that at least shows that we are beginning to get some improvement there.

In June we saw retail sales go up for the first time in several months, not only in nominal terms, but in real terms.

My point is a very simple one. Let's watch these figures. Let's not act too quickly. Let's not assume that every direction of a curve must be extrapolated forever in the direction that it is going, but that things will change.

Senator ROTH. Would the Secretary care to comment on the recent inflationary figures that were released today?

Secretary MILLER. Yes. The June CPI shows a 1 percent, and that compares, of course, with the 1.4 percent in the first 3 months, and nine-tenths of 1 percent in April and May.

If you break it down in components, food and beverages were up 0.5 percent; apparel and upkeep increased not at all, but stayed stable; transportation went down two-tenths; medical care was up 0.5; energy, 0.3, and the reason that the total ended went up 1 is because housing was in at a 1.8-percent increase because we still are reflecting the higher mortgage rates. There is about a 60-day lag before lower mortgage rates are reflected.

So this is more or less reinforcing in the components that we are continuing to get a decline in the rate of inflation.

The CHAIRMAN. Is that the wholesale price?

Secretary MILLER. No; this is the CPI. It was out at 9 o'clock this morning.

Actually, the wholesale price, or the producers' price index has gone lower already. The last one was 0.8 but the under averaged 0.4 percent in the 2 months before. So it has come down even more sharply. But I will just comment on today's figures.

Now turning to another very important chart, and that is in exhibit 18. It is not only important that we consider in terms of our tax policy first that we keep the budget discipline, which is the point of my exhibit 16, and second that we look carefully at the real course of the economy which is my exhibit 17, but also that we look at future tax programs to deal with structural issues in our economy. I think here we will find uniform opinion around this room, but I still want to cover it.

Exhibit 18 points out in another way what I have already covered, but points out in a very dramatic way what is the task to deal with our structural economic issues. On the left we again have my standard presentation looking at the period 1947 to 1965. During that period the capital to labor ratio, the amount of capital employed per worker in America, increased 3 percent a year, and productivity increased 3.2 percent a year. We employed more capital, and we got more productivity.

Look at what happened from 1965 to 1976. We were not increasing our capital in relation to labor, which was growing more rapidly now. In terms of absolute dollars, we were putting in as much capital, but we were not keeping up with the number of workers. So the amount of capital increase per worker fell, and productivity fell.

Look at what has happened in the last few years. We have not been keeping up with that dramatic growth in employment that I pointed out earlier in terms of tools. We have not been putting in place the tools, so our productivity has fallen. We all know this, but it is just something that I think is important that we reinforce as we begin to consider the kinds of tax measures that we should be taking.

Now as we began to discuss from this background the question of appropriate tax measures, I would like to just outline some basic considerations, basic considerations that I have already covered in these points that I have just been making, but just to reiterate them very briefly.

First, Congress should maintain the progress it has been making in restraining the rate of growth in expenditures.

Second, it is difficult to know just how the economy is forming. Our models don't work very well in the kinds of inflationary environments we have had in the last 10 years. The economic forecasts are not reliable. We should be careful to act in terms of the best information we can get, and not act too hastily.

Third, I must say, again, that I do not believe that we should try to develop a tax program to deal with the long-term structural needs of our economy in the pressure cooker atmosphere of an election. If there is, indeed, a genuine interest in addressing these structural problems, there is no reason why Congress cannot act after the election with just as much accuracy, and with just as much impact in terms of timing as it can act now.

There is no reason to hurry, unless it is an election reason because it can be just as well done after the election. Improved depreciation schedules could be made effective on January 1. If the homework is done now, Congress could act very swiftly in the coming year.

Fourth, it seems to me that there is a risk in rushing now before an election, not just because of the election atmosphere itself, but we will have everybody's special interest on the table, and the ability to contain the thrust of policy toward the core needs of the economy will be dissipated. The amount of physical commitment to tax cuts we could make would be dissipated by a whole series of Christmas tree ornaments that I do not believe can be contained in the election atmosphere.

I say this frankly. I say that in the quiet time after election, more responsible legislation can be enacted if it is desirable.

A tax program may be appropriate next year. In anticipating that it may, I would like now to set out a series of criteria which this committee, and this Congress should begin to consider in order to be prepared for the program.

My point here is simply this. If we are going to have a tax program, let's first decide on principles, and then decide on specifics. What are the principles that should govern any kind of tax program? I have listed these briefly on exhibit 19.

First, any tax program should be consistent with maintaining budget discipline. We must continue to work to contain expenditures, and not use the tax cut as an excuse to let up the pressure there. I might say, in talking about budget discipline, the tax program must be weighed in terms not only of its first year effects, but in terms of its effects in the outyears, because we can be very easily misled about a nice, noninflationary tax cut of only a small amount, and find ourselves with enormous problems downstream if we don't design it properly.

Second, any tax program should be consistent with continuing to wage a vigorous war against inflation.

Third, any tax program must maintain the confidence of the financial markets. If there appears to be some politically motivated, irresponsible tax program; I am not suggesting that anybody wants that, but if that is the perception of the market, interest rates will shoot up, inflationary expectations will shoot up, housing starts will go down as mortgage rates go up, auto sales will go down because individuals cannot afford those newer high interest rates, and we will have undone what we sought to accomplish.

Fourth, any tax program should look to improving productivity growth. We should look into attacking the core problem of productivity.

Fifth, any tax program should seek to strengthen our international competitiveness.

Sixth, we should promote the most effective use of our total resources, our human resources, and our capital resources. We should be efficient.

Next, we should have a tax program that observes the principles of progressivity. We should continue to look for equity. Those who have been most impacted by inflation are those in the lowest ladders of income, those who have the least resources, those who are more tied into fixed incomes. We should have a tax program that looks very carefully at that.

Finally, any tax program should reflect close consultation with Congress. We should not rush in here with a tax program that is our favorite. We should listen to the advice of Congress. We should listen to the advice of other experts. We should hammer out together a program that makes sense.

Let me consider against those criteria some of the choices we have.

The principal objectives of economic policy and the current structure of the tax system indicate that any future tax changes should be pointed in two major directions. First, to reduce the burden of taxes on households and on labor costs; second, to provide incentives for productive business investments.

A strong case can be made for a number of tax policy options, but putting a tax program together will require making hard choices among those options. Revenue simply will not be available, if we are to achieve those criteria, to do everything that everyone wants. We are going to have to choose among the proponents of this and that.

First, let me then talk about making these choices, about reducing the tax burden on labor income, and what our choices may be there. The taxation of wage earners is mainly determined by the structure of individual income tax rates, and the rate of payroll taxes for social security. The purpose of the graduated rate structure in our income tax system is to apportion that tax equitably among households of different means.

A byproduct of this structure is that there is an automatic tax increase resulting from year-to-year increases in inflation, sometimes referred to as bracket creep. This has led Congress from time to time to make adjustments, especially in times of inflation. Up till now, Congress has kept pace with inflation. The adjustments that have been made have kept families more or less in line. But in 1981 we will have some upward increase, and when a tax program is appropriate, therefore it makes sense to address this.

The scheduled increases in payroll taxes on January 1, 1981, will add to this kind of problem, and will increase the marginal costs that employers must pay to increase the real incomes of their employees. So we know we have a problem. We have to decide now on how to approach it at the right time, when the time for a tax program is appropriate.

One approach that has been suggested to deal with this particular aspect is to provide an income tax credit for individuals and for businesses to offset the social security tax increases due to take effect in January. If there were a tax credit, then individuals would be able to avoid the increase and maintain more of their real income.

As for businesses, of course, there would be a relief of a business cost, which would have an anti-inflation component, which would therefore reduce business costs, and hold down prices.

If this approach were taken, it would be necessary to have refundable credits for employers and employees who don't have tax liabilities, because otherwise municipal governments, for example, would not get any benefit. Since they don't pay taxes, we would have to actually refund it. So there are some problems around that approach.

Another approach is to simply deal with the brackets themselves, and to adjust brackets of individuals to approximately, or very closely offset the increase in social security. That is one way to approach this whole problem of reducing individual tax and business increases from those sources.

In terms of some of my testimony dealing with matters of saving, I think the committee may want to address that separately, but I would like not to take your time with that, but turn to another tax policy choice that also faces us, and that is, how to encourage capital investment to raise productivity.

Our view is that acceleration of depreciation allowances offers the greatest potential for success in this area. In general, such a provision would reduce the tax bite on the return to successful investment, and also enable higher returns to be made to direct or indirect suppliers of capital, whether they are lenders, or shareholders, or members of pension funds, or depositors in financial institutions, or whatever. If you go in this direction, you actually can help the whole system.

As compared with tax breaks for particular types of savings, the benefits of accelerated depreciation are more directly tied to productive investment, and less susceptible to gaming by simultaneous borrowing and lending transactions, and to other techniques for shifting individual portfolios.

Quite often, when we talk about these incentives for savings, all we do is shuffle portfolios around. This is really the most effective way to tackle the problem.

The particular program that is being discussed a great deal here, and has been mentioned already, is the so-called 10-5-3 proposal. This proposal does approach it in the very fundamental way that we favor, but it has some shortcomings that we think ought to be addressed and corrected before any tax action.

For one thing, the program would become very expensive in the outyears. Also it is uneven and haphazard in the way it spreads its benefits among types of assets, and among industrial sectors. It also has a very complicated transition phase that may actually result in investment delay.

Most proposals to accelerate depreciation for newly acquired assets will generate revenue losses that grow more rapidly than the economy for several years. Almost anything we propose will do that. Careful budget planning is required, therefore, so that the depreciation program will work consistenty with our other objectives.

The way this works, as you know, is that depreciation for a new asset one year builds on depreciation for new assets the next year, and it builds up. The 10-5-3 proposal somewhat exaggerates this pattern in its transition phase, specifying a phase reduction in lives over the first 5 years.

For example, in the first year, machinery and equipment would be written off in no more than 9 years. The next year, in 8 years, and so on down to 5. This may be intriguing the Congress as seeming to offer a very low downpayment, but the revenue costs under this approach would grow about twelvefold in the first 5 years, from less than $5 billion a year to nearly $60 billion a year.

The 10-5-3 proposal becomes so expensive because it would eventually allow the same combination of deductions and investment credits for nearly all classes of machinery and equipment. These allowances would be more generous than those for even the shortest writeoff periods in present law.

This approach greatly increases the value of deductions for long-lived kinds of equipment, such as those used in powerplants and shipbuilding. In contrast, the increased allowances for equipment that wear out rapidly, or become quickly obsolete such as tools used in metal fabricating, as in the automobile industry, or the electronics industry, would receive relatively smaller benefits.

For owners of commercial and industrial buildings, the value of additional tax saving is, in turn, much larger than the average increase for investors in machinery equipment. Thus the 10-5-3 proposal indiscriminately favors the movement of capital into structures.

Incidentally, this might result in a great deal of exodus of industry from the Northeast because it is so favorable to build a new building, why rehabilitate or keep an old one? So it would really be a serious problem, I think, in regional dislocation.

It would be a pattern of increasing the tax benefit for both structures and for long-lived equipment, and therefore not be so even. The pattern is clearly not related to any objective criteria for cost effectiveness in adding to productivity overall, or to our other economic goals.

Now, so that we don't get to a confrontation, I am trying to indicate ways that there are defects in 10-5-3, but I want you to understand that when a tax program becomes appropriate this administration will support an approach that will cover some of these deficiencies, and will provide a means for accelerating depreciation allowances.

We think that there should be a connection retained between deductions for depreciation, and the actual depreciation experienced for assets used in different kinds of production activities. Such an approach, we think, would be an improvement over 10-5-3 because, first, it would flatten out the trend in revenue losses, providing the tax reductions earlier, but having less effect in later years.

Second, it would not require the kind of phased introduction scheme that imposes the additional accounting burdens of keeping vintage year accounting for all these phase-in years. Therefore, it would be simpler, and I think better for small business. It would introduce less distortion into the pattern of investment incentives. We would not drive all the capital into long-term assets and into buildings. We would spread it through the economy, and therefore be better off.

A capital recovery system that includes simpler accounting, greater certainty, and reduced administrative complexity can be developed along the lines that I think the sponsors of 10-5-3 want, but we think would be an improvement.

Mr. Chairman, those are the points that I wanted to make in my testimony from my exhibits. Let me conclude by saying that during the next 5 years, the United States must take the steps required to build a strong foundation for superior economic performance, and for increased economic security. We must show the discipline to make sacrifices needed to strengthen our economy for the long run, while at the same time providing assistance to those most adversely affected by short-term economic disruption.

The United States stands at the threshold of a new economic era. What we do over the next 5 years will determine whether this new era brings an unparalleled standard of economic well-being or a slow drift to mediocrity. To make the most of this opportunity, we must not only build on past gains, but also be willing to reverse past errors.

Many of the economic problems now facing us stem from an unwillingness, stretching back at least 15 years or longer, to confront directly the difficult trade-offs and the difficult choices. Hard choices must be made if the U.S. economy is to thrive in an increasingly competitive world.

There are four major objectives for economic policy for the next 5 years. First, to improve our economy's productive capacity so that we can enjoy strong growth in real incomes. Second, to return to longer run price stability which will permit us not only to provide jobs and to reach high levels of employment, but to sustain those high levels. Third, to enhance our competitive position internationally so that we can keep our markets at home, and expand our exports abroad. Fourth, to reduce our vulnerability to externally generated shocks, and particularly our vulnerability to energy interruptions, or energy price shocks.

A tax program that is properly timed, that is consistent with the criteria that I have outlined, can make a significant contribution to attaining these objectives. If we move in that direction patiently and responsibly, we will be able to improve greatly our economic outlook not only for the short term, but for the balance of this century.

Thank you for your patience in listening to a rather long dissertation, but the issue is so important that I felt compelled to share with you this broad aspect of the problem.

The CHAIRMAN. Thank you very much for your statement, Mr. Secretary.

We do business here more often than not by the so-called early bird rule, and I am going to continue to use that, and ask that each Senator be limited to 7 minutes on his first round of interrogation, and then we will have another round thereafter, if they further wish to ask questions.

Let me urge each Senator, who has not had the opportunity to do so, to take the Secretary's statement with him when he leaves, and if he has not read every word of it, please do so. The Secretary has abbreviated his statement here today, but we should certainly get the full logic of the Secretary's statement, whether we entirely agree with it or not, because he has made a very useful and thoughtful statement today.

Let me now call on Senator Harry Byrd, who was the early bird here this morning. [Laughter.]

Senator BYRD. Thank you, Mr. Chairman.

Mr. Secretary, I don't need to tell you, of course, of my high regard for you. You already know that. We have been friends. Anything that I say that might appear critical of your testimony, or the administration is not directed at you.

Mr. Secretary, nearly every Democrat in the Senate signed a resolution mandating the Financing Committee to report a tax reduction bill by September 3. Do you feel that such action was wise, or unwise?

Secretary MILLER. I would be the last to advise distinguished members of the Senate, Republic or Democrat, about the wisdom or propriety of their actions. It is always, in my opinion, wise. [Laughter.]

I think reporting a bill that would be the framework for discussion, and for consideration of a tax bill after election would be a contribution.

Senator BYRD. Is it your view that there should be no tax reduction legislation enacted by the Congress during 1980?

Secretary MILLER. It is my view, Senator Byrd, that there should be no tax bill enacted before the election because of the reasons that I have outlined.

Senator BYRD. I might say that I was one of only three, I believe, on the Democratic side who did not endorse that resolution. However, since President Carter's statement to the Congress on Monday, my view has changed considerably.

You mentioned in your exhibit 19 that the tax policy should reflect close consultation with the Congress. The Congress is prepared to act. The Congress is prepared to act now. The Democrats in an overwhelming number have endorsed it. The Republicans unanimously have endorsed a reduction in taxes.

You said during your testimony that it is the considered judgment of the Carter administration that there should be no tax reduction legislation during 1980, or prior to the election of 1980. That considered judgment of the administration, I think, needs to be taken in context with other considered judgments that the administration has had over the past 3½ years.

I sort of reminded of a tombstone in the southwestern part of my State in the coal mining section. This coal miner died, and he instructed his executor to put on his tombstone this statement addressed to his wife: "As I am now, so will you be. So fear not, and follow me." His wife studied that, and she had her own statement then put on the tombstone, "To follow you, I am not content, until I know which way you went." [Laughter.]

The considered judgment of the Carter administration must be taken, I think, with a grain of salt. It was the considered judgment of the Carter administration in 1977 to have a $50 tax rebate. That was withdrawn after it was laughed out of the ball park. So there have been many other examples of what I consider to be, and apparently the Congress and the American people consider to be, foolish judgments.

But when you do have good sound judgment—when the administration has good sound judgment, then it tends to reverse itself.

President Carter during March, April, May, June, and much of July said that the budget must be balanced, and he contended that the budget was balanced. But his statement to the Congress on Monday accepts a $61 billion deficit for 1980 and a $30 billion deficit for 1981. During all of this period, when these two smashing deficits will face the country—at the same time—the Government is taking the highest percentage of income in taxes in the history of our country, and taking it from the American people.

Mr. Secretary, on page 1 of your statement, you credited the administration and this Congress with "responsible budgetary actions." Is it your view that an $85 billion increase in spending, the largest increase in the Nation's history, is responsible budgetary action?

Secretary MILLER. Senator Byrd, first let me comment that as you know in the budget submission we have outlined the reasons for the change in the midyear session budget review——

Senator BYRD. There are always reasons. We have to deal with the facts.

Secretary MILLER. We have outlined the changes from March. In March, the economic outlook was more favorable. The President's talk over the period since March has been one very consistently, in my opinion, of urging the Congress to restrain spending.

Senator BYRD. May I ask at this point. Is it a restraint in spending to increase spending by $85 billion, an unprecedented increase? Never before has spending been increased by that extent. Is that responsible?

Secretary MILLER. I would still like to address the point of what causes those changes.

For example, the change in economic conditions—incidentally, neither the President nor anyone else ever spoke of a balanced budget for fiscal year 1980, so I think that we have to be sure not to mix that up in our thinking.

Senator BYRD. That is not mixed up. He spoke of a balanced budget for 1981. Am I not correct that on Monday, he submitted to the Congress a statement saying that there would be a $30 billion deficit for 1981. Is that correct or incorrect?

Secretary MILLER. The President in March sought with the Congress to achieve a balanced budget for 1981. This has not been possible. Let me just outline the differences. Economic conditions have resulted in $11 billion of increased outlays, not through actions of the Congress, and not through actions of the President, but higher unemployment, higher support programs and the economic stabilizers that are built into our laws. Receipts are estimated to drop $18 billion, not because laws have been changed by the Congress, but because a deeper recession means lower income.

Defense spending, here there may be differences of opinion. But the President has favored a certain growth in Defense spending, and Defense is now projected to be $7 billion higher, and Congress in that regard has favored higher spending.

In terms of other changes, there have been outlay changes of $4.2. The proposed gasoline conservation fee the President proposed in his budget has been disapproved by the Congress, taking about $10 billion out of the budget. Also, there have been some other changes, but we can see that the primary causes are the results of the economy. The next largest cause is the disapproval of the gasoline conservation fee. The third largest cause is the increase of Defense spending. These are joint decisions.

I would not change my statement that in terms of overall beginning to contain spending, and to being willing to forego and to reduce outlays for programs, and to cut out others, defer others, the Congress has been showing more willingness to do this during the last several months than it has for a long time.

We must remember that when we are all through, we have to look at what the results are. Exhibit 16 should be kept handy because whatever may be the evaluation of these numbers, they represent much better performance in terms of containing spending than we have had for the past 30 years. So if it is not absolutely adequate——

I cannot disagree with you, Senator Byrd, I think your view, and your leadership and your drive in this direction are unrelenting, so I know that each time I come here I must face your very determined effort to be a leader in helping us control spending.

I would not want to mislead in saying that I thought we have come all the way we have to come. But journeys of 10,000 miles begin with single steps, and the steps that begin to bring spending under control are encouraging. When we see the annual increases in outlays over a period of time beginning to decline over what they have been for 30 years, then we begin to see some progress, and we should not fail to express our appreciation.

Senator BYRD. You have talked for 3 or 4 minutes, and you have not answered my question yet. But I am going to continue to ask it, and you can continue to refuse to answer it 10 different times, if you wish.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Roth.

Senator ROTH. Mr. Secretary, I see basically no change in the attitude of the administration on a tax cut, and I find this very hard to understand since there seems to me to be a growing consensus that there needs to be some real tax relief to get this country moving.

I would like to point out that the Joint Economic Committee report for 1980 makes a strong case for the need for a tax cut.

I am also mystified, in view of the fact that your own chart shows productivity going down very substantially during the 4-Carter years, the worst record in recent time.

More important, I would like to point out to you that most economists, Waller Heller, for example, Alan Greenspan, Paul McCracken, Otto Eckstein, all agree that we need tax relief now. It should not be postponed. Eckstein, for example, says that if tax cuts are deferred, "this string of minuses is likely to stretch into next year and make this recession a more massive disaster."

So in view of the dismal record on productivity, why doesn't the administration finally agree that we ought to have some tax relief now?

Secretary MILLER. Senator Roth, let me see if I can outline the areas where we agree, and apparently the areas where we either have a lack of communication capacity or a misunderstanding.

First, I don't know of anyone on that list, or you, or anyone else, who has proposed a tax reduction effective this year.

Senator ROTH. We are talking about enacting it now for 1981. We are in agreement.

Secretary MILLER. They are talking about 1981, so we are in agreement on that.

If we are in agreement that there should be no tax cut—I am not agreeing there be a tax cut in 1981. I am agreeing there should be no tax reduction effective in calendar year 1980. Then the proposition that we must do something now to deal with the economy must be in the context of doing something in 1981. We can't have it both ways.

You know, we are either doing something in 1981, or we are doing something today. If the proposition is that we are going to do something in 1981, then let's talk about 1981, and we can put aside whether there is some reason to rush out.

Senator ROTH. You were a businessman, weren't you, Mr. Secretary?

Secretary MILLER. I would like to continue answering the first question because it is very important that we get our communications straight. I think that there is more agreement than people will admit. Nobody is proposing——

Senator ROTH. It is my time, Mr. Secretary, so I would like to ask the question.

The CHAIRMAN. You asked him the question, so why not let him answer it?

Secretary MILLER. I would like to answer the question. I am willing to stay here. I will stay here this afternoon. I will come back tomorrow. I will come back in the evening. If this is important to the Nation, let's get it out, and let's do it thoroughly. Let's take 7 minutes, 12 minutes, or 100 minutes, but let's do it, and not try to——

What I want to say is, if we want to talk about 1981, let's talk about it. What is our proposition? Don't enact a 1981 tax bill before election! That is not a very appalling proposition. It leaves plenty of room. If we can be persuaded that the economy needs it. If we can be persuaded that the Congress is going to keep control of spending, if we can be persuaded that we can structure something that is not just a handing out of special interest little goodies to everybody before election, if we can be persuaded of that, and the election is behind us, we can then talk turkey.

We have plenty of time to do something in 1981, so what is the issue? The issue is, do you do it before election, and what is the motivation? I will not answer that. You all can answer that. What is the motivation? There is no economic reason to do it before election. It could be done after election better. There is no reason given by any proponent that it has to be done before the election, because they are not proposing it to be effective before the election.

So when you get down to the intellectual argument, it seems to be tied around election day, and that makes me nervous.

Senator ROTH. Mr. Secretary, last January the administration had another rationale for not getting a tax cut. They said, "Let's balance the budget." The question is that we cannot afford to wait and see.

You mentioned automobiles, how long do you think Chrysler has in becoming a viable company? They are going to start producing a small car in September. If this recession is still on, do you see that they can continue to exist?

Secretary MILLER. On the economic path that we intend to direct Chrysler will recover.

Senator ROTH. What level of cars will have to be sold for them to recover?

Secretary MILLER. The level of cars that we are showing next year is substantially up from this year, but it is not back to the peak year, because we recognize that the path of the automobile industry is not only a path that is related to recession and recovery, but it is related to consumer choices over available automobiles that are fuel efficient.

Let me take the Chrysler situation. It is extremely important that the automobile business in the United States be supported with Government policies that will allow it to make the transition from the period in which rear-wheel, heavier, larger automobiles dominated the market, and the period where market forces now require lighter weight, more fuel efficient, front-wheel drive cars.

I do not think that we need to debate whether we got to the condition of the automobile business we are in today because of somebody's decision, whether it was management or Government or whatever. The point is, we are there. Our efforts will be to help in the transition.

I might say again, that the problem would be worse today if Congress had not started the procedure of requiring higher fuel efficiencies, because even the cars now on the drawing boards that will be coming out next year from U.S. producers would not have been ready to come out.

Chrysler is in a unique position to make very substantial gains in the marketplace because it is going to introduce a number of very well designed, very attractive, new front-wheel drive cars in production numbers that are going to be somewhat larger than any other new entrants.

Senator ROTH. Would the Secretary yield?

I would like to ask you, do you think that Chrysler can succeed at the current level of car sales, or what level do you think they have to be this fall?

Do you think that we can wait and see, and let the economy continue to go in the direction it is?

Secretary MILLER. We do not intend to wait and see. We have put into the midyear budget review what we think would happen to the economy without any economic action. We have indicated that we are not satisfied with that, and we will be taking action. We intend to do so looking at all options, of which taxation is one.

In fact our projections of automobile sales are such that Chrysler will be successful, will be self-financing beyond 1983, which is the statutory date, and will not be requiring any further Government support. That is our view. It is the view of the board which is made up of myself, Chairman Volcker, and Comptroller General Stats.

Senator ROTH. Mr. Chairman, my time is up, but I would just like to reiterate——

The CHAIRMAN. If you want to ask another question, go ahead. I interrupted you before.

Senator ROTH. As I mentioned, a number of economists, people like Otto Eckstein, have called for tax cuts now, and I would like to repeat what he said: "If tax cuts are deferred, the string of minuses in economic activity is likely to stretch into next year, and make this recession a more massive disaster." This is an economist who advised a Democratic President.

I point out, Mr. Secretary, that in the testimony you presented, it shows that in the past several years our economic growth was low, productivity was low, inflation was high, unemployment is growing. Isn't it just possible that it is the tax and spending burden that is causing this problem, and we ought to do something about it now to change the direction?

Secretary MILLER. Mr. Eckstein in his statement talks about a tax cut in 1981. I am back to my original proposition.

Senator ROTH. I said, "if tax cuts are deferred." He is talking about doing something now.

Secretary MILLER. No; he is talking about them being effective in 1981. He has made no other statement that I know of. If he talking about them being effective in 1981, they do not have to be legislated before the election.

Walter Heller, as you mentioned, he is talking about 1981. All these people are talking about 1981. Everyone is talking about 1981. There are quite a few months between now and 1981.

Senator ROTH. As a businessman, as you once were, would it make a difference to you if you knew now that there were going to be tax cuts in effect next January, or doesn't it make any difference in your planning?

Secretary MILLER. In terms of the business community, in my humble opinion, it does not make that difference because, if the principle were announced that deprecitiation reform would start next year, this could be known before next year, even without enacting something before the election.

For example, let me just tell you about the investment boom that we are going to have in the 1980's. The new changes in energy policy, including pricing decisions, are already resulting in the greatest activity in exploration and development of oil and gas that we have ever seen. More wells will be drilled. Coal production will begin to expand.

We will begin to turn to the question of retrofitting homes. We will go into the utility backout. The automobile industry will spend $80 billion retooling. These things are going to go forward regardless of tax laws because they are fundamental to the economic strategies of the enterprises involved.

I can guarantee that General Motors is going ahead with its programs, and Chrysler is going ahead with its programs, and Ford is going to go ahead with its programs regardless of what we do in taxes. Businesses will make their strategic decision. Now they are working out of the biggest backlog we have ever seen in orders for equipment. Their decisions mean that the plants are going into effect in 1982. I can guarantee you that 3 or 4 months will not swing their strategic plan.

If they can know in due course what our program is, they will be able to unwind their plans, and put their systems into go. They now have enormous backlogs of orders. Orders have been down for several months, but there was actually a leveling last month, and the backlog continues very high.

The CHAIRMAN. Let me now call on Senator Heinz.

Senator HEINZ: Thank you, Mr. Chairman.

Mr. Secretary, one of the minor and occasional frustrations that one gets when serving in the legislative branch is when you hear the economic facts and economic history of a nation being written down by a high Government official, and what in your own judgment you consider to be a revisionist view, and wrong view, of what is in fact happening.

I would hope that when people come back and read this record 5 or 10 years from now, assuming anybody does, that they would not get the idea that real gross national product per capita is increasing at a wonderful and astounding rate, or that real GNP per worker is increasing at a wonderful and astounding rate as, for example, exhibits 1 and 2 in your testimony, and I cite those as only two examples, might appear to suggest. Nor would I want the record to reflect what I take the sense of your testimony to be, which is that there is a strong implication that tax cuts are in some sense a principal cause of deficits.

I think the evidence would be hard to marshal to prove that. The evidence, on the other hand, could be very easily marshalled to show that uncontrolled spending would be the principal cause of deficits.

Third, I would hate to leave unchallenged the implication in your statement that a tax cut, whether it is a 1980 tax cut, or a 1981 tax cut, would only be justified if "circumstances and facts warranted it. 'The assumption underlying that statement is that tax cuts must inherently be oriented toward demand management.

We have been trying the demand management approach for a number of years, and it seems rather tired and shopworn, inasmuch as it does not seem to work except to increase inflation.

Having said that, I would like to review what I understand to be the sense of your testimony. As I understand your testimony, you have proposed nothing specific. You have taken shots at just about every proposal. You have provided information to us in your exhibits at some length, and the most striking fact is that we have a very serious problem with respect to labor productivity. It is a problem that we have had for a considerable period of time, perhaps as long as since 1973. That that is not entirely new information, I think it is fair to say. We had the same information a year ago, a year-and-a-half ago at the beginning of this Congress.

As I understand your conversations with some of my colleagues last year, what you said last year, maybe a little earlier than this time last year, was "I am deeply concerned about our failure to increase our growth rate and productivity. Wait so that we can all work on this together." This year you are saying, "Wait. This is an election year."

I don't know what the administration will say next year. But I say that it is time for the administration to stop playing politics with the economy, because simply to say, wait, wait, wait, when you have long-term problems is not only to play politics, but it is to ignore doing things that need to be done.

My question is, whether or not you want to enact them in 1980 or 1981, what do you specifically propose to address our long-term problems, leaving aside whatever you might want to do for demand management and tinkering kinds of things that have been largely discredited. What specifically do you want to do, whether it is this year, next year, or as you may say, next year or the year after?

Secretary MILLER. Senator, perhaps the best way to approach your concern is to make a personal observation, and point out what the strategy about the economy is, and therefore get us back into context.

You seem to imply that nothing is being done. I would suggest to you that there are a series of things that are terribly critical to addressing the major problems of our economy which are underway, and have been underway, and must be sustained.

Senator HEINZ. Mr. Secretary, I don't mean to denigrate those efforts. I meant to focus my question on tax policies exclusively, and I did not make that as clear as I should.

Secretary MILLER. Fine.

In the first place, we are disavowing in this testimony the concept of demand management. We are saying, as I tried to say very clearly, that we are not going to solve our problems by unleashing a new round of demand without providing for greater capacity to fill that demand, and building the potential of the economy. That was the heart of my approach.

One of our concerns about tax policy is not to unleash a high level of demand at the same time that we are trying to stimulate investment for there must inevitably be a lag before the potential output is increased. To have high demand in 1981, 1982, 1983, and capacity come on in 1984 and 1985 doesn't do us any good. We can let inflation eat us up again, and we will be back in the soup again.

If I could outline for you our long-term economic strategy that we are now on, I could point out to you that in terms of dealing with fiscal policy, monetary policy, international policy, incomes policy, energy, structural problems, I could spend 2 hours telling you this because it has been fundamental.

Senator HEINZ. You already have.

Secretary MILLER. I already have from time to time, and I may again. Whenever I need to filibuster, I may bring it up again. [Laughter.]

Senator HEINZ. What are you practicing for, Mr. Secretary?

Secretary MILLER. Let me go to the heart of the issue. For example, this last February if I had come here, you would have been hitting me very hard about what was my plan now that we had a permanently dead and buried bond market. That was the opinion of financial experts. It was not my opinion.

I was called by people at high levels in the market saying, there will never be a long-term bond sold again for an industrial company. That is over. That era is gone. Now, at this point of time we have sold more. Corporations have gone to the market for a higher volume of borrowing long term than they ever have. This will be the biggest year in history.

Senator HEINZ. Mr. Secretary, with all due respect, I did not ask that of you today, and I would not have asked it of you then.

Secretary MILLER. One must remember——

Senator HEINZ [continuing]. But I am getting the answer either way.

Secretary MILLER. You need to know it. [Laughter.]

You need to know that the decision to deal with inflationary expectations was terribly important in turning that market around. In dealing with tax policy, we just cannot reverse ourselves and get back into the psychology that inflation is going to be acceptable again, and that we are going to return to doing something long term to take care of this week's fad.

That is what it was in February. It was this week's fad.

Senator HEINZ. In fairness to my other colleagues, may I summarize your answer?

My question was, What specifically do you propose as long-term solutions to the long-term problems that you, yourself, have identified? I take it that you are not prepared to give us that answer today.

Secretary MILLER. I can tell you exactly what it is in generalities. [Laughter.]

Senator HEINZ. I think that you have more than exceeded that particular goal.

Thank you, Mr. Chairman.

Secretary MILLER. I will answer you, however, and say, as I pointed out, that the time may be ripe, and it may be in 1981. We don't deny that. We don't say it is, and we don't say that it isn't. But at the time we will endorse a very effective and strong program for liberalizing depreciation as the cornerstone of tax policy. There will be other policies, but that will be one.

Senator HEINZ. When will we see it?

Secretary MILLER. I think we will see it——

Senator HEINZ. You know, it would not be inconsistent for you to send a proposal now and say, "We want you to consider this. Don't enact it until 1981."

Secretary MILLER. I know that, and I certainly will take that under advisement. What I am afraid of, quite frankly, is that if we submit a proposal of exactly what we would be willing to look at in due course, it will be read by everyone in this room as, we have now made a proposal, and we want it now. We are just playing games.

Because of the criticism that Senator Byrd makes, I am determined to make clear what our position is, to hold back what we propose until the time is ripe for moving forward to enactment. Otherwise, we will be perceived as being coy, and putting out a proposal and saying, we really don't want it, but of course if you enact it it will be law. I just don't think that we want to get into that game. We don't want to game it. We want to do it in a respectable way, and we shall certainly do it.

Real per capita income from 1947 to 1965 rose at an annual rate of 2 percent, real disposable income. From 1965 to 1976, it was 2.5 percent. From 1976 to 1979, it was 2.3 percent. So over this whole period of time, yes, we have grown in absolute dollars on a per capita base.

Senator HEINZ. That was GNP per capita.

Secretary MILLER. We can get those figures for you, too.

Senator HEINZ. I know you can.

Thank you.

[The following was subsequently supplied for the record:]

Growth in real GNP per capita over the three time spans was as follows:

	Percent change, annual rate
1947-65	2.1
1965-76	2.0
1976-79	3.2

The CHAIRMAN. Mr. Secretary, you came before our committee when you were serving as Chairman of the Federal Reserve Board, and you were kind enough to share your views with us on what you thought the best tax policy would be at that time.

We were in process of recommending in this committee an additional 2 percent investment tax credit, with an additional allowance for employee stock ownership. You suggested that in your judgment we would be most effective in stimulating the economy if we were to do something to liberalize depreciation.

Secretary MILLER. Yes, sir.

The CHAIRMAN. What this committee was focusing on at that point and what you were recommending were fundamentally the same thing. It provided an incentive for business to provide new plant and equipment.

Look at your chart exhibit 18. Senator Packwood suggested that if you take the last year, it would show that both productivity and the capital/labor relationship are in the minus column. I would like to ask that this information be provided to us.

Secretary MILLER. We will break these down by year. Yes, sir.

[The following was subsequently supplied for the record:]

Annual changes in growth in the capital-labor ratio and productivity in the private business sector are presented below for recent years. These figures correspond to those used over longer time periods in Secretary Miller's testimony, and in Exhibit 18.

	Percent change	
	Capital/labor	Productivity
1977	−0.7	1.8
1978	−.4	.5
1979	−.7	−.8
Average annual growth: 1976–79	−.1	.5

The CHAIRMAN. I would submit that what that chart shows is that you were right, and so were we. We should have been focusing at that point on trying to provide more and better tools for the American working people. It seems to me that it was the need then, and it is the need now. It was the need in 1978, when we passed the tax bill providing some additional relief. But business said at that time that they would rather have a cut in the corporate tax rate. So we did not go for the concentration on the incentive to buy new equipment.

I would just submit that the chart that you present here, especially if you would show separately the last year on your chart, is the best evidence that we ought to be moving as soon as we logically can move to provide business with the incentive to build new plants and acquire the new equipment.

You don't really differ with that, do you?

Secretary MILLER. Mr. Chairman, I support what you say. In 1978, it was my opinion that the tax that was passed that year would have been much better had it taken the business side and put it on depreciation.

The CHAIRMAN. You were right, and so were we. Isn't that right?

Secretary MILLER. That is absolutely correct. I don't disagree with you now that at the time that the tax program is ripe, which undoubtedly will be in the near future, this must be the centerpiece of our thrust. I wish I could persuade everyone to look at this after election.

The CHAIRMAN. Mr. Secretary, I don't know near as much about running a bank as you do. I have never been president of a bank, or Chairman of the Federal Reserve, or anything like that.

Secretary MILLER. I am always cautious with a leadoff sentence like that.

The CHAIRMAN. You know a lot more about running a big corporation than I do. But I know more about politics than you do. [Laughter.]

You expressed your concern that as much as you thought we ought to do something to stimulate new investments in equipment and plant, it should not be done between now and the election because of your concern that people who have some special interests will say, "How about our little item? Congress has always indicated sympathy for us on our particular matter, why don't you take care of that?"

Mr. Secretary, let me just tell you this: I have been around for 28 years on this committee, and 32 years in the Senate, I can't recall when it has ever been any different. It does not matter whether it is an election year or not. If someone wants something, they are going to come around and ask for it, election or no election.

The President is going to react the same way in any event, if he is a good President, and I think your boss is a good President, and if he has a good Secretary, and I think that you are a good Secretary, you are going to turn a deaf ear to these special pleas.

If too many things find their way into a bill that you object to along that line, he is going to veto the bill. He is going to send it back, and say, "I guess I could sign it if you would take these items out, but in view of the fact that this has been loaded down with things that we object to, I am going to veto it."

What is wrong with that way of dealing with the problem? Hasn't that always been the process? That has been my experience.

Secretary MILLER. Well, I hope we ourselves can resist the pressures for particular items that would dissipate the core thrust of what we want to accomplish. Whether we can or not, I don't know. Whether the Congress can or not, I don't know.

But I am afraid, while I don't know anything about politics, it seems to me human nature is such that when you get up against a deadline of an election, and this sort of thing is sitting there on the table, there is a tendency to move a little emotionally, rather than rationally, and I don't think that it is fair to put a President in a position of having to deal with that a few days before an election. I just don't believe that that is the best way.

Bismark said it very well, I think——

Senator DOLE. What did he run from? [Laughter.]

Secretary MILLER. Then you know what he said.

The CHAIRMAN. Mr. Secretary, it seems to me that as far as economic recovery is concerned, we are headed in the wrong direction, if you have forecasts that the administration is putting in the newspaper saying that the situation is going to get worse before it gets better.

It would seem to me that we should not lose 6 months' time in providing the kind of incentives and encouragement that the business community would like to have in order to make a business decision to make investment.

I cannot for the life of me understand why, if you think this kind of thing is needed, we should not be getting on with the matter and giving the business community the encouragement they would like to have.

Secretary MILLER. Mr. Chairman, I think this committee will be doing a great service by having these hearings, and I am sure you have a long number of witnesses, including people who are from business, and represent business. I think that it will be well to hear from them.

I don't want to prejudge. I have been talking to a number of them myself, and my view has been that they are in accord with the fundamentals of what we are talking about. They would like to see liberalized depreciation next year. But I find many of them have the same view I have, that it would be best done after the election to be sure that we have the thing drawn right, and carefully done, and not done when it might just be watered down by trying to rationalize and make room for everybody else's favorite project.

They are not politicians either, and you will be hearing from them.

The CHAIRMAN. I am not going to trespass further on other Senators time by asking you additional questions now. But between now and my next turn we will have a recess, I want you to take a look at this proposed Senate Resolution 481 that we Democrats voted for, and let me know what, if anything, is wrong with it.

I was kind of happy with that resolution. I thought that it was a real nice resolution. It has not come to a vote in the Senate, but it is here before this committee for thought. You can just look it over and carefully analyze it. If you can find anything wrong with it, let me know.

I am not going to ask you to respond right now. Just stick it in your pocket, and when you have a chance to think about it, let us know.

Secretary MILLER. I only would note that it starts out with Mr. Bentsen, so it cannot be all bad. [Laughter.]

The CHAIRMAN. I will not ask you to respond to that right now, Mr. Secretary, because it is Senator Dole's turn now, and I think he ought to have his time without being delayed. So I will just ask you to comment later.

Senator Dole.

Senator DOLE. I missed some of your testimony, and I am sorry about that. But I understand most of it.

I must say there is a lot of concern about a tax cut, and when it should be implemented. Inflation has to be the biggest problem. I think that most people, Democrats and Republicans, share that view.

I don't want to rehash all the questions, but we had a meeting last week in Detroit. Some of you were not there, and I don't know whether you have had a chance to read our platform. It is a very nonpartisan, objective document that is widely read. It has been in great demand, and we are running out copies. [Laughter.]

Secretary MILLER. Should I get a copy now?

Senator DOLE. I am going to leave you a copy before I leave.

We addressed—I must say in all candor that there was some difference of opinion among Republicans. So I suggest that we certainly understand the reservations on the part of some people.

I saw a U.S. News & World report comment on the midsession review of the 1980 budget, which indicated that early drafts contained a recommendation for a tax cut. Is that accurate report?

Secretary MILLER. No, that is not accurate. The early drafts contained a provision, and not a recommendation. It contained a provision because Congress was moving toward this direction, and the question was, If Congress is considering action, if the Senate intends to recommend out a bill, should there be a recognition in the budget of the impact, and the effect on the deficit if there were a tax cut effective in 1981?

It was decided not to put it in because it was too premature. Nobody in the administration is prepared to recommend one, and never intended to recommend one in the budget. It doesn't seem at the moment that any of us have come to the point where we can identify a tax program, or as appropriate timing, or what not.

So it seemed better to put the midyear budget out as purely an extrapolation of the existing situation, and not trying to anticipate what Congress might do.

Senator DOLE. I think perhaps we make a mistake, and certainly I do at times, because we are not really talking about a tax cut, but about a reduction in the amount of tax increases, which is what we are addressing today. I don't think anybody would quarrel with that.

The administration has proposed tax increases of over $100 billion for fiscal year 1981. So we may get carried away with tax cut discussions, but we are really talking about a reduction in the increase.

Is there any benchmark on how high unemployment must go before this administration would recommend a tax cut?

Secretary MILLER. This administration is not satisfied with the projected unemployment later this year and in 1981 in any case, and would intend to initiate economic recovery actions that would ameliorate that, and would reduce the level of unemployment. But whether it should be taxes or something else, I think, has to be discussed.

Anything that we should do should be looking not at some stimulus that would merely let inflation go again, but would be addressing the structural problems, whether it is tax or something else. We have some industrial policies we have to look at. We have some regulatory problems that we have to look at. I think there are a number of areas that deserve being addressed in terms of improving the structure, and getting the economy on a sound footing to grow to its potential, and to grow in the 1980's.

Senator DOLE. You have mentioned some concern, and I agree with the chairman, there are always some political tax cuts; some of them come on even numbered years, as I look back over my 20 years in the Congress. It just happens to work out that way. The checks arrive in October.

Having indicated your concern about having an election year tax cut, or one just before the election even though it would not be effective until 1981, can we also assume that the administration does not plan to impose wage and price controls right before the election?

Secretary MILLER. You can be guaranteed of that. We have been absolutely opposed, and faithful in our opposition to mandatory wage and price controls. One of the problems earlier this year is that in the political campaigning in January and February there was talk about wage and price controls, and I think that this resulted in some disturbances as people tried to act in anticipation.

We are just opposed to them. They don't work. They create distortions. They would work against the structural reforms we are talking about.

Senator DOLE. I think that that is very helpful.

Finally, you talked about the different special interests and there is one group, which I suppose is a special interest, and that is the small royaltyowners. There are around 1 or 2 million little royaltyowners out there in several States.

Do you favor some relief for small royaltyowners who have been hit hard by the windfall tax, who pay the same rate as the major companies?

I know that there have been hearings in my State, and in the State of Oklahoma, and just last Thursday, I understand Senator Bentsen had 3,500 people appear at a hearing. The leaders in this committee have devised sort of a token relief for the small royaltyowners.

Is that an area that you have been able to look at and indicate some support? They are paying a 60-percent rate. Their royalty checks are being reduced by 35 percent. The majority of these people are landowners, small landowners, farmers, and retired people.

Secretary MILLER. Senator Dole, I think that one of the problems is that people have a misconception about that. As you know, in the first place, the windfall profit tax applies to a price over a certain base, therefore, it is not a 60-percent base on all their income. It is only above a rate that turns out to be much higher than most of them expected to get, except for OPEC's actions in any case.

Senator DOLE. Again, that gets back to politics. If you go out and try to explain that to royaltyowners, it is not acceptable.

Secretary MILLER. I understand that, and I am not disputing their concern. I am just saying that the perception is that some small person has suddenly had a tax thrown on him. The fact is that the windfall profit tax was intertwined inevitably with the decision to decontrol.

The decontrol brought them a higher price, and that brought them a higher price early. The windfall profit tax was enacted by Congress later, and they forgot the increase in price. They are concerned about the increase in the tax.

The CHAIRMAN. Mr. Secretary, if I might interrupt, there is a misunderstanding here. I think that it is generally shared by a great number of people, and I suspect that you share that misunderstanding.

In 1976 we passed the Alaskan pipeline bill, and on that bill Senator Bartlett from Oklahoma succeeded in adding an amendment that exempted stripper wells from the price controls. So they were decontrolled in 1976.

Then we passed the bill with the windfall profit tax. Take the case of a widow who gets a social security check, and let's say a check for $120 from a royalty on oil. This is a typical situation. Because of that windfall profit tax, they are taking $40 a month out of that royalty check, and that is simply a disaster for that little old lady. She is very upset about it, and very unhappy. This accounts for 3,500 of them showing up at a hearing on this subject when Senator Bentsen held it in Texas.

Those people with stripper oil royalty holdings already had their oil decontrolled. They had it decontrolled 2 years before we voted on the windfall profit tax, and the tax amounted to a drastic reduction of their income. It would have been different if the windfall profit tax occurred at the same they got decontrol, but they had already received decontrol 2 years earlier for those little stripper wells. That is why they are so upset.

Senator DOLE. A price rollback is what it is.

Senator BENTSEN. Let me speak to that point, Mr. Chairman, because I saw a lot of smiles around the room when you talked about the widow and the small amount of income.

Seventy-eight percent, a survey showed, were receiving less than $100 a month from royalty income. I am sure that there are probably some fat cats and wealthy people amongst the 100 percent, but 78 percent were under $100 a month.

Senator DOLE. That was true also, when Senator Boren and I were in Oklahoma and Kansas.

Again, this may not be the place to make the case, but we don't want those people to be forgotten. It would be helpful if the Secretary could indicate some support. I know there is sympathy, but support would be more helpful.

Secretary MILLER. Senator, the figures I have, and they may not be correct, and I may misunderstand the problem. I understand what has been happening out there. According to the figures that we have put together the royalty owners' income at this time is about $24 net after tax, after the windfall profit tax. In March 1979 it was $15. So it has gone from $15 to $24 even with the tax.

I would have to know more about the problem. It may be that I misunderstand the problem.

Senator DOLE. Yes, but everything else has gone up, too. I think that this is a point that we have overlooked. As the chairman pointed out very properly, it is, in effect, a price rollback, because Senator Bartlett when he was here offered an amendment, along with Senator Bentsen and others of us, which was adopted. But that is another matter we can discuss.

I appreciate very much your concern. I can just say, as somebody on this side of the aisle, we hope that there will be a tax cut enacted to take effect next year, but the work done this year. I don't think that it will get out of hand because we have a political contest. There will always be a political contest. Next year some other group will be running, and the following year it will be another group.

I would hope that we can adopt the resolution introduced by Senator Bentsen and others. I will just say that the Republicans are ready and willing to help to figure out what to do.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. Thank you, Mr. Chairman.

Is the administration's position that we should enact a tax cut in 1981, probably retroactive to the first of the year, in many cases, or should we wait until 1981?

Secretary MILLER. Senator Packwood, our fundamental position is being skeptical and concerned about trying to enact a tax cut with the short number of legislative days remaining, and with the pressure that is going to be on everyone to do it before election.

We have not had any position about whether it could be done after election if Congress has not completed its work, or whether it should be considered early next year. So we do not yet have an administration position. We felt that as long as it was not going to be our position to do it before election, we would have the opportunity in these hearings, and in the hearings of the House to try to crystalize the principles, to get agreement on the criteria. At some point there ought to be agreement on the magnitude. If you agree on the criteria and the magnitude, you can begin to shape something. Then we would be prepared to act after the election, if we thought that it was appropriate.

I guess we are in a position of saying, we are happy to debate the issues, and get prepared for a time when a tax program will be appropriate, and then to reserve judgment as to when that would be.

Senator PACKWOOD. May I paraphrase your answer to say that the administration has not yet decided whether there should be a tax cut enacted in 1981.

Secretary MILLER. That is correct. We recognize that it may well be desirable. We are not disputing that. It is just that we have not yet developed——

Senator PACKWOOD. There is a fundamental difference between whether or not there should be one enacted before the election because politics may intervene or, because the administration's position may be that there should not be any tax cut.

Secretary MILLER. That is, of course, true. But if there is the will of Congress to have a tax cut, and the will of the administration not, it still could be done after the election, in which case we might still have better terms.

Senator PACKWOOD. Mr. Secretary, do you think that Federal deficits cause or worsen inflation, if they are not the principal cause?

Secretary MILLER. In any particular year, it is hard to create a correlation. Obviously, in economic paths, in periods of excess output beyond the potential of the economy, inflation is very dangerous. It is important to have surpluses in order to bring us back to potential, and not unleash prices. In periods of recession, a deficit is creating economic activity that does not fill up the gap completely, and should not necessarily create inflation.

The problem is that what we have had in the United States for too many years has been deficits. So we have had deficits in good times and bad, and the aggregate bias of that, I believe, has been inflationary. In any one year, it may not be, but over time, as you accumulate nothing but stimulus from deficits, and never the offsetting balancing out of boom periods, I think one does have bias toward inflation.

Senator PACKWOOD. If continued, deficits probably would exacerbate inflation.

Secretary MILLER. Yes.

At the present time, with the recession and the economy operating substantially below capacity, I don't think that we are going to see inflation go down even with the deficit.

Senator PACKWOOD. If we were to enact the so-called Roth-Kemp bill, either for 1 year at 10 percent or 3 years at 30 percent, do you think: One, it would increase the deficit, two, would it run the risk of worsening inflation?

Secretary MILLER. I think that it would do both. I think that it would increase the deficit. I think it would worsen inflation.

The proposal starts the first year at about $35 billion—this is calendar year, and not fiscal year—in reduction of taxes. The feedback from that would start slowly to build. By 1985, on a gross basis, the cost per year of that proposal would be $282 billion.

In the first place, the stimulative effect of reducing individual taxes would be felt immediately. The impact for more economic potential, economic capacity because of the 10-5-3 component of that proposal, will come on several years later. So we would have a stimulus of demand again, ahead of our capacity to produce. My fear is that what we will almost certainly get is a period of pressing up against capacity where we get not more output, but higher prices.

To answer your question about a deficit, I think in the short term, quite clearly a tax cut which cannot feedback fast enough will add to the deficit. You might ask, what about 1985, when you have had more time for feedback.

Senator PACKWOOD. The second part of the question was, would it worsen inflation.

Secretary MILLER. Would it worsen inflation, yes, because of the demand. The other one about the deficit, yes, but even when you go out further, and you look at the $282 billion, even the most courageous feedback effect—that is a gross number. That would be a gross reduction in revenue. It would be less than that if the economy were stimulated by the program.

Senator PACKWOOD. Excuse me, but did you say courageous feedback?

Secretary MILLER. Courageous estimate, I think.

If you took the most generous feedback assumption, you still are talking about a very large reduction of revenues. I don't see in the budget where you could cut out expenditures and avoid much higher deficits.

Senator PACKWOOD. Do you think that a tax cut by any author that tilts heavily toward individual tax cuts would be unwise at this time because it would probably stimulate inflation?

Secretary MILLER. Yes, sir. I think we have to balance it so that we do give relief to households and individuals, but individuals throughout America now know the danger of inflation. They need some relief of burden, but I think they are willing not to take some large influx of increase in earnings from reduction of taxes, only to have it dissipated by inflation. I think that that is the problem that we have to guard against.

Senator PACKWOOD. Mr. Chairman, a moment ago, you indicated that you knew more about politics than the Secretary. I think that is probably true. In Oregon, 80 to 90 percent of the people I talked to from coffee shacks to service clubs would prefer no tax cut, to a tax cut and widening inflation. The polls seem to corroborate that.

I don't know where this makes the politics of this come out, but I just offer it for what it is worth.

Secretary MILLER. I think Americans have become deeply concerned about inflation. I think they have begun to realize that there is no way to conquer it through some easy path. Our forebears in this country were always willing to tighten their belts and go through periods of austerity in order to build a better country for their children. I think that people want to do that today. I think that that is the attitude.

Senator PACKWOOD. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Mr. Secretary, assuming that you don't want an individual tax cut, but that we will have one, I wondered if your statement on page 27 relates to the little tax bill that I introduced that provides 10 percent income tax credit against social security taxes, which was also introduced in the House. Is that statement there a favorable statement of that tax cut?

Secretary MILLER. My statement there refers to your bill, yes.

Senator BRADLEY. You think that if we go to a tax that is one of two ways that you think would be responsible under the circumstances.

Secretary MILLER. I think when we are looking at individuals that is one choice that ought to be looked at seriously. It has very many merits to it. I think we ought to weigh it against the alternative of bracket adjustment. But I think it deserves very careful attention as one of the alternatives to reduce the burden for individuals, which also will reduce the burden of labor costs, and have some effect there.

Senator BRADLEY. I would like to clarify some of the numbers on the Roth-Kemp, Reagan-Roth, whatever the name of it is. Depending on what forum you are in, you are going to use different names for the tax cut. You have stated that it would have a $35 billion revenue loss in each of the 3 years that it would be in effect.

Secretary MILLER. I will get from one of my associates the entire scale. The first year, the gross revenue reduction from the Reagan-Kemp-Roth—we call it Reagan-Kemp-Roth because Kemp-Roth was 10 percent a year for 3 years, and the Reagan proposal includes 10-5-3. So we put them together, and you have the Reagan-Kemp-Roth proposal. The first year, the gross reduction of revenues for calendar year 1981 would be $35 billion, 1982 would be $48 billion, 1983 would be $68 billion, 1984—these are not the right numbers.

Senator BRADLEY. You were just quoting the Kemp-Roth.

Secretary MILLER. I was doing it just with the first year only. Let me give you the numbers again. I was incorrect. The first year, $35 billion; the second year, 1982, $75 billion; the third year, 1983, $135 billion; fourth year, 1984, $206 billion; and the fifth year, 1985, $282 billion. That is the gross reduction of revenue.

The CHAIRMAN. Do you have a net figure?

Secretary MILLER. The net figure is one of very considerable debate. Our view is that it depends on monetary policy. The feedback assumptions depend on monetary policy. If you assume that the Federal Reserve———

The CHAIRMAN. But they are very extensive.

Secretary MILLER. They run from 20 to 40 percent, that is how wide they run.

Senator BRADLEY. Mr. Secretary, could we go on. I wanted to confirm the revenue loss under the Reagan-Kemp-Roth.

If you look at productivity, and the goal as you portrayed it, and as many of us have spoken about, is to improve productivity. Rather than ask you what are the causes of productivity decline, let me ask you some specific questions related to that productivity decline.

What effect do you think idle capacity in the economy has on productivity?

Secretary MILLER. I, again, think you cannot answer that generally because if you take much of the idle capacity in the United States, it is uneconomic capacity. It is not modern. People shut down a line that is no good. They say, "We could produce more, but it is going to be high cost."

The point is that much of it, therefore, does not contribute to productivity, and if you put it on stream it actually reduces average productivity because it takes more hours of input to get the output.

Senator BRADLEY. Would you say most private enterprise operations are organized so that they have optimum utilization of that capacity?

Secretary MILLER. They endeavor to do that, depending on the type of business.

Senator BRADLEY. When monetary and fiscal policy change, do you think that companies disinvest fast enough to continue to maximize their capacity?

Secretary MILLER. No. Quite often they are not able to. They are like a lot of other people, they make judgments. For example, in certain kinds of industry, they are willing to pay the price of hoarding labor. They don't want to lose a trained labor force, therefore, they will not optimize, and they will absorb some of it. They will reduce profits.

Senator BRADLEY. The result is that if you are talking about output per man-hour, when you idle a significant amount of capacity, you decrease productivity.

Secretary MILLER. It is normally what happens.

Senator BRADLEY. So that if we want to increase productivity in the country, one of the things we don't want to do is create a lot of idle capacity in our economy through fiscal-monetary policy.

Secretary MILLER. That is correct.

Senator BRADLEY. Let me ask you. What in your judgment are the relative rates of productivity increase among sectors of the economy, such as the service sector, and the manufacturing sector?

Secretary MILLER. The economy at large does not do as well. Let's put it this way. Agricultural has a higher one than average. Manufacturing, generally, has slightly higher productivity than average. The service part usually has shown the least improvement in productivity.

Senator BRADLEY. The number that I have seen is per manhour in manufacturing, you get about $8.22 cents worth of output. In the service sector, you get a little over $4 per manhour. Some services like financial, you get $11 per manhour.

Secretary MILLER. The figures have changed.

Senator BRADLEY. If we are again focusing on productivity, and it is interesting that you brought up agriculture because that is now the most productive section. One of the reasons for the increase in productivity in the last 30 or 40 years was the movement from agriculture to industrial, to manufacturing.

We are now in an economy, would you not agree, that is moving dramatically from manufacturing to service oriented industries.

Secretary MILLER. Absolutely.

Senator BRADLEY. Therefore, we have an inherent drag in productivity simply by the direction that our economy is heading.

Secretary MILLER. The changing mixture is bringing down the overall rate.

Senator BRADLEY. So that if you were talking about productivity, at least two of the major causes of the decline in productivity would be the creation of idle capacity in the economy, and the general mix between high productivity and low productivity industry.

Secretary MILLER. Correct.

Senator BRADLEY. Therefore, any tax policy or economic policy would have to take at least those two facts into consideration.

Secretary MILLER. Correct.

We should remember when we think that way, however, that since you do need all of these addressed, it is still in our interest to improve the productivity of the manufacturing sector, even though it is cyclically declining. The fact that we have such high productivity in agriculture has, of course, been a very positive course even though that has become a smaller part of the overall.

Senator BRADLEY. Could I say just one other thing.

That would argue, then, I refer to your export table, that we should increase our exports in agriculture. That would argue that we should have access to markets that are now denied us for agriculture, if we were interested in increasing productivity.

Secretary MILLER. It is to our advantage not only to expand our markets for agriculture, but for nonagriculture, and get it as a higher percentage of GNP to support this trend. Absolutely.

The CHAIRMAN. Senator Wallop.

Senator WALLOP. Thank you, Mr. Chairman.

Mr. Secretary, you object to the Kemp-Roth-Reagan proposal, but you have steadfastly refused to state anything as an alternative. You said in your testimony that there was no hurry to deal with productivity, energy, inflation, unemployment, if there is a genuine interest to deal with the structural problems.

It just has to be a smokescreen to say that a tax cut is being pursued in an election atmosphere. We have been trying to catch the administration's attention on these same structural problems for 3 years. You have yet in the administration to make a realistic economic assessment.

The President says that the recession is going to be short and mild, and that we have turned the corner on it. Mr. Kahn puts out inflation estimates that are several percentage points below reality. You continue here this morning to state blankly that you will reduce demand by increases through bracket creep rather than to find some specific means of creating production capacity.

Your chart No. 9 says, no capital, no production, no potential. It seems fair to say that the administration insists on dropping the actual increase rather than increasing the potential.

Again, I would say, you have as much as stated that the administration has no economic plan.

The Joint Economic Committee produces a figure on the Roth-Kemp-Reagan bill that is $100 billion 5 years out, less than what you just read to us. How do you explain that discrepancy?

Secretary MILLER. Who produced that?

Senator WALLOP. The Joint Economic Committee.

Secretary MILLER. That doesn't include the 10-5-3, probably.

Senator WALLOP. It does as far as I know.

Senator BENTSEN. Would the Senator repeat the statement of what the Joint Economic Committee did?

Senator WALLOP. It is the Joint Committee on Taxation. I am sorry, I misread that.

Mr. Chairman, I would like to put this table in the record.

I would like to ask you, Mr. Secretary, if in fact you are now prepared to say what kind of an economic game plan the administration is going to follow, other than to blame it on the American people. We have not had an answer to that. Senator Heinz tried to get it. Others have tried to get it. Is there a plan which you can describe.

Secretary MILLER. Yes, sir. If you would like for me to describe the overall economic plan, I would be pleased to do so, but what Senator Heinz wanted to know was just the tax part of it.

The overall economic program, of course, addresses the whole issue of fiscal policy, and not just taxation, but spending. The economic policy also must address the monetary issue. It also must address the international accounts, and the value of a dollar.

Senator WALLOP. I know it must. I am asking what the plan is, not what it must address. We have had a Republican economic platform, and this is the third one we have had, and we have yet to see an economic proposal in specifics out of this administration since I have been here.

Secretary MILLER. If you mean a tax proposal——

Senator WALLOP. Taxes, and all the rest.

Secretary MILLER. I have spelled out the economics.

Senator WALLOP. Not what it must address, Mr. Secretary, but how it must address what it must address.

Secretary MILLER. Then I will tell you. It will take me about 20 minutes, and I will be happy to spell it out for you if you would like.

Senator WALLOP. I am not going to infringe on other people's time. Would you submit it to the committee?

Secretary MILLER. Certainly. It involves the marshaling of policies. You cannot neglect—let's take the dollar situation. Major programs consulted with the Congress and initiated by the administration on November 1, 1978, have been effective in stabilizing and assuring a higher value of the dollar. That must be continued. We must not upset it with fiscal or monetary policies to change that. It is just one of the whole series of things that have been the policy of the program and continue to be. We spelled them out in testimony time after time and I will be happy to submit them.

Senator WALLOP. No; Mr. Secretary, what you have spelled out is what we must address.

Secretary MILLER. I have spelled out what we have done, and what we intend to do on fiscal policy, on monetary policy, on incomes policy, on international policy, on energy policy, on structural reforms, on regulation. We have an enormous charter of economic policies that have been pursued consistently. We have been making tremendous headway. I will be happy to submit to you a paper on that.

Senator WALLOP. I would be happy to see that.

Secretary MILLER. Taxes are a very narrow part of it.

Senator WALLOP. It does little precious good to deal in gross figures, even gross figures that are distorted according to at least one other group's estimate, and not talk about net figures, because the American public is not capable of drawing a conclusion about net unless somebody is willing to, at least, lay down that figure.

Gross numbers can scare the hell out of people, and I don't blame them. But the gross figures, you will admit, will not be what the actual monetary consequences of these things are.

Secretary MILLER. May I explain, Senator Wallop, that one of the problems with approaching this idea only giving net figures is that those are really very unreliable because net figures depend upon monetary policy, for example, which would give you different results depending on your assumptions.

If we start a process of estimating net numbers, you can't do it just for taxes. You have to do it for spending. You would find proposals before this committee, or before the spending committees, the Appropriations Committee, saying, "Let's spend $100 billion for this because when we feed it back net it only costs us a little bit."

So if we go down that path, we go down a very dangerous path. The only way we can give good data to the committee is to just tell you the gross effect. Everybody can go through the maneuvers about net effects, but when we finally make the expenditure of tax programs in the budget, then we can go through our computers, and we can come out with models that will tell us what the economy will do, and we will know the net results of our outgoes and income.

If we start trying to take expenditures and taxes, and giving net figures, I am afraid we will get into gaming. It will prove that neither spending nor taxing costs anything because that is the ultimate result of gaming on the effect of these things. So we must present it as a gross figure.

One would argue that if you had a stable monetary policy, the feedback effect could be 20 percent or so. If the Federal Reserve relaxes monetary policy, and supports a higher level of spending through tax cuts, you will have more feedback but more inflation.

So those are the reasons why it is very hard for us to give precise answers to the questions. We can compute out the numbers in a gross way.

Senator WALLOP. Mr. Chairman, my time is up. I would like unanimous consent to put the Joint Committee on Taxation's April 30 figures in the record.

Senator BYRD. Without objection.

[The document follows:]

TABLE 1.—TAX REDUCTION FROM THE ROTH-KEMP BILL, S. 33, AS COMPARED TO TAX INCREASES FROM INFLATION [1] AND SOCIAL SECURITY [2]

[Billions of dollars]

	1980	1981	1982	1983	1984	1985
S. 33:						
Calendar	27.0	55.0	96.5	128.4	164.8	207.2
Fiscal	16.8	4.4	80.8	116.8	151.6	191.8
S 33 with 1981 effective date:						
Calendar		31.8	64.9	113.8	148.7	189.5
Fiscal		19.8	52.4	95.4	136.0	174.6
Inflation—GNP deflator.						
Calendar		16.0	37.2	62.2	91.4	125.4
Fiscal		10.0	29.2	52.8	80.4	112.6
CPI:						
Calendar		23.4	45.9	72.8	103.0	138.4
Fiscal		14.6	37.4	62.7	91.6	125.0
Social security:						
Calendar		13.7	18.4	21.2	24.1	40.5
Fiscal		9.8	17.5	20.5	23.4	36.4

[1] Estimated by indexing the rate brackets, including the zero bracket, the personal exemptions, and the earned income credit for the increase in the Consumer Price Index of the preceding fiscal year These increases were 13.3 percent, 10.0 percent, 9.7 percent, 8.7 percent, and 8.3 percent for fiscal 1981 through 1985, respectively These are the inflation rates underlying the First Concurrent Budget Resolution for Fiscal 1981

[2] The excess of present law estimated revenue over the revenue if the 1980 6.13-percent rate were held constant and the $25,900 wage ceiling were indexed upward each year for the previous fiscal year's inflation

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Senator BYRD. Senator Moynihan.

Senator MOYNIHAN. Thank you, Mr. Chairman.

Mr. Secretary, I have three friendly questions.

You were about to quote Bismarck, and I know just what you were going to say. Bismarck said that you cannot intervene in a complex system and change only one thing. Is that right?

Secretary MILLER. Among other things, he said that. If he didn't, then he should have. [Laughter.]

Senator MOYNIHAN. Your remark on page 29 of your testimony is about the 10-5-3 formula. It is a very short time to recover the cost of structures; and if we were to adopt it, it could stimulate real movement of plant out of the Northeast. This would be an unanticipated result which would not necessarily be an economic one, but would be a response to a tax artifact.

I believe you have testified before on that.

Secretary MILLER. Yes.

Senator MOYNIHAN. We are going to pass a tax bill. We are under instructions to ourselves. I know that Senator Bentsen has been very sensitive and thoughtful about the subject.

Could we get your estimate on what would be the effect, and how to minimize that sort of unanticipated movement, of resources around the country.

Secretary MILLER. I will try to get you an estimate of dislocation effects.[1] It will be somewhat empirical. I think I can give you the philosophy of the response to it. I think in the structures area, we already have really quite good depreciation schedules. So I don't think that that is the place to concentrate in seeking productivity.

I think we should concentrate again on the depreciation allowances for machinery and equipment. There, you really get more, because instead of giving away these tax benefits to structures where it is not necessary to create the facilities, you concentrate the same money where you get more bang for the buck.

Senator MOYNIHAN. We would appreciate that, and the sooner the better.

Secretary MILLER. We will get that.

Senator MOYNIHAN. The second thing. This is a very hypothetical question, and it is meant to be and it will turn out friendly, I assure you. [Laughter.]

There is a stereotype about administrations. The conservative administration increases the defense spending, and cuts the social services. Is that right?

Secretary MILLER. Yes.

Senator MOYNIHAN. Then there is a stereotype that liberal administrations cut defense spending, and increase social services. Is that right?

Secretary MILLER. Correct.

Senator MOYNIHAN. May I refer you to your exhibit 16. Remember Senator Packwood's remark that over here on the very edge, we are likely to have a negative increase in nondefense, which is a good surrogate for social services. Which is the most liberal, and which is the most conservative period in postwar American history?

Secretary MILLER. It looks to me that under your theory the liberals were sure in control in 1965 through 1976, and the conservatives in 1976 through 1981. Is that what you are saying?

Senator MOYNIHAN. Right. I am saying that for the benefit of those radicals over there on the right.

Senator ROTH. Would the Senator yield for just one question? Who controlled the Congress during that period?

Senator MOYNIHAN. That is right. I forgot about that.

Secretary MILLER. Senator Roth, I can tell you. No one. [Laughter.]

Senator MOYNIHAN. I think it is absolutely shameless the way that meeting in Detroit wiped out the memory. Down the memory hole went Dwight D. Eisenhower, Richard Nixon, and Gerald Ford. They did not exist, and only this Democratic Congress, and poor Speaker O'Neill did.

I simply wanted to make the point to my friends on my side that when your economy goes bad—this administration did not come to

[1] See appendix at the end of these hearings.

office intending to cut social spending, and certainly not to reduce it—nothing else goes right, does it?

Secretary MILLER. No.

Senator MOYNIHAN. We have on the record here the most conservative period of fiscal policy in the postwar American history, and that is because the economy went bad, and the best intentions in the world will not overcome it. This is a lesson that we have to learn because we have taken the health of our economy as a given fact, and thought that the big issues were, "How do we distribute the annual surplus?" When we haven't got one, you see what happens.

I think you would sympathize. I know your social concerns have been as broad and as positive as any Secretary of the Treasury we have had, yet you have had to preside over a very austere period, haven't you?

Secretary MILLER. Very.

Senator MOYNIHAN. We did get into it slowly, and we are not going to get out of it quickly.

Secretary MILLER. It is going to be a very long-term process.

Senator MOYNIHAN. For a person of liberal disposition, the first lesson to be learned is that absent a sound economy, there is not much liberal social policy that is going to happen, regardless of what speeches you make, and how you pronounce it.

Secretary MILLER. A sound economy, the ability to bake a bigger pie, gives the ability to handle programs better. Our ultimate security depends upon it also.

Senator MOYNIHAN. Thank you very much, Mr. Secretary.

May we thank you for your patience with us. We are not always the most orderly people.

Secretary MILLER. I expected a worse day, frankly.

The CHAIRMAN. Senator Bentsen.

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

Mr. Secretary, a statement was made earlier that President Carter had been playing politics with the economy. I don't believe that is a correct statement. In this situation, he is going into a campaign in a Presidential election trying to hold down expenditures. Traditionally, the political thing to do is to wind up the economy, to have a lot of fresh spending, and certainly not to have increasing unemployment. I think that he deserves credit for the courage he has shown in that regard.

Now having said that, Mr. Secretary, I also think that it is time for the administration to get its face up off the floor. I think that we ought to be talking about some of the things that have to be done about this economy. I want to look at the realities of getting a bill through the Congress.

If you wait until next year, and we have to reorganize the Congress, with a new Congress, that takes time. I believe that it is important, as we go into this election, that the American people know that this administration is committed to a tax cut in 1981, and that they have some idea of the specifics of that tax cut.

This ought to be explored both in these hearings in the Senate, and in the House. The administration ought to be giving us some ideas of what they think should be done. I don't care whether that tax cut is passed before the election, or after the election. But because I think we are going to have an increase of some $47 billion in taxes next year, and that is going to be a drag on the economy, that it is absolutely imperative that we have a balanced tax cut between demand and supply, a targeted tax cut that will not increase inflation.

I don't believe there is any tax cut that is going to reduce the time of this recession being done this late, but I do think that we can improve the quality of that recovery, and not have the kind of an inflationary thing that happened in 1974 and 1975, but bring one about that increases productivity, that increases employment in this country, and in turn helps keep inflation down.

The American people are absolutely right that we should not have a tax cut if it adds to inflation.

My friend from New York is talking about rehabilitation, and I think he is right. In 1978 we passed a 10-percent tax credit for rehabilitation of certain buildings. I think that we ought to consider 15, 20, and maybe 25 percent, because in one way or another all the people of this country will pay for the problems of the Ohio Valley, and for the Northeast. The Sun Belt will pay along with everybody else.

You have the personal loss in families by having to move. The loss the mass transit system that was there. The tax loss in the community. So we ought to be giving some consideration to a tax credit for rehabilitation, wherever it is across the country, with the full realization that most of it is going to be in areas that are depressed, and are older areas.

We should not go the route of trying to give great tax credits for new shopping centers, or new office buildings. Instead we should be trying to get a balance between supply and demand and increased productivity.

Would you care to comment on that?

Secretary MILLER. Philosophically, that is correct. I think we, in terms of our efforts to suggest modifications of 10-5-3, are very conscious of the principles that you are outlining. We don't want to create distortions either in the location siting decisions. We don't want to drive capital into areas which represent nice shelters for taxes but don't create jobs and productivity, and build modifications and the technological advances that we need to assure the preeminence of American industry.

We need a corresponding industrial policy. It may be that you are correct, that we need once again to look at additional benefits for rehabilitation. We have done that in some areas where there were some advantages.

Senator BENTSEN. Investment tax credit, or some other approach. But I really think that we ought to be concerned about rehabilitation.

Secretary MILLER. What we don't want to do is have the depreciation rate the same for a nuclear powerplant and a machine tool that is going to work for only 2 years building an engine at a vehicle plant because what happens is, again, you distort everything. What you need is some relation between the economic use of a facility, and the rates that we establish.

I think that we can do all that if we apply ourselves to it.

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

The CHAIRMAN. Mr. Secretary, it is now 3 minutes until 1. I think that most Senators have some additional questions. Would those who would like to ask additional questions raise their hand?

There are only three who would like to interrogate you further. We will just stick around, and finish the questioning now.

Secretary MILLER. Surely.

The CHAIRMAN. Senator Byrd.

Senator BYRD. Mr. Secretary, I would like to get three figures from you. What was the total spending for fiscal 1979?

Secretary MILLER. $490 billion outlays.

Senator BYRD. Thank you.

What will be the total spending for fiscal 1980 as presented to the Congress by the President on Monday?

Secretary MILLER. $579 billion.

Senator BYRD. Would you tell the committee the difference between those two figures?

Secretary MILLER. $85 billion.

Senator BYRD. So is the Senator from Virginia correct in asserting that there will be an increase of $85 billion in spending between 1979 and 1980?

Secretary MILLER. In nominal dollars, that is correct, yes, sir.

Senator BYRD. Would the Secretary of the Treasury inform the committee whether there has been any other year in the history of our Nation where spending has been increased in 1 year by $85 billion?

Secretary MILLER. I am not aware of any prior year.

Senator BYRD. The Secretary of the Treasury is saying that he is not aware of any year in which spending has been increased as much as $85 billion.

Secretary MILLER. Correct.

Senator BYRD. So would the Senator from Virginia be correct in asserting that the increase in spending for this fiscal year is unprecedented, and will be the greatest increase in spending of any year in the history of the Nation?

Secretary MILLER. Senator Byrd, if we are going to talk in those terms, we have to relate it to GNP.

Senator BYRD. Mr. Secretary, if you don't mind, I am asking a factual question.

Secretary MILLER. I don't want anyone to forget the difference.

Senator BYRD. I am asking a factual question. Is it correct, or is it incorrect.

Secretary MILLER. It certainly is correct, but I believe it would be well to relate it to the total GNP.

Senator BYRD. I am not speaking about the GNP, Mr. Secretary. I am talking about spending. I happen to think that if we get spending under control, then we don't have to worry too much about taxes. Taxes will take care of themselves.

What I object to is the public being misled by the administration and by the Congress in saying that spending is being restrained. How is spending being restrained when in this 1 year there will be the largest increase in the history of the Nation?

Secretary MILLER. Again, I think, if you want an objective answer to that, you have to look at how much of it was from high rates of inflation, and what it is in relation to the total economy. In the figures that I gave you, I worked them back to real dollars. I think in terms——

Senator BYRD. Can you give me an answer to my question?

Secretary MILLER. Congress has enacted a law that indexes many payments for the Federal Government. The indexing in many cases is greater than the actual inflation rate. You may be correct that that issue should be addressed, but I think that the administration would be misleading anyone to say that inflation is higher because the law requires that certain benefits be paid in higher dollars. It just happens to be the law of the land. The administration did not propose anything. It did not suggest the programs. It did not ask Congress to pass anything.

Senator BYRD. The administration has been asserting, and the Congress has been asserting that Federal spending is being restrained. The facts show that Federal spending is not being restrained. The facts show, which you just substantiated, that in the current fiscal year the increase in spending will be greater than any year in the history of the Nation. These are the facts.

Secretary MILLER. Senator Byrd, I think that in order to be factual, one has to look at spending, and the question of restraint in terms of constant dollars, otherwise we mislead ourselves. If we look at constant dollars there has been a reduction in the rate of growth.

I agree with you, we could perhaps do more, but I don't think that we should not be fully communicative in pointing out that while the nominal dollars may go up—take the bill for oil in the Defense Department of the Federal Government, it is not because of failure to control expenditures. It is the fact that oil prices have gone up 150 percent. There you are. If you are going to have a defense force, you are going to have to have fuel for it.

Senator BYRD. It is not my purpose to argue with you. I am just asking some questions, and you can answer them in any way you wish.

Is it your view that a $61 billion deficit for the current year is responsible budgetary action?

Secretary MILLER. That in relation to the economy is not a stimulative result. If we had 6 percent unemployment, rather than the 8 percent that we now have, the budget would, I believe, be in balance. So in that sense——

Senator BYRD. You don't have 6 percent unemployment. You are going back to the old full employment budget concept that was discarded by this administration 4 years ago.

Secretary MILLER. High employment would show us that we are not creating at the moment through that deficit unusual strains on the economy, or unusual stimulus.

Senator BYRD. It is very enlightening to the Senator from Virginia that the Secretary of the Treasury feels that a $61 billion deficit is an appropriate deficit.

Let me ask you this: Is it your view that a $30 billion deficit for the upcoming year, 1981, is responsible budget action?

Secretary MILLER. Considering the level of economic action, and the level of economic output, and the level of unemployment, I believe that it is actually a restraining budget. The fiscal drag in that budget would be higher than the fiscal drag this year.

Senator BYRD. It is a very interesting comment.

President Carter told the American people in March, again in April, again in May, again in June, and most of July that the country should have a balanced budget, and would have a balanced budget. Now the Secretary of the Treasury says that a $30 billion deficit is an appropriate deficit.

Secretary MILLER. No. I said that this particular deficit, is the result of economic conditions, and the failure of some of our proposals to be accepted by Congress, changes not brought out by our desire, but by either the circumstances, or disapproval of our actions. In that sense, we have a deficit which is actually more restraining on economic growth than the financial conditions of 1980.

As it has been pointed out in this committee, for example, this morning, social security taxes go up, and this deficit reflects an increase in those taxes which represent a fiscal drain. The only way I know to analyze an economy is in fact the balanced budget concept, and I have said this over and over, we should seek an approximate balance of outgo and receipts over a business cycle. If an output of the economy is above the normal trend, then there should be a surplus. If output is below trend, then there should be a deficit. If we are producing right on trendline, then we should be in balance.

Right now we are below capacity, so we expect a deficit just because the economy operates automatically that way, and it cannot generate the revenues if we have people not at work, not earning, and not paying their taxes.

Senator BYRD. Mr. Secretary, how important do you think it is to balance the budget?

Secretary MILLER. I think that it is very important to do so over the budget cycle, and that is why I have said that you have to relate this to the level of the cycle. If we had 5 percent unemployment, this deficit would be outrageous. But we have predicted 8.5 percent unemployment, in which case there is slack in the economy that produces a deficit. So it is balancing the budget over the business cycle that is the key, I think, to policy. I don't disagree with you on that.

Senator BYRD. The Carter administration has given up on a balanced budget in 1981.

Secretary MILLER. We see economic conditions such that to balance the budget would drive unemployment rates higher, would impose enormous suffering on Americans, and would not turn our economy around, and would not solve our problem. The only way we can balance this budget is to throw another few million people out of work. I don't believe that it would be appropriate to do that.

Senator BYRD. The answer to my question is that the Carter administration has given up the balancing of the budget for fiscal year 1981.

Secretary MILLER. We do not believe, with the economic downturn, that it is possible to balance the budget in 1981. We have not given up the philosophy of balancing the budget, but I think that it would be wrong policy. I don't believe that any of us would support it when we get down to the cases.

To balance the 1981 budget with the present condition of the economy—if we tried to do it—it would merely mean higher unemployment for millions more people.

Senator BYRD. Do you favor or oppose to the Congress taking steps this year to liberalize depreciation rates for buildings and machinery?

Secretary MILLER. I would prefer that liberalization of depreciation be handled as part of the total tax program after the election. As we have already mentioned, there should be a very careful look at depreciation on buildings because that could create distortions in regions of the country, or between cities and outlying areas, and I think would work against our economic policies.

Senator BYRD. My time has expired. I ask, Mr. Chairman, unanimous consent to insert in the record the table showing the receipts and the outlays of the Federal Government for the fiscal years 1958 through 1981.

The CHAIRMAN. Without objection, it is agreed to.

[The document follows:]

UNIFIED BUDGET RECEIPTS, OUTLAYS, AND SURPLUS OR DEFICIT FOR FISCAL YEARS 1958-81, INCLUSIVE

[In billions of dollars]

	Receipts	Outlays	Surplus (+) or deficit (−)
Fiscal year:			
1958	79.6	82.6	−3.0
1959	79.2	92.1	−12.9
1960	92.5	92.2	+0.3
1961	94.4	97.8	−3.4
1962	99.7	106.8	−7.1
1963	106.6	111.3	−4.7
1964	112.7	118.6	−5.9
1965	116.8	118.4	−1.6
1966	130.8	134.6	−3.8
1967	149.5	158.2	−8.7
1968	153.7	178.8	−25.1
1969	187.8	184.6	+3.2
1970	193.8	196.6	−2.8
1971	188.4	211.4	−23.0
1972	208.6	231.9	−23.3
1973	232.2	247.1	−14.8
1974	264.9	269.6	−4.7
1975	281.0	326.2	−45.2
1976	300.0	366.4	−66.4
1977	357.8	402.7	−45.0
1978	402.0	450.8	−48.8
1979	465.9	493.7	−27.7
1980[1]	517.9	578.8	−60.9
1981[1]	604.0	633.8	−29.8

[1] Estimates.

Source: Office of Management and Budget.
Prepared by Senator Harry F. Byrd, Jr., of Virginia, July 1980.

The CHAIRMAN. Senator Roth.

Senator ROTH. Thank you, Mr. Chairman.

Mr. Secretary, you have indicated that the administration may recommend a tax cut in 1981. You have already admitted that there will be a deficit of $31 billion. Earlier this year the administration said that there should be no tax cut until the budget is balanced. Is it realistic for the American people, under those circumstances, to expect the administration, if it were reelected, to recommend a tax cut next year?

Secretary MILLER. The policy in terms of that goes back at least 18 months. In January, in the message to Congress and the Economic Report, the President said that our first task is to impose greater discipline on Federal spending. If we are able to complete that, then after 1980—he said this in January 1979—after 1980, we will be in a position to consider a tax reduction.

In January 1980, 1 year later, he said the same thing. In March he said: "We shall endeavor to achieve a balanced budget," but he said, "the primary thing is to control spending. If Congress exercises restraint and discipline over spending, we will be in a position, after that is demonstrated, to consider tax reductions in 1981."

So his position is that if we show restraint on spending, if we do not let that particular item of activity get out of control, we will be in a position to consider and to recommend, if appropriate, tax reductions in 1981.

Senator ROTH. In all candor, I would have to agree with the Senator from Virginia. I don't see much restraint in spending.

Let me ask you. I have heard very little said by you about the plight of working Americans. How many more Americans do you think will be unemployed before the end of the year?

Secretary MILLER. We project 8.5 percent unemployment in the fourth quarter. We are not satisfied with this. It distresses us. We know the hardship involved.

Senator ROTH. How many people does that involve?

Secretary MILLER. It is about 8.5 million people unemployed. Do you mean how many more than now?

Senator ROTH. Yes.

Secretary MILLER. About 400,000 more.

The CHAIRMAN. Let me interrupt for just a moment.

You talk about 8.5 million people, Mr. Secretary, but these people have families. Maybe you ought to provide for the record how many individual people you are talking about. You are not talking about just the unemployed man. You are talking about his family.

Secretary MILLER. We are talking about unemployed workers, and you are talking about many of them being part of two-family wage earners with one out of work. You are talking about others with a single wage earner in the family. You are talking all those things.

Senator ROTH. Yet, you are saying that in view of the fact that you expect increased unemployment—and your figures according to some economists may be low—we should hold firm on the present course of the administration.

Secretary MILLER. No; that is not it. As a matter of fact, I will repeat, as I have said often: If that is a problem, I don't know of anyone in this committee who has recommended putting a tax cut in this year.

Senator ROTH. We have gone over this several times, Mr. Secretary——

Secretary MILLER. We are talking next year. If you are talking next year, I am saying that we are willing to consider next year. We want to consult. We want to work. We don't want to try to do it in an election year atmosphere.

Senator ROTH. Perhaps one of the problems with the administration is that it has lost touch with the people. The American people want some certainty. It is a lack of confidence as to what direction you are going that is part of the problem.

Secretary MILLER. They do not want a tax cut that will unleash inflation, though.

Senator ROTH. The problem with your answer earlier, as to whether it made any difference if we enact it this year or next year, is that we are not just talking about big business. You are talking about General Motors, Ford, and Chrysler. It involves small business. It involves the individual. One of my concerns is that there seems to be no concern either about the smaller guy, or the working guy.

Let me ask you this question. How much more taxes is the average working person paying today than he did in 1976?

Secretary MILLER. I will have to have someone check that. I don't happen to have the figure in mind.

[The following was subsequently supplied for the record:]

Income tax liability for a single person with median income in 1976 and 1980

Calendar year 1976:	
Income	$5,375
Tax liability	$427
Effective tax rate (percent)	7.9
Calendar year 1980:	
Income	$8,124
Tax liability	$811
Effective tax rate (percent)	10.0

Office of the Secretary of the Treasury, Office of Tax Analysis, July 31, 1980.

Secretary MILLER. The tax structure after the 1978 tax decrease kept the tax burden about the same as it had been. So until this year or next year we had not had any increase. We know there is an increase. We do show deep concern. We are concerned not only about the unemployed. We are concerned about the burden of taxes on people. But we are also concerned about telling them the truth, giving them the realities about the economy.

A demand oriented tax reduction that just stimulates purchasing, and does not put in place the capacity, drives us up against capacity limitations, and unleashes inflation again, and this will not serve the American people well. They know this, and that is why two to one they are voting at the moment in the polls, at least, in the surveys that are being done in favor of not having a tax reduction.

Senator ROTH. You don't know, Mr. Secretary, how much taxes have gone up on the typical American family in the last three years?

Secretary MILLER. In real dollars?

Senator ROTH. Do you know how much they will go up next year in dollars.

Secretary MILLER. I know the aggregate number, but I don't know per average family. I would have to go back and get the per capita.

[The following was subsequently supplied for the record:]

Income tax burdens for median income 4-person family, 1977-81[1]

Calendar year 1977:	
Income	$18,723
Liability	$1,952
Effective tax rate (percent)	10.4
Calendar year 1978:	
Income	$20,428
Liability	$2,262
Effective tax rate (percent)	11.1
Calendar year 1979:	
Income	$22,339
Liability	$2,409
Effective tax rate (percent)	10.8
Calendar year 1980:	
Income	$24,138
Liability	$2,742
Effective tax rate (percent)	11.4
Calendar year 1981:	
Income	$26,284
Liability	$3,042[2]
Effective tax rate (percent)	11.6

[1] Liability calculations assume deductible expenses equal to 23 percent of gross income.
[2] Includes $400 exclusion of interest income allowed for 1981 and 1982 under the Crude Oil Windfall Profit Tax Act of 1980.

Office of the Secretary of the Treasury, Office of Tax Analysis, July 31, 1980.

Senator ROTH. According to figures here, it has gone up $1,400 since 1976.

Secretary MILLER. During that same period, real disposable income has increased.

Senator ROTH. How much will revenue go up between 1980 and 1985 for the Federal Government?

Secretary MILLER. I can take the budget figures and do a little arithmetic. Somebody will have to do that for me because there are several projections depending on which part of Humphrey-Hawkins you assume. But revenues will go up based upon the current policy, based upon the growth of the economy, and inflation which will drive money incomes up.

[The following was subsequently supplied for the record:]

Federal receipts are expected to rise by $537 billion between fiscal year 1980 and fiscal year 1985. [From $524 billion to $1,061 billion.]

Senator ROTH. Let me point out that according to CBO and the Joint Tax Committee, the typical American family of four who made $15,000 in 1976 would have to earn roughly $20,000 to $21,000 today to have the same purchasing power. His taxes have gone up in these 3 years by $1,400. Next year it is anticipated that it will go up $600.

I would also point out to the Secretary that it is anticipated that revenue of the Federal Government by the same congressional sources would double. It would go roughly between $500 billion and $1 trillion.

Your own midterm review points out that current revenue estimates for 1980 are roughly $518 billion, and are going up to $1 trillion, or $1.52 trillion in 1985. That is double.

It is interesting to me that you use a very high figure that is not accurate, at least according to Congressional sources, as to the cost of Roth-Kemp. I just point out that the CBO's estimate, and I cannot say that they are necessarily supporters of it, estimate that in the 5-year period it would cost $174 billion, the 10-5-3 would cost $42 billion for a total of $216 billion. It is a lot less than you are saying.

I would also point out, that it is roughly half of the total tax increase that is going to take place in the next 5 years. This brings me back to what I was saying earlier.

I don't think that the administration understands the seriousness of the situation, both short and long range. Let me point out that by the end of the century it is estimated that Japan is going to have an economy as large as ours. They are already spending as much on plant and equipment as we are.

I don't see any proposal or any suggestion by the administration that is going to help us work out of our economic problems. You say, wait and see, but what is going to happen to those 400,000 workers who are going to lose their jobs if you wait and see?

Secretary MILLER. Let me say first, on quoting figures, I think that we had both better be careful. I think that your figures are fiscal year, and mine were calendar year. Our differences are narrower if you put them on the same yearly basis. We may have some different estimates.

In terms of what we do about our economy, I don't think there is any disagreement in this room that when a tax program is appropriate, assisting and creating incentives for investment by greater depreciation on productive equipment invested in the United States is desirable. We have said this and I said that the administration will support this at the proper time.

So we don't have any philosophical difference, and I can't believe that these long-term problems that go over decades and relate to the fundamental question of whether we are going to control inflation, which is the tax of all, doesn't require us to be patient and do right. If we unleash the excess demand without addressing the productivity and investment issue adequately, we may end up just working against ourselves.

Senator ROTH. Would you agree that if there were no campaign in November that it would be far better to have the tax cut enacted now? Wouldn't it have some beneficial impact on the economy if the business people knew what was going to happen, and the individuals who might save?

Secretary MILLER. I think that enacting is not as important. I think that in the process of this debate, we will all come up and be able, in the process of the next few months, to identify what it is. I think that the Administration will be in a position to be more specific.

Senator ROTH. You don't think that it would help the small businessman, or even the large businessman to know today what the tax cuts were going to be next year?

Secretary MILLER. I don't think that it would have a significant impact. I think what would have the impact is to be in effect at the time when the cash flow begins to happen.

Senator ROTH. Do you think that it would be important for those business people if they knew what the tax proposals for the next several years were going to be? Would that provide some certainty, some confidence?

Secretary MILLER. I think the more that long-term plans depend upon these things, the more certainty, the better. But I say, long-term plans and siting of major plants, and major investments don't swing in 2 or 3 months. They swing over a much longer planning period.

In terms of smaller enterprises, these decisions are made much quicker, and will be related to the event of the tax change, and not to whether it is planned. I don't think that any small business in America is going to make much different plans based upon some proposal for 1984. I just don't think that that is the way they think.

They are going to try to run their business today. If today they are going to have more benefit from making an investment, they will go out and make it.

Senator ROTH. Then you think tax policy really does not make very much difference?

Secretary MILLER. It does. I don't think you were listening to what I said. There is a tax policy in effect today.

Senator ROTH. High taxes. The highest taxes in the history of the country.

Secretary MILLER. The tax policies in effect today are showing increasing burdens in some sectors, but the policy is there. You are saying, changing it makes more certainty. No, changing it lets you know that there is a change, but it does not make it more certain.

So I am just merely saying that when we do make a decision to move in the fundamental direction that I have outlined, if we do it in the next few months, I think that that will be adequate time to deal with what is a decade long issue.

As I have pointed out over and over again, if this Congress by its action begins to create the impression that it is losing interest in the fundamental discipline, the fundamental willingness to fight inflation, I can guarantee you that inflationary expectations will flare up again. I can guarantee you that interest rates will go up again. I can guarantee the dollar will sag again, and I can guarantee you economic recovery and prosperity for Americans will be impaired, and not enhanced.

Senator ROTH. Last year you guaranteed that we were halfway through the recession.

Let me ask you one question, and then I will yield.

Would the President veto any tax legislation adopted by the Congress?

Secretary MILLER. I think that it would be out of order for me to indicate the President's decision on something hypothetical. I think the President is the President of the United States, and he must make his decisions.

Senator ROTH. Would you recommend that he veto any tax cut this year?

Secretary MILLER. No; I never said that. It depends on what it is. I have often said, if we believe in the next few months that a tax program for 1981 is appropriate, and if we could have it enacted just the way we would like it, we could accept success.

Senator ROTH. Mr. Chairman, I would ask that we be able to submit further questions for answer in the record.

The CHAIRMAN. Without objection, it is agreed.

Let me say, Mr. Secretary, that you are a very able witness for your position. I think that you have explained it very well. While I believe that at the moment your position is at variance with the prevailing view in the U.S. Senate, there is a lot to be said for your side of the argument. You did very well, and I must congratulate you on that.

Secretary MILLER. I am always worried about that kind of statement.

The CHAIRMAN. There is no hook in that, Mr. Secretary.

Secretary MILLER. Thank you very much.

The CHAIRMAN. I just want to highlight one difference that has developed here since I had my last turn. You brought out in the course of the interrogation that when this Nation has more than 8 percent of its labor force unemployed, it is virtually impossible, and certainly not good economic policy, to try to cut spending down to the point that you would balance the budget with that many people out of work.

Secretary MILLER. I think that it would be very poor policy.

The CHAIRMAN. In other words, the human tragedy that would occur to so many families, millions of families in the country, just does not justify that type of approach. It is more essential at that point that we think in terms of getting the country going again, and getting the people back on jobs. That is your philosophy, as I take it from your previous answer.

Secretary MILLER. Absolutely.

The CHAIRMAN. I think you are right about that, Mr. Secretary. I was making speeches all over the country, especially in Louisiána, telling the people that I thought we could balance the budget. But as unemployment kept going up, I told them that if unemployment went above 8 percent I did not think we could balance the budget.

I do think, Mr. Secretary, that aside from the politics that we discussed, the situation is somewhat appropriate for the kind of tax program that President Kennedy recommended, and that President Johnson followed through when they took the country over in a recession, and proceeded to advocate policies of an expanding, growing economy, with a tax policy to implement that.

There are some of us who are still around, and I am one of those, who managed some of those bills. We got the country going again, and really had it not been for the Vietnam war we would have achieved what President Kennedy was saying could be done. We could expand production, and have a balanced budget, with relatively full employment.

It seems to me that the kind of policies that President Kennedy was speaking to at the time, and which President Johnson followed through and enacted, clearly would be appropriate for our present situation.

What we are really arguing about, I think, is a difference of a few months. We are talking about a difference of maybe 6 or 8 months. You are saying, don't do it right now. But basically, if I understand your argument, you really think that if this recession is going to continue, and it is predicted to continue for almost 1 year from now, that the type of tax bill we are discussing would be appropriate.

Secretary MILLER. We certainly recognize that it could well be.

The CHAIRMAN. Let me say also what I understand Senator Byrd's position to be. I am very fond of him. I love him very much. I can understand your difference of opinion with him with regard to the deficit.

If I understand your answer, you are saying that when you look at the increase in spending, you should also take the size of the economy into account. Basically, what you are saying is that in relative terms, taking all factors into consideration, this is not an unprecedented deficit. It is to be expected under these types of economic circumstances.

Secretary MILLER. In 1976, Mr. Chairman, the deficit was 4 percent of GNP. This deficit is 2.4 percent of GNP. Relatively, it is much lower.

The CHAIRMAN. Taking inflation into account, all factors into account, I can certainly see your point, and I can also see Senator Byrd's point.

There are some people who probably think right now that we could balance this budget by cutting spending, and cutting taxes, and provide more for national defense, all at the same time. If we are going to do that, would it not be necessary to make some very drastic cuts in programs like unemployment insurance, health, welfare, food stamps, and would we not be doing that at a time when the people really need those programs?

Secretary MILLER. Mr. Chairman, there are 43 percent of the outlays here that represent entitlements to individuals. That go to what Congress and the Nation have perceived to be areas where individuals, families, children, need to be protected from economic hardship, or to be benefitting from the fruits of their lifetime of labor.

If one wants to change those, one can do it. But if you take that 43 percent, and add the interest on the debt, and add the transfer of moneys to cities and States, and add the defense budget, you are up over 80 percent of the budget, and what you have to cut from is so small. I just don't see how you could make that magic formula work of having more defense, a balanced budget, and reduced revenues.

The CHAIRMAN. We talked about the political aspects of the matter, but I would think that everybody on this committee, as well as everybody in your administration who is in a position of high responsibility, recognizes that there is absolutely no possibility that we are going to deny social security payments to retired people, or families that are receiving those payments because of the death of the wage earner. That is not going to happen, is it?

Secretary MILLER. It should not happen, and it will not happen.

The CHAIRMAN. It should not happen, and it will not happen. Anybody who wants to do that, if he is running in an election year, he will probably learn how unwise it was to do that at the polls.

Secretary MILLER. If I found a candidate like that, I would be tempted to run against him. I never thought that I would run for office, but that would be a cinch, I would think.

The CHAIRMAN. When you really look at how much you really have left to cut on, to work your economies on your social welfare programs, there is just no potential to balance the budget, even if you got to the point of being very brutal and cruel to a lot of unfortunate people in this country.

Secretary MILLER. I just don't see how it can be done.

The CHAIRMAN. At this point, it cannot be done.

Secretary MILLER. I think that we can balance the budget by getting our economy going again, and building more output, building the basic potential, and thereby creating the real wealth from which we can pay for the needs, and at the same time reduce the needs by reducing unemployment and reducing the distress.

So we have to work on both sides. We expand it on the side of production, and reduce it on the side of need. Then we can balance the budget. But that has to be by getting the economy moving.

The CHAIRMAN. It may be that one of the candidates for President might try to explain that to the American people in other terms. But I predict that whoever is elected President, be he Democrat or Republican, or from a third party, once he has the responsibility, he is going to be explaining it just about the way you are explaining it now, Mr. Secretary.

Thank you very much.

Senator Bradley.

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

I will be brief because I know that everyone is about at that point.

I had occasion to get a copy of the Republican platform, and in looking it over I noticed that there are things other than simply the Reagan-Roth-Kemp, or the Kemp-Reagan-Roth, or Roth-Reagan-Kemp, or whatever.

Senator ROTH. Would the Senator yield?

When I heard Senator Long say that he favored a Jack Kennedy-type tax cut, I thought that we might call it the Long-Reagan-Roth-Kemp tax cut. [Laughter.]

Senator BRADLEY. As you know, rising tide lifts all boats.

The CHAIRMAN. I favor a Kennedy-type tax cut. I managed that bill in the Senate. I am not saying that we will do precisely the same thing, but it is a good idea. Basically, I have a lot of sympathy for what is being suggested by the committee.

Senator BRADLEY. Looking this platform over, I find that there are not only tax cuts, but there are a lot of other tax expenditures. They talk about spending and spending. I was curious if the Treasury Department had done any assessment of what is the cost of such as tax incentives for the removal of architectural and transportation barriers, tax rate decreases for investment income and savings, substantial increase in the corporate surtax exemption, abolish excessive inheritance tax, and no estate tax when a spouse inherits a property.

There is a long list of tax expenditures in this platform. I did not even mention the windfall profits tax element.

I was curious to know if the Treasury Department had costed this out at all so that we know exactly, when we talk about tax reduction, how much is being spent in the way of its expenditures. If we know that, we can then see who benefits from these tax expenditures, which I think would be of great interest to the American people.

Secretary MILLER. Senator Bradley, we have this list, and we have not costed it out yet. Some of them are in general terms, so we don't know if you are going to have a lower tax rate on savings, and if so, how low a rate, for example. We have not costed them out. We could give you the exact figures on such things as eliminating a gift tax, or eliminating estate tax.

Senator BRADLEY. Could I ask the Treasury on behalf of the committee, because I think if the chairman concurs, that this would be an interesting thing for us to have in the tax debate, to know exactly what the tax expenditures might cost. If you have problems with what the savings tax rate would be, then take several rates and draw some hypothetical situations.

As one Senator, I would like to have that, and I would ask you to do that, and provide it for the record to the committee.

Secretary MILLER. We will be glad to.

Senator ROTH. Mr. Chairman, in the true spirit of bipartisanship, I would ask that after the New York convention the same be done on the expenditures of all types of the Democratic platform. [Laughter.]

Senator BRADLEY. Could you draw up it in a staff document.

Secretary MILLER. I think that this is a good tactic because we can debate for 3 or 4 months on these expenditures, and it will be past the election. [Laughter.]

The CHAIRMAN. It is all right with me for everybody to put their argument in the record.

Thank you very much for your appearance here, Mr. Secretary.

Secretary MILLER. Thank you very much.

[The prepared statement and charts of Secretary Miller follow:]

<u>FOR RELEASE ON DELIVERY</u>
<u>Expected at 10:00 a.m.</u>
July 23, 1980

STATEMENT OF THE HONORABLE G. WILLIAM MILLER
SECRETARY OF THE TREASURY BEFORE THE
FINANCE COMMITTEE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

Thank you for inviting me to present the Administration's views on the important subject of tax policy. The question is whether a tax reduction package should be enacted in the near future, and if so when and with what characteristics and of what magnitude.

The issues involved are complex and require careful study and deliberation. There are many criteria against which alternate courses of tax action should be evaluated. The timing and scale of any tax reduction are particularly critical in view of inflationary expectations and budgetary realities--and the impact of these factors on domestic and international financial markets.

It is the considered judgment of the Administration that the Congress should not seek to enact tax cutting legislation prior to the national election.

During 1981, properly targeted tax cuts directed at strengthening the productive foundations of the economy may well prove to be desirable. If designed with care and deliberation as part of an overall economic program, such action may well improve our economic performance over the next several years.

But hasty tax cutting now could be counterproductive. One proximate cause of the current recession was the fever of inflationary expectations early this year which brought serious disarray into the financial markets and resulted in severe credit constraints on businesses, farmers, and families. Following strong initiatives undertaken by the Administration last March after extensive consultations with Congress, both inflation rates and interest rates have come down dramatically. These trends, aided by responsible budgetary actions by the Congress, are laying a foundation for recovery. Taking premature action which might be perceived as undermining fiscal responsibility could well interrupt or reverse those trends and thus complicate the recovery.

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In addition, the brief and busy legislative session remaining before the election is not likely to provide the time or climate for properly analyzing the kind of structural and well-focused tax and other economic measures essential to the long-term health of the economy. Our joint responsibility is to secure a robust, non-inflationary path of growth for the economy over the years ahead. This objective is not served by rushing forward at this time with large injections of purchasing power or undigested plans for transforming the revenue side of the fiscal accounts.

Acting after the election rather than in haste over the coming weeks would also allow us to gain a much better understanding of the economy's evolution into recovery, a much better view of trends and decisions on federal spending, and a firmer consensus on other economic measures needed to improve the economy's performance over the new decade.

Nevertheless, the opportunity to examine in depth the important issues before this Committee is greatly appreciated. In order to do so, it is proposed to review long- and short-term economic developments, to suggest appropriate criteria against which to evaluate any future tax program, and to outline some of the major choices in establishing tax policy.

NEED FOR LONGER-RUN PERSPECTIVE

There is a natural tendency to place emphasis on short-term economic policy even though the underlying problems are long-term in nature. The adverse trends in inflation and productivity which we are experiencing did not occur overnight. They have been developing for at least the last fifteen years. Therefore, we need to give serious attention to the origin of these and other economic problems as a basis for dealing with them effectively.

The 1950's and the early 1960's were a period of strong U.S. economic performance in both domestic and international markets. Throughout much of the period, U.S. productive strength was unquestioned and the dollar was strong. It has become a more difficult world during the 1970's and early 1980's. Inflation has become a clear and present danger. Energy prices have been pushed up very sharply by the oil exporting countries. The international financial system has been placed under great strain. International trade has become increasingly competitive, and domestic industries sometimes bear a heavy burden of adjustment. We face a range of complex economic problems at home and abroad. There are no simple solutions, no easy ways out. These problems can be mastered — but only if we face them squarely and resolutely, eschewing easy answers based purely on hope or rhetoric.

Significant gains have been made in the last few years. There is an increasing realization throughout the country that many of our economic problems are structural in nature and long-standing in origin. The energy problem is being attacked now in a coordinated way for the first time. Fiscal and monetary policies are being formulated with greater discipline to bring inflation under control. New approaches are being explored to reinvigorate the industrial sector of our economy. Substantial progress has been made in reducing the burden of government regulation on the private economy.

At the present, a great deal of attention is properly being focused on the economic downturn. There have been six previous periods of contraction since World War II and on average they have lasted a little less than one year. The weight of informed economic opinion--inside and outside of government--is that the current period of contraction will end late this year or early next, and will not be as deep as in 1973-75.

The current recession was not deliberately sought. It has inevitably caused real suffering, which we are acting to mitigate. The downturn, also inevitably, will result in some reduction in the rate of inflation. Recovery must proceed without reigniting inflationary forces.

As we contemplate recovery over the coming year, economic policies should therefore be shaped in the interest of longer-run stability. The economy needs to perform much more strongly in the future in the key areas of capital formation, productivity growth, and international competitiveness, so that employment gains can be sustained, without generating new waves of inflation. That will not be accomplished by a hasty, across-the-board tax cut. Any tax program to reinforce recovery should be carefully constructed to be consistent with overall economic objectives.

If our difficulties were simple or of recent origin, the straightforward countercyclical use of fiscal policy might meet the needs of the situation. But our problems are deep-seated. They have developed over a long period of time. Simply pumping purchasing power into the economy will not raise the capital-labor ratio, increase the rate of growth of potential output or improve U.S. competitive ability in foreign markets.

The range of policy options that we should have under active consideration can best be appreciated by reviewing the general trend of economic events that forms the background to the current situation.

THE POST WAR ERA, 194?-65

The roots of our current economic problems go back several decades. During the 1950's our economy performed significantly below its potential. As a result, in the early 1960's we were able to improve our economic performance by exploiting under-utilized resources. We did not have to face difficult trade-offs, but were able to have more of everything by running the economy closer to capacity. Our current problems began after the mid-1960's when we tried to continue this approach long after we were running up against economic limits. Policies of economic stimulus began to be reflected primarily in rising prices, not in rising output.

In the first twenty years of the postwar era, the U.S. international payments position was strong and we were able to assist in the rebuilding of war-ravaged foreign economies. Thereafter, we have been faced intermittently with balance of payments difficulties in an intensely competitive international economic environment. In the earlier period, energy was cheap and readily available. As a result, U.S. production methods and patterns of consumption were heavily conditioned by low relative prices of energy. Subsequently, a difficult and painful adjustment has had to be made in an environment of energy scarcity.

Relatively Stable Prices. During the period from 1947 to 1965, the GNP deflator rose at a 2.3 percent annual rate and the consumer price index at a 1.9 percent annual rate. There was a sharp run-up of prices at the time of the Korean War, but relative stability in the price level was characteristic of much of the rest of the time. During the same 1947 to 1965 period, compensation per hour (wages plus fringes) in the private business sector rose at an average of 5.1 percent annually, but there was a strong 3.2 percent annual rate of increase in productivity, which held the rise in unit labor costs to a relatively modest 1.8 percent annual rate of increase. This was about in line with the rise in the price level. Cost-push factors were no particular problem and inflation was held fairly well in check.

Longer-term price movements over this period masked some shorter-term swings. For example, the period 1955 through 1957 was one of moderately accelerating inflation and relatively high rates of resource utilization. The capacity utilization rate in manufacturing was pushed into the range generally associated with accelerating rates of inflation. Considerable concern was expressed at the time over the threat of inflation. However, the ensuing period from 1957-1963 was one of relatively low resource utilization and decelerating inflation. The manufacturing utilization rate dropped to 80 percent and the rate of unemployment averaged 6 percent during those years. As a result, the annual rate of increase in the GNP deflator fell back to 1-1/2 percent, about one-half of the rate experienced in the 1955-57 period. The following two years, 1964 and 1965, saw a transition to a fully utilized economy, and by the mid-1960's the postwar period of relatively low rates of inflation was drawing to a close.

Strong Growth in Productivity. The early postwar decades featured a return to the fairly steady rates of growth in productivity which had been characteristic of much of U.S. 19th and early 20th century economic experience. Between 1947 and 1965, output per hour in the private business sector rose at a 3.2 percent annual rate, or at a 2.6 percent annual rate with agriculture excluded. Real nonresidential fixed investment averaged in the 9 to 10 percent range as a percentage of GNP throughout the period. There was a relatively strong rate of growth in the stock of capital employed in the private business sector, about 3-1/2 percent per year on a gross basis and more than 4-1/2 percent per year on a net basis (after allowance for capital replacement). These rates of growth in the capital stock were substantially higher than have been achieved in subsequent periods.

The civilian labor force grew at a relatively modest rate by current standards, only 1.2 percent annually over the years from 1947 to 1965. The combination of a rapid rate of growth in the capital stock and a relatively slow rate of growth in the labor force meant that the capital-labor ratio showed strong gains during the first two postwar decades, rising at a 3 percent annual rate on a net basis over the 1947-1965 period.

There is general agreement that the growth in economy-wide productivity reflects many influences. However, there has been a close association in the postwar period between the capital-labor ratio and the rate of growth in productivity. The more rapid application of capital into the productive process means that labor works on the average with more and better tools of production. This generally results in improved productive performance.

By the early 1960's, there was some expression of concern that the U.S. rate of investment was beginning to lag, particularly in relation to that of some other major industrial countries. Through much of the early postwar period, however, the capital stock had expanded steadily and the rate of growth in productivity was relatively satisfactory. Difficulties in this crucial area only surfaced in unmistakable fashion during the 1970's.

<u>Cheap and Readily Available Energy</u>. In the early postwar period, domestic energy production was able to supply the needs of the economy at relatively stable and even falling prices. Total energy consumption rose at about a 3% annual rate and the ratio of energy per unit of GNP drifted down slightly. Gasoline, heating oil, and electricity prices rose less rapidly than the consumer price index, thereby encouraging energy consumption rather than conservation. Natural gas prices rose faster than the consumer price index, but on a heat-content basis, natural gas use rose faster then heating oil throughout the period. The average price of electricity dropped and electricity consumption expanded.

The average fuel costs to the electrical generation industry can be used as a proxy for industrial energy prices. Between 1950 and 1965, coal costs decreased 9 percent in current dollars and fuel oil costs rose only 5 percent. Natural gas costs on a heat-content basis were less than oil, and less than, or about the same as, coal throughout the period. In the 1950's, natural gas was still largely an unwanted by-product of oil production and exploration.

Between 1950 and 1965, crude oil reserves grew from 25.3 billion barrels to 31.4 billion barrels. Quotas limited the importation of foreign oils, which undersold domestic production. Nevertheless, imports of petroleum grew from 550,000 barrels per day in 1950 to 2.3 million barrels per day in 1965. Natural gas reserves grew from 185 trillion cubic feet in 1950 to 287 trillion cubic feet in 1965, and natural gas distribution systems and consumption expanded rapidly during the period. Coal production was limited only by demand.

In general, the energy situation in the early postwar period was conducive to rapid economic growth and relatively low energy prices encouraged its consumption. Supplies of energy increased rapidly and there were periods of overproduction and falling prices. No serious constraints to growth had emerged by the mid-1960's, although it was becoming apparent by then that the long period of cheap and abundant U.S. crude oil resources was coming to an end.

<u>Strong Dollar Internationally</u>. In the immediate postwar period, the dollar reigned supreme. This was the era of "dollar shortage" during which foreign countries resorted extensively to capital and exchange controls to protect their currencies. Full currency convertibility was only established for the European countries in the late 1950's.

The U.S. balance of payments situation was very strong from 1946 to 1949 with a merchandise trade surplus averaging about $7 billion a year and a favorable balance on current account averaging nearly $4-1/2 billion, even after massive unilateral transfers to enable other countries to rebuild their devastated economies. From 1950 to 1959, the merchandise trade surplus averaged only about $3 billion a year, and the favorable balance on current account averaged less than $1 billion annually. Subsequently, in the 1960 to 1965 period, the U.S. payments position swung back in the direction of improvement with an average annual trade surplus of nearly $5-1/2 billion and a favorable balance on current account of nearly $4-1/2 billion annually. By the end of this period, some signs of strain began to emerge, but chiefly on capital account where low U.S. interest rates and freely accessible capital markets encouraged a high rate of U.S. lending to foreign borrowers.

Exchange rate adjustments throughout the first two postwar decades were on the initiative of foreign countries against the dollar, which remained at the center of the international financial system in a fixed relationship with gold. Following the reestablishment of currency convertibility in the late 1950's, the dollar appreciated gradually against other major currencies until the late 1960's and early 1970's. By 1965, although some signs of balance of payments strain were emerging, the dollar remained the anchor of the world monetary system.

Rising Standard of Living. Economic expansion yielded sizable gains during the first twenty years after World War II, despite interruptions to growth during four recessions. From 1947 to 1965, real gross national product rose at about a 3.9 percent annual rate. Real disposable personal income (personal income after taxes and corrected for inflation) rose at about a 3.7 percent annual rate, and at nearly a 2 percent annual rate on a per capita basis. Median family income in real terms was more than 60 percent higher by 1965 than it had been in 1947.

The combination of strong economic growth, rapid rates of increase in the private capital stock and rising productivity contributed to gains in real income. Energy supplies were adequate and a reasonable degree of success in containing inflation kept the dollar strong at home and abroad.

THE ERA OF TRANSITION, 1965-1976

The transition to more difficult times began after 1965 when production was expanded for a war effort without cutting back in other areas. Indeed, a sizeable--although long overdue--expansion of domestic social programs was undertaken at about the same time.

In the early 1970's, new demands were placed on the economy for environmental quality without making trade-offs to give up something else. There was a continued belief that we could have more of everything when this was no longer possible. The oil boycott and oil price shock added to the difficulties. Inflation was the inevitable result. An ill-fated effort to apply mandatory wage-price controls in the early 1970's only worsened the underlying situation.

Partly as a consequence of domestic inflation, the dollar weakened in foreign exchange markets and came under speculative attack. The dollar was devalued twice in the early 1970's, and then was permitted to float, more or less freely, against major currencies. In late 1973 the OPEC oil embargo and subsequent cartel pricing signalled the end of an era of inexpensive energy and placed this country in a position of dangerous dependence on uncertain sources of foreign supply.

The 1965-1976 period was a rude awakening to economic reality. New demands were added onto the economy faster than the capacity to satisfy them was expanded. More and more was demanded from the economy and by the end of the period the capacity to produce in the future had been eroded substantially.

Deteriorating Price Situation. The period from 1965 to 1970 was one of excessively high rates of resource utilization. The rate of unemployment averaged below 4 percent and demand pressures were more or less chronic during most of the period. Inflation as measured by both the GNP deflator and the consumer price index averaged over 4 percent, more than double the rate in the first half of the 1960's. During the period from 1970 to 1975, the after effects of excess demand pressures from the late 1960's combined with a series of shocks, including the OPEC boost in oil prices, to produce additional acceleration in inflation. Inflation as measured by both the GNP deflator and the consumer price index averaged about 6-1/2 percent during the 1970-76 period and peaked in the double-digit range prior to the 1974-75 contraction.

Compensation per hour (wages plus fringes) in the private business sector moved up to a 7.6 percent rate of increase in the 1965-1976 period, some 2-1/2 percentage points above the 1947-1965 average rate of increase. In addition, the rate of growth in productivity fell off by more than a full percentage point to a 1.9 percent rate of growth between 1965 and 1976. As a result, labor costs per unit of output rose at a 5.6 percent annual rate in the 1965-1976 period, nearly 4 percentage points above the increase between 1947-1965. Cost-push pressures became firmly imbedded in the wage-price structure by the mid-1970's, making the permanent reduction of the rate of inflation a difficult task.

Declining Rate of Growth in Productivity. During the 1965-76 period, the strong rate of productivity growth established in the first two postwar decades began to taper off. Output per hour in the private business sector grew at a 1.9 percent annual rate, or 1.6 percent with agriculture excluded. This represented a significant decline from the 3.2 percent, or 2.6 percent rate with agriculture excluded, recorded between 1947 and 1965.

Growth in the civilian labor force picked up speed, rising 2.2 percent annually in the 1965-1976 period in contrast to 1.2 percent between 1947 and 1965. Growth in the stock of private business capital was relatively well maintained, although showing some retardation in growth on a net basis and after exclusion of pollution abatement expenditures. As a result primarily of the more rapid rate of growth in the labor force, the capital-labor ratio grew much more slowly in the 1965-1976 period than it had in the first two postwar decades.

It is not possible to identify the exact point at which the U.S. rate of productivity growth began to decline. Some of the slowdown may have arisen gradually over time. Some may have been occasioned by the sharp rise in energy prices after 1973. It is clear that the rate of growth in productivity had slowed drastically by the close of the 1965-1976 period.

Energy Shock. In 1973, events in international oil markets, in particular the oil embargo, pushed world oil prices far above those for domestic controlled oil. The resulting shock to the U.S. was substantial since imports and consumption of oil had been rising rapidly while domestic production of oil and gas had been declining after 1970.

From 1965 to 1973, total U.S. energy consumption grew at a 4.4 percent annual rate, compared with a 3.1 percent annual rate during the previous fifteen years. The energy to GNP ratio rose to a peak by 1970. Motor gasoline consumption was stimulated by the completion of thousands of miles of interstate highways, increased motor car ownership, and rising personal income.

Supply problems began to appear in the energy field in the early 1970's. The use of coal was inhibited by environmental regulations and other factors. Natural gas deliveries could not keep up with demand and reserves began to top out in 1972. Domestic crude oil production peaked in 1970 and reserves would have fallen appreciably by 1975 except for the discovery of the Alaskan North Slope fields. Domestic oil production could no longer expand to meet demand and imports filled the gap. Imports increased from 2.3 million barrels per day in 1965 to 6 million barrels by 1973 and then dropped slightly by 1975.

The OPEC oil embargo hit with particular force because of the growing dependence of the U.S. economy on oil imports. Imported oil prices rose from $2.14 per barrel in 1966 to $3.37 per barrel in 1973. Following the embargo in the winter of 1973-74, imported oil shot up to $11.45 per barrel in 1975.

Gasoline prices rose 83 percent and heating oil prices by 144 percent in the 1965-1975 period, compared to a 71 percent rise in the consumer price index. Most of the oil price increases were in the last two years of the period when gasoline prices increased by 27 percent and heating oil prices by 71 percent. Natural gas prices increased by 66 percent between 1965 and 1975, with a 33 percent increase between 1973 and 1975.

Industrial energy prices rose much faster than consumer prices during the 1965-1975 period.

- o Coal prices advanced 254 percent, with a 106 percent increase between 1973 and 1975.
- o Natural gas prices for industrial use increased 201 percent, with a 113 percent increase between 1973 and 1975.
- o Fuel oil prices advanced 509 percent, with a 195 percent jump between 1973 and 1975.

A Weakening Dollar. The 1965-1975 period was one of intensifying pressure on the U.S. dollar. At the beginning of the period, the U.S. was running a surplus of about $5 billion both on merchandise trade and on current account. By the early 1970's, both of these surpluses had been wiped out and the international competitive position of the dollar was severely impaired. The international financial system was fundamentally changed in August 1971 when the United States announced suspension of the convertibility into gold of dollars held by foreign monetary authorities. Following this action, major exchange rate alignments, coupled with devaluation of the dollar in terms of gold, were negotiated in December 1971 and February 1973. Subsequently, the international monetary system moved to a regime of managed floating.

Between 1969 and 1974, the U.S. dollar depreciated about 16 percent on a trade weighted basis against the currencies of other major industrial nations. Cyclical improvement in the U.S. balance of payments and other factors led to some temporary strengthening of the dollar and by 1976 the trade weighted depreciation was about 10 percent relative to the base rates of May 1970. By the end of the 1965-75 period, the U.S. trade account had moved back into a $9 billion surplus and the current account was in surplus by $18 billion. Exchange rate adjustments and temporary cyclical factors were largely responsible for the improvement. However, the longer run balance of payments outlook was clouded by the existence of a rapidly rising bill for oil imports.

Standard of Living Continues to Rise. Despite the sharp adjustments occurring after the mid-1960's, standards of living continued to rise. In the 1965-1976 period, real GNP rose at a 2.9 percent annual rate, a little below the postwar average rate of increase. Real disposable income rose at a 3.5 percent annual rate and at about a 2.5 percent annual rate on a per-capita basis. However, constraints on growth were much more evident at the end of the period than at the beginning, and the rate of inflation had accelerated. A sharp decline was developing in the rate of growth in productivity which would limit the potential for future gains.

RECENT ECONOMIC PERFORMANCE, 1976-1980

By the last half of the 1970's, the Nation faced a watershed in its economic history. The world economy was changing at a revolutionary pace. The adverse trends which had developed with respect to inflation, productivity growth, and international competitiveness moved to center stage in the Nation's discussions of economic policy. The Nation responded to these challenges by moving to break important deadlocks in a number of important areas of economic management.

This process has involved painful choices. Changing the Nation's course on matters of such fundamental economic importance as energy policy and control of federal spending could not be accomplished overnight or without intensive debate. We have not succeeded completely on every front: there remains a significant agenda of unfinished business. But in many key areas of economic policy, a new strategic consensus has been forged, laying the basis for improving our basic economic performance over the next decade.

Some of the key areas in which progress has been made include:

o Fiscal prudence: The Administration and Congress have made the containment of domestic spending growth a major priority of economic policy. Working together, we have strengthened budget procedures and discipline and provided for rigorous annual review of "off budget" items through the new Credit Budget. Real growth in non-defense spending has been dramatically reduced from the high rates registered over the previous decade.

- Domestic monetary policy: The Federal Reserve Board has improved its control over the long-term growth of monetary aggregates as a means for bringing down the inflation rate.

- Wage-price policy: The Administration has disavowed mandatory controls and has instead developed a structure of voluntary wage-price standards. Econometric tests indicate that the inflation rate is now 1 to 1.5 percentage points lower than it would have been without the program.

- Energy policy: Programs for implementing the phase-out of price controls on crude oil and new natural gas are now in place. Massive new initiatives have been adopted to develop alternate energy sources and spur conservation of oil. The new Synthetic Fuel Corporation will help create a huge, new industry of energy supply, drawing upon the Nation's abundant coal and shale oil resources.

- Deregulation: Regulations have been substantially reduced with respect to airlines, trucking and financial institutions. Large portions of the U.S. economy have been returned to the discipline and opportunities of competitive market forces.

While considerable progress has been made, in many areas continuing efforts will be required over a number of years. Future policies must place great stress on controlling inflation and stimulating productivity. In reviewing the record of recent years, it is important to recognize accomplishments, but even more important the need for continued progress.

Real Growth. Substantial gains have been made in recent years in terms of real growth. From the trough quarter of economic activity early in 1975 through the first quarter of 1979, real GNP grew at an annual rate of 5.1 percent. From the end of 1976 through the first quarter of 1979, that growth rate was 4.8%. In the next four quarters, real growth slowed to about a 1 percent annual rate, and in the second quarter of this year real growth declined sharply--at an 9.1 percent annual rate according to the preliminary estimates released recently. However, even after this decline, real GNP is about 20 percent above the early 1975 low.

This is a strong performance by past standards, but it obviously reflects cyclical gains to a considerable extent. Real growth since the last cyclical peak in the fourth quarter of 1973 has been about 2-1/2 percent annual rate. This corresponds more closely to estimates of the economy's current trend rate of potential economic growth. Potential growth has been estimated by CEA as having been about 3 percent between 1973 and 1978 and likely to fall to a 2-1/2 percent annual rate between 1979 and 1982. This stands in marked contrast to an annual trend rate in potential of about 4-1/2 percent from 1947 to 1953, and about 3-1/2 percent from 1953 to the early 1970's. Aside from cyclical movements, the real progress of the economy is inevitably limited to its trend potential.

Tax cuts designed simply for fiscal stimulus do little to enhance the economy's potential to produce goods and services. Attention needs to be directed toward tax policies to promote long-term growth potential, i.e., to raise the economy's ability to produce goods and services. The lesson of the recent expansion is that the economy encounters real barriers to expansion, reflected in an acceleration of inflation, long before unemployment can be reduced to desirable levels. Efforts should therefore be directed at the supply side of the economy, including selective programs to attack structural unemployment.

Productivity and Investment. Productivity fell off sharply in the 1973-75 recession, and then made a strong cyclical recovery in 1975 and 1976. During 1977 and 1978 productivity increased by an average of only 1 percent per year. Over the past year, productivity has actually declined by about 1-1/2 percent. During the early stages of a recovery, growth in output tends to exceed increases in labor input by wide margins, but productivity gains tend to slow rather markedly as the expansion ages. The more disturbing feature of productivity experience is the apparent lower trend since the late 1960's. Between 1948 and 1968, productivity in the private nonfarm business sector of the economy rose 2.6% per year; between 1968 and 1973 that growth slowed to 1.7% per year; and during the 1973 to early 1980 period growth slowed still further to less than 1/2 of one percent.

The causes of the apparent secular decline in productivity are still the subject of academic inquiry and difference of opinion. Some of the more important causes of the slower trend growth in productivity that have been advanced are:

- o Demographic factors have been important since the mid-1960's, as the proportion of new, young and inexperienced workers in the labor force increased.

- o An increasing proportion of capital investment has been diverted in recent years to meeting government regulations directed at improving the health and safety of workers and the environment. Labor resources have also been diverted. While these are essential efforts they do not contribute directly to measured output in productivity. These programs will continue but are unlikely to increase at the rates of the recent past.

- A variety of other factors-- such as the increase in energy prices and a decline in worker motivation--have also frequently been cited as adverse influences.

- In the opinion of many observers, the most important single factor has been a dramatic slowdown in the rate of growth of the capital-labor ratio. More capital per worker generally contributes to higher productivity, and the sharp fall in that ratio is a matter of real concern. In the 1976-79 period, the ratio of the capital stock to the civilian labor force edged up only slightly on a gross basis and actually fell on a net basis. This stands in marked contrast to average gains in the net capital-labor ratio of 3 percent annually from 1945 to 1965 and nearly 2 percent annually from 1965 to 1976.

It must be emphasized that business fixed investment has made a strong cyclical recovery in recent years. The problem is to assure that these are sufficient incentives to boost the amount of capital investment in the permanent fashion that is required to raise productivity and the trend rate of potential growth. That should be one of the major objectives of tax and other policies over the years ahead.

Employment. Growth in employment has been a major achievement of the Carter Administration. Since late 1976, civilian employment has increased by nearly 11 million persons, even after allowance for the cyclical employment declines of recent months. The ratio of employment to working age population has reached record levels, although receding from its peak in recent months. On the other hand, the rate of unemployment has remained higher than desirable, reaching a low for the expansion in the 5-1/2 to 6 percent range, before rising rapidly in recent months. The rise in the unemployment rate in the current contraction has been heavily concentrated among blue collar jobs which are predominantly held by adult men. This cyclical rise in the unemployment rate will be reduced when the economy turns up again. However, more remains to be done in combatting structural unemployment if the average level of unemployment over the cycle is to be reduced to more acceptable levels.

The largest employment gains have been made by women and minority groups. Employment of adult women has increased by nearly 16 percent since late 1976, compared to about 5-1/2 percent for adult men. Employment of blacks and other minority groups has increased by 12 percent compared to a 9 percent rise for all groups.

Employment gains are an important measure of the performance of the economy. However, it is also crucial that productivity advance rapidly so that increased employment will mean rising standards of living.

Energy. Considerable progress has been made in reducing the Nation's reliance on insecure sources of foreign oil. Programs now in place should yield increasing returns in the period ahead. Already some tangible signs of progress can be seen. Between 1975 and 1979, total energy consumption grew at a 2.4% annual rate, slower than at any time during the previous 25 years. The energy/GNP ratio dropped steadily during the 1975-1979 period, and indications are that the ratio will drop further in 1980. Gasoline consumption peaked in 1978 at 7.4 million barrels per day and dropped to 7.0 million in 1979. In 1980, gasoline consumption could drop to about 6-1/2 million barrels per day if present trends continue.

Domestic energy supply has increased over the period. Crude oil production edged up to 8.53 million barrels per day from 8.38 million barrels per day in 1975. Much of the increase was due to the exploration of the Alaskan North Slope fields beginning in 1977. Oil production in 1980 is expected to increase due to more Alaskan production and in response to the phasing out of crude oil price controls. Natural gas production stayed relatively flat during the 1975-1979 period rather than continuing the decreases exhibited in the preceding years. Production in 1979 exceeded 1978 levels. Coal is making a comeback, with 1979 production 18 percent above 1975, and 1980 production running well above 1979 to this point.

The heavy impact of rising oil prices on the domestic economy and U.S. balance of payments has continued throughout the period. The price of imported oil (f.a.s.) rose by 63 percent from $11.45 per barrel in 1975 to $18.67 per barrel in 1979. The price of imported oil in 1980 will be $31.50 to $32 per barrel or about 70 percent higher than in 1979. Net oil imports rose from 5.9 million barrels per day in 1975 to 7.9 million barrels per day in 1979, with a peak of 8.6 million barrels per day in 1977. So far this year net imports are about 14 percent below the levels of last year. In general, the trends toward slower growth in energy consumption, increased domestic production, and reduced imports are all in the right direction.

Recent experience demonstrates that higher energy prices significantly reduce energy demand. There is no realistic alternative to reliance on the price system to insure that scarce energy resources are employed most efficiently, and that adequate incentives are offered for future domestic energy production and conservation.

<u>Inflation</u>. The most discouraging feature of recent economic performance was the acceleration of inflation in the late stages of the current expansion. The worst of the inflationary fever has now been broken, by the policy measures taken at mid-March and by the onset of recession. The task that lies ahead is to insure that the next period of economic expansion does not simply ratchet the rate of inflation to still higher levels, but instead that recent progress can be continued in a methodical trend toward genuine price stability.

Between 1976 and 1979 on the basis of annual averages, the GNP deflator rose at a 7.4 percent annual rate and the consumer price index at an 8.4 percent annual rate. These compare with 5-1/2 percent annual rates of increase in the 1965 to 1976 period. More recently, rates of inflation have reached even higher levels, before turning down. Over the past six months or so, consumer prices have risen at about a 15 percent annual rate, producer prices at about a 12-1/2 percent annual rate, and the GNP deflator at about 10.

As a result of recent inflationary pressures and workers' attempt to maintain real incomes, compensation per hour (wages plus fringes) has been boosted to the 9 to 10 percent range. Because productivity growth has been negative, unit labor costs have been rising in the 11 to 12 percent range for the past year and a half.

Those who favor an across-the-board tax reduction to stimulate the economy should ponder the implications in terms of inflation. Over the past 15 years, every period of economic expansion has driven the rate of inflation to new heights at the top of the cycle. The ensuing periods of contraction have temporarily lowered the rate of inflation, but each time the rate of inflation at the trough has been higher than before.

<u>The International Position of the Dollar</u>. A major objective of the Administration's international monetary policy has been the maintenance of global confidence in a sound and stable dollar. The program to strengthen the dollar, initiated by President Carter in November 1978, represented a watershed in the U.S. exchange market policy. This program combined domestic measures to improve the U.S. balance of payments--by curbing inflation and reducing dependence on imported oil--with more active intervention in the foreign exchange market to maintain orderly conditions.

The November 1978 program demonstrated a clear-cut U.S. commitment to a sound dollar and stability in exchange markets. Since that program, the dollar has increased in value on average in terms of other major currencies. The U.S. balance of payments has, moreover, scored major gains, despite large increases in oil prices and consequently in oil import costs.

It must be recognized, however, that the strength of the dollar depends, in the last analysis, upon our demonstrated ability to keep the domestic economy strong and to reverse the inflationary trend of the past 15 years.

CURRENT ECONOMIC SITUATION AND THE BUDGET REVISIONS

Change in Economic Assumptions. At the turn of the year when the January Budget estimates were being completed, the economy was continuing to show far more strength than most economists had expected. In fact, some additional momentum appeared to develop late in 1979. A mild recession was generally expected, based on the downturn already underway in housing and the prospect that consumers would slow their rate of spending. The timing of a recession was uncertain, however, and few signs of an imminent downturn were in evidence. Retail sales, production and employment all rose in January.

The economic climate shifted rapidly through early March. The shift was triggered by a number of factors. The long projected recession failed to materialize. As evidence began to build that the first quarter would show positive real growth and January retail sales turned in an especially strong showing, some economic and financial market participants began to question whether a recession was really in prospect. Because of heightened international tensions, financial markets began to anticipate an increased defense effort, in consequence much larger budget deficits, more inflation, and higher interest rates. There was an upsurge of speculative activity in commodity markets which was both a cause and a result of shifting anticipations as to the future course of inflation. Rapidly rising energy prices plus rising mortgage interest rates helped cause the CPI to shoot up by 1.4% (18% annual rate) in each of the first three months of the year.

These developments combined to generate a dramatic shift in inflationary expectations. Businesses began to post price increases in anticipation of higher rates of inflation and the fear that wage-price controls would be imposed. Excluding food and energy, producer prices jumped at a 15% annual rate in the first three months of the year at the finished goods level and a 17% rate for semi-finished goods. Interest rates began to shoot upward. Yields on commercial paper, which had averaged about 13% in December, were well above 16% in early March.

The intensified anti-inflation package announced on March 14 was designed to reverse these developments. Its principal components were increased fiscal discipline, including a reduction of some $17 billion from FY-1981 planned outlays, a program of credit restraint, and structural reforms directed at improving the longer-term performance of the economy. The package also included proposals in the energy area and steps to strengthen the wage-price guideline program.

The program, along with actions taken by the Federal Reserve, reversed the inflationary psychology. Interest rates continued to rise into early April, but then declined dramatically. Commercial paper rates moved above 17-1/2% in early April, but subsequently fell to the 8% range. By early June, commitment rates for conventional home mortgages had fallen 300 basis points from the 16-1/2% of early April to 13-1/2%. The Treasury bill rate temporarily fell below 7 percent in contrast to an early peak near 16 percent. From its peak of 20 percent, the prime rate has fallen back near 11 percent. These interest rate declines are laying the foundation for the recovery of the economy.

Meanwhile, the greater than expected strength in activity early in the year led most economists to mark up their projections of real activity, at least for 1980. However, as figures became available for March, April, and May, it became evident that demand and production had been dropping rapidly. New car sales plunged (from a 10.8 million annual rate in the first quarter to a 7.7 million rate in the second), total retail sales took a record drop, industrial production fell by 4-1/2% between February and May, and orders placed with manufacturers of durable goods plummeted by 17% from January to May.

Again, forecasts for 1980 were revised to incorporate these new realities. The tabulation below shows the shifting consensus forecast of about 40 top private business economists.*

Forecasted 1980 Changes in Real Gross National Product

Forecast date	4th to 4th	year to year
	(--------percent----------	)
January	-1.0	-1.0
March	-0.4	+0.1
July	-3.3	-1.4

*Blue Chip Economic Indicators, Capital Publications Inc., various issues.

The economic path underlying the Mid-Session Review of the Budget registers the downturn in activity that is now underway and parallels the change in assessment of near-term economic events that has taken place among private economists. Real GNP is now projected to decline by 3.1% between the fourth quarter of 1979 and the fourth quarter of 1980, with the steepest part of that decline in the second quarter of this year. The economy is expected to move downward still further in the second half, but at a more moderate rate, with the slide perhaps bottoming out late in the year.

The projected course of the economy would carry the unemployment rate up to the 8.5% range by the turn of the year, and the very moderate recovery of real GNP and employment thereafter would do little to bring the unemployment rate down over 1981. As measured by the GNP deflator, inflation is projected to moderate from 10.1% for this year to 9.7% in 1981, both measured fourth quarter to fourth quarter.

It is important to emphasize the great uncertainty associated with all of these projections. Throughout this year, economic forecasts from virtually all sources have undergone major revisions on nearly a monthly basis.

Nevertheless, it is clear that the projected course of economic performance is not satisfactory. As the recovery develops, policy steps to improve the economy's performance, both in 1981 and for the longer term, may well be appropriate. The Administration is reviewing the various possibilities and welcomes the opportunity to consult with the Congress about them.

However, the steps need not and should not be taken in haste. The economy's structural problems require carefully designed structural answers.

Turning to the nearer term, we expect that the natural forces of recovery will begin to manifest themselves.

The consensus expectation of economists, inside and outside of government, is that the upturn will occur late this year or early next. This would conform in a rough way to the postwar cyclical pattern. The average duration of periods of contraction in the six previous postwar recessions has been 11 months, although 1973-75 was longer, and the peak of the recent expansion has now been dated by the National Bureau of Economic Research as having occurred in January 1980.

A recent survey* of 40 private economists at major banks, corporations, and private research organizations sees successively smaller declines in real GNP during the third and fourth quarters of this year and a return to positive growth early next year. This is the generally expected pattern. It may not occur exactly as predicted. Economic forecasting is a very imperfect art. The important point is that the official forecast accords reasonably with the consensus of private forecasts and constitutes a realistic appraisal of the near-term outlook.

Recent readings on the economy suggest that the decline is still continuing, but not at the accelerated pace of the early part of the second quarter. The economy is still moving downward, the third quarter will almost certainly register another decline in real GNP. However, there are signs that the rate of decline has slowed markedly.

-- Retail sales scored a 1.5% increase in June. Excluding autos, sales rose slightly more than inflation.

-- New car sales in early July bounced up from their depressed second-quarter pace (though we should not attach too much significance to this rise until confirmed by additional data).

-- Seasonally adjusted initial claims for insured unemployment have fallen back in early July from their earlier peaks.

-- Housing starts and permits rose strongly in June, reversing the trend of earlier months. Housing activity appears to be benefiting already from the interest rate declines in recent months.

-- Businesses have been making a determined effort to keep inventories under control. The decline in business inventory holdings in May indicates some success in these efforts, lean inventory positions would imply that when demand turns up, production would shortly follow.

-- Demands for short-term business credit show signs of renewed strength.

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*Blue Chip Economic Indicators, Capital Publications Inc., July 10, 1980, Vol. 5, No. 7, esp. p. 3.

The Revised Budget Estimates. The Mid-Session Review shows substantial changes in budget estimates. The basic numbers are presented in the table below.

BUDGET TOTALS
(in billions of dollars)

	1979	1980 Estimate			1981 Estimate		
	Actual	Jan.	March	July	Jan.	March	July
Receipts	465.9	523.8	532.4	517.9	600.0	628.0	604.0
Outlays	493.7	563.6	568.9	578.8	615.8	611.5	633.8
Deficit, current estimate	-27.7	-39.8	-36.5	-60.9	-15.8	16.5	-29.8
Budget authority	556.7	654.0	665.8	653.7	696.1	691.3	707.2

The 1980 deficit is now estimated to be $60.9 billion, up from $36.5 billion in March. Outlays are currently estimated at $578.8 billion and receipts at $517.9 billion. The current estimate for 1981 is for a deficit of $29.8 billion, rather than the $16.5 billion surplus estimated in March. Outlays are currently estimated at $633.8 billion and receipts at $604.0 billion. Both the increase in the 1980 deficit and the shift from surplus to deficit in 1981 are mainly the result of changes in the economic situation, though the estimates also reflect legislative events, higher spending on defense and emergency relief programs, and some minor technical changes.

The 1980 deficit is now estimated to be $24.4 billion higher than in March. Of this amount, about two-thirds, or $16.6 billion is due to the change in economic conditions. Receipts are down nearly $11 billion and outlays up $7 billion for this reason alone. Policy changes and Congressional action have reduced receipts by $4 billion in 1980 and $8.4 billion in 1981, and are partially offset by technical re-estimates and other factors. In addition to the effect of changed economic conditions, outlays are running somewhat higher because of defense outlays and increases for disaster relief, alien assistance, and other unavoidable events.

The larger budget deficits do not reflect an upsurge in discretionary federal spending. Congressional responses to the President's proposal for spending restraint have been constructive. While there are some differences in program priorities, the Congressional budget efforts to this point are generally consistent with the policy of fiscal stringency proposed by the President.

Financing the Deficit. Policy steps over the next 18 months could of course alter the economic and budgetary projections released this week. We have, however, analyzed the financing requirements implicit in these projections.

The Treasury's FY 1980 and FY 1981 financing requirements, while increased from the levels projected in mid-March, are not expected to strain the credit markets. Private demands for credit will likely be more than correspondingly reduced as a result of continued weakness in economic activity for the remainder of 1980.

Even with the Treasury's increased borrowing in the months ahead, the ratio of public holdings of Treasury securities to GNP is not likely to rise much above the current level of about 26 percent. In FY 1976, when a budget deficit of over $66 billion was financed, this ratio rose to nearly 30 percent.

Looking ahead to FY 1981, our borrowing needs will probably be heaviest in the first two quarters of the fiscal year. The use of a wide variety of borrowing options currently available to the Treasury should minimize any undesirable impact of this increased financing.

The recovery in the economy is expected to begin late this year or early in 1981, but in the absence of other actions the upturn is projected to be relatively slow. Private credit demands are typically slow to rise in the initial stages of an upturn, and the expected moderation in the rate of recovery may further hold down private borrowing.

Financing policy is not greatly challenged when the automatic stabilizers in the economy tend to result in deficits in periods of slack economic activity. But the string of deficits experienced in the postwar period in boom years as well as in periods of slack, has imposed an added burden on the performance of the economy and its financial markets. If the monetary authorities finance such untimely deficits, excessive growth of credit is generated, and an inflationary atmosphere is created. If, on the other hand, the monetary authorities decline to make credit available to finance the deficit, the available pool of savings and capital formation and productivity suffer. The solution must be a move toward budget balance over the course of the cycle. Sizable surpluses in periods of prosperity may well be desirable, particularly if tax and other policies are successful in promoting more robust private investment performance. We are making progress toward such a long-term fiscal policy, but continuing efforts are required.

TAX POLICY AND AN APPROPRIATE FISCAL STRATEGY

In turning now to the issue of appropriate fiscal policy under present circumstances, several basic considerations should be kept in mind.

First, Congress has been making progress in restraining the rate of growth in expenditures. This basic fiscal discipline must be maintained. Too often in the past, expenditure control has been a short-term enterprise which was soon abandoned. Now that the painful decisions have been made, we should follow through in a clear demonstration that a new fiscal course is being followed. Failure to do so runs the risk of dissipating all the gains that have been made to this point. Domestic financial markets are functioning smoothly at home and the dollar is showing encouraging stability abroad. Both domestic and international financial stability require that we continue to pursue a responsible fiscal course.

Second, it is difficult to predict the exact course that the economy will follow. Interest rates have fallen much more sharply than most observers expected. This could induce an earlier upturn in credit sensitive sectors of the economy. If the economy were to rebound more quickly than expected, fiscally stimulatory actions might prejudice our progress in bringing down inflation.

The Venice Economic Summit reinforced our view that relaxation of demand management policy in the major world economies would be premature. The Venice communique clearly stated that "the reduction of inflation is our immediate top priority...Determined fiscal and monetary restraint is required to break inflationary expectations." Global inflation rates are still unacceptably high and we have not yet succeeded in reducing inflationary expectations. Too early a retreat from restraint, might re-ignite inflationary expectations and erase the hard-won gains we have just begun to make.

Third, the kind of future tax program that should be developed, with full consultation between the Administration and the Congress, will necessarily involve some complex issues and controversial decisions. There are enough choices and technical problems in depreciation reform alone to consume more legislative time than is now remaining before scheduled adjournment. Even proposals that start with apparently simple formulas would not be easy to enact into law, especially in a politically-charged environment. The only program that is simple enough -- slashing rates according to a formula -- would be counterproductive.

Fourth, it would be unwise to try to complete a large tax cut program in this session of Congress. The effort to do so would be caught up in all of the political cross-currents of an election year. It would be subject to the full weight of pressure from every faction that has an interest in special relief. If any agreement were to emerge from this environment, it would very likely be a melange of special interest provisions -- just the opposite of what is needed.

A tax program may well be appropriate for next year. Anticipating this possibility, now is a good time to set out criteria and to begin to consider the outlines of such a program.

Criteria for a tax reduction program

Accord with fiscal discipline and spending restraint. A tax program should be considered in the context of the restraint demonstrated on the spending side. Any tax reduction agenda must consider the revenue effects for at least five years, not just for the first year. This budget planning should be based on reasonable projections for expenditures and economic conditions, including realistic economic responses to any tax changes. They should not be based on hopes, wishes, or magic formulas.

Combat inflation. An anti-inflation tax program should have at least two main attributes. First, in the short run it should not create excessive additional demand pressures or rekindle inflationary expectations. Second, it should help encourage investment and, thereby, improve productivity and reduce unit labor costs. If, at the same time, the program could directly contribute to cost reduction, that would be an added plus.

Maintain confidence in financial and foreign exchange market. In recent months, the program of fiscal restraint has gone a long way to reassure investors at home and abroad that the long upward trend of inflation has been broken. It is important that any major fiscal program be perceived as one that maintains a steady course. Deliberate development of a program aimed at long-run objectives can reinforce this perception. In contrast, an abrupt shift toward stimulus could disturb financial and currency markets, complicating the recovery.

Focus on improving productivity growth and international competitiveness. We must give more attention to the supply side of the economy. The realization of our public and private goals -- a strong defense, expanding employment, growth in real income and opportunity, energy independence, and improved international accounts -- depends on increasing the rate of investment to modernize the capital stock and increase capital per worker. This requires that tax incentives be concentrated on capital expansion, not dissipated in special interest provisions that only move capital from place to place.

Promote the most effective use of available resources. It is not enough to expand the size of the capital stock and increase jobs. The jobs and capital should go where they will have the highest payoff. This is the least costly way to achieve real economic expansion.

The best judge of the prospective payoff is not the government; it is private markets. Reducing taxes where they interfere the most and avoiding the creation of new tax distortions are the keys to the effective allocation of jobs and capital.

Preserve the progressivity of the tax structure. Inflation and reduced energy supplies have further restricted the choices for families with modest incomes. The payroll tax also takes a disproportionate share from wage earning families of low and moderate income. Although "bracket creep" has occurred for every class, those with lower incomes are least able to absorb or avoid the higher rates. Any plan for reducing individual tax rates must carefully consider the effects on the progressivity of the system.

Reflect close consultation with Congress. The criteria offered here indicate priorities and suggest an agenda, but there are large choices within them concerning methods and degrees of emphasis. The Administration wishes to work out these choices in close consultation with this and other committees and with individual members of Congress. Your knowledge and experience are vital to the process of constructing an effective program.

MAJOR TAX POLICY CHOICES

The principal objectives of economic policy and the current structure of the tax system indicate that any future tax changes should be pointed in two major directions. The first would be to reduce the burden of taxes on households and on labor costs. The second would be to provide incentives for productive business investment. A strong case can be made for a number of tax policy options. Putting a tax program together, however, involves choice. Revenue simply is not available to make all the changes everyone would like.

Reducing the tax burden on labor income

The taxation of wage earners is mainly determined by the structure of individual income-tax rates and the rate of payroll taxes for social security. The purpose of the graduated rate structure in the income tax is to apportion the tax burden equitably among households of differing means. A by-product of this structure is automatic tax increases resulting from year-to-year increases in money incomes. This tendency -- often called "bracket creep" -- has led Congress to make periodic adjustments, especially in periods of inflation.

Over the period from 1969 to 1979 legislated adjustments to the rate schedule produced nearly the same effect as indexing for middle-income families. A family of four of median income ($24,400 at 1980 levels) would have paid income tax of 10.0 percent in 1969 and 10.4 percent in 1979, if its income had just kept pace with inflation over those years. However, rapidly increasing money wages continue and more households have begun to encounter the steeper portions of the rate schedule that was enacted in 1978. Consequently, the same family of median income will pay 11.4 percent in federal personal income taxes for 1980 and 12.1 percent in 1981.

Increasing individual tax rates and, particularly, the higher rates that apply to any additions to family income are felt especially by families with two wage earners. Consideration should be given to the marriage penalty in connection with individual rate adjustment.

The other main element in the taxation of labor income -- the payroll tax -- has been increased steadily to provide funding for increasing real benefit levels to a growing population of social security recipients. In combination, the income and payroll taxes add substantially to the differential between the cost of labor to businesses, on the one hand, and the after-tax pay of workers, on the other. At current rates of income and payroll taxes, an employer must pay $1.52 in wages and payroll tax to add $1.00 to the after-tax pay of an employee in a median income family. This represents a combined marginal tax rate on labor income of 34.1 percent.

Scheduled increases in the payroll taxes will increase these marginal rates of tax by nearly a percentage point in 1981, considering the increases for both employer and employee. In seeking equitable ways to reduce the taxation of labor income, attention should be given to the added burden on labor costs from payroll tax increases and also to the funding needs of the Social Security system.

One approach to this problem is the proposal put forward by Congressman Gephardt. Under this plan, individuals and businessmen would be permitted an income tax credit for a portion of social security taxes paid. The credit could be refunded to employers and employees who owe no income tax liability. This method would offset the increase in payroll taxes without interfering with funding for the social security system.

Other approaches to the increasing burden on wages also deserve exploration. A result similar to the Gephardt plan may be attained by matching individual income tax cuts to the payroll tax increases, for example. However, direct reduction of the payroll tax should not be considered except in the context of a comprehensive analysis of trust fund financing issues.

Tax treatment of saving

Taxation of income from ownership of property has also generally been increasing. This is partly because the average individual saver who receives interest, dividend, rental or business income has also moved up into higher income tax brackets. Another reason is that inflation leads to overstatement of business profits. But these increases are by no means uniform. The many sources of property income are subject to a great variety of tax treatments. For example, income from corporate equity may be fully subject to corporate taxes and also subject to individual taxes when distributed as dividends to shareholders. At the other extreme, the first $400 of interest income, interest from municipal bonds, earnings on individual retirement accounts, and vested pension funds are all effectively tax exempt. Still other kinds of property income, such as from real estate, minerals, and appreciation of corporate stock are only partially subject to tax.

While many of the savings incentive provisions adopted piecemeal over the years may have been intended to increase availability of capital, some are extremely inefficient and may even be counterproductive. The ability of taxpayers to switch their assets from one form to another, or to borrow in order to invest in a tax-preferred asset, has reduced, if not eliminated, the ability of many of these provisions to increase overall savings. Revenues lost because of tax preferences for certain types of income require increases in rates of taxation on all taxable income. The approach of providing "saving incentives" to certain narrowly defined uses of funds or special kinds of investments should be rejected in favor of more direct, broad based and efficient incentives for investment.

Another important result of the uneven treatment of property income is to divert saving and investment away from the relatively high-taxed industrial sector. Industrial corporations and public utilities are those most likely to bear the full corporate income tax and produce taxable dividends. They also are hardest hit by the erosion of depreciation allowances resulting from inflation. This causes depreciation--a major cost of using capital goods--to be understated and inflates taxable profits.

Depreciation reform

Among choices for encouraging capital investment and raising productivity, acceleration of depreciation allowances offers the greatest potential for success. In general, such a provision would reduce the tax bite on the return to successful investment and also enable higher returns to be paid to direct or indirect suppliers of capital, whether they are lenders, shareholders, members of pension funds, or depositors in financial institutions. As compared with tax breaks to particular types of saving, the benefits of accelerated depreciation are more directly tied to productive investment and less susceptible to "gaming" by simultaneous borrowing and lending transaction and other shifts in individual portfolios.

The particular program for accelerating depreciation that emerges should avoid the kinds of problems that afflict the 10-5-3 proposal. That proposal would quickly become very expensive. It is uneven and haphazard in the way it spreads benefits among types of assets and industrial sectors. Its transition phase is needlessly complicated and may promote investment delays.

Most proposals to accelerate depreciation for newly acquired assets will generate revenue losses that grow more rapidly than the economy for several years. Careful budget planning is required, therefore, for any depreciation program. The reason for this increasing cost is that each year's investment adds increased depreciation deductions on top of the higher deductions still being taken on investments made before. The 10-5-3 proposal exaggerates this pattern by specifying a phased reduction in lives over the first 5 years. For example, in the first year machinery and equipment would be written off in no more than 9 years, the next year in 8 years, and so on down to 5. This may entice the Congress by offering a very low downpayment. But the revenue cost under this approach would grow about twelve-fold in the first five years, from less than $5 billion to nearly $60 billion.

The 10-5-3 proposal becomes so expensive because it would eventually allow the same combination of deductions and investment credits for nearly all classes of machinery and equipment. These allowances would be more generous than those for even the shortest write-off periods in present law. This approach greatly increases the value of deductions for long-lived kinds of equipment such as those used in power plants and ship building. In contrast, the increased allowances for equipment that wears out rapidly or becomes quickly obsolete (such as tools used in metal fabricating and electronics) would be relatively small. For owners of commercial and industrial buildings the value of additional tax saving is, in turn, much larger than the average increase for investors in machinery and equipment. Thus, the 10-5-3 formula indiscriminately favors the movement of capital to structures as well as to long-lived equipment, a pattern not clearly related to any criteria for cost effectiveness in adding to productivity or other economic goals.

The Administration will support at the appropriate time a more even-handed approach to accelerating depreciation allowances. A connection should be retained between deductions for depreciation and the actual depreciation experience for assets used in different kinds of production activities. Such an approach would be superior to 10-5-3 in a number of important respects:

- It would flatten out the trend in revenue losses, providing the tax reductions earlier and having much less impact on future budget options.

- It would not require the kind of phased introduction scheme that imposes additional accounting burdens and weakens the investment incentives at the time they are most needed.

- It would introduce less distortion into the pattern of investment incentives. Additional capital made available by the promise of increased returns and by prudent budget policy would be generally attracted to industries with profitable investment opportunities not directed to particular kinds of property.

A capital recovery system that involves simpler accounting, greater certainty, and reduced administrative complexity can be designed without the cost or distortions of 10-5-3.

CONCLUSIONS

During the next five years, the U.S. must take the steps required to build a strong foundation for superior economic performance and increased economic security. We must show the discipline to make the sacrifices needed to strengthen our economy for the long run, while at the same time providing assistance to those most adversely affected by short-run economic disruption.

The U.S. stands at the threshold of a new economic era. What we do over the next five years will determine whether this new era brings an unparalleled standard of economic well being or a slow drift to mediocrity. To make the most of this opportunity, we must not only build on past gains, but also be willing to reverse past errors. Many of the economic problems now facing us stem from an unwillingness, stretching back at least 15 years, to confront directly difficult trade-offs and choices. Hard choices must be made if the U.S. economy is to thrive in an increasingly competitive world.

There are four major objectives for economic policy for the next five years: First, to improve our economy's productive capacity so we can enjoy stronger growth in real incomes. Second, to return to longer run price stability, which will permit us not merely to reach a high employment level but to sustain it. Third, to enhance our competitive position internationally. And, fourth, to reduce our vulnerability to externally generated shocks, such as energy interruptions.

A tax program, properly timed, and consistent with the criteria outlined above can make a significant contribution to attaining these objectives. If we move in that direction patiently and responsibly, we will be able to improve greatly our economic outlook for the balance of this century.

EXHIBITS FOR TESTIMONY
OF SECRETARY OF THE TREASURY
G. WILLIAM MILLER BEFORE

SENATE FINANCE COMMITTEE

July 23, 1980

Exhibit 1

Real GNP and Growth

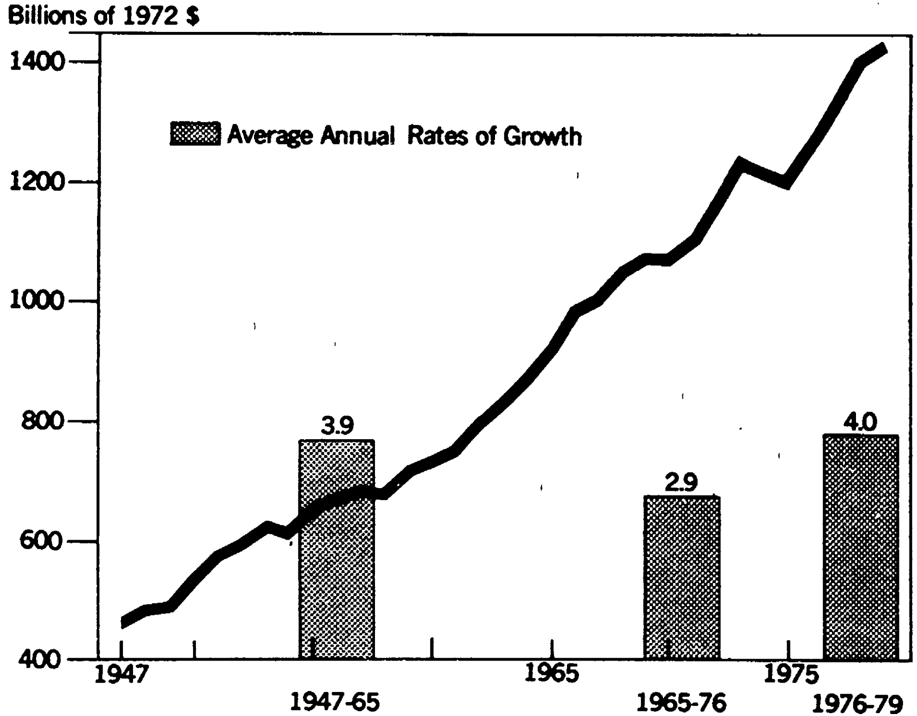

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Exhibit 2

Civilian Labor Force and Growth

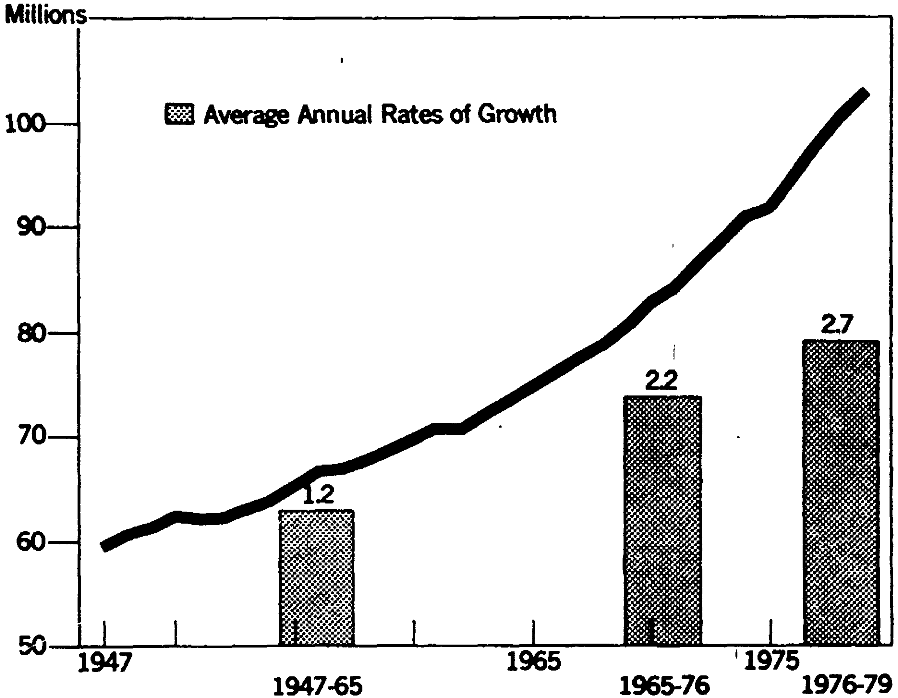


Exhibit 3

Unit Labor Costs and Productivity Private Business Sector

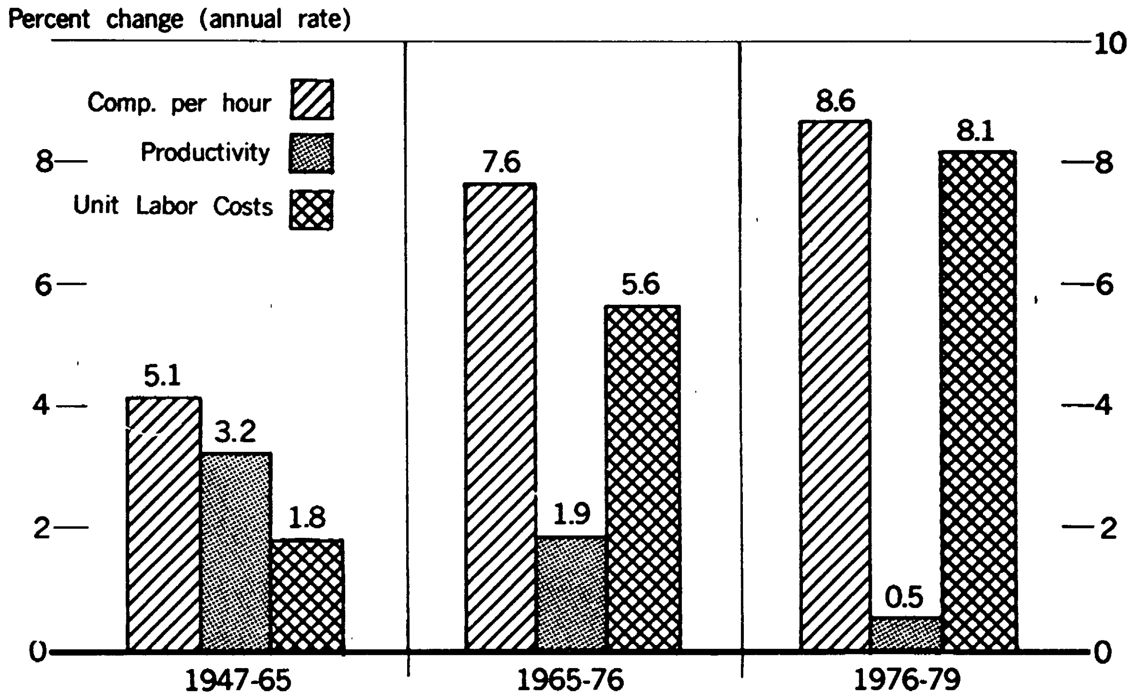
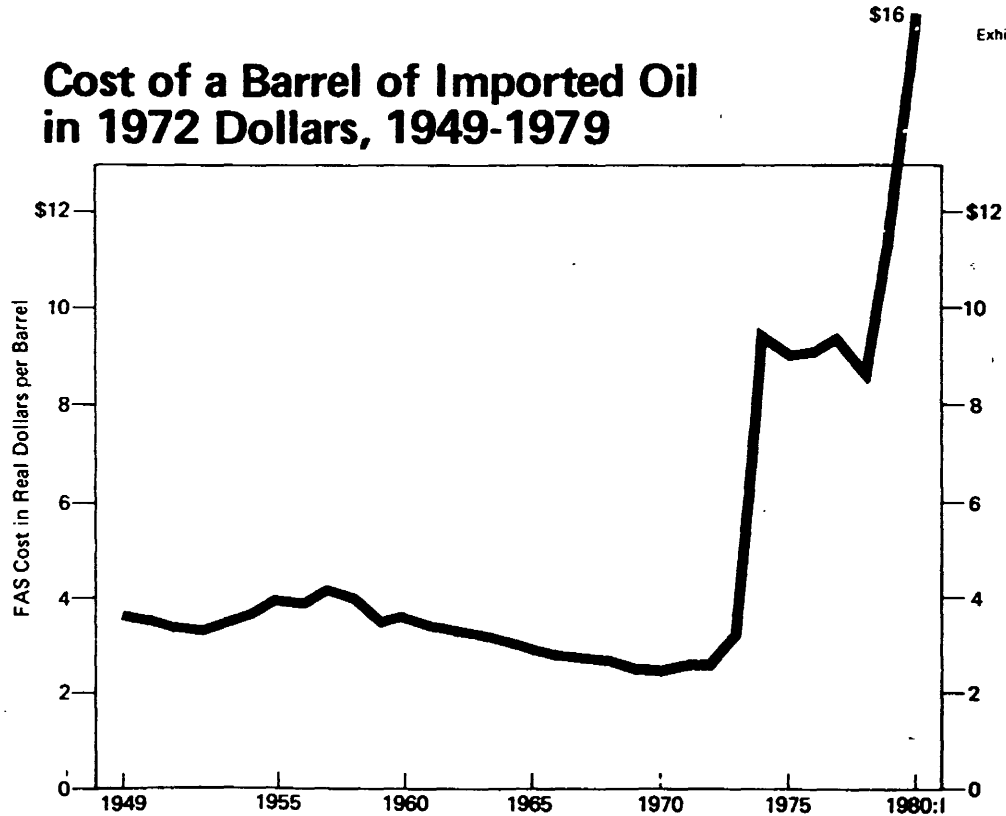


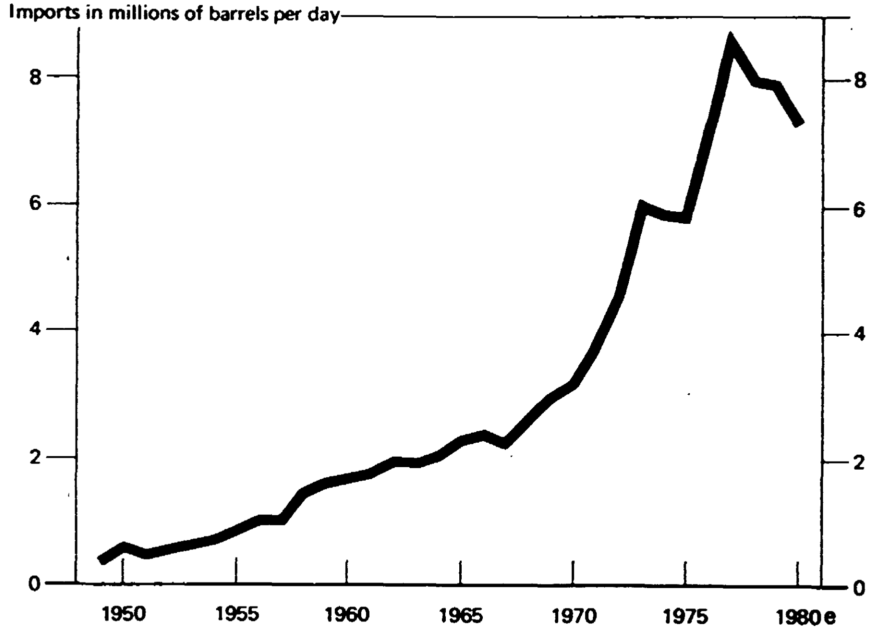
Exhibit 4

Cost of a Barrel of Imported Oil in 1972 Dollars, 1949-1979



Volume of Total Petroleum Imports, 1949-1980*

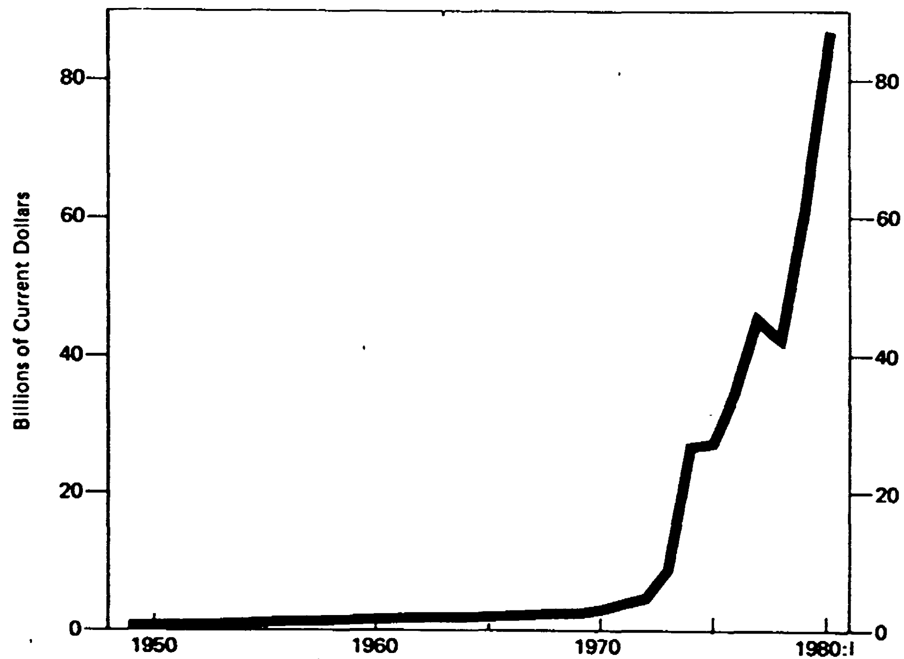
Exhibit 5



* millions of barrels per day on the DOE net trade basis

U.S. Oil Import Bill*, 1949-1980:I

Exhibit 6



*Balance of Payments Basis

Exhibit 7

Ratio of Energy Consumption to Real GNP, 1949-1979

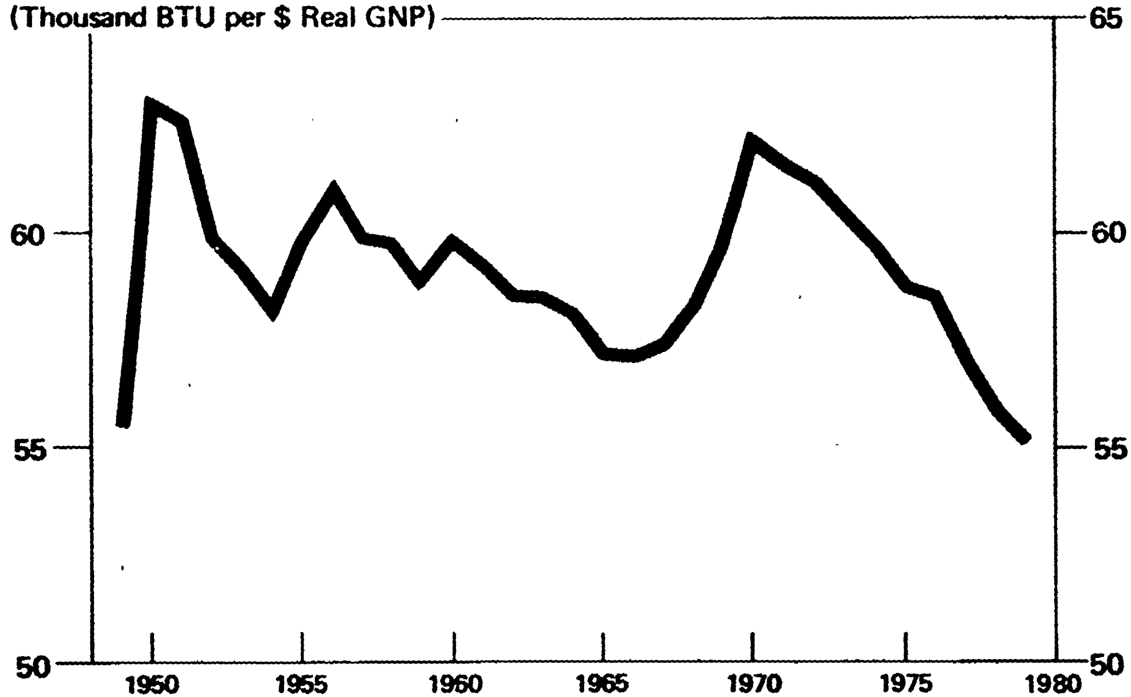
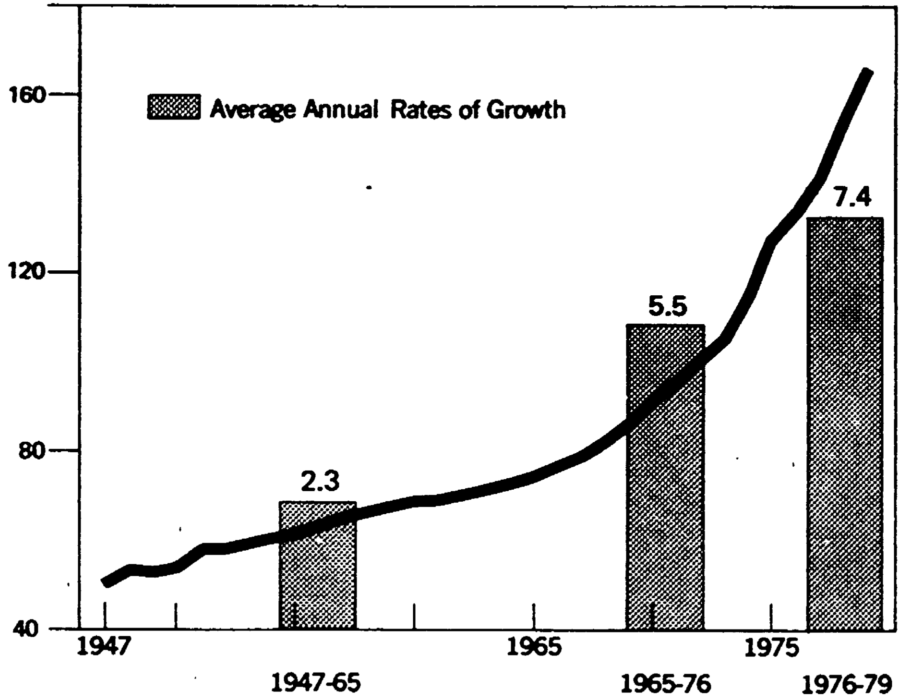


Exhibit 8

Price Performance*

Index (1972=100)



*Implicit GNP price deflator.

Actual and Potential Gross National Product

Exhibit 9

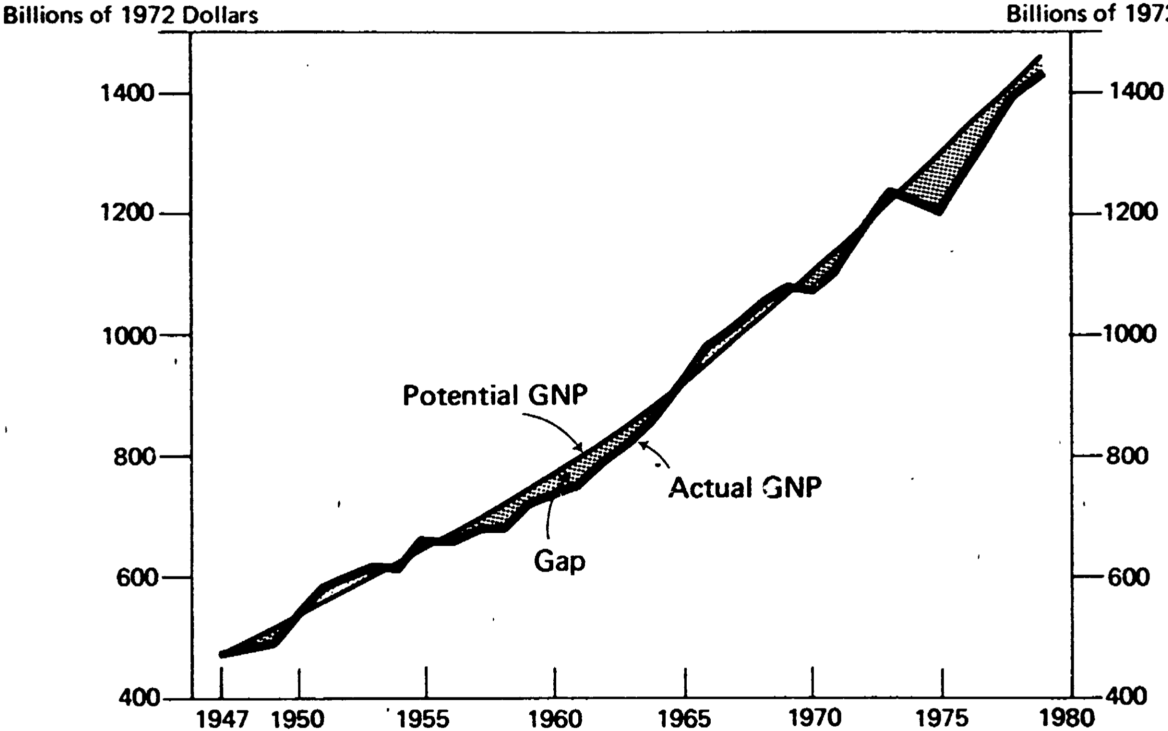
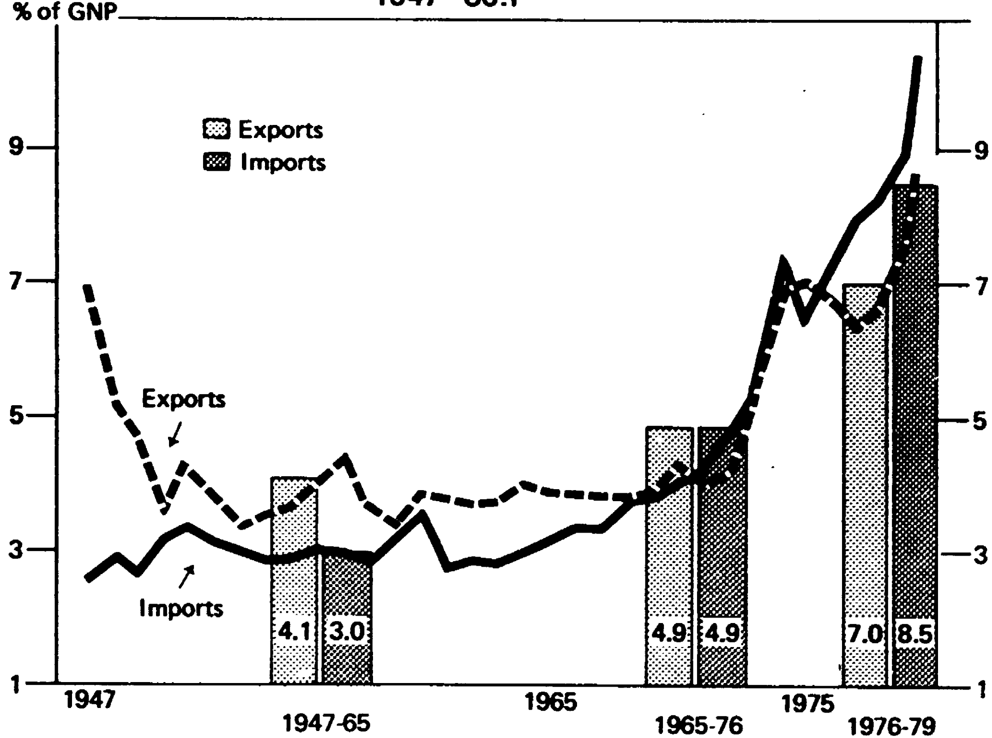


Exhibit 19

Exhibit 10

U.S. Exports and Imports as Percent of GNP

1947 - 80:I



U.S. vs MAJOR OECD COUNTRIES

1976-79

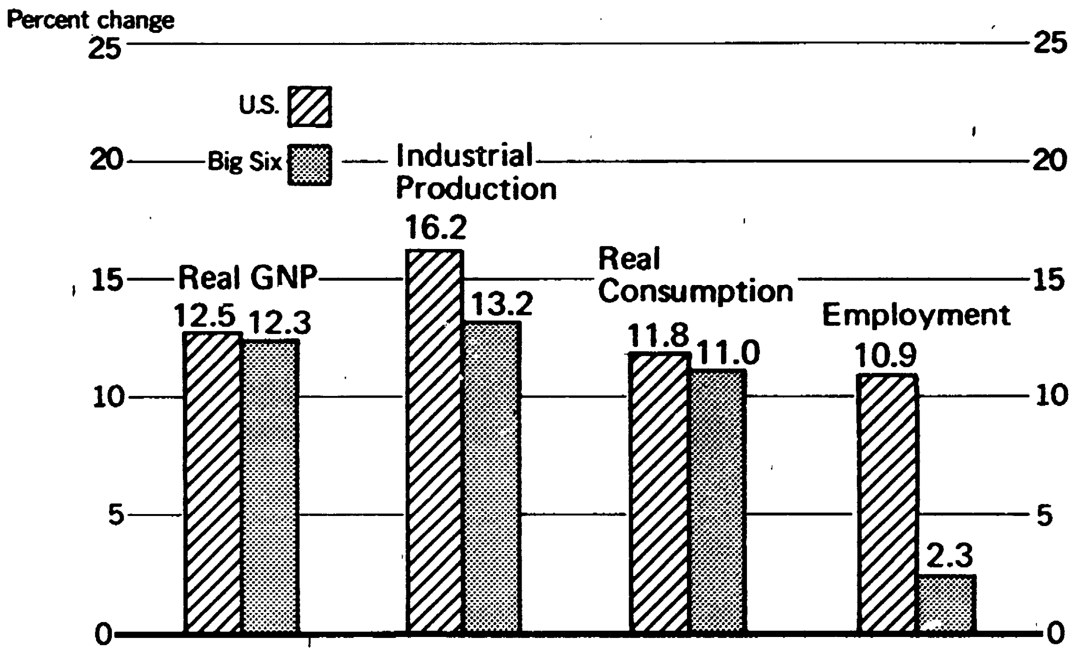


Exhibit 12

Recent Movements in Short-Term Interest Rates and Prices

(CPI at an annual rate; interest rates are monthly averages)

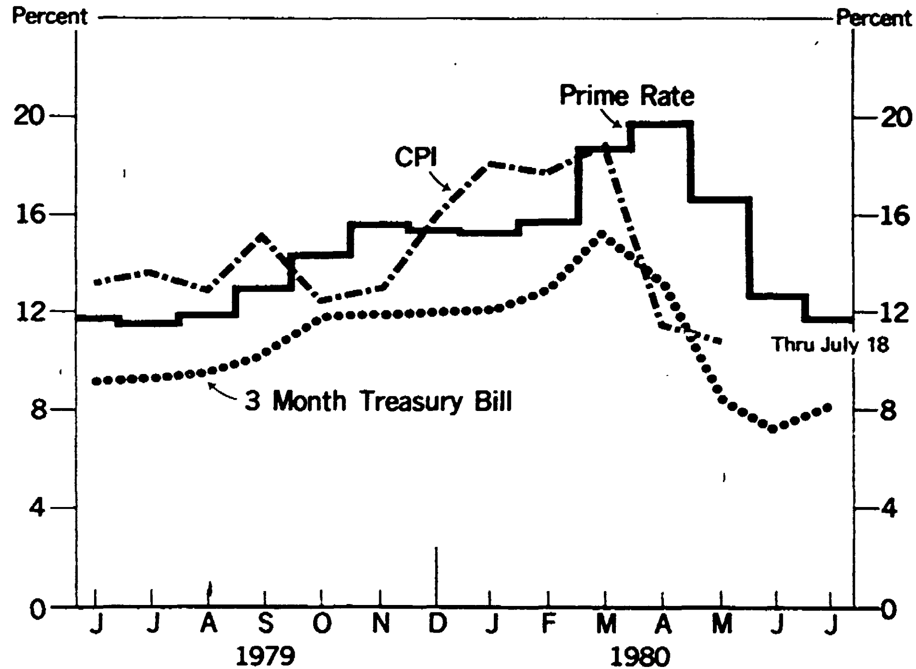


Exhibit 13

Duration and Depth of Business Cycle Contractions Since World War II

Contraction period	Duration in months	Peak to trough Decline (—) in Real GNP[1]
1948-49	11	—1.4%
1953-54	10	—3.3
1957-58	8	—3.2
1960-61	11	—1.1
1969-70	10	—1.2
1973-75	16	—5.7
Average	11	—2.6
Outlook for current recession:		
Consensus of 42 private forecasts[2]	12	—3.5

1/ Actual peaks and troughs in GNP.
2/ Blue Chip Economic Indicators, June 1980, Vol. 5, No. 6, pg. 8.

Comparison of Mid-Session Budget and Private Economic Forecasts

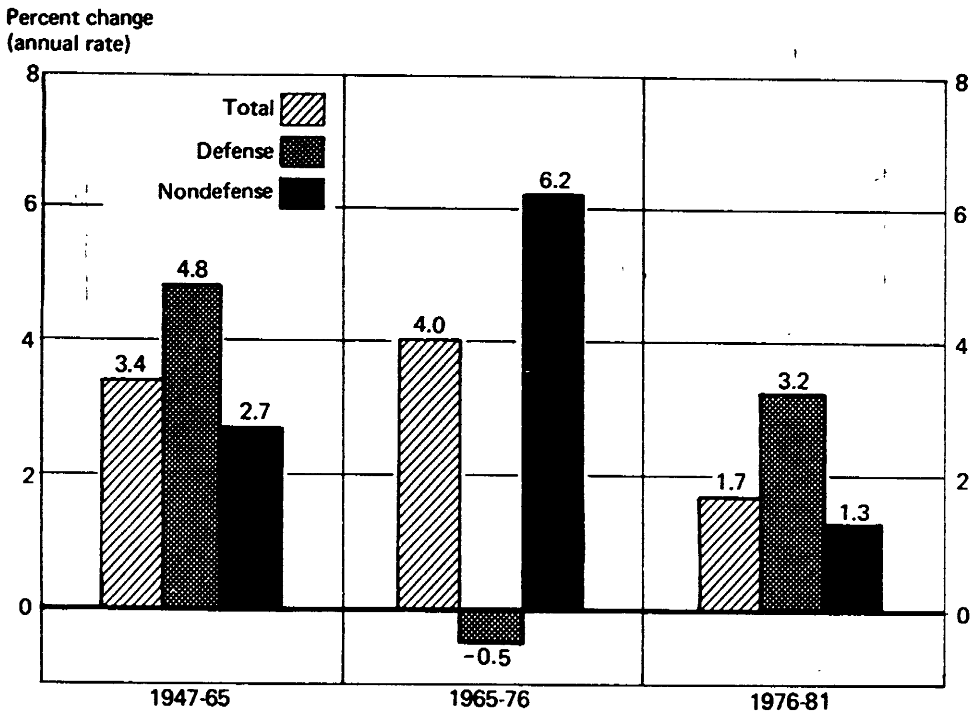
	Real GNP		Unemployment rate		Consumer price index		GNP deflator	
	1980	1981	1980	1981	1980	1981	1980	1981
	(Percent change, 4th to 4th)		(Percent, 4th quarter)		(---- Percent change, 4th to 4th-----)			
Four leading models Average	–3.7	3.5	8.6	8.3	12.4	9.2	9.4	8.9
Consensus of business forecasters (July)	–3.3	3.5	8.8	8.3	12.0	8.9	9.4	8.6
Mid-Session Review path	–3.1	2.6	8.5	8.5	12.0	9.8	10.1	9.7

Budget Totals
(in billions of dollars)

	1979	1980 Estimate			1981 Estimate		
	Actual	Jan.	March	July	Jan.	March	July
Receipts	465.9	523.8	532.4	517.9	600.0	628.0	604.0
Outlays	493.7	563.6	568.9	578.8	615.8	611.5	633.8
Deficit, current estimate	–27.7	–39.8	–36.5	–60.9	–15.8	16.5	–29.8
Budget authority	556.7	654.0	655.8	653.7	696.1	691.3	707.2

Exhibit 16

Real Growth in Budget Outlays*



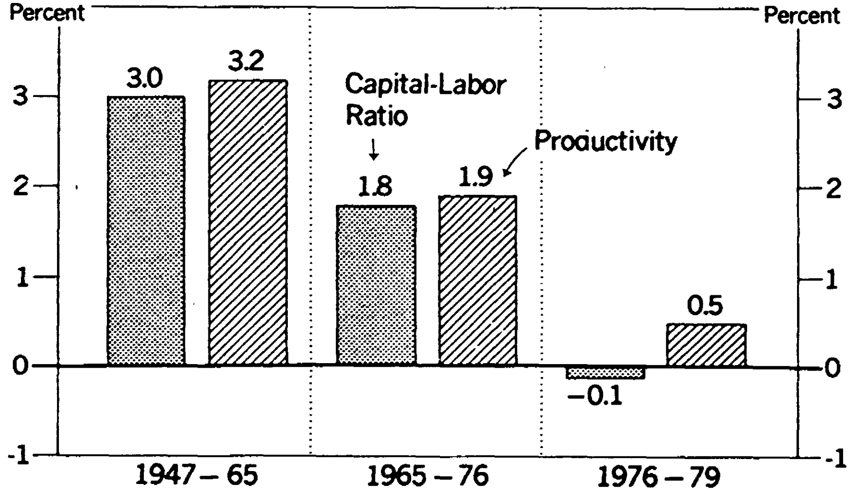
*Fiscal years

Some Better Signs

- June **Housing Starts and Permits** up to highest since February.
- Early July **Initial Claims for Insured Unemployment** (sea. adj.) fell back sharply from peaks.
- May decline in **Business Inventory Holdings.**
- Early July **Auto Sales** (sea. adj.) bounced up from depressed second quarter.
- June **Retail Sales** (ex. autos) rose slightly more than inflation.

Rates of Growth in the Capital-Labor Ratio and in Productivity

(annual rates in percent)



Note: Capital-labor ratio is real net capital stock (gross stock less replacement requirements and pollution abatement expenditures) in the private business sector divided by the civilian labor force.

Productivity is output per hour of all persons in the private business sector.

Criteria for a 1981 Tax Program

An effective tax program for 1981 should:

- Maintain budget discipline.
- Combat inflation.
- Maintain confidence in financial markets.
- Improve productivity growth.
- Strengthen international competitiveness.
- Promote effective use of resources.
- Preserve progessivity.
- Reflect close consultation with Congress.

Elements of a Program to Liberalize Depreciation

- Simplify accounting, reduce audit uncertainty, and streamline administration.

- Avoid phase-in that may delay investment.

- Provide tax benefits as large as fiscal prudence allows.

- Retain connection between tax allowances and actual depreciation experience.

The CHAIRMAN. The committee is in recess until 10 o'clock tomorrow.

[Whereupon, at 1:20 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, July 24, 1980.]

[By direction of the chairman the following communications were made a part of the hearing record:]

ECONOVIEWS
INTERNATIONAL INC.

A TIMELY TAX CUT IS IMPERATIVE*

Richard D. Karfunkle**

SUMMARY & CONCLUSIONS:

The contour of the business cycle has traced an abruptly downward path of particularly severe dimensions, beginning just prior to the mid-March, 1980 overt tightening of domestic monetary and credit policy and the concurrent Presidential and Congressional movement to balance the Federal budget in fiscal 1981 (on paper, at least). But, the circumstances, as far as tax cut/reform measures are concerned, while heightened by anti-recession fervor, essentially remain unchanged. My analysis concludes that a continuum of tax cut/reform packages is required during the first half of this decade in order to facilitate an economic growth record of more satisfactory dimensions during the second half of this decade and beyond.

A timely tax cut now would, incidentally, help blunt what remains of the downside of this particular recession by restoring confidence

*A Statement prepared for the Senate Finance Committee's Hearings on Tax Cut Proposals, beginning July 23, 1980.
**Mr. Karfunkle is President of Econoviews International, Inc., and is Economic Consultant to Jefferies & Co., Inc. of Los Angeles, CA

and purchasing power to the private sector. Considering the tax increases built into the 1981 outlook -- social security and inflation's bracket creep, to cite just two, a tax cut, effective by January 1, 1981, of $30-40 billions, would not be alarmingly large.

CYCLICAL CONSIDERATIONS:

As U.S. economic events have developed, the mid-March, 1980 policy "overkill" could not have been timed more badly. By early June, the official business cycle turning point determiner, the National Bureau of Economic Research, had selected January, 1980 as the cycle peak. Thus, severe policy restraint was imposed about six (6) weeks after the confluence of economic forces had produced a peak. The untimely restraint program did manage to scare the consumer, disturb the businessman and otherwise exacerbate the down-side of an already weakening domestic economy, all in the name of fighting dangerous, double digit inflation.

In order to prevent the ongoing cyclical contraction from surpassing the dimensions of the 1973-75 recession, there have to be put in place, as soon as possible, great and growing expectations by the private sector of a substantial tax cut.

POLICY CONSIDERATIONS:

The uncomfortable position occupied by Administration/policy makers/Congress as to whether anti-recession or anti-inflation ought to be their appropriate policy objective may be too simplistic -- that is, the perceived dilemma may not exist in reality.

For example, an examination of inflationary pressures within the context of the Consumer Price Index clearly shows that inflation has been concentrated in energy, food and mortgage interest rates. When these "shock" factors are removed from price statistics, though, the underlying inflation rate, seemingly imbedded in the foundations of the U.S. economy, essentially has doubled from the mid-70s to stand at approximately +10%. This secular rate of inflation coincides almost precisely with the calculation of the rate of increase in unit labor costs or wage compensation (-) productivity, or output per manhour.

It follows that heightened productivity -- via advanced technology, investment to scale, enlightened Government regulatory burdens, improved worker attitudes, etc., and, simultaneously, a willingness on the part of labor, management and, yes, even Government, to permit wage compensation gains to decelerate, if only in anticipation of deflated inflationary expectations, would produce a reduction in the imbedded inflation rate.

Here, a policy to cut taxes now has a double cutting edge: first, a consumer tax cut, especially in the face of ongoing tax increases, will restore lost purchasing power, liquidity and confidence; second, a business tax cut will stimulate investment, in part in the expectation of a recovery in consumer demand, with said investment increments likely to enhance productivity trends. This tendency will be even more pronounced if, as expected, labor force demographics are more reasonably translated into a much slower growth in total non-agricultural employment during the ensuing recovery-expansion, compared to the explosive, energy trade-off- conditioned bulge in post -1975 employment. For example, between mid-75 and mid-1980, such employment grew 13.2 million; from its previous cyclical peak, the gain totalled 11.8 million. The compound annual growth rates were +3.2% and +2.4%, respectively, and should be halved in years immediately ahead.

THE COLLAPSE OF CONFIDENCE:

The nature of biases in the structure of our domestic inflation and its measurement, the decreases in industrial production and operating rates, the large increases already recorded and yet to come in unemployment and, perhaps most importantly, the collapse of confidence in our political-economic leadership -- domestic and international... indicate to me that the first in a series of tax cut/reform packages must be initiated as soon as possible.

Because it will take, by my economic modelling, until late 1981 to restore U.S. Gross National Product (in 1972 dollars) to the record level reached in first quarter, 1980, even with a January 1, 1981 effective date for tax cut package #1; because even that period did not produce record highs for manufacturing operating rates or lows in unemployment; because, statistically, real consumer purchasing power either has declined from $109 weekly to less than $95, between 1971 and 1980, or, on a per capita disposable personal income ($72) basis, has not grown significantly since fourth quarter, 1978; because the savings rate has trended down from 7.7% of disposable income to below 4.0%; because home owners/ equity, a complement to traditional savings, is less certain to grow &/or be realizable in periods of tight money; because of all of the above, it is imperative that tax cut package #1 be implemented as soon as possible.

Any concerns I have about an ill-timed, ill-conceived tax cut package causing a simultaneous or even lagged boost in the institutionalised inflation rate because of a transient, cyclical swelling of the Federal budget deficit are overwhelmed by the other social and economic considerations voiced above.

A CONTINUUM OF TAX CUT/ TAX REFORM PACKAGES in the 80s:

The decade of the 80s has begun as the decade of the 70s began. But, the energy shocks of the 70s ought not be repeated -- after all, twice forewarned should be sufficient to finally instill an energy crisis ethos into policymaker and consumer/businessman alike.

What we, as a nation, now need, in additon to this ongoing energy adjustment, is a restoration of faith in our "capitalistic" system, its leaders and its policymakers. This, in turn, will produce a higher confidence factor which enlightened management should quickly translate into rising investment in new plant and equipment. These are essential to economic progress and success, as measured by an expanding GNP pie. This will offer the opportunity, at least, for rising living standards for most, if not all, Americans .

Moreover, it cannot be stated too often that, given a weak or still-weakening economy, timely tax cuts, especially in series, as in the early 60s, not only will be the catalyst for such growth, but will generate incremental Federal tax revenues that more quickly will permit a cyclical shrinkage of a short-lived, enlarged, not necessarily inflationary Federal budget deficit.

A Proposal for Reform of the Capital Gains Tax:

Taxation of Capital Gains - The Problem

by

John Dane, Jr.

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Commonwealth of Massachusetts

A Proposal for Reform of the Capital Gains Tax

Taxation of Capital Gains - The Problem

By John Dane, Jr. - Partner, Choate, Hall & Stewart

Even before inflation came to play as large a role in the economic scene as it does today, the taxation of capital gains has presented a host of problems, conceptual, philosophical and economic.

Dan Throop Smith, in "The United States in the 1980's - Issues in Tax Policy", published by the Hoover Institution of Stanford University, has the following comment:

> "The appropriate tax treatment of capital gains is highly controversial. Many countries do not tax capital gains at all. No country taxes capital gains at the same level as ordinary income. Trust law, corporate law, national income accounting, and traditionally, people thinking about their own financial affairs all distinguish between capital and income."

These problems lie in two areas in particular. First, there has been a serious question in the minds of many people on the question of whether capital gains are really "income" and, as such, properly subject to an "income" tax. Admittedly, the Supreme Court of the United States has held that capital gains could be taxed under the Sixteenth Amendment to the Constitution which permits a tax on incomes. Proper as this decision may be from a purely legalistic point of view, it does not entirely accord with the everyday perception of the average man. Income is generally thought of as a flow of cash which continues with reasonable regularity, as is the case with wages and salaries, interest and dividends. It is something that can be counted on and can prudently be spent. Capital transactions are as likely to give rise to gains as to losses. Treating capital gains as spendable income can be the height of imprudence as many college endowment fund managers have learned to their cost and that of the institutions whose funds they have managed. As a matter of fact, over the last decade there has been little, if any, overall appreciation in security values.

The second characteristic of capital gains which makes their equitable taxation extremely difficult is the so-called "bunching" problem. Where a capital asset has been held for a number of years and is eventually sold at a gain, this gain has, in the usual case, accrued over the period, but under the capital gains tax, the entire gain is taxed in the year of sale on top of the seller's other income. With even a moderately progressive tax system, this imposes on capital gains a burden not borne by other income received annually.

Were it not for inflation, our present system of taking only 40% of gains as ordinary income would, in general, seem to be a reasonably equitable solution to the problem. however, once we factor in inflation, the result becomes far less satisfactory. In many instances what is being taxed under the assumption that it is gain is not really gain at all--if we mean by "gain" an increase in purchasing power. It is really a decline in the purchasing power of the dollar.

Previous solutions to problem
of taxing capital gains

We could go back to the system which was in force from 1934 through 1937 and scale down the amounts of gain taken into income, depending upon how long the property which is sold has been held: 100 percent if held less than one year; 80 percent--one to two years; 60 percent--two to five years; 40 percent--five to ten years; and 30 percent--over ten years. This system achieves a sort of rough and ready justice but it is not very efficient in removing from taxable income the decline in the purchasing power of the dollar.

A more conceptually satisfying way of approaching the problem is thru the use of indexing, or expressing both the purchase price and the sale price in constant dollars. For example, if the CPI has doubled from the time of purchase to the time of sale, the sale price would be divided by two to determine the amount of taxable gain.

A third solution has been suggested by Prof. Dan T. Smith of the Hoover Institution. Based on the procedure now applicable when residential property is sold at a profit and the entire sale price is invested in a new residence, it would permit the owner of securities to establish an investment fund. So long as the proceeds of the sale of securities are retained in the fund and not withdrawn for consumption, no capital gain would be recognized for income tax purposes. Whenever cash is withdrawn from the investment fund and used for consumption, the amount so withdrawn is subject to income tax and treated as ordinary gains in the fund. This plan has much inherent logic. If the taxpayer treats the gain on the sale of securities as income by using it for consumption, he is not in a good position to complain if the tax gatherer takes the same view of the transaction.

Proposed Solution

Congress should amend the provisions of the Internal Revenue Code relating to the taxation of capital gains so as to provide:

1) Each individual taxpayer would be entitled to set aside specific securities and/or cash in a segregated Investment Fund. Additions could be made to such fund at any time in the taxpayer's discretion.

2) Whenever the taxpayer sold a security held in the Investment Fund, such a transaction would not be treated as giving rise to either gain or loss for

federal income tax purposes provided that the entire net proceeds of the sale were retained in the Investment Fund.

3) Whenever the taxpayer made a withdrawal from the Investment Fund, he would be treated as having received ordinary income (not capital gain) in an amount equal to the lesser of (a) the amount of the withdrawal and (b) the dollar amount of the net gain on previous security sales. In the case of multiple withdrawals, the "net gain on previous security sales" would be reduced by the portion of such gain which had previously been treated as ordinary income in connection with prior withdrawals.

4) In determining the amount of the gain resulting from the sale of a security held in the Investment Fund, the cost basis of the security sold would be increased to reflect the increase in the consumer Price Index which had occurred between the time of the purchase of the security and the time of its sale.

Operation of Proposed Solution

The present proposal is a refinement of Prof. Smith's investment fund plan by combining it with indexing.

The operation of the above proposal can be illustrated by the following simple example.

Knowing that he will need to buy a house in 1980, Mr. Investor established an Investment Fund in 1970. He knew that he could, at that time, have purchased the kind of house he wanted for $100,000, but expecting that costs would rise, he decided that the best way to protect himself from inflation would be to invest the entire fund in common stock. Mr. Investor's anticipation of inflation proved to be amply justified. Taking 1970 as 100, the CPI stood at 186.9 at the end of 1979. Mr. Investor proved to be equally farsighted in his choice of investments and the stocks which he purchased in 1970 for $100,000 were sold in at the end of 1979 for $186,900. Early in 1980, Mr. Investor withdrew the entire amount in his Investment Fund and, assuming that the increase in the cost of houses paralleled the increase in the CPI, he was able to buy the type of house he had in mind in 1970. However, the day of reckoning came on April 15, 1980 when he found that he had a taxable long term gain of $86,900. Forty percent of this, or $34,760, had to be added to his other income in the computation of his federal income tax. Assuming an average 50% tax rate applicable to this additional income, his income tax on the gain was $17,380.

Under the present proposal, Mr. Investor's cost basis for his securities would be increased, based on the increase in the CPI from $100,000 to $186,900, and he would have had no gain in his Investment Fund, and hence no taxable income, when he withdrew the entire fund in 1980 and purchased a house.

Assuming that he had been even more successful, and had sold all his securities for $196,900 in 1979, 100% of the $10,000 gain over his cost basis adjusted for inflation would, under the proposal, be taxed as ordinary income.

The foregoing is a possibly oversimplified example, because it is unlikely that Mr. Investor would have made no changes in securities during a ten year period. If we assume such changes, the unfairness of the present law and the desirability of the proposal becomes even more apparent.

Let us suppose that in 1975, Mr. Investor sold the securities which had cost him $100,000 in 1970 for $138,600, and reinvested the proceeds in his Investment Fund. Under the then present law, he would have had to pay a tax on 50% of his $38,600 long term gain. Under the proposal, he would have had no tax to pay because he reinvested the entire proceeds of the sale in his Investment Fund and did not withdraw anything for consumption. This would have been true even if the gain on the securities sold had been greater than the increase in the CPI from 100 in 1970 to 138.6 in 1975.

June 2, 1980

65-969 O - 80 pt.1 - 10

SUMMARY OF

Statement of W. S. White, Jr.,
Chairman of the Board of
American Electric Power Company, Inc.

To

The Senate Finance Committee

On

Tax Reduction Through Deferred
Taxation of Reinvested Dividends

Deferring taxation to the shareholder of dividends reinvested in newly issued common stock of the corporation, and in general treating the additional shares acquired in the same manner as stock dividend shares, should be proposed by the Senate Finance Committee because such treatment --

1. Would raise large amounts of common stock equity for capital-intensive corporations which must sell common stock on a recurring or regular basis.
2. Would furnish a savings incentive for stock-owning individuals, which would permit them to accumulate assets to produce retirement income supplementing Social Security.
3. Would initially result in a tolerable revenue loss, and would in the long run produce revenue gain.
4. Would alleviate to some extent the present double taxation of corporate earnings distributed to shareholders.

STATEMENT OF W. S. WHITE, JR., CHAIRMAN OF THE BOARD OF AMERICAN ELECTRIC POWER COMPANY, INC.
TO
THE SENATE FINANCE COMMITTEE
ON
TAX REDUCTION THROUGH DEFERRED TAXATION OF REINVESTED DIVIDENDS

This statement is submitted, in connection with hearings commencing July 23, 1980 being held by the Finance Committee on tax reduction, in support of permitting deferred taxation of dividends reinvested at the election of the shareholder in unissued stock of the corporation. Such tax treatment would both encourage savings by individuals for later retirement income, and provide capital to the corporation for investment in productive plant.

American Electric Power Company, Inc. (AEP) is the parent company of an electric utility holding company system. Its operating subsidiaries serve the public in parts of seven states, Indiana, Kentucky, Michigan, Ohio, Tennessee, Virginia and West Virginia.

The electric utility industry is the most capital-intensive industry in the country. While the emphasis is now on conservation, the demand for electricity continues to grow, partly as a substitute for more scarce forms of energy. In order to continue providing adequate and reliable service to its customers, the American Electric Power System (AEP System) must each year spend large amounts for new facilities for the generation, transmission and distribution of electric energy. Such construction, particularly of generating facilities, has long lead times. During the last ten or twelve years there have been very large increases in the cost of new facilities, including dramatically increased pollution control and other environmental expenditures. This, coupled with higher interest rates, has meant that a larger proportion of the needed capital must be raised externally.

AEP System companies are required by the Securities and Exchange Commission to maintain a certain ratio of equity capital to debt capital. All of the common stock of the operating companies must be owned by AEP. As a result all of the common stock equity capital of the operating companies is furnished by AEP, mainly through contributions to capital but also through purchases of additional shares of their common stock. This means that AEP must sell large amounts of its own common stock on a recurring basis. At the same time, AEP must as a practical matter offer a high cash dividend payout.

AEP raises a portion of the common stock capital requirements of the AEP System through a dividend reinvestment plan, under which holders of its common stock may elect, through an agent, to reinvest cash dividends in unissued shares of AEP common stock at a price equal to 95% of current market value. Under present law the value of the stock purchased, including that acquired through the 5%

discount, is given the same treatment as cash dividends actually received by the shareholders.

There are a number of bills pending in Congress which would permit deferring the taxation of dividends reinvested in newly issued stock of the corporation, up to $1,500 per year on a separate return and $3,000 a year on a joint return, and would treat such reinvested dividends very much like stock dividends. On July 19, 1979 Senator Nelson introduced such a bill, S. 1543, in the Senate, limited to dividend reinvestment. This bill now has 13 sponsors. An identical bill, H. R. 654, was introduced in the House on January 15, 1979 by Representative Pickle, and now has 93 sponsors. Section 201 of H. R. 7015, the Tax Restructuring Act of 1980, introduced by Representative Ullman on April 2, 1980, also provides for deferral of reinvested dividends, under the captions of Capital Formation and Savings Incentives. In order to prevent abuse each of these bills has restrictive provisions on the sale of the corporation's common stock by the shareholder and the purchase by the corporation of its common stock.

At hearings before the Ways and Means Committee on January 29, 30 and 31, 1980, a number of witnesses testified in favor of pending dividend reinvestment proposals. Their statements appear at pages 137-334 of the transcript of the hearings, Serial 96-75. The record contains (pages 146-263) a lengthy statement by Robert R. Nathan Associates, Inc., an economic consulting firm. The summary (page 146) estimates that by its third full year the tax incentive provided would more than double participation in qualifying reinvestment plans, expanding it to a total of $2.5 billion annually and generating an annual increase of $1 billion in fixed private business investment, a level of national output $2.7 billion more than it would otherwise be, and the creation of 50,000 jobs.

The Staff of the Joint Committee on Taxation has estimated the maximum annual revenue loss at somewhat over $1 billion, but its estimate does not take into account any revenue offset or gain by reason of increased capital formation and economic stimulus.

Our economy is suffering from a lack of capital brought about in large part by a tax system which encourages consumption and penalizes savings and therefore capital formation. Adoption of tax deferral of dividends reinvested in newly issued stock would substantially aid those companies which must sell common stock on a regular or recurring basis. AEP's plan resulted in reinvestment in newly issued AEP shares of over $21,360,000 of the dividends paid in the first half of 1980. We are convinced that if tax deferral of reinvested dividends were to be enacted, the amount of common stock equity capital raised through dividend reinvestment would at least double. Increased equity capital so generated permits the issuance of more debt securities. Furthermore, such treatment of reinvested dividends would help reduce the double tax on corporate earnings which now exists when the earnings are passed on to shareholders.

In addition to providing needed capital for corporations, dividend reinvestment furnishes shareholders an optional method, through the acquisition of additional shares on which cash dividends may be received in the future, of setting aside funds for producing retirement income to supplement Social Security, such as is now provided under IRA and Keogh plans. An alternative is to purchase stock in growth companies which pay out little of their earnings in dividends. Electric utilities must, however, offer a high dividend payout. Dividend reinvestment plans, with their election as to what amount of dividends, if any, to reinvest during the year, offer shareholders a flexible plan for adding to their assets for retirement income in years when the shareholders can so afford. Most of the reinvestment of AEP dividends in newly issued AEP shares has been by shareholders with small holdings of AEP stock.

In summary, tax deferral reinvested dividends would help capital formation, somewhat alleviate the double taxation of corporate earnings, and furnish a saving incentive for stock-owning individuals. It should be proposed as part of the tax reduction program under consideration by the Finance Committee.

Iowa Electric Light and Power Company

J.B REHNSTROM
SENIOR VICE PRESIDENT-FINANCE
AND SECRETARY

July 15, 1980

The Honorable Russell B. Long
Committee on Finance
United States Senate
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Long:

SUBJECT: Hearings on Tax Cut Proposal

In connection with the scheduled hearings of your Committee on Finance to commence shortly on the advisability of a tax cut, we wish to take this opportunity to urgently recommend that if any broad tax legislation be enacted, it should include provisions which will assist in capital formation by industry.

As a company in the highly capital intensive utility industry, the ability to meet future capital requirements in order to supply energy demands of our customers is a matter of vital concern. The continued high rate of inflation, lagging response of regulators to rate increase requests, and the heightened demands of industry and government for investor's funds all combine to make more difficult our ability to access the public securities market at reasonable cost.

A number of companies like ourselves have found a source of equity funds through the adoption of a Dividend Reinvestment Plan. Under this plan, holders of our Common Stock may automatically reinvest their dividends in new Common Stock of the Company. While the present plan has proven to be beneficial with approximately 10% of our stockholders participating, we believe the extent of reinvestment could

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be materially increased if investors were given the option of deferring the payment of Federal income tax on reinvested dividends in original issue stock until such stock was sold.

H.R. 654 sponsored by Representative J. J. Pickle and others and S. 1543 sponsored by Senator Gaylord Nelson and others have been introduced providing for such legislation. Under these proposals the tax on dividends could be deferred and in addition dividends so invested would be treated as capital gains when the stock is sold rather than dividend income at ordinary rates when received. We understand a proposal similar to the aforementioned bills is contained in Section 202 of H.R. 5665 sponsored by Representative Al Ullman.

We believe any meaningful income tax legislation must include provisions such as the above if companies such as ourselves are going to be able to attract the massive amounts of capital needed for new plant and equipment in the next decade. Therefore, we urge your committee to give the deferral of tax on new issue Dividend Reinvestment Plans a very high priority in your deliberation.

Thank you for the opportunity to present our views.

Very truly yours,

J. B. Rehnstrom
Senior Vice President-Finance
and Secretary

JBR:blw

Statement of the Unitary Tax Campaign, Ltd.

Mr. Chairman, Members of the Senate Committee on Finance, fifty-eight United Kingdom companies listed on the attached "Exhibit One" have previously formed the Unitary Tax Campaign, Ltd., to seek limitation of the use of the "worldwide combined reporting system method of corporate tax assessment" as would be effected by legislation currently pending such as S. 1688 and its identical House of Representatives counterpart, H.R. 5076. Those bills would provide that individual States can not tax income of foreign affiliates of domestic corporations until such time as that income is taxed by the Federal government.

These corporations have invested heavily in the United States. They have affiliates in the United States participating in American trade and employing American citizens. Thus they are vitally concerned with capital investment, employment, and other facets of the economy of the United States which your Committee will be considering during these hearings on tax cut proposals.

These companies are all members of corporate groups with affiliates operating worldwide in many diverse lines of business. They became exposed to the vagaries of the method of corporate tax assessment that has become known as the "worldwide combined reporting system" by virtue of having operations in the few individual States within the United States that use such system.

As has been explained many times in the record of the United States-United Kingdom Income Tax Treaty, and hearings before the Senate Committee on Finance, Subcommittee on Taxation and Debt Management on S. 1688 on June 24, 1980, and before the House of Representatives Committee on Ways and Means, on H. R. 5076 on March 31, 1980, most of the individual States use some apportionment formula to determine the tax liability of the unitary operations of a single multistate corporation. A substantial number of States enlarge that formula to a controlled group of corporations when the operations and management of the group are unitary in nature, i.e., integrated to engage in one business or have related business purposes. That application has become known as the "unitary method" of taxation.

A few individual States, mainly California, and Alaska, Idaho, Montana, North Dakota, and Oregon, somewhat, carry the unitary method one additional step. They apply unitary apportionment to the worldwide operations of foreign affiliates of United States corporations, even when those corporations are involved in non-unitary and unrelated lines of business and are not conducting business in the taxing State, or even in the United States. It is this unwarranted extension of the unitary method to worldwide operations of affiliated corporations that has become known as the "worldwide combined reporting system."

The extent of the unwarranted intrusion into international commerce can be illustrated by examining the Proposed Guideline for the Preparation of Combined Reports Which Include Foreign Country Operations of the California Franchise Tax Board. While the complete text was included in the record of the hearing on H.R. 5076, before the House Of Representatives Committee on Ways and Means on March 31, 1980, in the statement of Arthur Andersen & Company, the following provide good examples of the lengths to which the dictates of California are imposed on corporations which it forces to combine, though they are not doing business there and are engaged elsewhere in unrelated lines of business:

> 3. Adjustments will be made to the profit and loss statement to conform it to the tax accounting standards required under the California Revenue and Taxation Code.
>
> 5. Business and nonbusiness income as determined under California law will be identified and segregated.
>
> 6. Nonbusiness income will be allocated to a jurisdiction on the basis of the rules provided for in the Uniform Division of Income for Tax Purposes Act as adopted by California. (emphasis ours)

In addition, those Guidelines require conformance of accounting methods, inventories, and depreciation to California specifications, though they vary from established procedures throughout the world.

The corporations which make up the Unitary Tax Campaign originally banded together to support the United States-United Kingdom Income Tax Treaty because in Article 9(4) the United States and the United Kingdom agreed not to use the worldwide combined reporting system to assess the taxation of corporations of either country. The original Treaty would have applied that limitation to not only the Federal Government, but the individual States of the United States, as well.

The Unitary Tax Campaign supported Article 9(4) because it would have prevented double taxation, would have removed obstacles to investment in the United States and would have served to not only retain employment there, but to increase the number of job opportunities. Of course, that is precisely the purpose of a tax treaty; to avoid double taxation and prevent evasion of taxes without hindering international trade and investment.

In consideration of the Treaty by the Senate Foreign Relations Committee, Senator Church unsuccessfully attempted to remove the limitation of Article 9(4) by reservation. When the Senate debated the Treaty in June, 1978, Senator Church again proposed the reservation regarding 9(4) and the reservation was again defeated. In the vote by the Senate on the Treaty, the following day, the Treaty fell five votes short of the required two-thirds majority. After several days of discussions the Treaty was ratified by a vote with the Church reservation included, to which the Treasury Department agreed to gain passage of the Treaty with no further hindrance.

Thus when the House of Commons considered the Treaty with the amended Article 9(4), it was forced to do so with a major portion of the Treaty absent. In the unamended Treaty the Federal Government had agreed with England that it would not use the worldwide combined reporting system, which it does not in fact use, and the same rule would apply to the States. In the amended Treaty, the individual States were free to use the worldwide combined reporting system, thereby creating a potential for fifty-one different tax policies. The House of Commons, did, however, approve the Treaty with the confidence that the United States Congress fully intended to examine the adverse effects of the application of the worldwide combined reporting system by the few individual States.

Michael Grylls, Member of the House of Commons, made that point quite clear in his speech on the Treaty located at pages 189-190 of the February 18, 1980, Hansard, which is the official report of the House of Commons debates:

> It is crucial for business relations between two countries as close as Britain and the United States that this matter should be resolved. Otherwise we risk generating friction not only between our business enterprises but between our

> countries. We explained to people in Congress, as fellow parliamentarians, the real problem that existed and that the change they had made in the treaty had created a problem for us. We appealed for their help to try to solve it.
>
> It is not right for individual states to speak with different voices on matters of international business. We are relying on them. Britain has the biggest investments of any foreign country in the United States. We are the closest of friends. I am sure that we want to go on investing and expanding business there. I am sure that this also benefits the United States.

Member of the House of Commons, Roger Moate, pointed out that it was not only England that was concerned:

> It is a bad international precedent for the British Government or any other nation to have to look to perhaps 50 states in the United States for an understanding of the way in which we are to conduct our international tax affairs. That cannot be right. I am sure that the United States understands that this is a grossly unsatisfactory situation.
>
> It is a bad international precedent, because of the damage that it could do all world trading nations. page 194, February 18, 1980, Hansard

Since approval of the Treaty the nine governments which make up the European Economic Community have indicated their strong arguments against the worldwide combined reporting system and have in correspondence to the Department of State on March 19, 1980, urged:

> ...you to support this legislation in so far as it relates to the unitary tax issues raised above, with a view to early enactment.

The members of the Organization for Economic Cooperation and Development, which include the United States, have recognized that limitation of the worldwide combined reporting system is necessary. Its Model Income Tax Convention and the <u>1974 Guidelines for Tax Treaties Between Developed and Undeveloped Countries</u>, prepared under the auspices of the United Nations adopt the arms length method as used by the Federal Government as the standard.

During the Senate debates, opponents of Article 9(4) and proponents of the Church reservation raised the point that since that provision of the Treaty would limit the States in their application of the worldwide combined reporting system, that problem should be addressed legislatively by both Houses of Congress.

In August, 1979, S. 1688 and H.R. 5076 were introduced. The first section of those two bills would limit the use of the worldwide combined reporting system by conforming the State rules to the Federal rules regarding the taxation of foreign source income so as to have uniformity on the one issue of the time at which the foreign source income of foreign affiliates of United States corporations is taxed. The second section of the legislation concerns the extent to which the States may tax dividends paid to United States parent corporations from overseas affiliates.

Though the record as to why this legislation should be enacted is complete and contains extensive discussion of the reasons support for it is so widespread in the United States and abroad, the members of the Unitary Tax Campaign feel that there can be no reasonable justification for a tax system which:

(a) apportions income on the basis of any one or more of a number of factors not necessarily directly related to actual income and the expenses of the business;

(b) taxes income outside of and not in any way related to the taxed companies' operations;

(c) uses bases and factors which can be and are varied by the tax authorities from year to year;

(d) calls for accounts and information on a basis totally different from any other tax system and even beyond the kind of information readily available to an international trading company, except at unacceptably huge additional costs;

(e) with seperate tax authorities using the same basic method, but with different factors and definitions in their calculations, can lead to multiple-taxation - even of extra-territorial income;

(f) could, for example, place a U. K. company in the impossible position of being requested to disclose classified information on the details of its operations when the group or part of it is involved in the defence equipment industry;

(g) is difficult to administer and is an inaccurate method of apportioning the income of multinational business among taxing jurisdictions;

(h) may result in the State taxing income of the multinational enterprise that is not derived from or substantially related to the operation of an affiliate of the enterprise in the taxing State;

(i) to produce equitable results requires equality of factors combined, when cases of truly unitary entities with equal rates of profit, property, and labor, occur seldom if ever in the context of multinational business.

The House of Representatives Committee on Ways and Means in 1976 formed the Task Force on Foreign Source Income to analyze the issue involved in the taxation of foreign source income. It recommended that the States be precluded from taking into account, under the unitary method or any other method, the income of foreign affiliates of corporations doing business within the States until such time as that income was subject to Federal income tax. The provisions of S. 1688 prohibiting the application of the unitary method on a worldwide combination basis generally follow this recommendation.

The Treasury Department supports the provisions of such legislation that would limit the use of the worldwide combined reporting system. In his recent testimony before the Senate Committee on Finance, Subcommittee on Taxation and Debt

Management, Assistant Secretary for Tax Policy, Donald C. Lubick, said:

> The Treasury Department supports the goals of S.983 (a more comprehensive bill containing a limitation of the use of the worldwide reporting system) and S. 1688 with respect to affiliated groups controlled by foreign persons. We do not oppose the provisions of these bills insofar as U.S. controlled corporate groups are concerned. (explanation ours)
>
> ...Because it is critical that we resolve the unitary apportionment problem expeditiously, we favor going forward now with the the unitary portion of the bills before us,...

The need for such limitation has even been recognized by the legislature and executive branches of California, the Franchise Tax Board of which is the leading exponent of the worldwide combined reporting system. AB 525 which would limit the application of that method to foreign based corporations has passed the California Assembly and has been voted on favorably by two Senate committees. It awaits only full Senate approval. Governor Jerry Brown has indicated that he also supports the legislation as well.

The members of the Unitary Tax Campaign have substantial industrial and commercial investments in the United States. They employ a large number of Americans and purchase materials and use services provided by other American corporations. The worldwide combined reporting system is not only unfair. It impedes industrial investment and decreases job opportunities as a result.

We applaud this Committee's efforts in exploring whether revisions in the taxing climate should be effected. We are hopeful that any legislation enacted will include the provisions of S. 1688.

By so doing this Committee will be assuring that the United States speaks with one voice in regards to matters of international taxation. It will be encouraging investment in this country by corporations eager to do so, but hesitant because of the use of the worldwide combined reporting system's use by only a few States which exposes their worldwide operations to the vagaries of that system. By encouraging investment here as opposed to abroad, it will be decreasing the chances for unemployment and increasing the employment opportunities for Americans.

Thank you.

E. John Symons
Deputy Chairman,
BAT Industries, Ltd.
on behalf of the Unitary Tax
Campaign

"Exhibit One"

UNITARY TAX CAMPAIGN, LTD. MEMBERS

Albright & Wilson Limited
1 Knightsbridge Green
London SW1X 7QD

Allied Breweries Limited
Allied House
156 St. John Street
London EC1 P 1AR

Babcock & Wilcox Limited
Cleveland House
St. James's Square
London SW1Y 4LN

J. Bibby & Sons Limited
Richmond House
1 Rumford Place
Liverpool L3 9QQ

Blackwood Hodge Limited
Hunsbury Hill Avenue
Northampton NN4 1AR

BOC International Limited
Hammersmith House
London W6 9DX

Booker McConnell Limited
99 Bishopsgate
London EC2M 3XD

The Bowater Corporation Limited
Bowater House
Knightsbridge
London SW1X 7LR

BAT Industries Limited
P.O. Box 345
Windsor House
50 Victoria Street
London SW1H ONL

Bunzl Pulp & Paper Limited
Friendly House
21/24 Chiswell Street
London EC1Y 4UD

Cadbury Schweppes Limited
1-10 Connaught Place
London W2 2EX

Cape Industries Limited
114 Park Street
London W1Y 4AB

Carreras Rothmans Limited
Oxford Road
Aylesbury
Bucks HP21 8SZ

Cavenham Limited
Cavenham House
Millington Road
Hayes
Middx UB3 4AY

Charterhouse Group Limited
1 Paternoster Row
St. Paul's
London EC4M 7DH

Chloride Group Limited
52 Grosvenor Gardens
London SW1W OAU

Coates Brothers & Company Limited
Easton Street
London WC1X ODP

Richard Costain Limited
111 Westminster Bridge Road
London SE1 7UE

Croda International Limited
Cowick Hall
Snaith
Goole
North Humberside DN14 9AA

Dalgety Limited .
10 Upper Grosvenor Street
London W1X 9PA

Davy Corporation Limited
15 Portland Place
London W1A 4DD

The Delta Metal Co. Limited
1 Kingsway
London WC2B 6XF

EMI Limited
30 Gloucester Place
London W1A 1ES

Ferranti Electronics Limited
Fields New Road
Chadderton
Oldham
OL9 8NP

Foseco Minsep Limited
36 Queen Annes Gate
London SW1

Glaxo Holdings Limited
Clarges House
6-12 Clarges Street
London W1Y 8DH

Guest Keen & Nettlefolds Limited
Group Head Office
P.O. Box 55
Smethwick
Warley
West Midlands B66 2RZ

The Guthrie Corporation Limited
120 Fenchurch Street
London EC3M 5AA

Hansen Trust Limited
180 Brompton Road
London SW3

Harrisons & Crosfield Limited
1-4 Great Tower Street
London EC3R 5AB

Hawker Siddeley Group Limited
18 St. James's Square
London SW1Y 4LJ

IMI Limited
P.O. Box 216
Birmingham B6 7BA

Inveresk Group Limited
Clan House
19 Tudor Street
London EC4Y 0BA

Laporte Industries (Holdings) Limited
Hanover House
14 Hanover Square
London W1R 0BE

Lead Industries Group Limited
14 Gresham Street
London EC2V 7AT

London Chamber of Commerce and Industry
64 Cannon Street
London EC4

LRC International Limited
North Circular Road
London E4 8QA

Lucas Industries Limited
Lucas House
46 Park Street
London W1Y 4DJ

J. Lyons Group of Companies
Allied House
156 St. John Street
London EC1 P 1AR

Mallinson Denny Limited
130/150 Hackney Road
London E2 7QR

Metal Box Limited
Queen's House
Forbury Road
Reading
Berks RG1 3JH

Morgan Grenfell and Co. Limited
23 Great Winchester Street
London EC2P 2AX

Mothercare Limited
Cherry Tree Road
Watford
Herts WD2 5SH

Pegler Hattersley Limited
St. Catherine's Avenue
Doncaster
South Yorkshire DN4 8DF

The Plessey Company Limited
Millbank Tower
London SW1P 4QP

Racal Electronics Limited
Western Road
Bracknell
Berkshire RG12 1RG

The Rank Organisation
38 South Street
London W1A 4QU

Ransome Hoffmann Pollard Limited
76 Jermyn Street
London SW1Y 6NU

Reckitt & Colman Limited
P.O. Box 26
Burlington Lane
London W4 2RW

Smiths Industries Limited
Cricklewood
London NW2 6JN

Stone-Platt Industries Limited
10 Grafton Street
London W1X 3LA

Tate and Lyle Limited
Sugar Quay
Lower Thames Street
London EC3R 6DQ

Thorn Electrical Industries Limited
Thorn House
Upper Saint Martins Lane
London WC2H 9ED

Tozer Kemsley & Millbourn (Holdings) Limited
28 Great Tower Street
London EC3R 5DE

Transport Development Group Limited
Kingsgate House
66 Victoria Street
London SW1E 6SR

Tricentrol Limited
Capel House
New Broad Street
London EC2M 1JS

Tube Investments Limited
TI House
Five Ways
Birmingham B16 8SQ

George Wimpey & Co., Limited
Hammersmith Grove
London W6 7EN

The City of Baton Rouge
and Parish of East Baton Rouge
P O BOX 1471
Baton Rouge, Louisiana 70821

W W "WOODY" DUMAS
MAYOR PRESIDENT

July 10, 1980

Mr. Michael Stern
Staff Director
Committee on Finance
Dirksen Senate Office Building, Rm 2227
Washington, D. C. 20510

Dear Sir:

In an effort to obtain funds for the United States Olympic Committee we feel the most effective means will be to obtain federal legislation proposing tax credits as an incentive, particularly to large corporations.

Following many hours of research, consulting with members of the U.S.O.C. and congressional delegates, we have concluded that the most effective way of approaching this is to pursue the avenue of obtaining a tax credit so that all monies will go directly to the U.S.O.C.

It is suggested that the Tax Credit Bill be one and one-half percent (1½%) of the taxable income of corporations and a maximum of $500 for an individual. Monies would be used for the following:

1) Administration and operation of the U.S.O.C.

2) Administration and operation of existing Olympic Training Centers.

3) National Sports Governing Body Development Programs.

4) Construction of Olympic Training Centers.

5) Construction, development and/or operation and administration of satellite training centers

* The above not necessarily the order of priority

I am sure you recognize the advantages of a tax credit over a tax deduction. I feel a tax credit would also be more politically palatable than the federal government making an outright grant. However, your judgment in these matters is far superior to mine.

Here are my thoughts for your consideration:

1) The tax credit would be available to corporations, individuals, trusts, partnerships and estates.

2) The non profit corporations formed would be required to be audited annually by a Certified Public Accounting firm and file a certified list of contributors who gave over $10,000 with the Internal Revenue Service.

3) It would be nice to have an unlimited tax credit, however, that may be unrealistic. Therefore, perhaps the credit should be the lesser of 10% of the taxpayer's federal income tax liability or $1,000,000 annually for a five year period for tax years ending after January 1, 1981. Also, any excess tax credit would have a five year carry forward provision (no carry back provisions would be allowed because we do not want the federal government to have to pay any money out, but just reduce collections for the next five years).

4) The Internal Revenue Service would design a form for the taxpayer to attach to his tax return, similiar to the Investment Tax Credit form which is currently required to be attached to a tax return.

These are a few ideas that we feel may possibly assist the U.S.O.C. in its efforts to develop future amateur sports in this country.

I am, therefore, asking you to consider proposed tax legislation to be introduced.

I hope I have given you enough ideas to mold into a tax credit. If I can be of any further service to you or your staff, please do not hesitate to ask - I would consider it an honor.

Thank you for your support of this very worthwhile project.

Sincerely,

W W Dumas

W. W. "Woody" Dumas
Mayor-President

WWD/nh

Summary Statement of

ROBERT S. SALOMON, Jr.

before the

COMMITTEE ON FINANCE

July 28, 1980

Distinguished Members of the Committee:

In recent years our country has been plagued by a host of economic problems, including inflation, unemployment, and a slowing rate of productivity growth. Legislation is urgently needed to deal with what I believe to be one of the primary factors underlying these problems: an inadequate rate of savings and investment on the part of individuals.

Legislation contained in S. 1543 is intended to encourage individuals to reinvest income derived from ownership of common stock by providing a tax deferral for such income when it is reinvested in newly issued shares under a qualifying Dividend Reinvestment Plan. I believe that provision of such a deferral would increase participation in Dividend Reinvestment Plans significantly and contribute greatly to an increased rate of equity formation.

In recent years, corporations have found it difficult to raise money through the sale of new stock. Particularly in the case of public utility companies, which tend to have both a high rate of dividend payout and a great need for money to build new facilities, sale of stock has frequently been possible only at the expense of diluting the equity of existing owners. As a result, there has been more and more reliance on debt financing. This increased use of debt has led to a lowering of credit ratings for many businesses, an increase in the financial risk of the companies concerned, and an enormous increase in the amount of new debt securities that must be sold each year.

In an attempt to offset this increasing dependence on debt financing, a number of companies have turned to issuance of new stock through a Dividend Reinvestment Plan. There has been a significant response to such plans, and we estimate that in 1979 approximately $1.9 Billion of new equity was generated by such plans.

Existing plans, however, present one serious drawback for the participant: current income tax must be paid on reinvested dividends, even though no cash is received. The investor is therefore put in a negative cash flow position, and may in many cases find that he simply cannot afford to participate.

By providing for a tax deferral on such reinvested dividends, with reasonable limits on the amount, the legislation proposed will make dividend reinvestment much more attractive to individuals, and, in my opinion, provide a fairer tax structure.

In summary, I believe that adoption of the proposal to defer taxation on dividends reinvested in original issue stock will significantly increase participation in such plans and therefore help increase the rate of individual savings and investment in our economy. By encouraging savings, this legislation will create a stronger base for economic growth and will aid in the effort to minimize inflation, increase employment, and help the United States maintain its competitive position in the world markets of the future.

I thank you for this opportunity to be heard on a subject of such importance.

Robert S. Salomon, Jr.
General Partner, Salomon Brothers

Salomon Brothers
One New York Plaza
New York, N.Y. 10004

Testimony of

ROBERT S. SALOMON, JR.

General Partner, Salomon Brothers

before the

COMMITTEE ON FINANCE

of the

United States Senate

July 28, 1980

CONTENTS

Testimony of R.S. Salomon, Jr.

Tax Deferral for Reinvested Dividends

Introduction

I welcome the opportunity to testify on behalf of Salomon Brothers on the subject of a tax deferral for reinvested dividends. We believe that a properly structured deferral of income taxation on dividends reinvested in original issue shares will be of benefit to individuals, to business, and to the future health and well-being of the entire United States economy.

Salomon Brothers is a leading firm in the investment banking and brokerage industry. We have ten office locations, including establishments in London and Hong Kong. In addition to our activities as market makers and brokers of financial instruments, we have extensive investment banking relationships with many major corporations, both domestic and foreign. During our last fiscal year, we participated as manager or co-manager in financings by more than 150 domestic and foreign companies, aggregating in excess of $14 Billion.

As a result of these activities, we have become familiar with the problems businesses have had in raising money for new investment in recent years, particularly the very high cost of that money under current market conditions.

Testimony of R.S. Salomon, Jr.

Qualifications

Regarding my qualifications, I received a Bachelor of Arts degree from Amherst College in 1959. I am a member of the Financial Analysts Federation and the New York Society of Security Analysts. I am Chairman of the Board of Trustees of St. Luke's School, New Canaan, Connecticut. I serve as Chairman of the Board of Trustees of the Financial Analysts Federation Investment Management Workshop, which is currently held on the Princeton University campus one week each summer for senior investment executives. I am a general partner in the Industry and Stock Research Department of Salomon Brothers.

Before joining Salomon Brothers in 1975, I was with United States Trust Company of New York for sixteen years, serving as Senior Vice President, as Chairman of the U.S. Trust Company's stock selection committee, and as Portfolio Manager in charge of pension, endowment, and other institutional accounts. In my work at Salomon Brothers, I have published three studies on Dividend Reinvestment Plans over the past two years:

"Buying Stock at a Discount", Sept. 12, 1977

"More Stocks Available at a Discount", Aug. 4, 1978

"Still More Stock Available at a Discount", Aug. 2, 1979

I have also addressed a number of groups on Dividend Reinvestment and made numerous presentations to Salomon Brothers' clients on the subject, both domestically and internationally. Two of my most recent speeches to outside bodies were:

Testimony of R. S. Salomon, Jr.

"Portfolio Strategy and Dividend Reinvestment"

Dec. 14, 1979. An address to the National Economists Club, Washington, D.C.

"Investment Alternatives and Dividend Reinvestment"

June 21, 1979. An address to Corporate Pension Officers, Stamford, Connecticut.

Dividend Reinvestment Plans

Dividend Reinvestment Plans (DRPs) originated in September of 1968, when Allegheny Power Systems, Inc. offered its stockholders the opportunity to participate in such a plan to be managed by First National City Bank of New York (now Citibank). After the American Telephone and Telegraph Company adopted a similar plan in 1969, DRPs spread rapidly.

These early plans were viewed primarily as a service to shareowners, and merely acted as a purchasing medium, buying new shares in the marketplace. Because the plan administrator had the advantage of large volume purchasing, a significant reduction in transactions cost could be passed along to the participants.

In 1973 companies began to issue new or "original issue" shares to DRP participants. Today there are in excess of 150 companies having such plans. (Exhibit A lists those companies we know to be currently employing an original issue Dividend Reinvestment Plan.) The distinction is important, because only original issue plans can be said to generate new investible funds. The older "market" plans merely buy existing shares from existing owners, and therefore contribute nothing to corporate equity.

Market purchase plans will probably continue to be a valuable shareowner service in many cases, but the focus here is on original issue DRPs. Provisions of bill S. 1543 apply only to Dividend Reinvestment Plans that issue new shares, and it is these plans alone toward which this testimony is directed, unless otherwise indicated.

Savings and Investment Necessary for Economic Growth

Real economic progress of the sort that produces an increasing standard of living depends on an adequate rate of investment. Increases in per capita consumption of goods and services is possible only if per capita output, or productivity, also increases. Productivity growth, in turn, results from a number of factors, including increased worker skill and knowledge, improved business organization, technological progress, and increased investment in productive assets. All of these factors are necessary ingredients for real economic growth.

Over the past decade there has developed an increasing suspicion that the United States is lagging in overall economic progress. This is believed to result from an inadequate level of savings and investment, resulting in lower productivity growth.

U.S. Productivity Lags

In the January 1978 "Economic Report to the President," the Council of Economic Advisors termed the slowdown in U.S. productivity growth "one of the most significant economic problems in recent years."

The continued productivity slowdown during 1978 and 1979 has greatly increased the public's awareness of this problem. Concern about the growth rate of productivity is well-founded, because productivity growth is the major source of increase in our standard of living and one of the keys to the reduction of inflation.

Charts 1 and 2 show two measures of productivity. Chart 1 shows real GNP divided by the quarterly average of civilian employment, while Chart 2 shows output per hour in the private business sector. In both cases, the productivity measure is shown from 1948 to the present in logarithmic form to indicate trends in growth. The downturn of the curves in recent years is obvious.

Productivity growth in the Seventies, particularly since 1973, has been extremely sluggish. From 1948 to early 1973, the trend rate of growth of real GNP per worker was 2.4% per year; since then the average rate of growth has been essentially zero. The same pattern appears in Chart 2 where the trend rate of growth was 3.0% per year until the first quarter of 1973, while the recent rate has been 0.5 percent. In both cases, productivity decreased sharply during 1973-74, and, despite the relatively rapid expansion of output and employment since 1975, the rate of productivity growth has remained extremely slow. Table 1 shows that this trend has been true for every major sector of the economy.

Testimony of R. S. Salomon, Jr.

CHART 1

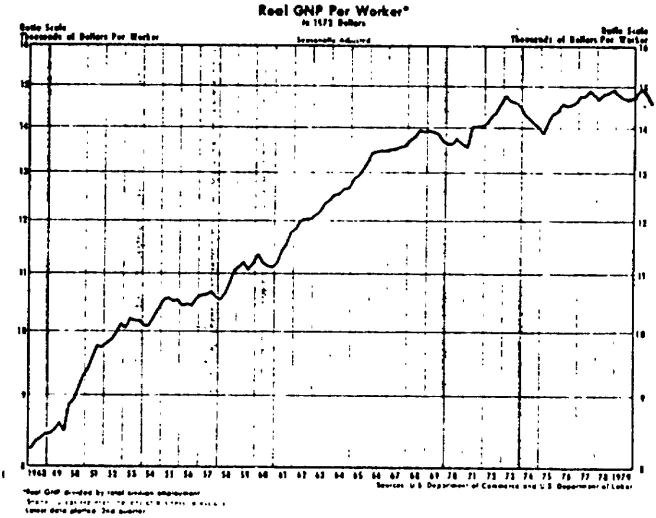
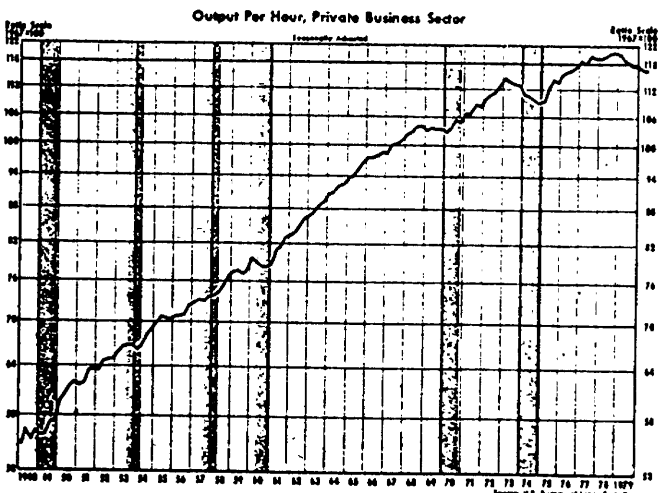


CHART 2



Source: Federal Reserve Bank of St. Louis
(Updated by Salomon Brothers to include latest data.)

Testimony of R. S. Salomon, Jr.

Table 1

Productivity Growth Rates for Major Sectors
(Annual Average Percentage Rates of Change)

Sector	1947-1967	1967-1972	1972-1978	1977:4 1979:2
Private Business	3.2	2.2	1.2	-0.3
Hours	0.5	1.1	1.8	3.5
Output	3.7	3.3	3.0	3.2
Nonfarm Business	2.6	1.9	1.9	-0.5
Farm	5.7	5.2	2.1	N.A.
Manufacturing	3.0	3.0	1.8	1.4
Durable	2.7	2.5	1.2	0.7
Nondurable	3.3	3.6	2.6	2.6
Nonfinancial Corporations	3.2	2.0	1.3	1.7

Source: Federal Reserve Bank of Kansas City

The paramount reasons, in my view, for the slowing of productivity growth are the decline in the pace of capital formation and the tremendous increases we have seen in energy prices.

Table 2 shows starkly that the growth rate of capital has declined markedly over the last thirty years, as has that of the capital to labor ratio.

Table 2

Annual Growth Rates of Productivity and Inputs Between Business Cycle Peaks (Per Cent Per Year)

	Output Per Hour	Capital Labor Ratio	Capital	Labor Hours
1948-53	3.65	4.21	4.59	0.36
1953-57	2.42	4.05	4.15	0.10
1957-60	2.45	2.91	2.68	-0.21
1960-69	3.07	3.29	4.65	1.32
1969-73	2.34	2.50	3.71	1.18
1973-78	1.11	1.32	2.69	1.35

Source: Bureau of Labor Statistics

The Federal Reserve Bank of St. Louis estimates that the level of capital per worker by mid-1979 was about 17% lower than that implied by the 1950-72 trend. The effect of this 17% loss would reduce private business output per hour by approximately 4.8%, and accounts for 39% of the decline of productivity growth between the periods 1952-1972 and mid-1972 to mid-1979. Thus capital formation has played a major part in the stagnation of productivity in the 1970's.

Inflation, of course, is also an important source of reduced business capital formation. Higher rates of inflation tend to reduce the purchasing power of fixed depreciation expenses which results in lower real cash returns in future periods. Also, the U.S. tax system treats interest payments made by firms as income to recipients and taxes them accordingly.

When interest rates rise to compensate investors for the loss in purchasing power of original sums lent to investors, these receipts - which are necessary to maintain the real wealth of investors - are treated as income. As a result, higher before-tax real rates of return are required to compensate for these taxes, further reducing incentives for firms to raise investment funds. And, since higher inflation rates also tend to increase uncertainty about the future, investors and firms view the cash flows that are expected from investment projects as riskier and are therefore more reluctant to invest.

Finally, the sharp rise in the relative price of energy since 1973 has been a major factor in the reduced rate of capital formation. It has created incentives to reduce energy, plant, and equipment usage per unit of output, by employing less energy per unit of capital and more labor-intensive methods of production. This has retarded the growth of plant and equipment.

The United States has been suffering from a relatively poor level of productivity. Table 3 shows that the United States has had the lowest growth rate from 1973-80 among major industrialized nations.

Table 3

Productivity Growth Rates for
7 Industrial Nations
(GNP/Employment)

	Total Economy, percentage changes, seasonally adjusted at annual rates, 1973-80(a)
West Germany	3.1
France	2.7
Japan	3.5
Italy	1.9
Canada	-0-
United States	-0-
United Kingdom	0.4

(a) Forecast values for 1980

Source: OECD Economic Outlook.

Furthermore, the 1979 Economic Report of the President reported that whereas in the U.S. 13.5% of Gross Domestic Product was devoted to investment, the corresponding figures for other major nations were: Japan 26.4%, Canada 17.2%, France 16.7%, West Germany 17.4% and the United Kingdom 14.9%. I therefore feel strongly that unless more incentives are created for capital formation in the United States, this country's relatively low productivity growth rate will continue and our position among worldwide economies will be eroded further.

Equity Investment has Become Unattractive

During the past decade, corporations turned more and more to the debt markets to satisfy their needs for money. In part, this is attributable to the tax disadvantage that equity investment has at the corporate level. Because of the corporate income tax on net income, it is much more difficult to support a dollar of equity than a dollar of debt. To illustrate this, a simple example may be helpful:

Suppose a taxpaying corporation is earning 16% on invested equity capital, a level we believe appropriate in today's market, and that debt costs 11%. If one dollar is raised through issuance of debt, the company will have to generate 11 cents of cash to pay the interest. For the equity, however, 30 cents will be needed--16 cents to support the earnings, and 14 cents to pay the corporate income tax. Thus, in this example, nearly three times the amount of price increases or sales growth is required to support the equity.

A second reason for the increased corporate emphasis on debt financing is the relatively low level of market price of many corporate stocks. In the current environment, a number of corporations find that their stocks are selling at substantial discounts from book value. Under such conditions the sale of new shares tends to reduce the basic equity value of all shares and therefore "dilutes" the future earnings of existing shareholders. Naturally, managements prefer not to take such action, and have turned to the debt markets instead. Table 4 illustrates the extent to which reliance on debt financing has increased in the last five years.

Testimony of R. S. Salomon, Jr.

Table 4

Sources of Corporate Funds
(Billions)

Year	Internal Cash Generation Amount	Internal Cash Generation %	Net New Debt Amount	Net New Debt %	Net New Equity Amount	Net New Equity %	Total Amount	Total %
1975	$106.9	72.9	$29.9	20.4	$9.9	6.7	$146.7	100%
1976	125.3	67.3	51.4	27.6	9.5	5.1	186.2	100
1977	140.0	62.0	79.9	35.4	5.9	2.6	225.8	100
1978	148.7	60.4	94.0	38.2	3.5	1.4	246.2	100
1979	158.4	59.3	106.2	39.8	2.4	0.9	267.0	100

Source: Salomon Brothers

Despite the emphasis on innovative funds generating mechanisms such as the increased investment tax credit (ITC), the ITC based Employee Stock Ownership Plan, Dividend Reinvestment Plans, and employee savings plans, debt financing has continued to grow as a proportion of total sources of corporate funds.

We believe this increased reliance on debt financing has seriously eroded the borrowing margins of businesses generally, and has contributed to a general decline in the quality of debt as perceived by investors. More importantly, perhaps, it has increased the leverage of the affected corporations and therefore their financial risk.

Capital-Intensive Businesses Most Vulnerable

Obviously, companies with the greatest ongoing new investment needs have been most adversely affected by the current conditions described above. When growth rates are high and money is relatively expensive, corporations have a need to conserve cash for additional investment. In relatively high-payout industries such as public utilities, originial-issue Dividend Reinvestment Plans have been increasingly adopted, and, as mentioned above, the number of companies offering such plans now exceeds 130.

Companies that find it necessary to conserve cash have no real alternative to Dividend Reinvestment Plans. The only other way to keep earnings in the business is to reduce or eliminate the dividend, not a realistic alternative in today's market environment, where many shareholders require cash income, and many stocks sell on a yield basis.

Testimony of R. S. Salomon, Jr.

The Need For Legislation Such as S. 1543

Although Dividend Reinvestment Plans offering original issue stock have achieved a significant level of participation, it seems to me that individuals enrolled in the plans are disadvantaged under existing tax laws. Despite the fact that a participant receives no cash or other disposable income, reinvested dividends are taxed as ordinary income. An investor who chooses to reinvest his or her dividends therefore has a net outflow of cash, and suffers a decline in disposable income.

This situation is in marked contrast with the treatment of owners of stock in so-called "growth" companies - companies that normally pay out none or a small proportion of their earnings. Such companies frequently pay stock dividends instead, and are attractive because the return to the holder is taxed at more favorable capital gains rates.

To illustrate this, I assume that the average individual investor falls into the 30% tax bracket, and owns two types of stock. The first pays a 10% annual dividend and has a dividend reinvestment plan. The second declares stock dividends of 10%. If the investor participates in the reinvestment plan, the net effect on his ownership will be the same--he will receive no cash, but will end the year with 10% more shares. The tax consequences, however, are quite different. Tax at the 30% rate will be due on the reinvested dividends, whereas no immediate tax is due at all on the stock dividends. Obviously, this is a disincentive to reinvest.

Impact of S. 1543 on Investors

The stock of high yielding capital intensive companies tends to be more heavily held by individuals than that of corporations generally. For example, a recent study undertaken by Salomon Brothers indicates that, on average, 76.5% of the stock of the 27 large public utilities for which data are available is held by individuals. This compares to 67% for all shares traded on the New York Stock Exchange. In comparison with other industries, therefore, those that are in greatest need of funds are also most heavily owned by individuals. Because individuals tend to be in higher tax brackets than institutional shareowners, (many of which are tax exempt), the passage of S. 1543 should be most effective in precisely those businesses where it is most needed. In my opinion this would have three highly beneficial effects.

The first benefit would be to make such shares more attractive to individuals, thus widening the shareowner base. It is reasonable to believe that a wider ownership would contribute to increased stability in the marketplace and reduced price volatility.

A second benefit would be to attract back to business a number of individual investors who have been concentrating on tax shelters, tax-free investments, and real assets such as land, art, and precious metals. In this regard it is interesting to note that the institution of a 5% discount to existing plans caused a significant increase in participation, more than 100% on average. It also seems reasonable to expect that higher bracket individuals who currently find corporate equities unattractive would be brought back into the market.

The third benefit is that the legislation would put the cash or stock dividend decision in the hands of owners of the stock, who are presumably in the best position to choose the alternative best for them.

On balance, it seems reasonable to believe that provision of a tax deferral would cause participation in qualifying Dividend Reinvestment Plans to at least double, and would provide a valuable incentive for individuals to reenter the equity markets as long term investors.

Impact of S. 1543 on Corporations

By increasing participation in Dividend Reinvestment Plans, a greater proportion of a corporation's cash needs could in effect be met internally. The decreased reliance on external financing would relieve pressure on the capital markets and strengthen corporate balance sheets. This will contribute to improved quality of corporate credit and a lower long-term cost of capital.

Because an increased proportion of dividends will be retained within the business, companies will have flexibility to increase the dividend rate, while still maintaining a low effective payout ratio. This in turn will enable the companies to meet the needs of both older, income-oriented shareowners, and those who prefer to increase their investment base.

The relatively smooth inflow of new equity through Dividend Reinvestment Plans reduces the need to sell stock in large amounts. This helps the company avoid having to finance in unusually adverse markets, and can, over time, reduce total financing cost.

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Finally, it should be noted that Dividend Reinvestment provides benefits to the existing owners of the company, and helps increase shareowner loyalty and enthusiasm.

Because of these benefits, those businesses not presently employing an original issue Dividend Reinvestment Plan will have an increased motivation to begin one. Lacking any direct experience, it is impossible to precisely quantify the number of additional corporations that would institute such plans as a result of the passage of this legislation. However, it seems reasonable to expect that the great majority of capital-intensive, high-payout companies would choose to participate. Based on this belief, it is my estimate that the number of corporations offering such plans would at least double, from approximately 150 today, to 250 or more.

Impact of S. 1543 on Market Prices

There is no doubt in my mind that the ability to defer taxes is valuable to investors, and that passage of legislation such as S. 1543 would cause the price of eligible stock to rise. The exact magnitude of any such price change is hard to estimate, but an increase of 10% or more would not be unreasonable. This estimate is based partly on a general feel for the market, and partly on a study of the only directly relevant example: Citizens Utilities Company.

Citizens Utilities is unique in having two series of stock that, in effect, permit holders to select stock dividends or cash dividends. Based on our studies, details of which are shown in Exhibit 8, the ability to receive stock dividends has recently been worth about a

10% premium. Even more interesting is the fact that both series traded at a premium to utility stocks generally, as measured by comparison to the Standard & Poor's Utility Index.

This anticipated increase in market price could be expected to have a number of secondary effects. First, it would improve the market to book ratios of the affected companies, and reduce the dilutive impact of the issuance of new shares. Again, this is especially important for utilities, which are regulated as to return on book value. Exhibit C indicates that 86% of the offerings of common stock by Public Utilities since the beginning of 1979 were below book value.

Another effect would be to cause a shift in ownership away from large institutions, such as pension funds, that are already tax exempt, towards individuals. As mentioned previously, this should lead to a more stable market with less price volatility.

Impact of S. 1543 on Tax Revenues

As I have said above, I believe that an increased rate of savings and investment on the part of individuals will have a long run beneficial effect on the rate of economic growth in the United States. In the short run, however, there is no doubt that the main attraction of the proposed legislation is the tax deferral, and some reduction in tax revenues could be expected. I have not made a detailed study of the tax implications of this legislation, but I am aware of several studies by others.

Analytical work by Robert Nathan Associates points to the potentially beneficial impact of proposals contained in the Senate version of this legislation. It is estimated that by the third full year of operation, the tax incentive provided would more than double the participation in qualifying reinvestment plans, to about $2.5 Billion. This is estimated to generate an increase of $1.0 Billion in fixed private business investment, of $2.7 Billion in national output, and be likely to create 500,000 new jobs.

The Nathan study further estimates that the effect of the increases in employment, wages, and profits would be an annual net gain by the third year of some $600 Million in federal taxes. Net revenue losses in the first year are projected to be in the region of $350 Million, but this would disappear in the second year and be replaced by a net gain from the third year onward.

It seems to me that in addition to the stimulative effect of the additional investment, the tax impact of the proposed legislation will be lessened by two additional factors. First, it is to be expected that many of the individual investors who will be attracted to a tax-deferred Dividend Reinvestment Plan are those who currently invest in tax-exempt or tax-deferred vehicles. Because such investors currently pay little or no tax on their investments, the net impact of their participation will be minimal.

Secondly, shares held by institutions are largely tax free under current law. Any shift in ownership from tax exempt institutions will have no immediate effect on tax revenues.

Finally, it should be noted that the proposed new legislation would create a tax deferral, not a tax forgiveness. In the short run, individual investor decisions will no doubt result in sale of a portion of the newly-issued shares, and current taxation of the proceeds. In the long run, as the shares are ultimately sold, the reinvested dividends will be subject to taxation (although perhaps at a lower rate).

Impact of S. 1543 on the Securities Business

It may seem strange that Salomon Brothers should be in favor of legislation that in effect enables corporations to bypass the investment banking community in the issuance of new shares. However, although passage of this bill would no doubt have an initial impact on the volume of equity underwritings, I believe that its long term effect will be positive for our business. As in the case of tax revenues, the enhanced level of overall economic growth, and the improvement in the securities markets that results, will more than make up for any initial adverse impact on investment banking.

A second consideration favoring this legislation from the viewpoint of the investment banker is its beneficial effect on the credit markets. As noted earlier, the great bulk of external corporate financing is in the form of debt securities. Although the proposed legislation will increase the formation of equity capital, there will always be a need for large amounts of new corporate debt. By strengthening the overall credit ratings of the affected corporations, this legislation will permit increased financing activities of all kinds, and a greater volume of business for the financial community in the long run.

Conclusion

I believe that the arguments presented above indicate that a reasonable provision for deferral of taxes on dividends reinvested in original issue stock will be of overall benefit to all concerned. The dollar limits proposed in S. 1543 certainly bring it within the bounds of reason, and should insure that the primary tax benefits flow to the smaller individual taxpaying investor.

The potential benefits of this legislation are so important, and its need so critical, that I urge the members of the Committee to expedite its prompt passage into law.

Thank you for the opportunity to testify on this matter.

Respectfully submitted,

Robert S. Salomon, Jr.
General Partner, Salomon Brothers

EXHIBIT A

Corporations Currently Offering Original-Issue
Dividend Reinvestment Plans

Alabama Bancorporation
Allegheny Power System
Allied Chemical
AMAX
American Electric Power
American Security Corp.
American Telephone & Telegraph
Ampal-American Israel Corporation
Arizona Bank
Arizona Public Service
Atlantic City Electric Company
Baltimore Gas & Elec.
Bank of Virginia
Bankers Trust
Bell Canada
Black Hills P&L
Boston Edison
Brooklyn Union Gas
Carolina Power & Light
Carter Hawley Hale
Central Illinois Light
Central Ill. Pub. Svce.
Central Maine Power
Central and Southwest Corp.
Central Tel. & Utilities
Central Vermont Pub. Svce.
Cincinnati Gas & Elec.
Columbus & So. Ohio Elec.
Commonwealth Edison
Consolidated Natural Gas
Consumers Power Co.
Continental Telephone
Crocker National Corp.
Dayton Power & Light
Delmarva Power & Light
Dentsply International
Detroit Edison
Dominion Bankshares
Duke Power Co.
Earth Resources
Eastern Gas & Fuel Associates
Empire District Elec.
Equimark
First Penn Corp.
First Security Corp.
Florida Power & Light
Florida Public Service
Gas Service Co.
General Public Utilities
General Tel. & Electronics
Gulf States Utilities
Harnischfeger Corp.
Hartford National Bank
Hawaii Bancorp.
Hawaiian Elec.
Houston Industries
Illinois Power
INCO
Integon
Interlake
International Paper
Interpace
Interstate Power
Iowa Electric L&P
Iowa - Illinois G&E
Iowa Power & Light
Iowa Public Service
Iowa Resources
Iowa Southern Util.
Jewel Companies Inc.
Kaiser Aluminum
Kansas Gas & Elec.
Kansas Nebraska Natl. Gas.
Kansas Power & Light
Kansas City Power & Light
Kemper Corp.
Kentucky Utilities
Lincoln First Banks
Long Island Lighting
Louisiana P&L
Louisville G&E
Macy, R.H.
Madison Gas & Elec.
Manufacturers Hanover
Marine Corporation
Mercantile Texas Corp.
Middle South Util.
Minnesota Power & Lt.
Montana Power
NCNB
Nevada National Bancorp.
New England Gas & Elec.
New England Elec. Sys.
New York State E.&G.
Niagara Mohawk Power Corp.
NICOR
NN Corporation
Northeast Utilities
Northern Ind. Pub. Svc.
Northern Natural Gas
Northern States Power
Northern Telecom
Northwest Natural Gas Co.
Ohio Edison
Oklahoma Gas & Elec.
Oneida Ltd.
Orange & Rockland Utilities
Otter Tail Power Company
Pacific Gas & Elec.
Pacific Power & Light
Pacific Real Estate Investment Trust
Panhandle Eastern Pipeline Company
Pennsylvania Power & Light
Peoples Gas
Philadelphia Elec. Co.
Pioneer Corp.
Portland Gen. El.
Potomac Electric Power
Public Service Colorado
Public Service E&G
Public Service Indiana
Public Serv. New Mexico
Puget Sount P&L
Pullman, Inc.
Rochester G&E
Safeway Stores
San Diego G&E
Savannah Electric Co.
Seaboard Coast Line
Seafirst Corp.
Sears Roebuck
Shell Oil
Sierra Pacific Power
So. Carolina E&G
So. California Ed.
Southern Company
Southern Indiana
Southwestern Public Service
Sperry Rand
Standard Brands
Suburban Propane Gas
Texas Utilities
Texasgulf
Transco
UGI Corporation
Union Carbide
United Illuminating
United Jersey Banks
U.S. Steel
United Telecom.
Universal Foods
Utah P&L
Virginia Electric & Power
Virginia Natl. Bankshares
Williams Companies
Wisconsin Elect. Pwr.
Wisconsin P&L
Wisconsin Public Service

EXHIBIT B

Citizens Utilities Company

Citizens Utilities Company is unique among widely held, publicly-owned companies in having a two-series capitalization which provides investment media suitable for all classes of investors.

Citizens Utilities Series B shares carry conventional cash dividends and appeal to investors who wish to receive current taxable income. Since 1956, their Series A shares have paid stock dividends only and therefore have particular attraction to those investors who wish to compound their investment at no additional cash cost and without taxation during the compounding period.

Under the provisions of the Tax Reform Act of 1969 [Section 421 (b)(2)(a)] there is no taxable income to Series A stockholders on stock dividends received through December 31, 1990, and those stock dividends fall in the capital asset category. Sale of the stock received generates capital gains or losses. Such gains or losses are based on the difference between sale price and "adjusted basis" per share. "Adjusted basis", in turn, is calculated by reducing the original purchase cost or investment per share by the percent of each stock dividend subsequently received. Furthermore, if the original shares upon which stock dividends are paid have been held for more than the long-term capital gains period, any gain on sale of shares representing stock dividends (even if immediate) is treated as a long-term capital gain.

The favorable tax implications of holding Series A shares leads one to expect that Series A shares should trade at a premium to

EXHIBIT B (Continued)

Series B shares. Tables 5 and 6 show that this has indeed been the case.

During 1979 and 1980 (through June) Series A shares consistently traded at a premium over Series B shares. This premium (based on monthly data) was, on average, 12.62%. Furthermore, over the last five years, the A shares traded at a premium over the B shares for 16 of 20 calendar quarters.

Table 7 compares the yield on Citizen Utilities shares with the yield on the S&P Utility Index. Not only is the yield on Series A for the last three years below that of Series B (as might be expected), but yields on both Series are well below yields on the S&P Utililty Index. Thus, the market is placing a premium on all of Citizens Utilities shares, which we feel is more than partially due to the existence of the tax deferral on its Dividend Reinvestment Plan.

EXHIBIT B (Continued)

Table 5: Quarterly Data

Citizens Utilities Comparison of Series A (Stock Dividend) and Series B (Cash Dividend) Shares During 1979 and 1980

		Series A		Series B	
		HIGH	LOW	HIGH	LOW
Quarter					
1979	1	37.000	35.250	32.000	29.500
	2	40.250	36.000	36.500	32.000
	3	40.000	38.250	36.500	33.750
	4	38.250	32.125	33.500	27.750
1980	1	33.046	26.581	31.750	26.250
	2	37.835	28.017	33.500	27.250

Table 6: Monthly Data

		Series A			Series B			Premium of A Last Bid Over B Last Bid
		HIGH	LOW	Last Bid	HIGH	LOW	Last Bid	
1979	Month							
	Jan.	37.000	36.000	36.250	30.250	30.000	30.000	20.83%
	Feb.	36.250	35.500	35.500	30.500	29.500	30.250	17.36
	Mar.	36.000	35.250	36.000	32.000	30.500	32.000	12.50
	Apr.	38.750	36.000	37.500	33.750	32.000	33.000	13.64
	May	39.500	37.500	39.500	35.000	32.750	35.000	12.86
	Jun.	40.250	37.750	40.000	36.750	34.750	36.500	9.59
	July	40.000	39.500	39.750	36.500	36.000	36.250	9.65
	Aug.	40.000	39.500	39.750	36.250	35.000	35.000	13.57
	Sept.	39.750	38.250	38.250	35.000	33.750	33.750	13.33
	Oct.	38.250	34.500	35.500	33.500	30.000	30.250	17.36
	Nov.	37.000	32.125	36.750	30.250	27.750	30.000	22.50
	Dec.	36.500	33.750	34.750	32.500	30.000	31.500	10.32
					1979 Average Premium			14.46%
1980								
	Jan.	33.046	30.651	31.609	31.750	29.750	31.000	1.96%
	Feb.	32.807	29.694	29.694	31.750	29.000	29.000	2.39
	Mar.	30.412	26.581	27.299	29.750	26.250	26.750	2.05
	Apr.	33.764	28.017	33.046	29.500	27.250	28.500	15.95
	May	37.596	33.046	36.638	31.000	28.500	30.000	22.13
	Jun	37.835	35.750	35.750	33.500	30.000	32.750	9.16
					1980 Average Premium			8.94%

EXHIBIT B (Continued)

Table 7

Citizens Utilities: Comparison of Series A and Series B Share Yields With the S&P Utilities Index (December Averages)

Year	Series A Yield	Series B Yield	S&P Utility Index Yield
1979	7.8%	8.1%	9.43%
1978	6.8	7.7	8.99
1977	6.6	6.6	7.62
1976	6.8	6.4	7.22
1975	7.5	6.7	8.39

EXHIBIT C

Summary of Utility Public Common Stock Offerings
1979 Through 7/9/80

Date	Company	Size: Shares (000)	Size: Amount (000)	Price/Book Ratio*
1979				
1/ 9	Middle South Utilities	8,500	$130,050	84%
10	Louisville Gas & Elect.	1,000	21,000	84
16	Pub.Svc.Co. New Hamp.	2,000	41,000	89
18	Iowa Power & Light	375	9,609	99
23	Texas Utilities Co.	5,000	97,500	96
23	El Paso Electric Co.	1,500	16,500	108
24	Atlantic City Elec.	1,000	19,875	93
2/ 7	Houston Industries	2,000	58,250	89
8	Commonwealth Edison	7,000	187,250	91
14	Ohio Edison Co.	6,000	99,000	101
27	Portland General Electric	5,000	89,375	98
3/ 8	Northwest Energy Co.	500	15,250	71
13	Minnesota Power & Light	1,000	20,150	90
14	Duke Power	5,500	107,250	92
28	Kentucky Utilities	1,000	20,000	80
4/ 3	Philadelphia Electric	4,000	65,500	85
3	Iowa Public Service	1,000	21,500	96
11	Otter Tail Power	500	10,875	92
18	South Carolina E & G	1,000	16,875	91
19	Illinois Power Co.	3,000	66,750	101
24	Pub.Svc.Co. Colorado	2,500	40,313	91
5/ 8	Kansas City Pwr. & Lt.	1,600	40,800	76
15	Pub.Svc. New Mexico	2,500	48,125	87
23	Delmarva Pwr. & Lt.	2,000	25,250	79
6/ 6	Missouri Pub. Svc.	300	3,525	78
13	Northern Indiana Pub.Svc.	2,000	30,500	79
13	Washington Energy Co.	600	8,700	77
19	Toledo Edison Co.	2,000	42,250	86
21	Utah Power & Light	2,200	41,800	106
27	Arizona Public Service	2,000	39,250	89
7/10	Continental Telephone	2,000	33,500	116
11	Pub.Svc.N. Hampshire	2,000	39,000	84
17	Detroit Edison	6,000	89,250	79
17	San Diego Gas & Elec.	3,000	45,000	85
18	NICOR Inc.	1,500	47,250	95
31	Boston Edison	2,000	44,750	72
31	United Energy Resources	1,000	44,000	131

EXHIBIT C (Continued)

Summary of Utility Public Common Stock Offerings
1979 Through 7/9/80

Date	Company	Shares (000)	Amount (000)	Price/Book Ratio*
1979				
8/ 1	Cleveland Elec. Illum.	4,500	81,000	95
7	El Paso Electric	1,500	16,500	109
14	Oklahoma Gas & Elec.	2,500	41,875	100
15	Idaho Power	1,500	38,438	89
21	Nevada Power Company	750	19,969	105
22	Allegheny Power System	4,700	82,955	83
28	Public Service Indiana	2,000	50,500	105
9/ 6	American Electric Pwr.	8,000	$150,400	87%
20	Central & Southwest Corp.	5,000	73,250	92
25	Niagara Mohawk Power	3,500	46,375	75
25	Southwest Gas Corp.	2,000	24,500	111
26	Northwest Energy Co.	1,800	43,200	106
10/ 2	Mid-Continent Telephone	1,000	20,125	123
3	Kansas Pwr. & Light	1,800	33,300	79
10	Public Service E. & G.	3,000	59,250	76
16	Houston Industries	2,500	68,750	82
23	Pacific Gas & Electric	9,000	196,875	73
30	Long Island Lighting	7,489	99,981	67
31	Kansas Gas & Elect.	2,000	31,000	72
11/ 1	Gulf States Utilities	3,500	39,813	72
7	Duquesne Light Co.	3,800	53,200	93
13	Northwestern Pub.Svc.	300	4,500	77
13	Middle South Utilities	5,000	65,000	70
14	Northwest Natural Gas	700	10,605	121
19	Kentucky Utilities	1,000	18,375	73
19	Virginia Elec.&Pwr.	6,000	66,750	58
20	Arizona Public Service	2,500	43,125	75
20	Montana-Dakota Utilities	850	15,513	85
27	Pennsylvania Pwr. & Lt.	2,500	46,250	71
28	Central Illinois Pub.Svc.	2,200	26,400	83
29	Puget Sound Pwr. & Lt.	3,000	43,125	77
12/ 4	Consumers Power Co.	4,000	81,000	71
4	Iowa Electric Lt. & Pwr.	1,000	14,625	79
4	Eastern Utililties Assoc.	600	7,575	70
11	Union Electric Co.	5,500	63,938	72
12	Northern Indiana Pub. Svc.	2,000	28,750	76

EXHIBIT C (Continued)

Summary of Utility Public Common Stock Offerings
1979 Through 7/9/80

Date	Company	Shares (000)	Amount (000)	Price/Book Ratio*
1980				
1/10	Portland General Elec.	4,000	$ 57,500	79%
16	Pacific Power & Light	3,000	7,963	87
17	Hackensack Water Co.	350		
29	Cincinnati Gas & Elec.	3,400	54,825	78
2/ 4	Ohio Edison Co.	6,500	87,750	84
5	Southern Calif. Edison	7,000	161,875	68
13	Carolina Pwr. & Light	4,500	75,938	66
13	El Paso Electric	1,500	14,438	93
20	Pub. Svc. New Hampshire	1,500	22,125	66
21	Central Hudson G & E	500	8,250	60
26	Pub. Svc. Colorado	2,750	31,625	67
26	United Illuminating	500	10,250	67
28	Commonwealth Edison	8,000	147,000	64
3/ 4	Eastern Gas & Fuel Assoc.	1,500	33,375	127
4	Texas Utilities	5,000	77,500	75
5	Arizona Pub. Svc.	4,000	59,000	65
5	Montana Power	1,500	31,500	78
6	Illinois Power	3,000	47,625	71
19	Kansas City Pwr. & Light	1,500	27,750	58
20	San Diego Gas & Elec.	2,500	28,750	66
4/ 2	Upper Peninsula Power	200	2,400	60
8	North-West Telephone	175	2,843	104
9	Otter Tail Power	500	9,000	73
15	Houston Industries	3,000	82,125	79
28	Kentucky Utilities	1,500	26,438	73
29	Middle South Utilities	7,000	88,550	69
5/ 6	Sierra Pacific Power	1,500	20,100	83
8	Public Service E & G	5,000	101,875	77
12	Duquesne Light Co.	4,000	59,000	83
13	Connecticut Water Service	200	2,100	78
13	Kansas Gas & Electric	1,500	24,562	80
14	Detroit Edison	4,000	52,500	71
15	Central Louisiana Energy	2,000	46,500	95
20	Toledo Edison	2,000	38,500	79
28	Fitchburg Gas & Elec. Lt.	100	2,300	84

EXHIBIT C (Continued)

Summary of Utility Public Common Stock Offerings
1979 Through 7/9/80

Date	Company	Shares (000)	Amount (000)	Price/Book Ratio*
1980				
6/ 3	United Cities Gas	200	$ 2,200	63%
4	Montana-Dakota Utilities	1,000	20,000	92
5	Northern Indiana Pub. Svc.	2,000	26,500	71
12	Washington Water Power	1,600	30,000	76
18	Gulf States Utilities	3,000	37,500	80
19	Nevada Power Co.	1,000	24,135	118
19	United Illuminating	1,000	22,125	73
24	Niagara-Mohawk Power	4,000	56,500	80
30	Central & South West	6,000	87,750	89
7/ 7	Piedmont Natural Gas	400	8,250	93
8	Dayton Power & Light	2,500	36,875	80
9	Louisville Gas & Elec.	1,500	28,688	79
9	Pub. Svc. New Hampshire	2,200	37,675	79

	Issues	
	Number	Percent
Issues under book	104	86%
Issues at or over book	17	14
Total common issues	121	100%

*Reoffering price as a percentage of Book Value

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Tax Cut Proposal
for consideration by
U.S. Senate, Committee on Finance
August 1, 1980

We have some problems in our economy today but we also have 92.2% of our labor supply working and this tremendous and vital resource could help solve current and longer term problems if economic attention is focused through the responsible use of tax incentives which are anti-inflationary and not a "quick fix".

Every tax incentive program has a revenue impact. However, a responsible tax incentive AND anti-inflationary program will only delay or defer current revenues and permit our economic system to employ this capital to help solve its basic need for investment resources.

My recommendation is to support and encourage CONSUMER INVESTMENT a principle that has been widely endorsed by past and current members of the U.S. Senate and House of Representatives, elected officials, the President's Commission on Pension Policy, every major financial association, most economists and by both major political parties.

The anti-inflation and responsible tax cut which I endorse is simply expanding the present Individual Retirement Account structure with new eligibility as follows:

	New IRA Eligibility	Coverage
I.	Homemaker IRA	30,000,000 Homemakers
II.	Limited ($1,000) IRA	50,000,000 Employees now in a pension plan.
III.	Increase IRA Contribution Limit from $1,500 to $2,000	55,000,000 Employees now eligible for an IRA

ESTIMATED WORKING AMERICANS IMPACTED - 135,000,000

The IRA would also then be the Economic ERA for millions of citizens now excluded from a tax incentive savings program for retirement and millions more would be able to shore-up an otherwise inadequate employee pension plan by using a personal tax-favored savings plan.

The anti-inflation and therefore responsible part of the tax cut exists as a taxpayer would only receive the tax reduction IF they actually put the money into savings, the most important and needy segment of the capital structure of our economy.

The U.S. Treasury Department has stated that it favors expansion of the IRA if it is non-discriminatory and these proposals meet that test. Utilization on a broader basis than currently exists would also be assured as financial institution would be more active in promoting the benefits to those who are eligible.

On behalf of American CONSUMERS, I strongly urge the Committee on Finance to include in its tax cut proposals a CONSUMER INVESTMENT INCENTIVE by expanding eligibility for the Individual Retirement Account. Such a proposal would be absolutely anti-inflationary and, therefore, responsible and can be efficiently implemented within existing structures.

Americans can and will solve problems. It is just a lot easier to do with the proper tools and providing these IRA Savings tools should be a high priority for you and your associates.

Thank you for this opportunity to present my views.

Edwin A. Klose

Edwin A. Klose
President and Senior Consultant

ELEMENTS OF TAX REFORM

Statement of Cornelius C. Shields

Vice President

Public Policy

Sun Company, Inc.

100 Matsonford Road

Radnor, PA 19087

215-293-6540

PREPARED FOR SUBMISSION TO

SENATE FINANCE COMMITTEE

July 31, 1980

SUMMARY

The statement discusses two structural deficiencies in the U.S. tax system which are seen as important contributors to inflation, low capital formation, and declining productivity:

- "Super" indexing of tax revenues which drives up both individual and business taxes faster than inflation, and

- Failure of the tax system to encourage adequate saving and investment, particularly by lower and middle income persons.

Correcting reforms are identified and urged to be made effective in 1981:

- Adjust individual tax brackets, personal exemptions, and depreciation deductions by the proper factor, such as the GNP deflator; i.e. index them correctly.

- Enact a system of Individual Savings and Investment Accounts to which contributions would be deductible, up to a predetermined ceiling (or alternate credit), and from which withdrawals would be taxable.

INTRODUCTION

Mr. Chairman and Members of the Committee:

This Statement is submitted for your consideration in appraising the need for tax change and on the advisability of enactment of a tax cut this year to be effective in 1981.

The statement discusses two structural deficiencies in the U.S. tax system. While these are not the only tax matters in need of reform, they are quite fundamental and appear to be linked closely to U.S. economic difficulties. They are:

- The "super" indexing of tax revenues, for both individuals and business, which drives taxes up faster than inflation, and

- Failure of the tax system to encourage adequate saving and investment particularly by lower and middle income persons.

STATE OF THE U.S. ECONOMY

The U.S. economy evidences greatly impaired ability to provide productive employment and a rising standard of living for its people. Inflation ratchets to higher and higher levels.

	1956-1966	1966-1976	1979	Early 1980
CPI	1.8	5.8	13.3	18-20

Rates of increase in nominal GNP since 1965 mask deteriorating rates of growth in real terms and a truly precipitous decline in the last few years (Exhibit 1).

The U.S. has experienced a steady drop in its rate of productivity increase, from 2.6% in 1965 to 2% between 1965 and 1972 and less than 1% since 1973. Although the U.S. was still ahead in total productivity in 1979, at existing rates of change it will lose the lead in 1981.

Since the mid-60s, the U.S. has posted the lowest investment record of any country in the industrialized world. Between 1966 and 1976 the U.S. devoted 13.5% of real gross domestic product to investment while Japan averaged 26.4% and West Germany, 17.4%. And relative to all other industrialized countries, the U.S. has the lowest rate of personal savings as a share of personal disposable income (1970-1977) and with the exception of the U.K., the lowest average annual rate of growth in productivity (1960-77).

The federal budget has not shared these declines. Federal outlays as a percentage of GNP have increased from 19.1% in the 1960-1964 period, to 20.4% in 1970-1974, and 22.3% in 1975-1979. This has been accompanied by a similar increase in state and local expenditures (Exhibit 2). Income security and grant programs have been the principal beneficiaries, while national defense has been the big loser (Exhibits 3 and 4).

Capital investment and productivity are the keys to improving the economic standard of living. Machinery, equipment, buildings, inventories, must continually be replaced if the U.S. economy is to maintain even current levels. Greater capital formation is essential if the U.S. is to experience rising real incomes. To achieve this goal, more capital must be employed to produce more per person.

Clearly, this has not been happening. Inflation and government social expenditures are increasing; savings, investment, and productivity are decreasing. We are a long way from the early 1960s and the optimistic outlook for fiscal dividends and full employment surplus in an expanding economy.

A "SUPER" INDEXED TAX SYSTEM

The structure of the present federal tax system is a contributor, and very likely a substantial contributor, to these disheartening results.

First, the system is "super" indexed. Individual and business taxes necessarily and automatically increase faster than the rate of inflation. The result is a strong, embedded inflation bias. Stated another way, the tax system was not designed to operate efficiently in an inflationary environment. Exenditure programs, each desirable on its own merits and each with a supportive constituency, need not be held in check by the necessity of an explicit, legislated tax increase. The inflation stimulated by the expenditures will automatically increase tax revenues at a rate faster than the rate of inflation.

For individuals, inflation as an automatic tax escalator operates through bracket creep and a diminished real value of fixed dollar allowances, such as personal exemptions. The escalator is in the neighborhood of 1.5; that is, for each one percent increase in inflation, individual income tax revenues increase approximately one and one-half percent. The dollar amounts are large. One Joint Committee staff estimate is that at 9.3% inflation the tax escalator will yield an additional $21 billion from individuals, over and above the proportional increase from inflation.

The claim is made that periodic tax cuts have adjusted for the effects of inflation on individuals. This has not always been true, and clearly has not been the case in recent years. Further, aggregate data masks the fact that the combination of an automatic inflation tax escalator and uneven periodic tax cuts has resulted in a significant redistribution of the individual income tax burden--to the detriment of moderate income taxpayers (Exhibit 5).

As with individuals, the tax sytem does not tax business in proportion to inflation, but rather, more and more heavily as inflation grows. "Super" tax indexing for business operates primarily by decreasing real depreciation deductions as inflation increases. Revenues are counted and taxed in dollars of the current year, and the higher the rate of inflation, the higher the revenues in current dollars. But depreciation deductions are computed on the basis of the historical dollars spent when the assets were acquired. The result is systematic overtaxation, which becomes worse as inflation increases.* One estimate gives $15 billion as the size of this overtaxation of business by 1981.

Work which Sun Company has done in connection with Coopers & Lybrand, the public accounting firm, indicates that the interaction of inflation with the present tax depreciation system has resulted in increased tax burdens on business which have more than offset the larger investment tax credit and ADR depreciation since the 1960s (Exhibit 6). Internal analysis at Sun shows a sharply accelerating drop in the value of the depreciation deductions associated with certain 1980 capital additions as the anticipated rate of inflation grows (Exhibit 7). Depreciation deductions for assets on hand also are impacted substantially by future inflation (Exhibit 8).

* * * * * * * * * * *

"Super" indexing should be eliminated from the tax system. A system which automatically increases tax revenues faster than the rate of inflation has too much potential for itself turning into an engine of inflation. Nor does it seem in keeping with the spirit of a Constitutional government in which taxes are to be expressly and solely voted by Congress.

* This result is also demonstrated by the effect of Financial Accounting Standards Board Statement #33 on the financial reporting for 1979 of the Fortune top 1000 companies. (*See*, the May 1980 study of Price Waterhouse & Co., "Disclosure of the effects of Inflation: An Analysis.")

And the heavy hand which such a system lays upon business investment is a real cost to the entire society, a cost whose full dimensions can only be guessed. What longer term, higher risk investments have been dropped in favor of shorter, safer ones because the automatic escalator bears particularly hard upon the longer and riskier? What investments have never happened because the inflation escalator has raised uncertainty to an unmanageable level?*

* Exhibits 7 and 8 illustrate that applying a proper index to depreciation is fundamental to business tax reform. Unless the present "super" indexed system is replaced with a correct index, there will always be a limit to the inflation rate which a revised depreciation system, such as the "10-5-3 bill" can offset. Also, depreciation reform legislation typically looks only to newly acquired assets. Thus, inflation will continue to overtax income from assets already on hand, as well as income from newly acquired assets, by decreasing the real value of remaining depreciation deductions; Exhibit 8.

The technical way to eliminate "super" indexing is straightforward. Simply adjust individual tax brackets, personal exemptions, and depreciation deductions by the proper factor, such as the GNP deflator, i.e. index them correctly.

INDIVIDUAL SAVING AND INVESTMENT

The United States has a low and declining rate of personal savings. It is now the lowest among major industrialized nations (Exhibit 9).

The result is not surprising. The U.S. relies heavily upon a Haig-Simons income tax which favors consumption over savings. And earnings from the principal equity investment open to most people, corporate stock, are taxed at both the corporate and individual levels. Interest and dividends are taxed in nominal terms, on the dollars as they are paid, but gains and losses are computed on the basis of the historical dollars used in acquiring the investments. The attitude of the government is reflected in excluding investment income from the 50% maximum tax and instead subjecting it to rates up to 70%.

The average individual cannot save and invest at positive real rates of return. Even if yields and market prices improve so that real before-tax rates of return are positive, present tax rules make it unlikely that real after-tax rates also will be positive. See Exhibit 10 which summarizes the results of a study which Sun made of "The Individual Investor and Inflation--Analysis of Three Investment Strategies, 1973-1977."

Economic growth requires much greater capital formation. The tax laws are a powerful, probably the key, policy instrument in bringing about the needed shift from consumption toward saving and investment. But in making this change in public policy, it is vital to have the full support of the American people. The present tax bias against individual saving and investment must be replaced with encouragement, particularly for lower and middle income persons. More people must have a stake in a growing America.

A straightforward approach would be a system of newly authorized Individual Saving and Investment Accounts (S&I Accounts).

Description

In concept, S&I Accounts would be similar to existing Individual Retirement Accounts ("IRA's") in that an income tax deduction would be allowed for a contribution by an individual to an S&I Account. Unlike IRA's, balances in S&I Accounts could be withdrawn on demand without penalty; however, withdrawals would be includable in gross income and taxed accordingly. To give an extra saving incentive for those with lower incomes, an optional credit instead of a deduction would be provided.

Eligibility

Any individual required to file a federal income tax return would be eligible to establish an S&I Account, regardless of participation in pension or profit sharing plans, Keogh Plans, or IRA's.

Operation

S&I Accounts, which would be tax exempt, would be administered by corporate fiduciaries, not individuals, Earnings on S&I Account balances, including capital gains, would accumulate tax free.

Limitations

The amount allowed as a deduction and contribution to an S&I Account would be determined and phased in over, e.g. three years to control the revenue loss associated with this proposal. Similarly, the optional credit allowed would be one-third the amount of the contribution, up to a maximum credit determined consistently with the phasing in of the allowed deduction. To prevent borrowing to finance contributions to S&I Accounts, no tax deduction would be allowed for debt-financed contributions.

REVENUE IMPACTS

Elimination of "super" indexing and replacing it with a correct index for individual brackets and exemptions and business depreciation would entail static or first order annual revenue losses of approximately $36 billion ($21 billion for individuals, $15 billion for business). Sun is working on a further analysis and hopes to have both static and dynamic revenue estimates, plus an analysis of effects on important economic variables, which it will share with the Committee.

To date Sun has not identified an economic model, whose level of detail and behavioral assumptions permit full dynamic analysis of the Individual Saving and Investment Accounts proposal. Ideally, analysis would include a number of different possible deduction/credit ceilings. However, the absence of this information does not appear serious. Revenue impacts can be controlled by setting the deduction/credit ceiling at any desired level. Caution might suggest starting with a relatively modest ceiling and raising it as experience dictates.

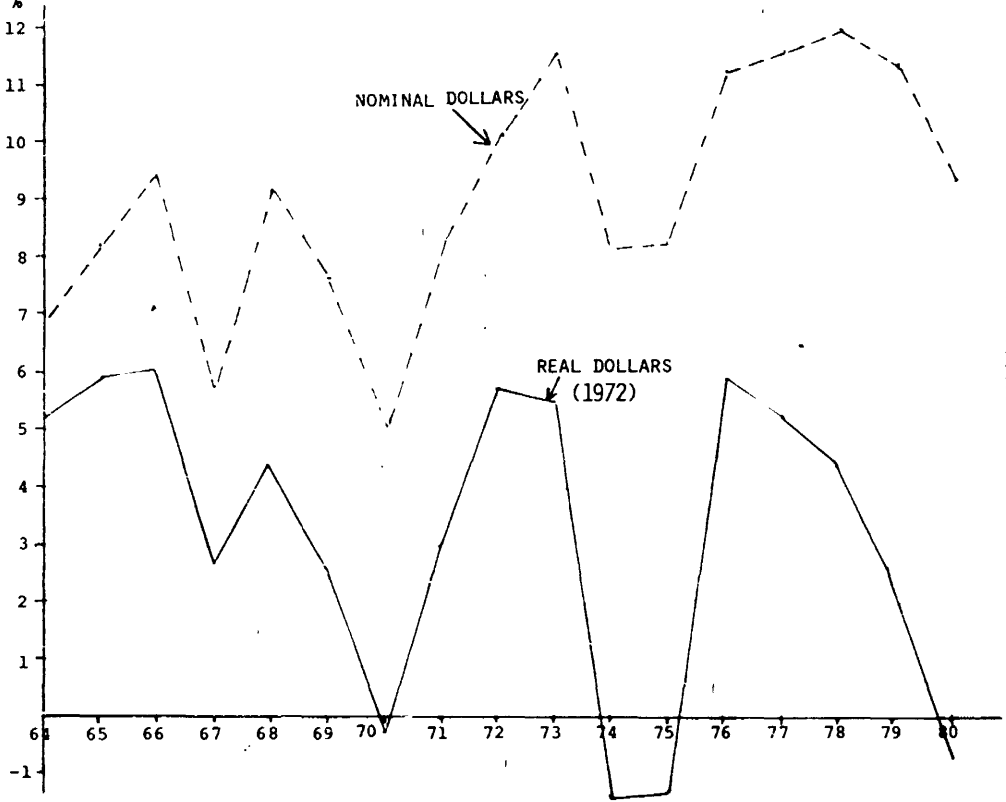
Those who argue that the U.S. Treasury cannot afford a tax cut in 1981 might recall that the Administration's planned increase in federal government receipts, fiscal year 1981 over fiscal year 1980, was over $100 billion, of which almost $75 billion was new or increased taxes (Exhibit 11).

CONCLUSION

Sun Company, the 20th largest U.S. company and an organization comprised of 40,000 employees, 190,000 stockholders and royalty owners, and 66,000 retirees, has a vital stake in the U.S. economy. Action must be taken to reverse the decline in our nation's rate of savings and capital investment. Sun urges that the two tax changes discussed in this statement be enacted promptly, to be effective for 1981.

EXHIBIT 1

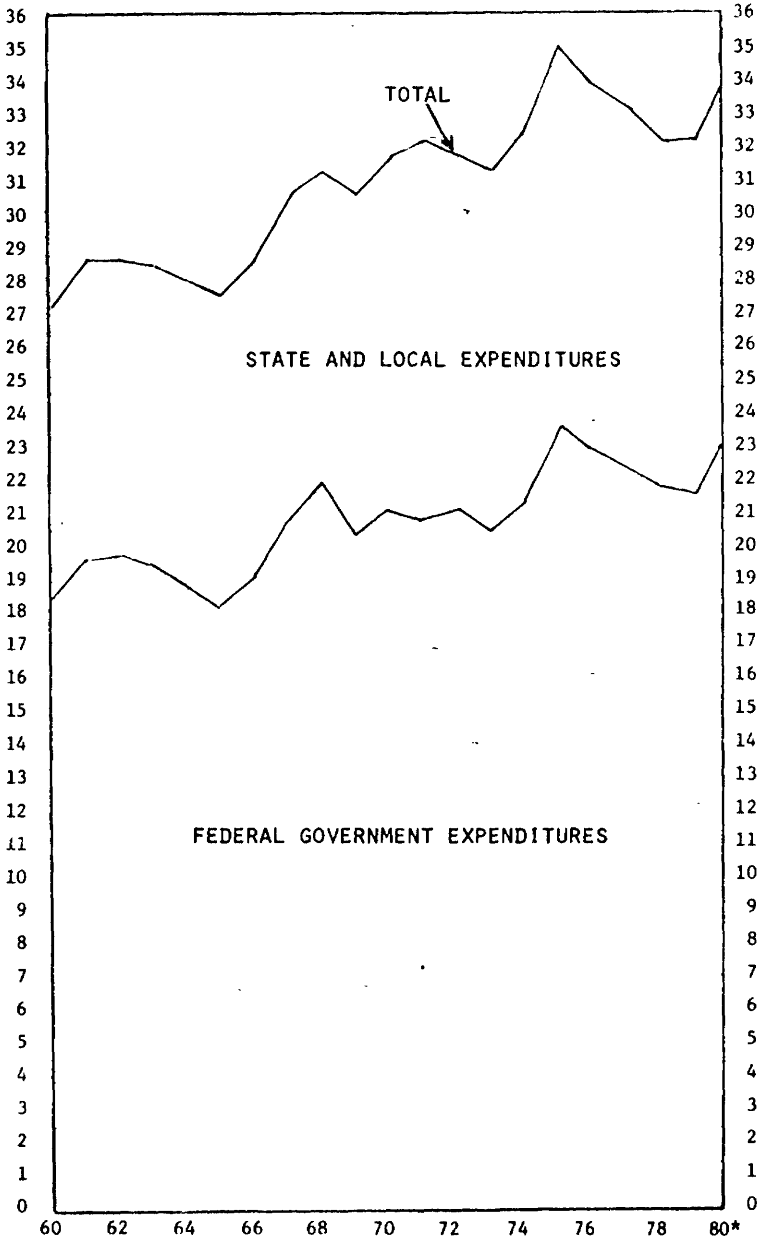
RATES OF INCREASE IN GNP



SOURCE: M. L. LORD, SUN CO., INC.
(JULY 1980)

PUBLIC SECTOR EXPENDITURES AS PERCENTAGE OF GNP

EXHIBIT 2

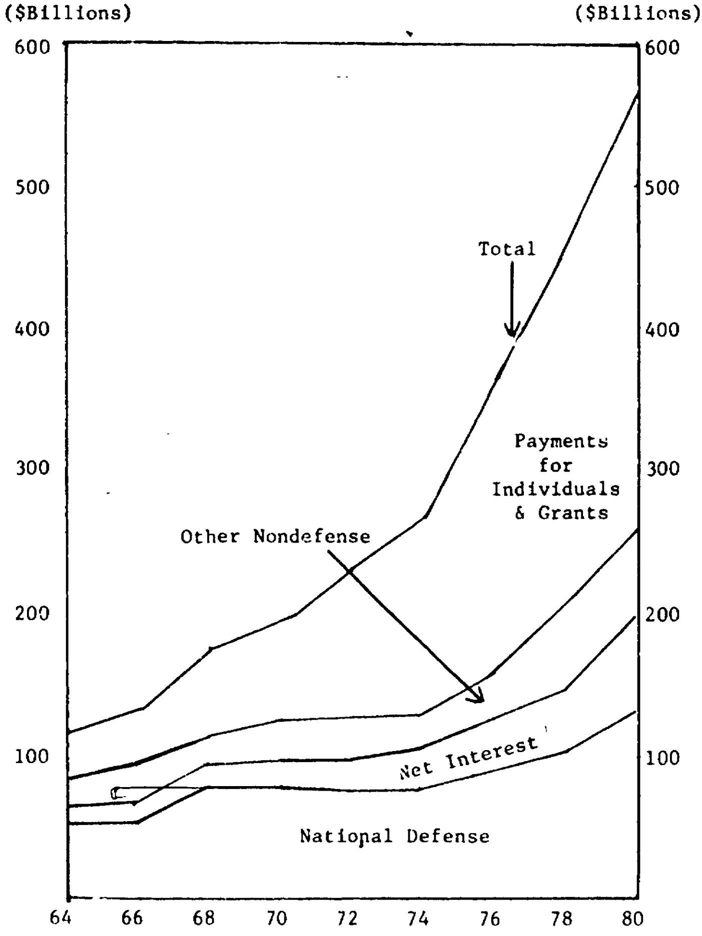


*ESTIMATED

SOURCE: M. L. LORD, SUN CO., INC. (JULY 1980)

EXHIBIT 3

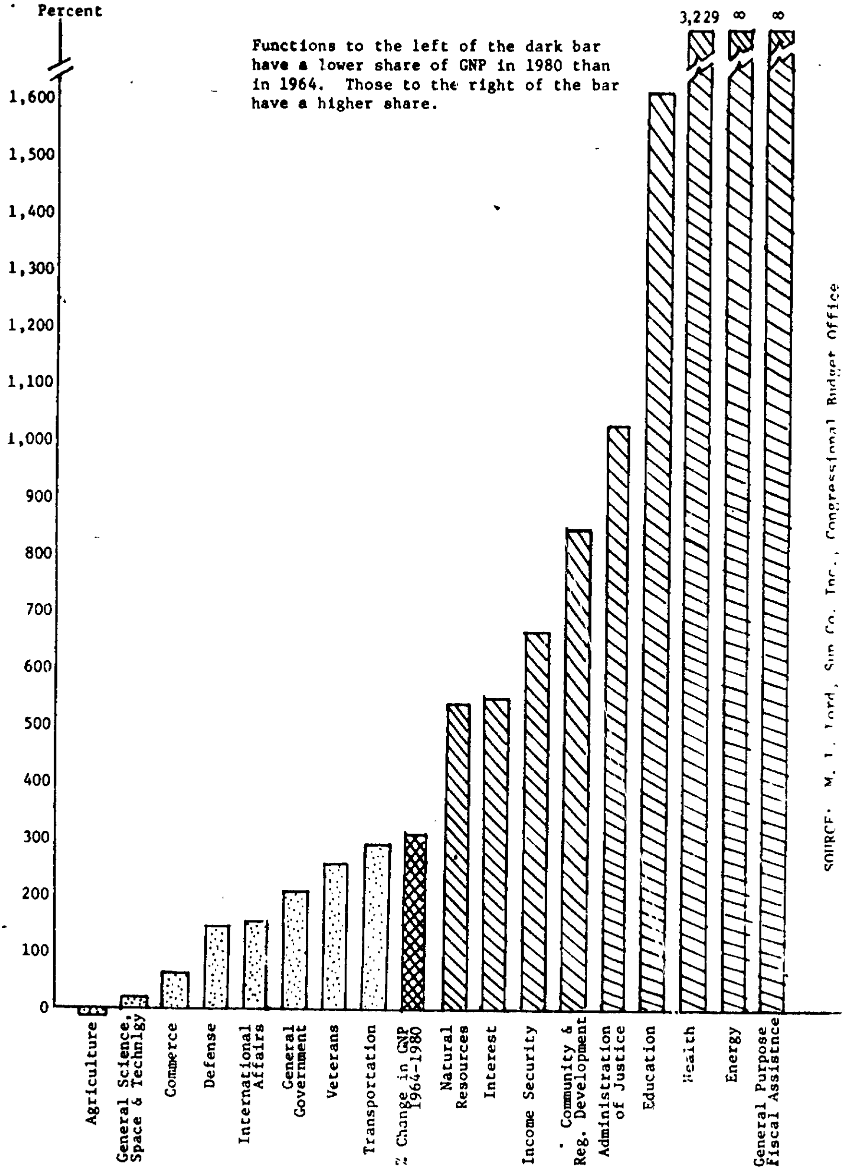
FEDERAL
BUDGET OUTLAYS
(1964-1980)



SOURCE: M. L. LORD, SUN CO., INC.
(JULY 1980)

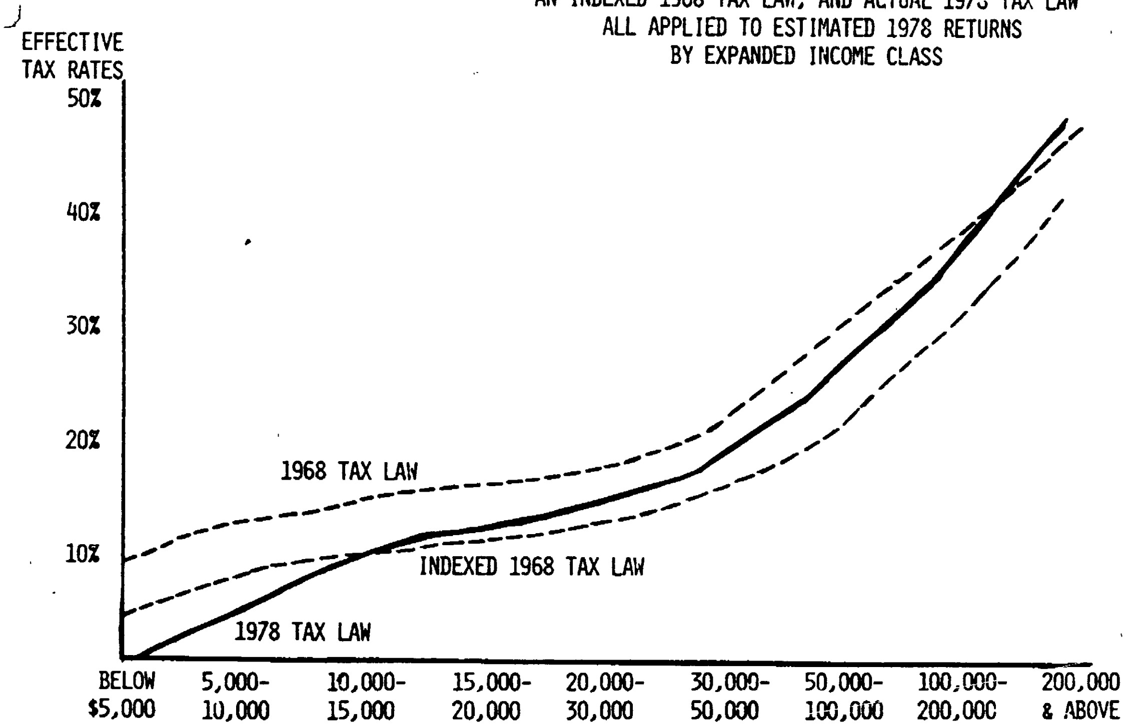
EXHIBIT 4

Percentage Changes in Federal Outlays, Fiscal Years 1964-1980



SOURCE: M. L. Lord, Sun Co. Inc., Congressional Budget Office

EFFECTIVE TAX RATES FOR 1968 TAX LAW,
AN INDEXED 1968 TAX LAW, AND ACTUAL 1978 TAX LAW
ALL APPLIED TO ESTIMATED 1978 RETURNS
BY EXPANDED INCOME CLASS

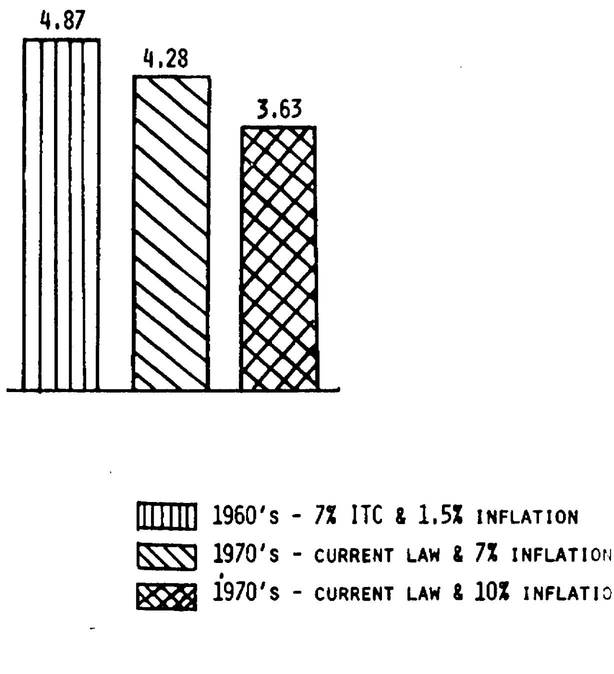


SOURCE: JOINT COMMITTEE ON TAXATION; TAX FOUNDATION

EXHIBIT 5

EXHIBIT 6

ADDED INCENTIVES OF 1970'S MORE THAN
OFFSET BY INFLATION SINCE THE 1960'S
INTERNAL RATES OF RETURN (%)
(100% EQUITY FINANCING)



SOURCE: SUN CO., INC. AND COOPERS & LYBRAND, "EFFECTS OF THE FEDERAL INCOME TAX ON U.S. MANUFACTURING INVESTMENT IN THE PRESENCE OF SUSTAINED INFLATION," AUGUST 28, 1978

SUN COMPANY, INC. AND SUBSIDIARIES
PROJECTIONS ON 1980 ADDITIONS
TAX BENEFITS OF DEPRECIATION/ITC

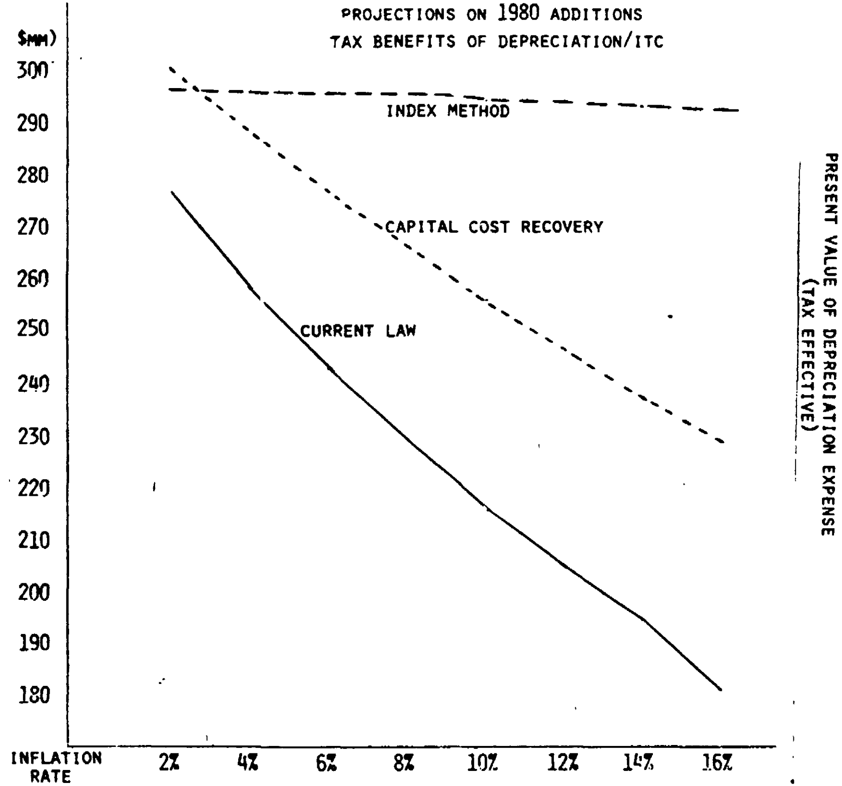


EXHIBIT 7

EXHIBIT 8

SUN COMPANY, INC. AND SUBSIDIARIES
PROJECTED DEPRECIATION ON EXISTING ASSET BASE
AT 12/31/78 (1979-2000)

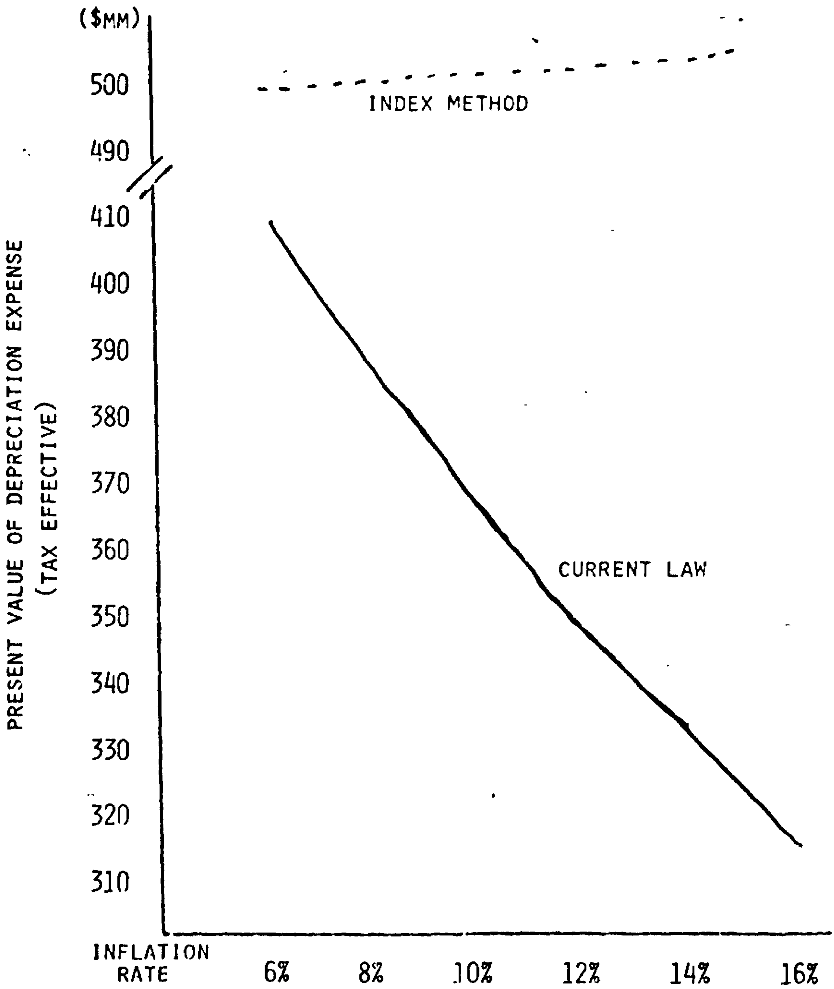
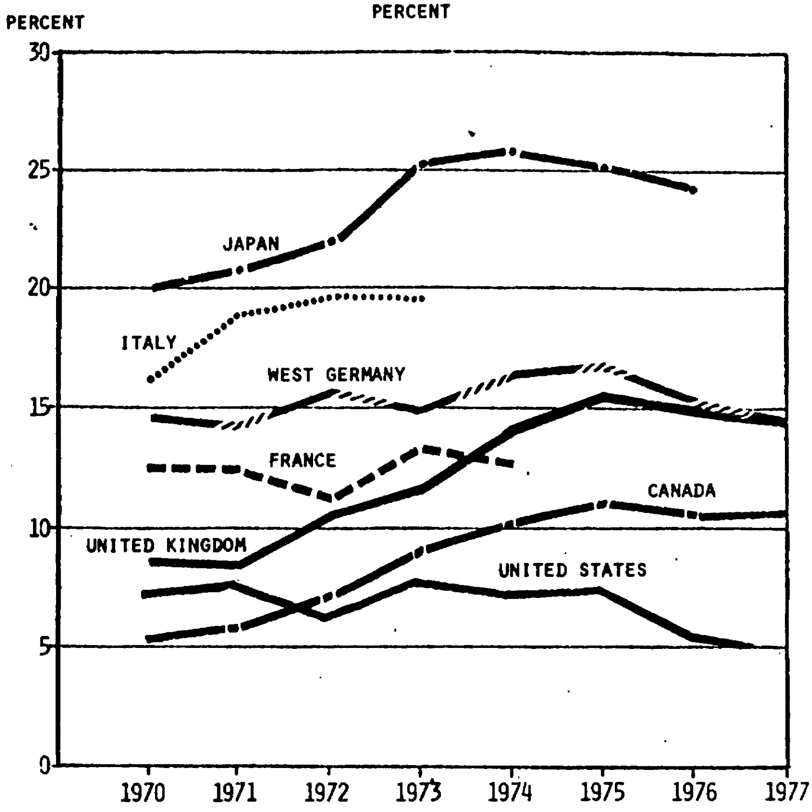


EXHIBIT 9

PERSONAL SAVINGS: SHARE
OF PERSONAL DISPOSABLE INCOME
PERCENT



SOURCE: NATIONAL ASSOCIATION OF MANUFACTURERS, INDICATORS OF INTERNATIONAL ECONOMIC PERFORMANCE -- FACTORS IN ECONOMIC GROWTH, OCTOBER 1978

EXHIBIT 10

VALUE OF INVESTMENT IN NOMINAL TERMS

	PRE-TAX	AFTER TAXES INVESTOR A	AFTER TAXES INVESTOR B
U.S. TREASURY BILLS	+35.6%	+27.0%	+17.8%
SAVINGS ACCOUNT	+29.9%	+22.7%	+15.6%
COMMON STOCKS	+ 8.8%	+ 8.8%	+ 4.3%

VALUE OF INVESTMENT IN REAL TERMS

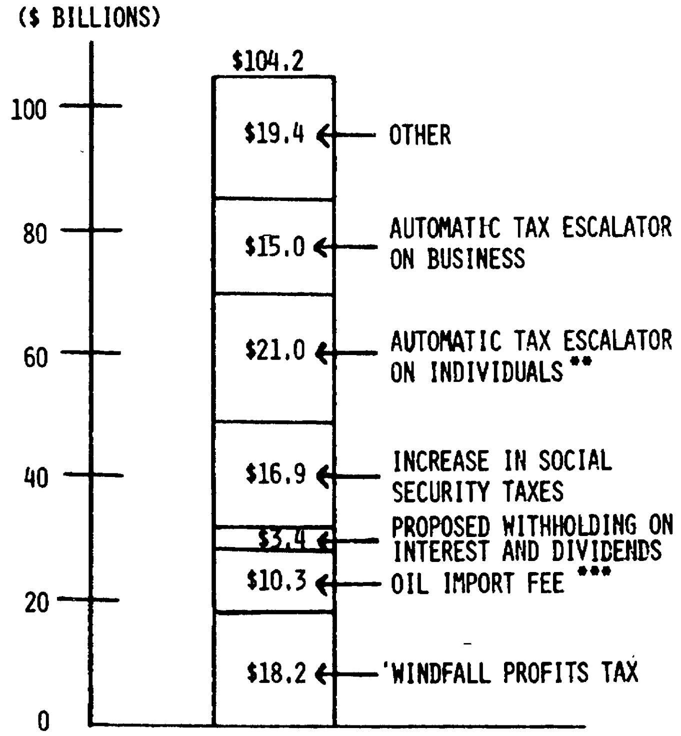
	PRE-TAX	AFTER TAXES INVESTOR A	AFTER TAXES INVESTOR B
U.S. TREASURY BILLS	- 7.3%	-13.1%	-19.4%
SAVINGS ACCOUNT	-11.2%	-16.1%	-20.9%
COMMON STOCKS	-25.6%	-25.6%	-28.7%

SOURCE: SUN CO., INC., "THE INDIVIDUAL INVESTOR AND INFLATION--ANALYSIS OF THREE INVESTMENT STRATEGIES, 1973-1977," JULY 27, 1978.

MLL:DD LPP51*

EXHIBIT 11

INCREASE IN FEDERAL GOVERNMENT RECEIPTS
FISCAL YEAR 1981 OVER FISCAL YEAR 1980*



* PRESIDENT CARTER'S REVISED 1981 BUDGET
** JOINT COMMITTEE ON TAXATION ESTIMATE BASED ON 9.3% INFLATION RATE
*** DECLARED UNCONSTITUTIONAL BY LOWER COURT ON MAY 13, 1980.
REJECTED BY CONGRESS, JUNE, 1980

TRANSPORTATION ASSOCIATION OF AMERICA

PAUL J. TIERNEY
PRESIDENT

SUITE 1107 . 1100 17TH STREET, N.W. . WASHINGTON, D.C. 20036 . (202) 296-2470

July 30, 1980

Honorable Russell B. Long
Chairman
Senate Finance Committee
Washington, D.C. 20510

Dear Chairman Long:

On behalf of the across-the-board membership of the Transportation Association of America (TAA), I should like to submit the attached statement for inclusion in the formal record of tax reform hearings now under way by your Committee. The proposals made in this statement, in our view, would stimulate capital investment in equipment and facilities that will increase productivity, provide meaningful and lasting jobs, conserve energy, and make American industry healthier and more competitive both domestically and internationally. This package of tax-incentive proposals would be of particular benefit to the nation's transportation industry and its publicly regulated segment, including those not now able to share in present tax incentives for capital formation because of statutory limitations.

The statement is virtually identical to one presented today by a TAA witness to the House Ways and Means Committee. The TAA spokesman was Jerome W. Van Gorkom, Chairman and Chief Executive Officer, Trans Union Corporation, and our statement is being submitted in his name. He advocated, on behalf of TAA, a balanced package designed to strengthen all segments of the nation's transportation industry and its supporting industries. In brief, this package consists of the following:

A - CAPITAL COST RECOVERY SYSTEM - The creation of a new capital cost recovery system which will liberalize and simplify the existing ADR system of tax depreciation--such as proposed in S. 1435--provided such a system is tailored to leave sufficient net revenues for utilization of other tax incentives for capital formation.

B - INVESTMENT TAX CREDIT UTILIZATION - To enable the transportation industry to more fully utilize its earned investment tax credits (historically only slightly more than 50% have been used), especially by those companies in this industry with heavy capital needs and insufficient taxable incomes, the following changes should be made:

1 - Permit a one-time transfer or sale of earned but unused ITC's, which would enable carriers with little or no income to utilize such credits.

2 - Authorize refunds for earned but unused ITC's, which would help stimulate capital investment by transportation companies with low or no income --particularly those with heavy capital investment requirements to meet public service obligations.

3 - Allow full use of ITC's for shorter-lived property, which would stimulate capital outlays for transport equipment having a tax depreciation life or cost recovery period of not less than three years.

4 - Increase the income tax write-off limitation for ITC's by acceleration of the limitations to 90% in 1981, and raising it to 100% for 1982 and later years.

C - NORMALIZATION - Congress should again make it unlawful for federal agencies to deny or limit tax-incentive benefits for capital formation to regulated carriers through such steps as forced reduction in their rates or by disallowance of that share of property purchased with ITC aid in the carrier's rate base.

If you, any members of your committee, or staff have any questions about these TAA proposals, either Mr. Van Gorkom or I shall be happy to answer them. We also shall be pleased to assist in any way possible in your development of constructive tax-reform legislation.

We request that this letter and the attached TAA statement be included in the transcript of your current hearings on needed tax law revisions.

Sincerely,

Paul J. Tierney

Paul J. Tierney, President

PJT/cl
Attachment
cc: Members of Senate Finance Committee

STATEMENT OF JEROME W. VAN GORKOM
CHAIRMAN AND CHIEF EXECUTIVE OFFICER, TRANS UNION CORPORATION
ON BEHALF OF THE TRANSPORTATION ASSOCIATION OF AMERICA
TO THE SENATE FINANCE COMMITTEE
RELATIVE TO TAX LAW CHANGES NEEDED IN 1981
JULY 30, 1980

My name is Jerome W. Van Gorkom, and I am Chairman and Chief Executive Officer of the Trans Union Corporation, with general headquarters in Lincolnshire, Illinois. Trans Union is engaged in a wide range of business enterprises, which are conducted through its subsidiaries, a major one being the manufacturing and operational leasing of railroad freight cars. Our interests in transportation are broad and long-range, however, and we are thus a member of, and active in, the Transportation Association of America, on behalf of whom I am submitting this statement. Trans Union is also represented on the TAA Board of Directors.

As indicated, I am presenting these views on behalf of TAA, which is located at 1100 17th Street, N.W., Washington, D.C. 20036 (296-2470). TAA is a national transportation policy organization composed of transportation interests of all kinds, including users, suppliers, investors, and carriers of all modes -- airlines, motor carriers (bus and truck), freight forwarders, oil pipelines, railroads, and water carriers (inland and ocean). These interests work together to develop policy positions designed to provide the strongest possible U. S. transportation system under private-enterprise principles.

The views that I am expressing are based on policy positions developed by the above member interests, as represented by eight permanent advisory panels consisting of top executives representing users, investors, and the six carrier modes listed above. Following clearance of the policy proposals through this Cooperative Project, and the expression of support of non-opposition to them by all eight Panels, the proposals were formally adopted by the 115-member TAA Board of Directors, a current roster of which is attached to this statement.

In response to the question raised by your Committee as to whether a tax cut is needed, the answer, in TAA's opinion, is definitely Yes. We say this because there appears to be general agreement that one of the underlying reasons for the nation's present economic problems is our declining productivity. This, in turn, can largely be traced to the increasing difficulties of key U.S. industries -- including the transportation industry -- in generating the capital needed to replace and modernize their plant and equipment.

For the past three decades, the nation's commercial transportation industry has been faced with the serious problem of trying to earn or attract, in competition with other industries, sufficient investment funds to replace outmoded equipment with more productive but very costly equipment. To illustrate, in 1950, transportation's share of total U.S. industry outlays for new plant and equipment was 11.7 percent, which dropped to 8.5 percent in 1960 and 7.6 percent in 1970. While a further decline to 5.1 percent in 1977 appears to have been reversed -- largely because of liberalization of investment tax credit eligibility for airlines and railroads -- the overall transport share is expected to be only 6.0 percent in 1980.

Unfortunately, the capital formation problem in the transportation industry has worsened, as for other industries, because of inflation. Already faced with high labor costs and continued pressures of powerful unions, the transportation industry also is faced with the problem -- of equal impact with labor for the airline industry -- of rapidly rising fuel costs. Unfortunately, the transportation industry is virtually 100 percent dependent on petroleum-based fuels, with no alternative fuels expected to be available in reasonable volume for at least a decade. Further compounding the problem is the mandatory compliance, regardless of financial status, of numerous environmental and safety rules imposed by the Federal Government. We thus have seen a drain on carrier revenues which in turn have squeezed net income to such an extent that tax incentives for capital formation -- such as accelerated depreciation and the investment tax credit -- have been only partially utilized.

For these and other reasons, our transportation industry needs all the help it can get in attracting capital. These needs are very sizeable. For example, a sizeable portion of our railroad roadbed has deteriorated because of deferred maintenance amounting to over $2.8 billion, with 41,643 miles, or 13.4 percent of total railroad trackage, operating under train slow orders in 1979. Railroads must also replace about 60,000 rail freight cars each year at about $30,000 each. Commercial air carriers must replace, at a rate of 125 a year, an obsolescent fleet of jet transports with new aircraft costing an average of $20 million each. About 1,500 river barges are needed each year at a cost of over $200,000 each, plus 50,000 tractor-trailers at $60,000 per unit and 1,200 intercity buses at $100,000 each. In other words, the transportation industry is very capital intensive, its equipment is very costly, and the turnover rate for much of this equipment is high because of intensive use.

In response to the Committee's question about the effect of a tax cut, TAA believes that passage of tax incentives for capital formation will quickly bring benefits to the nation through greater productivity. More and better capital equipment increases productivity and reduces operating expenses through use of advanced technology. Greater output comes about through more efficient utilization of labor, sizeable reductions in fuel use and costs, and more attractive service to the public. The result should be the stimulation of long-lasting jobs in the transportation supply and service industries -- and less need for government assistance to prevent the financial collapse of carriers or corporations providing essential services to the nation.

TAA's response to the remaining questions of the Committee is to advocate a package of capital formation incentive tax proposals which, if passed into law, should stimulate investment outlays in the transportation and its support industries. Also, several proposals in this package should enable public carriers in financial difficulty to make capital outlays not now possible by removing roadblocks that prevent their fair utilization of accelerated depreciation and investment tax incentives.

TAA recommends the enactment, for application starting in 1981, of a business capital formation incentive-tax legislative program that represents, in our view, a <u>balanced package</u> of measures designed to strengthen all segments of the transportation industry and its supporting industries. In brief, this package consists of the following:

A - CAPITAL COST RECOVERY SYSTEM - The creation of a new capital cost recovery system which will liberalize and simplify the existing ADR system of tax depreciation. This new program could be one such as that proposed in the pending Senate bill S. 1435, but the terms of the new capital cost recovery system should be tailored to leave sufficient net revenues for utilization of other tax incentives for capital formation.

B - INVESTMENT TAX CREDIT UTILIZATION - While the benefits of the investment tax credit have been helpful to the transportation industry, this credit has not been fully utilized -- especially by those companies in this industry with little or no taxable incomes. Greater utilization of the ITC by all the industry, including the low- and no-profit segment, would take place with the following changes:

1 - <u>Permit a one-time transfer or sale of earned but unused ITC's</u>, which would enable carriers with little or no income to utilize such credits.

2 - <u>Authorize refunds for earned but unused ITC's</u>, which would help stimulate capital investment by transportation companies with low or no income -- particularly those with heavy capital investment requirements to meet public service obligations.

3 - <u>Allow full use of ITC's for shorter-lived property</u>, which would stimulate capital outlays for transport equipment having a tax depreciation life or cost recovery period of not less than three years.

4 - <u>Increase the income tax write-off limitation for ITC's</u> by acceleration of the limitation to 90 percent in 1981, and raising it to 100 percent for 1982 and later years.

C - NORMALIZATION - TAA also believes that for changes such as proposed in A and B above to become fully effective in the regulated transportation field the benefits therefrom should be allowed to flow to regulated carriers in the same manner as unregulated firms. This could be done by not permitting regulatory agencies to circumvent Congressional intent by denying or limiting these benefits through steps such as forced reduction of rates and the exclusion from the carrier's rate base that share of property purchased with ITC aid.

Following is a more detailed discussion of each of the recommendations made above, with emphasis on their impact on the transportation industry.

A - CAPITAL COST RECOVERY SYSTEM

To simplify and liberalize the existing ADR system of depreciation, TAA recommends the establishment,effective January 1, 1981, of a capital cost recovery system as proposed in the pending so-called 10-5-3 bill (S. 1435). TAA believes, however, that such legislation should be tailored to leave sufficient net income for utilization of the other tax-incentive measures described below, in a balanced package of which the capital cost recovery system should be one part.

The general reasons for support of such a liberalized system of depreciation are well documented in previous hearings of this Committee. TAA has long favored such an approach as a means of helping transport companies replace equipment whose depreciation allowances are far below the costs of the new equipment. The rising rate of inflation during recent years has, of course, widened this gap, so the need for such a legislative change has increased.

We should again like to emphasize that this should be only one part of a balanced capital stimulation package. As noted previously, the transportation industry contains many companies who cannot utilize the accelerated depreciation proposal because of their poor net income status. Thus, any tax incentives for capital formation should allow room for utilization by all types of companies, despite their present profitability situation. If the new capital cost recovery system is shaped to provide so much more in tax depreciation deductions that no revenue room is left to balance it by inclusion of the other measures proposed in the package, many transportation companies will find the resulting legislation to be of no benefit to them. Some companies will even find themselves disadvantaged by its enactment, since the added benefits will largely be channeled to companies already at an advantage under existing tax-incentive statutes.

B - INVESTMENT TAX CREDIT UTILIZATION

The Investment Tax Credit is an effective, proven, and widely-endorsed mechanism for spurring capital formation and outlays. Capital-intensive industries such as transportation are major creators of ITC's and are thus potential major contributors to economic expansion through use of these credits. During the lifespan of the ITC, the commercial transportation industry has created over 10 percent of all ITC's, but unfortunately it has been able to use only a little over half of these earned credits. This compares to an historic use of ITC's by industry as a whole of about 78 percent. Changes such as proposed below should help close this gap:

1 - Permit a one-time transfer or sale of earned but unused ITC's. One solution is to permit firms which cannot themselves use the ITC to transfer or sell their ITC rights to other companies. Such transferability would immediately compensate the capital investor. It would encourage investments by firms, including many in the transport industry, with large unused ITC's. This, in turn, should stimulate further investments.

The concept of transferability has basis in fact as well as law. A company purchasing new equipment today for the purpose of leasing it can elect to have the credit deduction pass to the user/lessee rather than keep it as owner/lessor.

A properly certified transferable credit could be sold close to its face value, because any taxpayer purchasing it would employ the ITC in lieu of cash in the payment of his taxes. Banks, investment bankers, or corporations per se would negotiate the transaction. Since the instrument would be backed by the full faith and credit of the Treasury, ITC paper would be readily marketable.

Unrestricted transfer of unusable ITC's would eliminate the large volume of ITC's lost today by companies that must "sell" them in the form of leveraged leases, or forego the benefits entirely because of expired capture periods. The mechanism would eliminate the complex transactions and tax problems involved in leveraged leasing. Equipment users would not abandon the residuals or benefits of ownership.

Transferability is logical, straightforward, and simple to administer. It remains wholly within the business sector, which would obviate public and political concern over corporate subsidies. Also, it would directly benefit the many capital-intensive transport companies with little or no taxable income.

2 - Authorize refunds for earned but unused ITC's. The concept of refundability for application to the ITC is another way to stimulate capital formation, especially for transport companies with heavy capital needs and insufficient taxable income. The concept calls for removal of the requirement for tax liability to use ITC's, thus making the credit fair and equitable for all capital equipment investors.

Refundability calls for treating ITC's as credits against the firm's taxes to the extent taxes were due, with any excess credits refunded to the corporate taxpayer. The process is logical within the concept of having the Government support desirable private actions in the general public interest -- as now done via subsidies, price supports, tax penalties, and other mechanisms.

It should be stressed that refundability represents an effective, simple, and fair way to make the investment tax credit available to that sector of American business enterprise which does not realize the cash benefits of the

ITC. Again, we point out that transportation and other companies operating at a tax loss will not realize one dollar of stimulative benefit from a package that only allows larger tax depreciation deductions or larger investment tax credits. Companies in this position include new and small businesses operating at a loss in start-up years, many regulated transportation companies that are an essential part of the nation's transportation system (e.g., airlines, bus companies, barge lines, railroads, trucking companies), and automotive and other manufacturers of transport equipment. Making the ITC refundable would provide immediate stimulus to such businesses.

TAA also believes that making the ITC refundable would be anti-recessionary and anti-cyclical. This is particularly relevant to the economic conditions prevailing in this country at the present time. The existing statutory limitation on the ITC based on amount of federal income tax causes a business suffering a temporary, recession-generated shrinkage of its tax profits and taxes to be less likely to make capital expenditures for investments in productive machinery and equipment. This is because that equipment will cost more when the ITC is not available than it would in a later year when the credit is available. This is exactly the opposite of the result desired in times of an economic down-turn, and tends only to deepen the down-turn instead of to shorten it.

This unfortunate aspect of existing law should be eliminated by making the ITC fully and immediately refundable to any company that does what the credit is intended to stimulate; namely, make expenditures for investment in depreciable machinery and equipment. And it would do this by aiming the incentive at the very business enterprises that may be most adversely affected by an economic down-turn.

A further argument in favor of refundability is that it will actually promote, rather than diminish, competitive conditions for private business enterprises and also combat forces tending toward monopolistic concentration of private business activities. Making the ITC competitively neutral in the economic marketplace is most important. The non-refundable ITC now on the books allows a business that can immediately take the full cash benefit from its use to purchase equipment at a price that is 10 percent less than the price that must be paid for the identical equipment by a competitor able to use the ITC. In other words, an anti-competitive condition has been established not by the activity of any private business but by legislative fiat. The Government, instead of fostering competition in the economic marketplace, is actually pursuing a policy that makes the economically disadvantaged business enterprise grow weaker in relation to the economically fortunate ones. This contributes to business failures or to takeovers by stronger companies.

3 - Allow full use of ITC's for shorter-lived property. TAA proposes that full use of the 10 percent ITC be allowed for assets having tax depreciation lives or cost recovery periods of not less than three years. The objective of this proposal is to remove the severe discrimination under present law against businesses investing in shorter-lived assets. Existing law allows only a 1/3 credit for property with a tax life of three or four years, and only a 2/3 credit for property with a life of five or six years.

The need for such a change has been recognized in the pending Senate bill S. 1435, which would allow a full credit for property with at least a five-year life.

The new capital cost recovery systems proposed under the pending bill would shorten lives and increase depreciation deductions substantially more for businesses investing in longer-lived assets. The discrimination thus added against businesses investing in shorter-lived assets should be at least partially compensated by providing a full credit for the shorter-lived assets. While the credit increases for shorter-lived property made by the ~~two~~ pending bills move a substantial distance in the right direction, the task cannot be considered finished until a full 10 percent credit is provided for property having a tax life or cost recovery period of three or more years.

This proposed change has been recommended in the past by the Treasury Department for the purpose of making the ITC more neutral economically in the marketplace. This change also will simplify the tax law by eliminating the differing rates of credit and by cutting back greatly on operation of the complex investment credit recapture rules. The change will also further the purpose of the credit, as well as the overall purposes of a capital formation tax program, by stimulating capital spending by business and by creating new jobs. A dollar spent by a business for shorter-lived equipment is at least as productive as a dollar spent for other equipment.

4 - Increase the income tax write-off limitation for ITC's. As proven by the recent experiences of both the airlines and railroads (both of which were given higher ITC write-off limits), the acceleration of these write-off limits for all businesses to 90 percent in 1981 and to a full 100 percent in 1982 and later years would provide maximum incentive for all industries with any taxable net incomes to plow back these earnings into productive capital investments and help modernize both small and large companies.

C - NORMALIZATION

To assure that federally regulated transportation companies are not wholly or partly denied the full benefit of capital formation tax incentives (such as the investment tax credit, accelerated tax depreciation or proposed capital cost recovery allowances) enjoyed by other businesses, Congress should take the legislative actions necessary to ensure that no agency or instrumentality of the United States is permitted to circumvent Congressional intention by denying or limiting the benefit of such incentives for regulated industries (through reduction of rates for service, valuation of property, or by any other means).

Because of the problems in the past with transport regulatory agencies' denying carriers the benefits of tax incentives for capital outlays, TAA adopted the following policy directed solely to such actions:

> "The purpose and intent of Congressional legislation granting tax incentives to general and regulated industry for expansion and diversification should not be circumvented by any agency or instrumentality of the United States through interpretations and rulings by which the benefits of such legislation are denied or limited for regulated industries while fully enjoyed by all other industries."

The above policy was used by TAA as the basis for its support of legislation passed in 1964 which barred, under Sec. 203(e), such actions by federal regulatory agencies. However, with lapse of time, changes in federal income tax laws, and increasing uncertainties as to what policies will be adopted or adhered to by federal regulatory agencies and their reviewing courts regarding the treatment of tax incentives in rate making (including property valuation) proceedings, it is important that Congress again express its intent that the full benefits of such tax incentives be enjoyed by regulated as well as unregulated businesses. This is especially important now when consideration is being given to instituting a new capital cost recovery system for federal income tax purposes.

More than 16 years have elapsed since the Revenue Act of 1964 was enacted on February 26, 1964. During the interim, numerous changes have been made in the tax laws; e.g., Sec. 203(e)(1) is no longer applicable, and 203(e)(2) is more limited in scope. In addition, tax incentives other than the investment tax credit, such as accelerated depreciation and a variety of current tax legislative proposals to replace tax depreciation with a new capital cost recovery system, have assumed major importance in the financing of many American business enterprises, regulated and otherwise. Moreover, there is concern that regulatory agencies and their reviewing courts, in the absence of an updated Congressional standard, may not follow the intent of Congress.

Conclusion

In summary, TAA believes that any tax-reform program should include a choice of options to stimulate capital investment in equipment and facilities that will increase productivity, provide meaningful and lasting jobs, conserve energy, and make American industry healthier and more competitive both domestically and internationally.

We believe the package of proposals offered in this statement, if adopted, will help us reach these goals -- and should be of a particular benefit to the nation's transportation industry and its publicly regulated segment. By providing a choice of tax incentives, all industry should be able to benefit, including those not now able to share in the tax incentives for capital formation because of statutory limitations.

TAA thanks the Senate Finance Committee for allowing it to express the views of its membership on this important policy issue, and we shall be happy to work with your Committee and its staff in the development of tax-reform legislation that, in our opinion, is long overdue.

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STATEMENT OF THE TAX COUNCIL

ON A TAX CUT EFFECTIVE IN 1981

SUBMITTED TO THE FINANCE COMMITTEE

U.S. SENATE

July 30, 1980

The Tax Council is a non-profit business membership organization concerned with federal tax policy. Our members represent a wide array of industries including heavy and light manufacturing, mining, transportation, public utilities, consumer products and services, retailing, public accounting, banking and other financial services.

Since its inception in 1967, The Tax Council has emphasized the benefits accruing to all sectors of our economy from increases in our nation's stock of capital. The Council has consistently advocated a tax structure that would encourage capital formation and preservation.

Briefly, The Tax Council makes the following recommendations to this Committee:

(1) It is appropriate to consider tax reduction legislation now to become effective January 1, 1981.

(2) Corporate tax reduction through depreciation reform and rate reduction is of primary importance from the perspective of long-term effectiveness and need for relief of tax obstacles to capital formation.

(3) Individual taxpayers do need relief from the effects of "taxflation".

Before commenting on the timing and desirability of tax legislation, it is important to put such a bill in perspective. No specific tax legislation can substitute for or circumvent monetary and other policies dedicated to reducing the serious inflation we have had for over a decade. Any tax changes now must be consistent with such an effort. This means that (1) any tax changes should not merely bloat the budget deficit in another attempt to stimulate spending in the economy, and (2) they should have specific and realistic goals to improve productivity and reduce inflationary pressures over the long-term.

Timing and Desirability of Tax Legislation

Federal Budget receipts will rise approximately $75 billion in Fiscal 1981 over 1980 due solely to legislated and unlegislated tax increases. This rise will include about $17 billion in additional social security taxes resulting directly from past legislation, the 1977 amendments and before, which will raise the wage base and tax rate during 1981. The Windfall Profits Tax will take another $22 billion. Nuisance tax increases through the "reconciliation" process of the Budget will add $1 billion. And most significantly, the interaction of inflation and the structure of both the individual and corporate income tax will result in an approximate $30 billion unlegislated tax boost. Preventing these hikes from being too big a drag on our weak economy is sufficient reason to cut taxes effective by the first of next year. This should not be viewed as a way of spending our way out of the current recession, but rather to prevent a longer, more severe tax restraint on investment, initiative, and employment in the future.

Despite the thrust of the First Concurrent Budget Resolution, it is no longer possible to pretend that the Federal budget will be in balance or anywhere close to balance in fiscal 1981. The recession's effect on the real growth of the tax base and its automatic triggering of higher transfer payments for unemployment compensation, etc., will overwhelm the First Concurrent Resolution. But while a significant deficit for fiscal 1981 is inevitable, adding large sums to that deficit either through carelessly devised tax policy or new direct spending programs is not. We must resist both courses or concede the likelihood of even higher rates of future inflation with all its economic and social dislocations. In this connection, we consider it essential that any tax cut be carefully designed to avoid such a result. In terms of priority national objectives, the form and direction of the next tax cut is more important than its timing, regardless of the recession.

There does appear to be a wide consensus on what the general shape of the next tax cut should be. There is a consensus that it should be aimed much more at reducing tax obstacles to capital formation and investment than was the case with most tax legislation in the 1960's and 1970's. Given the will to enact a responsible tax program along this line, there is no inherent reason why it cannot be initiated right now and the first phase made effective as of January 1, 1981.

Form and Economic Effects

Tax Council believes the next tax cut, whether enacted in this year or delayed until 1981, should follow the following priorities:

(1) A phased-in capital cost recovery reform of significant dimension - not just a rejiggering of the ADR system.

(2) A tax rate cut for individuals preferably across-the-board and including, in any event, reduction in the top marginal rate from 70% to 50%. An alternative to across-the-board rate cuts in 1981 would be a temporary credit to employers and employees for social security taxes paid.

(3) A small cut in the corporate rate structure itself.

Redesigning our tax treatment of depreciation is most appropriate now because:

(1) The existing system based on the "useful life" concept and historical cost dollars is seriously flawed and unnecessarily complex;

(2) Depreciation allowances constitute over 50% of the total private savings available for new investment, ensuring that changes in their tax treatment will have significant impact on the overall economy.

H.R. 4646, the Capital Cost Recovery Act, is the leading proposal in the depreciation area for this Committee to consider. It virtually eliminates the remaining attachment to the useful life concept and it compensates for the ravages of inflation on our capital base. The system would be mandatory and of simple application eliminating the need for over 100 ADR classifications and salvage value determinations. According to various analyses of the Capital Cost Recovery Act, the first year cost is relatively modest on the order of only $4 billion, held down by a five-year phase-in of the program. Revenue cost would rise significantly after the first year.

The Treasury has objected to the five-year phase-in on the grounds that it would discourage capital spending in the interim by holding out the promise of larger future benefits. If this is a problem, an even longer phase-in procedure should be considered both to smooth the "notch" problem in investment planning and further reduce the near term revenue cost.

As the corporate rate structure itself is still the most basic impediment to capital formation in the corporate sector, a program of phased reductions in the basic rate also should be considered. This would apply to both capital-intensive and labor-intensive industries and would maximize the market system's allocation of funds to productive use. The Council has advocated an objective of five or more steps of corporate rate reduction bringing the top rate down to 35%. For the near term a reduction of two points effective in two steps in 1981 and 1982 should be considered. The initial impact revenue consequences would be approximately $2 billion in 1981 and $4.2 billion in 1982.

On the individual side, from a long term perspective, across-the-board reduction in income tax rates would do the most for equity and efficiency because the rate structure has been the main problem with inflation's tax penalty on individual incomes. Substantial changes have been made in the flat allowances to keep up with inflation but only minor changes has been made in the rate structure. One change in the rate structure is particularly pressing and that is to reduce the top marginal rate from 70% to 50% equalizing the treatment of personal service and investment income. The encouragement to savings and investment per dollar of initial revenue cost of this measure is very high --understandable since the investment potential at that income level particularly for risk investment is very high. While the immediate direct benefit of this measure would be confined to only about 1% of all taxpayers, its revenue cost would be quite modest - on the order of $2-3 billion in initial impact. The effect on net federal revenue after accounting for "feedback" might well be positive because of its very high investment incentive.

The major alternative to across-the-board rate reduction at this time is some form of relief for social security taxes designed to offset the stiff increases in these taxes to take place in 1981 under existing legislation. The leading candidate, H.R. 7046, would allow a temporary refundable 10% income tax credit against social security taxes paid by both employers and employees.

There are some advantages to this approach as a short term relief measure. It would reduce labor costs and have some positive effect on maintaining employment. As a precedent for future tax policy, the plan is more troublesome. Technically, it does not involve general revenue financing of social security because no change would be made in the payroll tax trust funds. But it leads away from solving the basic problem. Social security taxes have become very onerous because a benefit structure has been fashioned without sufficient care as to the demographics and the economy's ability to carry it. Obviously, an income tax credit would do nothing about this problem.

H.R. 7046 is designed as a temporary measure to apply to 1981 and 1982 only. And in this case, its temporary nature may be a redeeming feature. Should Congress choose to adopt this approach, we should emphasize that the rest of the program should be permanent, aimed at long range objectives.

As a rough order of magnitude a package along the lines we have recommended would carry an initial revenue cost of approximately $20 billion in 1981. Such a program should be split about 50/50 between the corporate/capital formation sector and individuals (assuming that individuals bear the full burden of payroll taxes including both the employer and employee portion.)

Restructuring the System

The above recommendations are designed as a step in a more far reaching program to remove tax obstacles to capital formation. As such, they are consistent with a long-term restructuring of the income tax system. High on the list for future steps in the program beyond 1981 are:

(1) A continuation of gradual rate reduction both individual and corporate.

(2) Consideration of more liberal tax treatment of research and development expenditures.

(3) Resolution of the problem of double taxation of corporate earnings.

Whether or not future development of a restructuring program can be implemented without replacement revenues will depend on: our success in controlling the expenditure side of the budget, and our ability to focus carefully on phased-in relief measures that will have the maximum impact on productivity and help build a better revenue base.

SUMMARY STATEMENT OF FRANK E. McGRATH
DIRECTOR OF TAXES, CENTRAL TELEPHONE & UTILITIES CORPORATION
ON BEHALF OF THE UNITED STATES
INDEPENDENT TELEPHONE ASSOCIATION

Mr. Chairman and members of this Committee, my name is Frank E. McGrath. I am Director of Taxes of Central Telephone & Utilities Corporation.

I am testifying today as a representative of USITA, The United States Independent Telephone Association.

USITA represents the almost 1,500 independent telephone companies not affiliated with the Bell System, has one-quarter of the 4.5 million industry shareholders, and serves one-half of the entire geographic area of the U.S.

The Question of a Tax Cut and Its Effects

In the last decade, the United States has experienced an unprecedented period of inflation, averaging over eight percent each year. And 1980's rate is running ahead of that average. The U.S. is behind many countries in adapting its institutions and tax laws to counter inflation.

A permanent reduction in the inflation is preferable to adaptive policies, but this will not happen overnight. In the meantime, adaptive policies can improve the prospects for productivity, reducing inflation in a significant way.

While productivity growth was high through the 1960's, its growth over the last decade has been a subject of concern. By most measures - income per employee, output per manhour - it appears that growth has decelerated in the 1970's, and may have stagnated over the last year.

Personal savings as a percentage of disposable income and GNP also have been declining since the early 1970's. This decline is partially because private savings in the U.S. are quite sensitive to variations in real net-of-tax rates of return. As inflation has pushed up nominal rates of return on investment, the progressive tax structure has eroded those of return. Thus, real rates have fallen - and with them, real savings as Americans attempt to keep the level of consumption steady.

In addition, the remaining real savings have been diverted away from productive investments, such as equities, and into real estate, private housing, and speculative commodities, as investors search for safety and a hedge against inflation. As Treasury Secretary Miller testified before the Ways and Means Committee last November, an increase in business's demand for capital, without a corresponding incentive to increase the supply of capital, merely produces an increase in the cost of capital - namely interest rates.

Private savers are not the only ones affected by inflation. A 1979 study found an inflationary impact on corporate taxes, as well. Although present since 1954, it had been relatively small through 1970. But since 1970, the "excess" tax attributable solely to the reduction in the real dollar value of depreciation has been doubling every three years. The study concluded that the effect of inflation was to raise the effective tax rate in the nonfinancial corporate sector from 43 percent to 66 percent in 1977.

What is necessary is to restore the incentive to save, and to channel those funds into productive investments.

We believe that a Federal tax cut would have a significant positive effect on both sides of the money-goods equation. A tax cut would encourage savings and capital formation and provide business with the means to retain more of its capital invested in productive assets. Such a move is the necessary first step in bringing down inflation and interest rates, spurring capital formation, and creating more private sector jobs.

Therefore, a properly formulated tax cut, to be effective for 1981, should be a top priority for the Congress.

Form and Composition of A Tax Cut

Current economic conditions warrant a tax reduction approximately $25 billion, to be shared equally by business and individuals.

USITA urges that two proposals, which have already received considerable attention, be part of a 1981 tax cut:

1) The Capital Cost Recovery Act, introduced as S. 1435, and
2) The Deferral of Taxation on Reinvested Dividends, a concept embodied in S. 1543.

These two proposals are particularly attractive because they remove the disincentives to savings, provide badly needed capital, and mitigate - and in fact reverse - inflationary trends in today's economy.

A general rate reduction for individuals or similar measures which provide supply-side relief are also appropriate.

Specifically, depreciation reform is necessary because present Federal tax policy acts as a disincentive to investment. Current tax law delays capital recovery until after an asset becomes obsolete and after inflation has eroded the real value of the amounts recovered.

There are three vital reasons for enacting a new, rapid capital recovery allowance system.

The first and most important is the overall economic benefit which would result. A faster rate of recovery on productive assets would increase internally generated capital; reducing the demand and lowering the cost of external capital.

Second, a simplified system would extend the benefits of rapid recovery, both small and large American businesses, without the restrictions and inhibitions of today's complex recordkeeping and accounting rules. IRS/taxpayer audit controversies also would be reduced dramatically.

Third, faster recovery would reduce the erosion of capital which inflation causes under the existing long depreciation periods dictated by the "useful lives" concept. Even at an annual inflation rate of 10%, for each $1 million the industry invests in plant today, using a composite life of 16 years, it will recover slightly less than one half this amount, measured in terms of real dollars.

USITA also endorses language contained in the Act which mandates the "normalization method" of accounting for these tax benefits. This is a continuation of current policy, codified in Section 167 (1), and must be continued to resist the "Phantom tax" arguments of industry critics. Current limitations on rate regulation are essential to assure the financial integrity of members of the industry.

A necessary complement to the investment demand-oriented depreciation reform is deferral of taxation on reinvested dividends. It is a needed and desirable tax reduction for the individual.

This proposal would:

1) Represent an immediate spur to capital formation.
2) Stimulate savings and productivity.
3) Increase Treasury receipts within three years.
4) Provide for fairer tax treatment of shareholders, and
5) Principally aid small shareholders.

By channeling funds away from consumption and into savings, this proposal relieves upward pressures on interest rates. Because dividend reinvestment is both investment generating and deflationary, USITA believes that it will be beneficial to the nation as a whole. It is the most efficient vehicle for injecting new capital into the U.S. economy.

We also note that a dividend deferral program might be a first step in an integration of corporate and individual taxation.

The complexities and inequities of our current system are legion drawing sharp criticism from all quarters.

Depreciation reform in the name of simplicity, and integration of corporate and individual taxes, in the name of equity, should be the initial phase of a broader restructuring of our system.

Conclusion

Inflation, with its persistent deleterious effects on interest rates, capital formation, and unemployment has increased the uncertainty business must face in the U.S. And as importantly, it has, in combination with the present tax code, greatly increased the necessary return on new investments, reduced the potential benefits of new savings, and sent the economy on a consumption-oriented spree which this country can ill afford. Both the rate of capital growth and development of new technology have slowed as a result, contributing to a fall in productivity.

Thus, bringing down the inflation rate remains the first priority of any Federal tax policy. USITA believes that the three policies outlined

1) depreciation reform,
2) deferral of taxation on reinvested dividends, and
3) general tax relief for individuals,

are both deflationary and provide the proper incentives for savings and new capital formation.

Accordingly, USITA urges this Committee that they be made a part of a 1981 tax cut.

STATEMENT OF FRANK E. McGRATH
DIRECTOR OF TAXES, CENTRAL TELEPHONE & UTILITIES CORPORATION
ON BEHALF OF THE UNITED STATES
INDEPENDENT TELEPHONE ASSOCIATION

Mr. Chairman and members of this Committee, my name is Frank E. McGrath. I am Director of Taxes of Central Telephone & Utilities Corporation.

Before joining Centel in early 1979, I was a Tax Manager with the international public accounting firm of Arthur Andersen & Company, where my practice consisted primarily of regulated industries and international taxation.

I am testifying today as a representative of USITA, The United States Independent Telephone Association.

USITA represents the almost 1,500 independent telephone companies not affiliated with the Bell System. These companies own 19 percent of the country's 175 million phones and 20 percent of the $155 billion U.S. telephone plant. Independent telephone companies spent 20 percent of the $21 billion used for industry construction for 1979, and accounted for 17 percent of the $55 billion in 1979 industry revenues. Independents employ 18 percent of the one million industry workers, have 25 percent of the 4.5 million industry shareholders and serve one-half of the entire geographic area of the U.S.

The Question of a Tax Cut and Its Effects

USITA believes that tax policy is a large part of the key to opening the lock which inflation and declining productivity have put on our economy.

In the last decade, the United States has experienced an unprecedented period of inflation, averaging over eight percent each year. And 1980's rate is running ahead of that average. By standards of some other countries, such as Brazil or even the United Kingdom, this rate is modest. However, the U.S. has been slower than many other countries in adapting its institutions and tax laws to counter inflation.

It is worth noting that such adaptive policies would not be necessary in an economy with little or no inflation. And while a permanent reduction in the inflation rate is preferable to adaptive policies, this will not happen overnight. In the meantime, such policies not only improve the prospects for productivity, but also can contribute to such a permanent reduction in inflation in a significant way.

In the United States, as in any free-market economy, savings are critical for productivity. Savings provide the resources for investment.

Technological change is also an engine which drives productivity, and which is in large measure fueled by savings. Robert Solow estimated that 90 percent of the increase in output per capita in the United States from 1909 to 1949 was attributable to technological change.[1] Edward Denison, considering factors such as improved education and economies of scale, found it to be closer to 50 percent, from 1930 through 1957.[2]

However, the growth of productivity over the last decade has been a subject of concern. By most measures employed - income per employee, output per manhour - it appears that growth has decelerated in the 1970's, and may have stagnated during the last year.

Why this has happened is unclear. However, it may be instructive to note that the percentage of GNP devoted to Research and Development fell over much the same period from 2.97 percent to 2.25 percent. Dr. Edwin Mansfield suggests that it may be that the profitability of such expenditures stabilized or fell off during this period.[3]

It is also instructive to note that personal savings as a percentage of disposable income and GNP have also been declining since the early 1970's. (Appendix A). These are the funds which the private sector must have to grow, in real terms.

The decline is partially attributable to the fact that private savings in the U.S. are quite sensitive to variations in real net-of-tax rates of return. In a 1978 study, M. Boskin noted that for every 1 percent change in the real interest rate, real savings change by 0.4 percent.[4] As inflation has pushed nominal rates of return on investment upward, the progressive tax structure has eroded real after-tax rates of return. Therefore, real rates have fallen - and with them, real savings as Americans attempt to keep the level of consumption steady.

Congress enacted a series of tax cuts between 1960 and 1975 (Appendix B) which kept real tax rates almost constant over that period. However, since that time inflation has accelerated, and the Federal tax cuts in 1976, 1977, and 1978 have not been enough to prevent real tax rates from rising. Without a tax cut in 1980 or 1981, the real rates may rise above the historical high of 1969.

As if this were not enough, the remaining real savings have been diverted away from productive investments (equities, manufacturing assets, etc.) and into real estate, private housing, speculative commodities, and other investment mediums as investors searched for safety, higher returns, and a hedge against inflation. As Treasury Secretary Miller noted in his testimony before this Committee last November,[5] an increase in business's demand for capital, without a corresponding incentive to increase the supply of capital, merely produces an increase in the cost of capital - namely interest rates.

Therefore, USITA believes that it is necessary to restore the incentive to save, and to channel those funds into productive investments.

This would produce a ripple effect throughout the economy - bringing down nominal interest rates and inflation, while providing more funds for real growth in the private sector.

The phenomenon of reduced real after-tax rates of return is not restricted to private savers. Because the current tax system does not differentiate between real and nominal returns to capital, tax liabilities measured in absolute dollars rise with inflationary corporate profits, depressing real after-tax income and thereby depressing retained funds available for reinvestment.

In a 1979 study, Feldstein and Summers[6] found an inflationary impact on corporate taxes as well. This had been present since 1954, but had been relatively small through 1970. But since 1970, the "excess" tax attributable solely to the reduction in the real dollar value of depreciation has been doubling every three years. They concluded that the effect of inflation was to raise the effective tax rate in the nonfinancial corporate sector from 43 percent to 66 percent in 1977.

Coupled with the diminished amounts of private savings and an increase in the cost of those funds, this reduction of available capital has put tremendous restrictions on productivity. This is due in part to secondary effects of inflation and corporate taxation.

First, the interaction of inflation and taxation affects the allocation of investment, favoring short-lived assets and penalizing large, heavy-capital investment. Since, to some degree, there is a need for longer-gestating, longer-lived projects to take advantage of technology, this is a particular problem for most U.S. industries. Second, because of the tax advantage associated with debt, corporations have tended to finance more of their activity by debt and less by equity. This further erodes the equity base, upon which debt may be added for financing additional productive assets. For example, among most utilities $1 of equity will result in $3 of productive assets, whereas $1 in debt produces only $1 in productive assets (Appendix C).

This is again a particular problem in our industry because the industry is capital intensive. On the average, we require about $2.60 of capital investment to generate $1 of revenue, compared with $.50 of capital required for manufacturing operations. We generate only 70 percent of our capital internally, with the rest coming from stockholders and bondholders.

Mr. Robert LaBlanc, Vice-Chairman of Continental Telephone Corporation, has testified[7] before the House Ways and Means Committee, that the industry is already in the incubator stage of a "telecommunications revolution", with 47 percent of U.S. GNP attributable to the information business.

Numerous examples exist of the tremendous technological leaps the telephone industry has made in the last two decades, which have been marked by thousand-fold improvements in cost, size, speed, capacity and reliability.

But these advances have not been made without the commitment of staggering amounts of capital. According to the investment banking firm of Solomon Brothers, utilities, including the telephone industry, accounted for 39 percent of all public debt and equity offerings from 1975 through 1979. In 1980 alone, we expect the capital requirements for the industry to reach approximately $22 billion.

USITA, therefore, believes that a tax cut which encourages capital formation will keep the industry's level of productivity and productivity growth on an upward trend, producing real growth, and abating inflationary trends.

As we know, American business - a healthy American business - creates jobs when it has the capital and resources that it needs. And to obtain these resources, both private savers and corporations must be encouraged and assisted in channeling available funds into productive assets.

A Federal tax cut would have a significant positive effect on both sides of the money-goods equation, by encouraging savings and capital formation (removing the disincentives), and by providing business with the means to retain more of its capital to invest in productive assets. Such a move will be the necessary first step in bringing down inflation and interest rates, spurring capital formation, and creating more private sector jobs.

Therefore, a properly formulated tax cut, to be effective for 1981, should be a top priority for the Congress.

Form and Composition of a Tax Cut

USITA recommends that tax relief be provided to both business and individuals. Current economic conditions warrant a tax reduction approximating $25 billion, to be shared equally by business and individuals.

USITA urges that two proposals, which have already received considerable attention, should be part of a 1981 tax cut. These proposals are:

1) The Capital Cost Recovery Act, introduced as S. 1435 in the Senate, and H.R. 4646 in the House, and
2) The Deferral of Taxation on Reinvested Dividends, a concept embodied in S. 1543 and H.R. 654, H.R. 5665.

These two proposals are particularly attractive because they meet the criteria previously discussed for removing the disincentives to savings, providing badly needed capital, and mitigating - and in fact reversing - inflationary trends in today's economy.

As noted, it is not enough to simply stimulate the demand for capital - the supply, furnished by individual savers, must also be encouraged. A general rate reduction for individuals or similar measures which provide supply-side relief are also appropriate.

Specifically, depreciation reform is necessary because present Federal tax policy acts as a disincentive to investment because it requires the taxpayer to depreciate the cost of fixed assets over their estimated physically useful lives. This traditional approach to depreciation, as applied to the telephone industry, is not accurate or realistic due to the forces of technological change, inflation and competition. Current tax law acts to delay capital recovery until after an asset becomes obsolete and after inflation has eroded the real value of the amounts recovered.

The dramatic technological improvements in our industry during the last 10 years have allowed the industry to meet the demands for ever-increasing, sophisticated requirements without substantial cost increases to the user. But in order to maintain the best telephone system in the world, as the United States now has, we must have a more rapid recovery of our depreciable plant costs.

Many other countries have stimulated capital investment and productivity increases through improvement of their capital recovery allowances. The opportunity now exists for the U.S. to do the same.

There are three vital reasons for enacting a new, more rapid capital recovery allowance system.

The first and most important is the overall economic benefit which would result. A faster rate of recovery on productive assets would increase internally generated capital; reducing the demand, and lowering the cost of external capital. The resulting expansion and modernization of the industry's capacity would improve productivity, in turn easing price pressures.

Second, a simplified system would extend the benefits of rapid recovery to all segments of American business, both small and large, without the restrictions and inhibitions of today's complex recordkeeping and accounting rules. IRS/taxpayer audit controversies also would be reduced dramatically.

The Subcommittee on Access to Equity Capital and Business Opportunity of the House of Representatives released its report, "Capital Formation and Retention," on January 10, 1980. In that report, the Subcommittee noted that simplicity is one of three criteria important to any capital recovery system (the others being equity and recovery period). It further noted that the current Class Life Asset Depreciation Range system was an attempt to provide that simplicity, but the report stated that system is still too complex.

It is generally conceded, that in fact the Subcommittee maintained in its findings, that, ". . .one of the major constraints on internal capital retention has been the inability of small capital intensive firms to easily and quickly recover their costs of capital, due to the complexity of the current depreciation schedules in the tax law. . .".

Treasury Secretary Miller,[8] testifying before the Taxation and Debt Management Subcommittee on the proposed Capital Cost Recovery Act, noted that the present depreciation conventions are onerous, cumbersome and complex, and need simplification. A reformation of today's system is a desirable goal in itself, and the proposed Capital Cost Recovery legislation is an appropriate vehicle.

Third, faster recovery would reduce the erosion of capital which inflation causes under the existing long depreciation periods dictated by the "useful lives" concept. Even at an annual inflation rate of 10 percent and using approved accelerated tax depreciation methods, for each $1 million the telephone industry invests in plant today, using a composite life of 16 years, it will recover slightly less than one half this amount, measured in terms of real dollars.

While the recovery of capital under traditional concepts has been viewed historically as accurately reflecting true income, today's unprecedented rate of inflation requires a reexamination of those concepts. The Securities and Exchange Commission recognizes the adverse impact of inflation on reported income of publicly-traded companies. The Commission has consistently pressed for corporations to disclose the impact of inflation on their ability to recover their capital costs, and replace existing capacity.

The Capital Cost Recovery Act addresses the same concerns, and significantly counteracts the effect of inflation on taxpayers' ability to replace existing capital assets and capacity.

Any capital recovery legislation should have as its primary goal the benefit of the national economy as a whole, rather than the benefit of a selected segment of the economy.

USITA believes that the Act meets this test, and therefore, strongly urges this Committee include it in any proposed 1981 tax cut.

USITA also endorses language contained in the Act which mandates the "normalization method" of accounting for these tax benefits. This is a continuation of current policy, codified in Section 167 (l), and <u>must</u> be continued to resist the "phantom tax" arguments of industry critics. Current limitations on rate regulation are essential to assure the financial integrity of members of the industry.

A necessary complement to the investment demand-oriented depreciation reform is deferral of taxation on reinvested dividends. It is a needed and desirable tax reduction for the individual.

By channeling funds away from consumption and into savings, this proposal relieves upward pressures on interest rates. Increasing the supply of funds relative to demand results in a real increase in the formation of needed equity capital, reducing inflation while aiding productivity. Because dividend reinvestment is both investment generating and deflationary, USITA believes that it will be beneficial to the nation as a whole, and capital intensive industries as well. It is the most efficient vehicle for injecting new capital into the U.S. economy.

Mr. Robert LaBlanc of Continental Telephone has previously testified before the House Ways and Means Committee on the benefits of such a proposal.[9] We would like to reiterate some of those benefits. The proposed legislation would:

1) Represent an immediate spur to capital formation at a time of a conceded crisis in that area;
2) Stimulate savings and productivity;
3) Increase Treasury receipts within three years;
4) Provide for fairer tax treatment of shareholders by reducing the inequitable double taxation of dividends; and
5) Principally aid small shareholders.

In the same testimony, Mr. LaBlanc pointed out that 85 percent of participants in Continental's dividend reinvestment program own less than 200 shares each. And Mr. William Malone, Vice President of General Telephone & Electronics, in testimony before the Senate Finance Committee, pointed out that 84 percent of his company's participants owned 100 shares each or less.[10] At my own company, Central Telephone & Utilities Corporation, 66 percent of the participants in our plan own less than 200 shares each, and over 87 percent own less than 500 shares each. Clearly this would be a boon to the small investor.

A statement was also presented to the House Committee in January, 1980 by Mr. Herbert B. Cohn[11], which estimated that the effect of deferral of dividend taxation would be to:

1) Increase dividend reinvestment to about $2.5 billion;
2) Increase national output by approximately $2.7 billion annually;
3) Increase business fixed investment by about $1 billion annually;
4) Add about 50,000 jobs per year; and
5) Involve a net revenue loss of some $350 million in the first complete year of operation, a wash in the second year, and an annual net revenue gain of $600 million in the third year and thereafter.

This proposal would be particularly beneficial because of the telephone industry's dilemma. We are one of the most capital intensive industries in the country, with a voracious appetite for new capital which is absolutely required by our customer's demands for sophisticated and reliable service. Yet we are poorly received in the equity markets and discriminated against by the present tax code.

Between 1965 and December 1979, the Standard and Poors Industrial Index rose 20 percent, while the Utility Index, excluding AT&T, fell 40 percent. The mean average rate of return for utilities is only two-thirds that of non-utilities (13.63 percent vs. 20.75 percent). Further, utility shares, with a current market price of 1.16 times book value, sell at only 60 percent of the corresponding 1.95 figure for non-utilities. As of December 31, 1979, 9 out of the 17 largest U.S. telephone utilities had a market to book ratio of less than one, as did 97 out of the 100 largest electric utilities, and 16 out of the 25 largest gas distribution companies.

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To compensate for these disadvantages, utilities must pay higher dividends out of earnings, and, in lieu of increasing equity, issue more debt.

Among major utilities, electric companies in 1978 averaged a 11.2 percent yield with a 77 percent payout, gas distribution companies yielded an average 8.7 percent with a 60 percent payout, while telecommunications companies averaged a 9.2 percent yield with a 62 percent payout.

Utilities have fared no better in the credit market. Utility debt issues have, on balance, been downgraded by Moody's and Standard & Poor's, the two leading private bond rating houses. The outlook here could even get worse if state regulatory authorities follow the lead of the California Public Utilities Commission, which recently forced a rate refund which in turn could result in reduced Federal tax credits due Pacific Telephone & Telegraph. Utilities were especially hard hit by last year's explosion in interest rates, since the higher cost of credit can be passed on to the ratepayer only if state authorities prove cooperative. Unfortunately, they have not proven to be so where rate increases are involved.

A simple example illustrates the squeeze on telephone utilities. Since we must invest $2.60 to generate $1 of income, and can generate only 70 percent internally, we must raise 30 percent ($.78) in the marketplace. The typical manufacturing corporation needs a $.50 investment to earn that same dollar of income, of which 55 percent is generated internally, and 45 percent ($.22) is raised externally (Appendix D). Thus, for the same dollar of income, telephone utilities must raise six and a half times as much internally, and three and a half times as much in the open market.

In order to attract investors, the utilities must have a significantly higher dividend payout ratio than non-utilities. Thus, while an industrial firm may provide a return to investors through growth -- on which taxation is deferred and then taxed at capital gains rates - utilities must pay out a substantial part of earnings, which are taxed currently at ordinary rates.

In the face of this bleak capital market picture, utilities find themselves sorely in need of an alternate external source of capital and equitable tax treatment for its investors. Dividend reinvestment is a proven method.

We would also note that a dividend deferral program might be a first step in an integration of corporate and individual taxation. The complexities and inequities of our current system are legion drawing sharp criticism from all quarters.

Depreciation reform, in the name of simplicity, and integration of corporate and individual taxes, in the name of equity, should be the initial phase of a broader restructuring of our system.

Conclusion

Inflation, with its persistent deleterious effects on interest rates, capital formation and unemployment, has increased the uncertainty business must face in the U.S. As importantly, inflation in combination with the present tax code, has greatly increased the necessary return on new investments, reduced the potential benefits of new savings, and sent the economy on a consumption-oriented spree which this country can ill afford. Both the rate of capital growth and development of new technology have slowed as a result, contributing to a fall in productivity.

Thus, reducing the inflation rate remains the first priority of any Federal tax policy. USITA believes that the three policies outlined above:

1) depreciation reform,
2) deferral of taxation on reinvested dividends, and
3) general tax relief for individuals,

are both deflationary and provide the proper incentives for savings and new capital formation.

Accordingly, USITA urges this Committee that they be made a part of a 1981 tax cut.

FOOTNOTES

1 R. Solow, "Technological Change and the Aggregate Production Function", Review of Economics and Statistics, (Aug., 1957).

2 E. Denison, "The Sources of Economic Growth in the U.S.", Committee for Economic Development, 1962.

3 E. Mansfield, "Economic Growth or Stagnation", National Planning Association, (Spring, 1980).

4 M. Boskin, "Taxation, Saving and the Rate of Interest", Journal of Political Economy, (April, 1978).

5 W. G. Miller, "Testimony Before the House Committee on Ways and Means", Department of Treasury News, M-186, (November, 1979).

6 Feldstein and Summers, "Inflation and Taxation of Capital Income in the Corporate Sector", National Bureau of Economics Research, WP No. 312, (January, 1979).

7 R. LaBlanc, "Summary Testimony on Behalf of USITA, Before the Ways and Means Committee of the House of Representatives", (January, 1980).

8 W. G. Miller, "Testimony Before Senate Finance Taxation and Debt Management Subcommittee", October 22, 1979.

9 R. LaBlanc, op. cit.

10 W. Malone, "Summary Testimony of William Malone, Vice President, General Telephone and Electronics Corporation, on behalf of the United States Independent Telephone Association, before the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance", October 31, 1979.

11 H. B. Cohn, "Statement of Mr. Herbert B. Cohn, Committee for Capital Formation Through Dividend Reinvestment, filed with House Committee on Ways and Means, Hearings on Tax Incentives for Savings," January 29, 1980.

Appendix A

U.S. SAVINGS TRENDS

(PERCENTAGES)

	Personal Savings as a Percent of Personal Disposable Income	Personal Savings as a Percent of GNP
1970	7.4	5.2
1971	7.7	5.4
1972	6.2	4.2
1973	7.8	5.4
1974	7.3	5.1
1975	7.4	5.5
1976	5.7	4.0
1977	5.0	3.4
1978	4.9	3.4
1979	4.5	3.1

Source: Economic Report of the President, 1980.

Appendix B

FEDERAL INCOME TAXES AND PERSONAL INCOME, 1960-1979
(BILS.)

YEAR	PERSONAL INCOME	FEDERAL INCOME TAXES $	FEDERAL INCOME TAXES % OF PERSONAL INCOME	FEDERAL INCOME TAXES WITHOUT AD HOC CUTS
1960	$ 401.3	$ 39.7	9.9 %	9.9%
1962	438.4	45.6	10.4	
1963	462.3	47.6	10.3	
1964	490.4	48.7	9.9	11.6
1965	527.3	48.8	9.3	
1966	576.8	55.4	9.6	
1967	625.6	61.5	9.8	
1968	674.9	68.7	10.2	
1969	740.4	87.2	11.8	
1970	803.0	90.4	11.3	12.9
1971	858.2	86.2	10.0	
1972	928.8	94.7	10.2	
1973	1,033.2	103.2	10.0	
1974	1,147.6	119.0	10.4	14.9
1975	1,251.9	122.4	9.8	
1976	1,372.8	131.5	9.6	
1977	1,547.9	157.8	10.2	
1978	1,726.4	181.0	10.5	
1979[1]	1,924.2	217.8	11.3	
1980[1]	2,137.6	234.2	11.0	
1981[1]	2,372.6	277.2	11.7	
1982[1]	2,626.1	322.8	12.3	
1983[1]	2,884.3	370.0	12.8	
1984	3,153.6	421.9	13.4	

[1] Estimates based on current law.

SOURCE: Office of Management and Budget

Appendix C

COMPARISON OF ASSETS AND EQUITY INVESTMENT
50 LARGEST UTILITIES

($000,000)

YEAR	ASSETS	EQUITY	RATIO
1979	$338,133	$119,358	2.8
1978	302,041	114,941	2.6
1977	275,629	105,541	2.6
1976	252,743	95,745	2.6
1975	232,238	87,485	2.7
1974	214,[illegible]1	80,324	2.7
1973	181,206	72,555	2.5
1972	171,875	68,196	2.5
1971	154,191	61,720	2.5
1970	131,846	53,668	2.5

Source: FORTUNE

Appendix D

SOURCES OF CORPORATE FUNDS
(BILLIONS)

	INTERNAL CASH GENERATION		NET NEW DEBT		NET NEW EQUITY		TOTAL	
	Amount	%	Amount	%	Amount	%	Amount	%
YEAR								
1975	$104.6	72.1	$ 30.5	21.0	$9.9	6.8	$145.0	100%
1976	132.5	68.6	51.2	26.5	9.5	4.9	193.2	100
1977	139.6	61.7	80.8	35.7	5.9	2.6	226.3	100
1978	152.1	60.7	94.8	37.9	3.5	1.4	250.4	100
1979E	149.5	54.8	121.2	44.4	2.3	0.8	273.0	100

SOURCE: Federal Reserve Board of Governors, Flow of Funds

COMMITTEE FOR SMALL BUSINESS EXPORTS

Statement of

Richard C. Fenton
President
Fenton International, Inc.

On behalf of the

Committee for Small Business Exports (COSBE)

submitted to the

Committee on Finance

United States Senate

August 1, 1980

I appreciate the opportunity to testify on the advisability of the enactment of a tax cut this year to be effective in 1981.

My name is Richard C. Fenton. I am President of my own small company of Management Consultants, Fenton International, Inc., which helps small and medium size companies develop their international business. I am also representing the Committee for Small Business Exports (COSBE), of which I am President. The Committee for Small Business Exports (COSBE) has been operating just over 1 year, and has a membership of more than 50 companies in 23 States from Coast to Coast. All the members are smaller companies, well below the Fortune 1000 in size, and all are manufacturers, traders, or consultants involved in exports from a variety of industries. Although the number of our actual members is at present relatively small, it is growing steadily all the time. We also know that several associations of smaller companies around the country are sympathetic to our principal

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recommendations. Very similar recommendations were also made by the White House Conference on Small Business. So we believe we speak for thousands of smaller companies which are involved in exports.

In our opinion, a tax cut is urgent and its enactment should not be delayed. A tax cut should be designed first to ease the so-called fiscal drag on the economy as a whole, which most experts seem to regard as very serious for 1981 and beyond. You will certainly hear from greater experts than I on this subject. Secondly, the tax cut should be designed to stimulate productivity, innovation, savings/investment and exports. I want to concentrate on the last of these, first because it is the field of my expertise, and second because I suspect it may be the most neglected by other witnesses.

Stimulation of exports may be the most urgent of the considerations, in view of our continuing massive trade deficits. These deficits cause downward pressure on the value of the dollar, exacerbate domestic inflation by increasing the cost of imports, put upward pressure on domestic interest rates, and hobble the ability of the United States to play a leadership role in the world. The balance of payments current account may have been theoretically in balance in 1979, but this was achieved by statistical sleight of hand, since the balance was arrived at after counting on the plus side many billions of dollars of

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earnings of direct foreign investments which in fact were reinvested locally abroad and not repatriated.

I know that proposals have been put forward which are designed to stimulate innovation, productivity and savings, including the proposed Tax Restructuring Act, and some of these will have a favorable effect on exports. There are other measures now being considered by the Congress, such as the Export Trading Company Act, which will help, but none of these will, in my opinion, have enough effect to lift the proportion of GNP going to export from the present 7% or 8% to a minimum of 10%-12%, which is what is needed to pay for the increasing volume and rising costs of imports. Just as there needs to be a major shift in the economy from consumption to savings, so there must be a major shift from production for domestic consumption to export.

In our opinion, this shift to exports will not take place without deliberate and direct fiscal stimulation. It will not take place if we rely on a cheaper dollar, which is harmful in itself beyond a certain point. It will not take place if steps are only taken to improve innovation, productivity and savings. Something more must be done, at least for smaller companies, to persuade managements to put more of their time and resources into the effort to build exports. In fact, the better the conditions in the domestic market, the greater the need to improve the attraction of exports.

A sufficient shift to exports will also not take place just by adding people, money and programs in Government agencies. They

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can encourage companies to export, can point the way, assist, and sometimes get out of the way. But Government agencies cannot do the marketing in foreign countries from a production base in the U. S. It is the independent company and its management that must find the will and the means to do the job. And it must see the profit in doing so. The independent company, particularly the smaller company, needs incentives. The incentives should make more profit and cash flow available to do the job.

In the short run, only the large multi-national corporations can make a major contribution to the solution of this problem since they are the large exporters and the source of repatriation of income from their production abroad. On the other hand, perhaps they are already doing everything they can do. Certainly, in the long run, the solution is going to depend on the thousands of smaller companies which are already exporting and on many other thousands of smaller companies which could export but are not now doing so to any significant extent. There is plenty of evidence that smaller exporting companies can become large exporters in a matter of a very few years. The key is incentives.

Action needs to be taken without further delay to improve the incentives for smaller companies to export more.

The only real incentive at the present time is the Domestic International Sales Corporation or DISC. It would be easier to improve the DISC than to think out and put in place some new incentive.

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Based on the data in the Treasury's 1978 DISC Annual Report, there are now probably 7,000-8,000 active DISCs out of over 12,000 elections. What is often overlooked is that most of these DISCs are owned by smaller companies. They have to be because of the large numbers. Also, the report shows that not only do more than 50% of the DISCs have export gross receipts under $1 million, and more than 80% under $10 million, but also of the parent companies of the DISCs, about 80% had assets under $50 million, almost 60% had assets under $10 million, and almost 50% had assets under $5 million.

The experience of individual smaller companies which have used DISC reinforces the argument that DISC has been an important incentive for them. We have seen a substantial number of letters from such companies attesting to this. A number of common threads run through these letters. Companies which had not been exporting previously began to do so because of DISC ... companies which once did not place emphasis on exporting now do so because of DISC ... companies which had considered moving production facilities overseas maintained them in the United States because of DISC ... companies which found their export growth stunted because of their inability to make available competitive credit were able to use DISC to do so ... companies which found themselves continually short of investment and working capital have been able to use DISC funds to improve their availability of capital.

The increased profit and cash flow generated by DISC act to stimulate exports in three ways. First, most important, and most often

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underrated, company managements are stimulated to begin or expand export operations, and excouraged to spend more time, effort and resources on exports. Second, DISC provides the productive capital and cash flow for expanding existing export business. Third, DISC encourages companies to service export markets by manufactruring in the U. S. rather than abroad or through licencing agreements.

The key to the DISC concept is the fact that taxes on qualified export income are deferred--but only as long as the deferred taxes are reinvested in the export business. DISC results in the building of a capital fund that grows and is continuously reinvested in specified export activities and assets.

Among the most common export-related assets in which DISC-deferred taxes have been reinvested over the years of DISC's existence have included:

Export receivables, where the DISC funds are used to extend and finance credit to foreign buyers and to reduce the risk and higher costs of carrying accounts receivable on export shipments, which normally require longer payment periods than domestic sales;

Funds for initiating, expanding, and improving export marketing and promotion programs;

Producer loans, whereby DISC funds are made available to the DISC's parent for investment in new, expanded, or modernized facilities, to produce goods for export, and to develop products adapted to export markets.

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The principal objection we have heard to improving the DISC for smaller companies is that objection to the whole DISC program has been raised in the GATT. This is discussed in the Treasury's Annual Report for 1978. The heart of the objection is, apparently, that no interest is charged on the deferred taxes. If we compare this objection to the major objections that have been raised to the incentives and subsidies of many kinds practised by most of our principal competitors in international trade, some of which are discussed in the Treasury's report, the comparison does not seem to be very even. The mote in our eye, if it is a mote, seems rather small, considering also that the DISC is the only export incentive we have, compared to the large beams in the eyes of our competitors. We cannot believe that this is a good enough reason for not taking action which is clearly in the interest of the U. S.

Another objection that has been made against improving the DISC for smaller companies, is that the DISC is too complicated and expensive for smaller companies to handle. This is simply not true. The fact that there are many thousands of active DISCs owned by smaller companies, as already discussed, is persuasive evidence that they find DISC both economical and not too complicated to operate. My own evidence from clients and COSBE members comfirms this. Certainly the regulations can be simplified, and certainly the relatively simple procedures that are possible need to be better known. I will refer to this again shortly.

Another objection, echoed by the Treasury, has been that the DISC will not be more effective than lower exchange rates. This is not

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persuasive. Exchange rate movements are unreliable and hard to predict. The DISC is hopefully permanent. Company managements react to predictability.

<u>What improvements in the DISC for smaller companies do we propose?</u>

First, we urge this Committee to incorporate in the proposed tax cut Bill the improvements in the DISC for smaller companies which are embodied in Section 5 of S. 1127 the Small Business Tax Relief Act. This Section would make two amendments to the DISC law which would have the effect of exempting a DISC with taxable income of $1 million or less from the "incremental" rules and from the "deemed distribution" to the parent of 50% of the income. These two amendments would have a substantially beneficial effect on smaller companies exporting, by increasing and, in many cases, more than doubling the amount of tax deferrals. The additional cash flow would be used as I have described to enable these companies to increase their exports.

The cost to the Treasury of Section 5 of S. 1127 has been estimated at $19 million the first year, rising to $137 million in the fifth year. However, these are gross costs, and do not take into account the tax effect of the increased exports that would be generated by the increased cash flow. By the operation of the pricing rules, even if all the DISC income remained in the DISC and there was no "deemed distribution", close to half of the profits on the new exports would still be taxed to the parent. Furthermore, the indirect effects of the additional exports on jobs and on suppliers would generate additional taxes. All in all, it seems probable that there would be

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no net cost to the Treasury but, instead, a net gain.

The amendments to the DISC law in Section 5 of S. 1127 are close to one of the principal recommendations of the White House Conference on Small Business with regard to International Trade. Two other related recommendations of the Conference were: "(1) allow for deduction of twice the monies expended for participatioin in any bona fide trade fair by a DISC; (2) allow for the deduction of twice the amount of premiums paid to Eximbank and FCIA as legal deductions prior to payment of DISC taxes." We urge the Committee to incorporate these suggestions in the amended DISC law as applying to smaller companies. If you wish, we would be happy to suggest possible wording for consideration by the Committee staff.

Participation in a trade fair can be particularly important to get a smaller company started in export, and for the first few years, and this is the time when financial help is particularly needed. Similarly, as I have already mentioned, export receivables are usually much longer for exports than for domestic sales, yet they are often harder and more expensive to finance, particularly for smaller companies which are often short of capital. Very often banks insist the the receivables be insured by Eximbank/FCIA before they will finance them. The premium charged is relatively quite high for a smaller company. The Eximbank/FCIA find it difficult to reduce the premiums for smaller companies, because they say, probably correctly, that the cost of insuring a smaller company's export receivables is often greater than the cost of insuring a larger company's. The FCIA is, of course, a non-governmental entity.

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In order to encourage smaller companies to devote more management time and resources to exports, it would be very desirable to reduce as much as possible the gap in cost between export and domestic financing of receivables. It is not normally necessary for domestic receivables to be insured. The cost of insuring a smaller company's export receivables could be made very small by incorporating this suggestion into the DISC law as applied to smaller companies.

We cannot estimate the cost to the Treasury of these two additional suggestions, but it has to be quite small. Again, we would urge that in practise there would be a tax gain because of the additional exports that would be generated.

Finally, all these amendments to the DISC law for smaller companies would have a substantial beneficial effect on the exports of smaller companies. If the Department of Commerce, with the cooperation of the Treasury, and with the assistance of the proposed export advisory "one-stop service shops" around the country, would make determined efforts to publicize the revised DISC law, and at the same time would try to show smaller companies how to set up and operate under the law relatively simply and economically, we believe that a profound change could occur in the attitude of smaller companies to exporting. These measures, added to the proposed Export Trading Company Act, could result in a few years in smaller companies making a major contribution to the solution of our very serious foreign economic problems.

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ALAN T. WENZELL
MANAGING DIRECTOR

July 17, 1980

Mr. Michael Stern
Staff Director
Committee on Finance
United States Senate
Room 2227 - Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. Stern:

It has been brought to my attention that the Committee on Finance of the United States Senate is holding hearings beginning Wednesday, July 23, on various tax cut proposals. During the January 29-30 hearings of the Committee on Ways and Means of the U. S. House of Representatives, I presented our views on H. R. 65·. regarding the tax treatment of qualified dividend reinvestment plans. The corresponding Senate bill dealing with the tax treatment of qualified dividend reinvestment plans is S. 1543.

Unfortunately I will not be able to testify at the upcoming Senate hearings. Therefore, I would like to briefly present our views in writing and respectfully request that they be included in the July 23 hearing record of the Committee of Finance.

For several years we and our parent company, Paine Webber Incorporated, have been seriously concerned with the low level of capital formation in the U. S. economy and the impact of tax policy on such capital formation. The Committee undoubtedly will consider many important proposals focusing on the issue of capital formation. We believe S. 1543 should be adopted since, for the reasons discussed below, it will stimulate the raising of equity capital in industries that are most important to the performance of the U. S. economy in the 1980's.

* * *

There are several national goals whose fulfillment will require very high levels of private investment over the next decade, such as energy independence, increased defense spending, environmental standards, and the partial rebuilding of the infrastructure of our urban centers. Tax policy for the 1980's should be concerned with promoting capital formation and increasing productivity to help lessen the severe inflation that is plaguing the U. S. economy.

The coincidence of reductions in capital formation and productivity growth, with rising inflation, is suggestive of an interactive process. Weak capital formation limits the growth of labor productivity. Low growth in productivity contributes to greater inflation. Increased inflation depresses business fixed investment by affecting the cost and availability of capital.

In the years 1977-1979 internal funds of non-financial corporations available to finance capital expenditures totalled approximately \$412.7 billion. External funds provided \$239.6 billion. Most significantly, only \$9.4 billion, or about 4%, of these external funds came from net new equity issues. Debt-equity ratios have doubled over the past decade for all non-financial corporations, to approximately 1.5 times in the year ended 1979.[1/]

1/ Our definition based on data of non-financial corporations by the Federal Reserve Board, Flow of Funds Accounts. It includes both short and long term debt. Our 1979 figure is an estimate based on three quarters of reported 1979 data.

This has obviously been influenced by the encouragement the tax laws give to financing through debt. Now many managements are constrained from going further into debt, especially in today's high interest rate environment. We believe that the concern for getting too deeply into debt has curtailed capital expenditures.

Unfortunately, the alternative of seeking equity in the capital markets has not helped in supplying needed capital funds. As investment bankers, we have perceived a growing disparity in the ability of companies to raise new equity based on differences in investor valuation. Investor valuation, which is largely based on perceived prospects of future earnings, is critical since the price-earnings multiple accorded a company affects the cost of expanding its equity base. Unfortunately, in general it is the asset intensive companies which sell at relatively low multiples. These are the companies which face large capital expenditure programs to replace assets at far higher costs than those currently accounted for.

We would like to document the environment for new industrial equity offerings over the past three years, and in this connection have examined each of the 108 common stock offerings of NYSE and AMEX-listed industrial companies brought to market in 1977-1979.

Of these offerings, only 16 were for companies listed in The Fortune 500 sales ranking as of 1979. Only one was for a corporation considered in the 30 company Dow Jones Industrial grouping. Only four were for companies listed in Standard & Poor's "basic industries" category, which are asset intensive. The bulk of the issues were for companies engaged in high growth industries, where investors perceived an opportunity for long-term appreciation, paying capital gains taxes upon eventual disposition. Many other slower growth industrial companies needing equity failed to come to market, either because underwriters were unwilling to bring the issue, or because doing so would be at too high a cost in relation to the expected return on the proceeds.

Utilities have to sell equities frequently and in very large amounts. During 1977-1979, utilities raised approximately $12.3 billion through the issuance of shares of common stock, which were able to be marketed principally because of the attraction of high current dividends. Shares were often sold at below book value, resulting in a dilution of the investment of existing shareholders.

We expect that the electric utility and telecommunication companies alone will need to raise at least $800 billion over the next ten years to build enough capacity to meet demand. Because of high dividend payouts and inadequate depreciation, a large part of this staggering sum will have to be financed externally. Without a combination of regulatory and tax relief, this appears to be a tremendous undertaking.

* * *

The Benefits of S. 1543

Clearly the United States must take measures to encourage savings and capital formation in the private sector so as to improve productivity, restrain inflation, and make our goods internationally more competitive, particularly in the light of the vast new commitments we must make in many new areas.

I believe I have demonstrated that we need to encourage the buildup of savings that will go directly into equity investments in American corporations. While, standing alone, S. 1543 does not serve as a panacea for all our problems, its adoption would help considerably.

According to a study by Georgeson & Co., the investor relations firm, dividend reinvestment plans (DRP's) have grown by 500% in less than seven years. Today there are over 1,000 DRP's, compared with 200 in 1972. However, only 138 of those 1,000 DRP's are designed to reinvest dividends in the newly-created stock of the sponsoring corporation.[2/] Thus, only 13.8% of current DRP's are creating new equity capital for corporate enterprises, and they raised approximately $1.25 billion in 1979.

Let me now comment more specifically on the salient positive effects of S. 1543.

- Clearly, the tax-deferral provisions of S. 1543 would encourage the formation of more original issue DRP's, and more frequent participation by shareholders in existing ones, which in turn would encourage individuals to plough back dividends into corporate capital. This should help to narrow the short-fall in new equity capital needed by many segments of American industry. Thus, this legislation is designed to aid in the process of capital formation especially for those companies and industries that are most in need of help, i.e. those that payout a substantial part of their earnings in dividends, who require large amounts of additional capital, and who, for various reasons, have had difficulty bringing public issues to market.

2/ Georgeson & Co., Trends, August 1979.

- Companies which form original issue DRP's as a result of S. 1543 will be able to reduce the cash drain on their balance sheets, and reinvest that money in more productive capital projects, while maintaining or perhaps even increasing per share dividend rates. To the extent that equity capital is increased, the credit quality of the company's senior securities is improved.
- Investors in these companies will have the option, exercisable each year, to reinvest dividends and so postpone their taxes. If an investor exercises this option, the tax deferral of his dividends and the subsequent capital gains treatment increase his after tax return. This should make the stocks of these companies appealing to more investors (vis a vis the low payout growth companies) and tend, therefore, to increase the price earnings multiples at which they sell in the market. Also, new issues of these companies may become somewhat more feasible as these multiples increase.
- The $1,500 cap on individual tax deferral targets the legislation to benefit smaller stockholders. Studies by the New York Stock Exchange indicate that shareowners have a median household income of $18,000; 55% of all dividends are received by individuals with incomes of less than $50,000; 50% of all shareholders have portfolios valued at less than $10,000.[3/]
- We believe that this legislation takes a first step in addressing the double taxation of corporate dividends, and by so doing, represents an important step towards the establishment of an inventive structure for future economic growth.

3/ 1979 New York Stock Exchange Fact Book.

- Finally, the legislation is productive because it will help the eroding worldwide position of many American companies whose capital expenditures have lagged. Indeed, there is every reason to expect positive effects on production and employment, the productivity of labor, and the pace of innovation, and we understand that studies have been presented to the Committee to quantify these perceptions.

Respectfully yours,

Alan T. Wenzell

Alan T. Wenzell

ATW:lc

MANUFACTURERS HANOVER TRUST COMPANY

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ROBERT A BYRNE
SENIOR VICE PRESIDENT

July 21, 1980
Telephone Number
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Mr. Michael Stern
Staff Director
Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Stern:

As a participating member of the Committee for Capital Formation Through Dividend Reinvestment we would like to recommend the inclusion of our dividend reinvestment proposal as part of the tax reduction bill you are reviewing.

The following reasons support the proposal:

- because the proposal is limited to plans which utilize original issue stock, it would directly impact the formation of new capital

- the deferral of taxation is an important step in the attempt to reduce the double taxation on dividends

- would foster savings and provide supplemental retirement income

- allows equivalent tax treatment to both stock dividends and dividend reinvestment

- counter-inflationary by absorbing cash dividends and increasing our capital which in turn will increase our ability to finance productive facilities

In summary, the dividend reinvestment legislative proposal would both help individuals to save and aid our industry to raise external capital.

Very truly yours,

R. A. Byrne
Senior Vice President

STATEMENT OF WILLIAM D. WEBB,
ASSISTANT VICE PRESIDENT-FEDERAL AFFAIRS,
KANSAS CITY POWER & LIGHT COMPANY
IN SUPPORT OF THE ENACTMENT OF A TAX CUT
BEFORE THE SENATE FINANCE COMMITTEE
BEGINNING JULY 23, 1980

My name is William D. Webb. I am Assistant Vice President-Federal Affairs of Kansas City Power & Light Company. The Company provides electricity to some 340,000 customers who reside in 94 communities in 23 western Missouri and eastern Kansas counties. I would like to present my views, and the views of the Company, on the inclusion of the provisions of S. 1543 in any tax cut proposal.

Let me start by saying that Kansas City Power & Light Company strongly supports the approach outlined in S. 1543 which would defer current Federal tax on dividends reinvested in original issue stock of a company having a qualified dividend reinvestment plan and believes that the provisions of this bill should be included in any tax cut proposal.

As I understand the bill, a single taxpayer would be allowed to reinvest a maximum of $1,500 in dividends annually while a married taxpayer filing a joint return would be allowed to reinvest a maximum of $3,000. The proposal would encourage capital formation and would provide a stimulus to the construction of essential capital facilities, thus creating employment opportunities which would lead to a strong economy.

Kansas City Power & Light Company is a fairly typical electric utility. It is a medium-size company. Its stockholders reside in all 50 states. Like other companies, it is going about its business of furnishing electric service to its customers at reasonable rates consistent with reliable service, and raising its capital in the most economical ways possible.

Two years ago, the Company adopted an original issue dividend reinvestment plan in an effort to raise needed equity capital. At present, there are some 3,800 common stockholders and 200 preferred stockholders enrolled in this plan. The common stockholders participating are, generally speaking, small stockholders with stockholdings having a current market value of about $7,000. The amount currently being reinvested by common and preferred stockholders, in the aggregate, is $3,900,000 annually.

We are pleased with these results. True, this amount of money is not large, but it does provide needed funds for part of the Company's construction program. Inclusion of the provisions of S. 1543 in any tax cut proposal would encourage additional stockholders of the Company to reinvest in the Company's common stock, thereby providing Kansas City Power & Light Company with much needed funds at an economical cost, which savings will ultimately benefit its customers.

NATIONAL FOREIGN TRADE COUNCIL, INC.
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July 30, 1980

Mr. Michael Stern
Staff Director
Senate Finance Committee
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Stern:

The National Foreign Trade Council, a non-profit organization whose membership comprises a broad cross-section of over 600 U.S. companies with highly diversified interests engaged in all aspects of international trade and investment, wishes to make the following suggestions in regard to tax legislation currently being considered by the Senate Finance Committee. We are primarily concerned about the competitive position of the United States in world markets, which has been adversely affected by our declining productivity, increasing inflation and inadequate capital formation. That declining world market share in turn has contributed to our worsening balance of payments position and to the dollar's decline. Therefore, we strongly urge that any tax reduction at this time be directed toward encouraging capital formation, improving productivity and improving the U.S. position in world markets. To achieve these objectives, the Council endorses the following proposals:

1. The Capital Cost Recovery Act (H.R. 4646 and S. 1435). We believe that enactment of this legislation would provide additional cash flow needed for investment in new plant and equipment. The additional capital investment in plant and equipment will help increase productivity, reduce unemployment, reduce inflation and improve the world-wide competitiveness of U.S. industry. Therefore, we believe the Capital Cost Recovery Act should be the cornerstone of any tax reduction legislation.

2. The elimination of the withholding tax on interest paid to foreign portfolio investors. We believe that the elimination of that tax will make foreign investment in U.S. debt securities more attractive, providing additional capital needed for more efficient plant and equipment.

3. Amendment to Section 861 of the Internal Revenue Code, to provide that expenditures for research and development under Section 172 of the Code are U.S. source deductions. The regulations issued under Section 861-8 of the Code, providing for allocation and apportionment of research and development expenses are burdensome and complex. Because of the high costs and great risk in product development research today, corporations need to be assured of an effective tax deduction for those high costs. Since Section 861-8 regulations require apportionment of a substantial part of R&D to foreign source income, a part of the deduction is effectively lost for taxpayers with foreign tax credits in excess of their limitations. This provision, therefore, significantly increases the cost of R&D. R&D should be encouraged, since new products flowing from R&D can improve productivity. Therefore, Code Section 861 should be amended to insure an effective U.S. tax deduction for R&D expenses.

4. Liberalization as well as simplification of Sections 911 and 913 of the Internal Revenue Code. U.S. corporations which reimburse employees for excess taxes attributable to their foreign employment under their tax equalization programs are finding it prohibitive to keep U.S. citizens abroad, since all items of reimbursement not excluded by Section 913 must be included in taxable income. In particular, this includes reimbursement for any taxes (foreign or U.S.), thereby creating a pyramiding effect. Since other major trading nations of the world do not tax the foreign earned income of their citizens, U.S. companies are at a competitive disadvantage. A recent study by Chase Econometrics assets that the added costs of keeping U.S. citizens abroad caused by Sections 911 and 913 are adversely affecting the U.S. share of the world export markets, contributing to our balance of payments deficit and unemployment.

5. Repeal of the foreign convention rule of Section 274(h) enacted by the Tax Reform Act of 1976. Section 274(h) limits the deduction under Code Sections 162 or 212 to two foreign conventions a year. By limiting the deductibility of "foreign convention" expenses to two meetings per year, without adequately defining "convention," Section 274(h) has cast doubt on the deductibility of a significant category of business expenses which have been considered ordinary and necessary since the earliest Federal income tax laws.

We respectfully request that our comments be made a part of the record of the hearings.

Respectfully submitted,

Carter L. Gore

Carter L. Gore
Director
Tax/Legal Division

CLG:bg

AMI

ALLIANCE OF METALWORKING INDUSTRIES

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STATEMENT OF THE ALLIANCE OF METALWORKING INDUSTRIES

FOR SUBMISSION TO THE

SENATE FINANCE COMMITTEE

HEARINGS ON TAX CUT PROPOSALS

JULY 1980

MEMBERS

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INTRODUCTION

The Alliance of Metalworking Industries (AMI) is a coalition of six national trade associations. Each association represents a different segment of the contract metalworking industry.

Companies represented within AMI employ 880,000 persons in nearly 20,000 manufacturing plants in the United States. Combined sales exceed $34 billion annually.

Members of AMI include: American Metal Stamping Association
Forging Industry Association
Metal Treating Institute
National Screw Machine Products Association
National Tooling & Machining Association, and
Spring Manufacturers Institute.

This testimony is presented on behalf of AMI and its six member associations by Michael N. Winn, Director of Government Relations for the National Screw Machine Products Association.

The industries represented by AMI consist principally of independently owned and operated contract manufacturers of component parts, produced to customer specification. While some companies produce end products and/or catalogue items, most companies are suppliers to a wide variety of manufacturers whose products are found in practically every market in this country.

Major customers include industries such as aerospace, defense, automotive, appliance, construction equipment, energy, electronics, agricultural equipment, nuclear, transportation, and recreation.

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Member companies average 46 employees per plant and $1.8 million in annual sales. Thus, the typical company can be truly considered as a small business. Together, these small businesses represent a far reaching influence on the manufacturing capability of the country, and have a major impact on this nation's economy.

SUMMARY OF THE LEGISLATION

AMI has previously testified in favor of the principle of accelerated depreciation in order to stimulate capital formation and renewed productivity.

In testimony by AMI and others it has been well documented that productive investment in capital equipment, and productivity itself have not kept pace with the rest of the industrial world. The United States outpaces all other countries in capital expenditures for antipollution, safety, and health equipment. The United States lags behind others in expenditures for equipment for real growth. This is evidenced by the fact that in 1979 productivity actually declined by nearly one percent. Productivity did not slip further only because of increased farm productivity. As the United States continues to fall behind in its manufacturing capability it clings to a tax system which discourages the replacement of obsolete and inefficient machinery and plants, and the purchase of new productive equipment.

"Reindustrialization" has become a "buzz" word around Washington and throughout the country. AMI suggests that the examples of Japan, West Germany, and others be recognized, and the buildup of new plants and equipment be left to the private sector, backed up by government policies to encourage investment and growth.

Other industrial nations provide fast write-off of capital equipment; and, in most cases, immediate write-off of equipment mandated for pollution, safety, and health purposes. AMI contends that continuing and on-going Reindustrialization will start if this Congress enacts a capital cost recovery program. This will enable business to increase productivity by investing in new equipment, and to create new jobs.

This increased productivity which created new jobs can result in increased profits, which in turn are reinvested and create more jobs.

Today there is, in most cases, a greater return in capital by investing in government debt than by investing in new metalworking equipment. And government debt does not put people to work.

AMI has consistently supported the capital formation proposals contained in the Capital Cost Recovery Act (H.R. 4646 & S. 435): the so-called "10-5-3 bill". AMI notes that with more than 300 co-sponsors in the House and 55 co-sponsors in the Senate, this Congress, in effect, shares the feeling that it is time to abandon the present depreciation schedule in order to encourage capital formation through an accelerated capital cost recovery program.

Of all the tax reform proposals advanced, including proposals that advocate a cut in capital gains tax and/or corporate income tax cuts, 10-5-3 has drawn the most attention. AMI has consistently supported 10-5-3 and remains convinced that this is the best proposal introduced to date. However, this specific proposal, in spite of bipartisan support has become subject to election year politics. As an early and unyielding supporter of 10-5-3, AMI cannot ignore the fact that opponents of the bill have attempted to make it appear to be a partisan bill--in sipte of overwhelming bipartisan support.

Other proposals which AMI urges this Committee to consider include:

The Used Machinery Credit Adjustment Act

(S. 2152 and H. R. 6171) to raise the annual $100,000 tax credit limit on the amount spent for used equipment. While this proposal would put a ceiling of $200,000 on the annual tax credit, AMI recommends lifting the ceiling completely.

The Small Business Capital Incentive Act of 1980

(H. R. 6617) This bill would depreciate all machinery, equipment, and vehicles in 4 years on an accelerated schedule, provide a 10% investment tax credit, and include a $1 million per year ceiling on the amount that can be depreciated.

A 15 year schedule is provided for buildings and structures on an accelerated schedule with a $3 million per year ceiling.

The ceiling, or "caps" contained in this bill would, according to most static economic models, cost less to the Treasury in lost taxes, and therefore may be more politically acceptable. This proposal has previously been described in other testimony as a small business alternative to 10-5-3. Most AMI member companies would be satisfied with such a proposal. In most cases the annual amounts of depreciation would not exceed the "caps". However, AMI recognizes that capital investment incentives for "big" business also spur the economy. Thus, AMI has supported proposals for all business, not just small business.

Therefore, while AMI again advocates implementation of the 10-5-3 proposal, AMI recommends that all proposals to spur capital cost recovery, economic development, and simplified depreciation schedules be considered.

ECONOMIC IMPACT OF LEGISLATION

This and other committees have been surfeited with economic analyses which attempt to describe the impact of the various capital cost recovery proposals. AMI is aware of testimony which describes how changes in depreciation would, for example, affect one company's spending $50,000 for capital equipment. AMI has reviewed Congressional analyses, reports by the Treasury, and those prepared by business, research, and accounting groups which attempt to project the economic impact on the United States economy as a result of various proposals. AMI also realizes that according to static economic models the cost of various capital cost recovery proposals to the Treasury range from several billions on up. AMI recognizes, however, that rapid depreciation is an economic fact of life in Japan and other Western economies where productivity far outpaces that of the United States.

What about the impact on a single industry? One AMI member recently surveyed its members in an attempt to estimate what impact a capital cost recovery program could have. From a sampling of 10% of the 1,700 United States companies producing component parts on automatic bar machines (screw machines) it was learned that the average company would spend $845,000 over the next five years for capital equipment. This is in an industry where less than 25% of the capital equipment has been purchased in the last 10 years. In fact, nearly 50% of the equipment used in this industry was purchased more than 20 years ago.

Projections on new equipment purchases could be estimated as if an accelerated depreciation schedule had been adopted. Long lead times from the date of order to the date of delivery normally require advance planning. Thus, the projections are assumed to be an accurate indicator. This industry, in general, presently depreciates its new equipment on a straight line basis over a 12 year period.

These respondents stated that they would expect to purchase at least $92 million worth of new equipment during this five year period. This figure is in 1980 dollars. Extended to the entire screw machine products industry capital equipment purchases could total as much as, and probably more than, $920 million during that five year period. (The cost for new equipment more than doubled during the previous five years.) As these companies told NSMPA, a capital cost recovery program would definitely affect their plans to go ahead with capital equipment purchases.

Given that the average machine costs approximately $100,000 today, this $920 million means the purchase of 9,200 machines. Industry figures show that each new machine results in the creation of 1/2 new job, paying approximately $12 per hour in wages and fringes over fifty 46-hour work weeks. Thus the creation of 4,600 new jobs, a 10% increase in the industry, and a payroll at the end of five years (phased in at one fifth of the new jobs each year) of over $380 million.

These figures are in 1980 dollars, and thus, this $380 million in the fifth year would certainly rise. And this figure would then become the base figure five years out.

This increase in jobs, in sales, and yes, taxes, is the result of the impact on one industry--wherein sales totaled $2.5 billion in 1979. Extended 10-14 times to take in the other 5 AMI member associations, or thousands of times to the United States economy, and we have a country back in gear again.

CONCLUSION

AMI supports passage of a capital cost recovery program to spur investment in capital equipment which increases productivity, and creates jobs. AMI has opposed caps or ceilings while advocating a simplified and accelerated method of depreciation.

AMI expects this Committee, in this session, to recognize the opportunity it has to approve meaningful tax reform, and AMI supports a depreciation schedule which logically includes immediate write-offs for mandated pollution abatement, safety, and health equipment.

AMI reminds the Committee that I. R. S. figures show most small businesses continue to use straight line depreciation schedules. Therefore, capital cost recovery legislation should be simple enough to use from the day it is enacted.

Retroactivity should also be considered in order to avoid delays on new equipment purchases during a phase-in period. Auto sales in states considering sales tax cuts for new cars have fallen as customers await a tax break. This type of delay must be avoided.

MNW:jac
7/22/80

Statement of Herman A. Propst, President
National Cotton Council of America
for the Record of Hearings on Tax Cuts
of the Senate Committee on Finance
July 31, 1980

I am Herman A. Propst, cotton and grain farmer from Anson, Texas, and president of the National Cotton Council, in whose behalf I appear. The Council is the central organization of the U. S. cotton industry, representing growers, ginners, warehousemen, seed crushers, merchants, cooperatives and textile manufacturers from the Carolinas to California.

The Council strongly recommends a tax cut for business and investors as a basic means of controlling inflation and providing jobs. Our nation for too long has stimulated consumption but neglected to stimulate the production of goods and services to satisfy that consumption. Consequently, as demand outstripped the supply of those goods and services, inflation became widespread.

Two major factors have inhibited the production of goods and services. (1) Excessive government regulation in many sectors has required heavy expenditures for largely non-productive equipment and installations. In many cases, this has actually inhibited production while adding to unit costs. (2) Taxes have bled off capital needed for research and for expanding and modernizing production facilities. This has held down badly needed increases in worker productivity and kept costs higher than they should have been.

Huge regulatory costs -- estimated at $121 billion in 1979 by a widely recognized authority, Dr. Murray Weidenbaum of Washington University at St. Louis -- divert capital from productive investment.

We in the cotton industry have firsthand experience with such costs. The Occupational Safety & Health Administration has mandated excessively stringent cotton dust standards, to be phased in by 1984, in our textile mills and other workplaces where raw cotton is handled. The capital outlay required to come as close as is technically possible to meeting the standards is about \$2½ billion — and that's <u>billion</u>, with a "B".

Most of this cost burden — something over \$2 billion of it — falls on textile mills. The normal annual capital expenditure for the affected mills is less than one-fourth this amount. Thus, over a four-year period, all capital normally allocated to improving productivity will be absorbed by largely non-productive expenditures to meet the cotton dust standard. And this is an industry that is struggling hard to meet the competitive challenges of cheap foreign labor in the only way open to it — increased productivity. The annual cost of meeting the standard, including amortization of capital expenditures under present depreciation schedules, is greater than the after-tax profit.

Textile mills, of course, like to run cotton because consumers want it, but they have an alternative raw material in man-made fibers. Faced with a loss situation resulting from the OSHA standard, they will either move to man-made fibers or go out of business. Either way, it means less competition from cotton to keep man-made fiber prices down and less overall competition within the textile industry. The end result will be higher prices for consumers.

When all affected sectors of the cotton industry are considered, the OSHA cotton dust standard adds 20 to 25¢ to the cost of making a pound of cotton yarn. This is the equivalent of a 12 to 15% cost increase.

Meeting cotton dust standards is not the only capital cost outlay required by government regulations. Our textile, cottonseed crushing and ginning sectors are heavily impacted by EPA requirements under the Clean Water and Clean Air Act. Our crushers also must meet Food and Drug Administration regulations, and all segments are affected to some degree by Department of Energy edicts. Some of these regulations are already in effect, but many more have been proposed and are in the offing —

including the highly expensive noise standard.

We strongly recommend special write-off provisions for non-productive equipment and installations mandated by government. Senator Bentsen made such a proposal in 1978 for one-year expensing together with full eligibility for the investment tax credit. The present 5-year write-off for EPA-mandated equipment is helpful as far as it goes, but is too narrow and has too long a write-off period.

I mentioned earlier that taxes have bled off capital needed for research and investment. Business Week on June 30, 1980, reported that since the mid-1960's real industrial research and development expenditures in the U. S. as a percentage of real gross national product have dropped by a fourth. During this same period, Germany and Japan -- our principal world trade competitors -- have increased their R & D spending in relation to GNP. Both of these foreign competitors far outstrip the U. S. in new plant and equipment investment as a percentage of GNP. Is there any wonder that their inflation and unemployment rates have been much lower and that the value of the German mark and the Japanese yen has remained much stronger than the American dollar? These countries continue to get the best of us in trade competition, and the resulting unfavorable U. S. trade balance has contributed heavily to inflation.

Our low rate of investment in research and plant and equipment also has been a factor in the very weak gains in worker productivity. In the last six years, output per man hour in U. S. manufacturing averaged a gain of only 1.6% a year, compared with 4.1% for Japan and over 5% for Germany. Obviously, our gains in worker output failed to keep up with rising wages, and more inflation fuel was poured on the fire.

One of many examples of the need for more capital in the cotton industry is found in textiles. New, high speed looms are now available which will greatly enhance worker productivity. But many of our mills are multi-story buildings built around the turn of the century. These new high-speed looms create too much vibration when placed on second and third floors. New single-level buildings are needed, but the present 45-year depreciation period makes their financing highly difficult. Under present rules, the change-over will be very slow. But, with a more realistic write-off period, this new technology could be adopted rather soon.

Rapid inflation of recent years has created a special need for more rapid capital recovery. By the time a machine's depreciation period is completed, the replacement cost is often three, four or five times the cost of the original equipment. Thus, the cash flow generated by depreciation is woefully inadequate to cover replacement. A shorter write-off period would provide some relief for this situation, which is now inhibiting investment for increased productivity.

We believe that a tax climate in Germany and Japan that is much more favorable toward investment is largely responsible for their superior economic performance in recent years. Therefore we recommend: (1) significantly greater depreciation allowances such as those embodied in the Capital Cost Recovery Act, which has strong bipartisan support in the Congress; (2) elimination of the double taxation of corporate dividends; (3) reduction or elimination of taxes on the portion of personal income that is invested, especially capital gains, and (4) eligibility of all agricultural buildings for the investment tax credit, rather than "single-purpose" structures. Our industry also believes that tax rates should be indexed inversely with general price increases so that inflation does not automatically increase taxes by moving the taxpayer into higher tax brackets.

The adoption of these measures, in our view, will go a long way toward restoring vigor to the U. S. economy by helping curb inflation and providing new jobs.

STATEMENT OF

JEROME O. HENDRICKSON, PRESIDENT
THE VALVE MANUFACTURERS ASSOCIATION
McLEAN, VIRGINIA

Mr. Chairman:

I am Jerome O. Hendrickson, President of The Valve Manufacturers Association (VMA), a national trade organization with headquarters at Suite 711, 6845 Elm Street, McLean, Virginia 22101. The Valve Manufacturers Association includes 73 manufacturers accounting for more than 75 percent of the total United States industrial valve production. We are an industry primarily composed of small and medium sized businesses.

VMA supports the passage of S. 1435, the Capital Cost Recovery Act. This legislation would replace existing depreciation schedules for business plant, equipment, and rolling stock, and substitute in its place a simplified system of rapid depreciation for such assets. The bill has been referred to as the "10-5-3" proposal, providing a 10-year write-off for buildings, a 5-year write-off for equipment, and a 3-year write-off for a limited investment in cars and light trucks.

Last year the United States industrial valve industry recorded annual sales of $2.2 billion and employed over 50,000 people. It is estimated that an equal number are employed in supplying and supporting companies. In 1978, the last year figures available, the industry had a return of 5.3 percent on sales and an 8.9 percent return on net worth.

One of the most serious problems facing our members is that of capital formation. Currently annual industry capital expenditures are $104 million, or 5.2 percent of sales. Since outside sources of capital are scarce, growth must be financed internally to a large extent. One way to facilitate this type of activity is by creating a capital cost recovery system which is fair, simple, and competitive with domestic and international competitors.

The present system is not equitable, requiring our industry to write off the original cost of its plant and equipment, on the average, over a period of twelve years. The need for effective capital cost recovery, however, extends well beyond our industry alone. The concept of "useful life" and the asset depreciation range (ADR) work to inhibit investment and capital formation in our nation as a whole. A continued low level of investment in this country has resulted in sagging productivity, sluggish production, and faltering competitiveness in world markets.

The Capital Cost Recovery Act is designed to encourage real economic growth by stimulating investment in better, more efficient plant and equipment. By restructuring the method of depreciation to one which places emphasis on capital recovery instead of "useful life", this legislation, if enacted, will stimulate capital investment and make the United States more competitive in world markets. The Bill would also permit U.S. companies to "catch-up" with the more rapid depreciation rates already permitted in many other industrial nations.

We earnestly solicit you and your colleagues to support the Capital Cost Recovery Act for the following reasons:

1. S.1435 is a simplified rapid capital recovery system which both encourages investment and reduces the administrative hassles with Internal Revenue Service. It should be adopted without major changes in order to provide the maximum economic benefit.
2. S.1435 is essential to the overall revitalization of American industry because it will encourage needed investment throughout the economy in more productive, more energy efficient plants and equipment.
3. S.1435 should be the productivity and investment-oriented portion for business in the 1980 tax package. Smaller, targeted proposals for particular industries should not become competitors with S.1435 for business generally.
4. S.1435 should be enacted soon to insure that the 1980's climate for investing in new plants and equipment is favorable.
5. S1435 is not a partisan issue. The 307 House cosponsors and 54 Senate cosponsors are well balanced between Democrats and Republicans, indicating a very broad awareness of the need for enactment.

Therefore, for these reasons, we of The Valve Manufacturers Association urge the Congress to act quickly to approve the Capital Cost Recovery Act. By encouraging further investment in modern plant and equipment, it will provide major benefits to the United States economy and to our industry.

WRITTEN COMMENTS SUBMITTED BY
PETER J. HART
NATIONAL DIRECTOR OF TAX POLICY
PRICE WATERHOUSE & CO.
TO THE
SENATE FINANCE COMMITTEE
AUGUST 1, 1980

I am pleased to have the opportunity submit written comments on behalf of Price Waterhouse & Co., a United States public accounting firm, regarding the advisability of a tax cut in 1981. We are concerned that this country's present tax structure places a heavy emphasis on taxation of income, thereby impairing savings and investment. This concern is heightened during periods of rapid inflation.

Our current rate of inflation is having a dramatic adverse impact on American industry, impairing its ability to maintain and expand the present capital base. Expansion of the capital base in the business sector of our economy is vitally important if we are to reverse this country's disturbing trend in productivity and help relieve inflationary pressures. In our opinion, bold and imaginative tax legislation can provide an important catalyst toward improving the distressing situation which exists in the United States economy today.

Price Waterhouse & Co. would like to offer the following recommendations and observations regarding what we believe should be considered in connection with legislating a tax cut for 1981:

1. We are in an entirely appropriate time to develop a well thought out and balanced program for tax reduction and relief designed to take effect as soon as practicable. This tax reduction program should be designed in such a manner so as not to further kindle inflation.

2. A balanced program of tax relief should place special emphasis on measures designed to provide incentives for capital investments which will improve productivity and encourage innovation.

3. A major portion of the final tax reduction should be devoted to the business sector of the economy. The major portion of this reduction should be directed toward improving recovery of investment in capital assets owned by American business.

4. Strong consideration should be given to a reduction in the corporate income tax rates in recognition of the ravages of inflation, and the desirability of eventually eliminating double taxation of corporate earnings.

5. Thought should be given to measures which will reduce the current disincentives to individual savings and encourage additional savings. Attention should be directed to eliminating the bias against investment and investment income.

6. Tax relief should be provided to individual taxpayers in recognition of the additional tax burden which will be imposed on them next year as the result of inflation adjusted earnings.

Inflation is a major reason for the necessity of developing a balanced approach to tax reduction. Our Firm recently completed an analysis of the effects of inflation on United States business, and we would like to share the results of that study with you. The balance of our written comments are based upon our analysis of disclosures, which appear for the first time in 1979 corporate annual reports.

The new disclosure results from adoption, by the Financial Accounting Standards Board, of Financial Accounting Standard No. 33, "Financial Reporting and Changing Prices," better known as

FAS 33. FAS 33, adopted in 1979, represents a milestone in U.S. financial reporting--a positive, authoritative response to the challenge of inflation. It is not merely another reporting requirement. Application of this standard elicits a vital story: A story of earnings that are anything but "obscene"; a story of illusory growth patterns in sales, earnings and dividends; and a story of hidden, confiscatory taxation.

What FAS 33 Does

Before submitting the results of our analysis, the following discussion will provide some background to explain what FAS 33 does, and why the results it produces are so important to the future of the U.S. economy--an economy desperately in need of revitalization.

Economists differ on the causes of inflation, on how to control it--even on its nature. But they agree that its result is, simply, the erosion of money's command over things. Americans in all walks of life have another way of putting it: "The dollar doesn't go as far as it used to." For American business, the impact might be stated slightly differently: "There aren't as many dollars as it seems there are"--not in terms of profits, not for capital investment and expansion, not for stockholders. For years, traditional financial reporting served to mask that simple, crucial fact.

Traditional financial reporting is based on cost, measured in historical units of money. A fundamental assumption is that the unit is stable--once a dollar, always a dollar, whether invested in the business a century ago or booked as sales a week ago.

Inflation demolishes the stable-unit assumption. With the erosion of U.S. purchasing power, financial statements that mix dollars of 1965, 1972, 1976, and 1979--and most statements do--in effect, invisibly commingle four different currencies.

Because of the disparate purchasing power of the four currencies, a dollar of cost incurred in 1965, or 1972, or 1976 is not recovered by a dollar of 1979 revenue. Failure to recover costs produces a corresponding overstatement of earnings--as reported and as taxed. The results are the famous "obscene" profits, and the infamous unseen taxation of shareholders' capital.

Inflation has other consequences for financial reporting, too. Every rise in the general price level depresses the economic value of money. The owner of monetary assets--cash and receivables--losses purchasing power, while the borrower of money realizes gains. These losses and gains can be a significant factor in evaluating business results and financial position in inflationary times. Under traditional accounting, these losses and gains go almost completely undetected.

After many years of discussion and development here in the United States, we now have FAS 33, which first became applicable in 1979 Financial Statements. FAS 33 requires disclosure of supplementary data to the corporate financial statements which help demonstrate the erosive effect of inflation on business capital.

Under FAS 33, approximately 1,500 large, publicly-held companies must include information in their annual reports about the effects of both general price changes (constant dollar information) and specific price changes (current cost information).

Only constant dollar information was required for 1979. Both approaches will be required in 1980.

Price Waterhouse Analysis of FAS 33

During the first few months of 1980, we began informal monitoring of disclosures under FAS 33, mostly for our own information. The results of even limited sampling appeared to be of obvious interest to our clients and others in the business and investment communities. As a result, we formalized the project and its parameters.

Our more formal study was completed last month. This study of the first results under FAS 33 entailed review of 215 published annual reports, issued by some of the most prominent companies in America, operating in eighteen different industries. We believe that our study represents a good cross-section of experience to date and provides reliable, enlightening answers to a key question: What is emerging by way of new, useful information that dramatizes the ravages of inflation on American business?

In our study of experience with FAS 33, we concentrated on five key statistics of business performance and viability, and on two key statistics of particular relevance to public investors. The statistics for business performance are:

- Sales growth,
- Income from continuing operations,
- Return on net assets,
- Dividend payout ratios, and
- Effective tax rate.

The statistics of interest to investors are:

- o Growth in dividends, and
- o Growth in year-end stock price.

Each of these statistics were dramatically affectd by the inflation adjustments made in accordance with the rules of FAS 33. The results are informative and significant.

In order to present an overview of the results of our survey, these comments will focus on the composite averages in the seven areas of measurement for the 157 industrial companies whose reports we analyzed. They represent fourteen broad industry groups and are by far the largest part of our sample. The statistics are a dramatic indication of just what inflation is doing to business and investors. Here it is important to note that while information is currently only available for large publicly held companies, the story is much the same for smaller companies as well.

Effects of Inflation on the Five Measures of Business Performance

Sales growth from 1975 to 1979 averaged 76 percent on a historic basis. This represents a compound annual growth rate of approximately 15 percent during the four-year period. On their face, those numbers show healthy, reassuring growth in volume of business; but how much of it was merely the result of inflation?

When these same sales were restated in constant dollars, the average growth from 1975 to 1979 was reduced to 33 percent, which is approximately 8 percent compound annually. That's considerably less healthy, and far from reassuring. In other words, a very significant portion of apparent growth was, in fact, attributable to inflation.

Income from continuing operations computed in constant dollars declined in every instance from the corresponding amount computed in historical units of money. In a number of cases respectable profits were reduced to substantial losses. Excluding those loss situations, the average decline was 40 percent.

For the companies that chose to give 1979 current cost information, the average decline in income from continuing operations as restated was about the same, with some intriguing exceptions. Certain high-technology companies reported improved results on a current cost basis, reflecting increasing efficiency of productive plant and effective cost containment in the manufacture of products.

Under FAS 33, purchasing power gains and losses on net monetary assets are excluded from restated income from operations. Companies with substantial debt disclosed substantial purchasing power gains, in some cases more than offsetting declines resulting from other aspects of restatement. On the other hand, many companies are not significant borrowers. In these situations companies often reported substantial losses in purchasing power of net monetary assets.

Informed opinion differs sharply on whether such gains and losses should be a component of inflation-adjusted earnings. In any event, those companies which are net borrowers appear to have shifted a portion of the inflationary burden from owners to creditors, while companies which are not net borrowers may have incurred further detriment in the value of assets that is not currently included in inflation adjusted earnings.

Return on net assets, or RNA, computed to reflect changing prices, exhibits a similar picture of decline when compared with traditional measurement. Based on historical units of money, RNA for all the surveyed companies averaged about 17 percent. Restated, average RNA declined to 8 percent on both a constant dollar and a current cost basis.

Dividend payout ratios, which averaged about 33 percent on the traditional basis, increased overall, and in some cases dramatically, upon restatement. They averaged about 65 percent on both bases of restatement.

Effective tax rate is a most important statistic from the standpoint of viability today and capital formation tomorrow. As traditionally measured, including deferred tax provisions, it averaged 39 percent. As restated, it averaged 53 percent for both constant dollars and current costs, well in excess of statutory rates that ostensibly mark limitations imposed by law.

Effects of Inflation on the Investor.

The measurements of growth in cash dividends and year-end stock prices are of particular relevance to the investor. FAS 33 requires presentation of cash dividends paid per share and of year-end stock prices, for the five most recent years, expressed in constant dollars for all years. Clearly, these figures are of direct interest and high importance to investors. They go to the heart of the matter: How am I really doing with my investment in X Company in inflationary times, as contrasted with how I appear to be doing?

Based on historically quoted stock prices, the average increase for the period from 1975 to 1979 was 74 percent. This declined to 24 percent when restated in constant dollars of 1979 purchasing power. In the case of cash dividends, the average increase for the four-year period dropped from 90 percent to 41 percent when restated in constant dollars. It appears that many investors were aware of the effects of inflation long before the implementation of FAS 33 early this year.

Included in the composite averages are many individual cases in which restatement transformed apparent growth--share prices, dividends, or both--into decline. Indeed, if restated amounts exhibit <u>any</u> growth, it means that the investors in that company have, in fact, more than held their own during those five inflation-ridden years. Many investors have not, and many did not do as well as they may have thought they were doing.

<u>What Needs to be Done</u>

The data convey valid and cogent messages about the position of American business in an inflationary era. It is of considerable interest that the messages are about the same overall, regardless of whether the basis of restatement is constant dollars or current costs.

We submit that these inflation-adjusted data:

- Portray a pattern of business growth that gives significant cause for concern,
- Confront and put aside the charge of "obscene" business profits,
- Suggest that dividend <u>expectations</u> may not mesh with realities of capital formation, and

- Demonstrate that American business needs realistic tax relief from inflation if it is to provide full employment and maintain competitive productivity.

From both the standpoint of the investor and of business itself, the inflation messages conveyed by these statistics are compelling. If business is to effectively deal with the erosive effects of inflation and, more importantly, increase productivity, employment, and competitiveness in the years to come, there must be monetary and fiscal initiatives that enable and encourage American business not only to maintain existing capital, but to have increased access to new and expanded capital.

In summary, we feel the information set forth in our study presents a demanding and compelling case for a statesmanlike response from Congress and the Administration. The questions of declining capital investment and productivity must be addressed through solid tax legislation designed to attack the problem in a manner which fully recognizes the present bias against savings and capital formation brought about by inflation. A well defined program of tax relief will be a major step forward in combating the inflationary pressures with which we all have become too familiar.

Statement of Financial Accounting Standards No. 33

DISCLOSURE OF THE EFFECTS OF INFLATION: AN ANALYSIS

FINANCIAL REPORTING AND CHANGING PRICES

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Introduction

In September 1979, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 33, *Financial Reporting and Changing Prices*. This statement requires certain large, publicly held companies to include information about the effects of both general price changes (constant dollar information) and specific price changes (current cost information) beginning with 1979 annual reports.

Constant dollar accounting is simply the expression of historical cost financial statement amounts in units of the same purchasing power. Current cost accounting is a method of measuring and reporting assets and expenses associated with the use or sale of assets at their current cost or lower recoverable amount at the balance sheet date or at the date of use or sale.

FAS 33 requires disclosure of specific quantitative data for the current fiscal year and for the five-year period ending with the current fiscal year. Data to be disclosed for the current fiscal year include:

1. Information on income from continuing operations on both a current cost and a constant dollar basis.
2. The purchasing power gain or loss on net monetary items.
3. The current cost amount of inventory and property, plant and equipment.
4. The increase or decrease in the current cost amount of inventory and property, plant and equipment, net of inflation.
5. Total depreciation expense on both a current cost and a constant dollar basis.

The following information is required for each year in the five-year period in addition to items 1, 2 and 4 above:

1. Net sales.
2. Income per common share from continuing operations on both a current cost and a constant dollar basis.
3. Net assets at year-end on both a current cost and a constant dollar basis.
4. Cash dividends per share.
5. Year-end market price per share.
6. Consumer price index.

Only sales, dividend and market price information must be presented for years ending before December 25, 1979, and presentation of current cost information for 1979 may be postponed until the 1980 annual report is issued.

In FAS 33, the FASB stated, "The measurement and use of information on changing prices will require a substantial learning process on the part of all concerned." It also encouraged experimentation within the guidelines of FAS 33. This study summarizes selected data produced as a result of FAS 33. Additional techniques which will be useful in analyzing the data will undoubtedly be developed as users of financial statements become more familiar with the changing prices information and the methods used to compute it.

May 1980

Findings

Seven statistics have been chosen which are believed to be both interesting and useful in evaluating the changing prices data. Although some might contend that comparing measurements computed using different measuring units is inappropriate, we believe the FASB intended that such comparisons be made as part of the experiment in reporting information on changing prices and have thus provided the data.

Income from continuing operations as a percentage of historical income — This statistic is the ratio of income from continuing operations as reported on a constant dollar and current cost basis to that reported in the historical financial statements. Both the gain or loss in purchasing power from net monetary items and the increase or decrease in current cost amounts are excluded from this computation. The FASB required that these items be reported separately because of the controversy over whether they should be considered income. If the purchasing power gain or loss had been included in constant dollar income, that amount would have been higher for all industries except the financial companies and, in several instances, would have exceeded 100% of historical income.

Summary of findings

Income

	Historical	Constant dollar	Current cost
Industrial	100%	60%	63%
Financial	100	95	NR
Retailing	100	42	NR
Transportation	100	56	30
Utilities	100	31	17

NR — Not reported because of insufficient data

Effective tax rate — This statistic is an overall comparison of the effective tax rate on historical, constant dollar and current cost bases Deferred taxes are included. While it might be useful to measure the tax rate on several other bases, such as domestic vs. foreign and current vs. deferred, we have not done so because the information is not available as to foreign taxes and we consider it simplistic to omit all deferred taxes since all timing differences eventually reverse. Furthermore, should some form of indexing be adopted in the tax system to recognize inflation, it is possible that there would be a trade-off for some existing tax incentives. Thus, we believe that measurement of the gross tax rate is the most useful at present.

Summary of findings

Tax rate

	Historical	Constant dollar	Current cost
Industrial	39%	53%	53%
Financial	28	28	NR
Retailing	42	68	NR
Transportation	30	44	50
Utilities	34	62	78

NR — Not reported because of insufficient data.

Return on net assets — This statistic is the percentage return on net assets on historical, constant dollar and current cost bases. In this statistic the purchasing power gain or loss and the increase or decrease in current cost amounts are excluded from income but are generally included in the computation of net assets as required by the FASB.

Summary of findings

Return

	Historical	Constant dollar	Current cost
Industrial	17%	8%	8%
Financial	14	13	NR
Retailing	16	5	NR
Transportation	16	5	2
Utilities	10	4	2

NR — Not reported because of insufficient data.

Dividend payout ratio — This statistic measures the percentage of income paid as cash dividends on common stock on historical, constant dollar and current cost bases. The ratios were computed based on income measurements prescribed by the FASB which exclude the purchasing power gain or loss and the increase or decrease in current cost amounts.

Summary of findings

Payout

	Historical	Constant dollar	Current cost
Industrial	33%	65%	66%
Financial	32	35	NR
Retailing	31	299	NR
Transportation	29	42	72
Utilities	76	543	521

NR — Not reported because of insufficient data.

Growth — The information presented in 1979 annual reports permits the measurement of growth in terms of constant dollars over five years in three areas:

1. Sales.
2. Dividends.
3. Year-end stock price.

The sales growth statistic permits an investor to determine what proportion of the reported increase is primarily the result of inflation. The dividend and stock price information permit an individual investor to determine how his investment has fared in the face of inflation. If the stock price shows any growth, the investor has more than held his own against inflation. Likewise, if the dividend shows any growth, the yield on the stock has more than held its own against inflation.

Summary of findings

Growth

	Sales		Dividends		Stock price	
	H	C	H	C	H	C
Industrial	76%	33%	90%	41%	74%	24%
Financial	86	38	46	12	69	22
Retailing	112	57	104	51	12	(21)
Transportation .	99	49	81	33	99	42
Utilities	64	22	18	(9)	(4)	(32)

H — Historical   C — Constant dollars   ( ) — Decrease

The detailed results of our study of the changing prices information are presented in the accompanying series of graphs which include:

1. An industrial company composite graph.
2. Separate graphs for the 14 industries included in the industrial company composite.
3. Separate graphs for the financial, retailing, transportation and utility companies.

Segmentation of the study

Our analysis of the results of the FAS 33 disclosures encompassed the annual reports of 215 companies:

- 157 industrial
- 25 financial
- 12 retailing
- 10 transportation
- 11 utilities

The 157 industrial companies were further broken down into 14 broad industry groups as follows:

Aerospace	Metal manufacturing
Automotive	Office machinery
Chemicals	Paper and forest products
Electronics and appliances	Petroleum
Food and beverage	Pharmaceuticals
Glass products and containers	Publishing
Machinery and equipment	Tobacco

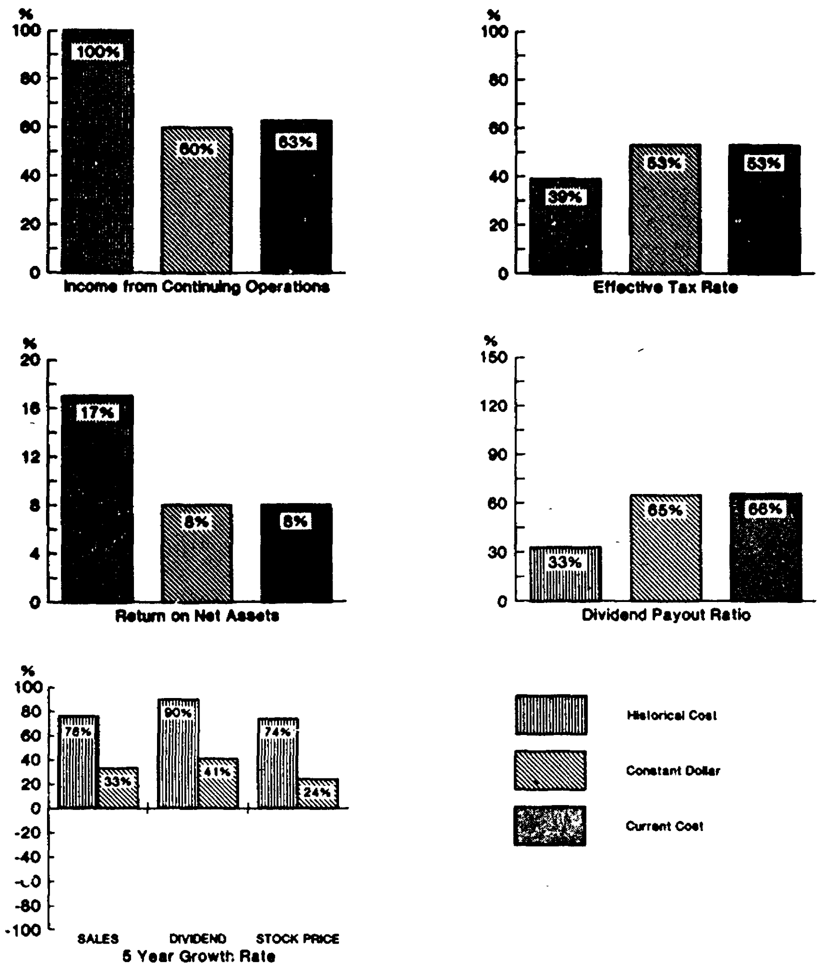
Of the 215 companies, 83, or about 39%, chose to present current cost data. All were required to present constant dollar data.

Companies were selected on a judgmental basis from the 1979 *Fortune Directory* of the 500 largest industrial, 150 largest banking, life insurance and financial, 50 largest retailing, 50 largest transportation and 50 largest utility companies. We attempted to obtain a representative group for analysis. Companies which had losses on any basis of measurement were excluded. The composite and industry statistics were derived as simple arithmetic averages of the percentages computed for the individual companies. Thus, no individual company's results dominate the statistics.

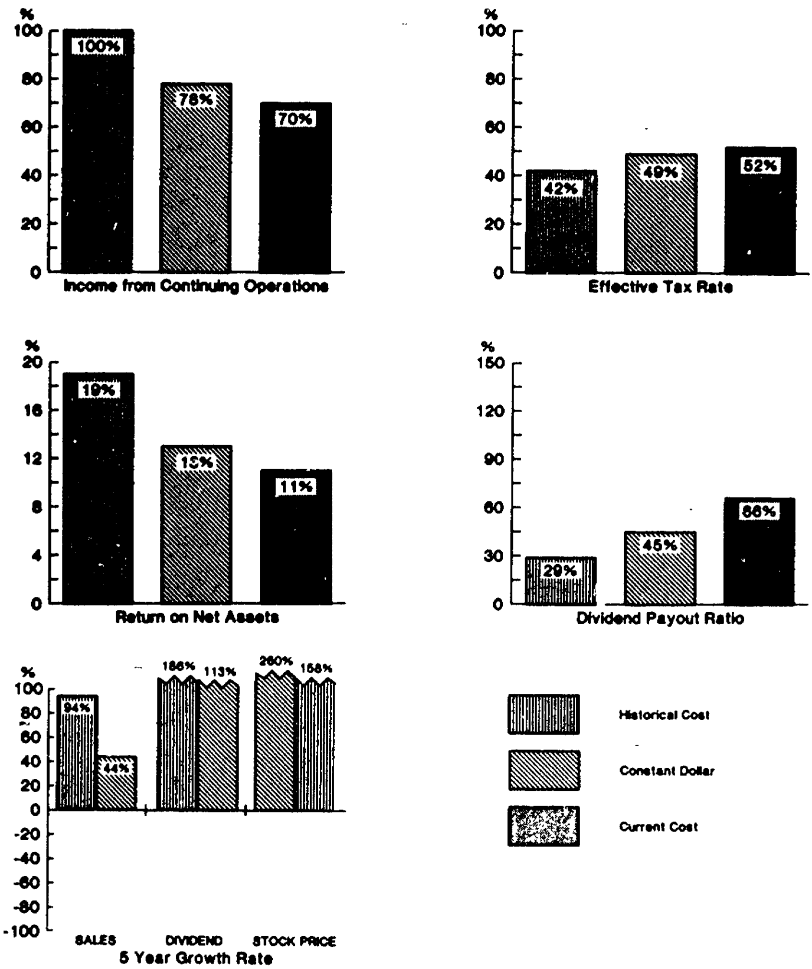
The sample of 157 industrial companies for the composite constant dollar disclosures comprises over 30% of the *Fortune 500;* the sample of 68 for the composite current cost disclosures comprises about 14%. We believe these sample sizes are sufficient to ensure that the overall industrial composite statistics are reasonably reflective of the group as a whole. The individual industry statistics, computed from much smaller sample sizes (particularly for current cost) and based on a judgmental assignment of companies to industries, is obviously less statistically reliable. These latter statistics, we believe, should be used only as general indicators of orders of magnitude.

The historical and constant dollar data represent all 215 companies included in the study. The current cost data represent only the 83 companies which reported current cost data. We recognized that this difference in sample size could result in noncomparability of the current cost data with the other data and investigated the degree of noncomparability. The difference in the number of companies included in the two samples has no significant effect on the comparability of the industrial company composite statistics. There is, however, some lack of comparability of the current cost data with the other data in the individual industry statistics because some of the individual percentages for historical and constant dollar data are different when only the companies which presented current cost data are included. This causes slight differences in expected relationships among the data as presented Major trends, though, are generally the same as that of the larger group of companies, e g , constant dollar income is less than historical income and current cost income is less than constant dollar income The only industries in which the apparent trends would be reversed are the food and beverage and glass products and containers industries We did not present separate historical and constant dollar statistics by industry for the companies which reported current cost data because of the relatively small number of companies for each industry in the current cost sample which make the data less reliable and because we wanted to avoid presenting an excessive amount of data.

Industrial companies composite



Aerospace



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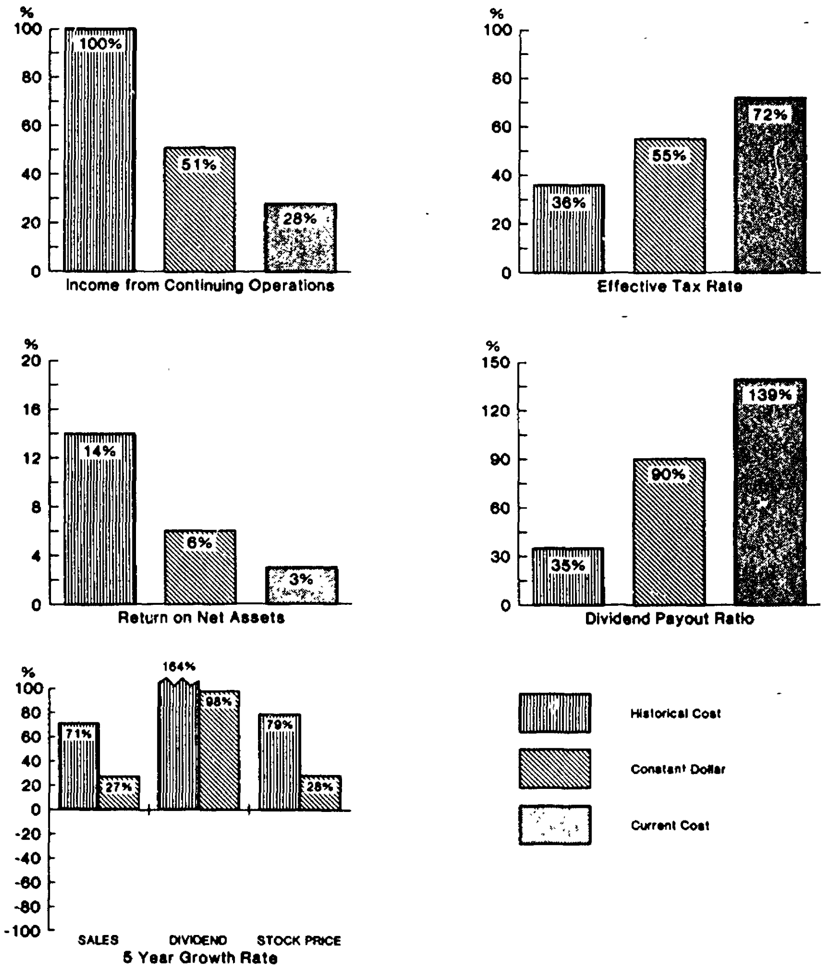
Automotive



%
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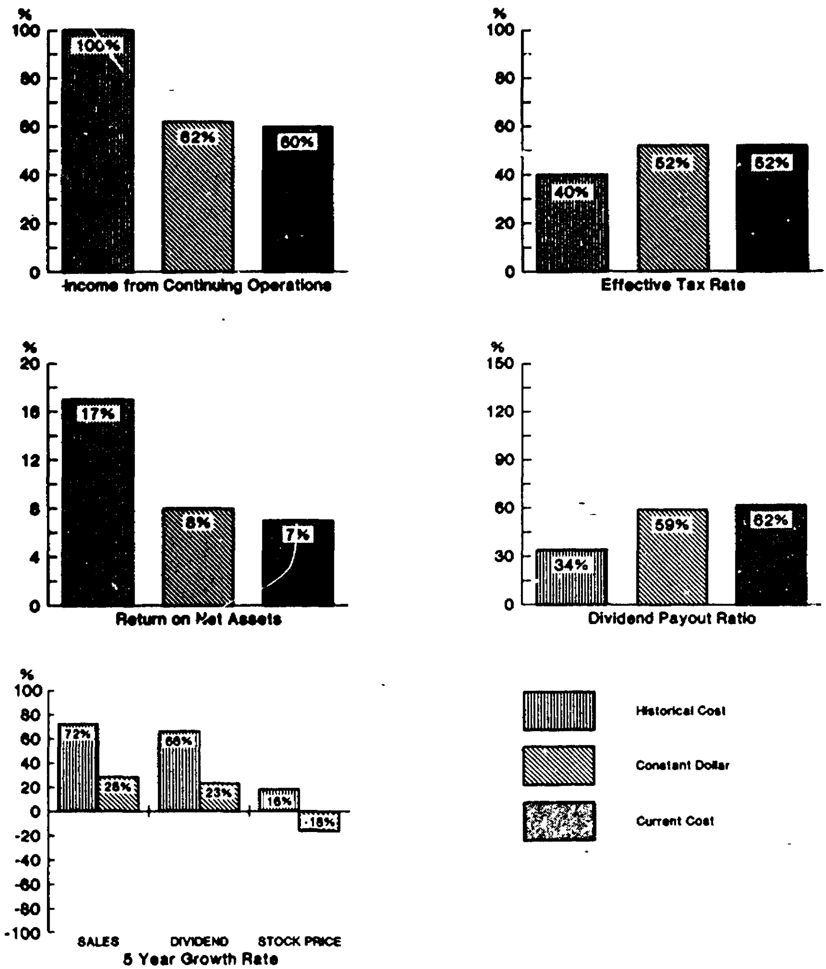
80
60
40
20
0
100%
51%
28%
Income from Continuing Operations
%
100
80
60
40
20
0
36%
55%
72%
Effective Tax Rate
%
20
16
12
8
4
0
14%
6%
3%
Return on Net Assets
%
150
120
90
60
30
0
35%
90%
139%
Dividend Payout Ratio
%
100
80
60
40
20
0
-20
-40
-60
-80
-100
71%
27%
164%
98%
79%
28%
SALES
DIVIDEND
STOCK PRICE
5 Year Growth Rate
Historical Cost
Constant Dollar
Current Cost

Chemicals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100%
62%
60%
Income from Continuing Operations
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100
80
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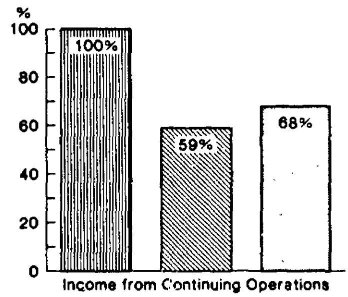
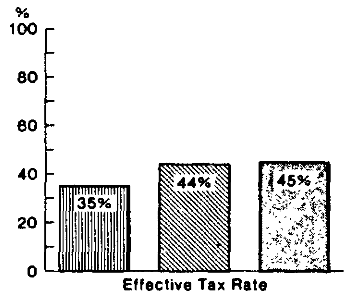
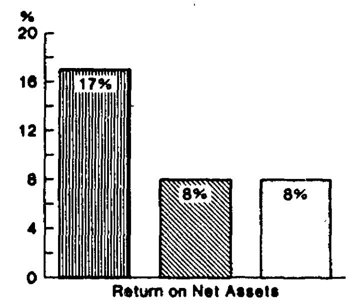
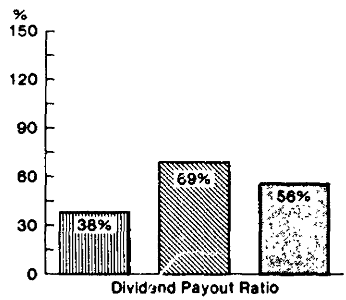
40
20
0
40%
52%
52%
Effective Tax Rate
%
20
16
12
8
4
0
17%
8%
7%
Return on Net Assets
%
150
120
90
60
30
0
34%
59%
62%
Dividend Payout Ratio
%
100
80
60
40
20
0
-20
-40
-60
-80
-100
72%
28%
66%
23%
16%
-18%
SALES
DIVIDEND
STOCK PRICE
5 Year Growth Rate
Historical Cost
Constant Dollar
Current Cost

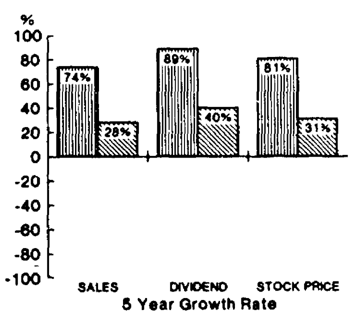
Electronics and appliances

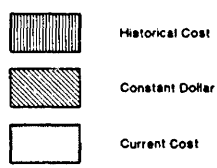




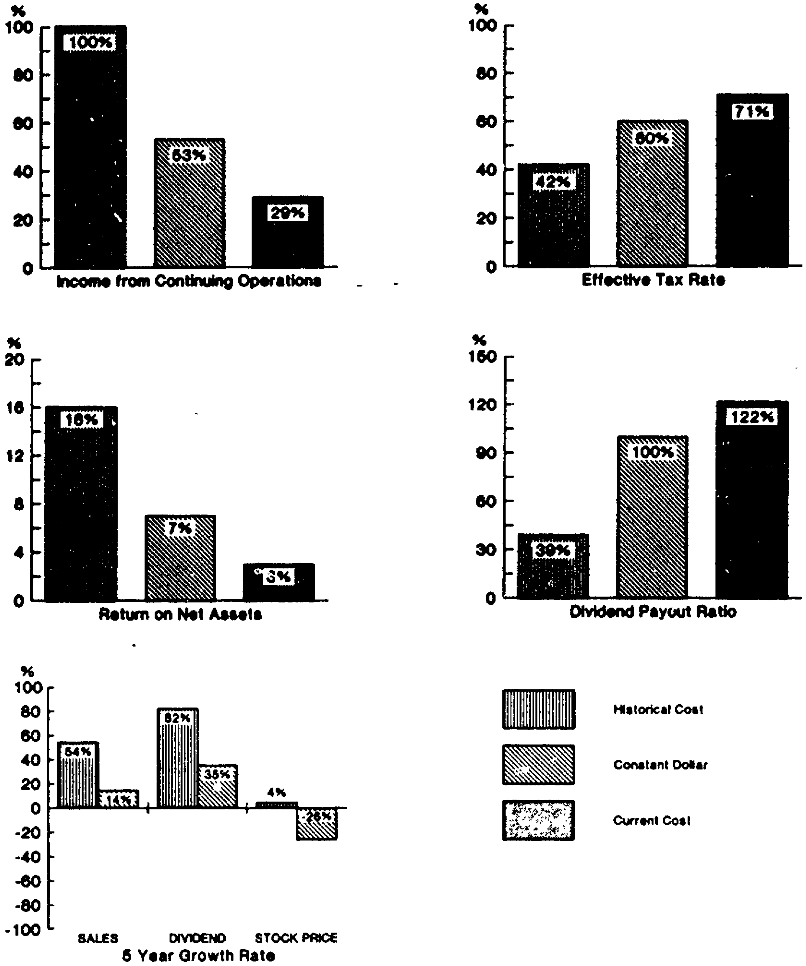




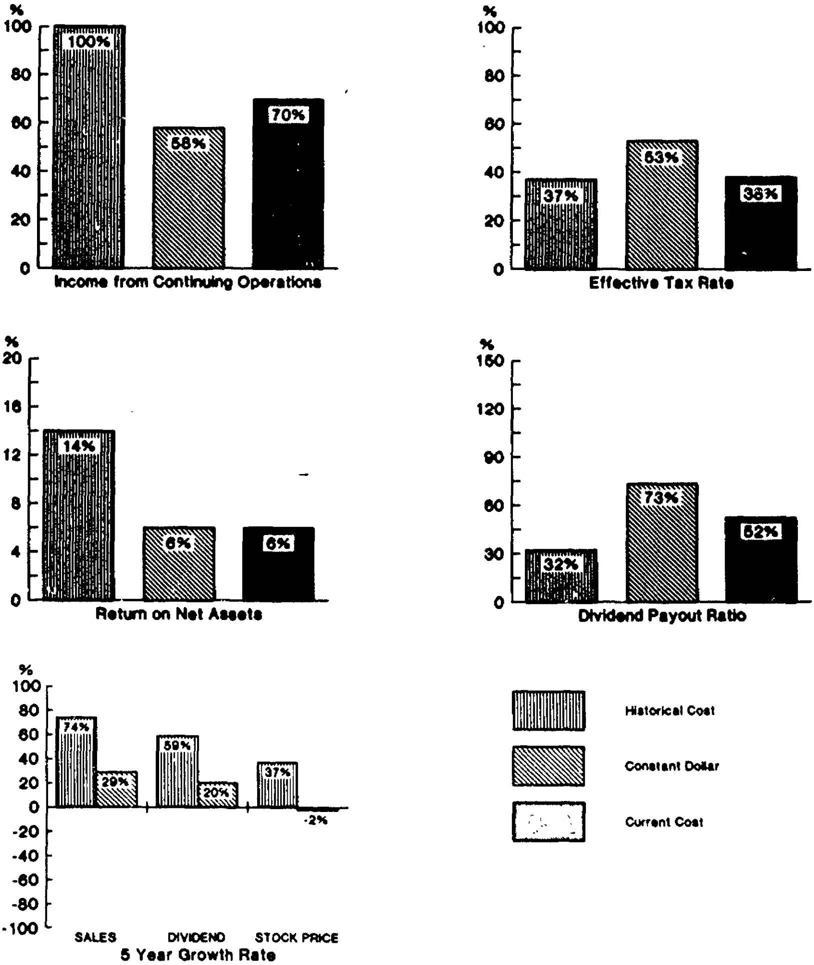




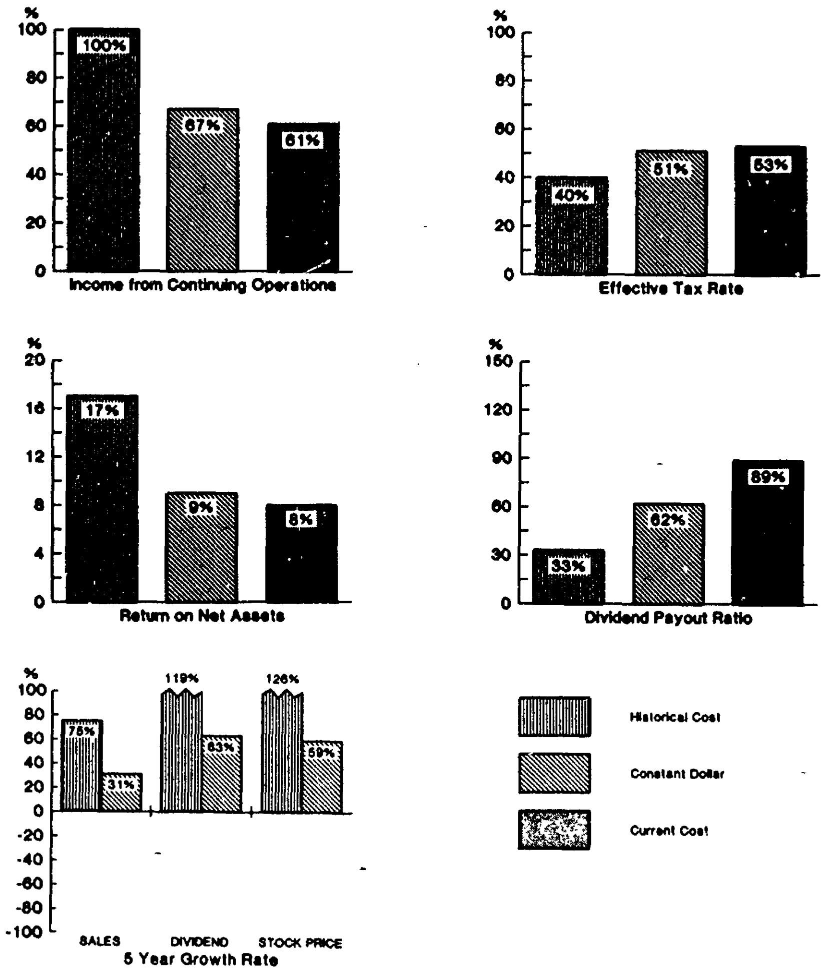
Food and beverage



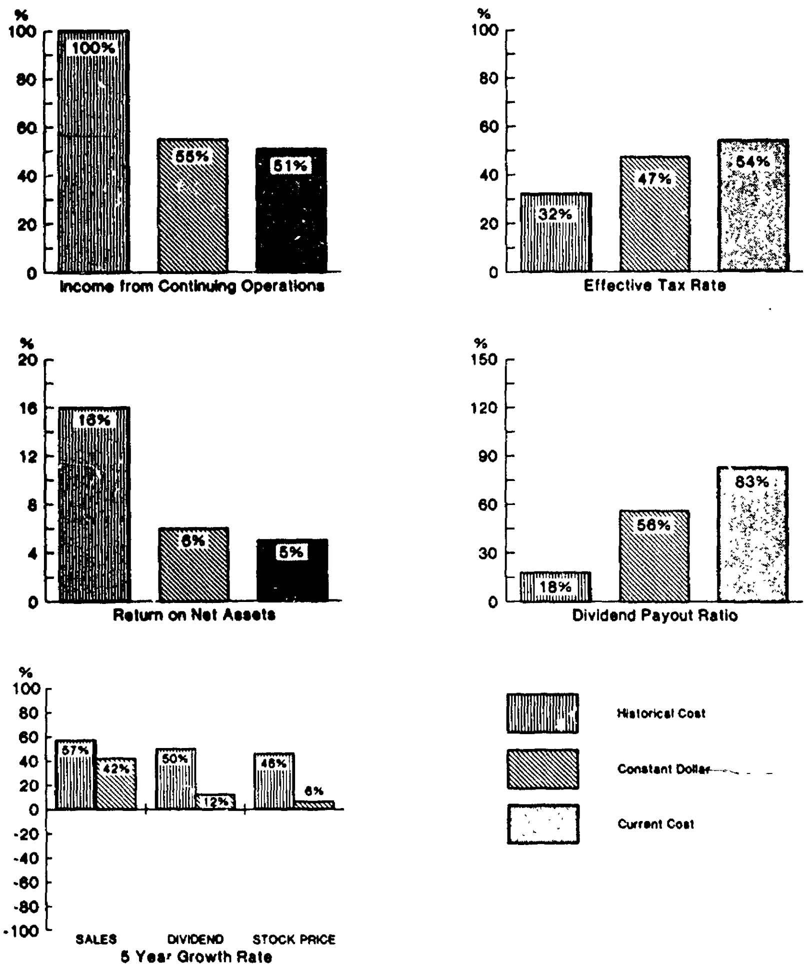
Glass products and containers



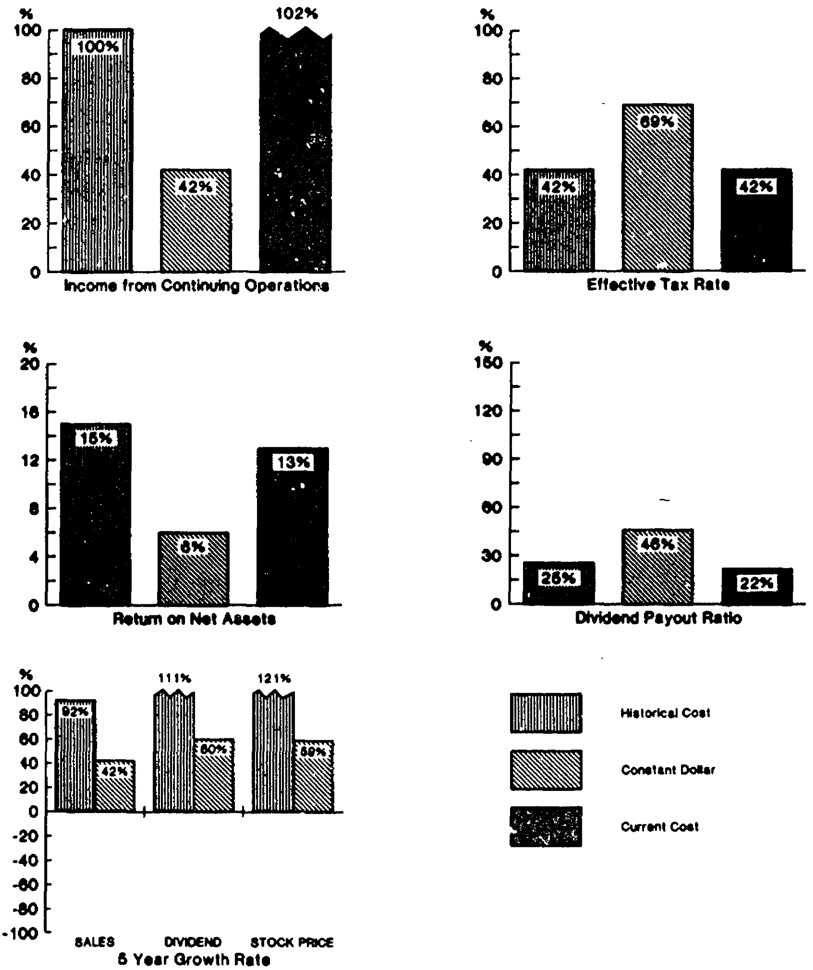
Machinery and equipment



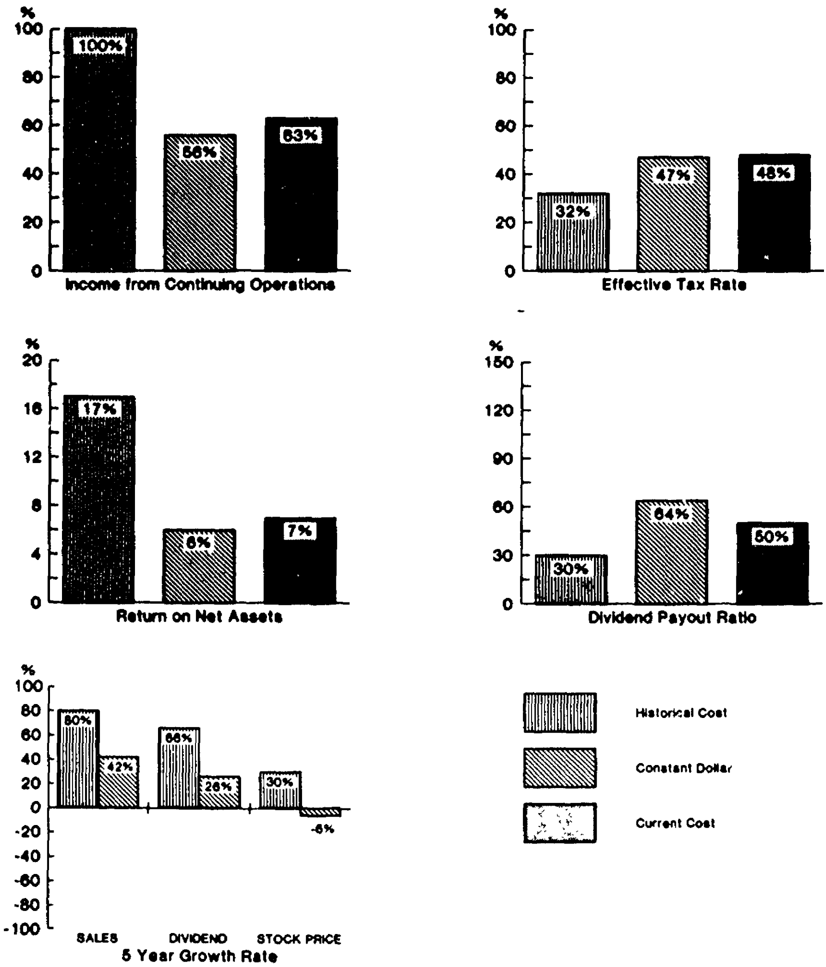
Metal manufacturing



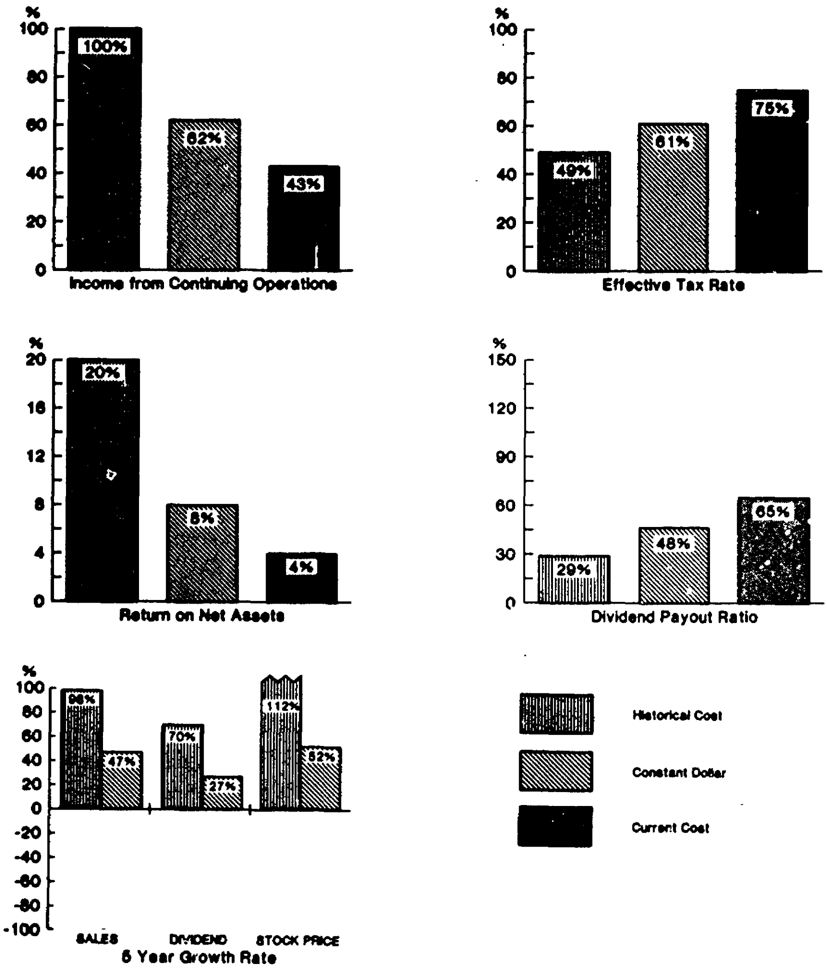
Office machinery



Paper and forest products



Petroleum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100
80
60
40
20
0
100%
62%
43%
Income from Continuing Operations
%
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80
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40
20
0
49%
61%
75%
Effective Tax Rate
%
20
16
12
8
4
0
20%
8%
4%
Return on Net Assets
%
150
120
90
60
30
0
29%
48%
65%
Dividend Payout Ratio
%
100
80
60
40
20
0
-20
-40
-60
-80
-100
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70%
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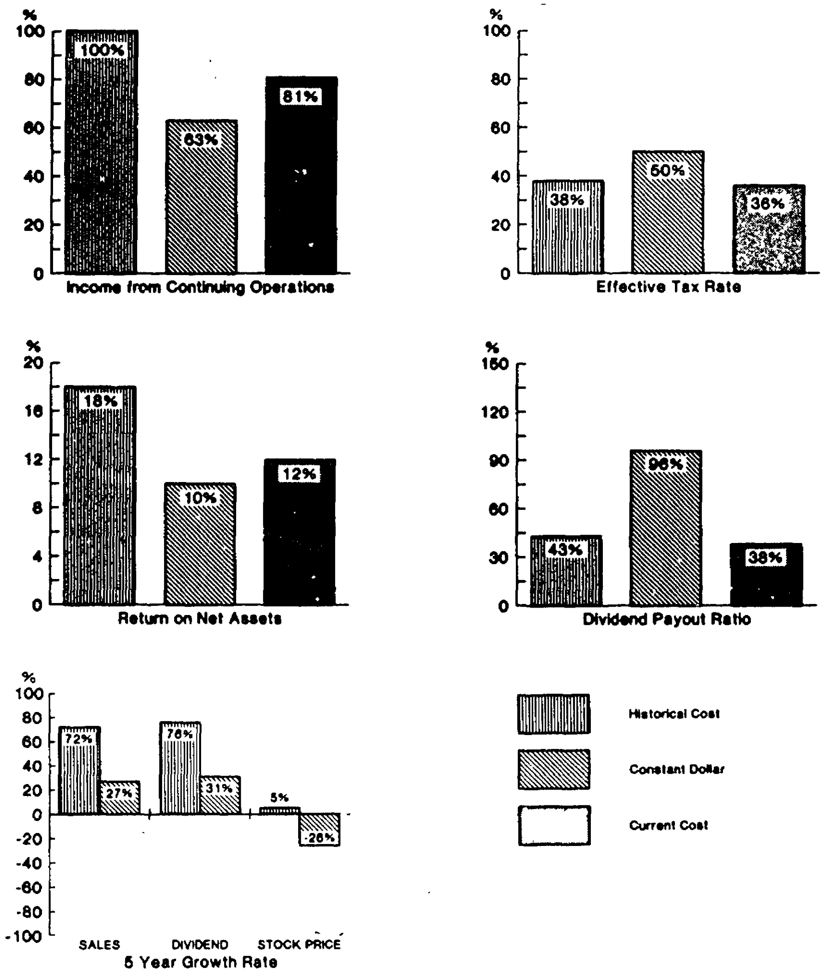
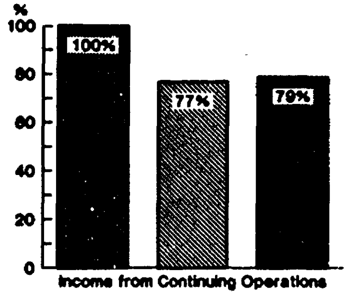
112%
52%
SALES
DIVIDEND
STOCK PRICE
5 Year Growth Rate
Historical Cost
Constant Dollar
Current Cost

Pharmaceuticals



Publishing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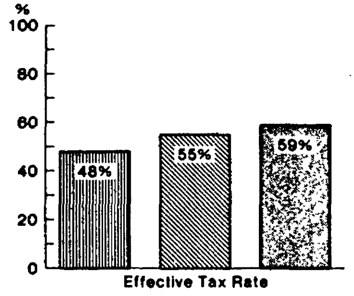
77%
79%
Income from Continuing Operations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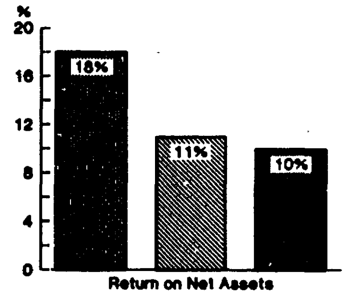
59%
Effective Tax Rate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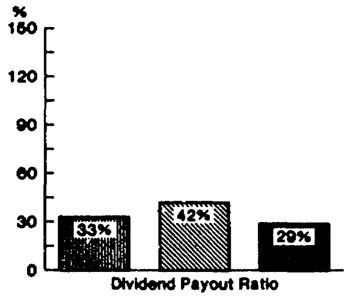
20
16
12
8
4
0
18%
11%
10%
Return on Net Assets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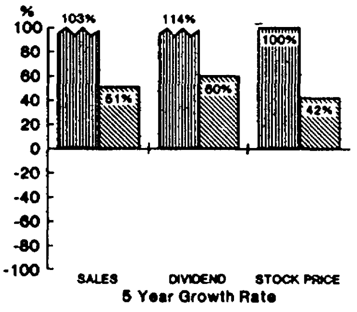
29%
Dividend Payout Ratio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103%
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114%
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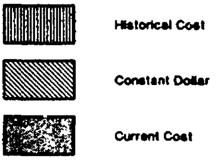
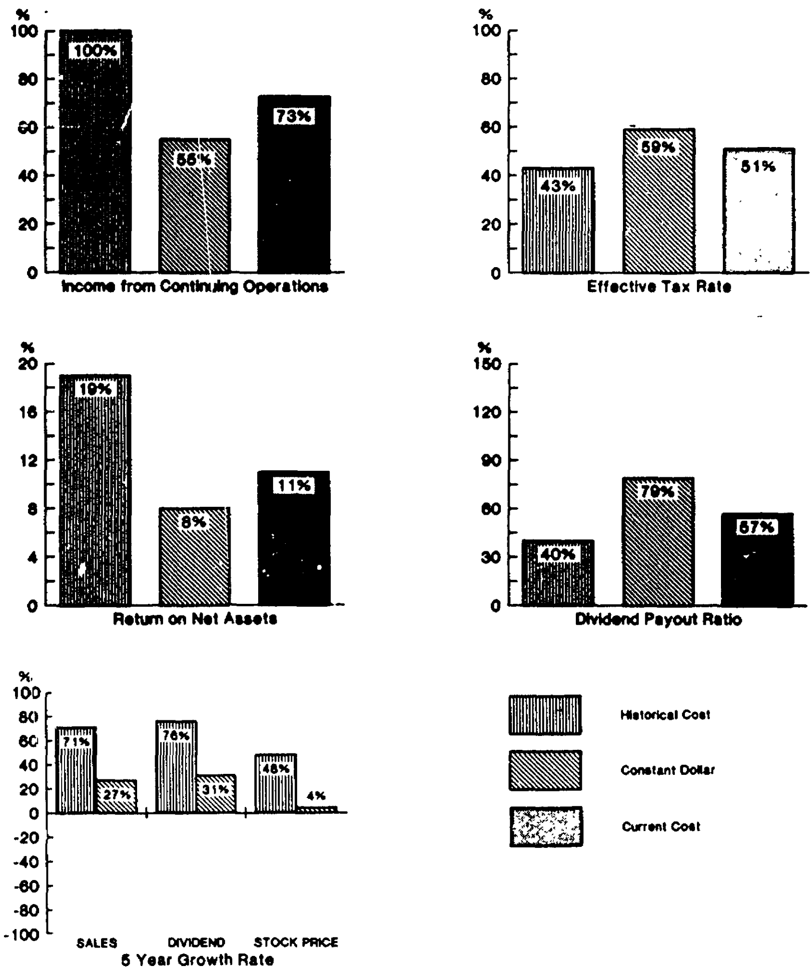
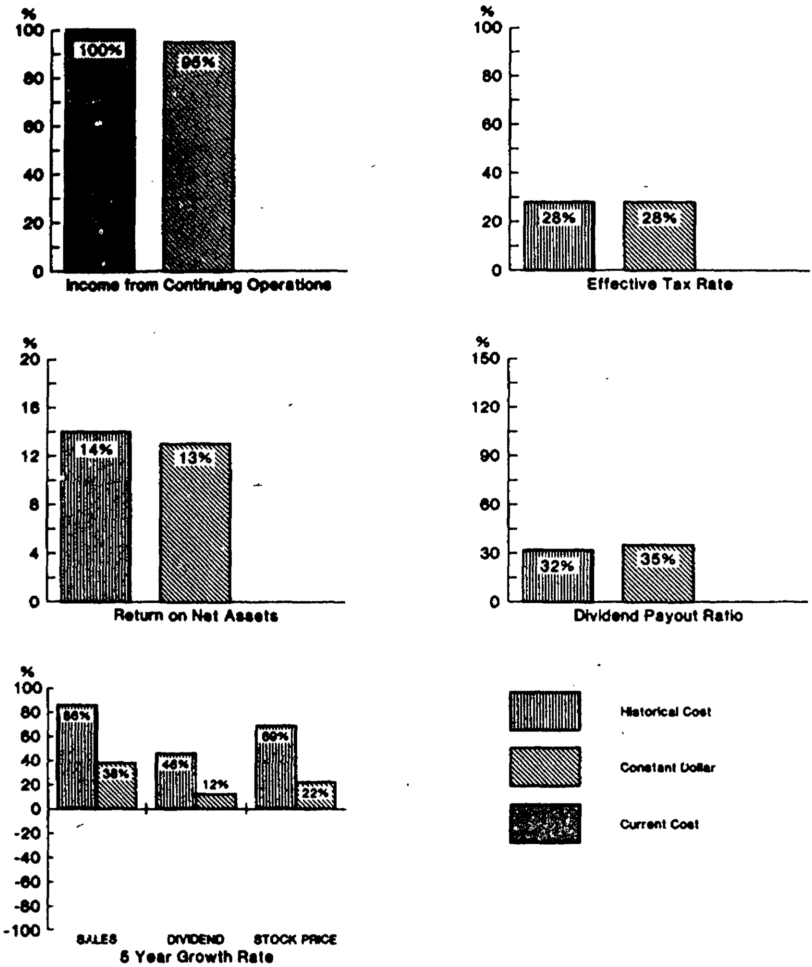
42%
SALES
DIVIDEND
STOCK PRICE
5 Year Growth Rate


Historical Cost
Constant Dollar
Current Cost

Tobacco


%
100%
55%
73%
Income from Continuing Operations
%
43%
59%
51%
Effective Tax Rate
%
19%
8%
11%
Return on Net Assets
%
40%
79%
57%
Dividend Payout Ratio
%
71%
27%
76%
31%
48%
4%
SALES
DIVIDEND
STOCK PRICE
5 Year Growth Rate
Historical Cost
Constant Dollar
Current Cost

Financial


100%
95%
Income from Continuing Operations
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Effective Tax Rate
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13%
Return on Net Assets
32%
35%
Dividend Payout Ratio
86%
38%
46%
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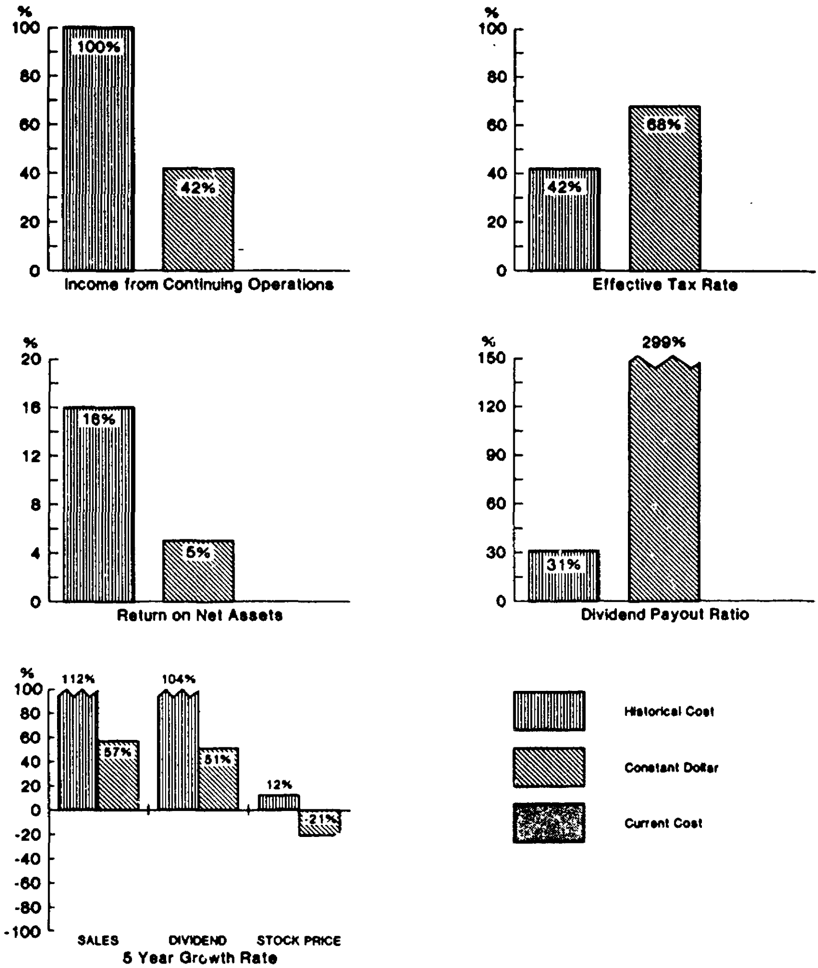
69%
22%
SALES
DIVIDEND
STOCK PRICE
5 Year Growth Rate
Historical Cost
Constant Dollar
Current Cost

Retailing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Income from Continuing Operations
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100
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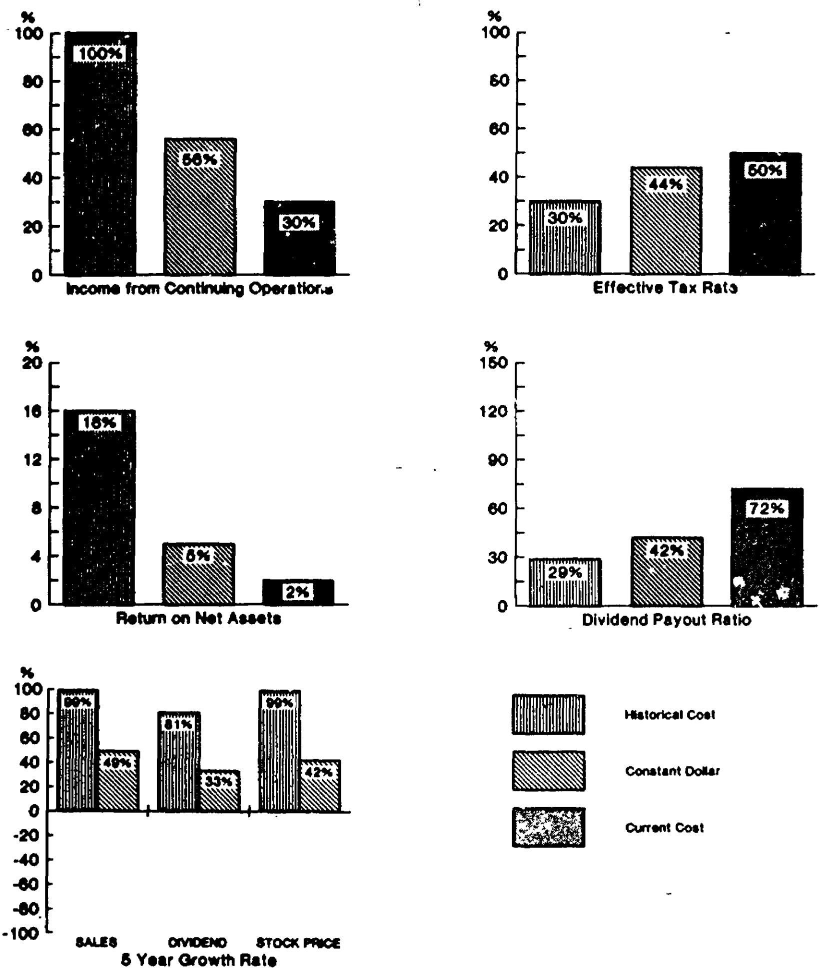
60
40
20
0
42%
68%
Effective Tax Rate
%
20
16
12
8
4
0
16%
5%
Return on Net Assets
%
150
120
90
60
30
0
31%
299%
Dividend Payout Ratio
%
100
80
60
40
20
0
-20
-40
-60
-80
-100
112%
57%
104%
51%
12%
-21%
SALES
DIVIDEND
STOCK PRICE
5 Year Growth Rate
Historical Cost
Constant Dollar
Current Cost

Transportation



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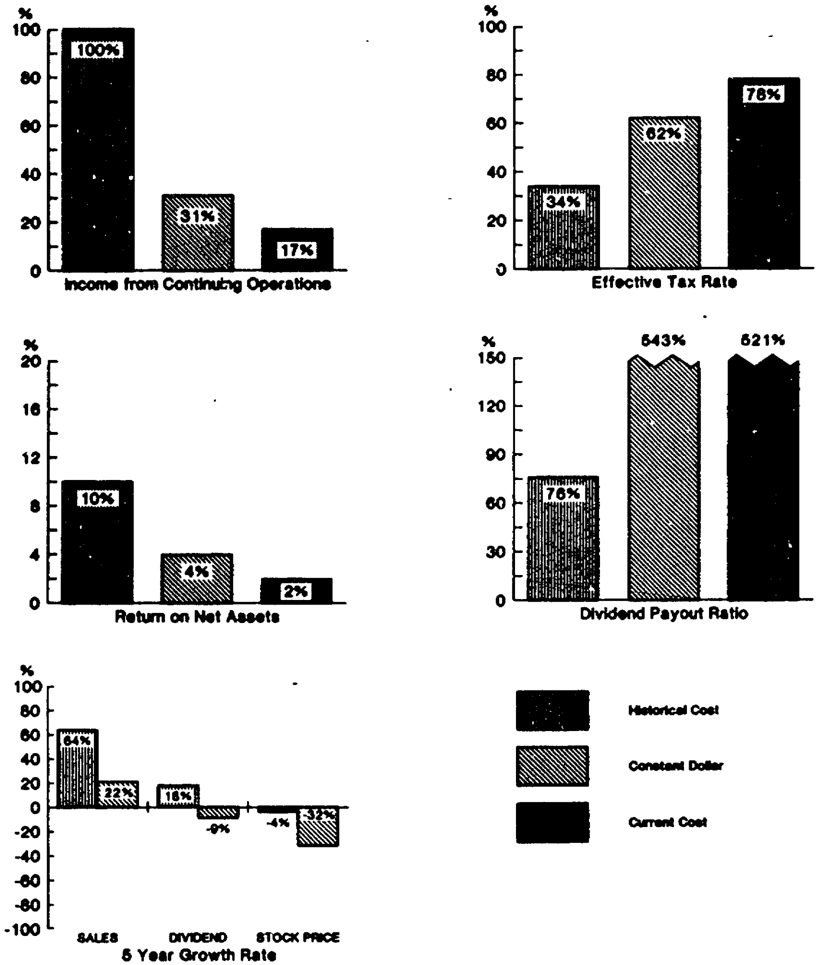
Utilities


%
100
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100%
31%
17%
Income from Continuing Operations
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100
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40
20
0
34%
62%
78%
Effective Tax Rate
%
20
16
12
8
4
0
10%
4%
2%
Return on Net Assets
%
150
120
90
60
30
0
76%
543%
521%
Dividend Payout Ratio
%
100
80
60
40
20
0
-20
-40
-60
-80
-100
64%
22%
18%
-9%
-4%
-32%
SALES
DIVIDEND
STOCK PRICE
5 Year Growth Rate
Historical Cost
Constant Dollar
Current Cost

STATEMENT SUBMITTED BY WILLIAM M. BATTEN
CHAIRMAN, NEW YORK STOCK EXCHANGE, INC.
TO THE SENATE FINANCE COMMITTEE
August 1, 1980

I am pleased to take this opportunity to offer the Committee some broad reflections on the issue of tax policy as it relates to the nation's urgent need to revitalize the competitive thrust which, historically, has fueled America's economic strength and progress.

The Loss of U.S. Competitiveness

As the Committee knows, the New York Stock Exchange last April co-sponsored with your Subcommittee on International Trade and Harvard University a conference on the loss of U.S. competitiveness. The conference proceedings have been published by the Subcommittee as a committee print statement. It concludes that:

> The cold facts are that during the past decade the United States has had the lowest rate of productivity increase of all major industrial nations. Last year we moved from several years of stagnant productivity to a net decline. All Americans have a stake in turning this economy around...A comfortable and stagnant United States will continue to lose markets, suffer higher unemployment and forego one of the most effective antidotes to inflation. We must confront the reality that we are not Number 1 in economic performance and will suffer continued decline unless we undertake very basic changes in our attitudes and policies.

The American public knows we are in a crisis. They know our economic problems will be difficult to solve and will persist for awhile. As input to the Harvard Conference, a broad public opinion poll was commissioned by the New York Stock Exchange and conducted by Garth Associates among a cross-section of the U.S. populace.

A full 90 percent of the respondents believe our economy is heading in the wrong direction. They know the causes of our problems are not simply OPEC or the cost of energy. They know our productivity growth is low and has been declining. And they know that our economic problems have contributed to our nation's other problems at home and abroad.

Business, government and labor all share responsibility for the decline of our competitive position in the opinion of those surveyed.

Taxes Slated to Increase in the Current Recession

There is little doubt now that the recession of 1980 will be deep. Most economists expect the recession to be almost as severe as the decline in 1975. Real GNP in the second quarter declined some 9% per annum. A further reduction in activity lies ahead in the third quarter although economists expect the rate of decline to diminish. No one knows precisely at what point the momentum of decline will cease and give way to an upturn. The consensus of expert opinion appears to be that the decline will end and an upturn begin by the opening months of 1981.

At that time, the rate of unemployment may reach 8-1/2 to 9 percent of the labor force. The utilization of industrial capacity may fall below 75 percent.

In an economy such as I have been describing, economic policy in the past would have favored a tax reduction. The fact is, however, that taxes are slated to rise by some $40 billion in the next fiscal year.

This will come about as

Social Security taxes rise......................	$11 billion
Inflation places individuals in higher brackets ("bracket creep")....................	14 billion
Windfall profits tax generates..................	14 billion
The combination of these tax increases will pull out of the spending stream..........	$39 billion

That is the estimate for fiscal 1981. For the calendar year, these tax increases will be closer to $50 billion.

I stress these facts because the question confronting the nation is not whether to cut taxes but whether, under present circumstances, taxes should be allowed to increase by some $40 billion.

There is much discussion about a tax cut of $30 to $40 billion. I think many people will regard these proposals as tax offsets rather than tax reductions.

Encouraging Long-Term Productivity and Real Growth

In devising tax policy, the big challenge is to adopt measures which will help the economy not only in the short run but encourage growth and reduce inflation over a longer period.

We could just pump up consumer incomes and spending through personal tax reductions. Such a policy would be in the tradition of Keynesian demand management. My fear is that it would generate rising inflation, perhaps not in the next six to twelve months, but in the years ahead. It would send all the wrong signals to the public, here and in international markets, about our understanding of America's basic long-term economic problems and our willingness to tackle them.

A major reason for the lack of entrepreneurship in America today is the rate of taxation. A recent study by Professors Feldstein and Summers concluded that the distorting effects of inflation have returned corporate taxes to the level of the mid-1950s before accelerated depreciation and the investment tax credit began to reduce the tax burden.* The real return on corporate capital before federal income taxes is about 12 percent. After taxes, it is only one-third of this, or 4 percent. That is to say, the effective or inflation-adjusted rate of tax on corporate income is 66 percent. Obviously, a real return on capital of only 4 percent is an insufficient incentive to sustain a desirable level of saving and risk-taking.

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*M. Feldstein and L. Summers, "Inflation and the Taxation of Capital Income in the Corporate Sector," National Bureau of Economic Research, Working Paper No. 4, January, 1979.

To deal effectively with the longer-term challenge of making America more productive and more competitive, half of any tax reduction ought to be specifically designated to provide direct encouragement to capital investment. Our national goal must be to lift savings and investments to higher levels so that we begin to improve in comparisons with Germany, Japan and other countries which invest a much higher proportion of their GNP.

In Summary

The message is simple: We need to encourage the installation of the most modern plant and equipment based on the most up-to-date technology. Half of any tax cut should go to stimulate the efficiency of production and supply. A tax "offset" to encourage increased productivity and risk-taking will, in a longer perspective, create growth and jobs, raise living standards for all workers, and reduce inflation. In connection with inflation, it is particularly interesting to note the results of recent research carried out by the New York Stock Exchange with the cooperation of the Joint Economic Committee. It shows that a two percent gain in productivity growth can produce as much as a six percentage-point reduction in consumer prices over three years.

This Committee ought to consider these objectives in reviewing the specific tax bills and proposals to "best" accomplish our national economic goals. Many roads lead to Rome -- from accelerated depreciation, to investment tax credits, to reduced capital gains taxes, to lower corporate rates, to eliminating the pejorative concept of unearned income, to greater exemptions for investment income, to permitting tax-free rollovers, and so on. Encouragement to higher R & D outlays would also contribute to ensuring the technological leadership of the U.S. in the years ahead.

However, in considering how we can best cushion the impact of the tax increases already in store for the nation in fiscal 1981, we should be thinking in terms of measures that can be specifically designed to stimulate saving, investment and productivity. Properly designed, such measures will be non-inflationary. They will help create new jobs for American working people. They will be an important first step toward raising living standards for all Americans. And they will help set us firmly on the path to restoring America's economic leadership worldwide.

Summary of Major Points in Statement:

1. The U.S. has suffered a severe loss of international competitiveness and the public is deeply aware and concerned about the problem.

2. The U.S. is in a severe recession with unemployment rising and industrial utilization rates dropping.

3. Enacted legislation will increase taxes some $40 billion in fiscal year 1981 and nearly $50 billion in calendar year 1981.

4. The economy would benefit from an offset to these tax increases.

5. The U.S. has an opportunity to reduce taxes in a way which will promote longer-run productivity growth and minimize inflation later on.

6. Half of a tax cut should encourage savings and risk-taking. The need is urgent to step up the modernization of U.S. plant and equipment and to promote greater entrepreneurship.

7. In the longer-run, such a policy will create jobs and improve real living standards.

TESTIMONY OF BRIAN O'CONNELL

PRESIDENT
INDEPENDENT SECTOR

ON
TAX CUT PROPOSAL HEARINGS

BEFORE

SENATE FINANCE COMMITTEE

August 1, 1980

INDEPENDENT SECTOR
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Mr. Chairman and members of the committee, I am Brian O'Connell, President of INDEPENDENT SECTOR. I am pleased to be able to submit this testimony for the record on behalf of the Charitable Contributions legislation, S.219. We urge that it be included in any major tax legislation considered by Congress.

INDEPENDENT SECTOR is a new organization created to preserve and enhance our national tradition of giving, volunteering and not-for-profit initiative. Our one hundred ninety members are nonprofit organizations, corporations and foundations with national interests in philanthropy and voluntary action related to the educational, scientific, health, welfare, cultural and religious life of the nation. INDEPENDENT SECTOR was formed through the joint efforts of the National Council on Philanthropy and the Coalition of National Voluntary Organizations and now is the successor to those organizations.

Out of the history of this sector of American society has come an incredible variety of institutions-- libraries, museums, civic organizations, great universities, symphony orchestras, garden clubs, historical societies, hospitals, religious organizations, and on and on. The groups and organizations number in the millions. They constitute a vitally important part of American life. Most of the recognized advances in American society owe their beginnings to ideas and actions generated within this sector.

Problems have been developing, however, which make the sector not as useful as it could be and in some danger of decline. Chief among these problems is the decline in giving as a proportion of disposable personal income and of Gross National Product.

Unfortunately, today, a provision of the tax law which was designed to simplify the personal income tax -- and indeed it has -- is serving to reduce contributions to charitable organizations. I'm referring, of course, to the standard deduction. As the standard deduction increases, the number of taxpayers who itemize their deductions decreases. There is a demonstrated decline in the percentage of personal income contributed by taxpayers who no longer itemize.

Fortunately, legislation to remedy the problem is already pending in Congress: the Moynihan-Packwood bill in the Senate (S.219) and the Fisher-Conable bill in the House (H.R.1785). These bills would allow taxpayers to deduct their charitable contributions whether or not they use the standard deduction. The major benefits of this legislation would be: to stem the erosion of private giving; to broaden the base of giving; to stabilize the level of services provided by charitable organizations and to increase the share of Gross National Product being invested in the independent sector.

Thirty-three witnesses testified in favor of the Charitable Contributions legislation on January 30 and 31 of this year, before the Subcommittee on Taxation and Debt Management of this Committee. In addition, 90 organizations and individuals submitted statements for the hearings record. The witnesses came from across the country and represented an unusually wide range of interests. They ran the gamut from one who spoke for a small Midwestern arts association to one representing ten national associations in the field of higher education. Their reasons for support were as varied as their backgrounds. But, the common base of their concern is the preservation of a vital sector of our society.

One such witness, INDEPENDENT SECTOR Chairperson John W. Gardner, stated at that time, "The countless informal organizations of the independent sector permit the expression of caring and compassion; they make possible a sense of belonging, of being needed, of allegiance and all the other bonding impulses that have characterized humans since the prehistoric days of hunting and food-gathering. But all of these nonprofit activities depend on another powerful American tradition -- the tradition of private giving for public purposes. The ingredient of private giving supplies the element of freedom."

Since those hearings in January, support for the Charitable Contributions legislation has been growing rapidly in both houses of Congress to the point where today 239 Congresspersons -- a clear majority of the House -- are co-sponsors. Forty-two Senators are on the co-sponsor list which includes a majority of this important committee.

Historically, U.S. tax policy has encouraged deducting contributions. This has provided a significant incentive for giving, but even more importantly has served to remind all of us that it is the philosophy and policy of the people and our government that giving is an act for the public good which is to be fostered. During the past ten years, this principle has been unintentionally but seriously undermined.

To simplify the income tax system, the Government has increased the level of the standard deduction five times since 1969. In 1979, approximately two-thirds of all U.S. taxpayers used the standard deduction. This reduced incentives for giving among enough taxpayers to represent a loss of more than a billion dollars in 1979. A billion dollars may not seem like much to a government with a budget of $600 billion, but it still goes a long way in the independent sector. For example, that's all of the money raised in 1979 by <u>all</u> United Way campaigns across the country.

We can learn a valuable lesson from the decline of voluntary activity in Great Britain. The Wolfenden Commission Report traces many of England's public service difficulties to an overdependence on one governmental system, but laments that the country has let its voluntary structure deteriorate so badly that a truly independent sector has been lost.

Americans of all philosophical and political persuasion are intellectually committed to our country's unique degree of voluntary action, but we are assuming that this pluralism will continue without planning to be sure that it will.

The Charitable Contributions legislation would increase contributions by an estimated $5 billion a year. That would allow an expansion of voluntary services in the order of ten percent. Even if the Government were to lose a like amount, and the estimates are that the loss would be considerably less, the total would represent only a fraction of one percent of Federal expenditures.

INDEPENDENT SECTOR is mindful of efforts to hold down the federal deficit. We are also aware of proposals which would phase in the legislation over a period of several years, and minimize the Treasury loss in the first years after enactment. Although we do not have a position on a specific phase in proposal, we believe there are reasonable ways to phase in the legislation which would not place an undue burden on the budget.

From time to time, the Treasury Department has expressed interest in placing a floor on the deductibility of charitable contributions. This proposal would permit the deduction of all contributions in excess of some established dollar figure, usually $100. INDEPENDENT SECTOR firmly opposes a floor. At a recent meeting of its 31-member Government Relations Committee, a resolution strongly opposing a floor passed unanimously.

The opposition of INDEPENDENT SECTOR and its member organizations is based on the following considerations:

1. The large number of small contributors gives the bulk of all funds to charity.
2. The institution of a floor would discriminate against the small giver and not provide the encouragement to giving by low and middle income persons that is the central purpose of the Charitable Contributions legislation.
3. The institution of a floor for non-itemizers opens the door to the institution of a floor for itemizers as well, which would severely undermine the incentive of all persons to give.
4. The institution of a floor is de facto recognition of the wrong-headed notion that gifts to charity are a tax expenditure, that is, that those gifts are a part of a person's taxable income. INDEPENDENT SECTOR believes, as do many tax theorists, that money given away to groups determined to be charitable organizations should not be considered part of a person's income, subject to tax.

As I mentioned earlier, the estimated $5 billion per year increase from the passage of the Charitable Contributions legislation would allow an expansion of voluntary services in the order of 10%. For a society rapidly learning the practical limitations of big government and turning to voluntary organizations for help in troubled times, a 10% expansion of the voluntary sector, using money voluntarily contributed and intended for the sector in the first place, is a very sensible step in the right direction.

Thank you.

Hearings Before the Senate Finance Committee
on Tax Reductions for 1981

STATEMENT
OF THE
CIGAR ASSOCIATION OF AMERICA
(August 1, 1980)

The Cigar Association of America, which represents domestic manufacturers of over 90 percent of the large cigars sold in the United States, urges the Senate Finance Committee to amend the cigar excise tax provisions to correct certain structural defects and to reduce a competitive disadvantage caused by the tax itself.

Section 5701(a)(2) of the Internal Revenue Code imposes an excise tax on manufacturers of large cigars of 8.5 percent of the wholesale price of their cigars, which is defined in section 5702(m) as the "suggested delivered price at which the cigars are to be sold to retailers". The Association recommends that the tax base be changed to the actual selling price received by the manufacturer and that the tax rate be reduced to 7.5 percent. The Association further recommends that the ceiling of $20 per 1,000 cigars under present law be retained.

The change in the tax base would conform the cigar tax base to the tax base used for all other *ad valorem* excise taxes on manufacturers, would eliminate a difficult, if not impossible, administrative burden on the industry, and would remove any potential conflict between the existing cigar tax compliance system and the antitrust laws of the United States with respect to resale price maintenance.

The rate reduction from 8.5 percent to 7.5 percent would restore the rate on large cigars to the pre-World War II level, would reduce the discrimination against the cigar industry that now favors competing products, and would provide needed relief to an industry that is now suffering severe economic difficulties. In view of what appears to be broad sentiment in favor of both reducing taxes generally and providing incentives to business to create additional jobs, this proposal is particularly timely.

A. Adoption of Manufacturer's Selling Price as Tax Base.

1. The cigar tax base should be conformed to that of other ad valorem manufacturers excise taxes.

Examination of the excise tax provisions of the Internal Revenue Code that are phrased in terms of a percentage of value shows that, except in the case of large cigars, all such taxes are imposed on the manufacturer's selling price of the commodity. See, for example, the taxes imposed by sections 4061 and 4161 on trucks, buses, tractors, and certain sporting goods. It is only logical and reasonable that a tax on a manufacturer's sale of his products should be imposed on the actual manufacturer's selling price since this price represents the value of the product and is readily available to the manufacturer-taxpayer. The proposed change would conform the cigar tax to the system used for other ad valorem excise taxes.

2. A manufacturers excise tax based on the manufacturer's selling price would be easier to administer.

Under the current system the Bureau of Alcohol, Tobacco and Firearms requires manufacturers to establish suggested wholesale prices to retailers. The BATF further requires that these prices be representative of current actual wholesale prices. 27 C.F.R. §270.22(a). Thus, manufacturers are responsible for making sure that the resale prices charged by unrelated distributors or wholesalers are in accordance with the manufacturer's suggested resale price. This is a difficult, if not impossible, burden.

Since manufacturers cannot control wholesale prices and since they cannot obtain pricing information with respect to transactions to which they are not privy, it is unfair to impose this burden on them.

3. Adoption of manufacturer's selling price as the tax base would remove the potential for conflict with antitrust laws.

According to the Justice Department "resale price maintenance is *per se* illegal and, therefore, may properly be prosecuted criminally". See, Ewing, Remarks before the Fifth Annual Symposium on Antitrust Law, the Southwestern Legal Foundation, Dallas, Texas, 17 (May 9, 1980). The potential for conflict has increased recently. As stated by Mr. Ewing --

> "Our new Assistant Attorney General, Sanford Litvack, has said repeatedly over the last four months that more aggressive prosecution of vertical price fixing is one of his highest priorities". *Ibid.* (emphasis added).

The operation of the cigar excise tax, as presently constituted, is fundamentally at odds with the public policy against resale price maintenance. Despite disclaimers by the Bureau of Alcohol, Tobacco and Firearms, the current cigar excise tax system *requires* manufacturers *to assure* that their distributors/wholesalers resell cigars at the manufacturers' suggested resale price, thereby tacitly encouraging manufacturers to venture into forbidden waters. It seems obvious that the tax law should not place cigar manufacturers in this potentially intolerable dilemma. The recommended change in the tax base would remedy this problem.

B. Reduction of Tax Rate to 7.5 Percent.

1. The cigar tax rate should be reduced to its pre-World War II level, as in the case of other excise taxes.

The second aspect of the Association's recommendations is that the tax rate be reduced from 8.5 percent to 7.5 percent, while retaining the current ceiling of $20 per 1,000 cigars. The most obvious reason for this change is to restore the tax rate for cigars to the pre-World War II level. As the attached legislative history (Exhibit A) shows, cigar excise taxes are the only excise taxes that were increased to help pay the costs of World War II but have not been restored to their pre-World War II level. It is unfair for the cigar industry to continue paying this excise tax on a war-time basis while other excise taxes have been repealed or reduced at least to their pre-war levels.

2. The cigar tax discriminates against the cigar industry because the excise tax on competing products was repealed in 1965.

Taxes on competing products (chewing tobacco, snuff and pipe tobacco) were repealed in 1965. See Exhibit A. This discrimination is patently unfair. Nevertheless, the Association is not recommending complete repeal to the cigar tax, but simply a reduction of the competitive disadvantage presently imposed by the excise tax on the cigar industry.

3. <u>A change in the tax base and tax rate would provide needed relief</u>.

Finally, as with many other industries, the American cigar industry currently is suffering severe economic difficulties. Between 1972 and 1979 cigar sales dropped from over 7,200 million units to 4,400 million units, with a commensurate decline in plants and jobs. The estimated $8.5 million in tax relief that the proposed changes would provide would significantly assist the the industry at this time.

For the reasons stated above, the Association respectfully recommends that the Committee on Finance include in its tax reduction bill for 1981 a provision reducing the tax on large cigars to 7.5 percent of the manufacturer's selling price, with a ceiling of $20 per 1,000 cigars. In addition to the legislative history of the cigar tax, we are attaching as Exhibit B the text of an amendment that would produce this result.

Attachments

Exhibit A

LEGISLATIVE HISTORY--CIGAR TAX

Taxes have been imposed by the federal government on cigars in one form or another since 1862. In 1917 the tax was changed from $3.00 per thousand cigars to a graduated bracket approach keyed to the intended retail selling price of the cigars. This change included an increase in the overall effective rate in order to increase revenue to the Federal government to finance World War I. The 1917 rates were increased in 1918. Following World War I the 1918 rates were reduced in 1926. In November 1942 the rates were essentially doubled to provide revenue for the government, this time to finance World War II. The 1917, 1918, 1926, and 1942 tax rates were as follows:

CIGAR TAX RATES 1917-1942

[Per thousand cigars]

Class of cigar	Revenue Acts and effective date			
	1917 (Nov. 3)	1918 (Feb. 25, 1919)	1926 (Mar. 29)	1942 (Nov. 1)
Small cigars	$1.00	$1.50	$0.75	$0.75
Large cigars (intended retail price per cigar):				
Not over over 2½ cents	[1] 3.00	4.00	2.00	2.50
Over 2½ cents but not over 4 cents	[1] 3.00	4.00	2.00	3.00
Over 4 cents, but not over 5 cents	[2] 4.00	4.00	2.00	4.00
Over 5 cents, but not over 6 cents	[2] 4.00	6.00	3.00	4.00
Over 6 cents, but not over 7 cents	[2] 4.00	6.00	3.00	7.00
Over 7 cents, but not over 8 cents	6.00	6.00	3.00	7.00
Over 8 cents, but not over 15 cents	6.00	9.00	5.00	10.00
Over 15 cents, but not over 20 cents	8.00	12.00	10.50	15.00
Over 20 cents	10.00	15.00	13.50	20.00

[1] Price class was "less than 4 cents."
[2] Limits of price class were "4 cents and not over 7 cents."

In 1950 the House approved a reduction of the tax on cigars to their pre-World War II rates. By the time the Finance Committee considered the House amendments, however, the Korean War had broken out. As a result the Senate, and later the

House, dropped all of the excise tax reductions contained in the House bill and enacted a bill that increased revenues rather than reducing them, this time to finance the Korean War.

The next major bill reducing excise taxes was the Excise Tax Reduction Act of 1965. In this bill most of the tax increases enacted at the beginning of World War II were rolled back and some of the excise taxes were competely repealed. For example, the taxes on snuff, chewing tobacco, and manufactured tobacco were completely repealed. When it considered the cigar tax the Committee on Ways and Means initially agreed to reduce it to 5 percent of the intended retail price, which would have restored the tax to its pre-World War II overall effective rate. However, this motion was reconsidered at the request of Representative Herlong because he felt that it would have an adverse impact on one of the major employers in his district (which subsequently was found not to be the case). The Committee then instructed the staff of the Joint Committee on Internal Revenue Taxation to work with the staff of the Treasury Department to produce a detailed study of the taxes on cigars. The resulting study was not published until October 21, 1966.

In the Tax Reform Act of 1976 Congress dropped the old bracket system and replaced it with the current system under which the tax is computed at the rate of 8-1/2 percent of the suggested wholesale price.

Exhibit B

PROPOSED CIGAR TAX AMENDMENT

Section ______. LARGE CIGARS.

(a) RATE OF TAX.--Section 5701(a)(2) is amended by substituting "7-1/2 percent" for "8-1/2 percent".

(b) TAX BASE.--Section 5702(m) is amended to read as follows:

> "(m) Wholesale price.--'Wholesale price' means the price at which the cigars are sold by manufacturers or importers, inclusive of the tax imposed by this chapter or section 7652, but exclusive of any State or local taxes imposed on cigars as a commodity, and before any trade, cash, or other discounts, or any promotion, advertising, display, or similar allowances. Where the manufacturer's or importer's wholesale price is not adequately supported by bona fide arm's length sales, the wholesale price shall be the price for which comparable cigars are sold in the ordinary course of trade as determined by the Secretary".

(c) EFFECTIVE DATE. The amendments made by this section shall apply to sales after December 31, 1980.

STATEMENT BY
NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
AUGUST 1, 1980

I. INTRODUCTION

II. CAPITAL COST RECOVERY AND INVESTMENT TAX CREDIT POLICIES

A. Accelerated Depreciation ("10-5-3") -- S. 1435

B. A doubling, to $200,000, of the annual amount of used machinery eligible for the investment tax credit

III. OTHER TAX INCENTIVES

A. An increase, to $150,000, in the amount of corporate income taxable at a rate lower than 46% -- S. 2136

B. An allowance for the rollover of dividends, interest, and capital gains which are reinvested in the equity market -- S. 1964

C. A tax credit for business firms funding research at colleges and universities -- S. 2355

D. A modification in the taxation of income earned by Americans overseas -- S. 2283, S. 2418

IV. TAX CUTS FOR INDIVIDUALS

A. The largest possible individual tax reduction consistent with prudent, noninflationary fiscal policy

V. SOCIAL SECURITY TAXES

A. An income tax credit for the massive Social Security tax increases scheduled to go into effect in 1981

VI. PRODUCTS LIABILITY TAX TRUST FUND

A. A deduction for limited contributions to products liability loss reserve accounts -- S. 542

VII. SUMMARY

A. The controversy seems to be not whether to enact a January 1, 1981 tax cut -- but when to enact it. We firmly believe that, as the need exists now: The time to act is now.

STATEMENT BY
NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
AUGUST 1, 1980

I. INTRODUCTION

The National Machine Tool Builders' Association (NMTBA) is a national trade association comprised of about 370 member companies which account for approximately 90% of United States machine tool production. Although the total machine tool industry employs approximately 110,000 people with a combined annual output of $4.0 billion, most NMTBA member companies are small businesses with payrolls of 250 or fewer employees.

While relatively small by some corporate standards, American machine tool builders comprise a very basic segment of the U. S. industrial capacity, with a tremendous impact on America. It is the industry that builds the machines that are the foundation of America's industrial strength. Without machine tools, there could be no manufacturing; there would be no trains, no planes, no ships, no cars; there would be no power plants, no electric lights, no refrigerators and no agricultural machinery.

We welcome this opportunity to assist this Committee in its assessment of whether a tax cut to take effect in 1981 should be enacted this year. With the United States economy currently crunched between continuing serious inflationary pressures, and what quite probably will be the most severe post-war recession, it is absolutely essential that tax measures designed to help bolster our flagging economy be carefully targeted so as not to further exacerbate the inflationary fires that have increasingly beset our economy over the past several years.

In this regard, we wish to comment on a number of tax proposals which, when carefully crafted into an overall "tax cut," we believe will be effective in alleviating the current economic squeeze on the individual U. S. citizen (resulting from both the immediate economic downturn and the long term inflationary spiral), while at the same time providing the type of financial atmosphere necessary for the kind of productivity improving business investments so necessary in our efforts to drive down soaring inflation.

In previous public statements and Congressional testimony, we have directed our remarks to the reassessment of the current U. S. capital cost recovery system, in an effort to encourage even greater capital formation, higher employment, and greater economic opportunity through a more productive industrial base. Today we reaffirm our belief that more flexible and rapid depreciation for capital goods should be the centerpiece of any proposed tax cut for 1981.

At this time we also wish to suggest several other changes in the tax law which we believe should be integral parts of an overall 1981 tax cut. Specifically, we propose:

(1) A doubling, to $200,000, of the annual amount of used machinery eligible for the investment tax credit;

(2) An increase, to $150,000, in the amount of corporate income taxable at a rate lower than 46%;

(3) An allowance for the rollover of dividends, interest, and capital gains which are reinvested in the equity market;

(4) A tax credit for business firms funding research at colleges and universities;

(5) A modification in the taxation of income earned by Americans overseas;

(6) The largest possible individual tax reduction consistent with prudent, noninflationary fiscal policy;

(7) An income tax credit for the massive Social Security tax increases scheduled to go into effect in 1981; and

(8) A deduction for limited contributions to products liability loss reserve accounts.

II. CAPITAL COST RECOVERY AND INVESTMENT TAX CREDIT POLICIES

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

At the outset, we commend to this Committee the concept of accelerated depreciation as an engine of productive growth in the American economy. Capital cost recovery has been, and continues to be an extremely effective method of oth encouraging critically necessary capital investment in the U. S. economy, and of offsetting the ravages of inflation on America's ability to become more productive.

For the past decade we have all been bombarded with talk about the causes of inflation. There is cost push inflation; there is demand pull inflation; there is the wage-price spiral. All of these theories are probably partially correct. However, within the relationship between costs, wages, prices, and productivity lies a weapon that can be used to counteract the insidious damage that inflation is causing.

The ultimate result of inflation is increasing prices. And in manufacturing, or any business for that matter, prices have three major elements: the cost of purchased components; the cost of labor; and the cost of all other non-labor payments.

Non-labor payments are the sum of profits and other non-labor costs such as interest, depreciation, rents and royalties, taxes, regulatory and inspection fees, etc. Chart 1 illustrates how each of the main elements of non-labor payments are related and how inflation has affected them.

Chart 1 also shows, rather dramatically, that every element in the non-labor payments of American businesses has increased substantially, with the single exception of profits. As a matter of fact, the relative decline in profits compared to other non-labor cost factors has had a dampening effect on inflationary pressures.

The second element is the cost of labor. Unit labor costs are what we pay our workers, divided by the real value of their output.

The final element, the cost of purchased components, is a pass-through item that has little effect upon the ultimate price of a nation's manufacturing output. As a result, it is the total labor costs and non-labor payments, by everyone in the stream of commerce, that finally determines the price of goods.

Therefore, when we look at the costs that affect prices for all manufacturing, we need to study just two factors: unit labor costs; and unit non-labor costs.

In examining how these two factors have reacted upon prices, we begin by looking at Chart 2 which starts in 1955 -- just after the Korean War and its post-war recession.

During the first three years, until the 1958 recession, aggregate non-labor costs for taxes, interest, etc., including profits, were rising at a rate of less than 1½% per year. However, it is important to point out that during this time period most components of non-labor costs were actually rising at a much faster rate, with the notable exception of corporate income which was actually falling.

This was true because unit labor costs were climbing at an average rate of almost 4½% per year. Unit labor costs would have risen even faster, but we were able to offset much of the increase in labor rates by an average annual growth in productivity of more than 2%.

Of course, with unit labor costs rising and with unit non-labor payments rising, prices charged for manufactured products had to rise. And they did; at a rate of about 3% per year, beginning an inflationary period.

During the years 1958 through 1965, non-labor payments continued to climb at a modest rate of about 2% per year and business profitability was recovering. However, when we look at unit labor costs we note that they were constant during this period.

The key to our success in keeping labor costs under control for seven years, in spite of wage increases which occurred during the early 1960's, was productivity growth. During the seven-year period from 1958 through 1965, productivity grew at an average annual rate of 3½%, completely offsetting the increases in workers' wages and holding unit labor costs in manufacturing at a constant level.

The benefit of stable labor costs over this period was reflected in the stable price level. In fact, the average annual increase in wholesale prices was less than one-half of one percent. That is less than today's monthly inflation target.

From this discussion we conclude that if reasonable wage increases are balanced with adequate productivity gains, the result is constant unit labor costs. And if unit labor costs are constant, then everyone gains; because prices are stable, profits rise for business, tax income rises for government and real spendable income rises for workers. All of these things happened in the early 1960's.

Unfortunately, in the mid-1960's the economy lost this former stability. First, productivity growth began to falter -- declining to an average annual growth rate of about 2% -- down nearly one-half from the productivity improvement rates of the first half of the decade.

Wages began to accelerate. And without additional productivity growth, unit labor costs began to increase dramatically. In fact, during this period, unit labor costs were increasing at an average rate of about 5% per year.

In contrast, non-labor costs remained almost constant. Throughout the entire period, taxes, interest and other costs were rising -- but American businesses, in an effort to counteract the rapidly rising unit labor costs, were again forced to cut their profits to stem price increases and remain competitive. Nevertheless, rising labor costs forced prices upward at an annual rate approaching 3%, sowing the seeds of today's inflationary problems.

Then came the 1970's. Productivity growth in the private economy came to a near standstill -- rising at a rate of only 1.5% per year over the past five years.

Of course labor rates skyrocketed -- fueled by inflationary expectations and a "catch-up" philosophy. As a result, unit labor costs have been rising at an average annual rate of 7.0% during the last half decade. Moreover, unit labor costs made this dramatic increase even though we experienced a severe recession, coupled with unusually high unemployment.

Taxes, interest and all of the other non-labor costs of running a business were also leaping upward at an unprecedented rate of 7.5% per year. And, as we all know, the result was a dramatic 8% rise in prices.

From this economic history we have learned two very important lessons. First, that as unit labor costs increased prices also went up.

Secondly (and this is the point we wish to strongly emphasize to this Committee), that wage increases are not, <u>necessarily</u>, the inflationary culprit, because with rapidly rising productivity it is possible to offset increasing wage rates, thus dampening -- or even eliminating -- unit labor cost increases.

In other words, one way to bring prices under control -- either as a nation, as an industry or as an individual company -- is to increase productivity faster than total wages.

Chart 3 shows the productivity growth of America's total private business sector and the driving force that pushes productivity upward -- investment. For more than 25 years our national growth in productivity has traveled hand-in-hand with investment. Whenever we increase our investment in more efficient equipment, our productivity improves. And furthermore, when we invest in new, more productive equipment, we produce higher quality products and all the people of America benefit.

Although pleased by Congress' recognition of this critical need for improved investment incentive which has been reflected in the adoption of accelerated depreciation methods and the asset depreciation ranges (ADR's), along with the increase of the investment tax credit from 7% to the present 10% level, we still feel it imperative that more be done to increase productivity, thereby allowing business to combat the current double-digit inflation.

Thus, depreciation reform must be viewed not as a tax incentive nor as a "tax expenditure" -- but as a weapon in the war on inflation. And also it must be viewed as a weapon in the war on post-OPEC economic stagnation, because productivity improvements will enable American industry to regain its competitiveness, both at home in the domestic market and in international trade. And this will translate into more jobs for U. S. workers.

In 1978, NMTBA conducted a study of 16 major metalworking companies' annual reports. Without question, the companies selected are leaders in their industries. Ten of them are in the top hundred of the Fortune 500. And every one of the 16 would be considered a Blue Chip on Wall Street. We have reviewed the results of this study in previous testimony before this Committee. Those results are so instructive and so dramatic that we repeat them here.

Briefly summarized, the results of this study reflect a capital spending history that exhibits the beneficial effect of the confidence and stability of the early 1960's, which reached an investment plateau that lasted seven years. After a pause during the 1970 recession, capital spending took off again in 1973, but these gains were almost completely wiped out by inflation. Actually, real capital spending has been declining steadily since 1965.

This decline is even more dramatic when considered in light of the fact that during this period sales were rising. When viewed as a percentage of sales, the portion of every dollar re-invested by these companies has fallen nearly 40%, from 6.6% to 4.1%, since 1965.

The effect of these years of underinvestment in America's manufacturing plant are dramatically illustrated by the average age of machine tools in use in the industrialized nations. The United States of America has the lowest proportion of machine tools less than ten years old -- and the highest proportion that are more than 20 years old, of any of the seven nations shown in the table below.

MACHINE TOOLS IN USE IN SEVEN INDUSTRIAL NATIONS

Country	Percent of Total	
	Under 10 Years	Over 20 Years
United States	31%	34%
West Germany	37	26
United Kingdom	39	24
Japan	61	18
France	37	30
Italy	42	28
Canada	47	18

Our aggressive international competitors from Japan have the opposite standing. Nearly two-thirds of their machine tools are new, modern and ultra-efficient, while only 18% of their machine tools are candidates for resale at an antique shop.

When you consider the dramatic improvements that have occurred in machine tool productivity during the past ten years, with the application of computer control to virtually every type of machine tool, is it any wonder that Japanese manufacturers are overrunning some segments of our manufacturing economy?

In short, because of chronic underinvestment since 1970, America's metalworking industry has been in unconscious and involuntary liquidation. And the same probably holds true for almost all of America's manufacturing industries.

It is time that we clear the air and stop liquidating America's industrial base so that we can modernize and grow -- thereby making America once again fully competitive in world markets and providing the capital equipment needed to create jobs for all Americans.

In this regard, we take this opportunity to commend the far-sighted leadership of Senators Nelson, Bentsen, Packwood and Chafee in sponsoring S. 1435, the "Capital Cost Recovery Act of 1979." We also applaud those other Senators (currently nearly 75% of the Senate) who have also lent their support to this concept of productivity improving accelerated depreciation.

Under S. 1435 the current ADR system would be replaced by a capital cost recovery system calling for accelerated amortization of:

- Buildings over a ten-year period;
- Machine tools and other long-life equipment over a five-year period; and
- The first $100,000 worth of rolling stock over a three-year period.

Adoption of this system would abolish salvage value requirements. Additionally, the 10% investment tax credit (ITC) would continue to apply to equipment with a 6% ITC for rolling stock. Furthermore, S. 1435 is devised to be phased-in over a period of years to minimize revenue loss to the Treasury.

As an association predominately representing small business, we strongly oppose suggestions, which some have made, to put a "cap" on the amount of annual investment in plants and equipment eligible for the faster amortization provisions of S. 1435. In a misguided (albeit, well-meaning) effort to assist small business, these suggestions will do very little to upgrade America's store of new plants and equipment; they will not help the thousands of small businesses who supply equipment and construction services to larger companies; and they will do next to nothing in providing for the critically necessary improvements in our nation's lagging rate of productivity. Their adoption would reduce the effectiveness of S. 1435 as a weapon in the war on inflation and joblessness from a cannon to a pop gun.

Improving the cash flow of industry through the changes provided in S. 1435 has never been more important than it is in today's inflationary times. As demonstrated by our study of the 16 metalworking firms, current capital recovery mechanisms are inadequately dealing with the rising prices of new productive machinery. And every year that this unrealistic policy remains in effect results in a further shortfall between the cash flow generated by depreciation and the actual outlay needed to replace the depreciated equipment.

The key feature to any of these changes in depreciation allowances is that they would attempt to treat capital spending in a more progressive sense. Depreciation charges generated by capital spending would be treated more rationally as a true cost of doing business rather than simply as a tax allowance for the wear and tear on equipment which is now effectively the case. A depreciation policy that allows business to more fully recoup the replacement cost of aging capital equipment over a shorter time span also means that a firm's operating profits would not have to be utilized to replace obsolescent machinery.

The current practice of inadequate depreciation allowances creates phantom profits, as depreciation expenses are far too low, and artificially inflates the bottom line of a firm's income statement. The changes which S. 1435 recommends, and we support, would simply move the source of funds used for capital spending out of the retained earnings ledger back into the depreciation expense accounts where it more accurately belongs. Such a change in tax policy would reduce the tax liability of the average firm, but the tax reductions would not be unjustified. The tax applicable to the firm's reduced earnings would then be a true tax on profits not an unwitting tax on improperly amortized capital assets.

As previously stated, the 10% investment tax credit (ITC) would continue to apply to equipment, with a 6% ITC for rolling stock. We firmly support retaining the current level of investment tax credit in addition to increasing the rate at which capital assets can be depreciated. Working together, these two tax policies can be a very powerful stimulus to increased capital investment. However, a specialized application of the ITC in which we believe an increase would be particularly appropriate and beneficial would be to double, to $200,000, the annual amount of used machinery eligible for the investment tax credit.

Under the current law a limit of $100,000 is placed on the amount of used property which can qualify for the investment tax credit in any tax year.[1] Historically the investment tax credit was designed to encourage the purchase of new machinery as opposed to the resale of used equipment, with the obvious underlying policy objective of increasing productivity. From the standpoint of an industry whose business it is to manufacture such new machinery, it is obvious that we support such a policy as being in both our own as well as the overall economy's best interest. However, we also believe that legislative policy should take into account the limited amount of financial capital small business sometimes has at its disposal. Also, the cost of used machinery has been affected by inflation to a large degree since 1969.[2]

Therefore, although we continue to underscore the necessity for the U. S. industrial base to update its equipment by investing in new machine tools that are engineered for specific operations and incorporate all the latest technological features, we also recognize that many small businesses are most apt to buy used capital equipment when expanding their facilities. And that an updated, more productive piece of equipment for a small manu-

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[1] The ceiling on the cost of used equipment taken into account for the investment tax credit was raised in 1975 from $50,000 to $100,000. Public Law 94-12, §301(c). March 29, 1975.

[2] For example, a 7-year-old Marvel Saw 81A cost $7,250 in 1969. In 1979, a 7-year-old Marvel Saw 81A cost $26,500. U. S. Congress, House of Representatives, <u>Capital Formation and Retention</u>, H. Rept. 96-732, 96th Cong., 2d Sess. 1980, p. 10.

facturer is quite likely to be a used piece of equipment rather than a newly manufactured one.[3]

Therefore, we urge this Committee to include in any business tax cut a provision which would double to $200,000 the annual amount of used machinery eligible for the investment tax credit. Similarly, the carryback and carryforward provisions now available for new equipment should also be made available to the purchase of used equipment.

Faster and more simplified depreciation laws will encourage many corporations to purchase new machines, thereby making available more late model equipment for small and medium sized manufacturers, who in turn would have more funds available to purchase such equipment were more of it eligible for the investment tax credit.

Implementation of policies designed to make it possible for American industries to increase the amount of capital available are important, not only to the machine tool industry, but to the nation's general economic welfare. The tax changes that S. 1435 proposes, in conjunction with the specific changes and expansion of investment tax credit policy which we have described, will promote the investment needed to boost lagging productivity, create new jobs,

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[3] Hearing testimony presented by Machinery Dealers National Association, U. S. Congress, House of Representatives, Capital Formation and Retention, H. Rept. 96-732, 96th Cong., 2d Sess., 1980, p. 10.

reduce inflation, and generate the level of economic activity which will promote the balancing of the federal budget. A tax policy which recognizes capital accumulation as the cornerstone of our industrial society is needed to prevent the economy from falling further into a pattern of unacceptably slow or negative growth. These changes would also re-establish the U. S. as the world's leader in technology and economic strength.

III. OTHER TAX INCENTIVES FOR INCREASED PRODUCTIVITY, RESEARCH AND DEVELOPMENT, AND MORE AGGRESSIVE EXPORTING

A number of other tax proposals (aside from "10-5-3") designed to serve as incentives for increased capital investment, research and development, and more aggressive exporting of U. S. products have been introduced during this Congress. We believe that these other proposals, in addition to accelerated capital cost recovery policies, should be given careful consideration and included as part of an overall business stimulating tax relief package.

One measure which we believe would be of substantial assistance in increasing capital investment is Senator Nelson's bill, S. 2136, the "Small Business Tax Reduction Act of 1979," which would increase to $150,000 the amount of corporate income taxable at a rate lower than 46%. We support this proposal as a means of providing more money for capital investment, which we believe has the potential to be especially beneficial to small business.

Continuing the theme of "freeing-up" more funds for business investment, we also firmly support Senator Heinz's bill, S. 1964, the "Savings and Investment Act of 1979," which would provide for the tax exempt rollover of dividends, interest, and capital gains, which are reinvested in the equity market.

Both of these approaches, we believe, are creative inducements to productivity improving capital investment which we would urge this Committee to incorporate into any overall tax cut legislation.

Focusing our attention on the area of research and development, we commend Senator Tsongas for his insightful leadership in sponsoring S. 2355, the "Research Revitalization Act of 1980."

S. 2355 recognizes that R&D spending can result in economic benefits similar to those brought about by capital investment, and is an essential factor in returning domestic and international economic strength to the United States. Specifically, in providing incentives for business firms to fund research performed at colleges and universities, the Research Revitalization Act would:

(1) Allow a 25% tax credit for cash contributed to a research reserve during the taxable year[4] (subject to a ceiling of 5% of taxable income and contingent upon the expensing of such funds within four years);[5]

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[4] S. 2355, 96th Cong., 2nd Sess., Sec. 2(d)(4) provides that the credit is good only in the year in which funds are placed in the reserve, and that the subject tax credit may be applied only after application of other appropriate tax credits.

[5] S. 2355, Sec. 2(d)(2).

(2) Provides that the research reserve will be tax exempt;[6] and

(3) Permits a deduction in the taxable year for aggregate payments from the reserve for research or experimentation[7] performed by universities.[8]

The benefits of S. 2355 are numerous. It will create a greater incentive for innovative and industrially useful R&D; by involving universities it will encourage more and broader based research; it will help refocus a portion of university research on industrially useful innovation; and finally it will contribute to expanding the pool of highly trained engineers and scientists who are oriented to the ongoing research needs of industry.

Moreover, we would especially emphasize that measures to revitalize our R&D efforts, as exemplified by Senator Tsongas' bill, are extremely important in strengthening the United States' international economic and technological position.

Finally, concerning the tax treatment of income earned overseas by American citizens, we commend the leadership of

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[6] S. 2355, Sec. 2(c)(1) states that research reserve will be tax exempt except for taxes imposed by I.R.C. Sec. 511 (which relates to tax on unrelated business income of charitable, etc., organizations).

[7] S. 2355, Sec. 2(c)(3) defines qualified research expenses as the amounts paid for research or experimentation, within the meaning of I.R.C. Sec. 174 and performed by institutions of higher education.

[8] S. 2355, Sec. 2(c)(4) defines "Institutions of Higher Education" as described in Sections 1201(a) or 491(b) of the Higher Education Act of 1965 (as in effect on January 1, 1978).

Senators Chafee and Bentsen in proposing certain changes in the U. S. tax laws, so as to reduce the current financial disincentives for American companies to employ U. S. citizens in foreign countries.

Currently, the United States is the only major industrial nation which taxes its citizens on such income. Presently, the combination of such taxation with the exorbitantly high cost of living in many foreign countries (particularly in Western Europe and emerging third-world areas that are in the process of industrialization) makes it almost prohibitive for American companies to adequately compensate American citizens employed overseas. As a result, U. S. companies often look to foreign nationals to man such overseas corporate posts. The resultant problem of this strategy often is that such foreign employees of U. S. companies draw upon the industrial resources of their own countries, which they naturally are more familiar with, rather than utilizing other U. S. products in overseas projects. The ultimate outcome is that less business goes to U. S. firms than would otherwise be possible, and U. S. workers lose hundreds of thousands of jobs at home because of lost export sales.

To combat these problems, we support the efforts of Senators Chafee and Bentsen (as set forth in their respective bills, S. 2283, the "Export Incentive Tax Act of 1980," and S. 2418) to modify I.R.C. Sections 911 and 913, so as to make it less burdensome for U. S. companies to employ American citizens overseas. Generally, our recommendations in this area are as follows:

(1) To do away with the "company camp" concept in the current law[9] and simply allow a deduction of up to $65,000/yr. for earned income from foreign sources,[10] plus an exclusion from taxation for housing allowances or housing costs which exceed 20% of earned income;[11]

(2) To reduce the amount of time American citizens would have to work overseas from the present requirement of 17 out

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[9] Under current U. S. tax law, I.R.C. Sec. 913 provides that a qualifying U. S. citizen who works abroad and receives earned income from foreign sources is entitled to a deduction from gross income for the excess costs of living in a foreign country. According to I.R.C. Sec. 913(b) this deduction is the sum of five items: (1) qualified cost-of-living differential; (2) qualified housing costs; (3) qualified schooling expenses; (4) qualified home leave travel expenses; and (5) qualified hardship area expenses.

As an alternative to this deduction, a taxpayer who resides in an employee camp in a foreign hardship area may elect pursuant to I.R.C. Sec. 911 to take an annual exclusion from gross income up to $20,000 of foreign earned income. (It is calculated that the $50,000 exclusion in S. 2283 will provide tax relief nearly identical to the current $20,000 exclusion which was originally enacted by Congress in 1962.)

[10] The term "earned income" as defined in I.R.C. Secs. 911(b) and 913(j)(1)(A) and as used in both S. 2283 Sec. 1(a) and S. 2418 Sec. 1 includes wages, salaries, or professional fees, and other amounts received as compensation for personal services rendered or, in the case of a trade or business in which both personal services and capital are material income-producing factors, a reasonable allowance as compensation for the personal services rendered but not in excess of 30% of the individual's share of the net profits of such trade or business.

[11] S. 2283 Sec. 1(a).

of 18 consecutive months[12] to a requirement of 11 out of 12 consecutive months;[13] and

(3) To make special provision for an individual who for any period is a bona fide resident of or is present in a foreign country and who must leave such foreign country because of dangerous international circumstances.[14]

We are aware that some have criticized this approach by pointing out that U. S. citizens currently are allowed to take a tax credit against their U. S. income taxes for income taxes paid to a foreign government. While we support this as an equitable policy, we would point out that it fails to adequately take into account other forms of taxation imposed upon U. S. citizens residing and working in foreign countries (such as a value added tax (VAT) which is widely and in some cases heavily utilized in many Western European countries) for which no credit against U. S. income taxes is possible.

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[12]Under the current law, in order to qualify for either the Sec. 913 deduction or the Sec. 911 exclusion, a U.S. citizen working abroad must meet either the bona fide resident test or the physical presence test.

Both S. 2283 and S. 2418 would keep the present bona fide resident test (I.R.C. Sec. 911(a)(1) and 913(a)(1)), which states that a taxpayer must be a bona fide resident of a foreign country or countries for an uninterrupted period that includes a full tax year, (i.e., Jan. 1 - Dec. 31 for a calendar-year basis taxpayer).

[13]S. 2418, Sec. (1) and (3), although maintaining the Secs. 911 and 913 dychotomy would reduce the qualifying period in both circumstances under the physical presence test to 11 out of 12 consecutive months.

[14]S. 2418, Sec. 1.

Therefore, we urge this Committee to carefully consider this issue and adopt such changes to I.R.C. Sections 911 and 913. We believe that these changes will greatly assist the U. S. in becoming more competitive internationally, which in turn will translate into more jobs here at home.

IV. TAX CUTS FOR INDIVIDUALS

Because of the unfortunate confluence of what now promises to be the most severe U. S. recession in postwar history, with the persistence of recent record high rates of inflation, it is inevitable, both from an economic as well as a political viewpoint, that any tax cut enacted this year must contain reductions in individual taxes as well as incentives for business investments. In this regard, we would urge (without at this point attempting to put an exact dollar figure on such a reduction) the deepest possible individual tax reduction consistent with prudent, non-inflationary fiscal policy.

Only last month Mr. Alfred Kahn, Chairman of the Council on Wage and Price Stability (COWPS), in testimony before the Joint Economic Committee pointed out that any tax cut legislated this year would have to contain both an individual as well as a business component.[15] Furthermore, he stated that although

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[15] Testimony of Alfred E. Kahn, Chairman, Council on Wage and Price Stability, June 24, 1980, Consumer Price Index. Hearings before the Joint Economic Committee, United States Senate, 96th Cong., 2d Sess., 1980, p. 20.

we must be careful not to exacerbate inflation in our tax cutting zeal, there are valid economic reasons for stimulating consumer demand as well as encouraging capital investment. And that "it is not merely political that [there needs to be] a balance between the two."[16]

However in support of our position in favor of a more realistic and productivity oriented capital cost recovery system, we would emphasize that Mr. Kahn continued to observe that he feels "very strongly that the balance [between consumer demand vis-a-vis business investment] has got to be more on the investment side than before." And that "[a]s a kind of long-term development in our country, we've got to devote a larger proportion of our resources to [capital investment]."[17]

V. SOCIAL SECURITY TAXES

In addition to being a year during which the U. S. economy has experienced continuing inflation, while at the same time slipping into a recession, 1980 will also be a critical and pivotal year for the Social Security system. Unless Congress acts sometime before the end of this year, the 1977-passed massive

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[16] Ibid.

[17] Ibid., pp. 20-21.

increase in Social Security taxes, one of the biggest tax increases in history, will take place less than six months from now in January 1981.

According to a 1978 Congressional Budget Office report, the scheduled hike in payroll taxes from 6.13% to 6.65% -- together with an expansion in the amount of wages subject to the levy -- will cost American taxpayers approximately $15.4 billion in 1981, and potentially could add up to half a percent to the inflation rate.

To add such massive Social Security tax increases to the burdens already shouldered by U. S. taxpayers, who in the throes of an economic downturn are still forced to cope with double-digit inflation, may be too much to ask of the American worker. It should be noted that some businesses (particularly small ones) and many individuals pay more in Social Security payroll taxes than they do in corporate or personal income taxes. Furthermore, as life expectancy increases, and as the birth rate (as a percentage of total population) decreases, an ever narrowing base of wage earners will be expected to continue to provide (through increased payroll taxes) sharply indexed benefits to an ever-increasing number of retired Americans.

Given this background, it is clear that something needs to be done now to alleviate what could possibly be the severe effects of the 1977-passed Social Security tax increases scheduled to go into effect next year.

The U. S. machine tool industry is aware of and has formed a special industry committee to study the recommendations proposed earlier this year by the Department of Human Resources' (formerly HEW) Social Security Advisory Committee. Although our industry's Social Security Study Committee is still considering various alternatives for long-term modifications in the Social Security system's benefit indexing features, we have initially decided to support, and would strongly urge this Committee to support, a provision to be included in a tax-cut enacted this year which would provide a temporary tax credit for Social Security taxes paid.

As a general proposition, we believe in treating causes not simply symptoms of deeper problems. And in this regard we recognize that a tax credit for Social Security taxes paid may only be a temporary solution to the present dilemma -- an immediate response to the current crisis. But it is a response which would clearly help American taxpayers through their current difficulty.

Of course, we would hope to eventually see the underlying problems with the Social Security system resolved. But, pragmatically, we realize that there simply is not time for this Congress to address these complex issues. As another general proposition, we believe that adopting such complex and controversial legislation in a crisis environment often proves to be counterproductive in the long run. Therefore, we strongly encourage the 97th Congress to adopt as a very high priority an in-depth analysis of the basic assumptions upon which the Social Security system is funded -- perhaps resulting in some very fundamental and far-reaching modifications of the system. We would of course be pleased to participate in such a process.

VI. PRODUCTS LIABILITY TAX TRUST FUND

Finally, we wish to address an issue that we in the machine tool industry, as producers of the machinery of metal-working productivity, believe to be of critical importance to our industry, and of great (albeit perhaps not fully appreciated) significance to the U. S. economy generally. Specifically, we refer to the problem of products liability.

Although the products liability problem may not be the direct result of the inflation that we have up to now been talking about, it is very definitely the result of another kind of inflation, namely inflated products liability judgments and inflated products liability insurance premiums. And we would stress that this latter kind of inflation has been galloping at an even greater pace than the inflationary spiral of the overall economy. For example, some of our members products liability premiums have increased over ten-fold during the past decade.

A 1980 survey of our members shows that over half still either have no primary coverage or have substantial deductibles under their 1980 policies. This year the average NMTBA member is paying $111,700 for primary products liability coverage. This figure represents some easing from 1979's average of $143,900. However, in 1976 the average products liability premium was only

$71,000 which still seems large when compared to 1970's average of $10,000.

One out of eight members reported no products liability coverage. This is better than last year's 20%. However, another 5% believe either that their policies will be cancelled or that their premiums will be increased substantially within the next year. Moreover, of those members with products liability insurance, 8% seriously doubt the financial stability of their insurance carrier.

Some of our members have only nominal products liability insurance. The combination of their annual premiums and deductibles nearly equals (and in some cases surpasses) the ceiling of their primary coverage. These companies have purchased this paper insurance to satisfy customers' sales requirements or to qualify for umbrella coverage, which protects the insured from catastrophic claims which threaten their assets. And even at these staggering prices, still an appalling 23% of machine tool builders with annual sales in excess of $2.5 million are unable to secure umbrella coverage.

Thirty-nine percent (39%) of our members reported average deductibles or self-retentions, of $94,300 compared to $80,500 last year and $27,000 in 1975. This is up from 30% last year.

Although our industry is presently defending a plethora of lawsuits, its courtroom record is quite impressive. In fact, of 1,217 closed claims reported in 1976, 1978, 1979 and 1980 surveys, only 14% actually reached trial. Of these, our members won 70%.

In other words, only 4% of the total number of products liability claims against our members have resulted in judgments substantially in excess of the plaintiff's workers' compensation lien -- an accumulated average courtroom loss of $164,000. Forty-nine percent (49%) are settled for an average of $25,800 and the remaining 39% are dropped without awards being paid.

It is the quantity of products liability suits, not the quality of our products, which have persuaded many products liability insurers either to abandon the field or to charge high premiums unrelated to the insured's claims experience. Defense costs equaling 35¢ for every dollar paid out rather than actual judgments are spooking products liability carriers. The average amount expended on each of these 1,217 claims (including defense costs) was $25,900.

In addition, the "trendline" in design defect and "failure to warn" cases is in the direction of imposing liability on product sellers without a demonstration of fault. This is also expected to increase insurance costs in the absence of remedial legislation.

The point is, the current products liability mess is a massive disincentive to the innovation and production of new and more efficient industrial equipment. Although it is very difficult to quantify the negative effects of such a situation, on a number of occasions members of our industry have stated that they have foregone the opportunity to market a newly engineered machine due to the fear of expanding their exposure to products liability suits, which could possibly result in judgments large enought to bankrupt their companies.

We certainly do not advocate increased industrial innovation and productivity at the expense of the safety of people. What we do advocate is a more rational approach to the whole area of products liability, so that we do not continue to set up road blocks and disincentives along the way to increased industrial productivity.

Although the total scope of the products liability problem is generally broader than the particular topic of this testimony, we would briefly like to commend a number of members of Congress for their interest in this problem and their efforts to find solutions to several of its facets.[18/]

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[18] In its final report, the U. S. Department of Commerce's Interagency Task Force on Product Liability identified questionable products liability insurance ratemaking practices and aberrational developments in products liability tort law as two primary causes of the products liability crisis. Legislation addressing each of these two aspects of the problem has been introduced during the 96th Congress.

Products Liability Insurance Ratemaking:

S. 1789, the "Product Liability Risk Retention Act of 1979," co-sponsored by Senators Culver, Nelson, Pressler, Inouye and Tsongas (pending Commerce Committee action); and H.R. 6152, the "Product

One such solution which is, however, related to the tax area is a bill, S. 542 sponsored by Senators Culver and Nelson, which would amend the Internal Revenue Code (I.R.C.) to allow a deduction for limited contributions to products liability loss reserve accounts. We strongly support this measure as a creative way for capital goods manufacturers to protect themselves against the cost of defending and settling most products liability litigation.

As this Committee is aware, the 95th Congress enacted an amendment to the IRC making it possible for companies with net operating losses to carry back for ten years (rather than three) operating losses attributable to products liability. Although we commend the efforts of the 95th Congress in taking this helpful

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Liability Risk Retention Act of 1980," cosponsored by Congressmen Preyer and Broyhill (adopted on March 10, 1980 by a vote of 332 to 17); both: (1) facilitate the formation and operation of risk retention groups organized for the primary purpose of assuming and spreading products liability or completed operations liability risk exposure among product sellers; and (2) facilitate the purchase of products liability and completed operations liability insurance on a group basis.

Products Liability Tort Law Modifications:

A number of bills dealing with the underlying tort law of products liability have been introduced in the House of Representatives. Two of the more widely commented upon of these bills are H.R. 7000, the "Uniform Product Liability Act," cosponsored by Congressmen Preyer and Broyhill; and H.R. 5626, the "National Product Liability Act," introduced by Congressmen Sensenbrenner for himself and Congressmen Broyhill, Roth, Sawyer, Corcoran, Stockman, Luken and Ireland. Each of these bills, to one degree or another, attempts to arrest the more significant aberrational developments in the case law of products liability in some jurisdictions, and to correct some unfair aspects of the law in most jurisdictions.

step toward reducing some of the products liability burdens faced by capital goods manufacturers, we should point out that this approach is of limited value, since thankfully most machine tool companies continue to make profits and avoid losses, despite the sometimes quite difficult circumstances.

As a means of helping capital goods producers who, although profitable, continue to be hard pressed in the areas of products liability insurance premiums and law suit judgments, S. 542 would allow any taxpayer who incurs a severe products liability insurance problem to deduct up to $100,000 from federal income taxes for amounts transferred to a products liability loss reserve account, or amounts paid by the taxpayer to a captive insurer, with respect to the products liability of the taxpayer.

It is a logical extension of the "self-help mechanism" (H.R. 6152) for resolving products liability problems advanced by the Administration and overwhelmingly adopted by the House earlier this year. It, along with the Risk Retention Act, provides a meaningful option for companies plagued by unaffordable products liability insurance premiums and/or substantial deductibles.

Although in the past this approach has been criticized as resulting in a substantial loss in Treasury revenues, we believe that as redrafted S. 542, limits major revenue losses while at the same time providing an important market option to those manufacturers most seriously in need of it.

VII. SUMMARY

Our testimony has set forth what we believe should be the thrust of a January 1981 tax cut. Productivity and international competitiveness, we believe, must be improved by the increased investment which can only be achieved through depreciation reform. During this very difficult economic period, the individual taxpayer must be relieved from the effect of the largest tax increase in our nation's history. The alternative, we believe, is continued economic stagnation; continued loss of jobs and business to our foreign competitors; and continued inflation and erosion of Americans' purchasing power.

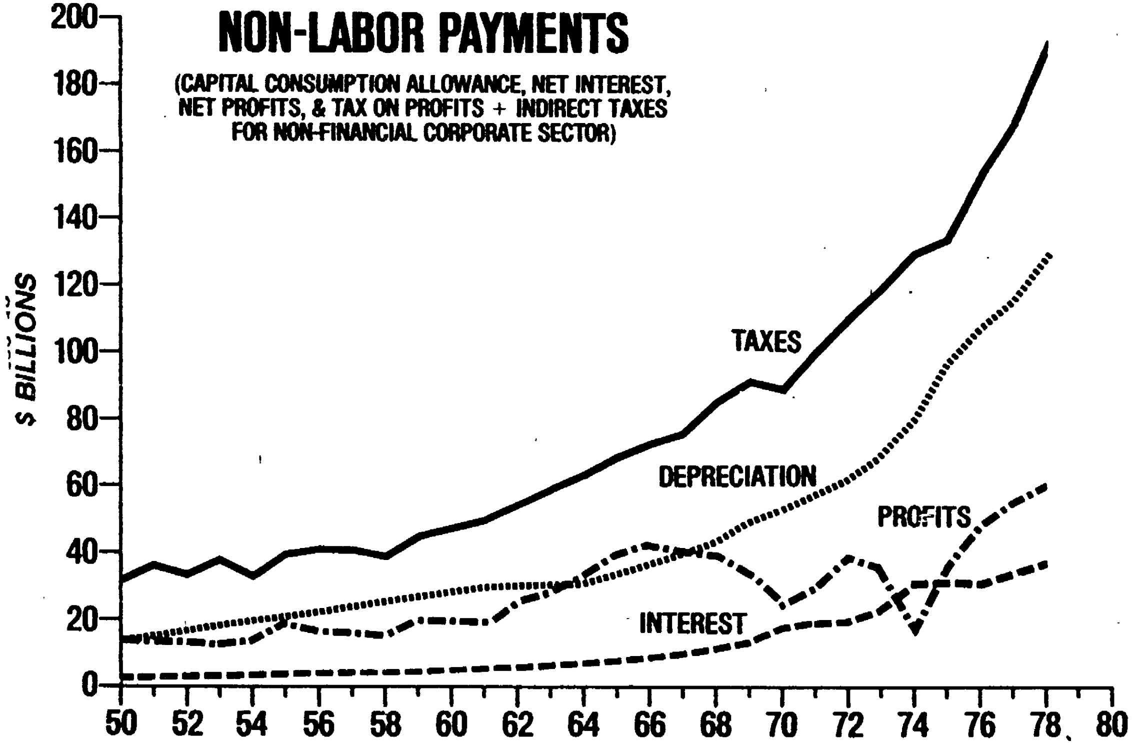
The controversy seems to be not whether to enact a January 1, 1981 tax cut -- but when to enact it. We firmly believe that, as the need exists now: The time to act is now.

Immediate action is particularly important in terms of bolstering the supply side of the economy. As you know, businessmen do not make economic decisions in a vacuum. Rather, they carefully consider the effects of U. S. tax laws, as well as the fluctuating national economy on these decisions. Therefore, it is only logical (and managerially prudent) to expect that American business will delay making certain investment decisions if critically needed tax policy changes are also delayed. Moreover, since the benefits of depreciation reform will be long term, the longer passage is delayed the longer those benefits will be delayed. The promise of future action will not affect prudent business decisions. Decisions to invest will be affected by action not by promises.

Some have argued that a tax cut should not be enacted in a "political year." We would suggest that every year is a "political year." To reject a tax cut now on the basis of its relation to politics, we believe, begs the question. You and your colleagues in the Senate will be judged by the American people on the basis of your commitment to economic growth and job security. That commitment, we believe, is tested not by some jockeying for ethereal partisan advantage but by your willingness to do that which is needed when it is needed.

The time for action is now. We urge you to adopt the tax proposals we have advocated now, so they become effective on January 1, 1981 and so that our nation's growth, its productivity, its international competitiveness, and its economic health can be restored forthwith and the standard of living of the American people can be preserved.

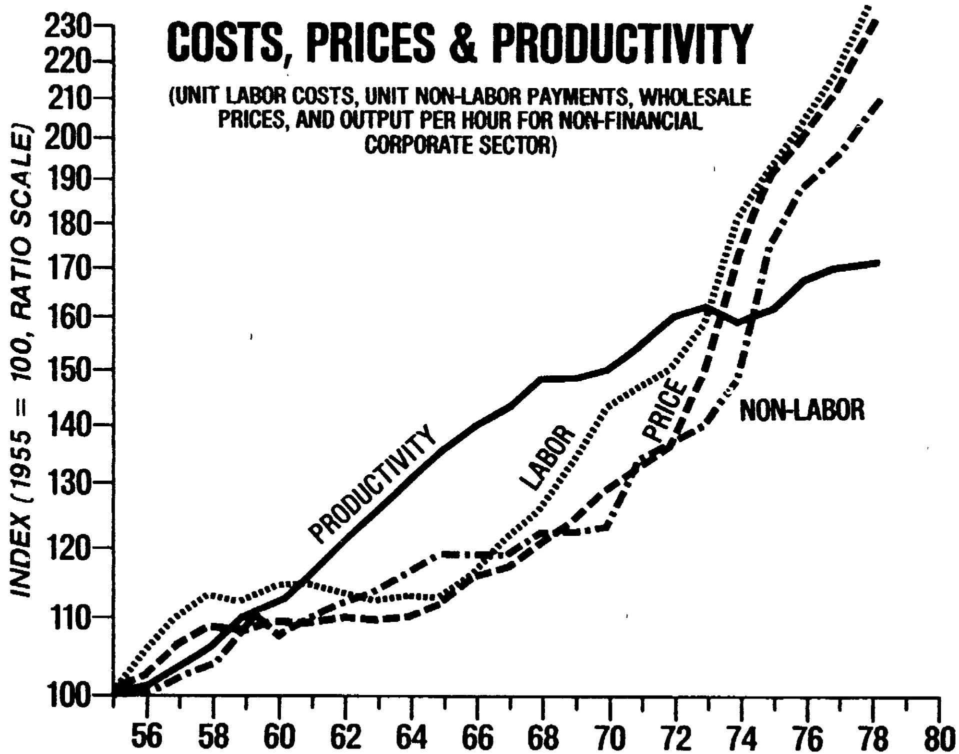
CHART 1



Prepared by NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION—3/79

SOURCE: BUREAU OF ECONOMIC ANALYSIS

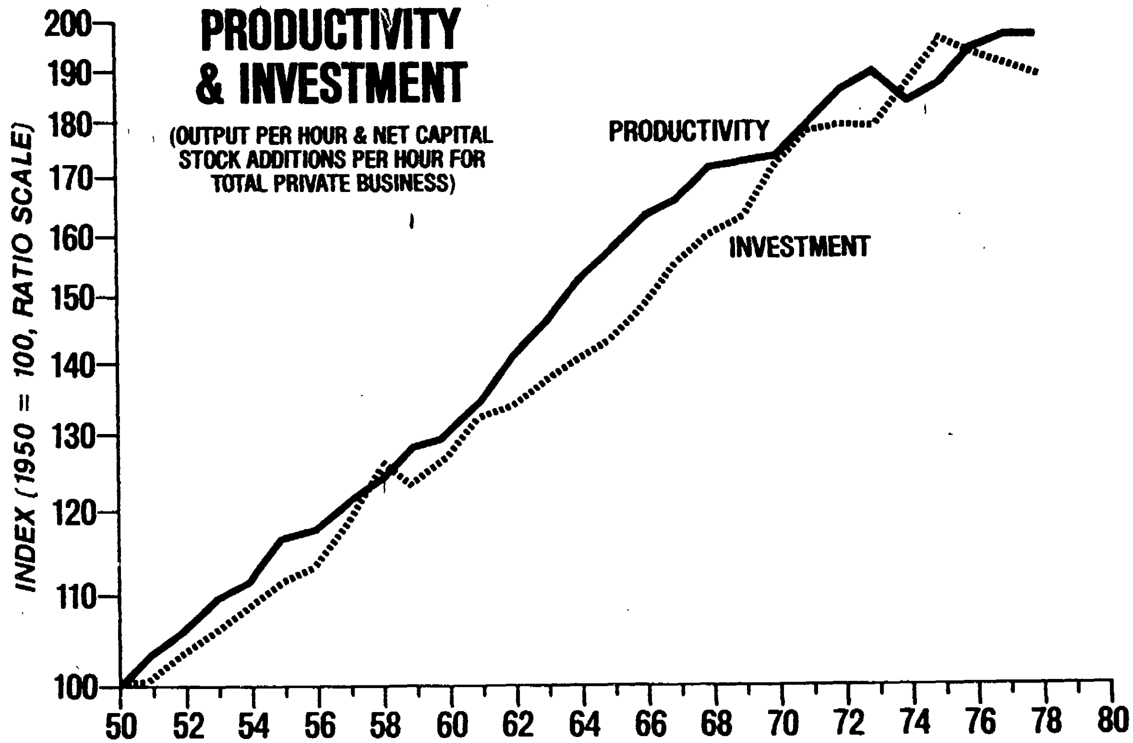
CHART 2



Prepared by NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION—3/79

SOURCE: BUREAU OF ECONOMIC ANALYSIS

CHART 3



Prepared by NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION—3/79

SOURCE: BUREAU OF LABOR STATISTICS

DP&L The Dayton Power and Light Company
Courthouse Plaza Southwest, Dayton, Ohio 45401

Robert E. Frazer
President

STATEMENT OF

R. E. FRAZER

PRESIDENT

AND CHIEF EXECUTIVE OFFICER

THE DAYTON POWER AND LIGHT COMPANY

IN SUPPORT OF

DIVIDEND REINVESTMENT TAX PROPOSALS INCLUDED IN S. 1543

H.R. 654, SECTION 202 OF H.R. 5665, AND SECTION 201 OF H.R. 7015

AS PART OF

TAX REDUCTION PROPOSALS

BEFORE

UNITED STATES SENATE

COMMITTEE ON FINANCE

AUGUST 1, 1980

R. E. FRAZER

The Dayton Power and Light Company
Courthouse Plaza Southwest, Dayton, Ohio 45401

Robert E. Frazer
President

I submit this statement on behalf of The Dayton Power and Light Company (DP&L), an investor-owned public utility serving a population of 1.3 million in West Central Ohio.

With the energy shortages facing this nation and the national goal of curtailing oil imports, we at DP&L are convinced that electricity and natural gas will be called upon to salvage the future deteriorating national economy as it becomes starved for the additional energy it needs. To this end, DP&L has a system in which 98% of its electricity is produced by American-mined coal and through joint ownership arrangements we have four additional coal-fired generating units and one nuclear generating unit under construction.

To obtain the funds necessary to build and maintain these plants in addition to our existing facilities, DP&L depends heavily on a continuous flow of new investment capital. It is questionable whether utilities such as DP&L will be able to raise sufficient capital in the future without tax incentives for investors. The dividend reinvestment proposals included in H.R. 654, Section 202 of H.R. 5665, Section 201 of H.R. 7015 and S. 1543 provide for deferral of current Federal tax on dividends reinvested in an original issue stock of any company having a qualified dividend reinvestment plan. Adoption of the dividend reinvestment proposals would:

1. Encourage capital formation.
2. Eliminate or reduce the double tax on dividends reinvested.
3. Encourage individual savings for supplemental income after retirement
4. Treat stock acquired by reinvestment of dividends as conventional stock dividends.
5. Assist in financing essential energy facilities and in dealing with the energy problem.
6. Help reduce consumer demand and counter inflation.

DP&L has an Automatic Dividend Reinvestment and Stock Purchase Plan and actively supports the work of the Committee for Capital Formation through Dividend Reinvestment. We are vitally concerned about our ability to raise the necessary capital to continue the construction program essential for our customers' future energy needs. The Company's capital expenditures for the 1980-1984 period will total more than $1 billion. It is anticipated that $245 million of this sum will be spent in 1980, primarily for the construction of new electric generation facilities.

In summary we feel the adoption of legislation permitting deferred taxation of dividends reinvested would stimulate greater participation in dividend reinvestment programs such as ours and make a significant contribution to capital formation in the utility industry where capital is so urgently needed. We strongly urge your favorable consideration of this legislation as part of the tax reduction program.

UNITED TELECOMMUNICATIONS, INC.
STATEMENT OF FEDERAL INCOME TAX CUT PROPOSALS
SUMMARY OF COMMENTS AND RECOMMENDATIONS

United Telecommunications urges the enactment of legislation in 1980, effective January 1, 1981, to reduce the tax burden on business and individual taxpayers in the following manner:

1. Deferral of taxes on reinvested dividends.
2. Adoption of a capital cost recovery system to replace the existing methods of depreciation.
3. Increase the investment credit rate to 12%.

The need for an economic stimulus at this time is apparent from the current recession, as evidenced by rising unemployment, declining construction activity, and a declining growth rate in the Gross National Product. In addition to providing immediate relief to our lagging economy, a tax cut including the above features would have the following long-term benefits:

1. Provide business the necessary incentive to expand and modernize its aging production facilities and equipment.
2. Provide an internal source of funds for capital expansion, thereby reducing the demand for capital from other sources and at the same time reducing the upward pressure on interest rates.
3. Provide an incentive and reward for individuals to increase their rate of savings, which presently is among the lowest in the world.

# # #

STATEMENT OF
UNITED TELECOMMUNICATIONS, INC.
ON THE NEED FOR A TAX CUT IN 1981
SUBMITTED TO THE
SENATE COMMITTEE ON FINANCE

United Telecommunications, Inc. ("United") owns and operates the United Telephone System, the nation's third largest telephone system, and also participates in other telecommunications and computer services markets. The 23 companies comprising the United Telephone System serve more than 4.6 million telephones and 3,000 communities in 21 states, utilizing $4.5 billion of telephone equipment and employing more than 26,000 people.

United supports the passage of tax cut legislation in 1980, effective January 1, 1981, to provide immediate relief for our sagging economy, to provide a long-term solution to capital needs of industry, and to provide an incentive to individuals to increase their declining rate of savings. To accomplish this, the following legislation is recommended:

1. Deferral of taxes on reinvested dividends.
2. Adoption of a Capital Cost Recovery System to replace the existing concept of useful-life depreciation.
3. Increase in the investment credit from 10% to 12%.

Deferral of Taxes in Reinvested Dividends

United endorses the concept of deferring the taxation of reinvested dividends as provided in H.R. 654 and S. 1543. Passage of these bills would provide a two-fold benefit to our economy.

First, they would provide an incentive and a reward to small investors. Many small investors represent the middle class working group which presently has few options open to them for deferring taxes compared to larger investors with better access to sophisticated tax shelter and tax deferral investment vehicles. Legislation should encourage additional participation in dividend reinvestment plans, which presently is estimated to be over 5,000,000 individuals in more than 1,000 companies.

Second, the increase in dividend reinvestment participation would make available to business and industry additional capital so greatly needed for expansion and modernization of production facilities and equipment. In turn, this would increase productivity rates of labor, a factor which has become an increasing concern of economists as a cause of the declining growth in the Gross National Product.

The mechanism for implementing and administering this legislation already is functioning in the existing dividend reinvestment plans. Further, it is compatible with the provisions of Code Section 305, which permits the deferral of taxes on dividends distributed in the form of capital stock.

Adoption of Capital Cost Recovery System

United recommends the adoption of a Capital Cost Recovery System similar to that described in H.R. 4646 and S. 1435, a concept which already has strong support in both houses of the Congress.

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This legislation would result in a tax deferral, rather than a tax cut, for American business and industry. In the process, it would make available the capital needed to build the production facilities and equipment necessary to stimulate production and expand employment. It would represent a first step in aiding American business to become more competitive in the world markets -- markets which are increasingly being dominated by foreign companies whose governments permit even faster capital cost recovery methods than that contained in these bills.

Because of inflation, the real value of tax benefits presently realized through depreciation under the useful life concept diminishes each year. By accelerating the recovery of capital costs, a more realistic matching of tax benefits and economic costs is achieved.

Some will say that the present Class Life Asset Depreciation Range System is designed to accomplish the objectives mentioned above. While it is an improvement over previous depreciation methods, its complexity has discouraged most small businesses and many large businesses from adopting it. The simplicity of a capital cost recovery system as formulated in H.R. 4646 and S. 1435 would make it attractive to companies of all sizes and, at the same time, materially reduce taxpayer disputes with the Internal Revenue Service.

Increase Investment Credit to 12%

A further incentive to business for the expansion and modernization of production facilities is an increase in the investment credit from 10% to 12%. Because the credit is directly proportional to the investment in capital equipment needed to expand productivity of our economy, an increase in the credit is the most logical and direct means of stimulating and encouraging such investment. By providing a direct and immediate source of funds to those businesses and industry groups which are the most capital intensive, the greatest gains in productivity can be realized. These funds would be put to work in the form of additional capital equipment.

Summary

Much has been said and written recently about the need for capital funds to expand our national economy. This need has been demonstrated by showing that U.S. production facilities are older than those in most countries, that the average output per worker is declining in relation to that in other countries and that the growth rate in the Gross National Product is declining. United firmly believes that legislation to defer or reduce taxes as described above is a realistic step toward solving these problems, and that passage of such legislation now rather than in 1981 will remove the uncertainties prevalent among businesses and permit them to make their plans for the future in an orderly and assured manner.

We would like to thank the Committee for allowing us the opportunity to express our views on the need for such tax measures. We look forward to working with the Committee on these most important matters.

STATEMENT

of the

NATIONAL RETIRED TEACHERS ASSOCIATION

and the

AMERICAN ASSOCIATION OF RETIRED PERSONS

before the

SENATE COMMITTEE ON FINANCE

on

TAX CUT PROPOSALS

August 1, 1980

TABLE OF CONTENTS

I. Introduction: The Need to Direct Tax Policy Toward Reducing Inflation

Our Associations believe that any tax cut bill must be unique since the problems to be addressed are unprecedented and sizable. Fiscal policy must work in a more subtle way than it has in the past, since merely manipulating levels of aggregate demand will not solve our current difficulties. Instead, we urge the Committee to seek innovative ways to use the potent economic tool which you control -- our system of taxation. With this in mind, our Associations have some suggestions for equitable and efficient tax reduction steps to offer.

Before structuring a tax bill, the problems that need resolving should be clearly evaluated. Despite the present recession, we have no indication that the disastrous levels of inflation which we have encountered in the recent past will soon be reduced to manageable levels. In fact, we are very concerned that an upturn in the business cycle will start at a higher level of inflation than has been the case in the past. Once a recovery begins, it would not take long for inflation to surge upward again.

From all contacts we have made with our 12.5 million members, we have clearly received the impression that inflation is by far the most significant problem that older Americans face today. We emphatically deny the contention of many that the elderly fare well in an inflationary period because of indexed social security benefits. Social security alone cannot provide an adequate retirement income. Most of the means of social security benefit supplementation, including private pensions and savings, are unprotected from inflation. Those who rely on such supplementation find that their retirement income is continually dwindling in value. In addition, our Associations have recently issued a report which indicates that the elderly will continue to lose ground to inflation in the next decade, assuming no legislated, large scale expansion in government programs.

While inflation is destroying individual retirement planning which the government encourages (through tax preferences for retirement-oriented savings), it is also threatening the viability of the only major component of the elderly's income stream that compensates, though inadequately, for inflation -- the social security system. Economic trends have undermined in a very short time period Congress' attempts in 1977 to place social security on a sound financial basis for many years to come. Instead, this Committee is well aware of the need to respond to another short-term crisis because of inadequate financing. The social security system is much too important to the nation's elderly to threaten it through economic policy that hinders growth and exacerbates inflation.

Because of the underlying inflationary tendencies of the economy, we are convinced that a traditional demand-stimulative tax cut is not a proper response to the current recession.

Clearly, because inflation automatically increases the nation's real level of taxation, some response to "bracket creep" must eventually be offered. However, we caution the Finance Committee to proceed slowly and to look unfavorably on any measure that is demand-stimulative.

Rather than risking a continuation of the past and present destructive rates of inflation, our Associations suggest that actions be taken to repair the structural defects in our economy that are causes of the problem. We must be able to accommodate increases in demand through productivity growth, an aspect of our economy that has been sorely neglected. We believe that tax policy can work toward this goal by rewarding and encouraging savings and investment, rather than consumption. We hope that the Finance Committee will take this direction.

We feel that a tax package should be passed by Congress in 1981, which would compensate individuals somewhat for rising levels of taxation. However, the bulk of the cut should be devoted to rewarding and encouraging productive activities. This type of cut should have a long-term favorable impact on the economy and therefore on the amount of funds available to the government. Our Associations are very concerned about balancing the budget. However, we are willing to forego some government revenue today if it will promote a more productive economy in the future and contribute to a balancing of the federal budget within two to three years and a maintaining of that balance thereafter over the business cycle.

II. Tax Cuts Designed to Stimulate Productivity

A. Revitalizing Business

To encourage savings and investment, Congress must work with both the corporate and individual sectors of the economy. To touch on the corporate sector briefly, we agree that it is essential that laws be enacted to encourage business to invest in new productive capital assets. The present problem is that, due to inflaiton, the historical cost of an asset differs greatly from its replacement cost, and therefore present depreciation rules inadequately account for anticipated expenses. We are somewhat concerned that the most talked-about remedy to this problem, the "10-5-3" bill, is an inaccurate proxy for inflation. We think that this legislation is an expensive guess at how to remedy inflation's effects on depreciation, and we would prefer that Congress take an approach that is a more direct path to a resolution of the problems for business investment caused by inflation. At all times, our Associations must stress that there is only a limited amount of money that can responsibly be spent on a tax cut bill -- therefore, economic efficiency must be a priority.

B. Individual Savings Incentives: Providing for Retirement and Equitable Measures for Retirees

We would like to devote some attention to tax law changes for individuals whose interests our Associations represent. When we consider tax reduction measures affecting individuals, we have a number of goals in mind. Consistent with our overriding concern that inflation be brought under control, we are looking toward ideas that favor savings and investment. A second goal is that equity be provided to elderly taxpayers, many of whom are seeing the non-social security components of their income stream destroyed by inflation after having been prodded for many years to save for retirement. As a third goal, we have found that tax-related proposals that make good economic sense can also be useful tools for retirement planning. We would like to see these tools developed in the future tax cut package. Policy choices which combat inflation while encouraging retirement saving will result in real income gains for the older population of the future.

A tax cut bill designed to encourage people to save should, as a priority, address present law's bias against saving -- even saving for retirement. Specifically, a large percentage of the present work force is excluded from the tax benefits that should be available for retirement-oriented savings. A number of provisions presently prohibit potential "self-help" measures. Employees who contribute to their qualified pension plan do not presently get a deduction for those contributions. Additionally, anyone who is a participant in a qualified pension plan is prohibited from utilizing an Individual Retirement Account (IRA).

We believe that the result of limitations on tax benefits for retirement saving leads to less capital available for the economy, as well as an increased reliance by individuals on government programs for retirement income (and, as we have stated, social security cannot alone provide an adequate retirement income). Also, in the case of IRA eligibility rules, current tax law creates tremendous inequities. We have received much correspondence from members who "participated" in qualified pension plans, yet who never vested. Many seem to have been willing to utilize the IRA if it had been available to them. By ruling them ineligible, the tax code has diminished their retirement planning resources significantly.

Our Associations believe that all income classes are entitled to an adequate retirement income -- which we define as the highest standard of living an individual obtained in his/her pre-retirement years. For almost all people this goal requires some degree of personal saving. We think that all should be encouraged to make this choice. To outline our Associations' strategy for equitable retirement planning options, we suggest that Congress:

1. Allow an employee a deduction for contributions to a qualified private pension plan.
2. Remove the requirement of nonmembership in a qualified pension plan for IRA eligibility.
3. Raise the current IRA deductibility limit.

While we have not endorsed any particular bill at this time, we are aware that a number of Senators and Congressmen have offered legislation embodying the concepts that we support. We believe that, with the passage of the next tax bill, the Finance Committee would be creating sound policy by taking our suggested steps.

While we believe that the primary efforts of the Finance Committee in the tax incentive for savings area should be a strengthening of IRA's, we would also favorably consider an approach that defers taxation until withdrawal or one that splits off unearned income from earned income to lower the tax rates for interest and dividend income. The first idea would allow the formation of a roll-over account, the income of which is only taxed upon withdrawal, while the second would eliminate the present savings disincentive of tax rates for interest and dividend income that are stacked on top of the earned income component. However, because we are well aware of the need to save for retirement to supplement social security, we would prefer that Congress first work to eliminate the inequities and inconsistencies of retirement-oriented tax policy.

Because tax benefits designed to encourage people to save more only give benefits to those who are able to increase their savings, and because the past decade has witnessed a destruction of the value of the elderly's savings, we urge Congress to take separate action to aid those who can save no more -- retirees. As an equity measure our Associations support an exemption (beyond that provided in this year's Windfall Profits Tax legislation) of interest and dividend income for those who are over 65. We suggest a \$500/\$1000 exclusion of interest and dividend income for people over 65.

An exemption for people over 65 would give some benefits to those who saved for retirement during a difficult time, and who continue to lose ground as interest rates on passbook accounts remain artificially low as a result of Regulation Q, which is being phased out very slowly. A recent study undertaken for the Associations determined that, adjusting for taxes (assumed at 10 percent) but allowing interest to compound, the value of a $1,000 saving account in 1967 would have been reduced to $865 in 1978. If the investor decided to divide his/her interest between current income and reinvestment, his/her savings would be reduced to only a real value of $667 in 1978.

Statistics show that older people have a disproportionate amount of income from savings. In fact, according to 1976 Internal Revenue Service statistics, 24 percent of the elderly's reported income was interest income, while interest income represented only 4.6 percent of the income of all taxpayers. The figures that we have, in addition to comments we receive from our members, indicate that the approach of this tax cut bill should have two goals in mind: make saving attractive for those who are able to save and reward existing savers who are no longer able to increase their savings.

III. Additional Personal Income Tax Cut Goals

A. Tax Credit for the Elderly

An additional equity problem, which our Associations want to see resolved in the future tax cut bill, is the disparity of tax treatment between social security recipients (whose benefits are, and should remain, tax-exempt) and those who do not receive social security. In contrast to social security benefits, a government pension is generally taxable to the retiree. Congress, however, enacted the Retirement Income Credit (RIC) in 1954 to provide public annuitants -- such as retired teachers, policemen, firemen, and others -- with tax relief roughly comparable to that available for social security beneficiaries.

Congress restructured the RIC in 1976, creating a new Tax Credit for the Elderly (TCE). This provision increased the tax relief available to most non-social security retirees by substantially raising the maximum base amounts for computing the 15 percent credit. However, the TCE is clearly outdated now, since it has not been adjusted in four years.

Our Associations support passage of S. 753 and suggest that it be made a part of a broader tax cut package as a means of improving the TCE in a legislatively feasible manner. This bill is virtually identical to a measure approved almost unanimously by the House and Senate in 1978. Strong support existed then to update the TCE. The case is even more compelling now because inflation is whittling away at the tax relief provided by the TCE. Federal persons who rely on taxable forms of retirement income are in acute need of compensation for some of their inflation losses and relief for taxflation.

S. 753 has two key provisions. First, the maximum amounts for computing the 15 percent TCE would be raised from

$2,500 to $3,000 for older single persons and from $3,750 to $4,500 for elderly couples. This change alone would provide up to $75 in additional tax relief for aged individuals and $112.50 for older couples.

The Associations believe that the adjusted gross income phase-out provisions for the TCE should be increased along the lines proposed in S. 753. Under present law, the maximum amount for computing the credit is reduced by $1 for each $2 of income above $7,500 for aged individuals and $10,000 for elderly couples. The net impact is that the TCE is effectively phased out for individuals with adjusted gross income of $12,500 and for couples with adjust gross income of $17,500.

These phase-out levels are too low and deny many middle-income taxpayers essential tax relief. Moreover, these restrictions contradict the credit's basic objective, which is to provide equal tax treatment for social security and non-social security retirees. Social security beneficiaries receive their monthly retirement payments tax-free regardless of their total income.

S. 753 would raise the adjusted gross income phase-out provisions to more realistic levels -- from $7,500 to $15,000 for aged individuals and from $10,000 to $17,500 for elderly couples. Under this approach, single aged taxpayers would be potentially eligible for the TCE if their adjusted gross income is less than $21,000. The cut-off point for elderly couples would be $26,500. While not providing identical tax treatment for social security and non-social security recipients, S. 753 would provide greater equity than is presently available in the tax code.

B. <u>Helping Families Care for Elderly Relatives</u>

An additional change in the personal income tax laws which we recommend to the Finance Committee is designed to help families care for elderly relatives.

A problem of increasingly great magnitude for older Americans and their families is the cost of long-term care services. Many members of Congress have expressed a desire to provide some degree of protection to Americans against the high cost of catastrophic illness. Our Associations have opposed such initiatives largely because they have not addressed the major source of catastrophic health expenses faced by the aged -- specifically, those associated with long-term care and nursing home services. The present health care financing system has greatly contributed to the families' inability to care for their dependent elderly relatives. Programs such as Medicare and Medicaid with their statutory bias toward institutional care offer only very limited services to assist families in maintaining older persons in their homes. Title XX, the Older American Act and other legislative initiatives designed to help create home and community based alternatives to institutionalization have recieved limited funding and fallen short of their goals. Moreover, in most instances only low-income individuals qualify for assistance under such programs. At the same time, families' financial problems are compounded by a high rate of general inflation and the rising cost of goods and services needed to care for the dependent elderly. The impact of such trends on the willingness of families to care for their relatives at home and on the budgets of State and Federal government is rapidly approaching crisis proportions. Medicaid nursing home costs (total Federal and State share) in FY 1981 will be more than $11 billion.

Our Associations recommend that this Committee and the Congress amend the Internal Revenue Code to allow for a tax credit to families caring for dependent elderly of at least $250 per taxable year. We are mindful of the potential revenue implications of such a suggestion but would remind the Committee that nursing home costs are the fastest growing of all health care expenditures and, if left unchecked, by 1985 will reach the $45 billion mark. Our concerns that the families receive a greater degree of support in caring for their dependent relatives are shared by many members of the Congress, several of whom have recently approached us with similar ideas.

IV. <u>Dealing with the 1981 Payroll Tax Increase</u>

An additional concern which our Associations would like to express to the Committee results from the economic effects of the payroll tax increase scheduled to go into effect in 1981. By increasing the cost of labor for employers and lowering the after tax wages of employees, the payroll tax increase will strengthen the economy's inflationary and recessionary tendencies. Instead of the planned payroll tax increase, we would prefer the provision of a limited amount of general revenues on a temporary basis for the social security system. Also, because even scheduled payroll tax increases cannot bring short-term solvency to the system, our Associations support the use of additional general revenues to insulate the social security system from the damage caused by inflation and recession. We emphasize that the maintenance of the social security system is essential and must dominate in the consideration of methods of offset the economic effects of payroll tax increases.

Our Associations do not agree with one method of offsetting the 1981 payroll tax increase, which was suggested by the 1979 Social Security Advisory Council. The Advisory Council's recommendation to substitute general revenues for payroll taxes in financing the HI (Medicare) program is in our view inappropriate and inadequate. If this proposal has anything to recommend it, it is in the context of reforming and restructuring health care programs. HI payroll tax payments are supposed to be comparable to insurance premium payments to establish benefit eligibility; if this is eliminated, then something else -- a means test perhaps -- may end up being used to determine eligibility.

V. Conclusion

In conclusion, we would like to reiterate our point that the next tax cut must make good economic sense. The reduction of some of the effects of taxflation and the economic consequences of payroll tax increases must be combined with changes in the code which encourage savings and investment and compensate those who saved and lost due to inflation. Also, we would like Congress, in the course of its tax cut deliberations, to provide equity for non-social security retirees through the tax credit for the elderly mechanism and to encourage people to care for elderly dependents in their home through a tax credit mechanism.

STATEMENT OF RIK FULSCHER, PRESIDENT OF THE NATIONAL APARTMENT ASSOCIATION BEFORE THE SENATE FINANCE COMMITTEE ON THE REAL ESTATE CONSTRUCTION AND REHABILITATION INCENTIVES ACT OF 1980.*

August 1, 1980

Mr. Chairman and Members of the Committee:

My name is Rik Fulscher, and I am an apartment owner, manager, and developer in Denver, Colorado. I am President of the National Apartment Association, a trade association of approximately 103 local and state affiliates whose combined membership includes about 45,000 owners, managers, and developers of rental housing.

Before I discuss the specific tax legislation which is needed to provide incentives to invest in rental housing, I want to take a few moments to describe the serious rental housing crisis that faces this nation in the 1980's.

A 1978 study prepared for the Joint Economic Committee by Professors Sternlieb and Burchell of the Center for Urban Policy Research, Rutgers University, estimates that during the decade of the 1980's, there will be a demand for approximately 6,149,000 rental units in buildings of 2 or more units during the 1980's or 614,900 units per year. Compared to the projection of only 300,000 multifamily rental starts in 1980, this number is staggering.

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*The National Apartment Association is an association of over 103 local and state apartment associations whose combined membership includes over 45,000 developers, owners, and managers of rental housing. Its headquarters is located at 1825 K Street, NW, Washington, D.C. 20006; and its national officers are: President Rik Fulscher of Denver, Colorado; President-Elect Stanley Taube of Minneapolis, Minnesota; Vice President Robert Esrey of Kansas City, Missouri; Secretary Robert Martin of Dallas, Texas; Treasurer Jack Wood of Marina del Rey, California; NAC National Vice President James Reeder of Fremont, California; and Executive Vice-President Raymond S. Olsen of Washington, D.C.

Furthermore, each year more and more of the rental housing production is government subsidized or insured. As can be seen from exhibit A, in buildings of five or more units, the proportion of federally subsidized starts has increased from 22% in 1972 to 44% in 1978. According to HUD in 1979, government subsidized or insured starts accounted for approximately 70% of the total rental starts in buildings of five or more units. HUD Secretary Moon Landrieu, in testimony before the Senate Subcommittee on Housing and Urban Affairs on February 27, projected that only 50,000 unsubsidized uninsured multifamily rental units would be started in 1980. In other words over 75% of multifamily rental starts in 1980 will be subsidized or insured by the Federal Government.

Why? To quote Secretary Landrieu, "The reason is simple: Rental housing today is not perceived as a good investment in the building and financial community."

The results of the low amount of rental production are becoming apparent. Already, the national vacancy rate of 5% is the lowest in the 24 years that the data has been collected.[1] Housing experts agree that at least a five percent vacancy rate is needed to provide flexibility in the housing market for our mobile society in which approximately 40% of the tenants move at least once a year.

Due to lack of new production, the attrition rate for rental housing through abandonment and demolition, and increased demand, we predict that the vacancy rate will continue to drop.

A recent report by the General Accounting Office entitled, "Rental Housing: A National Problem That Needs Immediate Attention" underscored the need for

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[1] Changes in sample size make direct comparisons to previous years difficult. Under the previous methodology the vacancy rate dropped to 4.8% in the first quarter of 1979. Under new methodology, the vacancy rate for the first quarter of 1979 was 5.1%.

national action to cope with the growing crisis in the availability of rental housing, and recommended that the Congress establish a Commission to:

> *"develop alternative strategies to minimize the impact of the crisis which recognize, among other things, the preservation of existing stock as well as new construction of rental housing and identify incentives necessary for private industry to enlarge its role in the rental market, and propose a national rental housing policy and plan of action to foster the availability and affordability of rental housing."*

Incentives must be provided to encourage private enterprise to invest in both the preservation of the existing rental housing stock and the construction of new rental housing.

Earlier this year, I announced a seven-point program which I feel will provide a comprehensive solution to the residential rental housing crisis in the 1980's. Included in this program are tax incentives similar to those provided in S. 2969, the Real Estate Construction and Rehabilitation Incentives Act of 1980 pending before this Committee.

The National Apartment Association supports this legislation as comprehensive tax legislation needed to provide incentives for private investment in rental housing necessary to avoid a rental housing shortage in the 1980's.

I would like to cover some of the major provisions of S. 2969 as it effects rental housing.

DEPRECIATION

S. 2969 would provide for twenty year straight line depreciation for all real property, including residential rental property (Fifteen year straight line depreciation for low income rental property).

A set depreciation schedule will save owners of rental housing and the government from the waste of time and money resulting for needless audits to determine "useful life" of real property.

Even more importantly, twenty and fifteen year depreciation will provide an increased incentive to invest in rental housing without the need for accelerated depreciation with its complicated recapture and minimum tax provisions.[2]

Presently, using component depreciation rental property can be depreciated over approximately 25 years.[3] *Though the existing tax code provides for accelerated depreciation to provide increased incentives for investment, the ordinary income recapture and minimum tax provisions of the tax code discourage the use of accelerated depreciation.*[4] *Based on my conversations with many developers of rental housing, ordinary income recapture and the minimum tax are the two major reasons that accelerated depreciation is not taken, resulting in the loss of a major incentive for productivity first enacted by Congress in 1954.*

DEDUCTION OF CONSTRUCTION PERIOD INTEREST AND TAXES....S. 2969 would repeal section 189 of the Internal Revenue Code first enacted in 1976. Section 189 requires the amortization over a ten year period of all construction period interest and taxes involved in the construction of residential rental property and other

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[2]S. 2969 would eliminate accelerated depreciation for real property.

[3]The bill will eliminate component depreciation. However, the legislation must be clarified to provide that the depreciation of improvements made to section 1250 property after the taxpayer purchases property will be determined by the useful life of the improvement and not the twenty year schedule. Otherwise, there would be a disincentive to make improvements on rental property.

[4]Ordinary income recapture means that excess depreciation (the amount that accelerated depreciation exceeds straight line depreciation) is taxed as ordinary income on sale. Section 1250 of the Internal Revenue Code. The minimum tax provides that excess depreciation is a tax preference item subject to a 15% minimum tax. Section 56 of the IRC.

real property.[5] *Repeal would permit the immediate deduction of these expenses, which are actual out of pocket expenses, when incurred.*

In today's market, rental housing construction can no longer be leveraged to the same extent as in the early seventies. A much larger equity investment must be made. To encourage equity investment in rental housing with the prospect of little or no positive cash flow, the developer must look to the advantages of expensing these costs. Historically, taxes and interest have always been deductible when paid. There is no basis for making construction an exception to the general rule.

The revenue impact of the twenty year depreciation schedule and the repeal of section 189 is small compared to other tax cut legislation, such as the 10 year depreciation schedule of the Capital Cost Recovery Act. As can be seen from exhibits B and C, the cost of the Real Estate Construction and Rehabilitation Act from 1981-1984 ($16.49 billion) is less than 40% of the cost of the 10 year depreciation portion of the Capital Cost Recovery Act from 1981-1984 ($43.2 billion).

The actual revenue impact of the Real Estate Construction and Rehabilitation Act will be even less than indicated in exhibit B, due to increased tax revenues resulting from increased procuction of rental housing.

<u>REHABILITATION EXPENSES</u>

S. 2969 would make permanent provisions of the tax code which provide for 60 month amortization of rehabilitation expenses for low income housing and extend the provisions to all residential rental housing.[6]

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[5] *Low income residential rental property, residential rental property, and other real property each have different transitional provisions.*

[6] *S. 2969 raises the minimum and maximum expenditure limits from $3000 and $20,000 respectively, to $5000 and $30,000 to reflect recent inflation cost increases.*

Over 41% of the nation's rental housing was built in 1939 or earlier. The median income of renters in these units is $7,500, 15% less than the over-all renter median income of $8,800.

To quote from the GAO report cited earlier, "Given the importance of the older rental units in terms of being a significant portion of the existing stock and of housing primarily lower income tenants, it is imperative that such units are preserved and remain affordable to lower income tenants."

Preservation of existing rental housing is the cheapest and most efficient method of insuring an adequate and affordable supply of rental housing in the 1980's. Five year amortization for rehabilitation expenditures on rental housing will provide the needed incentive for investment in the preservation of all rental housing.[7]

CAPITAL GAINS TREATMENT OF CONVERSIONS

Under current tax law, if an owner of rental property desires to convert the building into condominium, in order to receive capital gains treatment, the owner must sell the building to a middleman, who then converts the project and sells the units to individual tenants. If the owner sells the units directly to tenants and other individuals, he will be considered a "dealer" of property and taxed at ordinary income rates.

S. 2969 provides that an owner of rental property will receive capital gains treatment on the sale of units directly to tenants and other individuals where the terms and conditions of the conversion have been negotiated with an

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[7]Under existing law, the excess depreciation resulting from a five year write off is a tax preference item subject to the minimum tax. The minimum tax greatly discourages the use of the five year write off. The Act reduces the amount of excess depreciation includible as a tax preference item to the excess of double declining balance (available for new rental construction) over straight line depreciation. A similar provision was adopted by the Senate in its consideration of the Revenue Act of 1978.

organization representing a majority of the tenants. By providing an owner with the opportunity to sell directly to individual purchasers, the added expense of a converted unit is avoided, resulting in lower prices to purchasers.

Though we support the concept of this bill that avoids the necessity of selling a rental building to a middleman prior to conversion, we feel that the requirement of negotiations with a tenants organization is an unnecessary complication.

A recent study by HUD, proves that condominium conversions are not the scourge of the nation that they have been painted to be. Only 1.3% of the occupied rental units have been converted.

In a typical conversion tenants are given a first right to purchase at a discount. The HUD study states that about one-half of the states require that tenants be given a first right of regusal, and 90% of tenant buyers receive a discount. There is no need for a provision in the tax code which will unnecessarily complicate the conversion process, and may end up defeating the original purpose -- lower costs to purchasers.

EXPENSES INCURRED PRIOR TO REALIZATION OF INCOME

The Internal Revenue Service contends that in the case of real estate activities involving the construction and operation of property, the expenses incurred by the owner of property, prior to the actual realization of income are not immediately deductible, but are treated as capital expenditures.

S. 2969 will clarify what we feel is basically an incorrect position held by the Service, avoiding much unnecessary litigation. The bill would amend the Code to provide for the deductibility of expenses paid or incurred in connection with the acquisition, development, construction or erection of residential rental properties or other real estate if such expenditures occur within 24 months *before the realization of gross income from the property, unless a longer period is approved by the IRS.*

Let me emphasize that this provision will provide the needed certainty of the tax consequences of real estate investment and thereby encourage such investment.[8]

This concludes my statement. I am grateful for the opportunity to express the views of the National Apartment Association.

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[8] *S. 1638 addresses this problem. However, we find two faults with the bill. First, the bill still leaves undefined when a trade or business starts. There is no doubt the IRS would continue its present incorrect position. Secondly, there is no reason that ordinary and necessary business expenses should be amortized over five years instead of being immediately deductible.*

EXHIBIT A

PERCENTAGE OF FEDERALLY SUBSIDIZED MULTIFAMILY RENTAL STARTS TO TOTAL MULTIFAMILY RENTAL STARTS

Year	Multifamily Starts (5 units or more)	Federally Subsidized	Percent
1972	906.2[a]	199.3	22%
1973	656.0	156.1	24%
1974	277.6	78.3	28%
1975	178.3	53.4	30%
1976	251.2	82.8	33%
1977	357.4	127.2	36%
1978	373.0	164.6	44%

[a] includes condominium units

Source -- General Accounting Office, "Rental Housing, A National Problem That Needs Immediate Attention", November 8, 1979 CED-80-11.

EXHIBIT B

PROJECTED STATIC REVENUE LOSSES FOR TWENTY YEAR DEPRECIATION AND CURRENT EXPENSING OF CONSTRUCTION PERIOD INTEREST AND TAXES
($ in billions)

	1981	1982	1983	1984	1985	Average 1986-90 Annual Rate
20 year Life for Real Property						
Multifamily Rental Residential	0.04	0.12	0.20	0.30	0.44	1.04
As a % of Federal Receipts	--	0.02	0.03	0.03	0.04	0.07
Single Family Rental Residential	--	--	0.01	0.01	0.02	0.04
As a % of Federal Receipts	--	--	--	--	--	--
Non-Residential Structures	1.17	2.39	3.71	5.08	6.54	12.11
As a % of Federal Receipts	0.2	0.3	0.5	0.6	0.7	0.9
Total Real Property	1.21	2.51	3.92	5.39	6.99	13.19
As a % of Federal Receipts	0.2	0.3	0.5	0.6	0.7	1.0
Current Expensing of Construction Period Interest and Taxes						
Non-Residential	0.6	0.6	0.7	0.6	0.6	0.6
Residential	0.2	0.26	0.26	0.24	0.23	0.3
Total	0.8	0.86	0.96	0.84	0.83	0.9

SOURCE: National Association of Realtors

EXHIBIT C

"10-5-3" ACCELERATED CAPITAL RECOVERY PROGRAM:
"NO PHASE-IN" -- STATIC REVENUE LOSSES
(BILLIONS OF DOLLARS, SEASONALLY ADJUSTED ANNUAL RATES, RELATIVE TO BASELINE)[1]

Year	1980	1981	1982	1983	1984	Average
Class I	2.3	5.8	6.8	13.5	17.1	9.1
Class II + III[2]	6.9	17.0	22.5	25.8	28.4	20.1
Uniform Tax Credit[3]	0.8	0.9	0.9	1.0	1.2	1.0
Total	10.0	23.7	30.2	40.3	46.8	30.2

[1]Business fixed investment is assumed to grow at a 9% annual rate, based on assumptions by the Joint Committee on Taxation. Equipment lifetimes are assumed to be 5 years, down from the current 11 years, except autos and light trucks, with lifetimes remaining at 3 years. Structures lifetimes are shortened from the current 23 years to 10 years. The Class I, II, and III assets use a combination of double declining balance (DDB) and sum-of-the-years digits (SYD) depreciation methods, while the baseline assumes SYD for equipment and a combination of 1.5 declining balance and straight line depreciation methods for structures (also Joint Committee on Taxation assumption).

[2]Class I is the National Income and Product Account counterpart to Section 1250 property (structures) including corporations, proprietorships, and partnerships. Class II is the National Income and Product Account counterpart to Section 1245 property (equipment), including corporations, proprietorships, and partnerships, except autos and light trucks. Class III is autos and light trucks.

[3]Autos and light trucks receive a 6% investment tax credit, compared to the 3.33% credit assumed in the baseline. All Class II property receives a 10% investment tax credit.

SOURCE: Data Resources, Inc.

SUBMITTED STATEMENT OF

THE

CREDIT UNION NATIONAL ASSOCIATION, INC. (CUNA)

TO THE

SENATE FINANCE COMMITTEE

ON

TAX INCENTIVES FOR SAVERS

AS A PART OF A TAX CUT IN 1981

AUGUST 1, 1980

The Credit Union National Association, Inc. (CUNA) is an association of credit union leagues, representing each state and the District of Columbia. Through the leagues, CUNA represents approximately 20,000 federally and state chartered credit unions which serve up to 40 million members. Credit unions are cooperative, non-profit associations that offer various financial services to their members.

This statement is submitted by Mr. J. Alvin George on behalf of the Credit Union National Association, Inc. (CUNA). Mr. George is Chairman of The Credit Union National Association. The Association position is that tax incentives for savers should be considered in any tax cut package enacted by Congress this year or next.

THE ROLE OF CREDIT UNIONS

Credit unions are a cooperative-type financial institution which are completely owned by their members. We do not serve the general public as other financial institutions do, but serve only members with a common bond of occupation, association or community groups. Each eligible individual of these groups is entitled to membership and equal representation to the volunteer Board of Directors of his or her respective credit union. Each member has only one vote in the affairs of the credit union.

Credit unions are thus unique among financial institutions. Benefits accrue to the individuals in the form of earnings on shares, reasonable loan terms, and services offered. Our institutions, in the normal course of their activities, act to balance the borrowing and saving functions of their members and in fact, the Federal Credit Union Act requires by law that credit unions "encourage thrift".

It is primarily because of that charge that we submit this statement to the Senate Finance Committee.

ACTION BY THE 96TH CONGRESS

At the outset, Mr. Chairman, let me take this opportunity to acknowledge the accomplishments this committee and the 96th Congress have made in the area of tax incentives for savers. I am speaking of the enactment of legislation (Title IV, Sec 404, P.L. 96-223) permitting a $200 individual or $400 joint tax exclusion for any combination of interest and/or dividends for tax years 1981-1982.

This Association appeared before this committee earlier in this Congress advocating the concept of tax incentives for savers. We supported both the utility and desirability of a national tax policy that encourages (or at least does not discourage) individuals to provide for themselves through savings and investment.

The exclusion enacted in Title IV of P.L. 96-223 is a very positive step toward such a national tax policy but advocates of saving incentive legislation agree that the concept has not yet been fully developed. For instance the savings incentive measure enacted this spring should be made permanent. Also, more could be done to encourage specific activity as saving for the purchase of a home; special considerations should be enacted for the elderly and their saving needs; a tax deferred saving account should be created that does not impose such heavy restraints on the use of such an account; a "rollover" concept should be adopted to encourage and allow individuals to shift their saving investments without loss of the tax incentive.

This Association does not intend to infringe upon the generosity of this committee by urging an expansion of the present tax exclusion at every opportunity that presents itself. CUNA does hope that the Congress can give some detailed attention it has as yet not been able to give to the variety of tax incentive proposals before it. Considering the emphasis that is now being placed on supply side economics, and for a number of other reasons to be presented shortly, we are led to the conclusion that it would be entirely appropriate for Congress to include, as a part of any pending tax cut, provisions which would act to develop individual saving and investment.

THE NEED FOR TAX CUTS DIRECTED TO BENEFIT SAVING AND INVESTMENT

Our remarks are limited today to the issue of whether or not, in a tax cut bill, provisions should be incorporated to further enhance individual saving and investment?

Our testimony will later present ideas on the structure of a general savings account where the principle and interest earned is tax-deferred. Individuals would receive real monetary benefits from such an account and money would not be put in the hands of spending consumers, thus avoiding to a large degree, unwanted inflaticnary consequences. For these and the following reasons, we answer our opening question, concerning the need for savings incentive provisions in a tax cut bill affirmatively.

1). PEOPLE DO CHANGE THEIR BEHAVIOR IN RESPONSE TO THE TAX LAWS

The credit union movement believes that there is now a greater awareness among individuals concerning the return on their savings investment. An intergral part of their savings strategy involves the tax consequences of their actions. This can be shown, for instance, by increased real estate investment and the growth of IRA/Keough accounts. Increased incentives to invest in the business sector was the intent and the result of the 1978 reduction in capital gains tax rates. There are examples which demonstrate that taxpayers do react positively to the opportunity to save money.

2). RECOMMENDATION NO. 3 of the Joint Economic Report of 1980, "Plugging in the Supply Side", (S. Report 96-618) states support for a 12.5 billion tax cut to encourage savings and investment.

The joint committee of Congress charged with the responsibility to provide Congress with a national economic overview said in its report:

"We are convinced that we need to consider a modest tax cut on the order of $25 billion to take effect no later than the summer of 1981, even though there is considerable uncertainty surrounding the economic outlook.

The tax cut we propose here is not the conventional kind which mostly benefits consumers. On the contrary, at least half of the tax reduction should be targeted to enhance productivity through savings and investment with the remainder going to help relieve taxpayers of the pressure of increased taxes and higher costs.

It is important to recognize why a conventional tax cut is not in order. We do not need another boom in consumer spending. Savings and investment must command a larger percentage of our GNP or we will fail to reverse our dismal productivity performance with the result that we will make little headway in our efforts to slow inflation and raise real incomes. Moreover, it is important that whatever tax relief is given to the business community it be given on the basis of its performance in expanding plant and equipment expenditures. We leave it to the tax-writing committees to work out the precise details of the tax cut proposed here.

If there is a downturn in the economy over the next 18 months and a sharp increase in the unemployment rate, Congress is likely to enact a tax cut. If there is no downturn and the unemployment rate remains in the neighborhood of 6 percent, according to the Administration, substantial budget surpluses will begin to accrue in fiscal year 1981 and Congress is also likely to enact a tax cut. In either case, Congress must make sure that the tax cut does not result in exacerbating the rate of inflation.

Recommendation No. 3

Should either of these events occur, the Joint Economic Committee recommends a targeted tax cut of approximately $25 billion to take effect no later than the summer of 1981, designed to improve productivity and partially offset the tax increase on individuals caused by inflation. At least half of the tax cut should be directed toward enhancing savings and investment."

3). INDIVIDUAL SAVINGS RATES ARE ABNORMALLY LOW FOR AMERICANS AT THE PRESENT TIME

This Congress, and particularly this committee, has been deluged with statistics in the last six months pointing to the dismal saving rate in this country. All this information indicates that since 1975 the rate of saving as a percentage of disposable income, has declined from 7.7% in 1975 to 3.3% in the last quarter of 1979.

Furthermore, a low or declining savings rate indicates pressure to increase the cost of available money for loans, thereby reducing capital investment (particularly in small business), productivity and jobs.

If the determination is made that an increase in private sector investment, through savings accumulation is vital, a tax-deferred savings fund might well have a beneficial effect greater and sooner on the rate of saving in this country than the $200/$400 tax exclusion will be able to generate. Revenue losses to the Treasury will be lessened and only delayed by deferring taxes earned on amounts placed in this account.

4). <u>TAX INCENTIVE FOR SAVING MEASURES WILL NOT HAVE THE POTENTIAL ADVERSE EFFECTS ON INFLATION THAT BROAD-BASED TAX CUTS MIGHT</u>

Much of the deliberations surrounding the tax cut issue is the trade-offs that accompany the act of reducing the federal tax liability of individual citizens, thereby increasing spendable funds. Tax incentive measures will leave more of an individuals financial assets with the individual, rather than the federal government, and do so without the threat of fueling inflation.

The loss to the Treasury comes only after the act of putting the money in a savings account has occured, thus aiding capital formation and avoiding inflationary consequences.

5). <u>AMERICAN WORKERS NEED RELIEF FROM THE UNLEGISLATED TAX INCREASES THAT OCCURS AS INFLATION REDUCES REAL DISPOSABLE INCOME</u>

American wage earners find themselves in a situation where any increases in wages earned by the individual are, in real terms, actually reduced by inflation. Yet the increased tax liability that comes by being placed in a higher bracket is real and is increasing as a percentage of income.

This has been documented by the Administration when Treasury Secretary G. William Miller, in testimony before the House Ways and Means Committee on July 22, 1980, stated that "bracket creep" caused by inflation will provide the federal coffers with an unlegislative windfall of some $30 billion next year. This amounts to 1/2 of the entire assets of the credit union movement in this nation.

<u>The Wall Street Journal</u> article of July 7, 1980, attached to our statement illustrates that for some families taxes represents the fastest rising cost of the household. As "thrift" institutions, credit unions recognize the pressure that our members are under in this regard and which detract from their ability to initiate or maintain regular savings plans.

A GENERAL TAX DEFERRED SAVINGS PLAN

One suggestion the committee might consider as an approach to improve personal savings rates and to enhance capital formation in the private sector is this: a general or universal savings fund account where there exists a tax-deferral on the principal and interest earned. Only upon withdrawal would the funds be subject to taxation.

This is patterned very closely to the IRA account, and our conception of what an account of this type should have as features includes the following:

o Elimination of penalities that are currently applied to IRA accounts for withdrawing funds prior to the age of 59 1/2. This would be a distinction between true retirement accounts and a tax-deferred savings fund. Upon withdrawal only the liability to pay taxes on amounts withdrawn should occur. Eligibility limitations must be minimized to eliminate inequities among those who can make use of accounts.

o Retain and make permanent present provisions that protect the small saver and investor as the low range tax exclusion. This is the \$200/\$400 tax exclusion enacted this year.

o As a near facsimile to an IRA account a tax-deferred savings fund account will allow individuals to save for whatever worthy purpose they aspire to save for - a home, an educational fund, an automobile or for a personal financial security.

Such a general account will prevent Congress from being petitioned continuously in the future to designate a multitude of activities as worthy of tax incentives. Worthy causes are infinite. Yet if Congress did feel it necessary or desirable to further target aid to certain specific activities, for instance the purchase of a first home, it could do so by providing for a percentage credit for funds taken from the account and used for that purpose.

o Encourage long range saving through tax exclusions based on the maturity of balances maintained in an account. For instance, earnings on funds maintained in an account for over 10 years might be given a percentage tax exclusion; 20 years a full exclusion. An acceptable accounting technique would have to adopted.

o The concept of a "rollover account" should be seriously considered by this committee. It is emphasized that this approach results in tax-deferral, not tax avoidance. Although there would be some adjustments needed in short-term Treasury revenues, in the long-run taxes on earnings would be paid and, our economy would benefit by increased capital formation in productive investment areas.

ACTIONS THE 96th CONGRESS CAN TAKE NOW TO ENCOURAGE SAVINGS AND INVESTMENT

However desirable, necessary and effective such an account could be, the short period of time that remains in the 96th Congress may preclude action on this front. If this proves to be the case, another approach to enacting tax cuts to benefit individuals and capital formation would be to make the existing tax exclusion permanent and to address the limits and inequities that occur under the present IRA statute.

MAKE THE $200/400 SAVINGS INCENTIVE PERMANENT

This Congress should consider making permanent the present tax exclusion provided for in P.L. 96-223. In order for this to truly be a tax incentive for savers, savers must know and depend upon a continuing tax incentive. As it now stands, the exclusion enacted in P.L. 96-223 is more of a "break" than an "incentive" because it is not permanent. Once it is made permanent, savers will react positively to the incentive, save more money and thereby aid capital formation needs of the natior.

HOMEMAKER IRA'S

Aother subject needing attention, and which could be dealt with in the concept of a tax cut measure, falls into that category of tax ramifications commonly known as "marriage penalties".

Those married couples who diligently seek to provide for themselves in later years through deferred compensation plans (i.e IRAs) will automatically fail to adequately do so. This is due to defects in IRA qualifications and contribution limitations. I am speaking specifically about non-employed spouses and those spouses who are employed part-time - and are, therefore, excluded from making meaningful contributions to IRA accounts.

In the first case, if a spouse is not employed, an IRA contribution is in effect limited to $250 over and above the $1,500 contribution limit provided the employed spouse. This represents less than 17% of the amount deemed sufficient for one partner. When it comes time to withdraw those funds, the couple will surely find the amount inadequate for two, or that IRA account is prematurely depleted.

The second case is even more discriminary in nature. In this instance, a spouse who works on a part-time basis is disqualified from making any IRA contributions at all. The de facto statement here is that these spouses must trade off future security for current earnings, a trade off not required of most others in this country. This is a harsh choice to make for the many reasonable individuals concerned about both their current welfare as well as their future security.

CUNA supports the proposals before this committee that would correct these inequities in the deferred compensation plans. One method to alleviate this burden might be to allow the non-working spouse to establish an IRA based upon the working spouse's income, regardless of whether the working spouse is eligible to establish an IRA.

RAISING IRA CONTRIBUTION LIMITS

Inflation has taken its toll on the value of a $1,500 individual or $1,750 joint allowance for contributions to the tax-deferred retirement account. For this very simple reason we would support moves to increase the contribution limits.

Since 1974 when the US Congress authorized the use of individual retirement accounts the cost of living has risen substantially. It should be recalled that the $1,500 or 15% limit was first proposed almost 10 years ago and, with the expectation of continued inflation, a $1,500 annual contribution limit is not now as substantial as the Congress intended it to be.

EQUITY AND ADEQUACY ARGUMENTS REGARDING IRA'S.

IRA's, Keough plans and private pension plans are methods by which individuals are encouraged to provide for themselves in later years. Demographics and the projected difficulties of the social security system now and in the years to come make it imperative that these private plans be seen as the primary method of income support for retired individuals. Public policy must then encourage the development and use of these plans and thereby reduce the status of the social security system to a supplemental income maintenance system. However problems exist, many of a complicated nature, that limit the real effectiveness and availability of these private plans and thus add to the heavy burden of the social security system.

Many Americans shift jobs frequently enough that vesting does not become a reality in their pension plans. The present exclusion of "active participants" in a qualified employer plan from IRA use disregards the adequacy of such plans. For these and other reasons the utility of these otherwise meritorious programs are lessened to an important degree. We encourage this committee to eliminate these difficulties where possible in the context of a tax cut bil this year.

SPECIFICALLY:

- Broaden the use of IRA's by allowing all workers, whether covered by a pension plans or not, to establish an IRA account. This can be done by removing the present prohibition against use of IRA's by persons who are "active participants" in a qualified employer plan.

- Eliminate the 15% of income limitation on contributions. Presuming that IRA's will still be limited to wage earners, eliminating the 15% restriction will allow moderate income wager earners to make better use of the account. This will simplify the contribution limits under the law, leaving only an annual contribution limit of $1,500/1,750 joint or such higher ceilings established by Congress.

- Permit non-deductable contributions to IRA Accounts. Individuals then could save at a faster rate, further aiding the formation of capital and long-term availability of funds. Only interest would be tax deferred for non-deductable contributions, thus the revenue loss to the Treasury would be minimal.

CONCLUSION

An opportunity exists in which this Congress can act to meet and merge the immediate and long-term needs of many segments of our nation by providing as a part of a large tax cut package, tax cuts for people through the non-inflationary form of greater tax-incentives for saving and investment.

Through this method, the opportunity exists whereby Congress could go great lengths toward correcting the inequities and inadequacies surrounding the use of private retirement plans. Public policy could be altered this year to further encourage individual saving and investment, enhancing the future financial security of our citizens, lessening dependance on social security, and providing financial institutions and other intermediaries with a source of stable funds for lending and investment, thus reducing pressure on interest rates and otherwise enhancing capital formation in this nation.

Furthermore, since it is apparent that the federal government will have an extra $30 billion in its hands due exclusively to inflation and bracket creep in 1981, it would be in the public's interest to divert this valuable resource back to the private sector where it will serve a better purpose.

Therefore, we urge the committee to heed the advice of the Joint Economic Committee in its 1980 report and provide for a tax cut, a significant portion of which should be directed to encouraging savings and investment.

The Wall Street Journal July 7, 1980

Your Money Matters

Figuring Out Your Personal Rate of Inflation: Surprise! Taxes Are Your Fastest Rising Costs

By WILLIAM G. FLANAGAN
Staff Reporter of THE WALL STREET JOURNAL

As any numbers cruncher worth his calculator knows, the highly touted Consumer Price Index is about as accurate a measure of inflation as a 40-inch yardstick.

Despite the widespread acceptance of the CPI, experts are quick to point out that it has at least two major flaws: It doesn't include personal income taxes, and it is much too heavily weighted for housing costs. (Few people buy houses the month that figures are compiled, of course. Yet according to recent CPI figures, people are spending 44% of their incomes on shelter—which is obviously much more than most of us actually pay.)

Yet the CPI endures, and, in fact, prevails. This is so for mainly two reasons. Labor loves it as a gauge of cost-of-living increases because it is generally higher than other inflation benchmarks. And the government loves it because, directly or indirectly, it bumps wage earners into ever-higher tax brackets.

But what is the real effect of inflation on you personally? How hard are you really being hit in the wallet? Calculating just how much of a bite inflation is taking is more than just an exercise in math—or futility. It permits you to tinker with your budget so that you can, to a degree, pinpoint where you are being hurt the most.

Take the case of one Marcia Sherwood, for example, a financial writer with Touche, Ross & Co. in New York City. As a member of the tenants' committee in her West Side apartment building, she wanted to calculate exactly how much she and her fellow tenants were spending on shelter, in order to counter arguments for converting the building into a co-op. Some of the arguments were based on the CPI inflation rate, which Mrs. Sherwood deemed inappropriate for herself and fellow renters in a rent stabilized building. She suspected that their real inflation rate was considerably lower than the CPI rate.

She insisted that even after the tax advantages of ownership were taken into account, and considering the effect of inflation down the road after going co-op, most of her fellow tenants would wind up spending much more for their apartments than they were already paying, or would have to pay in the future.

A New Inflation Measure

As an employe of one of the Big Eight accounting firms, Mrs. Sherwood had easy access to the firm's actuary department and its mountains of statistics. The actuaries quickly produced data from the Department of Labor that amounted to another measure of inflation much closer to reality than the CPI. For one thing, it includes personal income taxes. For another, it is based on actual expenditures for consumables and other items and services, not what the prices for those items might be. (Consumers often change preferences or buying patterns because of high prices—but before the items in the CPI market basket can reflect those changes. When meat is high, for example, consumers buy less of it. But it can take months before the CPI reflects that change.)

How Inflation Hits "High-Budget" Families

	*Monthly Outlay**	*% of Budget*	*% Change 1978-79*
Food	$530	20.9	+ 9.5
Shelter	582	23.0	+ 9.9
Transportation	201	8.0	+18.0
Clothing	201	8.0	+ 3.4
Medical Care	102	4.0	+ 9.9
Other Consumption	140	5.6	+ 6.7
Personal Income Tax	530	21.0	+10.8
All Other (Including Social Security)	241	9.5	+17.7
Total	$2,526	100.0	10.6

Source U.S. Bureau of Labor Statistics, Touche Ross & Co

**Assumes a "high" budget, with annual expenditures of $30,300 for a family of four with one breadwinner.*

Mrs. Sherwood pored over the most recent Labor Department figures on expenditures, which were released in May (see accompanying table). Using those numbers and categories as a guide, she calculated exactly what her budget outlays were in dollars and cents for each item—food, shelter, clothing and the rest. Then she turned those numbers into percentages of her total budget. Finally she multiplied those percentages by the annual percent change caused by inflation to arrive at her own personal inflation reading for each category.

For example, her transportation costs came to only 6% of her monthly budget, because, living in the city, she generally uses public transportation and doesn't drive much. Using the average annual increase in transportation – 18% – she calculated that her own inflation rate for transportation was just 0.1%.

Higher Food Costs

But her food costs were higher than the national average for someone in the high-budget category—24% of her total budget each month. Multiplying this by the 9.5% increase in food costs, she found that her personal rate increase for food was 2.28% annually.

In all, however, she found that her personal inflation rate added up to only 9%—1.6 percentage points below the national average. And she vowed to do something about her food costs to get her rate down even lower.

But Mrs. Sherwood's elation at being able to stay under the national inflation rate—even as computed by expenditures, not prices—was tempered by a shocking discovery. And that was what she was laying out each month in personal income taxes—in her case 28% of her total budget. Worse, it turned out that personal income taxes accounted for 2.69%, or almost a third, of her total 9% personal annual inflation rate. Yet taxes are the one thing she can do little about.

Probing a little deeper, Mrs. Sherwood looked up Labor Department figures for New York City showing increases in expenditures from 1967 to 1979. The results were sickening. The percent change in personal income taxes for New Yorkers in the "high-budget" income category was 311%.

By contrast, over the same 12-year span, food costs rose 148%; housing, 121.6%; medical care, 138.2%; other consumption items, 78.9%; and all other items, including Social Security, 159.6%.

Nationally, the figures are similar. Food was up 145.9%; housing, 108.7%; transportation, 113.9%; clothing, 67.2%; medical care, 146.9%; other consumption items, 74.1%; and all other, 159.6%. The highest item of all, again, was personal income taxes—222.9%. (The increase in personal income taxes was higher in New York City than the national average because of increases in city and state taxes on top of federal personal-income-tax rises.)

What is the trend now? Recent figures show that for people in the high-budget category—that is, generally with more than $30,000 in expenditures each year—inflation's deepest bites are still taxes and, for a change, transportation, thanks to the rapid rises in fuel and automobiles. The rate of increase in taxes in 1979 was 10.8%, with an 18% increase for transportation. But the average high-budget income-earner was spending 21% of his budget on personal income taxes versus only 8% on transportation.

Where you live can affect your inflation rate, of course. From 1978 to 1979, the inflation rate—based on actual expenditures—was 10.4% in New York, 9.8% in Boston, 10.0% in Chicago and 13.4% in Los Angeles.

- more -

STATEMENT OF
THE AMERICAN TEXTILE MANUFACTURERS INSTITUTE
REGARDING ADVISABILITY OF ENACTMENT OF TAX CUTS
SENATE FINANCE COMMITTEE
AUGUST 1, 1980

The U.S. textile industry is a significant factor in the U.S. economy employing approximately 900,000 workers with aggregate shipments of about $50 billion this year. The industry has operations in all but one of the United States. Our industry is deeply concerned about the direction of our economy. These concerns have been exacerbated by the current recession, but do not relate exclusively to the recession.

Our greatest problem is a shortage of capital. We are suffering from what might be called "capital anemia" as reflected in Exhibit A which indicates that our industry has spent 78% of its retained cash flow for capital improvements during the past 4 years as compared with 55% for all U.S. manufacturers.

Our "capital anemia" is brought about by a series of factors stemming from the very low level of profits in our highly competitive industry which averages 3% on sales - just 52% of the average profits for all U.S. manufacturers. These limited earnings must go to satisfy the preemptive regulatory demands of OSHA, EPA and other regulatory burdens placed upon our industry, which when fully implemented, are estimated to cost several times the normal annual reinvestment rate of our industry.

Furthermore, our industry is going through a technological revolution which is increasing its capital intensiveness. A plant one company will bring into production late this year represents an investment of over $100,000 per job created. Technologically, for example, fly shuttle looms are being replaced by new developments as rapier, air-jet, and projectile looms. Fly shuttle looms which cost an average of $6,500 in the past decade are being replaced by looms which cost between $25,000 and $65,000 each.

Our commitments to improve quality for consumers and to maintain a competitive position with respect to foreign producers virtually mandates that a company make substantial capital investments if it is to survive the decade of the 1980's.

We strongly recommend the immediate implementation of the 10-5-3 depreciation proposal in order to ease the crushing burden of this "capital anemia". We are confident also that implementation of this depreciation revision would key a capital investment boom in our economy which would do much to reduce unemployment, strengthen American industry's competitiveness in domestic and foreign markets, restore productivity growth and contribute significantly to the long term effort of controlling inflation.

I can think of no single action taken by the Congress which would do more to restore business confidence and encourage business executives to assume additional risks. This renewed confidence in the economy and the Congressional management of the economy could readily become an important first step in building the partnership between business and the Congress for the broader restructuring of the tax system which is to be considered by this Committee next year.

A second critical factor which is currently undermining the health of our economy is the serious decline in real take-home pay of American workers. As you can see in Exhibit B, the real take-home pay of an American worker has plunged dramatically. Indeed the June 1980 figure is the lowest in 20 years.

This decline has reduced consumer spending in virtually all segments of American industry. The staggering contraction in the automotive and housing industries have monopolized business headlines, but these declines have also affected textiles as a major supplier to these industries. Furthermore, real final sales fell over 2% in the second quarter - a 9.6% annual rate paced by a 60% decline for residential construction, a major customer of our industry.

We believe that the American taxpayer is due the equity of an immediate tax cut in order to level off the continuing decline in his real take-home pay which has been effect during 1978, 79 and 1980.

In summary, we believe that American industry because of the growing financial burdens imposed by government regulation, uncontrolled inflation and growing competition from abroad has incurred "capital anemia" which must be overcome in order to reindustrialize America and to key an expansion of capital investment which will contribute substantially to overcome our current economic problems.

The American worker has also suffered from declining real take-home pay which must be arrested in order to provide consumer demand for the products of American agriculture and industry. Corrective action on these economic needs should be taken in the form of an immediate depreciation revision instituting the 10-5-3 schedule, a corporate tax reduction of 2% and an individual income tax reduction of 10% to become effective with the 1981 fiscal year.

We recognize that these recommendations will result in a reduction in projected income for the federal government in 1981. However, we believe that the economic stimulus resulting from them will provide self correcting action. Furthermore we are confident that the expansion of capital investment will favorably affect production, productivity and inflation.

EXHIBIT A

TEXTILE INDUSTRY CAPITAL SPENDING
VS. ALL MANUFACTURING

	TEXTILE INDUSTRY			ALL MANUFACTURING		
	Retained Cash Flow	Capital Spending	Percent Spent	Retained Cash Flow	Capital Spending	Percent Spent
	---- $ Billion ----		%	---- $ Billion ----		%
1976	$ 1.38	$ 1.09	79	$ 76.7	$ 40.7	53
1977	1.43	1.22	85	82.0	47.7	58
1978	1.81	1.38e	76	95.9	53.6e	56
1979	1.93	1.41e	73	115.9	62.6e	54
	AVERAGE		78%			55%

Retained Cash Flow

= Profits after taxes, after dividends plus depreciation allowances

e= estimate

Estimates and calculations by American Textile Manufacturers Institute, Inc.

SOURCE: Federal Trade Commission and Bureau of the Census

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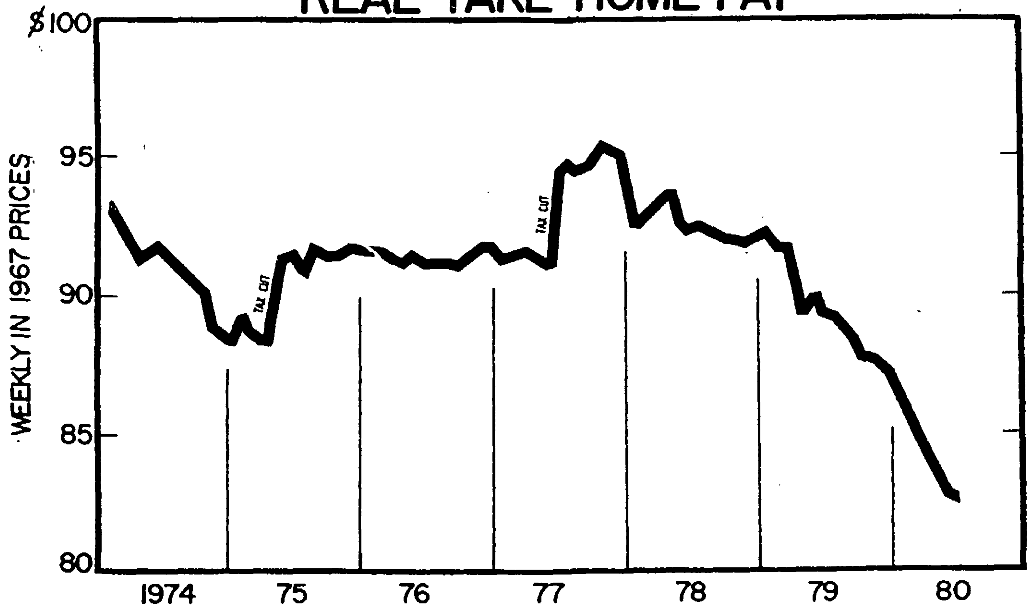
EXHIBIT B

REAL TAKE HOME PAY



WEEKLY TAKE-HOME PAY PRIVATE WORKERS WITH THREE DEPENDENTS, IN 1967 DOLLARS.

SOURCE: Bureau of Labor Statistics

AEDC

AMERICAN INDUSTRIAL DEVELOPMENT COUNCIL, INC.

STATEMENT SUBMITTED TO THE SENATE FINANCE COMMITTEE
TAX HEARINGS - JULY, 1980

My name is Thomas E. Bundy. I am the current Chairman of the Board of the American Economic Development Council (formerly known as the American Industrial Development Council). This professional organization represents 1100 practitioners who work daily in the field of economic development. These developers work at city, community, area, state and corporate levels to encourage the economic health and well-being of their assigned regions.

This work brings them into contact with the decision making process used in the formation of capital. They are intimately aware of the reasons for making, or not making, capital investment decisions. With this knowledge and experience, they are well qualified to state that encouragement of capital investment into modern productive plants and equipment is absolutely vital to the economic future of this nation.

A general tax cut, while providing a temporary stimulus to the current economy, will not bring about long range investment by business and industry. What is needed, at the earliest possible moment, is a system of incentives designed to induce and to encourage commitment for large capital expenditures, in order that our economy will remain competitive in growing world markets.

AEDC would like to call attention to two methods that will provide the needed encouragement. One is not in existence, while one has a proven record of success and should be expanded.

The new program needed is a carefully designed plan for allowing rapid depreciation of capital expenditures in industrial facilities. The concept of "useful" life must be abandoned and be replaced with a selective system of early "write-offs" for buildings and equipment that will give our industries a more competitive base to maintain present markets and to expand into new ones.

Plans for rapid depreciation have been thoroughly discussed during the past year. Our organization believes immediate action and implementation is vital and urges early Congressional action.

The proven program has been the use of industrial development revenue bonds. With the recent history of record high interest rates, these bonds have been the only method available to encourage new capital investment. The reduced interest rate provided through the tax exempt feature of these bonds have kept many expansion plans from being shelved.

The attractiveness and the efficiencies of this program have meant quick action to provide expansion of existing industries, cleaning up the environment through pollution control, rehabilitation of older sections of our cities,

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establishment of new branch plants in rural areas and provision of needed facilities for economic development.

With the proven success of these bonds, one wonders why there seems to be a growing fear of their use. Most of the criticism centers around their effect on federal revenues. Since federal revenue rises and falls on the economic health of this country, we respectfully submit that all programs of this nature must be preserved and expanded, or federal revenues will suffer a disastrous decline with the future shrinkage of our economic base.

Our organization has studies and information available that conclusively prove the use of IDRBs has increased federal revenues over the long term through additional tax base, namely increased jobs and return on corporate investment. We would be glad to provide this information to any member of the Committee that expresses an interest.

To improve this program and to provide for further success, we submit the following suggestions for the Committee's deliberations, when they design a new Revenue bill.

1. Due to inflationary increases in costs the top dollar limit should be raised from $10,000,000 to $15,000,000 and you should raise the limit under the UDAG rule to $25,000,000. The UDAG rule gives special incentive for investment in our cities.

2. Raise the threshold limit under the Capital Expenditures rule from the present $1,000,000 to $3,000,000. This request is based on the effects of inflation, also, since the $1,000,000 threshold was established in 1968.

3. Permit the Economic Development Administration, the Farmers Home Administration and the Small Business Administration to guarantee IDRBs. This would open up a secondary market in these bonds and would offer an advantage to small business. At present, a small business that is not bankable pays a premium in interest, because they need the extra collateral to get a loan. Guarantees by the SBA would enable small business to enjoy the benefits of lower interest rates through tax exempt financing.

May I close by offering the services of our organization to this Committee in any way possible to assist you with your work in designing a meaningful revenue bill. Thank you.

STATEMENT
GEORGE A. CONN, NATIONAL LEGISLATIVE DIRECTOR
PARALYZED VETERANS OF AMERICA
SUBMITTED FOR THE RECORD
TO
THE SENATE COMMITTEE ON FINANCE
CONCERNING
REFORM OF THE INTERNAL REVENUE CODE OF 1954
JULY 23, 1980

Mr. Chairman and Members of the Committee, it is a privilege for Paralyzed Veterans of America to be allowed to present this statement concerning needed changes in the Internal Revenue Code of 1954. We are very pleased that this Committee is reviewing the need for changes in the nation's taxation laws. PVA feels confident that this Committee will recommend judicious and significant changes that will lead to greater national productivity and a more viable economy, while providing incentives for disabled citizens to contribute to the nation's economic well-being.

Mr. Chairman, the recommendations which PVA will make in this testimony are based on years of observation and study, not only by our organization, but by others that are concerned with the productivity of seriously disabled citizens and with the nation's economy. PVA is a veterans' service organization with approximately 11,000 members, all of whom have experienced spinal cord injury or dysfunction.

Basically, what PVA wishes to accomplish is greater incentives for seriously disabled citizens so that they may return to the productive work force. We propose that this be accomplished, first, by removing architectural barriers, so that mobility impaired individuals can have ingress and egress to places of employment and commerce. Second, we propose that individuals who are totally and permanently disabled can, with proper and adequate incentives, return to the work force and thereby reduce governmental expenditures for income maintenance programs.

The simpler aspect of our dual approach is the removal of architectural barriers that impede the movement of disabled citizens. Presently Section 190 of the Internal Revenue Code provides for a tax deduction for expenses incurred in making publicly used, privately owned, facilities accessible to elderly and disabled citizens. The maximum allowable deduction is $25,000.

This provision of the Tax Code was to have expired last December 31, but this Committee and Congress recognized the wisdom and utility of this measure and extended the tax deduction until December 31, 1982. Paralyzed Veterans of America sincerely appreciates this action. We regard Section 9 of Public Law 96-167, entitled "Extension of Certain Temporary Tax Provisions," as evidence that Congress views income tax deductions for the removal of architectural barriers as being in the best interest of all Americans. It is a cost effective measure that allows members of our society to reach their full potential. We would like to thank Senator Robert Dole, Ranking Minority Member of this Committee, and an outstanding spokesman for disabled citizens, for originally introducing this beneficial tax provision. This was accomplished through Section 2122 of the Tax Reform Act of 1976, Public Law 94-455.

In March 1979 PVA wrote to Senator Dole, explaining that several limitations were causing Section 190 of the Tax Code to be less than maximally effective. First, the existence of the new tax provision was not sufficiently known to business operators. (To help rectify this lack of information, PVA has written several thousand businesses and trade assocations concerning this available tax deduction, and has featured its provisions in its publications on several occasions.) Second, the size of the allowable deduction was proving to be inadequate for individuals, or corporations, with several sites in need of alteration. Finally, the temporary nature of the tax deduction did not allow businesses sufficient lead time for long-term planning.

Senator Dole quickly addressed these matters and introduced S. 1694, a bill which would increase the maximum allowable deduction from $25,000 to $100,000. Furthermore, it would make this a permanent provision of the Internal Revenue Code. On behalf of PVA, I would like to thank Senator Dole for his continued awareness of the needs of disabled citizens.

S. 1694 deserves the consideration of this Committee, to which it was referred, and the support of the entire Congress. The number of elderly and disabled citizens is increasing in the United States. Despite many recent advances, many still find it difficult to participate in society as customers and employees. As consumers, they spend billions of dollars annually, but this trade is limited by scope and amount to merchants who have accessible buildings. It should be noted, also, that handicapped individuals make excellent workers when employed in readily accessible facilities, thus increasing their potential participation in the economy of our society.

Besides helping disabled citizens enjoy greater mobility, the income tax deduction can generate additional commerce as well. For example, if a merchant decides to renovate his place of business a number of other pursuits benefit, because he is likely to have more extensive work performed for the purpose of making his place of business truly accessible. This means projects for architects and builders and increased loan activity for banks.

PVA sincerely feels that providing mobility impaired individuals access to places of employment is vital in reducing federal expenditures. They can then return to earning their own livelihoods, increase the economy's cash flow, and better enjoy the consumption of goods and services. While S. 1694 would not accomplish all this alone, it would be a major move in the right direction. Very importantly, this needed incentive for business operators would help boost the economy at a minimal cost to the government.

It is well worth noting that increasing the productivity of citizens with severe disabilities is no mere idle thought of a special interest group. The Republican Party Platform for 1980, as adopted July 15 at the party's national convention in Detroit, reads:

> The Republican Party strongly believes that handicapped persons must be admitted into the mainstream of American society. It endorses efforts to enable our handicapped population to enjoy a useful and productive life.
>
> Too often in the past, barriers have been raised to their education, employment, transportation, health care, housing, recreation, and insurance. We support a concerted national effort to eliminate discrimination in all these areas. Specifically we support tax incentives for the removal of architectural and transportation barriers. We pledge continued efforts to

improve communications for the handicapped and to promote a healthy constructive attitude toward them in our society.

PVA is very pleased that the National Republican Party has made such a strong statement on behalf of the role disabled citizens are to play in our society. We trust that the National Democratic Party will likewise make such a statement when it meets next week to nominate its Presidential candidate and to draft its Party Platform.

The societal costs of disability have received great attention during the past few years. A time-honored major political party sees correction of these ills as important to the nation as a whole. Congress and the Administration recently gave great attention to this matter with passage of H.R. 3236 and the signing into law of the "Social Security Disability Amendments of 1980," Public Law 96-265. H.R. 3236 was introduced by Representative J.J. Pickle and reported by the House Committee on Ways and Means as an effort to encourage disabled citizens to return to the work force and to reduce expenditures in the Social Security Disability Insurance (SSDI) program. Public Law 96-265 seeks to do this by creating needed work incentives, and by reducing benefits payments for certain recipients who become disabled on or After July 1, 1980. This Committee, in its consideration of H.R. 3236, also recognized the need for improved work incentives in the Disability Insurance program.

The final version of H.R. 3236, as written into law, contained provisions that will affect a broad range of Social Security programs. It clearly received Congressional support because of its joint approach for increasing employment among disabled citizens and for reducing federal expenditures arising from disabilities. Many Members of Congress who strongly opposed reducing SSDI benefits payments supported passage of H.R. 3236 because of its improved work incentives that will enable many disabled citizens to resume gainful employment.

PVA will not repeat the well-known provisions of the "Social Security Disability Amendments." Nevertheless, it is imperative to examine briefly the law's approach to increasing productivity by this segment of the American population. A disabled person in receipt of SSDI benefits may feel, with his physician's advice, that he is capable of returning to his former job, or seeking a new or less strenuous type of employment. With the passage of

Public Law 96-265, this person can safely return to work, and have sufficient time in which to determine his degree of employability, before cessation of all benefits.

If employment proves to be impossible, he can regain his Medicare eligibility for health care services without having to wait the second 24-month period, as was previously required. This added availability of essential health care coverage gives many disabled workers the security they must have if they are to seek employment. Furthermore, Congress recognized the need for assured health care benefits, and included in the law a measure which would extend Medicare benefits beyond the receipt of SSDI benefits (up to one year) for employees who have not fully recovered medically. Otherwise, they are not likely, in light of their disability, to sacrifice guaranteed medical coverage.

Second, the disabled worker continues to draw disability insurance cash benefits for 12 months after becoming gainfully employed and is eligible for an additional 12 months to return to the SSDI rolls should employment prove medically unfeasible. This, too, is intended to ease the transition and to give the worker time in which to determine if his health will sustain the increased activity. During these early stages of re-employment the worker may be able to withstand only part-time activity and his earnings may not prove to be sufficient for his self-support. Furthermore, many may have to undergo apprenticeships or training periods because of the need for less physically demanding employment. This would be a time of low income which Public Law 96-265 wisely takes into consideration. The SSDI recipient may require benefits in order to cover the expenses of preparing himself for re-employment. Additional equipment or supplies that he previously did not require in order to be gainfully employed may be needed to assist the disabled citizen to become gainfully employed.

Finally, Congress, in its effort to allow disabled citizens to once again become productive, gave the Secretary of Health and Human Services great latitude to design innovative measures toward that end. Public Law 96-265 authorizes the creation of experimental or demonstration projects. This will include a "study of the effects of lengthening the trial work period, altering the 24-month waiting period for medicare benefits, altering the way the disability program is administered, earlier referral of beneficiaries for rehabilitation, and greater use of private contractors, employers and others to develop, perform or otherwise stimulate new forms of rehabilitation." (Conference Report Number 96-944 to accompany H.R. 3236, page 73).

Mr. Chairman, PVA has long supported work incentives for disabled citizens who seek to test their employability. If such experiments prove successful the product is a participating, tax-paying member of society, who no longer relies on government income maintenance programs for total support. If these valiant efforts fail in individual cases, there is no extra cost to the government beyond that which would be borne had the person never soughnt to become re-employed.

In passing we must state that PVA strongly opposed those portions of H.R. 3236 which would greatly reduce benefits payments for certain individuals who become disabled on or after July 1, 1980. Proponents of this measure argued that many SSDI recipients are malingerers who do not deserve SSDI benefits or whose present benefits exceed pre-disability earnings. PVA agrees that SSDI is a worthy social program which must not be abused. However, we fear that for disabled persons who are unable to return to work, and especially for those with dependents, these reduced benefits may prove to be indadequate. Nevertheless, the point is abundantly clear that Congress seeks to establish sound programs that will encourage disabled individuals to again become productive citizens. Please allow me to thank this Committee for sharing PVA's concern for disabled persons who are unable to seek gainful employment. In its effort to protect SSDI beneficiaries, this Committee successfully worked for and achieved grandfathering of the benefits reductions. Those disabled prior to implementation of Public Law 96-265 remain protected from these cuts but are eligible to utilize the beneficial work incentives contained in the Amendments of 1980.

Congress has, through the "Social Security Disability Insurance Amendments" provided recognizable incentives. Furthermore, if S. 1694 becomes law, there will be increased accessibility so that disabled citizens with mobility impairments can enter places of work. Yet, despite these existing and potential improvements, certain disabled citizens will need greater assistance if they are to join the work force.

America's productivity has declined for the past six consecutive quarters, and this Committee recognizes the need for examination of the nation's tax laws. PVA feels that an additional tax provision would help contribute to the nation's well-being. We refer here to a double personal income tax exemption for totally and permanently disabled citizens. Such an exemption already exists for citizens who are blind, and for those who are age 65 or greater.

The double tax exemption has been used by Congress to offset the individual's expenses which arise because of blindness or advancing age. Where such persons are gainfully employed, they experience greater costs in their employment because of necessary equipment or supplies without which they cannot remain employed.

Recently PVA conducted an informal survey of some of its members at our Annual Convention. All respondents are permanently and totally disabled bnecause of spinal cord injury or illness, and several are gainfully employed. An itemization of the average disability-related expenditures is helpful to understanding the personal need for the double income tax exemption:

Health care	$2,164 (annual)
Therapy/Counseling	893 (annual for initial years of disability)
Prosthetic devices	1,129 (annual)
Attendant services	3,548 (annual)
Adaption of residence	5,947 (one-time)
Added employment-related expenses	912 (annual)
Homemaker services	1,962 (annual)

It must be noted that adaption of residence is not an annual expense, but many disabled citizens must hire someone to perform commomplace maintenance chores for them. Not all persons with spinal cord dysfunctions pay an average of $893 per year for therapy and/or counseling for the remainder of their lives after disability. Rather, this is usually a cost to be continued for the first few years after onset of injury.

Our recent survey is informal and incomplete when compared with other studies. Yet, based on more detailed data, conducted by foundations with sophisticated research procedures, this sub-sample is indicative of the costs of disability.

In August 1979, the National Spinal Cord Injury Research Center at the Good Samaritan Hospital, Phoenix, Arizona, published its analysis of the cost of disability. This study, "Statistical Information Pertaining to Some of the Most Commonly Asked Questions About SCI," shows clearly that disability is not only financially destructive to the injured or sick individual, but is also burdensome to our nation's economy. Quite importantly, the "Statistical Information" study was financed in part by the Rehabilitation Services

Administration of the Department of Health, Education and Welfare in a governmental effort to determine the price society pays for disability.

The study estimates that the average spinal cord injured person is young and lives twenty-five years after the onset of disability. The average pre-disability earnings of such persons was over $10,000 annually. It can safely be assumed that this average amount of productivity, along with federal and state income-related revenue and municipal taxes are lost forever unless the disabled individual becomes gainfully employed again. At least $250,000 in earnings alone is taken from society each time a person becomes disabled and does not return to gainful employment.

As mentioned earlier, the double tax exemption for totally and permanently disabled citizens would have a two-fold effect. It would help offset personal losses experienced by disabled individuals. It was stated that our estimates of additional expenditures associated with paralysis are informal findings. However, these figures correspond with those of the cited study. A double exemption, like that already recognized in cases of blindness or advancing age, would clearly help those who have experienced paralysis or other permanent and total disabilities. PVA has historically focused on the needs of persons with spinal cord related disabilities. Our experience has shown, however, that these needs frequently parallel those people with other severe disabilities.

Congress has addressed the need for returning individuals to productivity and gainful employment. The "Social Security Disability Insurance Amendments of 1980" reflects this desire to reduce reliance on federal income maintenance programs. However, the provisions of Public Law 96-265 do not assist the disabled individual beyond the initial months of re-employment. His employment-related expenses remain considerably greater than those of an able-bodied worker, but there is no assistance for him to meet these costs after his first months off the SSDI rolls. We propose the double personal income tax exemption as a means of providing this assistance.

Mr. Chairman, PVA has two requests. First, we believe fully that the provisions of S. 1694 must become law in order that places of business and employment will become accessible to disabled and elderly citizens. Second, the provisions of Public Law 96-265 must be augmented by a double personal income tax exemption for disabled citizens who return to the work force, if the provisions of this recently enacted law are to be maximally effective.

PVA realizes that a workable definition of "disability" must be derived before such a double personal tax exemption could be implemented. Perhaps reasonable and appropriate guidelines could be taken from the requirements used by the Social Security Disability Insurance program. After all, it is these requirements and definitions at which Public Law 96-265 is aimed. PVA believes that the provisions of this recently-implemented law, and the double income tax exemption could be combined effectively.

Mr. Chairman, this concludes my statement, and on behalf of the members of Paralyzed Veterans of America and all seriously disabled citizens, I sincerely appreciate the opportunity to submit this statement for the record.

STATEMENT
on
TAX REDUCTION
before the
SENATE COMMITTEE ON FINANCE
for the
ASSOCIATED EQUIPMENT DISTRIBUTORS
by
ROBERT R. STATHAM
August 1, 1980

My name is Robert R. Statham. I am a partner in the Washington, D.C., law firm of Statham & Buek. I am appearing here today on behalf of the Associated Equipment Distributors as its tax counsel.

Mr. Chairman, the Associated Equipment Distributors is grateful for this opportunity to present its views on the advisability of enactment this year of a tax cut to be effective beginning January 1, 1981.

The Associated Equipment Distributors is a national trade association comprised of nearly 1,100 distributors and 500 manufacturers of construction, mining and logging equipment and machinery. AED members, the vast majority of which are small, independent businesses, sell, rent and service a wide variety of construction equipment ranging from small pumps to large cranes. We are intimately involved in this nation's largest industry, the construction industry. We feel that this industry, more than any other, is bearing the brunt of current economic conditions, and we suggest that our nation's economic future is in large part dependent on the future of this basic industry.

Summary

We need to cut taxes and to cut them at the earliest possible time. The answer to inflation is to increase productivity. The present tax laws inhibit investment and economic activity. The tax reform efforts of the past few years have not been sufficient to encourage the level of investment which is required to increase productivity and strengthen our economy.

Something has to be done, and Congress should take the initiative. Businessmen are tired of being told that relief from excessively high taxes must wait until government spending can be reduced. We need action and we need it now. As long as the revenues are available, government spending will continue to grow.

High taxes and more government bureaucracy promote waste and higher inflation. Small businessmen are the targets of excessive taxation. The small businessman is the backbone of the American economic system. If he is to maintain that role, there must be a reduction in the burden of taxes on small business. Savings and investment increase productivity and deter inflation and unemployment. Tax penalties for savings and investment in the tax laws should be eliminated so that capital formation is encouraged rather than deterred.

Need for Anti-Inflationary Tax Cut

We are in a recession and business is in a critical way. This year's 20% interest rates and business credit curbs have taken their toll. The recession has had a highly detrimental impact on the average equipment distributor. Tight money, runaway inflation and business recession all spell disaster for the equipment distributor.

We are all aware that much of the country is suffering from economic ills. The current situation is a grave one. Inflation during the first three months of this year exceeded 18%. And while inflation has somewhat crested, it is far in excess of what it should be. Unemployment has reached 7.5% and we are told that there is every reason to believe that it is going even higher in the months ahead.

We must improve our productivity rate if we are to solve our inflation problem. What we have been doing through our taxing system is discouraging rather than encouraging capital formation. The rates are simply too high. The system encourages consumption and discourages savings and investment.

The statistics of recent years indicate that we indeed have a productivity problem of major proportions. From 1960 to 1970, there were seven years when the U.S. had productivity gains of two percent or better. However, during the ten-year period 1970 to 1979 there were only three years when productivity gains exceeded two percent, and there were two years, including last year, when productivity registered a loss.

Solutions to past recessions have been to increase Federal spending. This has resulted in making more consumer dollars available to compete for fewer consumer goods. Increased government spending has meant that greater amounts of taxes are required to meet increased costs. More government spending and more taxes have resulted in greater strains on productivity. And so we continue to fuel the fires of spiralling inflation.

We need to increase productivity if we are to effectively win the fight against the spiral of inflation. Productivity rates in this country have lagged behind those of other industrialized nations of the western world. The average annual percent of change in productivity from 1950 to 1977 was 1.8% in this country compared to 7% in Japan, 4.7% in West Germany, 4.4% in Italy, 4.3% in France, 2.3% in Canada and 2.2% in the United Kingdom. Growth in industrial production has been greater since 1967 in some of these other industrialized countries. In Japan it has been 201.1%, Canada 160.8%, West Germany 155.8%, United Kingdom 126.8% and France 154.7%. In the meantime growth in industrial production in this country has been 144.9%.

Although the United States retains its top role in productivity, it may not be able to maintain that position in the future. Using a scale of 100, with the U.S. at the top, here is where the other major industrialized nations stood in 1977: Canada 91.6, France 84.7, West Germany 79.1, Japan 62.2, United Kingdom 55.1 and Italy 54.3. Based on present trends, France and West Germany are expected to exceed U.S. productivity by the mid-eighties, and Japan and Canada are expected to exceed U.S. productivity shortly thereafter.

An important factor favoring increased productivity rates in these countries is the make-up of their capital cost recovery systems. Australia, Belgium, Canada, France, West Germany, Italy, Sweden and the United Kingdom all allow capital cost recovery within a period of no more than ten years, while the United States has an average capital cost recovery in excess of 15 years.

Need for Depreciation Reform

The report of the White House Conference on Small Business released in April of this year said: "Federal tax policy is the single most important instrument for encouraging or discouraging the flow of capital to small business." The chief preoccupation of the delegates to the White House Conference earlier this year was with problems of small business finding and retaining business capital.

It is the view of the Associated Equipment Distributors that our Federal income tax provisions are insufficient to stimulate the needed rapid recovery of capital investment.

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Business should be freed from the present archaic and complex system of income tax depreciation based on useful lives. In its place, a modern capital cost recovery system should be adopted that groups assets into a few general classes of capital investment to which a rapid capital cost recovery percentage is applied to assets by class. Capital cost recovery should be available on an expenditure basis and computed without regard to salvage value.

S. 1435, the so-called "10-5-3" legislation introduced by Senators Gaylord Nelson (D.-Wis.), Lloyd Bentsen, (D-Tex.), Bob Packwood (R-Oreg.) and John Chaffee (R-R.I.), accomplishes these goals and AED is in support of this measure. However, it is the view of AED that the $100,000 cap on Class III property should be raised to $500,000.

Adoption of such a program would encourage increased productivity, combat equipment obsolescence, improve the climate for capital formation, encourage savings and investment, and combat unemployment. And adoption of a capital cost recovery system along the lines recommended would have a permanent and long-range impact on the economy.

The adoption of the Asset Depreciation System (ADR) in 1971 was a step in the right direction. But the ADR system has over 125 categories of assets and is exceedingly complex. The result is that most small businessmen have opted not to use the system. Less than five percent of small business use the ADR system. We must replace the

ADR system with a system that is simple, underotandable and adaptable to the needs of small business. We must eliminate the paperwork, the complex regulations, and the needless bickering with the Internal Revenue Service over inconsequential matters of depreciation. We must adopt a simplified system that small businessmen will use and that will prompt increased productivity.

Investment Tax Credit

It is the view of the Associated Equipment Distributors that the investment tax credit should be increased to 12% without any limitation based on tax liability, that it should be provided in full for all assets with a useful life of three years or more, be available as soon as the expenditure is made, be computed without distinction between new and used equipment, and that it should be unnecessary to forecast the useful life of the asset.

An increase in the investment tax credit, in addition to the adoption of a capital cost recovery system, would be an additional stimulus to investment and the replacement of outmoded and obsolete machinery and equipment. It would increase productivity and further combat inflation.

History has proven the stimulating impact of the investment tax credit. The credit was repealed in 1969 to slow down an overheated economy. When the credit was restored in 1971, new investment dramatically increased and unemployment decreased. We need a similar stimulus to the economy now.

Prior to the enactment of the Revenue Act of 1978, the amount of the investment tax credit a taxpayer was able to apply against his tax liability in any one year could not exceed the first $25,000 of tax liability, plus 50 percent of the tax liability in excess of $25,000. The Revenue Act of 1978 increased the previous 50 percent tax liability limitation to 90 percent to be phased in at an additional 10 percentage points per year beginning with taxable years which ended in 1979. As a result, the limitation was 60 percent for taxable years ending in 1979, 70 percent for 1980, 80 percent for 1981 and 90 percent for 1982 and subsequent years. It is the view of AED that this limitation should be eliminated entirely.

As far as used equipment is concerned, now is the time to do what should have been done long ago. Eliminate the distinction. Under present law the availability of the investment tax credit for used equipment is limited to $100,000 in each taxable year for a taxpayer. The limitation was increased temporarily to $100,000 in 1975 and made permanent in 1978. The $100,000 limit is inadequate. In real dollars it is obviously worth far less than it was in 1975, when the present limit was set, and the limitation should be eliminated entirely.

Small businessmen must depend on used equipment when they cannot afford to purchase new equipment. At today's costs, $100,000 does not go very far. Stimulating the purchase of used equipment can also stimulate productivity. And the purchase of a used piece of equipment can mean that someone up the line will also be buying a new piece of equipment as a further stimulant to increased productivity.

Additional First-Year Depreciation

Under present law a deduction is available for additional first-year depreciation in an amount not exceeding 20 percent of the cost of eligible property. Eligible property is tangible property with a useful life of six years or more. The cost of property which may be taken into account may not exceed $10,000 ($20,000 for individuals who file a joint return). Therefore, the maximum additional first-year depreciation deduction is $2,000 ($4,000 for individuals filing a joint return). It is the view of the Associated Equipment Distributors that the percentage should be increased to 25% and the dollar limitation should be increased to $20,000 ($40,000 for individuals filing joint returns).

Capital Gains

Present law provides that a noncorporate taxpayer may deduct from gross income 60 percent of the amount of any net capital gain in the taxable year. The remaining 40 percent of the net capital gain is subject to tax at the otherwise applicable rates. Unfortunately, what may appear to be an increase in value of an asset during a period of spiralling inflation may in actuality be a mirage. The "profit" may only be an expression of additional dollars with a decreased value. It is the view of AED that the tax laws should provide an additional sliding scale exclusion above 60 percent for capital gains, based on the length of time an asset is held, of 3% for each year up to 90 percent.

Expensing of Government Mandated Safety Equipment

It is the view of the Associated Equipment Distributors that the tax laws should provide for the immediate expensing of government mandated equipment including, but not limited to, equipment mandated by the Occupational Safety and Health Act (OSHA) and the Environmental Protection Agency (EPA). The purpose of this recommendation is to provide a rapid write-off to businesses forced to invest in government mandated equipment. The Revenue Act of 1978 required the Treasury Department to conduct a study on the appropriateness of providing additional tax incentives in the case of expenditures required by OSHA and the Mining Safety and Health Administration of the Department of Labor.

Subchapter S Corporations

Under present law, a subchapter S corporation cannot have more than 20 percent of its gross receipts from passive income. It is the view of AED that the passive income limitation should be repealed.

The passive income restriction has created a great deal of uncertainty in the law. The result has been a number of inadvertent retroactive terminations of elections. It has also caused a number of businessmen to enter into litigation in an effort to achieve clarification as to what constitutes passive investment income.

The principal reason for the inclusion of the passive income limitation, when it was adopted in 1958, was to reduce the incentive to incorporate a person's investment activities for the primary purpose of obtaining tax deferral benefits accorded to pension, profit-sharing, and other similar qualified plans. This reason was generally eliminated by Congress in 1969 with the imposition of the H.R. 10 type of limitation on contributions made ~~for an emp~~loyee holding more than five percent of the subchapter S corporation's stock.

We suggest that this change could be made in the tax law without cost to government, but with considerable improvement in the tax laws for small business.

Estate Taxes

Ranking fourth among the fifteen top priority recommendations of the White House Conference in its report released in April of this year was the proposal to revise the estate tax laws to ease the tax burden on family-owned businesses. The delegates to the White House Conference were concerned that many small business persons work hard to build businesses for their children, but that the heirs of a small business frequently must sell the business to pay estate taxes. Small businesses that in the past would not have been concerned about estate taxes now find that double-digit inflation has pushed them into extremely high tax brackets.

Our present estate tax laws are a destructive force for small business. The heirs of small businesses are being forced to sell out to large businesses just to pay high estate taxes. Relief is needed if we are to permit small businesses to survive. Family-owned businesses are vital to our economy and to our society. While we are exploring tax reduction it is also a time to reassess the impact of the estate tax on small business and to provide relief.

It is the view of the Associated Equipment Distributors that the estate tax laws should be revised to ease the tax burden on family-owned businesses and to encourage the continuity of family ownership.

Individual and Corporate Tax Rates

Both individual and corporate Federal income tax rates should be reduced. A few decades ago, no one in his wildest imagination would have believed that the United States, in a peacetime economy, would impose the burden of taxes on our citizens that we have today. It is the view of AED that the income tax should not take more than 50 percent of an individual's income, and that corporate rates should be reduced below 40 percent.

With regard to the corporate rate, it is the view of AED that the divisions within the graduated corporate rate should be expanded to $500,000 before the maximum rate is attained. The present corporate rates are:

Taxable Income	Tax Rate
$ 0- 25,000	17%
$25,000- 50,000	20%
$50,000- 75,000	30%
$75,000-100,000	40%
Over $100,000	46%

If there is concern that tax rate reduction is inflationary, then an expansion of the above divisions within the present graduated corporate rate structure to $500,000 should be in order. More graduation in the corporate rate would not put more money in the hands of consumers, but it would put money in the hands of small businesses that need funds to expand, invest in more productive assets, replace obsolescent and outmoded equipment, and provide more employment.

Exclusion for Dividend Reinvestment

It is the view of the Associated Equipment Distributors that the tax laws should provide for an annual exclusion for dividends reinvested to purchase original issue stock of $1,000--$2,000 for those filing a joint return. Present tax law discourages the movement of capital from less productive to more productive corporations. Such a provision would reduce the tax penalty and thereby encourage reinvestment in new and more productive ventures.

Net Operating Loss Carryover

Under present law, net operating losses may be carried back three years and carried forward seven years. This suggests that there is a period of ten years when new businesses may apply their losses for tax purposes. However, for new businesses, the three-year carryback is of no use, since there are no prior years for the business. Extending the carryforward period would assist new businesses with high start-up costs and early break-even years by providing an expanded period during which losses could be applied.

It is the view of the Associated Equipment Distributors that the present net operating loss carryover should be expanded to eight instead of the present seven years.

Accumulated Earnings Credit

The Tax Reduction Act of 1975 increased the accumulated earnings credit from $100,000 to its present level of $150,000. Since then there have been substantial increases in the costs of obtaining and accumulating capital by small business. Increased borrowing costs are forcing small businesses to rely on the internal generation of capital for possible future needs. At the same time the tax laws discourage the accumulation of capital.

The present accumulated earnings credit is inadequate. IRS auditors can question the need for accumulation of funds by business and the ensuing dispute can be exceedingly costly for a small business to defend itself from the imposition of penalty taxes. Small businesses, particularly those that are closely held, are often the target of the accumulated earnings tax. For this reason small businesses are often reluctant to accumulate capital out of earnings for their reasonable needs.

It is the view of the Associated Equipment Distributors that the present accumulated earnings credit should be increased to at least $500,000. Such a provision will encourage savings and investment and will result in increasing business productivity.

Conclusion

Mr. Chairman, I would again like to express the appreciation of the Associated Equipment Distributors for this opportunity to express its views. If there are questions I would be happy to attempt to answer them.

STATEMENT OF

THE CHEMICAL MANUFACTURERS ASSOCIATION

SUBMITTED TO

THE COMMITTEE ON FINANCE

UNITED STATES SENATE

FOR INCLUSION IN THE RECORD

OF THE HEARINGS

ON

VARIOUS TAX CUT PROPOSALS

AUGUST 1, 1980

The Chemical Manufacturers Association (CMA) is a nonprofit trade association having 192 U.S. company members representing more than 90 percent of the production capacity of basic industrial chemicals within this country.

We welcome this opportunity to reaffirm the views of the chemical industry concerning the impact of the Federal tax system on capital formation. We have long believed that the recurring cycles of inflation and recession can only be broken by expanding basic productive capacity. We welcome the concurrence in these views of a growing number of professional economists, both within and without the government.

We do believe that there should be a reduction of corporate tax liability sufficient to provide for the implementation of the provisions of S. 1435, the "Capital Cost Recovery Act." We believe that this reduction should be effective at the earliest possible time, not only because of its impact on current 1980 or 1981 economic problems, but, more importantly, because the present bias against increased capital investment must be removed for the long-range stability of the American economy. Accelerated capital recovery deductions, computed without regard to the depreciation-useful life principle, are an essential part of any restructuring of our tax system.

Effect of an Expanded Industrial Capacity of Inflation

Inflation is generally regarded as the number one threat to our economic stability and well-being. Conventional wisdom calls for combatting inflation by dampening demand. This was the approach followed by the Administration in the Spring of this year through the imposition of credit restraints. Unfortunately, such a policy can have the short-term effect of fostering a recession. This has been the result of the Administration's approach. Such a recession is then fought through tax rate cuts and increased Federal spending, each of which serves to spur demand, perhaps again to inflationary levels.

It is, accordingly, time to reorient our thinking. Remedies must focus less on the demand side of the economy where adjustments seem to produce short term cures at best. Instead, emphasis must be shifted to the supply side. By stimulating investment we can increase productivity and economic growth, which will mean more goods produced more cheaply. It will also mean real, not inflationary, wage increases. Simply put, with greater productivity and growth, a stronger economy can be created in which everybody can benefit. One major benefit is that the lowered cost of goods can be readily translated into increased competitiveness in, and a resultant larger share of, world markets. This, in turn, would mean a diminished trade deficit, which is again counter-inflationary. And, of course, an integral part of the above scenario is increased employment.

Trends in the American Economy

Thirty years ago the American economy was first among industrial nations in Gross National Product, per capita income, and productivity. Today, while we remain preeminent in GNP, our margin has slimmed. In per capita income we have fallen to eighth. And in basic overall productivity (a crucial inverse determinant of inflation), although still first, we have slipped dramatically. This last result stems from our rate of productivity growth decreasing steadily to the point that our average productivity increase over the five-year period 1974-1978 was less than one percent. (Economic Report of the President, 1979, Department of Labor, Bureau of Labor Statistics.)

An often-cited but, regrettably, not yet heeded, Department of Treasury study reveals that from 1960 to 1973 the average annual productivity growth rate of the United States was the lowest of seven major industrial nations, behind even the United Kingdom. In fixed investment as a percentage of GNP over the same period, we also lag behind the United Kingdom:

Real Non-Residential Fixed Investment as a Percent of Real Gross Domestic Product, 1966-1976

Country	% of gross domestic product
Japan	26.4
West Germany	17.4
Canada	17.2
France (1970-1975)	16.7
United Kingdom	14.9
United States	13.5

Source: Economic Report of the President, 1979, Organization for Economic Cooperation and Development

These figures explain the drop in industrial growth and productivity. Without increased investment there can be no modernization and expansion of plant and equipment; absent that, workers simply cannot be more productive.

Capital Spending by the U.S. Chemical Industry

The U.S. chemical industry has been near the lead among the nation's industries in capital spending. This reflects the basic capital intensive nature of the industry. The chemical industry spending of $8.4 billion for 1979 was 10.6 percent of that for all manufacturers. The average annual increase in chemical industry capital expenditures for the ten years 1969-1979 was 10.5 percent. Although 1978 expenditures were up only 4.0 percent over 1977, the 1979 figure indicates a rebound of 18.3 percent over 1978.

The foregoing is shown by the following table:

New Plant and Equipment Expenditures
(billions of dollars)

	1977	1978	1979
Petroleum	$13.87	$15.50	$16.70
Chemicals	6.83	7.10	8.40
Transportation Equipment	5.32	6.40	7.74
Machinery, Non-Electrical	5.76	6.29	7.51

However, the sharp inflation rate in construction costs has significantly decreased real plant and equipment expenditures of the chemical industry, specifically, and the nation, generally. If the above expenditures are adjusted for this factor, they reflect either little real growth or a decline in capital additions:

	1977	1978*	1979*
Petroleum	$13.87	$13.81	$13.33
Chemicals	6.83	6.32	6.70
Transportation Equipment	5.32	5.70	6.18
Machinery, Non-Electrical	5.76	5.60	5.99

* 1978 and 1979 figures have been reduced to 1977 dollars by use of the Department of Commerce Composite Construction Index.

Moreover, it must be remembered that real expenditures on plant and equipment do not necessarily increase productive capacity. For example, the U.S. chemical industry has expended the following amounts for facilities constructed to satisfy pollution control requirements since 1977:

Chemical Industry Spending on New Plant and Equipment for Pollution Abatement (millions of dollars)

	1977	1978	1979*
Air	$ 346	$ 383	$ 406
Water	604	393	416
Solid Waste	50	66	70
TOTAL	$1,000	$ 842	$ 892
All Plant and Equipment	$6,830	$7,100	$8,400
% Spent on Pollution Abatement	14.6%	11.9%	10.6%

* Estimated (Based on 6 percent average annual growth rate as reported in Survey of Current Business, February, 1980)

Source: U.S. Department of Commerce, Bureau of the Census, Current Industrial Reports, 1978

The portion of spending shown above for pollution abatement has an impact beyond reducing investments in productive new plants. For one thing, the installation of such equipment must be preceded by costly research efforts to achieve new technology. Furthermore, the operating costs of pollution abatement equipment, in addition to capital ~~and research~~ costs, inevitably add significantly to the consumer's product cost.

CMA believes that a strong American economy represents the only proper response to these problems. To achieve that strength, we believe emphasis must now be placed on increasing the productive capacity and, as a result, the productivity of industry.

The Need for Depreciation Reform

At present, as in the past, tax policy in many ways discourages capital investment, with a resulting adverse effect on the supply and cost of products. We believe that reform of the existing depreciation laws is one of the most significant steps that can be taken to redress this problem. Such a policy, when combined with continued investment credits at at least the prevailing rate, should directly encourage investment in capital goods. Moreover, the burdensome administrative costs associated with the current useful life/salvage value approach would be eliminated under a simplified capital cost recovery scheme. Lastly, the approach is one which would benefit all sectors of the business community.

As the members of this committee well know, tax depreciation is the system by which the cost of business investments is deducted over time from gross income. The amount which can be deducted in a given year is largely based upon the complex and antiquated useful life concept, which results in deductions stretching out over substantial periods of time. As a result, the cost of capital is raised significantly, particularly for capital intensive industries. Deductions for depreciation spread out over a lengthy period of time mean higher total interest charges or foregone earnings on unrecovered capital. Furthermore, these essentially frozen capital dollars mean less new investment in technology and plant, and the capital which finally is recovered is actually worth less due to the eroding effect of inflation. That is to say, the prevailing depreciation concept not only raises the cost of capital and frees less of it for new investment but, combined with inflation, it also decreases the value of recovered dollars. Thus, fewer new assets are purchased. And this means less growth, less productivity, fewer new jobs -- and more inflation.

In addition, current depreciation law results in countless disputes with the Internal Revenue Service. The Asset Depreciation Range (ADR) has permitted some taxpayers a faster recovery of capital investments than was previously available. However, all business taxpayers, whether utilizing ADR or not, are faced with a maze of regulations and complications concerning depreciation. And, the Internal Revenue Service spends too much time resolving disputes and wrestling with interpretations of depreciation rules. These transaction costs are more than a nuisance. They are expensive, and the American people are forced to bear the cost both through higher taxes and higher-priced goods.

Investment credits and capital recovery allowances strongly affect capital investment decisions; however, international comparisons of these items alone do not adequately show the competitive shortfall of United States policy toward capital investment. Other major factors include the availability of extended or low cost financing, captive domestic markets, special treatment of exports, and favorable tax treatment of personal income from investments. The United States lags seriously behind in all these respects: United States government-backed financing is minimal; export incentives are modest; and personal taxes on investment income are close to confiscatory.

It follows that there is need for United States policy on investment credits and capital recovery to be more than competitive. Our investment credits of 10 percent on equipment (but not buildings) are at the low end of the basic range of 7 percent to 20 percent of project capital offered by other industrial nations with relatively open borders. Furthermore, most other nations offer regular or negotiated extra credits in special situations.

United States depreciation on most industrial equipment is limited to a modified, but unindexed, double declining balance schedule, which places this country at the low end of the scale among industrialized nations. While Japanese and West German schedules appear slightly less favorable, they are actually close in value, if not better, when the lesser rates of inflation in those countries are taken into account. At the other end of the spectrum, the United Kingdom and Canada allow one and two year write-offs, while most other European countries not only offer faster statutory capital recovery than the United States, but in addition, some will negotiate special, more rapid write-offs.

Improved capital recovery allowances are virtually certain to have a positive effect on U.S. exports. The resultant improved capital formation will increase manufacturing capacity and efficiency. Thus, more capacity will be available for exports on a more competitive basis. Although no recent definitive study has been published relating export growth to capital formation, there is historical evidence that they go hand in hand. Those industrial countries showing superior growth in manufacturing exports since 1961, i.e., Austria, France, Japan, and Spain, all had high rates of capital formation. Conversely, the laggards in manufacturing export growth, i.e., the

United States and the United Kingdom, also lagged in capital formation.

CMA recognizes that the notion that capital assets should be depreciated for tax purposes as real economic depreciation occurs is the foundation of the existing system. This is consistent with the view of many tax theorists who assert the so-called "income" theory that depreciation is a device by which to reflect net income accurately. We suggest that when American productivity is lagging as at present, to the serious detriment of the American people, the time for slavish adherence to purist theory has long since passed. Congress has on many prior occasions utilized our tax laws to further certain public policy objectives. We believe that none of those circumstances was any more compelling than that addressed herein.

For all of the foregoing reasons, CMA feels that some form of capital cost recovery system should be the mainspring of the effort to remove the bias against investment from our system of taxation. On the general level it will stimulate investment, supply and exports. It will also afford sorely needed simplification to one of the more mystical areas of our Federal income tax system, thereby benefitting the entire business community and, accordingly, the consuming public.

CMA is cognizant of the concerns of Congress with regard to the Federal tax revenue cost of a capital recovery system such as that under discussion. Those econometric studies thus far done indicate that the impact on Federal tax receipts could be quite large if the program is considered in isolation from its effects on the economy. However, it would be anomalous to consider this proposal on such a static basis when the very reason for such a program is its expected beneficial impact on the economy. When considered on a so-called "feedback" basis, those studies show that the higher GNP induced by the Capital Cost Recovery Act would produce substantial offsetting Federal tax revenues. Moreover, in its 1979 report, the Joint Economic Committee concluded that per dollar of revenue loss, liberalization of depreciation allowances would be the most effective stimulant of investment.

Conclusion

Investment patterns are strongly influenced by the cost of capital. As the cost decreases, capital investment increases. Under a capital recovery approach this increased investment would be recovered quickly, and would likely then be reinvested. The result is increased capital formation with all its tangible benefits, the ultimate one of which is a strong, vital and competitive American economy.

Accelerated and simplified capital cost recovery is the best way to stimulate investment and capital formation so as to decrease our trade deficit, increase productivity, create jobs, and as a result, fight inflation. We urge Congress to pursue this approach.

COUNCIL OF STATE HOUSING AGENCIES

August 1, 1980

The Honorable Russell B. Long
217 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Long:

The Council of State Housing Agencies represents 47 member housing finance agencies (HFAs), as well as over 150 affiliated organizations including developers, investment bankers and others involved in the state housing finance agency movement. The tremendous growth of our movement illustrates the success of this approach to moderate and low income housing. Within a short period of time, virtually all 50 states will have housing finance agencies. Since 1968, HFAs have built over 300,000 units of badly needed multi-family housing.

The Council is concerned with effects that tax cut legislation may have on low and moderate income housing. We would like the committee to be aware of the importance of both single and multi-family low and moderate income housing, the need for legislation which would insure the availability of equity capital for such housing, and the ramifications of mortgage revenue bond legislation currently before Congress. Specifically, we support the low and moderate income housing provisions contained in the Real Estate Construction and Rehabilitation Incentives Act of 1980 (S. 2969) introduced by Senator Harrison Williams.

Low and moderate income multi-family housing is in seriously short supply. Developers find it increasingly burdensome to build low and moderate income housing. The proliferation of local zoning requirements and other governmental regulation has made building low income housing a very difficult and expensive business. The production of rental housing has declined substantially, while condominum conversions further dwindle the available supply. Those apartments which are being constructed tend to be high rent luxury developments. Fueled by the rapidly growing number of elderly Americans on a fixed income, the unavailability of low and moderate income rental housing is becoming a major crisis. Conventionally financed unsubsidized rental housing for low and moderate income families has gone the way of the dinosaur.

1133 15th STREET, NORTHWEST / SUITE 514 / WASHINGTON, D.C. 20005 / PHONE: (202) 659-6560

New developments either have a direct subsidy or have federally financed tandem mortgages or tax exempt financing.

Currently, Section 189 of the Internal Revenue Code permits the immediate deduction of construction interest for low and moderate income housing projects and requires deductions over longer periods for conventional projects. Recapture provisions are also more liberal for low and moderate income projects. With the benefit of these tax advantages, developers are able to raise equity capital and to build quality low income housing, while still maintaining a fair profit. The interest deductibility provision of Section 189 expires on December 1981.

CSHA is not wedded to any certain program which would generate equity capital for rental housing. We would be pleased to work with Congress and HUD in developing program alternatives as called for in the Tax Reform Act of 1976. Given however, the present time frame and the tremendous housing need, we believe it is necessary to proceed now with new legislation and not wait until 1981 when present legislation expires. The low income housing provisions contained in S. 2969 are generally good ones. The housing industry is in trouble, and production of housing requires lead time. The industry needs to know now that these incentives will be continued and S. 2969 will insure this. Should these tax advantages cease to exist, developers would earn little or no profit, hence eliminating the incentive to produce low and moderate income housing. A failure to take prompt action will contribute to a further handicapping of the effort to provide adequate housing for all Americans.

We especially endorse the 15 year depreciation period for low and moderate income housing instead of the 20 year period proposed for other real estate developments. It will encourage rental housing development, and induce investment in low income housing.

In regard to single family housing, the Council of State Housing Agencies opposes H.R. 5741, which has an unreasonable sunset provision, strangles the single family financing program with unreasonable and unnecessary regulations, and unduly limits the program volume. At the same time that the demand for single family housing is constantly rising, the high cost of home ownership mortgage loans combined with the rapidly growing costs of housing production, have made home ownership impossible for millions of Americans. Because of the movement of the baby boom generation into the single family housing market, the decade of the 80's will be one of a growing demand for ownership of housing. These young couples are finding it increasingly difficult to buy modest first time housing. The Council supports the concepts of S. 2064, which provides for the responsible use of mortgage revenue bonds and is a much better alternative than the arcane restrictions of H.R. 5741. S. 2064 would give low and moderate income families the opportunity which they would not otherwise have, of purchasing their own homes. We ask that legislation affecting mortgage revenue bonds undergo careful and indepth examination in the Senate and that the normal legislative processes be followed. Tax legislation dealing with the delicate area of housing production should be adopted in the context of the potential effects on the availability of decent housing for all of our citizens.

In conclusion, CSHA supports legislation which would retain and improve on the necessary tax incentives to provide equity capital for low and moderate income housing. We reinterate our willingness to join in the consideration of any new ideas, but we recommend immediate action on S. 2969 so that we can continue the enormous task of financing the needed housing. Additionally, CSHA reaffirms our support for the full consideration and passage by the Senate of legislation providing for responsible mortgage revenue bond usage and reiterates our opposition to H.R. 5741. We urge the committee not to support legislation which may undercut the providing of housing for low and moderate income families.

Thank you for taking these issues into consideration.

Sincerely Yours,

John Ritchie, Jr.

John Ritchie, Jr.
Chairman
Tax and Securities Committee
Council of State Housing Agencies

JR/mo

BEFORE THE
SENATE COMMITTEE ON FINANCE

TESTIMONY OF

ROBERT W. STALEY
PRESIDENT
NATIONAL COMMITTEE ON SMALL ISSUE
INDUSTRIAL DEVELOPMENT BONDS

August 1, 1980

INTRODUCTION

Mr. Chairman and members of the Committee, my name is Robert W. Staley. I am the President of the National Committee on Small Issue Industrial Development Bonds. I am also Senior Vice President, Finance and Chief Financial Officer, Emerson Electric Co. We appreciate this opportunity to present our views on the advisability of a tax cut. The National Committee on Small Issue Industrial Development Bonds is a non-profit membership organization dedicated to preserving and increasing the effectiveness of small issue industrial development bonds as mechanisms for capital formation and job creation. The Committee presently has 58 members, principally manufacturing corporations, but also state economic development organizations, investment bankers and other supporting individuals and groups. 1/

CONCERN WITH CAPITAL FORMATION

Our National Committee is concerned about the crisis in capital formation in the United States today that has caused a decline in productivity, competitive stagnation, the loss of exports and a rise in unemployment. The United States has an

1/ List of Members of the National Committee on Small Issue Industrial Development Bonds (Attachment A).

immediate need for increased capital formation to modernize plant and equipment, to stimulate research and development, to increase the number of productive jobs, and to reverse the decline in productivity. The 1970s was a period of postponed investment in plants, facilities, research and development; spiraling inflation; and increasing financing costs. From 1975 to 1978 the nominal increase in productivity was achieved by substituting labor for capital. 1/ Last year, there was an actual decline in productivity for U.S. manufacturers. The continuing and critical nature of this problem was recently confirmed by the Department of Labor in reporting on results of the Second Quarter of 1980. The productivity rate fell at a 4.1 percent annual rate, the biggest drop since the Second Quarter of 1974.

A recent comparison of national economic indicators for the U.S.A., Germany and Japan confirms that our competitive position in world trade is continuing to decline. The study shows:

	U.S.	Germany	Japan
Real growth	down 1.5%	up 2.9%	up 4.3%
Industrial output	down 5.6%	up 3.6%	up 6.6%
Inflation	13.5%	6.0%	8.7%
Unemployment	8.8%	3.9%	2.0% 2/

While the U.S. is experiencing a further decline in real growth and industrial output, Germany and Japan are forecasted to experience increases. The conclusion is inescapable:

1/ *Wall Street Journal*, July 1, 1980, p. 1.

2/ *N.Y. Times*, June 22, 1980, Section 3, p. 1. Data provided by Data Resources, Inc.

the U.S. rate of investment has not been sufficient to provide increases in productivity to meet competition from Germany and Japan.

For these reasons we support a tax cut in 1980, effective as soon as possible, that would be targeted to business investment. A delay in the tax cut until 1981 will force businesses to postpone investment decisions, will deepen the recession, increase unemployment, increase federal transfer payments, and decrease federal revenues resulting in a larger federal deficit.

SMALL ISSUE IDBs: INCREASE IN DOLLAR LIMITS

There is a proven and highly effective incentive for capital formation that is presently available to business and investors, that is, the small issue industrial development bond. This capital formation mechanism could be used even more effectively in a plan to re-industrialize America if its limits were increased substantially and constraints on its use modified or removed entirely. On behalf of the National Committee on Small Issue Industrial Development Bonds, I urge this Committee to increase the tax-exempt limits on small issue industrial development bonds.

In a recent study 1/ of small issue industrial development bonds (IDBs), Dr. Norman B. Ture has concluded that

> "IDBs are productive instruments for promoting economic development by making saving and investment more attractive to individuals and businesses. Their use results in overall gains in capital formation, employment, and output, rather than merely changes in the location of economic activity. The magnitudes of these results

1/ Norman B. Ture, Inc., "Economic and Federal Revenue Effects of Changes in the Small Issue Industrial Development Bond Provisions", 1980, pp. 3-4. (Attachment B).

"are quite modest, primarily because the capital expenditure limitation severely restricts the projects eligible for IDB financing. Increasing the capital expenditure limit above the present $10 million would enlarge the inventory of eligible projects and expand total capital outlays, employment, and real GNP. The resulting expansion of tax bases -- individual and corporate income and payroll taxes -- would generate net gains in tax revenues for the Federal government and for the state and local governments of the issuing jurisdictions."

The detailed analysis in the study, of different assumed changes in the tax law, demonstrates that complete removal of the capital expenditure and dollar amount limitations would result in very large increases in investment in plant and equipment and large gains in employment and GNP.

The study also refutes the oft-repeated Department of Treasury assertion that IDB financing results in a loss to the Treasury. The Treasury estimates have been made on the unrealistic assumption that there are no changes in economic activity in response to the change in the tax law. Dr. Ture shows that the changes in economic activity that would actually occur would create revenue gains for the Treasury, not losses, and would in addition create additional revenues for the State and local treasuries.

Based on Dr. Ture's analysis and on the proven worth of IDBs as a capital formation and job-creating mechanism, we believe that a strong case can be made for removing entirely the dollar limitations on small issue IDBs.

We recognize, however, that a majority of the Finance Committee may not be willing to go this far without further evaluation which we do not believe could be completed during this session of Congress.

Therefore, simply to compensate for the erosion caused by inflation, our members seek an increase of the present $1,000,000 exempt limit, which is not subject to the capital expenditures limitation, to $3,000,000, and an increase from $10,000,000 to $15,000,000 of the exemption subject to the capital expenditures limitation. The $1,000,000 limit is often referred to as the "clean" limit, and I will use that term in my further discussion.

EXPLANATION OF A SMALL ISSUE IDB

Small issue industrial development bonds, or "small issue IDBs", are bonds issued by states or municipalities for the purpose of acquiring or building industrial or commercial facilities. The bond issuers lease or sell these facilities to private companies at a price sufficient to amortize and pay debt service on the bonds. Under present section 103(b)(6) of the Internal Revenue Code, interest on these bonds is exempt from federal income tax if the face amount of the total bond issue, of which a particular IDB forms a part, does not exceed $10,000,000, including certain "capital expenditures" made during a six-year period. That is, the $10,000,000 exempt amount includes not only the face amount of the bond issue, but also the amount of any capital expenditures the user of the IDB-financed facility may make with respect to that facility or other facilities in the same vicinity during a six-year period beginning three years before the date of the bond issue and ending three years thereafter. As a result of the capital expenditures limitation and IRS restrictive rulings, IDBs cannot, as a practical matter, be issued in the full amount of the $10,000,000 exempt limit. IDBs issued as part of a bond issue having an aggregate face amount not in excess of the "clean" $1,000,000 limit, qualify for a tax exemption without regard to the capital expenditures limitation.

DATA ON IDB USE BY MEMBERS OF THE NATIONAL COMMITTEE

Historically, members of the National Committee have used the proceeds of numerous issues of tax-exempt small issue industrial development bonds to build new plants, expand existing plants, and acquire additional machines and equipment. Our corporate members have used IDBs in most states of the Union to build new plants or expand existing plants. As an example, Emerson Electric first used the proceeds of an IDB issue to finance a new plant in Tupelo, Mississippi in 1948. Since that time, Emerson has financed 39 more new plants with small issue IDB proceeds, and has used 11 other issues of small issue IDBs to finance plant expansion and new machinery. These financings have taken place in 18 different states. 1/ These 51 plants employ over 14,500 persons. I can assure this Committee that without the availability of IDB financing many of these plants and most of these jobs would not be in existence today.

Another example of the use of IDB financing by a member of our National Committee to modernize plant and equipment is the case of The Marmon Group, headquartered in Chicago, Illinois. From 1968 through 1978 Marmon used IDB financing to construct 27 plants. Since the passage of the Revenue Act of 1978 (which

1/ Table of Emerson Electric Company Industrial Revenue Bonds (Attachment C).

raised the $5,000,000 limit to $10,000,000 for small issue IDBs), Marmon has built, or proposes to begin construction of this year, 17 new plants in 10 different states:

Georgia	Connecticut
North Carolina	Pennsylvania
Tennessee	Alabama
Missouri	Arkansas
Virginia	Utah

Marmon's response to the increase in IDB limits from $5 million to $10 million in the 1978 Act is a dramatic illustration of how investment in new plant and equipment has been stimulated by that one single and simple change in the tax law.

BENEFITS OF SMALL ISSUE IDBs

Small issue IDBs are a valuable tool to encourage investment in new plants and equipment. IDBs are attractive to investors because interest earned on IDBs is tax exempt in the hands of the bondholders who may be households, commercial banks, fire and casualty insurance companies or non-bank financial institutions. The tax-exempt nature of the interest allows the bonds to be sold at a lower interest rate than would otherwise be possible and, therefore, the user reduces his cost of financing new investment. In periods of high inflation, high interest rates or a credit crunch, this enables a business to invest in productive facilities when otherwise the investment would be turned down or postponed because the cost of financing such investment is too high. This is one useful targeted incentive for investment in the manufacturing or industrial sector in the present American tax system, which system generally discourages investment in plant and equipment and encourages investment in real estate and non-productive assets. This distortion in our tax system is shown in a recent economic study which concluded that the structure of 1978 net investment hurdle rates was such that business investment projects expected to earn 15% were not being undertaken while housing and state and local structures expected to earn less than 10% were being constructed. 1/

IMPACT OF INFLATION

Small issue IDBs are being used for fewer new plants and less equipment than would be the optimum for increasing capital formation in the U.S.A., because small issue IDBs have severe dollar limits of $1,000,000 or $10,000,000 subject to a capital expenditure limitation that covers all capital costs over a six-year period. Inflation has ravaged the real buying power of these dollar amounts so that a plant that could have been built for $5,000,000 in 1968 cannot be built for less than $11,607,000 today, which is above the limit that can be financed by small issue IDBs. By early 1985, the plant that could have been built for $5,000,000 in 1968 will cost $20,000,000. 2/ Consequently, many modern plants, with the latest, most efficient equipment, cannot be financed with small issue IDBs and, therefore, only smaller projects are being undertaken.

1/ Hendershott, Mortgage Revenue Bonds: Tax Exemption With a Vengeance, National Bureau of Economic Research, Working Paper No. 44, February 1980, p. 13. This is because of the double taxation of income from corporate capital and the failure to tax imputed rental from owner-occupied housing. Inflation aggravates this distortion because real after-tax debt rates decline and housing is much more heavily debt-financed than is business capital. Id., p.2.

2/ Norman B. Ture, Inc., pp. 3-4.

The small issue IDB is the only tax-exempt bond designed to encourage investment in plant and equipment. It is an anomaly that of all of the tax-exempt bonds permitted by section 103(b) of the Internal Revenue Code for housing, airports, pollution control and other purposes, only the small issue IDB is limited by dollar amounts, dollar amounts enacted in previous decades, which purchase less each month.

SMALL ISSUE IDBs FOR PRODUCTIVITY, RESEARCH AND DEVELOPMENT

U.S. productivity has suffered as a result of the disincentives to invest in plant and equipment. Investment in research and development has also declined in the last decade. Because of these factors, the United States has lost its competitive edge in world trade; and the key to reversing this decline is a policy of healthy capital formation.

In recent Senate hearings on Industrial Innovation, Professor Jorgenson testified that the most important thing we can do to stimulate innovation and productivity growth is to have a healthy rate of capital formation, which we do not have now. He compared U.S. and German productivity and attributed our declining productivity to our policy of capital formation. German productivity has not suffered the severe consequences of rising energy prices that the United States productivity has because Germany has avoided the severe kind of credit crunch that occurred in the United States immediately after the first energy price increase that took place in 1973. The Germans and the Japanese have maintained a much more consistent policy of fostering investment and plant modernization so that capital formation has suffered less. 1/ In addition, German and Japanese interest rates for financing investments in plant and equipment generally are lower than U.S. rates. 2/ A policy of supporting research and development investment in conjunction with small issue IDBs would be an immediate stimulus for long-term progress. It would be complementary to changes in a system of depreciation because these firms do not have major investments in plant and equipment.

Also for the small businessmen, the availability and the cost of capital have become the greatest unaddressed problems. 3/ Small issue IDBs are one way a small businessman has access to lower cost capital. Small businesses are a significant source of innovation in the United States and the major employers. Our data shows that small businesses are among the major users of small issue IDBs.

IMPACT OF IDBs ON URBAN REVITALIZATION

IDB financing has been extremely successful in programs of urban revitalization and a key to the success 4/ of HUD's program of Urban Development Action Grants (UDAG). 5/ The UDAG amendment to the Revenue Act of 1978, which was introduced by

1/ Prof. Dale W. Jorgenson, Industrial Innovation, Hearings before the Committee on Commerce, Science and Transportation, U.S. Senate, 96th Cong. 1st Session, November 14, 1979, part 2, p.73.

2/ September 1978: U.S., 9.7%; Germany, 8.4%; Japan, 8.0%. Weisberg and Rauch, A Comparative Study of Export Incentives In the United States, France, the United Kingdom, Germany and Japan, Chamber of Commerce of the U.S., Washington, D.C. 1979, p.20.

3/ Advisory Committee on Industrial Innovation, Final Report, September 1979, U.S. Dept. of Commerce, p.7.

4/ Robert C. Embry, Jr., Assistant Secretary for Community Planning and Development, HUD, June 30, 1978, Speech, DER BNA, July 9, 1980.

5/ Housing and Community Development Act of 1974; Housing and Community Development Act of 1977, I.R.C. Section 103(b)(6)(I).

Senator Bayh, amended the Internal Revenue Code to provide that projects that are part of a UDAG grant can use up to $10 million in small issue IDBs and can incur an additional $10 million in capital expenditures. This is an additional cushion of $10 million for capital expenditures beyond what is available to other facilities financed with small issue IDBs. In the first two years of the UDAG program through February 1980, 594 projects received preliminary approval, which would create 178,000 new permanent jobs and retain 89,000 existing jobs. In early 1980, HUD officials reported that 80% to 85% of the UDAG recipients were financing at least part of the project with small issue IDBs. 1/ The HUD program of attracting private investment to economically distressed areas and the community involvement in the issuance of IDBs is a good example to duplicate and expand.

Small issue IDBs have also provided assistance to many large metropolitan areas by stemming the migration of unemployed rural and agricultural workers to our large cities. With the decline in agricultural employment, many rural workers would have had no alternative but to seek employment in our large cities but for the location of industrial facilities in their own communities. The availability of industrial development bonds and other incentives has resulted in the location of many facilities in our smaller communities, thus providing directly and indirectly (service and related businesses) employment opportunities in their local community. This has effectively

1/ David Cordish, UDAG Program Director, DER BNA, April 29, 1980, p. G-1.

reduced the unemployment and welfare rates in our major cities, and assisted in urban revitalization by reducing welfare and unemployment costs. At the same time, this geographic dispersion of industry has served to improve our national defense by decreasing the nation's vulnerability to nuclear attack or sabotage.

NET REVENUE EFFECTS

Small issue IDBs will not damage the Congressional effort to reduce the federal deficit because small issue IDBs will increase revenues for federal, state and local government. On the assumption that the present $10,000,000 limit is increased to $15,000,000, Dr. Ture's study shows a direct net increase to the federal tax revenue of $100 million by 1984. 1/ Whatever revenue is lost by the tax-exempt interest in the hands of the bondholder is more than compensated for by the higher taxes paid by the corporations which will have lower interest deductions because of the lower interest rates on tax-exempt debt. There are also increased payroll taxes and increased income tax generated by the workers employed by the plant and the multiplier effect of jobs and services added to the community.

Treasury, in making its estimates of revenue loss, uses the static approach; but even if the static approach is used, these Treasury estimates have been shown to be in error in testimony by Roger C. Kormendi before the Senate Finance Committee 2/ and the analysis by Kormendi and Nagle. 3/ Their studies show

1/ Norman B. Ture, Inc., Table A-1.

2/ Testimony of Roger C. Kormendi before the Senate Finance Committee on the subject of the Interest Rate and Federal Tax Revenue Effects of Tax-Exempt Financing, June 24, 1980.

3/ Kormendi and Nagle: The interest rate and tax revenue effects of tax-exempt revenue bonds, University of Chicago, May 1980.

that the losses estimated by Treasury and the Congressional Budget Office are based on assumptions contrary to fact and on statistical errors. Whereas Treasury claims a direct loss of $30 million in federal tax revenue on each $1 billion of additional tax revenue bonds, including mortgage revenue bonds, pollution control bonds and industrial revenue bonds, Kormendi and Nagle's study shows at most a $15 million revenue loss from all tax-exempt revenue bonds. Treasury's estimates are based on the assumption that the relevant substitute asset for tax-exempt bonds is taxable bonds. In fact, investors with high marginal tax brackets hold little taxable debt and substitute tax-exempt bonds for other assets that are subject to favorable tax treatment such as corporate equities. Because of this, small issue IDBs will not significantly raise the borrowing costs for state and local governments or crowd some borrowing out of the market as Treasury has frequently asserted.

Kormendi and Nagle have re-estimated the Treasury's estimates of the impact of any increase in tax-exempt rates on general obligation rates and discovered that the true effect was approximately one-tenth as large as the effects assumed by the Treasury. Treasury estimated 5 basis points per billion dollars and Kormendi estimates .6 basis points. 1/

The markets for small issue IDBs and for general obligation bonds are different and different investors hold the two types of bonds depending on the investment criteria and objectives of the bondholder. A study by E. F. Hutton concludes that "the primary purchasers of tax-exempt small issue industrial development bonds are the municipal bond funds and property/

1/ Kormendi, Testimony, p. 2.

casualty insurance companies; and, to a <u>much lesser extent</u> retail investors and commercial banks. The primary purchasers of general obligation bonds are the commercial banks and, to a <u>much lesser extent</u> retail investors located in states wherein such bonds enjoy an exemption from a substantial state personal income tax and a very small segment of the property/casualty insurance industry consisting of extremely conservative companies." 1/ In addition, the increased tax base of the community from the IDB financed facility will raise local revenues and decrease the need to borrow funds with additional issues of general obligation bonds. 2/

CONCLUSION

A response to the capital formation crisis, decline in productivity and erosion of our competitive position in world trade, requires prompt and aggressive action. Therefore, we support the enactment of a tax bill in this session of Congress which is targeted to these critical issues.

Small Issue IDBs are a proven vehicle for:

- stimulating capital investments
- creating jobs
- aiding in urban revitalization
- reducing U.S. cost of manufacture, making exports more competitive

1/ A. Weston, E.F. Hutton, "The Marketing of Tax-Exempt Small Issue Industrial Development Bonds in Contradistinction to the Marketing of General Obligation Bonds", July 22, 1980, p. 6.

2/ Norman B. Ture, Inc., p. 8.

Based on sound analysis and economic evaluation, the use of small issue IDBs produces revenue gains, rather than losses as alleged by Treasury, and does not substantially affect the cost of other government financing.

Therefore, we urge this Committee to enact this year a bill which contains increases in the dollar limits for small issue industrial development bonds. At the very least, the $1,000,000 limit should be increased to $3,000,000 and the $10,000,000 limit increased to $15,000,000.

Our proposal to reduce the financing cost of plant and equipment is complementary to and supportive of the "10-5-3-" provisions embodied in S. 1435 which has been endorsed by members of the Finance Committee. An effective reduction in the cost of obtaining the initial funds to construct a facility in combination with a more rapid recovery of the overall investment will certainly stimulate capital investment and job creation, and help stem the drastic decline in productivity in the U.S.

ATTACHMENT A

National Committee on Small Issue
Industrial Development Bonds

July 22, 1980

MEMBERS

American Greetings Corporation
Anheuser-Busch, Inc.
The B. F. Goodrich Co.
Baldor Electric Company
Ball Corporation
The Binswanger Co.
Borg-Warner Corp.
Campbell Taggart, Inc.
Copeland Corp.
Corning Glass Works
The Dyson-Kissner-Moran Corporation
E. F. Hutton & Company Inc.
Emerson Electric Co.
The First Boston Corporation
Franklin Electric Co.
The Frazer Lanier Co.
Goldman, Sachs & Co.
Hart Corporation
Hayes, Inc.
Hoover Universal, Inc.
International Telephone & Telegraph Corporation
Joy Manufacturing Company
The Marmon Group, Inc.
McDonald and Company
Monsanto Company
Norris Industries, Inc.
Plymouth Tube Co.
PORTEC, Inc.
Powell & Satterfield, Inc.
PPG Industries, Inc.
Ralston Purina Company
Redken Laboratories, Inc.
The Robinson-Humphrey Co.
Ryder Truck Rental, Inc.
Schmid Laboratories, Inc.
South Haven Rubber Co.
Southwire Company
Stephens Inc.
Stifel, Nicolaus & Company Incorporated
Stihl Incorporated
T. J. Raney & Sons, Inc.
Vermont American Corp.
Wagner Electric Corp.

SUPPORTING ORGANIZATIONS AND INDIVIDUALS

Alaska Industrial Development Authority
Friday, Herschel H.
Gambrell, Russell and Forbes
Georgia Industrial Developers Association, Inc.
Commonwealth of Kentucky, Development Finance Authority
State of Illinois, Department of Commerce & Community Affairs
State of Indiana, Department of Commerce
State of Maryland, Department of Economic and Community Development
State of Minnesota, Department of Economic Development
North Carolina Industrial Developers Association
Pennsylvania Association of Industrial Development Authorities
Promote Employment (Thomas E. Bundy)
Southern Industrial Development Council (Carter K. Hooks)
Tennessee Industrial Development Council
Commonwealth of Virginia, Division of Industrial Development

ATTACHMENT B

ECONOMIC AND FEDERAL REVENUE EFFECTS OF CHANGES IN THE SMALL ISSUE INDUSTRIAL DEVELOPMENT BOND PROVISIONS

A Report Prepared for the National Committee on Small Issue Industrial Development Bonds

by

Norman B. Ture, Inc.

1980

INTRODUCTION

While small-issue industrial development bonds (hereafter IDBs) have financed relatively small proportions of total business capital outlays each year, they are nonetheless strategically important to the firms on whose behalf they are issued. Limitations legislated in 1968 on the use of these bonds brought about a significant reduction in the number and amount of such issues. These limitations were eased somewhat in 1978, but when one allows for the effects of inflation the present limits are more severe in real terms than the 1968 limits were 12 years ago. Further easing of the limiting provisions in the Internal Revenue Code would contribute to a net expansion of investment, employment, and output. On balance, Federal tax revenues would be somewhat increased.

Present-Law Provisions

The expansionary economic effects of IDBs derives from the fact that the interest received on these bonds, issued by state and local governments, may be exempt from federal taxation under the small issue exemption (Section 103(b)(6) of the Code). To qualify, substantially all of the proceeds from the issue must be used to acquire, construct or improve production facilities. Prior to 1968, all industrial development bonds were tax exempt. Under the 1968 legislation, issues of $1 million or less were allowed the exemption without any strings attached, but the exempt status was limited to not more than $5 million in issues, subject to a capital expenditure rule. This rule specified that capital expenditures to the financing of which any one bond issue contributed were not to exceed $5 million for a 6-year period, 3 years before and 3 years after the issue. The effect of this rule, ostensibly aimed at confining the benefits of IDB financing to small companies, was to exclude from its purview all but quite small capital projects, whether contemplated by small or large companies. With the continuing and accelerating rise in the prices of capital facilities, moreover, the capital expenditure rule became increasingly restrictive.

The Revenue Act of 1978 raised the $5 million small issue exemption election to $10 million, subject to a $10 million capital expenditures limitation. The $1 million "clean" limit was not changed. Thus, issues of $1 million or less still are not subject to the capital expenditures rule. This means that a $1 million small issue industrial development bond could be floated with the proceeds used to finance part of a, say, $20 million facility, and the interest on the issue still would be exempt from federal taxation.

Effects of Inflation

The liberalization of the limits afforded by the Revenue Act of 1978 was inadequate to account for the increase in the level of prices of capital facilities. Based on the recent mix of structures and equipment financed by small issue IDBs, the 1978 increase in the capital expenditure limit to $10 million permitted financing of projects which were the equivalent of only $4,723,823 in 1968 dollars.[1/] The 1978 legislation, in other words, not only failed to increase the limit in real terms above the 1968 level but actually reduced it below its worth in 1968. By the end of 1979, the continuing sharp increases in prices of capital facilities had further depressed the maximum project size to $4,307,560 in 1968 dollars.

Moreover, if the recent rate of gain in capital facility prices (i.e., the annual rate of increase from the last quarter of 1978 through the fourth quarter of 1979[2/]) were to continue

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1/ The $10 million limit was deflated by the implicit deflators for nonresidential structures and for producers' durable equipment, using 1968 = 100, and weighting the indices by .667 and .333, respectively, the proportional allocation of IDB financing between the two classes of facilities in recent years. See U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, September 1979, and January 1979 Economic Report of the President, Table B-3.

2/ The annual rate of increase from 1978 through 1979 was 10.3 percent for non-residential structures and 7.3 percent for producers' durable equipment.

for another five years, the $10 million limit would allow the purchase in 1984 of only $2,760,154 in facilities measured in 1968 dollars. The "clean" limit of $1 million will, in effect, be only $276,015 in 1968 dollars. Indeed, if the present $10 million limit were raised to $20 million, by early 1985 it would be the equivalent of only $5 million in dollars of 1968 purchasing power. Merely allowing for the prospective increase in the price level, therefore, indicates that a substantial increase is called for in the present statutory limits if the real value of the IDBs is not to be greatly eroded.

Proposed Amendments of Present-Law Provisions

Several proposals to ease the existing statutory limits to adjust for actual and prospective inflation have been formulated by the National Committee on Small Issue Industrial Development Bonds. The principal proposal is to raise the "clean" limit to $4 million and to extend the $10 million option to $20 million subject to a $20 million capital expenditure limitation.[3/]

One of the major issues posed by any such proposal is whether it would contribute to net increases in total investment, employment, and output or merely change the location of investment and employment without affecting the respective aggregates. To address this issue, the economic effects of the proposal have been simulated using the Analysis of Tax

3/ Several other proposals are described and analyzed in Appendix A.

Impacts Model (ATIM). The ATIM is an econometric model used to measure and analyze the effects of changes in the tax laws on major economic aggregates, such as employment, investment, output. The model estimates the trend values of economic magnitudes under present law and their value under changes in the tax law. The results shown are differences between these two sets of values, expressed in constant 1979 dollars.

A number of assumptions have to be made about variables which may be determined outside the model. For example, annual rates of inflation of 8.5 percent in 1980-81, 8 percent in 1982-84, and 7 percent thereafter are assumed. These rates are assumed to remain the same after the tax change takes effect. Similarly, the amount of Federal government expenditures each year in the projection period are assumed to be the same under the tax changes as if the tax laws were unchanged.

Economic Effects of the Proposed Tax Change

The use of IDBs reduces the cost of capital to firms on whose behalf the IDBs are issued by reducing an important element in their financing costs. Individual bondholders -- the ultimate suppliers of the capital obtained through this financing -- are exempt from Federal taxes on the interest on the bonds, thereby increasing the after-tax rate of return on their investment. The response is both an increase in the proportion of their saving channeled into these investments and an increase in total saving. For companies, the tax exemption also serves to reduce the coupon rate on the obligations, requiring the firms to pay less in providing the revenues to the issuing authorities for the service of the bonds. The response is an increase in the optimum amount of capital firms want to use, leading to an increase in the business demand for capital facilities. The resulting increase in capital inputs raises the capital:labor ratio, which increases the productivity of labor compared to levels under present law. Increases in productivity are associated with rises in real wage rates, which induce increases in the amount of labor services supplied. These increases in the supply of and demand for the services of labor result in an increase in the employment level. This higher level of employment brings about an increase in total labor compensation. And the increases in labor and capital inputs in production results in expansion of total output compared to the levels that would otherwise be realized. The higher levels of real output, hence total real income, in turn generate higher levels of both consumption and saving and capital formation.

Sometimes cited as a significant deficiency of IDBs is their allegedly adverse effect on the overall financing costs of the governments involved. The view that IDBs increase the interest rates which the issuing governments must pay on all of their obligations rests on the assumption that investors do not distinguish among these quite different classes of debt instruments. On this assumption, the increase in the aggregate amount of the government unit's obligations, resulting from its issuance of IDBs, must depress the prices and raise the yields on all of the obligations it issues in any given period of time.

Quite apart from the question as to the market's differentiating between IDBs and the general obligations of a government, there are two sets of considerations which argue forcefully against IDBs' increasing overall financing costs. For one thing, as already noted, IDBs are an extremely small fraction of aggregate state and local government obligations. In 1978, for example, small issue IDBs accounted for .36 percent of all state and local government debt issues. To be sure, the ratio of IDBs to total debt issued that year varied among jurisdictions issuing these instruments, but with scarcely more than a third of one percent of all new debt issues of states and localities represented by small issue IDBs, it is extremely improbable that these instruments played an important role in determining the marketability of any state or locality's general obligations.

In any event, the view that IDB issues adversely affect the issuing government's overall financing costs ignores the economic consequences of these issues described above, and the

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resulting expansion of the jurisdiction's tax bases and tax revenues. The additional facilities financed by IDBs add, for the most part, directly to the jurisdiction's property tax base. The additional employment, output, wages, and returns to capital similarly must generate additional revenue flows to the local government and to the state government as well. These incremental revenues must be perceived as reducing the affected government's need to issue additional general obligations, thereby offsetting, in varying degree, any effect the IDB issue might be deemed to have in raising the jurisdiction's financing costs.

The magnitude of all these effects obviously depends on the extent to which IDBs are used. As suggested above, IDB financing accounts for a very small portion of total investment (see Appendix B) under present law. In large part, the extremely limited use of IDB financing is attributable to the capital expenditure rule. The effect of this limit, restricting IDB financing to relatively small projects, is to exclude a large number of capital projects for which technological considerations dictate a substantially larger scale than the present limit. For very small companies, whose capital projects probably fall to a much larger extent under the limit, the information and transaction costs entailed in securing IDB financing may very well outweigh the explicit financial gains therefrom in their decision making. The capital expenditure rule under present law is counter-productive to the legislative purpose of IDBs. Tax proposals which would continue this type of limitation would do little to extend the use of IDBs, hence would produce modest aggregate economic effects, unless the limit were to be very substantially raised.

Raising the "clean" limit from $1 million to $4 million and extending the $10 million option to $20 million with a $20 million capital expenditure limitation would have modestly expansionary economic effects, summarized in Table 1. As of 1989, there would be about 28,000 more full-time equivalent employees at work than projected under present-law trends. Gross private domestic investment would increase by modest amounts each year during the first five years as the economy adjusted to the new, slightly higher desired stock of capital in response to the modest reduction in the ccst of capital effected by the tax change. This adjustment would entail increases in outlays for nonresidential structures and for producers' durable equipment and slight reductions in investment in residential structures. The change in total outlays therefore would be the net gain. Beyond 1984, the incremental investment represents the small additional amounts associated with a new, slightly higher trend path of economic expansion. Thus, in 1989 gross private domestic investment is about $2.2 billion greater (in constant 1979 dollars) than it would be under present law.

The returns to the additional capital plus the modestly greater employment income sum up to an increase in real GNP of about $4.5 billion over projected present-law levels in 1989. In that year, consumption would be about $2.3 billion greater than under present law, in contrast with the period 1982-1984 during which there would be modest decreases below present-law levels as individuals shifted the allocation of their income toward saving and investment.

Federal tax revenues would be very little affected by this change in the tax law. There are two ways of measuring changes in the Federal tax revenues in response to a change in the law. Initial impact estimates measure returns under the unrealistic assumption that there are no changes in economic activity in response to the tax change. On this assumption, the volume of private investment is unaffected by the amount of IDBs issued, implying that each additional dollar of IDB-financed investment displaces a dollar of taxable bond -- or equity -- financed capital outlay. On this basis there would be a slight revenue loss -- less than $50 million -- in 1989. If the amount of IDBs were deemed to be associated with additional investment -- that is with investment which otherwise would not be undertaken -- the initial impact revenue effect would be zero, since no displacement of other financing, by hypothesis, would have occurred. The alternative net-of-feedback measure takes into account changes in economic activity in response to the tax change and the effects of these changes in the economy on tax bases. In this instance, additional IDB financing results in net additions to the volume of capital formation, rather than displacement of taxable-bond-financed investment. As shown, this additional investment leads to gains in output and income. Taking account of these feedback effects, there is a $700 million revenue gain in 1989.

There are several factors that cause these net-of-feedback gains. For one thing, the corporate tax base would be expanded slightly as a result of the increase in the stock of capital and the returns thereto. Somewhat larger revenue gains would be obtained from increases in individual and payroll taxes caused by increases in employment over present law. Thus, net-of-feedback revenues would be positive.

Conclusions

IDBs are productive instruments for promoting economic development by making saving and investment more attractive to individuals and businesses. Their use results in overall gains in capital formation, employment, and output, rather than merely changes in the location of economic activity. The magnitudes of these results are quite modest, primarily because the capital expenditure limitation severely restricts the projects eligible for IDB financing. Increasing the capital expenditure limit above the present $10 million would enlarge the inventory of eligible projects and expand total capital outlays, employment, and real GNP. The resulting expansion of tax bases -- individual and corporate income and payroll taxes -- would generate net gains in tax revenues for the Federal government and for the state and local governments of the issuing jurisdictions.

Table I.

Extend the "Clean" $1 . Million Limit to $4 Million

and Extend the $10 Million Option and Capital

Expenditure Limitation to $20 Million

Increase or Decrease (-) in:	1980	1982	1984	1989
	(Dollar Amounts in	Billions of 1979 Dollars)		
Employment (thousands of full-time equivalent employees)	9	14	24	28
Annual Wage Rate	7	12	19	23
Gross National Product (billions)				
Total	1.2	2.0	3.4	4.5
Business sector	0.9	1.5	2.7	3.6
Gross Private Domestic Investment (billions)				
Total	0.3	2.3	4.3	2.2
Nonresidential	0.6	3.0	4.9	2.3
Consumption (billions)	0.9	(0.3)	(0.9)	2.3
Federal Tax Revenues (billions)				
Net of feedback	0.2	0.3	0.4	0.7
Initial impact	*	*	*	*

Note: The figures are the differences between the estimated amount of the respective economic magnitudes under the tax change and under present law in each year.

Amounts shown in parentheses are decreases from present law in that year, not from the preceding year under the tax change.

Estimates of employment effects are rounded to the nearest 1, 000; estimates of annual wage effects are rounded to the nearest $1; estimates of effects on GNP, capital outlays, consumption, and Federal revenues are rounded to the nearest $ .1 billion.

*Less than 50 million dollars.

APPENDIX A

Simulations of Proposed Revisions of Statutory Limits on Use of IDBs

In addition to the proposal to raise the "clean" limit to $4 million and the $10 million option and capital expenditure limit to $20 million, several other proposals formulated by the National Committee on Small Issue Industrial Development Bonds to ease existing statutory limits were analyzed by the use of the ATIM. These proposals are:

- Extend the $10 million option under present law to (a) $15 million, subject to a $15 million capital expenditures limitation; (b) $15 million subject to a $20 million capital expenditures limit; and (c) $20 million, subject to a $30 million limit;
- Introduce an exemption from the present capital expenditure rule for the first $10 million of capital expenditures per bond issue; and
- Extend the "clean" $1 million limit under present law to $15 million, eliminating the present $10 million option and capital expenditures rule.

The results of the ATIM simulations of these proposed revisions are presented in Tables A-1 through A-VI.

A-1. Extend the $10 million option to $15 million, subject to a $15 million capital expenditure rule.

The economic results of this revision, shown in Table A-1, would be very modest. There would be small gains in gross private domestic investment over amounts projected under present law, reflecting adjustment to the lower cost of capital during the first five years and, thereafter, the slightly higher amounts of replacement investment associated with the modestly greater level of the growth path of the stock of capital.

The gains in employment associated with this limited expansion of capital formation would be quite modest. By 1989, there would be about 6,000 more full time equivalent employees at work than projected under present law.

The gain in GNP would similarly be of small scale. In 1989, GNP in constant 1979 dollars would be about $900 million more than the level projected with existing tax provisions.

Little difference in tax revenues would result from this revision in the law. The initial impact effect, measured by ignoring changes in economic activity resulting from the tax changes, would be a loss of less than $50 million in 1989. The full effect on Federal tax revenues, taking the economic response to the tax change into account, would be a gain of about $100 million in 1989.

A-II. Extend the $10 million option to $15 million and raise the capital expenditure limitation to $20 million.

Raising the capital expenditure limitation to $20 million instead of to $15 million would slightly increase the expansionary effects of IDBs. Thus, the employment gain after 10 years would be about 11,000 instead of 6,000 as under the first proposal. The gain in real GNP would be about twice as great as would be that of gross private domestic investment. Federal tax revenues, allowing for feedback effects, would also be twice the amount under the first proposal. Nonetheless, all of these expansionary effects would be of modest magnitude (Table A-II).

A-III. Extend the $10 million option to $20 million and raise the capital expenditure limitation to $30 million.

With the significantly higher capital expenditure limit under this proposal, the expansionary economic effects would be considerably greater than in the prior cases. After 10 years, employment would be about 26,000 more than projected under present law. Real GNP would be about $4.1 billion more, about half of the gain going into additional investment and the other half into greater consumption. With the larger tax bases, the net-of-feedback effect on Federal tax revenues would be a $500 million gain (Table A-III).

A-IV. Retain the $10 million option and exempt the first $10 million of capital expenditures from the capital expenditure limitation.

The economic effects of introducing an exemption for the first $10 million of capital expenditures are essentially the same as those of the second proposal, only slightly smaller in magnitude. In effect, this proposal would raise the capital expenditure limit to $20 million without increasing the $10 million option. It would, therefore, permit the use of up to $10 million of IDB financing for projects up to $20 million in scale. The slightly smaller gains in employment, real wages, and investment translate into gains in real GNP which are a little less than those of the second proposal. In 1989, real GNP is estimated to be about $1.3 billion greater than projected under present law. While initial impact Federal revenue losses are less than $50 million in 1989, net-of-feedback revenues are $200 million greater than present law, stemming from the higher level of total output (Table A-IV).

A-V. Extend the "clean" $1 million limit to $15 million and eliminate the $10 million option and capital expenditure limitation (low and high estimates).

The economic effects of extending the $1 million "clean" limit to $15 million and eliminating $10 million option and capital expenditure rule are much more dramatic than those of the preceding proposals. The major reason for this is that the proceeds from such bond issues could be used to finance portions of much larger projects. As a consequence, a considerable volume of capital projects which (a) are ineligible for IDB financing under present law because of their size, (b) cannot be scaled down economically because of technological constraints, and (c) without IDB financing are expected to produce net returns which are somewhat less than those required to warrant their undertaking would become attractive and eligible under this proposal. Eliminating the capital expenditure limit and extending the dollar amount of the IDB issue, therefore, would expand the inventory of each firm's capital projects for which IDB financing would be feasible. In addition, not only would corporations realize substantial savings on investment projects greater than $15 million, but individual bondholders would also desire an increase in their holdings of such bonds.

With a $14 million increase in the "clean" limit, it is projected that the volume of IDB-financed projects would increase from 5 to 15 times the amount under present law. These responses are, admittedly, arbitrary limits, since there are no relevant data on the basis of which to estimate more precisely the magnitude of the response.

For purposes of the low estimates in Table A-V, it was assumed that this proposal would result in IDB financing of 12 percent of capital outlays for industrial structures and 2 percent of outlays for corporate equipment, compared with about 2.4 percent and 0.4 percent, respectively, under present law. These gains would represent net increases in capital outlays, leading to increases in employment, real wages, and GNP, which in turn would contribute to further increases in capital formation. When the adjustment was substantially completed in 1984, there would be a net increase of about 28,000 in the number of persons employed on a full-time equivalent basis, compared with employment levels projected under present law. Additional employment gains would be registered thereafter, reaching about 32,000 in 1989, with real GNP (in 1979 dollars) about $5.2 billion greater than otherwise. This increase in GNP would afford a net increase in Federal tax revenues of about $700 million, compared with an initial impact revenue loss of about $100 million.

Table A-VI presents the "high" estimate of the economic effects of the proposal. This simulation assumes that IDB financing would increase to about 36 percent of outlays for industrial structures and about 6.3 percent of capital spending for corporate equipment.

The results on the "high" assumption are substantially greater than under the other proposals and the "low" assumption for this proposal. Full-time equivalent employment would be 116,000 greater in 1989 than under present law. In constant 1979 dollars, total private investment would be almost $9.2 billion more, and consumption spending would be $9.4 billion greater. Real GNP would be $18.6 billion more than projected under present law. At these higher levels of activity, the flow of tax revenues to the Federal government would be about $2.3 billion more than otherwise.

Table A-I.

Extend the $10 Million Option to $15 Million, Subject to a $15 Million Capital Expenditure Limitation

(Billions of 1979 Dollars)

Increase or Decrease (-) in:	1980	1982	1984	1989
	(Dollar Amounts in Constant 1979 Dollars)			
Employment (thousands of full-time equivalent employees)	1	2	5	6
Annual Wage Rate	$**	2	3	4
Gross National Product (billions)				
Total	$.01	0.3	0.6	0.9
Business sector	$*	0.2	0.5	0.7
Gross Private Domestic Investment (billions)				
Total	$0.2	0.5	0.8	0.4
Nonresidential	$0.2	0.7	1.1	0.4
Consumption (billions)	$(0.1)	(0.2)	(0.2)	0.5
Federal Tax Revenues (billions)				
Net of feedback	$ *	*	0.1	0.1
Initial impact	$(*)	(*)	(*)	(*)

Notes: The figures are the differences between the estimated amount of the respective economic magnitudes under the tax change and under present law in each year.

Amounts shown in parentheses are decreases from present law in that year, not from the preceding year under the tax change.

Estimates of employment effects are rounded to the nearest 1,000; estimates of annual wage effects are rounded to the nearest $1; estimates of effects on GNP, capital outlays, consumption, and Federal revenues are rounded to the nearest $ .1 billion.

** less than $0.50

* less than $50 million

Table A-II.

Extend the $10 Million Option to $15 Million and Extend the Capital Expenditure Limitation to $20 Million

(Billions of 1979 Dollars)

Increase or Decrease (-) in:	1980	1982	1984	1989
	(Dollar Amounts in Constant 1979 Dollars)			
Employment (thousands of full-time equivalent employees)	2	5	9	11
Annual Wage Rate	$2	4	7	9
Gross National Product (billions)				
Total	$0.4	0.8	1.3	1.8
Business sector	$0.3	0.5	1.1	1.4
Gross Private Domestic Investment (billions)				
Total	$0.4	0.8	1.6	0.9
Nonresidential	$0.5	1.2	2.0	0.9
Consumption (billions)	$ *	*	(0.3)	0.9
Federal Tax Revenues (billions)				
Net of feedback	$0.1	*	0.1	0.2
Initial impact	$(*)	(*)	(*)	(*)

Note: The figures are the differences between the estimated amount of the respective economic magnitudes under the tax change and under present law in each year.

Amounts shown in parentheses are decreases from present law in that year, not from the preceding year under the tax change.

Estimates of employment effects are rounded to the nearest 10,000; estimates of annual wage effects are rounded to the nearest $10; estimates of effects on GNP, capital outlays, consumption, and Federal revenues are rounded to the nearest $1 billion.

* Less than $50 million

Table A-III.

Extend the $10 Million Option to $20 Million and Extend the Capital Expenditure Limitation to $30 Million

(Billions of 1979 Dollars)

Increase or Decrease (-) in:	1980	1982	1984	1989
	(Dollar Amounts in Constant 1979 Dollars)			
Employment (thousands of full-time equivalent employees)	8	13	22	26
Annual Wage Rate	$6	10	17	20
Gross National Product (billions)				
Total	$1.1	1.8	3.1	4.1
Business sector	$0.8	1.4	2.5	3.3
Gross Private Domestic Investment (billions)				
Total	$0.7	2.0	4.5	2.0
Nonresidential	$0.9	2.7	4.6	2.1
Consumption (billions)	$0.4	(0.2)	(1.5)	2.1
Federal Tax Revenues (billions)				
Net of feedback	$0.2	0.2	0.3	0.5
Initial impact	$(*)	(*)	(*)	(*)

Note: The figures are the differences between the estimated amount of the respective economic magnitudes under the tax change and under present law in each year.

Amounts shown in parentheses are decreases from present law in that year, not from the preceding year under the tax change.

Estimates of employment effects are rounded to the nearest 1,000; estimates of annual wage effects are rounded to the nearest $1; estimates of effects on GNP, capital outlays, consumption, and Federal revenues are rounded to the nearest $ .1 billion.

* Less than $50 million

Table A-IV.

Retain the $10 Million Option and Exempt the First $10 Million of Capital Expenditure· From the Capital Expenditure Limitation

(Billions of 1979 Dollars)

Increase or Decrease (-) in:	1980	1982	1984	1989
	(Dollar Amounts in Constant 1979 Dollars)			
Employment (thousands of full-time equivalent employees)	1	3	7	8
Annual Wage Rate	$1	3	5	6
Gross National Product (billions)				
Total	$0.2	0.5	0.9	1.3
Business sector	$0.1	0.4	0.8	1.0
Gross Private Domestic Investment (billions)				
Total	$0.2	0.8	1.0	0.7
Nonresidential	$0.2	1.2	1.4	0.7
Consumption (billions)	$*	(0.3)	(0.1)	0.6
Federal Tax Revenues (billions)				
Net of feedback	$0.1	0.1	0.1	0.2
Initial impact	$(*)	(*)	(*)	(*)

Note: The figures are the differences between the estimated amount of the respective economic magnitudes under the tax change and under present law in each year.

Amounts shown in parentheses are decreases from present law in that year, not from the preceding year under the tax change.

Estimates of employment effects are rounded to the nearest 1,000; estimates of annual wage effects are rounded to the nearest $1; estimates of effects on GNP, capital outlays, consumption, and Federal revenues are rounded to the nearest $ .1 billion.

* less than $50 million

Table A-V.

Extend the "Clean" $1 Million Limit to $15 Million, and Eliminate the $10 Million Option and Capital Expenditure Limitation

(Low Estimate)

Increase or Decrease (-) in:	1980	1982	1984	1989
	(Dollar Amounts in Constant 1979 Dollars)			
Employment (thousands of full-time equivalent employees)	10	17	28	32
Annual Wage Rate	$8	13	21	26
Gross National Product (billions)				
Total	$1.4	2.3	3.9	5.2
Business sector	$1.1	1.8	3.1	4.1
Gross Private Domestic Investment (billions)				
Total	$0.4	2.5	5.1	2.6
Nonresidential	$0.7	3.2	5.6	2.6
Consumption (billions)	$1.0	(0.2)	(1.2)	2.6
Federal Tax Revenues (billions)				
Net of feedback	$0.2	0.2	0.4	0.7
Initial impact	$(*)	(*)	(*)	(0.1)

Notes: The figures are the differences between the estimated amount of the respective economic magnitudes under the tax change and under present law in each year.

Amounts shown in parentheses are decreases from present law in that year, not from the preceding year under the tax change.

Estimates of employment effects are rounded to the nearest 1,000; estimates of annual wage effects are rounded to the nearest $1; estimates of effects on GNP, capital outlays, consumption, and Federal revenues are rounded to the nearest $ .1 billion.

* less than $50 million

Table A-VI.

Extend the "Clean" $1 Million Limit to $15 Million, and Eliminate the $10 Million Option and Capital Expenditure Limitation

(High Estimate)

Increase or Decrease (-) in:	1980	1982	1984	1989
	(Dollar Amounts in Constant 1979 Dollars)			
Employment (thousands of full-time equivalent employees)	43	66	95	116
Annual Wage Rate	$34	52	75	93
Gross National Product (billions)				
Total	$5.7	9.1	13.7	18.6
Business sector	$4.5	7.1	10.8	14.6
Gross Private Domestic Investment (billions)				
Total	$2.5	9.6	15.3	9.2
Nonresidential	$3.8	11.4	16.8	9.4
Consumption (billions)	$3.2	(0.5)	(1.6)	9.4
Federal Tax Revenues (billions)				
Net of feedback	$1.0	0.9	1.2	2.3
Initial impact	$(*)	(.1)	(0.1)	(0.2)

Notes: The figures are the differences between the estimated amount of the respective economic magnitudes under the tax change and under present law in each year.

Amounts shown in parentheses are decreases from present law in that year, not from the preceding year under the tax change.

Estimates of employment effects are rounded to the nearest 1,000; estimates of annual wage effects are rounded to the nearest $1; estimates of effects on GNP, capital outlays, consumption, and Federal revenues are rounded to the nearest $.1 billion.

* less than $50 million

Appendix B

Estimating Effects of a Rise in Capital Expenditure Limits

Raising the capital expenditure limit increases the proportion of investment in equipment and structures financed by IDBs. Using Goldman-Sachs data, approximately 2.4 percent of all industrial structures and 0.4 percent of all corporate equipment were found to be financed by small industrial development bond issues under present law. Using the same data, a substantial increase in IDB activity was observed since the 1978 change in the law (from a $5 million to a $10 million option subject to the capital expenditure rule). According to our estimates, over half of the small issue IDBs issued in the first 9 months of 1979 were over $5 million, i.e., greater than the old capital expenditure ceiling. Projecting this growth forward, extending the $10 million ceiling to $15 million would result in a 66 percent increase in the volume of IDBs. This would increase the proportion of such investment in industrial structures to 4 percent and the portion of corporate equipment financed by IDBs to two-thirds of one percent. Extending the ceiling to $20 million would result in a 99 percent increase in IDB financing, again projecting forward from the Goldman-Sachs data. This would indicate that approximately 4.8 percent and 0.8 percent of industrial structures and corporate equipment, respectively, would be financed by IDBs. The effects of the other proposals on the volume of IDBs is estimated by the same method.

ATTACHMENT C

EMERSON ELECTRIC CO.

INDUSTRIAL DEVELOPMENT BONDS

City	State	Date Issued	Dollar Amount
Tupelo	Mississippi	10/48	$1,125,000
Russellville	Kentucky	8/60	2,450,000
Philadelphia	Mississippi	12/62	2,150,000
Prescott	Arizona	6/64	1,000,000
Bennetsville	S. Carolina	6/64	1,800,000
Paris	Tennessee	6/65	3,150,000
Rogers	Arkansas	10/65	1,050,000
Mena	Arkansas	2/66	2,500,000
Centralia	Missouri	7/67	1,000,000
Harrison	Arkansas	4/68	3,300,000
Batesville	Arkansas	4/68	600,000
Paragould	Arkansas	4/68	4,000,000
Paragould	Arkansas	10/68	3,500,000
Rogers	Arkansas	10/68	1,450,000
Russellville	Kentucky	8/70	1,000,000
Eaton	Ohio	12/70	3,000,000
Statesboro	Georgia	4/71	2,400,000
Durant	Oklahoma	7/71	4,570,000
Centralia	Missouri	5/72	1,000,000
Florence	Kentucky	3/73	1,500,000
Dayton	Ohio	5/73	285,000
Eden Prairie	Minnesota	5/73	1,500,000
London	Kentucky	6/73	700,000
Lakeville	Minnesota	6/73	725,000
Aiken	S. Carolina	11/73	2,000,000
Harrison	Arkansas	4/74	3,300,000
Caddo Parish	Louisiana	5/74	1,000,000
Wytheville	Virginia	7/74	1,500,000
Ava	Missouri	9/74	2,100,000
Wood County	W. Virginia	10/74	750,000
Russellville	Kentucky	2/75	375,000
Prescott	Arizona	5/75	1,000,000
Independence	Kansas	7/75	1,000,000
Maysville	Kentucky	9/75	1,000,000
Hillsboro	Ohio	12/75	1,000,000
Nashville	Arkansas	3/76	4,000,000
Morehead	Kentucky	4/76	4,300,000
Vernon	Alabama	4/76	4,300,000
Gainesville	Georgia	6/76	1,500,000
Ogden	Utah	7/76	4,000,000
Orange	Virginia	9/76	2,000,000
Florence	Kentucky	12/76	550,000
London	Kentucky	6/77	1,000,000
Murphy	N. Carolina	3/79	4,000,000
Louisville	Kentucky	3/79	1,000,000
Heber Springs	Arkansas	6/79	6,300,000
Chatsworth	Georgia	6/79	7,000,000
Nashville	Arkansas	12/79	5,700,000
Proposed: Eagan	Minnesota	5/80	2,130,000
Burnsville	Minnesota	8/80	8,000,000
Mumette	Arkansas	1/81	3,250,000

INGAA

August 1, 1980

The Honorable Russell Long
Chairman
Committee on Finance
United States Senate
Dirksen Senate Office Building
Room 2227
Washington, D.C. 20510

Dear Senator Long:

The Interstate Natural Gas Association of America (INGAA) would like to submit its views regarding Tax Cut Proposals for the consideration of the Committee on Finance.

INGAA is a nonprofit national trade association whose membership consists of virtually all of the major interstate natural gas transmission companies in the United States. INGAA's members account for approximately 90 percent of the natural gas that is transported and sold in interstate commerce. All of our members are subject to regulation by the Federal Energy Regulatory Commission (FERC) under the Natural Gas Act (15USC717, et sēq.) and the Natural Gas Policy Act of 1978 (15USC3301, et seq.).

Two major problems in this country today are high inflation and low capital formation. INGAA believes a tax cut, if properly constructed, could contribute to an increase in productivity which will--"get this country going again" as phrased by the late John F. Kennedy during a similar period in our history. Just as Congress acted when the country was in a depressed condition at that time, we feel that Congress should act in the present situation with a program designed to provide industry with the capital necessary to modernize plants and equipment so productivity can be increased.

To illustrate this point, our own industry will need billions of dollars of new investment to build pipelines to bring to market the natural gas from the far reaches of Alaska and the Arctic; as well as the off shore areas of the Atlantic and the Gulf of Mexico; to build coal gasification plants to replace and supplement conventional sources of natural gas; to provide facilities and ships for the conversion and transportation of liquefied natural gas (LNG); and at the same time continue the costly exploration programs to find and develop domestic gas reserves--all of which is to serve the residential and industrial markets for natural gas.

While we support the specific tax reductions set out below, it is essential that Congress not create the kind of incentive that rekindles the double digit inflation, unmanageable interest rates and capital shortages of 1978 and 1979. In our view, an across-the-board tax cut will not be as effective in the long run as a tax cut designed to encourage capital formation.

CAPITAL RECOVERY

There are several bills in Congress which provide a more rapid recovery of capital costs than presently allowed. Without indorsing one bill over another, the natural gas pipeline industry, owing to the nature of its business, would prefer to have the present ADR system liberalized. We also believe the present rules regarding normalization should be retained. These rules have been in effect for a considerable period of time and are well understood by the IRS, regulatory bodies and the taxpayers.

INVESTMENT TAX CREDIT

Adequate energy is critical to this nation's well being. In order to encourage an industry to undertake new projects for alternate energy sources, Congress should give consideration to legislation which would allow higher investment credits relating specifically to such supplemental energy sources as coal gasification and synthetic fuel projects.

PRE-OPERATING EXPENSE DEDUCTION

Energy projects are becoming more complicated, more expensive, and require longer lead times from the planning stage to the operations stage than we have experienced in the past. INGAA supports legislation which would allow current deductions for feasibility and environmental studies and other pre-operating expenditures in connection with new energy projects, rather than requiring such expenditures to be capitalized and written off with the physical assets of the enterprise. We submit that inadequate attention has been given to this problem in which our industry is involved. Such a deduction would make new projects substantially more attractive, particularly if the economics would otherwise be unfavorable or borderline.

INVESTMENT INCENTIVES FOR INDIVIDUAL TAXPAYERS

INGAA recognizes that the Finance Committee does not contemplate drafting a broad and sweeping tax act during 1980. If, however, investment incentives for individual taxpayers are to be considered, one or more of the three outlined below should be included.

1. Capital Gains - We urge the Committee to reduce the tax rate on capital gains to 20 percent, which at a later date could be

further reduced and eventually eliminated. The purpose would be to encourage investment and make taxable securities more attractive.

2. Double Taxation - In order to make taxable securities an attractive investment option to increase capital formation, INGAA recommends that the Committee increase the present $200 exclusion on both dividends and interest to a more meaningful number, perhaps $1,000 for the year 1981, as a part of the eventual elimination of taxation of dividends and a reduction in the taxation of interest.

3. Dividend Reinvestment - INGAA believes that the most beneficial method of interesting investors in buying and holding securities in American business is to reduce and eventually eliminate capital gain taxes and taxes on dividends. For the present, however, we feel legislation which would allow investors to reinvest their dividends in U.S. corporations, without the imposition of a tax thereon, and on the eventual sale of the securities to pay tax only at capital gain rates should also be considered. It should be noted that we do not favor legislation which would restrict this treatment to originally issue stock such as the Pickle Bill provides (H.R. 654).

We wish to thank the Committee for permitting us to submit our views on Tax Cut Legislation which we believe is critical to this country.

Respectfully submitted,

Arthur G. Gillum

Arthur G. Gillum
Director, Finance and Accounting

NAFCU
National Association of
Federal Credit Unions
P.O. Box 3769
Washington, D.C. 20007
703/522-4770

July 30, 1980

The Honorable Russell B. Long
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Chairman Long:

On behalf of the members of the National Association of Federal Credit Unions -- the only national trade association exclusively representing the interests of our nation's federally chartered credit unions -- I urge you and your Committee to act expeditiously and deliberately in formulating a constructive tax cut proposal for implementation during calendar year 1981.

Specifically, the National Association of Federal Credit Unions believes that any tax cut plan approved by the Committee on Finance must contain the following three essential features in order to best serve the interests of America's small savers and consumers:

--an expansion and permanent approval of the tax incentive for savers contained in Section 404 of Public Law 96-223;

--an increase in the contribution limit and a broadening of the eligibility criteria currently in effect regarding Individual Retirement Accounts (IRAs); and,

--a firm rejection of the Administration's proposal which would require credit unions and other financial institutions to withhold the tax due on interest and dividends paid to savers.

Mr. Chairman, the National Association of Federal Credit Unions had requested an opportunity to appear before the Committee on Finance to explain in detail why the tax policy recommendations set forth above would benefit the American public. I understand that due to the large number of individuals who wish to testify before the Committee on tax cut proposals and the short time available for hearings our request has been denied.

Accordingly, I am enclosing with this letter the written statement NAFCU's President, John J. Hutchinson would have delivered before the Committee if time had allowed him to appear before you personally. I respectfully request that this written statement be included in the hearing record of the Committee, and further request that it be given the same consideration it would have received had it been delivered orally.

Thank you, Mr. Chairman for the opportunity to contribute to the efforts of the Committee on Finance. If you have any questions regarding the enclosed witness statement or any other matter affecting Federal credit unions do not hesitate to contact me or Bill Donovan, our director of government affairs.

Sincerely,

Richard M. M. McConnell
Executive Vice President

Statement of John J. Hutchinson

Mr. Chairman and Members of the Committee, I am John J. Hutchinson, president of the National Association of Federal Credit Unions and manager of Hamilton Standard Federal Credit Union in Windsor Locks, Connecticut. The National Association of Federal Credit Unions (NAFCU) is the only national trade association exclusively representing the interests of our nation's federally chartered credit unions. There are 12,773 Federal credit unions throughout the country whose 25.4 million members hold more than 30.7 billion dollars in savings.

I appreciate the opportunity to appear before you today as you consider the advisability of enactment this year of a tax cut to be effective beginning January 1, 1981. The tax policy decisions made by this Committee at the culmination of these hearings will have a substantial impact not only upon our nation's credit unions, but upon every American consumer. With me today is Dick McConnell, the executive vice president of our association.

INTRODUCTION

Mr. Chairman and Members of the Committee, the spectrum of issues before you today reflect concerns very much present in the minds of all Americans, particularly those of us who are responsible for the management and direction of our nation's consumer oriented financial institutions. We have a fiduciary responsibility to our member owners which we do not take lightly. The Federal Credit Union Act states clearly that a Federal credit union is "a cooperative association organized ...for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes...". (12 U.S.C. 1752(1)). Unfortunately, due to economic conditions far beyond their control, an ever-growing number of Federal credit unions are finding it more and more difficult to fulfill these statutory obligations. The recommendations I will now present to the Committee, if acted upon favorably, would greatly assist member-owned credit unions in meeting these obligations and in realizing the goals envisioned by the Congress when it originally approved the Federal Credit Union Act nearly one-half century ago.

In determining the form and composition of a viable tax cut plan, I would urge this Committee to: expand and make permanent the tax incentive for savers authorized by Public Law 96-223; relax the eligibility requirements and contribution limits for Individual Retirement Accounts (IRAs); and reject the Administration's proposal to require Federal credit unions and other financial institutions to withhold the tax due on interest and dividends. It is the position of the National Association of Federal Credit Unions, as well as my own personal conviction, that such actions by the Congress would be non-inflationary, help reduce interest rates, and encourage capital investment and housing construction.

TAX INCENTIVES FOR SAVERS

Over the past number of years the National Association of Federal Credit Unions, with the welcome support of many members of the Congress and this Committee, has recommended that the Internal Revenue Code be amended in order to reward rather than penalize consumer savings. The tax incentive provision contained in Section 404 of the "Crude Oil Windfall Profit Tax Act of 1980" -- which permits the exclusion from taxable income of the first $200 ($400 in the case of a joint return) of interest or dividends earned on savings or investments in domestic corporations during calendar years 1981 and 1982 -- is an encouraging first step. Nevertheless, it is obvious to the more than 5,860,000 individual credit union members represented by NAFCU that the Congress must go much further in providing truly meaningful savings incentives.

As every member of this Committee realizes, many other nations have enacted various tax incentive plans to generate additional personal savings. Such efforts have proven to be highly successful in generating capital formation and encouraging personal savings.

In Britain, where the savings rate is 12.3%, National Savings Certificates are tax-free up to the equivalent of $2,237.50. British Savings Bonds, Save As You Earn accounts, and National Savings Bank accounts are totally tax free.

In Germany, where the savings rate is 13.4%, deposits at savings and loan associations are deductible based on family size, veterans' status, and other factors.

In Japan, where the savings rate is 8.6%, any person receiving either interest or dividend income may choose to have this income taxed at a flat rate of 35%, while it otherwise could be taxed at a rate as high as 75%.

Meanwhile, here in the United States, where a temporary tax incentive plan has been approved but is not yet functioning, our savings rate is a deplorable 3.2%. Today, as consumer savings are subjected to constant erosion due to continuing inflation, the need and demand for further relief in this area is imperative. Each month the Congress delays acting on this crucial matter, the concern of the American consumer intensifies. One year ago 75% of NAFCU members recommended to our Board that we work with the Congress to seek exemption from taxation of the first $1000 of share dividends paid to credit union members each year. Today, 79.4% of our members are urging us to seek exemption from taxation of all dividends paid to credit union members each year.

Mr. Chairman and Members of the Committee, the majority of American people, as well as your colleagues in the Congress, recognize the severity of the problem created by the deterioration in the net value of savings held by consumers -- for the most part small savers -- in their accounts at our nation's traditional savings institutions. I therefore urge this Committee to include in any tax cut legislation provisions which would expand the partial tax incentive for savers already provided by Public Law 96-223, and to make that measure permanent.

INDIVIDUAL RETIREMENT ACCOUNT (IRA) AMENDMENTS

Mr. Chairman and Members of the Committee, numerous proposals have been put forward by Members of this Committee and others to amend the provisions of the Internal Revenue Code pertaining to Individual Retirement Accounts (IRAs). We strongly encourage these efforts to make the establishment and maintenance of IRA accounts more attractive both to individual savers and the financial institutions which service these consumers on a day-to-day basis. We urge that amendments to the Code pertaining to the treatment of IRA accounts be addressed in conjunction with, rather than at the expense of, expanded tax incentives for savers such as those discussed earlier.

The Individual Retirement Account (IRA) program, established by the Employee Retirement Income Security Act of 1974 (ERISA), encourages eligible individuals to create their own retirement plans through a constuctive system of tax incentives. Contributions to such plans are excludable, within limits, for Federal income tax purposes, and no Federal tax is paid on those funds or their earnings until they are withdrawn -- normally after age 59 1/2. Benefits previously available only to individuals covered by an employer's pension plan or the self-employed were made available through the introduction of IRA accounts to most working Americans. IRA accounts are attractive to credit unions and other financial institutions since they provide the institution with a highly stable pool of long-term funds which may then be extended to borrowers in the form of consumer or mortgage loans.

Recent figures indicate that while over 55 million people are eligible to open an Individual Retirement Account (IRA), less than 6% of those eligible had established such accounts. While the Congress and the regulatory agencies have done much to facilitate the establishment of IRA accounts since their inception in 1974, further refinements of the statutes and regulations impacting on these accounts are in order.

Specifically, the National Association of Federal Credit Unions endorses prompt affirmative action by the Congress to implement changes to expand IRA eligibility to include homemakers; to permit persons now participating in pension plans to establish an IRA in addition thereto; and, to expand the maximum tax deductible limit from the present $1,500 to at least $2,000.

If these proposals are positively acted upon by this Committee and passed into law, a greater number of citizens would become eligible to establish Individual Retirement Accounts. Obviously, this would benefit the individual credit union member, and also promote a fundamental public policy of providing added retirement security for our older citizens.

Objections to further expanding IRA coverage have been voiced in some quarters, generally couched in the argument that this would result in an excessive revenue loss to the government. As members of this panel realize, participation in an IRA plan is not a tax avoidance plan, but primarily an incentive to save. Once an individual starts making withdrawals from his or her IRA account, Federal taxes are paid on the amount withdrawn. The benefit to the taxpayer is that, in many cases, tax payment will be made in a lower tax bracket than previously was the case. In addition, this same individual is far less likely to draw upon the resources of other taxpayers or the general Treasury through utilization of various social service programs, since he or she will have a reliable source of self-generated retirement income to meet day-to-day needs.

Additionally, greater participation in IRA programs which one could anticipate from adoption of many of the suggestions made earlier would translate into an increased individual savings rate for each credit union member, and a corresponding increase in the total deposits. These funds could then be extended by the credit union to other members in the form of loans, thus assisting the credit union in fulfilling its statutory mandate to serve as "a cooperative association organized...for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes...". (12 U.S.C. 1752 (1)). Such an expansion of savings would contribute substantially to the capital formation needs of our nation.

WITHHOLDING TAX DUE ON INTEREST AND DIVIDENDS

The National Association of Federal Credit Unions believes that the Administration's proposal that would require the "withholding [of] taxes at a rate of 15% on payments of interest and dividends" would have a devastating impact upon our nation's financial institutions. If Congress were to approve such a plan, which now appears unlikely, any benefit to be derived from a tax incentives for savings plan would be stripped away and replaced by a plan which promises to discourage savings.

The National Association of Federal Credit Unions believes that enactment of this proposal would have an immediate adverse impact on the nation's already weakened economy. It would incease operational costs and reporting requirements for the nation's financial institutions. And, more importantly, it would further frustrate an already over-taxed public by reducing their return on savings and effectively increasing their tax rate.

As member owned co-operatives, credit unions must oppose any proposition that would take savings out of the accounts of our consumer-members prematurely or unnecessarily. Consequently, this misguided proposal of the Administration concerns all of us who are responsible for the management and direction of consumer-owned Federal credit unions.

Mr. Chairman and Members of the Committee, while our objections to the proposal are numerous, I would like to focus on three major areas of concern: the operational burdens the proposal places on the nation's Federal credit unions; the real dollar loss that the proposal imposes on millions of savers; and the prospect of shifting policing of Federal tax law from the taxpayer and Internal Revenue Service to our nation's financial institutions.

For example, the proposed withholding plan would mean substantial alterations in credit union operations. Those credit unions utilizing computers will face the initial cost of reprograming. Thousands of small credit unions, which hand-post their accounts, would incur even greater expense over time since additional staff positions and staff overtime will be needed to comply with the requirement.

These increased costs would be further aggravated by the necessity of singling out those member accounts which are exempt from the withholding requirements. Each exception will require additional staff time and attention, thereby further escalating credit union operational costs.

Who will pay for these increased costs? The saver. Since credit unions are member owned cooperatives, any expense incurred by the credit union in complying with the proposed withholding plan would result in reduced earnings. This would mean a reduction in dividends to credit union savers. In effect, the costs of compliance with the plan will become a "hidden tax" on every credit union member.

This "hidden tax" would then be coupled with an actual reduction in total dividends earned by credit union members. Consumers are now rewarded for keeping dividends earned in their account. Dividends that remain in a credit union member's account earn additional dividends, in effect helping to build savings. By withholding taxes on dividends earned, this proposal would deprive the consumer of additional savings revenue. The benefits of compounding dividends would be diminished and psychologically consumers would feel that money which is rightfully theirs is being taken from them.

Further, we believe that Congressional approval of the withholding plan would demonstrate a callous disregard for the well-being of substantial segments of the population who, due to age, disability or other reasons, are living on fixed incomes. These people are often dependent upon the interest and dividends their life savings presently earn.

Consider the case of a retired person, who is living on a fixed income and has a small share account at his or her credit union. Presume that based on the amount and source of annual income, this individual may reasonably expect to

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be free from tax liability, as he or she has been for many years. If the Administration's withholding proposal were to be enacted into law, and this person failed to file an exemption certificate, he or she would be required to re-initiate filing of an annual 1040 form to recoup funds which were unnecessarily withheld.

We must also point our that there will be consumers who remain unaware of the need to file a return in order to recover from the government money which is rightfully theirs. In these cases, the general Treasury would enjoy unjustified growth through the escheat process. We must also raise the question of who will inform citizens that they have the right to file an exemption form? Is this another burden which is to be placed on the financial institution?

Mr. Chairman and Members of the Committee, credit unions have and will continue to comply with all applicable tax laws and regulations. However, we ardently oppose shifting the burden of policing and complying with Federal tax laws from the taxpayer and the Internal Revenue Service to our country's credit unions. If taxpayers fail to pay taxes on their interest and dividends it is the responsibility of the government -- not the nation's financial institutions -- to take steps to enforce the tax code.

The information reporting program currently in place clearly provides the government with adequate data to enforce the provisions of the Internal Revenue Code in regard to the payment of taxes on dividends earned at our nation's credit unions. The fact that the Internal Revenue Service is reluctant to "close the entire gap of unreported income by means of...audit procedures...which would almost inevitably be regarded as harassment of little people..." is insufficent justification to require Federal credit unions to in effect serve as agents of the IRS. We encourage the government to find ways to upgrade the existing system and correct inaccuracies now in place without shifting its responsibilities to the nation's financial institutions.

CONCLUSION

In summary, Mr. Chairman and Members of the Committee, the National Association of Federal Credit Unions urges you to incorporate into your tax cut recommendations provisions which will:

*expand and make permanent the tax incentive for savers authorized by Public Law 96-223;

*relax the eligibility requirements and contribution limits for Individual Retirement Accounts; and,

*soundly reject the Administration's proposal to require Federal credit unions and other financial institutions to withhold the tax due on interest and dividends.

I thank the Committee for the opportunity to appear before you today, and will be pleased to respond to any questions you might have at this time.

Statement
Submitted to U.S. Senate Finance Committee
on behalf of The Equitable Life Assurance Society of the U.S., New York
by
Francis H. Schott
Senior Vice President and Chief Economist
July 31, 1980

Putting aside the question of the proper extent and the correct timing of structural tax reform, there is excellent reason to favor improved tax treatment of individual savings. The proposal to permit the working public to place specified amounts of retirement savings into a tax-deferred account has merit as a savings and investment stimulus.

The United States has become a "high consumption" country--a characterization that correctly implies that private savings and investment have declined as a percentage of income and output. Savings as a percentage of national income averaged 6% in the 1960's. The ratio rose to over 7% in the first half of the 1970's but averaged only 5½% in the last half of the 1970's. Gross fixed investment as a percentage of GNP is down to recent figures of 10%-11% from the 12%-13% range of the 1960's and the early 1970's. These figures are near the bottom among industrialized countries.

Savings and investment are indispensable aspects of capital formation. In turn, capital is a key factor in productivity developments. Augmented capital per employee tends to produce productivity gains, which are the only lasting source of additional real income and wealth. Recent U.S. productivity trends are alarming. We have experienced declining productivity, rather than make any gains,in several periods of the late 1970's. The negative chain that runs from low savings to low investment and poor productivity is a serious impediment to the nation's effort to provide worthwhile work to a growing labor force in a highly competitive international economic environment.

It is clear that the U.S. also ranks low in the official treatment of savings. Tax cuts in the past have been heavily "consumption oriented," and the consumer has become the swing factor in the cyclically volatile inflationary environment of the past 15 years. "Buy-now-pay-later" psychology has contributed to inflation and future inflation expectations and has lowered savings rates. Measures to reform the tax system in the direction of encouraging savings are directly useful in breaking the negative chain that runs from low savings to low investment to poor productivity and high inflation rates.

The proposed measure is also justified in terms of individual vs. corporate savings incentives. Personal savings as a percentage of total private sector savings have declined sharply in recent years--the ratio averaged over 30% in the early 1970's but less than 25% in the second half of the past decade. This occurred despite the fact that the few existing individual savings incentives, such as IRA Accounts and H.R. 10 Plans, have proved popular. One must assume that the strict eligibility requirements of such plans have impeded the effectiveness of an otherwise useful and desirable savings incentive.

In sum, the restoration of vitality and growth of the U.S. economy can be aided by--indeed requires--a growth in private savings. Creating savings incentives is a valid goal of structural tax reform.

WARBURG PARIBAS BECKER
INCORPORATED

A. G. BECKER INCORPORATED

July 31, 1980

United States Senate
Committee on Finance
Duke Senate Office Building
Washington, D.C. 20510

Mr. Chairman and Members of the Committee:

We submit this statement for inclusion in the printed record relating to the hearings beginning Wednesday July 23, 1980 on various tax cut proposals. This statement specifically addresses the concept of deferring current federal income tax on dividends reinvested in original issue stock of any company having a qualified dividend reinvestment plan (DRP-OI) as embodied in S. 1543.

As investment bankers, we assist corporations in raising funds for capital investment. We at Warburg Paribas Becker have had extensive exposure to the efforts which industry in general, and the utility industry in particular, have mounted to raise needed capital. Our firm participates in the underwriting and distributing of the equity and debt securities of the utility industry, and, accordingly, we are interested in both the needs of the industry and the condition of the capital markets.

Our affiliate, A.G. Becker Incorporated, currently issues commercial paper for 82 utilities, including electric, gas and telephone companies, representing approximately 45% of all utility companies active in the commercial paper market. We, therefore, carefully follow the progress of the industry and are concerned with the financial standing of our clients.

Based on our experience, we are concerned that you appreciate the needs of the utility industry for additional equity capital and the incentive which the proposed tax deferral would provide for increasing the supply of equity capital for that industry. Because of current inflation and high interest rates, American business in general is encountering increasing difficulties in obtaining the necessary capital to fund its operations. Utilities - telephone companies in particular -are among the most capital-intensive industries in the country, and for them, the acquiring of additional equity capital is of utmost importance in meeting the very large capital requirements necessary to provide essential services to the public.

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Obviously, the reinvestment of dividends in a utility (or in any business) adds to the equity capital. In turn, this additional equity permits a utility to issue additional debt, thereby enabling it to invest in additional productive capacity. We believe that the deferral of taxes on dividends reinvested in original issue stock through a qualified dividend reinvestment plan could provide an incentive for additional savings and additional equity investment. The proposed tax deferral contained in S. 1543 would support Dividend Reinvestment Plans as an important and supplemental source of equity for capital intensive industries such as the utility industry and could assist the industry in financing new investments in productive assets.

Accordingly, we urge your favorable consideration of the proposed tax deferral plan to encourage productive investment through carefully focused tax reduction.

Respectfully submitted.

Robert L. Henkle

Robert L. Henkle
Managing Director

Statement of
N V. Reichert
Vice President-Finance, Trailer Train Company
Before The
Committee on Finance
United States Senate
August 1, 1980

Mr. Chairman and members of the Committee, I appreciate the opportunity to present this statement in support of a refundable investment tax credit.

Trailer Train was organized in 1955. All of its capital stock is presently owned by twenty-nine operating railroads, trustees of the estates of two former operating railroads, and one freight forwarding company. Trailer Train is engaged in the business of leasing a fleet of standardized railroad flatcars to railroads in the United States. Through its wholly-owned subsidiary, Railbox Company, Trailer Train also provides a pool of standardized general service boxcars to the railroad industry. In July of this year, Trailer Train undertook to provide a pool of general service gondola cars to the industry through another subsidiary, Railgon Company. Maintenance facilities for these cars are maintained and operated through wholly-owned subsidiaries and authorized private repair facilities.

The flatcar pool represents the largest private car line fleet in the United States. It consists of three basic classes: (1) those designed to transport highway trailers and cargo containers (referred to as "intermodal" cars), (2) those designed to accept special railroad-owned superstructures for the transport of automobiles, trucks and other vehicles (referred to as "autorack" cars), and (3) those equipped to transport lumber, farm machinery and other goods and products (referred to as "special use" cars).

The concept of a nationwide fleet of flatcars originated when railroads sought to combine the cost advantages of long haul rail transportation with the flexibility of trucking. The plan required a large number of cars that could be readily interchanged among railroads and which were capable of transporting highway trailers in high mileage service under widely varying operating conditions. Implementation of the plan required standardized design, heavy duty construction and volume purchase. Trailer Train was organized to acquire, finance and maintain a fleet of such cars. Railbox was subsequently formed to alleviate the recurring problem of availability of general service boxcars. To date, Trailer Train and its subsidiaries manage freight cars, the original acquisition costs of which is approximately $2.9 billion. This investment consists of approximately 116,000 freight cars. Trailer Train and its subsidiaries have to date generated $132 million of investment tax credit of which $26 million has been utilized and $24 million has expired. The remainder represents our present investment tax credit carryforward. Trailer Train has entered into leverage leases on approximately 33,000 freight cars under which the investment tax credit was retained by the owner/lessor.

Trailer Train plays a significant role in the transportation industry of the United States. Its fleet comprises a majority of intermodal and autorack cars in service in the United States. As the cars are interchangable, the fleets accrue car hire charges on virtually every railroad in the United States. Trailer Train is subject to competition from other car companies as well as from railroad owned fleets.

The acquisition of new freight cars by Trailer Train is eligible for the 10% investment tax credit. However, under existing law Trailer Train and its subsidiaries are unable to fully utilize the investment tax credit earned because of limitations based on federal income tax liability. Under existing law the investment credits earned may be utilized against only 70% of income tax liability for tax years ending in 1980, 80% of income tax liability for tax years ending in 1981, and 90% of income tax liability for tax years ending after 1981. As a result of these limitations, Trailer Train has substantial amounts of investment tax credit which it has earned but which it will not be able to currently utilize. Current law permits a carryback of unutilized credits for three years and a carryforward of such unutilized credits for seven years. Deferred utilization of the credit, however, means that the credit has substantially less value to a company such as Trailer Train than it would to a competitor able to utilize the credit on a current basis. Moreover, my most recent forecast indicates that a portion of the unutilized credit will expire.

The current law limitations based on federal income tax liability are patently unfair and discriminatory. The effect of these limitations allows one company to pay 10% less for the same piece of equipment than its competitor which is unable to utilize the credit.

While basic fairness and equity should play a significant role in the proper structuring of the investment tax credit, there are equally important economic reasons for making the investment tax credit refundable.

First, among the several major tax legislative proposals now pending before the Congress and the Administration to stimulate capital formation, proposed legislation to make the investment tax credit refundable is the only measure that can provide any stimulative economic incentive to that large sector of American business enterprise which does not realize the cash benefits of the investment tax credit subsidy because of insufficient liability for federal income tax. Pending proposals to allow liberalized depreciation deductions, to provide investment tax credit at higher rates, to broaden the categories of property eligible for the investment tax credit, or to reduce corporate or business tax rates are very desirable for the businesses whose activities they would stimulate. Such proposals, however, would provide no stimulative economic benefit to that large and vital sector of American business enterprise that does not have the level of federal income tax or taxable income needed to derive the benefit intended from such stimulative measures. By contrast, making the investment tax credit refundable would provide immediate economic stimulation to that sector of American business enterprise. This forgotten sector of American business is large and vital. It includes: new and small businesses which often operate at a loss during their startup years but which are serving an important economic function of pioneering in the development of new techniques and concepts; a major portion of the nation's transportation industry, including railroads, airlines, inter-city buslines, interstate trucking lines and water shipping companies; basic industries that manufacture and supply equipment used in our transportation system, including manufacturers of railroad rolling stock, aircraft equipment and shipbuilders; farmers and fishermen; basic heavy goods manufacturers such as steel and copper companies; and building construction industry companies.

Considerations of sound economic policy, as well as equality and fairness, dictate that this sector not continue to be overlooked in the shaping of a tax stimulative program. Numerous tax stimulative measures have been enacted during the last ten years, including depreciation liberalization, tax rate reductions, and increases in the rate of investment tax credit. Each time this disadvantaged business sector has been neglected. The time for elimination of the discriminatory and anti-competitive aspects of the investment tax credit is now. It is important that this nation's economic policy not continue to neglect this important but disadvantaged sector of the economy (which sector has, unfortunately, grown recently). This can be accomplished by the enactment of a refundable feature to the investment tax credit as a component of the business stimulative tax package.

Second, the refundable investment tax credit proposal is the only pending capital formation proposal that will promote competition. Current law effectively allows a company which can fully utilize the credit to purchase its equipment for 10% less than the price which must be paid by its competitor that is unable to utilize the investment tax credit. In other words, a competitor that is unable to utilize its investment credit is forced, by government policy, to pay a price that is 11-1/9% higher for its machinery and equipment. The result of this government policy can contribute to business failures and to take overs by stronger companies. This problem can be also remedied by making the investment credit fully and immediately refundable.

Third, a refundable investment tax credit would be anti-recessionary in that it would provide an investment incentive to businesses most adversely affected by a recession. This benefit to be derived from a refundable credit is particularly important and relevant to the economic conditions prevailing at the present time. A company experiencing a temporary, recession-generated shrinkage of tax liability is likely to defer making capital expenditures in productive machinery and equipment until such time as it can fully utilize the investment tax credit. Thus, this feature of existing law may deepen a recession instead of shortening it. This unintended aspect of existing law would be eliminated by making the investment tax credit refundable. A refundable investment credit would operate during a recession in the manner in which the credit was intended; that is, to stimulate investment by providing the subsidy to all businesses investing in depreciable machinery and equipment. A refundable investment tax credit would aim the incentive at the very business enterprises that may be most adversely affected by a recession.

Fourth, each dollar of tax revenue spent in making the investment tax credit refundable would yield many multiples in added capital investment and in new tax revenues. The immediate tax revenue losses are comparatively modest. The feedback effect that would be generated from making the investment tax credit refundable is not theoretical. The immense feedback that would be generated from a refundable investment tax credit is documented by the business community's response to the original enactment of the credit, its subsequent suspension and restoration, and various changes that have been made to the credit since its inception.

Fifth, as previously stated, more liberal depreciation allowances for American business are, of course, certainly desirable in stimulating capital formation. However, equipment intensive industries such as transportation, automotive and steel find that these increased allowances result in a reduced utilization of investment tax credit because the credit is limited to a percent of a reduced tax payment.

As a result of this paradox, equipment intensive companies that are in a tax loss or a marginal tax position are increasingly forced to pass investment tax credits through to a third party owner/lessor by use of leverage leases. From a business and economic standpoint those transactions often are artificial and more expensive than outright ownership. If the current trends continue, the ultimate result will be that transportation equipment would be owned increasingly by non-transportation companies. The same would be true in other capital intensive industries.

Finally, it should be noted that even those businesses which believe that they are currently benefiting in full from the investment tax credit often cannot be certain that the benefit will not be lost until several years have passed. For example, a company may generate sufficient tax liability in a given year to utilize the investment tax credits generated in that year. However, the company may incur net operating losses three years later, which losses would be carried back to the year in which the credits were generated. The carryback of these losses will in turn reduce the tax liability for the earlier year, which may cause the company to lose the benefit of all or a part of the credits previously generated. This lack of predictability can dampen the incentive effect of the investment tax credit.

In formulating a tax incentive capital formation program that will respond to current economic conditions, I urge that you be guided by principles of basic fairness and equity, and that you strive toward a balanced program that will provide an effective economic incentive to all important sectors of our economy. If you are guided by these principles and considerations, I believe you will conclude, as have we, that the time has come to make the investment tax credit refundable as one component of a balanced tax capital formation program.

We will be happy to work with you and your staff to supply any further information or assistance you need concerning the refundable investment tax credit proposal. We, in this connection, would invite you to contact Mr. Larry C. Johnson, who is our assistant general counsel in Chicago, where his telephone number is (312) 786-1200, or our counsel in Washington on this matter, Wickham & Craft, whose telephone number is (202) 785-8150.

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Statement of Nolan K. Bushnell
Chairman, Alliance for American Innovation
submitted to the
Committee on Finance, U.S. Senate
August 1, 1980

The Alliance for American Innovation is an organization whose purpose is to promote policies and legislation that will help individuals create new businesses based on their innovative ideas.

I am an inventor and businessman, having founded the Atari company based on my conception of the video game. I am now engaged in building a new form of entertainment and fast food enterprise called Pizza Time Theater, Inc. My own experience has shown me that it is difficult for individuals with new ideas but no previous record of business success to start their own companies.

Many obstacles stand in the way of the innovative businessman. The very newness or genius of his idea may make it hard to sell even to investors who are used to taking big risks. For this and other reasons, the major problem for most new businessmen is obtaining adequate investment capital. The availability of such "risk capital" is thus at the very core of the problem of the innovativeness, productivity, and competitiveness of the American economy.

Thus an important public policy issue is to devise changes in laws and policies that will help create the climate in which adequate risk capital will flow to the support of new ideas, and we hope, successful new businesses.

Another important policy objective is to increase employee participation in ownership of the companies for which they work. My own experience is that employee ownership is an important element of a new firm's success. The fact that a significant number of a new company's employees have a stake in the business can mean a higher level of dedication and performance at the most critical stage of a new company's existence.

The Alliance for American Innovation proposes a change in the tax laws that would both increase the availability of risk capital for new enterprises and increase employee stock ownership.

Under our proposal, capital gains tax rates for individuals and corporations would be cut in half for investments in small businesses that are substantially owned by their employees. The basic long-term capital gains tax deduction of 60 percent recognizes the importance of encouraging investment, and the increase to 60 percent provided in the 1978 Tax Act has enhanced substantially the availability of investment capital. But the current deduction has not, we believe, proven sufficient to encourage the amount of investment that we believe necessary to promote new enterprise.

Under current law, 40 percent of long-term gain is taxable as ordinary income. Our proposed change would result in significantly more favorable treatment for qualifying investments. Under our proposal, the deduction for individuals would be increased to 80 percent, leaving 20 percent to be taxed as ordinary income. For corporations, the alternative tax would be reduced from 28 percent to 14 percent. To qualify for this special capital gains tax treatment, the investment would have to be in a small company that has diversified share ownership among its employees.

To be considered "small", a company must have at least two of the following characteristics:

--- total gross revenues of not more than $30 million

--- net worth of not more than $15 million

--- no more than 1000 employees.

To qualify under the employee ownership criterion, 25 percent or more of the non-management employees of the business must own an amount of shares equal to at least 15 percent of the total outstanding shares of the company. Non-management personnel are all employees other than officers and members of the Board of Directors of the company. This provision ensures that lower level managerial and support staff as well as hourly employees can own shares. Diversification of share ownership can be accomplished in a number of ways. An employee stock ownership trust is one obvious vehicle by which employee participation can be achieved. But shares could also be distributed by giving them as bonuses, or selling them to employees at low concessional prices.

This is our proposal in brief. It would help accomplish several important objectives:

--- it would make it easier for individuals who have innovative ideas to obtain investment capital;

--- it would in general increase the availability of venture capital for investment in new enterprise; and

--- it would give more working men and women an ownership stake in American business, making each of them capitalists with their own claim to the company for which they work.

We also believe that, in tandem with the special capital gains treatment for qualified small firms we propose, it is important to move now to liberalize general capital gains tax rules. The deduction for individuals should be increased to 70 percent, and the alternative tax for corporations should be reduced to 21 percent from 28 percent. These changes are contained in S. 2923, recently introduced by Senators Cranston and Percy, a measure we strongly endorse.

In addition to these important changes in the capital gains tax, we believe that there are at least three other changes in tax law that are important for the stimulation of investment in new enterprise.

First, the law should be changed to expand the availability of the Subchapter S election to corporations owned by as many as 100 shareholders, and that these shareholders may be corporations, partnerships, or trusts. The use of the Subchapter S corporation to eliminate double taxation of corporate income on a much broader scale could substantially increase venture capital investment in businesses that often lose money in their first years of operation, especially R & D intensive businesses where initial losses can be very substantial.

Second, the law should be changed to permit capital gain to be deferred when an investment is rolled over from one qualifying enterprise to another, under a system analogous to the current tax deferral on sale of a personal residence. Proceeds of the sale would have to be reinvested in another qualifying small enterprise within 24 months. The number of such deferrals, or "rollovers" would be unlimited. The obvious advantage of this proposal would be to create an incentive to reinvest capital gains in qualifying businesses.

Third, the law should be changed to reinstitute restricted stock options for employees of qualifying small enterprises. Such stock options are necessary to attract talented management to small high-risk ventures in competition with bigger companies.

Much has been said recently about the need to "reindustrialize" America. Frankly, this concept, as it is often expressed, concerns me because it is put forward in the context of the need to re-invigorate old industries. Advocates of "reindustrialization" seem to want to devise government policies that would attempt to inject new life into industries that have lost their competitive drive. I believe it is essential not to concentrate on these "sunset" industries but instead focus on creating the climate in which "sunrise" industries can flourish. Government policies should bear on stimulating the new winners, not on rescuing the old losers.

I believe that these proposals would materially improve the climate for innovation and the creation of new enterprise. I want to stress that they are fundamentally meant to benefit the innovative individual who has a new idea and wants to build his or her own business on it. I believe that by making risk capital more available to such men and women we go to the heart of our problem of lagging productivity and world competitiveness. We build a stronger America.

STATEMENT

OF

THE AMERICAN SOCIETY OF PENSION ACTUARIES

The American Society of Pension Actuaries is a national professional society whose 1800 members provide actuarial, consulting and administrative services to approximately 25 percent of the qualified retirement plans in the United States. We advocate that Congress enact a law permitting a deduction for employee contributions to qualified retirement plans up to the Individual Retirement Act (IRA) limits to stimulate capital formation and to expand the coverage of the private pension system.

It is commonly recognized that a very serious problem currently confronting the United States is that of inadequate capital formation. In this regard the position paper of the Investment Work Group of the DOL Advisory Council on Employee Welfare and Pension Benefit Plans, issued January 24, 1978, stated:

"Some economists believe that one of the greater obstacles facing the nation's economic health over the next ten years would be a lack of available funds flowing into capital formation. Capital consumption between 1965 and 1974 totalled approximately $1.6 trillion. The supply of capital grew at a compound annual rate of 6.7 percent during the period. As the economy grows, the capital needed will continue to expand. In addition, capital requirements have grown as attempts are made to improve energy efficiency, reduce pollution, and make working conditions safer. The resulting capital requirements of the 1975-85 period have been estimated by some at over $4.0 trillion, requiring that capital supply grow at a compound 8.7 percent rate annually. Another study of the nation's capital requirements through 1980 indicates similar requirements. Further, the Bureau of Economic Analysis has estimated that business fixed investment, as a percentage of Gross National Product, must rise from the 10.4 percent level of the past decade to approximately 12 percent to meet national goals of lower unemployment, environmental protection, and improved energy efficiency."

The limited financial resources of small business are such that the shortage of available capital is felt most acutely by small business. Typically, the small business organization has the greatest need for capital and the most difficulty in obtaining it when the supply is tight. When these facts are considered in light of the contributions of small business to our economy, the present capital shortage takes on a significance that might not be immediately apparent. As noted in the April 1980 report to the President of the White House Commission on Small Business, new and existing small companies in recent years have provided 86.7% of the nation's new jobs in the private sector. Furthermore, a study by the Office of Management and Budget shows that more than half of the major technological advances in this century originated from individual inventors and small companies. It is certainly true that the shortage of capital affects large as well as small business. The point that we would like to emphasize is that the capital shortage impacts most severely on small business, and small business plays a vital role in technological innovation and new job creation.

At present the investments backing up private pension plans exceed $300 billion. We feel that the enactment of a deduction for employee contributions to private pension plans would serve to significantly expand the total assets of such plans, and thus ease the capital shortage. As we indicated above, easing the capital shortage would be particularly helpful in the small business area.

Approximately 26,500 defined benefit plans have terminated from the time of ERISA's passage through March, 1980. The rate of terminations has been particularly heavy among small plans. If one considers all types of pension plans, there has been a decrease in the ratio of new plans to terminated plans from 14.4 in 1973 to 4.3 in 1978. Such data indicates that there presently is serious trouble in the private pension system.

The major reason for the number of terminations and considerable reluctance of employers to initiate new plans is cost. Not only do the vesting, funding and other substantive provisions of ERISA serve to increase costs, but the new and burdensome reporting and disclosure requirements have resulted in significant increases in administrative costs. The impact is particularly severe in the small plans area. The summary of the Cost of Government Regulation Study developed by Arthur Anderson & Co. for the Business Roundtable stated, in part, that "The incremental administrative costs of ERISA are disproportionately greater for small businesses than for larger businesses. For example, the ten smallest employers incurred average incremental costs per employee in 1977 nearly seven times those of the ten largest."

The United States private pension system has been behind the systems of other countries for many years because deductions of employee contributions have not been allowed. Our Society believes that such deductions would provide a strong incentive to establish and maintain tax qualified retirement plans, particularly in the small plan area. This will, of course, help to alleviate the escalating pressures on the Social Security System which otherwise will become progressively more burdensome as the ratio of workers to retirees declines in the future.

In conclusion, we believe that Congress should enact legislation to permit deductions for employee contributions to qualified retirement plans to ease the capital shortage and to expand private pension coverage.

NIAGARA MOHAWK

NIAGARA MOHAWK POWER CORPORATION/300 ERIE BOULEVARD WEST, SYRACUSE, N.Y. 13202/TELEPHONE (315) 474-1511

JOHN M. HAYNES
SENIOR VICE PRESIDENT

July 28, 1980

Mr. Michael Stern
Staff Director
Committee on Finance
Room 2227 - Dirksen Senate Office Building
Washington, D.C. 20510

Re: Legislative Bills S.1543 and H.R.654

Dear Mr. Stern:

Niagara Mohawk Power Corporation has an original issue Dividend Reinvestment Plan and vigorously supports the above-referenced legislation that would defer taxation of dividends reinvested in such plan.

The economic impact of these bills would be in the national interest and if adopted would substantially increase dividend reinvestment for capital intensive utility companies like Niagara Mohawk Power Corporation. This legislation would reduce the double tax on dividend income by deferring the tax at the stockholder level when dividends are reinvested under a qualified plan.

It is our belief that this proposed legislation is counter-inflationary because it will remove cash dividends from the mainstream of consumer spending and reinvest them in seriously needed energy producing facilities which will significantly contribute to higher productivity.

We believe these bills to have wide support from our stockholders and on their behalf, wholeheartedly endorse the expeditious passage of these bills.

Very truly yours,

NIAGARA MOHAWK POWER CORPORATION

John M. Haynes

John M. Haynes
Senior Vice President

cc: Hon. Daniel P. Moynihan
Hon. Charles B. Rangel
Hon. Thomas J. Downey
Hon. Barber B. Conable, Jr.

Statement of

JAMES M. DUNN, JR.
38 KELLOGG DRIVE
WILTON, CONNECTICUT 06897

In support of
S. 1543
submitted to the
Senate Committee on Finance
July 31, 1980

As a citizen, a businessman, a director of a bank and a director of an educational institution, and as one who has approximately thirty years of professional, diversified experience with the securities markets, I strongly recommend the enactment of S. 1543. This legislation which embodies the concept of tax deferral for reinvested dividends has the following major benefits:

1) Promotes capital formation in a most efficient manner because it would significantly increase individual savings and investment and generate increased equity capital, which is the segment of our economy most in need of assistance. Salomon Brothers and others have done extensive studies regarding the need for increased equity capital.* Enactment of this legislation would improve the attractiveness, marketability and price of common stock because it would increase investors' anticipated net after-tax returns. Because of the resultant improvement in balance sheets and the

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*"Restoring Corporate Balance Sheets: An Urgent Challenge," by Dr. Henry Kaufman et al, Salomon Brothers, July, 1980.

reduction in debt/equity imbalances it would also tend to moderately increase bond prices and thereby reduce interest rates.

2) Is anti-inflationary because it encourages savings and investment at the expense of consumption. It also encourages the production of more goods and services and increases in productivity.

3) Primarily helps the small investor because the benefits are limited to only $1,500 per individual. Small investors are the ones who dominate participation in dividend reinvestment plans. Thus, this legislation will help to reverse the trend in the declining number of small investors in the security markets.

4) Supports economic recovery because it helps GNP, job formation, etc. (based on a study by Robert R. Nathan Associates, Inc.)**

5) Reduces double taxation of dividends and eliminates tax discrimination against cash dividends as compared to stock dividends.

6) Is inexpensive to the Treasury because of the cap of $1,500 per person and because it is tax deferral rather than tax forgiveness. It generates tax reveneus by the third year after enactment. The Nathan study shows a

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**"Economic Impact of a Tax Incentive for the Reinvestment of Dividends," by Robert R. Nathan Associates, Inc., 1978. Also see testimony and statement submitted by Robert R. Nathan Associates, Inc. to your Committee, July/August 1980.

modest tax cost in the first year, no cost in year two and $600 million of additional tax revenues in year three.

From an economic and financial point of view, based on my educational background (B.S. in Economics, Wharton School, and M.B.A. in Finance, Harvard Business School) and my business experience, I feel that the best focused and most cost efficient method of encouraging equity capital formation is this tax legislation presently before the Congress. Given the state of the economy and the tremendous long-term need for increased equity capital and productivity, I strongly urge enactment of S. 1543 as an <u>individual</u> tax cut to become effective January 1, 1981.

TESTIMONY OF J. RICHARD BOULIS, PRESIDENT, SOUTH BEND LATHE, INC., SOUTH BEND, INDIANA, BEFORE THE SENATE COMMITTEE ON FINANCE, JULY 29, 1980.

MR. CHAIRMAN, it is a tremendous pleasure for me to appear today to testify before you and other Members of the Senate Committee on Finance regarding Employee Stock Ownership Plans. I think it is fair to say that the only reason I am able to be here today as President of South Bend Lathe is the direct result of our adoption of an Employee Stock Ownership Plan and the intervention of Senator Russell Long on our behalf to help us and the City of South Bend obtain Federal assistance so that we could buy our company before it was liquidated by the parent corporation. For this reason, Mr. Chairman, we will always be in your debt.

During the past several years, I have testified before several Congressional Committees regarding the impact which our Employee Stock Ownership Plan has had on South Bend Lathe and the effect which I believe such a program could have on other companies. My testimony, and the testimony of other executives before these Committees have carried one common message: ownership works. It inspires employees to be more concerned about the success of their company because they share directly in that success as shareholders. In addition, our testimony has been borne out through independent studies conducted by the University of Michigan and other research groups, all of which reflect that employee-owned companies have higher productivity and are more profitable than non employee owned companies. If there has been any limitation on the benefits which employee stock ownership has created for South Bend Lathe, Mr. Chairman, it has been the result of a lack of support from the international union. I have to admit that this had reduced the effectiveness of the ESOP in our company.

During the last two weeks, two significant ESOP bills have been introduced in the Senate, one by Senator Herman Talmadge (S. 2953) and one by Senator Long (S. 2982). I overwhelmingly support the provisions in both these bills. It is my belief that if these proposals were to become law, hundreds, perhaps thousands, of other companies would adopt Employee Stock Ownership Plans, making capitalists out of several million more employees.

For example, in Senator Long's bill, it is proposed that each employer which adopts and contributes to a Tax Credit Employee Stock Ownership Plan, which is also known as a TRASOP, will be eligible for a Federal income tax credit equal to 1% of the total wages and salaries it pays to its employees who are participating under the plan. This could have a tremendous impact on the business community. The major drawback of tying the TRASOP to the investment tax credit provisions of the Internal Revenue Code has been that too few companies have sufficient capital investments to warrant the adoption of such a plan. I believe that if the payroll based tax credit were to become law, most retailers, banks, and other labor-intensive companies would adopt these plans. This would mean that instead of having approximately 500 employers with TRASOPs, we could have a thousand such companies; this could ultimately provide stock ownership for millions more employees. Also, in order that employers which have already adopted TRASOPs may continue to maintain these plans for the benefit of their employees, Senator Long's bill makes the investment tax credit provisions a permanent part of the Internal Revenue Code.

This bill would also provide a deduction for an employer for dividends which are paid with respect to stock in an Employee Stock Ownership Plan and passed through currently to employees and included by the employees in income. This proposal would have limitless possibilities in terms of employee motivation and communication, and I strongly believe it is something that this Congress should consider seriously. Instead of an employee simply receiving his pay check in consideration of the work he does, he would receive an annual reminder, in the form of dividends on company stock, that he is indeed a shareholder and an owner of the company. This clearly will have a major motivational effect on the employee because he receives direct proof of the impact his work product can have on the success of the company and the benefits that accrue to him as a shareholder.

Senator Talmadge's bill also contains provisions which I strongly support. This bill is intended to promote the acquisition by employees of major ownership interests in their companies. There must be several thousand companies in the United States today which have adopted Employee Stock Ownership Plans, or similar plans, for the benefit of their employees.

However, most of these plans are only able to acquire a minority interest in the company for the employees. Although the motivational effect of this ownership has been recognized, it is clear that if the employees' percentage of ownership was significantly increased, the effects on them would be likewise enhanced. This was the conclusion of the survey done by the Survey Research Center of the University of Michigan. Clearly, then, Congress should try to facilitate the acquisition of greater degrees of ownership of their companies by employees.

Mr. Chairman, the employees of South Bend Lathe were able to buy the company because the Federal government provided a $5 million grant to the City of South Bend which was in turn loaned to the employees for the purpose of acquiring all the stock of the company. This loan is to be repaid over 25 years with annual interest at 3%. This saved the company from liquidation and preserved over 500 jobs.

However, if the employees had been required to borrow this money from a normal commercial lender, and had South Bend Lathe also maintained any other qualified employee benefit plan for employees, it would have been totally impossible for us to buy the company through an ESOP. The Internal Revenue Code limitation on deductions which an employer may claim for contributions to qualified plans and limitations on the amount which can be allocated to an employee's account under these plans would have prevented the amortization of these loans through the ESOP over a sufficiently short period of time to convince a lender to loan us the money. It might have been possible for the employees to buy a small portion of the stock of the company, but a total purchase would have been impossible. Senator Talmadge's bill removes these limitations in situations like South Bend Lathe and would permit these major acquisitions by employees of stock of their companies. I believe the enactment of these provisions will be crucial to the continued development of employee stock ownership.

Senator Talmadge's bill also provides that the determination of the value of closely-held employer stock in an ESOP which owns all or substantially all of the stock of that employer is to be made by reference to the "book value" of the company rather than by comparison to the value of stock of comparable, but totally unrelated, publicly-traded companies. I think this is an excellent suggestion. It makes absolutely no sense for employees to own all the stock of a company and to believe that their efforts can make their company more profitable, and then for them to discover that they really can have no impact on the value of the company stock because it is determined by reference to the value of another company whose economic performance they cannot affect. I do not believe that I can stress strongly enough the negative effect this could have on employee motivation.

Finally, Senator Talmadge's bill proposes that if an ESOP owns all or substantially all of the stock of a company, each employee's benefit should be distributed to him in cash rather than stock. I feel that this also makes sense. Clearly, stock

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ownership is a valuable benefit for current employees; however, retired employees will no longer have the strong affinity with the company and will not be able to affect its economic future. Also, in a closely-held company, there is no market for the stock other than the company or the ESOP. In addition, most employees would rather have the cash than the stock at the outset, especially since the employee has to pay tax on the stock distributed to him from the plan. I would also think that any employee who elects to receive stock will soon wish to sell it back. This means that a company has to incur a great deal of expense simply to issue and then cancel a stock certificate in what is truly a meaningless transaction. Finally, by holding the stock in the plan we can assure that there will be stock available for new employees. I believe it would be far preferable to simply distribute the participant's benefit to him in cash at the outset and avoid this bureaucratic headache.

In summation, Mr. Chairman, on behalf of the employees of South Bend Lathe, I would like to thank you personally for your continued support and interest in the success of our company and I would like to thank the other Members of the Committee for their interest. We strongly support any actions which this Committee or this Congress can take to promote employee stock ownership and to give employees a true stake in the future success of their companies and in our National economy.

Thank you.

STATEMENT OF THE
INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE
AND AGRICULTURAL IMPLEMENT WORKERS OF AMERICA (UAW)
TO THE
SENATE COMMITTEE ON FINANCE

AUGUST 1, 1980

The UAW is concerned that enactment of a tax cut now would produce unsatisfactory results.

There are two basic reasons for our position. First, the importance of the issue demands a discussion conducted in a climate as free as possible of partisan politics. The upcoming elections hardly provide that climate. Second, there is, in our judgment, too little time left for this Congress to act responsibly and deliberately on such a major piece of legislation. Congress can improve significantly on the fairness of our tax code as a cornerstone of the industrial policy needed for the 1980s. But it should not waste that opportunity by rushing into what would more than likely become inadequate legislation. Furthermore, stimulating through tax expenditures should not be given priority over the more pressing needs of adequate funding of existing, but underfunded federal programs.

As the economy has plunged more deeply into recession, millions have become unemployed. Others have lost all hope of finding work. Hours of work have been cut. Earnings have fallen far behind the rise in prices.

We in the UAW are better acquainted with this problem than most other groups. Our members in the auto and parts supplier industries are suffering the worst layoffs since World War II. Many of the laid off have run out of benefits. Except for higher seniority workers, supplemental unemployment benefit funds have stopped payments at two of the major auto companies. Thousands of workers have exhausted their extended UI benefits; for many others, trade readjustment assistance benefits will end soon or were never available.

Congress should act now on measures to stimulate the economy. Substantially expanded job creating programs constitute the quickest, most direct method of reversing the upward unemployment trend.

There are other countercyclical programs begging for funds. The cap on appropriations for food stamps must be lifted if the program is not to run out of money. More funds must also be budgeted for FY 1981 to ensure that full benefits can accrue to the swelling rolls of those eligible.

Workers displaced from their jobs on account of a greater influx of imports are entitled to benefits for income maintenance under the Trade Adjustment Assistance Act (TAA). The Act also authorizes retraining, job search and relocation assistance. However, the income maintenance and the retraining programs ran out of money midway through FY 1980. The readjustment assistance program later resumed payments, but the interruption in benefits will occur again if Congress does not act.

The retraining program in TAA, on the other hand, was allowed to fold in April; no funds have been available since. It is wrong to deny the jobless help to relocate when it is most needed; it is shortsighted to eliminate retraining opportunities at a time when major technological innovations are rapidly changing the skill requirements of many jobs. We urge Congress to appropriate funds for all programs authorized by TAA.

TAA benefits are only available to some of the unemployed workers in the auto industry. Workers in parts supplier companies, jobless because of increased imports of cars and trucks, are not entitled to benefits. Yet, a worker laid off from a parts supplier due to imports is as much in need as an unemployed worker from an auto assembly plant. The UAW, together with other unions, has been pressing Congress for passage of legislation which would extend TAA coverage to workers in the parts industries.

In spite of rising, widespread unemployment, there is real danger that the extended unemployment insurance program will be weakened and scaled down in Congress. We urge this Committee to resist those pressures; if the program is amended, the changes should go in the direction of expansion, not reduction. That is the only policy that makes humane and economic sense in a contracting economy.

With respect to individual tax relief, the focus should be on the increased bite that the Social Security tax will take out of paychecks starting next January. In the aggregate, that will amount to $7 billion; more than two-thirds of that will come out of the pockets of individuals with earnings under $30,000.

One way to deal with the heavier Social Security tax burden is by freezing the payroll rate at the 1980 level of 6.13 percent. There are other ways, however, such as offsetting the rate increase on workers by enacting a refundable income tax credit equal to a certain percentage of the individual's payroll tax.

The time is coming when Social Security will be, as it should be, financed partly through general revenues rather than only from the Social Security funds. It would be responsible and humane to begin financing a significant portion of Social Security through income tax revenues.

Leaving the present FICA tax provision undisturbed is likely to prevent any alterations or rollbacks in the current progression of the maximum taxable wage level. We strongly support increases in that level so that ultimately all employees will be contributing to Social Security on the basis of their total earnings.

Some of the proponents of an immediate tax cut have endorsed a package of proposals which includes a 10 percent across-the-board individual income tax cut with the Capitol Cost Recovery Act, or 10-5-3. This package has been also adopted as a plank in the Republican Party platform. The UAW is opposed to these proposals. The huge revenue loss which would result from them would seriously cripple the federal government's ability to fund essential social programs. According to recent projections by the Administration, by FY 1985 open-ended programs and fixed costs, plus substantially expanded defense programs, are expected to take about 80 percent of budget outlays. Of the outlays remaining for non-defense discretionary spending, over half would have to be slashed to accommodate the loss in receipts. In other words, there would be a transfer of funds from social programs for the less privileged to programs of tax relief heavily tilted towards the well-off and the corporations.

Indeed, the statistics on the distribution of the tax cuts that the proposal would grant to individuals are staggering; in 1981, almost 50 percent of the relief, or about $15 billion, would accrue to individuals with incomes over $30,000 who compromise 15 percent of the taxpaying population. At the same time, as stated earlier, almost 70 percent of the scheduled increase in the Social Security tax would come from employees making less than $30,000. Additionally, there are over 15 million workers who earn too little to pay income taxes. These workers would get absolutely no relief from this proposal; there would be no offset to the increase in their Social Security tax.

On the corporate side, the 10-5-3 proposal would bestow a huge arbitrary giveaway on corporations in the form of the accelerated depreciation scheme. The Treasury's receipts would be slashed by more than $50 billion by 1985, almost half of projected corporate income tax revenues; the corporate share of income tax revenues would plunge to 12 percent from an already low 23 percent in FY 1979.

In spite of the massive amount of foregone revenues, there would be no strings attached; thus speculative ventures and corporate takeovers would doubtless result from some of the increased cash flow, and that portion would add nothing to the productive capacity of our economy or to the fulfillment of public needs.

Changes in public policy regarding investment should be made, but they should involve qualitative decisions about the industrial and geographic areas to be stimulated and the public goals to be achieved as well as quantitative decisions about the form and amount of stimulus.

The impact of 10-5-3 on the auto industry naturally would be of great interest to us. Because of the importance of the industry in terms of employment, productive capacity and extensive economic influence, its current plight and the difficulties it faces in the short-term future affect the entire American economy.

The changes in depreciation lives proposed in 10-5-3 would influence the motor vehicle industry from two angles as they affect the return on its own investment, and as they affect the demand for those of its products which fall into the capital goods category.

From the standpoint of its own short-term investment, 10-5-3 would provide no substantial benefits to the motor vehicle industry. Currently, the industry writes off machinery and equipment at an average of 5.8 years. This would be reduced by 0.8 to 5 years -- while the average reduction for all industries is from 10.2 years to 5 years. In the first year after implementation, there is in fact an increase in the tax liability of the auto industry, because the phase-in rule immediately increases the recovery period for the industry's special tools from three years up to five years. This tax increase would come at a particularly inappropriate time, when the companies are gearing up to substantially expanded production of smaller vehicles at significant capital costs.

From the standpoint of the auto industry's market, there would be a relatively small reduction in the write-off time for autos and light trucks, from 3.5 to 3.0 years. Although additional tax benefits would accrue from an increase in the investment credit which is part of the proposal, any advantage created for auto products would be dwarfed by the advantage given to most other types of machinery and equipment.

However, the industry would realize significant savings on long-term investments such as new plants. Thus, we fear additional instances of worker displacement and of community disruption as the auto industry responds to this incentive for capital relocations. Yet, neither this proposal nor other federal law provides for special measures to protect workers and communities who might be adversely affected by the measure.

In short, 10-5-3 appears to be relatively disadvantageous to the auto industry and its workers, and to the communities in which its facilities are located.

The proposal would indiscriminately scatter vastly different amounts of investment stimulus among industries, instead of targeting in on key industries at a crucial stage in their development, or whose long-term competitiveness is at stake. This lack of targeting is indeed the most damaging feature of 10-5-3, because it also makes for an unconscionably expensive proposal.

Any tax relief proposal falls short of what we need, except as a part of a carefully designed industrial plan to revitalize and address the problems of troubled industries and communities. Let us again illustrate this point with reference to the auto industry. Retooling costs to produce smaller, more fuel-efficient cars will greatly strain the financial ability of some auto and parts supplier firms. Many companies currently show accumulated losses rather than tax liabilities. For them, reduction in taxes may have little or no value; to augment their financial resources, some more direct mechanism to provide immediate cash flow needs to be considered. It should be explicit that such financing will be used to achieve public policy goals, including those already adopted for future implementation.

Any kind of federal assistance should be contingent on certian conditions; workers and communities must be protected from disruption resulting from company utilization of such aid; tax relief for new construction should be limited to locations of high unemployment, etc. Be it in the form of grants or tax relief, simply giving public funds to industries or firms is not industrial policy; it is a giveaway.

In conclusion, the UAW urges this Committee and Congress to:

* Resist the temptation to plunge headlong into enactment of tax legislation in 1980;
* Reject outright the Republican tax proposal;
* Gear any individual income tax relief to offsetting the increase in Social Security tax rates effective January 1, 1981;
* Provide adequate funds for countercyclical employment, income maintenance, and retraining programs;
* Promote an industrial policy that would include, but not be limited to, carefully targeted tax incentives and direct grants to those industries and firms which must play a key role in national productivity growth. Help would be strictly conditioned on the fulfillment of requirements such as worker and community protection, job creation, etc. Public capital formation must also be a key component of any industrial policy.

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AMERICAN COUNCIL ON EDUCATION
ONE DUPONT CIRCLE
WASHINGTON, D. C. 20036

DIVISION OF GOVERNMENTAL RELATIONS
(202) 833-4736

August 4, 1980

The Honorable Russell B. Long
Chairman
Committee on Finance
U. S. Senate
2227 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Chairman:

On behalf of the American Council on Education and the National Association of Independent Colleges and Universities, representing over 1,600 colleges and universities, we are pleased to present our views on the proposed tax-reduction legislation presently being considered by your committee and request that this letter be included in the hearing record.

Above-the-Line Treatment of Charitable Contributions

As noted in our earlier statement, presented by President Terry Stanford of Duke University before the Subcommittee on Taxation and Debt Management Generally, on January 30, 1980, we strongly support the enactment of S. 219, the Charitable Contributions Legislation of 1979. This legislation would extend the deduction for charitable giving, now limited only to those who itemized their deductions, to all taxpayers. The charitable deduction has a unique status in our tax code. It is the one deduction that is given, not for spending income on oneself, but for sharing with the whole community. This legislation, by including all taxpayers, would strengthen the principal of the deductibility of charitable giving. We believe this is sound public policy worthy of the attention and support of this committee.

Spiralling energy costs, rising inflation, and the myriad costs of complying with increased government regulations in the 1970's substantially increased college and university operating expenses. To meet this crunch, made more severe by the unexpected nature of it, many colleges begin to dip into their capital and rely heavily on sums generated by annual giving drives. Like many businesses institutions have dangerously drawn down their reserves to keep their heads above water causing the deferral of maintenance and the failure to replace plant and equipment. Preservation of the financial health of our sector in the long term will require increases in charitable giving.

While the need for voluntary giving has increased in education, changes in the tax code in the last decade, most notably the substantial increases in the zero bracket amount, have combined to produce a less favorable tax climate for such giving, resulting in a rate of growth lower than the projected actual needs of the sector.

It is true that today higher education receives a substantial portion of its voluntary gifts from individuals who itemize their deductions. However, an important long-term effect of limiting the tax incentive for charitable giving to the 23% of the population who itemize is that the younger alumnus, who is most likely to utilize the zero bracket amount, will be less likely to develop early the habit of annual giving. Moreover, as studies have shown, those who contribute their time become involved often by first contributing their money. Thus, the gradual narrowing of the tax incentive for charitable giving which has occurred in the last decade has social consequences as well. S. 219, democratizes charitable giving strengthening the underlying democratic pluralism of society by giving recognition to every taxpayer for the public character of his or her private voluntary giving and by encouraging broader and more responsive participation by all citizens in the public life of their communities and nation.

Lastly, the change proposed in S. 219 would be effective, efficient, and fair, yielding more than a dollar in additional charitable donations for every dollar lost in tax revenue. The change, for example, would have increased charitable giving by at least $4.16 billion in 1978 over what was donated that year. It would also be fairer to lower- and middle-income taxpayers by recognizing their gifts.

Social Security Relief

We support proposals which would provide a degree of relief from increasing social security taxes in a manner which would maintain the integrity of the Social Security Trust funds. To that end, we strongly endorse S. 2029, introduced by Senator Bradley, which would allow all employees and for-profit businesses an income tax credit equal to 10% of the social security payroll taxes paid in 1981 and 1982 and which would provide a 10% rebate to non-profit employers.

The bulk of the employees at institutions of higher education earn salaries within the current social security wage-base ceiling adopted in the social security amendments of 1977. Thus the impact of increased social security taxes has been felt very heavily by our sector. Unlike for-profit businesses we have not been able to cushion that impact by deducting these taxes from income tax liability. Moreover, in combination with rapid inflation and increased energy costs the absorption of increased social security costs is extremely difficult.

A study of social security costs at independent colleges and universities notes that the 1977 Social Security Amendments will likely increase average employer salary costs at these institutions by 27% in 1981 and 29% in 1982. In dollar terms this represents an estimated increase cost of $36 million in 1981 and $40 million in 1982.

We believe social security relief across the board for non-profit and for-profit employers is an important item to be considered in the development of any tax bill targeted at decreasing unemployment and increasing productivity.

Charitable Remainder Trusts

We urge that Congress consider the enactment of a permanent provision under which governing instruments of charitable remainder trusts, charitable lead trusts, and pooled income funds may be amended to meet the requirements of the Federal estate, gift, and income tax law imposed by the Tax Reform Act of 1969 and, thus, preserve the assets of said trusts for the intended charitable remainder.

Since the Tax Reform Act of 1969, the Congress has periodically enacted provisions permitting such amendments, the most recent of which was Section 413 of the Revenue Act of 1978 extending until December 31, 1978, the time to amend (or commence judicial proceedings to amend) instruments establishing such trusts which were executed before December 31, 1977. Various bills are pending in both Houses which would extend this period but only with instruments executed on or before December 31, 1977.

We are aware of instruments creating charitable remainder trusts for the benefit of colleges and universities by will or lifetime instruments since December 31, 1977, which for one reason or another have been declared by the Internal Revenue Service to be invalid. If the trusts are subject to Federal estate, income, or gift tax, the principal burden of that loss will fall on the colleges or universities or other charities as remaindermen. Most of these have been conformed to the 1969 Tax Act provisions under the extension statutes referred to above.

We are particularly concerned with the effect of the present set of circumstances on the creation of charitable remainder trusts. As a general rule, lawyers throughout the country are not familiar with charitable remainder trusts. Those who have some familiarity are well aware of the very restrictive attitude evidenced by the Internal Revenue Service in regulations and rulings published and unpublished and of the danger inherent in their drafting such instruments because failure to meet a standard expressed or unexpressed of the Internal Revenue Service in the drafting of such instruments will not only result in a denial of an income or estate tax deduction but, also in the case of lifetime gifts, may result in a gift tax on the remainder interest passing to charity. As a result, the creation of such trusts are inhibited. The presence of a provision permitting amendment would relieve this concern.

We feel confident that, as every year goes by, worthy cases deserving the consideration of Congress will be brought to its attention, leading to subsequent extensions of the right to amend. For this reason, we recommend that serious consideration be given to a permanent provision for amendment which will permit the intent of Congress in enacting the 1969 Act provisions to be given effect. The beneficiaries of such a provision will be the charities which would otherwise have their remainder interest depleted by a tax where a charitable gift or bequest was clearly intended.

Deferred Compensation

We strongly endorse the adoption of a provision which would confirm the proposal embodied in H. R. 6824 (on which hearings were held before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means on April 17, 1980) that a deferred compensation plan or agreement maintained by a tax-exempt organization be governed by the same rules as the deferred compensation plans maintained by taxable employers. The Revenue Act of 1978 prohibited the Service from adopting the proposed regulations with respect to taxable entities and state and local governments but was silent with respect to the deferred compensation arrangements maintained by organizations exempt from tax under IRC Section 501. In the face of that silence the Service now proposes to proceed with its original intention to tax currently any non-qualified deferred compensation arrangements of tax-exempt organizations. While we had strong misgivings about the proposed change as applied to deferred compensation plans for all types of employers, we find the Service's attempt now to impose a special and unfavorable rule on the arrangements of tax-exempt institutions alone incomprehensible and fundamentally wrong.

In the first place, the revenue impact would be minor. Current ERISA limitations limit the availability of deferral arrangements of tax-exempt organizations to highly-compensated employees and independent contractors. (See ERISA Section 4021(b)(6).) Thus, the number of individuals affected by these proposed regulations is necessarily slight and revenue gains inconsequential. In truth, considering the cost of administration, it seems clearly possible that the regulation could result in an outflow of funds from the Treasury. One wonders whether the effort is worthy of the attention.

The very limited class affected by the proposed regulation raises another issue, namely, the proposal would treat differently employees of taxable and exempt organizations solely by reason of the status of their employer. Indeed, the Service has traditionally rejected such a basis for differential tax treatment of employees unless there is compelling justification. Neither the 1978 Revenue Act nor the rationale for the proposed regulation suggests any such compelling necessity. Beyond that, the legislative discussions accompanying the enactment of the 1978 Tax Reduction Act raised serious questions concerning both the concept and the administrative workability of the Service's proposed regulation on deferred compensation.

It should be noted that deferred compensation arrangements are not now widely used in higher education. Yet the limited usage bears an inverse relationship to the potential importance and practical significance of these arrangements. The availability of such a mechanism to institutions of higher education in flexibly tailoring compensation agreements to the individual needs of key personnel can quite literally be determinative of the institution's ability to recruit in some instances.

Finally, we would note that deferred compensation arrangements offer important financial benefits to tax-exempt employers. The obligation to pay out the funds in the future, even where the employer sets aside those funds, is usually less than the obligation to pay out of current funds. In this connection, it should be noted that inflation may play an important role in lessening those obligations.

National Research Service Awards

We endorsed S. 2938 recently introduced by Senator Dole. This includes a permanent provision establishing the tax status of Uniformed Services Health Professions Scholarships and similar programs, such as those providing for the National Health Service Corps. In addition, it provides a one-year moratorium on the taxation of National Research Service Awards.

Insofar as the Armed Forces Health Professions Scholarships and similar programs are concerned, where the recipients are required to perform future service as Federal employees, the qualified tuition and related expenses, including tuition, fees, books, supplies, and equipment, are excludible from income provided the grantee establishes that, in accordance with the terms of the grants, the amounts were used for such expenses.

In setting the levels for the National Research Service Awards, Congress assumed they would be treated as nontaxable scholarships and fellowships. However, the Internal Revenue Service in 1977 ruled that these awards constituted "income" to the recipients. (Revenue Ruling 77-319, 1977-2 C. B. 48.) Subsequently, the House Committee on Interstate and Foreign Commerce restated Congress' intent that the awards be exempt from taxation and asked the Internal Revenue Service to reverse its ruling. The Service declined to do so. As a result, Congress included in the Revenue Act of 1978 a provision that the awards should be treated as scholarships or fellowships under Section 117 if made during the calendar years 1974 through 1979. This exclusion was extended to awards made during 1980 by Public Law 96-167 (H. R. 5224). In so doing, Congress, through the Committee Report, stated that it believed "that amounts received as National Research Service Awards should be accorded tax-exempt treatment pending further study" or, as in the case of the Uniformed Services Health Professions Scholarships, "a comprehensive review of the appropriate tax treatment of these grants as a part of overall national policy." See "General Explanation of the Revenue Act of 1978" prepared by the Joint Committee on Taxation, page 118. No such study has been made.

As indicated by the committee authorizing the awards, subjecting award recipients to taxation will frustrate national purpose. In fact, although the individual National Research Service Awards have been increased because they are no longer sufficient to attract individuals into research for several reasons, the number of grantees has decreased by more than 1,000 in the fiscal year 1980.

As noted by the Association of American Medical Colleges in its testimony at the hearing with respect to H. R. 7009 (now Section 1 of H. R. 7171), the situation is especially critical in the case of clinical medical research fellows. The level of support provided by the awards is in many cases less than one-quarter the amount which the grantees can expect to receive if they follow other alternatives.

The decrease in both quality and quantity of recipients will have a very deleterious effect on the effort to encourage qualified individuals to pursue necessary research in all areas. For this reason, we urge that, at the very least, the one-year moratorium through the end of 1981 on the taxation of National Research Service Awards be adopted.

<u>Refundable Investment Tax Credit</u>

We support the establishment of a refundable investment tax credit for non-profit organizations.

Colleges and universities, museums, libraries, churches, and other non-profit institutions that provide substantial opportunities for employment and that make significant capital investments in equipment should be able to avail themselves of the benefits presently accorded solely to the business community.

Simple equity dictates that the non-profit sector should not be excluded from the benefits of the investment tax credit merely because Congress has chosen to dispense assistance through the income tax system rather than by direct federal grants. Making the investment tax credit refundable would materially assist non-profit institutions and stimulate the nation's economy as a whole.

We strongly urge your consideration of this proposal and stand ready to provide you with any additional information that you might require.

Sincerely,

Sheldon Elliot Steinbach

Sheldon Elliot Steinbach
General Counsel

Christine Y. Topping-Milliken

Christine Y. Topping-Milliken
General Counsel
National Association of Independent Colleges and Universities

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STATEMENT OF

WILLIAM C. MCPIKE

CHAIRMAN, COMMITTEE FOR EFFECTIVE TAX INCENTIVES

BEFORE THE

FINANCE COMMITTEE OF THE UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

My name is William C. McPike and I am Chairman of the Committee for Effective Tax Incentives. Membership of this Committee is comprised mostly of businesses engaged in the renting and leasing of motor vehicles.

It is the objective of this Committee to eliminate the discrimination in our tax laws against short lived assets and to create a tax system that will encourage investment, increase productivity, and reduce inflation. We believe that the present tax structure discriminates against short lived assets by not making them eligible for investment tax credits. Any depreciation reform must be coupled with investment tax credit reform otherwise it will be counter productive. Depreciation reform without investment tax credit reform will have a most detrimental effect on industries investing in short lived assets.

These remarks are specifically directed to HR 4646 and S 1435 which attempt to create a more equitable tax system by their proposed investment tax credit changes and for that reason we support these Bills. To eliminate the present discrimination in our tax system, it is vitally important that qualified tangible property held one year receive the full or partial investment tax credit and we would support any such legislation that will assure this is accomplished.

HR 4646 and S 1435 as drafted will stimulate capital investment in the car and truck renting and leasing industry, producing benefits in areas of energy savings, the economy, small business growth and the environment. They will also have a beneficial impact on the truck and automobile manufacturing industry. This will be done by:

1. Stimulating purchases of new vehicle fleets,
2. Accelerating the renewal of the nation's motor vehicle population,
3. Materially advancing fuel conservation efforts,
4. Increasing efficiency in the motor carrier transportation industry,
5. Facilitating reduced vehicle transportation costs and related charges,
6. Aiding attainment of national environmental goals,
7. Strengthening the operation of related small commercial enterprises,
8. Strengthening the motor vehicle manufacturing sector and related industries.

By changing the investment tax credit structure, so that shorter lived assets qualify, new vehicle purchases will be more economically feasible, and thus will appreciably accelerate the industry's new vehicle purchases.

Such a stimulus will be especially timely in light of our present national climate of inflation, high interest rates, and increasing energy costs, all of which have tended to slow the purchase of automobiles for rental service. Historically, companies replaced rental automobiles after twelve months' use, but the present economic climate has delayed vehicle replacement lengthening this holding period to eighteen months or more. Passage of a investment tax credit structure as in HR 4646 and S 1435 will help reverse this trend, and revitalize rental vehicle purchases which would accelerate renewal of the nation's motor vehicle population.

More than 90 percent of all one-year-old used cars sold to used car purchasers are former car rental units. To the extent that car rental companies turn over their fleets, the influx on newer model vehicles into the nation's motor vehicle population increases. By encouraging more rapid fleet turnover, it will accelerate the renewal of the national motor vehicle population.

This accelerated renewal enables a greater number of people to benefit from the advantages of new models. Current model vehicles are produced with latest automotive technologies, enhancing reliability, safety and efficiency. In different ways, these benefits accrue to the vehicle owners, customers, drivers, passengers, pedestrians and the general community. Through its effect on the motor vehicle rental and lease industry, the investment tax credit provisions of HR 4646 and S 1435 will increase the availability of these benefits.

By encouraging new rental and lease vehicle purchases, the investment tax credit provisions of HR 4646 and S 1435 can be expected to advance national fuel conservation goals. Because newer vehicles are substantially more fuel efficient than the vehicles they replace, fuel consumption levels of rental and lease fleets will decrease. In the truck renting and leasing industry, which purchases an increasing number of new trucks equipped with diesel engines, the effect on fuel conservation will be even more pronounced.

The high initial costs of fuel-efficient diesels, however (generally $3,000-$7,000 more than a gasoline engine), has been largely responsible for limiting their use. Currently, only two percent of mid-range trucks on the road are diesels. Through the new investment tax credit incentives, the ability of truck fleet operators to finance diesels will be enhanced.

By stimulating purchases of new vehicle fleets, the proposed bills will improve overall operating efficiencies for the truck renting and leasing industry. New vehicles are not only more fuel efficient, but also are generally equipped with standard features and designs which increase overall operating efficiencies, thereby reducing operating costs.

The investment tax credit for shorter lived assets including trucks and automobiles can be expected to hasten the attainment of national environmental goals. By encouraging the rapid turnover of rental and leased fleets, these bills will accelerate the introduction of late model vehicles, equipped with the most advanced environmental devices. The reduction in mobile source pollutants resulting from increased use of new vehicles is expected to be substantial, and to accelerate over time.

An improved capital cost recovery system will, moreover, be to strengthen the financial stability of smaller firms and improve the economic positions of thousands of business users who daily depend on our industry's transportation services by lowering costs. The small business enterprise especially, unable to afford private fleets, will benefit. It is easy to understand that legislation affecting the purchasing power of the vehicle renting and leasing industry will also impact the manufacturing industry.

By producing a beneficial economic stimulus for the industry, the effects will also pass through immediately to help industry suppliers.

In conclusion we urge this Committee to eliminate the discrimination against short lived assets and when it reports out new tax legislation it should include provisions allowing tangible property qualified under present law held one year be eligible for a full or partial investment tax credit.

Statement of

Brice O'Brien
12613 Bluhill Road
Silver Spring, Maryland 20906

Mr. Chairman:

My name is Brice O'Brien, and I appear here as an individual without anyone's portfolio.

I ask this committee to approve a $5,000 exemption for income received from private pension plans by persons who are rated by the Social Security System as totally and permanently disabled.

Unfortunately, I fall into that category.

The justifications are numerous, but simple.

First, it would roughly make such income from private plans equal to existing treatment for government employees' income of this type.

Actually, private retirees are more in need of relief, since private plans cannot afford to index retirement income to inflation, as government does.

Second, inflation hits private retirees fully as hard as it does government employees.

Third, in my own experience, $5,000 a year is very close to the additional expense I incur because of my inability to do things for myself. It is just about the amount I spend each year to hire maids to help my invalid wife, to till my garden, mow my lawn, and do the countless things that healthy men ordinarily can do for themselves.

I appreciate the opportunity to present my case, and will try to answer any questions you might have.

Thank you.

August 4, 1980

The Honorable Russell B. Long
Chairman, Committee on Finance
United States Senate
217 Russell Senate Office Building
Washington, D.C. 20510

Re: Hearings on Tax Reduction

Dear Mr. Chairman:

The Nokota Company is a North Dakota corporation based in Bismarck which has extensive holdings in the Fort Union coal deposit in western North Dakota and northwestern South Dakota. Nokota is presently conducting engineering, environmental, economic, marketing, and other studies of the feasibility of constructing an 85,000 BPD coal-to-methanol plant at Dunn Center, in west-central North Dakota. Nokota's Dunn Center coal deposit is one of the largest economically recoverable lignite coal deposits in the United States, and utilizes coal from the same formation as the Great Plains Gasification Associates project thirty miles east.

The cost of the facility proposed by Nokota will be about $2 billion (1980), exclusive of financing costs. The entire output of the project will be high quality fuel grade methanol suitable for stationary power plant use, agricultural drying, residential heating, and in internal combustion engines.

The methanol plant will be integrated with a mining operation and will include coal handling and processing facilities, electric power and oxygen generation facilities, and tankage for storage of the product prior to shipment. An extensive investment will be required in equipment to meet environmental requirements at the plant.

Nokota is following closely the development of federal government assistance programs for the construction of such plants. The Congress has addressed the question of long-term purchase commitments and guarantees in S. 932, and has provided specific tax incentives for synthetic fuel plants in the Crude Oil Windfall Profits Tax Act. Nokota supports these steps and suggests one additional area of concern and two corrective actions by this Committee.

The Nokota Company /P.O. Box 1633 316 No. 5th St. Bismarck, N.D. 58501 701/223-6188

Capital Recovery

Nokota supports broadly based capital recovery reform along the lines of the "10-5-3 Proposal." The availability of such a system will provide a substantial and needed incentive to the formation of the large amounts of capital required for synthetic fuel plants. The 10-5-3 Proposal should be implemented in a manner which will permit depreciation deductions to begin during the construction.

Corrective Actions

Alcohol Fuel Production Credit. Section 232 of the Crude Oil Windfall Profits Tax Act of 1980 extends the excise tax exemption for gasohol through the year 1992 and provides a 40¢ per gallon income tax credit for alcohol fuels not eligible for the exemption. However, no exemption or credit would be provided for alcohol produced from coal. The Senate version of the Act, § 232 of S. 3919 as passed on December 17, 1979, gave a 20¢ per gallon credit to alcohol derived from coal, which is a not unreasonable difference, given the relative BTU value of ethanol and methanol. However, the credit for alcohol derived from coal was eliminated entirely during the Conference.

Methanol from coal requires a substantially larger investment in plant than alcohol fuels from other sources. However, coal is a virtually inexhaustible resource and methanol from coal can be produced after 1985 in substantial quantities at reasonable cost. This source of alcohol fuel must be available in addition to ethanol in order to provide the high production levels necessary to significantly reduce American dependence on imported petroleum without adversely affecting food production. There is no basis for the present denial of equivalent tax incentives to methanol. However, a reasonable differentiation which reflects the relative BTU values of methanol and ethanol is not inappropriate. (Methanol has a BTU value about 75% of that of ethanol.)

Energy Investment Tax Credit. The Nokota project, as is typical of other large coal-to-methanol plants, will include many integrated systems and subsystems contributing to the coal conversion process. Some have expressed concern that the language of the 10% energy investment credit, as amended in the Crude Oil Windfall Profits Tax Act, leaves open the possibility that equipment not directly involved in the conversion process will be excluded from the credit. Nokota suggests that this should be clarified and that the credit should be available for all components of an integrated methanol production facility including oxygen generation facilities and other equipment related and dedicated to production of the synthetic fuel.

Respectfully submitted,

Galen Andersen, President

STATEMENT
SUBMITTED BY

LOUISIANA GASIFICATION ASSOCIATES

TO THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

August 1, 1980

Introduction

The Louisiana Gasification Associates (LGA) are grateful for the opportunity to submit this statement to the Committee in connection with its tax cut hearings. We are a group of six industrial corporations: PPG Industries, Inc., Cities Service Company, Conoco Coal Development Company, Airco, Inc., United Energy Resources, Inc. and Bechtel, Inc. These companies are presently investigating the joint development of a commercial size coal gasification project in Louisiana. This facility will be designed to produce 125 billion Btu's of medium Btu gas and methanol per day from the initial planned gasification module, with allowances for construction of additional gasification modules as the need arises and the expansion can be economically justified. It is expected the cost of this facility will be approximately $1 billion. It will be one of the first large-scale gasification projects to go into production in the United States.

The LGA project will be an extensive and largely self-sufficient industrial facility, incorporating the most modern gasification processes and technology available, using coal as a gasification feedstock. (Petroleum coke is also being considered as a secondary gasification feedstock.) This plant will occupy a total land area of approximately one square mile. It will operate in strict compliance with environmental requirements.

As is typical for this type of facility, it will include equipment directly involved in the gasification process (such as feedstock storage, preparation and handling equipment, gasifiers, equipment to cool, dry, purify, upgrade, and compress the synthetic gas, and equipment to convert this gas to methanol). The facility will also include other equipment which is not directly involved in the gasification and methanol synthetization process, but which is nonetheless an integral part of the facility and is dedicated solely to support the gasification and methanol synthetization processes. Examples of this integrally related equipment in the facility include: equipment to provide oxygen, hydrogen or other ingredients or catalysts in the gasification process; equipment to treat or recover water, catalysts and other ingredients used in the process or to recover process byproducts; on-site equipment to store and transfer the synthetic gas, methanol or byproducts after they have been produced or recovered; process control equipment; on-site equipment to produce or transmit process heat or electricity for use in the facility; and property to control atmospheric and water pollution.

The need for facilities such as that contemplated by LGA is well documented. The LGA facility will be but one step in this nation's development of alternative energy resources in order to reduce our heavy reliance upon imported petroleum and the resultant problems of substantial trade deficits and vulnerability to sudden supply disruptions and price increases. However, developjng a new and multi-faceted synthetic fuel industry is a massive and complex undertaking and, unlike previous situations when there have been shortages of rubber and other critical materials, this is much too large an undertaking to be implemented in a few months or years on an emergency basis. Even though the availability of petroleum and natural gas to fuel our industrial and transportation systems and to provide chemical feedstocks has been an increasing source of concern since the oil embargo of 1973-1974, not a single commercial-scale coal conversion facility is currently operating in the United States.

There are a variety of reasons for the hesitancy of American industry to commit what is estimated to a total capital investment of well over $100 billion during this decade in order to achieve the national goal of producing synthetic fuels and feedstocks to substitute for the equivalent of 1.5 million barrels of imported petroleum per day. Tremendous risks and uncertainties are inherent in these long-leadtime projects, including the possibility of the development of more efficient processing technologies, high construction costs, and the inability to project the pricing structure for the product more than five years later when the plant enters production.

The Congress and this Committee have made great strides during the last several years to make possible the development and use of alternative energy resources by enacting energy tax incentives in the Energy Tax Act of 1978 and the Crude Oil Windfall Profit Tax Act of 1980 to encourage entrepreneurial development, and by passing the Energy Security Act earlier this year, to make available governmental financial assistance through the United States Synthetic Fuels Corporation. The Synthetic Fuels Corporation is authorized to provide various forms of indirect or direct financial support to projects which are selected after applying numerous subjective criteria. Both the energy tax provisions and the Energy Security Act include rules to prevent duplications in the various forms of government assistance.

Foremost among the authorized forms of assistance by the Corporation are loan guarantees, purchase guarantees and purchase agreements. Giving priority to these forms of indirect financial assistance means that much of the capital for construction of synthetic fuels plants still will come from private industry. It is essential that the proper financial atmosphere be provided in order to encourage the flow of private capital to these investments.

Given the size of facilities such as that contemplated by LGA and the specialized nature of the equipment involved in the construction of the plant, the time from the first capital investment until the plant is in operation can be expected to span a period of five to eight years. This estimate does not take into account those delays that are bound to occur in obtaining the various permits and clearances relating to land use, zoning, clean air, clean water, or technological and labor problems. In short, projects such as the LGA facility will require exceptionally large expenditures of capital over protracted periods of time before any revenue can be expected. Under present law, depreciation deductions are not permitted until the plant and equipment are placed in service, a rule which will prove to create hardships for projects of this kind.

The Louisiana Gasification Associates echo and fully support the sentiments expressed by the host of witnesses who have appeared before the Committee in support of innovative tax measures to improve capital cost recovery and resulting productivity, such as the "10-5-3" proposal. Improvements in the capital cost recovery system could not be of greater importance to any segment of the private industrial sector than is the case with the inordinately capital-intensive and emerging synthetic fuels industry. Of particular importance to long-term projects such as the LGA facility is the rule in the "10-5-3" proposal which allows depreciation deductions to begin when payments are made during the construction period.

Although the focus of the Committee in these hearings has been largely restricted to the broader question of capital cost recovery as effected by tax policy, the LGA is of the opinion that it would be misleading if mention is not made of several specific deficiencies in the statutory rules of the existing energy tax provisions, which need to be clarified and redefined in order to more fully reflect the original Congressional intent to create adequate and meaningful incentives for the commitment of entrepreneurial capital to high-risk and highly uncertain synthetic fuels and substitute feedstock projects. There are three specific issues of concern to the LGA. These issues involve the energy investment credit and production incentives for alcohol fuel.

ENERGY INVESTMENT CREDIT FOR EQUIPMENT WHICH USES PETROLEUM COKE OR PITCH

The rules found in Code section 48(l)(3) of present law provide the 10-percent energy investment tax credit for equipment to burn an "alternate substance" as a primary fuel or to convert an "alternate substance" into a synthetic solid, liquid or gaseous fuel. This energy credit is also available for equipment to convert coal (including lignite) into a substitute for an oil or natural gas derived feedstock or into methanol, ammonia, or a hydroprocessed coal liquid or solid. An "alternate substance" is defined as a substance other than oil, natural gas, or a product of oil or natural gas. These limitations in the existing statutory provisions prevent an energy credit for equipment which uses any petroleum by-product as a primary fuel or as a basic feedstock to produce methanol, a substitute for a petroleum or natural gas feedstock, or a synthetic fuel.

There are petroleum by-products, such as fuel-grade petroleum coke and petroleum pitch, which are generally not marketable and are the "bottom-of'the'barrel" residues which remain after the maximum amounts of gasoline and other light distillates used as transportation fuels have been extracted from crude oil. Petroleum coke, for example, is produced in a secondary process to petroleum refining. Fuel-grade petroleum coke has physical and Btu properties similar to coal and, like high-sulphur coal, contains significant percentages of impurities, such as sulfur, nitrogen and metals. These concentrations of impurities discourage the use of petroleum coke as an energy resource in the United States because of the attendant need to use expensive pollution control equipment in order to satisfy environmental restrictions. (Fuel-grade petroleum coke is unlike the other type of petroleum coke, calcined coke,in that fuel-grade coke is produced from sour crudes and contains high percentages of impurities. Approximately 56 percent of the total petroleum coke currently produced in the United States is fuel-grade coke. This percentage is expected to increase in the future.)

The heavy sour crude oils from which this petroleum coke is derived are more difficult to process and provide lower percentages of gasoline and other distillates than light crude oils. The world supplies of light crude oils are rapidly diminishing and U.S. refiners will be forced to import and refine increasing quantities of heavy crude oils and the residual oils which are derived from heavy crudes. There is a declining demand for residual oils, primarily because large fuel users are converting to coal. In addition, it is necessary to maximize the refining of gasoline and distillate transportation fuels. As a result, coking will increase in future years and there will be greater and greater quantities of petroleum coke. It should be pointed out that there are alternatives to coking for the treatment of residual oils. These treatment alternatives, hydrotreating and hydrocracking, are catalytic processes under which hydrogen is added to residual oil at high temperature and pressure conditions to convert part of the residual oil to gases, gasolines, and distillate fuels. However, neither of these alternatives to coking for the processing of heavy sour residual oil produces as much gasoline and distillates as coking. These processes also yield larger quantities of unconverted materials than does coking. In addition, the technology for these alternatives is not now highly developed and is generally more expensive than coking equipment. Although hydrotreating and hydroprocessing may eventually become more efficient processes for converting residual oils, their impact is not expected to occur for 10 or 15 years.

Because the environmental costs for using fuel-grade petroleum coke make it a less desirable feedstock or fuel, the producers of petroleum coke are confronted with a disposal problem. Most of the fuel-grade petroleum coke produced today is not used in the United States, but is exported if a foreign market can be found for it. Where a foreign market can be found for petroleum coke, the exportation of petroleum coke derived from imported residual oils has in fact an adverse effect upon the United States balance of trade. A ton of petroleum coke can be sold for a price in the range of $20 per ton and contains a Btu equivalent of 4.7 barrels of residual oil. If the present price of approximately $20 per barrel was paid for the residual oil from which the petroleum coke was derived, the United States is in effect exporting more than $4.70 for each $1 it receives for the petroleum coke.

Fuel grade petroleum coke and other generally unmarketable petroleum by-products, such as petroleum pitch, are available and in over-supply in the United States similar to coal, which is in abundant supply. However, like coal, these substances require significant environmental control investments in connection with their use. Further, it is costly energy policy to export these valuable energy resources or to let them go unused. For these reasons, the LGA suggests that the same energy incentives should be allowed for use of these substances as are provided for coal. It is consequently proposed that the energy investment credit provisions under Code section 48(l) be amended to allow the energy investment credit for equipment, including related fuel or feedstock handling and storage equipment and required pollution equipment, to burn these substances as a primary fuel or to create a synthetic fuel or a substitute feedstock (including methanol or ammonia) from these substances.

OFF-STREAM PROPERTY IN SYNTHETIC FUEL AND SUBSTITUTE FEEDSTOCK PLANTS

The statutory rules for synthetic fuels and substitute feedstock equipment eligible for the 10-percent energy investment credit under clauses (iii) and (v) of Code section 48(l)(3)(A) define such equipment by using the phrases "equipment for converting" and "equipment to convert." There is concern that the literal language of these two statutory phrases may require that equipment eligible for the credit must be directly involved in the conversion process (such as gasifiers) and will exclude other equipment at a facility which produces a synthetic fuel, substitute feedstock, methanol or ammonia from eligibility for the energy credit if the equipment is not directly in the conversion stream. For example, the Conference Report on the Crude Oil Windfall Profit Tax Act of 1980 observes that equipment not directly involved in a coal conversion process (but which produces a feedstock or catalyst for the process) will not qualify for the energy credit.

As already noted, the LGA project will be an extensive industrial facility. It will include equipment directly involved in the gasification process, such as feedstock storage, preparation and handling equipment, gasifiers, equipment to cool, dry, purify, upgrade, and compress the synthetic gas, and equipment to convert this gas to methanol. Morever, a substantial portion of the facility (as much as 35 percent) will be comprised of other equipment which is also an integral part of the facility and is dedicated solely to support the gasification and methanol synthetization processes and equipment. Examples of this integrally related equipment in the facility include equipment to provide oxygen, hydrogen or other ingredients or catalysts in the gasification process, equipment to treat or recover water, catalysts and other ingredients in the process or to recover process by-products, on-site equipment to store and transfer the synthesis gas, methanol or by-products after they have been produced or recovered, process control equipment, on-site equipment to produce or transmit process heat or electricity for use in the facility, and property to control atmospheric and water pollution. The gasification and methanol synthesis processes could not occur without this supporting equipment.

These categories of equipment are not only necessary and integral parts of a synthetic fuel or substitute feedstock plant, but are also a substantial part of the capital investment in these plants. The statutory intent is not clear, and the LGA believes it was the intent of Congress to allow the energy investment credit for all equipment used in the production of a synthetic fuel or a substitute feedstock, such as those categories of equipment described above, which are integrally related to the functioning of the plant. It is, therefore, proposed that the provisions of clauses (iii) and (v) of Code section 48(l)(3)(A) be clarified to reflect this intent, eliminate uncertainity and provide a proper investment incentive for these facilities.

PRODUCTION INCENTIVES FOR ALCOHOL FROM COAL

The energy tax provisions enacted in the 1978 and 1980 legislation allow several production incentives for alcohol fuels. Under Code sections 4081 and 4041, gasohol, a blend of 90-percent gasoline or another motor fuel and 10-percent alcohol, is exempted from the 4-cent-per-gallon federal excise tax on motor fuels. However, gasohol which contains alcohol made from coal is not eligible for this exemption. Similarly, under Code section 44E, a 40-cent-per-gallon income tax credit for the production of alcohol fuels is provided in situations where the excise tax exemption does not apply; however, alcohol produced from coal is not eligible for this production credit. Both of these energy incentives apply through 1992.

Present law also makes available, under Code section 44D, a theoretical production credit of $3 per barrel-of-oil equivalent for certain qualified fuels, including alcohol produced from coal and used either as a fuel or as a chemical feedstock. While this production credit is generally available through the year 2000, it includes a phase-out rule which causes it to phase-out completely when the average wellhead price of unregulated domestic crude oil reaches $29.50 per barrel, adjusted for inflation after 1979. Since the price of unregulated domestic oil is now, and is also expected to continue to be, higher than the $29.50 phase-out price, this theoretical production credit is academic; and neither now provides nor can it reasonably be expected in the future to provide a pricing incentive to produce alcohol from coal.

The rationale which underlies the existing workable incentives for alcohol production is that the production of this liquid fuel from indigenous sources other than oil or natural gas reduces the need to import high-priced and less secure supplies of crude oil or natural gas from the OPEC nations. (There are also advantages to the Government in that this type of incentive requires no financial risk by the Government and is easy to administer.) It follows that alcohol fuel production from such indigenous sources should be encouraged and that tax incentives for this production should not discriminate against alcohol derived from coal and in favor of biomass-derived alcohol.

Alcohol derived from coal can make a valuable contribution to energy independence. Coal is America's most plentiful energy resource and existing coal reserves can supply America's energy needs for hundreds of years. If this alcohol replaced 500,000 barrels of imported crude oil per day, at a present average OPEC price level $36 per barrel this would result in an improvement to our balance of trade of $6.5 billion per year. Coal-derived alcohol is a highly versatile substance and can be used to fuel gas turbines and captive fleets (such as fork lifts) and also as a petrochemical feedstock.

LGA consequently requests that the existing discrimination against alcohol derived from coal be eliminated under the present production tax incentives for alcohol fuels. However, some degree in differentiation in the amount of the present 40-cents-per-gallon production credit is justified to reflect the fact that coal-derived methanol has a Btu value of slightly more than 75 percent that of biomass-derived ethanol. In addition, the economics of scale for large coal-derived alcohol plants, when compared to the smaller biomass-derived alcohol plants, produces a projection that coal-derived alcohol is entitled to a production credit of one-half that provided to biomass-derived alcohol. It is therefore proposed that the existing production credit provisions be amended so that alcohol produced from coal and other alternate substances will receive a production credit under Code section 44E equal to one-half that for biomass-derived alcohol, or a credit of 20-cents-per-gallon under present law.

Summary

The Louisiana Gasification Associates applaud the Committee's examination of depreciation reform initiatives at this time. The LGA strongly supports the 10-5-3 proposal and its rule to allow depreciation on long-term projects to begin as payments are made during the construction period. In addition, the LGA suggests that the Committee re-examine the existing energy tax incentives to: allow petroleum coke and pitch and other generally unmarketable substances as eligible feedstocks or fuels for purposes of the energy investment credit, clarify the definition of qualifying alternative energy property in synthetic fuel and feedstock plants, and eliminate descrimination in existing law between production incentives for biomass-derived alcohol and those for alcohol derived from coal and other alternate substances.

65-969 O - 80 pt.1 - 40

STATEMENT OF
GENERAL TELEPHONE & ELECTRONICS CORPORATION

On
Tax Cut Proposals

Submitted to the
Committee on Finance
United State Senate
August 1, 1980

General Telephone & Electronics Corporation (GTE)[1/] supports the concept of tax deferral of reinvested dividends embodied in S. 1543, H.R. 654, and H.R. 7015. GTE urges that Congress incorporate the dividend reinvestment concept in any major tax legislation the Congress may enact in the near future; hopefully, tax legislation to be effective January 1, 1981.

Deferral offers an important direct incentive to increased investment in the American economy and would help reduce inflation. Of the various capital formation proposals now before the Committee, dividend reinvestment has attributes that give it a very high priority as an incentive for increasing the supply of equity capital and personal savings.

1/ GTE is the parent company of more than sixty communications, products, research, and service subsidiaries with operations in forty states and twenty countries abroad. GTE's domestic telephone companies serve nearly fifteen million telephones in 7500 communities with a total population of about twenty-two million people in portions of thirty-one states. GTE Satellite Corporation (GSAT) operates three of seven earth stations in the joint AT&T-GTE domestic communications satellite system. GTE, through its Products Group companies here and abroad, manufactures a wide variety of communications products, from telephones to microwave systems to satellite earth stations. GTE, through its Communications Network Systems Group, provides terminal equipment and long-haul public and private network facilities for business, voice, and data customers. GTE has over 160,000 domestic employees and over 450,000 shareowners.

The Need for Increased Equity Investment

There is little dispute that the current flow of investment funds into United States industry is inadequate -- whether measuerd by comparison to the savings rate in other industrialized nations such as Japan or measured by the historical percentage of GNP or measured in any other way. There has been a severe lack of equity investment in the U.S. over the past several years (See Exhibit I),2/ and increased dividend reinvestment will help to reverse this trend. Furthermore, it will add equity, particularly to the capital-intensive industries, which is the most assured method of actually adding to productive assets in the U.S.

Equity investment, as opposed to other forms of investment, will have a far greater impact on total productive assets because of the multiplier effect associated with equity investments. Each dollar of equity adds to the base on which additional debt can be sold, thereby financing additional productive assets. For example, among most utilities, $1 of equity will result in nearly $3 of productive assets, whereas $1 in non-equity investment results only in $1 of productive assets. We believe that the best individual incentive before the Congress which will result exclusively in such efficient equity investments is the dividend reinvestment proposal. That is, without new equity investment, there is no tax benefit.

2/ During the past decade, corporate liabilities have grown more than twice as fast as corporate equity. Corporate liquidity ratios, current ratios, debt maturity ratios, and interest payment coverages have plummeted to record lows.

In a study titled "Restoring Corporate Balance Sheets: An Urgent Challenge," (Salomon Brothers, July 21, 1980), Dr. Henry Kaufman et al demonstrate the U.S. industry has become dangerously under-capitalized. For all manufacturing companies, equity has decreased as a percent of total capitalization from two-thirds in 1960 to one-half currently.

Utilities Industry's Urgent Need for Capital

The utilities industry is currently encountering considerable difficulty in raising new capital to satisfy demands for service. Utilites are already burdened by a substantial amount of debt and must seek additional equity capital. A recent analysis shows that 91% of all the electric and telephone companies' new common stock offerings in the first 6 months of 1980 were issued below book value (see Exhibit II). In fact, over the past 5 years, the vast majority of utility common stock sales have been below book value, with 1980 being projected as the worst year of all. This condition makes it difficult for utilities to issue additional common stock without fear of diluting the stockholders investment. Selling securities below book value for any prolonged period of time would lead to a degenerative spiral of stock prices and utlimately to a complete inability to issue equity or debt securities.

This trend which has plagued the utilities industry is exacerbated by the effects of inflation. Last year the Financial Accounting Standards Board, in FASB No. 33, required large corporations to show in their annual reports, figures which reflect the effects of inflation on their company's financial statement. The figures in Exhibit III clearly show the effect inflation has made on net income, taxes paid, stock prices, and how much greater the effect on utilities has been compared to other industries. Exhibit IV further demonstrates the effects of inflation on utility shareowners as they receive their dividends. The inflation adjusted dividends received have actually been declining over the past 10 years.

Discrimination in the Tax Code

Over the past 50 years, dividends have proven to be an important part of an investor's total return on common stocks. In fact, in a highly regarded study conducted by respected members of the academic world, it was shown that dividends provided more return to investors than they received through price appreciation (see Exhibit V). Unfortunately, the tax code discriminates against dividends in preference to capital appreciation.

Traditionally investors in utility stock have sought a high dividend yield. Because of the substantial portion of shareholders who are currently investing in utilities for income rather than capital gains, the utilities have always maintained a high dividend payout ratio. Thus, while a non-utility may provide a return to investors through growth - on which taxation is deferred until sale and then based on capital gains rates - a utilities stockholder's return on his investment, in the form of dividends, is taxed as ordinary income.

The discrimination is seen most clearly in the cases of stockholders who receive only stock dividends which are not subject to immediate taxation, and stockholders of a high-dividend reinvestment plan after taxes. The theoretical calculations in Exhibit VI show that the discrimination against a high-dividend-payout company can amount to thirty-one percent over a ten-year period. These calculations are verified by actual experience in the market.

Other successful industrialized countries, against which we compete in the world marketplace, recognize the importance of dividends in their tax code. Exhibit VII demonstrates how Japan and West Germany, known for their high rates of investment - and productivity - minimize the discrimination against dividends through both personal and corporate tax incentives. The chart also shows that Great Britain, known for its economic problems, offers no tax incentive for dividend income.

The dividend reinvestment concept offers an equitable and administratively practical approach to removing this discrimination and to lessening the fundamental burden of double taxation by applying Section 305 of the Internal Revenue Code to reinvested dividends. Under S. 1543, H.R. 654 and Section 201 of H.R. 7015 stockholders of all businesses would be permitted to reinvest up to $1,500 per year ($3,000 on joint return) of their dividends in newly issued stock of the dividend-paying corporation without being penalized by having to pay a tax on dividends that are never actually received.

The concept goes even one step further. Not only does it eliminate discrimination, it actually places the choice of the type of dividends a stockholder wants in his or her hands. Under S. 1543 or H.R. 654, the stockholder himself decides whether he will receive a regular cash dividend with current tax consequences, or a tax deferred dividend which he automatically reinvests, similar to a stock dividend.

<u>The Importance of Dividend Reinvestment Plans</u>

An immediately significant advantage of this proposal is that it would increase the flow of reinvested dividends into existing dividend reinvestment plans. More than 150 companies currently have plans and more than two million investors participate in them. The amount of money invested annually in these plans has nearly quintupled over the last five years. Exhibit VIII illustrates that dividend reinvestment is the fastest growing source of equity capital and represents $1 out of every $8 of new equity issued.

Enactment of the legislation would also encourage other corporations to form these types of plans. With the legislation, it is estimated the participation in the plans would at least double.

Dividend Reinvestment Primarily Benefits the Small Investor

The dividend reinvestment concept is particularly well-suited to the needs of the small investor, since dividend reinvestment plans provide an automatic, convenient, systematic, and inexpensive means of investing. Furthermore, in an increasing number of plans, participants pay no brokerage commissions or service charges, and many plans pass on the savings in issue costs to the participating shareholder in the form of a five percent discount on the price of the stock.

The popularity among small investors is illustrated on Exhibit IX which shows that the vast majority of plan participants at three telephone companies own less than 200 shares and it is believed that is typical of most companies. In fact, at GTE 80% of the participants own 100 shares or less.

Conversely, participation among investors with large shareholdings is very modest. Of registered GTE shareholders with over a thousand shares, less than five percent particpate, and they comprise less than one half of one percent of the total plan participants. The proposal in no way gives a new tax benefit to the high-bracket taxpayer. He can currently minimize his taxes by investing in low dividend-payout companies or in tax-exempt securities.

Summary of the Benefits of Dividend Reinvestment

The adoption of the proposal to defer taxation on reinvested dividends would significantly increase participation in dividend reinvestment plans and thereby increase the rate of savings and investment in our nation.

By promoting savings over consumption, the proposal would help dampen inflation, build a stronger fundamental economic base, and create conditions more favorable to further investment.

Allowing stock issued under automatic dividend reinvestment plans to be treated for tax purposes as a stock dividend under Section 305 would reduce the current discrimination against high dividend-paying stocks for prospective investors interested in capital appreciation, while retaining traditional investment appeal for shareholders seeking cash dividends.

Stock dividend reinvestment would also provide increased and reliable equity investment to help strengthen the capital structure of all businesses. Specifically it would stimulate equity investment in capital intensive industries including public utilities, the very industries which have the greatest need for external funds. Since utilities have a greater degree of individual ownership than other companies, and since individuals are more likely to be taxpayers than institutions, this legislation would direct investment to the individuals and companies that can best benefit from the plan.

It would also begin to eliminate both the tax bias favoring the issuance of debt rather than equity and the double taxation of dividends.

Further, it would reduce reliance on outside capital markets, improve cash flow, and provide funds required to increase captial expenditures, employment, and productivity.

<u>Dividend Reinvestment Should be Included in the Next Tax Reduction Proposal</u>

(see Exhibit X)

What makes the dividend reinvestment concept such an attractive one for inclusion in any major tax incentives bill the Congress may enact is that the benefits could be realized quickly and at relatively little cost to the Treasury. Unlike many other proposed deductions or tax credits, dividend reinvestment involves tax <u>deferral</u> rather than tax <u>forgiveness</u>. Revenue estimates show that the initial cost to the Treasury is only about $350 million for the first year, a wash for the second year, and a net revenue gain of $600 million in the third year.

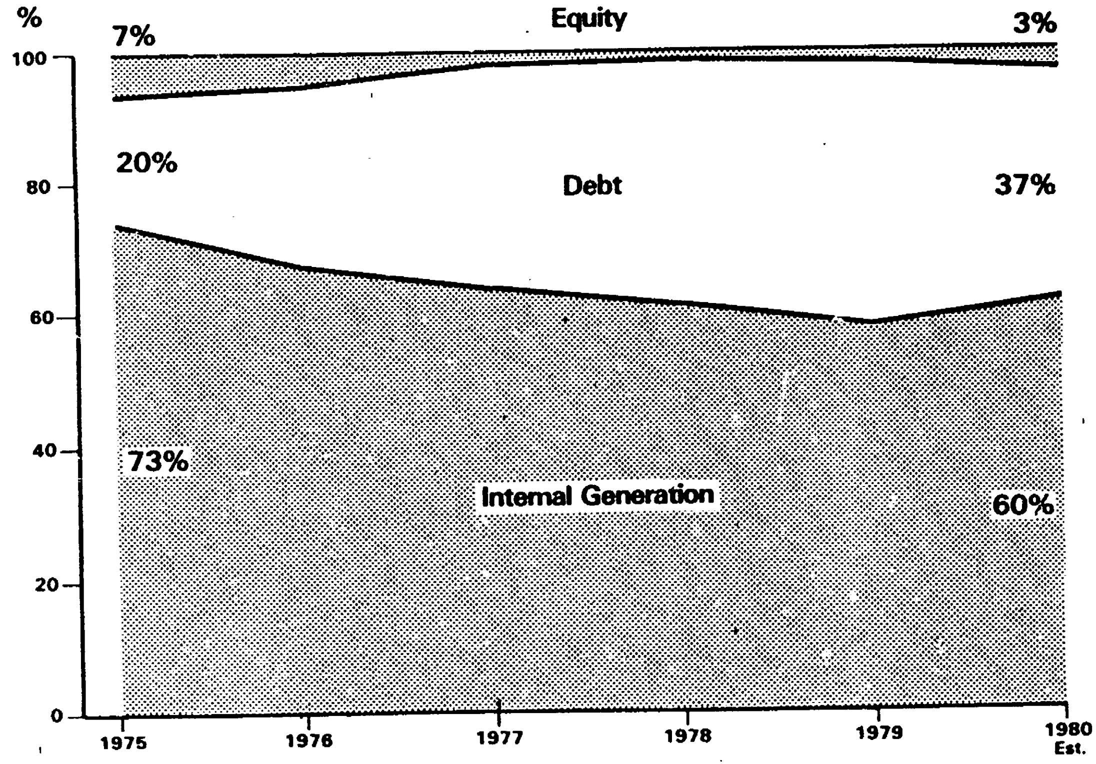
Dividend reinvestment plans are already in place at many companies, and there is great potential for growth in these plans. New plans could be readily established at additional companies. The benefits from expansion of dividend reinvestment would be anti-inflationary and capital-specific, <u>i.e.</u>, the tax benefits are achieved only as to fresh dollars invested in equity capital for a minimum holding period. For utilities the equity dollars are in turn leveraged three-fold by the company's ability to float additional debt for capital investment purposes. S. 1543 and H.R. 654 are bills which are oriented toward tax incentives for individuals, and as such, are complementary to, and enhance capital recovery proposals for businesses. These bills will help to raise external equity investment while capital recovery legislation is designed to promote internal generation of equity funds.

Conclusion

For all these reasons, dividend reinvestment is the most appropriate and effective incentive for increased personal savings and investment, and GTE urges that this individual tax deferral proposal be incorporated in judicious, selective tax legislation which would encourage savings, investment and capital formation. It is further recommended that such legislation be effective January 1, 1981.

Exhibit I

SOURCES OF CORPORATE FUNDS



Source: Federal Reserve Board of Governors, Flow of Funds

Exhibit II

PUBLIC COMMON STOCK OFFERINGS BELOW BOOK VALUE

January 1, 1980 – June 30, 1980

Company	Market/Book Ratio	Company	Market/Book Ratio
Kansas City Power and Light Co.	.58	The Washington Water Power Co.	.76
Central Hudson Gas & Elec. Corp.	.60	Public Service Elec. & Gas Co.	.77
Upper Peninsula Power Co.	.60	The Cincinnati Gas & Elec. Co.	.78
United Cities Gas Co.	.63	The Montana Power Co.	.78
Commonwealth Edison Co.	.64	Houston Industries, Inc.	.79
Arizona Public Service Co.	.65	Portland General Elec. Co.	.79
Carolina Power & Light Co.	.66	The Toledo Edison Co.	.79
Public Service Co. of New Hampshire	.66	Gulf States Utilities Co.	.80
San Diego Gas & Elec. Co.	.66	Kansas Gas & Elec. Co.	.80
Public Service Co. of Colorado	.67	Niagara Mohawk Power Corp.	.80
United Illuminating Co.	.67	Pacific Power & Light Co.	.81
Southern California Edison	.68	Duquesne Light Co.	.83
Middle South Utilities, Inc.	.69	Sierra Pacific Power Co.	.83
Detroit Edison Co.	.71	Fitchburg Gas and Elec. Light Co.	.84
Illinois Power Co.	.71	Ohio Edison Co.	.84
Northern Indiana Public Service Co.	.71	Pacific Power & Light Co.	.88
Kentucky Utilities Co.	.73	Central & South West	.89
Otter Tail Power Co.	.73	Montana – Dakota Utilities Co.	.92
United Illuminating Co.	.73	El Paso Elec. Co.	.93
Texas Utilities Co.	.75	Central Louisiana Energy	.95

	1975	1976	1977	1978	1979	6 Months 1980
Issues Under Book	87%	58%	45%	65%	83%	91%
Issues Over Book	13	42	55	35	17	9
Total Common Issues	100%	100%	100%	100%	100%	100%

Source: Salomon Brothers

Exhibit III

EFFECTS OF INFLATION AS PUBLISHED IN ANNUAL REPORTS PER FASB STATEMENT NO. 33

Industry Group	Net Income 1979		Tax Rate 1979		Growth in Stock Price 1975-79	
	Reported	Inflation Adjusted	Reported	Inflation Adjusted	Reported	Inflation Adjusted
Industrial	100%	60%	39%	53%	74%	24%
Financial	100	95	28	28	69	22
Retailing	100	42	42	68	12	(21)
Transportation	100	56	30	44	99	42
Utilities	100	31	34	62	(4)	(32)

SOURCE: PRICE WATERHOUSE STUDY, MAY 1980

Exhibit IV

IMPACT OF INFLATION ON DIVIDENDS
1969—1979

	Industrials Standard & Poor's 400		Utilities Standard & Poor's 40	
	Dividends	Inflation Adjusted*	Dividends	Inflation Adjusted*
1969	$3.25	$3.25	$3.08	$3.08
1970	3.20	3.02	3.16	2.98
1971	3.16	2.86	3.24	2.93
1972	3.22	2.82	3.28	2.87
1973	3.46	2.85	3.31	2.73
1974	3.71	2.76	3.35	2.49
1975	3.72	2.53	3.49	2.38
1976	4.22	2.72	3.63	2.34
1977	4.95	2.99	3.91	2.36
1978	5.37	3.02	4.23	2.38
1979	6.04	3.05	4.66	2.35
Annual Growth Rate	6.7%	⟨0.3⟩ %	3.8%	⟨3.1⟩ %

* Adjusted by Consumer Price Index

Exhibit V

COMMON STOCKS
1926 – 1979

TOTAL RETURN	9.0%
via DIVIDENDS	5.0%
via APPRECIATION	4.0%

Dividends Provide The Greatest Portion Of Total Return In Long Run, Therefore, Tax Treatment Of Dividends Is Of Major Importance

SOURCE: R.G. Ibbotson and Co.

Exhibit VI

TAX LAWS DISCRIMINATE AGAINST CAPITAL INTENSIVE HIGH DIVIDEND COMPANIES AND FAVOR NON-CAPITAL INTENSIVE LOW DIVIDEND COMPANIES

ASSUMING $100 INVESTMENT

Type of Company	Market Price Appreciation	Dividend	Pre-Tax Total Return	After-Tax Dividend[a]	Total Return 1st Year	After-Tax Return Upon Sale After 10 Years[b]
	(1)	(2)	(3) (1)+(2)	(4)	(5) (1)+(4)	(6)
UTILITY Capital Intensive High Dividend	$ 2.00	$10.00	$12.00	$ 7.00	$ 9.00	$133.10
NON-UTILITY Non-Capital Intensive Low Dividend	$10.00	$ 2.00	$12.00	$ 1.40	$11.40	$173.88
Net Tax Disadvantage To High Dividend Paying Stocks					$ 2.40	$ 40.78

a) Assumes a 30% Tax Bracket, And Therefore A 12% Capital Gain Tax.
b) Assumes Reinvestment Of Appreciation And After-Tax Dividends

Exhibit VII

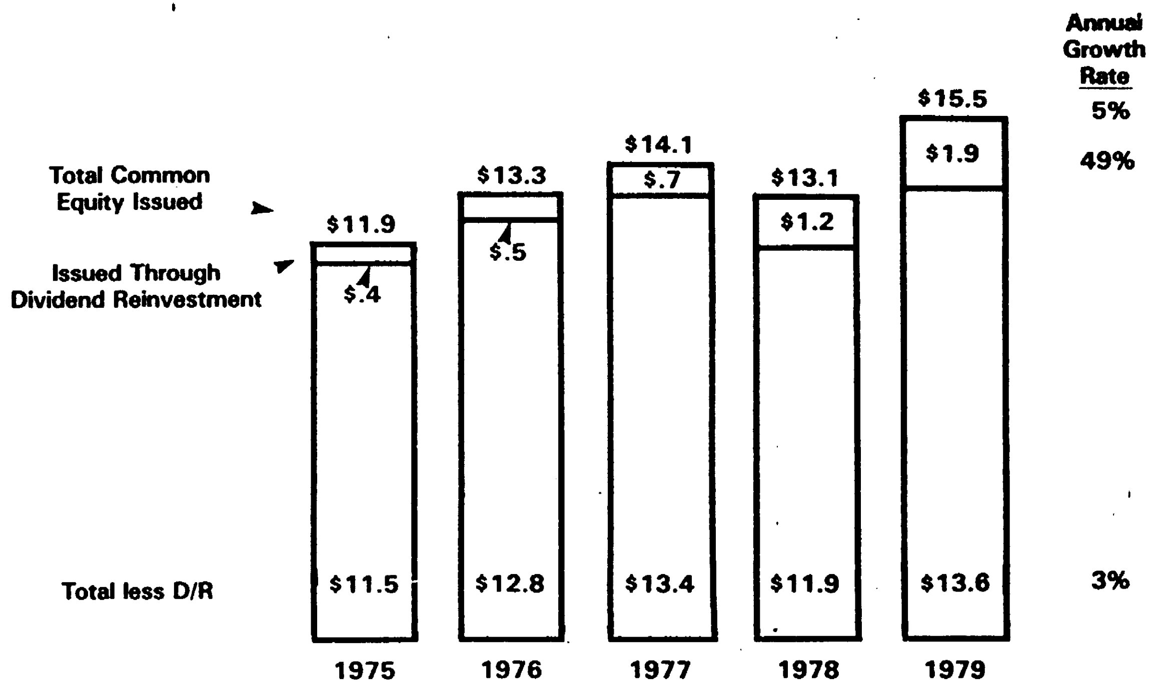
COMPARATIVE TAX TREATMENT OF DIVIDENDS *

Country	Special Corporate Tax Rate on Dividends Paid	Personal Tax Credit or Exclusion on Dividend Income
Non-Supportive of Capital Formation		
United States	None	Exclusion—First $200 ($400 joint) of dividend income
Great Britain	None	None
Supportive of Capital Formation		
Japan	75% of normal rate	Credit—5% to 10% of dividends received
West Germany	64% of normal rate	Credit—100% of taxes paid by corporation on dividends

*Treatments shown are those generally applied to dividends paid by local companies to residents of the countries listed

Exhibit VIII

DIVIDEND REINVESTMENT
as a
SOURCE OF COMMON EQUITY CAPITAL
(Billions of $)



	1975	1976	1977	1978	1979
% From Dividend Reinvestment	3.4%	3.8%	5.0%	9.2%	12.3%

Exhibit IX

ILLUSTRATION OF SMALL SHAREOWNER PARTICIPATION IN DIVIDEND REINVESTMENT PLANS

	Percent Of Plan Participants Owning 200 Share Or Less
Central Telephone & Utilities Corporation	66%
Continental Telephone Corporation	85%
General Telephone & Electronics Corporation	91%

Exhibit X

ORIGINAL ISSUE DIVIDEND REINVESTMENT PLANS AND BENEFITS OF H.R. 654 AND S. 1543

GROWTH OF PLANS

- First Plan Established IN 1973
- Currently There Are Over 150 Plans With 2 Million Participants

PARTICIPATION IN PLANS

- Small Shareowners Dominate

DISINCENTIVE TO PLANS

- Shareowner Is Taxed Without Receipt Of Cash Dividend

REMEDY

- H.R. 654 And S. 1543 – Allow Tax Deferral On Dividends Up To $1500 Per Individual

BENEFITS OF LEGISLATION

- Increases Plan Participation
- Greater Savings, Investment, And Employment
- Improves Capital Formation
- Anti-Inflationary
- Reduces Double Taxation Of Dividends
- Inexpensive To U.S. Treasury

STATEMENT SUBMITTED ON BEHALF OF THE INTERNATIONAL TAXICAB ASSOCIATION TO THE SENATE FINANCE COMMITTEE IN ITS CONSIDERATION OF A TAX CUT

August 5, 1980

This statement is submitted on behalf of the International Taxicab Association, which is the sole trade association in the taxicab industry, representing taxicab operators in every state and in all major cities of the United States. The Association's members own or control over half of the approximately 5,400 principal corporations that operate taxicabs in the United States.

The focus of the Association's comments is on suggested changes to the Internal Revenue Code on which testimony was submitted during the Committee's hearings. These proposals, embodied in S. 2998, would provide an exemption from the Federal excise tax on fuel for qualified bus operators. In 1978, Congress enacted a similar,though temporary,provision to refund the Federal gas tax to qualified taxicab operators. While the present rebate provision for the bus operators is permanent, that for the taxicab operator expires on December 31, 1980.

The taxicab industry is seeking a one-year extension to the present rebate for qualified taxicab operators. Congress mandated a two-year experimental program in its original enactment, but the program will have less than one-years actual operation by the end of 1980 that could, in any way, be used to evaluate the success of the program. First, in a survey conducted by the International Taxicab Association of 350 companies, one-third of the eligible applicants had not received any rebate, as of July, 1980.

Second, the application form for the rebate was quite slow in coming, and was not generally available to the industry until the early summer of 1979. As recently as June, 1980, some IRS offices still did not have the required application form that would enable a taxicab operator to apply for the rebate.

The delay in implementing the program has also delayed the information-gathering about its success. The Department of Transportation has only just started to collect data on the increase in ride-sharing programs that has resulted from the enactment of the rebate. Clearly, the two-years granted by Congress for this experiment have not been provided by the program's administrators due to these progammatic delays.

The bases for the program was set forth in the conference report on the Surface Transportation Assistance Act of 1978 (95-1797):

> The fuel tax exemption is intended to permit Congress to determine the effectiveness of the exemption in encouraging more energy efficient taxicabs and in removing barriers to ride-sharing. This determination is to assist Congress in deciding whether the exemption is to be extended or not. The conferees expect that the treasury department and the taxicab industry will determine, and report to the tax writing committees before the end of the two-year exemption, the extent to which government (and other) barriers to ride-sharing have been removed and more energy efficient vehicles purchased.

The taxicab industry, in cooperation with the Department of Transportation, is in the midst of its study of the effectiveness of the rebate. All data collected by the taxicab industry show that the rebate program has been successful. In both the Congressional conditions placed on the rebate, the taxicab industry has been able to increase its shared-riding programs and increase its purchases of vehicles that meet the rebate's prohibition against gas guzzlers.

As a result of the shared-riding programs stimulated by gas tax rebate, the number of passengers carried per trip has increased from about 1.2 in 1975 to a present level about 1.8 passengers per trip. When these figures are viewed in terms of gasoline consumed per passenger trip, the taxicab industry has reduced its fuel consumption per passenger trip by 38 percent since 1975. These statistics reflect both the success of the program and the efforts of the taxicab industry to increase its energy conservation.

Taxicab companies have also increased their purchases of fuel efficient vehicles. According to the Association's survey, 89 percent of the vehicles bought since the enactment of the rebate meet the strict requirement prohibiting gas guzzlers used in taxicab service from qualifying for the refund.

The taxicab industry believes that a one-year extension to the present temporary provision will permit the successful conclusion and evaluation of the two-year experiment that Congress originally enacted. The importance of the rebate to the taxicab industry and to the public can be seen in the light of an example; the experience of the taxicab industry in Lousisiana. In that State, taxi companies operate in 39 communities with approximately 2,200 cabs, with over 2,500 employees. In New Orleans, for example, there are 1,650 cabs operating as "independents" with about half being minority enterprises. The experience of Louisiana, in particular, shows both the need for the rebate and how effective it has been. Of the 89 companies providing taxicab service in the State, 11 companies have recently failed, most of these failures occurring in rural areas like Oakdale, Rayne, and Winnsboro. But companies in New Orleans have also gone under. When these companies fail, especially in rural areas, they take away the only source of public transportation. In the State as a whole, 28 communities are exclusively served by taxicabs for local transportation. Taxicab companies in Louisiana responded to the rebate by significantly increasing their shared-ride programs. At present the State average or taxicab service is 2.6 passengers per trip, one of the highest averages in the Nation. Moreover, companies in the State have also qualified under the rebate's prohibition against gas guzzlers. However, as described earlier, refunds due eligible applicants have been extremely slow in coming.

In the Nation, the importance of taxicab service is often overlooked; it is an integral part of the transportation system in this country. As a collection of by and large small bussinesses, taxicabs carry about 40 percent of all purchased local transportation and employ a majority of individuals in the local transit industry. In fact, taxicabs carry over 3 billion passengers every year.

Taxicab service is an important source of transportation in small communities, and for the elderly and the handicapped. Across the Nation, 21 percent, the taxicab industry serves 3,400 communities as compared with only 1,079 communities served by transit. The elderly constitute approximately 20 percent of all taxicab users. A recent study done at Harvard University stresses the importance of the taxicab as a means of local transportation for the poor. For these groups the taxicab is the principal, if not the only, source of transportation.

The rebate represents both a means of increasing energy conservation in this industry and a method of holding down fares. Traditionally, fare increases for the taxicab company are infrequent, occurring about once every one or two-years. These fare increases are neither in the interest of the public or the taxicab company since fare increases are always accompanied by a loss in ridership. A number of economic studies have documented that the elasticity of demand for taxicab service is negative and near unity. For these reasons, a continuation of the rebate is in the interest of operators, drivers, and passengers.

The taxicab industry urges the committee to consider a one-year extension of the current provision refunding the Federal gasoline excise tax to qualified taxicab operators. We believe that such an extension is expecially relevant since Congress is now considering a similar enactment that applies to the bus operators in the United States. A consistent treatment of public transportation, we believe, militates for the permanent exemption of the Federal fuel tax for the bus operators, and a continuation of the rebate to qualified taxicab operators in order to permit a full and fair evaluation of this program's meits. The International Taxicab Association wishes to thank the Senate Finance Committee for permitting the inclusion of this statement into the Record.

TESTIMONY OF WILLIAM COTTER, PRESIDENT OF THE YELLOW CAB COMPANY OF HARTFORD, CONN. and TREASURER OF THE TAXI CAB ASSOCIATION OF CONN. SUBMITTED TO THE SENATE FINANCE COMMITTEE IN CONNECTION WITH HEARINGS ON TAX REDUCTION PROPOSALS, AUGUST, 1980

On behalf of the Taxi Cab Association of Connecticut, and the Yellow Cab Company of Hartford, Connecticut, I would like to express my gratitude to this Committee for allowing me the opportunity to present our views on the Small Business Investment Act of 1980, introduced by Senator Nelson and Co-sponsored by Senators Bentsen, Wallop, Moynihan, Durenburger, Culver and Stewart.

The Connecticut cab companies favor legislation, such as S 2998, which facilitates the cash flow of small businessmen venturing into, or competing in, today's high risk business environment. In particular, we commend Section 10 of S 2998 which authorizes a complete and direct exemption from motor fuel excise taxes paid by bus operators engaged in intercity, charter, local and special operations.

We believe that the Congressional sensitivity which S 2998 displays to the financial plight of the bus industry should be extended to a lesser degree to the cab industry. This can be accomplished without controversy by authorizing a one year extension of the current law enabling cab companies to claim a tax rebate of the current 4 cents per gallon federal excise tax on gasoline.

The Congress authorized an extension to the taxi industry of the federal excise tax rebate with the passage of the Surface Transportation Act of 1978. The rebate had long since been granted on a permanent basis to all other modes of public transportation. The extension of the rebate to the taxi industry was done on a two-year experimental basis to provide an incentive to conservation efforts. A cab company may not qualify for the rebate unless it purchases fuel efficient automobiles and operates its cabs in jurisdictions which allow shared riding.

The Conference Report directed the Treasury Department and the taxicab industry to "determine, and report to the tax writing committees before the end of the two year exemption period, the extent to which government (and other) barriers to ride sharing have been removed and more energy-efficient vehicles purchased." This study was to determine the effectiveness of the rebate programs in meeting Congressional intent. This study has not been completed.

While preliminary data collected by the taxi industry indicates that the program has achieved the desired Congressional objectives, there is no reliable data base for a thorough evaluation of the program due, principally, to the failure of responsible federal agencies to fully implement the rebate programs. For example, fully one-third of the eligible applicants have not received any rebates. This may be due, at least in part, to the failure of the IRS, as of June, 1980, to make its rebate application form (4136-T) available to all local IRS offices. In addition, the Department of Transportation has only now begun to collect data on the changes in local ordinances and ride-sharing programs. Additional time and study is essential to determine the effectiveness of this experiment.

Preliminary evidence of the effectiveness of the rebate program in Connecticut is evident in the fixed price shared ride program sponsored by the Waterbury Yellow Cab and Service Company of Waterbury, Connecticut. This program permits a flat rate for shared rides and has proven exceptionally beneficial to these persons on low or fixed incomes who can now anticipate and plan the cost of door to door transportation. Moreover, the program has made transportation more affordable and accessible for those elderly and infirm persons who require door to door transportation.

The Yellow Cab Company of Hartford has purchased 53 new fuel efficient automobiles in the past year, out of a fleet of 58 automobiles. In addition, upon receipt of its outstanding rebate, the company will purchase two additional fuel efficient automobiles. Similar results are reported by such companies as Yellow Cab of New London and Groton, Inc., Union Lyceum Taxi Co., Groton Cab Co., and Waterbury Yellow Cab and Service Co., among many others.

The effectiveness of the federal rebate is also demonstrated in other ways. Many states have adopted gas tax rebates which are intimately linked to the federal policy. Thus, a failure to renew the rebate may have a domino effect on state rebates. Currently, the combined federal and Connecticut rebates amount to 10.5 cents per gallon, or a total of $35,000 annually to the Yellow Cab Co. of Hartford. Moreover, the rebate enhances the financial statement of companies, enabling them to obtain credit to make purchases of fuel efficient automobiles sooner than would be possible without the rebate.

While our figures are as yet not fully developed, it is clear that there are demonstrable indications that Congressional intent is being realized. It would be detrimental to a notable effort by the Congress to conserve energy by altering the transportation patterns of people if this rebate provision were to die before the experiment has fully run. It would also be inequitable to strike at the heart of a bastion of the free enterprise public transportation industry, by allowing the rebate to die for cab companies while it continues with renewed vigor for federally subsidized modes of public transportation. If the rebate is to die, let it not be through administrative lethargy and Congressional inactivity. We ask that the future of the taxi rebate rest upon clear and convincing evidence that Congressional intendments have or have not been achieved, after a thorough and complete study as mandated by the Congress in 1978. Accordingly, we urge this committee to extend the taxi rebate experiment for a minimum period of one year to permit the accumulation, by the Treasury and Transportation Departments and the Taxi Companies, of data necessary to fully evaluate the taxi rebate program.

STATEMENT BY CAROLINA POWER & LIGHT COMPANY
RECOMMENDING THAT TAX DEFERRED DIVIDEND REINVESTMENT BE A PART
OF INCOME TAX REDUCTION LEGISLATION

This statement is submitted by Carolina Power and Light Company (CP&L), an investor owned electric utility serving a 30,000 square mile area in North Carolina and South Carolina. CP&L is a member of the Edison Electric Institute (EEI), the principal association of investor owned electric power companies in the United States. EEI representatives have consistently supported proposed legislation to encourage capital formation.

CP&L is engaged in a substantial construction program designed to provide reliable electric power to an expanding body of customers. Like other electric utilities, CP&L is encountering difficulty in attracting adequate capital to finance construction. CP&L's financial problems are shared by other investor owned electric utilities in the following respects:

(1) The utilities are capital intensive and are unable to finance major maintenance and construction programs through internal cash generation;

(2) An ongoing need exists for utilities to obtain additional common stock capital in a limited equity capital market; and

(3) Utilities find attracting necessary equity capital through large public offerings in the market place to be difficult and, often prohibitively expensive.

Electric utilities in general are carrying a heavy debt burden and must obtain equity capital to stabilize their capital mix. Recent analyses show that the common stock of a majority of the country's electric utilities' is trading below book value. This condition makes new issues of common stock difficult since each new issue of common stock at a price below book value will dilute the value of the investments held by existing stockholders. The dilution will further depress market value with additional dilution accompanying subsequent stock issues. This sequence of events could ultimately make utility common stock unmarketable.

CP&L and other electric utilities have found that dividend reinvestment plans offer some relief in the effort to attract common stock investors. Dividend reinvestment plans, under which stockholders have the option of automatically investing cash dividends in newly issued common stock, have proved to be an effective approach to obtaining new common stock equity capital. Dividend reinvestment is found to be particularly attractive to small investors, as it offers both convenience and savings on brokerage fees and commissions.

CP&L adopted a Dividend Reinvestment Plan in 1977, at which time 8,280 stockholders elected to participate, contributing an additional $2,300,000 to the company's capital. By May 1980 the number of participants has grown to 10,946 and the 1980 contribution is expected to be about $4,500,000. The equity funds provided by reinvestment are significant and could increase substantially with tax deferral on reinvested dividends. There is a benefit to the company as the reinvested dividends reduce the number of shares which must be sold in large public offerings, causing significant additional market pressures on the stocks' price (likely to already be below book value), and a counter-inflationary benefit to the economy from capital investment rather than consumption.

Income tax deferral on reinvested dividends has been advocated in recently proposed legislation, including H.R. 7015 introduced by Congressman Ullman, H.R. 654 by Congressman Pickle and others, and S. 1543 by Senators Nelson and Bentsen. These proposals are designed to provide incentives for capital formation through tax deferral on reinvested dividends.

Federal income tax is currently imposed at ordinary income tax rates on the value of stock received by a stockholder who participates in a dividend reinvestment plan. The tax discourages participation by stockholders who may need cash dividends to pay the current tax. Tax deferral should greatly increase dividend reinvestment participation, and encourage individual savings and investment as a consequence. Correspondingly, business should benefit from additional common equity capital.

Without tax deferral on reinvested dividends the income tax burden is applied unevenly to investors in different types of stock. Stockholders of a fast growing low dividend company may realize gain only when their stock is sold, which gain is taxed at capital gain rates. As a practical matter utilities are low growth entities which must pay out high dividends taxable currently at ordinary income tax rates. The consequence of this tax discrimination is a higher cost of capital to utilities and higher rates to utility customers.

The ability of electric utilities to provide reliable and adequate energy is contingent upon capital investment in the equity markets and the impact of tax reduction legislation should be considered in terms of the effect it will have on the willingness of stockholders

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to engage in capital formation activities such as automatic dividend reinvestment plans. Therefore, it is the express opinion of CP&L and of other EEI member companies that qualified automatic dividend reinvestment should be afforded an income tax deferral, as provided in H.R. 7015, H.R. 654 and S. 1543.

COMMITTEE FOR EFFECTIVE CAPITAL RECOVERY

formerly Ad Hoc Committee For An Effective Investment Tax Credit

August 6, 1980

Honorable Russell B. Long
Chairman
Senate Committee on Finance
2227 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Chairman:

As discussed with your staff, we are submitting this letter and the enclosed written statement (which was presented to the House Committee on Ways and Means) for inclusion in the record of your hearings on proposals for a tax cut in 1980.

Very briefly, we believe that the "10-5-3" Capital Cost Recovery Act must be enacted at the earliest possible opportunity, for the following reasons:

First, this bipartisan bill, with 307 cosponsors in the House, the majority of whom are Democrats, and 54 cosponsors in the Senate, recognizes the immediate need for divorcing our depreciation rules from the useful life concept, and accelerating our depreciation rate.

Much has continually been said about productivity, particularly in the past 10 years. But United States productivity has steadily been dropping at an alarming rate, and for the past two years, has been negative. No miracle is going to make this change. It will change only through a continuous program of new plant and equipment, and modernization of old plant and equipment. That is what depreciation is all about.

The argument that the enactment of "10-5-3" should wait on the decline of inflation is illogical. Basically it puts the cart before the horse. We cannot wait for inflation to abate before dealing with its causes. One of its principal causes is our rapidly declining productivity.

Second, to argue that Congress cannot adopt a tax cut now because it lacks the discipline to do so, is unfair to the Congress. The issues are not new nor

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unforeseen. Both the Committees and the staffs of the Finance Committee and that of the Joint Committee on Internal Revenue have been studying this issue for over a year. It has been carefully considered and thoughtfully worked out.

Third, if the bill is delayed until next year, much investment will be held up pending adoption of the bill. Even now suggestions are being made that the adjournment date of the Congress be used as the effective date for the depreciation change. How much better would it be for sound business planning if investors knew the magnitude of the depreciation change that will be adopted and would know it now rather than a year from now.

In conclusion, my job is to cope daily with what is happening in our economy as it affects my company. Right now I must tell you that, based on our July production, our economy is in serious difficulty--with a drop in production being the most severe we have yet seen. There is no indication that August will be any better and I would not know how to forecast September.

All signs point toward the need for bold action by the Congress on the economic front. If you believe, as I do, that savings and investment are the real keys to making the United States competitive with its working partners, to lowering real inflation rates, to returning this country to its once great productive eminence, and to continuing our previously growing standard of living for all our people--then it was imperative to pass S. 1435 yesterday, not tomorrow. The least you can do is to pass it now.

Thank you for your consideration of these views.

Sincerely,

George A. Strichman

George A. Strichman
Chairman
Committee for Effective
Capital Recovery

Chairman of the Board
Colt Industries Inc

GAS/nn
Enclosure

COMMITTEE FOR EFFECTIVE CAPITAL RECOVERY

(formerly Ad Hoc Committee For An Effective Investment Tax Credit)

SUMMARY AND STATEMENT OF

GEORGE A. STRICHMAN
CHAIRMAN OF THE BOARD
COLT INDUSTRIES INC.

ON BEHALF OF THE

COMMITTEE FOR EFFECTIVE CAPITAL RECOVERY

ON
PROPOSALS FOR A TAX CUT IN 1980

BEFORE THE

HOUSE WAYS AND MEANS COMMITTEE

July 29, 1980

1901 L Street NW, Suite 303, Washington, D C 20036 (202) 223-3293

COMMITTEE FOR EFFECTIVE CAPITAL RECOVERY

BEFORE THE

HOUSE WAYS AND MEANS COMMITTEE

WASHINGTON, D.C.

JULY 29, 1980

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SUMMARY STATEMENT OF

GEORGE A. STRICHMAN

The Committee for Effective Capital Recovery is a voluntary coalition of 519 business firms and 54 business associations. It is representative of virtually all segments of industry including manufacturing, retail, minerals, transportation and utilities. A list of the member companies and supporting associations is attached (see Appendix A).

My subject on behalf of the members of the Committee for Capital Recovery is the urgent need for improved tax treatment and plant and equipment expenditures. I am here particularly to urge you to enact, this year, H.R. 4646 known as "10-5-3".

Reasons to Act

We believe that H.R. 4646 is designed to deal with the central economic challenge facing America in the 1980s. It will help fulfill our enormous need for capital--for an ever-expanding population, for dramatically increased energy prices, for environmental protection, and for plant modernization. It has been said the action should not be taken in the midst of this inflationary period. But the fact is that to delay enactment of this restorative of productivity will only prolong inflation because the decline of productivity is the root cause of inflation.

- As a result of our failure to revise U.S. tax laws to take into account economic realities, corporations are paying huge federal taxes on illusory profits--profits that result solely from the impact of inflation. These taxes have led to reduced corporate cash flows and inadequate capital investments, which have had a slow but seriously deleterious impact on the economic health of our nation.

- Capital recovery allowances accounted for approximately 88 percent of all business savings in 1979; and business savings comprised approximately 76 percent of total national savings in that year. Thus, if the Congress wishes to increase savings, it must improve capital recovery allowances. H.R. 4646, the "10-5-3" Capital Cost Recovery Act, would improve and simplify capital recovery allowances and would do more to increase savings and enhance our nation's economic health than any other proposal currently before the Congress. Allen Sinai of Data Resources, Inc. estimates that the increase in savings in the nonfinancial corporate sector resulting from enactment of the Capital Cost Recovery Act would range from $5.5 billion in 1980 to $48 billion in 1984.

- The United States has fallen far behind its major trading partners in most key economic indicators; particularly those dealing with productivity. Other nations have recognized the importance of adequate capital recovery allowances and liberalized their tax laws accordingly; some have done so years ago and some recently. The United States has not been effective in this respect. As a result, our capital recovery provisions are far from adequate to meet our needs; and it shows up in a crisis of competitiveness for world markets between the United States and other modern industrial nations.

* * *

In one sense we are here urging not a tax cut, but urging the avoidance of a tax increase in 1981. In FY 1981 social security taxes on individuals will increase by about $10 billion and inflation will increase real income tax liabilities by another $10 billion through erosion of the real value of the tax brackets and other fixed dollar limits in the Code.

In addition, there are other tax increases in the business area of a similar kind. These tax increases taken together will operate as a significant restraint on the economy at a time when it's trying to recover from its present doldrums. The adoption of the bill H.R. 4646 would help to alleviate the depressing effect of these tax increases.

Time to Act is Now

But most important we must enact H.R. 4646 now. In this connection:

1. In my opinion, it would be unwise to wait until some future year for the enactment of this critically important legislation because the depreciation issue holds the key to the easing of a number of outstanding and serious economic problems. Primary among them is inflation. Realistic restraint of inflation depends on stimulation of productivity. And, as my full statement demonstrates, improved productivity is a predictable consequence of the improvement in treatment of depreciation.

2. The argument which I hear that the enactment of "10-5-3" should wait on the decline of inflation is illogical. Basically it puts the cart before the horse. We cannot wait for inflation to abate before dealing with its causes. One of its causes is lack of productivity and increases in costs.

3. To argue that Congress cannot adopt a tax cut now because it lacks the discipline to do so, is unfair to the Congress. The issues are not new nor unforeseen. Both the Committees and the staffs of Ways and Means and that of the Joint Committee on Internal Revenue are among the most experienced in the Congress. They have been dealing with these issues for years and can deal with them now. Further, it's hard to say that the Senate, which is almost certain to have a bill this year, is more able to deal with these issues than is the House.

4. If a tax bill is postponed until next year, there will clearly be further delays. A new Congress in January will first have to organize itself and that will take time. If the concern is that special interests will be able to work their will in the heat of this election year, it is even more likely that with more time available to them they will be even more effective. In other words, it is likely that the bill, if enacted, will not become law until late in the year.

5. If the bill is delayed until next year, much investment will be held up pending adoption of the bill. Even now Chairman Ullman has suggested that the adjournment

date of the Congress be used as the effective date for the depreciation change. How much better would it be for sound business planning if investors knew the magnitude of the depreciation change that will be adopted and would know it now rather than a year from now.

Conclusion

All signs point toward the need for bold action by the Congress on the economic front. H.R. 4646, the Capital Cost Recovery Act, goes to the heart of our economic problems. It is simple. It ties the tax benefit to the economic activity sought to be achieved, that is, the expansion of plant and equipment expenditures. It will not be inflationary but instead will deal with the causes of inflation. It will stimulate employment and output; and its revenue cost is manageable. In the early years it is relatively small. In the later years, 1983-84-85, revenue gains will substantially offset the higher revenue costs expected. Furthermore, the "10-5-3" legislation is designed in such a way as to permit stretching out the transition period or shortening it to meet appropriate revenue targets which the Congress can establish, either now or in the future.

For all these reasons, it is imperative that action be taken in this Congress. Everyone agrees that depreciation changes are long overdue and that U.S. productivity and other economic circumstances require a change in plant and equipment allowances. The techniques for making that change are readily understood and can be adopted quickly. There seems to be no substantial reason for further delay. With all due respect, we urge the Congress to take action immediately.

STATEMENT OF

GEORGE A. STRICHMAN

The Committee for Effective Capital Recovery is a voluntary coalition of 519 business firms and 54 business associations (See Appendix A).

Formerly called the Ad Hoc Committee for an Effective Investment Tax Credit, the Committee has long been active in efforts to improve, strengthen, and make permanent capital cost recovery allowances working initially on the investment tax credit.

In confirmation with its work on the investment tax credit, the Committee has always had the improvement and restructuring of depreciation allowances as one of its key objectives. Indeed, in late 1978 the Committee changed its name to the Committee for Effective Capital Recovery to reflect more accurately the breadth of its policy goals.

I. The Economic Justification for Improved Capital Recovery

A. Low Rates of Savings

Table I shows that Americans are saving a far smaller proportion of their disposable income than are the citizens of the five major industrialized nations. Moreover, the rate for the United States has declined over the past decade, while the rate for the other countries, except possibly West Germany, has increased.

TABLE I

Personal Savings As A Percent
Of Disposable Personal Income

Country	1970	1977
United States	8%	6%
Canada	6%	11%
Britain	6%	11%
West Germany	15%	13%
France	12%	13%
Japan	17%	21%

Source: United Nations, Yearbook of National Accounts Statistics, 1978, Vol. 1, Table 16.

The most recent statistics for the United States provide no encouragement under present tax policies. In 1978, the rate of savings fell to 5.3 percent; in 1979, there was a further drop to 4.5 percent; and in the fourth quarter of 1979, the rate was 3.5 percent, the lowest savings rate since 1951.

2. Business Savings

When business savings are added to the equation, the United States still ranks far behind its trading partners, with the exception of the United Kingdom, as shown in Table II.

TABLE II

Total National Savings As A
Percent of Gross National Product 1978

United States	6%
United Kingdom	7%
West Germany	12%
France	12%
Japan	17%
Canada	9%

Source: United Nations, Yearbook of National Accounts Statistics, 1979.

One of the principal reasons why the United States ranks last in rates of personal savings is that our tax policy discourages savings and productive investment. Individuals find themselves moved for tax reasons to invest in other type of investments. Or they may place their savings in tangible, non-financial investments, such as gold, real estate, antiques, silver, art, rare stamps, and other assets which appreciate rapidly in value, but on which taxes can be deferred.

Japan, West Germany, France, Canada, and the United Kingdom all have formal and informal tax policies which provide significant encouragement for private saving. The fact that the United States lags in such incentives explains in part our comparatively dismal performance with respect to capital investment and rates of productivity growth.

3. Relationship Between Capital Recovery Allowances and Total National Savings

Based on Department of Commerce statistics, business saving as a percent of total national savings was 75.8 percent in 1979. Consequently, business saving is now the largest factor to be considered in an examination of the issue of total national savings.

In turn, the major factors in business saving are the capital recovery allowances of the Internal Revenue Code.

According to the Commerce Department figures, these allowances accounted for 88.0 percent of total business savings in 1979.

It therefore becomes clear that the most effective means of increasing national savings would be to improve our capital recovery allowances. To achieve this goal, I strongly urge you to enact the "10-5-3" Capital Cost Recovery Act. It is estimated by Dr. Allen Sinai of Data Resources, Inc. that the increase in savings in the nonfinancial corporate sector resulting from enactment of the Capital Cost Recovery Act would range from $5.5 billion in 1980 to $48 billion in 1984.

B. Low Rates of Capital Investment and Productivity

The direct relationship between personal savings and investment and productivity growth is described in the Joint Economic Committee's midyear review of the U.S. economy: "Personal saving is a major source of funds for investment and productivity increases."

Having noted the low rate of savings outlined on pages 1-3, it should come as no surprise that the United States ranks last among the major industrialized nations in investment as a percent of gross domestic product, indeed having a ratio of approximately half that in Japan. This is shown in Table III.

TABLE III

Average Annual Ratio of Capital Investment as a Percent of Output*/

1960-78

Japan	28.0
Canada	19.6
Germany	19.4
France	19.0
United Kingdom	17.0
United States	14.7

Source: U.S. Department of Labor, Office of Productivity and Technology, Division of Foreign Labor Statistics and Trade, July 1980.

C. Low Rates of Productivity Growth

Low rates of savings and capital investment lead inevitably to low rates of productivity growth. The U.S. ranks last among its major trading partners in this important respect. Table IV shows the average annual percentage change in productivity for the U.S. compared with those trading partners.

TABLE IV

Average Annual Increases of Output Per Hour in Manufacturing 1960-1979

Japan	8.3 percent
France	5.6 percent
Germany	5.4 percent
Canada	4.0 percent
United Kingdom	3.2 percent
United States	2.5 percent

Source: U.S. Department of Labor, Office of Productivity and Technology, Division of Foreign Labor Statistics and Trade, July 1980.

*/ Capital investment, excluding residential dwellings, as a percent of gross domestic product at factor cost, in current prices for the total economy.

Moreover, the trend for U.S. productivity is ominous. From 1955 to 1965, U.S. productivity increased at an average annual rate of 3.1 percent; from 1965 to 1973, at a rate of 2.3 percent; from 1973 to 1979, 1.2 percent. During 1979, output per hour in the private business sector actually decreased by 0.9 percent. This is only the second time since 1947 that we have seen a decline in the annual rate of productivity growth in this country.

There are some who argue that the United States is going through an inevitable period of low productivity. The truth is that there is nothing inevitable about the decline in American productivity. We have caused it ourselves by discouraging investment while our partners in the free world have been growing in productivity at rates two to three times ours.

Continuation of this trend threatens to destroy America's position as competitive industrial power.

D. Important Effects of Low Rates of Savings, Capital Investment, and Productivity Growth on Key Elements of the United States Economy

1. Inflation and Growth of Real Income

a. Economic Report of the President

The Committee for Effective Capital Recovery strongly agrees with the statement made by President Carter in his 1979

Economic Report to the Congress:

> With slower productivity growth, our living standards individually and as a Nation cannot rise as fast. Slower productivity growth means that the resources available for carrying out governmental programs becomes scarcer. It means that large increases in wages and other incomes put greater upward pressure on costs and prices. If we ignore the realities of slower productivity growth--if governments continue to press forward with unabated claims on resources, and private citizens continue to demand large gains in money incomes--our inflationary problem will worsen.

b. Analysis of the Council on Wage and Price Stability

The Council on Wage and Price Stability, in A Special Report on Inflation (April, 1978), highlighted the relationship between productivity and inflation:

> Trends in labor productivity are important elements of the inflation process. Improvements in output per man hour reduce unit labor costs and provide a wedge between wage increases and higher prices. Thus, productivity growth is a means of improving living standards for all participants in the economy. In its absence increased incomes for some can come only at the expense of reduced real earnings for others.
>
> A sharp falloff in productivity growth has been an important cause of the disappointingly small gains in real

> income over the last decade and it has exacerbated the inflation .... The effect of this slowdown [of productivity] has been to reduce total real incomes by 19 percent in 1977 (the equivalent of $280 billion in today's prices) compared to what would have been achieved by a sustained growth of productivity at the rate of the prior two decades.

c. Relationship Between Capital Investment, Productivity, Wages, and Prices

There is a striking correlation between capital investment and wage rates by industry in this country. Table V shows the most recent data from the Department of Labor on this subject. It shows 1971 capital investment data and compares it with production worker average earnings by related industry group.

TABLE V

CAPITAL INTENSITY AND WORKER EARNINGS

Industry	Capital Per Employee		Production Worker Average Earnings	
	CPE	Rank	Per Hour	Rank
Group 1				
Petroleum & Coal	$ 87,190	1	$ 4.57	1
Chemicals	36,450	2	3.94	3
Primary Metals	35,060	3	4.23	2
Paper	29,440	4	3.67	4
Stone, Clay & Glass	20,550	5	3.66	5
Food	14,160	6	3.38	7
Rubber/Plastics	14,140	7	3.40	6
Tobacco	12,690	8	3.15	8/9
Lumber	10,270	9	3.15	8/9
Miscellaneous	6,490	10	2.97	10
Furniture	5,210	11	2.90	11
Leather	2,530	12	2.60	12
Apparel	2,110	13	2.49	13
Group 2				
Transportation Equipment	12,080	1	4.41	1
Non-Electric Equipment	11,640	2	3.99	3
Fabricated Metals	11,540	3	3.74	5
Ordnance	10,560	4	3.84	4
Instruments	9,410	5	3.52	6
Electrical Equipment	8,830	6	3.48	7
Printing	8,580	7	4.20	2
Group 3				
Textiles	10,840		2.57	

Source: Department of Labor (1971).

Reviewing this data during his testimony before the Joint Economic Committee in mid-1975, then-Secretary of Labor Dunlop concluded:

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

d. International Comparison: Productivity and Wage Rates

There appears to be an inescapable correlation between growth in productivity and improvements in a nation's standard of living and in wage rates. Table VI compares the United States with five industrialized nations in terms of productivity increases and increases in the wages received by workers in those countries. There is a striking similarity in the rankings in each category.

TABLE VI

Comparison of Productivity
and Increases in Hourly Wages

	Avg. Annual Increase of Output per hour in Manufacturing 1960-1979	Rank	Avg. Annual Compound Rate of Change in Hourly Wage for Production Worker 1960-1978	Rank
Japan	8.3%	1	14.9%	1
France	5.6%	2	11.9%	2
Germany	5.4%	3	9.8%	4
Canada	4.0%	4	8.2%	5
United Kingdom	3.2%	5	11.9%	2
United States	2.5%	6	6.5%	6

Source: U.S. Department of Labor, Office of Productivity and Technology, Division of Foreign Labor Statistics and Trade, July 1980.

2. U.S. Balance of Trade

In its days of ever-improving productivity, the United States was not only a major exporter but was also able to keep its imports and exports in a favorable balance. Unfortunately, this is no longer the case. Table VII shows the discouraging trends with respect to the U.S. trade deficit, which reached a level of $29 billion in 1979.

TABLE VII

U.S. Balance on Merchandise Trade

(millions of dollars)

1960	4,892	1970	2,603
1961	5,571	1971	-2,260
1962	4,521	1972	-6,416
1963	5,224	1973	911
1964	6,801	1974	-5,343
1965	4,951	1975	9,047
1966	3,817	1976	-9,306
1967	3,800	1977	-30,873
1968	635	1978	-33,759
1969	607	1979	-29,469

Source: Survey of Current Business, June 1980, U.S. Department of Commerce.

Underlying this trend is the decline in the U.S. share of total manufactured exports worldwide. As a nation, we are falling further behind in international economic competition. To reverse this decline, we simply must act boldly to improve our productivity performance.

In recent years, policymakers have begun to pay closer attention to the relationship between our trade deficit and the value of the dollar, domestic inflation, and the overall strength of our economy. There is now a widespread consensus that we need a strong, coherent, and effective export program. Improved capital recovery allowances can and should be an important ingredient of that program.

E. Impact of Inflation on Real Value of Depreciation Allowances

In January of 1979 Martin Feldstein and Lawrence Summers published a paper on "Inflation and the Taxation of Capital Income in the Corporate Sector." The paper examined the effect of inflation on the taxation of capital used in the nonfinancial sector of the U.S. economy. It concluded that:

> ... the effect of inflation with the existing tax laws was to raise the 1977 tax burden on corporate sector capital income by more than $32 billion, an amount equal to 69 percent of the real after tax capital income of the nonfinancial corporate sector .... This extra tax raised the total effective tax rate from 43 percent to 66 percent of capital income in the nonfinancial corporate sector.

The paper concluded that the principal reason for this increase in the effective tax rate on capital income is that the historic cost method of depreciation causes a major overstatement of taxable profits.

Specifically, Messrs. Feldstein and Summers found that inflation reduced the depreciation allowed on existing plant and equipment by $39.7 billion in 1977. Thus, the impact of inflation on depreciation allowances alone increased corporate tax payments by $19 billion or almost one-third of the $59 billion of corporate tax liabilities for 1977.

The increased taxes resulting from inflation in 1977 should be compared with the revenue cost of the Capital Cost Recovery Act (see page 25). It will be seen that the revenue "losses" resulting from this proposed bill are far less than the increase in corporate taxes due to inflation described and, although a start in the right direction, do not fully restore business profits to the level necessary to offset inflation.

F. International Comparison of Capital Recovery Systems

As indicated earlier, one of the key results of improved capital recovery allowances would be to bring our system in line with the most progressive of our trading partners.

Based on the implications of productivity data and other information, it is widely assumed that some of our trading partners (Japan and West Germany, for example) already have relatively more modern plants and equipment than does the United States. One of the principal reasons for this situation is the fact that for years Japan and West Germany provided capital recovery allowances which were far more realistic than those in the United States.

The United Kingdom and Canada, which have had levels of plant and equipment modernization far closer to those of the

United States than the levels of Japan or Germany (see productivity data set forth on page 6), have come to recognize the importance of adequate depreciation. They liberalized their depreciation systems and are now far more effective in providing for more adequate capital formation than is the United States.

Specifically, the United Kingdom permits 100 percent of the cost of machinery to be written off in the year of purchase. Similarly, Canada permits machinery and equipment to be written off over a two-year period. By these standards, the United States is obviously far out of date.

A full comparison of the major industrialized nations has been provided by Price Waterhouse and it is attached as Appendix B.

II. The Capital Cost Recovery Act of 1979

Clearly, there is overwhelming evidence of the need for improved capital recovery allowances in our tax system. Although there are other ways to move toward this goal, the Capital Cost Recovery Act of 1979 seems to be the most practical and effective approach.

The "10-5-3" proposal would greatly simplify our capital recovery system and accelerate the recovery. It would remove at last the useful live concept from our tax code and replace it with a more reasonable and simpler method of computing depreciation allowances. It would remove the factor of salvage values in capital recovery computations. It would strengthen the investment tax credit. Capital recovery allowances and the investment tax credit would no longer be deferred until the property is placed in service but rather would be allowable in the taxable year in which funds are expended to acquire the property. The Capital Cost Recovery Act would also remove the distinction between investments in new and used property for purposes of capital cost recovery allowances.

The bill would substantially benefit small businesses by replacing the current complexity of the Asset Depreciation Range system. A Treasury Department study completed in 1974 (the most recent data available) found that only one-half of one percent of all corporations with less than $5 million in total assets elected the ADR system. Thus, even the modest benefits of the last major improvements in depreciation (20 percent ADR) are readily usable for only a small portion of American businesses. By way of contrast, the Capital Cost Recovery Act is simple, direct, and can be used by large and small businesses alike. Table VIII shows the results of the Treasury study.

TABLE VIII

Use of ADR by U.S. Corporations

Size of Total Assets	Total Number Of Firms In Population	Firms Electing ADR Number	Percent
$1 to $500,000	1,493,000	5,482	0.4
$1M to $5M	42,000	1,788	5.0
$5M to $10M	5,000	665	13.0
$10M to $50M	4,000	991	38.0
$50M to $100M	625	804	49.0
$100M to $200M	396	242	61.0
$200M to $300M	156	107	69.0
$300M to $600M	203	167	82.0
$600M to $1B	88	80	91.0
Over $1 Billion	166	152	94.0
Total	1,601,634	11,042	0.7

Source: 1974 Statistics of Income, Department of Treasury.

A. Effectiveness of "10-5-3" in Stimulating Investment

There appears to be a growing consensus that enactment of legislation along the lines of "10-5-3" would be an extremely effective and efficient way to stimulate increased capital investment. The following items are submitted as evidence of this view:

- Unanimous report of the Joint Economic Committee, March 1979: "Some of the tax changes in the Revenue Act of 1978 will stimulate investment, but these are not sufficient. The Committee believes that per dollar of revenue loss, liberalization of depreciation allowances would be the most efficent stimulant.

- Statement by the Honorable G. William Miller, then-Chairman of the Federal Reserve Board, before the Commonwealth Club of California, July 19, 1979: "My own proposal has been that we endorse a simple formula: 1-5-10. 1-5-10 stands for a new policy of liberalized depreciation under which all mandated investments for environment, safety and health would be written off in one year; all new investments for productive equipment would be written off in five years; and all capital in structures and permanent facilities would be written off in 10. This acceleration of the depreciation allowance offers the most direct and efficient way to boost investment, for two reasons: first, accelerated depreciation ties each dollar of revenue loss directly to capital investment; and, second, because this formula reduces risk and thus gives strong incentive for investment in the cost-saving and modern production facilities. Our estimates indicate that 1-5-10, after five years, could raise the investment share of output close to 1 per cent higher than what it would otherwise have been."

- Statement by Allen Sinai before the Committee for Effective Capital Recovery, September 13, 1979: "Of the various tax incentives to capital formation most often considered, the impacts from the accelerated capital recovery rank near the top in terms of instrument effectiveness. Only the investment tax credit would produce an equivalent or greater bang-for-a-buck."

- In addition, the Capital Cost Recovery Act has been cosponsored by over 300 Members of the House and is supported by the National Association of Manufacturers, Business Roundtable, Chamber of Commerce, National Federation of Independent Business, and the American Council for Capital Formation and virtually every business organization in the United States which has studied the matter.

B. Application of the Capital Cost Recovery Act to Structures

Notwithstanding the evidence in support of the Capital Cost Recovery Act, a degree of controversy has arisen with respect to the provision of S. 1435 which would require a ten-year write-off for nonresidential buildings and structures.

The Committee for Effective Capital Recovery believes that the ten-year depreciation schedule is an extremely important component of the "10-5-3" bill. We subscribe to the views outlined by then-Secretary of the Treasury Michael Blumenthal in his testimony before the House Ways and Means Committee on January 30, 1978:

> ... a particularly weak aspect of the current economic recovery is the low rate of business investment in long-lived structures; investment in structures reached its peak almost four years ago and is now 11 percent below that level. The tax preference for depreciation of structures has been reduced through the operation of the 'recapture' rules and the minimum tax ....

While Secretary Blumenthal's statement was in support of the Administration's proposal to have structures qualify for the investment tax credit, the argument applies equally well to the need for improved depreciation allowances for buildings and structures. In the case of the "10-5-3" legislation the recapture rule for buildings has also been tightened.

President Carter's recently assured the building and construction workers union that construction would not be unduly burdened by the 1980 economic recession because of progress he would initiate. Short of a major and costly program of direct federal funding of building construction, we can think of few better ways to help the President keep his promise than to improve depreciation allowances for buildings.

C. Similarity of the Effects of Capital Cost Recovery Act and Indexing

One of the principal arguments for improved capital recovery allowances is that inflation significantly erodes the real value of depreciation allowances, thereby increasing the net cost of corporate investments.

One method of addressing this problem is to simply index depreciation allowances, *i.e.*, adjusting the value of allowable depreciation each year for the rise in the consumer price index since the previous year.

Dr. Martin Feldstein circulated a paper in October, 1979 comparing the effectiveness of indexing with accelerated depreciation*/ in eliminating the impact of inflation on the net cost of capital investments.

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*/ The specific accelerated depreciation proposal studied by Dr. Feldstein was the proposed Capital Cost Recovery Act of 1979.

The paper concluded that "for moderate rates of inflation and real discount rates, the acceleration proposal ("10-5-3") and full indexation are quite similar."*/

The following is an excerpt from the Feldstein analysis:

> The figures in [Table IX] indicate that the specific acceleration proposal is a quite close approximation of indexing at moderate rates of inflation and real interest. This also implies that the acceleration would essentially offset fully the effects of inflation under existing historic cost depreciation. Consider, for example, equipment with an allowable depreciation period of 13 years, an economy with an 8 percent rate of inflation, and an investor with a 4 percent real rate of discount. ... [Table IX] shows that the acceleration proposal would eliminate almost all of the increased cost under these circumstances. In particular, the real net cost is only three percent higher with the shortened depreciation life than it would be with complete indexation.
>
> ... The relative net cost of acceleration and indexing remains between 0.9 and 1.1 for almost all combinations of real discount rates between 4 and 7 percent, inflation rates between 4 and 12 percent, and lives between 3 years and 25 years. ...

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*/ It should also be noted that Dr. Feldstein found that "For low rates of inflation, high discount rates, or very long-lived investments, the acceleration proposal causes greater reductions in net costs than would result from complete indexing. Conversely, for high rates of inflation, low discount rates, or very short-lived investments, the acceleration method fails to offset the adverse effects of inflation."

TABLE IX

The Relative Net Cost of Equipment Investment

with the Acceleration ("10-5-3") and Indexing Proposals

Real Discount Rate	Inflation Rate	Allowable Depreciation Life Under Existing Law (Years)					
		3	8	13	18	25	35
0.0	0.00	0.87	1.00	1.00	1.00	1.00	1.00
	0.04	0.94	1.08	1.08	1.08	1.08	1.08
	0.08	1.00	1.15	1.15	1.15	1.15	1.15
	0.12	1.05	1.21	1.21	1.21	1.21	1.21
	0.16	1.10	1.27	1.27	1.27	1.27	1.27
0.04	0.00	0.89	0.96	0.92	0.88	0.84	0.79
	0.04	0.96	1.03	0.98	0.94	0.89	0.84
	0.08	1.01	1.08	1.03	0.99	0.94	0.89
	0.12	1.05	1.13	1.08	1.04	0.99	0.93
	0.16	1.09	1.18	1.12	1.08	1.02	0.97
0.07	0.00	0.91	0.94	0.88	0.84	0.79	0.75
	0.04	0.96	1.00	0.94	0.89	0.84	0.79
	0.08	1.01	1.05	0.98	09.3	0.88	0.83
	0.12	1.05	1.09	1.02	0.97	0.92	0.86
	0.16	1.09	1.13	1.06	1.01	0.95	0.89

Each figure in the table is the ratio of the net cost of equipment investment with the acceleration proposal divided by the net cost of the investment with complete indexing.

Dr. Feldstein notes that in the final analysis the choice between accelerated depreciation ("10-5-3") and indexing "requires balancing the administrative simplicity and other possible advantages of acceleration against the automatic protection that indexation offers against the risk of significant changes from the recent inflation rates and discount rates."

The Committee for Effective Capital Recovery believes that the Congress should opt for the Capital Cost Recovery Act of 1979 (H.R. 4646). It would be more practical to achieve in the Congress and would be far more likely to be used by all businesses, both large and small. Indexation would likely present enormous problems of complexity and record keeping burdens for small businesses, which are the principal reasons why the current ADR system has proven so ineffective for that sector of our economy.

D. Economic Impact of "10-5-3"

Allen Sinai, Vice President and Senior Economist of Data Resouces Inc., prepared an analysis of the proposed Capital Cost Recovery Act,*/ using the DRI Model of the U.S. economy. The DRI analysis assumes that the proposed bill is enacted and will be effective for taxable years ending after December 31, 1979. The DRI analysis is attached to this testimony as Appendix C.

*/ One difference between the simulation and the proposed legislation (S. 1435 and H.R. 4646), is that the latter uses a five-year transition period for Class I property (buildings) and the DRI analysis assumed a ten-year period. Thus, both the stimulus from the measure and revenue loss are somewhat underestimated.

Of the tax incentives for capital formation most often considered, Data Resources, Inc. found that the accelerated capital recovery proposal is particularly effective. The program would provide strong stimulus to business fixed investment, real economic growth, productivity, and employment, without a significant rise in inflation.

The analysis done with the DRI model (see Table X) indicates that the "10-5-3" proposal would raise real business fixed investment by $10 billion per year between 1980 and 1984, would boost the growth of real GNP by 0.3 percent annually, and would increase productivity growth by 0.7 percent. An additional 500,000 persons would be employed by 1984 who would not be employed without enactment of the Capital Cost Recovery Act.

TABLE X

Incremental Economic Effect of the "10-5-3" Accelerated Capital Recovery Program*/

"10-5 Phase-In," DRI Model Simulation Results

	1980	1981	1982	1983	1984
Real Business Fixed Investment	0.2	4.1	9.8	15.3	20.9
Real Equipment Spending	0.2	3.2	7.4	11.7	16.3
Real Plant Spending	0.1	0.9	2.4	3.6	4.5
Revenue Losses					
With Feedback	4.2	9.8	11.8	14.6	16.1
Without Feedback (i.e., static)	4.8	12.6	19.2	26.3	32.9
Productivity Growth (%)					
Increase Over Current Law	0.1	0.6	0.7	1.0	0.9
Additional Growth in Real GNP (%)	0.0	0.4	0.3	0.4	0.4
Added Employment (Millions)	0.0	0.1	0.2	0.4	0.5

*/ Billions of Dollars, Relative to Baseline.

Because of the stimulus to the economy which careful calculations show would result from this bill, it would be partially self-financing. The study shows revenue costs both with and without feedback from other parts of the economy. The benefits of cash flow are partly paid for by increases in employment, productivity, and GNP.

The large cash flow generated by the improved capital recovery would provide financing for a higher rate of capital expenditures. The ratio of cash flow to capital outlays of nonfinancial corporations should rise five to six percentage points higher than the baseline case, yielding a much stronger financial position for the nonfinancial corporate sector as a result of the measure. Particularly in view of the very high interest rates business is facing, every extra dollar of internally generated capital means a reduction in interest costs that can either be passed along to consumers in the form of lower prices or recycled again within the company in the form of additional investment.

The DRI concludes that apart from the investment tax credit the "10-5-3" plan would have a more favorable impact on the economy (more "bang for the buck") than would occur from any other tax policy change studied.

III. Conclusion

For all of these reasons, the Committee for Effective Capital Recovery supports prompt enactment of S. 1435.

It should be remembered that what is involved here is not tax forgiveness but rather deferral of tax revenues. At a reasonable cost in terms of deferred corporate tax payments, passage of this legislation will constitute a significant step in the direction of improving the productivity performance of our nation's economy. This improved productivity will mean a higher standard of living for American families, an enhanced competitive posture in world trade, a fiscally healthier business community, and, ultimately, will hold the key to breaking the inflation spiral that threatens us all.

APPENDIX A

COMMITTEE FOR EFFECTIVE CAPITAL RECOVERY

MEMBERSHIP

July 15, 1980

AMCA International Corporation
AMP Incorporated
ASARCO, Incorporated
A-T-O, Inc.
Acme-Cleveland Corporation
Air Products and Chemicals Inc.
Airco, Inc.
Akzona Incorporated
Albany International Corp.
Allegheny Ludlum Industries, Inc.
Allegretti & Company
Allen-Bradley Co.
Allied Products Corporation
Allis-Chalmers Corporation
ALUMAX, Inc.
Aluminum Casting & Engineering Co.
AMAX, Inc.
Amerace Corporation
American Brands, Inc.
American Can Company
American Financial Corporation
American Greetings Corporation
American Hoechst Corporation
American Hoist & Derrick Co.
American International Group, Inc.
American Natural Service Company
American Petrofina, Inc.
American Thread Company
Ampex Corporation
Amtel, Inc.
Anchor Hocking Corporation
Apache Corporation
Arcata National Corporation
Arkansas Best Corporation
Arrow Gear Co.
Arvin Industries, Inc.
Ashland Oil, Inc.
Atlantic Metals Corporation
Atlantic Richfield Company
Automatic Catering, Inc.
Avnet, Inc.
Avon Products, Inc.

Bache Halsey Stuart Shields Inc.
Ball Corporation
Baltimore Gas and Electric Co.
BankAmerica Corporation
Barry Wright Corp.

Bartlett-Brainard & Eacott, Inc.
Baxter Travenol Laboratories Inc.
Bear Creek Corporation
Beard Oil Company
Beatrice Foods Co.
Beech Aircraft Corporation
Belden Corp.
Bell & Howell Co.
Bemis Company, Inc.
Beneficial Corporation
Betz Laboratories, Inc.
Big V Supermarkets, Inc.
Black & Decker Mfg., Co.
Blandin Paper Co.
Bloom Engineering Company, Inc.
Blue Bell, Inc.
Blue Ridge Stone Corp.
The Boeing Company
Bowater Incorporated
Brunswick Corporation
Bucyrus-Erie Company
The Budd Company
Bunker Ramo Corporation
Burlington Industries, Inc.
Burroughs Corporation
Bush Brothers & Company
Butler Manufacturing Company

CBS Inc
CCI Corporation
C/E Construction Company
CF Industries, Inc.
California Casualty Insurance Group
Carlisle Corporation
Carnation Company
Carolina Freight Carriers Corp.
Carpenter Technology Corporation
Carrier Corporation
Casa Grande Valley Newspapers Inc.
Castle & Cooke, Inc.
The Ceco Corporation
Cessna Aircraft Company
Champion International Corp.
Chart House Inc.
Chemetron Corporation
The Chesapeake Corporation of Virginia
Chesapeake and Ohio Railway Company
Chesebrough-Pond's Inc.
Chicago Bridge & Iron Company
Chicago Pneumatic Tool Company
Chloride Incorporated

Christie Electric Corp.
Chromalloy American Corporation
Cincinnati Incorporated
The Cincinnati Mine Machinery Co.
Citibank N.A.
Cities Service Company
The Citizens and Southern National Bank
City Investing Company
Clark Equipment Company
Clearprint Paper Company, Inc.
Clow Corporation
Coachmen Industries, Inc.
Coastal States Gas Corp.
Coats & Clark Inc.
The Coca-Cola Bottling Co. of New York, Inc.
Coca-Cola Bottling Co. of South Arkansas
Collins & Aikman Corporation
Colt Industries Inc
Columbia Gas System Service Corporation
Columbus McKinnon Corporation
Commercial Shearing, Inc.
Comtel Corp.
ConAgra, Inc.
Concise Casting Corporation
Congoleum Corporation
Connecticut General Insurance Corp.
Conoco Inc.
Consolidated Foods Corporation
Consolidated Freightways, Inc.
Consolidated Papers, Inc.
Consumers Power Co.
Consumers Steel Co. Inc.
Container Corporation of America
Continental Group, Inc.
Continental Illinois Corporation
Continental Machines, Inc.
Continental Telephone Corporation
Cooper Industries, Inc.
Cooper Tire & Rubber Company
Copper Range Company
Crankshaft Machine Company
Crocker National Bank
Crompton & Knowles Corp.
Crouse-Hinds Company
Crutcher Resources Corp.
Cubic Corp.
Cyclops Corporation
Cyprus Mines Corporation

Dana Corporation
Dart Industries, Inc.
Dataproducts Corporation
Daylin, Inc.
Dearborn Rubber Corporation
Deere & Company
De Kalb Agresearch, Inc.
DeLaval Turbine, Inc.
Delsteel, Inc.
Delta Brick & Tile Company, Inc.
Delta Steamship Lines, Inc.
Dennison Manufacturing Company
Detroitbank Corporation
Diamond Shamrock Corporation
Dibrell Brothers, Inc.
A. B. Dick Company
Di Giorgio Corporation
Digital Equipment Corp.
Dixie Yarns, Inc.
DoAll Company
Dominion Mortgage & Realty Trust
Donaldson Company, Inc.
R. R. Donnelley & Sons Company
Dover Corporation
Dresser Industries, Inc.
Dynamics Corporation of America

ESB Ray-O-Vac Corporation
E-Systems, Inc.
Eagle-Picher Industries, Inc.
Earth Resources Company
Eastern Gas and Fuel Associates
Jas. D. Easton, Inc.
Eaton Corporation
The Echlin Manufacturing Company
Economics Laboratory, Inc.
Edwards Brothers Incorporated
EL-GE Potato Chip Co., Inc.
Elgin National Industries, Inc.
The Elk Cotton Mills
Davis H. Elliot Co., Inc.
Eltra Corporation
Emerson Electric Co.
ENTELCO Corporation
Erb Lumber Co.
Erie Castings Company
Esmark, Inc.
Eubanks Engineering Co.
Evans Products Company
Everett/Charles, Inc.
Ex-Cell-O Corporation

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

GK Technologies Incorporated
Gamble-Skogmo, Inc.
Gannett Co., Inc.
Gast Manufacturing Corporation
General Care Corp.
General Cinema Corporation
General Dynamics Corporation
General Foods Corporation
General Portland Inc.
General Signal Corporation
General Telephone & Electronics Corp.
Getty Oil Company
Giddings & Lewis, Inc.
Gifford-Hill & Company, Inc.
Globe-Union, Inc.
Gould, Inc.
W. R. Grace & Co.
Grafton Foundry Company
Great Northern Nekoosa Corporation
Green Bay Packaging Inc.
Greif Brothers Corporation
Greyhound Leasing and Financial Corp.
S. J. Groves & Sons Company
Grow Group, Inc.
The Guardian Life Insurance Company of America
Gulf Oil Corporation

H & H Industries, Incorporated
Hannaford Bros. Co.
Harnischfeger Corporation
Harris Corporation
Harris Trust & Savings Bank
Harsco Corporation
Hart Schaffner & Marx

Hayes-Albion Corporation
Walter E. Heller International Corp.
Hesston Corporation
Hewlett-Packard Company
Hillyer Corporation
Edward Hines Lumber Company
Houdaille Industries, Inc.
Household Finance Corporation
Harvey Hubbell, Inc.
S. E. Huffman Corp.
Hughes Tool Company
Hurco Manufacturing Co., Inc.
Hyster Company

IC Industries, Inc.
IU International Corp.
Iandoli's Super Markets, Inc.
Ideal Basic Industries, Inc.
Illinois Tool Works Inc.
Ingersoll-Rand Company
Inland Steel Company
Intel Corporation
International Business Machines Corporation
International Minerals and Chemical Corporation
International Multifoods Corp.
International Paper Company
International Telephone & Telegraph Corp.

JLG Industries, Inc.
Jewel Companies, Inc.
Johns-Manville Corp.
Johnson & Johnson
Earle M. Jorgensen Co.
Josten's Inc.
Joy Manufacturing Company

Kaiser Cement Corporation
Kaman Corporation
Keebler Company
Kennametal Inc.
Kennecott Copper Corporation
Kerr-McGee Corporation
Kingsbury Machine Tool Corporation
Kirsch Company
Kraft, Inc.
Kuhlman Corporation
Kysor Industrial Corp.

The LTV Corporation
Laclede Steel Company
Lakeview Forge Company

Lampert Lumber Company
Lance, Inc.
Land O'Lakes, Inc.
Lear Siegler, Inc.
Leaseway Transportation Corp.
K. O. Lee Company
Lehigh Portland Cement Co.
Edw. C. Levy Co.
Liggett Group Inc.
Lockheed Corporation
Longyear Company
The Louisiana Land & Exploration Co.
Louisiana-Pacific Corporation
Lucky Stores, Inc.
Ludlow Corp.
Lukens Steel Company

McCall Oil & Chemical Corporation
McGraw-Edison Company
McJunkin Corporation
McKee Baking Company
McQuay-Perfex Inc.

MBPXL Corporation
MCA Inc.
Macmillan, Inc.
Marathon Manufacturing Company
Marathon Oil Company
The Marmon Group
Marquette Company
Marriott Corp.
Maryland Cup Corporation
Masonite Corporation
Massachusetts Mutual Life Insurance Co.
A. T. Massey Coal Company Inc.
The Mead Corporation
Medical Mutual of Cleveland, Inc.
Melville Corporation
Memorex Corp.
Menard, Inc.
Merrill Lynch, Pierce, Fenner & Smith Inc.
Mesa Petroleum Company
Michigan General Corporation
Michigan National Corp.
Microdot, Inc.
Midland-Ross Corporation
Milliken & Company
Mitchell Energy & Development Corporation
Modern Industrial Engineering Co.

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Modine Manufacturing Company
Mohasco Corporation
Monsanto Company
Moore McCormack Resources, Inc.
NCR Corporation
NL Industries, Inc.
NVF Company
Nabisco, Inc.
Nalco Chemical Company
National Automatic Tool Company
National Distillers & Chemical Corporation
National Gypsum Company
National Presto Industries, Inc.
National Semiconductor Corp.
National Starch & Chemical Corporation
Newmont Mining Corporation
Norris Industries, Inc.
Northwest Industries, Inc.
Northwestern Steel & Wire Co.
Northern Natural Gas Co.

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

Pantasote Company
Parker-Hannifin Corp.
The Parker Pen Company
Peabody International Corporation
Pechiney Ugine Kuhlmann Corporation
Pennsylvania Power & Light Company
Pepsico, Inc.
Perkin-Elmer Corporation
Peter Paul, Inc.
Phelps Dodge Corporation
Philip Morris Incorporated
Phillips Petroleum Company
Pitney-Bowes, Inc.
Pittsburgh-Des Moines Steel Company
Pittsburgh Forgings Company
Pittsburgh & Lake Erie RR.
Pittway Corporation
Portec, Inc.
Porter Paint Co.
Potlatch Corp.
Processed Plastic Company

Public Service Electric & Gas Company
Purex Corporation

Raybestos-Manhattan, Inc.
Red Wing Shoe Company, Inc.
Reeves Brothers, Inc.
Reliance Electric Company
Republic Corporation
Riegel Textile Corp.
Ring Power Corporation
H. H. Robertson Co.
The Roegelein Company
A. H. Robins Company, Inc.
Rockwell International Corp.
Rogers Corporation
Rohm and Haas Company
Rohr Industries, Inc.
Roper Corporation
Roto-Finish Co.
Royal Industries
Rubbermaid, Inc.
Russell Corporation

SPS Technologies, Inc.
Safeguard Industries, Inc.
Safeway Stores, Inc.
St. Joe Minerals Corporation
St. Regis Paper Company
Sangamo Energy Management
Santa Fe Industries, Inc.
Scientific-Atlanta, Inc.
Scott, Foresman & Company
Scott Paper Company
Scovill Inc.
Seaboard Coast Line Industries, Inc.
Sea-Land Service, Inc.
G. D. Searle & Co.
Sears, Roebuck and Co.
Seattle-First National Bank
The Signal Companies, Inc.
Signode Corp.
SmithKline Corporation
Snap-on Tools Corporation
Soundesign Corp.
Southern Railway System
Southwest Forest Industries
Southwestern Portland Cement Company
Sprague Electric Co.
Stanadyne, Inc.
Standard Brands Incorporated

Standard Oil Co. of California
Standard Oil Co. (Indiana)
Standard Oil Co. (Ohio)
Standard Register Co.
Standex International Corporation
Stanley Home Products, Inc.
The Stanley Works
Stauffer Chemical Company
Steiger Tractor Inc.
Sterling Drug Inc.
J. P. Stevens & Co., Inc.
Storage Technology Corp.
Sun Company, Inc.
Sunbeam Corporation
Sundstrand Corporation

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

U A L Inc.
UOP Inc.
UV Industries, Inc.
Uarco, Incorporated
Unarco Industries, Inc.
Union Camp Corporation
Union Carbide Corporation
Union Pacific Corporation
United States Borax & Chemical Corp.
United States Filter Corporation

The United States Shoe Corporation
U.S. Tobacco Co.
United Telecommunications, Inc.
Universal Leaf Tobacco Co.
VF Corporation
VSI Corporation
The Valeron Corporation
Van Dorn Company
Van Pelt Corporation
Varo Inc.
Vollrath Co.
Vulcan Materials Company

Walker Magnetics Group, Inc.
Wallace Murray Corporation
Ward Foods, Inc.
Warner-Lambert Company
Warner & Swasey Company
Wawa, Inc.
Wean United, Inc.
Western Electric Co., Inc.
Western Publishing Company
Westinghouse Electric Corporation
Weyerhaeuser Co.
Wheelabrator-Frye Inc.
Whirlpool Corporation
White Castle System, Inc.
Williamhouse-Regency Inc.
The Williams Companies
Wilsey Bennett Co.
Winn-Dixie Stores, Inc.
Woodward Governor Company
Woolrich, Inc.
F. W. Woolworth Co.
Wm. Wrigley Jr. Co.
Wylain, Inc.
Wyman-Gordon Co.

Xerox Corporation

COMMITTEE FOR EFFECTIVE CAPITAL RECOVERY

SUPPORTING ASSOCIATIONS

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

APPENDIX B

COMPARISON OF COST RECOVERY ALLOWANCES

The following table summarizes a comparison of cost recovery allowances for industrial machinery and equipment in leading industrial countries with similar allowances in the United States. The capital cost recoveries for each of the countries have been computed on the assumption that the investment qualifies for any special allowances, investment credits, grants or deductions generally permitted.

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

March 28, 1979

Comparison of Cost Recovery Allowances

	Representative cost recovery periods (years)	Aggregate cost recovery allowances (percentage of cost of assets) First taxable year	First 3 taxable years	First 7 taxable years
United Kingdom	1[1]	100.0	100.0	100.0
Canada	2[2]	60.1	108.3	108.3
	2[3]	64.2	111.7	111.7
Sweden	4[4]	48.2	86.2	118.2
Italy	6[5]	25.0	75.0	100.0
Australia	6[6]	50.0	70.0	110.0
	8[7]	30.0	50.0	90.0
Japan	8[8]	37.2	66.6	96.8
France	8[9]	31.3	67.6	94.6
Netherlands	8[10]	36.0	56.0	96.0
	9[11]	24.0	44.0	84.0
Germany	10[12]	25.0	57.8	86.7
Belgium	10[13]	26.0	54.8	86.3
United States				
1962 Law	10[14 15]	30.7	56.1	86.1
1969 Law	12[16]	16.7	42.1	72.1
1971 Law	8[14 17]	35.1	64.8	97.0
1975 Law	7[16 18]	41.1	70.8	103.0
1978 Law	7[18 19]	42.8	72.5	104.7

Comparison of Cost Recovery Allowances

Footnotes

[1]Full cost recovery the first taxable year.

[2]Canada has an investment tax credit of 5 percent of the cost of new buildings, machinery and equipment to be used in manufacturing and processing and other specified activities. The cost of the property acquired is reduced for federal tax purposes by the investment tax credit received. Canada permits 50 percent of the cost of machinery to be recovered the first year and the other 50 percent in the following year.

[3]Assumes that the 7 percent investment credit as proposed by the 1979 Budget will be enacted.

[4]Sweden has a 25 percent investment allowance. The investment allowance, which does not affect the basis of the asset for depreciation purposes, is deductible for state corporation income tax purposes but not for municiple corporation income tax purposes. This results in an effective additional investment allowance of 18.2 percent.

Forty percent of a Swedish corporation's taxable income may be allocated to a reserve for future investment in fixed assets. Where the acquisition is deemed to have been made from this reserve, full cost recovery occurs before the investment is made.

[5]Straight line depreciation with 15 percent additional depreciation in each of the first three taxable years.

[6]Depreciation in Australia is based on an estimate of "effective life" and taxpayers may elect to use either the prime cost (straight line) method or the 150 percent diminishing value (declining balance) method. In addition, a 40 percent investment allowance for new property may be deducted from the tax base in the year the property is ready for use. This investment allowance is reduced to 20 percent for assets acquired pursuant to a contract entered into after June 30, 1978 or placed in service after June 30, 1979 (regardless of the date the contract was entered into). This calculation assumes the machinery was purchased prior to June 30, 1978 and therefore eligible for the 40 percent allowance.

[7]Assumes the machinery is eligible for the 20 percent allowance (see footnote 6).

[8]A declining balance method of depreciation is used. The current rate is 206 percent on an asset with a 10-year life. The computation assumes that the 10 percent investment tax credit (equivalent to a 16.6 percent deduction at the present national and local maximum tax rate) is available. This investment credit, however, may be abolished in 1979.

[9]250 percent declining balance depreciation, which is switched to straight line after the fifth year. Although not considered, effect may be given to multiple shift operations by reducing the service life of the assets.

[10]Straight line depreciation. A 7 percent premium for new investments in fixed assets is given in the form of an investment tax credit. If the total of the premiums exceeds the tax liability, the excess of the premium over the tax liability is payable in cash to the taxpayer.

In addition, bonus premiums from 0.25 to 6 percent for small investments up to Dfl 800,000 ($398,000) is available. This calculation assumes machinery is eligible for this 6 percent bonus premium. The tax benefit for the premiums is computed using a 48 percent corporate tax rate.

[11]Assumes machinery is only eligible for the 7 percent premium for investment (see footnote 10).

[12]250 percent declining balance depreciation.

[13]Double declining depreciation which is switched to straight line after the fifth year. As a temporary measure to promote investments, a one-time special deduction of 15 percent is allowed on certain acquisitions of fixed assets made during 1979 and 1980. The special deduction will be allowed to the extent that 1979 or 1980 investments in fixed assets exceed the average annual investments for the years 1974 to 1976. The 15 percent deduction is only applicable to a maximum of 40 percent of the total new investments.

[14]The tax benefit of the investment credit is computed using a 50 percent corporate tax rate. Therefore, the investment credit increases the capital cost recovery by 14 percent the first year for a 7 percent credit and by 20 percent the first year for a 10 percent credit. The credit does not reduce the recoverable base cost.

[15]Guideline life of 12 years and 7 percent investment credit. Double declining balance depreciation, which is switched to straight line after the sixth year.

[16]Guideline life of 12 years but no investment credit. Double declining balance depreciation, which is switched to straight line after the sixth year.

[17]ADR life of 9.5 years and 7 percent investment credit. Double declining balance depreciation, which is switched to straight line after the fifth year.

[18]ADR life of 9.5 years and 10 percent investment credit. Double declining balance depreciation, which is switched to straight line after the fifth year.

[19]The tax benefit of the investment credit is computed using a 46 percent corporate rate. Therefore, the investment credit increases the capital cost-recovery by 21.7 percent for the first year. Computation assumes that the assets do not qualify fo the additional 10 percent investment credit for energy savings property or the one percent ESOP credit.

APPENDIX C

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Economic Impacts of Accelerated Capital Cost Recovery

by Allen Sinai
Vice President and Senior Economist
Data Resources, Inc.

Speech before the Committee for Effective Capital Recovery, presented in the Caucus Room, Cannon House Office Building, Thursday, September 13, 1979.

Economic Impacts of Accelerated Capital Cost Recovery

by Allen Sinai*

During the past twenty years, Federal tax policy has been used in several ways: first, as a contracyclical tool to stabilize the economy; second, to promote spending in socially desirable areas; and third, to improve the structure of the tax system. In the decade of the 60s, tax policy was designed primarily to stimulate economic growth and close the gap between potential and actual output. In the 70s, a series of adjustments to limit the drag of a tax system buffeted by inflation and measures to enhance household and business saving have been put into place.[1]

What tax policies are appropriate for the 80s? What are the goals to be accomplished? Does "accelerated capital recovery" fit into the "optimal" tax policy framework of the 80s? In particular, how would the Capital Cost Recovery Act of 1979 impact on the U.S. economy? What would be its benefits and costs? And, how does the accelerated depreciation that is the hallmark of the Capital Cost Recovery Act rank in the range of potential tax actions that could be undertaken?

In brief:

- Tax policy for the 1980's should be concerned with promoting capital formation and increasing productivity to help lessen the severe inflation that is plaguing the U.S. economy. This means tax measures favoring saving and business investment spending are preferable to more typical aggregate demand policy stimuli, such as across-the-board cuts in personal income taxes. A measure such as the Capital Cost Recovery Act of 1979 should be seriously considered for implementation, since both capital formation and business saving would be enhanced by its enactment.

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*The research reported here was based on work done with the DRI Model of the U.S. Economy, in a series of studies prepared for the Committee for Effective Capital Recovery. Terry Glomski of Data Resources collaborated in the studies that were performed.

[1] Tax policy to stabilize the economy was employed in 1964 (rate reductions for both personal income and corporate profits taxes), 1968-70 (tax surcharge on personal income and elimination of the investment tax credit), and in 1978 (personal income and corporate profits tax reductions). Tax incentives to promote business investment were enacted in 1962 (investment tax credit and shorter equipment lifetimes), 1971 (reinstatement and liberalization of the investment tax credit and ADR service lifetimes for machinery and equipment), 1975 (higher investment tax credit), and 1979 (liberalization of the investment tax credit). Changes in the exemptions for personal and corporate income taxes were enacted in 1970, 1971, 1972, and 1978, offsetting to some extent the "bracket" effect of inflation, as did the per capita tax credits of 1975, 1976, and 1977. Earned income credits were instituted in 1975. Household and business savings were aided by a reduction to 50% in the maximum tax on the earned income of persons in 1972, the 1978 reduction in capital gains taxes, the liberalized depreciation of 1971, and corporate profits tax reductions in 1971, 1975, and 1978.

- In the current environment of near full employment and high inflation, public policy should be concerned with measures to restrain growth in demand while at the same time promoting a more rapid rise in potential supply. In this way, the inflation potential for the U.S. economy in the 1980s can be limited. The U.S. economy of the late 70s is vastly different from the early 60s, when aggressive measures to stimulate aggregate demand were needed. Now, a policy mix of restraint in government spending combined with tax policies that simultaneously enhance investment demand, potential supply, and the flow of savings would be preferable.

- The Capital Cost Recovery Act of 1979, also known as the "10-5-3" program, would provide a strong stimulus to business fixed investment, real economic growth, productivity, and employment at almost no cost in additional inflation. Analysis with the DRI model of the U.S. economy shows that the Conable-Jones proposal would raise real business fixed investment by $10 billion per annum between 1980 and 1984, raise the growth in real GNP by 0.3% per year, and increase productivity growth by 0.7 percentage points compared to a situation with existing tax laws. Employment gains would range between 100,000 and 500,000 persons over the next five years. No significant rise of inflation would result.

- The net cost of the Capital Cost Recovery Act as simulated in the DRI model would be $11.3 billion per year over 1980 to 1984, ranging between $4.2 billion in 1980 and $16.1 billion during 1984. The simulated program assumes: 1) a phase-in of new structures lifetimes over a 10 year period toward a 10 year lifetime; 2) a phase-in of new equipment lifetimes, except for autos and light trucks, over a five year period toward a five year lifetime; and 3) a 10% tax credit on all equipment except autos and light trucks, which receive a 6% credit.[2] These figures are gross of all Federal tax receipts after taking account of the stimulus to the economy generated by the measure. Given the tax structure, the higher GNP that would result from the Capital Cost Recovery Act will induce additional Federal tax revenues that offset the static revenue loss obtained when considering the program in isolation from its effects on the economy.

- The Capital Cost Recovery Act is self-financing to a degree, both for the Federal Government and for corporations. Because of the stimulus provided to the economy, induced personal income and corporate profits tax receipts should offset $7.8 billion per annum of the expected tax loss, a return of $0.41 per dollar per year of the ex-ante or static revenue loss. In addition, the huge cash flow generated by the reduced lifetimes will provide much of the financing necessary to carry out a higher rate of capital expenditures. The ratio of cash flow to the capital outlays of nonfinancial corporations rises 5 to 6 percentage points higher than in the baseline case, indicating a much stronger financial position for the nonfinancial corpoate sector as a result of the measure.

- The "bang for a buck" from the Capital Cost Recovery Act, defined as the rise in real business fixed investment per dollar of revenue loss, would be $0.53 per year between 1980 and 1985, before economy feedback is considered. This is a signficantly greater impact than would occur from equivalent reductions in corporate profits taxes. When allowance is made for the full feedback effects of the economy stimulus on tax receipts, the bang for a buck of the accelerated capital recovery measure is even greater.

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[2] The actual proposed legislation, H.R. 4646, the Jones-Conable bill, uses a 5 year transition for structures. The net cost is $2 to 3 billion a year compared with a 10 year phase-in.

- Of the various tax incentives to capital formation most often considered, the impacts from the accelerated capital recovery rank near the top in terms of instrument effectiveness. Only the investment tax credit would produce an equivalent or greater bang-for-a-buck. In addition, there are side benefits to productivity and the financial markets from the improved corporate liquidity that would result. There is also essentially no rise in inflation from the highly stimulative measure, given the rises in productivity and potential output that occur.

The organization of the statement is as follows: Section I discusses the changing economic environment and its effect on tax policy. In Section II, the relation between the poor performance of capital formation, productivity growth, and inflation is indicated. Section III deals with the notion of accelerated capital recovery. In Section IV the economic impacts of the Jones-Conable Capital Cost Recovery Act of 1979 are presented and discussed. The final section summarizes the benefits of the program to the economy, as simulated in the DRI model of the U.S..

I. The Backdrop for Tax Policy in the 80s

The focus of fiscal policy is radically changing as a result of 15 years of intensifying inflation in the U.S. economy. Whereas most previous major tax measures were designed to promote economic stability and growth, the severe inflation, low productivity, and high unemployment that have been occurring suggest the need for a different approach. Regardless of the source of inflation, continually rising prices reduce the effective purchasing power of households through the bracket effect of rising nominal incomes under a progressive income tax structure. In the case of business, there is an analogous effect that arises because of historic replacement costs and FIFO inventory accounting. The inflation drag on expendable cash flows in a period of rapid inflation thus is a deterrent to private sector spending. If the spending category is business capital formation, then growth in productivity is also hampered and inflation worsened further. In addition, a high inflation environment is suggestive of excess demand pressure against supply. Tax measures designed to increase the supply of work effort, capital, and new technology appear to be warranted in light of the need for a more rapid rise in the potential supply of the economy.

Thus, tax policy in the current, highly inflationary environment must be different from what was employed in the slack economy of the 60s. Continued raises in exemptions and reductions in nominal tax brackets may be needed to sustain purchasing power. More importantly, without measures designed to promote capital formation and productivity, the inflation process will continue to be self-generating, with rising inflation dragging down capital spending, cutting the growth in productivity, raising labor costs, and bringing on more inflation. To break this loop, creative approaches to Federal taxation are required, including methods that would accelerate the depreciation writeoffs of business. Policies that stimulate the after-tax return to savings, supply of work effort, and capital formation are more approporiate if the goal is to limit inflation and reduce unemployment simultaneously.

This backdrop for tax policy in the 80s suggests measures designed to promote a balanced growth in demand and potential supply, along with enhancing the savings flows of households and business. Hints of a tendency toward such measures have already appeared, starting with the maximum tax on earnings in 1972, the reduction in capital gains taxation during 1978, and the swelling interest in measures to promote business capital formation and saving. Further evidence of the emerging trend also appears in proposals to increase the after-tax return on savings by households, through exemption or deductions of some interest earnings from taxes.

II. Capital Formation, Productivity, and Inflation

The spiraling inflation in the U.S. economy since 1966 is a national crisis. The undesirable economic and political effects of continuing high rates of inflation are well documented. Like a cancer, the ingredients of inflation are multi-dimensional. No single cure exists for the problem, the effects of which are exacerbated by secularly rising rates of unemployment. Between 1966 and 1979, inflation of the implicit GNP deflator has varied from 3% to an estimated 8.8% for this year. In only three years were the inflation rates below 5%; 1967 and 1968, and in 1972. In this last year, the low rate of inflation was the result of the wage-price freeze and Nixon Administration guidelines.

At the same time inflation has exhibited a secular rise, the rate of capital formation and growth in productivity have shown a secular decline. Table I shows the proportion of GNP devoted to non-residential fixed investment during the postwar period and, aside from a burst in the early 70s, currently reflects a lower ratio than previous peaks. In addition, expenditures on pollution and abatement equipment have taken about 0.3 to 0.4% of this ratio, with perhaps more accounted for by government mandated requirements on business capital formation.

Table I
Capital Formation in the U.S. Economy
(Business Fixed Investment Relative to GNP)

	(1) Nonresidential Business Investment/GNP	(2) (1) Less Spending on Pollution and Abatement/GNP
1953	9.4	
1954	9.3	
1955	9.6	
1956	10.4	
1957	10.5	
1958	9.3	
1959	9.3	
1960	9.4	
1961	9.0	
1962	9.1	
1962	9.1	
1963	9.0	
1964	9.4	
1965	10.4	
1966	10.8	
1967	10.3	10.2
1968	10.3	10.2
1969	10.6	10.4
1970	10.2	10.0
1971	9.8	9.5
1972	10.0	9.6
1973	10.4	10.0
1974	10.7	10.3
1975	9.8	9.4
1976	9.7	9.3
1977	10.0	9.6
1978	10.4	10.1
1979E	10.7	10.3
1980E	10.6	10.2
1981E	10.6	10.2

E - DRI forecasts.

Growth in labor productivity has been steadily declining, falling to 2.3% per annum in 1965-73 after the 3.2% growth from 1947 to 1965, and plummeting lower in recent quarters. The downward trend has contributed greatly to inflation and shows no signs of a reversal.

Table 2
Growth of Labor Productivity
(Average Annual Rates of Change)

	1947-65	1965-73	1973-78	1978:4 - 1979:4
Sector				
Private Business	3.2	2.3	1.1	-3.3
Nonfarm Business	2.6	2.0	1.0	-4.3
Manufacturing	3.2	2.4	1.6	0.6
Nonfinancial Corporations	3.7*	1.9	1.1	-1.8**

* 1958-65; Data not available for years prior to 1958.

** 1978:4 to 1979:1

Source: Bureau of Labor Statistics

The coincidence of reductions in productive capital formation and productivity with rising inflation is suggestive of an interlocking process in the U.S. economy. Though the starting point may be hard to define, growth in capital for a given labor force raises productivity, reduces unit labor costs, and therefore lowers inflation. A more rapid pace of capital formation thus is one means to raise labor productivity and mitigate inflation. Though not the only possibility, the effect of newly formed capital on potential supply, the quality of capital, the marginal productivity of labor, and the pace of innovation is likely very significant. Indeed, the periods of most rapid formation of capital, 1962 to 1966 and 1975 to 1977, were associated with a relatively strong performance in productivity, and improved results on inflation.

At the same time, higher inflation hurts business capital formation.[3] First, higher inflation causes reductions in real economic growth as purchasing power drops, interest rates rise, the stock market weakens, higher debt burdens restrain spending, and unemployment moves up. These events, which unfold with time lags, affect expectations of final sales and business plant and equipment spending through the "accelerator." Second, a more rapid rate of inflation reduces the ratio of product price to the effective price of capital, or the "profit margin" on new plant and equipment. The combination of a higher supply price of capital goods,

[3]See "Inflation and Business Capital Spending", Testimony before the Joint Economic Committee, U.S. Congress, Hearings on Aspects of Inflation, "The Fixed Investment Decision," Washington, D.C., June 21, 1978.

increased nominal costs of financing capital expenditures, and a lower present value for the tax deductable depreciation expenses, causes the rental price of capital goods to grow more rapidly than business can increase product prices. The lower marginal return on new capital goods negatively affects business fixed invest ment. Third, higher inflation raises both short- and long-term interest rates. Bond yields rise through the effect of inflation on the premium demanded by investors for supplying savings. Short-term interest rates rise through the pressure of increased nominal loan demands against the liquidity of the commercial banking system and as a result of the tighter monetary policy that is instituted to fight inflation. Rising interest rates impact business fixed investment by raising the rental price of capital goods, and by increasing the debt service burden of nonfinancial corporations relative to cash flow. Fourth, the higher interest rates damage the stock market, causing a rise in the cost of equity financing and an increase for the rental price of capital. Fifth, business profits and the internally generated funds available to finance capital outlays are sharply diminished during periods of rapid inflation, because of illusory inventory profits and the rising replacement costs for capital goods. Corporate profits are typically overstated during periods of inflation because of FIFO methods of inventory accounting and historical cost expensing for depreciation. In both cases, actual cash outlays for replacement of inventories and capital goods are much higher. After correction for these factors, the cash flow for nonfinancial corporations is sharply reduced. Sixth, higher inflation causes the nominal external financing requirements of business to grow and increases bank loan indebtedness, commercial paper issues, and the mortgage and bond financing necessary to fund desired capital outlays. This rising indebtedness raises the debt service burden of corporations and eventually restrains spending through the increased financial risk of corporate balance sheets. Finally, an autonomous acceleration of inflation can cause reductions in capacity utilization by limiting aggregate demand. Reducing the intensity of use of existing capital lowers replacement investment.

Together, these factors make for sizeable reductions in the rate of business capital formation during periods of rapidly rising prices. To the above endogenous influences must be added the potential restraining effects on aggregate demand from tighter fiscal and monetary policies. The effects of restrictive stabilization policies on expected sales can be quite substantial and sharply diminish the planned rate of capital outlays by business.

III. Accelerated Capital Recovery

Accelerated capital recovery refers to a shortening of tax allowable or useful lifetimes to reduce the period over which capital outlays are fully expensed. While used to a high degree in some of our trading partners, U.S. tax policy has never embraced the concept. Although tax allowable lifetimes have progressively been reduced in a marginal fashion over the years, a switch to accelerated capital recovery would constitute a much greater change. The notion that capital assets should be depreciated for tax purposes as real economic depreciation occurs is well entrenched. Accelerated capital recovery departs from this traditional approach, recognizing the need to stress capital formation and business saving as a primary goal.

Accelerated capital recovery would stimulate the demand for physical capital, the supply of money capital, and potential output. The "income" and "relative price" effects of such a measure are highly potent in the DRI model framework where cash flow, interest charges on outstanding debt, stock market effects, and replacement investment loom so importantly for business capital formation. In particular, the cash flow and interest rate impacts, both short- and long-term, combine to make policies for accelerated depreciation quite powerful. The provision of additional business saving from accelerated depreciation at the same time incentives to capital formation are being legislated is particularly appropriate in an economy that is near full employment. In addition, a program of more rapid capital recovery would move the economy closer to replacement cost depreciation and away from the anachronistic historical cost depreciation that currently exists.

IV. A Simulation Analysis of the Capital Cost Recovery Act of 1979

The accelerated capital recovery program considered was a "10-5-3" shortening of lifetimes on newly purchased plant and equipment, whether new or used.[4] The program consisted of the following elements:

1) a reduction in the tax allowable lifetimes for buildings to 10 years from the current 23 year average;

2) a reduction to five years in the tax allowable lifetimes for equipment, except autos and light trucks;

3) a three year tax allowable lifetime on investment in autos and light trucks;[5]

4) a uniform investment tax credit of 10% on all equipment, except for autos and light trucks, to which a 6% credit would apply;

5) the capital recovery is based on tables constructed using accelerated methods of recovery, i.e., double declining balance with a switch to sum-of-the-years digit methods.

Given the potential large revenue loss from this "10-5-3" accelerated capital recovery program, a transition program was instituted where equipment lifetimes, except for autos and light trucks, were phased-in toward a five year lifetime over a five year period. New 10 year lifetimes for buildings were phased-in over a 10 year period. The uniform tax credit was immediately put into effect, along with a 6% credit for autos and light trucks.

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[4] H.R. 4646; also introduced in the Senate by Senators Nelson, Bentson, Packwood, and Chafee. One difference between the accelerated capital recovery program simulated and the proposed legislation is the transition period for buildings or Class I property. The bill uses five years; the analysis assumed 10 years. Thus, both the stimulus from the measure and revenue loss are somewhat underestimated; approximately $3 to 4 billion a year in revenue loss calculated on a static basis and $2 and $3 billion on a net, full economy-feedback basis.

[5] Assets that are not autos or light trucks and that currently have lifetimes shorter than five years would be changed to five years.

Table 3 shows the revenue loss from this "10-5-3" accelerated capital recovery program, on an ex-ante (static) basis. The ex-ante (static revenue loss) corresponds to the Federal corporate tax receipts that would be lost under given assumptions on the pace of plant and equipment spending for the next five years.[6] The expected revenue loss can be seen to vary from $4.8 billion in 1980 to $32.9 billion in 1984, averaging $19.1 billion per annum.[7]

Table 3. "10-5-3" Accelerated Capital Recovery Program: "10-5" Phase-In Static Revenue Losses (Billions of Dollars, Seasonally Adjusted Annual Rates, Relative to Baseline)[1]

Year	1980	1981	1982	1983	1984	Avg.
Class I	0.7	2.2	3.7	5.4	7.4	3.9
Class II & III[2]	3.3	9.5	14.6	19.9	24.3	14.3
Uniform Tax Credit[3]	0.8	0.9	0.9	1.0	1.2	1.0
Total	4.8	12.6	19.2	26.3	32.9	19.1

[1]Business fixed investment is assumed to grow at 9% for the baseline. Equipment lifetimes, except autos and light trucks, are phased in towards a 5 year lifetime over a 5 year period. The baseline assumes an 11 year average lifetime for equipment. Structures lifetimes are phased in over a 10 year period toward a 10 year lifetime, while the baseline assumes an average lifetime of 23 years.

[2]Class I is the National Income and Product Accounts counterpart to Sec. 1250 property (structures) including corporations, proprietorships, and partnerships. Class II is the National Income and Product Accounts counterpart to Sec. 1245 property (equipment), including corporations, proprietorships, and partnerships, except cars and light trucks. Class III property contains autos and light trucks.

[3]The investment tax credit for autos and light trucks is raised from 3.33% to 6%. All Class II property receives a 10% credit.

[6]The assumption for the growth of nominal fixed business investment was 9% per year, based on estimates by the Joint Committee on Taxation. This assumption was imposed on the baseline solution of the DRI model used in simulations of the accelerated capital recovery program.

[7]The actual revenue loss from the Jones-Conable bill would be somewhat higher because of the five year phase-in compared with a ten year lifetime for structures. Table 3 assumes a 10 year phase-in process. Doubling the Class I revenue loss would change the figures to range between $6.2 billion in 1980 and $47.7 billion in 1984. The average would be $23.0 billion instead of the $19.1 billion reported. In ex-ante or static terms, the expected revenue losses over the five year period make this tax policy one of the most expensive in the postwar period.

In Table 3, the tax loss for Federal corporate tax receipts without economy-wide feedback, averaged $14.3 billion over the five year period and was $3.4 billion for structures.[8] The loss due to the uniform tax credit and new 6% investment tax credit on autos and light trucks was $1 billion per year. A total of $4.8 billion of Federal corporate tax receipts was lost in the first year of the program, and $32.9 billion in 1984. Appendix Tables A.7 to A.10 show the calculation of the ex-ante revenue losses in Table 3.

The basic methodology used to calculate the static revenue loss was a computation of the difference between the assumed depreciation rates under the capital cost recovery program and the DRI baseline solution. This difference was then multiplied by the relevant investment series based on growth assumptions in nominal terms from the Joint Committee on Taxation, producing increased depreciation expense over the baseline simulation. When multiplied by an assumed effective tax rate, a static or ex-ante revenue loss was produced.

The "phase-in" or transition program considered used the "10-5-3" lifetimes but phased them in over a 10 year period (for structures) and 5 year period (for equipment), i.e.,

1) Class I property was allowed a tax lifetime of 10 years, with the new lifetimes phased in over 10 years. Appendix Tables A.2 to A.6 contain the phase-in schedules for each year of investment from 1980 to 1984. This class of assets coincides with Section 1250 property, including all tangible real property (such as leases of land), but exempts Section 1245 property, buildings and their structural components.

2) Class II property has a tax lifetime of 5 years, except for certain exceptions, with the new lifetimes phased in over 5 years. Appendix Tables A.2 to A.6 contain the phase-in schedules for each year of investment between 1980 and 1984. This property coincides with Section 1245 property. Section 1245 property is depreciable property which is either personal property (tangible and intangible), or 2) other tangible personal property (not including a building or its structural components), used as an integral part of a) manufacturing; b) production; c) extraction; and d) the furnishing of transportion, communications, electrical energy, gas, water, or sewage disposal services. The research facilities used in connection with these activities are also included.

3) Class III assets were allowed a lifetime of 3 years. Class III assets are the classifications of Section 1245 property that are either automobiles or light trucks.

4) Class II property received a 10% investment tax credit. There was a 6% tax credit for Class III assets.

5) All categories of eligible assets used a combination of double declining balances (DDB) and sum-of-the-years digits (SYD) depreciation methods.

6) A half-year convention was included. All assets purchased in a given year were depreciated as if bought at mid-year.

[8] Corporations, proprietorships, and partnership tax revenues were simulated via corporate tax revenues in the DRI model. Reference to "corporate" taxes therefore includes proprietorships and partnerships.

The transitional schedule operated as follows. For the first year of the program, Class II property was broken into 5 lifetime categories, each based on ADR lower limits. These categories were 1) 5 year-or-less, 2) 6 year, 3) 7 year, 4) 8 year, and 5) 9 years, or more. Depreciation was then calculated, using the double declining balance and sum-of-the-years digits based on these lifetimes. For subsequent years, the lifetime categories were shortened so that in each successive year the average lifetime of all subgroups moved toward 5 years, ultimately reaching so by the fifth year of the program. Capital purchased in any specific year of the phase-in period was depreciated using these lifetimes and associated depreciation rates. This procedure was continued until 1984, when all Class II lifetimes reached a 5 year span. Appendix Tables A.2 to A.6 display the subgroups for Class II assets and their depreciation schedules for the first few years of their lifetimes. Table 4 shows the final capital cost recovery table in the Jones-Conable bill.

Table 4
Capital Cost Recovery Table
(In percent)

Ownership year	Class of investment I	II	III
1 ----------------	10	20	33
2 ----------------	18	32	45
3 ----------------	16	24	22
4 ----------------	14	16	
5 ----------------	12	8	
6 ----------------	10		
7 ----------------	8		
8 ----------------	6		
9 ----------------	4		
10 ----------------	2		
	100	100	100

The accelerated capital recovery program described was then simulated in the DRI Quarterly Econometric Model of the United States.[9] The DRI Model is particularly well suited for simulating the impacts of tax incentives on business fixed investment, capital formation, productivity, real output and inflation, given its detailed treatment of business flow-of-funds, the integration of tax policy parameters into the investment equations, and the role of cash flow along with other financial ingredients on investment spending, capital formation, real economic growth, and productivity.

[9] For other studies on tax incentives and capital formation using the DRI model, and a description of the mechanism and framework behind the results, see Andrew F. Brimmer and Allen Sinai, "The Effects of Tax Policy on Capital Formation, Corporate Liquidity and the Availability of Investment Funds: A Simulation Study," Journal of Finance, May 1979, pp. 287-308; Christopher Caton, Otto Eckstein, and Allen Sinai, "Tax Reform and Capital Formation in the U.S. Economy," Data Resources Review, August 1977; Allen Sinai and Terry Glomski, "The Carter Tax Proposal: Is It Needed?" Data Resources Review, January 1978, pp. 11-17; Allen Sinai, "Tax Expenditures and Business Capital Spending," Testimony presented at the Hearings on Tax Expenditures Committee on Ways and Means, Subcommittee on Oversight, March 27, 1979, and Otto Eckstein and Allen Sinai, eds., The Data Resources Model of the U.S. Economy, (Amsterdam: North-Holland, forthcoming), ch. 7.

Each element of the accelerated capital recovery program was translated to changes in the parameters for tax policy represented in the DRI model. This included the baseline or Control values for equipment lifetimes, structures lifetimes, the depreciation rule assumed, and the investment tax credit. The baseline case assumed that the lifetime for Class I assets (structures) was 23 years, with the combined Classes II and III (equipment) at 11 years. The baseline depreciation rules were sum-of-the-years digits in Class II and a weighted average of 40% straight line and 60% 1.5 declining balances for Class I.

The method employed was to calculate the difference in depreciation rates between each program and the baseline, then to derive the additional depreciation expense by multiplying these differences by the relevant investment stream. The greater depreciation expense was then entered into the DRI model solution as an increase in book value capital consumption. This caused, without considering feedbacks, a rise in cash flow equal to the average corporate tax rate multiplied by the rise in depreciation, which was also the static revenue loss. The shorter lifetimes for Class I and combined Class II and III assets were entered explicitly into the DRI model, as the main channel of influence to business fixed investment for the Capital Cost Recovery Act. The vehicle for this effect was the lessened price of capital relative to product prices. The tax credit effects were entered by changing the value for the effective investment tax credit to a level that would produce the additional tax losses associated with the program's new 6% tax credit for autos and light trucks without model feedback.

Table 5. "10-5-3" Accelerated Capital Recovery Program: "10-5 Phase-In", DRI Model Simulation Results
(Billions of Dollars, Seasonally Adjusted Annual Rates, Relative to Baseline)

	1980	1981	1982	1983	1984	Average
Real Business Fixed Investment*	0.2	4.1	9.8	15.3	20.9	10.0
Real Equipment Spending*	0.2	3.2	7.4	11.7	16.3	7.7
Real Plant Spending*	0.1	0.9	2.4	3.6	4.5	2.3
Revenue Losses						
Total	4.2	9.8	11.8	14.6	16.1	11.3
Corporate	4.1	10.0	14.6	20.6	26.8	15.2
Personal	0.1	0.0	-1.4	-3.3	-6.0	-2.1
Social Security	0.0	-0.3	-1.2	-2.5	-4.3	-1.6
Excise	0.0	0.0	-0.1	-0.2	-0.4	-0.2
Productivity Growth(%)						
10-5 Phase-In	2.7	1.8	2.2	2.9	3.2	2.6
Baseline	2.6	1.2	1.4	1.9	2.3	1.9
Difference	0.1	0.6	0.7	1.0	0.9	0.7
Growth in Real GNP(%)	0.0	0.4	0.3	0.4	0.4	0.3
Employment(Millions)	0.0	0.1	0.2	0.4	0.5	0.2
Ratio: Increase in Real Fixed Investment to Corporate Tax Loss	0.06	0.42	0.68	0.74	0.78	0.53

The results are shown in Table 5, relative to the baseline case, i.e., as increments to the baseline, except for the productivity figures. These reflect the dynamic simulation and feedback from the effects of the tax stimulus on the economy, inflation, corporate finance, and capital stock. In the real world, the full impacts of any change in a tax policy instrument include both autonomous and induced effects. In evaluating the strength of the various tax expenditures, the full endogenous response of tax receipts to the various changes in the economy should be taken into account. Monetary policy was assumed neutral, operating to keep nominal short-term interest rates constant.[10]

In this "10-5-3" phase-in case, the loss in corporate tax receipts averaged $15.2 billion per year. The gain in real business fixed investment averaged $10 billion per annum. Growth in real GNP was 0.3% higher per year, and employment averaged 200,000 persons above the baseline solution over the five year period. Growth in productivity was 0.7 percentage points a year above the baseline value of 1.9%, averaging a respectable 2.6% for the period. The "bang-for-a-buck" was $0.53 under this accelerated capital recovery program, before feedback.[11]

Other results indicate that there would be little change for inflation from the accelerated capital recovery program. Whereas most programs to stimulate capital formation have been inflationary as the stimulus to demand outpaces the rise in supply, the effects of the Capital Cost Recovery Act on inflation were minimal. Neither the All Urban Consumer Price Index nor implicit GNP deflator showed any significant change from the baseline simulation. The inflation of wholesale prices, on the other hand, did show a slight increase in 1982 to 1984, when the program was most stimulative. The rise in the inflation of commodity prices was 0.1 to 0.2% during those years. However, the benefit to unemployment was much greater, with 0.2 to 0.4% declines in the overall unemployment rate relative to the baseline solution.

This minimal effect on inflation from the strong stimulus to business capital formation arises because the increased capital formation and improved cash flow promote a sizeable rise in productivity, declines in unit labor costs, and rises in potential output. Other tax policies, e.g., the investment tax credit, have been found to be more inflationary.[12] Thus, the cost of the program in terms of additional inflation is essentially nil with considerable benefits to capital formation, productivity growth and employment.

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[10] The huge injection of additional cash flow from the accelerated capital recovery program caused a drop of interest rates in the DRI model as business external financing requirements eased and excess funds in the near-term flowed into short-term investments. Since corporate spending lagged the stimulus, the early effects pressed interest rates lower. Treasury financing of the additional deficit did not increase as much because of the extra tax receipts induced by the program. To eliminate any extra stimulus from this source, the Federal Reserve was assumed to cut bank reserves to raise short-term interest rates to their baseline values.

[11] The "bang-for-a-buck" refers to the rise in real business fixed investment per dollar of corporate tax revenue lost. It is the gain in real capital outlays per dollar of revenue cost to the Federal government. Of course, the loss in business taxes is less after allowing feedback than when the extra tax receipts generated by higher corporate profits is included. If all induced tax receipts from the stimulus are accounted for, corporate and otherwise, the gain per dollar of revenue loss would be even greater.

[12] See A. Sinai, ibid, "Tax Expenditures and Business Spending."

V. Concluding Comments

The salient features from the simulation of the Capital Cost Recovery Act of 1979 in the DRI model suggest a string of benefits to enactment of such a measure.

1) The accelerated capital recovery program has a powerful effect on business fixed investment. In real terms, business spending rises a total of $50 billion over the five year period, with increasingly larger impacts into the mid-80s. Few policies to promote business capital formation would be so stimulative, while at the same time generating a means of financing and virtually no additional inflationary pressure.

2) The net cost of the Capital Cost Recovery Act is considerably less than the pre-enactment static estimates. Taking acount of the full feedback effects from the stimulus on the economy, the revenue loss is only $11.3 per annum, varying from $4.2 billion in the first year to $16.1 billion in the fifth year. Taking account of the induced tax revenues, both personal and corporate, that arises from the policy stimulus, is necessary for a realistic assessment of the program costs. Fully $0.41 of the initial cost of the accelerated capital recovery program is recaptured because of its beneficial impacts on the economy.

3) The accelerated capital recovery program is self-financing, both for the government and for corporations. The induced tax revenues diminish the amount of deficit financing that must be undertaken and the huge rise in cash flow provides a means for business to finance the higher rate of capital spending. Few other tax policies would provide this degree of financing.

4) Growth in productivity is enhanced, rising 0.7% percentage points above the baseline. Thus, instead of the forecasted 1.7% per annum growth in labor productivity for 1980 to 1984, a respectable 2.6% pace of growth occurs. The increased productivity arises from the effects of the induced capital formation on potential output and productivity. It is primarily the large rise in the pace of business capital spending that generates the better performance on productivity.

5) The inflation costs from the accelerated capital recovery program are minimal, with virtually no change in key inflation rates arising from the policy stimulus. Most other tax stimuli push demand up faster than supply, giving rise to inflationary effects. The path for demand and supply would be more balanced under the Capital Cost Recovery Act, permitting rising employment and increased economic growth without a serious reacceleration of inflation.

6) There are substantial benefits to business liquidity from the accelerated capital recovery program, stemming from the large rise in cash flow that occurs. Some of the increased cash flow is used to finance capital outlays. Other portions are directed toward reductions in debt and improvement in the asset side of the corporate balance sheet. To the extent that these feedback effects occur, the "financial risk" of the corporate sector is diminished and a more aggressive posture on capital spending can be undertaken.

In this time of high inflation, low productivity growth, and rising unemployment, the time may well have come for implementation of a decidedly different tax policy from what has been used in the decades of the 60s and 70s. Simulation of the Capital Cost Recovery Act of 1979 with the DRI model suggests significant beneficial effects on real economic growth, capital formation, productivity, employment, and the financial position of corporations. These benefits are obtained at little cost in terms of additional inflation. Along with other advantages, such as simplification of the tax code, these quantitative impacts on the economy from accelerated capital recovery suggest the measure is well worth serious consideration instead of the more typical expansive fiscal policies that have been used to bring the U.S. economy out of past recessions. History indicates that each round of these efforts has brought more inflation and further economic instability. For the revenue loss associated with accelerated capital recovery, the potential gain appears to be substantial.

APPENDIX

Table A.1 Baseline Depreciation Schedule in DRI Model*
(Percent)

Year of Asset Lifetime	Class I	Class II, III
1	8.4	2.9
2	16.0	5.6
3	14.4	5.3
4	12.9	5.1
5	11.4	4.8

*Assumes a 23 year lifetime for Class I, 11 years for combined Classes II and III. Sum-of-the-years digits was the depreciation rule for Classes II and III, while 40% straight-line and 60% 1.5 declining balances were assumed for Class I assets. A half-year convention was assumed.

Table A.2 Phase-In Depreciation Schedule - "10-5" Program
(First Effective Year)
For Investment Made in 1980

	Class of Investment					
	Class II					Class I
Lifetime	(5)	(6)	(7)	(8)	(9)	(19)
Year After Asset Purchased						
1	20%	17%	14%	13%	11%	5%
2	32%	28%	25%	22%	20%	10%
3	21%	20%	19%	17%	16%	9%
4	15%	15%	15%	15%	14%	9%
5	12%	11%	12%	12%	12%	8%

Table A.3 Phase-in Depreciation Schedule "10-5" Program
(Second Effective Year)
For Investment Made in 1981

	Class of Investment			
	Class II			Class I
Lifetime	(5)	(6)	(7)	(18)
Year After Asset Purchased				
1	20%	17%	11%	6%
2	32%	28%	20%	11%
3	21%	20%	16%	10%
4	15%	15%	14%	9%
5	12%	11%	12%	9%

Table A.4 Phase-in Depreciation Schedule - "10-5" Program
(Third Effective Year)
For Investment Made in 1982

	Class of Investment			
	Class II			Class I
Lifetime	(5)	(6)	(7)	(17)
Year After Asset Purchased				
1	20%	17%	14%	6%
2	32%	28%	25%	11%
3	21%	20%	19%	10%
4	15%	15%	15%	10%
5	12%	11%	12%	9%

Table A.5 Phase-In Depreciation Schedule - "10-5" Program
(Fourth Effective Year)
For Investment Made in 1983

	Class of Investment		
	Class II		Class I
Lifetime	(5)	(6)	(16)
Year After Asset Purchased			
1	20%	17%	6%
2	32%	28%	12%
3	21%	20%	11%
4	15%	15%	10%
5	12%	11%	9%

Table A.6 Phase-In Depreciation Schedule
For Investment Made in 1984

	Class of Investment	
Lifetime	Class II (5)	Class I (15)
Year After Asset Purchased		
1	20%	7%
2	32%	13%
3	21%	11%
4	15%	10%
5	12%	10%

Table A.7 takes the subgroups of Class II assets and creates a single depreciation schedule for each year by taking the average across the subgroups.

Table A.7 Aggregate Depreciation Schedule for Class II Assets - "10-5" Program (Phased-In Method, Percent)

Year After Asset Purchased	1980	1981	1982	1983	1984
1	15	17	18	19	20
2	25	27	30	31	32
3	19	19	20	21	21
4	15	15	15	15	15
5	12	12	12	12	12
Average Lifetime	8.4	8.3	6.7	5.7	5.0

Since there is only one Class I lifetime assumed for each year, it is not necessary to aggregate Class I depreciation rates. Table A.8 displays these depreciation rates, derived from the lifetime assumptions for each year of the phase-in.

Table A.8 Depreciation Schedule for Class I Assets - "10-5" Program (Phased-In Method, Percent)

Year After Asset Purchased	1980	1981	1982	1983	1984
1	5.3	5.6	5.9	6.3	6.7
2	10.1	10.6	11.2	11.8	12.5
3	9.3	9.7	10.2	10.6	11.2
4	9.7	9.1	9.5	9.9	10.4
5	8.2	8.5	8.9	9.2	9.6

The DRI baseline depreciation rates were then subtracted from the new program schedules (Tables A.7 and A.3). The resulting differences in depreciation rates (Tables A.9 and A.10) were then multiplied by the relevant investment series to calculate the increased depreciation expense under the various programs. When the additional depreciation expense was then multiplied by the average effective corporate tax rate, ex-ante corporate tax losses could be computed.

Table A.9 Differences in Depreciation for Class I Assets in 10 Year Phase-In Plan and Baseline (Percent)

Year After Asset Purchased	1980	1981	1982	1983	1984
1	2.4	2.7	3.0	3.4	3.8
2	4.5	5.0	5.6	6.2	6.9
3	4.0	4.4	4.9	5.3	5.9
4	3.6	4.0	4.4	4.8	5.3
5	3.4	3.7	4.1	4.4	4.5

Table A.10 Difference in Depreciation Rates for Class II Assets in 5 Year Phase-in Plan and Baseline (Percent)

Year After Asset Purchased	1980	1981	1982	1983	1984
1	6.6	8.4	9.8	11.0	11.6
2	9.4	11.4	13.8	15.2	16.0
3	4.2	5.0	6.0	6.6	6.6
4	1.9	1.9	2.1	2.1	2.1
5	0.4	0.4	0.4	0.4	0.6