# TAX REDUCTION PROPOSALS

## HEARINGS

BEFORE THE

## COMMITTEE ON FINANCE
## UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

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# TAX REDUCTION PROPOSALS

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## THURSDAY, MAY 21, 1981

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

The committee met, pursuant to notice, at 9:30 a.m., in room 2221, Dirksen Senate Office Building, Hon. Robert J. Dole (chairman of the committee) presiding.

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

The CHAIRMAN. We are about to start what I hope to be the last day of public hearings on tax reduction proposals. Before calling the first witness, I want to include a statement of Senator Sasser who was scheduled to be our leadoff witness had a scheduling conflict and can't be here today.

He asked that I insert his statement.

[The statement follows:]

### STATEMENT OF SENATOR JIM SASSER IN SUPPORT OF THE DIRECT EXPENSING ACT OF 1981, S. 172

Thank you Mr. Chairman, I am here this morning to commend to you the Small Business Direct Expensing Act of 1981 which I introduced in January of this year as S. 172 and in the last Congress as S. 2689.

This bill would allow small business to deduct, or "Direct Expense," up to $10,000 worth of depreciable property in one year. Current law requires that such a capital expenditure be written off over a period of years. The bill, in addition, allows direct expensing without reducing the benefit of the investment credit which is so beneficial to growing firms. These features allow greater flexibility than is now possible for small business to modernize and make their operations more efficient.

Another important aspect of the bill is the simplification it brings to this very complicated area of the tax law. Depreciation is responsible for a tremendous number of errors on tax returns every year. These errors are often made by taxpayers who have great need of the tax benefit provided by depreciation but who cannot afford to retain an accountant to maintain accurate depreciation records. A tax advantage does little good if it is so complicated that the taxpayer to whom its benefits are directed is unable to comply with it terms.

The benefits conferred by this bill are primarily directed toward smaller firms, Mr. Chairman, because of their great need and because of their demonstrated ability to use funds efficiently. The statisitics that have come out of studies on research and development, for example, have shown that small companies achieve results in their research comparable to large firms while spending far less money.

Small firms have also proven to be tremendously efficient job creators. In one study conducted by the M.I.T. development foundation, five small companies were compared with six large firms. It was found that the small companies, despite having combined annual sales of less than one-fortieth of the giants, created 10,900 more jobs over a five year period than did the larger corporations. Over this period the small companies experienced and average growth in jobs of 41 percent while the larger corporations created jobs at an annual rate of less than 1 percent, other studies support these results.

We need to make use of this potential, Mr. Chairman. The economy sorely needs the contribution that an unrestrained small business community can make. My

legislation provides the congress with an excellent opportunity to enhance this contribution, but we must act swiftly. Small businesses today are being threatened by a severe capital shortage. The investment funds they need to continue their contributions to our economy are extremely hard to come by. This week the prime rate, once again, hit 20 percent, this highlights the problem that small businesses have borrowing the capital they need to grow. When they are able to borrow at all, the charge is often 2 points above the prime rate.

And borrowing is one of the few means of securing capital left to small business. The capital markets are virtually closed to them, preventing their selling issues of securities to raise capital. The retained earnings that many businesses rely upon for funds do not accrue as easily to small firms because accelerated depreciation is much too complicated and costly for them.

Business bankruptcies are now at record highs. The numbers this year surpass by leaps and bounds the numbers of last year at this time, and many of those failing are surely capital-starved small businesses. Action is needed to assist this valuable segment of our economy. I think direct expensing is needed and that my bill provides the means to begin Small Business needs this help and we need Small Business's productivity, its jobs and its innovation far too badly not to act.

The real strength and relevance of this proposal, Mr. Chairman, is derived from the fact that it comes directly from the small business community. The Tennessee delegates to the White House Conference on Small Business first brought the concept to my attention. They felt strongly about it because they know better than anyone what the problems and the needs of small business are. They canvassed their small business colleagues to refine the idea and to insure its broad acceptance and workability. Then they began to push their idea.

Our first witness this morning is the Honorable James Shannon, a Member of Congress from the State of Massachusetts.

Congressman Shannon, I assume you have a written statement. It will be made a part of the record and you may proceed in any way you wish.

[The prepared statement of Hon. James M. Shannon follows:]

STATEMENT OF HON. JAMES M. SHANNON

Mr. Chairman, distinguished members of the Committee, I appreciate being here this morning to testify on the subject of tax incentives for research and development, which is being reviewed by the House Committee on Ways and Means, as well as by members of this Committee.

Over the next few weeks, Congress is going to be amending the Tax Code to provide increased investment incentives for business. We can use this opportunity to initiate, not just a business tax cut, but a national industrial policy.

We're all very much aware that the United States has a productivity problem. Increased capital investment is a major element in an improved productivity rate, and the depreciation changes which are likely to be adopted will address that problem. There are, however, two additional basic elements that determine productivity growth: the skill level of the workforce, and development of new technologies. In order to affect all three elements, we need a program that will complete the Administration's proposal.

We should revise the current depreciation schedule; encouraging capital investment is a sound, fundamental approach. But we must also support a tax policy that rewards foresight and long-range planning. We have to target tax incentives for innovative ideas that will benefit new, innovative industries. The revitalization of American industry depends on investment in technologies that will be important to our economic future. Incentives for research and development that can provide US industry with technological innovation merit our consideration, and inclusion in the tax bills our respective Committees will report out.

The members of the Committee have sponsored research and development legislation in the past. This session, Senators Danforth and Bradley introduced S. 98, which would create a 25 percent tax credit for increases in industrial R and D spending over the annual R and D outlays for the previous three years. A companion bill, HR 1539, was introduced in the House by my colleagues Hon. Guy Vander Jagt and Hon. J. J. Pickle.

The Research and Revitalization Act of 1981, H.R. 1864, which I introduced in the House, would establish a Research Reserve Fund to provide resources to colleges and universities. The bill is sponsored, as S. 692, by three members of this Committee, Senators Packwood, Danforth, and Bradley. With partisan support on both the

Senate Finance and House Ways and Means Committee, I am confident that we will be able to include incentives for research and development in the tax bill.

There is another legislative proposal, H.R. 2472, the Equipment Donations Act, of which I am the sponsor, that has not yet been introduced in the Senate. It would amend the Tax Code to increase the deduction that is presently allowed for donations of newly manufactured equipment to universities, colleges, and vocational schools. The Act is intended to accomplish two objectives: it would assist universities in expanding research programs, and it would help reduce the current shortage of trained technical personnel.

Equipment donations made to educational institutions to date have been inadequate; the Internal Revenue Code limits deductions for charitable contributions of equipment to considerably less than fair market value. The provisions of the Act are consistent with recent reforms in the Tax Code and would significantly increase incentives for firms to make equipment donations.

We can do a lot more to encourage the kind of co-operation between business and universities that will benefit them both, and create jobs.

Last month, when Paul E. Gray, President of the Massachusetts Institute of Technology testified before our Committee, he emphasized the importance of tax incentives for research and development to the "effective transfer of new technologies." The talent of university scientists and engineers is a creative resource that American industry could employ more effectively. Currently, less than 3 percent of university research is supported by industry. An expanded industry-university research relationship would develop a new source of innovative ideas for the nation's business community, and increase the scope of university basic research efforts, based on industry identification research goals. And, of course, with this sort of exchange, universities can graduate students who are well prepared for jobs in industry: The productivity issues is addressed directly.

A decade ago, the United States had the highest living standard of any country in the world. We now rank tenth among industrialized nations in per capita income. American productivity has declined in each of the last three years. From 1970 to 1978, manufacturing productivity in West Germany rose 73.3 percent faster than in the U.S.; in Japan, it rose 71.2 faster; and in France, 42.2 percent faster. Those countries are committed to industrial research and development; the United States is not. Japan, for instance, targets high-potential industries and provides developmental subsidies, accelerated depreciation, and soft loans for R and D. All Japanese businesses are allowed a 20 percent tax credit for R and D, and special depreciation for R and D plant and equipment expenditures. Although approximately three-quarters of the United States GNP in this century can be attributed directly to innovations made possible by research and development, the U.S. now offers few R and D incentives.

The Administration has included a special three-year depreciation category for R and D in the Capital Cost Recovery Act. This provision, however, is inadequate. Equipment purchases constitute only a small portion of the total research and development expenses; the predominant expenditures are for salaries and overhead.

I agree with members of this Committee, and with my colleagues in the House who have sponsored and supported legislation for R and D incentives: The tax bill that this Congress passes should include provisions that will benefit the new industries that could provide jobs, and give us an international technological advantage in the next decade.

The cost would be minimal. For example, in fiscal 1983, H.R. 1864, my provision for a Research Reserve Fund would cost $249 million. The Equipment Donations Act would cost $10 million. The Joint Committee on Tax has estimated the price of the Capital Cost Recovery Act to be $25.2 billion for fiscal 1983.

Incentives for research and development mean support for the ideas that will determine our economic future. Restoration of our productivity rate depends, not only on investment in plant and equipment, but on investment in the new technologies that are essential to a comprehensive national industrial policy. Yankee ingenuity has always been a good investment.

Thank you, Mr. Chairman.

## STATEMENT OF HON. JAMES M. SHANNON, U.S. REPRESENTATIVE FROM THE STATE OF MASSACHUSETTS

Mr. SHANNON. Thank you Senator. I have a very brief statement. I appreciate being here this morning to testify on the subject of tax incentives for research and development which is being reviewed

by the House Committee on Ways and Means as well as by members of this committee.

Over the next few weeks, Congress is going to be amending the tax code to provide increased investment incentives for business. We can use this opportunity to initiate, not just a business tax cut, but a national industrial policy.

We are all very much aware that the United States has a productivity problem. Increased capital investment is a major element in an improved productivity rate, and the depreciation changes which are likely to be adopted will address that problem.

There are, however, two additional basic elements that determine productivity growth. The skill level of the workforce, and development of new technologies. In order to affect all three elements, we need a program that will complete the administration's proposal.

We should revise the current depreciation schedule. Encouraging capital investment is a sound, fundamental approach. But we must also support a tax policy that rewards foresight and long-range planning.

We have to target tax incentives for innovative ideas that will benefit new innovative industries. The revitalization of American industry depends on investment in technologies that will be important to our economic future. Incentives for research and development that can provide U.S. industry with technological innovation merit our consideration; and inclusion in the tax bills our respective committees will report out.

The members of the committee have sponsored research and development legislation in the past. This session, Senators Danforth and Bradley introduced S. 98, which would create a 25 percent tax credit for increases in industrial R. & D. spending over the annual R. & D. outlays for the previous 3 years.

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With bipartisan support on both the Senate Finance Committee and the House Ways and Means Committee, I am confident that we will be able to include incentives for research and development in the tax bill.

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The provisions of the act are consistent with recent reforms in the Tax Code and would significantly increase incentives for firms to make equipment donations.

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Last month, when Paul Gray, the president of the Massachusetts Institute of Technology testified before our committee, he emphasized the importance of tax incentives for research and development to the effective transfer of new technologies. The talent of university scientists and engineers is a creative resource that American industry could employ more effectively.

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Of course, with this sort of exchange, universities can graduate students who are well prepared for jobs in industry. The productivity issue is addressed directly.

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Those countries are committed to industrial research and development; the United States is not.

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Thank you.

The CHAIRMAN. Thank you. Senator Danforth.

Senator DANFORTH. Mr. Chairman, from what I heard and what I have read of Mr. Shannon's statement, I agree with every word.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman.

I have no questions either, but I would like to commend Congressman Shannon for his farsightedness as demonstrated in his testimony. His bill in the House on research and development is very similar to bills that have been introduced in the Senate by Senator Danforth and Senator Bradley and I want to compliment him.

I think that he has provided real leadership in the House, not only on research and development, but also on depreciation, and I think that the combination of those two are important for us to consider and I appreciate his testimony.

Mr. SHANNON. Thank you, Senator. We will do the best we can in the House to make sure that the Bradley and Danforth ideas are included and count on you to protect them when they get over here.

The CHAIRMAN. Well, we may have a little different opinion——

Senator BRADLEY. Mr. Chairman, you mean that you don't think that the research and development tax credit comes under the reduction in the Federal tax rate.

The CHAIRMAN. Yes; under a heading called subsidies. But, I am not sure how many subsidies we are going to be able to pass out this year.

I don't have any quarrel with the concept that the free market system is not working. Maybe we better take a look at why it is not working rather than pile on more tax cuts. But I hope we would by negotiating with the House before we get into too many complications.

I appreciate very much your testimony.

Mr. SHANNON. Thank you very much, Mr. Chairman.

The CHAIRMAN. I might say to all the witnesses, starting at 11 this morning we are going to have a series of votes in the Senate that could go into past 12 and unless you particularly like to spend the day here, I would keep that in mind as you testify.

In other words if we can wind up this morning and have three panels by 11 it would be helpful and then we wouldn't have to inconvenience someone in the last panel who might have to stay until 2 or 3 o'clock.

Our first panel consists of Robert L. Swiggett, John Nesheim, Paul Cherecwich, Jr., and Gerald Howard. I understand that Mr. Kennedy, president of Stanford University, may arrive—oh, he's here, good.

## STATEMENT OF ROBERT L. SWIGGETT, PRESIDENT OF KOLLMORGEN, ON BEHALF OF AMERICAN ELECTRONICS ASSOCIATION

Mr. SWIGGETT. My name is Bob Swiggett. I am president and CEO of Kollmorgen Corp. which employs 4,000 people in 17 plants, 15 in the United States, 2 in Europe. We had in 1981 $225 million in sales of electronic components, electrical and mechanical instruments and electrical-optical instruments.

Historically, we have doubled our business every 4 or 5 years and we expect to double it again in the next 3 to 4 years.

I am honored to speak today for the more than 1,500 electronics companies in the American Electronics Association which employ over 1 million people in the United States.

Kollmorgen is typical of those companies. We were small 15 years ago, just like over half of AEA's companies that have less than 200 employees today. By the end of the decade we expect to be at over $1 billion in sales, comparable to some of the larger ones, like Hewlett-Packard, who are also members of our organization. We are the only industry that consistently delivers much more value per dollar every year.

At $100 billion in the United States today, we are the strongest force in the creation of new jobs and better productivity.

If this is true now, watch our smoke when we hit $400 billion at the end of the decade.

Our organization, the American Electronics Association, has worked hard to think through and present what we believe are high leverage tax proposals. The logic behind them and the statistical backup for that logic is presented in the 26-page written document which has been presented to you. But I will try a quick summary.

We believe the following things: Technological leadership is absolutely key both to a strong growing economy and a strong defense posture. Technical innovation is fundamental to productivity improvement—tools, machinery, robotics, and so forth, enhance physical output while computers and communications extend the power of the intellect.

Technical innovation is fundamental to international trade competitiveness. We can only beat Japan and Germany by innovation. By running faster.

Technical superiority is the only way to overcome the numerical superiorty of the Russians in the military power game.

The reams of statistics such as those that Congressman Shannon just reported show that our technical leadership has been slipping dangerously. What are we going to do. We can't force innovation by massive bureaucratic Government intervention. It can only be fostered by creating an environment that gives freedom and incentives to innovators, entrepreneurs, and investors.

The most powerful instrument available to the Federal Government for fostering technical innovation is a tax policy that stimulates investment, entrepreneurship, and technical research.

Three years ago the American Electronics Association presented to the House Ways and Means Committee the results of a survey of the capital formation and growth experience of U.S. electronics companies.

We are proud to say that it helped get the Steiger/Hansen capital gains reduction bill off the ground.

The results of capital reduction in 1978 have been beyond expectation by far. Our statement that we have presented to you documents the greatly improved flow of venture capital and new security offerings. Stock prices of growth companies are much higher. Numbers of shareholders have increased significantly.

Incidentally, my company raised $17 million last year for expansion in this improved equity market. And the icing on the cake has been an actual increase in tax revenues not a loss.

This is what we mean by a high-leverage tax policy.

Congress should now eliminate capital gains taxes completely on new investments. This would motivate investors to buy into the growth areas of our economy. The odds on risky investment would be vastly improved. Our report explains why through unlocking tax revenues would actually increase.

It would have an even greater effect on the 1978 reduction on economic expansion, job creation and be a fantastic stimulus to innovation investment and new technical ventures.

The CHAIRMAN. You can summarize very quickly now.

Mr. SWIGGETT. We strongly support S. 98, a highly leveraged bill creating a 25-percent tax credit for increases in industrial R. & D.

We also strongly support S. 692 sponsored by Senators Packwood, Danforth, and Bradley. You will hear more about these from the other panelists.

Lastly, the pivotal motivational effect of a restricted stock option should be restored to its pre-1964 status. This is proposed in S. 639, sponsored by Senators Packwood and Bentsen.

The stock option was a great motivator for me when I cofounded a company. It was the only way I was ever able to get a significant stock ownership position in that company.

We need this kind of driving force in our companies today. It would be a great thing for our country.

Thank you.

The CHAIRMAN. Mr. Nesheim.

## STATEMENT OF JOHN L. NESHEIM, TREASURER, NATIONAL SEMICONDUCTOR CORP., ON BEHALF OF THE SEMICONDUCTOR INDUSTRY ASSOCIATION

Mr. NESHEIM. Good morning, Mr. Chairman. I am the treasurer of National Semiconductor Corp., which is the second largest integrated circuits manufacturer in the United States with sales about $1 billion and 35,000 employees around the world. About 30 percent of our products are exported to electronics markets around the world outside the United States.

Our company has a compound growth over the past 14 years of our existence of about 40 percent per annum.

You are aware of the challenge that has been presented to the semiconductor industry by our foreign competitors. That challenge has been manifest principally in the 40-percent share market which the Japanese have quickly obtained in the fastest growing segment of our business.

The fundamental problem, we feel, lies not in our lack of competitiveness. This is an intensely competitive industry. Rather our problem lies in the economic policies of the foreign governments supporting their indigenous industry.

The Japanese are clearly in the lead with an ability to raise very large amounts of capital without regard for financial performance.

We are not seeking protection. We like to meet our competition head on. We have been asking, for instance, that tariffs on semiconductors be brought down to zero around the world. We are pleased with what has been accomplished today, but more must be done.

We don't want to imitate the policies of our trading partners. We want instead a uniquely American solution that will preserve the ability of our small- and medium-sized companies to remain growing and highly productive. We also want access, in fact as well as principle, to both markets as well as to capital. We want an American response to the international challenge. Finally, we want to carry out our fundamental mission—to keep our customers competitive with the foreign competition by providing them the highest performance, highest-quality parts at the lowest cost.

We support the overall Reagan economic program. We feel that they are beginning to address some of the fundamental problems of the country, but we are here today to offer a refinement to that program.

This year my company will invest about a quarter billion dollars in research and development and new equipment. That's betting the company's entire net worth on the future. That is very typical of what happens in the industry.

Our industry views research and development very much in lock step with investments in the latest factories. Unless we provide the latest innovations, we will find ourselves quickly producing the most obsolete products in the most modern factories in the world.

We are in support of S. 98, which encourages companies to spend more for research and development. We have to renew the country's commitment to basic as well as applied research. In my own company we have serious proposals far in excess each year of those that we can fund. I am just finishing our latest 1-year plan. This year we had to turn down 25 to 50 percent of the proposed projects. I could not fund them. S. 98 and similar bills would reduce the cost, increase the cash flow and provide the stimulus to undertake more of these projects and thus do more for our customers as well as for our industry.

We are also critically short of engineers and basic research. Our universities have to be encouraged and we feel very strongly that they need money. Cash flow makes the world go round at universities as well as at companies.

Our equipment very quickly becomes obsolete in 3 to 5 years typically mostly because of technology and competition. The administration's bill with a 5-year writeoff for manufacturing equipment would not provide us a significant depreciation incentive. In fact in some circumstances it could even hurt the industry.

We urge any depreciation proposal include a 2-year writeoff and a full tax credit for short-lived equipment. Such treatment is provided by Senator Bentsen in his bill S. 317.

We are also in support of other bills to eliminate R. & D. expenses against foreign income, to reinstate qualified stock options, to reduce capital gains tax rates and to reduce the taxation of Americans working abroad.

[Senator Dole is back.]

These proposals will be discussed in more detail by others in this panel.

In summary, we desire an American economic program that optimizes our economic role through revitalization of commercial research coupled with investment in modern plant and equipment.

The two must go hand-in-hand, otherwise you will have a car without an engine.

We are concerned with how rapidly our foreign competition is making painful economic incursions in our business. In spite of the reportedly strong U.S. economy, this past quarter, American semiconductors companies reported profits dropping between 25 and 90 percent for most of us. Our customers are buying less from more suppliers now that includes as major competitors the Japanese.

America cannot afford to delay action needed now. Your leadership on this tax cut bill can be the first step toward keeping the U.S. semiconductor industry viably competitive.

Thank you.

The CHAIRMAN. Mr. Cherecwich.

## STATEMENT OF PAUL CHERECWICH, JR., MANAGER—CORPORATE TAX, THE FOXBORO CO., ON BEHALF OF SCIENTIFIC APPARATUS MAKERS ASSOCIATION

Mr. CHERECWICH. Thank you, Mr. Chairman. My name is Paul Cherecwich. I am the corporate tax manager of the Foxboro Co. in Massachusetts. We have annual sales of about $500 million and we employ over 7,000 people in the United States. We export approximately one-third of our production.

I have prepared a written statement which I have submitted and will summarize for you. I am here today representing the Scientific Apparatus Makers Association. We are manufacturers and distributors of scientific, industrial and medical instruments and equipment.

This industry has over $11 billion in annual sales, employs over a quarter of a million people and exports over one-third of its domestic production.

We should generally support the President's program. We feel however, that it does not go far enough to adequately address the needs of high-technology industry. I would like to take just a few moments to focus on high-technology industry and on the need for research and development and the importance of it in our life.

R. & D. intensive industries have had a positive trade balance for the last 20 years. We cannot say the same thing for those industries that are not R. & D. intensive.

We notice that the productivity gains of R. & D. intensive industries are more than double those gains of non-R. & D. intensive industries.

Finally, the R. & D. intensive industries have nearly tripled their expansion.

During this period unfortunately, R. & D. expenditures, as a percentage of GNP in the last 20 years have declined by over 17 percent. That means we are unlikely to be able to continue the trends that the R. & D. intensive industries have been showing us.

Our trade association, SAMA, conducted a survey in 1979 to determine R. & D. expenditures. We found that typically this industry spends 5.6 percent of its sales volume on R. & D. activity. That's 87 percent of after-tax profits; 150 percent of capital expenditures is spent on R. & D.

We feel that is not enough or we will lose that competitive position that we have fought for so hard. We note that the Presi-

dent's program does in fact address the needs of R. & D. intensive industries, but unfortunately we think it addresses it in the wrong manner. It provides for a 3-year writeoff of equipment that would be used in R. & D. along with the 6-percent investment tax credit in in lieu of the 5-year writeoff in 10-percent investment tax credit.

On a discounted cash flow basis this produces no real incentive.

We also note that the greatest R. & D. expenditures are on people not on equipment. What is needed therefore is a series of targeted solutions.

I specifically would like to address the Research Revitalization Act, S. 692 introduced by Senators Bradley, Danforth, and Packwood of this panel.

This bill would address the problems that have been caused by Government-directed university R. & D. and begin to shift that emphasis to industry directed R. & D.

We find that universities obtain 67.4 percent of their R. & D. funds from Government and less than 4 percent from industry.

What is needed is more industry-university interaction. Thus S. 692 will provide that through a tax incentive which allows industry to spend $1.86 for the same after tax cost that they can get for spending one dollar today.

More importantly, this bill would provide the attention needed to increase the industry-university dialog which seems to have been missing in this country for the last several years.

Finally, this would help to generate more trained people. We find that there is a very serious shortage of solemnly trained technical people in the United States today.

We also favor S. 98 introduced by Senators Danforth, Bradley, and others for tax credits for inhouse R. & D. and we support H. R. 2473 which has not yet been introduced in the Senate which would correct the problems with certain tax regulations that provide an incentive for conducting R. & D. outside this country rather than inside the country.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Cherecwich.

Mr. Howard.

## STATEMENT OF GERALD K. HOWARD, ON BEHALF OF SPERRY CORP.

Mr. HOWARD. My name is Gerald K. Howard. I am vice president of tax administration of the Sperry Corp. Sperry is a diversified high-technology company in the business of developing, manufacturing, and selling computer systems and equipment, farm equipment, guidance and control equipment and fluid power equipment.

I welcome the opportunity to testify on the President's proposed tax reduction program.

We believe that the administration's plan to stimulate the American economy by increasing the after-tax rewards for work, savings, and investments, and as a companion of reduced Government spending, and less Government regulation, is a bold and promising remedy for the Nation's economic ills. We believe it will accomplish its underlying objectives including renewing the business community's confidence in the future.

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We are testifying before this committee to suggest ways in which the President's program can be further strengthened.

As you know, the administration has recognized the need to provide tax relief for investment in machinery and equipment used in research and development by including in its accelerated cost recovery plan, a special 3-year writeoff period for such investments that will qualify for a 6-percent investment tax credit.

However, a close examination of this proposal indicates that the tax benefits of a 5-year writeoff period and full 10-percent investment credit for machinery and equipment not dedicated to research and development exceeds the benefits of a 3-year writeoff with partial investment credit for machinery and equipment used in research and development.

As a high technology company, we can testify to the fact that less than 10 percent of our total research and development budget represents investment in machinery and equipment.

The major portion of our R. & D. investment involves the cost of applied research, new product development and product improvement.

Economic growth through technology may be demonstrated in recent statistics covering the U.S. role in international trade.

The United States suffers from a large and persistent trade deficit including $24.6 billion in 1979 and $20.3 billion in 1980.

The U.S. market share of world exports of manufactured goods dropped from 16.8 percent in 1976 to 15.5 percent in 1979.

The high technology component is striking when one considers that in the period from 1960 to 1979, R. & D. intensive manufacturing industries increased their export surplus from $5.9 billion to $39.3 billion.

Within the same time period industries without technological basis declined from near zero to a negative $34.8 billion.

In order to encourage investment in research and development, we ask the committee to support tax incentives designed to spur increased research and development expenditures by the private sector.

It is clear to us and others that tax incentives for research and development are necessary if we are to achieve growth and productivity, expansion of exports, creation of new job opportunities and expansion of plant and equipment.

Sperry strongly supports S. 98 as introduced by many members of this committee. As you are aware this bill provides for a 25-percent credit for research and development expenditures in excess of base period expenditures for this purpose.

In reviewing the administration's depreciation proposal, we believe special consideration should be given to the following issues.

Whether current law or those proposed should apply to depreciable assets located outside the United States and in computing the earnings and profits of foreign subsidiaries of U.S. companies.

Whether the use of the accelerated cost recovery system should be required by law or voluntary as it is under current law.

Whether the full 10-percent investment credit should apply to machinery and equipment dedicated to research and development efforts.

The CHAIRMAN. Your time has expired. Thank you.

Mr. Kennedy.

STATEMENT OF DONALD KENNEDY, PRESIDENT OF STANFORD UNIVERSITY

Mr. KENNEDY. Thank you very much, Mr. Chairman. I am president of Stanford University, but today I am speaking for the Association of American Universities and for the National Association of State Universities and Land Grant Colleges. These two organizations include most of the Nation's research universities, and as a consequence, they have a very strong interest in our country's research capacity.

I think the testimony by my industry colleagues on this panel shows well that a sound active research base is essential for economic growth.

American universities conduct most of the basic research that is done in this country, about two-thirds of it, and it is from that kind of research that advances in science and technology made in companies like those represented on the table here ultimately come.

Yet, industry has not, by and large, been a heavy supporter of such work in universities. As you have been told, on the average of 2 to 4 percent of basic research in universities has been industry funded over the past 10 to 15 years.

Even at Stanford where we have more than the average number of collaborative programs because we are strong in engineering and related disciplines, the figure is less than 5 percent.

Industry-university collaboration has been difficult to establish for a variety of reasons but there are very good examples of cases in which it works and in my own testimony I have provided a couple of them from our institution and others could provide equivalent ones.

In certain academic disciplines, traditional distinctions between basic and applied research have become blurred as the distance is shortened between basic research and the application of the knowledge gained from it in useful products and processes. Biotechnology and microelectronics are good examples.

Universities have the capacity to do more basic research to meet the needs of industry and the industry can't duplicate the conditions for fundamental research that exist in universities. Yet we believe without additional incentives significant changes in the pattern of industry supported basic research, are not likely to occur.

I can assure you that universities have been seeking private sector support from industry and individuals for many years without blushing about it at all and we are in a good position to know that new incentives are needed.

S. 692 provides tax incentives to encourage industry to support university basic research that will ultimately meet its needs.

We think that the enactment of that legislation would lead to significant university-industry collaboration which in turn would stimulate innovation, increase technology transfer and perhaps as a by-product yield scientists and engineers with training better matched to industries needs.

So we are very enthusiastic, Mr. Chairman, about those proposals.

Thank you very much.

The CHAIRMAN. Thank you.

Senator Danforth, you are the early bird.

Senator DANFORTH. Mr. Chairman, I am going to ask two questions very quickly and I would appreciate it in the interest of time if you could answer them very briefly.

The first one is this—if a 25-percent tax credit for R. & D. were enacted, how much would your R. & D. spending increase?

Mr. HOWARD. Senator, speaking on behalf of Sperry Corp., our research and development people tell us that their research efforts would be increased by as much as 40 to 50 percent with this additional funding.

Mr. NESHEIM. In the building blocks area of semiconductors it is 25 to 50 percent on this year's budget.

Mr. SWIGGETT. The number that my colleague on the left used of 1.86 times is a very good factor it seems to me and I would suspect that our R. & D. budget would go up to the order of 25 to 30 percent. The same thing would be true of most AA companies.

Mr. CHERECWICH. Senator, my company is facing a cash—right now, and we are going to be hard pressed to maintain the level of funding that we had and yet to be competitive we have to increase.

I also would like to just note on the university R. & D. bill that our trade association took a survey and the response there indicated that they would increase the university R. & D. spending by 65 percent.

Senator DANFORTH. The second question is this: The Federal Government is already very heavily involved as Dr. Kennedy pointed out. Do you believe a tax credit aimed at stimulating more joint research between universities and industry would be worthwhile?

Mr. CHERECWICH. I think that the problem that we have run into with the Government funded research is that we are just missing the dialog that takes place with industry and it is that dialog between industry and university that helps identify the areas necessary for productivity improvement.

I think in a free market economy we need to have as much cost fertilization as possible and you get that in a broad market based economy and broad market based incentive programs rather than a top down directed program.

Mr. NESHEIM. We have a project that developed semiconductor applications at a university. It involved most recently an application that improves productivity, though a checkout system at a supermarket utilizing a laser scanning terminal that checkmarks the price while the computer is printing out a complete description of, for example, 10 cans of green beans at 33⅓ cents. That's productivity. That was accomplished through a coop program between a small funded activity at a university and a company. We would like to see much more of that.

Mr. HOWARD. Senator, I think the passage of S. 98 would choose the type of research that would be conducted too. I think there would be more speculative research, but also more rewarding research to companies.

Mr. KENNEDY. Senator, I think that anything that increases the pluralism of the support pattern is going to be desirable. The Government programs tend to be rather concentrated in particular

areas. They have been enormously valuable, but if you diversify the sources of support I think you are going to help the whole system.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman. I would like to ask the industry members and the university member—but mainly the industry members—if they are concerned that funds will be transferred if we do enact these tax credits from charitable gifts to restricted research funds. Are you concerned that we will not get more new investment in research and development but instead will simply get the substitution of contributions to research and development for charitable gifts.

Mr. CHERECWICH. Mr. Bradley, our company does not make that kind of tradeoff. We have a charitable giving program that is a social support program with a set budget every year.

The tradeoff with university R. & D. funding never enters into those deliberations. Those deliberations take place in two totally different organizations within our corporation. I do not see any of these bills, at all, doing anything to the current voluntary philanthropy by corporations in the United States today.

Mr. SWIGGETT. We have discussed that point at some length in the AEA and I would concur with my colleague here. The charitable decisions are really made at a different time and at a different place and in a different way and there is likely to be no cross reference.

[Senator Bentsen arrived.]

Mr. KENNEDY. Senator, just to add from the point of view of those who would be the most scared if this were a likely prospect, we think that those decisions are independently made and indeed if it were the case that those were traded off you would predict that the corporations that support most of the research at Stanford would be among the less generous and vice versa and it just isn't true.

Senator BRADLEY. Do you think that the tax credits should be restricted to the hard sciences as opposed to social science or economics.

Mr. NESHEIM. I think the credit should apply for basic research and for the people conducting that research.

Senator BRADLEY. So you would eliminate everything but the basic research and hard science.

Mr. NESHEIM. Yes, sir.

Senator BRADLEY. Mr. Howard.

Mr. HOWARD. I would support that also.

Mr. SWIGGETT. Yes.

Mr. CHERECWICH. Yes.

Mr. KENNEDY. I would beg to disagree. These gentlemen obviously represent a particular sector of science. I wouldn't think that it should be restricted to those. There are after all private organizations, profit organizations involved in social science research and they sometimes sponsor activities in universities. I don't see why they shouldn't get the same benefits that the physical sciences would.

Senator BRADLEY. Dr. Kennedy, do you see any detrimental effects on the university from greater cooperation with the industry.

Mr. KENNEDY. Senator, as long as the present conditions under which research support is developed in universities, whether from Government or private organizations, I don't see that danger. It is an eyes-wide-open event by and large between a group of investigators with a set of research aims and a supporting organization with research aims. The problems can be negotiated out in advance and have been successfully.

Senator BRADLEY. Are you concerned that if there is an increase in industry support that Government will reduce its direct support for research and development.

Mr. KENNEDY. I think that we have already seen in real terms the beginning—significant beginnings of Government withdrawal so I tend to see the problem the other way around. I think we are following the horse with the cart here.

Senator BRADLEY. An argument has been made that with our present mix of capital and labor and the run up in energy prices we need major breakthroughs I research and development that will result in new technology, not simply greater investment in existing technology in order to have a sustained surge in productivity and real economic growth.

I would suspect that you would agree with that thesis but I would like to know first of all whether you do agree and specifically how a breakthrough in research and development might affect economic growth and international trade.

Since the bell rang, I decided to combine three questions into one. [Laughter.]

The CHAIRMAN. Answer them with yes or no. [Laughter]

Mr. NESHEIM. In semiconductors we are very confident that we have not reached the limits on our technology. We can go at least several more generations ahead which would mean a 30- to 40-percent cost reduction per annum in the types of production machines we have working in electronics.

That should supply tremendous incentives for the sunset industries as well as the new technology industries that are small and still merging.

Mr. SWIGGETT. The driving energy of the whole electronics business in the sort of advances that are coming along out of semiconductors. But each one of those advances calls for a whole new level of product R. & D. to make it into useful things which will create the kind of growth that I predicted.

Mr. CHERECWICH. Sir, in the process measurement and control industries, we manufacture instrumentation to control liquid flow, pressure and temperature. These are fairly basic controls and yet they are vitally important in the energy field, in the synfuels area for example.

The most efficient economic way to manufacture oil out of synfuel is going to come about only with the development of industrial instrumentation that currently exists only in the idea state.

Senator BRADLEY. So that if you simply gave incentives for greater investment in current technology it is unlikely that you would get that major jump.

Mr. CHERECWICH. I think that is correct, sir.

Mr. HOWARD. Senator, I think you should also keep in mind that it takes a long period of time before research and development efforts become productive.

In our computer industry for example, sometimes it takes as long as 10 years from the beginning of research and development efforts to the time that a product is actually produced.

Senator BRADLEY. What I think I hear you saying, and I have to yield to the chairman, is that if what we want is a real surge in productivity and economic growth, it's better to place our bets on research and development than on increased capital investment per se.

I recognize that you would say they are both important and I think they are too. But if we have to identify which is marginally better, the emphasis on research and development in your judgement is going to give a bigger spurt to growth and to increased productivity. I see everyone nodding their heads, I assume that means yes for the record, Mr. Chairman.

The CHAIRMAN. Senator Bentsen.

Senator BENTSEN. I think Senator Bradley's overtime questions pretty well took care of my own time questions. But, I found in the Joint Economic Committee studies that we have made the point that he has been ably making. That we grind out the increases in productivity at a very painful rate. That's a difficult thing for us to do over a long period of time. Inasmuch as I am for accelerated depreciation, buying that new equipment and that new machinery and finally translating it to increased productivity is going to take years and years to accomplish.

We keep hoping for the major breakthroughs in technology and that is where we have made great strides in the past—through increasing productivity. That is a major reason why I am a very strong supporter of the incentives for additional R. & D.

So, with that editorial comment, Mr. Chairman, I will have expressed my time.

The CHAIRMAN. Thank you.

I have some questions, I will just ask a couple of them. We are going to have witnesses later on that will indicate that the free market is working as far as they are concerned and at least in obtaining adequate R. & D. and if there is a market failure, or if there is not a market failure, maybe we can find out from the other panel, there may be some question why the Government should intervene.

But, I think there is widespread support in various degrees for many of the things that have been touched on this morning. But right now, as I understand it, treatment of intangible capital assets, created by R. & D. expenditures, under created expensing is more generous than that permitted any other type of asset under present law.

The current super incentives for R. & D. have not produced adequate results, maybe it is time that we take a look at the efficiency of tax incentives for R. & D. rather than piling on another layer of subsidies. We are talking about different proposals which in the first year would cost about a half a billion dollars.

There are many concerns about how much we are going to spend for tax reduction. Some don't think we should spend any. You can address that question or not.

Mr. NESHEIM. I would like to Mr. Chairman.

We would suggest that you could easily reduce the cost of the overall depreciate program that the Reagan administration has proposed to accommodate the relatively low costs of the R. & D. proposals.

We feel that it is not a subsidy that we are asking for. We are asking for a recognition of the reality that cash flow makes the world go round. We need more of it to compete against competitors that are getting direct cash subsidies from their government and have an ability to raise—capital without regard to financial performance.

The CHAIRMAN. Which governments are giving direct subsidies.

Mr. NESHEIM. France, Canada and Japan are subsidizing their industries. In Japan the government has provided direct aid computed to be at $2 billion.

The CHAIRMAN. But, Japan is spending less as I understand it—BNP than we are.

Mr. NESHEIM. Not in semiconductors and computers specifically measured by company dollars as a percent of sales or by cash flow.

Senator BENTSEN. If I might, Mr. Chairman, interrupt there. We sent people over from JEC to study that. They found that part of the import tax on computers goes into the fund for R. & D. for major or large computer research, the building of large computers. This constitutes very major subsidies.

Mr. NESHEIM. We are indeed very concerned. They are catching up fast. It is not an open market. You are absolutely right.

The CHAIRMAN. Are there any other comments.

Mr. SWIGGETT. There have been some studies made by DRI which would indicate that the secondary effects of this sort of an R. & D. thing would increase Treasury revenues very early in the game by a significant amount.

The CHAIRMAN. That may be the case. Everybody was testifying that their amendment would be a plus to the Treasury. Maybe we ought to adopt them all. They are all supply side amendments, is that what you are suggesting.

Mr. HOWARD. Yes, sir.

The CHAIRMAN. Mr. Kennedy.

Mr. KENNEDY. Well, Mr. Chairman. I feel confident that the leverage particularly of S. 692 is very important and that it supplies so much of an indirect addition to the direct Government support programs that it is a very wise allocation of dollars.

The CHAIRMAN. I don't want to leave the impression that it may not be, but I think we are going to have to put together a program one of these days. I suggest you keep a close eye on it. I have no further questions.

Senator BRADLEY. Mr. Chairman, let me see if I can just make one further point about why the Federal Government should properly involve itself in funding research and development.

The problem is that no one company or group of companies can be expected to invest the amounts in research and development that would be optimal from the Nation's standpoint. Because indi-

vidual companies can't capture all of the benefits of their R. & D. investment, for example by acquiring a patent, they almost always underinvest. And even if they could capture all the benefits by monopolizing the results of the research such a monopoly wouldn't be in the society's interest. The reason is that widespread technological change requires that new information be broadly and rapidly disseminated. It's highly inefficient to go on reinventing the wheel which is what would happen if you could successfully monopolize your inventions. So these externalities result in a suboptimal allocation of private resources to research and development. It's therefore up to the public sector to make up the difference and to further the society's interest in optimizing research and development.

So, in some senses, research and development unlike practically anything except defense, has a very real and legitimate role for Government to play.

Do you agree or disagree.

Mr. CHERECWICH. Senator, I agree with that. I also would like to point out that if you take a look at the statistics of the nationalities of the persons filing patents in the U.S. Patent Office, I think you will find that over the last 10 to 15 years, the percentage of foreigners filing U.S. patents has been growing at a much greater rate than the percentage of Americans who have been filing patents.

I also feel that particularly in the dialog between universities and industries will see a much greater propensity to publish the results of that research than we would if we had some purely Government sponsored research.

Senator BRADLEY. So, you're saying that keeping in mind it will be an even greater dissemination.

Mr. CHERECWICH. Yes, sir.

The CHAIRMAN. Thank you very much.

We'll keep you in mind. We appreciate it.

Mr. NESHEIM. Thank you.

Mr. HOWARD. Thank you.

Mr. SWIGGETT. Thank you.

Mr. CHERECWICH. Thank you.

Mr. KENNEDY. Thank you.

The CHAIRMAN. We have another panel consisting of Charles Stewart, Craig Smith, and Sidney Lieberstein.

I'm not certain whether you have any predetermined order. If not, perhaps you may proceed as your names were read. Again, I would indicate to this panel, we do have a series of votes starting at 11. It's obvious that we are not going to complete this and then Mr. Seibert and then the other panel, so I might suggest that at 11 we will be in recess until about 11:30, so the members of the third panel here can spend an hour to do something else if they would like.

Your statements will be made a part of the record, as though given in full.

There are members who will have questions, so if you could summarize your statements, highlight the important points, it would give us some time for questioning.

Thank you.

[The statements of the preceding panel follow:]

THE CASE FOR A TECHNOLOGY-ORIENTED TAX POLICY
And
SPECIFIC RECOMMENDATIONS FOR A TECHNOLOGY-ORIENTED TAX POLICY

Statement of

Robert L. Swiggett, President and Chief Executive Officer
Kollmorgen Corporation
Before The
Senate Committee on Finance
May 21 1981

Summary

The Case for a Technology-Oriented Tax Policy:

- Leadership in technology is the most valuable national resource of the United States;
- Our leadership in technology has been on a steady decline over the past twenty years;
- Fostering technological achievement requires both freedom and incentives for innovators;
- Tax policy is the most powerful instrument in the hands of the federal government for fostering technological innovation.

Specific Recommendations for a Technology-Oriented Tax Policy:

- Tax Credits to Stimulate Corporate R&D and University Research
- Restoration of Restricted Stock Options
- Elimination of Capital Gains Taxes on New Investments

THE CASE FOR A TECHNOLOGY-ORIENTED TAX POLICY
And
SPECIFIC RECOMMENDATIONS FOR A TECHNOLOGY-ORIENTED TAX POLICY

Statement of
Robert L. Swiggett, President and Chief Executive Officer
Kollmorgen Corporation
on Behalf of the
American Electronics Association

before the

Senate Committee on Finance

May 21, 1981

Mr. Chairman and Members of this distinguished Committee.

My name is Robert L. Swiggett. I am President and Chief Executive Officer of Kollmorgen Corporation. Headquartered in Stamford, Connecticut, we employ over 4,000 people in 15 manufacturing plants between New Hampshire and California and two in Europe. We will ship over $225 million in 1981. Historically, we have doubled our business ever four to five years and expect to double it again within the next three to four years.

We are technical and market leaders in the areas of printed circuits and electronic interconnection systems, specialty servo motors with electronic controls, and sophisticated electro-optical instruments such as submarine periscopes. Our future growth depends primarily on the quality of our technical innovation and our ability to pay for and man increasingly complex and expensive manufacturing facilities.

I am appearing before you this morning, representing the American Electronics Association, to offer the viewpoint of an entrepreneur in a high technology industry for this discussion concerning the appropriate tax policy for the United States at this time. The AEA

is a trade association of more than 1,600 high-technology companies in 43 states. Our members are manufacturers of electronic components and equipment or suppliers of products and services in the information processing industries. While our member companies employ more than one million Americans and include some of the nation's largest companies, more than half of our member companies are small and employ fewer than 200 people.

I realize that in formulating and enacting changes to the existing tax laws, Congress must consider many complex factors: the amount of tax revenue that will be generated, the impact on various income groups, the effects on business activity, fairness, and the simplicity of implementation. This morning, I would like to suggest that there is another important factor which should also be considered when formulating tax policy: The impact of that tax policy on the rate of technological innovation in the United States.

Mr. Chairman, our case is based upon the following fundamentals:

- Leadership in technology is the most valuable national resource of the United States;
- Our leadership in technology has been on a steady decline over the past twenty years;
- Fostering technological achievement requires both freedom and incentives for innovators;
- Tax policy is the most powerful instrument in the hands of the federal government for fostering technological innovation.

Here are the specifics.

TECHNOLOGICAL LEADERSHIP IS OUR MOST VALUABLE NATIONAL RESOURCE.

The quality of life of American citizens depends upon having a strong economy which is able to produce an abundance of goods and services and also provide enough well-paying jobs. Our quality of life also depends upon a strong national defense that makes any attack by foreign aggressors unthinkable. Technology is the key to both a strong economy and a strong defense. I'll elaborate.

- Technological innovation is fundamental to economic growth. We are able to grow when we find better, more efficient ways to do things and when we develop new products that meet unfulfilled consumer needs at home and abroad. Professor R. Solow of the Massachusetts Institute of Technology confirmed this in a study showing that approximately 80% of the growth in the GNP of the United States between 1909 and 1949 was due to technological change.

- Technological innovation is fundamental to productivity improvements. Through the ages, the physical capabilities of people have been enhanced by machinery, leaving more time for intellectual activities. More recently, the power of the human intellect has been extended by computers, data storage, communications systems, and visual display devices. Now we are entering the age of robotics in which the two are combined to do certain work more effectively and efficiently than ever before. It's not surprising that a recent Brookings Institution study determined that more than one-half of the productivity increases in the United States between 1948 and 1969 were the direct result of technological innovation.

- Technological innovation is fundamental to international trade competitiveness. In recent years, while the export performance of the United States has produced some disturbing trends with trade deficits of $26.5 billion in 1977, $28.4 billion in 1978, and $24.7 billion in 1979, exports of R&D-intensive products (e.g., high technology electronics, capital equipment and pharmaceuticals) have shown excellent growth. From 1960 to 1979, R&D-intensive manufacturing industries increased their export surplus from $5.9 billion to $39.3 billion. During the same period, the trade balance of industries without technological bases declined from near zero to a negative $34.8 billion. With our trading partners recognizing the importance of innovation and technology, it is becoming even more important to emphasize technology advancement as the key to competitiveness at home and abroad.

<u>Technological innovation is fundamental to a strong national defense</u>. If we assume that maintaining parity in weapons with the Soviet Union is essential to a strong national defense, we must rely on technology and its implementation in weapons systems as the basis for our defense strategy.

Over the past decade, the Soviet Union has eroded much of the advantage we used to have by improving the power and accuracy of their strategic weapons and by increasing dramatically the amount of military equipment they produce. Although the situation is not yet desperate, the trends are frightening and the need to be reversed immediately.

We can't reverse the trends by trying to regain numerical superiorits. That approach would be financially infeasible and ineffective. However, we can reverse the trends by using our technology, which in important areas is far more advanced than the Russians. We have the technology to make our munitions more accurate, our aircraft, submarines, and missiles more difficult to detect, and our surveillance and electronic warfare systems more effective. In the 1980s, our defensw must be based on the use of <u>finesse</u> through technological innovation rather than on pure <u>force</u>.

<u>OUR TECHNOLOGICAL LEADERSHIP IS DECLINING BADLY</u>.

Mr. Chairman, over the past twenty years, our technological leadership has been seriously eroded. We haven't squandered it, as we have some of our other resources, through overuse and waste. We've frittered it away through neglect.

The emphasis on R&D in the U.S. has been on a steady decline over the past two decades. From 1953 to 1965, industry's R&D expenditures grew (in constant 1972 dollars) by 7.2% per year, while from 1973 to 1978, the annual growth of R&D expenditures slowed to only 3.2% annually.

In 1964, as a nation, we spent 3% on GNP on research and development, but by 1979 we were spending only 2.2%. In real terms (1972 dollars), growth slowed from an annual 9.9% in 1953-1965 to 1.8% in 1973-1978. During a comparable period, two of our most aggressive trading partners--Japan and West Germany--were increasing their R&D expenditures. The following table compares the trends in those nations to those in the United States and provides data which suggests the economic implications of those trends.

| | United States | Japan | West Germany |
|---|---|---|---|
| R&D as percentage of GNP-- | | | |
| 1964 | 3.0% | 1.5% | 1.6% |
| 1976 | 2.3% | 1.9% | 2.3% |
| Average annual rate of productivity improvement-- | | | |
| 1960-78 | 2.6% | 8.5% | 5.4% |
| Share of world's exports-- | | | |
| 1960 | 18.0% | 4.0% | 10.3% |
| 1977 | 11.8% | 8.0% | 11.5% |

Given the decline in R&D expenditures in the United States, it's not surprising that our leadership in technological contributions has declined as well. In the 1950's, the United States was credited with 80% of the major inventions made during that period. However, during the 1970's, our share of major inventions had dropped to 60%. In addition, from 1964 to 1979 the U.S. patent balance -- the percentage of U.S. patents granted to U.S. citizens rather than foreign inventors -- dropped from 88% to 62%.

Although the statistics cited here are disturbing, the situation is not hopeless. Since technological innovation is derived from the talent of our people, it is within our control. That cannot be said for our energy sources or many of our raw material supplies. Indeed, the growing dependence of the United States on foreign energy and raw materials makes it all the more important that America's potential for technological innovation be realized.

FOSTERING TECHNOLOGICAL INNOVATION REQUIRES FREEDOM AND INCENTIVES. With technology being so important to our national interests and yet declining in America, the federal government must act now with a sense of urgency to stimulate technological innovation. Maintaining and extending our technological leadership should be a national priority.

Unfortunately, positive changes in the rate of technological innovation will come slowly. Innovation can't be forced; it can only be fostered. It is fostered by creating an environment that emphasizes freedom of scientific and industrial activities and that offers incentives to the innovators, entrepreneurs, and investors who have the talent and resources to advance technology. Massive government R&D programs aren't the answer. Innovation doesn't thrive in bureaucracies. Innovation takes place when an individual gets an idea, has the freedom to pursue it--perhaps to succeed but maybe to fail--and can earn an attractive reward if he or she is successful.

For example, most of the commercially useful breakthroughs in genetic engineering have taken place in the laboratories of small companies run by entrepreneurs. The development of the U.S. semiconductor industry is a history of entrepreneurship and small company contributions. In fact, according to a 1967 Department of Commerce report, more than half of the major technological advances in this century originated from individual inventors and small companies.

WE NEED A TECHNOLOGY-ORIENTED TAX POLICY TO FOSTER INNOVATION. Starting today, we must begin to recreate an environment in America that fosters innovation. It should be an environment based on free enterprise, free trade based on reciprocity and freedom from unnecessary regulation. It should also be an environment with incentives that encourage investment, risk-taking, new ideas, and entrepreneurship.

Eliminating ill-conceived regulations and government programs to protect and subsidize noncompetitive enterprises will go a long way toward unleashing creative forces and encouraging proper allocation of resources. However, the most powerful instrument available to the federal government for fostering technological innovation is a tax policy that stimulates investment, entrepreneurship, and technical research.

Over the past two years we have seen the powerful effect that such tax policy can have on economic growth and technological development.

Concrete Benefits from Risk Capital Investment

Exactly three years ago last week, we presented to the House Ways and Means Committee the results of a major survey of the capital formation experience of U.S. electronics companies conducted by the American Electronics Association (AEA). That survey was the first of its kind ever conducted and provided startling new information and valuable insight into the environment facing young, innovative companies and their contributions to our economy.

The AEA survey documented the importance of young companies in solving the nation's unemployment problem. It showed that young companies create jobs 20-115 times faster than mature companies in the electronics industry. In fact, although the mature companies in the survey averaged 27 times more employees than the younger companies, the younger companies were creating more new jobs per firm per year than the mature companies.

The AEA survey confirmed that risk capital investment is essential to the start-up and growth of high-technology companies. Such companies require constant infusions of risk capital in order to finance their growth and employment increases. On the average, about $14,000 of risk capital was needed to create each job in the electronics industry since 1955.

In addition to the creation of jobs, these young companies, if adequately financed, generate other benefits to the country. For example, for each $100 invested in electronics companies founded during 1971-75, by 1976 those companies were generating $70 per year in exports, spending $33 per year on R&D, and accounting for $30 per year in federal income taxes. In other words, the study documented the remarkable fact that the federal government could get a 30% annual return on the risk capital invested by individual investors if only those investors had adequate incentives to make such investments!

Unfortunately, such incentives had been substantially reduced during the 1970's with the doubling of the maximum tax rate on capital gains from 25% to 49%. As a result, the AEA survey confirmed that the risk

capital needed to start and finance the growth of high-technology companies had all but dried up. In the period 1971-75, companies in the electronics industry were able to raise less capital (in constant 1972 dollars) than at any time in the prior 15-year period.

In order to rekindle the incentives for needed risk capital investment, the AEA and others strongly urged in 1978 a sharp reduction in the tax on capital gains on the grounds that it would once again make risk capital available to young companies. The AEA predicted that this tax cut would increase federal tax revenues rather than decrease them since such a reduction would have a stimulative effect on the economy and the stock market.

Congress acted in 1978 and reduced capital gains tax rates, cutting the maximum rate to 28%. I commend the initiative and the foresight of the Congress in taking that action which reversed a decade of capital gains increases and provided new incentives for risk capital investment and entrepreneurship.

Concrete Results of the 1978 Capital Gains Tax Cut

The results of the new incentives have been extraordinary. Here are some of the highlights:

- Commitments of new capital to professional venture capital funds during the 18-month period between mid-1978 (when the passage of capital gains tax reduction appeared certain) and year-end 1979 totaled nearly $900 million. This increase in funds, which are now available for investment in young and growing companies, is more than double the total amount of capital committed to such funds during the 7-year period 1970-77.

- Investments from such venture capital funds into young companies since 1978 reached $1 billion per year, more than triple the rate of investment before 1978, and, importantly, more of this money is now going into start-up situations.

- Young companies are now able to obtain needed capital from the public market far more easily than before the capital

gains tax rates were decreased. In 1980, new capital raised through initial public offerings of company stock jumped to over $1 billion dollars, double the amount raised in 1979 and more than four times the average raised per year during the period 1975-78.

- Since the Revenue Act of 1978 was passed--despite accelerating inflation, rising interest rates and impending recession--the price appreciation of public company stocks, particularly those of small companies, has been excellent. Between April, 1978 and December, 1980 the Dow Jones Industrial Average rose 24.3%, and the Standard & Poors 500 stock index climbed 49.2%, thereby exceeding the 40% increase in stock prices that had been projected by Chase Econometric Associates, Inc. to occur by 1982 as a result of the capital gains tax reduction.

- Cutting the capital gains tax rates did not result in the large revenue loss that the Treasury had predicted. Instead, the Treasury collected $8.3 billion in capital gains taxes in 1979, the first year of the lower rates, 14% above the $7.3 billion collected in 1977 and the $7.2 billion collected in 1978. The Treasury is collecting more at the lower rates than at the higher rates without even including the higher corporate and personal income taxes resulting from the economic stimulation that the lower capital gains tax rates are producing.

From the experience of the 1978 Revenue Act and its effect on risk capital needed to promote technological innovation, we have seen proof of the power of tax policy in creating an environment to foster innovation.

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In order to maintain and extend our technological leadership, we must implement a tax program that stimulates the key ingradients necessary for innovation:

- Industrial and university R & D activities;
- Entrepreneurship and individual risk taking; and
- More risk capital investment.

American Electronics Association scientists and entrepreneurs have formulated specific proposals for stimulating each of these key ingredients most effectively and efficiently. We believe that inclusion of such proposals in the tax package being forumated by Congress this year will foster innovation and enable the United States to preserve and extend its leadership in technology, which is so vital to our basic national interests. Specifically, we need:

- Tax Credits to Stimulate Corporate R&D and University Research;
- Restoration of Restricted Stock Options; and
- Elimination of Capital Gains Taxes on New Investments

## I. TAX CREDITS TO STIMULATE CORPORATE R&D AND UNIVERSITY RESEARCH ARE NEEDED TO MAINTAIN OUR TECHNOLOGICAL LEADERSHIP.

We strongly recommend enactment of S.98/H.R.1539 sponsored by Senators Danforth and Bradley in the Senate and Congressmen Vander Jagt and Pickle in the House. It would create a 25% tax credit for increases in industrial R&D spending over the average annual R&D outlays for the previous three years. This bill was included in the tax bill reported by this Committee in the last Congress.

We also strongly recommend S.692/H.R.1864, sponsored by Senators Packwood, Danforth and Bradley in the Senate and Congressman Shannon in the House, which would establish a 25% tax credit for corporate funds contributed to colleges and universities for research.

The case for these bills is based on the essential role R&D plays in our economy and the fact that it is lagging today. Our nation's ability to combat inflation, increase productivity, jobs, exports and energy depends squarely on innovation spawned by industrial research. But R&D is lagging in the U.S. today.

- Real growth in industrial R&D has slowed from an annual average of 7.2% from 1953 to 1965 to 3.3% from 1973 to 1978.
- Too much of industry's R&D has been diverted to "defensive" efforts required to comply with government regulations. Too much has been diverted to quicker payout, lower risk projects because of uncertainties caused by high inflation, high taxes and vacillating economic policies.

Our industrial R&D is declining both in absolute terms and in relation to our major trade competitors. Those countries actively promote it; we don't. For example, Japan targets high potential industries with developmental subsidies, accelerated depreciation, and soft loans for R&D. All businesses are allowed a 20% tax credit for R&D increases. Germany grants low-interest loans for R&D, tax-free cash grants for investment in R&D facilities, and special depreciation for R&D plant and equipment. The U.S. has no such incentives.

As a result of these contrasting national policies, total U.S. R&D spending (government and industry) as a percent of GNP has declined from 3% in 1964 to 2.2% in 1979, while Japan's increased from 1.5% to 1.9%, and Germany's from 1.6% to 2.3%. Nearly all their government R&D goes to civilian and commercial R&D, while over 60% of U.S. government R&D goes to defense and space projects--essentially none to commercial technologies.

The role played by colleges and universities in industrial innovation has not kept pace with our needs. The programs, facilities, and equipment at most universities today are inadequate to assist industry in its search for technological innovation. This stems from inadequate incentives for corporate grants for research and university dependence on federal funds. Most colleges and universities today are not able to produce the quantity and quality of technical graduates our technological industries need. The electronics industries and others are facing a severe shortage of graduating engineers and technical people, especially those with "hands on" training in our fast-moving technologies.

It's a disgrace and a disturbing fact that Japan, with a population half as large as the United States, trains four times as many scientists and engineers per year as we do. Out of every 10,000 citizens in Japan, 400 are engineers and scientists while only 1 is a lawyer and 3 are accountants. Out of every 10,000 citizens in the United States, we have only 70 engineers or scientists, but we have 20 lawyers and 40 accountants. We're becoming a society of paper pushers rather than producers.

We believe these two bills are well-crafted to help alleviate these problems.

Provisions of S.98/H.R.1539 and S.692/H.R.1864

By focusing a 25% tax credit on increases in spending, S.98 targets the incentive on expanded industrial R&D spending, thereby

minimizing the Treasury's initial revenue loss. The bill would create a new statutory definition of R&D, adopting the Financial Accounting Standards Board (FASB) definition, long used by industry and accountants in non-tax areas. This definition is supported by an established body of learning, thereby eliminating many of the problems and uncertainties normally encountered in a new statutory definition.

S.98 also contains special provisions for new companies since small start-up firms are extremely innovative. It would allow them to calculate their first year tax credit using a base of 3 years of zero spending, the second year using 2 years of zero, etc. Any unused credits could be "carried forward" for seven years to insure they are not lost because of little or no tax liability in the first few years.

In addition to spawning a large body of badly needed university research, H.R.1864 would reorient many academic programs and facilities away from wholesale federal sponsorship with its attendant administrative burdens, and toward the needs of industry in searching for productive innovation. It would also increase the supply of urgently needed technical graduates.

Studies Document Benefits from R&D Credits

Tax credits for R&D, as part of a technology oriented tax policy, would generate a stream of positive benefits to our economy. A 1977 Data Resources, Inc. study sponsored by General Electric showed how increased R&D spending would benefit the U.S. economy. It compared the impact that three different levels of overall U.S. R&D spending might have on the economy through 1980. The cumulative difference in the GNP under the highest investment in R&D (approximately the 1960 level) was estimated at $90 billion, compared to the lowest level of R&D spending (equivalent to the 1972 level in constant dollars). At the highest level of R&D spending, price reductions would be some 7.2% and the growth rate of per capita income could be as much as 17% higher.

In another recent study sponsored by Texas Instruments, Data Resources, Inc. examined the effect of increased R&D spending on the economy. It estimated that a 25% tax credit for all R&D expenditures during the period of 1978 to 1987 would:

- Increase R&D spending by an average of $5.2 billion per year;
- Add an annual average of $36.2 billion to the GNP;
- Add an annual average of $1.7 billion to U.S. exports;
- Provide an additional average yearly increase in productivity of 0.28%;
- Reduce the average annual increase in the consumer price index by 0.42%.

An important finding of the TI-DRI study was that a 25% tax credit for R&D would actually produce a net increase in Treasury revenue averaging $6.1B per year! While this resulted from an assumed 25% tax credit on all R&D, we would argue that a 25% credit for increases in corporate R&D should stimulate much of the same positive "feedback" at a substantially lower initial revenue cost.

Mr. Chairman, as a matter of policy, we believe the tax credit approach is much preferable to greater direct federal spending on research and development for the civil and commercial sectors. This approach would expand the government's commitment to R&D, while allowing the marketplace to determine how R&D resources are allocated. We believe entrepeneurs and corporate R&D managers investing their own funds will produce substantially more innovation for the same tax cost than Civil Service program managers.

II. RESTORATION OF RESTRICTED STOCK OPTIONS IS NEEDED TO MAINTAIN OUR TECHNOLOGICAL LEADERSHIP.

As I pointed out earlier, technological advancement is fostered by an environment that stimulates new ideas, entrepreneurship, and risk taking by individuals. In the past, restricted stock options were used extensively by innovative high technology companies to provide incentives for such activities. However, in

1964, restricted stock options were eliminated by Congress.

In the last Congress, attempts were made to restore this valuable tool for innovation. A majority of the House Ways and Means Committee sponsored a bill introduced by Congressmen Jones and Frenzel to restore the pre-1964 tax treatment of employee stock options, and this Committee passed such a bill by 19-1 vote. Senators Packwood and Bentsen have reintroduced that bill this year as S.639. Congressmen Jones and Frenzel have also reintroduced the House bill, H.R.2797.

The case for restoring restricted stock options is unusually strong. It would:

- Provide new incentives for individual innovation and risk taking, particularly in small companies, and
- Increase federal tax revenues.

I shall describe briefly each of these positive results.

Restricted Stock Options Would Promote Innovation and Risk Taking

A restricted stock option gives the employee the right to buy shares in the company at today's price for a fixed period of time and to pay a capital gains tax on any gain he realizes from the later sale of the shares so long as the shares are held for a prescribed period. As such, it gives employees, who may not have capital to invest, the opportunity to invest their talents, energies, and careers in a venture and, if it becomes successful, obtain the same kind of rewards as the financial investors.

Granting restricted stock options would motivate employees to find new and better ways to do their jobs. A stock option only has value to the employee if the price of the company's stock increases through growth in its sales and profits. Therefore, stock options give employees a powerful incentive to find innovative ways to expand the company's business and conduct that business more efficiently. Business growth creates more new jobs; increased efficiency results in greater productivity.

Providing employees with a significant equity stake through options can have a dramatic effect on a company's growth. It can also give smaller, innovative companies a means of attracting talented employees away from secure jobs in larger, mature companies. Because the value of stock options depends on growth in value of the company's shares, the stock prices of smaller companies can usually rise, on a percentage basis, far faster than that of extablished companies. Thus, options are proportionately more rewarding in small businesses than in larger companies. Smaller companies can ill afford to pay the salaries necessary to compete with Fortune 500 companies for talented employees, buth they can partially offset that disadvantage with stock options.

The "non-qualified" options, which are the only type permissible today, are practially useless as incentives for innovation and risk taking. Under present law, when an employee exercises a non-qualified option, he must pay taxes--at ordinary income rates--on the "paper profit" between his option price and the price of the stock when he buys it.

Not only is taxation at ordinary income rates inconsistent with what other owners would pay on their capital appreciation, but in addition, the employee must pay tax before he realizes any gain from selling the stock. It's analogous to taxing the unrealized appreciation on a homeowner's house, before he sells it. Employees without reserves of funds can find it impossible to buy the stock and also pay the tax on a "paper profit." Furthermore, if the value of the stock acquired by means of an option should decline sharply before the employee sells it, the employee loses money on the stock after having paid taxes at ordinary income rates on a "gain" he never realized. This is not just a theoretical possibility. It has happened often enough in recent years to destroy any motivating effects employee stock options may have had for companies in rapidly changing industries.

## Restricted Options Will Increase Federal Revenues

Another compelling reason for restoring restricted stock options is that it will not cost the Treasury a dime. At today's capital gains tax rates, it will actually raise more revenue than the current demotivating tax treatment of stock options. Under the capital gains proposal we make below, restricted stock options would be revenue neutral. This is a matter of straight tax accounting, and it does not depend on any of the positive "feedback" effects that would certainly result.

Both cash compensation and non-qualified stock options generate employee taxes to the Treasury. However, these revenues are more than offset when the corporation deducts them as business expenses from its own taxable income. On the other hand, employee compensation in the form of restricted stock options would not be deductible to the corporation. Therefore, to the extent that these more attractive options replace cash and non-qualified options, corporate tax payments will increase.

A recent analysis of this bill, performed by the public accounting firm of Price Waterhouse and Company, confirms the positive revenue effect of this bill and indicates that, in most cases, the government is losing money under the current law. Also, the Joint Committee on Taxation examined the revenue impact of this proposal last year. It estimated that, after an initial adjustment period which should cost less than $10 million total, restricted stock options would raise $15 million in Fiscal Year 1984 and $30 million in 1985. This is a net revenue gain of $35 million in six years.

We agree with the general conclusion of the Joint Committee's analysis, but we think its estimate of the positive revenue flow under current law is too low. Since many companies desiring to issue options would gladly substitute restricted options for the less effective non-qualified options, we believe one good indication of the potential revenue to be gained from this bill is the amount of deductions companies now take for their non-qualified options.

Recently, AEA contacted 10 of its member companies and asked them to report their non-qualified option deductions for the last five years to the public accounting firm of Coopers and Lybrand. Coopers and Lybrand informs us that between 1975 and 1979, these companies deducted more than $68 million due to the exercise of non-qualified options. At the current corporate tax rate of 46%, that represents over $31 million less to the Treasury than these companies would have paid, if these had been restricted stock options. This loss exceeded the personal income taxes paid on the "paper profit" by employees (assuming the average employee tax rate was less than 46%). However, the Treasury was also deprived of approximately $10.2 million of capital gains taxes (assuming an average 15% rate) the employees would ultimately have paid on the same transactions if restricted stock options had been used. Since there are thousands of other companies which would grant restricted stock options if they were available, we think it is fair to expect that the positive net revenue flow to the Treasury will be far larger than the current official estimate for this proposal.

Mr. Chairman, we are asking you to let us pay higher taxes. You may not hear this very often. But we are willing--even happy to--because we believe restricted stock options are substantially more attractive to our employees than equivalent cash or non-qualified options. Of course, no company would be required to pay higher taxes. Only those companies which, with the approval of shareholders, chose to adopt a restricted stock option plan would pay more.

Recommended Treatment of Existing Stock Options

Mr. Chairman, as I mentioned, the Senate version of this bill passed this Committee in the last Congress. We believe this bill, as reintroduced, is superior to this year's House bill. I am referring to the way the bill would treat existing stock options.

This year's House bill would only apply to options granted after its effective date, while the Senate version would apply to outstanding options which are exercised after enactment. Briefly, there are four reasons we prefer the Senate version:

First, it would immediately end the inequity that results when people who exercise options and purchase shares have to pay tax, at ordinary income rates, on whatever increase there has been--even though they have actually realized no income. If the value of the stock then declines, as often happens, these people are stuck, having paid tax on a "profit" that subsequently vanished. This risk of loss on pre-paid taxes, when added to the risk of loss on the stock itself has seriously diminished the incentive value of stock options. Making the bill effective for options exercised after enactment would prevent this inequity for all outstanding options.

Second, if the bill defers the taxable event only for options granted after enactment, it will seriously dilute the value of all existing option plans and could contribute to an undesirable spate of job-hopping in our industry and others. We are quite willing to suffer such an effect if that is the price for reforming stock options. But it would easily be avoided by covering the exercise of existing stock options in the bill.

The third important reason to make this change is that it will further increase Treasury's revenue gain and begin that process immediately. Companies which elect to convert their existing options to restricted stock options would give up the off-setting deduction they now receive when the employee buys the stock and pays the tax.

Finally, covering existing options will allow more restricted stock options to be granted. Since most companies maintain a ceiling on the number of outstanding shares dedicated to options, an incentive to cash in the old ones would speed the process of converting to the new improved version. Conversely, if the

slower moving old options were left out of the bills, it would limit the number of new restricted options which the companies could grant.

Extending this bill to existing options would substantially improve its value to our industry. We hope you will do so, but let us be clear that our highest priority is enacting the substance of the bill.

III. <u>WE NEED TO ELIMINATE CAPITAL GAINS TAXES TO MAINTAIN OUR TECHNOLOGICAL LEADERSHIP</u>

Three years ago, we urged this Committee to roll back capital gains tax rates to the pre-1969 levels on the grounds that such a significant reduction would stimulate badly needed rish capital investment in the United States and would not result in a loss of revenue to the Treasury. Although it seems hard to believe today that proposal, fostered by the late Congressman Bill Steiger and Senator Clifford Hansen was viewed by many then as a radical idea which would have little effect on investor behavior, job creation or technological leadership. We have now had time to study the effects of the 1978 capital gains tax cut. It has clearly had an extraordinary impact on the supply of risk capital for innovative, growing companies and has already enabled many new companies providing thousands of new jobs to get started and grow. It has attracted 4.7 million individual investors--many of them young people--back into the stock market, bringing the number of individuals with an equity stake in the economic future of our country back to the pre-1969 level of $30 million. Most importantly, capital gains tax revenues have increased since rates were reduced rather than decreasing as the Treasury had predicted they would.

Mr. Chairman, we believe that Congress should now seize the opportunity to further stimulate technological innovation and productive investment by passing a bill which would eliminate capital gains taxes on new investments. Eliminating capital gains taxes on new investments would have two dramatic and positive effects.

- It would provide an incentive for taxpayers to recognize unrealized gains on current investments and pay taxes now. These windfall taxes would flow into the U.S. Treasury over the next few years and could be used to offset currently anticipated budget deficits as well as the expected revenue losses from other desirable tax cuts.
- It would provide a substantial incentive for investors to make new investments in the growth areas of our economy which create most of this nation's economic expansion and new job opportunities.

Eliminating Capital Gains Taxes On New Investments Would Help To Reduce Budget Deficits In The Short Term

We have already seen the effect of "unlocking" from the 1978 Revenue Act. Advanced data from 1979 tax returns indicate that capital gains realizations rose by 46% in 1979 to $67 billion from $45.9 billion in 1977, the last year before the capital gains tax rate reduction. The Treasury Department is now saying that induced capital gains realizations, or "unlocking", increased 1979 tax receipts by $2.5 billion. These estimates do not account for the feedback effect that produces incremental local, state and federal tax revenues from increased economic activity and the creation of new enterprises.

If capital gains taxes were reduced to zero on new investments, most investors expecting future gains would have a powerful incentive to sell immediately and reinvest the proceeds. Selling now will not only eliminate the need to pay taxes on future gains, but it will allow the investor to shift the funds into growth areas having a higher potential rate of return.

Although it is difficult to estimate precisely the amount of "unlocking" that would take place under this proposal, we believe that the bill should be written so that the "unlocking" effect would be maximized. We recommend the following features be included in the bill to maximize its positive near term revenue impact.

- It should apply to both individual and corporate tax payers on the theory that it is just as important to stimulate corporate investments in the future as it is to stimulate individual investments.
- It should apply to gains on appreciation of all assets except depreciable and depletable assets. We believe that trying to distinguish between "productive" and "non-productive" assets would lead to extensive controversy during the legislative process and to all kinds of gimmickry after the bill becomes law. We prefer to stimulate the environment for all investments in this country and let the market determine which are most productive. Investments having fundamental growth potential will be the most attractive to growth oriented investors, and, in the long run, capital will flow to these investments. Furthermore, many of the so-called "productive" assets are equity and debt securities held by non-taxable institutions. For that reason, the bill should apply to a broad base of assets including private corporations, proprietorships, land, art objects, etc. which are not usually held by institutional investors.
- It should contain provisions that would enable the tax payer to recognize the gain and pay resulting tax without selling the asset. This would unlock capital gains from assets that would not otherwise be sold while minimizing the disruptive effects of market churning and eliminating needless transaction costs.

Eliminating Capital Gains Taxes Would Have A Remarkably Stimulative Effect on Our Economy over the Next Several Years

Eliminating capital gains taxes would make our economy more productive in both absolute terms and in relation to our major trade competitors.

- Elimination of taxes on capital gains would bring our tax policy in line with our most aggressive competitors in world markets...Japan and West Germany...as well as with that of many other countries such as Australia, Belgium, Italy and the Netherlands.

- Elimination of taxes on capital gains would place individual investors on a par with institutions. It would encourage more individuals to invest in our country's opportunities and thereby decrease somewhat the propensity to consume.

- Elimination of taxes on capital gains will improve the mobility of capital. Much of today's invested capital is locked up in relatively unproductive assets because of the resistance to paying taxes on unrealized gains. If capital gains were not taxed in the future, an investor could shift from less productive to more productive investments easily without losing part of his capital in the process.

- Elimination of taxes on capital gains would have a dramatic impact on economic expansion and job creation. This modification in our tax policy would tilt investment preference toward the more innovative gorwth companies. Our surveys have shown that these companies create more jobs, enable us to compete more effectively in international markets, and make a greater contribution to economic expansion than more mature companies, but they require capital to do so.

- Elimination of taxes on capital gains would stimulate mature firms to become more innovative and growth conscious. A zero capital gains tax environment would increase the value of retained earnings relative to dividends, and dividend payouts would decline as corporations adopt a longer term perspective and reinvest more of their retained earnings and future growth. Stock prices can also be expected to improve, making it easier for companies to raise new capital by issuing additional shares. The net result would be to make all U.S. corporations more forward looking and growth oriented.

A proposal for zero capital gains taxes was first presented before the House Budget Committee on February 26, 1981 by Mr. Sam I. Nakagama. At that time, Mr. Nakagama presented the results of an econometric analysis

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of this proposal which was performed using the DRI model. The key assumptions made in this econometric analysis were that stock prices, as measured by the Standard & Poors stock index, would increase by 20% in the first year and the payment of dividends by corporations would decline by 10% in the first year. These assumptions certainly seem reasonable in light of the 40% jump in the S&P index during the 2½ years following the 1978 capital gains tax cut, and the strong new incentive this proposal would provide for corporations to invest more of their retained earnings in growth opportunities rather than paying out so much.

The compete results of the more conservative analysis of this proposal--assuming a non-accommodating monetary policy--are attached. Here are the highlights.

If capital gains were not taxed at all:

- GNP would grow $400 billion more by 1985 than it would under current policy, reaching $4.8 trillion in 1985.

- Business Fixed Investment (in constant 1972 dollars) would grow $20 billion more by 1985 than it would under current policy, reaching $197 billion in 1985.

- By 1985, 1.6 million more jobs would be created than forecast under current policy, yielding an unemployment rate then of 6.5% compared to the 7.7% rate of unemployment forecast under current policy.

- The federal budget deficit would be reduced in the first year by $21.5 billion, and by 1985 we would have an $89.3 billion surplus compared to a surplus of only $16 billion under current policy.

These projected results would be even more impressive if they were to take into account the unlocking of unrealized capital gains as investors

rush to make new investments whose future gains would not be taxed at all. These sales of appreciated assets, which would be taxed under this proposal at current capital gains rates, could, by themselves, wipe out the budget deficits currently forecast for the next few years.

In summary, eliminating capital gains taxes on new investments will:

- generate through "unlocking" massive amounts of capital gains tax revenues that could significantly reduce budget deficits in the near term.

- Generate additional incentives for risk capital investment in the growth areas of our economy which will promote technological advancement, innovation, and job creation.

Mr. Chairman, I appreciate this opportunity to share our thoughts with you and this Committee.

ECONOMETRIC ANALYSIS using DRI model
Prepared by Sam I. Nakagama, Kidder-Peabody and Co., Inc.
February 26, 1981

## Zero Capital-Gains Tax Proposal With Non-Accommodating Monetary Policy

| | Baseline Projections Assuming No Tax Changes | | | | | Projections Assuming Zero Capital-Gains Proposal* | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1981 | 1982 | 1983 | 1984 | 1985 | 1981 | 1982 | 1983 | 1984 | 1985 |
| Gross National Product | 2,910.2 | 3,252.1 | 3,611.8 | 3,986.1 | 4,418.3 | 2,959.3 | 3,374.0 | 3,810.0 | 4,273.3 | 4,810.2 |
| % change | 10.7 | 11.7 | 11.1 | 10.4 | 10.8 | 12.6 | 14.0 | 12.9 | 12.2 | 12.6 |
| GNP in '72 Dollars | 1,485.4 | 1,515.5 | 1,547.3 | 1,586.6 | 1,632.7 | 1,511.1 | 1,560.0 | 1,602.2 | 1,649.8 | 1,703.4 |
| % change | 0.2 | 2.0 | 2.1 | 2.5 | 2.9 | 2.0 | 3.2 | 2.7 | 3.0 | 3.2 |
| GNP Deflator (1972 = 1.00) | 1.959 | 2.145 | 2.334 | 2.512 | 2.706 | 1.958 | 2.162 | 2.378 | 2.589 | 2.823 |
| % change | 10.4 | 9.5 | 8.8 | 7.6 | 7.7 | 10.4 | 10.4 | 9.9 | 8.9 | 9.0 |
| Business Fixed Investment, '72 Dollars | 153.0 | 158.3 | 163.3 | 169.2 | 176.7 | 156.5 | 169.2 | 179.6 | 188.2 | 197.0 |
| % change | −3.0 | 3.5 | 3.2 | 3.6 | 4.4 | −0.8 | 8.1 | 6.2 | 4.8 | 4.7 |
| Personal Consumption Expenditures, '72 Dollars | 944.0 | 952.2 | 963.1 | 985.3 | 1,004.5 | 966.9 | 985.1 | 1,005.8 | 1,033.9 | 1,060.5 |
| % change | 1.1 | 0.9 | 1.1 | 2.3 | 2.0 | 3.5 | 1.9 | 2.1 | 2.8 | 2.6 |
| Total Employment, in millions | 98.1 | 100.4 | 102.0 | 103.3 | 104.8 | 98.4 | 101.5 | 103.4 | 104.8 | 106.4 |
| % change | 0.8 | 2.3 | 1.6 | 1.3 | 1.5 | 1.2 | 3.1 | 1.9 | 1.4 | 1.5 |
| Unemployment Rate | 7.8 | 7.5 | 7.7 | 7.9 | 7.7 | 7.5 | 6.6 | 6.6 | 6.7 | 6.5 |
| M2 | 1,779.1 | 1,897.3 | 2,032.9 | 2,172.4 | 2,310.1 | 1,776.0 | 1,914.0 | 2,056.5 | 2,173.2 | 2,275.6 |
| % change | 6.9 | 6.6 | 7.2 | 6.9 | 6.3 | 6.7 | 7.8 | 7.4 | 5.7 | 4.7 |
| Nonborrowed Reserves | 40.05 | 41.68 | 43.94 | 47.14 | 48.71 | 40.05 | 41.68 | 43.94 | 47.14 | 48.71 |
| % change | −2.9 | 4.1 | 5.4 | 7.3 | 3.3 | −2.9 | 4.1 | 5.4 | 7.3 | 3.3 |
| Three-Month Treasury Bill Rate | 13.19 | 13.75 | 12.28 | 9.54 | 9.43 | 13.15 | 13.33 | 12.51 | 10.74 | 11.02 |
| Twenty-Year Government Bond Rate | 12.29 | 12.06 | 11.71 | 10.74 | 10.65 | 12.27 | 12.35 | 12.39 | 11.81 | 11.91 |
| S&P Stock Price Index (1941-43 = 10) | 131.16 | 127.45 | 134.47 | 147.82 | 161.54 | 147.59 | 152.94 | 161.36 | 177.38 | 193.85 |
| % change | 10.4 | −2.8 | 5.5 | 9.9 | 9.3 | 24.3 | 3.6 | 5.5 | 9.9 | 9.3 |
| Federal Budget Position, NIA Basis | −54.5 | −35.1 | −20.0 | −12.2 | 16.0 | −33.0 | 7.7 | 37.4 | 48.3 | 89.3 |
| Personal Taxes | 299.1 | 339.0 | 381.8 | 426.6 | 475.6 | 308.4 | 352.2 | 398.4 | 451.5 | 514.2 |
| % change | 15.9 | 13.3 | 12.6 | 11.7 | 11.5 | 19.5 | 14.2 | 13.1 | 13.3 | 13.9 |

* Assumes capital gains tax reduced to zero on new investments without accommodating monetary policy.

**Statement of**

**John L. Nesheim**

**Treasurer**

**National Semiconductor Corporation**

**on behalf of the**

**Semiconductor Industry Association**

Good morning, Mr. Chairman. My name is John Nesheim. I am Treasurer of National Semiconductor Corporation, headquartered in Santa Clara, California. We are the second largest manufacturer of integrated circuits in the United States with annual sales in excess of $1 billion. Our worldwide employment is approximately 35,000 people. More than 30 percent of our sales are to markets outside of the United States. Our growth over the past 14 years is in excess of 40 percent per annum.

I appear before you today representing the 45 companies of the Semiconductor Industry Association (SIA).

Our purpose today is to analyze the effect of the tax cut proposals pending before you on the U.S. semiconductor industry and on the ability of U.S. semiconductor companies -- and other U.S. high technology companies -- to compete in international markets.

I would first like to emphasize that SIA supports President Reagan's overall economic program, including the tax cut proposals aimed at stimulating business investment. The program constitutes in the aggregate a positive step toward a correction of the economic ills which have beset the United States over the past decade.

Nonetheless, I would like to submit that refinements should be made to the President's depreciation proposal to take into account the circumstances of rapid obsolescence characteristic of high technology companies. Further, a priority should be given to adopting new tax incentives for research and development activities in private industry and in the universities. These two modifications to the President's proposals are moderate in terms of revenue loss in relation to the tax bill as a whole.

Before outlining the specific tax measures we propose, I would like to explain why it is urgent for America and for the semiconductor industry that current levels of commercially-oriented research and development in the United States be increased.

## The Role of Research in International Economic Competition

We, the United States of America, are declining industrially. Leading technology industries of the recent past, such as steel and automobiles are yielding to foreign competition, principally from Japan. To reverse this decline, it is necessary, as has been stated by a number of commentators in recent months, to increase capital investment. I submit that increasing the quantity of investment will prove inadequate;

we must increase the quality of investment as well. We can do this in large part by increasing our research, because the know-how we produce will enrich our overall investment effort.

The studies of John W. Kendrick, Edward F. Dennison and others indicate the extent to which increasing knowledge and technological innovation play a dominant role in productivity gains (see Attachment 1); 44 percent of all productivity gains are attributable to innovation and new knowledge. These factors overshadow such other factors as scale economies (16%), new plant and equipment (16%), and resource allocation (12%).

The rate of growth of R&D expenditures in the U.S. has steadily declined over the past two decades. From 1953 to 1965, R&D expenditures grew (in constant 1972 dollars) by 9.9% per year, while from 1973 to 1978, the annual growth of R&D expenditures slowed to only 1.8% annually. In fact, in constant (1972) dollars, our R&D expenditures in 1977 were no more than they were in 1967.

In 1964, we spent 3% of GNP on research and development, but by 1979 we were spending only 2.2%. During a comparable period, two of our most aggressive trading partners -- Japan and West Germany -- were increasing their R&D expenditures. The following table compares the trends in those nations to those in the United States and provides data which suggests the economic implications of those trends.

| | United States | Japan | West Germany |
|---|---|---|---|
| R&D as percentage of GNP-- | | | |
| 1964 | 3.0% | 1.5% | 1.6% |
| 1976 | 2.3% | 1.9% | 2.3% |
| Average annual rate of productivity improvement-- | | | |
| 1960-78 | 2.6% | 8.5% | 5.4% |
| Share of world's exports-- | | | |
| 1960 | 18.0% | 4.0% | 10.3% |
| 1977 | 11.8% | 8.0% | 11.5% |

The above table makes the recent trend clear: while our major trading partners have been increasing their R&D efforts (and at the same time have increased their exports and productivity rates), R&D in the United States has declined. Moreover, the R&D expenditures as set out in the table are overstated since about 35 percent of U.S. R&D spending goes for defense and space, while Germany spends only 9 percent and Japan less than 3 percent on these essentially noncommercial activities.

Throughout its history the United States has produced the world's highest productivity through leadership in technology and has produced trade surpluses in those industries containing the most advanced technology -- currently including civil aircraft, pharmaceuticals, agriculture, integrated circuits, communications, lasers and computers.

National Science Foundation research indicates that America's R&D-intensive manufacturers during the period 1960-1978

compiled a growing trade surplus for the U.S., whereas non-R&D intensive manufacturers slumped into deficit during the same period (see Attachment 2). Our nation's comparative advantage in world trade is inextricably linked to know-how and research-related goods. The experience of the U.S. semiconductor industry is a prime illustration of this link.

The Semiconductor Industry Experience

The U.S. semiconductor industry leads the world in terms of both technology and market share. But at present this position is severely challenged by Japan; within a few years our position will also be challenged by one or more of the Western European nations.

The worldwide semiconductor industry is expected to undergo explosive growth during the 1980's not only in sheer volume but also in the diversity of market applications. In 1980, world consumption of semiconductors reached $16.1 billion including both unrelated and related party uses. The world semiconductor industry supports approximately a $200 billion electronics equipment market. Industry analysts predict that the world semiconductor volume will reach or surpass $50 billion before the end of the decade and will support a world equipment market of over $500 billion.*/

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*/ The semiconductor industry with advancing technology will account for a continued increase in percentage of equipment value from 8 percent in 1980 to 10 percent by the late 1980's.

The U.S. semiconductor industry in 1980 accounts for 63% of world consumption, compared to 22% for the Japanese industry, and 12% for the European industry. International competition, however, is much more evenly matched at this juncture than overall market share data would indicate. The Japanese, who only began to export integrated circuits to the United States in volume in the mid-1970's, have achieved significant market shares in the United States in a whole array of advanced large scale integrated circuits (LSI) products: 16K RAM's, 42%; 64K RAM's, 50%; 4K CMOS RAM's, 80%; and 4-bit microprocessors, 30%. Furthermore, at a technical conference last year in San Francisco, all five technical papers on the 256K RAM, to be the workhorse memory circuit of the late 1980's, were Japanese.

In 1980, virtually 50% of the semiconductor volume was consumed outside the United States. In the quarter century history of the industry the U.S. merchant industry has fiercely competed in all markets worldwide and currently sells 35% of its production outside the United States; if historical trends were to continue, there is reason to believe that within 10 to 15 years, 45% to 50% of U.S. company sales would be in international markets.

Success in worldwide competition is determined by a company's innovation rate and the advancement of technological

complexity. As recently as 1970, the semiconductor industry was producing memory circuits of 1K, containing 1,000 elements of memory. At present, the industry is commencing production of a dynamic RAM with 64,000 elements on a chip, and by 1980, industry sources speculate that the most advanced chips will contain over 1,000,000 elements.

These high levels of growth and increasing complexity cause dramatic increases in the requirements of U.S. semiconductor companies for new capital. The U.S. semiconductor industry's investment in short-lived process equipment and in R&D is now 28% of sales, compared to the U.S. industry average of 7% of sales. To finance this investment the industry must constantly generate fresh capital. Indeed, the industry's principal challenge is the availability and cost of its capital.

This is not a problem shared equally by the major foreign producers of semiconductors. American companies have a significantly higher cost of capital compared to the Japanese semiconductor manufacturers, and potentially the Europeans as well, with whom they must compete. A study last year by Chase Financial Policy, a Chase Manhattan Bank subsidiary, revealed that the cost of capital for the typical American semiconductor company averages 17.5 percent, compared to only 9.3 percent for the Japanese competition. The reason for this potentially decisive divergence is the fact that in the Japanese economy

firms are financed heavily by debt, rather than equity. Debt is a far less expensive form of capital. The study also revealed that, although the American firms are compelled to earn a rate of return approximately equal to the cost of capital, currently 16.3 percent on operating capital, the Japanese companies fall short of covering capital costs with a return of only 7.5 percent.

In the long term, this structural advantage -- lower cost of capital and current profit indifference -- will work to the distinct disadvantage of American firms, jeopardizing their ability to earn sufficient return to cover capital cost and therefore their ability to compete.

The lower cost of capital available to Japanese companies in part reflects the fact that Japan is one of many industrialized countries which has set as a national goal the forging of a world class semiconductor industry; this national goal is itself but a stepping stone towards the real goal: the computer industry. Let there be no doubting their seriousness of intent. The Japanese Ministry of International Trade and Industry (MITI) stated in its document "The Vision of MITI's Policies in the 1980's," published March 17, 1980:

> "Technological innovation is the source of progress for Japan . . . [Japanese national objectives include] knowledge-intensive production systems equipmment with micro computers . . . [and] V.L.S.I. (Very Large

> Scale Integrated Circuit) . . . [The] share of governmental expenditures for R&D . . . should be raised in spite of the expected deficit in the national budget . . . . The Government must find a new source of funds for financing such projects."

Yet, the support of Japan and other countries for their semiconductor and computer industries goes beyond the relative cost of capital. It includes direct subsidies, research tax incentives and cartels, a sheltered domestic market, accelerated depreciation, soft loans and high leverage. This type of Government support amounts to a tacit guarantee to investors and results in virtual indifference by shareholders and creditors to low short-term profitability.

An American Response

The American response to the challenge of international competition in the semiconductor industry and in other high technology industries should not be to emulate the policies and practices of our trading partners. Our laws, our culture, and the high technology industries' successful strategries argue against emulation. But we should seek to achieve the same objective as the foreign high technology programs -- to achieve high levels of investment and research, including a balance between short-term developmental investment innovation and refinement and longer term fundamental research.

We must achieve this result without government direct intervention in the free market process. Instead, tax measures can be used to motivate private industry to increase the quantity of their investments and to extend the horizons of their research and development activities. Tax measures are preferable to more direct government intervention (*e.g.*, grants or loan guarantees), because the decision to invest and to undertake R&D activities can continue to be made by individual firms some of whom will prosper and some of whom will fail based solely on market performance.

So where do we start? I submit that we must not simply pick target industries as do our foreign competitors. We must instead reward innovative activity in firms throughout the length and breadth of American industry. We must structure our tax regime to reward research-intensive investment: a steel company whose R&D laboratories develop superior alloys, an automobile company which develops a more efficient engine, a biogenetics company which invents a process for the more efficient production of enzymes, or a semiconductor company which designs software into its chip architecture. The common denominator is innovation -- a high level of creative intellect -- which fosters productivity, growth, employment and international competitiveness.

## The Role of Tax Cut Legislation

We now address the question of how the tax bill before you can help in fostering an economic environment that can aid the kind of competitive strength America needs.

(1) Depreciation Reform

As we said at the outset, SIA supports the Administration's broad economic and tax programs. In particular, we believe that the President's proposal for depreciation reform will provide a major stimulus for further investment by U.S. business generally. We must point out, however, that the benefit of depreciation reform for semiconductor industry companies is indirect. It provides major benefits to our customers and our suppliers; the direct benefits to our own companies themselves are much less. For example, most U.S. semiconductor companies depreciate their manufacturing equipment over 5 years and receive a 6-2/3 percent investment credit. For such equipment the benefits to be derived from moving to 5 year depreciation with a 10 percent credit are almost insignificant. They are certainly small relative to the overall tax reduction contemplated for businesses generally under the proposal. We thus believe that the President's depreciation reform proposal can be improved by permitting equipment presently in the ADR 5 year category to be depreciated over a shorter

period of time (such as 2 or 3 years) with a full 10 percent investment credit.

We also applaud the interest shown by the Administration in providing an R&D incentive through its proposal to establish a special depreciation category for R&D equipment. Unfortunately, the proposal, which establishes a 3 year life for such equipment, does not appear to accomplish its intended purpose for two reasons.

Although the proposal does provide more accelerated depreciation for R&D equipment than for equipment generally, it also establishes the investment credit for such equipment at 6 percent instead of the 10 percent credit received by equipment to be depreciated over 5 years. These two effects tend, of course, to be offsetting and should be analyzed together. If the present value of the tax benefits from a 3 year depreciation schedule and a 6 percent investment credit are compared to the benefits to be received by equipment to be depreciated over 5 years and receive a full 10 percent credit, our own analysis shows that equipment in the 5 year, 10 percent category receives slightly more beneficial treatment unless a very high discount rate is used to determine present value. For example, if a 15 percent discount rate to present

value is used,*/ the present value of all tax benefits received from a $1,000 investment in equipment depreciated over 5 years but receiving a 10 percent investment credit would be $473. The present value of tax benefits for equipment in the 3 year category receiving a 6 percent credit would be $468 at the same 15 percent discount rate. Under this discount rate, it is clear that shifting R&D equipment from the 5 year to the 3 year category actually reduces the tax benefits associated with a $1,000 purchase of equipment by $5.

A second reason why the proposed special treatment for R&D equipment does not accomplish its intended purpose is that purchases of such equipment constitute a small fraction of the total costs of R&D activities (as well as of total equipment purchases) for semiconductor companies as for most high technology companies. We have made informal inquires to member companies and believe that for most such companies the amount of depreciation taken on R&D equipment is never more than 10 percent and for some companies is as little as 3 percent of total R&D costs; the predominant R&D expense, in fact, is for salaries. R&D depreciation is also estimated to

*/ Since discount rates normally reflect the rate of inflation plus a small real cost of money, a 15% rate should be considered to be relatively high in making judgments about tax policies designed to be continued over long-run business cycles.

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be a relatively small portion of total equipment depreciation taken in any year for most companies. Thus, even if the special treatment of R&D equipment were clearly preferential, the impact of that treatment on encouraging R&D activities generally would not likely be substantial.

The Administration's depreciation reform proposal also contains a provision which has the presumably unintended result of reducing the benefits of depreciation deductions -- and the foreign tax credit -- on foreign-held assets of semiconductor and other high technology companies. The Administration's bill generally provides for accelerated cost recovery over a period of five years for machinery and equipment. However, the bill also provides that machinery and equipment used predominately outside the United States is to be depreciated using the straight-line method over a recovery period of ten years.

Under current law, much machinery and equipment of high technology and many other companies (e.g., information systems, automobiles, buses and equipment to manufacture apparel, yarns, and knitted goods) is being depreciated abroad using accelerated methods over periods of substantially less than ten years. Thus, under the Administration's bill, the depreciation deduction for assets held by foreign branches of U.S. corporations will actually decrease in the initial years after such assets are placed in service, due to both

the increase in recovery period from five to ten years, and the move from accelerated to straight-line depreciation.

As written, the bill would have a similar effect on assets held by foreign subsidiaries. The result could be a dramatic decrease in the foreign tax credits available on the distribution of earnings by such subsidiaries. In fact, based on the actual experience of one corporation, under the bill the total U.S. tax imposed on the operations of a foreign subsidiary will actually double.

While there may be reason not to extend more generous depreciation treatment to foreign assets, no reason has been advanced for according such assets less favorable treatment than they receive under current law. Indeed, the punitive result under the bill is inconsistent with the purpose of the Administration's proposal: to provide a foundation for increased productivity and sustained economic growth through the encouragement of business investment. We thus urge that the bill be modified to permit assets held by foreign branches and subsidiaries of U.S. companies to be depreciated under the same depreciation rules as are provided for such assets under present law.

(2) Tax Credit for Corporate Research and Development Expenditures

As we indicated previously, we wholeheartedly support depreciation reform as a method to stimulate increased business

investment in new plant and equipment generally. However, if the tax system is to be modified in major ways to provide new incentives for increased productivity, incentives should also be provided for increased research and development activities. For this reason we favor legislation creating a credit equal to 25% of the actual increase of current year R&D expenditures over the average of expenditures for the prior three years. A bill to adopt such a credit (S.98) has been introduced by Senators Danforth, Bradley and other members of the Committee.

The objectives of obtaining enhanced productivity through increased private R&D spending, without government intervention in the resource allocation process, can best be served by a tax credit like that provided in S.98. The bill would require a modest revenue loss of about $500 million in the first year. However, the long-run return to the national economy, and thereby to federal revenues, could be substantial.

(3) Tax Credit for Corporate Contributions to University Research

Tax credits for accelerated industrial research will help close the gap with foreign competition. But we believe there must also be a renaissance of university research to increase the level of basic research for the nation and to assure the flow of sufficient engineers and scientists to

fill future openings in private industry. We submit that this renaissance in university research can in part be financed by private corporations.

Last year significant Congressional interest was generated in favor of legislation to grant a tax credit for corporate contributions to universities to aid university research activities. This year similar legislation has been introduced in both Houses. Both bills provide a corporation with a 25% credit for amounts set aside for use by (or amounts contributed to) universities for their own research activities. Unlike the corporate R&D credit, this credit would not be based on the excess of amounts expended over prior year levels. This credit would apply to all contributions on amounts set aside permanently for future contributions.

Academic research efforts focus primarily on basic and exploratory research tasks. Increases in academic research would thus be an efficient method by which to increase the amount of basic research undertaken in this country.

Summary and Conclusion

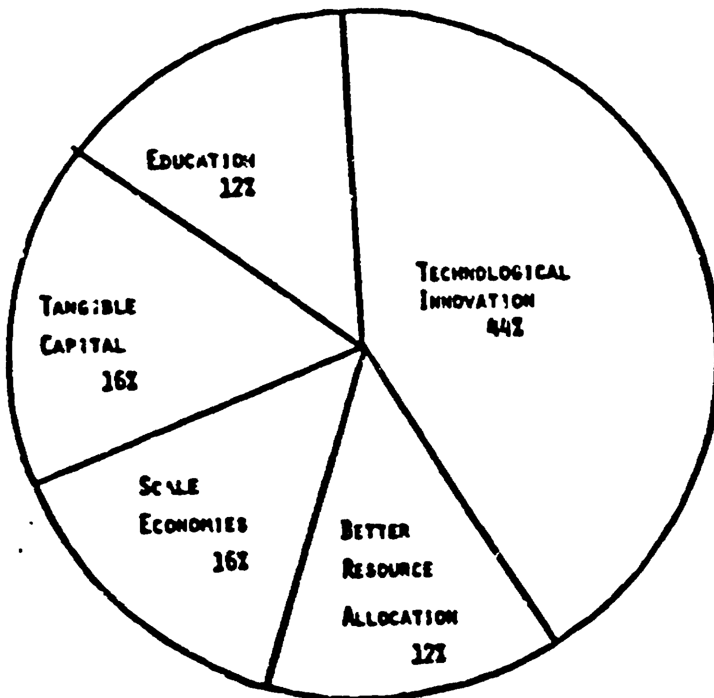
Our objectives are to optimize the nation's economic growth not only through increased investment in plant and equipment but also through the revitalization of our commercial research efforts. Tax legislation, in the form of refinements

to the President's tax bill, can assist in accomplishing these objectives with only moderate increases in revenue loss in the short run and with the probability of long term positive return to the nation's economy in general, to its international competitiveness and to the Federal Treasury. We are convinced that our legislative proposals represent a major step in the right direction.

**ATTACHMENT 1**

CHART 7

ELEMENTS AFFECTING PRODUCTIVITY GAINS

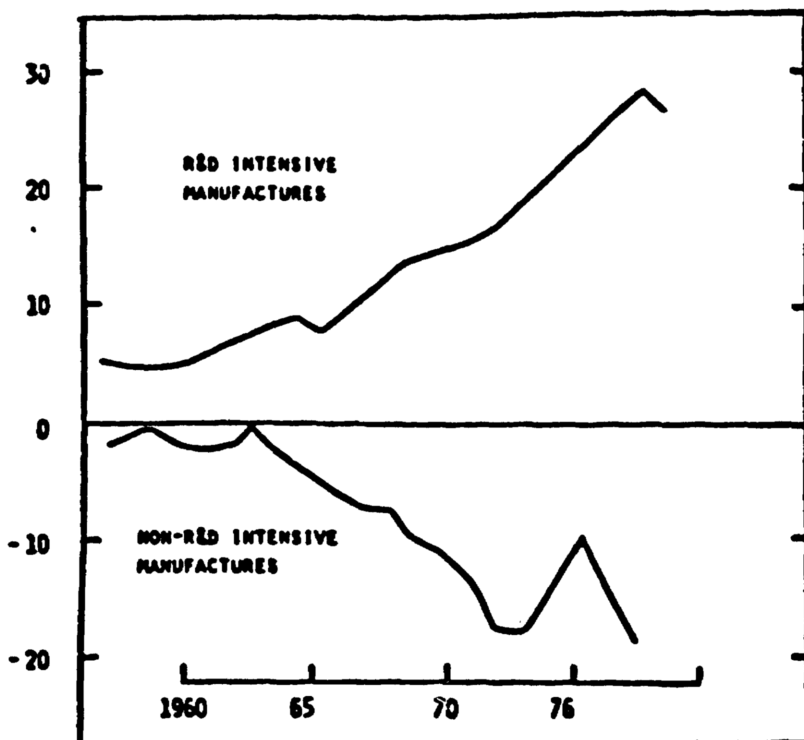



SOURCE: IEEE SPECTRUM, OCT. 1978. REPRINT FROM A
BROOKINGS INSTITUTE ANALYSIS.

ATTACHMENT 2

CHART 9

U.S. R&D TRADE BALANCE*




*EXPORTS LESS IMPORTS

SOURCE: NATIONAL SCIENCE FOUNDATION INDICATORS, AS DEPICTED IN THE "SCIENCE OLYMPICS," BUSINESS BRIEF, THE ECONOMIST, MAY 20, 1978, PP. 86,87.

STATEMENT OF
PAUL CHERECWICH, JR.
THE FOXBORO COMPANY

on behalf of

SCIENTIFIC APPARATUS MAKERS ASSOCIATION

Good morning. I am Paul Cherecwich, Jr., Corporate Tax Manager for The Foxboro Company in Foxboro, Massachusetts. I am appearing here today on behalf of the Scientific Apparatus Makers Association (SAMA) and I am Chairman of the Association's Tax Committee.

I would like to thank you for giving us this opportunity to appear before you during these important hearings. Our testimony today will focus on the forces which affect R&D and industrial innovation and the dependence of these forces on national policy and economic incentives.

Before doing so, let me briefly describe the nature of the Scientific Apparatus Makers Assocation. SAMA is a national trade association representing this country's manufacturers and distributors of a wide range of scientific, industrial and medical instruments and equipment. The member companies of SAMA constitute the bulk of American industry producing research, laboratory, analytical, electronic measurement and test, and process measurement and control instruments as well as equipment, clinical laboratory instruments, patient monitoring instruments, and a wide range of laboratory apparatus and equipment. SAMA's membership consists primarily of small to medium size companies. Of the largest corporate members, only a single division or two are involved.

In 1979, this industry produced and shipped products valued at over $11 billion. Exports account for about one third of total sales, and in some companies, exports amount to as much as 50 percent of total sales. A significant portion of the sales of this industry are made by small and moderate size firms located throughout the country, with major concentrations in the Northeastern, Western and Southern regions of the Nation. Companies comprising this industry employ somewhat in excess of a quarter of a million people in some 2,000 manufacturing establishments. Since over a third of their total sales are exported, it seems obvious that a substantial number of those jobs are indeed dependent on exports.

My own company, The Foxboro Company, had revenues approaching one-half a billion dollars last year. We manufacture process control equipment and instrumentation that keeps oil refineries, power plants, pulp mills, blast furnaces and the like running 24 hours a day, 365 days a year. We have about 9,000 employees of whom about 5,000 are domestic. Our overseas business represents about 60 percent of our total revenues.

## I
## BACKGROUND

### A. Objectives of Statement

First, I should like to emphasize that SAMA strongly supports the thrust of President Reagan's economic program, including liberal provisions for stimulating business investment. The program constitutes, in the aggregate, a very positive step towards fundamental correction of the economic ills which beset the United States as we enter the decade of the 1980's.

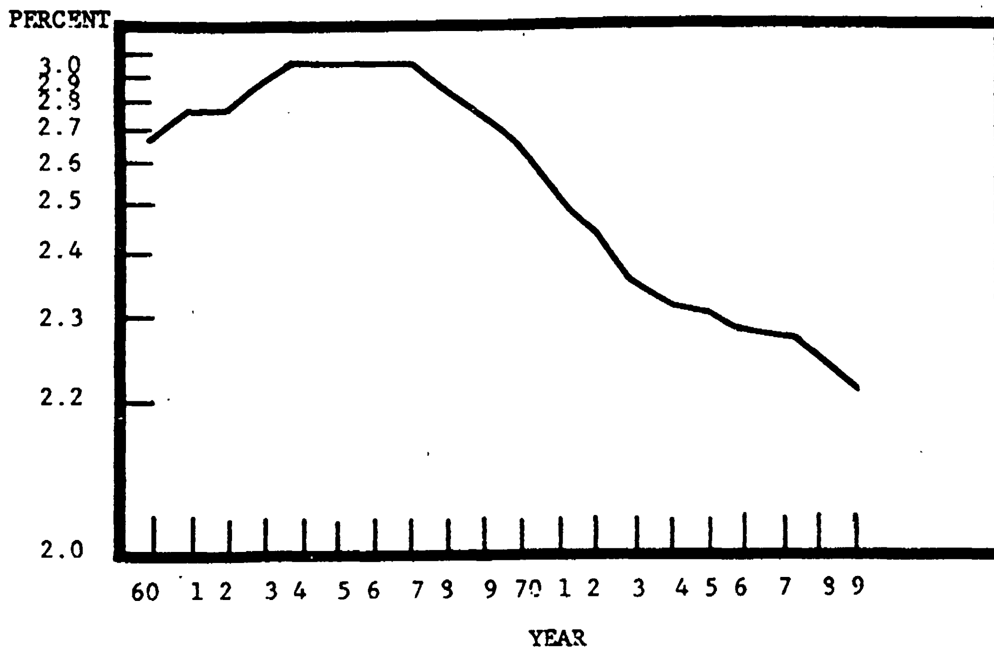
Second, as a representative of a high technology industry, I would like to submit that, if refinements are made to the President's tax bill in the legislative process, top priority should be given to measures that motivate accelerated research and development. In particular a priority should be given to research conducted in private industry and in the universities that has potential for commercial applications in world markets, as contrasted to research in support of governmental objectives such as military or space missions. This objective can be met with tax measures that are moderate in terms of revenue loss in relation to the tax bill as a whole.

Before outlining the specific tax measures we propose, I would like to explain why it is urgent for America to expand the current levels of commercially-oriented research and development activities.

FIGURE 1

RATIO OF NATIONAL R. & D.

EXPENDITURES TO GNP
1960-79




SOURCE: U.S. NATIONAL SCIENCE BOARD

B. R&D - The Key to Industrial Innovation and International Competitiveness

Mr. Chairman, the statistics on the U.S. trade balance in recent years have made it obvious, and painfully so for some, that we live in an economically interdependent world. We can do little to change the fact that the world around us is growing and advancing both economically and technologically. In fact, the realization of it is an objective sought by this nation's foreign policy for many years.

SAMA sees a need to concentrate on solutions to the deteriorating competitive position of U.S. business and the declining productivity of our workforce. One cause of this situation has been the decline of investments in research and development. U.S. expenditures for R&D since 1960 have declined in both real and relative terms. When measured as a percent of GNP (see Figure 1), U.S. R&D expenditures have dropped from 2.67 percent in 1960 to 2.21 percent in 1979, a decline of 17.2 percent. Further, the ratio in 1979 was 26 percent below the 1964 peak. A number of complex and inter-related factors can be seen as the causes for this decline, among them:the cost of money, the size of investments, and the risk faced in our unstable economy. These have made business unable to fund our research and development capacity to a level needed to maintain our competitive position relative to our trading partners.

I should like to begin, Mr. Chairman, by addressing my comments to an area taken so long for granted - the central and vital role of research and development in the success of our economy. More specifically, R&D is the key which has opened the door to the unparalleled success of this nation's high technology industries, both at home and abroad.

The need to focus more of this nation's resources on R&D appears quite obvious when viewed from the perspective of the current state of the economy. There is ample evidence of the positive and significant correlation existing between an industry's commitment to R&D and its growth and profitability. That correlation also applies equally to an industry's performance in export markets.

With the increasing economic interdependence of this country with the rest of the world, we must consider where and why we have various advantages, and exploit them. The relationship of export performance to innovation and research and development is neither mysterious nor obscure. All one has to do is to examine the list of products in which the United States enjoys a favorable balance of trade. They are the same as those which have exhibited strong growth trends and possess the potential for continued strength - high technology products and agriculture commodities. Both of these successes are the result of substantial and continuing commitments to research and development. Unfortunately, the future is clouded because this country's willingness to innovate and develop and adopt new technologies and processes is in question.

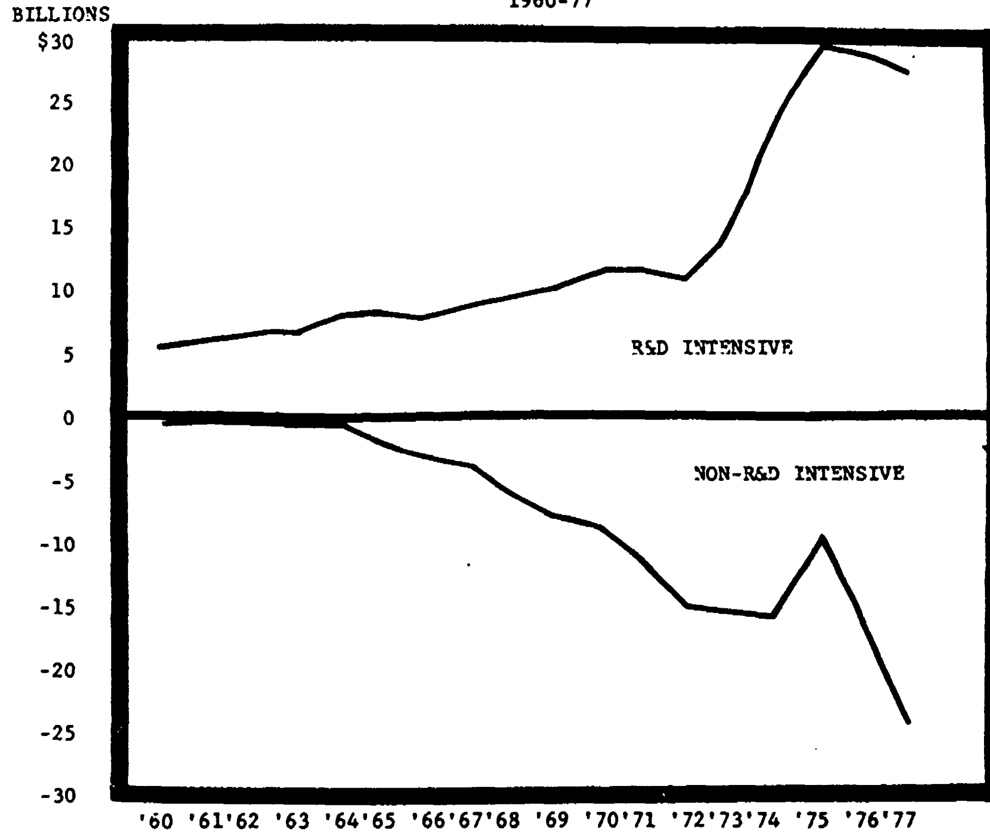
Manufacturing industries, those classified as R&D intensive, have a rapidly accelerating positive trade balance, while non-R&D intensive industries have produced an equally accelerating negative balance (Figure 2).

The effects of this nation's failure to take the steps necessary to maintain the technological lead we have enjoyed for much of this century can be devastating. The causes are both complex and inter-related. If we are serious about reversing the trends which are now becoming evident, we must start at what we believe to be a major underlying cause of our problems - tax policy and how it relates to industrial innovation, productivity, domestic and international competitiveness.

The sad fact of the matter is that present U.S. tax policy, more than any other single factor, has discouraged American industries from investing the monumental sums necessary to modernize plants and equipment. The results include one of the worst records of industrial productivity growth in the entire industrial free world, increased difficulty in meeting foreign competition in our home market, and loss of foreign markets to free world competitors with the resultant persistent trade deficits and loss of U.S. jobs which have existed for too many years.

FIGURE 2

U.S. TRADE BALANCE IN R.&D.-INTENSIVE AND NON-R.&D.-INTENSIVE MANUFACTURED PRODUCT GROUPS 1960-77




SOURCE: U.S. NATIONAL SCIENCE BOARD

II

## THE SPECIFIC LEGISLATIVE MEASURES WHICH SAMA ENDORSES

I shall now address the issue of how the tax bill before you can help in fostering an economic environment that encourages the kind of competitive strength America needs.

### (1) Depreciation Reform

Let me say at the outset, that we support the Administration's broad economic and tax programs. In particular, we believe that the President's proposal for depreciation reform will provide a major stimulus for further investment by U.S. business generally. We must point out, however, that the benefit of depreciation reform for high technology industries is indirect. It provides major benefits to our customers and our suppliers; the direct benefits to most high technology companies themselves are much less. For example, many of SAMA's members depreciate their manufacturing equipment either over 5 years and receive a 6 2/3 percent investment credit or over 7 years and receive a full 10 percent credit. In either case, the benefits to be derived from moving to 5 year depreciation with a 10 percent credit are not insignificant, but are small relative to the overall tax reduction contemplated for businesses generally under the proposal. I believe that the depreciation reform proposals can be improved by permitting all equipment presently in the ADR 5 to 7 year category to be depreciated over a shorter period of time (such as 3 years) with a full 10 percent investment credit.

SAMA also applauds the interest shown by the Administration in providing additional R&D incentives through its proposal to establish a special depreciation category for R&D equipment. Unfortunately, the proposal, which establishes a 3-year life for such equipment, does not appear to accomplish its intended purpose for two reasons.

Although the proposal does provide more accelerated depreciation for R&D equipment than for equipment generally, it also establishes the investment credit for such equipment at 6 percent instead of the 10 percent credit received by equipment to be depreciated over 5 years. These two effects tend, of course, to be offsetting and should be analyzed together. If the present value of the tax benefits from a three-year depreciation schedule and a 6 percent investment credit are compared to the benefits to be received by equipment to be depreciated over five years and receive a full 10 percent credit, our own analysis shows that equipment in the five-year, 10 percent category receives slightly more beneficial treatment unless a very high discount rate is used to determine present value. For example, if a 15 percent discount rate to present value is used, the present value of all tax benefits received from a $1,000 investment in equipment depreciated over 5 years but receiving a 10 percent investment credit would be $473. The present value of tax benefits for equipment in the three-year category receiving a 6 percent credit would be $468 at the same 15 percent discount rate. Under this discount rate, it is clear that shifting R&D equipment from the five-year to the three-year category actually reduces the tax benefits associated with a $1,000 purchase of equipment by $5.

A second reason why the proposed special treatment for R&D equipment does not accomplish its intended purpose is that purchases of such equipment constitute a small fraction of the total costs of R&D activities (as well as of total equipment purchases) for high technology companies. SAMA has made informal inquiries to member companies and I believe that for most of these companies, the amount of depreciation taken on R&D equipment is never more than 10 percent and for many companies as little as 3 percent of total R&D costs. The predominant R&D expenses, in fact, are for salaries and overhead. R&D depreciation is estimated to be a relatively small portion of total equipment depreciation taken in any year of most companies. Thus, even if the special treatment of R&D equipment were clearly preferential, the impact of that treatment on encouraging R&D activities generally would not likely be substantial.

The Administration's depreciation reform proposal also contains a provision which has presumably, the unintended result of reducing the benefits of depreciation deductions - and the foreign tax credit - on foreign-held assets of high technology comapnies. The Administration's bill generally provides for accelerated cost recovery over a period of five years for machinery and equipment. However, the bill also provides that machinery and equipment used predominantly outside the United States is to be depreciated using the straight-line method over a recovery period of ten years.

Under current law, much machinery and equipment of high technology and many other companies (e.g., information systems, automobiles, buses, and equipment to manufacture apparel, yarns, and knitted goods) is being depreciated abroad using accelerated methods over periods of substantially less than ten years. Thus, under the Administration's bill, the depreciation reduction for assets held by foreign branches of U.S. corporations will actually decrease in the initial years after such assets are placed in service, due to both the increase in recovery period from five to ten years, and the move from accelerated to straight-line depreciation. Indeed, if an asset is currently being depreciated over five years under the sum-of-the-years-digits method, under the bill the depreciation deduction will decrease by 70 percent in the first year and by 63 percent in the second year.

As written, the bill would have a similar effect on assets held by foreign subsidiaries. The result could be a dramatic decrease in the foreign tax credits available on the distribution of earnings by such subsidiaries. In fact, based on the actual experience of one corporation, under the bill the total U.S. tax imposed on the operations of a foreign subsidiary will actually <u>double</u>.

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In our view, Mr. Chairman, prompt enactment of the depreciation reform measures, taking into consideration our suggestions for greater equity, is a necessary first step to stimulating productivity and combatting that part of inflation caused by poor productivity. We earnestly hope, however, that the Congress does not lose sight of the fact that increased industrial research and development is also a necessary and essential component of a return to domestic and international economic strength. In this connection, Mr. Chairman, SAMA is actively supporting passage of the Research Revitalization Act, S. 692, which Senators Bradley, Danforth and Packwood, all members of this Committee, introduced earlier this year. They are to be commended for their foresight in seeing the need for an expansion of the resources committed to research and development focused more directly on the needs of industry. This bill is an essential compliment of legislation geared to provide increased capital to hard pressed U.S. industries. It will provide over time, the new technolgies necessary for efficient and productive investment of this Nation's capital. SAMA is also fully supportive of extending tax credits for the purpose of increasing corporate R&D and eliminating certain tax disincentives applicable to firms engaged in international business.

(2) Research Revitalization Act

As I indicated earlier, SAMA wholeheartedly supports the Administration's depreciation reform proposal as a method to stimulate increased business investment in new plants and equipment. However, if the tax system is to be modified in major ways to provide incentives for increased productivity, incentives should also be provided for increased research and development activities.

S. 692 recognizes the fact that one of the most significant changes in the entire process of industrial innovation has been the gradual shift of university research efforts away from industrial needs. This has largely resulted from the growing and dominant role of the Federal

Government in funding about 70 percent of such research and thus controlling its direction. This legislation is designed to redress the imbalance and direction of university research by providing certain tax incentives and cost accounting treatment similar to that afforded business-applied R&D activities.

The Research Revitalization Act would:

1. Allow a 25 percent tax credit for cash contributed to a research reserve during the taxable year.

2. Provide that the research reserve will be tax exempt.

3. Permit a deduction in the taxable year for aggregate payments from the reserve for research or experimentation performed by universities.

4. Carry certain restrictions:

   Misuse of the funds would subject the firm to a 300 percent penalty. Contributions to the fund must be spent within four years.

This bill recognizes that R&D spending results in economic benefits similar to those brought about by capital investment. But, it woes beyond this in several respects:

1. It creates a greater incentive for R&D spending by allowing a larger tax credit.

2. By involving universities, it encourages more and broader based research; it helps change the focus of a portion of university research away from the government toward industry; and it contributes to expanding the pool of highly trained engineers and scientists who are oriented to the ongoing research needs of industry.

3. It allows small and medium-sized firms to collaborate in the funding of research where such activity is feasible.

The bill would require a modest revenue loss in the first year of about $200 million. Significantly however, over the longer run, the return to the national economy, and the increase in Federal revenues will be many times that amount.

Need for the Research Revitalization Act

Pressure of the R&D dollar from inflation, interest rates, environmental and other regulations has translated into a substitution of short-term profitability goals for longer-term growth objectives by a large proportion of firms. At the same time, industry-university cooperation on research is at its lowest point in decades.

Until World War II, the university was a significant source of the new scientific knowledge and innovative ideas for industry. This is no longer true. In the last thirty years, the Federal government's funding of research at universities has mushroomed bringing government direction and control of work performed by university scientists. Academic researchers are increasingly oriented toward the needs of government. Political considerations are important in "selling" projects to government policy-makers, and interest in economic applications has declined. Furthermore, science graduates who formerly went into careers in industry are now staying on at the universities for teaching and research, or going to work directly for the government.

Academic R&D focuses on basic work (Table 1). Nearly 70 percent of all university research is basic research. Federal, state and local government funds account for 75 percent of the funding while institutional funds and non-profit institutions supply an additional 21 percent (Table 2). Private industry is responsbile for only 4 percent of the support for basic research.

Table 1

CHARACTER OF UNIVERSITY R&D
1979

| | Percent |
|---|---|
| Basic Research | 70 |
| Applied Research | 25 |
| Development | 5 |

Source: National Science Foundation

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Table 2

SOURCE OF UNIVERSITY R&D FUNDS
1979

| | Percent |
|---|---|
| Federal Government | 67.4 |
| State & Local Government | 8.9 |
| Industry | 3.6 |
| Institutional Funds | 13.1 |
| Other Non-Profit Institutions | 7.5 |

Source: National Science Foundation

In fact, one of the most significant changes in the entire process of industrial innovation has been the gradual shift of university research efforts away from industrial needs. The conventional wisdom, over a period of time, has been that basic or exploratory research requires huge amounts of money and time and the private sector simply cannot afford to take the risks of funding it.

The Federal government has thus become the primary source of funds for university research. As the provider of funds, the Federal government has also been instrumental in directing the course of university research and development.

During the period in which the conventional wisdom took hold and became institutionalized, the tax system adopted by the U.S. grew to penalize basic research and the adaptation of basic research to technology. Through a combined working of corporate income tax and capital gains tax, the system moved to greatly favor short-term investments, immediate gains and, in turn, has made long term investments in an uncertain future unattractive and unrewarding.

In an article appearing in Science Magazine (Vol. 204, 25 May, 1979), Peter Drucker explored the drifting apart of industry and the academic community. He noted the estrangement between the two communities was furthered by the Federal purse. Government offered scientists highly paid jobs -- in both the university and government. Government also appeared willing to support science for science's sake, rarely, if ever, raising questions as to accountability of grants-receiving scientists for performance and results. Drucker went on to point out that science had become accustomed to large amounts of public money in return for which it had to accept political rather than economic yardsticks for success and performance:

"the main yardstick being whether a program for the support of this or that major scientific enterprise could be sold to governmental policy makers; and - a logical consequence whether this or that search for knowledge fitted the political ideologies and popular fads of this or that clique or faction. Thus, American science, quite understandably, came to consider the question of economic application and economic benefits to be irrelevant and irksome . . . even more crucial to the estrangement from industry on the part of science is the fact that for the last quarter-century, work in graduate school has come to focus on the production of Ph.D.'s certified for teaching in institutions of higher learning. Prior to World War II, science teachers focused on undergraduates, as students who were likely to make science their career. In graduate school, the focus was largely on the preparation of research scientists for outside laboratories, that is, in private industry and, to a lesser extent, in government. The basic graduates were the ones who then got the good jobs in industry; other jobs for scientists were exceedingly rare."

The results of the estrangement are evident throughout industry today. The demands on the Federal budget have focused a concentration upon current problems. There has been a substantial drain on the storehouse of knowledge from which industry must draw to develop the needed new products and innovative processes to keep secure the U.S. technological edge.

As a result of the redirection of university research to the fulfillment of the goals of government, industry has come to face an additional problem - a significant shortage of scientific and engineering manpower. A greater number of these people have remained in the university system than have become employed by the government itself. As R&D spending has declined in the U.S., enrollments in science and engineering disciplines have declined over the last 10 years. Furthermore, foreigners now make up a higher percentage of science and engineering graduate students in the U.S. about 30 percent in 1978.

The Research Revitalization Act will address the decline in industry/university interaction. It will do so in several ways. First, by providing an adequate tax incentive to industry, it will encourage industry to increase its expenditures for university research. Second, by focusing attention on the need for industry/university dialogue, beneficial interchange will be increased in the natural course of events by the stimulus. The result of this increased communication will be a higher level of technological competence on the part of industry, which in turn should lead to the productivity improvements this country needs.

The commitment to U.S. technological preeminence requires that the storehouse of knowledge continually be replenished and expanded. If we act to enable this Nation's high technology industries to both participate in the development of the science, as well as the resultant products and processes, we will go a long way toward assuring our future.

The benefits of research and development to the U.S. economy and American society have been substantial. A result of the intensive effort in R&D over the last fifty years has been the development of a group of high technology industries which have, in turn, produced the products responsible for much of this Nation's economic progress. These industries are the primary industrial performers of R&D as well as major consumers of science and technology. The economic facts of life more than justify actions to promote increases in the level of R&D performance by these industries.

A recent study by Data Resources, Inc. concluded that benefits of progress achieved through the creation and adoption of advanced technology are much broader than opponents have suggested. The study concluded that high technology industries, in terms of all meaningful aggregate economic indicators, have surpassed low technology industries. Findings relating to real growth, productivity, inflation and employment, in fact, support the desirability of creating an economic environment conducive to the continuation of the activities responsible for the economic success of this group of industries.

The findings of the DRI study justify support for policies and initiatives to foster R&D and in turn, industrial innovation and the implementation of new technologies. These can be summarized as follows:

1. Real Growth: High technology industries expanded at 6.7% compound rate from 1950 to 1974, versus 2.3% for low technology industries.

2. Productivity: Output per employee increased 4.0% in high technology industries as opposed to only 2.0% in traditional activities.

3. Inflation: The favorable labor productivity record is mirrored in the price record. 0.5% annual inflation in high technology versus 3.0% in low technology firms.

4. Employment: The gains in output per worker were not at the expense of employment. The rapidly modernizing industries surpassed their conservative counterparts by a substantial margin - 2.6% versus 0.3%. The enhanced domestic and international competitive posture generated more than enough demand to expand employment at a fast pace.

The DRI study also identified the industry represented by SAMA (SIC 38 Professsional and scientific instruments) as the most "technology effort" intensive in the economy. In developing the measure, DRI analysis considered R&D expenditures relative to various performance measures such as sales, profits and product origination.

Table 3 presents the index of effort by industries at a 2-digit SIC Code level. Examination of these ratios suggests the indicated breakdown into "high", "low" and "mixed" technology. The line between high and mixed technology was defined to be .07, the average ratio of research and

Table 3

TECHNOLOGY EFFORT BY INDUSTRY

| CLASS | INDUSTRY ACTIVITY | | INDEX OF TECHNOLOGY EFFORT |
|---|---|---|---|
| High | Professional and Scientific Instruments | (SIC 38) | .106 |
| | Electrical Equipment | (SIC 36, 48) | .097 |
| | Chemicals | (SIC 28) | .093 |
| Mixed | Nonelectrical Machinery (including computers) | (SIC 35) | .060 |
| | Rubber and Plastic Products | (SIC 30) | .032 |
| | Petroleum Refining and Extraction | (SIC 39, 13) | .025 |
| Low | Stone, Clay and Glass | (SIC 32) | .018 |
| | Paper and Allied Products | (SIC 26) | .016 |
| | Primary Metals | (SIC 33) | .013 |
| | Fabricated Metal Products | (SIC 34) | .012 |
| | Food and Kindred Products | (SIC 20) | .008 |
| | Textiles and Apparel | (SIC 22, 23) | .003 |
| | Lumber, Wood Products and Furniture | (SIC 24, 25) | .003 |

Source: Data Resources, Inc.

development expenditures to output for all of manufacturing. Similarly, the division between "mixed" and "low" technology was defined to be .02 or, the average ratio of total expenditures for research and development to Gross National Product. Quite clearly, this study identifies both the industries which qualify as technology intensive and the benefits which they impart to the economy.

To examine more closely the relationsahip of R&D to members, overall business operations, and, in turn, to assess their responsiveness to measures such as the Research Revitalization Act, SAMA conducted a survey of its membership last year. The results are striking, but not surprizing. As had been expected, SAMA's high technology member companies consider research and development to be the life-blood of their business. (See Table 4)

While for manufacturing industries in general, capital expenditures constitute the major company investments, this is not the case for high technology companies. According the the survey, SAMA members, on an average, spend one and a half times as much on R&D as they do on new plants and equipment. Some companies expenditures are seven and eight times greater - and this is occurring at a time when investments in plant equipment are expanding dramatically in this industry.

In terms of after tax profits, SAMA members spend an average of about 87 percent on R&D.

Of the total amount devoted to research and development by those surveyed - an average in excess of $5.5 million per company annually -- 86 percent is devoted to applied product development and 14 percent to research. The economic facts of life emerging from these preliminary results are that unless the captial needs of the high technology companies are addressed in national policy formation, continued growth and expansion of domestic and world markets simply will not take place at anywhere near the historic rates.

Table 4

R&D EXPENDITURES AS A PERCENTAGE
OF CORPORATE SALES, PROFITS, CAPITAL SPENDING

SAMA MEMBER COMPANIES - 1979

| PRODUCT GROUPS | TOTAL COMPANY SALES | AFTER TAX PROFITS | CAPITAL EXPENDITURES |
|---|---|---|---|
| Process Measurement & Control | 4.5 | 157.1 | 222.5 |
| Instrument Companies* | 6.2 | 77.6 | 121.1 |
| Laboratory Apparatus Companies** | 6.1 | 51.4 | 122.6 |
| Composite | 5.6 | 86.9 | 150.9 |

* - Laboratory analytical, clinical and measurement and test instruments.

** - Manufacturers of laboratory equipment, reagent chemicals and sample handling.

Source: SAMA, Washington, DC

The survey responses also give a pretty good indication that the members of SAMA would avail themselves of the opportunities presented in the Research Revitalization Act should it become law. Three quarters of the respondents said that they would increase their outlays for university research by about 65 percent. Those surveyed currently devote about 2.5 percent of their R&D budgets to university research. This proportion would increase to more than 4 percent.

Mr. Chairman, we do not delude ourselves into thinking that the Research Revitalization Act is the cure for our country's productivity and balance of trade problems. Nor is it the solution for the problem of developing and maintaining a technology lead over our foreign competitors. It is however, a very solid step in the direction of achieving these two goals.

(3) Tax Credit for Corporate Research and Development Expenditures

SAMA also favors legislation creating a credit equal to 25% of the actual increase of current year R&D expenditures over the average of expenditures for the prior three years. A bill to adopt such a credit (S. 98) was introduced by Senators Danforth and Bradley of this Committee and other members of the Senate.

The objectives of obtaining enhanced productivity through increased private R&D spending, without government intervention in the resource allocation process, can best be served by a tax credit to the above. The bill would require a modest revenue loss of about $500 million in the first year. However, the long-run return to the national economy, and thereby to Federal revenues, could be substantial.

In testimony during the last Congress, before the Senate Finance Subcommittee on Taxation and Debt Management, Mark Shepard, Chairman and CEO of Texas Instruments reported that according to an econometric model by

by Data Resources, Inc., a 25 percent R&D tax credit would average a $2.3 billion annual net loss for the first ten years. However, in subsequent time periods, the cumulative impact of R&D should produce large dividends: an average increase in R&D spending of $5.2 billion per year; an average annual increase in GNP of $36.2 billion and in exports of $1.7 billion; a 0.28 percent annual increase in productivity; and a 0.42% decline in the annual inflation rate. This faster and more productive economic growth would produce larger tax gains; DRI estimated that the net tax impact would become a positive $6.1 billion per year in the second decade, more than offsetting the tax loss in the previous period. An incremental credit, such as that provided by S. 98, could provide about as large a positive return in future years and would minimize any short run drain on Federal revenues.

(4) Amendment of Regulation Section 1.861-8 of the Internal Revenue Code

Finally, Mr. Chairman, it is necessary to eliminate those provisions of our current tax policy which undercut our explicit national effort to encourage expanded R&D in the United States. Section 861 presents a disincentive for firms with foreign operations to conduct their R&D activity here in the U.S. through a denial of domestic-source deduction for all U.S. R&D expenditures. This disincentive affects not only U.S. companies manufacturing abroad, but also companies exporting or leasing their products from the United States and providing customary services to foreign purchasers. Legislation introduced in the House (H.R.2473), by Congressmen Shannon, Heftel, Jenkins, and Martin of the Ways and Means Committee, would amend 861 to allow all R&D expenditures made in the U.S. to be allocated to income form U.S. sources and, thereby, eliminate the current incentive for firms to relocate their U.S. R&D activities overseas. The revenue loss attributable to this measure is estimated by the Joint Committee on Taxation at $144 million. We support this proposal.

III

## SUMMARY AND CONCLUSION

Our objectives are to optimize the nation's economic growth not only through increased investment in plant and equipment, but also through the revitalization of our commercial research efforts. Tax legislation, in the form of refinements to the President's tax bill, can assist in accomplishing these objectives with only moderate increases in revenue loss in the short-run and with the probability of long-term positive return to the Nation's economy in general, to its international competitiveness and to the Federal Treasury. SAMA is convinced that our legislative proposals represent a major step in the right direction.

TESTIMONY OF GERALD K. HOWARD
ON BEHALF OF SPERRY CORPORATION
BEFORE THE SENATE FINANCE COMMITTEE
U. S. SENATE
MAY 21, 1981

MR. CHAIRMAN AND HONORABLE SENATORS, MY NAME IS GERALD K. HOWARD AND I AM VICE PRESIDENT OF TAX ADMINISTRATION OF THE SPERRY CORPORATION. SPERRY IS A DIVERSIFIED HIGH-TECHNOLOGY COMPANY IN THE BUSINESS OF DEVELOPING, MANUFACTURING AND SELLING COMPUTER SYSTEMS AND EQUIPMENT, FARM EQUIPMENT, GUIDANCE AND CONTROL EQUIPMENT AND FLUID POWER EQUIPMENT.

I WELCOME THE OPPORTUNITY TO TESTIFY ON THE PRESIDENT'S PROPOSED TAX REDUCTION PROGRAM.

WE BELIEVE THAT THE ADMINISTRATION'S PLAN TO STIMULATE THE AMERICAN ECONOMY BY INCREASING THE AFTER-TAX REWARDS FOR WORK, SAVINGS, AND INVESTMENTS--AND AS A COMPANION OF REDUCED GOVERNMENT SPENDING, AND LESS GOVERNMENT REGULATION--IS A BOLD AND PROMISING REMEDY FOR THE NATION'S ECONOMIC ILLS. WE BELIEVE IT WILL RENEW THE BUSINESS COMMUNITY'S OPTIMISM AND CONFIDENCE IN THE FUTURE.

WE ARE TESTIFYING BEFORE THIS COMMITTEE TO SUGGEST WAYS IN WHICH THE PRESIDENT'S PROGRAM CAN BE FURTHER STRENGTHENED.

AS YOU KNOW, THE ADMINISTRATION HAS RECOGNIZED THE NEED TO PROVIDE TAX RELIEF FOR INVESTMENT IN MACHINERY AND EQUIPMENT USED IN RESEARCH AND DEVELOPMENT BY INCLUDING A SPECIAL THREE-YEAR WRITE-OFF PERIOD FOR SUCH INVESTMENTS AS PART OF ITS ACCELERATED COST RECOVERY PLAN. HOWEVER, A CLOSE EXAMINATION OF THIS PROPOSAL INDICATES THAT THE COMPARATIVE TAX BENEFITS OF A FIVE-YEAR WRITE-OFF PERIOD AND FULL 10 PERCENT INVESTMENT CREDIT FOR MACHINERY AND EQUIPMENT NOT-DEDICATED TO RESEARCH AND DEVELOPMENT EXCEEDS THE BENEFITS OF A THREE-YEAR WRITE-OFF WITH PARTIAL OR 6 PERCENT INVESTMENT CREDIT FOR MACHINERY AND EQUIPMENT USED IN RESEARCH AND DEVELOPMENT.*

AS A HIGH-TECHNOLOGY ENTERPRISE, WE CAN TESTIFY TO THE FACT THAT LESS THAN 10 PERCENT OF OUR TOTAL R&D BUDGET REPRESENTS INVESTMENT IN MACHINERY AND EQUIPMENT. THE MAJOR PORTION OF R&D INVESTMENT INVOLVES THE COSTS OF APPLIED RESEARCH, NEW PRODUCT DEVELOPMENT, AND PRODUCT IMPROVEMENT.

* SEE EXHIBIT I

WE RECOGNIZE THE ADMINISTRATION'S SPECIAL TREATMENT OF R&D MACHINERY AS AN INITIAL STEP TO STIMULATE RESEARCH AND DEVELOPMENT EFFORTS. WE BELIEVE, HOWEVER, THAT ADDITIONAL STEPS MUST BE TAKEN IF THE GOALS OF INCREASED PRODUCTIVITY; INCREASED EXPORTS; SUSTAINED ECONOMIC GROWTH AND REDUCED UNEMPLOYMENT ARE TO BE ACHIEVED.

RELATIONSHIP OF R&D TO CHANGE IN PRODUCTIVITY GROWTH

EROSION OF PRODUCTIVITY IN THE U. S. ECONOMY HAS BEEN DOCUMENTED BY THE U. S. DEPARTMENT OF LABOR, REVEALING A DECREASE OF 0.4 PERCENT IN BOTH 1979 AND 1980.[1]

U.S. SPENDING FOR RESEARCH AND DEVELOPMENT, AS A PERCENTAGE OF THE GROSS NATIONAL PRODUCT, HAS DECLINED FROM 3 PERCENT IN 1964 TO 2.2 PERCENT IN 1979.

IN REFLECTING ON THOSE STATISTICS, IT SHOULD BE RECOGNIZED THAT HIGH-TECHNOLOGY ENTERPRISES LIKE SPERRY ARE KEY CONSTRIBUTORS TO INCREASED U.S. PRODUCTIVITY. ACCORDING TO A RECENT BROOKINGS INSTITUTION STUDY, MORE THAN ONE-HALF OF THE PRODUCTIVITY INCREASES IN THE UNITED STATES BETWEEN 1948 AND 1969 WERE THE DIRECT RESULT OF TECHNOLOGICAL INNOVATION.[2]

RELATIONSHIP OF R&D TO INTERNATIONAL TRADE

ECONOMIC GROWTH THROUGH TECHNOLOGY IS FURTHER DEMONSTRATED IN RECENT STATISTICS COVERING THE U.S. ROLE IN INTERNATIONAL TRADE.

THE UNITED STATES SUFFERS FROM A LARGE AND PERSISTENT TRADE DEFICIT INCLUDING $24.6 BILLION IN 1979, AND $20.3 BILLION IN 1980. THE U.S. MARKET SHARE OF WORLD EXPORTS OF MANUFACTURED GOODS DROPPED FROM 16.8 PERCENT IN 1976 TO 15.5 PERCENT IN 1979.[3]

THE HIGH-TECHNOLOGY COMPONENT IS STRIKING WHEN ONE CONSIDERS THAT IN THE PERIOD FROM 1960 TO 1979, R&D-INTENSIVE MANUFACTURING INDUSTRIES INCREASED THEIR EXPORT SURPLUS FROM $5.9 BILLION TO $39.3 BILLION. WITHIN THE SAME TIME PERIOD, INDUSTRIES WITHOUT TECHNOLOGICAL BASES, DECLINED FROM NEAR ZERO TO A NEGATIVE $34.8 BILLION.[4]

1 U.S. DEPARTMENT OF LABOR STATISTICS DURING THE 1948-65 PERIOD, SHOWED AN INCREASE IN PRODUCTIVITY OF 3.3 PERCENT.
2 EDWARD F. DENISON, THE BROOKINGS BULLETIN, VOL.15, NO.2 (1978)
3 U.S. DEPARTMENT OF COMMERCE, INTERNATIONAL ECONOMIC INDICATORS
4 NATIONAL SCIENCE BOARD, SCIENCE INDICATORS 1980 (FORTHCOMING)

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COMPETITIVE DISADVANTAGE

CURRENTLY, THE U.S. IS LOSING GROUND IN TECHNOLOGICAL SUPERIORITY TO ITS MAJOR FOREIGN TRADING COMPETITORS, JAPAN AND GERMANY. IN EACH INSTANCE, THE FOREIGN COUNTRY ENCOURAGES TECHNOLOGICAL DEVELOPMENT THROUGH TAX INCENTIVES. FOR EXAMPLE, JAPAN PROVIDES A 20 PERCENT TAX CREDIT FOR R&D EXPENDITURES, AND GERMANY PROVIDES TAX-FREE CASH GRANTS FOR INVESTMENT IN R&D FACILITIES AND SPECIAL DEPRECIATION FOR R&D PLANTS AND EQUIPMENT.

IN SPITE OF THE ACKNOWLEDGED FACT THAT THE U.S. IS LOSING ITS HISTORIC LEADERSHIP IN THE DEVELOPMENT OF NEW TECHNOLOGIES TO FOREIGN COMPETITORS, PRESENT U.S. TAX LAW PROVIDES NO TAX INCENTIVES TO ENCOURAGE INCREASED EXPENDITURES FOR RESEARCH AND DEVELOPMENT.

NEED FOR R&D STIMULUS

IN ORDER TO ENCOURAGE INVESTMENT IN RESEARCH AND DEVELOPMENT, IT IS ESSENTIAL THAT THE COMMITTEE SUPPORT TAX INCENTIVES DESIGNED TO SPUR INCREASED R&D EXPENDITURES BY THE PRIVATE SECTOR.

IN THE INTEREST OF PROVIDING THE COMMITTEE WITH A DETAILED DESCRIPTION COVERING THE RELATIONSHIP OF R&D TO THE PRODUCTION CYCLE WE HAVE ENCLOSED, FOR YOUR REVIEW, A CASE STUDY OF THE DEVELOPMENT AND PRODUCTION OF THE 1100/80 UNIVAC COMPUTER.*

IN BRIEF, THE CASE STUDY FOCUSES ON THE FOLLOWING FACTORS:

1. THE NEED FOR INDUSTRY TO COMMIT ITSELF TO INVESTMENT IN ELECTIVE (NEW PRODUCT) RESEARCH AND DEVELOPMENT.

2. IT REQUIRED A SUBSTANTIAL LEAD-TIME OF 10 YEARS FROM THE RESEARCH AND DEVELOPMENT PHASE TO THE PRODUCTION PHASE.

3. WITHOUT THE NECESSARY R&D INVESTMENT, THE NEED FOR INVESTMENT IN NEW OR EXPENSION OF EXISTING PRODUCTION FACILITIES WOULD NOT EXIST.

4. WITHOUT RESEARCH AND DEVELOPMENT, THE ADDITIONAL JOB OPPORTUNITIES WOULD NOT EXIST.

IT IS CLEAR THAT TAX INCENTIVES FOR RESEARCH AND DEVELOPMENT ARE NECESSARY IF WE ARE TO ACHIEVE:

- GROWTH IN PRODUCTIVITY
- EXPANSION OF EXPORTS
- CREATION OF NEW JOB OPPORTUNITIES
- EXPANSION OF PLANT AND EQUIPMENT

* SEE EXHIBIT II

IT SHOULD BE EMPHASIZED THAT THE BENEFITS OF INVESTING IN RESEARCH AND DEVELOPMENT ARE NOT LIMITED TO HIGH-TECHNOLOGY ELECTRONICS ENTERPRISES. EXEMPLIFYING THIS POINT IS THE EXPERIENCE OF SPERRY'S NEW HOLLAND DIVISION IN THE DEVELOPMENT AND MARKETING OF ITS TWIN ROTOR COMBINES. THE NEW HOLLAND DIVISION IS A MANUFACTURER OF HIGHLY SOPHISTICATED AND SPECIALIZED FARM MACHINERY.

THE TWIN ROTOR COMBINES, WHICH SPERRY NEW HOLLAND INTRODUCED TO THE MARKET IN 1975, HAVE BEEN HAILED AS A MAJOR BREAKTHROUGH IN GRAIN, CORN AND SOYBEAN HARVESTING. IT IS THE PRODUCT OF A MAJOR R&D PROGRAM INVOLVING MANY YEARS OF EFFORT.

SO GREAT WAS THE DEMAND FOR THIS COMBINE THAT IN 1975 SPERRY NEW HOLLAND CONSTRUCTED A PLANT IN LEXINGTON, NEBRASKA DEDICATED EXCLUSIVELY TO ITS MANUFACTURE. THE PLANT NOW EMPLOYS 873 PEOPLE, ALL PRODUCING A PIECE OF EQUIPMENT WHICH WOULD NOT HAVE BEEN COMMERCIALLY FEASIBLE WITHOUT SPERRY NEW HOLLAND'S COMMITMENT TO R&D.

IN SUMMARY, THE ESSENTIAL ROLE PLAYED BY R&D IN DRIVING OUR NATION'S ECONOMIC GROWTH PROMPTS US TO RECOMMEND THAT THE PRESIDENT'S ECONOMIC PROGRAM BE STRENGTHENED THROUGH TAX INCENTIVES DESIGNED TO SPUR INCREASED PRIVATE-SECTOR EXPENDITURES ON R&D.

SPERRY STRONGLY SUPPORTS A TAX CREDIT FOR INCREMENTAL R&D EXPENDITURES, AS INTRODUCED BY SENATORS DANFORTH, BRADLEY, BENTSEN, CHAFFEE, HEINZ, CRANSTON AND TSONGAS IN S.98.

FINALLY, WE HOPE THE COMMITTEE WILL FOCUS ATTENTION ON THE ADMINISTRATION'S DEPRECIATION PROPOSAL AND ITS DELIBERATION SHOULD INCLUDE CONSIDERATION OF THE FOLLOWING POINTS:

1. EXPANSION OF THE APPLICATION OF THE DEPRECIATION PROPOSALS TO INCLUDE FOREIGN ASSETS AND THE DETERMINATION OF EARNINGS AND PROFITS OF FOREIGN SUBSIDIARIES, OR ALTERNATIVELY, RETENTION OF CURRENT LAW STATUS.

2. REMOVAL OF MANDATORY REQUIREMENTS OF USING THE ASSET WRITE-OFF PERIODS AND ACCELERATED METHODS OF DEPRECIATION.

3. PROVISION FOR FULL INVESTMENT CREDIT FOR THE THREE-YEAR WRITE-OFF OF MACHINERY AND EQUIPMENT USED IN RESEARCH AND DEVELOPMENT, OR ELIMINATION OF THE PRESENT PROPOSAL.

WE HOPE THAT OUR TESTIMONY TODAY HAS HELPED FOCUS ATTENTION ON ISSUES CRUCIAL TO THE NATION'S ECONOMIC WELL-BEING AND HELPS TO STRENGTHEN THE PRESIDENT'S PROGRAM FOR ECONOMIC RECOVERY.

EXHIBIT I

ACCELERATED COST RECOVERY SYSTEM
PRESENT VALUE OF CAPITAL RECOVERY
AND INVESTMENT TAX CREDIT

| ACCELERATED COST RECOVERY CLASS | PRESENT VALUE TAX BENEFIT |
|---|---|
| 3-YEAR RECOVERY CLASS - 6% ITC | $468 |
| 5-YEAR RECOVERY CLASS - 10% ITC | 473 |
| RESULT - DETRIMENT, NOT BENEFIT | $ 5 |

* ASSUMING A $1,000 INVESTMENT AND A 15% DISCOUNT RATE.

EXHIBIT II

RESEARCH AND DEVELOPMENT OF
THE 1100/80 UNIVAC COMPUTER
-- A CASE STUDY

IN AN EFFORT TO COMMUNICATE THE FUNCTION OF RESEARCH AND DEVELOPMENT AND ITS EFFECT ON INVESTMENT IN NEW PLANT AND EQUIPMENT, WE HAVE PREPARED A BRIEF CASE STUDY ON THE DEVELOPMENT OF THE MAINFRAME FOR THE 1100/80 UNIVAC COMPUTER, ONE OF MANY UNIVAC COMPUTER PRODUCTS.

WHAT ARE R&D EXPENDITURES?

R&D EXPENDITURES CONSIST OF APPLIED RESEARCH, NEW PRODUCT DEVELOPMENT AND PRODUCT IMPROVEMENT.

APPLIED RESEARCH - CONSISTS OF COSTS OF INVESTIGATIONS DIRECTED TOWARD THE DISCOVERY OF NEW SCIENTIFIC KNOWLEDGE HAVING SPECIFIC COMMERCIAL OBJECTIVES WITH RESPECT TO PRODUCTS OR PROCESSES.

NEW PRODUCT DEVELOPMENT - CONSISTS OF COSTS OF TECHNICAL ACTIVITIES OF A NONROUTINE NATURE CONCERNED WITH TRANSLATING RESEARCH FINDINGS OR OTHER SCIENTIFIC KNOWLEDGE INTO PRODUCTS OR PROCESSES. THIS INCLUDES THE COST OF DEVELOPMENT PROGRAMS WHICH SIGNIFICANTLY EXTEND CAPABILITIES, EXPAND PERFORMANCE OR ADD FEATURES TO AN EXISTING PROGRAM OR ROUTINE, DIRECTING A COMPUTER (OR SIMILAR EQUIPMENT) TO PERFORM A DESIRED TASK OR SET OF TASKS.

PRODUCT IMPROVEMENT - CONSISTS OF COSTS THAT PROVIDE RELIABILITY, INCREASED PERFORMANCE OR IMPROVED MANUFACTURING PRODUCTIVITY OF EXISTING PRODUCTS. THESE INCLUDE IMPROVEMENTS IN ENGINEERING AND ARE APPLIED TO COMPONENTS AS WELL AS WHOLE PRODUCTS.

WHAT ARE THE COMPONENTS OF R&D EXPENDITURES?

APPROXIMATELY TWO-THIRDS OF THE TOTAL UNIVAC R&D COSTS CONSIST OF SALARY EXPENSES, WITH THE BALANCE COMPRISED OF COMPUTER TIME AND OTHER COSTS.

RELATIONSHIP OF R&D TO THE PRODUCTION CYCLE - 1100/80 COMPUTER

APPLIED RESEARCH - IN 1967 UNIVAC BEGAN A CYCLE OF RESEARCH INVESTIGATIONS INTO SYSTEM ARCHITECTURE, VERY HIGH SPEED INTEGRATED CIRCUITS AND HIGH DENSITY INTEGRATED CIRCUIT INTERCONNECTION TECHNOLOGIES.

GOAL - MAINTAIN COMPETITIVE POSITION IN LARGE SCALE COMPUTERS IN THE MID-1970'S AND 1980'S.

NEW PRODUCT DEVELOPMENT - IT WAS NOT UNTIL 1971 THAT THE DESIGN PHASE OF THE 1100/80 COMPUTER BEGAN.

IN 1974, AFTER COMPLETING THE DESIGN OF THE HARDWARE AND SOFTWARE, A PROTOTYPE WAS BUILT, WITH FINAL TESTS COMPLETED IN 1976.

PRODUCTION PHASE - AFTER SUBSTANTIAL INVESTMENT FOR NEW AND LARGER PRODUCTION FACILITIES AND EXPANSION OF THE WORK FORCE, MANUFACTURE AND INITIAL DELIVERY OF THE 1100/80 COMPUTER BEGAN IN 1977, AND PRODUCTION SHOULD CONTINUE INTO THE MID-1980'S.

PRODUCT IMPROVEMENT - IN ORDER TO REMAIN COMPETITIVE, UNIVAC IMPROVED THE 1100/80 COMPUTER SERIES BY INCREASING THE PROCESSING CAPACITY IN 1978, AND ENHANCING ITS SCIENTIFIC PERFORMANCE IN 1980.

SUMMARY

THE DEVELOPMENT OF THE UNIVAC 1100/80 COMPUTER MAINFRAME, PROVIDES A CLEAR EXAMPLE OF THE RELATIONSHIP BETWEEN R&D AND THE MARKETING OF NEW AND IMPROVED PRODUCTS.

1. R&D INVESTMENT

   THE COMMITMENT TO FUND NEW PRODUCT R&D IS NECESSARY IN HIGH TECHNOLOGY INDUSTRY SO AS TO REMAIN COMPETITIVE WITH DOMESTIC AND FOREIGN PRODUCERS.

2. LEAD-TIME

   A LEAD-TIME OF 10 YEARS WAS REQUIRED FROM THE R&D PHASE IN 1967 TO THE PRODUCTION PHASE IN 1977.

3. INVESTMENT IN MACHINERY & EQUIPMENT AND PLANT FACILITIES

   WITHOUT THE NECESSARY R&D INVESTMENT, THE CONSTRUCTION OF NEW, OR THE EXPANSION OF EXISTING, PLANT FACILITIES WOULD BE SUPERFLUOUS.

4. INCREASED JOB OPPORTUNITIES

WITHOUT THE R&D INVESTMENT AND RESULTING PRODUCT DEVELOPMENT, ADDITIONAL JOB OPPORTUNITIES WOULD NOT BE CREATED.

5. PRODUCT IMPROVEMENT

ONE TO TWO YEARS AFTER PRODUCTION COMMENCED, NEW R&D INVESTMENT WAS REQUIRED FOR IMPROVING THE FEATURES AND CAPABILITIES OF THE 1100/80 COMPUTER. PRIOR TO THE START OF THE 1100/80 PRODUCTION PHASE, RESEARCH CONCERNING THE NEXT MAJOR SYSTEM WAS UNDER WAY. THIS SYSTEM WAS INTRODUCED IN 1980. (SEE CHART "A" FOR A GRAPHIC PRESENTATION OF THE RELATIONSHIP OF RESEARCH AND DEVELOPMENT TO THE PRODUCTION CYCLE).

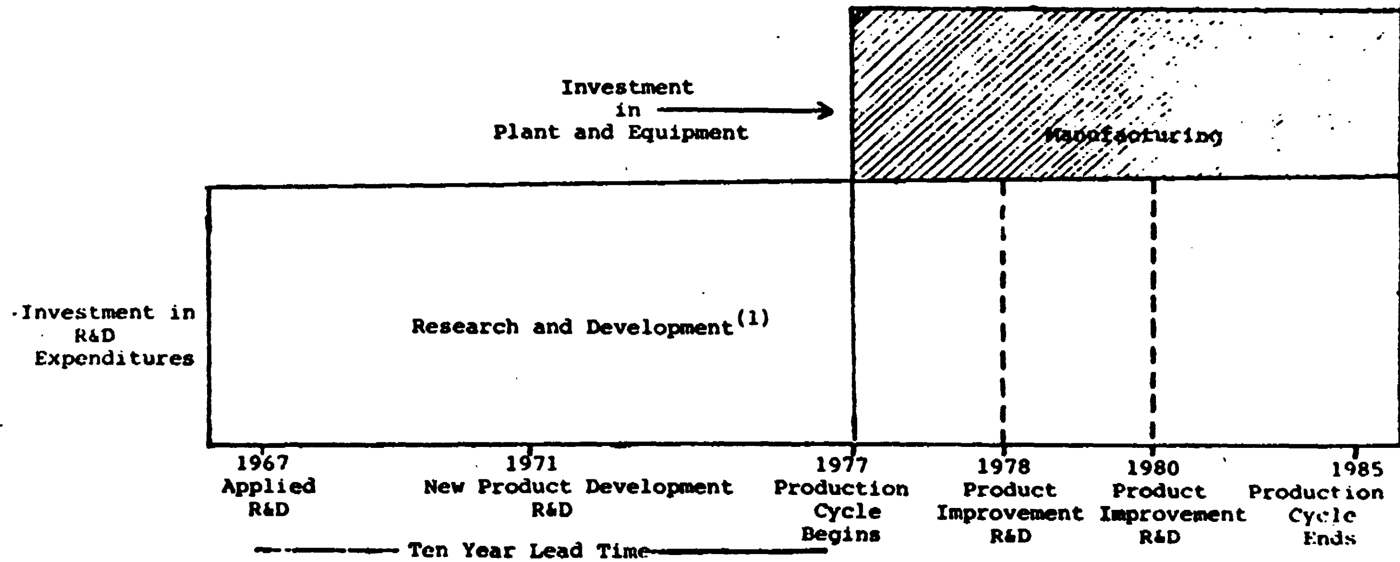
CONCLUSION

THE UNIVAC 1100/80 COMPUTER DEVELOPMENT STUDY DEMONSTRATES THAT RESEARCH AND DEVELOPMENT IS THE NECESSARY NUCLEUS IN THE CREATION OF NEW PRODUCTS, WHICH TRANSLATES INTO EXPANDED JOB OPPORTUNITIES AND NEW PLANT AND EQUIPMENT. ACCORDINGLY, THE NEED FOR R&D TAX INCENTIVES IS BASIC TO INDUSTRIAL GROWTH, AND IS THE NECESSARY COMPLEMENT TO THE PRESIDENT'S CAPITAL COST RECOVERY PROPOSAL.

5/21/81

CHART A

1100/80 UNIVAC COMPUTER - CASE STUDY
RELATIONSHIP OF RESEARCH AND DEVELOPMENT
TO THE PRODUCTION CYCLE




(1) Does not reflect new product development R & D for the subsequent series of large scale mainframe computers.

Statement by

Donald Kennedy
President of Stanford University

SUMMARY

There is wide agreement that a sound, active research base is essential for long term economic growth. American universities conduct most of the basic research in this country, and it is from basic research that the great advances in science and technology occur. The ideas that serve industry and society tomorrow flow from the basic research of today. Yet industry has not, by and large, been a heavy supporter of such work at universities. During the past 15 years, industry expenditures for research at universities ranged from 2.4% to 3.7% of the total research at universities.

For a variety of reasons, industry and university collaboration is difficult to establish; but there are excellent examples at major universities of productive arrangements. In certain academic disciplines, traditional distinctions between basic and applied research have blurred as the distance has shortened between the frontiers of knowledge and the application of that knowledge in useful products and processes.

Universities have the capacity to do more basic research to meet the needs of industry, and industry cannot duplicate the research capabilities of universities. Yet without additional incentives, significant change in the pattern of industry support of basic research cannot be expected. Universities have been aggressively seeking private sector support for many years; new incentives are needed.

S.692 provides tax incentives to encourage industry to support university basic research that meets industry's needs. Enactment of S.692 could lead to significant industry-university collaboration, which in turn could stimulate innovation, increase technology transfer, and -- as a by-product -- yield scientists and engineers with training better matched to industry's needs.

Mr. Chairman, I am Donald Kennedy, President of Stanford University, where I have been a member of the faculty of the Department of Biological Sciences since 1960. Before becoming Stanford's president, I served as Provost, the chief academic officer of the institution. In that post I was responsible, among other things, for arrangements to foster collaboration between industry and the university. I also have some experience with government, having served from 1977 to 1979 as Commissioner of the Food and Drug Administration, and before that as senior consultant to the then new Office of Science and Technology Policy in the Executive Office of the President.

I offer this statement on behalf of the Association of American Universities and the National Association of State Universities and Land-Grant Colleges. The membership of these two associations includes all the major research universities in America. For that reason, both have a keen interest in proposed legislation to strengthen our nation's research capacity.

Mr. Chairman, several bills pending before the Congress seek to boost our sluggish economy by providing new tax incentives aimed at channeling more resources into more research and development. There is wide agreement that a sound, active research base is essential for long term economic growth; and as members of this committee are

well aware, there is serious concern about the adequacy of the incentives in our current tax system to foster a satisfactory level of research and development by industry.

Although every university has reason to be grateful for instances of corporate generosity, industry has not, by and large, been a major source of funding for research at universities. National Science Foundation data show that between 1965 and 1980, industry expenditures for research ranged from 2.4% to 3.7% of total research expenditures at colleges and universities. At Stanford, our experience has been about the same; we estimate our current research support from industry to be about 5% of our total sponsored research.

The reasons for this low rate of industry-sponsored research are, of course, complex. There are some fundamental differences between what universities are willing to provide and what industry needs and wants. Not infrequently, there are also differences between the conditions set by universities and those acceptable to industry. Universities have traditionally worked on basic research at the frontiers of knowledge, and they have been vigilant to preserve openness of inquiry and the independence of faculties; industry, on the other hand, may want more immediate results than can normally be expected from basic research, and they are accustomed to secrecy in the handling of proprietary information. This is not to say

that satisfactory arrangements are impossible; indeed, good examples of such resolution exist at Stanford, MIT, Harvard, and -- I would guess -- at most other research universities. But the differences are nonetheless important, and each such arrangement has required special, often demanding negotiations between the parties directly involved.

In some areas, traditional distinctions between basic and applied research have become blurred. In certain disciplines -- microelectronics and biotechnology come most immediately to mind -- only a narrow distance separates the frontier of knowledge from the application of that knowledge to immediate problems and its utilization in products or processes in the stream of commerce. These areas represent especially fertile ground for industry-university collaboration.

A brief look at the electronics industry is instructive. The transistor was invented in 1948, followed some years later by the development of discrete transistors, then integrated circuit technology, and then microprocessors. We are now on the verge of another electronics breakthrough that could be as dramatic as the transistor: the development of Very High Speed Integrated Circuitry (VHSIC) which is both faster and smaller than anything we have known to date. As the electronics industry has matured, the time it has taken for each new development to find its way into industrial and societal use has grown progressively shorter. It took a

full ten years for the transistor to replace the vacuum tube; successive developments in integrated circuits and microprocessors each also took about a decade to become fully utilized in the electronics industry. New discoveries in VHSIC may require only very short lead time to go from the laboratory to the market place.

To support basic research in this new area, Stanford has turned to industry for help in establishing a Center for Integrated Systems. A consortium of major companies has entered into an innovative cooperative research partnership with Stanford; the corporate sponsors will fund a new multimillion dollar facility to house the research at Stanford. Continued support for equipment and research is in prospect, but would obviously be much facilitated by the legislation you are considering. This interaction between industry and university faculty will not only increase the likelihood of more rapid technology transfer and stimulate further research projects; it should also help train highly qualified scientists and engineers experienced in working with industry.

Another area of basic university research with promise for future commercial development comes from the Stanford Synchrotron Radiation Laboratory. Located at the Stanford Linear Accelerator Center, SSRL is a national facility with

a unique capability to produce extremely intense X-rays for the study of the composition and electronic states of materials. SSRL was initially funded by the National Science Foundation a few years ago, and since its inception, some 500 experimenters from approximately 50 universities and 30 corporations have used its facilities. Potential applications of synchrotron radiation include noninvasive means of studying and diagnosing the condition of human arteries, miniaturization of electronic circuits through x-ray lithography, and understanding the nature of the catalysts used in petrochemical processes.

I think the point need not be labored. Indeed, I doubt if anyone would challenge the fundamental premise that the basic research conducted at universities today will provide the knowledge that will be applied tomorrow in industry and throughout our society. In some fields, the distinction between basic and applied research has blurred. In these areas, there is an obvious, immediate occasion for productive collaboration between universities and industry; in other fields, it remains true that significant progress will not occur without that flash of new knowledge that comes almost invariably from basic research.

I have illustrated some successful areas of industry-university collaboration at Stanford, and have asserted the

intimate link between basic research and the self-interest of industry. Members of the Committee well might ask why I am here pressing for new tax incentives for industry to support basic research at universities. If it is happening now, in other words, why do we need new incentives?

I report with some sadness that the examples given do not support an optimistic general conclusion. Indeed, the difficulty of negotiating the arrangements that now exist points to the need for new incentives if we are to make any significant headway in expanding industry-university collaborations in research.

I should mention here a concern shared by most university presidents nowadays. It is this: as our national attention is fixed on the extraordinary difficulty of paring back government expenditures, one frequently hears it asserted that the private sector can be expected to accomplish those things from which the government now proposes to withdraw. Stanford and similar institutions have, however, been appealing to the private sector with all the skill, persuasion, and strong programs they can muster. Our very existence is renewed each year by the generosity of private sector donors; and as our alumni and friends will readily attest, we do not blush at passing the hat. The plain fact is that significant change in private-sector support, especially for research, will require new incentives. I simply do not believe that significant sources of funds exist in the private sector that we are not now tapping.

Let me turn now to specific proposals to add new incentives. S.98, known as the incremental bill, provides incentives to industry to increase their overall investment in research and development. This bill would serve an important national need, but it is quite different from S.692, which encourages companies to exploit the innovative resources of university researchers. These bills complement one another; both are needed.

I will focus my comments on S.692, which seeks to harness the basic research capacity of universities to serve the needs of industry. This bill, appropriately known as the "Research Revitalization Act of 1981," will permit businesses to receive tax credits on funds deposited in a special research reserve which can only be used to pay for "qualified research expenses" for research conducted at an institution of higher education. Funds may remain in the reserve for up to four years, an arrangement that will allow industry to accumulate research funds and permit them more flexibility in amounts to spend on a given project and more time to choose wisely than would be the case with a more time-restricted arrangement. When funds are properly spent from the reserve, a standard business deduction, now available in current law, is allowed. Misuse of the reserve funds, including failure to spend them within the time limit, is

heavily penalized -- a 300% penalty on the amount misused, and inclusion of that amount as taxable income in the year of the misuse.

Enactment of this bill would:

1. Provide industry with a sufficient incentive to invest in basic research it is not equipped to carry out, but which is essential for long-term progress.

2. Provide a new source of innovation for the nation's industrial sector.

3. Use the existing capacity of universities to conduct new research in fields of special interest to industry. (In some fields -- for example, high energy physics -- there is excess capacity now.)

4. Provide new funds to support basic university research, not as a substitute for federal funds, but as a new source for discoveries that should increase productivity and speed technology transfer. Such funds could, for example, help meet the critical need for improved instrumentation in university laboratories.

5. Yield, as a by-product of the close relationship between teaching and research, graduate scientists

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and engineers with training better matched to industry's needs.

In summary, it seems clear that there is enormous potential for gain from efforts to establish closer links between the research capacity of universities and the neglected needs of industry for basic research. The approach in S.692 provides a new incentive that can enable industry and universities to work together, but it will depend on industry and universities to negotiate the terms of research agreements. That in itself will not be a minor chore, but I believe that industry and the universities can do it. By creating the conditions that make university and industry collaboration more likely, the government will have performed a most important service -- without a new program, and without a new staff. (I might add, as an aside, that precisely this philosophy lay behind last year's passage of the University and Small Business Patent Act, of which the Chairman of this committee was the principal co-sponsor.)

## STATEMENT OF CHARLES W. STEWART, PRESIDENT, MACHINERY AND ALLIED PRODUCTS INSTITUTE

Mr. STEWART. Mr. Chairman and members of the committee, my name is Charles Stewart. I am president of the Machinery and Allied Products Institute which is the national organization representing the capital goods and allied products industries.

I understand our full statement will be included in the record and in deference to your time schedule I shall try to be brief and cover only certain highlights.

First of all, with respect to the recommendations before the committee on capital cost recovery allowances our view is that they are long overdue.

Our studies in this area go back to the fiftys, including a prominent publication by the institute entitled "Realistic Depreciation Policy" and currently a study on inflation and profits indicating that underdepreciation from inflation is running at $14 billion a year. This is an indication as to why it is urgent to enact a capital cost recovery allowance system that is much more liberal than is presently on the books.

I think it is fair to say that there is a remarkable consensus with regard to policy in this area. It cuts across parties, it cuts across disciplines and I think it is unnecessary for me to spend any major part of my 5 minutes redocumenting that case although it is covered thoroughly in our statement.

I would like to make some comments in more detail on the individual income tax side. Before doing so, perhaps it would be useful if I referred to a set of criteria set forth by Chairman Rostenkowski, who was among those who met with Senator Dole just within the last few days, with regard to his concept as to how a capital cost recovery system liberalization should be undertaken.

First, he says that the need for depreciation reform is unquestioned.

We agree.

He further indicates that he has not arrived at a formula. He believes that simplifying the present system by reducing the 130 different classes of assets under the ADR system and drammatically shortening capital cost recovery periods for personal or real property is a necessity.

We agree, except that I trust that he will not stop short of putting aside forever the so-called useful life approach to depreciation.

He would eliminate the uncertainty of debating facts and circumstances. There is a controversy on this issue particularly for high technology companies such as those which have just testified.

He seeks to prevent the combination of the investment tax credit and a liberalized depreciation formula from yielding back more than a dollar in tax relief for a dollar invested. I think this is a bogey. I haven't seen any system which accomplishes that and I am sure the recommendations before you do not.

He wishes to maintain tax neutrality between industries, between short-lived and long-lived assets, between commercial and residential structures and between owner-occupied and leased structures. He intends to give all capital investment a better cost recovery formula without creating any distortions. This is a highly

misleading concept which will lead only to a complicated system which the proposal before you and such other proposals as that of Senator Bentsen would try to get away from.

He suggest making any cost recovery system fully effective January 1, 1981. We agree, if at all possible.

Now I turn to one other aspect and that is the personal income tax side. Some may wonder why I testify to that subject, being a business representatve.

First of all, I do not believe the interests of business and the interests of the taxpaying public are mutually exclusive.

Second, I think that the individual taxpayer is the most underrepresented individual in our entire system.

I would like to suggest that if a compromise with respect to the personal income tax 3-year recommendation of the President is worked out by the Congress, that it be undertaken within the scope of certain criteria. And, I will be presumptuous enough to suggest what those criteria might be.

The CHAIRMAN. Could you do it quickly please.

Mr. STEWART. I will do so very quickly.

The concept of a multiyear tax cut should be preserved if at all possible.

The level of the reduction should be substantial and not token.

Reduction should be in marginal rates across the board avoiding the redistribution approach.

President Reagan submitted a proposal which would concentrate on capital cost recovery allowances and his personal income tax reductions with the notion that there would be a second package. Some feel the two should be brought together. I suggest that if they are we should not give up the simplicity of the initial package and not bog it down as if it were a Christmas tree.

With our full statement and those supplementary comments, we thank you sir.

The CHAIRMAN. Thank you, Mr. Stewart.

Mr. Smith.

## STATEMENT OF CRAIG R. SMITH, PRESIDENT, THE WARNER & SWASEY CO., AND CHAIRMAN OF THE NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION

Mr. SMITH. Thank you. Mr. Chairman, members of the committee, my name is Craig Smith. I am president of the Warner & Swasey Co., a wholly owned subsidiary of the Bendix Corp. I am also president of the industrial group of Bendix and chairman of the National Machine Tool Builder's Association.

I am here to present some economic facts that we urge you to keep at the forefront of your deliberations this year.

While American productivity remains the highest in the world, productivity growth rates are the lowest of all major free world nations and this decline is accelerating.

The United States is dead last among industrialized nations in investment as a percentage of gross national product. Japan is first.

American industry has the highest percentage of old machine tools in the free world. Japan has the lowest percentage.

The situation is even worse in defense industries. The average age of equipment for U.S. industry from 1966 to 1976 was 17 years, while the average age of Department of Defense machine tools was over 25 years.

Today, our industry is producing machines that are faster, more accurate, and more economical and with computerization robotics and other new automation technology we see the possibility of quantum leaps in productivity in the 1980's.

But to realize these productivity gains and to pass them on to the defense base, American industry and the machine tool industry in particular, must have capital—capital that can only be created by more aggressive investment policies.

We commend President Reagan for addressing this crucial issue by including as an integral part of his overall economic recovery program the accelerated capital recovery system or 10-5-3.

We commend Senator Heinz for his Senate sponsorship of this important tax reform.

We believe 10-5-3 is far preferable to the depreciation proposal your committee adopted last year. It permits earlier recovery of capital and it is far less complicated, and it provides the full investment tax credit to companies which choose to modernize equipment and become more productive.

One of the greatest beneficiaries of the reform will be our Nation's defense which has been relying on an ever smaller pool of resources while attempting to produce space age weapons with antique machine tools.

The House Armed Services Committee has concluded that turbulence and lack of capital in the defense base has resulted in serious bottlenecks which adversely affect the Defense Department's ability to procure military equipment in a timely and cost effective manner.

The passage of 10-5-3 will contribute greatly to strengthening our defense by increasing the availability of quality components dedicated to the defense industry.

We also support the individual marginal tax rate cuts proposed by the President. Inflation has pushed individuals into higher and higher tax brackets and caused a very real decline in the standard of living for American working people.

America's individual savings rates are far below those of other industrial nations with the gap continuing to widen.

Because of a tax system that taxes investment income at a higher rate than wage and salary income, many taxpayers have moved more and more to tax shelters distorting normal investment patterns and robbing the economy of much needed equity investment in venture capital.

We need to adopt an economic policy that will once again make equity investment attractive. Substantial individual rate cuts will accomplish this objective, but if a 3-year tax cut program is deemed too risky, there are alternatives which can also work.

For example, we endorse the immediate reduction of marginal tax rates on so-called unearned income from 70 to 50 percent.

Above all, we urge you to adopt measures geared to increased capital and the willingness to invest it.

Only then will American productivity at home and competitiveness abroad improve.

Thank you.

The CHAIRMAN. Thank you. Mr. Lieberstein.

I might note that our colleague Senator Taft is appearing with you.

## STATEMENT OF SIDNEY LIEBERSTEIN, VICE PRESIDENT, MACHINERY DEALERS NATIONAL ASSOCIATION

Mr. LIEBERSTEIN. Mr. Chairman and members of the committee, I am Sidney Lieberstein, vice president of the Machinery Dealers National Association. Our 500 member firms account for over 70 percent of the used machine tools sold in the United States.

Because used capital equipment is acquired from large manufacturers and usually resold to small manufacturers through our industry, MDNA members are in a unique position to articulate the economic problems of the small business community.

Consequently, our opinion of what influences small firm's investment decision comes from experience. We support a coordinated budget and tax cut package as being in the best interest of the country. And we believe that part of any effective tax legislation should target capital formation and retention problems of smaller businesses which need help.

We endorse the creation of a simplifed and accelerated capital cost recovery system and once again strongly recommend removal of the ceiling on the amount of used equipment eligible for the investment tax credit.

It appears that past congressional reluctance to accept this tax credit proposal was probably based on a lack of available or accurate statistics for revenue loss resulting in fear of the unknown and we understand the concern that this has caused your committee.

Economists at both the Treasury Department and Joint Committee on Taxation during recent visits admitted their studies were based on a large degree to conjecture. Therefore, if it is not possible at this time to remove the ceiling, then we believe that the ceiling should be raised to 500,000 or at least to 250,000 and elevated in phases to 500,000 by 1985.

In order to ameliorate the discriminatory impact of the ceiling, we further urge that the purchasers be allowed to carryback 3 years and carry forward 7 years the balance of their investment above the ceiling for which no tax credit is allowed in the year of purchase.

Under present law, there is a $100,000 limitation on the amounts of used equipment eligible for the investment tax credit, but there is no limitation on the investment tax credit available for new equipment.

Similarly, the carryback, carry forward provisions available for new equipment are not allowed to purchasers of used equipment who may not carry forward or carryback tax credits on investment over the limitation amount.

The original, arbitrary and inadequate limit of $50,000 was merely a token jesture to small business and in light of inflation

doubling the limit to $100,000 13 years later perpetuated the injustice.

The current disparity between the investment tax credit available to new and used equipment is in effect a congressionally mandated discrimination against small business which directly dilutes the ability of small business to compete with large firms and survive.

This disparity also allows new foreign machinery, even those from behind the iron curtain, a competitive edge through the investment tax credit advantage over equally efficient and price competitive late model quality used domestic machinery.

We assume this was not the original intent of the ceiling. The importance of this issue is evidenced by the fact that seven legislative proposals in the House and two in the Senate have already been introduced this year.

We will to thank Senator Bentsen for introducing bill No. S. 1140 and Senator Danforth for cosponsoring it along with Senators Baucus, Mitchell, and Chafee. The bill would raise the limitation to $250,000 and allow a carryback and carry forward of the cost of used equipment if it exceeds $300,000 for any taxable year.

Senator DANFORTH. Mr. Lieberstein, I am afraid your time has expired.

Mr. LIEBERSTEIN. Thank you, Senator Bentsen.

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

Thank you for your comment concerning legislation which we are supplying substantial support for.

I want to ask you about [I had someone talking in each ear as I was trying to listen to you and I apologize] but your comment about the 2-4-7-10, which we have enriched somewhat since we passed it through this committee last year.

One of my concerns with 10-5-3 as opposed to 2-4-7-10, obviously 10-5-3 finally results in more being done, I understand that, but I don't much go for the idea of phasing in. I really would not like to see a situation where a board meets and says well, you know, they have improved accelerated depreciation, but it is going to be a little better next year. Then meet next year and say, well you know, it is going to be a little better next year.

What we had proposed was that it all be put in at once.

Obviously, that doesn't leave as much room on the personal income tax side. We are talking about some kind of a limitation on how much we do in the way of a tax cut and we obviously have to have one.

So, I have favored trying to do something where we put it all in. In other words, we would say, you know, they have really finally done something about accelerated depreciation.

What we really have to do is have a psychological impact there where management and boards will say,

> You know, we better re-think our capital spending. We are going to have substantially more cash flow. We will go out and buy that new equipment.

I wanted to see something I thought a little more balanced and going maybe to three sixes or three sevens and having more room in there to do what we have to do on capital gains to cut it and investment income and put all the accelerated depreciation in at one time.

Do you have a comment on that.

Mr. STEWART. Yes, you can make a case for that proposition. But on the other hand, I think it is somewhat illusory to assume that capital investment decisionmaking is an ad hoc sort of thing versus a 5-year program, for example.

I think it is fortunate that business has become more statesmanlike with regard to its capital cost recovery planning.

So, I think that you can overstate, and do in my opinion, the point that you make with respect to giving business all that you are going to give them at once and avoiding the phase in.

I think, actually, the phase in, as you have implied, was installed in the proposal largely for revenue saving reasons.

You make a nice point when you say, let's do as much as we can and place it in effect immediately. I would counter by suggesting that when the variation of 10-5-3 which we have now is fully implemented, there will be a much stronger incentive system than the alternative that you suggest. I think also that business will respond in terms of their long-range capital planning and initiate programs when they can see several years down the road even with the sacrifice of the phase in.

That is the best response that I can offer.

Senator BENTSEN.

Well, obviously we don't agree on that one point.

We agree on the need for this approach, but as far as the implementation of it, I think that there will be marginal decisions where if it is done in a more dramatic way and put in at once, that you will have the psychological atmosphere for re-thinking of capital expenditures that will help.

Senator DANFORTH. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman. Mr. Leiberstein, you were talking about some of the problems a small business has with some of the limitations on used equipment and so forth, but how much of a problem is the inheritance tax for small business that you represent.

Mr. LIEBERSTEIN. Well, Senator, my experience after reading many of the bills that have been introduced in the discussion is that it is desirable— that it is a problem and it should be addressed to in this tax bill. Small business is trying to hand down the business from father to son, it is very strongly affected and that problem should be resolved.

Senator SYMMS. Thank you. Mr. Stewart, you have mentioned that you favored the marginal rate reduction for the individual taxpayers and I also favor that, but I might just make a quick comment, I know the chairman needs to keep the program moving this morning, but I met with a group of CPA's this morning and they advised us that the biggest single problem with this underground economy and people that are trying to avoid paying their taxes is the fact that in the biggest overall problem of the tax code is that the rates are too high everywhere. You know, corporate rates, capital gains rates, individual rates, inheritance tax rates.

One of the accountants made the point with me that he said really the simple thing for Congress to do would be to just lower all the tax rates and then everybody knows what the code is now and

that would give equality to everybody. Do you share that sympathy at all?

Mr. STEWART. Well, as a theoretical proposition, I certainly share it. As a practical one, in terms of what the Congress can do at one time, there is obviously some question about it.

I think that a corollary to the proposition that was advanced to you is that any personal income tax rate decrease should be across the board. I think that is consistent with what this gentleman is saying.

What can be done at any single time obviously has to be tested against the revenue situation.

Senator SYMMS. Thank you very much.

Just in closing, Mr. Chairman, I would just tell you, Mr. Smith, to please give my regards to your boss down there at Bendix Corp. I went to college with him at the University of Idaho.

Mr. SMITH. Fine.

Senator SYMMS. He helped me get through some of the business courses in fact.

Mr. SMITH. I will be pleased to do that.

[The statements of the preceding panel follows:]

STATEMENT OF CHARLES W. STEWART, PRESIDENT, MACHINERY AND ALLIED PRODUCTS INSTITUTE

Summary of MAPI Position on Tax Aspects of President Reagan's Economic Program Before the Senate Committee on Finance, May 21, 1981

1. General.--We endorse President Reagan's economic program generally, and urge that Congress approve the measures swiftly and as nearly intact as possible, including contemporaneous budgetary cuts of substantial magnitude moving on a "parallel track" with the planned tax reductions. Overall, the Reagan initiative is preferable to the Rostenkowski "alternative" approach, in our opinion.
2. Background.--MAPI economic research indicates that, among other things, the existing tax system does not adequately take into consideration the effects of inflation and is affecting savings adversely, thereby impeding investment, productivity growth, and the attainment of national economic goals.
3. ACRS.--We generally find the Accelerated Cost Recovery System to be acceptable as proposed, but request that consideration be given to (1) having a "banking" provision for cost recovery that cannot be used in a particular year; (2) providing a "useful life" election in place of ACRS for companies that can bear the burden of demonstrating asset service lives that are shorter than the recovery periods; (3) allowing depreciation and investment credits to be claimed as soon as expenditures are made in all cases, or at least on projects requiring 12 months to completion; (4) allowing shorter recovery periods for foreign assets so that deemed-paid foreign tax credits are not lost; and (5) reviewing the phase-in provisions as to their adequacy from the standpoints of equity and incentive.

4. Individuals.--We approve of the three-year 30 percent reduction in marginal tax rates for individuals, as proposed, and urge retention of the phase-in procedure, the simultaneous capital gains reductions, and the equalization of taxes on personal services and investment income.
5. Second bill.--We agree with the idea of "fast tracking" the two high priority tax changes for businesses and individuals by means of a two-bill approach. Congress should return as soon as possible after enactment of the first measure to correct the tax law as it pertains to the foreign earned income of U.S. workers abroad and to evaluate additional "savings" and "productivity" oriented proposals.
6. Conclusion.--MAPI believes that the President's proposals will have salutary effects, if enacted and implemented substantially as proposed. However, we do not expect any "prompt" or "miraculous" reversal of the current economic situation and realize that there may be some near-term discomfitures.

Presentation of the
Machinery and Allied Products Institute
to the
Senate Committee on Finance
Concerning Tax Aspects of
President Reagan's Economic Program
May 21, 1981

The Machinery and Allied Products Institute (MAPI) appreciates having this opportunity to appear before the distinguished Senate Committee on Finance to express views concerning tax aspects of President Reagan's Economic Program. MAPI is the national organization and spokesman for manufacturers of capital goods and allied products, and the Institute has a significant, continuing interest in policy issues involving savings, investment, and productivity. We are convinced that tax reform of the type proposed by the President would increase each of these measures of economic performance, and would be consistent with the nation's economic objectives.

To summarize our position, we urge the Committee to report to the full Senate in a timely manner a bill that embodies President Reagan's tax recommendations in principal part, with such technical changes as commentators have requested and Treasury will approve. The President has kept his campaign promises regarding taxation and the economy, and we believe that the vast majority of individuals and businesses are in accord with his program. In conjunction with the proposed marginal tax rate reductions for individuals and Accelerated Cost Recovery System (ACRS) for businesses, we support the President's initiatives for budgetary restraint and regulatory moderation. It is our further hope that

the independent Federal Reserve System will cooperate by means of slower growth of the monetary aggregates. Whereas the tax reductions are essential, they cannot alone turn the tide.

We commend the Administration for recognizing that the government itself is largely to blame for the U.S. economic malaise of recent years, including the "double-digit" inflation that has caused so much disruption. Federal government spending has been allowed to run out of control; the near-trillion dollar national debt is a national disgrace; and taxes have been permitted to escalate to unprecedented highs, giving rise to a flourishing underground economy and choking off the savings and investment needed to restore order. There is no reason why this country cannot return to its usual pattern of substantial growth in productivity, real income, and employment, become more competitive in world markets, and regain lost influence. However, Congress will have to act with boldness and resolve, and come promptly to grips with the situation rather than procrastinate and retreat before the challenge.

Our comments that follow consist of background observations and general and more detailed views addressed to points that need emphasis or proposals that could be reconsidered to facilitate taxpayer acceptance. In offering these thoughts at this time, MAPI does not intend to delay consideration of the program or to promote changes that would add substantially to the overall cost.

## Background

As a prelude to our remarks about the Administration's tax proposals, we wish to bring to the committee's attention the findings of selected recent MAPI economic research. They substantiate the Admin-

istration's position as a general matter, and do not support the contentions of those individuals who have faulted the program. Also, they establish a framework for our more specific remarks.

Inflation and Profits

In an April 1981 update of an earlier study, MAPI Economic Consultant George Terborgh used Department of Commerce figures to demonstrate the pernicious effects of the current federal tax system where historical cost accounting is employed, inflation is substantial, and appropriate adjustments are not made in the assessment of corporate income taxes./1

Beginning with profits after tax as reported by nonfinancial corporations for 1980 in the amount of $120.6 billion, Mr. Terborgh adjusted the amount for (1) the excess of current cost straight-line depreciation over income tax depreciation, and (2) the excess of current cost inventory consumption charges over their tax counterparts. The understatement of costs equaled $60.1 billion, leaving adjusted after-tax profits at $60.5 billion. Reducing after-tax profits by $40.4 billion in dividend payments, he found adjusted retained earnings of only $20.1 billion, which amounted to $11.3 billion when deflated using constant dollars.

Mr. Terborgh then computed effective federal and state (combined) tax rates on pre-tax profits of nonfinancial corporations as reported and as adjusted, and found the former to be 34.3 percent and the latter to be 51.1 percent for 1980. The 1980 adjusted effective tax

1/ "Inflation and Profits," by George Terborgh, MAPI Economic Consultant, MAPI Memorandum G-70 (April 1981). On a related subject, see "Inflation and the Taxation of Business Income," by George Terborgh, MAPI, January 1976.

rate was the highest in ten years, except for 1974 when it rose to nearly 66.1 percent. In conclusion, Mr. Terborgh commented in part as follows:

> Let us add further that the Alice-in-Wonderland accounting of costs and profits that now passes for orthodoxy is a problem not only for business management, but for the accounting profession, the regulatory agencies of the government, and, not least, for the tax authorities. It is high time for concerted action by all concerned. [Emphasis added.]

Comparative Savings

Another recent MAPI study looked into the relationship between a country's productivity growth and its level of gross savings, comparing trends in major industrial countries from 1960 to 1977./1 The findings were summarized in part, as follows: (1) This nation has experienced the slowest productivity growth of any major industrial country since 1960; (2) The relative level of gross savings is a significant explanatory factor, and there also is a close relationship between the personal savings ratio and productivity growth; (3) The tax structure appears to be a significant influence on savings and productivity growth, with

1/ MAPI Capital Goods Review No. 114 of April 1980 entitled "Savings Levels and Productivity Growth: Comparative Trends in Major Industrial Countries, 1960-77." An earlier MAPI study had considered the extent to which productivity growth was related to fixed investment by comparing the experience here with that of other industrial countries from 1960 to 1973 (MAPI Capital Goods Review No. 102 of February 1976). There was found to be a significant correlation between greater productivity growth and relatively high fixed investment, and the United States ranked at the bottom of the list of countries in both categories. The MAPI study pointed to the need for intensified efforts to expand and modernize U.S. industrial capacity, efforts that would require a high level of capital formation.

relatively greater emphasis on direct taxes tending to have a dampening effect; and (4) The foregoing findings strongly support the proposition that savings rates must be increased if the adverse trend in U.S. productivity growth is to be reversed, and a significant restructuring of U.S. taxes should receive high priority consideration in the effort to achieve this objective.

Among other forms of tax "restructuring" mentioned in the MAPI study were the adoption of such measures as further liberalization of the investment credit, a "much stronger capital cost recovery system to replace the present accelerated depreciation provisions tied closely to useful lives," less progressivity and "reduced rates" in the personal income tax, and possibly, direct tax relief for specified forms of personal savings. Furthermore, the study indicated that, whatever measures are adopted, they should result in a reduced reliance on direct income taxes in order that the rate of savings, investment, and productivity growth can be enhanced.

Government Role

MAPI recently inquired as to the relatively poor performance of the U.S. economy in the 1970s, and, for that purpose, broadened the Institute's prior examinations of the relationship between productivity and economic growth on the one hand and business savings and investment on the other by focusing on how government affects private savings and investment./1 Among the findings of the study are the following:

1/ "The Government Role in Private Sector Savings and Investment," MAPI Memorandum G-128 (February 1981). Also see "Productivity and Capital Formation," MAPI Memorandum G-112 (December 1979).

1. Real net national savings and capital expansion outlays, after increasing through the 1950s and 1960s, declined during the 1970s, and the decline accelerated in the second half of the decade.
2. The federal government's fiscal and monetary policies have been major factors in the decline.
3. Individual income and social security taxes have increased enormously during the past decade, and the federal government has greatly increased the tax burden on U.S. corporations by taxing book profits, which are substantially overstated during periods of rapid inflation.
4. The problem has been compounded by steep increases in federal grants-in-aid to state and local governments, and by the huge expansion in federal transfer payments that has redirected resources from savings to consumption.
5. Tax revenues, despite their steep increase, have been insufficient to finance federal government spending programs, and substantial recourse has been made to the credit markets, with federal government borrowing rising steeply to unprecedented levels.
6. Federal deficits have been financed in part through the banking system which has accommodated government needs by means of inflationary monetary policies.
7. Even with the inflationary financing provided by the banking system, the transfer of real income from the

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private to the government sector during the 1970s and the shift of funds from savers to consumers was sufficient to reduce real investment in plant and equipment expansion with adverse effects for economic growth.

8. Increased taxes have had a major adverse impact on private sector savings because the structure of the tax system is particularly burdensome for business and for middle and upper income groups. It follows that balanced budgets will increase savings only marginally if the balance is achieved at excessively high spending levels. Barring a drastic change in the tax structure that would shift more of the burden to consumers, it is vital that government spending be sharply curtailed. The alternative is the continuation of low investment, slow growth, and double-digit inflation.

<u>Summary</u>

Recent MAPI economic research points to the inescapable conclusion that federal taxes on businesses and individuals are now too high; that government spending must be sharply curtailed; that the Federal Reserve should restrain growth of the money supply; that regulatory bodies should be required to exercise their mandates with more care; and that the relative U.S. economic decline of recent years will continue and perhaps worsen in the absence of a new and very substantial commitment on the part of policy makers and their constituencies to correct the situation.

In General

For general commentary, we would like to (1) strongly urge swift, favorable action by Congress, (2) emphasize the need for contemporaneous budgetary cuts of substantial magnitude moving on a "parallel" track with tax reductions, coordinated in timing and amount to the extent practicable, and (3) direct attention to certain aspects of the Rostenkowski proposal that seem less desirable to us than the Reagan approach.

Swift Action

We believe that Congress should act on the President's program with all due haste, consistent with the need to respond promptly to the public mandate and to begin administering remedial measures to get the economy back "on track." In our opinion, this is not a time for delays, indecision, or obstructionism as to a new program that the electorate largely wants and will accept in the form offered. We hope that the committee will put aside partisan considerations and move to its mark-up sessions in a spirit of accommodation and cooperation as soon as a bill has been sent over from the House of Representatives.

In that connection, we have been encouraged by certain acknowledgements that the timing of the President's program is right and that there is broad public support for expedited consideration of the proposals. If Congress does not move swiftly, or if it dismantles the President's program or materially alters its thrust or direction, the opportunity to change course may be lost. The Administration would like to have Congress complete action on this first tax bill by early August, and we trust that the committee will do its part to abide by this schedule.

Additionally, the matter of keeping on schedule is important so that businesses and individuals can plan their affairs with certainty about the government's new fiscal policies and know when they will take effect. Moreover, the pace and intensity of congressional deliberations will reflect the degree of resolve on the part of Congress to act and, thereby, will have a direct bearing on expectations as to the new policies and how they will affect the performance of the economy.

The Budget

We hardly need remind the committee that the federal budget is not in good condition, and that excessive federal spending is as much--if not more--to blame for current conditions as the high levels of federal taxation that finance the outlays.

Spending overruns alone for the past two years have totaled nearly $100 billion, and spending growth has averaged 16 percent per annum. The federal government deficit in fiscal year 1981 probably will reach $80 billion, including off-budget amounts. In our opinion, the nation simply cannot continue to live beyond its means in this way./1 Consistent with the goals that have been set for strengthening the U.S. defense posture, retaining the Social Safety Net of programs established in the 1930s, and servicing the distended national debt, we agree that there must be substantial reductions in the absolute size and growth of other federal spending and even the elimination of certain programs.

In our judgment, the budget cuts are vital to counteract the deficit-enlarging effects of tax cuts, at least until "feedback" revenues and increased savings are realized. It is not feasible for the Federal

1/ See the MAPI study "The Decline of Fiscal Discipline," April 1981.

Reserve to accommodate the deficit by pumping up the money supply because a stabler and more gradual growth in the monetary aggregates is essential to dampen inflationary expectations. In the absence of major spending reductions, the result of an enlarged deficit and a restrained monetary policy would be an increased federal government presence in the capital markets, leading to higher interest rates and still more "crowding out" of private-sector borrowers.

We see no reason for fiscal and monetary policies to be at cross-purposes, and the results could be harmful. Accordingly, we urge Congress to keep spending reductions on a parallel track with tax cuts, and to coordinate them in timing and amount to the extent practicable.

Rostenkowski Proposal

The alternative to President Reagan's program that was announced on April 9, 1981, by House Ways and Means Committee Chairman Rostenkowski has not yet appeared in legislative text to our knowledge. However, some of the broad features are apparent from Mr. Rostenkowski's remarks of April 9 to the Chicago Association of Commerce and Industry, and they are worthy of comment.

First, the total Rostenkowski package is smaller and refuses to adopt a multi-year approach for individuals, which places the bill in the category of business-as-usual ad hoc inflation adjustments used in the past, generally without fully arresting the tax increase otherwise payable and without having any bearing on inflationary expectations--a subject to which we shall return. For reasons discussed later, we prefer the President's across-the-board reductions and feel that a

multi-year commitment to substantial tax reduction is critical to the program not only for its effects on expectations but also for the discipline it will bring to spending.

Secondly, Congressman Rostenkowski's view on depreciation reform is difficult to judge because of the lack of detail available to date, but it evidently does not contemplate a clean break with asset service lives and it emphasizes "tax neutrality" to such an extent that it surely would be more complex than the Reagan initiative. We do not wish to be "negative" about a proposal that still lacks adequate definition, but the point remains that the President's top tax policy experts forged a compromise around the "10-5-3" bill of Congressmen Jones and Conable, a bipartisan measure with sponsorship from more than half of the members of the House of Representatives and Senate. It would be a mistake at this stage to divert attention from the Reagan proposal--as compared to helping to refine it so it can move to enactment.

On a final aspect of the Rostenkowski proposal, it would involve a number of specialized, targeted relief items, some of which have been promoted actively by parties who perceive that they would be benefited in one way or another. Whereas we do not resist the enactment of effective stimulants for savings and investment, we find it difficult to rationalize a "fine tuning" approach to tax policy that makes distinctions among industry segments and strata, favors one geographical area over another, etc., to the exclusion or lessening of tax reductions affecting all or most individuals and/or entities. Targeted provisions also usually are more complex and difficult to administer than general

ones. In our opinion, the President has his priorities in order, and broad relief of substantial magnitude is the first order of business. Other matters can be considered later.

The Tax Proposals

President Reagan's tax proposals include: (1) an Accelerated Cost Recovery System (ACRS), effective January 1, 1981; and (2) individual tax reductions across-the-board of 10 percent per annum for each of three consecutive years, beginning July 1, 1981. We agree with the Administration's identification of a new, modernized, cost-recovery system and across-the-board individual tax cuts as being the two highest priority federal tax reforms. Also, consistent with the purpose of "fast tracking" the economic program and dealing with other important matters after the first program has been cleared, we concur in the decision to limit the tax initiatives at this time to those most needed.

At the same time, we recommend that the Administration and Congress move at the earliest feasible date to correct the inequities in foreign earned income taxation and to reconsider such "productivity" oriented changes as research and development tax credits and incentive stock option provisions. MAPI will have further and more detailed views to present on "structural" tax changes at the appropriate time.

ACRS

Overall, we approve of the proposed Accelerated Cost Recovery System (ACRS), and applaud the Administration for its initiative to modernize tax depreciation in this way. As already documented in MAPI studies and as suggested by independent analysis of the new, inflation-adjusted, financial disclosures under Financial Accounting Standards Board Statement No. 33, the current tax depreciation policy is inadequate,

particularly in times of inflation such as we are experiencing. Moreover, we believe that ACRS represents a fair compromise for now between the proponents and critics of the original Jones-Conable "10-5-3" approach.

We have compared the original "10-5-3" bill and ACRS, and have identified the major changes. One modification was to "stretch" depreciable realty in some cases to 15 or 18 years, and to mandate straight-line write-off without depreciation recapture upon disposition. Another change was to include research and development (R&D) machinery and equipment in the three-year class. Still another modification was to make ACRS exclusive, without alternatives, and to eliminate the "banking" provisions whereby cost recovery that could not be absorbed in a particular year could be saved for later years. In partial mitigation of the latter change, the net operating loss carryforward would be lengthened to 10 years.

Another alteration was aimed at restricting to long-term projects the permission to commence the cost recovery allowances as soon as amounts are spent. Finally, foreign assets would be subject to a straight-line depreciation schedule of 30, 20, 10, and 5 years.

"Banking" provision.--Although we do not intend to be critical of these changes, we take this opportunity to inform the committee of certain concerns that have been expressed to us. For one, the elimination of the "banking" provision removes some flexibility from the original proposal for taxpayers, and they presumably would have been better situated to have that flexibility rather than lengthened carryovers. The committee may wish to consider reinstating the "banking" provision if the original approach does not present an additional revenue loss contingency or have other, seriously objectionable attributes.

High-technology companies.--Another stated concern is that of high-technology companies that already justify relatively short service lives for much of their machinery and equipment because of the rapid rate of obsolescence in their industries. Certain of these companies would be required to use longer cost recovery periods for many production assets and, on balance, would not have a significantly improved recovery experience for such items, although the investment credit amendments would be beneficial. Without prejudice to ACRS as it would benefit other taxpayers, a number of these firms believe that some added consideration should be given to their situations, provided that the President's program would not be delayed or otherwise jeopardized in the process. The committee may wish to consider the feasibility of maintaining facts-and-circumstances depreciation on an elective basis for taxpayers who can demonstrate that their assets actually have service lives shorter than the periods to which they otherwise would be assigned.

"As spent" item.--Another matter of interest to some companies is to have some form of reinstatement of the provision in the original "10-5-3" bill that would have allowed depreciation and investment tax credits to commence as soon as amounts are spent. This would have coordinated the cost recovery with the cash outflow and would not have been limited to two-year projects as in the Administration's proposal. We suggest that the committee reconsider this earlier approach, or at least investigate the feasibility and cost of permitting an "as spent" option for shorter projects, such as those requiring 12 or 15 months to completion.

Foreign assets.--Treasury has proposed that the recovery periods for investments in foreign assets be 30 years for real property, 20 years for 10-year personal property, 10 years for 5-year property,

and 5 years for 3-year property. Straight-line depreciation would be required. For many companies, this would amount to a "stretch out" and reduction in depreciation allowances for foreign-based assets as compared to current experience.

We urge both Treasury and Congress to reconsider this proposal because it would adversely affect deemed-paid foreign tax credits. More specifically, the deemed-paid foreign tax credit that can be claimed by the U.S. parent company of a foreign subsidiary is equal to that portion of the foreign income tax paid by the foreign subsidiary that corresponds to the ratio of the dividend received by the U.S. parent to the net earnings and profits of the subsidiary from which the dividend was paid. If the net earnings and profits were to increase--as would occur in a computation involving longer depreciation lives and a straight-line rate--then the deemed-paid credit necessarily would decrease. This would be very costly, with double-taxation implications.

In recent years, U.S.-based taxpayers have suffered serious inroads on their foreign tax credits as a result of certain policy changes that we consider to have been somewhat ill-advised. We hope that the committee will avoid "foreign asset" provisions in ACRS that will be detrimental to taxpayers' credits.

Effective date.--We approve of the January 1, 1981 effective date for ACRS, and urge that it be retained. There is broad support for a modernized cost recovery system, and taxpayers have been told by the chairmen and ranking minority members of both tax-writing committees that any cost recovery system enacted by Congress will go into effect not later than March 11 and possibly as early as January 1, 1981. If the

committee or others in Congress subsequently give any impression that a later date may be set, we believe that it will cause some capital spending to be delayed in anticipation of the later effective date. As committee members are aware, the "real" capital spending plans of business for 1981 are not very strong as it is. The suspension of "discretionary" expenditures could have a depressing effect, with "valleys" now and "peaks" later in terms of actual spending, credit demand, and new orders placed with suppliers of producers' goods.

We do not wish to overstate this point because most capital spending plans obviously cannot be turned on and off at will. However, programs can be delayed or postponed to some extent and uncertainty about taxes can be very destabilizing.

Phase-in.--For the most part, we would prefer to have the phase-in rules proposed by Treasury be adopted by the committee. In our opinion, very little revenue would be saved by phasing in the three-year class, and we agree that it should become effective immediately as proposed. Also, we concur in having the investment credit changes be effective immediately. Such reservations as we have heard expressed about the phase-in rules have come from companies whose average composite asset lives are such (e.g., eight years) that they do not derive full ACRS benefits as quickly as other affected firms. Accordingly, the committee may wish to review the proposed rules from the vantage point of equity as well as cost. Overall, we favor having the phase-in rules be as simple as possible, and we acknowledge that they are essential to moderate the initial budgetary impact of ACRS.

On a related point, it should be recognized that the phase-in rules will prevent the full incentive effect of ACRS from being felt

immediately. Accordingly, the program should not be definitively judged until it is wholly in place.

We note that ACRS would not apply in any way to assets placed in service before the effective date, meaning that there is no plan at this time to bring pre-ACRS goods under the new system. We agree that the cost of any such proposal would be prohibitive if undertaken in a short timeframe. Still, there would appear to be advantages of simplification in moving to a single system. Assuming that ACRS is adopted in some form mutually acceptable to the Administration and Congress, we hope that further study will be given to "unifying" the separate approaches that otherwise will continue to exist until preexisting assets have been depreciated.

What to expect.--In our opinion, ACRS, in conjunction with other aspects of the President's program would lead to increased business savings and investment, an improved rate of productivity growth, more output of goods and services, and an increase in the "real"--as opposed to nominal--growth of the economy. We believe this will happen because ACRS will improve the after-tax rates of return on investment in plant and equipment, thereby encouraging business taxpayers (1) to expedite spending programs already underway, and (2) to make expenditures that otherwise would have been assigned a marginally lower priority because of a failure to satisfy internal investment-return criteria. As we already have indicated, there is a significant correlation between fixed investment and productivity growth, and high levels of both are conducive to the achievement of our economic goals.

Individuals

In recent years, MAPI has consistently recommended that there

be sizable tax reductions for individuals because of unlegislated tax increases that have resulted from inflation and because of the inequity of the current system for "middle-income" wage earners, properly defined. Past Congresses have allowed individual taxes to become so progressive and so high that nonproductive tax sheltering activity has reached unprecedented levels; the "subterranean" economy has grown at an alarming pace; work incentives have been reduced; and personal savings have declined to inadequate levels. Furthermore, past Congresses have allowed investment income such as dividends and interest to be taxed at higher rates than personal services income, thereby discriminating to some extent against personal savings.

We endorse the "10-10-10" proposal of the Administration whereby marginal tax rates would be reduced by 10 percent in each of three consecutive years beginning July 1, 1981. Regarding the effective date, we urge its retention, but also hope that Congress will move promptly on federal spending reductions to keep the budgetary deficit under control. Most persons want tax reductions as soon as possible, but not under circumstances that lead to recession or to rampant inflation that offsets or exceeds the tax cuts. We do not assume that this program will "pay for itself" in the short run, and we repeat that congressional timidity on the spending side of the ledger could be counterproductive.

Phase-in, etc.--We are in favor of the three-year phase-in. Further, we ask that the tax cuts be maintained across-the-board and not be used for additional income redistribution. As to the phase-in, we think it is desirable in that it would demonstrate a commitment to real tax reduction rather than appear to be an "ad hoc" inflation adjustment.

Also, the phase-in would ease the budgetary impact and allow time to assess whether the program is "taking hold" as intended. The proposals are calculated to reduce the rates from 70 to 50 percent at the top and from 14 to 10 percent at the bottom, with proportionate reductions through all of the income brackets. We agree that reductions of this magnitude are in order because the current level of taxes is restraining economic activity and personal savings.

We have noted with some dismay the inclination of certain members of Congress to dismiss the multi-year tax cut procedure for individuals on grounds that Congress would be sidelined in the setting of fiscal policy. This seems incorrect, and it fails to acknowledge the rationale behind the multi-year approach. First of all, Congress never is "out of the picture" on fiscal policy, and at any time can reverse or modify actions previously taken. Secondly, we repeat that taxes have become too high and that individuals now should be given the congressional commitment and relative certainty associated with successive years' tax reductions of a stated magnitude. This, it seems to us, is necessary to restore confidence for the longer pull among tax-paying citizens who are frustrated--almost numbed--by the interaction of inflation and the excessive tax-take. In our opinion, the desire of some members of Congress to be able to capitalize on their relations with constituents by voting in favor of "ad hoc" tax reductions is not a substantive argument against multi-year cuts.

Concerning the across-the-board nature of the proposed reductions, we urge the committee to retain it. Treasury's position in favor of reducing marginal rather than average tax rates is logical as it

relates to taxpayers' behavior and expectations. Moreover, it is even-handed and leaves almost all income classes unaltered as to the distribution of tax burdens. In our opinion, Congress has too often used ad hoc tax reductions for the purpose of income redistribution. This has narrowed the tax base and greatly increased the burden of persons in the middle-income brackets who also have experienced significant boosts in state, local, and payroll taxes. In our opinion, the tax cuts of recent years have been skewed away from the individuals most burdened by the system, and the least that Congress should do on this occasion is to provide equal percentage reductions for everyone. As a matter of fact, some special consideration for the middle-income brackets, broadly defined, could be justified.

Magnitude.--Some persons have contended that marginal rate cuts of 10 percent per year for each of three consecutive years would be overly generous and unaffordable. We do not consider such reductions to be overly generous at all when--as the Treasury Department and independent studies have shown--the marginal tax rate of a median income family of four would actually be lowered by only about 1 percent after the impact of projected inflation is taken into account. Also, we do not consider a "real" reduction of 1 percent to be unaffordable when the true culprit in the fiscal picture is profligate federal government spending. In our opinion, it is high time for government to cease regarding taxpayers as inexhaustible resources and to begin to exercise discipline with spending. The failure to do so is the thing we cannot afford, not a small amount of relief to those who have been dunned so relentlessly.

Investment income.--It is imperative to us that the taxes on interest and dividend income be brought into line with taxes on personal services income. Also, we generally approve of the reduction in the capital gains tax rates. If the key to economic revitalization is "savings" in the final analysis, as Treasury contends, then there is little sense in having discriminatory taxes on the returns to capital, as now exist in the case of significant amounts of interest and dividends. We also strongly object to official use of the pejorative phrase, "unearned income," and suggest that it be eliminated from the tax-law vernacular. Finally, we believe that further capital gains rate reductions should help to free "locked in" investments, thereby contributing to capital mobility. Increased realizations and tax recognitions may even yield a positive revenue flow, as was experienced following the 1978 reductions.

"Maximum" and "minimum" taxes.--Assuming that the tax rates on all income are brought down to a maximum of 50 percent, it would appear that the maximum tax on personal services income could be repealed. Although the "max tax" has served its purpose reasonably well over the last decade or so, there would be no continuing need for it under the President's proposals, and repeal would simplify the Code in some measure. Concerning the minimum tax applicable to so-called tax preferences, we urge the committee to review this misdirected policy in the near future. There is little point in complaining that the nation has too little savings and investment, and then allowing the minimum tax to remain as a disincentive to investment activity. As we have repeatedly indicated, the minimum tax diffuses legislative accountability, complicates the

Code, is inappropriately applied to both corporations and individuals, reflects a popular prejudice that is self-defeating, and imposes a penalty on savings and investment./1

What to expect.--We tend to agree with the proposition that, with taxes at current levels, the planned reductions will lead to higher output, less tax sheltering activity, and more realizations, all generating additional revenues to the government not accounted for by the Treasury Department's "static" revenue loss estimates. Further, we agree that in the aggregate personal savings will increase as a percentage of disposable personal income, much as it did following President Kennedy's tax reductions for individuals, even though the surrounding economic circumstances are different now than they were in the early 1960s. We would prefer not to speculate on the magnitude or the timing of the induced effects, but we have no difficulty with the assumptions that there will be "feedback" revenues and favorable behavioral responses to the tax changes, if enacted substantially as proposed.

## Concluding Comment

Although we are affirmative about the proposed "new direction" in U.S. economic policy, we would like to conclude this statement by observing that we do not expect "miracles," including any "overnight" rebound of the economy. Time will be required not only to put the new policies in place, but also to undo those that have served us unfavorably in the past. Also, we recognize that some discomfort may be occasioned in the near future by the remedial measures, including some discomfort to businesses of all sizes as well as to certain individuals because of

1/ See "The Minimum Tax on Tax Incentives: A Threat to Capital Formation," MAPI (November 1980).

various reductions in federal spending. We hope that the committee will be generally supportive of the program in all essential aspects, and will be both patient and impartial in evaluating its effects.

In our judgment, the alternatives--including the status quo or further pursuit of aggregate demand management--simply are unacceptable.

STATEMENT BY
CRAIG R. SMITH
PRESIDENT, THE WARNER & SWASEY COMPANY
AND CHAIRMAN OF THE
NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
May 21, 1981

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## I. INTRODUCTION

Good morning, my name is Craig R. Smith. I am President of The Warner & Swasey Company, a wholly owned subsidiary of The Bendix Corporation. I am also President of The Bendix Industrial Equipment Group and Chairman of the National Machine Tool Builders' Association (NMTBA). Accompanying me today is James H. Mack, NMTBA Public Affairs Director. NMTBA is a national trade association comprised of about 400 member companies which account for approximately 90% of United States machine tool production. The total industry employs over 90,000 people with a combined annual output of $4.0 billion.

While relatively small by some corporate standards, American machine tool builders comprise a very basic and essential segment of the U. S. industrial capacity and have a tremendous impact on America. Ours is the industry that builds the machines that are the foundation of the United States' industrial strength and military might. Without metal cutting and forming equipment -- machine tools -- there could be no manufacturing as we know and have

come to rely upon it today. From a consumer point of view, absent modern machine tools, unfortunately an increasingly more prevelant fact of life in industrial America, there would be no domestically affordable nor internationally competitive luxuries of modern life. And fundamentally more important, without state-of-the-art technology there would be a dangerously less reliable capability within the defense industrial base to meet the needs of national security in peaceful times, much less the demands of increased military production in time of a national emergency.

For these reasons, I am grateful for this opportunity to appear before this Committee to express the views of my own company, as well as those of the American machine tool industry, whose national association I chair, concerning the tax reduction element of the President's Program for Economic Recovery.

It is important to underscore the fact that the President's program is a package, the efficacy and success of which is largely dependent upon the interrelationships, both political and economic, among the various elements of the program. For this reason we believe it essential that a broad consensus of support for this program be maintained, and that parochial interests, however well intentioned and justified, be put aside in favor of achieving the fundamentally more important goals set forth by the President's economic recovery program. In a sense, both in terms of economic theory as well as political economy, this may be a classic example of the whole being greater than the sum of its individual parts.

## II. THE NEED FOR INCREASED PRODUCTIVITY

Rapidly rising productivity is needed 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. That we as a nation have failed in that endeavor over the past few years is painfully evident.

But what happened to American productivity in the 1970's is only part of the problem. For the past two decades our productivity gains have lagged significantly behind those of other industrialized countries. Painfully, it is increasingly evident that the United States is in the process of losing its industrial pre-eminence.

According to the Bureau of Labor Statistics, productivity growth rates for the total U.S. economy and for the manufacturing sector are the lowest of all major free world industrial nations and they continue to decline. For example, according to BLS statistics, for the past twenty years Japan's productivity growth rate for the total economy averaged over 7%, Italy's almost 5%, France and West Germany's 4%, the United Kingdom's 2.3% and Canada's 1.9% while ours limped along at 1.5%.[1]

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[1]U.S. Congress, House, Committee on Armed Services, Air Force Systems Command Statement on Defense Industrial Base Issues, by General Alton D. Slay, Commander, Air Force Systems Command, Before the Industrial Preparedness Panel of the Committee on Armed Services, House of Representatives, 96th Cong., 2d Sess., 1980, p. IV-2.

Focusing on only the manufacturing sector of each country, the statistics convey a similarly discouraging picture with Japan again leading the group with an average growth rate of over 8%, and with the U.S. again trailing in last place with only 2.5%.[2]

Several years ago the United States Council of Economic Advisors projected a 1.5% economic growth rate for the U.S. over the next decade. However, even this bleak projection may have been too optimistic in light of the past three years which have alarmingly resulted in actual negative productivity growth rates for our private business sector. Even assuming a continued 1.5% growth rate, the Council projected that France will overtake us in total worker productivity in 1986, Germany in 1987, and Japan in 1988, with some others not far behind.[3] (See Figure #1)

However, if we conclude that the more disturbing trend of the past three years toward a zero or negative productivity growth rate is more accurately the case, and also assume that France, Germany and Japan continue their projected course, then France and Germany will overtake the U. S. in 1982 and 1983, respectively, and Japan in 1985.[4] (See Figure #2)

Figure #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

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[2] Id.

[3] Id. at IV-5.

[4] Id. at IV-6.

productivity improves. And furthermore, when we invest in new, more productive equipment, we produce higher quality products and all the people of America benefit.

Given this fact, it is revealing to note that the U.S. is dead last among industrialized nations in investment in new and more productive equipment as a percentage of Gross National Product (GNP). (See Figure #4) Not surprisingly, the statistics indicate that the slowdown in our rate of productivity growth has gone hand-in-hand with this reduced rate of investment for new and better capital goods.[5] (See Figure #5)

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 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 Year |
| United States | 31% | 34% |
| West Germany | 37 | 26 |
| United Kingdom | 39 | 24 |
| Japan | 61 | 18 |
| France | 37 | 30 |
| Italy | 42 | 28 |
| Canada | 47 | 18 |

Source: American Machinist and NMTBA

[5]Id. at V-2.

Our aggessive 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. A major reason for this disparity is the considerably more favorable investment climate which exists in Japan and many of the other major western industrialized nations. For example, in contrast to our present depreciation policy which provides little incentive for capital investment, many of these other countries encourage very rapid depreciation, thereby encouraging new investment in more productive capital goods.

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 industries have been using up more capital equipment each year than they purchase. This means that they have, de facto, engaged in unconscious and involuntary liquidation. And the same probably holds true for many other American manufacturing industries.

It is time that we clear the air and stop this erosion of America's industrial base. We must invest in the capital goods needed to modernize and grow -- thereby making America once again fully competitive in world markets and providing jobs for all Americans.

III. ACCELERATED CAPITAL COST RECOVERY

We commend President Reagan for addressing this crucial issue by including the Accelerated Capital Cost Recovery System (ACRS) as an integral part of his overall economic recovery program. Also known as "10-5-3", this system provides critically needed accelerated recovery of the cost of machinery and equipment, and certain industrial and commercial buildings, over a period of 3, 5, or 10 years. The Administration's proposal is a derivative of Senator Heinz legislative initiative (S. 287), which has been cosponsored by 47 Senators, including 7 members of this Committee and by over 250 members of the House.

Without elaborating on all of the details of how ACRS will be phased in and work once fully in place, it is sufficient to say that this new system of more rapid depreciation for plant and equipment is a monumental improvement over the current cumbersome and ineffective capital cost recovery rules.

Although, fortunately, the support for the general policy of accelerated depreciation is broad based, we are mindful that a number of modifications and variations on this system have been suggested as possible alternatives to the President's program and that set forth in H. R. 1053.

Most notable among these variations on the "10-5-3" theme was adopted as part of the tax cut package proposed by your Committee during the last Congress. In our opinion last year's approach, albeit a marked and substantial improvement over the current state of the law, suffers by comparison with the Administration's ACRS plan. Although it would increase the rate at which investment in

capital goods could be written-off, it, nevertheless, retains some of the most complicating elements, such as Asset Depreciation Ranges (ADRs), of the current system. In addition, it takes away 40% of the anti-inflationary impact of the investment tax credit for machine tools and other equipment in the four year category. A version introduced by Sen. Bentsen earlier this year is a modest improvement over last year's product, in that the investment tax credit for the 4 year category is raised to 7-1/2%.

In contrast, besides offering early year capital recoupment, superior for most taxpayers to that attained under the 1980 Senate Finance Committee proposal, "10-5-3" introduces the highly beneficial element of simplicity into the tax code. Therefore, although we believe that some technical adjustment to the Administration's Accelerated Capital Cost Recovery System should be adopted, we strongly recommend that the basic thrust of this critically needed tax reform not be diluted.

The increased productivity which will undoubtedly result from increased capital investment will put America back on the high road to increased productivity and prosperity, and enable the United States to once again be a competitive industrial power, both domestically as well as in the world marketplace.

But perhaps the most important beneficiary of increased industrial productivity will be our national defense posture. The modernization and expansion of our industrial base which is so important to the well-being of our economy, is also critical to the maintenance of our military preparedness -- that is, the ability of America's industrial base to meet the needs of national security during

peaceful times, and to respond to the demands of military production in time of national emergency.

For an excellent in-depth study of this issue we would refer this Committee to the recent report of the Defense Industrial Base Panel of the House Committee on Armed Services.[6] This report points out the alarming shortcomings of our present defense industrial base.

In testimony last year before this House Armed Services Panel, General Alton D. Slay, Commander, Air Force Systems Command, pointed out that whereas the average age of plant and equipment for U.S. industry in general over the ten year period 1966 - 1976 was nearly 17.2 years, the average age of Department of Defense (DoD) owned machine tools was over 25 years! Moreover, General Slay further emphasized that when government-owned equipment is combined with DoD contractors' equipment, 60% of the metalworking equipment (machine tools) used on Defense contracts is over 20 years old!

We are gratified by General Slay's efforts to cause government policy-makers to focus on the ramifications of such shocking statistics. Obviously, the newer a piece of equipment the more efficiently it will accomplish the job it was designed to perform. However, we must not be concerned only about the age of our industrial defense base. Perhaps not so obvious, but even more significant is the

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[6]U. S Congress, House of Representatives, The Ailing Defense Industrial Base: Unready for Crisis, Report of the Defense Industrial Base Panel of the Committee on Armed Services 96th Cong., 2nd Sess. 1980.

relative lack of sophistication of this older equipment. Technology has not stood still while our machines have leisurely aged. Far from it! As we enter the decade of the 80's, robotics and flexible manufacturing systems promise further leaps in productivity improvements. But the Department of Defense and its contractors are still using, and incredibly in some cases actually still procuring antiquated machine tools to be used in Government-owned plants and contractors' factories.

Obviously, it is imperative for the national security of our country that we address and remedy the dangerous unreadiness which currently characterizes our defense industrial base. Therefore, of particular interest to this Committee is the Armed Services Panel's assessment that, "the United States needs a policy or strategy based upon the relationship between productivity and investment and the impact of tax policies on those factors." Regrettably, the panel "found no evidence of such a policy."[7] What the panel did find, however, was that "modification of current depreciation schedules to create an incentive for defense industry to invest in new factories and equipment" is "a matter of high priority" in restoring America's ailing industrial base.[8]

We strongly believe that enactment of "10-5-3" is perhaps the most important contribution Congress can make to achieving this objective.

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[7] Id. at 43.

[8] Id. at 44.

Finally, we believe it is critical to emphasize, as did the House Armed Services panel in its report, that although modernization of prime contractors' plant and equipment is extremely important, "the key element...may not be the (prime contractors') capacity but rather the plant capacity at the second or third tier supplier who may be operating at full capacity."[9] Unquestionably, this group of second and third tier suppliers, the vast majority of which are small businesses, would be helped immensely by enactment of "10-5-3". It is of paramount concern that the vitality of this crucial segment of industry be preserved.

IV. INDIVIDUAL TAX RATE REDUCTIONS

Turning to the individual tax reduction side of the President's economic recovery program, widely known as "Roth-Kemp", we would preface our comments by noting the point that is made repeatedly in the administration's proposal and which was mentioned a number of times by the distinguished panel of economists that addressed this Committee earlier in these hearings -- that is, the 30% across-the-board tax rate reduction scheduled to take effect over the next three years is simply a slowing in the rate of increase which is already built into the system.

There is no question that individual tax burdens have been increasing steadily over the past few years. Simultaneously, inflation has pushed individuals into higher and higher marginal tax brackets (so-called "bracket-creep"), and substantial Social Security Tax increases have occurred.

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[9] Id. at 19.

There is also no doubt that these high marginal tax rates have served as disincentives both to work and to save. Moreover, the near-confiscatory tax rates applicable to high income individuals, who are historically the source of most of America's investment funds, have forced such taxpayers to shelter their incomes by making what are, for the most part, non-productive investments. Thus, there is little doubt that high marginal tax rates have served to distort normal investment and have robbed the U. S. economy of the vitally needed equity investment and venture capital which has traditionally been the bedrock of America's economic growth.

We believe that the Administration is correct in its assessment that reduced tax rates will make such tax shelters relatively less attractive, and will have the beneficial effect of encouraging investment to move to those activities that are most productive.

Moreover, revenues to the government are lower when individuals invest in tax shelters that are less productive than other investments or when individuals simply avoid taxation legally by avoiding realization of income, (e.g., by not selling an asset that has appreciated in value.) Because lower marginal rates of tax will encourage more productive investment and will lead to an increase in recognition of income, revenue losses from the rate reduction will over time become revenue gains. This induced revenue effect is in addition to any increase in revenues which would result from increases in productivity and in the aggregate amount of individual work or savings.

A final benefit of the President's proposed three year rate reduction plan will be to bring the tax rates for both earned and

unearned income into harmony with a new rate schedule that will have a top marginal rate of 50%. This will eliminate another inherent bias in the tax code which has undoubtedly worked to the economy's detriment by discouraging what would otherwise have been more productive investment patterns.

We are aware that some have criticized this aspect of the Administration's economic recovery plan as being inequitable -- welfare for the rich, so to speak. Proponents of this position cite the fact that a 10% tax cut for an individual who earns $60,000 is considerably larger in simple dollar terms than a 10% cut for the taxpayer with an annual income of only $15,000. However, such arguments lose sight of the underlying fact that under current tax law individuals in the upper income brackets are subject to considerably higher marginal tax rates (particularly if the last dollars to be taxed are so-called "unearned" as opposed to "earned" income) than are wage earners in the lower income group.

Even more significantly, there is little doubt that it is the higher income taxpayer group who will be financially able to invest tax cut dollars and will have a predisposition to do so. A major goal of the proposed tax reductions is often lost sight of in the wake of the rhetoric over the "equity" of the program. This program is designed to achieve an increase in savings and investment in this country which will subsequently have a positive reinforcing feedback effect on the economy as a whole.

From other quarters there is the criticism that "Roth-Kemp" will not achieve its goal of increasing capital investment because too many taxpayers will spend their tax cut, rather than invest

it, and that it will be yet another inflationary pressure impacting on an already very shakey economy.

This criticism may well be valid if the Congress adopts only a one year across-the-board 10% rate reduction rather than the full three year proposal. Under such a scenario there would not be sufficient cumulative effect of marginal rate reductions in the higher tax brackets to generate the necessary amount of investment capital needed to stoke the boilers of the economy. We firmly support the proposition that "Roth-Kemp" will be an effective spur to increased capital investment which will result in increased productivity, and will be non-inflationary, but only if the full three year rate reduction in the higher brackets is realized.

V. THE NECESSITY OF CONCURRENT BUDGET CUTS

Unquestionably, well structured tax cuts are an essential element of the overall economic recovery program. However, as most would agree, without concurrent budget cuts of approximately the same dimension (although admittedly not precisely equal in strict dollar terms), the proposed tax cuts would be economic folly. We fully concur with those who have postulated the following alternative scenarios which would likely occur were such an imprudent course to be followed.

On the one hand, if monetary policy were adjusted to accomodate the immediate shortfall in the federal budget that would result from increased federal spending in the wake of reduced revenues, inflation would be exacerbated greatly. Interest rates could be kept low, but only at the cost of an inflationary injection of new dollars into the economy.

On the other hand, if monetary policy were to remain tight in the face of such budget overruns, the likely result would be a rise in interest rates and general economic stagnation. As the government went into the debt market, to finance the deficit, it would drain off available investment capital, leave less for industrial expansion efforts, and thereby curtail potential supply expansion. Incremental revenues to taxpayers from a tax cut would then end up being used to offset the rising prices created by business pass-throughs of higher production costs rather than creating new wealth in the economy.

Therefore, we believe that in order to avoid letting the economy slip into either of these two unacceptable conditions, the full three year program of tax cuts under "Roth-Kemp" would only be prudent if Congress is able to show an unwavering resolve to adhere to a consistent program of budget reductions of equal magnitude.

Absent such a firm resolve; or if Congress finds the annual budget process of the Federal Government makes outyear spending reductions too unpredictable, we would suggest, in the alternative, that this Committee target individual tax reductions toward the encouragement of savings and investment. In other words, we are suggesting that the effect on savings and investment of alternative legislation be the same as the Administration's projected effect of a 30% rate reduction. Specifically, some of the proposal adopted by your Committee last year merit your support this year, if the full 30% - 3 year tax cut is deemed to be imprudent.

These proposals include I.R.A. reform; increasing the 60% capital gains exclusion to 70% and reducing capital gains taxes paid by corporations to 20%; R & D tax credits; reform of Sec. 911 and 913 relating to the taxation of Americans working overseas; and small business tax cuts.

Most importantly, we support immediate reduction of the 70% top marginal rate for so-called "unearned income" to 50%.

The encouragement of savings and investments should be the principal objective of this Committee. So called "tax equity considerations" should take a backseat to the rejuvenation of the U.S. economy during your deliberations this year. No tax policy would be more inequitable to all taxpayers than continued stagflation resulting from under-investment and low productivity.

VI. CONCLUSION

In conclusion, we believe there is no question that American industry needs the Accelerated Capital Cost Recovery System proposed by the President -- and we need it Now! We would strongly urge this Committee to take up this necessary and widely agreed upon business tax cut as quickly as possible so as to send a clear signal to American business that there is nothing to be gained from delaying investments in better productivity. We know for a fact that many businessmen are delaying needed capital investment pending the outcome of your deliberations. The March 11th retroactive announcement by the Chairmen and ranking minority members of the two tax writing Committees has sent a strong signal to American business that nothing is to be gained by a delay in investment decisions. Your early action on the substance of depreciation reform will strengthen this signal.

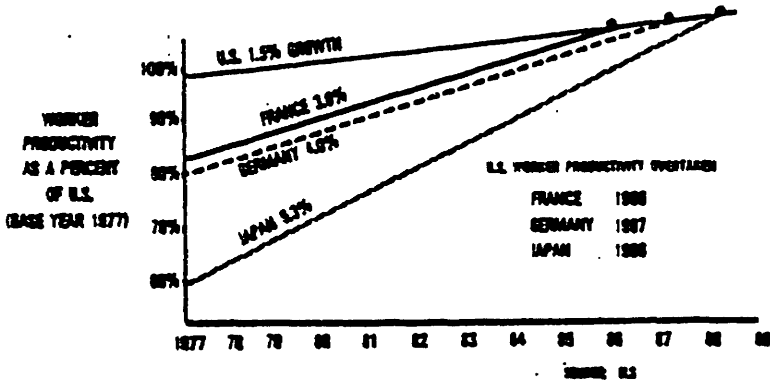
Again, we cannot over emphasize the critical need to balance tax cuts with budget cuts so as not to fan the flames of inflation or, in the alternative, potentially put the economy into a nosedive.

The precise shape of the individual tax cut is, as we have stated, entirely dependent upon the resolve with which the Congress commits itself to limit spending in the next several years. Absent an almost ironclad resolve in this area, we believe that the more prudent course would be a series of targeted tax cuts designed to stimulate productivity by enabling increased investment.

Of course, a critically important implicit assumption in all of our recommendations is that a prudent and stable monetary policy be maintained.

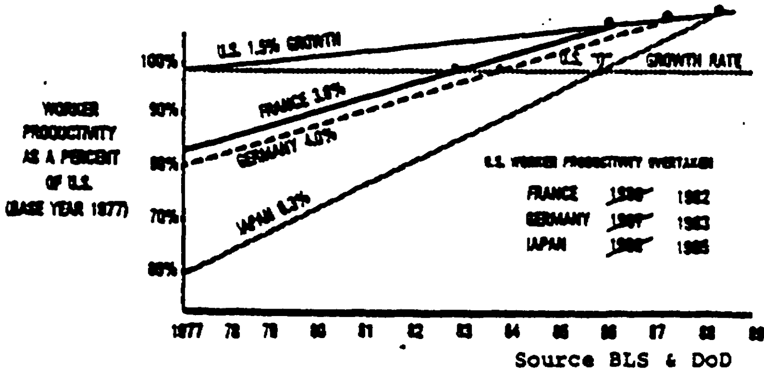
In the unhappy event that all the proposed budget cuts are not enacted, and as a result tax cuts must also be scaled back, we would strongly recommend that the Accelerated Capital Cost Recovery System as proposed by the Administration be given top priority and left intact. This proposal, above all others, is the critical linchpin of America's reindustrialization policy. Its immediate enactment is imperative to our nation's productivity, its economic well-being, and, ultimately its military defense posture.

FIGURE #1




WORKER PRODUCTIVITY PROJECTIONS (BASED ON PROJECTED GROWTH RATES - ALL INDUSTRIES)

FIGURE #2




WORKER PRODUCTIVITY PROJECTIONS (BASED ON PROJECTED GROWTH RATES - ALL INDUSTRIES)

FIGURE #3

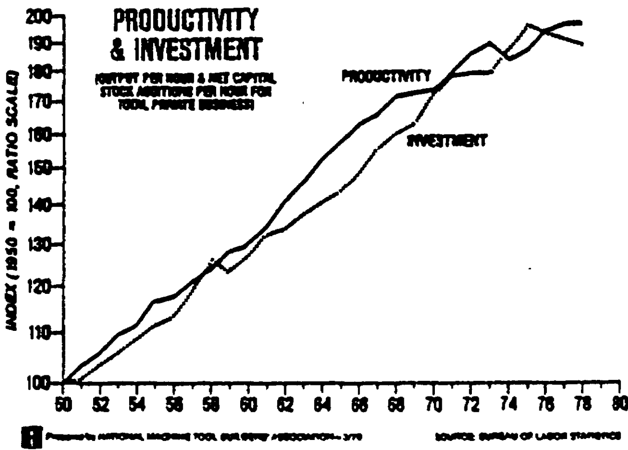
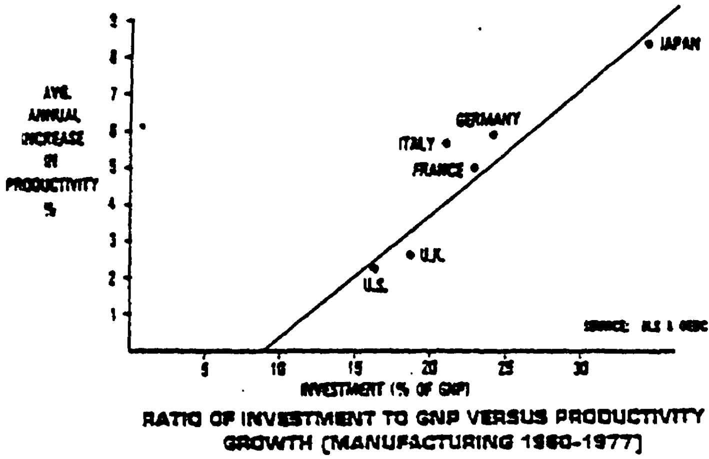
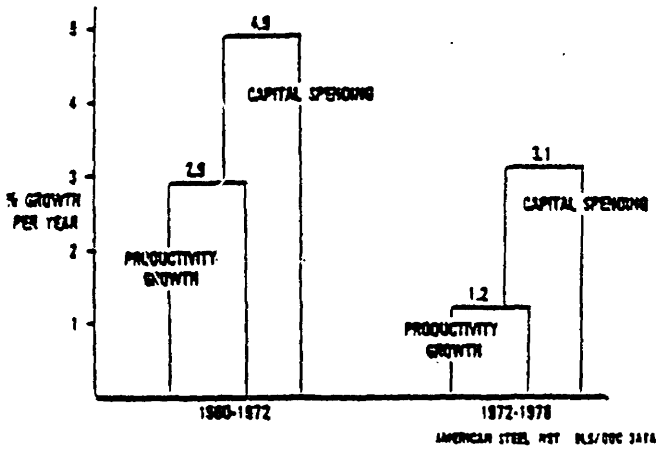


FIGURE #4




RATIO OF INVESTMENT TO GNP VERSUS PRODUCTIVITY GROWTH (MANUFACTURING 1960-1977)

FIGURE #5




U.S. PRODUCTIVITY GROWTH VERSUS CAPITAL SPENDING GROWTH FOR TOOLS OF PRODUCTION

STATEMENT OF SIDNEY LIEBERSTEIN
MACHINERY DEALERS NATIONAL ASSOCIATION
U.S. SENATE COMMITTEE ON FINANCE

SUMMARY

I am Sidney Lieberstein, vice president of Machinery Dealers National Association (MDNA). With me is Robert Taft, Jr. and Randolph J. Stayin of Taft, Stettinius & Hollister, General Counsel of our association. The 500 MDNA member firms are small businesses which account for over 70% of the used machine tools sold in the United States. Because used capital equipment is acquired from large manufacturers and usually resold to small manufacturers, MDNA members are in the unique position to articulate the economic problems of the small business community, which needs your help now.

Our opinion of what influences a small firm's investment decision comes from experience. We endorse a coordinated budget and tax cut package as being in the best interests of the country and we are pleased to offer our support. We believe that any effective tax legislation should target capital formation and retention problems of smaller businesses in order to revitalize our economy.

We strongly recommend the creation of a simplified and accelerated capital cost recovery system and the removal of the ceiling on the amount of used equipment eligible for the investment tax credit. However, we now understand that past Congressional reluctance to accept our tax credit proposal was based on a lack of available or accurate statistics for revenue loss figures and a consequent "fear of the

unknown." Economists at both the Treasury Department and Joint Committee on Taxation during recent visits admitted their studies are based to a large degree on conjecture.

Therefore, if it is not possible at this time to remove the ceiling, then we believe that the ceiling should be raised to $250,000 and elevated in phases to $500,000 by 1985. In order to ameliorate the discriminatory impact of the ceiling, we further urge that the purchasers be allowed to carryback three years and carryforward seven years the balance of their investment above the ceiling for which no tax credit is allowed in the year of purchase. The carryback/carryforward provision would create a minimal revenue loss, if any at all.

Under present law, there is a $100,000 limitation on the amounts of used equipment eligible for the investment tax credit, but there is no limitation on the investment tax credit available for new equipment. Similarly, the same carryback/carryforward provisions available for new equipment are not allowed to purchasers of used equipment who may not carryforward or carryback tax credits on investment over the limitation amount.

Since the original $50,000 ceiling was established in 1962, the cost of basic, unsophisticated used equipment has generally increased by over 500%. It would cost over $600,000 to start a small machine shop which would employ 10 people.

Furthermore, an established manufacturer has hardly begun to retool before he realizes that the $100,000

ceiling offers him very little assistance at all. The original arbitrary and inadequate limit of $50,000 was merely a token gesture to small business and in light of inflation, doubling the limit to $100,000 thirteen years later perpetuated the injustice.

This discriminatory tax treatment impacts directly and primarily upon small businesses which are already hindered by their inability to externally or internally generate the capital necessary to buy equipment. Capital stock formation among small business (which may be the nation's best source of economic growth) has been impeded by high interest rates, restricted availability of credit, the government's regulatory burdens, and tax laws which discriminate against small business. Since small business cannot generally afford or justify new machinery, it requires quick passage of tax incentives which will enable it to buy the used equipment it needs for start-ups or to boost productivity and expand the capacity of its current business.

The Joint Economic Committee and the White House Conference on Small Business both recognized the disparity between large and small businesses as they are affected by inflation and current tax policy. Both have called for tax measures targeted to small business that will enable smaller firms to retain a greater proportion of their earnings for reinvestment in capital improvements and plant expansion.

The current disparity between the investment tax credit available to new and used equipment is in effect a Congressionally mandated discrimination against small business

which directly dilutes the ability of small business to compete with large firms and survive. This disparity also allows new foreign machinery a competitive edge through the investment tax credit advantage over equally efficient and price competitive used domestic machinery. We assume this was not the original intent of the $50,000 and $100,000 ceilings.

Small businesses traditionally employ a small ratio of capital to labor so each purchase of a used machine generally translates into more jobs. We should remember that businesses with less than 100 employees accounted for 87 percent of the new jobs created in our country during the past 20 years.

Both the Senate and the House Small Business Committees have identified the tax credit for used equipment as one of the top priorities in their capital formation and tax recommendations. When introducing his proposal to raise the current arbitrary limitation (S. 360) Senate Small Business Committee Chairman, Lowell Weicker, stated that "the substantial small business dependence on used equipment, particularly in this high technology environment, suggests that as a matter of simple equity for our Nation's small businesses the existing ceiling on used investment should be increased, if not removed entirely." Senator Weicker's bill would raise the ceiling from $100,000 to $250,000. He has also urged the Finance Committee to phase in an elevation of the ceiling to reach $500,000 by 1985. Senator Weicker

concluded that "elementary justice" and the "improved productivity of our economy" required this basic change.

The importance of this issue is further evidenced by the fact that seven legislative proposals in the House and two in the Senate have already been introduced this year, including Senator Weicker's bill. Senator Bentsen introduced S. 1140 which is cosponsored by Senators Danforth, Baucus, Mitchell, and Chafee. The bill would raise the limitation to $250,000 and allow a carryback and carryforward of the cost of used equipment if it exceeds $300,000 for any taxable year. Senator Bentsen stated that he believes "that an increase in the regular investment tax credit for used equipment is necessary to assure that the small businesses participate in the general upgrading of productive facilities which this proposal is intended to stimulate... Finally, by allowing a carryover of any unused tax credit we insure that businesses make the necessary investment this year without being deterred from making such investments due to the limitation on the amount of property qualifying for the investment tax credit." We agree that the carryback/carryforward is vital in making any ceiling acceptable and effective in helping small business. We urge that Senator Bentsen's bill be modified to allow a phased increase in the limitation to reach $500,000 by 1985 and that the carryforward/carryback be applied to the cost of used equipment if it exceeds $250,000 which is the limitation set in Senator Bentsen's bill.

In the House, Congressman Bill Frenzel and Congressman Kent Hance have introduced H.R. 1377 and H.R. 3759, respectively, both of which eliminate the limitation entirely. Congressman Tom Downey has recently introduced H.R. which raises the limitation to $300,000 and allows a carryback/ carryforward of the cost of used equipment in excess of that limitation for any taxable year. Congressmen Jimmy Quillan, Dan Marriott, and Cecil Heftel have introduced bills which raise the limitation to $500,000, $300,000, and $200,000, respectively. We appreciate their efforts in attempting to help on this issue. However, the mere raising of the limitation without a carryback/ carryforward provision perpetuates the discrimination which is inherent in the current provisions of the tax code.

Last fall, the Senate Finance Committee reported out a tax bill which would have raised the limitation from $100,000 to $150,000. We believe the members of the Finance Committee are sincere in their desire to help bring equity and justice to small businesses. However, we urge them to recognize that the cost of machinery and equipment has increased by over 500% since 1962 when the cap was originally set at $50,000. If you were to raise the limitation in order to catch up with such inflation, the cap would be raised to an amount in excess of $250,000. Since there would be minimal revenue loss impact if carryforward and carryback provisions were added, we urge the Committee to give serious consideration to this approach which would

substantially ameliorate the discrimination against small business which is inherent in any limitation on the amount of used equipment available for the investment tax credit. Of course, we would prefer that you follow the decision that was reached in 1975 when the bill reported out by the Finance Committee and passed by the Senate eliminated the limitation entirely. Our recommendations have been endorsed by over 51 small business organizations and rank in the top three of all of their tax priorities.

We commend Chairman Dole, Senator Long, Chairman Rostenkowski, and Congressman Conable for their joint statement setting March 11, 1981 as the effective date for depreciation reform. This will induce business to begin capital investment now and stimulate the engines of growth, investment, innovation, and enterpreneurship.

Gentlemen, we implore you to treat small business now in a fair and equitable manner.

STATEMENT

Mr. Chairman and Members of the Committee,

My name is Sidney Lieberstein. I am President of Perfection Machinery Sales, Inc. of Wheeling, Illinois. I am also Vice President of Machinery Dealers National Association (MDNA). For the past 20 years I have been buying and selling used capital equipment. With me is Robert Taft, Jr. and Randolph J. Stayin of Taft, Stettinius & Hollister, General Counsel of the Machinery Dealers National Association.

MDNA welcomes the opportunity to once again urge an immediate reform of the Tax Code to encourage capital formation among smaller corporate taxpayers. We strongly recommend a simple change in the provision dealing with the tax credit available for used capital equipment investments: remove the ceiling on the amount of used equipment eligible for the investment tax credit. However, if the Committee believes that removal of the ceiling is not possible at this time, then as an alternative we recommend that the ceiling be adjusted upward to no less than $250,000 and that it be elevated in phases to $500,000 by 1985. In addition, the excess in cost of investment above the ceiling should be allowed to be carried back and forward for three and seven years, respectively. These needed corrections will significantly reduce the core component of inflation among smaller manufacturers.

This improvement offers four ingredients we believe essential to adequately encourage capital formation: the potential to increase productivity; the potential to increase employment; the potential to increase tax revenue; and the potential to treat everyone equally.

MDNA represents the metalworking industry aftermarket. Our 500 member firms are small businesses which probably account for over 70 percent of the used machine tools sold in the United States. MDNA also speaks for hundreds of thousands of small and medium sized manufacturing firms in the United States. Because used capital equipment is generally acquired from larger manufacturers and usually resold to smaller manufacturers, our members are in the unique position to see the relationship between large and small businesses. Our opinion of what influences a small firm's investment decision comes from experience. We believe that the tax legislation under consideration should target capital formation problems of smaller businesses because, although some are similar to, many are different from the problems of large businesses.

We are concerned about the future of small business in America. We fear that in our present economy, we will not be able to generate sufficient capital to start new businesses, to expand our current capacity, or to even stay in business. Inflation has taken a heavy toll.

We share the concern of the Joint Economic Committee about the potential of our economy over the long term to increase the standard of living for the average American, to create a job for every American who wants to work, and to

help hold down the cost of living by increasing the supply of goods and reducing the price of goods on the shelves of the nation's businesses. However, we are encouraged by the expressed intention of members of this Committee to support changes in our tax laws which will stimulate economic growth. We commend Chairman Dole, Senator Long, Chairman Rostenkowski and Congressman Conable for jointly announcing that any depreciation reform will be effective no later than March 11, 1981.

Decline in Productivity

For the first time in 20 years the 1979 Annual Report of the Joint Economic Committee was a unified report endorsed by both the majority and minority members of the Committee. We agree with its unanimous conclusion that an increase in productivity is vital to improvement in our economic standard of living and in the reduction of inflation. The fall in productivity in our country has been well documented, and this ominous trend has been the subject of discussion and concern of all of us for many years. The Council of Economic Advisors, in their 1978 report, referred to the productivity slow-down as "one of the most significant economic problems in recent years." As Chairman of the Federal Reserve, William Miller testified before the Senate Finance Committee on September 6, 1978, that:

> Inflation is our most important economic concern today. . . . The only way I know that we are going to break the cycle of wages chasing prices and prices chasing wages is to begin to realize productivity gains so that the prices do not have to go up in order to maintain profitability. Capital accumulation is a critical ingredient in the long-range growth of labor productivity and the raising of living standards. . . . Throughout the 1970's, the ratio of capital stock to labor has fallen ever shorter of its earlier growth trend line, and this, undoubtedly, has been a significant factor in the slower growth of productivity that we have experienced over this period. . . .(part 5, page 1173 et seq.)

This testimony was echoed in the 1979 Joint Economic Committee Report, which was issued on March 15, 1979:

> The lower rate of productivity growth in recent years is one of the causes of today's inflation, worker dissatisfaction, the deficit in our balance of payments, and the weakening of the international position of the dollar. Productivity gains provide the means by which historically disadvantaged minorities can increase their economic welfare. Thus, the adverse effects of a low rate of productivity growth extend far beyond economic issues. . . . (p. 119)
>
> One factor cited in virtually all studies of the productivity slow down as a major or a paramount cause is the low capital stock due to the recent inadequate levels of investment. If the capital stock-labor force ratio is to rise, that investment (gross investment less depreciation) must be sufficiently large so that the capital stock grows more rapidly than the labor force. This was the case until 1974, when the capital stock-labor force ratio peaked at $10,604 (in 1972 dollars) per person. Since then, investment has been inadequate relative to the rapid labor force growth, and the ratio has fallen by nearly 3 percent. This will adversely affect economic growth for several years in the future. (pp. 130-131)

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In its Summary of its 1980 Report, the Joint Economic Committee found that in 1979 the "U.S. posted its worst inflation record in more than 30 years and productivity actually declined by 2 percent. . . ." (p. 13) The 1980 Report concluded that a "growing small business sector offers a unique opportunity for addressing basic long-term structural problems by improving productivity, lowering inflation, and creating more jobs." (p. 71) Recommendation No. 23 of the 1980 Joint Economic Committee Report is as follows:

> When Congress enacts business tax incentives, it should pay particular attention to their effect on the ability of small businesses to obtain capital for growth and investment. (p. 73)

We agree with the conclusions of these authorities that further steps to increase productivity are sorely needed. From the small business perspective, this can be achieved through measures that will stimulate the purchase of used machinery and equipment. Capital stock formation among small business has been impeded by high interest rates, restricted availability of credit, regulatory burdens imposed by government, and tax laws which discriminate against small business. At this time, we believe that the Congress should focus its attention on reforming our tax laws in such a manner as to stimulate capital stock formation among small businesses through a simplified and accelerated capital cost recovery system and tha removal of discrimination in the investment tax credit available for used equipment.

## Allow a Full Investment Tax Credit for Used Machinery and Equipment

In addition to the depreciation proposals which have been discussed before this Committee, the small businesses of this country need reform of the investment tax credit. The Report of the White House Commission on Small Business, as its first goal, recommended equalizing the tax burdens on small business relative to large corporations. "The ability to attract and retain earnings relates directly to tax incentives built into the tax structure . . . The major areas of imbalance, however, are in depreciation methods, inventory accounting, and tax credits." (p. 27) Under present law, there is a $100,000 limitation on the amount of used equipment eligible for the investment tax credit, but there is no limitation on the investment credit available for new equipment. Similarly, the carryback/carryforward provisions available for new equipment are not allowed to purchasers of used equipment in that the cost of used equipment above the ceiling is lost entirely. This discriminatory tax treatment impacts directly and primarily upon small business which is already hindered by its inability to externally or internally generate the capital necessary to buy new equipment. In order to increase productivity in small and medium sized businesses, this discriminatory ceiling on the amount of used property eligible for the investment tax credit should be eliminated; and the carryback/carryforward provisions available for eligible new property

must also be available for similarly situated used property. We must allow small business to receive the same tax incentives provided to big businesses. The investment tax credit limitation is primarily a small business issue. Traditionally, small businesses purchase used capital equipment; large businesses basically purchase newly manufactured capital equipment. If used machinery and equipment is eligible for the full investment tax credit, the following benefits at least can be expected:

a. the ability of small business to compete, to maintain its current market share, and to expand its output and productivity will improve;

b. employment in the most labor-intensive part of the capital equipment industry will increase;

c. the current demand for less expensive machine tools will be alleviated and the incentive to turn to imported new machine tools will be reduced;

d. the demand for new domestic machine tools should increase;

e. any short-term inflationary impact of the tax credit will be reduced to the extent used machinery is purchased; and

f. the full benefit of the investment tax credit as an incentive for capital formation will be available to _all_ businesses, _equally_.

In its 1980 Report, the Joint Economic Committee expressed its concern about the disparity between large and small businesses as they are affected by inflation and current tax policy. It called for tax measures targeted to small business:

> In the past, the tendency of Congress has been to enact tax incentives which on the surface treat all firms equally but fail to acknowledge that most small businesses are unable to take advantage of them for a variety of reasons specifically related to the size of the business. Tax incentives need to be developed that will enable smaller firms to retain a greater proportion of their earnings for reinvestment in capital improvements and plant expansion. These programs should be targeted directly to small businesses. (p. 75)

The investment tax credit law does not treat "all firms equally" but rather creates a blatant discrimination against small businesses. I don't believe that Congress ever debated the issue of whether it should enact a tax policy that discriminates in favor of large businesses and against small businesses, but it did adopt such a policy by placing a ceiling on used equipment tax credits. The removal of the used equipment ceiling will give all businesses an equal opportunity for the use of the investment tax credit and will amount to a targeted change in our tax laws for the benefit of small businesses which in turn will benefit our overall economy.

Competitive Ability of Small Business

Of all the challenges facing small business, the ability to compete in an inflationary economy is perhaps the most difficult. The cost of obtaining capital for production equipment is high for everyone, especially those who cannot borrow at the prime rate. Those firms purchasing used capital equipment do not have a chance to offset some of their cost by taking the limited tax credit. This contrasts with large corporations borrowing at prime and purchasing new

equipment with the unlimited tax credit. Because large and small companies do compete, smaller firms are disadvantaged. The arbitrary limit on tax credit available for used equipment investments directly dilutes the ability of small business to compete with large firms.

Larger firms buy <u>new</u> machine tools that are either highly automated multi-operational machines or numerically controlled equipment, often designed for a specific purpose. Confining the investment credit to only equipment with the latest technology helps primarily the largest enterprises and basically ignores the largest segment of our economy which needs this tax credit the most. Normally, small and medium sized companies are competing in industries dominated by a handful of giant corporations.

Even so, with effective tax incentives small businesses can provide the cutting edge of competition in our economy. The 1980 Report of the Joint Economic Committee found that:

> Small business has historically provided the backbone of employment growth and inflation fighting innovation and competition in our economy. . . they are able to move faster and use resources more effectively than large companies. However, much of the innovation and diffusion process is dependent on whether the entrepreneurial risk-takers in the economy can raise enough money to convert new ideas into more productive technology. (p. 71)

The investment tax credit can be particularly helpful to a small business because it aids cash flow immediately, thereby making its financial statement more attractive to potential investors and lending institutions. It can enable a small business to generate more cash internally as well as external financing.

We believe that our government must adopt policies which will reverse the decline of small business in this country. Much of the reason for this decline lies in the inability of small businesses to acquire capital at the same costs as large businesses or to acquire it at all. These points were stressed in the Final Report of the 1978 hearings on the future of small business held by the Subcommittee on Antitrust, Consumers and Employment:

> We must recognize the necessity for major changes in our governmental policies--at both the Executive and Congressional levels--with regard to the preservation of competition and free enterprise. . . including a reformulation of government policy on such matters as tax structure and industry regulation. . . . (House Report 95-1810)

We believe that small business is crucial to the survival of a free enterprise system and that governmental policy must be adopted which will allow catch-up programs to enable faster growth for small business than in the past.

Small business is an effective force even in heavily concentrated markets, but its position is fraught with difficulties. The tax laws should not further handicap small businesses struggling to compete with industrial

giants. We urge, therefore, that used equipment, as well as new equipment, qualify for the full 10 percent credit to offset tax liability, with full carryback/carryforward options and with no $100,000 limit on eligible used property. If the additional handicap of this tax discrimination is removed, small businesses will be better able to maintain their market share and to compete against the larger domestic and foreign corporations.

The Ability of Small Businesses to Increase Productivity

The decline in our productivity is caused by several conditions. A partial cause is antiquated and poorly designed facilities. Another partial cause is the utilization of inefficient equipment, and yet another partial cause is the overall age of our country's industrial machinery. The 1977 American Machinist Inventory showed that the majority of machine tools in use today, in small and large companies, are over 20 years old and less than 11 percent are five years old or less. An urgent need for upgrading and/or renewal of equipment exists.

Therefore, to increase a plant's production capacity, or to develop a new production line, many machines must be acquired. Major corporations renew equipment which is 7 to 10 years old with new equipment, some of which costs over a million dollars. Medium to small firms renew equipment which is 15 to 18 years old with used equipment, usually 7 to 10 years old, some of which costs over $300,000. Very small or new firms may renew their equipment which is 25

years old or more with used equipment which is 15 to 18 years old. Such upgrading of equipment translates into increased productivity for a small business. If the full investment tax credit is allowed for used capital stock, it will speed up the process of renewal and upgrading of all of our industrial plants. The demand for used equipment will increase the price and market for a large firm's used equipment. This will encourage the large firm to sell its used equipment and buy new capital stock to replace the used. This will result in a significant increase in productivity throughout the economy.

Improving productivity does not necessarily require acquisition of younger machines. Often small manufacturers can increase their productivity by purchasing used equipment manufactured in the same year as its current equipment but more efficiently designed for its particular production needs.

In its 1980 Report, the Joint Economic Committee makes a convincing case for the importance of small business in improving the productivity of our system:

> In the area of innovation and productivity, the National Science Foundation has found that one out of every four of the most significant industrial product and process innovations since World War II was developed by firms of less than 100 employees, while one-half were accounted for by firms with less than 1,000 employees. (p.71)

I believe that further investigation would reveal that an extremely high percentage of those innovative products and processes were made or developed on used equipment.

When the small businessman is denied tax incentives to replace current equipment with used machines that are either more sophisticated or more appropriate for his operation our economy loses. His alternatives are to make do with existing equipment, to merge, to be acquired, or to close up shop.

For these same reasons, a full investment tax credit with a carryback and carryforward provision should apply to tax credits for eligible used machinery, as well as eligible new machinery. To penalize the manufacturer who installs $1 million of used machinery in a single year over the manufacturer who merely installs $100,000 worth, simply makes no sense in a sluggish economy at a time of slowing economic growth.

Allowance of the Full Investment Credit for Used Machinery Would Create Jobs

The investment credit should not only stimulate productive capability but it should also stimulate immediate employment. The members of the Committee are keenly aware of the unemployment problems with which this country is beset. Moreover, this Committee knows that the small business sector offers the greatest potential for increasing employment. The purchase of used machinery not only increases productivity but also directly creates new jobs. As noted earlier, small businesses increase productivity primarily with used equipment. Small business also is responsible for 55 percent of all employment in the private sector.

A 1979 study by the Massachusetts Institute of Technology, The Job Generation Process, shows that job creation and replacement is achieved through the small business sector. The data shows that the largest number of new jobs emanated from very small firms with 20 employees or less. For the period 1969 to 1976, these small firms generated 66 percent of all new jobs in the United States. Businesses with 500 or more employees, by contrast, created only 13 percent of the new jobs. Firms of intermediate size accounted for the remaining 21 percent.

If the investment tax credit ceiling on used equipment were eliminated, it would translate into more cash for a small business to reinvest in more and upgraded used equipment which results in new jobs. In its 1980 Report the Joint Economic Committee found that:

> Given the historical tendency of small business to employ a relatively lower ratio of capital to labor than large business, each additional dollar invested in small business is likely to generate more jobs than if it were invested in large business. A policy of small business growth would have its greatest effect in decaying cities where structurally unemployed have the most difficulty finding job opportunities. Traditionally, young people in this country use jobs in small businesses to gain the work experience needed for entry into jobs that lead to highly skilled careers. (p. 72)

It is my experience that there is a direct relation between increased installation of used machinery and increased employment. Furthermore, the small business owner is the last to lay off his employees. He has a strong social conscience which is reflected in his dedication to his employees and his community.

## Eliminating the Advantage to Foreign Equipment

In many instances, later year domestic used machinery and newly manufactured foreign machinery are price competitive. The new foreign machine has an advantage since there is an unlimited tax credit, with carryback and carryforward provisions available to its purchasers; but purchasers of used domestic equipment, which may be as efficient as new foreign equipment, are limited to a $100,000 ceiling with no carryback or carryforward privilege. Industries seeking to retool are faced with three choices:

1. making do with inadequate equipment;
2. purchasing imported new machine tools; or
3. acquiring more efficient used machinery.

If a manufacturer retains his inadequate machinery, there is no increase in productive capability and the goal of economic growth is frustrated. Retooling with imported machine tools is obviously undesirable, both in its ultimate effects on the domestic machine tool industry and in its adverse effect on the balance of payments. Only by retooling with more efficient used machinery can the maximum economic benefits to the nation be realized. The full investment tax credit should apply to purchases of used machinery so these benefits can be realized, and so that foreign new machinery is not given a tax advantage over equally efficient domestic used machinery. To the extent that domestic used equipment is purchased instead of new foreign equipment, there would be no revenue loss from allowing the full investment tax credit for used equipment.

Investment Credit and Inflation

While acknowledging the investment tax credit's effectiveness in stimulating capital investment, most economists recognize its potential to cause short-term inflation. This is a function of the lead time to implement investment decisions and the concomitant increase in prices for scarce supplies. In many instances, the lead time to place new equipment in service is as much as thirty-six months. The installation of used machinery, however, does not have this undesired inflationary impact since the equipment already exists and the time taken to install it is usually a matter of days, not months.

Inflation has made the $100,000 limit on the amount of eligible used equipment against which the credit can be applied woefully inadequate. The cost of both new and used machinery has increased dramatically since the $50,000 limit was imposed in 1962. In 1975, the limitation was increased to $100,000. Whatever basis there may have been for a limitation has been severely weakened because of inflation. The MDNA found that the average price for basic unsophisticated machine tools has increased by over 500% since 1962. Such dramatic jumps in price are typical with all machine tools. Today, I believe it would cost approximately $600,000 to start a small machine shop which would employ 10 people. Furthermore, an established manufacturer has hardly begun to retool before he realizes that the $100,000 investment tax credit ceiling offers him very little assistance at all.

The failure of Congress to eliminate the limitation currently imposed on purchases of used property eligible for the credit penalizes the users of such property - and the users are small businesses.

A Full Investment Tax Credit for Equipment Will Encourage Economic Growth and Stability in the Small Business Sector

We believe what influences a firm's decision to purchase used capital equipment is not fully understood, and we believe more companies make larger investments in used equipment than is perceived. The two most common factors in the decision to buy used equipment are cost and availability. Market and/or production conditions strongly influence the capital investment decision. When a smaller manufacturer has the opportunity to increase sales it often requires an immediate increase in production capacity. Most newly produced U.S. manufacturing equipment has from an 18 to 30 month delivery period, and this lag time would probably cancel the additional sales. Because they are so highly leveraged, some smaller manufacturers are not able to increase their productive capacities even with available used equipment because of the limitation on available investment tax credit. Even when a smaller manufacturer wishes to increase production efficiency and has the time available to acquire newly manufactured equipment, he often does not have adequate financing available to purchase highly expensive replacement machines.

It is becoming increasingly difficult to imagine competitive smaller manufacturers in the 1980's unless the

capital retention opportunities for these businesses are made equal to larger manufacturers today--regardless of a wise decision to shorten and simplify capital recovery. The cash flow which results from the tax credit is urgently needed by smaller firms either for additional equipment expenditures or other corporate investments in labor, research, marketing, or facilities. This advantage to the cash position of a small business will also add to its credit worthiness in the eyes of potential lenders or investors. Appendix A illustrates this situation. When a small screw machine company began operating in Des Moines, Iowa it received a $10,000 credit for the $290,000 investment in used capital equipment. The decision to purchase used equipment was based on availability and cost. Nonetheless, this company could have used well the full $29,000 credit, perhaps for an additional sales representative, office equipment, etc.

Pending Legislation and the Full Investment . . .
Tax Credit for Used Equipment

Both the Senate and House Small Business Committees have identified the tax credit for used equipment as one of the top priorities in their capital formation and tax recommendations. When introducing his proposal to raise the current arbitrary limitation (S. 360), Senate Small Business Committee Chairman Lowel Weicker explained:

> Mr. President, the evidence accumulated by the Senate Small Business Committee in respect of substantial small business dependence on used equipment, particularly in this high technology environment, suggests that as a matter of simple equity for our Nation's small businesses the existing

> ceiling on used investment should be increased, if not removed entirely. Accordingly, our bill proposes to raise the ceiling from $100,000 to $250,000. (Emphasis added)

For the purposes of "elementary justice" and the "improved productivity of our economy," Senator Weicker has urged the Finance Committee to make this upward adjustment and to phase in an elevation of the ceiling to reach $500,000 by 1985.

In his testimony before the Ways and Means Committee on April 7, 1981, Congressman Henry Nowak, Chairman of the Small Business Subcommittee on Tax, Access to Equity Capital and Business Opportunities, argued for relief for small businesses that suffer from the discriminatory impact of the $100,000 ceiling:

> The third provision of H.R. 2949 increases the amount of investment tax credit from $100,000 to $200,000, and is identical to a provision in H.R. 6171, which I introduced last Session. An identical provision was contained in last year's Senate Finance Committee tax cut bill, H.R. 5829. The increase is justified on several grounds: First, as was pointed out in my Subcommittee's Report on Capital Formation and Retention, smaller firms, to a great extent rely on used machinery. They either cannot afford new machinery or cannot wait the one or two years it takes to receive delivery of new machinery. Second, the credit was last raised in 1975, from $50,000 to $100,000. Simple adjustment for inflation would raise the limit to $200,000. There is strong evidence to suggest that the amount should be raised to $300,000, or eliminated altogether. (Emphasis added)

Last year, in hearings before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, the National Federal of Independent Businesses, the Small Business Legislative Council, and the National Association of

Wholesale Distributors specifically requested the removal of the arbitrary limitation. During the past several months, in testimony before the House Ways and Means Committee and the Small Business Committees of the House and Senate, these and many other small business groups have called for this reform because the full investment credit for used equipment would support a high level of capital investment and improve productivity among small business--the largest segment of our economy. See Appendix B for a list of fifty-one small business organizations who support this reform. It is believed that this issue ranks in the top three priorities of all small business organizations.

The importance of this issue is further evidenced by the fact that seven legislative proposals in the House and two in the Senate have already been introduced this year. As I previously indicated, Senator Weicker introduced S. 360 which would raise the limitation to $250,000 and he urges that it be elevated in phases to $500,000 by 1985. However, he would like to see the limitation eliminated entirely. Senator Lloyd Bentsen introduced S. 1140, cosponsored by Senators Danforth, Baucus, Mitchell, and Chafee, which would raise the limitation to $250,000 and allow a carryback and carryforward of the cost of used equipment if it exceeds $300,000 for any taxable year. In his introductory statement Senator Bentsen explained his reasoning:

> Many small businesses acquire significant amounts of used property. I believe that an increase in the regular investment tax

> credit for used property is necessary to assure that the small businesses participate in the general upgrading of productive facilities which this proposal is intended to stimulate. Further, the present $100,000 limitation which became a part of the tax law in 1975 has become insufficient in light of the inflation that occurred in the price of equipment today. Finally, by allowing a carry-over of any unused investment tax credit we insure that businesses make the necessary investments this year without being deterred from making such investments due to the limitation on the amount of property qualifying for the investment tax credit.

Absent a complete elimination of the ceiling, we would like to have Senator Bentsen's proposal modified to allow a phased increase in the limitation to reach $500,000 by 1985 and the carryback/carryforward provision should apply to the cost of used equipment if it exceeds $250,000, which is the limitation in his bill.

In the House the following bills have been introduced:

H.R. 1377 by Congressman Bill Frenzel which eliminates the limitation entirely;

H.R. 3459 by Congressman Kent Hance which eliminates the limitation entirely;

H.R. by Congressman Tom Downey which raises the limitation to $300,000 and allows a carryback and carryforward for three and seven years, respectively, of the cost of used equipment in excess of $300,000 for any taxable year;

H.R. 423 by Congressman Jimmy Quillen which raises the limitation to $500,000;

H.R. 3202 by Congressman Dan Marriott which raises the limitation to $300,000;

H.R. 2949 by Congressman Cecil Heftel which raises the limitation to $200,000.

We sincerely appreciate the support for legislative action on this issue and the effort being made by these Congressmen to help the small businesses which need an investment tax credit incentive equal to that available to large businesses.

The proposals to merely raise the limitation would be helpful, but they will not solve the problem nor pave the way for the growth necessary for small business in the 1980's. Simply raising the ceiling will require small business organizations to come back time and time again to make their case before Congress as inflation drives prices through each new ceiling. Furthermore, merely raising the limitation without the carryback/carryforward provision perpetuates the discrimination against small business.

In 1975, the Senate Small Business Committee recommended that the limitation be removed and Senator Nelson sponsored the necessary remedial legislation. The Senate Finance Committee approved his proposal, and the Senate passed a tax bill which included the elimination of a ceiling on investment tax credit available for used equipment. The Conference Committee resolved the issue by doubling the limitation from $50,000 to $100,000. We believe that the Conference Committee should have accepted the Senate proposal. If it had, we would not be here today, and the small business sector would have been able to grow substantially in the five years that have passed. The discrimination and bias in favor of big business which is inherent in the current tax credit law would have been eliminated in favor of an equal opportunity for small business to grow, compete, and be more productive.

When the 1962 decision to generally not allow the investment tax credit for used equipment was made, it was felt that if the credit were provided there would be a

strong inducement in the tax laws for businesses to sell used equipment to each other as often as possible. To suggest that the elimination of the limitation would actually encourage a chruning of these types of assets indicates the need for a clearer understanding of the industrial machinery market. In my opinion, this assumption is ambiguous and lacks substantiation. Under examination, it is impossible to imagine a situation where the disruption of business and the uncertain condition of the other equipment would justify the anticipated abuse. Fixed assets are expensive to remove, transport, and install. The larger these assets, the smaller the likelihood this possibility would even be considered. The decision to trade fully depreciated assets involves the type of risk inconsistent with prudent business practices. Except in extremely rare cases, for corporate taxpayers with the ability to acquire newly manufactured equipment, capital outlays for used equipment would simply lack common sense. Actually the objective of the tax credit will be more fully realized by also encourgaing capital formation with used equipment because it would be more profitable to upgrade than to churn existing assets. Finally, the recapture and other restrictive provisions of the Tax Code make it impossible to make a profit on churning.

Because of the lack of available data, we have found it impossible to make an accurate revenue loss prediction for removal of the ceiling. The official estimators of revenue loss admit that any estimate would be based on con-

jecutre because there are no statistics available on the total amount of used equipment purchased per year in the United States. We have found estimates for 1981 ranging from $190 million up to $400 million. These estimates would be reduced by the amount of new foreign equipment sales that will be replaced by sale of used domestic machinery as a result of this tax credit change. In any event, we believe any revenue loss would be minimal in comparison to the symbolic and real growth value of a full investment tax credit for used equipment. Such a provision would establish the policy of Congress for small business growth. Any revenue loss will be easily recouped through increased tax revenues generated from the sales of the used equipment, increased profits from more productive small businesses and new incomes for new jobs created. In addition, the social benefits of increased productivity, reduced inflation, more products at cheaper prices on the shelves, more jobs and better balance of payments position will further justify the necessary changes in our tax code.

An Alternative to Elimination of the Ceiling

While we believe strongly in the principle that this blatant discrimination against small business should be written out of our tax code and that small businesses buying used equipment should get tax credit treatment which is equal to that available to big businesses buying new equipment, we recognize that Congress has in the past been reluctant to re-

move the ceiling. Senator Lowell Weicker and Congressman Nowak have expressed their belief that the ceiling should be eliminated entirely but, as realists, they expect that it is unlikely to be repealed this year. Small business is experienced in the harshness of reality, both in the business world and on Capitol Hill. Therefore, we appreciate their efforts and advice.

We can support the proposals of Senator Bentsen and Congressman Downey because they have attempted to ameliorate the discriminatory impact of the ceiling by allowing the carryback three years and carryforward seven years of the excess investment above the ceiling for which no tax credit is allowed in the year of purchase. This would induce small businesses to make early sizeable investments resulting in immediate expansion based on the expectation that they will receive the investment tax credit over a period of years for their entire investment.

Under this approach the investment tax credit available for used equipment is limited to a fixed ceiling in any one year but a tax credit is available for the balance of the investment above the ceiling if it is carried back or forward. For example, under Senator Bentsen's approach, a small business which purchases $300,000 of used equipment in 1981 will receive an investment tax credit of 10% of investment up to $250,000

The balance of the investment, $50,000, can be carried backward or forward for an investment tax credit. This would be similar to the treatment accorded new equipment except that there would be a limitation on the amount of investment eligible for tax credit in any one year. This carryback/carryforward provision would be of great benefit to a small business in that it would eventually receive a tax credit for its full investment within the outside limits of this proposal. Our initial inquiries of economists with the Joint Committee on Taxation indicate that such a carryback/carryforward provision would have minimal revenue loss impact. Because there is an outside limit on the overall tax credit available over ten years, big ticket items such as airplanes, ships, etc. would be eliminated and the potential for abuse of this tax stimulus would be averted. The revenue loss for this proposal should not exceed $229 million in the first full year.

Capital Cost Recovery Legislation

Congressman Jones and Congressman Conable introduced H.R. 1053, the "Capital Cost Recovery Act of 1981", which would allow rapid recovery of capital costs through depreciation reform. The Reagan administration has backed a similar accelerated capital cost recovery system. Today, representatives of small business organizations have testified

in favor of such legislation. We enthusiastically endorse the concept of these proposals. In order to stimulate capital investment and increase productivity thereby, we must reform the current tax system for depreciation of equipment. These proposals would permit a small business to recover more rapidly capital that it has invested in machinery and equipment.

In its 1979 Report, the Joint Economic Committee found that one of the deterrents to investment spending has been the interaction of inflation and current tax law. The Joint Economic Committee concluded that:

> Some of the provisions of the corporate income tax code which were designed in a noninflationary economy, act as a deterrent to investment in the current inflation. Depreciation allowances based on historical costs do not allow sufficient deductions to recover replacement costs. Similarly, profits on inventory in one sense may be illusory, because inventory must be replaced at current cost. On the other hand, in inflationary periods, corporations benefit from reductions in the real value of outstanding debts. . . . (P.132).
>
> Some of the tax changes in the Revenue Act of 1978 will stimulate investment. But these are not sufficient. We believe that per dollar of revenue loss, liberalization of depreciation allowances would be the most effective stimulant. (P. 133)

As Chairman of the Federal Reserve, William Miller emphasized accelerated depreciation as a needed tax change in his testimony before the Senate Finance Committee on September 6, 1978:

> <u>Accelerated depreciation is a very efficient way to encourage investment.</u> The tax benefits of faster depreciation accrue to a firm only after new plant and

> equipment has been put in place. In addition, enlarged depreciation allowances would redress the serious drag on real corporate profitability that has occurred in recent years as inflation has caused replacement costs to exceed depreciation deductions by a wide margin. (emphasis added) (part 5, page 1173 et seq.)

We agree with the conclusions of the Joint Economic Committee and Mr. Miller and urge the passage of legislation which would allow the rapid depreciation of used equipment and machinery over a maximum period of five years. For many of the reasons previously stated with regard to the full investment tax credit, such depreciation tax reform would aid small businesses in generating the capital necessary to buy used machinery, resulting in expanded capacity and increased productivity.

The simplification of our tax laws with respect to depreciation, which would result from all of these proposals, would be of great benefit to small businesses. Small businesses cannot afford a battalion of tax lawyers and accountants to plan their capital investment. Being able to understand the simplified depreciation schedule, the small business person would be more encouraged to increase investment in machinery and equipment. Under existing law, a great deal of time is wasted by small business executives in trying to comprehend our complex depreciation laws and in computing the allowable depreciation for their equipment. One result is that depreciation accounting is one of the leading causes of errors on small business tax returns. Simplification of

the depreciation system will result in savings of money and time for both small businesses and the government tax officials who must process the current complex returns.

In some cases, the current depreciation tax laws are so complex that small businesses have chosen not to use the depreciation allowable. For example, the Asset Depreciation Range (ADR) System was used in 1974 by only .7 percent of all corporations, or 11,042 corporations out of a total of 1.6 million. Yet this system shortens the useful life of assets by up to 20 percent. While 94 percent of the firms with over $1 billion worth of assets use ADR, only 1 percent of the firms that have assets of less than $500,000 used ADR. (93.3 percent of the firms in this country are small businesses that have assets less than $500,000). It is clear that small business does not use ADR. We believe that it will use the simplified system.

The rapid capital cost recovery will protect the capital investment of small business against the erosion of inflation, which currently causes replacement costs to exceed depreciation deductions. Small businesses will be able to reinvest their capital in more or upgraded equipment. With the resulting increase in productivity, the entire economy will benefit and we will have scored another victory in our constant battle against inflation.

Furthermore, we need the proposed rapid capital cost recovery system in order to be competitive with other industrialized nations which have already adopted rapid

capital cost recovery sytems. For example, Canada has adopted a two-year depreciation system for most machinery and equipment, and Britain has adopted a capital recovery time of a single year. This has resulted in an accelerated capital stock renewal process which I analyzed earlier in my testimony. Used equipment is being replaced more rapidly by new equipment, and small businesses are replacing old used equipment with later year more advanced used equipment. The result is a more modernized overall industrial plant for those countries. The high demand for used machinery in these countries, we believe, is at least partially caused by the greater supply of used equipment created by the two or one-year depreciation system. We must adopt a similar rational tax policy which will stimulate domestic economic growth and allow us to be competitive in the international arena. If such steps are not taken, we will see increasing balance of payment deficits and further devaluation of the dollar.

## Conclusion

In summary, we must reverse the decline in productivity in our country through the increased capital formation which will be stimulated by reform of our tax laws through removal of discrimination in the investment tax credit and through a simplified and accelerated capital cost recovery system. Between these two reforms, we believe small business will benefit more by allowing it an equal opportunity to full use of the investment tax credit on its purchase of used machinery and equipment. The tax credit is

applied to taxes due, while the value of the depreciation deduction hinges on the amount of capital stock owned and the tax rate applicable to each company. However, we believe that both reforms are necessary and must be enacted in the very near future. These reforms will allow the generation of capital necessary to the renewal and upgrading of our nation's industrial plants. They will give small business a fighting chance against inflation and an opportunity for catch-up growth which we need in order to compete effectively against large domestic and international corporations. Most importantly, we can increase the productivity of our country achieve real growth, and assure a better standard of living for all Americans.

Thank you Mr. Chairman and members of the Committee.

COMMITTEE ON SMALL BUSINESS
USED CAPITAL EQUIPMENT INFORMATION

APPENDIX A

1. CITY: Chariton & West Des Moines, Iowa

2. TYPE OF BUSINESS: Contract Machinery & Screw Machine Products

3. MACHINERY USED IN OPERATION TODAY:

| TYPE OF MACHINES | USED PRICE | NEW PRICE |
|---|---|---|
| Potter & Johnson 400 Auto. Turret Lathe | $30,000.00 | $95,000.00 |
| Warner & Swasey 1-3/4" 5 Spindle Auto Screw | $27,500.00 | 135,000.00 |
| " " " " " " " | 27,500.00 | 135,000.00 |
| Warner & Swasey 2-1/4" " " " " | 40,000.00 | 150,000.00 |
| " " " " " " " | 40,000.00 | 150,000.00 |
| " " " " " " " | 40,000.00 | 150,000.00 |
| " " " " " " " | 40,000.00 | 150,000.00 |
| Jet Milling and Drilling Machine | 600.00 | 1,600.00 |
| Bridgeport Vertical Millling Machine | 4,750.00 | 5,800.00 |
| Jet Engine lathe | 1,800.00 | 2,500.00 |
| Warner & Swasey No. 2 Turret Lathe | 2,500.00 | 45,000.00 |
| Rockford Grinder | 1,000.00 | 2,250.00 |
| Rockford Horzontal Band ~~XXXX~~ Saw | 600.00 | 1,200.00 |
| Wilton Drill Press | 350.00 | 810.00 |
| (Use other side for additional machines) | 500.00 | 1,135.00 |
| (SUBTOTAL FROM OTHER SIDE) | | |
| MATERIAL HANDLING EQUIPMENT | 3,500.00 | 8,000.00 |
| CRANES | | |
| TRUCKS | | |
| INSPECTION EQUIPMENT | | |
| ACCESSORIES, PERISHABLES & SPECIAL TOOLINGS (TOTAL) | 35,000.00 | 62,000.00 |
| (CHUCKS, ETC.; DRILLS, ETC; JIGS, ETC.) | | |
| TOTALS | 295,600 | 1,095,295 |

| TYPE OF MACHINES | USED PRICE | NEW PRICE |
|---|---|---|
| Wilton Drill Press V.S.. | $400.00 | $910.00 |
| Rockford Drill Press | 100.00 | 225.00 |
| SUBTOTAL | $500.00 | $1,135.00 |

4. OTHER INFORMATION:

- Approximate Annual Sales (this year) $ 1,000,000 initial year
- Total Number of Employees 6
- Total Operating Costs $ 65,000 per month

(Includes: payroll, occupancy, sales, production, debt-financing costs)

Annual payroll $ 250,000

Office Equipment $ 10,000

Plant Size 7,000 sq. ft.

*This company would not be in business today if used equipment were not available when the company was started in 1976. The decision to begin this business was one very large order from a larger coporation. $250,000 was available through a bank loan and the delivery time for newly manufactured screw machines is 18 months.*

## APPENDIX B

### INVESTMENT TAX CREDIT

The decline in our productivity is caused by several conditions. For the first time in twenty years, the Joint Economic Committee Annual Report of 1979 unanimously concluded that an increase in productivity is vital to the improvement of our economic standard of living and to the reduction of inflation. A partial cause of this situation is the antiquated production facilities of many American manufacturers. Another partial cause is the utilization of inefficient equipment; and yet another partial cause is the overall age of our country's industrial machinery. The most recent U.S. survey of machine tools shows only 11% of the industrial machinery in use today is less than five years old; 76% is at least ten years old. Equipment renewal and upgrading are necessary in both large and small manufacturing companies. Increasing productivity through equipment renewal is best achieved for small business through the purchase of affordable used machinery and equipment.

Under present law there is a $100,000 limitation on the amount of used equipment eligible for investment tax credit, but there is no limitation on the investment credit available for new equipment. This discriminatory tax treatment impacts directly and primarily on small business which is already hindered by its inability to externally or internally generate capital necessary to buy new equipment.

In order to increase productivity and competition, the discriminatory ceiling on the amount of used property eligible for a tax credit must be eliminated; and, the carryover provisions available for new property must also be available for similarly situated used property. Traditionally, small businesses purchase used capital equipment; large businesses basically purchase newly manufactured capital equipment. The cost of obtaining capital for production equipment is high for everyone, especially those who cannot borrow at the prime rate. Firms purchasing used capital equipment do not have a chance to offset some of their costs through this tax credit. Confining the investment credit to only equipment with the latest technology helps primarily the largest enterprises and basically ignores the numerically greater small business segment of our economy which needs this tax credit the most. Because the small business sector offers the greatest potential for increasing employment, there is normally a direct relationship between increased installation of used machinery and increased employment.

RESOLVED

Small Business Legislative Council urges and supports changes in the IRS Code to allow a full investment tax credit for used machinery and equipment. This full investment tax credit will allow small businesses to receive the same tax incentive provided to big businesses and would allow small businesses to compete, to maintain their current market share, and to hopefully expand output and productivity.

The National
Small Business
Association Building
1604 K Street, N.W.
Washington, D.C. 20006
Telephone
(202) 296-7400

July 30, 1980

The position paper -- Investment Tax Credit -- is supported, as of this date, by 51 members of the Small Business Legislative Council:

American Assn. of MESBICs
Washington, DC

American Assn. of Nurserymen
Washington, DC

American Metal Stamping Assn.
Richmond Heights, OH

Assn. of Diesel Specialists
Kansas City, MO

Assn. of Indep. Corrugated Converters
Washington, DC

Assn. of Physical Fitness Centers
Bethesda, MD

Automotive Warehouse Distribs. Assn.
Kansas City, MO

Bldg. Service Contractors Assn. Intl.
Vienna, VA

Business Advertising Council
Cincinnati, OH

Christian Booksellers Assn.
Colorado Springs, CO

Direct Selling Association
Washington, D.C.

Eastern Manufs. & Importers Exhibit
New York, NY

Electronic Reps. Assn.
Chicago, IL

Independent Bakers Assn.
Washington, DC

Indep. Business Assn. of Michigan
Kalamazoo, MI

Indep. Sewing Machine Dealers of America
Hilliard, OH

Intl. Franchise Assn.
Washington, DC

Local and Short Haul Carriers Natl Conf.
Washington, DC

Machinery Dealers Natl. Assn.
Silver Spring, MD

Manufacturers Agents Natl.
Irvine, CA

*Of the National Small Business Association

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Marking Device Assn.
Evanston, IL

Menswear Retailers of America
Washington, DC

MN Assn. of Commerce & Industry Small
Business Council, St. Paul, MN

Narrow Fabrics Institute
New Rochelle, NY

Natl. Assn. of Catalog Showroom Merchs.
New York, NY

Natl. Assn. of Floor Covering Distribs.
Chicago, IL

Natl. Assn. of Plastic Fabricators
Washington, DC

Natl. Assn. of Plastics Distribs.
Jaffrey, NH

Natl. Assn. of Retail Druggists
Washington, DC

Natl. Candy Wholesalers Assn.
Washington, DC

Natl. Coffee Service Assn.
Chicago, IL

Natl. Electrical Contractors Assn.
Bethesda, MD

Natl. Family Business Council
West Bloomfield, MI

Natl. Home Improvement Council
New York, NY

Natl. Independent Dairies Assn.
Washington, DC

Natl. Insulation Contractors Assn.
Washington, DC

Natl. Meat Assn.
Washington, DC

Natl. Office Machine Dealers Assn.
Des Plaines, IL

Natl. Paper Box Assn.
Haddonfield, NJ

Natl. Paper Trade Assn.
New York, NY

Natl. Parking Assn.
Washington, DC

Natl. Patent Council
Arlington, VA

Natl. Pest Control Assn.
Vienna, VA

Natl. Small Business Assn.
Washington, DC

Natl. Society of Public Accountants
Washington, DC

Natl. Tire Dealers & Retreaders Assn.
Washington, DC

Natl. Tooling and Machining Assn.
Washington, DC

Natl. Tour Brokers Assn.
Lexington, KY

Power & Comm. Contractors Assn.
Washington, DC

Printing Industries of America
Arlington, VA

Sheet Metal & Air Cond. Contrs.
Natl. Assn., Vienna, VA

## CAPITAL INVESTMENT RECOVERY

Small business has seen its role in the U.S. economy dwindle for decades. Much of the reason for its decline lies in its inability to get the capital to be able to compete with large business in this country. The corporate giants, meanwhile, have access to the capital they need at the lowest available rates. They continue to increase their share of the Gross National Product at the expense of small business.

This competitive country must redirect its economic structure to return to the principles of private enterprise upon which it was founded. At the rate we are going there will soon be no small business in America. The American dream of starting one's own business and making it a success will be nothing more than a dream. No one man or woman will be able to come close to competing with the major corporations.

The U.S. Congress can help restore the American dream by passing legislation facilitating the recovery of capital. But it must be of genuine help for the small business and not a tool for big business to continue to take over and freeze out small business as it has been doing for years. The corporate giants, with their easy access to capital at the lowest rates, would use any legislation to accelerate expansion to the disadvantage of small business if there is not a ceiling on the benefits. The small retailer would get little joy from his newly won benefits if he found a major corporate chain was using them to open a store next door. This would happen without a ceiling. The small manufacturer would find the same thing. Whatever he was able to invest in new productive equipment would be more than matched by the well-heeled giant that had been running him out of business anyway. In some industries, major corporations who presently subcontract would find it a greater advantage to manufacture themselves should legislation without a ceiling be passed.

Any tax bill accelerating depreciation should provide a 10% investment tax credit for all equipment, machinery, and furnishings. It would allow them to be depreciated over four years. This type of capital investment could be depreciated as much as four or five times faster than presently allowed. These breaks would be targeted to small business by limiting to $1 million the amount of total investment in equipment, machinery and furnishings upon which accelerated depreciation would be allowed.

Buildings and fixtures would also be depreciated much faster. These types of investments could be written off in 10 years. This type of investment could be depreciated as much as six times faster than under present rules. This break would also be targeted to small business by limiting to $1 million per year the amount of investment in buildings and fixtures upon which accelerated depreciation would be allowed.

Over 97-1/2% of all U.S. companies would be able to use this legislation to full advantage. Most of the remaining 2-1/2% of companies, which account for 79% of the investment in this country, could use it up to the ceiling amounts. Thus this bill both would help small business and significantly reduce the revenue loss that would occur if there were no ceilings on benefits.

RESOLVED

Increased capital investment by small business is essential if this basic American institution is to survive and prosper. SBLC endorses legislation that will encourage increased capital investment by small businesses. The combined effect of more rapid depreciation and increased investment tax credit will assure small business a greater return on its investment in such capital, thereby making small business more profitable, and better able to compete in all markets.

The National
Small Business
Association Building
1604 K Street, N.W.
Washington, D.C. 20006
Telephone
(202) 296-7400

Small Business Legislative Council*

July 31, 1980

The position paper -- Capital Investment Recovery -- is supported, as of this date, by 51 members of the Small Business Legislative Council:

American Assn. of MESBICs
Washington, DC

American Assn. of Nurserymen
Washington, DC

American Textile Machinery Assn.
Washington, DC

Amusement & Music Operators Assn.
Chicago, IL

Assn. of Indep. Corrugated Converters
Washington, DC

Assn. of Physical Fitness Centers
Bethesda, MD

Automotive Warehouse Distribs. Assn.
Kansas City, MO

Building Service Contractors Assn.
Intl., McLean, VA

Business Advertising Council
Cincinnati, OH

Christian Booksellers Assn.
Colorado Springs, CO

Direct Selling Association
Washington, DC

Eastern Manufs. & Importers Exhibit
New York, NY

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Indep. Business Assn. of Michgian
Kalamazoo, MI

Indep. Business Assn. of Washington
Bellevue, WA

Indep. Sewing Machine Dealers of America
Hilliard, OH

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Washington, DC

Local and Short Haul Carriers Natl Conf.
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McLean, VA

Natl. Assn. of Floor Covering Distribs.
Chicago, IL

Natl. Assn. of Plastic Fabricators
Washington, DC

Natl. Assn. of Plastics Distribs.
Jaffrey, NH

Natl. Assn. of Retail Druggists
Washington, DC

Natl. Beer Wholesalers Assn. of Am.
Falls Church, VA

Natl. Burglar & Fire Alarm Assn.
Washington, DC

Natl. Candy Wholesalers Assn.
Washington, DC

Natl. Coffee Service Assn.
Chicago, IL

Natl. Concrete Masonry Assn.
Herndon, VA

Natl. Electrical Contractors Assn.
Bethesda, MD

Natl. Family Business Council
West Bloomfield, MI

Natl. Home Furnishings Assn.
Washington, DC

Natl. Home Improvement Council
New York, NY

Natl. Independent Dairies Assn.
Washington, DC

Natl. Office Machine Dealers Assn.
Des Plaines, IL

Natl. Office Products Assn.
Alexandria, VA

Natl. Parking Assn.
Washington, DC

Natl. Patent Council
Arlington, VA

Natl. Pest Control Assn.
Vienna, VA

Natl. Precast Concrete Assn.
Indianapolis, IN

Natl. Small Business Assn.
Washington, DC

Natl. Society of Public Accountants
Washington, D.C.

Natl. Tire Dealers & Retreaders Assn.
Washington, DC

Natl. Tooling and Machining Assn.
Washington, DC

Natl. Tour Brokers Assn.
Lexington, KY

Natl. Wine Distrib. Assn.
Chicago, IL

Power & Comm. Contractors Assn.
Washington, DC

Sheet Metal & Air Cond. Contrs.
Natl. Assn., Vienna, VA

Senator DANFORTH. Gentlemen, thank you very much.
The next witness is Donald V. Seibert, chairman, J.C. Penney Co.

## STATEMENT OF DONALD V. SEIBERT, CHAIRMAN OF THE BOARD, J. C. PENNEY CO., INC.

Mr. SEIBERT. I'll move as quickly as I can and just select some of what I view as the more important points out of my written statement which you have.

The CHAIRMAN. Thank you sir, I think all of us are apologetic for seeming to give the witnesses the rush treatment today, but that's the peril of the Senate schedule.

Mr. SEIBERT. I understand the program I have been here before.

I am Don Seibert, chairman of Penney's. This morning I am appearing on behalf of the American Retail Federation and the National Retail Merchant's Association and 12 of the Nation's largest retailers.

In our written testimony, we pointed out that the retail and wholesale sectors together account for about 17 percent of gross national product and the retail industry alone employs one out of every six workers.

We strongly endorse the administration's accelerated cost recovery system as contained in S. 683 because we believe that it properly recognizes retailing's place in the economy and our need for much quicker recovery of our investment in buildings.

The function of retailing is distribution just as the function of manufacturing is production and both are highly interdependent.

We make the point that inefficiencies in one sector will offset efficiencies in the other and that an efficient distribution system exerts a strong pullthrough effect on manufacturing and helps hold down final prices to the consumer.

Buildings are important productive assets of retailing and represent a significant portion of our fixed capital investment. Buildings of the proper size and design are critical to the efficient use of equipment and labor as well as energy efficiency.

Thus, the need to stimulate construction of efficient new buildings or the renovation of older ones is just as compelling as the need to stimulate the use of new machinery and equipment.

We point out also that small businesses as well as large will benefit from ACRS. It is simple to use; very few small companies now use the present ADR system because of its complexity. ACRS creates for many small businesses a new source of working capital, making ownership of their building and equipment more economically feasible.

There are two issues that have come up that I would like to spend just a few minutes on.

One has to do with the potential abandonment of urban or snowbelt locations. As far as retailers are concerned I would point out that retailers locate where their customers live and work and no tax bill could be a powerful enough incentive to take retailers away from their customers.

ACRS will in fact permit some investments in downtown shopping districts which would not otherwise be economically feasible.

It costs more to operate a downtown store, most often, and currently many downtown locations where retailers would like to

locate do not become realities simply because the marginal rate on investment prevent us from doing so.

The more rapid cost recovery provided by ACRS would transform many of these marginal projects into profitable ones.

Also, the discussion on the 10- and 15-year recovery periods for commercial buildings comes up often and I would point out that we view these as equitable treatment. They are an attempt to satisfy on an equitable basis, the different objectives of the real estate developers and industries such as retailing that are not in the business of real estate speculation.

Passive investors will receive substantially improved cost recovery from the 15-year writeoff. ACRS also provides them with their key objective of freedom from recapture when they sell a building, unlike an owner-user who must pay the recapture penalty in the form of ordinary income tax to the extent of the depreciation taken.

I do appreciate your interest and the opportunity to be here to represent our industry and would be happy to answer any questions you might have.

Senator DANFORTH. Thank you, Senator Symms.

Senator SYMMS. Thank you very much, Mr. Chairman. Like I say, Don, welcome to the committee, and we do apologize that there aren't more here, but we didn't know when this hearing was scheduled that the Senate would be going into session at 7 a.m. this morning trying to get the supplemental appropriation and the budget out before 5 p.m. this afternoon. So, I guess that's our problem.

There has been as you know some concern on the part of the retailers about being careful that you do not in some way in some tax compromise that might come out to lose the 10-5-3, and I think that's a concern that many of us share. I think that it is very important that you do keep the 10-5-3.

I guess that if the opportunity for any taxpayer to elect to take either the 10-5-3 with the recapture or to take the accelerated—I mean the straight-line depreciation there would be no objection as far as you are concerned as long as it is preserved for the retailer.

Mr. SEIBERT. Well, I would point out that as a retailer, our interest really lies in the recovery period. Thus, the attraction of 10-5-3 is very powerful. We have relatively little interest in the real estate aspect of the deal, but are quite interested on the one hand in gaining the recognition that efficiencies in the distribution sector are as important as efficiencies in the manufacturing sector. And I would commend this committee for having established that fact last year. We appreciate that.

I point out again the significance of the part of gross national product that retail accounts for and if you move beyond retailing to the entire service sector you have over half of GNP.

We think it is important to understand that you can be an efficient distributor, of course, or you can be an inefficient one.

To the extent that we maintain or improve our efficiency the consumer benefits, as well as the industrial side or manufacturing side.

Senator SYMMS. I think that is a very good point. I commend you for your statement, for the support that you have given, I know, for

the overall—for the President's economic program and I know of course that when you start talking about how the economy is going, well, J. C. Penney is certainly a good barometer, because you are all over the country in all 50 States and do have a sense of what is happening out there without asking a question that would interfere with your trade secrets—so you don't have to answer it if you don't want to, but are things going fairly well out across the country as far as business is concerned?

Mr. SEIBERT. Well, as far as our business is concerned, things are going well this year. Our year-to-year comparisons are very good.

I would point out that a year ago, things were not very good and that retailing was affected during this particular period by the effects of the Federal Reserve Board's so-called credit control program that went in in March.

Nevertheless, we are quite pleased with the way the consumer is behaving as far as general merchandise retailers are concerned. We are having strong sales increases. We think that the year will continue that way.

We are basing our plans on a forecast that we will see about a 2½-percent real growth this year in general merchandise sales. This assumes with about a 8½-percent sales increase with about a 6-percent inflation factor in it.

Senator SYMMS. Thank you very much. Thank you Mr. Chairman.

Senator DANFORTH. Thank you.

We are facing a series of rollcall votes and we are endeavoring to find out exactly how many there are, at least three I am told and possibly more. When we get that information we will be in a better position to announce precisely when we can resume.

[The statement of Mr. Donald Seibert follows:]

PREPARED WRITTEN STATEMENT
OF
DONALD V. SEIBERT
CHAIRMAN OF THE BOARD
J. C. PENNEY COMPANY, INC.
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

May 21, 1981

Summary Of Points

1. There are nearly two million retail establishments throughout the country. Some retailers are large, but most are small businesses. About half of all small businesses are retailers.

2. We in the general merchandise retail industry strongly support the President's proposal for an Accelerated Cost Recovery System (S. 683). ACRS should be enacted as soon as possible and made effective January 1, 1981.

3. Enactment of this capital cost recovery system is the most significant and forward-looking step that could be taken on the road toward making American business more competitive and increasing our output of goods and services.

4. A specific advantage of ACRS is that it places emphasis on achieving accelerated capital cost recovery rates for all types of business capital investment, in a substantially uniform and neutral manner.

5. ACRS provides reasonable cost recovery rates for that portion of a business firm's required fixed capital investment which is in buildings.

a. In the retail sector, buildings contribute importantly to the efficient distribution of goods, which holds down final prices. An efficient distribution system is just as important as an efficient manufacturing system. Inefficiencies in one may offset efficiencies in the other.

b. The bottom line impact of a cost recovery system is what counts -- the total reduction in the after-tax cost of the business firm's total required fixed capital investment. Any business consists of a mixture of equipment and buildings. In the retail sector about 40 percent of annual fixed capital investment is in buildings.

c. ACRS is premised on the idea that a major increase in cost recovery rates will stimulate capital investment sufficiently to greatly enlarge the GNP and ultimately offset any tax revenue loss. It's difficult to see how a successful program could be undertaken if major portions of the sources of GNP were wholly or partially excluded from the cost recovery system. The retail and wholesale industries alone account for about 17 percent of GNP, and the services sector, of which retail and wholesale is a part, accounts for about 52 percent of GNP.

6. Insofar as concerns tax cuts for individuals, we support the President's proposal for individual tax rate reductions spread over a number of years.

PREPARED WRITTEN STATEMENT
OF
DONALD V. SEIBERT
CHAIRMAN OF THE BOARD
J. C. PENNEY COMPANY, INC.
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

May 21, 1981

On behalf of American Retail Federation; National Retail Merchants Association and the following companies: Allied Stores Corporation; Associated Dry Goods Corporation; Carter Hawley Hale Stores, Inc.; Dayton Hudson Corporation; Federated Department Stores; K mart Corporation; R. H. Macy and Company, Inc.; The May Department Stores; Montgomery Ward & Company; J. C. Penney Company, Inc.; Sears, Roebuck and Co.; and F. W. Woolworth Co.

My name is Donald V. Seibert. I am Chairman of the Board of J. C. Penney Company, Inc. On behalf of my own company, as well as on behalf of the American Retail Federation and the National Retail Merchants Association, I urge the Committee to adopt a comprehensive program consisting of accelerated capital cost recovery rates for business investment in depreciable property of all kinds and substantial individual tax reductions. These important steps should be in line with the President's comprehensive program.

There are nearly two million retail establishments throughout the country. Some retailers are large businesses, but most are small businesses. In fact, about half of all small businesses are retailers. NRMA represents about 3,500 retailers with about 40,000 retail establishments. ARF represents 50 state retail associations plus other retail associations and retail companies.

We in the general merchandise retail industry strongly endorse the President's proposal for an Accelerated Cost Recovery System (S. 683). On numerous previous occasions, we have endorsed similar cost recovery proposals.

We join others in the business community in urging that the new capital cost recovery rules be enacted as early in this Congress as possible. This Committee should quickly make a formal decision that the new cost recovery rates will apply to investments made on or after January 1, 1981. While recent announcements by Congressional leaders have helped reduce those concerns, there is still a fear that the effective date for the new depreciation rules may be moved forward to late in 1981. A formal decision by this Committee to make the effective date March 11, 1981, for example, would not eliminate that concern. In one sense, such a decision might increase the perception that, once having been moved beyond January 1, 1981, the effective date

might slip still further as the Congressional process goes on later in the year.

S. 683 Improves Productivity

Enactment of S. 683 is the most significant and forward-looking step that could be taken on the road toward making American business more competitive and increasing our output of goods and services. There is, I believe, widespread agreement about that fact, in general terms. The specifics are, however, too often overlooked in the general debate.

In specific terms, S. 683 offers particular advantages which are vastly superior to the outdated depreciation system of present law. S. 683 is also superior to any of the other cost recovery systems which have been advanced as alternatives. A cost recovery system is distinguished from a so-called depreciation system based on economic or physical useful lives of particular business assets. Useful life depreciation is solely an accounting concept designed to measure income over a period of time, in a hypothetical and static situation assuming no changes in nominal price levels. Even the accounting profession admits that this approach is imperfect in the more dynamic world. In contrast, a cost recovery system, such as S. 683, or any of the currently suggested alternatives, is an instrument of national fiscal policy. A cost recovery system is, therefore, directed toward reducing the after-tax cost of capital investment and toward increasing the cash flow

to the business which makes that investment, taking into account future predicted interest rates and the rates of capital cost recovery for tax purposes. These are the important factors in influencing a business to increase its fixed capital investment.

Specific Advantages Of Cost Recovery Concept

The first specific advantage of S. 683 is that it will, when fully effective, provide a much greater decrease in the after-tax cost of capital investment and a much greater increase in cash flow. S. 683 is, therefore, a superior instrument of fiscal policy to accomplish the intended goal of increased capital investment and a greatly enlarged Gross National Product.

The second specific advantage of S. 683 is that it will result in more stimulation of capital investment, per dollar of revenue loss in the critical years of FY 1982 and FY 1983, than any of the recently suggested alternatives. That is because S. 683 is phased-in, with the cost recovery rates increasing step-by-step each year through 1985. Business decisions to make new investments will be made in 1981. Where the required lead-time is short enough, much new investment will be put in place in 1981. There should be no fear that these investments might be delayed in order to take advantage of the still further increased cost recovery rates as a result of the 1982 through 1985 steps in the S. 683 phase-in. On a present value basis, no single step in the phase-in is large enough to warrant foregoing the current deduction and paying larger taxes in 1981 or any

other year. Moreover, substantial additional investment decisions will be made in 1981 for projects that, because of longer necessary lead-times, cannot be put in place until 1982 or 1983. The known availability of increased cost recovery rates in 1982 through 1985 will play a major role in causing these investment decisions to be made in 1981 at no additional cost in Federal tax revenues in 1981. Stimulation of the initial investment decision, and the beginning of planning and work as early as possible, is the key to achieving a greatly enlarged investment base, in place and producing, as quickly as possible. This unique advantage of the S. 683 phase-in is too often overlooked.

A third specific advantage is that S. 683 places specific emphasis on achieving accelerated cost recovery rates for all types of business capital investment. This emphasis is a fundamental advantage of S. 683 because it enhances its efficiency as an instrument of national fiscal policy. In contrast, some recently proposed alternatives are, in fact, hybrids -- in part cost recovery systems and in part useful life depreciation systems. Useful life is a convenient accounting principle, but it is conceptually unrelated to fiscal policy. The two notions simply cannot successfully be blended.

A fourth, somewhat related, specific advantage of S. 683 is that it for the first time provides reasonable cost recovery rates for that portion of a business firm's required fixed capital investment which is in buildings. These cost

recovery rates are somewhat comparable to the cost recovery rates for machinery and equipment under present law. Buildings comprise a significant portion of the fixed capital cost necessary to produce goods and services in the manufacturing sector and in the retail and other distribution sectors of the economy. In the retail sector alone, about 40 percent of annual fixed capital investment is in structures necessary to perform the vital distribution function in the economy.

Buildings Vital To Efficient Distribution

Any cost recovery system must, if it is to produce the desired result, be directed toward the bottom line -- the overall, total cost of capital to business firms. Any business consists of a mixture of equipment, buildings and labor components to produce goods and services. That mixture is dictated by the requirements of efficiency in the production of goods and services; not by any social or economic preference for equipment over buildings or vice versa. In the retail sector, well-designed buildings, of the proper size and location, are critical to the efficient distribution of goods at the least cost. New designs and interior layouts permit maximum use of efficient techniques of goods handling, storage, etc. Energy efficiency is also increased. In the manufacturing area, differently designed factory buildings are often critical to the use of new technologies and to the most efficient use of labor. In many of the newer high technology and research industries, buildings are often a major

component of their fixed capital investment which would be affected by S. 683 or any similar system.

While new business buildings are important, S. 683 contains an equally important, unique feature for older buildings. Because S. 683 applies to new investment in existing buildings in older areas, it increases their economic attractiveness. Too often under present tax law, it is more economic to tear down older business buildings, or to move to a new area, than to invest in rehabilitation and expansion of the older building. Moreover, whether we are talking about a new building or an older building, the reduced after-tax cost provided by S. 683 makes it more possible for retailers to bear the higher land cost associated with downtown locations.

Inclusion of buildings in a new cost recovery system is so fundamental that it is difficult to see how, without their inclusion, a large business tax reduction such as S. 683 could rationally or successfully be undertaken. If S. 683 failed to include buildings at a cost recovery rate approximately comparable to that for equipment, S. 683 would not have fully addressed the capital cost problem of any industry. Moreover, S. 683 would have extended a major business tax reduction in a very discriminatory manner among different sectors of the economy. There would then be two classes of taxpayers, one of which is effectively taxed at a much higher rate than the other, even though their needed levels of capital investment in productive

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enterprise and their contributions to Gross National Product are the same or comparable. Inequity would not be the worst part of this irrational dichotomy. The worst part would be that Congress would have undertaken a major change in Federal tax policy in a way which would reduce, substantially, the likelihood that the new policy would be successful.

Distribution And Production Are Related

For example, through a combination of major tax reduction and budgetary restraint, it should be possible to achieve, quickly, a sufficiently large growth in real GNP so that, in a short period of time, the short-fall in Federal tax revenues will be made up and the deficit eliminated. However, if major elements of the sources of GNP were in whole or in part left out of this tax cut equation, then it could not rationally be expected that real GNP would increase as much. In this regard, it should be noted that the retail and wholesale industries alone account for about 17 percent of real GNP, and that the entire services sector of the economy, including the vital distribution sector of the economy, accounts for 52 percent. To wholly or partially exclude retailing and the rest of the distribution sector from S. 683 and the major business tax reduction involved, would make no more sense than to exclude the manufacturing sector.

No one would seriously suggest that S. 683 should include companies which manufacture machine tools but should exclude companies which use those machine tools to make automobiles.

It would be equally irrational to exclude the retail sector from a major part of the benefits of S. 683. An efficient distribution system exerts a strong pull-through effect on manufacturing and helps hold down final prices as reflected in the CPI. The final price of products includes both the costs of manufacturing and the costs of distribution. An efficient mass distribution system is just as important as an efficient mass production system. Inefficiencies in one will offset efficiencies in the other. Indeed, one cannot exist without the other.

Efficiency in retailing requires large fixed capital investments in buildings, including stores, warehouses and distribution centers. On the other hand, retailing is also associated with a large number of jobs, including a high proportion of women and minorities, per dollar of fixed capital investment. Retailing is also nationwide, not regional. All these retail characteristics are positive aspects in terms of enlarging real GNP, which desirable goal is dependent upon the efficient functioning of all the numerous interlocking elements in our complex economy.

The President's proposal correctly recognizes the importance of efficient mass distribution and the complex set of interrelationships in our economy which must be set in motion in order to achieve a greatly enlarged GNP. Therefore, S. 683 establishes a special category of industrial and retail/wholesale

distribution buildings which is provided a 10-year accelerated cost recovery rate. The 10-year cost recovery period for these buildings is directly comparable to the 5-year cost recovery period for equipment in the manufacturing sector. Based on past Treasury studies, both cost recovery periods bear about the same relationship to the estimated physical lives of the particular types of business property involved. Again like equipment in the 5-year S. 683 category, buildings in this special 10-year category are subject to full recapture of depreciation deductions under section 1245 of the Code; so that if the building were attempted to be sold at capital gains rates, all prior depreciation deductions would be recaptured and taxed as ordinary income. Moreover, this special 10-year category of buildings is limited to industrial and distribution buildings which a business firm owns and occupies in the active conduct of its own trade or business of producing goods and services. The owners of leased or syndicated buildings are not included in the 10-year category under S. 683.

Instead, S. 683, as proposed by the President, provides for an additional category of nonresidential business buildings, which will have a 15-year straightline cost recovery rate. This 15-year category includes those industrial and distribution buildings which are leased or syndicated, as well as all office buildings and other nonresidential buildings used for any purpose other than industrial or distribution purposes. Unlike equipment

and unlike the special 10-year category of industrial and distribution buildings, these buildings are not subject to section 1245 recapture. Thus, they may be sold at capital gain rates without recapture and without ordinary income tax on any prior depreciation deductions. While these buildings receive somewhat lesser cost recovery benefits, they receive a substantial additional benefit in the form of freedom from recapture of depreciation deductions.

Building Categories

By recognizing these two categories of business buildings, S. 683 achieves the desired goal, within the rationale of a major new cost recovery system, of providing substantially increased cost recovery rates for buildings acquired and used by America's business firms to produce goods and services (where leases, syndications, dispositions and recapture are not factors). At the same time, S. 683 does not greatly alter the rules, or create imbalances, with respect to that other category of speculation or development buildings, where lessors, and, frequently, syndications, are involved, and where freedom from recapture of depreciation is considered vital by the participants in those real estate developments.

The Administration's two-track approach in the case of business buildings seems to us in the retail industry to be sensible. In any event, it seems clear that any desire to preserve freedom from recapture of depreciation for those who benefit

from it, cannot stand in the way of providing appropriate 10-year accelerated cost recovery for those of America's business firms who acquire buildings to produce goods and services in their business, who do not receive any benefits from freedom from recapture, and who can only be assisted by more rapid accelerated cost recovery such as S. 683 provides.

For all these reasons, which range from concerns about the overall integrity and efficiency of any cost recovery system adopted by the Congress, to the particular role of the retail sector in our economy, we strongly support the President's Accelerated Cost Recovery System, S. 683.

Technical Suggestions

We would, however, suggest two significant technical defects in S. 683, where it differs importantly from 10-5-3 and ask that this Committee consider revisions in close cooperation with the Treasury.

The first of these defects and differences relates to the so-called "flexibility" rule under the original 10-5-3, which permitted a company the flexibility to deduct (in the year allowed) all, any part or none of the depreciation deduction provided. Any portion of the deduction which the taxpayer elected to defer, could then be used by the taxpayer in any future year. This flexibility is particularly important to new business, to businesses with cyclically high levels of capital investment, and all businesses with investment tax credits.

This flexibility in 10-5-3, which is absent from the particular statutory format submitted by the Administration for S. 683, permits maximum utilization of the investment tax credit. The flexibility rule is not of critical importance to the retail sector because much of the capital investment by retailers is excluded from the investment tax credit, which exclusion we believe is incorrect. Nevertheless, we believe that the flexibility rule in 10-5-3 is of such great importance to the proper functioning of the proposed new capital cost recovery system, that we join others in the business community in urging that it be restored to S. 683.

The second defect and difference from 10-5-3 does directly affect the retail sector. We believe that this defect was unintended and crept in during the technical drafting of S. 683. This relates to the fact that S. 683, in defining the 5-year category for machinery and equipment, refers to section 1245 which is related to section 48(a)(1)(B) for the investment tax credit. It so happens that because of an aberration in the investment tax credit certain retail properties, such as loading docks, are ineligible for the investment tax credit under section 48(a)(1)(B) and are accidentally excluded from the 5-year category under S. 683 even though the identical property used by any other business taxpayer is both eligible for the investment tax credit and eligible for the

5-year category under S. 683. We believe that this technical aberration in the investment tax credit should be corrected in order not to continue to treat retailers unfairly. We urge that this be done in connection with enactment of S. 683. At a minimum, S. 683 should be corrected so as not to further compound the inequity by, as the result of a technical cross reference, also excluding this particular retail property from the 5-year category under S. 683.

Individual Tax Cuts

In addition to our support for S. 683, we also strongly support the remainder of the President's comprehensive program of major individual income tax reductions and major reductions in the growth of Federal expenditures. The tax cuts for individuals should be applied as broadly and neutrally across the board to all taxpayers, as possible.

We also believe that the individual tax cut should be of the approximate size proposed by the President over three years. An across-the-board major reduction in marginal rates of tax applicable to all individuals, in all tax and income brackets, would be most desirable. Such a reduction in marginal tax rates applied to individuals would provide a significant incentive to greater productive effort and would provide a significantly increased ability to save and invest. The result should be an enlarged real GNP.

Our strong preference for the President's program of reduced marginal rates of tax, is not to deny that there might in the future still be some futher purpose to be served by specialized credits, deductions or exclusions to encourage additional amounts of savings by individuals. Rather, and having in mind that I am not a tax expert, I am merely suggesting that the effectiveness of such specialized exceptions seem to be premised upon and assume the existence of rather high nominal rates of tax. If that is the case, then it would seem that before considering such specialized proposals, the Congress should, as the President has proposed, first address itself to the fundamental question of how high marginal individual tax rates should be.

I will be pleased to attempt to answer any questions the Committee may have.

I thank you, Mr. Chairman, and the distinguished members of this Committee, for the opportunity to testify.

[A short recess was taken.]

Senator DANFORTH. Our next panel consists of William Wall, John Faircloth, John Harrington, Richard Loux, and Thomas Vanderslice.

If you gentlemen would like to proceed in the order of the names as they appear on the list.

## STATEMENT OF WILLIAM E. WALL, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, KANSAS POWER & LIGHT CO.

Mr. WALL. Mr. Chairman, if it please the committee, my name is William Wall and I am chairman and chief executive officer of the Kansas Power & Light Co.

I am speaking this morning for the Edison Electric Institute, the National Association of Investor Owned Utilities, which serves about 78 percent of all electric users in America, speaking about the tax aspects of S. 683 as it relates to investor-owned electric utilities.

Our position is one of strong support for S. 683, and we are most pleased that our industry is included within its provisions along with the rest of American enterprise.

We are also pleased that S. 683 makes mandatory the normalization of the benefits of accelerated depreciation. We think that only such an explicit provision will insure that the intent of this legislation, capital formation, is accomplished.

Capital formation is the single greatest problem facing my industry today, and no matter what assumptions one makes about future energy growth, or about conservation the inescapable reality is that our needs for capital during the rest of this century will continue to be enormous. In fact, just between 1981 and 1990, the decade we are in, by conservative estimates we will expend about $365 billion on powerplants, transmission lines, substations, and related equipment. Some to be built because old facilities wear out, some because they use oil and natural gas and must be replaced, and some because more electricity is used each year than the year before, and we must be able to satisfy that demand by building new plants.

While faced with the need to finance this massive construction program, we find ourselves today unable to generate enough capital internally and unable to attract the investment community to our securities.

It is regrettable, but true, that investors in this country and abroad view electric utilities as weak and distressed. What should be a strong industry, able to meet our people's electric energy requirements for home, industry, and farm, as it once was, is today unable to fully recover its costs or attract the capital it needs to renew itself.

Enactment of S. 683 would be a positive step toward easing that situation and, in general, we support the provision wholeheartedly.

If I may be permitted, I have two brief comments we believe would improve the bill.

First, we object to section 203(d). Briefly, it would take away, not add to, the capital formation provisions we already enjoy under existing law.

If 203(d) were to become law, it would allow regulatory agencies to defeat the purposes of the President's accelerated cost recovery system, not to effectuate its purpose, capital recovery, by bringing about short-term reductions in the cost of electricity in disregard of grave long-term consequences. Under present law, our customers and investors share benefits of the investment tax credit. Section 203(d) would end that, and make the consumer the sole beneficiary.

Congress has made it clear that it intends the sharing of credits between customers and investors in enacting the rate limitations applicable to public utilities. It is also worth noting that if section 203(d) were enacted, it would not only reduce cash flows to utilities, but result in a revenue loss to the Treasury.

We also believe that there are at least two additions to the bill which would be constructive.

First, to achieve the full purpose of the bill, we would urge that investment tax credits for electric utilities earned be used fully, without reducing benefits growing from accelerated depreciation. Put differently, investment credits would be used before the accelerated capital cost recovery allowance.

Last, we would strongly urge on principals of basic fairness that the tax advantages of using accelerated depreciation for construction work in progress be available to electric companies only when that same construction work in progress is allowed in rate base, to produce the very revenue which gives rise to the tax liability in the first place.

That concludes my remarks, Mr. Chairman. Thank you.

The CHAIRMAN. Mr. Faircloth.

## STATEMENT OF JOHN W. F. FAIRCLOTH, VICE PRESIDENT, TAXES, COLUMBIA GAS SYSTEM SERVICE CORP., ON BEHALF OF THE AMERICAN GAS ASSOCIATION

Mr. FAIRCLOTH. Thank you, Mr. Chairman. Mr. Chairman and Members of the committee, my name is John Faircloth and I am vice president, taxes, of the Columbia Gas System Service Corp.

I am testifying this morning on behalf of the American Gas Association and I would like to begin my testimony by saying that the AGA-member companies welcome and support the capital formation incentives which are provided in S. 683. To the extent that our member companies can benefit from, and are affected by this bill, I offer this testimony today and I also respectfully request the opportunity to supplement my remarks in the written record of these hearings.

Mr. Chairman, the challenge of forming new capital is a critical one for all American business, particularly so for capital-intensive industries such as the regulated gas industry. The AGA member companies believe that the accelerated cost recovery system which S. 683 provides would have a significant and positive effect on capital formation and will go far to rectify the serious difficulties that are currently facing the regulated gas industry in raising new capital. For these reasons, the AGA-member companies strongly support the capital formation principles underlying the depreciation reform aspects of S. 683.

As to the compelling need in our industry for new capital, an AGA study estimates that the cumulative investment that will be

required between now and the year 2000 is approximately $400 billion expressed in 1980 dollar terms. This will be necessary in order to finance the development of new gas supplies and the construction of additional pipeline and local distribution facilities. In short, over the next decades stimulating capital formation will be one of the most fundamental challenges facing the regulated gas industry and our nation as well. Indeed, the importance of stimulating capital formation in the regulated gas industry cannot be overemphasized if our Nation is to develop additional domestic energy supplies and reduce our dependence on imported oil.

At this point, Mr. Chairman, I would like to mention some specific provisions of S. 683 and how those provisions affect the regulated natural gas industry.

First, the American Gas Association strongly supports the requirement in S. 683 that, in order to be eligible for the accelerated cost recovery deduction, new investments in public utility property must be subject to a normalization method of accounting for ratemaking purposes. AGA's reasons for supporting this normalization requirement are the same as those which the Congress relied in providing normalization accounting for accelerated depreciation in the Tax Reform Act of 1969.

Now, as then, those reasons are: first, to implement the congressional intent to create a capital formation mechanism which stimulates new investment and plant modernization and second, to prevent the substantial future revenue losses to the Treasury which would occur if regulatory commissions are able, for ratemaking purposes, to flow through to ratepayers the excess of the capital cost recovery deduction over book depreciation expense.

In addition, normalization is equitable as between current and future ratepayers because under that method all ratepayers are able, over the lives of the assets, to share in the additional tax depreciation generated by the utility's capital investment.

The second point we would like to emphasize is that the AGA-member companies endorse the approach taken in S. 683 under which most new gas pipeline and local gas distribution facilities are placed in the 10-year recovery class. AGA believes that this 10-year period, together with the 4-year phase in feature of the bill, will be sufficient to enable our industry to compete successfully with other business in attracting new capital investment and at the same time this 10-year period will prevent the rapid build up in our deferred tax reserves and the concomitant reductions in our rate base which would otherwise occur if we were in the 5-year class.

Finally, I would like to add to what the other witnesses said by noting that the AGA is also substantially concerned about the effect of section 203(d) of the bill on our industry and we strongly recommend that that provision be removed.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Harrington.

## STATEMENT OF JOHN E. HARRINGTON, ASSISTANT COMPTROLLER, AMERICAN TELEPHONE & TELEGRAPH CO.

Mr. HARRINGTON. Thank you, Mr. Chairman. My name is John Harrington and I am assistant comptroller of the American Telephone & Telegraph Co.

I appreciate the opportunity to testify here today.

While I would like to make a brief statement at this point, I ask that my testimony be incorporated into the record.

The Bell System shares President Reagan's concern about the Nation's current economic condition and supports his efforts to reduce inflation and to achieve economic growth through capital formation and increased productivity.

We have long been in favor of a tax policy that assists in the formation and the preservation of capital. I must point out, however, that there are two provisions of the bill which cause us some serious concern.

One of these provisions deals with the investment tax credit, the other relates to the 10-year recovery period for most of our telecommunications property.

Let me address the investment tax credit first. The purpose of this credit is to stimulate additional investment by reducing the cost of acquiring property. This, in turn, increases the profitability of the investment.

To assure an investment incentive for public utilities, Congress provided that the benefits of the credit should be shared between the utility's customers and its shareowners.

In the Bell System, this sharing is achieved by amortizing the investment tax credit over the life of the plant generating that credit with our customers receiving the benefits of lower rates and, at the same time, our shareowners benefit by earning on the unamortized balance of the investment tax credit.

Section 203(d) of the administration bill—termed a technical amendment—would repeal the sharing concept of present law. Thus all the benefits of the investment credit will be passed on to the utility's customers and none of the benefits would inure to its shareowners.

Such regulatory action would convert the investment credit from an investment incentive which increases profitability to a source of cost-free capital which reduces prices.

This is contrary to congressional intent in establishing the credit. I do understand, however, that Treasury now intends to support the deletion of section 203(d) from the bill.

Turning now to the accelerated cost recovery system, the administration proposals specify that telecommunications property with a present ADR midpoint life of more than 18 years is in the 10-year class, rather than the 5-year class, if it is owned by a regulated public utility.

On this basis, 60 percent of our equipment would be placed in a 10-year class solely by reason of it being considered public utility property.

This discrimination and this treatment puts us at a competitive disadvantage with nonregulated providers of communication services.

There is pervasive competition in the telecommunications industry today. This competition is increasing and it affects all of our plant investment, so that by subscribing to various competitive services, customers may bypass part or all of the Bell System's premise equipment, switching and distribution plant.

Given this fact, it is inappropriate to place the property of a regulated telecommunications company in a less favorable class while similar or identical property of its unregulated business competitors obtains a capital-recovery period which is twice as fast.

Such discrimination between direct business competitors should not be introduced in the tax law. The tax law should be neutral. This is particularly true and important at this time when national telecommunications policy is moving toward deregulation.

Again, I thank you for the opportunity to present our views.

Senator DANFORTH. Mr. Loux.

## STATEMENT OF RICHARD C. LOUX, CHAIRMAN OF THE KANSAS STATE CORPORATION COMMISSION, ON BEHALF OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

Mr. LOUX. Senator, my name is Pete Loux. I am chairman of the Kansas State Corporation Commission and chairman of the Committee on Accounts of the National Association of Regulatory Utility Commissioners, commonly known as NARUC.

NARUC is a quasi-governmental nonprofit organization whose members include the regulatory bodies of the 50 States, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands.

The members appreciate your invitation to make our views known on Senate bill 683, a bill relating to the tax reform proposals of the President's economic recovery program.

In view of the time restrictions, I will confine my remarks to section 203(d) of the tax bill, which vitally concerns the consumers of the utility services in the State of Kansas and throughout the United States.

Section 203(d) is a technical amendment relating to the accounting treatment of the investment tax credits available to public utility companies. Given the complex nature of this matter, the effects of the proposed amendments can probably be viewed best by using a hypothetical example.

Assume that a utility company purchases an asset which costs $100,000 and that this asset has a life of 10 years. Because the asset qualifies for the investment tax credit, the utility company will be entitled to deduct 10 percent of the cost of the asset—in this case, $10,000—from the tax obligation which the company would otherwise owe the Federal Government.

Thus, the real cost of the asset to the company has been reduced to $90,000 since the Government has in effect provided a $10,000 capital subsidy at zero cost to the utility.

The controversy arises over how the benefit of this $10,000 investment tax credit should be accounted for in the utility ratemaking process. Current tax law provides that there should be a sharing of the ITC benefits between utility shareholders and ratepayers via an accounting technique known as normalization.

However, most of the utility companies have elected a normalization option, known as cost-of-service normalization, which is considerably more beneficial to the shareholders, to the detriment of the ratepayers.

Furthermore, this normalization option is inconsistent with the time-honored principles of the regulatory process.

Applying the cost-of-service normalization to the hypothetical case described earlier would call for the utility company to deduct one-tenth of the $10,000 benefit from the amount of revenues which the utility would otherwise be allowed to collect from ratepayers during each year of the life of the asset.

Thus, allowed revenues would be reduced $1,000 annually over the 10-year life of the asset.

During the period, the portion of the ITC benefits which have not been deducted from allowed utility revenues is listed in the company's balance sheet as an accumulated deferred investment tax credit.

The inequity results from the current tax law which forces ratepayers to pay a rate of return on this accumulated amount, just as though the investment tax benefits had been provided by the utility company's shareholders and bondholders.

However, as the hypothetical example shows, none of these benefits was provided by the utility's shareholders or bondholders but rather was provided as a capital subsidy at zero cost to the recipient utility.

The rate of return on the accumulated investment tax credits which utility customers in the State of Kansas and throughout the United States are being forced to shoulder is staggering and is actually increasing annually.

In a 1980 report published by the Energy Information Administration, the accumulated deferred investment tax credits of 205 class A and B privately owned electric utilities increased over $1 billion in a 12-month period from yearend 1978 to yearend 1979.

The Reagan administration has wisely proposed a technical amendment to the Internal Revenue Code which would allow the utility companies to continue to enjoy the capital formation incentives created by the investment tax credit without forcing utility ratepayers to pay a rate of return on the investment tax benefits.

In essence, section 203(d) is a recognition that the investment tax credit is a zero-cost capital subsidy to the industry which has actually been provided for by the ratepayers.

In hearings before the House Ways and Means Committee, utility representatives have repeatedly argued that section 203(d) would destroy the concept that the investment tax credit benefits should be shared by utility shareholders and ratepayers alike.

However, a recent economic study, to be published in the Journal of Business, proves that this argument is faulty. The article, written by Dr. Donald Kiefer of the Congressional Research Service, advocates an accounting technique known as economic normalization, which is essentially identical to what has been proposed in section 203(d) of the President's tax package.

Dr. Kiefer, who has performed exhaustive research in this area, concludes that: "economic normalization is consistent with the logic of the regulatory process, provides appropriate utility rate

reductions to consumers, and benefits utility companies through higher cash flows while avoiding providing 'excess profits' to the utility."

The inclusion of section 203(d) in this year's tax package is a vital concern to consumers of utility service throughout the United States. This proposed reform has the full support of NARUC.

Senator DANFORTH. Mr. Vanderslice.

STATEMENT BY THOMAS A. VANDERSLICE, PRESIDENT AND CHIEF OPERATING OFFICER, GENERAL TELEPHONE & ELECTRONICS CORP.

Mr. VANDERSLICE. Thank you, My name is Tom Vanderslice. I am president of GTE. GTE's telephone companies which comprise about 52 percent of our revenue provides service to approximately 16 million telephones in the United States.

I do appreciate the opportunity to appear today and testify on behalf of my company and on behalf of USITA, the U.S. Independent Telephone Association.

USITA represents the interest of some 1,500 independent telephone companies which provide about 35 million telephones and I find it necessary to testify to call your attention to two provisions in the bill that would impose serious inequities in the telephone industry.

I have submitted a detailed written statement on both those provisions and asked that they be incorporated into the record at this point.

Accelerated cost recovery system is the linchpin of the President's tax proposal for business. We applaud its underlying purpose of providing additional capital to businesses.

Unfortunately, my industry the highly intensive telephone industry has been treated as a stepchild under ACRS and excluded from its full benefits made available to our competitors. It can no longer be any argument about the existence of competition of telephone industry.

The FCC has opened the telephone industry to competition in all phases of its businesses and today we face competition from many well-capitalized competitors such as Exxon, IBM, Xerox, I.T. & T, RCA and so forth.

ACRS would permit most businesses including many of our competitors to recover their equipment costs over a 5-year period. We in the telephone industry would be restricted to a 10-year recovery period for he majority of our equipment.

No sound policy reasons supports his discriminatory treatment of telephone companies. It is based on a false premise that telephone property has an extremely long economic life and using as its measure rod the ADR guideline lives.

These guidelines for telephone properties are over 10-years old and they are hepelessly out of date and they are out of step with the new technology and new competition in the telephone industry.

The FCC has recently recognized that these forces are dramatically shortening the lives of telephone equipment and improved capital recovery is a critical issue for the industry.

It would be unfortunate if Congress and ACRS did not also recognize the telephone industry as it really is today and treat us

in an undiscriminatory manner, because we in the telephone industry are prepared to meet our new-found competition head on and to serve our country effectively and efficiently.

But, we simply cannot be asked to do so with one hand tied behind our backs as would happen under ACRS in the present form.

I would like to turn now, briefly, to the proposal in S. 683 which would change the way in which a utility accounts for he investment tax credit.

Because, cloaked in the disguise of a technical amendment, this proposal would in fact make a very substantive and adverse change.

The proposal is not new. Just last year, the House Ways and Means Committee overwhelmingly rejected a similar proposal, H.R. 3165 introduced by Congressman Stark, in one fell swoop, this proposal would eliminate the accounting rules that Congress carefully fashioned over a period of years and remove the stimulus and ability of utilities to make investments.

It would frustrate the very purpose sought by Congress in enacting a credit. It would reduce substantially the capital available to utilities just at the time when the utilities, buffered by inflation, suffered their greatest need for capital.

Most of us are shocked that the proposal is included in the President's economic recovery program. A program whose very purpose is to increase capital recovery for industry as a whole. Surely destroying our utilities is not the solution to strengthening our industrial base.

We are heartened to see that the Treasury Department has reconsidered its position and publicly announced that it will seek to remove this proposal from the bill and unquestionably this is the right result.

Thank you.

Senator DANFORTH. Well, it is my understanding that the Treasury Department's position on section 203(d) is that in fact it will remove it from the bill. Your argument is well put.

Could you just explain this issue a little more?

As I understand it there in essence, identical equipment that at A.T. & T. would have a useful life of more than 18 years.

Mr. HARRINGTON. That's correct. More than 18 years on the ADR schedule at this point in time. We do have property—two-thirds of our property falls in that category today and this then would be forced in the 10-year class for identical equipment used by our competitors would have a 5-year life. For example, microwave——

Senator DANFORTH. It would be 10 years versus 5.

Mr. HARRINGTON. Yes, sir.

Senator DANFORTH. Can you give us an example of what this equipment is, what it is used for, assuming that the members of this committee are not knowledgable in this area. We know what a telephone receiver looks like—but could you explain what the equipment is and what position you're in and your competitors are in?

Mr. HARRINGTON. Yes, sir. If you will accept a technical explanation from an accountant.

In a nutshell, take microwave equipment as an example. Some of our competitors for example, MCI will use our local switching network. You pick up a telephone, you want to make a long distance call through the MCI facility. You will have used our local distribution plant to take you to the central office. The central office will then switch you to the MCI facility. They will then use microwave equipment to span the long-distance part of that particular conversation and then reverse the situation on the other end.

So, here we would have a situation where microwave equipment is involved. We would have to use a 10-year writeoff, MCI, our direct competitor in this phase of the business would use a 5-year writeoff.

Senator DANFORTH. A.T. & T. is in that position. Are you alone in that position.

Mr. HARRINGTON. No; G.T. & E. also and many of the other telephone companies as well.

Senator DANFORTH. Why?

Mr. HARRINGTON. We believe that it is just discrimination.

Senator DANFORTH. I know, but why—what is the difference?

Mr. HARRINGTON. Oh, the operative provision in the ACRS law says that a 10-year life applies if property is owned by a public utility. A.T. & T. is considered by definition, a public utility, G.T. & E. and other companies as well, but MCI is not.

So our recommendation, vis-a-vis, that particular part of the statute would be to exclude telecommunication companies from that particular aspect.

Senator DANFORTH. If that were done, would the problem be taken care of?

Mr. HARRINGTON. Yes, sir.

Senator DANFORTH. Senator Dole sent word over that he, unfortunately, is tied up. For each of you I know it is very disappointing that you have come all this distance and you have only one Senator here—I apologize. I hope you don't think it is a waste of your time because your testimony will be reviewed by both the members and their staffs.

[The statements of the preceding panel follow:]

Summary of the Statement of William E. Wall
Chairman of the Board and Chief Executive Officer of
The Kansas Power & Light Company
on behalf of the
Edison Electric Institute
Before the U.S. Senate Committee on Finance
May 21, 1981

I. EEI supports the Administration's Accelerated Cost Recovery System (ACRS). As included in the legislation:

A. The electric utility industry should be included with industry generally in the new system for capital recovery;

B. A normalization method of accounting must be mandatory if the electric utilities are to achieve the intent of the legislation - capital formation.

II. The financial condition of the electric utility industry is poor:

A. Large amounts of capital are needed to construct facilities to meet the electric energy demands of the nation;

B. The electric utility industry can obtain capital from issuing new stock, selling bonds, or from the internal generation of capital;

1. Electric utility stock is selling below book value and bonds are only being marketed at extremely high interest rates;

2. Normalized accelerated depreciation deductions and investment tax credits (ITC's) internally generate capital.

III. EEI opposes the inclusion of Section 203(d) of S.683, which changes the public utility treatment of ITC's (Section 46(f) of the Internal Revenue Code).

IV. ACRS:

A. A survey of the electric utility industry indicates that ACRS would improve internal cash flow for electric utilities;

B. Two modifications of ACRS would better enable it to serve its intended purpose:

1. ACRS deductions should be available to the electric utility industry only to the extent that such deductions do not diminish the utilization of ITC's;

2. ACRS deductions based on expenditures for construction work in progress (CWIP) should be available to the electric utility industry only to the extent that such expenditures are included in ratebase for ratemaking purposes.

V. EEI supports efforts, at the appropriate time, to lessen the tax burden on individuals through the enactment of tax-deferred dividend reinvestment. It would aid the generation of capital from external sources.

VI. There are other tax issues which EEI hopes the Committee will address when it deems appropriate: providing for current deductions for decommissioning and spent fuel handling costs associated with nuclear power plants; making Tax Reduction Act Stock Plan (TRASOP) credits permanent; rescinding provisions of the Internal Revenue Code which exclude public utilities from the benefits of energy tax credits; and providing for expansion of the availability of tax exempt bond financing to help finance specific energy projects.

DRAFT

STATEMENT OF WILLIAM E. WALL

CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER OF

THE KANSAS POWER & LIGHT COMPANY

ON BEHALF OF THE

EDISON ELECTRIC INSTITUTE

BEFORE THE COMMITTEE ON FINANCE

U.S. SENATE

S. 683

May 21, 1981

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Mr. Chairman and Members of the Committee:

I am William E. Wall, Chairman and Chief Executive Officer of The Kansas Power & Light Company, and am here today on behalf of, and to express the views of, the Edison Electric Institute (EEI) with respect to the tax aspects of the President's Economic Program, specifically S. 683. EEI is the national association of investor-owned electric utilities in the United States. The member companies of EEI serve 99.6 percent of the ultimate customers in the investor-owned segment of the industry. EEI member companies serve about 69.6 million electric consumers, which comprise 77.5 percent of all electricity users in the country.

Our industry wholeheartedly endorses the Administration's Accelerated Cost Recovery System (ACRS) as provided in the Economic Recovery Tax Act of 1981 (S. 683). The electric utility

industry should be included with industry generally in any system of capital recovery, and, therefore, we are pleased that ACRS is to be available to our industry. We also are pleased that the legislation requires a normalization method of accounting for public utility property.

FINANCIAL CONDITION OF THE INDUSTRY

We are concerned with our industry's ability to finance the construction of electric generating plant and related transmission and distribution facilities to meet the country's future energy requirements. Thousands of jobs depend upon an adequate supply of electricity, and thousands more will be created in the construction of these needed electric facilities. We believe President Reagan's economic recovery program will help our industry meet these challenges.

A February 28, 1981 article in The Economist entitled "The Lights Are Going Out for America's Electric Utilities" states,

> America's electricity generating industry is in such deep financial trouble that it will provide the Reagan administration with its biggest industrial problem, dwarfing the troubles of steel and cars. The electricity utilities are squeezed by soaring construction costs, record interest rates, sluggish (and controlled) revenues, and long delays to most building projects because of environmentalist's objections. If the squeeze continues, parts of the country could be short of electric power by the end of the decade. Some utilities could go broke, heralding the end of America's mostly private electricity industry and thwarting President Ronald Reagan's free-market mission.

Similar statements regarding the electric utility industry have

been made in various financial publications. However, enactment of ACRS would alleviate some of the "squeeze".

The electric utility industry is faced with having to construct 400,000 megawatts of new facilities by the year 2000, if we assume a growth of GNP of only 1.7% per year. This information results from a study conducted by economic consultants using a low growth scenario. Growth, plus the following factors contribute to this 400,000 megawatts figure:

> 100,000 megawatts of existing generating capacity will have to be retired;
>
> 45,000 megawatts of gas burning capacity will have to be replaced prematurely if the provisions of Section 301(a) of the Power Plant and Industrial Fuel Use Act (restricting the use of gas) remain in force;
>
> over 50,000 megawatts of oil burning steam generating facilities which can not be converted to coal should be replaced in keeping with the National policy to reduce dependence on foreign energy sources.

EEI projects that for the ten year period 1981-1990, outlays on electric plant and equipment by investor-owned utilities will total $365 billion. This estimate, which is based on forecasts supplied by a sample of companies representing 30% of investor-owned electric revenues, incorporated an estimated average inflation rate of 9%.

From where will this heavily regulated industry raise the funds for this necessary construction? Companies either must generate the capital internally, issue bonds or issue new stock.

## COMMON STOCKS

A recent study by Salomon Brothers shows that the common stocks of 98 of 100 electricity utility companies are selling below book value. In 1980 earned return on equity fell to 11.4%, although state regulatory commissions, in rate cases decided during the year, authorized equity returns averaging 14.2%. This extreme discrepency between what is needed and what can be earned in the face of today's inflation is the major reason why most utility stocks are selling at less than 75% of their book values.

Individuals are hesitant to invest in stocks selling below book value. In addition, whenever a utility issues new stock, below book value, the value of the current stockholder's stock is diluted. These factors act as a deterent to individuals purchasing newly issued electric utility stock, making the raising of capital from this source more difficult.

## BONDS

Recently, electric utility companies have been forced to pay interest rates in the 17 percent range in order to market their long term bonds. Needless to say, high interest rates strain even healthy companies. Some utilities have found these rates so prohibitive that they have been forced to cancel or postpone issuing long term bonds.

## INTERNAL GENERATION OF CAPITAL

Given these problems associated with raising capital through issuing new stock or bonds, let us consider the internal generation of funds. Accelerated depreciation and investment tax credits (ITC's) are federal tax benefits which provide internal generation of capital to business. An electric utility internally generates capital from the normalization of accelerated depreciation and ITC's as well as earning a rate of return on ratebase. Normalization is the method of accounting which insures that the federal tax benefits of accelerated depreciation and ITC's are used to internally generate capital as opposed to being diverted into temporary rate reductions by public utility commissions.

Such temporary rate reductions would only force the utilities to raise the needed capital from more expensive external sources like the bond market. Because ratepayers must pay the costs associated with bonds, they would actually be paying higher rates for their electricity.

## NORMALIZATION

Many individuals are not familiar with how normalization operates. Normalization is a method of accounting which equitably allocates

lifetime tax benefits to all ratepayers who pay for the property investment and provides cash flow to utilities for the capital formation purposes intended by Congress. Let us briefly review the accounting mechanism to better understand how normalization achieves these results.

For public utility commissions to establish rates, they must determine the utility's cost of service and establish a rate of return which the utility can earn on its ratebase (generally assets). Tax expense is one component of cost of service. For ratemaking purposes, public utility commissions assume utilities pay federal tax based on straight line depreciation. Since they actually use accelerated depreciation, the difference in tax caused by the use of accelerated depreciation is categorized as a deferred tax reserve. ITC's are also separated into a deferred tax reserve account. The deferred tax reserves provide a source of interest free capital for the utility to use.

Deferred tax reserves stemming from accelerated depreciation are deducted from ratebase. Under current law deferred tax reserves stemming from ITC's are either deducted from ratebase or amortized to cost of service. The amounts in the deferred tax reserves are spread pro rata over the useful life of the related facilities.1/

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1/ The pro rata sharing of ITC's over the lives of the related properties is technically referred to as pro rata flow-through. However, individuals other than tax technicians use the term normalization to refer to both the pro rata sharing of accelerated depreciation and ITC's.

Given the poor financial health of the electric utility industry, plus the large amount of capital necessary to meet the most minimal requirements of the future, the ability to internally generate capital through accelerated depreciation and ITC's is crucial to this industry.

SECTION 203(d) OF S. 683

In 1971, Congress adopted what is now section 46(f) of the Internal Revenue Code, dealing with public utility treatment of ITC's. Because of the highly regulated nature of the public utility industry, Congress provided utilities with a choice of methods for treating ITC's. Utilities had a choice of either reducing the ratebase or the cost of service.

One method permits a regulatory commission, in setting rates, to deduct the unamortized credit from a utility's rate-base to which a rate of return is applied. Under this option, a regulatory commission may not reduce a utility's cost of service to reflect any portion of the credit. Under the second option, a regulatory commission is permitted to pass the ITC benefits on to ratepayers as a reduction in cost of service over the life of the asset creating the benefit, but not more rapidly than ratably. Under the second option, a utility's ratebase may not be reduced for the ITC.

Using one method or the other causes the benefits of ITC's to be shared between ratepayers and stockholders, and

achieves Congress' intent that "some of the benefit, at least, will go to the investors".2/

The internal generation of capital from ITC's results from the actual amount of the tax credit and the rate of return that is earned on the corresponding amounts in ratebase. The following figures show the amount, in millions, of capital internally generated to the electric utility industry by the actual credit, and the percentage of total construction costs that it represents.

| | | |
|---|---|---|
| 1976 | $ 1,193 | 6.8% |
| 1977 | 1,380 | 6.3 |
| 1978 | 1,314 | 5.7 |
| 1979 | 1,134 | 4.5 |
| 1980 | 1,330 | 5.0 |

Section 203(d) of S. 683 would amend section 46(f) of the Internal Revenue Code allowing a public utility commission to make both the ratebase and cost of service deductions in calculating rates. If this section is enacted into law, the internal generation of capital from the return on ratebase associated with the amount of the credit would be lost.

The clear intent of the Economic Recovery Act of 1981 is to encourage capital formation, particularly within highly capital intensive industries. Inclusion of section 203(d) would be most counterproductive to that goal.

We are heartened to learn from officials of the Department of the Treasury, that the Department will withdraw its support

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2/ See The Revenue Act of 1971, Senate Report No. 92-437, 1972 - 1 C.B. 559, 579.

of Section 203 (d) of S. 683. We understand that the Administration will formally convey that position in letters to Senator Robert Dole, Chairman of the Senate Finance Committee, and Congressman Dan Rostenkowski, Chairman of the House Ways and Means Committee, in the very near future.

ACCELERATED COST RECOVERY SYSTEM

Enactment of ACRS would be an important step towards providing needed capital and improving the overall financial condition of American business, especially the electric utility industry, by increasing the internal cash flows. The provisions in the bill requiring normalization of the benefits of ACRS for ratemaking purposes for public utility property are very important to our industry and are essential if the objectives of the proposal are to be fully realized.

Results from a recent industry survey, which included responses from more than 60 companies, representing approximately 75 percent of total utility plant, indicate significant internal cash generation benefits from the ACRS program. The operation of the transitional rules -- the phasing in of the shortened lives, the fact that ACRS is only applicable to expenditures

after 1980 -- coupled with the elimination of the repair allowance will greatly diminish the impact in the years 1981 and 1982. These companies report that in 1985, when the ACRS phase-in is completed, additional deductions for this 75 percent of the industry will amount to more than 4.5 billion dollars. At the present tax rates of 46 percent, this could produce more than $2.0 billion of additional capital from internally generated funds. These figures are based upon commencing the ACRS deductions when qualifying construction expenditures are made as is permitted by S. 683. Charts setting forth the foregoing information and other data are attached as Appendix A.

Although we enthusiastically support ACRS, we urge the adoption of two modifications which would enable ACRS to better serve its intended purpose.

USE OF ACRS JEOPARDIZING THE USE OF ITC'S

Under ACRS, depreciation deductions are mandatory. The construction plans for this industry will result in large depreciation deductions. Most of our companies will be able to absorb these additional depreciation deductions, but some will be able do so only at the cost of carrying forward to future years increased amounts of ITC's with the hope of using them in years beyond 1985. Thus, ACRS deductions may put some electric utility companies into the position of not being able to use their ITC's, despite the carryover period being extended from seven to ten years.

Investment tax credits are more important to a utility and its customers than depreciation deductions because (1) ITC's are a permanent reduction in tax, while ACRS deductions would result only in a deferral of the time when tax is paid; and (2) normalized ITC's provide more internally generated capital than do depreciation deductions. This results from the fact that under current law, utilities can earn a rate of return on amounts corresponding to ITC's, but not on amounts corresponding to accelerated depreciation. Increased amounts of internal generation of cash from ITC's, as opposed to accelerated depreciation deductions, means that more money is internally generated. As we have discussed, funds so generated do not have to be raised by going to the more expensive external markets.

We urge that the legislation be amended to provide that ITC's must be fully utilized by an electric utility before the ACRS deductions are permitted. This amendment would insure that the economic benefits of ITC's are fully realized by an electric utility and its customers.

## ACRS DEDUCTIONS ON CONSTRUCTION WORK IN PROGRESS FOR ELECTRIC UTILITIES

There is one more modification of ACRS which we urge. First, however, let us consider the background to the problem.

Many public utility commissions do not allow an electric utility to earn a rate of return on an asset while it is being

constructed. This is done by not including construction work in progress (CWIP) as part of the ratebase when rates are being established.

We previously mentioned that no rate of return is allowed to be earned on reserves attributable to accelerated depreciation. This is accomplished by deducting such reserves from ratebase.

Under the provisions of S. 683, depreciation can begin when the expenditure is made. However, a public utility taxpayer can elect to commence depreciation when the property is placed in service rather than when the expenditure is made. The election, if made, must be followed for all subsequent years unless the Secretary of Treasury consents to a revocation of the election.

Elective provisions present a unique problem for regulated industries. A public utility commission may impute a different election to the detriment of the utility. A situation could develop where a utility is not earning a rate of return on CWIP, because the assets are not included in ratebase. The utility could elect to not take depreciation until the asset is placed into service, properly matching revenues with depreciation. However, if the public utility commission imputed the election to take depreciation while construction was in progress, the corresponding imputed amount of deferred tax reserve would be deducted from rate base. In this manner, not only would the

utility not earn a return on CWIP but a return would be denied on an additional amount of ratebase as well. While this is obviously unfair, it could occur.

ACRS deductions allowed for construction expenditures should be available to an electric utility only to the extent its construction work in progress is included for ratemaking purposes in the ratebase of the utility in the same manner as plant in service. Only with this modification would there be a matching of ACRS deductions with a revenue flow from the related properties.

These two proposed modifications would be more in conformity with the intent of the ACRS to simplify capital recovery and provide certainty to capital investment decisions.

TAX DEFERRED DIVIDEND REINVESTMENT

We strongly support efforts, at the appropriate time, to lessen the tax burden on individuals through the enactment of a provision for tax-deferred dividend reinvestment. Tax deferral would act as an incentive to individuals who have invested in common stock of American corporations to increase their savings by reinvesting their dividends in newly issued stock of their company. Such an aid to the generation of capital from external sources would complement the ACRS proposal, which is designed to increase the internal generation of capital.

The electric utility industry must obtain much of the capital it requires through sources other than the internal

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generation of cash. In an effort to develop a system to take care of some part of their financing problems, many companies have adopted dividend reinvestment plans using newly issued stock. Under present law, an individual who participates in such a plan must pay inoome tax on the dividends.

Legislation has been introduced, S. 141 and H.R. 654, which would allow stockholders electing to receive dividends in the form of newly issued common stock rather than cash, pursuant to a qualified dividend reinvestment plan, to exclude from their gross income up to $1,500 per year, or $3,000 per year for a joint return. This income would be recognized upon sale of the stock. Thus, federal tax is deferred. We believe this would be a major contribution to capital formation.

On May 4, 1981 the Honorable John E. Chapoton, Assistant Secretary for the Tax Policy, Department of Treasury, testified before the Subcommittee on Savings, Pensions and Investment Policy of the Committee on Finance. Regarding dividend reinvestment plans he stated,

> ...Because the proposed incentive would apply only to a portion of capital income (dividend paying stock), much of the cost of the proposal is incurred for taxpayers who merely maintain their current behavior and do not actually increase their savings.

We respectfully disagree with this position taken by Mr. Chapoton. The proposal only applies when dividends are reinvested in a qualified plan, as opposed to being spent on groceries or even invested in another fashion. Tax-deferred dividend reinvestment takes dividends (income) and encourages people to

invest rather than consume them. Investing rather than consuming increases savings.

Mr. Chapoton also stated,

> ... Further, because the investor could reallocate portfolio assets to receive this tax break, it would not be necessary to increase savings in order to receive the benefits of the proposal.

Again, we must respectfully disagree. Reallocating portfolio assets does not give rise to this benefit. If an investor purchased stock in a company,the purchase of the stock would not come within this proposal. Only when the dividends of a company are reinvested in a qualified plan, which increases savings, does the tax deferral apply.

OTHER ISSUES

There are other tax considerations of concern to the industry which we hope the Committee will address when appropriate.

DECOMMISSIONING AND SPENT FUEL HANDLING COSTS ASSOCIATED WITH NUCLEAR POWER PLANTS

A few regulatory agencies permit the rates charged to customers of an electric company that owns a nuclear power plant to include an amount which will be used for the future decommissioning of that plant or for the handling of spent nuclear fuel. These amounts are currently taxable. No corresponding deduction is now allowed, because, according to the Internal Revenue Service, such anticipated costs do not meet the test of ascertainable time and amount required for a current tax deduction. Thus,

approximately half of the funds that are collected for the purposes of decommissioning nuclear power plants and handling spent fuel are instead paid in taxes, effectively doubling the amounts which must be currently collected from our ratepayers.

We propose that a current tax deduction be allowed in amounts equal to the charges in rates for the purposes of paying decommissioning and the handling of spent fuel. This would permit the utility to accumulate the full amounts that are collected from customers for such purposes. There would be no loss of revenue to the Treasury except to the very limited extent that amounts now collected by utilities for these purposes would be offset by the newly created deductions. This legislation is needed to minimize the impact on utility ratepayers resulting from the decommissioning of a nuclear power plant at the end of its useful life and the handling of spent nuclear fuel.

## TAX REDUCTION ACT STOCK OWNERSHIP PLAN CREDITS

TRASOP credits permit employees to have an ownership interest in company stock and thus participate in the free enterprise system. Such credits act to improve employee morale and efficiency. We, therefore, recommend that TRASOP credits be made permanent as proposed in S. 1162 to insure that this capital source to the company and benefit to employees is maintained.

## ENERGY CREDITS

The Energy Tax Act of 1978 and the Crude Oil Windfall

Profit Tax Act of 1980 amended the Internal Revenue Code by authorizing certain energy tax credits which are made available to individual and business taxpayers generally as incentives toward energy conservation and the development of alternative sources of energy. The industry is specifically excluded from claiming energy credits for investments in solar, wind, biomass, recycling, cogeneration and alternative energy (fueled by other than oil or natural gas) facilities. As a practical matter, an electric utility can only obtain energy credits for small hydro facilities.

It is in the best interests of our nation's energy policy and our industry -- both customers and shareholders -- that the electric utility industry be treated the same as other industries in the development of new sources of energy and in conversions away from the extended use of oil and gas as fuel.

In view of the pressing need to develop alternative forms of electrical generation to reduce the need for imported oil, the provision of the Internal Revenue Code which excludes public utilities from the incentives of the energy tax credits should be rescinded.

TAX EXEMPT FINANCING

Enormous amounts of capital are needed by the electric utility industry to meet the future energy requirements of our nation. Yet, the ability to use tax exempt bond financing, a relatively low cost source of capital, for required pollution

control facilities has been severely limited by Treasury Regulations and interpretations of the Internal Revenue Service. These restrictions, such as the exclusion of most radwaste facilities at nuclear power plants from the definition of pollution control facilities, should be removed either legislatively or administratively. We also support expansion of the availability of tax exempt bond financing to help finance specific energy projects which are in concert with the national energy goals, such as the conversion of oil-fired electric generation plants to coal.

Appendix A

EDISON ELECTRIC INSTITUTE

Survey of Effect of HR 2400 (S 683)

The following schedules are based upon initial survey data from 62 member companies representing approximately 75% of total utility plant (including CWIP) as of December 31, 1979.

| Year | Additional Deductions For Property Additions After 1980, Under ACRS* | |
|---|---|---|
| | Commencing Deduction When Property Placed In Service (Millions) | Commencing Deduction When Money Is Spent (CWIP) (Millions) |
| 1981 | $ (201) | $ 200 |
| 1982 | 90 | 1,132 |
| 1983 | 614 | 2,100 |
| 1984 | 1,360 | 3,163 |
| 1985 | 2,443 | 4,583 |

*ACRS deduction vs. present law ADR depreciation plus repair allowance

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| Year | Present Law ITC Generated (Millions) | Additional ITC Generated (Millions) |
|---|---|---|
| 1981 | $1,146 | $55 |
| 1982 | 1,114 | 72 |
| 1983 | 1,240 | 83 |
| 1984 | 1,366 | 88 |
| 1985 | 1,326 | 97 |

Appendix A    Page 2 of 3 Pages

The following schedules are based upon 59 companies representing approximately 67% of total utility plant (including CWIP) as of December 31, 1979.

COMPANIES ANTICIPATING NET OPERATING LOSSES (NOL'S)

A) Present Law (ADR Depreciation Plus Repair Allowance)

| Year | # Companies | Total Dollars Of NOL (Millions) | Tax Liability Before ITC All Companies Including NOL's (Millions) |
|---|---|---|---|
| 1981 | 2 | $ (69) | $1,586 |
| 1982 | 1 | (10) | 2,312 |
| 1983 | 0 | -- | 2,751 |
| 1984 | 0 | -- | 3,199 |
| 1985 | 0 | -- | 3,482 |

B) ACRS - (Commencing ACRS On Post 1980 Additions When Placed In Service)

| Year | # Companies | Total Dollars Of NOL (Millions) | Tax Liability Before ITC All Companies Including NOL's (Millions) |
|---|---|---|---|
| 1981 | 2 | $ (71) | $1,664 |
| 1982 | 1 | (12) | 2,257 |
| 1983 | 0 | -- | 2,552 |
| 1984 | 0 | -- | 2,715 |
| 1985 | 2 | (12) | 2,525 |

C) ACRS - (Commencing ACRS On Post 1980 Additions When Money Is Spent)

| Year | # Companies | Total Dollars Of NOL (Millions) | Tax Liability Before ITC All Companies Including NOL's (Millions) |
|---|---|---|---|
| 1981 | 2 | $ (80) | $1,532 |
| 1982 | 1 | (33) | 1,867 |
| 1983 | 2 | (15) | 1,992 |
| 1984 | 3 | (54) | 2,093 |
| 1985 | 2 | (116) | 1,895 |

Appendix A Page 3 of 3 Pages

The following schedules are based upon 59 companies representing approximately 67% of total utility plant (including CWIP) as of December 31, 1979.

ITC Carryforward Balance at December 31

| Year | # of Co.'s | Present Law ADR Depreciation Plus Repair Allowance | New Law | | | |
|---|---|---|---|---|---|---|
| | | | # of Co.'s | Commence ACRS When Property Placed in Service | # of Co.'s | Commence ACRS When Money Is Spent |
| 1981 | 26 | $1,571 | 26 | $1,564 | 26 | $1,655 |
| 1982 | 19 | 1,381 | 20 | 1,462 | 23 | 1,737 |
| 1983 | 14 | 1,251 | 15 | 1,488 | 20 | 2,008 |
| 1984 | 12 | 1,042 | 16 | 1,459 | 23 | 2,304 |
| 1985 | 10 | 783 | 17 | 1,337 | 22 | 2,467 |

There was not enough data available for years after 1985 to permit a meaningful analysis.

## Statement of John W. F. Faircloth, Vice President, Taxes, Columbia Gas System Service Corp., on Behalf of the American Gas Association

### SUMMARY

I. A.G.A. generally supports the depreciation reform principles underlying S. 683.

II. A.G.A. estimates that the U.S. natural gas utility industry requires, between the years 1981 and 2000, a cumulative capital investment of approximately $400 billion for financing system supply and construction.

III. A.G.A. supports the requirement that public utility property be subject to a normalization method of accounting to be eligible for the ACRS.

VI. A.G.A. supports the treatment of non-normalized public utility property because this treatment creates an incentive for regulatory commissions to permit a normalization method of accounting which is necessary if the Congressional intent with respect to utilities is to be fulfilled.

V. A.G.A. supports the concept of a mandatory annual ACRS deduction because it eliminates the imputation problem with respect to property actually placed in service. A.G.A. recognizes, however, that the potential for imputation by utility regulatory commissions exists under the election provision regarding qualified progress expenditures. A.G.A urges that appropriate nonimputation language be added to S. 683.

VI. A.G.A. strongly opposes Section 203(d) of S. 683 and urges that this section be deleted from the bill.

VII. A.G.A. supports the 18 year midpoint life threshold for determining what regulated gas utility property is 10-year property.

VIII. A.G.A. requests that the Senate Committee on Finance consider expanding the carryforward period for the investment credit.

Mr. Chairman and Members of the Committee:

My name is John W.F. Faircloth, Vice President -- Taxes, Columbia Gas System Service Corporation. I would like to begin by saying that the American Gas Association (A.G.A.) membership serves over 160 million customers and delivers approximately 85% of all natural gas sold by utilities in the United States. A.G.A. member companies welcome and generally support the depreciation reform principles underlying S. 683 (Dole, R-KS) because of the capital formation potential created by the bill. To the extent that the A.G.A. member companies can benefit from, and are affected by this bill, I offer this statement today.

Capital Formation Requirements

The challenge of forming new capital is particularly acute for capital intensive industries such as the energy utility industry. A.G.A. member companies believe that the Administration's accelerated cost recovery system (ACRS) will have a significant, positive effect on capital formation and that such a system will go far to rectify the capital investment dilemma currently facing American industries. For this reason, A.G.A. member companies support the capital formation principles underlying the depreciation reform proposal in S. 683.

The A.G.A. estimates that a cumulative capital investment of approximately $400 billion (1980 dollars) is required by the U.S. natural gas utility industry between the years 1981 and 2000 in order to finance gas supply and development and to meet the requirements for pipelines and distribution system maintenance and

construction.[1/] This $400 billion capital requirement is more than 6 times the industry's current level of total capitalization, which is $60 billion as of December 1978. In short, over the next two decades, stimulating capital formation will be the most fundamental challenge facing the regulated gas utility industry and the nation. Indeed, the importance of stimulating capital formation cannot be overemphasized if our nation is to develop domestic energy supplies in order to reduce our dependence on imported oil.

Generally, A.G.A. supports the depreciation reform principles underlying S. 683 over the plans in the 10-5-3 (H.R. 1053) and 2-4-7-10 (S. 317) proposals because, for the most part, the specific provisions of S. 683 are better suited for depreciation reform in the utility industry. I will now turn to a discussion of the specific provisions of S. 683 and elaborate on how these provisions affect the regulated natural gas utility industry.

## Normalization Requirements

A.G.A. fully supports the requirement that, in order to be eligible for the ACRS, public utility property must be subject to a normalization method of accounting. A.G.A. believes that

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[1]This capital requirement estimate is based upon the North American Focus, a gas supply scenario which emphasizes gas supply coming from secure sources, in North America. By the year 2000 this gas supply scenario is expected to yield natural gas supplies in the range of 26.0-32.0 Tcf. (The Gas Energy Supply Outlook: 1980-2000, A Report of the A.G.A. Supply Committee. The American Gas Association, Arlington, VA 22209; October 1980)

the normalization requirements contained in S. 683 are essential for the same reasons that the normalization requirements under section 167(l) of the Internal Revenue Code (IRC) are essential for accelerated depreciation. These reasons are: (1) to accomplish the Congressional intent to create a capital formation mechanism which will stimulate investment and plant modernization; and (2) to forestall the possibility of adverse IRS and state regulatory commission regulations which could undercut this intent of Congress.

Treatment of Non-Normalized Public Utility Property

Under the ACRS proposal, the Administration had the foresight to create a strong incentive for public utility regulatory commissions to permit a normalization method of accounting for public utility property. This normalization method of accounting provides the most equitable treatment of current and future ratepayers and is the only method by which the utility can avail itself of the cash flow benefits necessary to achieve the Congressional intent for plant and equipment modernization. Normalization is equitable as between current and future ratepayers because under this method these ratepayers are able to share, over the life of an asset, the depreciation benefits generated by the utility's investment in that asset. Also, normalization provides (as currently prescribed by Congress in IRC section 167(l)) a reserve account for deferred taxes which a utility can use for the intended Congressional purpose of plant and equipment modernization.

Under this provision it is very likely that the non-normalizing utility taxpayer will have no greater depreciation deduction than that allowable under the straightline method of depreciation. Consequently, the utility will not get the capital formation benefits from the internal generation of positive cash flow and will have to seek additional financing in the open market. Therefore, without normalization, current and future ratepayers are not treated equitably and the Congressional intent underlying liberalized depreciation is frustrated.

A.G.A. supports this treatment of non-normalizing utilities because it creates a strong incentive for public utility regulatory authorities to permit utilities to normalize the tax benefits which will arise under the ACRS proposal. A.G.A. also believes the incentive will forestall both the unjustified reduction of rates which takes place in flowthrough jurisdictions and the substantial future revenue losses to Treasury which occur as a direct result of the flowthrough practice in these jurisdictions. Indeed, if the purpose of depreciation reform is to permit American industry to rebuild, reinvest and modernize, then, in the public utility industry, this can only be accomplished if the utility is permitted to normalize the tax benefits resulting from the ACRS proposal.

Amount of the ACRS Allowance

The A.G.A. supports the concept that the amount of the annual ACRS deduction allowance is mandatory. The certainty created by a mandatory annual ACRS deduction under proposed Section 168(b) eliminates the potential of a regulatory authority

imputing to a regulated taxpayer more of a recovery deduction than the taxpayer actually took for property in fact placed in service.

Potential for Regulatory Commission Imputation of Qualified Progress Expenditures on Public Utility Property

Section 201(a) of S. 683 adds a new section 168(d)(3) to the Internal Revenue Code under which the Accelerated Cost Recovery Deduction is allowed on qualified progress expenditures made with respect to recovery property. Subparagraph (E) of section 168(d)(3) gives public utilities an election not to claim the recovery deduction on their progress expenditures for public utility property. This election for public utilities creates a potential for regulatory commissions to treat an electing utility for ratemaking purposes as if it had applied the recovery deduction to its qualified progress expenditures although in fact the utility did just the opposite on its tax return. In this way, the commission could impute a larger tax depreciation deduction, and therefore a smaller tax expense, for ratemaking purposes. The normalization rules provided in new Code section 168(f)(4) do not operate to prevent such an imputation in the case of qualified progress expenditures.

The same problem arises under Section 202(a) of S. 683 and the proposed new Code section 167(r)(12)(E), relating to the depreciation of qualified progress expenditures in the case of all section 1250 property other than that included in the 10-year recovery property class.

A.G.A. believes that this potential for regulatory imputation in the case of qualified progress expenditures constitutes a significant ratemaking problem for the regulated gas industry, and has a concomitant potential of adverse impact on federal revenues. Accordingly, A.G.A. urges that appropriate nonimputation language be added to the bill, and A.G.A. stands ready to provide any further information or assistance that this Committee or its Staff may desire in regard to this matter.

Modification in ITC Treatment Under Section 203(d)

A.G.A. believes that Section 203(d) should be deleted from S. 683 and that the current law under Internal Revenue Code section 46(f) should be retained.

The underlying rationale for enacting the investment tax credit (ITC) was "to aid in the modernization of our productive facilities."[2] In order to accomplish this purpose in the case of utilities, such companies must retain the level of ITC utilization currently available to them. Under present law, Congress has designed a method to permit the sharing of the ITC benefits both by ratepayers and the utility investors. In turn, these sharing provisions (sections 46(f)(1) and 46(f)(2) of the IRC)

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[2] H.R. Rep. No. 533, 92d Cong., 1st Sess. 24 reprinted in (1972) U.S. Code Cong. & Ad. News 1825. S. Rep. No. 437 92d Cong., 1st Sess. reprinted in (1972) U.S. Code Cong.& Ad. News 1918.

enhance the utility's profitability and improve the utility's investment capability.

Section 203(d) of S. 683, however, subverts this Congressional intent underlying the ITC and, in fact, dilutes the effectiveness of the ITC since it precludes enjoyment of the current level of ITC utilization which Congress specifically intended to be available. This occurs because Section 203(d) modifies the ratemaking treatment of the ITC tax benefits so that a regulated company's earnings can be reduced through both a rate base and a direct cost of service adjustment. Congress originally intended, however, that only one such adjustment should be made, *i.e.*, either a rate base or a cost of service adjustment.

In addition to causing a dilution of the effectiveness of the ITC to stimulate capital investment, the reduction in a utility's earnings which will result from enactment of Section 203(d) denies the utility (and its investors) the benefit Congress originally intended. Indeed, by twice reducing a utility's earnings, Section 203(d) essentially makes the ITC a U.S. Treasury subsidy used to reduce the price of the service or commodity which a regulated company provides. In this respect, Section 203(d) frustrates the specific intent stated in identical language by both the U.S. House of Representatives and the U.S. Senate in their respective reports on the Revenue Act of 1971:

"Moreover, the basic purpose of the investment credit is not an allocation of resources which will stimulate consumption of any particular type of product or service.[3] (Emphasis added.)

A.G.A. also notes that Section 203(d) would cause a greater loss of revenues to Treasury than occurs under the present law. This results from the fact that Section 203(d) would permit a utility's taxable earnings to be reduced by both a rate base and a cost of service adjustment, whereas present law permits only one such adjustment. Under Section 203(d) a utility would have less taxable income and, therefore, would conceivably pay less federal income tax than the same utility would pay under present law.

A.G.A. believes that in order to continue the Congressional intent underlying the investment tax credit and to preserve the integrity of that credit as an investment incentive, Section 203(d) of S. 683 must be deleted.

Carryforward Provisions of the Investment Tax Credit

A.G.A. believes that the capital recovery deduction under ACRS may produce situations in which some utilities or other companies, because of very large construction projects, would not be able to fully utilize their investment tax credits within the 10 year carryforward period even though this period

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[3] H.R. Rep. No. 533, 92d Cong., 1st Sess. 24 reprinted in (1972) U.S. Code Cong. & Ad. News 1839. S. Rep. No. 437, 92d Cong., 1st Sess., reprinted in (1972) U.S. Code Cong. & Ad. News 1943. There is nothing in the Statement of the Managers on the Revenue Act of 1971 which in any way alters this intent. (See H.R. Rep. No. 708, 92d Cong., 1st Sess. reprinted in (1972) U.S. Code Cong. & Ad. News 2053-2079.)

is more liberal than under present law. Indeed, loss of these credits is contrary to the purposes underlying both the liberalized capital recovery deduction and the investment tax credit, i.e., to stimulate capital formation and facilitate investment in new plant and equipment.

Therefore, A.G.A. respectfully requests that this Committee consider expanding the ITC carryforward period to mitigate the possible expiration of investment credits and thereby help to fulfill the Congressional intent underlying these credits.

Tangible Research and Experimentation Property

A.G.A. also supports the inclusion in the 3 year recovery property category of tangible section 1245 property which is used in research and experimentation. We believe that the inclusion of this property is important because it will help to stimulate the research and experimentation necessary to develop our domestic energy supplies.

Requirements for 10-year Property

The A.G.A supports the establishment of a 10 year recovery period for regulated gas transmission property and regulated local gas distribution property with an ADR midpoint life of greater than 18 years. Certain other segments of the utility industry may, however, desire to increase the 10 year recovery period threshold to a midpoint life greater than the proposed 18 year threshold for reasons of enhancing their competitive posture with respect to unregulated businesses. Such enhancement

would allegedly arise from including a greater amount of recovery property in the 5-year category. A.G.A. notes that any such modification should be applicable only to those segments of the utility industry which seek it. A.G.A. endorses and supports the current requirements for inclusion of regulated gas transmission and local gas distribution property in the 10 year recovery category.

## Savings and Investment Incentives

Should this Committee decide that savings and investment incentives for individuals ought to be part of this legislation, A.G.A. favors the inclusion of a tax deferral incentive for reinvested dividends such as that contained in S. 141.

## Technical Aspects of S. 683

A.G.A. generally endorses the principles of S. 683 regarding depreciation reform and we would appreciate the opportunity to discuss with members of this Committee and their staffs any technical matters which arise.

## Conclusion

A.G.A. is pleased to voice support for the principles underlying the Administration's depreciation reform proposal, the accelerated cost recovery system.

TESTIMONY OF JOHN E. HARRINGTON
ASSISTANT COMPTROLLER
AMERICAN TELEPHONE AND TELEGRAPH COMPANY
BEFORE THE COMMITTEE ON FINANCE
U.S. SENATE
May 21, 1981

SUMMARY

The Bell System supports in general the President's tax reduction program, and we share his concern regarding the nation's current economic condition. The capital recovery provisions included in the proposals should be a major contributor toward accomplishing the goals of increasing capital formation and productivity in the private sector of the economy.

The legislation to implement the Administration's proposal does, however, contain two provisions of concern to us. One provision, a "technical amendment", would repeal the statutory condition that public utilities earn a return on that portion of a capital asset purchased with the investment tax credit. A second provision would restrict most of our property to a ten-year life while our unregulated competitors can use a five-year capital recovery period.

The first provision would repeal the sharing concept of present law by allowing regulatory commissions to deduct the investment credit from a utility's rate base while also amortizing that credit to income. Thus, all of the benefits of the credit would be passed on to the utilities' customers and none would inure to its shareowners. This would convert the credit from an investment incentive to a price subsidy, contrary to Congressional intent.

The second provision would deny the public utility telecommunications industry the full incentives available to other taxpayers, against whom we must compete in the capital markets and in the marketplace for our goods and services. Given the pervasive competition in the telecommunications industry, it is inappropriate to place property of a regulated telecommunications company in a special class while similar or identical property of unregulated competitors obtains a capital recovery period which is twice as fast.

We recommend deletion of Section 203(d) of the bill and the elimination of the discriminatory treatment for telecommunications property, which places it in the ten-year rather than the five-year depreciation class.

TESTIMONY OF JOHN E. HARRINGTON

ASSISTANT COMPTROLLER

AMERICAN TELEPHONE AND TELEGRAPH COMPANY

BEFORE THE COMMITTEE ON FINANCE

UNITED STATES SENATE

MAY 21, 1981

This statement is submitted on behalf of American Telephone and Telegraph Company and the Associated Companies of the Bell System (listed on Attachment A). It supports President Reagan's tax proposals to increase capital recovery. However, it also addresses matters of concern to the telecommunications industry.

The Bell System shares the President's concern regarding the nation's current economic condition. We support his efforts to reduce inflation and foster sustained economic growth by increasing capital formation and productivity. The President's multifaceted program -- significant spending reductions, far-reaching regulatory reform, commitment to prudent monetary policy and significant tax reductions for both individuals and businesses -- is a bold initiative which provides a frontal assault on the key economic problems confronting the nation. Over time, his proposals should pay large dividends in terms of a stronger and more productive economy.

We have long been in favor of a tax policy that assists in the formation and preservation of capital as a foundation for improved productivity. We strongly support the Administration's efforts to reform the present tax law by accelerating the allowances for capital recovery.

The President's program to accelerate capital cost recovery breaks with the useful life concept, provides dramatic simplification, and goes a long way toward offsetting the effects that inflation has on the real value of depreciation deductions.

Inflation has severely distorted the nation's tax system by reducing the value of depreciation allowances which are based on historical costs. Under the present tax law the timing of depreciation deductions is inadequate to reflect recovery of the original costs of assets when related to the purchasing power that was invested in the assets. For example, in 1980 alone, corporate capital consumption allowances fell short of replacement cost by some $17 billion, representing an understatement of reported depreciation charges by more than ten percent.

We need a solid, workable cost recovery plan and we need it today.

By providing for more rapid capital recovery, the Administration's proposal will substantially increase the flow of internally generated funds, which in turn will reduce pressures on the

capital markets, and should lead to a moderation in interest rates. Without significant increases in investment capital it is unlikely that the economy will be able to achieve the increases in productivity that are necessary to produce a higher standard of living for all.

The Bell System is proud of its rapid productivity growth. From 1970 through 1980 our productivity (on a total factor productivity basis — i.e.: including the contribution of both labor and capital inputs) increased at a 4.4% annual rate while that in the private sector generally rose at just a 1.0% annual rate in this same period.

Productivity is a key factor enabling us to offset some of the increases in our costs due to inflation. Indeed, we have been able to hold our price increases far below the pace of overall price increases in the economy. For example, the Consumer Price Index increased by 117% between 1970 and 1980. In contrast, overall Bell System rates rose by 45% — much less than half the rise in the CPI.

Our experience has convinced us that productivity and its attendant benefits to the economy as a whole can neither be attained nor sustained without the large capital investment needed to develop and effectively employ new technology.

It is becoming increasingly difficult to raise capital -- in recent months, a number of utilities have cancelled or postponed long-term bond offers or replaced them by short-term notes. Investors

are increasingly reluctant to commit their funds to long-term debt securities. The Bell System, as the largest non-governmental borrower, is directly impacted by these capital market conditions. For example, recent bond issues have been sold at record high interest rates. (On April 28, 1981 Michigan Bell, a AAA rated company, sold $250 million in 40 year debentures at a cost of 16.07%) Without additional internally generated capital, we will have to constrain future capital investment.

Although we support the Administration's capital recovery tax proposals, we are concerned about two provisions of the proposed legislation. One of these provisions -- the repeal of the statutory condition that public utilities earn a return on that portion of a capital asset purchased with the investment tax credit -- is a major step backward. It would deprive utilities of the incentive available under current law and destroy the shared benefit concept which Congress has so carefully and properly constructed.

Another provision — restricting most telecommunications public utility property to a ten rather than a five year capital recovery period would deny us the full benefits of the incentives available to other taxpayers, including our unregulated competitors.

Each of these provisions would place us at a disadvantage relative to our competition -- both in providing services and in raising needed capital. Such discrimination is in direct conflict with the efforts to solve the national problem of capital formation and productivity growth.

Investment Tax Credit

The purpose of the investment tax credit is to stimulate investment. This stimulation of additional investment is accomplished by reducing the cost of acquiring property, so as to increase the profitability on that property.

Current law assures that public utilities will have the intended incentive to invest by requiring a sharing of the benefits of the investment credit between a utility's ratepayers and its shareholders. That sharing is generally accomplished under Section 46(f) of the Internal Revenue Code ("IRC"), in one of two ways:

1. by reducing the base upon which the utility earns but not reflecting the investment credit as a reduction of its cost of service; or

2. by reducing cost of service over the life of the property that generates the credit by the amount of the credit, but not reducing the rate base upon which it earns.

The Bell System has adopted the second of these methods: our customers benefit by receiving the direct benefit of the ratable flow through in the form of reduced rates; and our shareholders benefit by our ability to earn on the unamortized credit balance while utilizing the funds provided for capital investment. Also, lessened reliance on costly external sources of capital allows additional modernization investments which improve productivity and hold prices down.

Section 203(d) of the Administration bill, termed a "technical amendment", raises a very substantial and significant issue for regulated utilities. It would repeal the sharing concept of present law by allowing regulatory commissions to deduct the investment credit from a utility's rate base while *also* ratably amortizing that credit to income. Thus, *all* the benefits of investment credit would be passed on to the utilities' customers and *none* of the benefits of the ITC would inure to its shareowners. If permitted, such regulatory action would convert the investment credit tax reductions from an investment incentive which increases profitability to a source of cost free capital which reduces prices. The benefit of the credit would therefore be identical to that provided by the tax deferrals resulting from accelerated depreciation. This is contrary to congressional intent[1./] which sought to provide, not more rapid cash flow and capital recovery as does accelerated depreciation, but a new and different incentive to growth and profitability.

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[1./] S. Rep. No. 1881, 87th Cong., 2nd Sess. (1962) p. 11 stated: "The objective of the credit is to reduce the net cost of acquiring new equipment; this will have the effect of *increasing the earnings of new facilities over their productive lives and increasing the profitability of productive investment . . .*" (emphasis supplied.)

H.R. Rep. No 92-533, 92nd Cong., 1st Sess. (1971) p. 24 stated that: ". . . the basic purpose of the investment credit is not an allocation of resources which will stimulate consumption of any particular type of product or service."

For a regulated utility there is no increased profitability unless the utility is allowed to share in the benefits of the Investment Tax Credit.

In the various revenue acts dealing with the investment credit since its inception in 1962, Congress has steadily moved toward providing parity in the treatment of regulated and unregulated industries. Since 1975 the allowable percentage is now the same for all industries, and Section 46(f) permits utilities either to retain the credit or to earn on the unamortized portion. It is essential that this balanced sharing of the credit between the company and its customers be retained in order for the utility industry to compete with others on equal terms for available capital.

We believe that utilities should obtain at least some of the benefits of the credit which unregulated industry obtains. In this connection, it has not been demonstrated that unregulated businesses pass the credit through in lower prices, even in the long run. Indeed, the major econometric models of the economy implicitly assume that business retains the credit, and it is difficult to see how the credit could be a stimulant to investment at all if it were passed through in the form of lower prices. By contrast, we can demonstrate that our rates are reduced by the full amount of the credit over the life of the related assets. In 1980 our rates were reduced by $800 million through the amortization of investment credit. Yet, Section 203(d) of this bill would now remove the only benefit available to regulated utilities.

In summary this section should be deleted, because it is:

1. contrary to Congressional intent in adopting the credit;

2. contrary to Congressional intent in providing a sharing of the credit and[2./]

3. contrary to the overall thrust of the bill which is to increase capital investment incentives.[3./]

Accelerated Cost Recovery System

The provision to remove telecommunications public utility property with a current midpoint life of more than 18 [4./]years from the five year class is also of great concern to us. This discriminatory

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[2./]H.R. Rep. No. 92-533, 92nd Congress, 1st Sess. (1971) p. 24 specifically states ". . . it is appropriate to divide the benefits of the credit between the customers . . . and the investors . . . this represents the best balancing of the considerations of both investors and customers of the regulated companies."

[3./]It is interesting to note that an unintended result of this legislation would be a decrease in Federal revenues. If utilities no longer earn on the unamortized portion of investment credit, utility revenues, taxable income and Federal taxes will decrease.

[4./]It is clearly inappropriate to determine the tax life of regulated telecommunications property under ACRS using ADR lives which were promulgated over ten years ago and do not reflect the effects of competition and rapidly developing technology.

treatment of our property puts us at a disadvantage compared with other taxpayers and non-regulated providers of communications services in competition with us in the capital markets as well as the telecommunications marketplace.

In the last decade an explosion of technology coupled with regulatory and court decisions, culminating in the FCC Computer Inquiry II (FCC Docket No. 20828) have resulted in pervasive competition in the telecommunications industry. That competition is not limited to any type of property or any segment of our business. Our competitors range from small-sized firms to major corporations.

Evolution of telecommunications technology has been accelerating. Over the past two decades we have seen the introduction of electronic switching, digital multiplexing techniques, satellites, higher capacity microwave systems, fiber optics and cellular mobile radio. These new technologies, available to us and our competitors, are displacing existing facilities (electromechanical switching as well as cable and wire) and will become the predominant investment of the future.

Competitors provide alternatives to the traditional regulated services, and are entering this marketplace in ever increasing numbers. Customers may use either Bell or non-Bell terminal equipment, network distribution, and switching facilities. Subscribers to our competitors' services, who use microwave or satellite facilities, by-pass our intercity network (distribution and switching functions) to complete their calls. Other

competitors carry messages or data directly from the subscriber's premises at one location to a satellite, and return to earth at another premises, thus completely avoiding the use of Bell System facilities. In each case, competitors displace the switching function and all or part of our distribution plant. Thus, our entire plant investment (from customer premises to customer premises) is subject to increasing competition.

The telecommunications industry of the future will clearly be influenced as much by competitive, market and technological forces, as by regulatory actions. Given this fact, it is inappropriate to place most of the equipment of a regulated telephone company in a less favorable class while similar or identical property of its unregulated business competitors obtains a capital recovery period twice as fast. For example, if a regulated telephone company installs a microwave transmission facility, it would have a tax life of 10 years under the Administration's proposal. The identical facility placed in service by a non-regulated competitor would be written off in 5 years. Such discrimination between direct business competitors should not be introduced in the tax law. To gauge the magnitude of our disadvantage under this bill, we estimate that some 60% of our depreciable property placed in service in 1981, or $9 billion, would be placed in the 10-year class solely by reason of its being owned by a public utility. Every indication points to accelerated competition in all aspects of the telecommunications business with the rapid pace of new technology and the concomitant displacement of older physical plant.

We urge that the recovery of investment in telecommunications property should be determined without regard as to whether its owner is a

regulated public utility. These incentives should be applied in a fair and even-handed manner over all segments of the economy. This is particularly important at a time when national policy is moving towards deregulation.

In summary then, the Bell System supports the President's ACRS program and believes that it will have long range beneficial impacts on the economy. This would be accomplished through the stimulation of capital investment and the resultant increases in productivity. However, we are not in favor of two provisions of the bill:

1) We view as retrogressive the technical amendment which would eliminate the statutory condition that public utilities earn a return on the investment tax credit reserve. Accordingly, we strongly recommend that Section 203(d) be deleted from the bill.

2) We are greatly concerned about the provision of the bill which places public utility property with an ADR life of more than 18 years in the 10 year category. This is discriminatory and places us at competitive disadvantage with non-regulated suppliers of telecommunications services. The proposed language of Section 168(c)(3)(A)(ii) should be amended to exclude telecommunications companies.

## ATTACHMENT A

## BELL SYSTEM COMPANIES

American Telephone and Telegraph Company
The Bell Telephone Company of Pennsylvania
The Diamond State Telephone Company
Bell Telephone Laboratories, Incorporated
The Chesapeake and Potomac Telephone Company
The Chesapeake and Potomac Telephone Company of Maryland
The Chesapeake and Potomac Telephone Company of Virginia
The Chesapeake and Potomac Telephone Company of West Virginia
Cincinnati Bell, Incorporated
Illinois Bell Telephone Company
Indiana Bell Telephone Company, Incorporated
Michigan Bell Telephone Company
The Mountain States Telephone and Telegraph Company
New England Telephone and Telegraph Company
New Jersey Bell Telephone Company
New York Telephone Company
Northwestern Bell Telephone Company
The Ohio Bell Telephone Company
Pacific Northwest Bell Telephone Company
The Pacific Telephone and Telegraph Company
  and Bell Telephone Company of Nevada
South Central Bell Telephone Company
Southern Bell Telephone and Telegraph Company
The Southern New England Telephone Company
Southwestern Bell Telephone Company
Western Electric Company, Incorporated
Wisconsin Telephone Company

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UNITED STATES SENATE
COMMITTEE ON FINANCE

STATEMENT OF THE
NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS
1102 INTERSTATE COMMERCE COMMISSION BUILDING
CONSTITUTION AVENUE AND TWELFTH STREET, N.W.
POST OFFICE BOX 684, WASHINGTON, D.C. 20044
TELEPHONE (202) 628-7324

ON

SECTION 203(d) OF
S. 683, RELATING TO TAX NORMALIZATION
OF INVESTMENT TAX CREDIT BENEFITS AVAILABLE
TO THE PUBLIC UTILITY INDUSTRY

MAY 21, 1981

Summary of Remarks

- Section 203(d) is a technical amendment included in the President's tax package which is of vital concern to consumers of utility services throughout the United States.
- Current tax law forces utility ratepayers to pay a rate of return to shareholders on capital which the shareholders have not provided.
- The inequity created by current tax law is a clear violation of the time-honored principles of utility rate regulation and causes utility rate overcharges which are increasing annually.
- Section 203(d) of S. 683 would correct this problem with respect to future investment tax credits by more appropriately treating the ITC benefits as zero cost capital.
- A study forthcoming in the Journal of Business proves that the tax normalization technique mandated by Section 203(d) would provide a more equitable sharing of the ITC benefits in a manner which is consistent with regulatory principles.
- The NARUC urges that Section 203(d) be included in this year's tax reform package.

Mr. Chairman and Members of the Committee:

My name is Richard C. ("Pete") Loux. I am Chairman of the Kansas State Corporation Commission and Chairman of the Committee on Accounts of the National Association of Regulatory Utility Commissioners, commonly known as the "NARUC." Accompanying me today are Paul Rodgers, NARUC Administrative Director and General Counsel; Rose Ann C. Fraistat, NARUC Director of Congressional Relations; and Michael Foley, NARUC Director of Financial Analysis.

The NARUC is a quasi-governmental nonprofit organization whose members include the regulatory bodies of the fifty States, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands. The mission of the NARUC is to improve the quality and effectiveness of regulation for the benefit of the American people.

The members of the NARUC appreciate your invitation to make known their views on S. 683, a bill relating to the tax reform proposals of the President's Economic Recovery Program. In view of the time restrictions, I will confine my remarks to Section 203(d) of the tax bill, which vitally concerns the consumers of utility services in the State of Kansas and throughout the United States.

Section 203(d) is a technical amendment relating to the accounting treatment of the Investment Tax Credits available to public utility companies. Given the complex nature of this matter, the effects of the proposed technical amendment can probably be viewed best by using a hypothetical example.

Assume that a utility company purchases an asset which costs $100,000 and that this asset has a life of 10 years. Because the asset qualifies for the Investment Tax Credit, the utility company will be entitled to deduct 10% of the cost of the asset (in this

case, $10,000) from the tax obligation which the company would otherwise owe to the Federal government. Thus, the real cost of the asset to the company has been reduced to $90,000 since the government has in effect provided a $10,000 capital subsidy at zero cost to the utility.

The controversy arises over how the benefit of this $10,000 ITC should be accounted for in the utility ratemaking process. Current tax law provides that there should be a sharing of the ITC benefits between utility shareholders and ratepayers via an accounting technique known as "normalization."

However, the vast majority of utility companies have elected a normalization option, known as "cost-of-service normalization," which is considerably more beneficial to shareholders, to the detriment of ratepayers. Furthermore, this normalization option is inconsistent with the time-honored principles of the regulatory process.

Applying cost-of-service normalization to the hypothetical case described earlier would call for the utility company to deduct one-tenth of the $10,000 ITC benefit from the amount of revenues which the utility would otherwise be allowed to collect from ratepayers during each year of the life of the asset. Thus, allowed revenues would be reduced by $1,000 annually over the 10-year life of the asset. During the 10-year period, the portion of the ITC benefits which have not yet been deducted from allowed utility revenues is listed on the company's balance sheet as an "accumulated deferred ITC" (ADITC).

The inequity results from the current tax law which forces rate-payers to pay a rate-of-return on the ADITC's just as though the ITC benefits had been provided by the utility company's shareholders and

bondholders. However, as the hypothetical example shows, none of the ITC benefits were provided by the utility's shareholders or bondholders but rather were provided as a capital subsidy at zero cost to the recipient utility.

The rate of return on ADITC's which utility consumers in the State of Kansas and throughout the United States are being forced to shoulder is staggering and is actually increasing annually. In its 1980 annual report, for example, the Kansas Power and Light Company reported ADITC's on its balance sheet at the level of over $46 million, which is roughly $8 million higher than they had been just 12 months earlier (see Exhibit #1). In a 1980 report published by the Energy Information Administration, ADITC's of the 205 Class A and B privately owned electric utilities were reported to have increased over $1 billion in the 12-month period from year-end 1978 to year-end 1979 (see Exhibit #2). ADITC balances are also enormous in the gas and telephone industries.

The Reagan Administration has wisely proposed a technical amendment to the Internal Revenue Code which would allow utility companies to continue to enjoy the capital formation incentives created by the investment tax credit without forcing utility ratepayers to pay a rate of return on the ITC benefits. In essence, Section 203(d) is a recognition that the ITC is a zero cost capital subsidy to industry which has actually been provided by the ratepayers.

In hearings before the House Ways and Means Committee, utility representatives have repeatedly argued that Section 203(d) would destroy the concept that the ITC benefits should be shared by utility shareholders and ratepayers alike. However, a recent economic study,

to be published in the Journal of Business, proves that this argument is faulty. The article, written by Dr. Donald Kiefer of the Congressional Research Service, advocates an accounting technique known as "economic normalization," which is essentially identical to what has been proposed in Section 203(d) of the President's tax package.

Dr. Kiefer, who has performed exhaustive research in this area, concludes that "economic normalization is consistent with the logic of the regulatory process, provides appropriate utility rate reductions to consumers, and benefits utility companies through higher cash flows while avoiding providing 'excess profits' to the utility."

The inclusion of Section 203(d) in this year's tax reform package is of vital concern to consumers of utility services in the State of Kansas and throughout the United States. This proposed reform has the full support of the NARUC.

Thank you very much.

EXHIBIT # 1

KANSAS POWER AND LIGHT CO.

# Balance Sheet

| December 31, | 1980 | 1979 |
|---|---|---|
| **Assets** | Thousands of Dollars | |
| **Utility Plant** (Note 1): | | |
| Electric | $ 926,356 | $ 718,100 |
| Natural gas | 100,804 | 96,057 |
| | 1,027,160 | 814,157 |
| Less — Accumulated depreciation | 261,725 | 234,930 |
| | 765,435 | 579,227 |
| Construction work in progress | 85,659 | 188,125 |
| Net utility plant | 851,094 | 767,352 |
| **Current Assets:** | | |
| Cash | 5,310 | 3,966 |
| Deposits for payment of dividends and interest | — | 7,762 |
| Funds held by Trustee (Pollution Control) | 17,828 | 4,012 |
| Accounts receivable | 34,649 | 27,004 |
| Fuel, at average cost | 42,122 | 54,316 |
| Materials and supplies | 4,076 | 3,512 |
| Prepayments | 865 | 1,317 |
| | 104,850 | 101,889 |
| **Deferred Charges** | 10,973 | 9,777 |
| **Total Assets** | $ 966,917 | $ 879,018 |
| **Shareholders' Equity and Liabilities** | | |
| **Capitalization** (see statements): | | |
| Common stock equity (12,903,441 and 12,679,650 shares outstanding, respectively) | $ 310,689 | $ 292,286 |
| Preferred stock (Not subject to mandatory redemption) | 69,858 | 69,858 |
| Preference stock (Subject to mandatory redemption) | 30,000 | 30,000 |
| First mortgage bonds | 359,880 | 320,341 |
| | 770,427 | 712,485 |
| **Current Liabilities:** | | |
| Short-term debt (Note 8)— | | |
| Commercial paper | — | 9,880 |
| First mortgage bonds - current maturities | 5,198 | — |
| Accounts payable | 25,040 | 22,226 |
| Accrued taxes | 17,034 | 10,544 |
| Accrued interest | 7,553 | 6,914 |
| Accrued dividends | 8,537 | 7,761 |
| Other | 5,817 | 6,216 |
| | 69,179 | 63,541 |
| **Reserves And Deferred Credits:** | | |
| Deferred income taxes (Note 1) | 76,811 | 62,087 |
| ⟹ Federal investment tax credits (Note 1) | 46,259 | 37,959 |
| Other | 4,241 | 2,946 |
| | 127,311 | 102,992 |
| Commitments (Note 3) | | |
| **Total Shareholders' Equity and Liabilities** | $ 966,917 | $ 879,018 |

Source: 1980 Annual Report to Stockholders
Kansas Power and Light Company; P.20

# EXHIBIT # 2

## Privately Owned Classes A & B Electric Utilities, Composite Balance Sheet, as of December 31

(Thousands of Dollars)

| Item | 1979 | 1978 |
|---|---|---|
| **ASSETS AND OTHER DEBITS** | | |
| **UTILITY PLANT** | | |
| Electric utility plant | $182,514,261 | $170,834,972 |
| Electric construction work in progress [1] | 53,991,026 | 42,475,827 |
| Total Electric Utility Plant | $236,505,287 | $213,310,799 |
| Elec util accum prov for deprec., depl., and amort. | 47,607,780 | 42,921,476 |
| Net Electric Utility Plant, Less Nuclear Fuel | $188,897,507 | $170,389,323 |
| Nuclear fuel | $5,807,102 | $4,690,211 |
| Accum prov for amort of nuclear fuel assemblies | 2,091,800 | 1,561,044 |
| Net Nuclear Fuel | $3,715,302 | $3,129,167 |
| Other utility plant | $13,565,940 | $12,944,702 |
| Other utility construction work in progress | 302,727 | 237,384 |
| Total Other Utility Plant | $13,868,667 | $13,182,086 |
| Other utility accum prov for deprec., depl., and amort. | 4,217,058 | 3,932,073 |
| Net Other Utility Plant | $9,651,609 | $9,250,013 |
| All utility plant | $201,887,303 | $188,469,885 |
| All utility plant construction work in progress | 54,293,753 | 42,713,211 |
| Total All Utility Plant | $256,181,056 | $231,183,096 |
| All utility accum prov for deprec., depl., and amort. | 53,916,638 | 48,414,593 |
| Net All Utility Plant | $202,264,418 | $182,768,503 |
| Utility plant adjustments | | |
| **OTHER PROPERTY AND INVESTMENTS** | | |
| Nonutility property less accum. prov. for deprec and amort. | $323,508 | $269,970 |
| Investments in associated companies | 223,326 | 107,236 |
| Investments in subsidiary companies | 4,212,292 | 4,799,836 |
| Other investments | 858,011 | 756,004 |
| Special funds | 382,563 | 442,772 |
| Total Other Property and Investments | $5,999,700 | $6,375,818 |
| **CURRENT AND ACCRUED ASSETS** | | |
| Cash | $601,079 | $698,358 |
| Special deposits | 487,008 | 501,296 |
| Working funds | 78,065 | 67,682 |
| Temporary cash investments | 833,502 | 1,502,021 |
| Notes and accounts receivable (net) | 7,548,651 | 6,544,941 |
| Receivables from associated companies | 800,289 | 751,074 |
| Materials and supplies | 8,281,180 | 6,235,250 |
| Prepayments | 599,969 | 523,159 |
| Other current and accrued assets | 3,194,770 | 1,984,842 |
| Total Current and Accrued Assets | $22,424,513 | $18,918,623 |
| **DEFERRED DEBITS** | | |
| Unamortized debt expense | $416,202 | $381,595 |
| Extraordinary property losses | 910,924 | 565,986 |
| Preliminary survey and investigation charges | 129,733 | 100,107 |
| Clearing accounts | 62,719 | 39,414 |
| Deferred losses from disposition of utility plant | - | 42,559 |
| Research and development expenditures | 24,223 | 24,246 |
| Unamortized loss on reacquired debt | 48,735 | 63,680 |
| Accumulated deferred income taxes | 559,662 | 349,892 |
| Other deferred debits | 1,993,295 | 1,462,985 |
| Total Deferred Debits | $4,145,493 | $3,030,464 |
| TOTAL ASSETS AND OTHER DEBITS | $234,834,124 | $211,093,408 |

EXHIBIT # 2 (cont.)

**Privately Owned Classes A & B Electric Utilities, Composite Balance Sheet, as of December 31 —Continued**

(Thousands of Dollars)

| Item | 1979 | 1978 |
|---|---|---|
| **LIABILITIES AND OTHER CREDITS** | | |
| **PROPRIETARY CAPITAL** | | |
| Common stock issued | $30,227,480 | $27,782,879 |
| Preferred stock issued | 22,556,514 | 21,365,486 |
| Capital stock subscribed, liability and premium | 14,430,158 | 12,960,343 |
| Other paid-in capital | 6,307,471 | 5,274,002 |
| Installments received on capital stock | 1,890 | 1,883 |
| Discount on capital stock | 15,922 | 8,696 |
| Capital stock expense | 458,009 | 424,965 |
| Retained earnings | 21,025,655 | 19,276,548 |
| Unappropriated undistributed subsidiary earnings | 1,003,000 | 943,209 |
| Reacquired capital stock | 9,466 | 3,363 |
| Total Proprietary Capital | $95,163,771 | $87,387,453 |
| **LONG TERM DEBT** | | |
| Bonds (less reacquired) | $89,025,267 | $83,223,916 |
| Advances from associated companies | 107,242 | 195,949 |
| Unamortized premium on long term debt | 116,179 | 121,893 |
| Unamortized discount on long term debt (debit) | 280,356 | 241,482 |
| Other long term debt | 6,696,061 | 4,967,776 |
| Total Long Term Debt | $95,644,383 | $88,262,873 |
| **CURRENT AND ACCRUED LIABILITIES** | | |
| Notes payable | $6,654,513 | $3,549,168 |
| Accounts payable | 6,644,896 | 5,566,806 |
| Payables to associated companies | 1,488,234 | 1,122,437 |
| Taxes accrued | 2,321,360 | 2,415,582 |
| Interest accrued | 1,910,862 | 1,727,897 |
| Dividends declared | 933,994 | 802,671 |
| Tax collections payable | 241,144 | 229,836 |
| Other current and accrued liabilities | 2,209,143 | 1,902,325 |
| Total Current and Accrued Liabilities | $23,396,152 | $19,316,724 |
| **DEFERRED CREDITS** | | |
| Customer advances for construction | $409,488 | $356,217 |
| Accumulated deferred investment tax credits | 6,318,370 | 5,244,971 |
| Deferred gains from disposition of utility plant | 83,320 | 1,596 |
| Unamortized gain on reacquired debt | 90,115 | 57,919 |
| Accumulated deferred income taxes | 11,890,663 | 10,003,956 |
| Other deferred credits | 1,448,355 | 1,172,017 |
| Total Deferred Credits | $20,240,313 | $16,836,676 |
| **OPERATING RESERVES** | | |
| Total Operating Reserves | $367,506 | $310,482 |
| TOTAL LIABILITIES AND OTHER CREDITS | $234,834,124 | $211,093,406 |

[1] Includes Environmental Construction Work in Progress of $5,946,765 for 1979 and $5,091,451 for 1978.

Note: Due to rounding detail may not add to totals.

Source: "Statistics of Privately Owned Electric Utilities In the United States"; Oct., 1980; Pp. 19-20; Published by the Energy Information Administration; U.S. Department of Energy

STATEMENT OF THOMAS A. VANDERSLICE, PRESIDENT AND CHIEF OPERATING OFFICER, GENERAL TELEPHONE & ELECTRONICS CORP.

SUMMARY

Mr. Chairman and Members of the Committee:

My name is Thomas A. Vanderslice. I am President and Chief Operating Officer of General Telephone & Electronics Corporation, known as GTE. I am testifying today on behalf of my company and USITA, the United States Independent Telephone Association.

I find it necessary to testify before you today to call your attention to two provisions in S. 683 which would impose serious inequities on the telephone industry. I will discuss each of these provisions separately.

THE ACCELERATED COST RECOVERY SYSTEM WOULD PLACE TELEPHONE COMPANIES AT A SEVERE COMPETITIVE DISADVANTAGE.

Generally, the Accelerated Cost Recovery System ("ACRS") contained in section 201(a) of S. 683, places all business equipment in a 5-year recovery class. There is only one exception to this rule and it applies only to public utility property. This special rule would require that public utility property with an ADR midpoint life of more than 18 years be placed in the longer 10-year recovery class.

Under this special rule, a majority of GTE's telephone equipment would currently fall in the 10-year recovery class. Much of the equipment of our competitors, however, would not be subject to this special rule and would, therefore, fall in the 5-year recovery class. Clearly, requiring the telephone companies to recover their costs over a period twice as long as their competitors would place them at a severe competitive disadvantage. I simply do not believe that anyone intended this unconscionable result.

By a series of orders issued since 1957, the Federal Communications Commission ("FCC") has opened the telephone industry to competition and, today, the industry is subject to pervasive competition in all phases of its business. We in the telephone industry are prepared to meet our new-found competition head on, but we cannot be asked to compete with one hand tied behind our backs, as would happen if ACRS were enacted in its present form.

I understand that the justification for the discrimination between public utility property and all other property in ACRS is based on the perception that utilities have extremely long-lived assets. As applied to the telephone industry, this perception is simply not correct.

Given today's environment of pervasive competition and swift technological change in the telephone industry, it is no surprise that the lives of telephone property are being substantially shortened. The FCC has recognized this and adopted major changes in depreciation for the telephone industry in a recent order, released on December 5, 1980.

The composite actual life used by the FCC, before any application of its recent order, for the GTE telephone companies' major classifications of property was 14.5 years. Surely, an industry with a composite life of 14.5 years does not constitute an industry with extremely long-lived assets so as to justify the discriminatory treatment proposed for telephone property by ACRS.

Even a casual glance at the present ADR guidelines makes this clear. There are many industries with midpoint lives of 14 years or more whose assets will be permitted to fall in the 5-year recovery class, including industries such as tobacco, grain, sugar, rubber, glass, cement, stone and clay products, primary non-ferrous metals, foundry products, and steel mill products.

For these reasons, the provisions of ACRS must be changed to exclude telephone property from the special 18-year rule in ACRS.

THE PROPOSED CHANGE IN THE MANNER BY WHICH UTILITIES ACCOUNT FOR THE INVESTMENT TAX CREDIT UNDERCUTS CONGRESS' PURPOSE IN ENACTING THE CREDIT AND RUNS COUNTER TO THE WHOLE THRUST OF THE PRESIDENT'S ECONOMIC RECOVERY PROGRAM.

Today, a utility has the option of accounting for the benefits arising from the investment tax credit in one of two ways. The proposed change in section 203(d) of S. 683 would permit a regulatory commission to require that both adjustments be made, i.e., reduce a utility's rate base to reflect the credit and pass on the benefits of the credit to the ratepayers over the life of an asset by ratable reductions in a utility's cost of service.

The proposed change would emasculate the benefits of the credit for a utility and provide absolutely no stimulus to it to make an investment. This would completely undercut Congress' purpose in enacting the credit.

The proposal is not new. Just last year, the House Ways & Means Committee overwhelmingly defeated an attempt to add a similar provision (H.R. 3165, introduced by Congressman Stark) to another bill by a vote of 28-6.

The proposed change would operate to reduce substantially the capital available to utilites as a result of the investment tax credit. I am shocked that this proposal should be included in the President's Economic Recovery Program, a program whose very purpose is to increase capital recovery for industry as a whole. Perhaps for this reason, the Treasury Department has reconsidered its position and publicly announced that it will recommend to Congress that this proposal be removed from S. 683.

It would surely be a tragedy to revisit investment tax credit legislation and adopt the proposed change, thereby depriving utilities of a portion of the benefits of the investment tax credit and the badly needed capital involved. The loss of capital would be especially unfortunate in the telephone industry where rapidly advancing technology offers an array of productivity gains for telephone companies and their customers.

STATEMENT OF THOMAS A. VANDERSLICE

Mr. Chairman and Members of the Committee:

My name is Thomas A. Vanderslice. I am President and Chief Operating Officer of General Telephone & Electronics Corporation, known as GTE. GTE is the parent company of a group of companies that provide telephone service, other forms of communication service and manufacture electronic and electrical equipment and products. It is the second largest telephone system in the U.S., providing service to approximately 15.8 million telephones.

I am happy to appear before you today and testify on behalf of my company and on behalf of USITA - the United States Independent Telephone Association. USITA represents the interests of some 1,450 independent, or non-Bell, telephone companies, including GTE's telephone companies, which provide service to approximately 35 million telephones.

INTRODUCTION

I believe there can be no doubt that we urgently need to improve capital recovery and capital replacement in the U.S. economy as a part of the solution to our problems of inflation. The President's Economic Recovery Program, of which S. 683 is an integral part, would be a large step in the right direction and would clearly represent the major change in policy direction that is so desperately needed today. While, for those reasons, I fully support the Program generally and its underlying purpose, I

find it necessary to testify before you today for the purpose of calling your attention to two provisions in the Bill which would impose serious inequities on the telephone industry. I can suggest the necessary corrections to you with confidence because they will insure that the President's Program has its intended effect on the telephone industry, as well as other industries.

The first provision I would like to discuss is section 201(a) of the Bill which would discriminate against telephone companies by unreasonably delaying their cost recovery for federal tax purposes and, thereby, operate to place them at a severe disadvantage vis-a-vis their competitors which are not so treated. The second provision (section 203(d) of the Bill) would emasculate the benefit of the investment tax credit for telephone companies and impose a serious inequity on them and all other utilities in comparison to all non-regulated businesses. I submit that these are clearly unjustified results. I will discuss each of these provisions separately.

## I

## THE ACCELERATED COST RECOVERY SYSTEM IN S. 683 WOULD PLACE THE TELEPHONE COMPANIES AT A SEVERE COMPETITIVE DISADVANTAGE.

ACRS Would Require the Telephone Companies to Recover Their Costs Over Substantially Longer Periods Than Their Competitors - Generally, the Accelerated Cost Recovery System in S. 683 ("ACRS") would place all tangible property (except real estate, automobiles, light-duty trucks and research property) in a 5-year

recovery class. There is only one exception to this rule and it applies to public utility property - and only to public utility property. This special rule would require that public utility property with an asset depreciation range ("ADR") midpoint life of more than 18 years be placed in the longer 10-year recovery class.

Under this special rule, a majority of GTE's telephone equipment would fall in the 10-year class since the current ADR midpoint lives for telephone central office equipment and distribution - or outside - plant exceed 18 years. As explained below, however, this special rule may well not apply to the equipment of our competitors, including equipment identical to equipment used by a telephone company and equipment used to furnish communication services directly competitive with the services furnished by a telephone company. The result, of course, would be to permit the equipment of our competitors to be recovered over a 5-year period, while requiring that our equipment be recovered over a 10-year period. Clearly, this would place the telephone companies at a severe competitive disadvantage. I simply do not believe that anyone intended this unconscionable result.

We in the telephone industry are prepared to meet our new-found competition head on. But we cannot be asked to compete with one hand tied behind our backs, as would happen if ACRS were to be enacted in its present form.

The Telephone Companies are Subject to Pervasive Competition - The telephone industry is no longer a staid regulated monopoly. The Federal Communications Commission ("FCC") has, by a series of orders, opened the industry to competition. The actions taken by the FCC since 1957, as listed on the attached Chart 1, have accomplished its intent of creating a competitive environment, with the result that today the telephone industry is subject to competition in all phases of its business.

This can, perhaps, be best demonstrated by looking at each segment of the telephone business - namely, the sale of terminal equipment, the furnishing of intercity - or long distance - service and the furnishing of local service. The list of competitors in each of these segments and their new communications products and services seem almost endless. (Chart 2). The companies being attracted into the telephone industry's traditional markets, as well as into future telecommunications markets, include many well capitalized competitors such as Exxon, IBM, Xerox, ITT, RCA and Southern Pacific. (Chart 3). There are also many smaller, but rapidly growing competitors, such as MCI and Rolm.

It is sometimes mistakenly believed that competition in the telephone industry exists only in the sale of terminal equipment which equipment would fall in the 5-year recovery class under ACRS and, therefore, be treated in a nondiscriminatory manner. This is simply not so. The FCC has also opened both intercity and local service to competition. New examples of competition in these segments of our business appear almost daily. A few

examples may serve to indicate the types of direct competition the telephone companies face in the actual provision of telephone service.

IBM, along with Aetna Life and Comsat General, has formed a joint venture - known as SBS - to provide long distance telephone and data service. The SBS system completely bypasses the inter-city network of the telephone companies. SBS is in operation today and transmits voice and data messages through its satellite system. Its original thrust is to provide these services between different offices of large corporations and government agencies. It has also announced that it plans to link 75 cities by early 1982 - and 150 cities by early 1983 - and provide telephone service between these cities.

MCI is another example. It has one of the largest microwave systems operating today - over 8,000 miles long - providing telephone service to 112 cities. It offers an alternative to the long distance voice service provided by the telephone companies. You may have seen their ads on television, comparing their long distance rates to the rates of the telephone industry. It also offers data transmission through the same microwave network.

The third segment of our business - local service - is encountering competition from several sources. The cable companies - or CATVs - are an example. They now offer a 2-way capability over their cable lines. The CUBE experiment in Ohio is a case in point. It is a service which permits local television viewers to respond to questions over cable TV lines. Another

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case in point is Manhattan Cable and other CATVs which currently provide data transmission services over their lines.

I mentioned earlier that SBS bypasses the intercity network of the telephone companies. It also bypasses the local market, providing so-called point-to-point voice and data transmissions. The SBS system picks up a transmission at a customer's premises and transmits it through SBS' facilities - not the facilities of the telephone companies - directly to a recipient.

Still another example is the mobile radio telephone companies. In the past, mobile telephone service had only a limited usefulness because of its poor quality and long waiting periods for an open channel. Because of a technological breakthrough, termed "cellular" mobile radio, the mobile telephone now has the same high quality, and ready availability, as regular telephone service. The FCC has recently allocated half of the frequencies in each market to non-telephone companies. As a result, more and more non-telephone mobile radio companies will doubtlessly employ this new technology and compete directly with telephone companies in the provision of local service.

The key fact is this - telephone companies no longer have the only capability for 2-way transmissions into and out of the home and office. The same capability exists - and is being utilized - by satellite transmission, by microwave transmission, over the cable lines and by radio telephone. The competition from alternative 2-way transmission systems is real and present, and growing day by day.

The Special Rule Applicable Only to Public Utility Property Will Not Apply to Our Competitors - The special rule applies only to public utility property. The term "public utility property" is defined in section 167(l)(3)(A) of the Internal Revenue Code to encompass property used in the furnishing of various services, including "telephone services", if the rates for the services "have been established or approved" by a regulatory commission.

With many items of traditional telephone property becoming essentially computers - e.g., a digital electronic switch - and computer companies entering the telephone business, it seems likely that a computer company may place property which is virtually identical to the property of telephone companies in the 5-year recovery class. In the hands of a computer company, this type of equipment may well not be treated as used in the furnishing of telephone services and, hence, may well not be public utility property. In the hands of a telephone company, however, it will be public utility property.

The property owned by MCI provides a further example of the unjustifiable discrimination between telephone companies and their competitors. As I mentioned earlier, MCI offers an intercity telephone service which directly competes with the telephone industry's long distance service. The rates of carriers like MCI - termed specialized common carriers - are subject to perfunctory review by the FCC. They are required to file their rates with the FCC, and the FCC has the power to review them, and modify them if it wishes. At the moment, therefore, MCI's property would appear to be public utility property.

But look what is likely to happen. The FCC has proposed to end all regulation over the rates charged by carriers like MCI because it believes that competition will operate to hold down the rates. If this happens, as seems likely, its property will no longer be public utility property.

ACRS, in its present form, would also disadvantage telephone companies, even when compared with some of their regulated competitors. Under the present ADR guidelines, telephone companies are required to place microwave radio transmission property, and related control, switching and supporting structures, in guideline classes which have midpoint lives in excess of 18 years. Our regulated competitors, however, are permitted to place the identical equipment in different guideline classes which have midpoint lives of less than 18 years. As a result, the microwave property of a telephone company would fall in the 10-year recovery class; the identical microwave property of even our regulated competitors would fall in the 5-year class.*

Chart 4 vividly demonstrates the severe competitive disadvantage which ACRS would impose on the telephone companies.

The Apparent Reason For the Special Rule in ACRS Relating to Public Utility Property Has no Application to Telephone Property - Without a doubt, the special rule applicable only to public

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*It is my understanding that the ADR guidelines were in the process of being revised for telephone property and that any revision would have addressed this unwarranted discrepancy.

utility property is discriminatory in nature. While discrimination may be appropriate when it is based on a valid distinction, I submit that no valid distinction exists to support the discrimination against telephone property.

I understand that the justification for the discrimination between public utility property and all other property in ACRS is based on the perception that utilities have extremely long-lived assets. As a result, so the argument goes, utilities would receive a disproportionate benefit under ACRS if they were permitted to recover their investments over so short a period as 5 years. As applied to the telephone industry, this perception of long-lived assets is simply not correct.*

During the past decade, a variety of changes, economic, political, social and technological, have revolutionized the telephone industry. These changes have given birth to two major forces that are exerting unprecedented pressures on the telephone business as we have traditionally known it, and are operating to

*The current ADR composite midpoint life for the three major ADR guideline classes of telephone property is 16.4 years. This is not an accurate reflection of the useful or economic lives of this property. The ADR guidelines for telephone property have not been revised for over 10 years. Accordingly, they do not reflect the dramatic changes that have swept over the telephone industry in the last several years and, for that reason, are terribly inaccurate. The Treasury Department's Office of Industrial Economics has been conducting a study with a view to revising the ADR guidelines for the telephone industry. It is hoped that any such change would be made effective January 1, 1981, and that any provision of ACRS which refers to the ADR midpoint lives would use the lives in effect at a date no earlier than January 1, 1981, and not December 31, 1980, as S. 683 currently proposes to use.

shorten dramatically the useful lives of telephone property. These two forces are pervasive competition and swift technological change.

I have explained the pervasive competition facing the telephone companies today. The technological changes sweeping our industry are no less dramatic. Telephone systems and computers were married in the 1970s and have produced such rapid technological changes that the phenomenon is commonly referred to as an explosion.

Given today's environment in the telephone industry, it is no surprise that the lives of telephone property are being substantially shortened. Our customers are demanding the new telephone products and services which technology has made available - and rightfully so. They offer an array of opportunities for increased productivity for our customers and for the U.S. economy as a whole. Our competitors stand ready to offer these products and services.

The FCC, for ratemaking purposes, adopted major changes in depreciation for the telephone industry in a recent order, released on December 5, 1980. In it, the FCC specifically recognized that the forces of competition and technology are shortening the lives of telephone equipment, and authorized for the first time the use of equal life group - known as ELG - and remaining life methods of depreciation for ratemaking purposes. It also held open the door for accelerated methods of depreciation upon adequate documentation by the telephone companies.

The composite actual life used by the FCC, before any application of its recent order, for the GTE telephone companies' major classifications of property was 14.5 years. Surely, an industry with a composite life of 14.5 years does not constitute an industry with extremely long-lived assets so as to justify the discriminatory treatment proposed for its property under ACRS. It is just not accurate to say that the telephone companies would receive any disproportionate benefit if a majority of its property were to fall in the 5-year recovery class.

Even a casual glance at the present ADR guidelines makes this clear. There are many industries with midpoint lives of 14 years or more whose assets will be permitted to fall within the 5-year recovery class. Examples of these industries include the tobacco, grain, sugar, rubber, glass, cement, stone and clay products, primary nonferrous metals, foundry products and steel mill products industries.

It should be reemphasized that the FCC composite life of 14.5 years does not reflect its recent order. I believe it is fair to state that, currently and in the near future, as our telephone companies go back to the FCC for new depreciation rates, the actual composite life will be significantly shorter than the present 14.5 years.

Telephone Property Should be Excluded From the Definition of Public Utility Property in ACRS - I can think of no sound policy reason which supports the discriminatory treatment proposed to be accorded to telephone property under ACRS. I am confident you

will agree with me that this treatment must be changed by excluding telephone property from the special 18-year rule in ACRS applicable to public utilities.*

This change must be made so that:

1. the telephone companies and their competitors are treated equally under the tax law; and

2. the telephone companies are treated equally with other industries that have property with similar lives.

II

THE PROPOSED CHANGE IN THE MANNER BY WHICH UTILITIES ACCOUNT FOR THE INVESTMENT TAX CREDIT UNDERCUTS CONGRESS' PURPOSE IN ENACTING THE CREDIT AND RUNS COUNTER TO THE WHOLE THRUST OF THE PRESIDENT'S ECONOMIC RECOVERY PROGRAM.

Existing Statutory Provisions and the Proposed Change in S. 683 - Congress enacted the investment tax credit in order to stimulate investment and promote capital formation. In extending the credit to utilities, Congress recognized that the credit would not serve its intended purpose if the utilities were required immediately to flow through the tax benefits of the credit to their ratepayers. Accordingly, to ensure that the Congressional purpose would be accomplished, Congress devised a method by which the credit would operate to spur additional investments

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*This change can be easily accomplished by revising proposed section 168(c)(3)(A)(ii), dealing with property in the 10-year recovery class, to read as follows (new portion is underlined): "(ii) public utility property (other than property used predominantly in the trade or business of the furnishing or sale of telephone services and section 1250 property except to the extent clause (i) applies) with a midpoint life of greater than 18 years."

by a utility while, at the same time, allowing the ratepayers to share in a portion of the benefits of the credit. This carefully fashioned rule is contained in section 46(f) of the Internal Revenue Code.

Section 46(f) permits a utility to elect one of two methods for reflecting the investment tax credit for ratemaking purposes. Each of these options produces a sharing of the credit's benefits between a utility and its ratepayers. The first option permits a regulatory commission, in setting rates, to deduct the credit from a utility's rate base to which a rate of return is applied. When the rate base is reduced, the effect is to reduce the return allowed to a utility on its assets devoted to public service and, thereby, lower its rates. Under this option, a regulatory commission may not reduce a utility's cost of service to reflect any portion of the credit.

The second option, the option elected by GTE's telephone companies and most other utilities, permits a regulatory commission, over a period of time, to pass on the tax benefits of the credit to ratepayers as reductions in a utility's cost of service, thereby lowering its rates. The reductions in cost of service are made ratably over the life of the asset involved, rather than immediately in the year the credit is realized. Under this option, a utility's rate base may not be reduced to reflect the investment tax credit.

The proposed change in S. 683 would permit a regulatory commission to make both adjustments, i.e., to reduce a utility's

rate base to reflect the credit and to pass on the benefits of the credit to the ratepayers over the life of an asset by ratable reductions in a utility's cost of service.

The Proposed Change Would Undercut Congress' Purpose in Enacting the Credit - The investment tax credit was first enacted in 1962 as a device to stimulate additional investments by increasing "... the expected profit from their use."* The issue raised by the proposed change involves the manner by which a utility accounts for the credit so as to ensure that the underlying Congressional purpose of stimulating investments is satisfied. This issue has been considered several times before by Congress, including just last year by the House Ways & Means Committee.

The investment tax credit was suspended in 1969 and subsequently reinstated in 1971. As a part of such reinstatement, Congress adopted the present provisions in section 46(f). In so doing, Congress explicitly considered the balancing of the benefits of the credit between a utility and its ratepayers so as to assure that the credit would fulfill its purpose of stimulating investment, while also allowing the utility's ratepayers to receive a portion of the benefits.

When the investment tax credit rate was increased from 4 percent to 10 percent for public utilities in 1975, Congress reaffirmed its support for the existing two methods of reflecting

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*H.R. Rep. No. 1447, 87th Cong., 2d Sess.(1962), p.8.

the credit contained in section 46(f). It specifically provided that even those utilities allowed to flow through the benefits immediately in 1971 (certain utilities which historically flowed-through the benefits were allowed to continue doing so) would be required to use one of the two existing methods for the 6 percent increase in the credit, unless they expressly elected immediate flow-through.

Last year, this House Ways & Means Committee considered H.R. 3165, a bill introduced by Congressman Stark. That bill would have had the same effect on the manner by which utilities account for the investment credit as the change proposed in S. 683. The Committee defeated an attempt to add H.R. 3165 to another bill by a vote of 28 to 6.

Thus, over a period of many years, Congress has considered the proper treatment of the investment tax credit of a public utility and has consistently reached the conclusion that the treatment provided in present section 46(f) is the proper one. This is not surprising. If the proposed change were to become law, thereby denying a utility the ability to earn a return on the portion of its rate base attributable to the investment credit, the credit would provide absolutely no stimulus to a utility to make an investment. Obviously, this would completely vitiate the very purpose sought by Congress in enacting the credit.

The proposed change would also discriminate against the telephone companies. When Congress increased the investment tax

credit to 10 percent for a utility in 1975 in order to place it on an equal footing with other businesses, it did so in recognition of the fact that a lower investment tax credit rate for public utilities "discriminates against investment in utilities and impedes such investment at a time when the public utilities need large amounts of capital to build up their capacity to meet the growth in demand for their services."* Just as a difference in rates discriminates against utilities, including telephone companies, so also would the proposed change disturb the balance struck by Congress in 1975 between utilities and other businesses and make it even more difficult than it is today for utilities to compete for available capital.

The Proposed Change in the Investment Tax Credit Runs Counter to the President's Economic Recovery Program - The proposed change would emasculate the benefits of the investment tax credit for the telephone companies and would operate to reduce substantially the capital available to them as a result of the investment tax credit. In view of the aims of the President's Economic Recovery Program, I do not believe that the sponsors of the proposed change intend to decapitalize the telephone companies.

As I understand the position of the proponents of the proposed change, this is not their aim. Rather, they proceed from a highly theoretical economic model based on pure competition and

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*H.R. Rep. No. 94-19, 94th Cong.,1st Sess. (1975), p. 12.

conclude that the adjustments are necessary to achieve what has been termed "economic normalization". While I believe this approach suffers from a serious shortcoming because it is based on a set of assumptions that do not exist in the real world, one thing is clear - whatever may be the theoretical justification, it would be a practical mistake to deny to telephone companies any of the capital presently provided by the investment credit. This is especially true because telephone companies (and other utilities) are highly capital intensive and probably suffer more than any other industry from the ravages of inflation. GTE's largest telephone company, for example, requires $2.74 of capital to produce $1.00 of revenue; the 50 largest industrials require only about $.74 of capital to produce $1.00 of revenue.

I am frankly shocked that this proposal should be included in the President's Economic Recovery Program, a program whose very purpose is to increase capital recovery for industry as a whole. The whole thrust of the Program is based on a recognition of the urgent need to improve capital recovery and replacement in the U.S. economy. Perhaps for this reason, the Treasury Department has reconsidered its position and publicly announced that it will recommend to Congress that this proposal be removed from S. 683.

Utilities Desperately Need Increased Capital Recovery - As noted above, Congress recogni~ed in 1975 that utilities need large amounts of capital if they are to be able to meet the growth in demand for their services. This statement is even more true today than it was in 1975. In the telephone industry, for

example, our customers are demanding the new telephone products and services which expanding technology is making available. We must have adequate capital available if we are to meet these constantly increasing demands.

The marketplace reflects the precarious situation of the utilities. In terms of the market to book ratio, it is estimated that, during 1980, the common stock of utilities sold at only 76 percent of book value and industrials sold at 130 percent of book value; and, the utilities common stock sold at a 6.9 price to earnings multiple, compared to 8.2 for industrials.*

In this economic atmosphere, it would be a tragedy to revisit investment tax credit legislation that Congress made permanent only four years ago and adopt the proposed change, which only last year the House Ways & Means Committee overwhelmingly rejected (H.R. 3165), thus depriving the utilities of a portion of the benefits of the investment tax credit and the badly needed capital involved.

III

## ADDITIONAL REASONS SUPPORTING THE INCLUSION OF TELEPHONE PROPERTY IN THE 5-YEAR RECOVERY CLASS AND THE CONTINUATION OF THE PRESENT METHOD OF ACCOUNTING FOR THE TAX CREDIT.

It is generally recognized today that increasing our nation's productivity is essential if we are to revitalize the U.S. economy, increase the competitiveness of U.S. companies

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*These figures were derived from a compilation of Salomen Brothers' 100 Utilities and Standard and Poor's 400 Industrials.

abroad and improve our nation's overall standard of living. Increased capital recovery is a key ingredient to increasing our nation's productivity.

It is difficult to think of an industry in which improved capital recovery can provide more productivity benefits than the telephone industry. Its rapidly advancing technology offers an array of opportunities to improve productivity.

To embrace this new technology, we in the telephone industry must have sufficient capital available to us. Including telephone property in the 5-year class and continuing the present method of accounting for the tax credit would provide us with some of the additional capital we so desperately need.

One example of the way technology improves productivity in the telephone industry can be found in the basic switching system. (Chart 5). The replacement of an electromechanical switch with an analog electronic switch can reduce maintenance costs by as much as 60 percent and floorspace requirements by 40 percent. A digital electronic switch offers additional reductions of 35 percent for maintenance and 60 percent for floorspace. The overall savings for digital electronics as compared to electromechanical switching amount to about three-quarters of both the maintenance and floorspace costs.

The new telephone technology also offers an array of new services which will improve the productivity of other U.S. industries. The list is almost endless. I have shown but a few of the possibilities on attached chart 6. I'm sure you've all seen articles about the office and home of the future.

It would be a tragic mistake to discriminate against the telephone industry by depriving telephone companies of badly needed capital and deny our economy the full opportunity for significant productivity gains - one of the prime objectives sought in the President's Economic Recovery Program.

# FCC ACTIONS EXPANDING COMPETITION

| Year | Subject |
|---|---|
| 1957 | Hush-A-Phone |
| 1959 | Private Line Microwave |
| 1968 | Carterfone |
| 1971 | Specialized Common Carrier |
| 1972 | Domestic Communications Satellite |
| 1973 | Value Added Carriers |
| 1975 | Cellular Mobile Radiotelephone Systems - Experimental |
| 1976 | Terminal Equipment Registration |
| 1976 | Resale of Private Line Services |
| 1980 | Deregulation of Terminal Equipment and Enhanced Services (Computer Inquiry II) |
| 1980 | Entry into MTS/WATS Markets |
| 1980 | Resale of MTS/WATS Services |
| 1980 | Additional Domestic Communications Satellites |
| 1980 | Cellular Mobile Radiotelephone Systems |

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# THE TELEPHONE INDUSTRY IS SUBJECT TO COMPETITION IN ALL SEGMENTS OF ITS BUSINESS

| Business Segment | Competitive | Protected Monopoly | Examples of Competitors |
|---|---|---|---|
| **TERMINAL EQUIPMENT** | | | |
| **Telephone Instruments** | ✓ | | **ITT-Stromberg-Carlson** |
| **PABXs** | ✓ | | **Exxon-ITT** |
| **Other Terminal Equipment** | ✓ | | **IBM-Burroughs** |
| **INTERCITY SERVICE** | | | |
| **Voice** | ✓ | | **IBM-Southern Pacific** |
| **Data** | ✓ | | **ITT-Southern Pacific** |
| **Satellite** | ✓ | | **RCA-IBM** |
| **LOCAL SERVICE** | | | |
| **Local Distribution** | ✓ | | **Xerox-Warner Communications** |
| **Mobile Radio** | ✓ | | **Xerox-ITT** |

# TELEPHONE COMPANIES FACE COMPETITION FROM MANY LARGE COMPETITORS

| Competitor | Size* | Fortune** Rank |
|---|---|---|
| **Exxon** | **$4,295** | **2** |
| **IBM** | **3,011** | **3** |
| **Xerox** | **563** | **27** |
| **ITT** | **381** | **45** |
| **RCA** | **283** | **65** |
| **So. Pacific** | **180** | **121** |

*1979 NET INCOME ($ Millions)

**Fortune 500 Industrials, 50 Utilities, and 50 Transportation Companies, all ranked by Net Income

# COMPETITIVE DISADVANTAGE OF ACRS FOR TELEPHONE COMPANIES

## COMPETITORS

| Equipment | ACRS Recovery Period |
|---|---|
| Computers | 5 |
| Property of Non-Regulated Competitors | 5 |
| Regulated Microwave Systems | 5 |

## TELEPHONE COMPANIES

| Equipment | ACRS Recovery Period |
|---|---|
| Central Office Equipment | 10 |
| Outside Plant | 10 |

# NEW TECHNOLOGY IMPROVES PRODUCTIVITY AND REDUCES COST OF COMMUNICATIONS

| | Estimated Savings | |
|---|---|---|
| | Maintenance | Space |
| Analog vs. Electromechanical | 60% | 40% |
| Digital vs. Analog | 35% | 60% |
| Total: Digital vs. Electromechanical | 74% | 76% |

# NEW COMMUNICATIONS TECHNOLOGY WILL IMPROVE PRODUCTIVITY OF OTHER COMPANIES

- Electronic Mail
- Video Conferencing
- Data Base Access
- Electronic Funds Transfer
- Credit Verification
- Energy Control and Conservation

Senator DANFORTH. The Committee will stand in recess until 2 p.m.

[Whereupon, at 12:20 p.m., the hearing recessed, to reconvene at 2 p.m., the same day].

Senator WALLOP. Our last panel consists of Mr. Hallberg, Mr. Chalk, Mr. Seidman, accompanied by Mr. Bedell, and E. Hardy Eubanks III.

Gentlemen, would you begin. Mr. Hallberg.

## STATEMENT OF DAVID E. HALLBERG, PRESIDENT, RENEWABLE FUELS ASSOCIATION

Mr. HALLBERG. Thank you, Mr. Chairman. I appreciate the opportunity to be here today. I will keep my remarks very brief.

My name is David E. Hallberg. I am president of the Renewable Fuels Assocation. Our association was formed several months ago in order to promote the commercialization of all forms of alternative energy technologies, especially alcohol fuels and methane and we would like to make a few comments today about one of the provisions of the administration's proposal.

The Renewable Fuels Association generally supports the administration's goals of providing more rapid cost recovery as a means of stimulating investment and productive assets.

However, there is one provision in the ACRS proposal that could significantly reduce investment in alcohol fuel and other renewable energy ventures. That provision is section 203(g) of both S. 683 and H.R. 2400 and it applies the so-called at risk rule to the investment tax credit.

The ACRS proposal would provide that for any taxpayer for whom the at risk rule presently applies as a limitation on deductions which would be an individual subchapter S corporation, or a closely held corporation, the basis of property which is eligible for the investment tax credit and the energy investment tax credit would be limited to the amount that the taxpayer has at risk with respect to such property at the time it is placed in service.

The rest of the credit could only be claimed then as the principal amount of the nonrecourse liability was paid.

Thus, unlike the current at-risk rule which only serves as a limitation on the amount of deduction that a taxpayer could claim, this proposed at-risk rule would limit the amount of basis in the property which could be used in computing the ITC and the EITC.

If this proposal were adopted in its present form, it would have a substantial adverse effect on the attractiveness of investments in fuel alcohol and other renewable energy plants.

As you know, at the present time, such investments are relatively speculative and few investors are willing to commit funds to new ventures in alternative fuels without either direct Government assistance or extraordinary tax benefits.

In many cases the future profitability of these ventures is uncertain and also the equipment which utilizes unproven technology does not offer very much basis for certainty.

Therefore, few individuals or closely held corporations would be willing to invest in plants utilizing unproven technology on a recourse basis even if the ITC and EITC were available.

Consequently, most of the projects for the production of alcohol fuel which have been planned recently or since the enactment of crude oil Windfall Profits Tax Act of 1980 have utilized the limited partnership format and attempted to secure financing from individuals as limited partners in part by reason of the tax benefits available.

Implementation of the portion of at-risk rule provision then will have substantial adverse effects on many projects which are currently underway and this provision is retroactive back to January 1, 1981.

Hardy Eubanks with Blyth Eastman can testify to the fact that there are several projects now before DOE that would be severely compromised by this provision.

I think that it goes without saying that some of the steps that Congress has taken in the past, especially in legislation like the Energy Tax Act and the Energy Security Act, made clear that it was congressional intent that there be incentives for the widest possible private sector participation in the alternative energy technologies.

Because this proposal would not impact on widely-held corporations, but would on individual subchapter S closely held, we believe that it would be arbitrary and give an unwise and unnecessary competitive advantage to the widely held corporations.

We feel it would be unjustified because $1 of credit provides as much tax shelter for a widely held corporation as it does for an individual.

We also believe that one of the problems with this provision is that it will substantially limit the flow of funds into the production of alcohol fuels and other alternative fuels.

Third, we believe that it will encourage the production of alternative fuels only by big business which we think will exacerbate the concentration of ownership in production energy production facilities in this country and is therefore undesirable.

Fourth, we believe that this would provide an unwarranted premium to safe investments as opposed to risky investments with partial risk protection by use of nonrecourse financing.

Therefore, we would like to strongly urge that this committee take action to eliminate this proposal that would extend the at risk rule to investment tax credit.

In the alternative we would hope that the proposal would not be made applicable to types of investment which are eligible for the EITC.

Third, another solution would be to limit the basis of property eligible for the ITC or EITC to exclude only the amounts of nonrecourse indebtedness provided by the seller or person related to the seller unless the taxpayer can establish that the cost of the property including seller provided nonrecourse indebtedness does not exceed the property's fair market value.

We think this would help to prevent the use of artificially inflated purchase prices which we think are the objective of this provision.

Thank you very much.

Senator WALLOP. Thank you, Mr. Hallberg and your entire statement will be put in the record as though it had been delivered.

I will wait for questions until we have had the entire panel talk. Mr. Chalk.

## STATEMENT OF JOHN ALLEN CHALK, DIRECTOR OF THE AMERICAN PETROLEUM REFINERS ASSOCIATION

Mr. CHALK. Thank you, Mr. Chairman. My name is John Allen Chalk and I am vice president and general counsel of LaJet, Inc., a small petroleum refiner with 40,000 barrels of atmospheric distillation capacity with facilities at St. James, La.

I am appearing today as a director for the American Petroleum Refiners Association.

We have submitted today, Mr. Chairman, a full written statement with appendices A and B. Appendix A is a comparison of certain cost recovery provisions affecting depreciation of refinery equipment in the current provisions or bills that are pending before the committee.

Appendix B is a comparison of depreciation deductions for the independent refining industry under certain of the present proposals that are pending.

Today in my brief oral remarks I would like to make three points.

First of all, it is our contention that refining is a basic U.S. industry. We believe that the industry in this country has an investment base somewhere in the rough neighborhood of $20 billion on a 1979 book value estimate with a replacement cost in the area of $50 billion.

Our industry, the U.S. refining industry, employs at least 200,000 skilled refinery workers based on a rate of about 12 skilled technical workers to every 1,000 barrels of capacity in this country.

[Senator Grassley arrived.]

Mr. CHALK. However, as I am sure the chairman is aware, domestic refining in this country has been a net money loser in the first quarter of 1981. The domestic refining industry is running at a 65 percent utilization rate and we know approximately 40, maybe 50 individual refineries that are presently shut down.

As an example, first quarter figures for Gulf Oil Co. show marketing and refining losses in the $25½ million range and for Amoco in the $208½ million range.

We believe that decontrol——

Senator WALLOP. Let me just interrupt there. You don't suppose that those things will be ballyhooed by the press and politicians quite the way the profits were.

Mr. CHALK. No, sir. Unfortunately.

We believe that decontrol will actually encourage foreign refining, Mr. Chairman, at the expense of the domestic refining industry.

We believe that foreign refining investment is being very aggressively undertaken by OPEC nations. A report in the Wall Street Journal today on pages 1 and 2 details a new relationship that Dow Chemical and Saudi Basic Industries Corp. have recently reached regarding a $1.5 billion petrochemical plant in Saudi Arabia for the specific purpose of importing ethylene products back into this country.

This is only one example of the kind of thing that we see happening today.

We believe, therefore, that some incentive must be given to domestic refining in the present tax provisions.

Our second point to be made today in our oral testimony is that capital formation incentives are needed desperately by our industry. When I say our industry, I speak not simply for the independent sector, but I speak for the entire refining industry in this country, and I want that to be very clearly distinguished and our written testimony makes that clear as well.

In 1973 only 36 percent of our crude slate was sour and heavy crude. By next year it is expected and it presently looks like we are on target that 52 percent of our crude slate going into U.S. refineries will be sour and heavy crude.

That means that we are going to have to do retrofitting and upgrading in our refineries in this country.

Chase Manhattan Bank says we will have to spend $60 billion in the next 10 years.

The National Petroleum Council says we have to spend at least $12 billion in the next 3 to 5 years.

Within our own association, we expect that our members will need to spend $6 billion in the next 3 to 5 years and some of us need to spend that in the next 3 years just in order to stay in business.

With new foreign capacity refining the easier to process foreign crude oils, there is even more reason that the domestic refining industry must be able to refine sour and heavy crudes.

Mr. Chairman, with your permission I do want you to know of our strong support for your proposed amendments to the Energy Tax Act of 1978 amendments, S. 750 bill, which would provide additional energy investment tax credits for energy efficient investment.

Senator WALLOP. Thank you very much, Mr. Chalk, and I know that endorsement is welcome and we have at least gotten to the position where we do not have official opposition which is a big step in the right direction.

Mr. CHALK. We are encouraged.

Senator WALLOP. Mr. Seidman.

## STATEMENT OF L. WILLIAM SEIDMAN, VICE CHAIRMAN, PHELPS DODGE CORP.

Mr. SEIDMAN. Thank you, Mr. Chairman. I appreciate the opportunity to express to the committee the views of the American Mining Congress with respect to the proposed tax law.

I have with me Dennis Bedell who is chairman of the American Mining Congress Tax Committee and I have submitted a detailed statement for the record.

I will make a few comments highlighting that statement.

First, as I am sure you are aware, the mining industry is probably the most capital intensive industry in the United States. In our own industry which is primarily on the copper side it takes $4 of capital to produce $1 of sale.

Their projects are huge, they cost up to $1 billion and take 5 to 10 years to complete and recently the industry has been hit by very

large capital costs because of mandated environmental health and safety and other Government mandated expenditures because mining costs have escalated faster than the general rate of inflation and of course by the rising energy in interest costs.

In addition, a great part of the industry has been depressed by large amounts of imports and the depressed prices have drained capital from the industry.

If you look at the mining corporation's balance sheets today by and large they are all in a position where they are short of capital and unable to raise large amounts of capital.

Now, we have looked at the administration's proposed accelerated capital recovery system. We believe that it is a good one and it will be beneficial for the economy of the country and if it is good for the economy of the country it will be good for our industry.

Therefore, we support it.

There are two amendments that we think should be made to it of a minor but important nature to our industry.

First we strongly recommend providing more flexibility by permitting the taxpayer the option of deducting less than the proposed mandatory maximum cost recovery allowances.

In other words we would like to have more flexibility to use the new proposals writeoffs or less than that if it is for the benefit of the taxpayer.

Second, we recommend revising the proposed extended recovery rules for foreign assets so that these assets are eligible fore the same type of accelerated cost recovery or at least are eligible for recovery as rapidly as they were under present law. As you know, the proposal would make that in many cases less rapid.

Having said this about the bill as proposed, we want to emphasize that there are significant segments of the mining industry as well as many other major capital intensive industries which will not receive any direct or immediate benefit from the proposed cost recovery system. Even with the changes just suggested.

This is due to the current depressed state of the industry and the low amount of taxes currently paid.

As we have pointed out the mining industry needs large capital investment and it needs them now to provide for long delayed capital expenditures.

Thus, while the American Mining Congress supports the President's proposed recommendations to Congress, if this is the time for compromise or for finding a better capital formation vehicle for our industry and I hope it is we have the following suggestions.

There are four suggestions that we would like to propose to the committee.

First, provide for a refundable investment tax credit or some other method of allowing large unused investment tax credits to be used as a source for capital investment. As I am sure you have heard, there are a number of ways that you could do this. You could make the investment tax refundable, you could make it transferable, you could extend the carryback provisions for a longer period and remove the limitations or you could make it applicable against the minimum tax. Any one of these would move towards providing capital for an industry that is badly in need and

there is no sure way to insure that the capital investments are made and to provide this type of capital.

I have two other items I would like to mention.

One, we would like to propose to the tax treatment of environmental and other Government mandated expenditures received in a—investment tax credit much as the energy type tax credit which you have been so interested in and with respect to the energy tax credit we would like to propose that improvements to mining and mineral processing operations for energy efficiency be included in the credit.

Finally, we propose that the Congress consider the repeal of the minimum tax on corporations because it seems in Congress, that the Congress should allow a capital formation deduction such as depletion and then provide a special tax because the deduction—even though the deduction is used in the ordinary course of business.

We appreciate the opportunity to make this presentation.

Senator WALLOP. Thank you, Mr. Seidman. Mr. Eubanks.

## STATEMENT OF E. HARDY EUBANKS III, VICE PRESIDENT, BLYTH EASTMAN PAINE WEBBER, INC., REPRESENTING NATIONAL ALLIANCE FOR HYDROELECTRIC ENERGY

Mr. EUBANKS. Thank' you, Mr. Chairman. My name is Hardy Eubanks, vice president of Blyth Eastman Paine Webber and I am appearing before you today in my capacity as a member of the board of trustees of the National Alliance for Hydroelectric Energy.

NAHE is a trade assocation whose members represent all segments of the hydroelectric energy industry. NAHE members include hydropower developers and equipment manufacturers as well as engineering legal and fiscal consultants.

You have my written testimony. For the sake of brevity I will just hit the very major points.

Senator WALLOP. Thank you, and your statement with the others will be included in the record.

Mr. EUBANKS. The National Alliance for Hydroelectric Energy strongly opposes the proposed at risk rules application to tax credits as represented by section 203(g) and urges that it be deleted from S. 683.

We oppose for three primary reasons.

One, if the proposed at risk rules are enacted, they will frustrate the intent of the alternative energy financial incentive provisions previously enacted in other bills and result in the postponement or cancellation of significant energy projects.

Two, the at-risk rule as proposed is also contrary to the policy behind the President's program for economic recovery. It is contrary because it is understood that by cutting out several direct funding programs for alternative energy systems, the tax credits and other benefits would remain. The effect of the at-risk rule is to limit this.

Three, we propose the at-risk rule because it would discriminate against small businesses by making the rate of return on capital investments by individuals and small companies much lower than corporations which are not subject to the rule.

We believe that because of these three reasons that we should not have at-risk rule.

Senator WALLOP. I thank you very much, Mr. Eubanks.

Let me just toss a question to the panel on how you would respond if you as well as many others have testified this afternoon as being in favor of deleting or modifying the proposed amendment of the at-risk rules which would limit the ITC that the individual could obtain.

Apparently the concern at the present are with those instruments which are marketed as tax shelters throughout the investment community and indeed some prospectuses which have been sent to the staff indicate that some investments within your industries are so marketed.

How can we as a committee respond to the concern at Treasury without the adverse effects that you describe.

Mr. EUBANKS. Would you like for me to answer that.

Senator WALLOP. Anybody.

Mr. EUBANKS. I would prefer that they be referred to as tax-advantaged investments rather than tax-shelter investments. I think the key to the situation is that it particularly, in the case of hydroelectric—it is a key—you have a very similar type of a situation that you had in real estate—and real estate is exempted from at-risk rules—in that you have a substantial investment, one which must be put in place; two is that you have a reasonable level of risk inherent in the operation of the project and whether there will be any return at all; and three under existing circumstances, a rather low cash return on the investment itself.

Therefore, as was recognized in the Windfall Profit Tax Act, an additional incentive is necessary to attract capital from other investments, because essentially that's what you are trying to do, is attract the capital that would be going to another investment. The advantage of a tax credit in this case to an individual or closely held corporation is that one, it is realized very quickly and therefore on a discounted basis increases their return; two is that it gives them an incentive to invest their money for a long period of time without an immediate cash return because of the tax credit.

Senator WALLOP. I am a little concerned because I still don't think we have, from the standpoint of the committee, answered the concern that Treasury has expressed by way of marketing these various deals as tax shelters for the wealthy. Mr. Hallberg, did you have something to say?

Mr. HALLBERG. Mr. Chairman, I would like to make just one point. I am not an expert in this area, but my understanding is that one of the major concerns that Treasury had was the abuse potential that exists in this area where a valuation problem arises because of seller financing when a print perhaps is put in nonrecourse financing and the valuation is set very, very high—artificially high. In fact, that sort of artificial overevaluation does constitute shelter or a dodge that does not contribute to society's goals in this case.

However, I think that alternative energy projects can be distinguished from that sort of thing in two ways.

First of all, I think our objectives, in this case, bringing on line in the near term alternative energy which contributes to the Nation's energy security goals is very different.

Second, I think that as we stated in our third recommendation, it is possible for us to establish a fair market value even if you are using the seller financed nonrecourse approach, and in that sense I believe that we can come to an accommodation, make a distinction, and satisfy both objectives.

Senator WALLOP. Your feeling is that it ought to be done on the basis of establishing some sort of fair market value.

Mr. HALLBERG. Well, I would say that if in fact a compromise is necessary, and we are not able to completely do away with this provision that that would be one of the ways that it perhaps might be done.

Senator WALLOP. Does anybody want a turn on that?

[No response.]

Senator WALLOP. Mr. Chalk, as you are aware the Finance Committee did recently hold hearings on the future of the U.S. refining industry and during that hearing we heard testimony in favor of a crude oil purchasing cooperative concept to assist the small independent refiners with their crude access problems. Do you believe that the crude oil purchasing cooperative could be effective in helping small refiners?

Mr. CHALK. Yes, sir, I do, Mr. Chairman. I think the agricultural cooperatives, many of them give us excellent examples and excellent precedent with regard to the success of these endeavors.

We have encountered tremendous problems in attempting to buy crude especially from foreign governments. My own company has been in continuous negotiations over the last 24 months with three OPEC nations and one non-OPEC nation. We have been rebuffed continually even though treated with some hospitality, but still have not been able to arrive at a contract.

We are financially a solvent, we have excellent credit lines, we are able to meet all the financial demands, but we continue to get requests for additional information or for some additional step to be taken which causes us to believe that we are really at the bottom line seeing basically government-to-government purchasing of crude these days.

We do feel that a co-op or some such purchasing effort of a joint nature might meet with more success.

Senator WALLOP. Mr. Seidman, I wonder if you could in any way prioritize and give us some idea of the revenue offset tax.

Mr. SEIDMAN. I think the Congress highest priority is to make the proposed new cost recovery system flexible because that would allow the industry to maintain its depletion allowances at the maximum level. So, on a priority basis that would be the highest priority item.

I think the second priority would be two things really, the repeal of the minimum tax and some method of obtaining the unused investment tax credits.

Now the revenue estimates of those would vary of course, very markedly in how you did it. That is whether you gave a total investment tax credit and so forth.

I don't know whether Dennis, you have anything on the minimum tax. Do you have a number—and on the investment tax credit would you want to give them that?

Mr. BEDELL. Well, according to a survey which the American Mining Congress made, the unused investment credit at the present time of the mining industry including 1981 are approximately $385 million.

Now, as Mr. Seidman said, obviously it would depend on how the prior unused credits were phased in. The maximum revenue effect would be of a full refundability of 1981 and all prior would be in that $385 million.

Mr. SEIDMAN. I think it is important to point out that from the point of view of revenue impact of some type of use of the investment tax credit, you could pretty much set it at the level that it appears to be justified by the way that you phase it in or what type of——

Senator WALLOP. What percentage would you allow to be refundable?

Mr. SEIDMAN. Yes.

Senator WALLOP. What would happen in light of the fact that you have testified in favor of the repeal of the minimum tax and in support of the refundable concept with the investment tax credit, if we opted for a simple solution that would permit the investment tax credits to offset the minimum tax liability.

Mr. SEIDMAN. We think that that would be less desirable than doing the other two things, but certainly would be desirable and would certainly help us with our capital problems.

Senator WALLOP. How do you respond then, regarding the refundability of investment tax credit, to the challenge that the Tax Code does not permit sufficient control over disbursement at a time when the audit coverage is scheduled to drop to 2 percent of all returns filed.

Mr. SEIDMAN. I gather the question is, how do we respond to whether the refunded money is going into capital investment, is that what you are asking?

Senator WALLOP. My question really is that there appears or would appear to be a rather enormous lack of control if we are going to drop audits to 2 percent. Refundability is the simplest of all of those things to apply for and if you are going to audit 2 percent, where is the control mechanism? I am not asking you to do the Government business but how would you respond to that?

Mr. SEIDMAN. First, I think that the large amount in dollars of refundability deals with a major corporation in the country, and they are audited, almost all of them on an annual basis, so that in terms of the magnitude of the dollars involved there will be control through the regular process now in effect.

As to the investment tax credit which goes out to many additional taxpayers, I think it would be no different than we have now where a taxpayer can apply for a refund by any number of kinds of deductions or other items which he puts on his tax returns.

Senator WALLOP. I want to thank you all for being here and also the implicit courtesy of shortening your statements. I know that it is sort of a frustration to come all this way, but there are a

number, as you can imagine, that are yet to be heard from in this whole process.

Thank you all very much.

Mr. CHALK. Thank you.

Mr. EUBANKS. Thank you.

Senator WALLOP. The last witness is Mr. Peter McCloskey, president of Electronics Association who will be accompanied by Mr. Victor Rose, the director of Federal Income Tax at the RCA Corp.

Gentlemen, if you would proceed please.

[The prepared statements of the preceding panel follow:]

# Renewable Fuels Association

499 South Capitol Street, SW
Suite 420
Washington, D.C. 20003
(202) 484-9320

David E. Hallberg
*President/Chief Executive Officer*

Cindy Tholkes
*Administrative Assistant*

SUMMARY OF TESTIMONY OF
DAVID E. HALLBERG, PRESIDENT
RENEWABLE FUELS ASSOCIATION
ON
THE ADMINISTRATION'S TAX REDUCTION PROGRAM
BEFORE THE
COMMITTEE ON FINANCE

The Renewable Fuels Association generally supports the Administration's goals of providing more rapid cost recovery as a means of stimulating investment in productive assets. However, one provision in the Administration's Accelerated Cost Recovery System ("ACRS") proposals could significantly reduce investment in alcohol fuel, and other renewable energy, ventures.

This provision of the ACRS proposal would provide that, for an individual taxpayer (or a subchapter S corporation or a closely held corporation), the basis of property which is eligible for the investment tax credit ("ITC") and the energy investment tax credit ("EITC") is limited to the amount the taxpayer has at risk with respect to the property at the time it is placed in service. The credit on the rest of the investment could be claimed only as the taxpayer's amount at risk increases.

The proposal would have the following effects:

1. It would effectively prevent the raising of capital from individual investors for projects involving new technology, such as projects involving property qualifying for the EITC, and for such items as drilling rigs, because operationally such projects must use limited partnerships with some amount of nonrecourse financing.
2. Closely held businesses would receive less favorable treatment than more widely held businesses.
3. An unwarranted premium would be placed on safe investments as opposed to risky investments with partial risk protection by use of nonrecourse financing.
4. As results of items (1), (2), and (3), not only would the absolute amount of investment by individuals in energy property be decreased, but also the development of new energy sources would be more concentrated in large, widely held companies.

5. If the proposal were designed to prevent avoidance by proscribing all types of risk-limiting devices, it could be very complex.

There are at least three ways in which the ACRS proposal could be amended to address our concerns:

1. This new "at risk" provision could be eliminated;

2. Investments eligible for the EITC could be exempted from this new provision; or

3. In lieu of this provision, the committee could limit the basis of property eligible for the ITC or EITC by excluding only amounts of nonrecourse indebtedness provided by the seller or a person related to the seller unless the taxpayer can establish that the cost of the property including seller-provided nonrecourse indebtedness does not exceed the property's fair market value. This would prevent the use of artificially inflated purchase prices to inflate the amount of the ITC or EITC but would provide a full credit on the entire cost of property where there is actual investment (even though the property is financed in part on a nonrecourse basis).

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**Renewable Fuels Association**
499 South Capitol Street, SW
Suite 420
Washington, D.C. 20003
(202) 484-9320

David E. Hallberg
*President/Chief Executive Officer*

Cindy Tholkes
*Administrative Assistant*

THE ADMINISTRATION'S TAX REDUCTION PROPOSALS

STATEMENT OF
DAVID E. HALLBERG
PRESIDENT, RENEWABLE FUELS ASSOCIATION

COMMITTEE ON FINANCE
May 20, 1981

The Administration's recently introduced tax program (contained in S. 683 and H.R. 2400, the "Economic Recovery Tax Act of 1981") would generally liberalize the depreciation and investment tax credit rules for most depreciable property (under its new Accelerated Cost Recovery System, or "ACRS").

Many of the proposals contained in ACRS, as proposed, could be beneficial to the alcohol fuels/renewable fuels industry (as well as other industries). Under these proposals, the costs of industrial buildings would be recovered over a 10-year period (pursuant to a system of accelerated cost recovery under which 80 percent of the costs would be recovered in the first 6 years); costs of equipment (such as most equipment used in alcohol-producing facilities) would be recovered over 5 years under an accelerated method with a 10 percent investment tax credit; and costs of automobiles, light-duty trucks, and equipment used in research and experimentation would be recovered over 3 years under an accelerated method with a 6 percent investment tax credit. (The rules described above are to be phased in over a 5-year period.)

However, one provision of the proposed ACRS could have significant adverse effects on investment in alcohol fuel ventures. That provision (sec. 203(g) of S. 683 and H.R. 2400) applies "at-risk rules" to the investment tax credit.

Present at-risk rule

Under present law, the amount of losses or deductions (but not credits) that an individual, a Subchapter S corporation, or a closely held corporation (in which 5 or fewer shareholders own, directly or through attribution, more than 50 percent in value of the stock) can deduct with respect to an activity (other than real estate) is limited to the amount the taxpayer has at risk in the activity. Since the partners in a partnership are taxed on the income and losses of the partnership, the losses incurred by a partnership are subject to the at-risk rule when reported on the tax return of an individual partner. Thus, under this rule, if an individual invests $25,000 in a partnership, the partnership incurs a nonrecourse indebtedness of which his share is $125,000 and his share of the losses in the first year is $40,000, the partner's deduction would be limited to $25,000. However, if the $150,000 had been invested in property which qualified for the investment tax credit ("ITC") and the energy investment tax credit ("EITC"), the individual could claim tax

credits of $30,000 (20 percent of $150,000) and the amount of the credit is unaffected by the fact that nonrecourse financing is used.

ACRS proposal

The ACRS proposal would provide that, for any taxpayer for whom the at-risk rule currently applies as a limitation on deductions (an individual, a subchapter S corporation, or a closely held corporation), the basis of property which is eligible for the ITC and the EITC is limited to the amount the taxpayer has at risk with respect to such property at the time it is placed in service. This would mean that, in the example described above, the individual who has invested $25,000 in the limited partnership could claim a credit of only $5,000 (20 percent of $25,000) in the year the property is placed in service. The rest of the credit could be claimed only as the principal amount of the nonrecourse liability is paid. Thus, unlike the current at-risk rule which only serves as a limitation on the amount of deduction that a taxpayer could claim, this proposed at-risk rule would limit the amount of the basis in the property which could be used in computing the ITC and the EITC.

Problem with proposal

If this proposal is adopted in its present form, it would have a substantial adverse effect on the attractiveness of investments in fuel alcohol and other renewable energy plants. Under present situations, few investors are willing to commit funds to new ventures in alternative fuels without either direct government assistance or extraordinary tax benefits. This is because the future profitability of these ventures is highly speculative, and, in many instances, the ventures may require a substantial investment in equipment which utilizes unproven technology (as well as substantial other investment which will become virtually worthless if the production process does not prove successful). Few individuals or closely held corporations would be willing to invest in plants utilizing unproven technology on a recourse basis even if the ITC and the EITC were available.

Most of the projects for the production of alcohol fuel which have been planned since the enactment of the Crude Oil Windfall Profits Tax Act of 1980 (the "Windfall Profits Tax Act") have utilized a limited partnership format and attempted to secure financing from individuals (as limited partners) in

part by reason of the tax benefits available. These projects generally require a relatively long lead time (12 to 36 months) and this lead time and the preliminary expenses are increased considerably by dealings with other governmental agencies, such as DOE or USDA, which are required to secure a loan guarantee.

Implementation of the portion of the proposal applying the at-risk rule to the ITC and EITC will have substantial adverse effects on many projects which are currently under way. These effects will be exacerbated by the use of a January 1, 1981, effective date.

Under the proposal, the ITC and EITC would be fully available to widely held corporations that use nonrecourse financing or other risk-limiting devices (since the new at-risk proposal does not apply to such corporations).

Thus, the proposal would limit the full benefits of the tax incentives for fuel alcohol (provided in the Energy Tax Act of 1978 and the Windfall Profits Tax Act) to widely held corporations.

Clearly, such a limitation runs counter to the intent of Congress in passing the Energy Security Act and other

energy-related measures in the sense that it deters the widest possible participation of the private sector in the development of domestic alternative energy technologies. The net effect of this provision would be to further reinforce the concentration of ownership of energy production facilities in this country, at a critical juncture where the appropriate public policy signals might succeed in reversing the trend. Finally, inasmuch as the projects that would be most adversely affected by this provision would be the small- to medium-scale facilities which have the shortest lead times to commercialization, the net effect of the provision will also be to adversely impact on the Nation's near-term energy security.

Thus, the provision would have several deleterious effects. First, it results in an unfair competitive advantage for large, widely held companies. This advantage appears unjustified because $1 of credit provides as much tax shelter for a widely held corporation as it does for an individual. There may be a justification for applying the at-risk limitations on losses of individuals but not on losses of widely held corporations because deductions are more valuable to individuals in high rate brackets than to corporations. However, this justification cannot apply to limit credits because a credit reduces a corporation's tax liability to the same extent as it

reduces an individual's tax liability.

Second, the at-risk provision in the proposal will substantially limit the flow of funds into the production of alcohol fuels and other alternative fuels.

Third, the proposal will encourage the development of alternative fuels only by big businesses (probably those that already have substantial investments in conventional forms of energy). This will lead to increased concentration of the suppliers of energy, and such an increased concentration is undesirable.

Fourth, under the proposal an unwarranted premium would be placed on safe investments as opposed to risky investments with partial risk protection by use of nonrecourse financing.

Fifth, if the proposal were designed to prevent avoidance by proscribing all types of risk-limiting devices, it could be very complex.

Recommendation

The proposal to extend the at-risk limitations to the

investment credit should be eliminated. In the alternative, this proposal should not be applicable to types of investment which are eligible for the EITC since Congress has specifically indicated that such investments should be eligible for special treatment.

Another solution would be to limit the basis of property eligible for the ITC or EITC by excluding only amounts of nonrecourse indebtedness provided by the seller or a person related to the seller unless the taxpayer can establish that the cost of the property including seller-provided nonrecourse indebtedness does not exceed the property's fair market value. This would prevent the use of artificially inflated purchase prices to inflate the amount of the ITC or EITC but would provide a full credit on the entire cost of property where there is actual investment (even though the property is financed in part on a nonrecourse basis).

STATEMENT OF JOHN ALLEN CHALK, DIRECTOR OF THE AMERICAN PETROLEUM REFINERS ASSOCIATION

SYNOPSIS OF TESTIMONY
SENATE FINANCE COMMITTEE
MAY 21, 1981

THE AMERICAN PETROLEUM REFINERS ASSOCIATION IS THE LARGEST TRADE ASSOCIATION REPRESENTING INDEPENDENT U.S. BASED REFINING COMPANIES. INDUSTRY EXPERTS PROJECT THAT UP TO $60 BILLION IN NEW CAPITAL INVESTMENT WILL BE REQUIRED IN THE NEXT TEN YEARS JUST TO RETROFIT EXISTING CAPACITY TO PROCESS HEAVY, HIGH SULFUR CRUDE OILS. INDEPENDENT REFINERS ARE HAVING A MOST DIFFICULT TIME SECURING FINANCING FOR REFINERY UPGRADING. ACCORDINGLY, APRA URGES THE SENATE FINANCE COMMITTEE TO RECOMMEND:

* A FIVE-YEAR DEPRECIABLE LIFE FOR REFINING ASSETS, FULLY EFFECTIVE JANUARY 1, 1981. APRA OPPOSES A PHASE-IN OF DEPRECIATION REFORM FOR REFINING EQUIPMENT FOR THE FOLLOWING REASONS. FIRST, CRUDE OIL SLATES ARE RAPIDLY DETERIORATING, NECESSITATING IMMEDIATE INVESTMENT TO ENABLE REFINERIES TO HANDLE LOWER QUALITY CRUDE OILS. SECOND, PRICE CONTROLS ON THE REFINING INDUSTRY SINCE MAY OF 1973 DID NOT PERMIT THE PASS THROUGH OF NEW INVESTMENT COSTS IN THE PRICE OF PETROLEUM PRODUCTS. PRICE CONTROLS (ADMINISTERED BY BOTH COWPS AND DOE) TREATED THE REFINING INDUSTRY UNLIKE ANY OTHER BASIC INDUSTRY IN THIS RESPECT. AS A RESULT, INVESTMENT TIMETABLES HAVE ALREADY BEEN SERIOUSLY DELAYED. A PHASE-IN WILL POSTPONE NEEDED INVESTMENT EVEN FURTHER.

* DEPRECIATION REFORM WHICH PERMITS INVESTMENT IN REFINING EQUIPMENT PLACED IN SERVICE IN THE U.S. TO BE DEPRECIATED MORE RAPIDLY THAN SIMILAR INVESTMENTS MADE ABROAD.

* CLARIFICATION AND EXPANSION OF THE PROVISIONS IN THE ENERGY TAX ACT OF 1978 WHICH PROVIDE ENERGY CREDITS FOR INVESTMENT IN REFINING EQUIPMENT WHICH CONSERVES ENERGY. A PETROLEUM REFINERY OF ONLY MODERATE COMPLEXITY CONSUMES 12 PERCENT OF A BARREL OF CRUDE OIL IN THE REFINING PROCESS. SUBSTANTIAL REFINERY ENERGY SAVINGS (UP TO TEN PERCENT) CAN BE ACHIEVED THROUGH ENACTMENT OF S.750 (WALLOP R-WYO.) AND H.R.2640 (HEFTEL D-HAWAII).

MR. CHAIRMAN: MY NAME IS JOHN ALLEN CHALK. I AM PRESENTLY SERVING AS VICE PRESIDENT AND GENERAL COUNSEL TO LAJET, INC., AN INDEPENDENT PETROLEUM REFINING COMPANY THAT OPERATES TWO REFINERIES IN ST. JAMES, LOUISIANA, WITH A COMBINED THROUGHPUT CAPACITY OF APPROXIMATELY 40,000 BARRELS PER DAY. I AM APPEARING BEFORE THE COMMITTEE TODAY IN MY CAPACITY AS A DIRECTOR OF THE AMERICAN PETROLEUM REFINERS ASSOCIATION, A TRADE ASSOCIATION REPRESENTING 58 U.S. BASED INDEPENDENT REFINERS WITH A COMBINED THROUGHPUT CAPACITY OF OVER ONE MILLION BARRELS PER DAY.

I. PETROLEUM REFINING AS A BASIC U.S. INDUSTRY

A RECENT PAMPHLET PREPARED FOR THE CONGRESSIONAL TAX WRITING COMMITTEES BY THE JOINT COMMITTEE ON TAXATION LISTS CERTAIN SECTORS OF THE U.S. ECONOMY WHICH WERE PARTICULARLY DISADVANTAGED BY THE ECONOMIC EVENTS OF 1980. THE INDUSTRIES LISTED WERE AUTOMOBILES, HOUSING, SAVINGS AND LOAN ASSOCIATIONS, ELECTRIC UTILITIES AND THE STEEL INDUSTRY. IF THIS ANALYSIS WERE TO BE UPDATED FOR THE FIRST QUARTER OF 1981, THE PETROLEUM REFINING INDUSTRY WOULD ALSO WARRANT INCLUSION. DECONTROL OF OIL PRICES ON JANUARY 27, 1981, REMOVED A LONG-STANDING INCENTIVE FOR REFINING IN THE UNITED STATES.

NOT SUPRISINGLY, FIRST QUARTER PROFIT FIGURES FROM BOTH INDEPENDENT AND INTEGRATED COMPANIES SHOW LARGE LOSSES IN DOWNSTREAM REFINING AND MARKETING, A PHENOMENON WHICH IS PREDICTED TO CONTINUE. THIS NEGATIVE PROFIT PICTURE IS PARTICULARLY DISCOURAGING FOR

THE INDEPENDENT U.S. REFINERS WHO HAVE LITTLE, IF ANY, PROFITS FROM CRUDE OIL PRODUCTION AVAILABLE TO OFFSET REFINING LOSSES. INDUSTRY SOURCES PREDICT THAT, WITHIN THE NEXT YEAR, UP TO TWO MILLION BARRELS PER DAY OF U.S. REFINING CAPACITY WILL BE SHUT DOWN. DOZENS OF REFINERY CLOSINGS HAVE BEEN ANNOUNCED* AND ADDITIONAL CLOSURES ARE EXPECTED TO CONTINUE THROUGHOUT THE REMAINDER OF THIS YEAR. THE INDUSTRY IS ALREADY AT A UTILIZATION RATE OF UNDER 65 PERCENT, AN ALL-TIME INDUSTRY LOW.

MR. CHAIRMAN, IT IS INDEED UNFORTUNATE THAT THE UNITED STATES MUST IMPORT LARGE AMOUNTS OF FOREIGN CRUDE OIL TO MEET DOMESTIC DEMAND. HOWEVER, U.S. ENERGY SECURITY WILL BE FURTHER JEOPARDIZED IF OUR PETROLEUM REFINING INDUSTRY IS PERMITTED TO UNDERGO ATROPHY IN THE WAKE OF DECONTROL. U.S. ECONOMIC AND MILITARY SECURITY WILL BE IMPERILED TO AN EVEN GREATER DEGREE IF THIS COUNTRY WERE FORCED TO RELY ON IMPORTED PETROLEUM PRODUCT RATHER THAN CRUDE OIL. ANY FUTURE EMBARGO OF PETROLEUM PRODUCT WILL MAKE THE CRUDE OIL EMBARGO OF 1973 PALE BY COMPARISON.

THE REFINING INDUSTRY IS EXTREMELY CAPITAL INTENSIVE. THE EXISTING INVESTMENT BASE OF THE U.S. REFINING INDUSTRY IS ESTIMATED TO BE APPROXIMATELY $20 BILLION WITH REPLACEMENT COSTS OF THESE ASSETS ESTIMATED AT $50 BILLION. PETROLEUM REFINING EMPLOYS APPROXIMATELY 12 HIGHLY SKILLED WORKERS FOR EVERY 1,000 BARRELS PER DAY OF THROUGHPUT CAPACITY. AS A CONSEQUENCE, PETROLEUM REFINING DIRECTLY SUPPORTS APPROXIMATELY 200,000 EMPLOYEES IN

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*E.G. REPORTED REFINERY CLOSINGS BY MAJOR INTEGRATED OIL COMPANIES INCLUDE: AMOCO OIL CO., WOOD RIVER, ILL. - 100,000 B/D; TEXACO INC., LOCKPORT, ILL. - 72,000 B/D; GULF OIL CO., TOLEDO, OHIO - 50,300 B/D; MOBIL OIL CORP, BUFFALO, N.Y. - 43,000 B/D; CONOCO INC., WRENSHALL, MINN. - 42,600 B/D; GULF OIL CO., VENICE, LA. 28,700 B/D.

THE UNITED STATES, TOGETHER WITH MANY THOUSANDS OF ADDITIONAL EMPLOYEES ENGAGED IN TRANSPORTATION AND MARKETING PETROLEUM PRODUCTS.

JUDGED BY ANY STANDARD, THE U.S. REFINING INDUSTRY IS BASIC AND VITAL TO THE U.S. ECONOMY. ASIDE FROM PROVIDING JOBS, THE REFINING INDUSTRY IS VITAL TO U.S. NATIONAL SECURITY INTERESTS. IT IS AN INDUSTRY WHICH THIS COUNTRY CANNOT PERMIT TO BE EXPORTED SIMPLY BECAUSE FOREIGN STATUTES MAKE INVESTMENT ABROAD MORE ATTRACTIVE. THE CURRENT MEMBERS OF OPEC ARE VERY ANXIOUS TO CONTROL THE ECONOMICS OF PETROLEUM DOWNSTREAM AS WELL AS THE ECONOMICS OF CRUDE OIL PRODUCTION. THE UNITED STATES MUST GIVE A SIGNAL TO THESE COUNTRIES THAT IT INTENDS TO PRESERVE A STRONG AND VIABLE REFINING INDUSTRY. THE POLICIES THAT THIS COMMITTEE AND THIS CONGRESS ADOPT REGARDING TAX INCENTIVES FOR NEW REFINING INVESTMENT IN THE U.S. WILL EITHER DEMONSTRATE A COMMITMENT TO A STRONG REFINING INDUSTRY OR SIGNAL THE ABANDONMENT OF THIS INDUSTRY TO FOREIGN GOVERNMENTS.

## II. THE NEED FOR CAPITAL CREATION IN THE DOMESTIC REFINING INDUSTRY

MOST ECONOMISTS PREDICT THAT U.S. DEMAND FOR PETROLEUM PRODUCTS WILL EXPERIENCE A MODEST DECLINE THROUGHOUT 1981 AND 1982. TOTAL U.S. REFINERY CAPACITY SHOULD BE ADEQUATE TO MEET DOMESTIC DEMAND THROUGHOUT THE REMAINDER OF THIS DECADE. HOWEVER, A TREMENDOUS AMOUNT OF NEW INVESTMENT WILL BE REQUIRED DURING THIS PERIOD JUST TO UPGRADE AND RETROFIT EXISTING REFINING CAPACITY TO HANDLE HEAVIER, HIGHER-SULFUR CRUDE OILS WHICH INCREASINGLY CONSTITUTE AVAILABLE SUPPLY. IN 1973 ONLY 36 PERCENT OF THE CRUDE PROCESSED

BY U.S. REFINERIES WAS HEAVY, SOUR CRUDE OIL. BY 1982 THAT PERCENTAGE SHOULD REACH WELL OVER 52 PERCENT.† THE ECONOMICS OF PETROLEUM REFINING REQUIRE THAT VERY EXPENSIVE EQUIPMENT SUCH AS HYDRODESULFURIZATION UNITS, VISBREAKING, CATALYTIC CRACKING AND CATALYTIC REFORMING CAPACITY BE ACQUIRED TO BREAK DOWN MOLECULES OF HEAVY CRUDE OIL INTO LIGHTER FRACTIONS AND REMOVE SULFUR AND OTHER POISONOUS ELEMENTS. IT IS MANY TIMES MORE EXPENSIVE TO REFINE A BARREL OF POOR QUALITY CRUDE OIL INTO UNLEADED GASOLINE THAN TO REFINE A HIGHER GRAVITY SWEET CRUDE OIL INTO AN EQUIVALENT PRODUCT YIELD. THE CHASE MANHATTAN BANK RECENTLY ESTIMATED THAT OVER $60 BILLION OF NEW INVESTMENT WOULD BE REQUIRED DURING THE NEXT DECADE JUST TO UPGRADE EXISTING U.S. REFINERIES TO PROCESS LESS DESIRABLE CRUDE OILS. OUR ASSOCIATION ESTIMATES THAT APPROXIMATELY SIX BILLION DOLLARS OF NEW INVESTMENT IS NEEDED IN THE INDEPENDENT REFINING SECTOR JUST IN THE NEXT THREE TO FIVE YEARS.

## A. ACCELERATED DEPRECIATION

UNDER THE BUSINESS PROVISIONS OF H.R. 2400 AND S. 683, REFINING ASSETS ARE ASSIGNED A DEPRECIABLE LIFE OF FIVE YEARS. THIS REDUCTION OF THE DEPRECIABLE LIFE FROM THE PRESENT MIDPOINT LIFE OF 16 YEARS TO FIVE YEARS WILL DO MUCH TO BRING ABOUT DESPERATELY NEEDED INVESTMENT IN THE REFINING INDUSTRY.

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† NATIONAL PETROLEUM REFINERS ASSOCIATION STUDY, "CAPABILITY OF U.S. REFINERIES TO PROCESS SWEET/SOUR CRUDE OIL," MARCH 15, 1978.

However, APRA opposes any phase-in of a five year life for the refining industry. New investment in the refining industry, particularly in the independent sector, must occur between now and 1983. Rapidly changing crude oil slates, combined with the strict margin controls on the industry which have been in effect since May of 1973, have already placed investment timetables years behind schedule. To the extent that a phase-in of a depreciable life is adopted by this Committee, it will discourage new investment from occurring at a crucial time. If U.S. investment is discouraged until the phase-in is fully effective, the upgrading of foreign facilities will be well under way. A phase-in of depreciation reform may indirectly encourage an acceleration of OPEC plans to move into downstream processing. If needed refining investment in the U.S. is to be undertaken, it must be given the maximum amount of encouragement at the soonest possible moment.

Aside from rapidly changing crude oil slates, the refining industry can show additional justification for a five year life fully effective January 1, 1981. Since May of 1973, new investment by U.S. refiners has been severely hindered by Department of Energy price control regulations and Council on Wage and Price Stability (COWPS) guidelines which did not permit passthrough of new investment costs in the price of petroleum products. The domestic refining industry can be distinguished from every other U.S. industry in this respect.

In May of 1973 each U.S. refiner's profit on sales of price controlled products was frozen at a per barrel margin that, for the industry as a whole, averaged approximately 25 cents per barrel after taxes. In 1973, construction costs for new refinery

PROJECTS WERE BELOW ONE THOUSAND DOLLARS PER BARREL PER DAY OF CAPACITY. TODAY THE CAPITAL REQUIRED FOR REFINERY UPGRADING PROJECTS IS AT LEAST FIVE OR SIX TIMES THIS AMOUNT. THE DOE PRICE CONTROLS, WHILE ALLOWING FOR PASSTHROUGH OF INCREASED CRUDE OIL COSTS AND CERTAIN OPERATING COSTS, HAD THE EFFECT OF RENDERING RETURN ON NEW INVESTMENT OR EVEN RETURN ON EXISTING ASSETS VALUED AT REPLACEMENT COST EXTREMELY POOR.

COUNCIL ON WAGE AND PRICE STABILITY (COWPS) PRICE CONTROL GUIDELINES EXISTING AND EFFECTIVE FROM OCTOBER 2, 1978, THROUGH LATE JANUARY 1981, DISCOURAGED CAPITAL IMPROVEMENTS BY REFINERS. DUE TO RAPIDLY ESCALATING CRUDE OIL COSTS DURING THIS PERIOD, A SEPARATE GROSS MARGIN TEST HAD TO BE FORMULATED AND APPLIED TO THE REFINING INDUSTRY. UNDER THIS SEPARATE STANDARD, PETROLEUM REFINERS WERE PERMITTED ONLY A FIXED PERCENTAGE MARK-UP OVER THE COST OF PETROLEUM INPUTS USED IN THE REFINING PROCESS. BECAUSE THE COWPS STANDARD DID NOT TAKE INTO ACCOUNT ANY OTHER COST INCREASES, THE COST OF NEW INVESTMENT COULD NOT BE PASSED THROUGH IN THE FORM OF HIGHER PRICES TO CUSTOMERS. AS A RESULT, U.S. REFINERS FACED A SUBSTANTIAL BARRIER TO MAKING THE NEW INVESTMENT NECESSARY TO UPGRADE THEIR FACILITIES. BECAUSE THE COWPS PROFIT MARGIN TEST WAS ALSO BASED ON A PER BARREL MARGIN, DECLINING VOLUMES OF CRUDE RUNS CAUSED BY INSECURE CRUDE SUPPLIES AND DOMESTIC CONSERVATION EFFORTS FORCED DRASTIC PROFITABILITY DECLINES ON THOSE REFINERS WHO HAD TO REDUCE CRUDE RUNS TO STILLS.

THE ADVERSE EFFECT OF COWPS AND DOE REGULATIONS ON CAPITAL INVESTMENT IN THE REFINING INDUSTRY WAS BELATEDLY RECOGNIZED BY THE DEPARTMENT OF ENERGY AND BY COWPS. A MAY 30, 1980 DOE

STUDY ENTITLED "ANALYSIS OF IMPACT OF THE COWPS PROGRAM ON PRODUCTION AND INVESTMENT INCENTIVES FOR U.S. REFINERS" WELL DOCUMENTS THE DISINCENTIVES FOR CAPITAL INVESTMENT WHICH COWPS REGULATIONS CREATED IN ADDITION TO ACKNOWLEDGING THE SIMILAR DISINCENTIVES CAUSED BY DOE'S OWN REGULATIONS:

> NEITHER THE DOE GASOLINE PRICE CONTROL PROGRAM NOR THE COWPS LIMITATIONS ALLOW REFINERS TO PASS THROUGH THE FULL COST OF NEW INVESTMENT.
>
> THE COWPS GROSS MARGIN LIMITATION IS EVEN MORE RESTRICTIVE THAN THE DOE PROGRAM...BECAUSE IT PROVIDES NO EXPLICIT RECOGNITION OF ANY INVESTMENT COSTS.
>
> (ID. AT PAGES 7, 10)

AT THIS JUNCTURE, IT SHOULD BE NOTED THAT THE COWPS AND DOE PRICE REGULATIONS DISPROPORTIONATELY IMPACTED THE INDEPENDENT SECTOR OF THE REFINING INDUSTRY. INTEGRATED OIL COMPANIES POSSESSING CRUDE OIL PRODUCTION AS WELL AS DOWNSTREAM PROFIT CENTERS, COULD USE LARGE PROFITS FROM DOMESTIC AND FOREIGN CRUDE OIL PRODUCTION TO FINANCE NEEDED DOWNSTREAM UPGRADING. INDEPENDENT REFINING COMPANIES, CONTROLLING LITTLE IF ANY CRUDE OIL PRODUCTION, WERE FORCED TO RELY UPON REFINING PROFITS ALONE FOR INVESTMENT CAPITAL.

IT IS AXIOMATIC THAT PRICE CONTROLS ON AN INDUSTRY TEND TO DISCOURAGE NEW INVESTMENT. THE CURRENT INVESTMENT PLIGHT OF PUBLIC UTILITIES EXEMPLIFIES THIS PROBLEM. THE REFINING INDUSTRY, UNLIKE MOST U.S. INDUSTRIES, HAS JUST EMERGED FROM 7 YEARS OF CONTROLS. THE DISINCENTIVES THRUST UPON THE INDUSTRY DURING THIS PERIOD FULLY JUSTIFY A 5 YEAR DEPRECIABLE LIFE FOR REFINING ASSETS WITH AN IMMEDIATE EFFECTIVE DATE OF JANUARY 1, 1981.

THE FINANCIAL COMMUNITY IS VERY MUCH AWARE THAT THE INDEPENDENT

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SECTOR OF THE INDUSTRY HAS BEEN ADVERSELY IMPACTED BY PRICE CONTROLS ON PETROLEUM PRODUCTS AND IS VERY SENSITIVE TO THE FACT THAT PRICE CONTROLS COULD WELL BE REIMPOSED IF THE UNITED STATES WERE TO EXPERIENCE A SUPPLY DISRUPTION FROM ABROAD. AS A RESULT, INDEPENDENT REFINERS FACE VERY DIFFICULT CHALLENGES IN SECURING FINANCING FOR NEW PROJECTS. THIS COMMITTEE AND THIS CONGRESS, BY GRANTING AN ACCELERATED EFFECTIVE DATE ON DEPRECIATION TO REFINING ASSETS, WOULD SEND A NEEDED SIGNAL TO THE U.S. BANKING COMMUNITY THAT THE CONGRESS RECOGNIZES AND INTENDS TO RECTIFY THE DETRIMENTAL EFFECTS WHICH PRICE CONTROLS HAVE PRODUCED.

OUR ASSOCIATION HAS ATTACHED AS AN APPENDIX TO OUR TESTIMONY A TABLE SHOWING THE DEPRECIATION DEDUCTIONS WHICH WOULD BE AVAILABLE TO THE INDEPENDENT SECTOR OF THE REFINING INDUSTRY UNDER S.317 AND UNDER S.683, BOTH WITH AND WITHOUT A PHASE-IN OF A FIVE YEAR LIFE.

IT SHOULD BE EMPHASIZED AT THIS POINT THAT THE REVENUE LOSSES ASSOCIATED WITH AN ACCELERATED EFFECTIVE DATE ARE ESSENTIALLY IDENTICAL OVER A TEN YEAR PERIOD. OUR ASSOCIATION ASKS THAT THE COMMITTEE RECOGNIZE THE UNIQUE IMPEDIMENTS TO REFINING INVESTMENT WHICH WERE IMPOSED ON THE REFINING INDUSTRY DURING THE LAST 7 YEARS AND PERMIT DEPRECIATION OF NEW INVESTMENT TO BE TAKEN SOONER RATHER THAN LATER.

B. DEPRECIATION AVAILABLE FOR "RECOVERY PROPERTY" PREDOMINANTLY USED OUTSIDE THE UNITED STATES

AS INTRODUCED, S.683 WOULD PERMIT RECOVERY PROPERTY USED IN THE UNITED STATES TO BE DEPRECIATED ON A SOMEWHAT FASTER BASIS THAN SIMILARLY SITUATED PROPERTY PLACED IN SERVICE ABROAD. MEMBERS

OF THE AMERICAN PETROLEUM REFINERS ASSOCIATION ARE, WITHOUT EXCEPTION, U.S. TAXPAYERS THAT REFINE IN THE UNITED STATES. BECAUSE PRESENT U.S. TAX LAW, ENVIRONMENTAL RESTRICTIONS, AND TARIFF RATES ENCOURAGE THE REFINING OF CRUDE OIL OVERSEAS -- MORE FAVORABLE DEPRECIATION TREATMENT FOR ASSETS PLACED IN SERVICE IN THE UNITED STATES IS NECESSARY.

HOWEVER, IT IS UNDERSTOOD THAT THE ADMINISTRATION IS PRESENTLY RE-EVALUATING §201 OF S.683 WITH A VIEW TOWARD ENDORSING AN EQUALLY RAPID WRITE-OFF FOR FOREIGN ASSETS. IF THIS COMMITTEE DOES DECIDE TO PERMIT AN ACCELERATED WRITE-OFF FOR FOREIGN REFINING EQUIPMENT PLACED IN SERVICE BY U.S. TAXPAYERS, THE NEED FOR A SHORTER DEPRECIABLE LIFE WITH AN ACCELERATED EFFECTIVE DATE FOR REFINING ASSETS PLACED IN SERVICE IN THE UNITED STATES BECOMES EVEN MORE IMPORTANT.

C. INVESTMENT INCENTIVES FOR ENERGY-EFFICIENT, SOUR CRUDE, AND HEAVY OIL PROCESSING EQUIPMENT.

A PETROLEUM REFINERY OF ONLY MODERATE COMPLEXITY CONSUMES APPROXIMATELY 12 PERCENT OF A BARREL OF CRUDE OIL IN THE PROCESS OF REFINING THE REMAINDER OF THAT BARREL INTO USABLE PETROLEUM PRODUCTS. AS A CONSEQUENCE, THE POTENTIAL FOR ENERGY SAVINGS IN THE REFINING INDUSTRY IS QUITE SUBSTANTIAL. OUR ASSOCIATION ESTIMATES THAT WITH THE INSTALLATION OF MODERN ENERGY EFFICIENT REFINERY EQUIPMENT, ENERGY SAVINGS ON THE ORDER OF FIVE PERCENT CAN BE REALIZED. IN ONLY ONE SMALL REFINERY OF APPROXIMATELY 50,000 BARRELS PER DAY, A FIVE PERCENT ENERGY SAVINGS TRANSLATES INTO AN ANNUAL ENERGY SAVINGS OF 200,000 BARRELS OF OIL.

APRA SUPPORTS ENACTMENT OF S.750 AND H.R.2640, COMPANION MEASURES INTRODUCED BY SENATOR WALLOP (R-WYO.) AND CONGRESSMAN

Heftel (D-Hawaii). This legislation would expand and clarify existing provisions in the Energy Tax Act of 1978 to permit additional investment credits for investment in energy efficient industrial equipment. It is important to note that these energy tax credits are a supplement to, but in no way a substitute for, accelerated depreciation reform.

Every barrel of imported crude oil carries with it a total cost to the U.S. economy of between 60 and 100 dollars. To the extent that energy conservation is encouraged -- both by encouraging modifications in existing refining processes as well as the installation of more sophisticated processes which stretch a barrel of crude oil into more usable petroleum products -- the total U.S. demand for imported oil will be further lessened.

It should also be noted that original revenue estimate projections under the Energy Tax Act of 1978 predicted that over $600 million in energy credits would be claimed to date. In actuality, only $310 million in energy credits have been claimed in the two years since the effective date of the Energy Tax Act. In this regard, S.750 makes needed changes in the definitions of "specially defined energy property" and "alternative energy property" which will clarify some of the restrictive interpretation placed on legislative language by the Internal Revenue Service.

Energy tax credits can play a major role in encouraging energy conservation. The U.S. industrial sector accounts for nearly 40 percent of all U.S. energy requirements and is the fastest growing energy consuming sector in the U.S. economy. We would urge this Committee to consider granting additional energy credits to investments made in energy efficient, sour crude conversion and heavy oil conversion processing equipment.

## III. CONCLUSION

MR. CHAIRMAN, IT IS INDEED A PLEASURE TO APPEAR BEFORE THE SENATE FINANCE COMMITTEE THIS AFTERNOON TO PRESENT THE VIEWS OF THE AMERICAN PETROLEUM REFINERS ASSOCIATION ON THE NEED FOR NEW CAPITAL FORMATION IN THE DOMESTIC REFINING INDUSTRY. TO REITERATE, THIS INDUSTRY NEEDS AND DESERVES A DEPRECIABLE LIFE FOR REFINING ASSETS OF FIVE YEARS WITH A FULLY PHASED-IN EFFECTIVE DATE OF JANUARY 1, 1981. WE FEEL THAT THE REFINING INDUSTRY FULLY DESERVES THIS TREATMENT, BECAUSE OF THE VERY RESTRICTIVE PRICE CONTROLS WHICH THIS INDUSTRY HAS ENDURED OVER THE LAST SEVEN YEARS -- CONTROLS WHICH DID NOT PERMIT THE PASSTHROUGH OF NEW INVESTMENT COSTS. THE EFFECTS OF PRICE CONTROLS, COMBINED WITH RAPIDLY DETERIORATING CRUDE OIL SLATES, DICTATES THAT INVESTMENT TIME-TABLES MUST BE ACCELERATED TO COMPENSATE FOR THE LACK OF PRIOR INVESTMENT. A PHASE-IN OF DEPRECIATION REFORM WILL HAVE JUST THE OPPOSITE EFFECT BY ENCOURAGING THE POSTPONEMENT OR ABANDONMENT OF ESSENTIAL REFINERY UPGRADING.

THE INDEPENDENT REFINING INDUSTRY ALSO URGES THE CLARIFICATION AND EXPANSION OF THE ENERGY TAX ACT OF 1978 TO ENCOURAGE BOTH THE CONSERVATION OF ENERGY AT EXISTING PETROLEUM REFINERIES AND THE ENCOURAGEMENT OF NEW REFINING INVESTMENT WHICH HAS AS ITS PRINCIPAL PURPOSE THE UPGRADING OF HEAVY HIGH SULFUR CRUDE OILS INTO LIGHTER PETROLEUM PRODUCT.

OUR ASSOCIATION WOULD LIKE TO THANK THE COMMITTEE VERY MUCH FOR ALLOWING US THE OPPORTUNITY TO PRESENT OUR VIEWS. WE WOULD ALSO WISH TO HAVE INCLUDED IN THE COMMITTEE RECORD TWO APPENDICES TO OUR TESTIMONY WHICH LIST THE DEPRECIATION DEDUCTIONS WHICH WOULD BE AVAILABLE TO THE INDEPENDENT SECTOR OF THE U.S. REFINING INDUSTRY UNDER EACH OF THREE SEPARATE AND CURRENT DEPRECIATION PROPOSALS.

**APPENDIX A**

**Comparison of Certain Cost Recovery Provisions**

**Affecting Depreciation of Refinery Equipment**

**in S. 683, S. 394, S. 317 and H.R. 1053**

**S. 683**
**Reagan**

**Depreciation Rates**

Following % applies to unadjusted basis of property:

| yr. | 10 yr. | 5 yr. | 3 yr. |
|---|---|---|---|
| 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 | | |

§167(r)
15 yr. straight line depreciation for all other real property (e.g., office buildings).

**Property Classifications**

10 yr.
Owner-user building (including structural components), i.e., §1250 property of which 80% is used as industrial building for production or distribution (e.g., laboratory).

5 yr.
§1245 property §1245(a)(3) personal property used in manufacturing, production, or extraction (e.g., storage tanks).

3 yr.
autos, trucks, R&D property.

**Phase-In Rule**

10 yr.
1981-ADR lower limit (not in excess of 18 yrs.);
1982-ADR lower limit-2 yrs.;
1983-ADR lower limit-4 yrs.;
1984-ADR lower limit-6 yrs.;
but in no case < 10 yrs.

5 yr.
1981-ADR lower limit (not in excess of 9 yrs.);
1982-ADR lower limit-1 yr.;
1983-ADR lower limit-2 yrs.;
1984-ADR lower limit-3 yrs.;
but in no case < 5 yrs.

Special transition rules for 1st $100,000 of 5 yr. property.

**Placed-In Service Rule**

For components, depreciation begins when component placed in service. Half-year convention would continue.

For §167(r) property, pro rata depreciation over year in which placed service.

Adopts progress expenditure concept from investment tax credit rules.

**Other**

Investment Tax Credit-100% on 5 and 10 year property with amendment to existing recapture rules for disposition within 5 years. 60% recapture on 3 year property.

No recapture for early disposition of owner-user building or 5 year property.

Adjustments for earnings and profit differ from existing rules.

Rules effective for property placed in service after 12/31/80.

S. 394
Long

| Depreciation Rates | Property Classification | Phase-In Rule | Placed-In Service Rule | Other |
|---|---|---|---|---|
| Taxpayer elects 200%, 150% or 100% which is divided by number of years in the property's class life.<br>Class<br>1 2 yrs.<br>2 4 yrs.<br>3 7 yrs.<br>4 10 yrs.<br>Under each class, the property is aggregated within an account upon which the rate derived above is applied.<br>20 yr. straight line depreciation for §1250 property.<br>15 yr. 150% declining balance method for qualified owner-occupied building (i.e.80% of usable area used for production but not warehouse or storage area).<br>No componentizing.<br>Recapture applies.<br>May expense 1st $25,000 of recovery property each yr. | Property put in class which is 40% less than present ADR life. | None. Applies to all property placed in service after 12/31/80. | Adopts progress expenditure concept from investment tax credit rules. Actual amount dependent on whether property self-constructed or non-self-constructed. | Investment Tax Credit:<br>2-3 yrs. 25%<br>4-6 yrs. 60%<br>≥ 7 yrs. 100%<br>Earnings and Profits adjustment at 100% depreciation rate.<br>Oil or gas fired boilers excluded §48(a)(10).<br>Effective date 12/31/80. |

S. 317
Bentsen

Same as S. 394 except that it:

(1) repeals §179 rather than amending it for expense treatment of 1st 25,000 of recovery property.

(2) contains no revision of progress expenditure rules.

(3) does contain a provision extending investment tax credit and net operating loss carryover periods to 10 years.

(4) does repeal §189 for amortization of construction period interest and taxes.

H.R. 1053
Jones

| Depreciation Rates | Property Classification | Phase-In Rule | Placed-In Service Rule | Other |
|---|---|---|---|---|
| Same rates in S. 683. | #1 buildings and structural components.<br><br>#2 non #1 or #3 property.<br><br>#3 autos and trucks which may not >100,000 per year | #1 buildings and structural components.<br>1981-18 yrs.<br>1982-16 yrs.<br>1983-14 yrs.<br>1984-12 yrs.<br><br>#2 non #1 or #3 property<br>1981-ADR lower limit<br>1982-ADR lower limit-1 yr.<br>1983-ADR lower limit-2 yr.<br>1984-ADR lower limit-3 yr.<br>in no case <5 yrs., nor >9 yrs. | Time of payment except if placed in service in 1980 or self-constructed. | Carryover of unused depreciation.<br><br>Same Investment Tax Credit provisons as S 683.<br><br>Earnings and Profits adjusted at straight line rates.<br><br>Effective 12/31/80. |

APPENDIX B

## American Petroleum Refiners Association
## Comparison of Depreciation
## Deductions for the Independent Refining Industry
## Under S. 317 and H.R. 2400 and S. 683
## (in millions of dollars)

| | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|
| S. 317 | | | | | | | | | | | |
| Plant Equipment | 335.88 | 881.00 | 1,167.79 | 1,174.57 | 962.18 | 703.33 | 502.38 | 358.85 | 256.32 | 183.08 | 6,525.38 |
| Industrial Buildings | .73 | 1.51 | 1.51 | 3.64 | 5.07 | 5.59 | 5.03 | 4.53 | 4.08 | 3.67 | 36.16 |
| Other Buildings | .36 | .79 | .85 | 1.99 | 3.28 | 3.44 | 3.44 | 3.44 | 3.43 | 3.43 | 24.45 |
| Total | 336.97 | 883.30 | 1,170.15 | 1,180.20 | 971.53 | 712.36 | 510.85 | 366.82 | 263.83 | 190.18 | 6,585.99 |
| H.R. 2400 and S. 683 With Phase-in | | | | | | | | | | | |
| Plant Equipment | 259.40 | 749.61 | 1100.31 | 1,295.74 | 1,199.65 | 952.72 | 698.10 | 474.98 | 252.58 | -0- | 6,983.08 |
| Industrial Buildings | 1.08 | 3.15 | 5.56 | 7.36 | 7.73 | 6.94 | 6.44 | 5.84 | 5.15 | 4.36 | 53.61 |
| Other Buildings | .50 | 1.61 | 2.89 | 3.89 | 4.22 | 4.30 | 4.26 | 4.29 | 4.27 | 4.29 | 34.52 |
| Total | 260.98 | 754.37 | 1,108.76 | 1,306.99 | 1,211.60 | 963.96 | 708.80 | 485.11 | 262.00 | 8.65 | 7,071.22 |
| H.R. 2400 and S. 683 Without Phase-in | | | | | | | | | | | |
| Plant Equipment | 470.24 | 1179.66 | 1574.55 | 1,561.51 | 1,184.35 | 648.18 | 277.64 | 77.98 | 8.98 | -0- | 6,983.08 |
| Industrial Buildings | 1.81 | 5.18 | 8.42 | 10.25 | 9.92 | 8.69 | 7.32 | 5.96 | 4.60 | 3.23 | 65.36 |
| Other Buildings | .60 | 1.85 | 3.19 | 4.17 | 4.52 | 4.58 | 4.56 | 4.55 | 4.55 | 4.55 | 37.12 |
| Total | 472.65 | 1,186.69 | 1,586.16 | 1,575.91 | 1,198.79 | 661.45 | 289.52 | 88.49 | 18.13 | 7.78 | 7,085.57 |

AMERICAN PETROLEUM REFINERS ASSOCIATION
COMPARISON OF DEPRECIATION UNDER S.317
AND H.R.2400 AND S.683

Schedule of Assumptions

The assumptions made to calculate the depreciation presented in the table are as follows:

1. Total Expenditures (Adjused for Inflation) or Projects Placed In Service (In Millions of Dollars):

| | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|
| Plant & Pollution Equipment | 2,351.19 | 2,136.41 | 1,633.06 | 750.01 | 112.42 |
| Industrial Buildings | 18.06 | 19.27 | 20.59 | 9.08 | 1.34 |
| Other Buildings | 18.07 | 19.28 | 20.60 | 9.08 | 1.35 |
| Total | 2,387.32 | 2,174.96 | 1,674.25 | 768.17 | 115.11 |

2. All projects were assumed to be started on July 1 of the calendar year during which initiated, and to be finished on July 1 of the calendar year during which completed.

3. The rate of inflation was assumed to be 12% for 1980 and 1981, 10% for 1982, and 8% thereafter.

4. In the calculation of depreciation under H.R.2400 and S.683 with phase-in, it was assumed that each of the 86 companies would make the election to treat $100,000 of expenditures as qualifying for 5 year treatment rather than the rates applicable during the phase-in.

STATEMENT OF THE
AMERICAN MINING CONGRESS
TO THE
COMMITTEE ON FINANCE
U.S. SENATE
BY
L. WILLIAM SEIDMAN
VICE CHAIRMAN, PHELPS DODGE CORPORATION
May 21, 1981

The recognition of the need to lessen the corporate tax burden and thereby provide additional capital to the business sector is particularly appropriate in the case of the domestic mining industry which must make substantial capital expenditures in the years to come if it is to be able to provide the basic minerals on which our economy depends.

Mining is one of the most capital intensive of all industries. Single projects can cost as much as a billion dollars and involve a period of 5 to 10 years from discovery to completion of development. In recent years, the capital needs of the mining industry have been affected by the large increases in required environmental, health and safety, and other government mandated expenditures, the high cost of debt financing, rapidly escalating mine development and equipment costs resulting from inflation, rising energy costs, increased imports, and low profitability in the case of a number of our major mineral sectors.

The American Mining Congress supports the Administration's proposed accelerated capital recovery system. We believe that enactment of the proposal will stimulate needed investment and lead to improvement of productivity growth rates.

Presently, there are significant segments of the mining industry which will not receive any direct or immediate benefit from the proposed cost recovery system. However, the entire mining industry should benefit in the long-run from improved general economic conditions.

The American Mining Congress recommends two improvements of the proposal. First, we strongly recommend providing more flexibility by permitting the taxpayer the option of deducting less than the proposed mandatory maximum cost recovery allowance deduction. Second, we recommend revising the proposed extended recovery rules for foreign assets so that these assets are eligible for accelerated cost recovery or, at least, are eligible for recovery as rapidly as under present law.

The American Mining Congress supports the President's recommendation that Congress should consider a first tax package limited in scope to deal with the urgent issues of individual rate reduction and capital cost recovery.

At the appropriate time, we believe the Congress should also consider:

(1) Changes in the tax treatment of environmental and other government mandated expenditures to provide a credit of at least 10 percent of the expenditures, elimination of restrictive definitional and certification requirements of present law, elimination of amortization of pollution control facilities as a minimum tax preference, and expansion of tax-exempt financing to reclamation expenditures and for facilities whose principal purpose is pollution abatement.

(2) Extension of the energy tax credit to expenditures to improve the energy efficiency of mining and mineral processing operations of existing or new facilities.

(3) Repeal of the minimum tax on corporations.

(4) Provision for a refundable investment tax credit.

Mr. Chairman and Members of the Committee:

My name is L. William Seidman, I am Vice Chairman of Phelps Dodge Corporation, whose principal businesses are mining copper, uranium and other minerals and manufacturing copper products. I am accompanied by Dennis P. Bedell, Chairman of the Tax Committee of the American Mining Congress and a member of the Washington D.C. law firm of Miller & Chevalier, Chartered.

I am appearing before you today on behalf of the American Mining Congress in support of the President's Economic Recovery Program and to discuss the mining industry's recommendations on the tax aspects of that program.

The American Mining Congress is an industry association representing all segments of the mining industry. It is composed of (1) U.S. companies that produce most of the nation's metals, coal and industrial and agricultural minerals; (2) companies that manufacture mining and mineral processing machinery, equipment and supplies; and (3) engineering and consulting firms and financial institutions that serve the mining industry.

Capital Formation Needs

We are all familiar with the Presidential and Joint Economic Committee reports which show that, in recent years, the United States does not compare favorably with the principal industrialized countries of the world in terms of the ratio of business fixed investment to gross national product and growth rates of labor productivity. Although significant productivity gains were reported by the Labor Department for the first quarter of 1981, the trend of productivity gains over the past several years should continue to be a matter of great concern. The need to lessen the Federal tax burden on business to provide additional needed capital to the private sector continues to be crucial in reversing that trend and bringing about a sustained long-term improvement in productivity. The infusion of an appropriate amount of capital in the private sector will permit the expansion and modernization of our nation's productive capacity and the creation of needed jobs.

The recognition of the need for additional capital is particularly appropriate in the case of the domestic mining industry, which has the task of providing the basic minerals that are the backbone of our industrial economy and our national defense. The report issued on December 31, 1980, by the Defense Industrial Base Panel of the House Committee on Armed Services points out the importance of minerals to our national defense. In that report, entitled "The Ailing Defense Industrial Base: Unready for Crisis", the panel found that "a shortage of critical materials, combined with a resulting dependence on uncertain foreign sources of these materials, is endangering the very foundation of our defense capabilities..." and that "current tax and profit policies appear to discourage capital investment in new technology, facilities and equipment that would increase productivity and improve the condition of the defense industrial base...".

For the domestic mining industry to meet the challenge of obtaining the minerals the nation will need in the years to come, the expenditure of tremendous amounts of capital will be required. Existing facilities must be expanded and modernized to more effectively exploit known mineral deposits. In addition, new deposits must be discovered and developed.

The discovery and development of minerals in the United States is becoming more and more costly. Most of the

high grade mineral beds which are readily accessible have already been discovered. Today, the mining industry must expend great sums of money on exploration and development in the United States. This exploration requires sophisticated and expensive geological, geochemical, and geophysical equipment. Underground exploration is particularly costly. Moreover, if the deposits that are discovered are of a low grade, the technology required to make mining and processing economically feasible must first be developed. Also, to process low grade ores at an economically attractive cost requires tremendous capital investment in facilities for large-scale operations.

To emphasize the special capital formation problems faced by the mining industry, I would like to call your attention to the report entitled "U.S. Minerals Vulnerability: National Policy Implications" which was issued by the Subcommittee on Mines and Mining of the House Committee on Interior and Insular Affairs in November 1980 (Committee Print No. 9). At page 38, that report states:

> Mining is the most capital intensive of all industries. Single projects can cost as much as a billion dollars or more. Without question, the capital needs to finance vital growth and expansion in the mineral industry in the years ahead will continue to grow. Mining balance sheets already reflect an average of approximately one dollar of depreciable fixed assets to support each dollar of annual sales, the highest of the 24 industries reported quarterly by the Federal Trade Commission. /Footnotes omitted/

Further, a more striking example of the capital requirements of the mineral industry is the capital investment needed for a new greenfields copper project. The investment required for an integrated copper project through the refined stage is now a minimum of $7,000 to $8,000 an annual short ton. Today's price is $1,700 a short ton. Thus, on an annual basis, the investment ratio to sales is well over 4 to 1.

The heavy inflation of recent years also has placed substantial additional burdens on the mining industry. As a result of inflation, the industry is encountering substantially higher replacement costs. Moreover, it is faced with rapidly escalating costs on uncompleted mine development projects. The discovery of an ore body and the development of a mine are a long-term, 5-to 10-year project. The inflation induced escalation of costs of mining projects has imposed substantial new and uncontemplated capital expenditure burdens on the mining industry.

The November 1980 report of the Subcommittee on Mines and Mining recognized that the mining industry has been especially hard-hit by inflation. That report observes that:

> From 1970 through the end of 1979 the Commerce Department's price index of capital goods used in mining, including fuel mining, rose a staggering 182 percent. In contrast, capital goods used in all industries rose 121 percent and the Gross National Product price deflator only 84 percent. /Footnotes omitted/

The American mining industry is also faced with large increases in required capital expenditures as a result of the extensive environmental and health and safety legislation affecting the industry which has been enacted in recent years. These expenditures, which do not add to productive capacity or result in any significant economic return, further increase the mining industry's capital needs.

The Subcommittee report cited above, in recognizing this special problem for the mining industry, states (at page 39):

> The very nature of mineral operations requires large capital and operating expenditures for pollution control, health and safety equipment, and mined land reclamation. Funding for achieving these worthwhile objectives has placed a heavy burden upon the already strained mining industry. McGraw-Hill studies have found that pollution control expenditures during the last 9 years by the entire mining industry averaged 8 percent of their total capital expenditures (and a staggering 19 percent for the nonferrous metal industry) compared to only 6 percent for all industries. /Footnotes omitted/

Rising energy costs, increased imports, and recent adverse economic circumstances in the case of a number of major mineral sectors also have impaired the mining industry's ability to carry on the necessary expansion of our mineral productive capacity. As noted by the report of the Subcommittee on Mines and Mining, the profitability of certain domestically produced minerals has been severely eroded in some cases by excessive production of government-controlled overseas operations which trade off profitability for employment and foreign exchange.

In recent years the industry has been required to turn increasingly for capital funds to debt financing, thereby significantly increasing the industry's debt burden and its debt/equity ratio. The industry's ability to generate capital internally and to attract outside capital is dependent on its profitability, which determines its cash flow and return on investment. The lower the industry's profits are, the less funds there are generated internally to meet capital needs. Moreover, inadequate profitability seriously impairs the industry's ability to obtain external financing. Even if the industry is able to attract the needed funds, inadequate profits impair its ability to service new debt burdens.

Our tax laws must provide an improved climate for capital investment and adequate incentives to allow the mining industry to obtain the capital it needs if we are to have the needed discovery and development of mineral deposits and the needed modernization and expansion of mineral productive capacity.

Accelerated Capital Recovery System

The American Mining Congress supports the proposed accelerated capital recovery system. The enactment of the system would reduce the cost of capital investments and thereby stimulate reinvestments from the improved cash flow. The consequent increase in investment will lead to improvement in productivity growth rates. Thus, the proposal will have a favorable impact upon general economic conditions for all businesses.

Currently, there are significant segments of the mining industry which will not receive any direct or immediate tax benefit from the accelerated cost recovery system owing to depressed profits. Nevertheless, the entire mining industry will benefit in the long run from improved general economic conditions. Increased cash flow for customers of mining production will have a beneficial impact upon the industry. In the long run, accelerated cost recovery will generate the cash flow to expand and modernize mining operations. Accordingly, the American Mining Congress supports the Administration's proposed accelerated cost recovery system.

We do suggest, however, two improvements which will strengthen the impact of the system upon the capital formation efforts of the mining industry.

First, we strongly recommend that the system should provide more flexibility by permitting the taxpayer the option of deducting less than the proposed mandatory maximum cost recovery allowance deduction. The Canadian Capital Cost Recovery System provides flexibility and, based on the experiences of some of our member companies, has been successful. It is our understanding that flexibility has not caused any significant audit or administrative burden to the Canadian tax authorities.

If the mandatory feature of the system is retained, the capital formation efforts of certain segments of the mining industry might be adversely affected over a period of several years owing to the impact of larger depreciation deductions upon percentage depletion, the minimum tax, and the utilization of investment and foreign tax credits. A modification to permit flexibility would be very important in assisting the mining industry in its capital formation efforts. Certainly, no industry should be penalized as compared to present law as a consequence of enacting a proposal to stimulate capital formation.

Two potential adverse effects of the mandatory nature of the Accelerated Cost Recovery System, which are not alleviated by longer carryover periods, are the loss of depletion and the loss of cost recovery itself.

The reduction of the percentage depletion allowance can occur because the allowance is limited to 50 percent of the taxable income from the property and depreciation or cost recovery is taken into account in computing that taxable income. Thus, increased cost recovery deductions reduce the limitation and, accordingly, can result in a loss of depletion for taxpayers subject to the limitation.

Ways of dealing with this problem include the following: (1) making the accelerated cost recovery system flexible so that taxpayers would be permitted to claim less than the maximum

amount of depreciation allowable; or (2) providing that the amount of cost recovery taken into account for purposes of computing the taxable income limitation on percentage depletion is either the amount of depreciation used for financial statement purposes or a similarly determined amount.

Second, the loss of cost recovery itself can occur in the situation where a taxpayer is engaged in both domestic business operations and fully taxed foreign business operations and the depreciation allowances on the taxpayer's domestic assets result in a loss on its domestic operations. The loss, thus, will be offset against the taxpayer's foreign income which has been fully taxed by foreign governments.

This problem can be illustrated by the following example. Assume a taxpayer has $100 of income from foreign sources each year which is subject to foreign income tax at a rate of 46 percent. Assume also that the mandatory accelerated cost recovery system results in the taxpayer's domestic operations incurring a $20 loss. That loss will be offset against the taxpayer's foreign source income. The taxpayer thus obtains no benefit from the $20 of accelerated cost recovery because the allowance is offset against income which otherwise would not be subject to U.S. income tax, i.e., the foreign source income that already has been fully taxed by the foreign country. This problem could be cured by making the accelerated cost recovery system flexible.

Secondly, we recommend revision of the Administration's proposed extended recovery rules for foreign assets so that these assets are also eligible for accelerated cost recovery. In any event, the depreciation allowances provided under present law for these assets should not be reduced.

Under present law, assets used outside the U.S. may be assigned guideline lines under ADR (without the benefit of the 20 percent variation). Under the Administration's proposal, the following modified recovery periods and the straight line method would be prescribed for foreign assets: 30 years for real property, 20 years for 10-year personal property, 10 years for 5-year property, and 5 years for 3-year property.

Mining operations must be conducted where minerals are located. In the case of certain minerals, this fact necessitates mining operations outside the United States. It does not follow that these foreign operations will result in curtailment in domestic production. In fact, these operations are often critical to the domestic economy in general. Therefore, we believe that assets used in foreign operations should be eligible for accelerated cost recovery in the same manner as assets used domestically. However, assuming that some difference in treatment is considered necessary, we believe that, at the very least, foreign assets should be eligible for recovery under the basic 10-5-3 write-off period under a straight-line method instead of under the proposed accelerated method. In this way, the new system will roughly approximate the difference in current treatment of domestic depreciable assets and foreign depreciable assets.

Other Issues

The American Mining Congress supports the President's recommendation that Congress should consider two tax packages, with the first package limited in scope to deal with the urgent issues of individual rate reduction and capital cost recovery. However, at the appropriate time, the American Mining Congress believes that consideration should be given to other issues of great concern to the mining industry. In the context of a two-bill approach, the appropriate time for consideration of these other issues would be in conjunction with a second tax bill. If the Committee should expand coverage of the pending bill, these other issues should be considered currently in that context.

1. Environmental Control and Government-Mandated Expenditures.

As previously mentioned, the mining industry has been faced with increasingly heavy capital expenditures to meet the many new environmental requirements being imposed on it. Moreover, in future years the mining industry will be required to spend staggering amounts of capital for pollution control facilities and other government-mandated expenditures. The current treatment of pollution control facilities under the Code is so limited and restricted that it has not been effective in easing the industry's financial burden of meeting pollution control standards.

The American Mining Congress recommends that a special

credit against tax liability of at least 10 percent should be allowed for qualifying pollution control facilities. The allowance of this special credit would be in recognition that mandated expenditures for nonproductive assets to achieve a desired social objective are for the benefit of the general public and, accordingly, a tax credit should be provided to the impacted companies as a means of providing some additional relief from these substantial nonproductive costs. Ample precedent for providing a special tax credit for expenditures benefiting the general public is found in the energy tax credit provisions of present law. In addition, taxpayers should be allowed, at their election, to write off the cost of these facilities and expenditures over any period selected by the taxpayer, including the immediate write off in the year of expenditure.

Similar treatment should be extended to other mandated expenditures, including those required by the Occupational Safety and Health Administration and the Mine Safety and Health Administration.

In addition, to provide a meaningful recognition in the tax laws of the economic burden on industry of nonproductive pollution control and abatement facilities, further modifications are needed. The restrictive definitional and certification requirements of present law should be eliminated. Thus, the requirements of Federal and state certification, the limitations based on the useful life of a facility and receipts from the recovery of waste, and the exclusion of pollution control facilities used in connection with new plants should be eliminated. Instead, the test for whether a pollution control

facility qualifies for write-offs or five-year amortization should be whether the primary function of the facility is pollution abatement.

Under existing law the excess of deductions for amortization of pollution control facilities over ordinary depreciation deductions is included in the tax base for the 15-percent "minimum" tax as an item of tax preference, thus diminishing the effect of five-year amortization in many cases. We recommend that pollution control facilities be deleted from the base of the 15-percent minimum tax if that tax is to be retained.

Finally, tax-exempt bond financing should be available for reclamation expenditures and for facilities whose principal purpose is pollution abatement, regardless of the incidental recovery of byproducts from the facility.

In this Congress, several bills have been introduced to deal with a number of these problems. For example, Senator Heinz has introduced a bill, S. 169, to make it clear that process changes to prevent pollution are eligible for tax-exempt financing and to permit expensing of pollution control expenditures at existing and new plants. Another bill, H.R. 1862, was introduced by Congressmen Seiberling and Pease to provide three options for treatment of pollution control expenditures for plants in operation before January 1, 1971 (5-year amortization with a full investment credit, one-year amortization, or a double investment credit) and to make facilities eligible for amortization even though output or capacity may be increased by the facilities.

2. Energy Tax Credits.

The energy investment credit should be made available to investments which improve the energy efficiency of mining and mineral processing operations and should be applicable without regard to whether the investments are made with respect to existing or new facilities.

In this Congress, several bills have been introduced to deal with these problems. For example, Senator Wallop and Congressman Heftel have introduced the "Industrial Energy Security Tax Incentives Act of 1981" (S. 750 and H.R. 2640, respectively). These bills would provide a 20-percent credit for energy property modifying existing processes and resulting in savings of at least 1,000 barrels of energy equivalent; extend the 20-percent credit to investments in conversion from oil and natural gas to alternative substances such as coal; and expand present law by providing more inclusive definitions of specially defined energy property, recycling equipment, and cogeneration equipment.

Finally, we would like to note our belief that the regulations adopted by the Treasury Department (Fed Reg., Jan. 23, 1981, p. 7287 et seq.) to implement the energy credit provisions of the Energy Act of 1978, are too restrictive and do not adequately carry out Congressional intent. Specifically, we believe that the regulations are too restictive in (1) disqualifying certain derivatives from coal as an alternate

substance, (2) disqualifying equipment used beyond this point at which the first product marketable as a feedstock has been produced, (3) providing that only the incremental cost for certain property qualifies, and (4) disqualifying certain combinations of alternative substances.

3. Minimum Tax on Corporations.

The "minimum" tax on corporations should be repealed or at the very least made inapplicable to items arising in the active conduct of business operations.

At a time when there is a clearly recognized need to stimulate capital formation, it is anomolous that the benefits from utilization of incentives provided under present law are diluted by the imposition of the minimum tax. This is not to say that Congress should not be concerned with tax sheltering devices. However, we believe that there is a justifiable distinction between use of tax incentives in connection with an active trade or business and use of those incentives by individuals who are passive investors.

4. Refundable Investment Tax Credit.

The investment tax credit is an important incentive for capital investment and a source of funds for industry to use in meeting its capital needs. We urge the committee to give serious consideration to making the credit refundable.

Refundability of the investment tax credit would magnify the stimulative impact of the credit by giving current benefits to companies which may be unable to currently utilize credits due to depressed market or economic conditions of a temporary

nature. Current availability of the credit would reduce or neutralize the importance that delayed utilization of the investment credit may play in making investment decisions for major expansion or modernization projects by firms currently experiencing low profitability. With refundability, those major investment decisions should be made primarily on longer range projections for market and general economic conditions. For industrial projects which usually involve long lead times as is typical with mining projects, the problem of being unable to utilize investment tax credits during a period of depressed profits would not play an inordinate role in the investment decision process.

Since refundability would make the present value of the credit for loss or low-profit companies equal to that of high-profit companies, refundability would eliminate any discrimination against companies in an industry which is more susceptible to significant cyclical pressures or which experiences any prolonged readjustments. For some companies, a refundable investment credit may provide the additional source of funds which are necessary to proceed with modernization and expansion projects to enable them to become more competitive, efficient, and profitable in the long run. To that extent, refundability would enhance efforts to revitalize low-profit companies. Facilitating those efforts could have a favorable impact in maintaining competition in the marketplace.

In this Congress, several bills have been introduced to make the investment tax credit refundable. For example, one bill, H.R. 1863 introduced by Congressman Seiberling, would make credits attributable to qualified investments made after 1980 refundable. Another bill, S. 737 introduced by Senator Durenberger, would provide a refundable investment tax credit with respect to property used by railroads, airlines, steel manufacturers, automobile manufacturers, and mining businesses.

# SUMMARY OF TESTIMONY OF THE NATIONAL ALLIANCE FOR HYDROELECTRIC ENERGY BEFORE THE UNITED STATES SENATE FINANCE COMMITTEE ON S. 683, THE ECONOMIC RECOVERY TAX ACT OF 1981

S. 683, the Economic Recovery Tax Act, contains an "at risk rule" which would limit the energy and regular investment tax credits for certain taxpayers to a small fraction of their present amount. Under the proposed rule, individuals, Subchapter S corporations and certain closely held corporations would only be permitted to claim investment and energy tax credits with respect to the portion of the basis of an item of property for which they are at risk. Taxpayers would not be considered to be at risk with respect to loans for which they are not personally liable or for which they are protected against loss through third party guarantees or similar arrangements.

The National Alliance for Hydroelectric Energy strongly opposes the proposed at risk rule, and urges that it be deleted from S. 683. Alternative energy projects--and particularly hydropower projects--entail such high capital costs that they would not provide a sufficient rate of return without the added incentive of the energy and investment tax credits. Indeed, these incentives were enacted for the expressed purpose of raising the return on investment in energy projects to a point where it can compete favorably with that of other investments. If the proposed at risk rule is enacted, it will frustrate the intent of these provisions and will result in the postponement or cancellation of numerous alternative energy projects. Because of the urgent need to reduce our dependence on expensive and unreliable foreign sources of energy, this result must be avoided.

The at risk rule is also contrary to the policy behind the President's program for economic recovery. It is contrary to the tax portions of the program because the President's tax proposals are intended to encourage business investment, while the proposed at risk rule would actually discourage investment. It is contrary to the policy behind the recommended curtailment or elimination of many direct spending energy programs because those recommendations are based on the understanding that tax incentives for energy development will remain available.

The at risk rule would also discriminate against small businesses by making the rate of return on capital investments by individuals and small companies much lower than the rate of return on the same investments by corporations which are not subject to the rule. Because it would give a competitive disadvantage to small businesses, the proposed rule would create precisely the kind of distortion in the free market system which the President's economic recovery program is designed to avoid.

For these reasons, the proposed at risk rule should be deleted from S. 683.

WRITTEN STATMENT OF THE NATIONAL ALLIANCE
FOR HYDROELECTRIC ENERGY BEFORE THE
UNITED STATES SENATE FINANCE COMMITTEE
ON S. 683, THE ECONOMIC RECOVERY TAX ACT OF 1981

I am appearing before you today on behalf of the National Alliance for Hydroelectric Energy (NAHE). NAHE is a trade association whose members represent all segments of the hydropower industry. NAHE members include hydropower developers and equipment manufacturers, as well as legal and financial advisors.

SUMMARY

The Economic Recovery Tax Act of 1981 (S. 683) is intended to promote economic recovery by stimulating business investment and capital formation. Toward this end, the bill would provide substantial individual tax cuts, which are designed to increase the supply of money that is ultimately available for business investment. The bill would also make significant changes in the depreciation system to simplify its operation and to permit businesses to recover their capital investments more rapidly. If enacted, these proposals will create a much more favorable climate for business investment.

Unfortunately, there is one provision in the Economic Recovery Tax Act which would have precisely the opposite effect, and which would actually make it much more difficult to raise capital for certain business investments. This provision, contained in section 203(g) of the bill, would impose an "at risk" rule on the investment and energy tax credits. The proposed at risk rule would substantially restrict the availability of these credits for many taxpayers who finance capital investments--including investments in hydropower and other energy related projects--with the proceeds of non-recourse loans. If this at risk rule is enacted, many alternative energy projects will be seriously delayed or abandoned entirely because they will be difficult or impossible to finance. Indeed, the mere proposal of the at risk rule has already had a substantial chilling effect on such investments.

NAHE opposes the proposed at risk rule for investment and energy tax credits. The proposed rule would frustrate the fundamental national objective of increasing investments which will reduce our dependence on uncertain and unreliable foreign sources of energy because it would result in the postponement or cancellation of numerous alternative energy projects. The proposal is also directly contrary to the President's program

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for economic recovery, which relies heavily on the continued availability of tax incentives to encourage energy conservation and the production of energy from alternative sources. Moreover, by discriminating against small businesses, this proposal will create precisely the kind of distortion in the free market system which the President's economic recovery program is designed to avoid. Accordingly, NAHE urges this committee to delete the proposed at risk rule from the Economic Recovery Tax Act.

## FEDERAL INCENTIVES AND SMALL SCALE HYDROPOWER DEVELOPMENT

Hydropower--the production of electrical or mechanical energy from flowing water--was one of the nation's primary energy sources at the time of the industrial revolution. With the increasing availability of cheap fossil fuels, the use of hydropower as an energy source declined, and many existing hydropower projects were abandoned and allowed to fall into disrepair. However, the current energy crisis has led to a revived interest in hydropower development, and particularly in the redevelopment of existing small scale hydropower projects.

The increased interest in small scale hydropower development has been encouraged by numerous federal programs designed to remove financial and regulatory

barriers to hydropower development. The Crude Oil Windfall Profit Tax Act of 1980 provided an 11 percent energy tax credit (in addition to the basic 10 percent investment tax credit) for small scale hydropower projects installed at existing dams or at sites which do not use a dam or impoundment structure. That Act also permitted the use of tax exempt industrial development bonds to finance certain state or local government owned hydropower projects. The Public Utility Regulatory Policies Act of 1978 exempted qualifying small scale hydropower projects from federal and state utility rate regulation and required utilities to purchase the output of qualifying facilities at a rate which represents the utility's avoided cost of producing electricity. Finally, the Energy Security Act permitted the Federal Energy Regulatory Commission (FERC) to exempt certain small scale hydropower projects from federal licensing requirements.

These and related efforts aimed at eliminating the institutional barriers to hydropower development are only now beginning to bear fruit. This is confirmed by the dramatic increase in federal hydropower license applications during the past year. FERC currently has more than 1050 pending applications for licenses or preliminary permits, many of which are for small scale hydropower sites at existing dams.

Although small scale hydropower projects generally do not produce enough electricity to be of interest to large industrial companies or public utilities, numerous small businesses have entered the hydropower industry. Because traditional means of raising capital, such as public stock offerings are not appropriate for these companies, they must look to alternative sources of financing. For this reason, many hydropower projects will be financed with a combination of equity contributions from individual investors and non-recourse loans provided by financial institutions. Because of this pattern of financing, the small businesses which have entered the hydropower industry would be particularly hard hit by the proposed at risk rule for investment and energy credits.

## AT RISK RULE UNDER THE ECONOMIC RECOVERY TAX ACT

The at risk rule contained in the Economic Recovery Tax Act would limit the availability of the investment and energy tax credits for investments financed with funds borrowed on a non-recourse basis. If the at risk rule is enacted, individuals, Subchapter S corporations, and certain closely held corporations would only be allowed to claim an investment or energy tax credit with respect to that portion of the basis of an item of property for

which they are at risk. The amount which a taxpayer has at risk would generally be equal to the amount of equity contributed to the activity and used to purchase the property, plus borrowed amounts for which the taxpayer is personally liable. A taxpayer would not be considered to be at risk with respect to funds borrowed on a non-recourse basis or with respect to funds which are protected against loss through third party guarantees or similar arrangements.

The impact of the proposed at risk rule on a typical hydropower project can be illustrated by the following example. Assume that an individual taxpayer develops a $10,000,000 hydropower project, 85 percent of which is eligible for the investment and energy tax credits; and that he pays for the project with $2,000,000 of his own funds and $8,000,000 borrowed from a bank on a non-recourse basis. Under current law, the taxpayer would be eligible for a total of $1,785,000 of investment and energy tax credits (21 percent of the $8,500,000 eligible investment). However, under the proposed at risk rule, the same taxpayer would initially only be permitted to claim $420,000 of investment and energy tax credits, or 21 percent of the $2,000,000 with respect to which he is at risk. No investment or energy tax credits would be allowed

with respect to the portion of the project paid for with borrowed funds until those funds are repaid. Thus, if the taxpayer repays $1,000,000 of the $8,000,000 loan in a subsequent year, he would be entitled to an additional $210,000 in investments and energy tax credits --21 percent of the $1,000,000 payment--in that year.*/

## THE PROPOSED AT RISK RULE WILL DISCOURAGE INVESTMENT IN ENERGY PROJECTS.

One of the most serious problems facing the country today is our heavy dependence on expensive and unreliable foreign sources of energy. This dependence has undermined our economy and has diminished our country's effectiveness as an international leader. Because of the urgent need to reduce our dependence on foreign energy sources, energy conservation and the development of alternative domestic sources of energy are among our highest national priorities. By discouraging investments in energy projects, the proposed at risk rule will frustrate our efforts to achieve our fundamental national goal of energy independence.

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*/ This is an idealized example which does not reflect the fact that the credits will be taken over a multi-year period.

Many energy projects--and particularly hydroelectric projects--entail such high capital costs that they do not ordinarily provide a sufficient rate of return to attract investors. While the availability of the energy and regular investment tax credits has made these energy projects attractive to sophisticated investors, these investors would probably not invest in such projects if the at risk rule for energy and regular investment tax credits is enacted. As the attached exhibit demonstrates, the proposed at risk rule would reduce the average discounted after tax return on investment from a typical hydropower project by 35 to 50 percent, depending on the method used to price the electricity. Because this reduced rate of return would actually be less than that provided by many other, more conventional investments--such as corporate bonds and securities--very few private investors would be interested in investing in energy projects if they would be subject to the proposed at risk rule.

The impact of the at risk proposal has already been felt by many energy projects. Because the rule as proposed would apply retroactively to investments made after February 18, 1981, many energy project developers are discovering that it is impossible to find investors for

their projects. As a result, many energy projects have been postponed or abandoned altogether.*/

Every alternative energy project which is delayed or cancelled represents a lost opportunity for the country to increase its energy independence. Because of the overwhelming importance of reducing our dependence on uncertain foreign sources of energy, Congress cannot afford to adopt any provision which will let these opportunities slip away. The proposed at risk rule for the energy and investment tax credits will have precisely this effect, and for that reason, it must not be enacted.

THE PROPOSED AT RISK RULE IS CONTRARY TO THE INTENT OF BOTH THE ENERGY AND THE INVESTMENT TAX CREDITS AND IS INCONSISTENT WITH THE ADMINISTRATION'S PROGRAM FOR ECONOMIC RECOVERY.

The energy tax credit and the regular investment tax credit are designed to stimulate business investment by reducing the after tax cost of capital improvements. The energy tax credit in particular was intended to provide a substantial incentive for investments in energy conservation and alternative energy production.

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*/ This is consistent with the overall negative reaction of the financial markets to the administration's economic program. See Washington Post, May 7, 1981, at A1, Col. 1.

The energy tax credit reflects an understanding on the part of Congress that while energy projects serve a substantial public purpose, many energy investments need additional encouragement because they would otherwise yield an insufficient return on investment or because they entail an unusually high degree of risk.

The proposed at risk rule would directly frustrate the intent behind the energy tax credit and the regular investment tax credit by reducing the credits available to certain taxpayers to a small fraction of their present amount. The enactment of such a rule at this time would be particularly inappropriate because the problems which these credits were designed to remedy have not been resolved. Indeed, if anything, the need to encourage capital investments and energy conservation in the business community is greater now than it was when these incentives were originally enacted. Accordingly, Congress should not adopt a provision which would diminish the impact of either the energy or the investment tax credits.

The proposed restriction on the availability of the investment and energy tax credits is also contrary to the overall purpose of the Economic Recovery Tax Act of 1981. That bill is designed to modify the existing depreciation and investment credit rules to provide added incentives for business investment. If

a provision such as the proposed at risk rule is included in the bill, the overall incentive effect of the bill would be substantially weakened and its purpose would be frustrated. Moreover, the signals sent to the business community regarding the administration's commitment to business development would become very confused.

The proposed at risk rule is also inconsistent with other non-tax provisions in the administration's program for economic recovery. The administration has asked Congress to reduce or completely eliminate many of the direct spending energy programs that were enacted during recent years. In urging the acceptance of these recommendations, the administration has assured Congress that existing tax incentives for energy conservation and alternative energy production will be retained and that they will provide the added incentive needed to stimulate energy development. In the case of the hydropower industry, the administration has recommended the complete elimination of DOE's small-scale hydropower program on the ground that the combined 21 percent energy and regular investment tax credit for hydropower projects provides a sufficient incentive for hydropower development:

> The administration will propose a 34% reduction in energy supply programs in geothermal, energy storage, electric energy systems, energy impact assistance, environmental studies, uranium resource assessments and hydropower as part of the general effort to employ market forces instead of bureaucratically-administered programs to achieve national energy goals. These reductions will:
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> * * *
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> --terminate subsidies for all additional small hydropower demonstrations since sufficient incentives are already provided through a 21% investment tax credit and through credit programs in the Department of Agriculture.*/

By diminishing the impact of existing energy related tax incentives, the proposed at risk rule would undermine the very foundation of the energy proposals contained in the President's economic recovery program.

## THE PROPOSED AT RISK RULE WILL DISCRIMINATE AGAINST SMALL BUSINESSES

Under the proposed at risk rule, corporations which are not subject to the at risk rule would be given a substantial competitive advantage over small businesses run by individuals, partnerships, and Subchapter S or closely held corporations. This competitive edge is a result of the selective application of the proposed at risk rule, which would cause the return on investment to corpora-

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*/ The President's Budget Reform Plan, White House, (1981), p. 4-18.

tions which are not subject to the rule to be much higher than the return on the same investment to small businesses. Thus, the proposed at risk rule would unreasonably and unnecessarily discriminate against small businesses.

The effect of this proposal is demonstrated by the attached exhibit, which sets forth representative financial data for a typical hydropower project. The exhibit demonstrates that under current depreciation practices, the average discounted after-tax yield to a corporation which is not subject to the at risk rule for credits would be 13.7 to 15.8 percent, while to a taxpayer which is subject to the at risk rule--such as a small business conducted by a partnership or a closely held corporation--it would only be 8.0 to 8.9 percent. Thus, in this sample project, the return to the taxpayer who is subject to the at risk rule could be as little as one half of the return to the taxpayer who is not subject to the at risk rule.

There is no sound reason for enacting a provision such as the proposed at risk rule which would provide a substantial competitive advantage to corporations which are not covered by the rule at the expense of small businesses. Indeed, any such provision would be in di-

rect conflict with the administration's stated objective of eliminating federal programs which distort the workings of the free market. Moreover, any such provision would also be directly contrary to the numerous federal programs specifically designed to assist small businesses. Accordingly, the proposed at risk rule should be deleted from the Economic Recovery Tax Act.

## CONCLUSION

The proposed at risk rule for the energy and investment tax credits has no place in the Economic Recovery Tax Act. It is contrary to the clearly articulated policies behind the administration's economic recovery program and to the intent of Congress in enacting the energy and investment tax credits that are available under current law. Accordingly, NAHE urges this Committee to delete the at risk rule from S. 683.

SAMPLE HYDROELECTRIC PROJECT

SUMMARY COMPARISON OF "AT RISK" PROVISIONS OF

EXISTING LAW VS ECONOMIC RECOVERY TAX ACT OF 1981

($000's)

| | EXAMPLE A | | EXAMPLE B | |
|---|---|---|---|---|
| | CASE I | CASE II | CASE I | CASE II |
| <u>AFTER TAX BENEFITS</u> | | | | |
| Total | $3943 | $2535 | $3552 | $2943 |
| Discounted @15% | $3157 | $1610 | $2739 | $1776 |
| <u>RETURN ON EQUITY</u> | | | | |
| Average After Tax Yield | 19.7% | 12.7% | 17.8% | 14.7% |
| Average Discounted After Tax Yield | 15.8% | 8.0% | 13.7% | 8.9% |

<u>NOTES</u>:

EXAMPLE A - PROJECT REVENUE STREAM BASED ON PURPA

EXAMPLE B - PROJECT REVENUE STREAM BASED ON COST-OF-SERVICE

CASE I - AT RISK PROVISIONS OF CURRENT LAW

CASE II - AT RISK PROVISIONS OF ECONOMIC RECOVERY TAX ACT OF 1981

EXHIBIT

## STATEMENT OF MR. PETER F. McCLOSKEY, PRESIDENT, ELECTRONIC INDUSTRIES ASSOCIATION

Mr. McCLOSKEY. Senator, I am Pete McCloskey, president of the Electronic Industries Association, and this is Mr. Victor Rose from the RCA Corp.

I have a prepared written statement which I will submit for the record and I have an even briefer oral statement.

I am here today to point out a serious anomaly that exists in our Tax Code that is referred to as the 861-8 regulations. This is a regulation that mandates a company doing international business to allocate a portion of the research and development done in the United States against its international business for calculating its foreign tax credits.

The result is that in many cases, particularly in the case of a company that is already in an access foreign tax credit position, research and development done in the United States is effectively denied a deduction.

At a time when we are talking about incentives for research and development, in form of R. & D. tax credits, and so forth, we have a detrimental situation where we don't even have a deduction for research and development performed in the United States.

The result is that a wise corporate money manager has to think seriously about whether or not to put some of that research and development overseas.

We are just beginning to see the impact of this disincentive to U.S. R. & D. The 861 allocation has only been on the books for a few years.

Senator WALLOP. When was that put on?

Mr. McCLOSKEY. I think it was effective January 1, 1977 and it never had the benefit of tax hearings before either this committee or the Ways and Means Committee and before that time it never applied to research and development.

What really is happening today, is we see a declining posture for the United States in our high technology industries. We see a need for more money to flow into research and development and yet we don't have complete deductibility of research and development performed in the United States.

That is completely different in every other country of the world. Our detailed statement gives you an analysis of not only that particular issue, but all of the research and development incentives that the various countries provide by way of inducement to industry.

The point of that is that not only do other countries provide inducements, but we provide a disincentive and a combination of our disincentive and their inducements is a pretty strong reason for U.S. firms to locate R. & D. activities abroad.

We have in our exhibits as well, an example of what one can do should he decide to open a research and development facility in Canada versus the United States, taking advantage of all of the Candian inducements. The impact is startling.

It is our suggestion Senator, that legislatively we correct the problem and we make a simple change to the Tax Code that provides that all research and development in the United States is fully deductible and it is not chargeable against foreign tax credits.

I think that if we do that we will have assured that there is no disincentive for doing research and development in the United States at a time when I think we ought to be providing incentives.

There is one other issue that we address in our oral testimony and also in our written testimony which is the 911-913 issue.

The high technology industries depend on their livelihood for a world market. It is imperative that we have Americans working abroad in order to insure that we have sales from abroad. We should not be penalizing those Americans working abroad.

We are the only industrialized Nation that does and I think it is time that we take a serious look at 911-913. There are some provisions before this committee and I think they will go a long way toward helping.

Senator WALLOP. I appreciate the latter especially, Mr. McCloskey, I have long felt that it is hard for us to compete in overseas markets. I think there are more than adequate examples of how that has been a real deterrent to the expansion of American business abroad.

I had not heard before of the R. & D. disincentive. If you have or do you know of any kind of revenue estimate that might be appended to this proposed change in the tax laws?

Mr. MCCLOSKEY. Yes, we do. For the year 1981, we are talking about, for fiscal year 1982 rather, $108 million leading to $144 million by 1986.

There has been a bill introduced in the House—let me see if I have the cite for you—H.R. 2473 by seven members of the Ways and Means Committee which would accomplish what I have described—the removal of the disincentive. It has not as yet been introduced in the Senate, but I would strongly urge that it be given serious consideration by yourself and your fellow members of the Finance Committee.

I know we are talking about tax incentives and tax credits for R. & D. but when you allow a tax disincentive to continue makes little sense. Perhaps, from a pure tax philosophy point of view the matching of taxes to your income is appropriate, however, it is in stark contrast to the effect that it has in the practical world.

I don't think that we should have a public policy in the United States that encourages us to transfer R. & D. overseas for tax reasons and I think we have that today.

Senator WALLOP. You mentioned something to the effect that this provision arrived without any real consideration of its ultimate effect, what is the history of that provision, do you know?

Mr. MCCLOSKEY. Well, I think Mr. Rose can answer that a little better.

Mr. ROSE. It's in the code itself, it's in the regulations.

Senator WALLOP. We consistently see alarming articles which I think have more than kernels of truth in them about the challenge posed by Japanese electronic and semiconductor industries.

Do you believe that the accelerated cost recovery program combined with R. & D. tax credits over and above the problem that you raised would begin to solve our problems with the competition of the Japanese electronics industry?

Mr. MCCLOSKEY. Well, I think that for the high technology companies, the accelerated depreciation is useful, but it is not as useful

as to some of the more mature industries, because the high-technology industries already has fairly accelerated depreciation of plant and equipment.

However, there is some financial cash-flow that is going to be generated certainly.

I think the investment tax credits will—for research and development will help focus national attention on the importance of research and development, I think it will stimulate research and development, I think it will help in the area of industry-university cooperation if the full package is accepted and I think that will do a lot to stimulate not only university cooperation, but the flow of graduate students and training people into programs in close connection with industry which really hasn't happened today.

If that happens, then I think we will have a much better chance at assuring that where we have had a technological lead, we will continue to have one.

Senator WALLOP. In addition to the R. & D. disincentive which you describe are there other tax changes necessary to stimulate R. & D. and particularly our ability to compete with the Japanese?

[Senator Dole arrived.]

Mr. MCCLOSKEY. Do you mean specific R. & D. tax incentives?

Senator WALLOP. Yes, are there any other kind of tax changes?

Mr. MCCLOSKEY. Well, there are the 861 issues are certainly one. There are two versions of the tax credit for research and development that make sense.

One of them is for the incremental increase in R. & D. over a 3-year average. That would be a 25-percent tax credit for that which will stimulate research and development and the other one is for grants made by industries to universities for research and development.

Again, I think that those three would be all steps in the right direction.

Senator WALLOP. Do you believe that changing the tax treatment of Americans working abroad is a major stimulus necessary for increasing U.S. exports in electronics area.

Mr. MCCLOSKEY. I think it would be very useful in electronics for a change to the 911-913 regulations. I think there exists a burden. I think that the companies are encouraged to use foreign nationals. I think there is danger that we are losing business that we should be getting as a result of the tax burden on American companies trying to equalize the tax system to make it effective for the workers abroad.

Of course, there is an additional expense, in that the companies themselves are the ones that fill out the income tax of the complicated rules that currently exist and I think the primary burden is that we are not encouraging Americans to go abroad, we are really discouraging them by the tax structure.

Senator WALLOP. Senator Dole, do you have any questions.

The CHAIRMAN. No specific questions, just some general questions.

Are you supporting the President's tax reduction program.

Mr. MCCLOSKEY. Yes, Senator, we have supported it. We have supported the general tax program as well, but we have pointed out here that there are some anomalies that exist and the one that

84-165 O—81——26

we are particularly addressing today happens to do with a tax disincentive which has a rather small impact in terms of Treasury of $108 million next year, but which actually says to American companies that you can seriously think of locating your research and development abroad rather than doing it in the United States because you will get tax benefits by doing that.

We have tax disincentives here under our 861-8 regulations and any prudent business manager has got to give serious consideration to doing just that.

I think that is very, very unwise to have our tax policy at odds with what our public policy ought to be.

The CHAIRMAN. Thank you.

Senator WALLOP. Senator Grassley.

Senator GRASSLEY. No, Mr. Chairman, I don't have any questions.

Senator WALLOP. Mr. McCloskey, thank you very much and your entire statement will be put in the hearing record. I think you raised an interesting point about the existence of disincentives at a moment when we are struggling to create some incentives. It seems that the incentives would be step 1, but I guess it remains to the committee, whether he will reexamine the T.C. & D. allocation rules.

Thank you.

[The prepared statement of Mr. McCloskey follows:]

Statement of the
ELECTRONIC INDUSTRIES ASSOCIATION
"EIA"

I am Peter F. McCloskey, President of the Electronic Industries Association (EIA). Accompanying me today is Victor Rose, Director of Taxes for the RCA Corporation. We and EIA's 350 member companies, all manufacturers of electronic products in the USA, are grateful for this opportunity to present our views on the President's Tax Reduction Proposal to the Senate Committee on Finance.

EIA has been a strong supporter of the President's Program for Economic Recovery. One reason for our support is its simultaneous attack on the tax, the budget, the regulatory, and the monetary factors of recovery. A second reason is the magnitude of correction that it seeks to apply...not a miniscule approach but, rather, courageous cuts on the spending and revenue sides. Third, we have supported the First Phase because the President has pledged a Second Phase; in other words, an ongoing Program.

Within this context of a comprehensive and ongoing Program, we have supported the President's tax proposals...fundamentally the corporate income tax reduction. In this area, the President focused on Capital Cost Recovery as the manner of reform and on 10-5-3 as the means of applying it.

EIA's support is rooted in our conviction that a more rapid restitution of capital is essential to economic vitality. Our companies would not be primary beneficiaries under 10-5-3 inasmuch as high-technology equipment is already written off in a relatively short time. But, our customer-companies would benefit from 10-5-3 and, hence, our industry benefits indirectly.

Because high-technology companies depend upon research and development (R&D), and because R&D has a very high pass-through to increased productivity and innovation, we have been in favor of fiscal incentives toward the conduct of more R&D.

Not every research project is successful, nor is every invention applicable to a saleable product. R&D is a very risky business. It yields "dry holes" like oil-well prospecting. Investment in R&D must be made without assurance of return. And, the pay-out on successful research projects might be realized only in the long term, not in a firm's short-term bottom-line.

R&D is, though, exactly the kind of expenditure-cum-investment that should be encouraged...if, indeed, economic recovery is the objective. And that, Gentlemen, is where R&D Tax Credits come in. They hasten the recovery of capital and, hence, make more available sooner for ongoing R&D. Tax Credits do help at the bottom-line.

EIA supports Senate bills S.98 and S.692 offering tax credits for R&D.

However, despite the potential benefits of encouraging R&D through the use of tax incentives, there presently exists within our tax code an obscure provision that creates a disincentive for firms to conduct their R&D activites in the USA. I am referring to Regulation 1.861-8. Its effect is that not all capital invested in R&D in this country is deductible. That is why I would now like to devote attention to its counterproductive result.

We believe that legislation is needed to overturn this Regulation in order to remove its present disincentive to U.S.-based R&D efforts. "861" now requires that a portion of U.S.-incurred R&D expenses be treated as "foreign-source" if a portion of the products resulting from the R&D are sold abroad. By treating a portion of R&D expense as a foreign expense, the taxpayer's foreign tax credit is effectively reduced. For many taxpayers, this reduction is tantamount to disallowance of deduction for the R&D.

This disallowance is compounded by the fact that the foreign country into

which the products are sold will not permit any corresponding deduction for the R&D expenditures.

If 1.861-8 is allowed to remain in force, its net effect is structurally to tax-favor the transfer of R&D activity from the U.S. to foreign countries; they have no restrictions comparable to those found in "861." Regardless of any philosophical merit that it might have, this regulation's implementation is conductive to the exportation of, both, future technology and jobs.

Attached to this statement as Exhibit-I is a copy of H.R.2473, which provides simply that a U.S.-source deduction is allowable for R&D activities performed within the U.S. This short bill, which is being co-sponsored by nine members of the House Committee of Ways and Means can eliminate a needless disincentive to American research and development. Exhibit-II explains this in greater detail.

The Joint Committee on Taxation has estimated the revenue loss attributable to H.R.2473 as $108 million for the 1982 fiscal year, increasing to only $144 million by 1986. We consider this revenue loss to be small, especially in light of the transfer of technology and jobs which it is capable of inducing.

Exhibit-III attached to this statement compares the fiscal incentives for R&D which are offered by the major industrialized nations. Review of that exhibit will depict a dramatic difference between the USA and its foreign competitors. On that exhibit, the double asterisk indicates the comparison as to 1.861-8.

Exhibit-IV compares U.S. and Canadian tax law, attempting to quantify the inducement to remove a research facility located in the USA to Canada.

At this point, I would like to indicate ANOTHER part of the Internal Revenue Code which is counterproductive. High-technology industry requires a world market. Stated in another way, there is demand in many countries for the products of our electronic industries; our companies would like to supply that demand. To do so successfully, in the face of our foreign counterparts, we must be competitive...or else the business potential does not materialize. Yet the Internal Revenue Code puts another disadvantage on our companies that foreign competitors simply do not have.

I am referring to Sections 911 and 913 of the Internal Revenue Code.

EIA supports a substantial liberalization of these two sections. The United States is unique among developed nations in taxing its non-resident citizens. Perhaps it is appropriate that our non-resident citizens bear some U.S. tax burden for the privilege of citizenship. However, that burden should not be so great as to render American goods and services noncompetitive, thereby pricing them out of foreign markets. Nevertheless, under present law this is exactly what has happened.

A recent study by the General Accounting Office shows that $5 to 6 billion in foreign sales have been lost as a result of sections 911 and 913. No doubt, a number of witnesses during these hearings have recited horror stories of business lost because of these sections. Their adverse impact on American business has been sufficiently documented and need not be further reviewed by us.

A number of legislative remedies have been introduced by members of Commerce. Most of these involve the repeal of section 913 (allowing limited deductions for certain exceptional foreign expenses) COUPLED WITH an increase in the exclusion to between $50,000 and $70,000 for Americans living and

working abroad. Another approach would permit such Americans to exclude 80% of their income from tax. The latter proposal is S.867, introduced by Senator Moynihan; it has the advantages of simplicity and of obviating periodic adjustments to the excludable amount. There is substantial merit in each of the several proposals before your Committee. We ask that you give them careful consideration and enact legislation helping not hindering American business in its efforts to regain lost positions in the world market.

The electronic industries for which I speak today contribute over $100 billion to the GNP. Of that, we export over $20 billion. Our companies employ 1.6 million Americans. We are healthy, growing industries, and our prospects for the future are excellent. We urge you to help them materialize.

Now, Mr. Rose and myself will attempt to answer such questions as you might have.

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EXHIBIT-I

97TH CONGRESS
1ST SESSION

# H. R. 2473

To amend the Internal Revenue Code of 1954 to treat deductions for research and experimental expenses attributable to activities conducted in the United States as allocable to income from sources within the United States.

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IN THE HOUSE OF REPRESENTATIVES

MARCH 11, 1981

Mr. SHANNON (for himself, Mr. HEFTEL, Mr. JENKINS, and Mr. MARTIN of North Carolina) introduced the following bill; which was referred to the Committee on Ways and Means

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# A BILL

To amend the Internal Revenue Code of 1954 to treat deductions for research and experimental expenses attributable to activities conducted in the United States as allocable to income from sources within the United States.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That (a) section 861 of the Internal Revenue Code of 1954
4 (relating to income from sources within the United States) is
5 amended by adding at the end thereof the following new
6 subsection:

EXHIBIT-I



1 "(g) ALLOCATION OF RESEARCH AND EXPERIMENTAL
2 EXPENDITURES.—
3 "(1) IN GENERAL.—For purposes of subsection
4 (b) and section 862(b), all amounts allowable as a de-
5 duction for qualified research and experimental expend-
6 itures shall be allocated to income from sources within
7 the United States and deducted from such income in
8 determining the amount of taxable income from sources
9 within the United States.
10 "(2) QUALIFIED RESEARCH AND EXPERIMENTAL
11 EXPENDITURES.—For purposes of this subsection—
12 "(A) IN GENERAL.—The term 'qualified re-
13 search and experimental expenditures' means
14 amounts—
15 "(i) which are research or experimental
16 expenditures within the meaning of section
17 174, and
18 "(ii) which are attributable to activities
19 conducted in the United States.
20 "(B) TREATMENT OF DEPRECIATION,
21 ETC.—Rules similar to the rules of subsection (c)
22 of section 174 shall apply."
23 (b) The amendment made by subsection (a) shall apply
24 to taxable years beginning after December 31, 1980.

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EXHIBIT-II

ENCLOSURE

H.R. 2473, Amending
Sections 861 and 862 of the
Internal Revenue Code

H.R. 2473 would amend Sections 861 and 862 of the Internal Revenue Code to provide that all R & D expenses made in the U.S. shall be allocated to U.S. source income rather than being allocated in part to foreign source income.

Presently Sections 861 and 862 provide for the apportionment or allocation of deductions between U.S. and foreign source income to arrive at taxable income from each such source. To the extent deductions are allocated to and reduce foreign source income, they reduce allowable foreign tax credits by reason of the limitation under Section 904 of the Code. Regulations issued by the Internal Revenue Service under Sections 861 and 862 provide complex and highly theoretical rules respecting the allocation and apportionment of R & D expenditures incurred in the U.S. to foreign source income. However the allocation and apportionment of these expenditures are not recognized in the foreign jurisdictions from which the foreign source income is derived. The result, therefore, is often double taxation of such foreign source income and, more significantly, a disincentive to the expansion of R & D activities in the U.S.

The reasons for this are as follows:

1. Unlike the authority to allocate or apportion gross income or deductions between or among related taxpayers provided under Section 482 of the Code with respect to which many U.S. tax treaties provide procedures for relief from consequential double taxation,* the decrease in allowable foreign tax credit (double taxation) which results from the allocation or apportionment of U.S. R & D expenses to foreign source income under Sections 861 and 862 cannot be mitigated under any existing tax treaty. The result is that U.S. taxpayers are subject to double taxation. A simple calculation illustrating such double taxation and the relief offered under H.R. 2473 is attached.

The U.S. Treasury Department confirms the serious problem involved here. A paper published by Treasury's Office of Tax Analysis in December 1980 (OTA Paper 43) states in part: "By denying U.S. corporations a full deduction for domestic R & D expenses against domestic income and by assigning some portion to foreign source income, where it often is not allowed as a deduction by foreign tax authorities, the apportionment can effectively deny any tax deduction for a part of R & D expenses. Corportations engaging extensively in international business or in the production of technology-intensive products may, in some cases, be subject to a significantly higher over-all tax on their worldwide income."

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* H.R. 2473 would not in any way affect the authority of the Internal Revenue Service to distribute, apportion or allocate gross income, deductions, credits or allowances between or among related entities pursuant to Section 482 of the Code.

EXHIBIT-II

2. No other country in the world requires its taxpayers to allocate expenses incurred in the home country to foreign source income to determine the amount of foreign tax credit allowable. Hence foreign companies, unlike U.S. companies, are not subject to comparable double taxation. This gives them a significant competitive advantage over U.S. companies.

3. In the case of R & D expenses the operation of these two basic disadvantages is particularly costly to companies, especially high technology, state-of-the-art companies, and runs counter to the national interest. Subjecting companies to double taxation with respect to a portion of their R & D expenditures because of a quirk in the U.S. law stands in shocking contrast with the widespread concern over the inadequate levels of R & D being performed in the U.S., the concern over sagging U.S. productivity in the face of foreign competition, and the very attractive incentive programs offered by many foreign countries to attract R & D from abroad. The point is that Sections 861 and 862 presently are an incentive for transferring R & D to foreign countries, since by doing so, a U.S. taxpayer can avoid double taxation and benefit from R & D incentives offered by many countries. The combination, therefore, of the disincentive to do R & D in the U.S., because a portion of it will give rise to double taxation, combined with the incentives to do R & D abroad creates a situation where U.S. companies must weigh carefully some of the non-financial advantages of continuing to concentrate all their R & D in the U.S. against the clear financial advantage of transferring some of their R & D abroad. A transfer to Canada, for example, which is so close to the U.S. geographically, technically, in its business environment, and in other ways, and where attractive R & D incentive programs are offered, is a prospect U.S. companies must seriously consider.

4. One of the most anomalous aspects of Sections 861 and 862 is that they tend to operate against our own U.S. R & D incentive as embodied in Section 174 of the Internal Revenue Code. Section 174, enacted in 1954, some 36 years after Section 861, permits R & D expenses to be taken as a current deduction in the year incurred instead of being capitalized and depreciated over a number of years. (Payments for R & D fixed assets must still be capitalized.) This incentive is effectively frustrated to the extent that R & D expenditures of U.S. firms result in double taxation as a result of Sections 861 and 862.

(It should be noted, furthermore, that there is no evidence that anyone considered the possibly contradictory interaction of Sections 861/862 and 174 at the time Section 174 was adopted. Indeed, it was not until revised Sections 861 and 862 regulations were proposed in the 1970's that R & D expenses were even specifically referred to in the regulations as an item for allocation. Hence, the application of those regulations to R & D expenses has never been considered by Congress.)

5. Another extremely serious problem is the difficulty inherent in developing basic guidelines for applying in an equitable manner the very general allocation principles of Section 861 and 862 to the millions of international transactions that thousands of U.S. companies engage in over many years. In fact, equity is impossible to achieve unless each identical set of transactions is treated as a separate case. To take just a simple example: research expenditures incurred in the U.S. over a 5-year period finally result in a marketable product which is manufactured and sold to yield U.S. source income; three years later exporting begins, yielding foreign source sales income; and after another three years the product is either licensed to an unrelated foreign producer to yield foreign source royalty income, or manufactured by a foreign subsidiary to yield

EXHIBIT-II

foreign source dividend income (but the subsidiary manufactures many products, so it is impossible to know how much of the dividend is attributable to this product). Now -- how is the five years of research cost that began 14 years ago to be allocated year after year to domestic sales income, export sales income, and royalty or dividend income? Clearly, no fair matching of R & D outlay with foreign income is feasible to achieve. This example, furthermore, pertains to R & D for one product for one company. How can a general rule cover all R & D for all products for all U.S. companies?

Furthermore, this is only the beginning of the complexity and equity problems. For example, under the current Section 861 regulations, R & D must also be calculated using broad product categories, so that, to illustrate, R & D on intercontinental ballistic missiles can be allocated to the dividend income of a foreign subsidiary producing engine valves, because both fall into the "Transportation" category. Additionally such things as special exclusions for government-mandated R & D and alternate calculations to consider safe havens are required to take account of special situations.

The result, clearly, is that despite the best attempts of rule writers no set of Sections 861 and 862 rules can provide equitable treatment for any company.

Two other results of this particular deficiency are important to note. First, the cost of maintaining the accounting system required to meet the Sections 861 and 862 requirements runs into the millions of dollars for a company of any significant size. Second, the cost to the government of auditing this one section of the law must also run into the millions of dollars. This cost to the government is particularly questionable, because the revenue gain from the application of Section 861 and 862 must be relatively very small. In fact, Treasury claimed there would be no gain in revenues when the present rules were put into effect in 1977, and a recent estimate from the Joint Committee on Taxation of the revenue loss resulting from the allocation of all U.S. R & D against U.S. source income, as proposed in H.R. 2473, was only $61 million in fiscal 1981, increasing gradually to $144 million in 1986.

In light of this kind of cost/benefit situation as well as the other serious disadvantages to U.S. companies outlined above, Sections 861 and 862 should be amended as provided in H.R. 2473. We recognize that this change will remedy only one area of the Sections 861 and 862 problem -- that of R & D allocations. But we feel that the need to remove this R & D handicap is so urgent in light of the need to support increases in U.S. technology, economic growth, productivity and foreign trade, that action should be taken immediately in the R & D area.

May 11, 1981

EXHIBIT-II

Attachment

Illustration of Effect on H.R. 2473
on Foreign Tax Credit
and Double Taxation

| | $10 of U.S. R&D Deductions Apportioned to Foreign Source Income (Present Law) | | | No U.S. R&D Deductions Apportioned to Foreign Source Income (H.R. 2473) | | |
|---|---|---|---|---|---|---|
| | U.S. Source | Foreign Source | Total | U.S. Source | Foreign Source | Total |
| 1. Taxable Income before R&D | $200 | $100* | $300 | $200 | $100* | $300 |
| 2. U.S. R&D deductions | 20 | 10 | 30 | 30 | -0- | 30 |
| 3. Taxable Income | $180 | $ 90 | $270 | $170 | $100 | $270 |
| 4. U.S. Tax on $270 at 46% rate | | | $124.2 | | | $124.2 |
| 5. Foreign Tax paid on $100 at 50% rate | | | 50 | | | 50 |
| 6. Foreign Tax Credit allowable by U.S. authorities (46% U.S. rate x foreign source taxable income) | | $90 at 46% = | (41.4) | | $100 at 46% = | (46) |
| 7. Total Taxes Paid (Line 4 plus Line 5 minus Line 6) | | | $132.8 | | | $128.2 |

* Includes $50 foreign tax paid.

Under H.R. 2473 total taxes paid are reduced by $4.60 because the foreign tax credit allowable is increased by $4.60. H.R. 2473 eliminates the double taxation of $10 of foreign source income under present law.

## COMPARATIVE RESEARCH INCENTIVES

| | U.S. | AUSTRL. | BELG. | CANADA | DENM. | FRANCE | GERMANY | IRELAND | ITALY | JAPAN | NETH. | UK |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| IMMEDIATE DEDUCTION FOR R&D EXPENSE EXCLUDING CAPITAL ASSETS | YES | YES | YES | YES | YES | YES | YES | YES | YES | YES | YES | YES |
| IMMEDIATE DEDUCTION OR SPECIAL ACCELERATED DEPRECIATION FOR R&D CAPITAL ASSETS | NO | YES[1] | YES[2] | YES | YES | YES[7] | YES[9] | YES | YES[10] | NO | NO | YES[13] |
| DIRECT GRANTS | NO | YES | YES | YES[5] | NO | YES | YES[9] | YES | YES | YES | YES | YES |
| ** FOREIGN TAX CREDIT NOT REDUCED BY R&D (REGS. SEC. 1.861-8) | NO | YES | YES | YES | YES | YES | YES | YES | YES | YES | YES | YES |
| CHEAP LOANS | NO | NO | YES | NO | NO | NO | NO | NO | NO | YES | YES | YES |
| SPECIAL TAX CREDITS | NO | NO | NO | YES[4] | NO | NO | NO | NO | NO | YES[11] | NO | NO |
| DEDUCTION FOR PAYMENTS TO RESEARCH INSTITUTES | NO | YES | YES | YES | ? | YES | ? | YES | ? | YES | YES | YES |
| EXEMPTION FROM WITH-HOLDING TAX ON FOREIGN LOANS USED TO FINANCE R&D | NO | NO | YES | NO | NO | NO | YES | NO | NO | NO | NO | NO |
| PROPERTY TAX EXEMPTIONS ON R&D FACILITIES | NO | NO | YES[3] | NO | NO | NO | NO | NO | NO | NO | NO | NO |
| TAX EXEMPTIONS FOR R&D BUSINESSES | NO | NO | YES[3] | NO | NO | YES[8] | NO | NO | NO | NO | NO | NO |
| GAINS ON DISPOSITION OF R&D CAPITAL ASSETS EXEMPT | NO | NO | YES[3] | NO | NO | NO | NO | NO | NO | NO | NO | NO |
| SUBSIDY FOR R&D EMPLOYMENT | NO | NO | YES | NO | NO | NO | NO | NO | NO | NO | YES | NO |
| TAX DEDUCTIBLE R&D INVESTMENT RESERVE | NO | NO | NO | NO | YES[6] | NO | NO | NO | NO | YES[12] | NO | NO |

NOTES

1. 3-year 150% declining balance depreciation on R&D equipment; 3-year depreciation on buildings.
2. 3-year declining balance depreciation for R&D equipment; a choice of double the ordinary straight line on buildings or the generally available double declining balance method.
3. In economic "development areas."
4. 10% investment tax credit plus 150% deduction for R&D expense in excess of average at last 3 years.
5. 50% grant of amounts invested in R&D.
6. Up to 25% of profits.
7. 50% first-year writeoff.
8. If technical personnel own 40% or more of the R&D business, it is tax exempt.
9. 20% subsidy up to DM 500,000 -- 7.5% on excess. These subsidies replace special accelerated depreciation which was available until 1975.
10. 50% in first year, balance capitalized if project successful. If unsuccessful, balance written off in next year.
11. 20% of excess of R&D expenditures over those in the highest year since 1967.
12. If related to overseas market development, small firms may establish a tax deductibility reserve which is restored to income over 5 years.
13. 100% first-year writeoff.



EXHIBIT-III

EXHIBIT-IV

The following comparison of the U.S. and Canadian tax law demonstrates the significant differences:

Assume a $20 million research facility located in the U.S. which incurs $10 million in R & D each year. Compare staying in the U.S. to moving the R & D to a facility in Canada:

| | | U.S. | Canada |
|---|---|---|---|
| 1. | Depreciation on facility | $ 1,000,000 | |
| 2. | Deduction of facility in year acquired | | $20,000,000 |
| 3. | Deduct R & D expenses | 10,000,000 | 10,000,000 |
| 4. | Additional Deduction allowable for 50% of the excess of current expenditures over 3 prior years' average | | 15,000,000 |
| 5. | Total Deduction | $11,000,000 | $45,000,000 |
| 6. | Less Investment Credit allowed below for R & D | | (3,000,000) |
| 7. | Net Deduction | $11,000,000 | $42,000,000 |
| 8. | Tax Reductions at 50% rate | 5,500,000 | 21,000,000 |
| 9. | Investment Credit on R & D | | 3,000,000 |
| 10. | 861 Effect on Foreign Tax Credit | (1,000,000) | - |
| | Net Tax Reduction for R & D | $ 4,500,000 | $24,000,000 |
| | | | (4,500,000) |
| 11. | Tax Benefit in Canada over U.S. | | $19,500,000 |

Analysis of $19,500,000 Benefit

| | | |
|---|---|---|
| 1. | Timing difference on immediate expensing of building instead of depreciating over 20 years | $ 9,500,000 |
| 2. | Deduction for R & D expenses in excess of prior 3 years' average | 7,500,000 |
| 3. | Investment Credit on R & D | 1,500,000 |
| 4. | 861 Effect in U.S. for R & D allocated to foreign source income | 1,000,000 |
| | Total | $19,500,000 |

EXHIBIT-V

1981

The Electronic Industries Association (EIA) represents 350 American companies. Most make and sell component parts, equipment, and systems for consumer, industrial, governmental uses. Others conduct research and development or provide contractual services pertaining to electronics.

Their memberships include companies of all sizes, ranging from very small, single-product businesses to large, multinational corporations.

The U.S. factory sales of electronic products exceeded $100 billion in 1980. Over $20 billion of this was exported. That figure would be even higher if the electronic content in such equipment as airplanes and machine tools were to be separately identified.

Electronics manufacturing directly employs 1.6 million Americans. Of those jobs, at least 400,000 are tied to exports.

Last year, while the nation suffered a trade deficit of $27 billion, our industries generated a $6.9 billion trade SURPLUS.

To summarize: ELECTRONIC EQUIPMENT AND COMPONENTS

| | 1977 | 1978 | 1979 | 1980* | |
|---|---|---|---|---|---|
| U.S. Factory Sales | $61.3 | $70.5 | $85.4 | $100.5 | billion |
| Exports | 11.7 | 13.4 | 16.7 | 20.1 | billion |
| Imports | 8.8 | 10.7 | 11.8 | 13.2 | billion |
| Trade Balance | +2.8 | +2.7 | +4.9 | +6.9 | billion |
| Employment | 1.174 | 1.292 | 1.436 | 1.6 | million in the USA |

*Estimate based on 11 months' data.

Whether measured by production, trade or employment, ours continue to be growth industries, and our sector to be one of the major, positive factors in the U.S. economy.

Source: ELECTRONIC MARKET DATA BOOK published by EIA.

EIA/1BC/3-81 Revision

ELECTRONIC INDUSTRIES ASSOCIATION • 2001 EYE STREET, N W WASHINGTON, D C. 20006 • (202) 457 4900
TWX: 710 822 0148

Senator WALLOP. It is my understanding that there are no other witnesses, so the hearing is adjourned.

[Hearing adjourned at 3:34 p.m.]

[By direction of the chairman the following communications were made a part of the hearing record:]

84-165 O—81——27

STATEMENT

by

Senator Charles McC. Mathias, Jr.

on the

Marriage Tax Penalty

Mr. Chairman, getting this country's economy moving again is the most important job facing the 97th Congress. The President and an overwhelming majority of the members of Congress have supported the first part of the President's economic recovery program. Now we must turn to consideration of the tax cut proposal which is aimed at spurring productivity and easing the tax burden on all Americans. I applaud these efforts. The ripple effect of a major tax cut will give our economy the boost it needs and will help every household make ends meet in these inflationary times. Furthermore, a tax cut gives us a long delayed opportunity to end the most glaring inequity in our tax code--the marriage tax penalty--and I hope we seize this chance to do so.

In the last 20 years, our country has undergone great changes. We have put men on the moon, learned to wait in gas lines, and watched miniskirts and wide ties come and go. Along with these noteworthy events, American society has seen an important evolution in family lifestyle. In 1979, for the first time, more than 50 percent of all married American women were working outside the home--at jobs never before held by women, and at salaries more and more in line with the work they do. It is estimated that in the next 20 years, the number of women working outside the home will continue to increase, reaching 70 percent by 1990. Clearly, women wage-earners are now an integral part of American society.

Yet, in the face of this change, our tax system has stood still. Twenty-five years ago, we devised a system to allow married people to combine all family income and file their tax returns jointly. For a traditional family with one wage-earner, this is a good system. It recognizes the expense of raising a family, and taxes married people at an appropriately lower rate. As long

as the majority of married couples were "traditional" families, this system fell within our guidelines of being "fair and equitable to the majority of American citizens." Unfortunately, because of the changes in lifestyles, the majority of American couples are now forced to pay extra taxes based upon an antiquated system that is now "fair and equitable" only to a minority of people.

This inequity is called the marriage tax penalty. It taxes two wage-earner couples more if they are married than if they are not, because when two incomes are combined and filed jointly, the second income is thrown in to a higher tax bracket. This penalty affects all income levels, but hurts the middle income couple the most, increasing that couple's tax bite by as much as 63 percent. In short, our tax system has turned the so-called tender trap into a booby trap.

Clearly, this quirk in our tax code encourages people to save money by divorcing and simply living together, or never to marry at all.

It is our job as legislators to resolve this problem. Earlier this year, Representative Fenwick and I reintroduced our bills that would end the marriage tax penalty. Under our proposal, all married couples would have the option of filing jointly or of filing separately, using the rate schedule for single people.

The Interdepartmental Task Force on Women concluded a major study on the marriage tax penalty which strongly supported this

proposal as the "simplest way to eliminate the marriage tax penalty." Our proposal is, in fact, not only the simplest, but I think the best way to eliminate the marriage tax penalty. A tax credit or deduction against the second spouse's income may be less expensive for the Treasury, but the reduction in the penalty would not be uniform for all couples. Such a proposal would result in the over-compensation of a few and the under-compensation of the vast majority of taxpayers affected by this inequity. Furthermore, a tax credit equal to the marriage tax penalty on earned income does not address the matter of a penalty on unearned income, and, more importantly, it avoids the question of which is the proper tax unit--the family or the individual.

In the Senate, my bill has 45 cosponsors and Representative Fenwick's companion bill in the other body has over 250. Both the Republican and the Democratic platforms as well as 83 percent of the American public, according to a Gallup poll, support a reduction of the marriage tax penalty. The National Federation of Business and Professional Women, the National Taxpayers' Union, the Southern Baptist Convention, and Citizen's Choice are among the many groups that have endorsed my proposal. Clearly, the support for optional separate filing is widespread and continues to grow.

This penalty won't disappear if we ignore it. Every time a woman enters the workforce, it grows, as do the Treasury's windfall revenues. Understandably, Treasury has been reluctant to give up

this windfall, but I hope the new Administration will change this policy. The revenue loss--estimated by the Treasury Department to be between $7.4 and $9.2 billion for 1981--makes the case for my bill more compelling. It spotlights the magnitude of the inequity, and the amount of tax money involved will only become larger and more difficult to deal with in the years ahead. I do not think Congress should wait several years before resolving this problem; by then it may well be impossible to wean the budget from this extra bite.

Mr. Chairman, in conclusion, I want to applaud your efforts to focus attention on this basic inequity. I also want to thank you for this opportunity to address your Committee. I hope the Finance Committee will become convinced that we should eliminate the marriage tax penalty this year.

### Statement of Hon. Ron de Lugo re the Impact of the Reagan Administration's Proposals on the Virgin Islands

Mr. Chairman and distinguished colleagues, I am Ron de Lugo, the delegate to Congress from the United States Virgin Islands. I appreciate this opportunity to inform you about the special impact the President's tax proposal will have on the Virgin Islands.

The proposed 30% reduction in individual income tax and the proposed corporate tax deductions are intended to reduce the federal government's level of services to its citizens by limiting available federal funds. At the same time, the Administration proposes to sharply cut federal programs, thus forcing the local government to shoulder a greater share of the costs of these needed services.

As many of you already know, the Virgin Islands has a "mirror" tax system. Under the Naval Appropriations Act of 1922, 48 U.S.C.A. 1397, American tax laws are in force in the Virgin Islands, but the tax proceeds collected are covered over to the United States Virgin Islands. In effect, the federal tax law is the tax law of the United States Virgin Islands.

Under the "mirror" system of taxation, passage of a 5 percent tax cut would result in a loss of approximately $5.8 million for the Virgin Islands government in calendar year 1981 and the much larger sum of $15.1 million in calendar year 1982. Projected losses in income tax collections to the Virgin Islands would be over $56 million for calendar years 1983 and 1984 if the President's tax package is enacted.

OVER THE NEXT FOUR YEARS THIS LOSS OF REVENUE, IN CONJUNCTION WITH THE UNPRECEDENTED CUTS IN NECESSARY PROGRAMS PROPOSED BY THE ADMINISTRATION, WILL RESULT IN A SUBSTANTIAL DIMINISHMENT IN BASIC HUMAN SERVICES FOR THE PEOPLE OF THE VIRGIN ISLANDS. IN THE AREA OF CATEGORICAL GRANTS ALONE, FOR EXAMPLE, UNDER THE PRESIDENT'S BUDGET THE VIRGIN ISLANDS STANDS TO LOSE FROM 23 TO 30 MILLION DOLLARS IN FEDERAL FUNDS, ALMOST ALL OF WHICH ARE BEING UTILIZED BY THE GOVERNMENT TO DELIVER BASIC AND BENEFICIAL SERVICES TO THE POPULACE. WE PROJECT THE LOSS OF ALMOST 900 JOBS AND CUTBACKS IN SERVICES TO APPROXIMATELY ONE-HALF OF ALL RESIDENTS OF THE TERRITORY. PERHAPS EVEN MORE IMPORTANT IN THE LONG RUN, HOWEVER, IS THAT THE PRESIDENT'S PROGRAMS OF TAX INCENTIVES AND THE THEORY OF SUPPLY-SIDE ECONOMICS, WHATEVER ITS MERITS FOR THE NATION AS A WHOLE ARE SIMPLY NOT RELEVANT TO THE ECONOMIC REALITY OF THE VIRGIN ISLANDS. IN FACT, THE CUTS IN PUBLIC FUNDING FOR BASIC ECONOMIC DEVELOPMENT JUSTIFIED BY THE TAX INCENTIVES IN THE PRESIDENT'S PROGRAM POSE A SERIOUS THREAT TO OUR PLANS FOR GREATER FISCAL AND ECONOMIC SELF-SUFFICIENCY IN THE FUTURE. LET ME EXPLAIN.

WHILE THE VIRGIN ISLANDS DO NOT BENEFIT FROM ALL FEDERAL PROGRAMS TO THE SAME EXTENT AS THE STATES, THE PROPOSED CUTS IN FEDERAL AID TO EDUCATION, BASIC SOCIAL SERVICE PROGRAMS, DIRECT AND INDIRECT AID FOR LOW-INCOME HOUSING AND NUTRITION PROGRAMS WILL REQUIRE OUR LOCAL GOVERNMENT TO CONTRIBUTE MORE RESOURCES TOWARD THESE FUNCTIONS OR TO DISCONTINUE THEM. A REVENUE SHORTFALL IS INEVITABLE IF THE CURRENT LEVEL OF SERVICE IS PROVIDED WITH LESS FEDERAL ASSISTANCE. THE ADDITIONAL LOSS OF LOCAL TAX REVENUES WOULD REQUIRE FURTHER GOVERNMENT REDUCTIONS IN SERVICE TO THE MOST NEEDY AND CONCOMITANTLY INCREASE UNEMPLOYMENT AND POVERTY-RELATED PROBLEMS.

IN THEORY, THE REDUCTION IN INFLATION RESULTING FROM A BALANCED FEDERAL BUDGET AND THE STIMULUS TO PRIVATE ENTERPRISE RESULTING FROM THE PRESIDENT'S TAX PACKAGE WILL CREATE MORE JOBS IN THE PRIVATE SECTOR AS ENTREPRENEURS RUSH TO INCREASE PRODUCTION TO MEET ANTICIPATED DEMAND. THIS THEORY IS SUBJECT TO CRITICISM BECAUSE INCREASED DISPOSABLE INCOME FROM A TAX CUT CAN NOT BE USED BY CONSUMERS TO BOTH INCREASE DEMAND BY BUYING MERCHANDISE AND TO CREATE NEW CAPITAL BY SAVING. BUT EVEN IF IT HOLDS FOR THE NATION AS A WHOLE, IT IS TOTALLY UNWORKABLE IN THE UNITED STATES VIRGIN ISLANDS BECAUSE OUR PAUCITY OF NATURAL RESOURCES, OUR EMBRYONIC STATE OF INDUSTRIAL DEVELOPMENT AND THE MAGNITUDE OF OUR TRANSPORTATION PROBLEMS OVERWHELMINGLY NEGATE THE RELATIVE ADVANTAGES OF THE PRESIDENT'S TAX INCENTIVES FOR DEVELOPMENT.

IN FACT, AS MANY OF YOU ALREADY KNOW, THE VIRGIN ISLANDS HAS ALREADY BEEN FORCED TO OFFER PRIVATE INVESTORS SUBSTANTIAL TAX ADVANTAGES IN ORDER TO ATTRACT THEM TO OUR SHORES. THIS HAS BEEN ACCOMPLISHED BY ENCOURAGING THE DEVELOPMENT OF PRIVATE SECTOR EMPLOYMENT THROUGH BENEFITICAL TARIFF TREATMENT UNDER GENERAL HEADNOTE 3(A). IRONICALLY, WORLD ECONOMIC CONDITIONS AND THE LIBERALIZATION OF OUR TARIFF STRUCTURE FOR DEVELOPING NATIONS CURRENTLY THREATENS THE INCENTIVES OF THE GENERAL HEADNOTE 3(A) PROGRAM AND WILL CAUSE THE DEMISE OF SEVERAL EXISTING MANUFACTURING OPERATIONS IN THE VIRGIN ISLANDS IF CONGRESS DOES NOT ACT TO MODIFY THE PROGRAM. LEGISLATION THAT I HAVE INTRODUCED FOR THIS PURPOSE IS CURRENTLY PENDING BEFORE THE HOUSE TRADE SUBCOMMITTEE. THE PRESIDENT'S TAX PROGRAM WILL PLACE THE VIRGIN ISLANDS AT A RELATIVE DISADVANTAGE VIS-A-VIS THE REST OF THE NATION, SIMPLY BECAUSE IT WILL MAKE THE TAX ADVANTAGES WE HAVE BEEN OFFERING LESS COMPETITIVE.

THE PRESIDENT'S TAX PROGRAM IS ALSO INTENDED TO PROMOTE PRIVATE CAPITALIZATION FOR ECONOMIC DEVELOPMENT, THUS FEDERAL ECONOMIC DEVELOPMENT

AID IS TO BE CUT. THE DEVELOPMENTAL NEEDS OF THE VIRGIN ISLANDS ARE SO FUNDAMENTAL AND REQUIRE SUCH MASSIVE AMOUNTS OF CAPITAL THAT PRIVATE INDUSTRY CAN NEVER BE EXPECTED TO PAY FOR IT. NOT ONLY DO WE NEED FUNDS FOR SITE PREPARATION, WE NEED TO DEVELOP DEPENDABLE ENERGY AND WATER RESOURCES AND BASIC WATER, POWER AND SEWAGE TRANSPORATION SYSTEMS. MOST OTHER AREAS OF THE NATION ALREADY HAVE THESE FACILITIES DEVELOPED.

MOREOVER, THE PROPOSED TAX ON AVIATION FUEL, AIR FREIGHT AND SEA CARGO WILL FURTHER INCREASE TRANSPORATION COSTS TO AND FROM THE VIRGIN ISLANDS, WHICH IS TOTALLY DEPENDENT ON IMPORTS. THESE COSTS HAVE ALREADY SKYROCKETED AS A RESULT OF THE DECONTROL OF OIL PRICES.

AS IF THIS IS NOT ENOUGH, THE PROPOSED TAX ON AIR TRAVEL WILL FURTHER INCREASE THE COST OF AIR TRANSPORTATION AND INEVITABLY LEAD TO A DECLINE IN AIR TRAVEL TO THE VIRGIN ISLANDS. DECREASED DEMAND WILL LEAD TO FURTHER DETERIORATION OF AIRLINE SERVICE TO THE VIRGIN ISLANDS, SO THOSE TOURISTS WHO CAN STILL AFFORD TO COME MAY NOT BE ABLE TO. THIS TAX POLICY, IN CONJUNCTION WITH THE ADMINISTRATION'S PROPOSAL TO CUT FEDERAL AID FOR AIRPORT CONSTRUCTION WHICH WOULD TERMINATE THE IMPROVEMENT OF OUR ST. THOMAS AIRPORT, COULD SET OUR AIR TOURISM INDUSTRY BACK YEARS. MY COLLEAGUES, IF THIS IS WHAT THE ADMINISTRATION'S TAX PROGRAM CAN BE EXPECTED TO DO TO OUR LARGEST PRIVATE SECTOR INDUSTRY, TOURISM, THEN HOW CAN OUR GOVERNMENT HOPE TO BECOME MORE FISCALLY SELF SUFFICIENT?

ONE FINAL POINT. WE HAVE MADE THE REDUCTION OF INFLATION OUR NATIONAL GOAL. WE MUST REALIZE THAT THE INFLATION IN THE VIRGIN ISLANDS IS AMONG THE WORST IN THE NATION.

THE ROCKY MOUNTAINTOPS WHICH FORM THE VIRGIN ISLANDS LIMIT OUR AGRICULTURAL PRODUCTION. NATURAL WATER RESERVOIRS DO NOT EXIST IN THE

VIRGIN ISLANDS. OUR GEOGRAPHY FORCES US TO IMPORT THE VERY ESSENTIALS OF LIFE, FOOD AND WATER. THE COST OF CONSUMER GOODS IN THE VIRGIN ISLANDS IS 30% HIGHER THAN HERE IN WASHINGTON, D.C., AND THE CAPITAL AREA IS REPUTED TO BE ONE OF THE MOST EXPENSIVE PLACES IN THE COUNTRY TO LIVE.

THE REASON PRICES ARE SO HIGH IN THE VIRGIN ISLANDS CAN BE LINKED DIRECTLY TO TRANSPORTATION COSTS. RECENTLY, THE LARGEST SHIPPER TO THE VIRGIN ISLANDS RECEIVED A 33% RATE INCREASE. THIS INCREASED SHIPPING COST WILL INEVITABLY LEAD TO EVEN HIGHER PRICES FOR CONSUMER GOODS AS THE ECONOMIC MULTIPLIER TAKES EFFECT.

THE LIMITED AVAILABILITY OF LAND IN THE VIRGIN ISLANDS AND SUSTAINED REAL ESTATE SPECULATION BY WEALTHY MAINLANDERS HAS FORCED THE PRICES OF EVEN THE MOST MODEST HOMES TO OVER $100,000. MANY NATIVE VIRGIN ISLANDERS HAVE BEEN SQUEEZED OUT OF THE HOUSING MARKET ENTIRELY BY THIS SPECULATION.

THE HIGH COSTS OF LIVING IN THE VIRGIN ISLANDS IS A SERIOUS EXACERBATING FACTOR. IT COMPOUNDS THE PROBLEMS OF THE POOR WHO WILL BE FORCED TO MAKE DO ON LESS IF THE ADMINISTRATION'S PROPOSALS ARE EFFECTED, AND IT HAMPERS OUR EFFORTS TO BECOME MORE ECONOMICALLY SELF-SUFFICIENT.

BECAUSE OF THE CONDITIONS I HAVE DESCRIBED, I DO NOT BELIEVE THE ADMINISTRATION'S TAX PROGRAM CAN SUCCEED IN THE UNITED STATES VIRGIN ISLANDS. BY THE PRESIDENT'S OWN ADMISSION, THIS PROGRAM WILL TAKE TIME. IN THE FOUR OR FIVE YEAR INTERVAL BEFORE EVEN THE INDIRECT BENEFITS OF HIS PROGRAM REACH OUR SHORES, THE VIRGIN ISLANDS CAN ONLY EXPECT TO LOSE MUCH OF THE ECONOMIC GROUND WE HAVE STRUGGLED SO LONG TO GAIN. TO PREVENT THIS LOSS, I SEEK YOUR HELP IN HOLDING THE VIRGIN ISLANDS HARMLESS FROM THE REVENUE LOSSES THAT WOULD RESULT BY PASSAGE OF THE ADMINISTRATION'S INCOME TAX PROPOSALS.

IN THIS REGARD, I HAVE DIRECTED LEGISLATIVE COUNSEL TO DRAFT LANGUAGE THAT WOULD PREVENT THE VIRGIN ISLANDS FROM LOSING REVENUE AS A RESULT OF THE PASSAGE OF THE ADMINISTRATION'S PROPOSALS. THIS LANGUAGE IS ATTACHED AND IS SUGGESTED AS ONE WAY BY WHICH THE VIRGIN ISLANDS COULD POSTPONE THE FULL IMPACT OF THE PRESIDENT'S TAX PROGRAM LONG ENOUGH TO MAKE SATISFACTORY ADJUSTMENTS IN AN ORDERLY AND EFFECTIVE MANNER. THIS "HOLD HARMLESS" CONCEPT WAS EMBODIED IN THE TAX CUT LEGISLATION PASSED IN THE 95TH CONGRESS, P.L. 95-30, AND THE ENCLOSED LANGUAGE TRACKS THAT OF SIMILAR LEGISLATION PASSED BY BOTH HOUSES IN THE 95TH CONGRESS.

ON BEHALF OF THE PEOPLE OF THE VIRGIN ISLANDS, I URGE YOU TO CONSIDER OUR GREAT NEEDS AND THE SERIOUS IMPACT OF THE PROPOSED TAX PROGRAM ON OUR ATTEMPTS TO MEET THESE NEEDS OURSELVES. I HOPE THAT YOU WILL TAKE ACTION, AS THIS COMMITTEE HAS IN THE PAST, TO HOLD THE VIRGIN ISLANDS HARMLESS FROM THE ADMINISTRATION'S TAX PROPOSALS, AND THUS PREVENT THE SUBSTANTIAL DETRIMENTAL IMPACT I FEAR THAT WOULD OTHERWISE RESULT.

SEC.---PAYMENTS TO GUAM AND VIRGIN ISLANDS TO OFFSET REVENUE LOSSES.

(A) GENERAL RULE.--THE SECRETARY OF THE TREASURY IS AUTHORIZED TO MAKE SEPARATE PAYMENTS FOR EACH OF THE CALENDAR YEARS 1981, 1982, 1983, AND 1984 TO THE GOVERNMENT OF GUAM AND THE GOVERNMENT OF THE VIRGIN ISLANDS. THE PAYMENT TO THE GOVERNMENT OF A PARTICULAR POSSESSION FOR ANY CALENDAR YEAR SHALL BE IN AN AMOUNT EQUAL TO THE LOSS TO THAT POSSESSION WITH RESPECT TO TAX RETURNS FOR TAXABLE YEARS BEGINNING IN SUCH CALENDAR YEAR BY REASON OF THIS ACT, OR ANY SUBSEQUENT ACT OF CONGRESS, UNLESS OTHERWISE SPECIFICALLY PROVIDED IN SAID ACT, WHICH EFFECTS A REVENUE REDUCTION FOR THE GOVERNMENT OF GUAM OR THE GOVERNMENT OF THE VIRGIN ISLANDS. SUCH AMOUNT SHALL BE DETERMINED BY THE SECRETARY OF THE TREASURY UPON CERTIFICATION TO THE SECRETARY BY THE UNITED STATES GOVERNMENT COMPTROLLERS FOR GUAM AND THE VIRGIN ISLANDS.

(B) AUTHORIZATION OF APPROPRIATIONS.--THERE ARE HEREBY AUTHORIZED TO BE APPROPRIATED, OUT OF ANY FUNDS IN THE TREASURY NOT OTHERWISE APPROPRIATED, SUCH SUMS AS MAY BE NECESSARY TO CARRY OUT THE PROVISIONS OF THIS SECTION..

# STATEMENT OF THE ALLIANCE OF METALWORKING INDUSTRIES

THIS STATEMENT IS PRESENTED ON BEHALF OF THE SIX METALWORKING ASSOCIATIONS WHO TOGETHER REPRESENT 20,000 MANUFACTURING PLANTS EMPLOYING 880,000 INDIVIDUALS WITH COMBINED ANNUAL SALES OF OVER $34 BILLION. THE SIX MEMBER ASSOCIATIONS ARE THE AMERICAN METAL STAMPING ASSOCIATION, THE FORGING INDUSTRY ASSOCIATION, THE METAL TREATING INSTITUTE, THE NATIONAL SCREW MACHINE PRODUCTS ASSOCIATION, THE NATIONAL TOOLING & MACHINING ASSOCIATION, AND THE SPRING MANUFACTURERS INSTITUTE.

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.

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.

OUR ORGANIZATION WISHES TO COMPLIMENT THE ADMINISTRATION AND MANY MEMBERS OF CONGRESS FOR THEIR RECOGNITION OF THE IMPORTANCE OF DEPRECIATION REFORM. VIRTUALLY ALL THE EVIDENCE POINTS TO THE NEED FOR SUCH REFORMS. MOST OF THE INDUSTRIALIZED NATIONS WITH WHOM WE COMPETE HAVE FASTER WRITE OFFS FOR THEIR CAPITAL EQUIPMENT. THERE APPEARS TO BE A DEFINITE CORRELATION BETWEEN DEPRECIATION RATES, PRODUCTIVITY, AND THE ABILITY TO COMPETE IN WORLD MARKETS. WHILE OUR PRODUCTIVITY GROWTH IN RECENT YEARS HAS COME TO A HALT, THE PRODUCTIVITY OF COMPETING NATIONS HAS INCREASED SIGNIFICANTLY. PRESIDENT REAGAN CITED THE STATISTICS IN A WALL STREET JOURNAL COLUMN THIS PAST JANUARY WHEN HE WROTE:

> IN JAPAN PRODUCTIVITY INCREASED BY AN AVERAGE OF 9.9% FROM 1960 to 1973 AND BY 3.6% FROM 1973 TO 1978. IN WEST GERMANY, DURING THE SAME PERIODS, IT INCREASED BY 5.8% AND 4.2%, WHILE IN THE U.S. THE INCREASES WERE ONLY 2.9% FROM 1960 TO 1973 AND LESS THAN HALF THAT FROM 1973 TO 1978. SEVERAL MONTHS OF 1980 ACTUALLY SHOWED A NET DECLINE IN PRODUCTIVITY.

FOR THIS REASON, WE FEEL THAT IT IS URGENT THAT DEPRECIATION REFORM BE ENACTED AS SOON AS POSSIBLE. WE SUPPORT EQUALLY THE REFORMS PROPOSED BY THE ADMINISTRATION AND S. 287 . EITHER WOULD PROVIDE A MAJOR IMPETUS TO INVESTMENT AND WOULD GREATLY INCREASE PRODUCTIVITY IN THIS COUNTRY.

NO DOUBT MANY GROUPS WILL SUGGEST MODIFICATIONS WHICH WOULD INCREASE THE BENEFITS TO THEIR CONSTITUENCY OR PERHAPS IMPROVE THE ENTIRE BILL. WHILE WE COULD OFFER OUR OWN AS WELL, AMI FEELS THAT THE MOST IMPORTANT PRIORITY SHOULD BE THE PASSAGE OF THIS LEGISLATION AS QUICKLY AS POSSIBLE.

IF THIS COMMITTEE WISHES TO CONSIDER FURTHER "FINE TUNING" OF EITHER PROPOSAL, WE MIGHT SUGGEST SOME CONSIDERATION BE GIVEN TO THE FOLLOWING ALTERNATIVES:

FIRST, EITHER THE ADMINISTRATION's PROPOSAL OR S.287 MIGHT BE IMPROVED BY SIMPLIFYING THE PHASE-IN FOR SMALL BUSINESSES. MANY SMALL BUSINESSES DO NOT EMPLOY THE ASSET DEPRECIATION RANGE IN THEIR ACCOUNTING SYSTEM. BY PROVIDING A BASE FIGURE WHICH WOULD NOT BE SUBJECT TO THE PHASE-IN, SMALL BUSINESS INVESTMENT WOULD BE STIMULATED AND WOULD NOT HAVE ANY PROBLEM WITH THE PHASE-IN TECHNIQUE.

SECONDLY, MANY SMALLER COMPANIES, ESPECIALLY IN OUR INDUSTRY, BUY A SIGNIFICANT AMOUNT OF USED EQUIPMENT. THE REASON IS NOT ONLY COST, BUT BECAUSE THERE IS OFTEN A SIGNIFICANT WAIT FOR DELIVERY ON NEW EQUIPMENT. UNDER PRESENT LAW, THE AMOUNT OF USED MACHINERY ELIGIBLE FOR THE 10% INVESTMENT TAX CREDIT IS ONLY $100,000. WE SUGGEST THAT THE FIGURE BE RAISED TO $250,000 OR EVEN MORE. THIS TOO WOULD PROVIDE ADDITIONAL STIMULATION IN THE SMALL BUSINESS SECTOR OF OUR ECONOMY. SUCH STIMULATION WOULD BE WELL WORTH THE

EFFORTS SINCE IT IS THE SMALL BUSINESSES IN THIS COUNTRY THAT PROVIDE THE MAJORITY OF NEW JOBS, A DISPROPORTIONATE AMOUNT OF THE INNOVATIONS, AND HAVE THE GREATEST POTENTIAL FOR PRODUCTIVITY IMPROVEMENT.

THE MOST IMPORTANT CONSIDERATION, HOWEVER, IS THAT THE COMMITTEE SHOULD NOT LET SINCERE EFFORTS TO IMPROVE THE LEGISLATION, INCLUDING OUR SUGGESTIONS, SLOW THE LEGISLATIVE PROCESS TO THE POINT OF CREATING A BARRIER TO ENACTMENT.

WITH THE FOREGOING BRIEF STATEMENT OF OUR POSITION ON THESE PROPOSALS, AMI IS NOT ESPOUSING ANYTHING NEW, AMI HAS CONSISTENTLY SUPPORTED THE CAPITAL FORMATION PROPOSALS CONTAINED IN THE SO-CALLED "10-5-3 BILLS". WE HAVE COME BEFORE THIS COMMITTEE ON SEVERAL OCCASIONS IN THE PAST TWO YEARS AND WE HAVE TESTIFIED BEFORE THE HOUSE WAYS AND MEANS COMMITTEE AND THE SMALL BUSINESS COMMITTEES OF BOTH HOUSES OF CONGRESS.

AT THE RISK OF SOUNDING REPETITIVE, WE WOULD LIKE TO EMPHASIZE THE IMPACT OF PROPOSED DEPRECIATION REFORM ON A SINGLE ONE OF OUR INDUSTRIES. ONE AMI MEMBER SURVEYED ITS MEMBERS IN 1980 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

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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 1980. EXTENDED 10-14 TIMES TO TAKE IN THE OTHER FIVE AMI MEMBER ASSOCIATIONS, OR THOUSANDS OF TIMES TO THE UNITED STATES ECONOMY, AND WE HAVE A COUNTRY BACK IN GEAR AGAIN.

FINALLY, MR. CHAIRMAN AND MEMBERS OF THIS COMMITTEE, TO EMPHASIZE THE COMMITMENT OF OUR INDUSTRIES TO THE ENTIRETY OF THE PRESIDENT'S ECONOMIC PROGRAM,AMI WOULD LIKE TO INCLUDE IN THE HEARING RECORD THE FOLLOWING RESOLUTION. THIS RESOLUTION WAS UNANIMOUSLY ADOPTED ON MARCH 11, 1981, BY THE 220 CHIEF EXECUTIVES OF SMALL METALWORKING COMPANIES WHO ATTENDED AMI'S SIXTH ANNUAL WASHINGTON CONFERENCE.

THIS RESOLUTION SINCERELY EXPRESSES THE SENSE OF URGENCY WITH WHICH THE MEMBERS OF THE ALLIANCE OF METALWORKING INDUSTRIES IMPLORE THE CONGRESS TO ACT FAVORABLY ON THE PRESIDENT'S PROGRAM FOR ECONOMIC RECOVERY FOR OUR COUNTRY.

ALLIANCE OF METALWORKING INDUSTRIES

RESOLUTION IN SUPPORT

OF THE

REAGAN ADMINISTRATION ECONOMIC PROGRAM

March 11, 1981

WHEREAS the growth of the federal government, increased deficit spending, and excessive taxation have led the United States to the brink of economic calamity, and

WHEREAS the American people have expressed their will, in the November 1980 elections, to have the scope and costs of government vastly reduced, and

WHEREAS President Reagan has proposed a comprehensive program to reduce the growth of government spending and the proliferation of federal regulations, coupled with individual and business tax reductions, and

WHEREAS immediate action by the Congress is necessary to deal with this situation;

THEREFORE BE IT RESOLVED that the Executive Council and Members of the Alliance of Metalworking Industries endorses, in total, President Reagan's economic program; and

BE IT FURTHER RESOLVED that the Alliance of Metalworking Industries urges immediate Congressional approval of this economic program.

TELEPHONE 751-5800

THE ESOP ROLLOVER PROVISION

(More revenue for the IRS?)

The Expanded Ownership Act of 1981 contains a tax free rollover provision. Briefly, it would allow for a tax free rollover of the proceeds of a sale of small business stock to an ESOP or TRASOP. If proceeds are reinvested within eighteen months in other small business stock, gain would not be recognized for tax purposes until a subsequent sale is made. This discussion will attempt to illustrate some of the consequences of such a provision and to suggest that the Internal Revenue Service consider carefully what the net result would be.

As an example consider two cases: One in which a man dies at age 65 and his estate pays the normal death taxes. The other case in which a man at the age of 50 decides to use the proposed Rollover Provision to sell his stock over a fifteen year period to an ESOP Trust and then also dies at age 65. In each case the men die at the same age and presumably pay the same estate taxes. In the first case a small business may be destroyed in the attempt to pay estate taxes. Employees may be thrown out of work. The Treasury suffers the loss of future corporate tax on what was a going business as well as employee income tax. Also lost is the 6.65% employee and 6.65% employer contribution to Social Security. In addition, there are unemployment compensation costs attributable to those who do not find employment immediately. In the second case if a proposed Rollover Provision were in effect, a prudent man could plan his retirement years in advance. At retirement age he would own little, if any, stock in the original small business. His income would now continue to come from other investments which he had made by rolling his stock over. At his death the IRS would receive the same revenue as if he had stayed in his original business. Since the original business is still in operation, all normal taxes from this source would continue. There is even a further gain to the Internal Revenue Service if consideration is made of the increased corporate and personal income generated by this man's rollover investments during this fifteen year period. In addition to all this, his rollover investments would tend to be more liquid and thus facilitate his final estate settlement.

The example just cited oversimplifies conditions in the real world. There may be more than one stockholder involved. The time span may be longer or shorter. The conditions differ with almost any conceivable corporation. The one condition that does not change, however, is the fact that a transfer of ownership must take place sooner or later and this transfer, unless accomplished in an orderly manner, is harmful to the economic health of small corporations. The ownership of small corporations under present tax regulations is frozen into a state of suspended animation. Management tends to remain in the same hands

as long as possible and when age, desire or death forces a change, the employees are usually unable to afford the cost of "buying their own jobs" to continue the enterprise.

It appears that a Rollover Provision would be particularly suited to a small ESOP corporation for several reasons. The ESOP trust now acts as a market for stock. This market already is regulated by law to protect ESOP participants. The sale of stock to an ESOP trust is a simple process. Unlike a large corporation with publicly traded stock, the small ESOP corporation has more need for a system to encourage continuity. In an ESOP corporation this continuity could be accomplished in an evolutionary manner which would keep pace with the normal work life span of the average employee. In a non ESOP corporation, there is little incentive for a major stockholder to transfer his capital ownership unless it is through a tax free merger or liquidation. In an ESOP corporation there is some incentive because of capital gains treatment on stock sales to the ESOP trust. In an ESOP corporation with a Rollover Provision there is every reason to take a long term position and begin the transfer of ownership which must inevitably take place. That such a transfer of ownership accrues to present employees is a step in the direction of broadened capital ownership. And Congress has already "made clear its interest in encouraging employee stock ownership plans as a bold and innovative method of strengthening the free private enterprise system." (see Section 803(h) of the Tax Reform Act of 1976)

The ESOP Rollover Provision is not only for holders of stock outside the ESOP trust. At present any employee of an ESOP corporation, upon termination of his employment for any reason, may receive his vested portion of the ESOP trust and roll it over tax free into an Individual Retirement Account. The Rollover Provision under discussion is simply a further development of this idea. An individual would be able to receive his vested interest and purchase stock in another small business corporation or conceivably invest it in a business venture of his own. Such an action emphasizes the fact that ESOPs represent individual ownership of capital and are not meant to be risk free. Any venture in capital formation may fail or succeed, but it seems like a good idea to leave that choice and chance up to the individual.

The cost of an ESOP Rollover Provision occurs because of a tax deferral. No tax reduction is involved. After this initial time-cost of money has elapsed, no change in revenue occurs. Tax revenue then continues at the same pace. Against this initial delay in tax revenue must be weighed the perpetual health and continuity of small enterprises on one hand and the effect of mergers, inheritance taxes, liquidation or any other change in ownership that takes place eventually without an ESOP Rollover. The corporate use of ESOPs is a fairly new development. The total number of ESOP corporations is small compared to the total number of corporations. Therefore, any tax legislation concerning ESOPs will have a small effect caused by deferred revenue. If the idea of an ESOP Rollover is sound, now is the time to consider it.

# THE EFFECTIVENESS OF THE ACCELERATED COST RECOVERY SYSTEM AND ALTERNATIVE TAX INCENTIVES IN INDUCING INVESTMENT IN SHORT-TERM ASSETS

Prepared on behalf of the
American Automotive Leasing Association

## EXECUTIVE SUMMARY

The purpose of this study is to analyze the impact on investment in short-term assets, particularly automobiles and light trucks, of the Accelerated Cost Recovery System (ACRS) as proposed by the Administration and contained in H.R. 2400 and S.683 and to consider alternative tax incentives of equivalent cost to the U.S. Treasury. The study was prepared by Robert R. Nathan Associates, Inc. (RRNA) on behalf of the American Automotive Leasing Association.

The ACRS would stimulate spending on commercially used vehicles by (1) mandating a single accelerated depreciation method that is more accelerated than the most liberal existing alternative, and (2) increasing to 6 percent (2 percent per year) the maximum investment tax credit (ITC) on three-year assets from the present 3 1/3 percent, along with more liberal recapture provisions.

The ACRS proposal is a welcome step in the right direction, but, unfortunately, the ACRS will not have the favorable impact that it could have within the same revenue impact constraint. Most additional investment in commercially used vehicles results from an increase in the rate at which vehicles are replaced, rather than an increase in the

stock of commercial vehicles in use. The latter changes slowly over time with variations in general economic conditions. Proposals designed to induce additional investment in automobiles and light trucks should therefore be evaluated by their impact on vehicle replacement rates.

For over 15 years, commercial vehicle users have been slowing replacement. They are holding vehicles longer because of the rapid and continual rise in the monthly cost of using vehicles. By providing additional internal funds and thereby lowering interest expenses, both the depreciation and the ITC proposals of the Administration will slow or reverse the rising trend in monthly vehicle costs. This effect should retard or perhaps reverse the lengthening trend in replacement rates. However, neither the proposed depreciation provisions nor the ITC proposal will have as great an impact as desired, unless the incentives are shaped to influence directly decisions to replace individual vehicles.

Faster acceleration in depreciation rates affects replacement by influencing the financing cost component of the monthly cost of vehicles. But there is no direct and visible connection between more accelerated depreciation and individual replacement decisions. Moreover, the drop in financing expenses attributable to liberalization of depreciation occurs only once. Thus, because the ongoing financial advantage of accelerated depreciation is not continuously visible to fleet administrators or to others making replacement decisions, the impact of more liberal depreciation on replacement is limited.

The ITC has a much more visible and direct connection to vehicle replacement. With each replacement, the user can claim the full 6 percent ITC in the tax year in which the

replacement occurs, subject to recapture if the vehicle is not held three years. Compared to existing ITC provisions, the 2-2-2 ITC proposed by the Administration, which excludes one-third of the 6 percent ITC (2 percent) from recapture for each of the first three years the asset is held, will speed the replacement of vehicles. The existing ITC by requiring that assets be held for three years to retain the present 3 1/3 credit actually could retard replacement. Vehicles that would otherwise be replaced at 32 or 33 months may well be held a few more months to avoid recapture of the existing ITC.

Unfortunately, the proposed ITC will not stimulate faster replacement nearly as much as other designs because it provides for the same 2 percent credit a year regardless of when replacement occurs. If replacement occurs every 12 months, the ITC would total 4 percent after two years, 2 percent on one vehicle in the first year plus 2 percent on its replacement in the second year. However, the same 4 percent credit would be available in the two years on only one vehicle if replacement occurs every 24 months.

Greater stimulus for faster replacement would result under an ITC with an accelerated design, such as a 3-2-1 ITC which would provide for a 3 percent credit in the first year an asset is held, 2 percent in the second year, and 1 percent in the third year. The more accelerated the design, the greater will be the inducement for faster replacement. Thus, a 4-2-0 ITC, providing for a 4 percent credit in the first year, 2 percent in the second, and no credit thereafter, would provide an even greater incentive than the 3-2-1 design.

Such accelerated designs would, for example, provide an incentive for replacement at 12 months rather than at 24 months, since over a two-year period they would furnish greater credits in total if replacement is every year rather than every two years. With the 3-2-1 design and 12-month replacement, the total credit would equal 6 percent in the first two years, (3 percent on each new vehicle each year). With a 24-month replacement, the two-year total would be 5 percent (3 percent for the first year plus 2 percent on the same vehicle for the second year). The 4-2-0 ITC would supply even greater stimulus for replacement at 12 months, since it would provide over two years tax credits totaling 8 percent if replacement occurs every year compared to 6 percent with replacement at 24 months.

The accelerated ITC would also be somewhat less likely to cause delays in replacement in those cases where replacement would occur after the first year at other than 12-month intervals.

For example, independent of tax considerations, a commercially used automobile may ideally be replaced after 20 months in service. With the Administration's proposed 2-2-2 ITC, the fleet administrator would be encouraged to hold the automobile another four months in order to qualify for the second 2 percent. Under the 3-2-1 ITC or the 4-2-0 ITC, the commercial user would have already qualified for a 3 percent or 4 percent credit during the first 12 months the car has been in service. Having acquired these larger credits, the user would be less concerned about foregoing the additional 2 percent credit caused by replacement at 20 months. Similarly, when the vehicle user is considering replacement at 32 months rather than at 36 months, he is much more likely to choose the earlier replacement time if the foregone credit

is, at most, only 1 percent with an accelerated ITC as opposed to the 2 percent with the constant annual ITC.

Even with an accelerated ITC, some temptation to delay replacement from perhaps 20 months to 24 months or from 32 months to 36 months in order to qualify for additional credit would remain. This temptation can be removed by providing, after the first 12 months, tax credits proportional to the part of the year the vehicle is used. Assuming replacement at 20 months, either the 3-2-1 or 4-2-0 designs would provide for two-thirds of the second year's credit, or 1.33 percent of the cost of the vehicle. Therefore, the total tax credit with replacement at 20 months would be 4.33 percent under the 3-2-1 ITC or 5.33 percent with the 4-2-0 ITC. Since under either accelerated design, the commercial vehicle user would forego only a third of the second year's tax credit by refraining from delaying replacement to 24 months, the user is much less likely to delay replacement from 20 to 24 months.

In every situation the prorated and accelerated ITC, unlike the Administration's proposal, provides an incentive for earlier replacement. The resulting increase in purchases of automobiles and light trucks would have a number of beneficial effects.

Commercial users of vehicles rely almost exclusively on domestically produced vehicles. Therefore, more rapid replacement would serve to increase the sales of the U.S. motor vehicle manufacturers. Increased automobile sales stimulated by an accelerated ITC would generate greater domestic production, employment, and income not only in the automobile industry, but also in a vast number of other businesses and industries which supply products to the

automobile industry. Thus, the accelerated ITC would increase production and investment in large parts of the economy.

The shorter replacement cycle would result in commercial fleets with a larger proportion of new-model vehicles. New vehicles have been and will continue to be more fuel-efficient than those produced in previous model years. Therefore, significant reductions in gasoline consumption would be achieved, reducing reliance on oil imports. Because new model year's vehicles are safer and more emission-free, the accelerated ITC will improve the safety of vehicles on the road as well as lessen air pollution. Newer cars are smaller and lighter, resulting in less congestion and road wear.

More rapid replacement of commercial fleets would make more late-model used vehicles available to private households. The non-commercial driving public would therefore dispose of older models, consume less gasoline, and ride in safer and more pollution-free vehicles on less congested streets and highways. Furthermore, the increased supply of late-model used vehicles would hold down the prices of these vehicles.

Greater increases in the sales of automobiles and light trucks induced by an accelerated ITC will lead to additional increases in sales, incomes, and employment in the myriad of industries supplying the vehicle manufacturing industry and then ripple throughout the economy. The increases in taxable income and revenue generated by an accelerated ITC would be substantially larger than those caused by the Administration's 2-2-2 ITC, causing the tax revenue feedback resulting from the adoption of an accelerated ITC to be much

greater. The larger revenue feedback would more than offset the initial revenue reduction caused by substituting an accelerated ITC for the Administration's constant annual ITC.

Given the greater benefits and the smaller revenue reduction attributable to a prorated and accelerated ITC, RRNA urges its adoption.

STATEMENT OF JAMES S. FRANK, CHAIRMAN OF THE AMERICAN AUTOMOTIVE LEASING ASSOCIATION, ON THE TAX REDUCTION PROPOSALS OF THE ADMINISTRATION (S. 683)

Submitted to:

THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE

May 28, 1981

Mr. Chairman and Members of the Committee:

I am James S. Frank, a past President and present Chairman of the American Automotive Leasing Association (AALA), which is headquartered in Milwaukee, Wisconsin. I am also President of Wheels, Inc., a vehicle leasing firm located in Chicago, Illinois. AALA is a national trade association composed of approximately 160 companies engaged in the leasing of motor vehicles, primarily to commercial and industrial lessees (and, to a lesser extent, to consumer lessees). The member companies of AALA presently have on lease more than 700,000 motor vehicles. We appreciate the opportunity provided by your announcement of April 13, 1981, to submit the following statement for consideration by your Committee and the Senate as a whole.

The depreciation regulations and investment tax credit (ITC) proposed by the Administration should indeed help improve the investment climate in the American economy. While I cannot speak for all users of three-year assets, I know that the dollar volume of the financial incentives contained in S. 683 and H.R. 2400 are sufficient to increase the investment and productivity of the commercial users of automobiles and light trucks, a group that in addition to business sales and service fleets includes utility companies, taxicab companies, and rental car companies. In 1981 these businesses were using over nine million vehicles and replacing over three million of them each year.

Unfortunately, the design, as opposed to the size, of the Administration's proposals concerning three-year assets will substantially reduce the favorable impact the financial incentives would otherwise have, and may even create, in some circumstances, a disincentive to invest. In the case of commercially used automobiles and light trucks, greater investment occurs largely through more rapid replacement of existing assets. More generous depreciation is somewhat helpful, but it has little effect on vehicle turnover, and hence, should be sacrificed, if necessary, to provide an appropriately designed ITC, since the ITC can have a direct and distinct impact on replacement decisions. The ITC provisions for short-term assets in S. 683, which essentially provide an ITC of two percent in each of the first three years an asset is held, offer very little incentive for faster turnover. An accelerated ITC which, for example, provided for a three percent credit in the first year, two percent in the second year, and one percent in the third year, would have a much greater impact on the turnover rate, and thereby increase annual investments in vehicles.

With the ITC provisions in S. 683, the commercial user of vehicles receives the same two percent credit a year regardless of when replacement occurs. If replacement occurred every 12 months, the ITC would total four percent after two years, two percent on one vehicle in the first year plus two percent on its replacement in the second year. However, the same four percent credit would be available in two years on only one vehicle if replacement occurred every 24 months. The accelerated ITC described above, on the other hand, would provide an incentive for turnover at 12 months rather than 24 months, since the total ITC would equal six percent in the first two years (three on each new

vehicle each year) with annual replacement, compared to a five percent total (three percent for the first year plus two percent on the same vehicle for the second year) if replacement occurs at 24 months.

The accelerated ITC would also be much less likely to cause delays in replacement in those cases where replacement would occur after the first year at other than 12 month intervals.

For example, independent of tax considerations, a commercially used automobile may ideally be replaced after twenty months in service. With the Administration's proposed 2-2-2 ITC, the fleet administrator would be encouraged to hold the automobile another four months in order to qualify for the second two percent credit which is available only if the vehicle is held for 24 months. Under an accelerated 3-2-1 ITC, the commercial user would have already qualified for a three percent credit during the first twelve of the 20 months the car has been in service. Obtaining this three percent credit would, therefore, mitigate the impact of foregoing the additional two percent credit caused by replacement at 20 months. Similarly, when the vehicle user is considering replacement at 32 months rather than 36 months, he is much more likely to choose the earlier replacement time if the foregone credit is only one percent with the accelerated ITC as opposed to the two percent with the constant annual ITC.

Thus, in almost every situation imaginable, the accelerated ITC, unlike the Administration's proposal, provides an incentive for earlier replacement. With more rapid turnover, the annual purchases of new vehicles by commercial users would increase. This increase in purchases of automobiles and light trucks would have a number of beneficial effects.

Since commercial users of vehicles rely almost exclusively on domestically produced vehicles, the sales of the American motor vehicle manufacturers would rise substantially, and therefore provide welcome relief to Detroit in view of the problems currently faced by domestic automobile producers. The increased automobile sales stimulated by an accelerated ITC would not only generate greater production, employment, and income in the automobile industry, but also in a vast number of other businesses and industries which supply products to the automobile industry. Thus, the accelerated ITC would ultimately increase production and investment in a large part of the economy.

The shorter replacement cycle induced by an accelerated ITC would result in commercial fleets with a larger proportion of new model vehicles. New vehicles available from the American manufacturers each year have been and will continue to be more fuel efficient than those in previous model years. Therefore, significant reductions in gasoline consumption would be achieved, reducing reliance on oil imports, if an accelerated ITC is adopted. Because each model year's vehicles are safer and more emission free, the accelerated ITC will also help improve the safety of vehicles on the road as well as lessen air pollution, thereby reducing accident and health hazards. And because newer cars are smaller and lighter, road congestion would be eased and road wear would be reduced.

Since a more rapid turnover of commercial fleets will increase the proportion of late-model used vehicles available to private households, these same benefits will be intensified. As the non-commercial driving public has access to relatively more late-model used vehicles, they will dispose of older models, consume less gasoline, and ride in safer and more pollution free vehicles on less congested streets and

highways. Furthermore, the increased supply of late-model used vehicles would lower the prices of these vehicles, or at least diminish the rate at which their prices would rise.

An accelerated ITC would provide an effective incentive to commercial users of vehicles. Largely as a consequence of rapidly rising vehicle prices and very high interest rates, these commercial users have found it necessary to use each vehicle longer. Since the mid-1960s, for example, the average number of months that automobiles are used by lessees has increased from about 21 months to about 28 months, or by approximately 33 percent. With each rise in the average number of months that vehicles are in service, the users experienced increased maintenance costs and reduced productivity, because the resources required for the management of commercial fleets and the down time required for the repair and maintenance of commercial vehicles rose. More rapid replacement of vehicles generated by an accelerated ITC would reduce the number of momths vehicles are used, thereby lowering the costs and improving the productivity of vehicle users. As these cost reductions and productivity improvements were effected, the nation as a whole would benefit.

The extent to which these benefits are achieved depends on the design of the ITC. Therefore, AALA urges the Senate to substitute an accelerated ITC for the 2-2-2 ITC recommended by the Administration for short-term assets. The 3-2-1 ITC design is certainly desirable, but others might well be considered. AALA has retained Robert R. Nathan Associates, Inc., an independent economic consulting firm in Washington, D. C. to analyze the impact of alternative ITC designs that could be implemented for about the same Treasury revenue impact as the Administration's proposal, and to assess the benefits resulting from a more rapid replacement cycle. This study is nearing completion, and AALA will soon provide copies to the Senate Finance Committee and its Members. We urge your consideration of the study in your deliberations on the pending tax bill.

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**AMERICAN DENTAL ASSOCIATION**

WASHINGTON OFFICE • SUITE 1004 / 1101—17TH STREET, N.W. • WASHINGTON, D.C. 20036 • PHONE 202/833 3036

May 27, 1981

The Honorable Robert J. Dole
Chairman
Senate Finance Committee
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Dole:

The American Dental Association appreciates this opportunity to present its views on the tax reduction proposals of the Reagan Administration's economic recovery program. The Association requests that these comments be included in the Senate Finance Committee's hearing record.

While the dental profession agrees that tax reductions for individuals on a more permanent basis are essential to stimulate the economy, we believe that any tax reform proposal should include tax incentives with the dual objectives of promoting capital formation and encouraging long term private savings for retirement.

In the 97th Congress, several legislative proposals, such as S.243, the Savings and Retirement Income Incentive Act of 1981, have been introduced to expand participation in individual retirement account plans (IRAs), increase the maximum tax deductible contributions IRA limits, and make other equitable changes to encourage participation in IRA retirement programs.

However, as presently drafted, the proposed legislation omits any reference to making similar equitable changes to encourage participation in retirement programs for self-employed individuals and their employees, commonly referred to as H.R. 10 or Keogh plans.

On behalf of the 130,000 dentists of our nation, the Association strongly recommends that any proposed tax reduction legislation include provisions designed to encourage participation in self-employed individuals retirement (Keogh) plans.

At the very minimum, the Association urges that the present $7,500 limit on tax deferred contributions by self-employed individuals should be increased to $15,000 or 15% of earned income, whichever is lesser. This proposed increase is necessary and equitable in order for the retirement funds of self-employed persons and their employees to keep pace with the dramatic inflationary impact of cost of living increases based on the Consumer Price Index that have occurred since 1974 when Congress last adjusted the present limit.

Since the enactment of the Self-Employed Individuals Tax Retirement Act of 1962, Congress has adjusted the maximum deductible contribution limits on two occasions to reflect subsequent inflationary increases to protect the retirement funds of self-employed persons and their employees.

Besides ameliorating inflationary pressures on retirement funds for self-employed individuals and their employees, this proposed increase would also enhance the formation of capital on a more permanent basis to further economic development and growth.

The Association would also request your Committee to consider eliminating many of the overlapping artificial limitations and restrictions of existing qualified Keogh retirement plans which are no longer necessary in light of the comprehensive requirements established by the Employee Retirement Income Security Act (ERISA) of 1974. These restrictions relate to coverage, vesting, fiduciary responsibility, prohibited transactions, benefits and limits on tax deductible contributions.

As a result of these Keogh plan restrictions, especially when compared to comparable corporate pension plans, many self-employed individuals have been induced to incorporate their practices to gain tax advantages. The Association has no objection to dentists incorporating their practices; however, the Association is convinced that many dentists would not consider incorporating their practices if they could obtain tax treatment or retirement benefits as self-employed persons reasonably similar to those available under other qualified ERISA retirement plans.

Thus, the elimination of these special H.R. 10 limitations and restrictions would promote the goal of equity of tax treatment for similarly situated individuals and remove the present artificial distinctions which encourage many self-employed persons to incorporate.

Moreover, elimination of the Keogh restrictions would result in a major simplification of the present tax laws, while extending coverage of the private pension system to many low-income employees not presently protected.

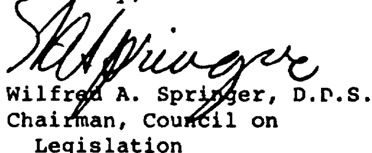
The Association would also recommend consideration of a provision that would allow self-employed individuals to act as their own trustees of their Keogh plans. Such a proposed change would be consistent with possible trustee arrangements under other pension plans covered by ERISA.

Mr. Chairman, the dental profession is supportive of the Administration's efforts to provide tax relief for the American public as a means to stimulate the economy; and, we strongly urge that your Committee adopt tax reduction legislation that would specifically encourage long term savings, promote capital formation and protect retirement plans from the adverse effects of inflation.

It is our hope that you and your Committee will apply these worthwhile public policy objectives to design legislation not only to individual retirement account (IRA) participants, but also to self-employed individuals and their employees.

The Association appreciates your consideration of our comments, and urges Congress to act on these recommendations at the earliest possible opportunity.

Sincerely,



Wilfred A. Springer, D.D.S.
Chairman, Council on
Legislation

WAS:jes

Statement By The

American Federation of State, County
and Municipal Employees, AFL-CIO

INTRODUCTION

The American Federation of State, County and Municipal Employees, AFL-CIO -- a union with more than one million members who deliver public services across the nation -- shares this Administration's stated goals of reducing inflation and stimulating economic growth. We too are dissatisfied with this country's economic performance during the last few years. We agree with the President that new policies are needed if we are to put our economic house in order. And it is precisely for these reasons that we vigorously oppose the Administration's cruel and pernicious tax and budget policy.

AFSCME believes that bringing down the rate of inflation must be a top national priority. The incomes of most moderate income people are rising much more slowly than the prices of the basic necessities of life. Wages in the state and local public sector are lagging especially far behind inflation. While the average state and local government employee was earning 104 percent of the average private sector worker in 1973, the ratio had fallen to 96 percent by 1979 and has declined even further since.

Our membership is deeply dismayed that, at a time when public workers' wages are being so severely eroded by double-digit price increases, the Administration is pushing a package of huge and untargeted reductions in individual and corporate income taxes which will only fuel inflation. This program should be rejected,

and instead the Congress should act to slow the wage-price spiral directly through an incomes policy and targeted programs to relieve bottlenecks in the supply of key goods and services. Properly executed, a comprehensive anti-inflation policy of this kind would have a good chance of cooling inflation without the tremendous social and economic costs entailed in the Administration's current tax and spending proposals.

AFSCME is equally concerned about our nation's high level of unemployment. We are worried that the Administration lacks a credible policy for relieving the economic distress and social misery which sustained high joblessness is visiting upon cities and states throughout the U.S. Indeed, the President's program will actually raise unemployment by axing programs like public service employment -- which provides jobs for hundreds of thousands of disadvantaged Americans.

CETA and other targeted federal initiatives to encourage job creation and economic growth in high unemployment areas are essential. Otherwise, even if there is growth in the overall economy the capital and human resources in distressed areas will remain underutilized. This waste of potentially productive resources can only aggravate America's economic problems.

Below, we examine more closely the main pieces of the Administration's tax package. We hope to demonstrate that the President's proposals will decrease productivity and spur inflation while transferring income from low- and middle-income workers to large corporations and wealthy individuals. We conclude by outlining some elements of an alternative economic program which AFSCME believes would begin to move this country towards the Humphrey-Hawkins goals of full employment with price stability.

PERSONAL INCOME TAX REDUCTION

A slightly modified version of the Kemp-Roth personal income tax cut is a major piece of the Administration's tax package. The Reagan proposal would reduce tax rates by about 30 percent over three years starting in mid-1981. This tax cut would lower federal revenue by $44 billion in fiscal year 1982, according to Administration estimates. By 1986 the revenue loss would balloon to over $162 billion. Let us examine several of the most important flaws in this proposal.

1. Reagan's personal income tax cut would make it impossible to continue to fund the "social safety net."

The sheer size of this tax cut is one of its chief drawbacks. The large proposed reduction in federal revenue would make it very

difficult for the Federal Government to adequately fund programs promoting social welfare and economic development over the next three years. While that is clearly the wish of some of the supporters of this tax cut, AFSCME stands four-square against any attempt to trap Congress into a blind commitment to ill-considered budget cutting in future years.

2. A gigantic three-year tax cut would be inflationary.

With slow economic growth and low levels of capacity utilization expected for much of the coming year, a good case can be made for an immediate tax cut. But the course of the economy beyond the next year is highly uncertain. By 1984 we could well be approaching a cyclical peak. And in that case a further sharp tax cut would only stoke the fires of inflation.

AFSCME agrees with the economic experts who have testified before this Committee that it simply makes no sense to commit the nation now to a massive three-year tax reduction. It would be far more prudent to approve a shorter tax cut of moderate size. Further action can be considered in 12 to 24 months in light of the economic conditions prevailing at that time.

3. <u>Reagan's Kemp-Roth proposal is tax relief for the rich; the ordinary working person will lose out under this plan</u>.

President Reagan's cut in the individual income tax would channel 30 percent of the total tax reduction to the richest 5 percent of the taxpaying population. The 60 percent of American taxpayers who earn less than $20,000 annually would only receive 18 percent of the total tax relief. The taxes of a family taking in $100,000 a year would fall by $6,900 in 1984. But an AFSCME worker earning $15,000 would get a tax cut of less than $360.

Actually, even these figures give a misleadingly generous picture of the distribution of tax relief under the Administration's economic program. Citizens for Tax Justice recently compared the effect of the Reagan tax cut on different income groups with the size of the tax increase resulting from inflation-induced "bracket-creep" and increased Social Security taxes.

What CTJ discovered was shocking: The three-fifths of taxpayers who have incomes below $20,000 per year will actually face a net <u>tax increase</u> under President Reagan's proposals. Bracket-creep and higher Social Security taxes will more than offset the proposed income tax cut for the average low- and moderate-income taxpayer. Middle-income households with incomes of between $20,000 and $50,000 would get an average net tax reduction of only $52 in 1984.

At the same time, the average rich taxpayer who is taking in over $200,000 per year would enjoy a net real tax cut of over $19,000 in 1984. The extremely regressive nature of the President's proposals is perhaps best illustrated by the fact that 85 percent of the total net real tax relief will go to the 5 percent of households with incomes over $50,000.

4. This plan's alleged "supply-side" benefits are unfounded.

One of the major selling points of Kemp-Roth is its alleged "supply-side" effects. We are told that cutting tax rates will stimulate both labor supply and saving. Proponents have even claimed that this tax cut will so stimulate economic activity that the sharp rate reductions will not lower federal personal income tax receipts. However, an examination of the available economic evidence on these points provides very little support for the claims of the supply-siders.

In regard to labor supply, it is not clear that an increased supply of labor is even desirable. The U.S. labor market is suffering from a large excess of supply over demand. Many more skilled and productive workers are seeking jobs than America's depressed economy can currently absorb. This problem is expected to persist for at least several years. The May 1980 Data Resources Incorporated forecast of the U.S. economy predicts that

despite an expected economic recovery over the next two years, unemployment will still average almost 7 percent in 1983. Our economy needs more jobs not more job seekers.

But in any case, this tax proposal is unlikely to significantly boost labor supply. Surveys of high income persons have found no indications of a major reduction in labor supply resulting from high marginal tax rates -- even though many of these studies were conducted in Britain where marginal income tax rates are as high as 90 percent compared to a 50 percent maximum on earned income in the U.S.

Econometric studies confirm that labor supply is relatively independent of tax rates. A large number of studies have found that the labor supply of adult males is unresponsive to changes in after-tax income, and hence to income tax rates. The labor supply of married adult women, however, does show a small positive response. Overall, a 10 percent rise in the take-home wage is found to cause at most a 1 percent to 3 percent increase in the supply of labor. Even in the very unlikely event that all new job seekers were productively employed, this response is much weaker than would be needed for the tax cut to "pay for itself" as some proponents have claimed it would.

Arguments that this personal income tax cut would greatly spur saving are also without solid foundation. Most economic

analyses have found that the personal savings rate as a percentage of GNP is relatively independent of changes in the after-tax rate-of-return on saving. The bulk of the evidence indicates that a cut in income tax rates would have little effect on personal saving. Furthermore, it is important to recall that personal saving only accounts for about one-fourth of gross national saving. Therefore, even if a substantial increase in personal saving were to occur, this would have a relatively small impact on the total rate of saving. It would have even less of an affect on investment in plant and equipment, for a large share of personal saving is channeled into home purchases.

In summary, AFSCME firmly believes that the purported "supply-side" benefits of this Kemp-Roth tax cut are illusory. We strongly urge the Committee to reject this inflationary and inequitable proposal.

Let us now look at the other major piece of the President's tax package.

A TAX BREAK FOR CORPORATE AMERICA

AFSCME finds it disturbing that at a time when funding for most major federal programs serving lower income people is being

slashed, it has become fashionable to argue that big business needs a huge tax break. It is unfortunate that corporate special interests have won widespread support in the Administration and Congress for an accelerated depreciation proposal which makes no economic sense. As we point out in more detail below, the President's Accelerated Cost Recovery System (ACRS) would enrich America's largest firms at the expense of workers and small business, would severely distort investment decisions, would encourage a proliferation of tax shelters and would lower national productivity.

Congress should stand firm against the strong pressure to expand tax breaks to large private companies. Corporate America already receives too many unjustifiable tax subsidies. A fair sharing of sacrifice in this period of austerity would require that many of the existing business tax loopholes be closed. A big step could be taken in this direction by repealing ADR, DISC, deferral of corporate income taxes on foreign income, the tax credit for doing business in U.S. possessions, the expensing of intangible drilling costs and depletion allowances. Elimination of these loopholes alone would save over $13 billion a year in tax expenditures.

The Administration's accelerated depreciation scheme is very similar to the 10-5-3 plan which corporate lobbyists have been

pushing for the past several years. The President's proposed Accelerated Cost Recovery System (ACRS) would cut the number of depreciation classes for capital investment from 100 to 5 and would allow firms to "write-off" (that is, deduct from gross income to get taxable net income) the cost of capital investments much more rapidly than is permitted under current law.

According to its proponents, ACRS would strongly stimulate the growth of productivity. But the reality is that this expensive and badly designed piece of legislation is unlikely to significantly spur investment, productivity or economic growth. Among its more important problems are the following:

1. <u>ACRS is too costly</u>.

Although ACRS would only cut corporate income tax collections by several billion dollars in the first year of implementation, revenue losses would rise swiftly over the program's five-year phase-in period. According to Treasury Department estimates, 1986 corporate income tax receipts would be cut by $59 billion -- a reduction of almost 40 percent. This huge revenue loss would force a sharp boost in the federal deficit and/or big cuts in federal expenditures.

Because most state corporate income taxes follow the federal depreciation provisions, state governments stand to lose $9 billion

in 1986 (see Appendix I for the cost to some specific states). Given the precarious fiscal condition of most states together with the drastic reductions in federal grants-in-aid which the President has pushed through the Congress, this is sure to mean serious cutbacks in important state government services. It is indeed a bitter irony that an Administration which is verbally committed to turning responsibilities and tax sources back to lower levels of government has as a centerpiece of its economic program a proposal which would take away 40 percent of the states' corporate income tax revenue.

2. ACRS is unnecessary: business investment already receives highly preferential tax treatment, and has remained at a high level in the 1970s.

Thanks to repeated "liberalizations" over the past 20 years (in particular: the implementation of ADR, the investment tax credit and accelerated depreciation), business currently benefits from very rapid write-off of the cost of new investment. These generous provisions already compensate firms sufficiently for the cost of replacing old capital assets.

A recent study by George Kopits at the International Monetary Fund found that the U.S. taxes investments less heavily than every major Western industrial nation except Britain, and few people would hold that country up as a model of industrial vitality. Moreover, he found that if ACRS is adopted, America would be subsidizing investment far more than even Britain.

Some ACRS supporters claim that liberalized depreciation is necessary to counteract the erosion of the value of depreciation allowances by inflation. But they usually fail to mention an effect which tends to offset this erosion: inflation also acts to boost profits by decreasing the real cost of a firm's old debt.

More concrete evidence that ACRS is unnecessary is provided by a quick look at data on capital spending. Contrary to a widely held misconception, the U.S. rate of investment has not dropped in the 1970s. In the U.S., total investment as a percentage of GNP rose from 17 percent in 1970 to 18 percent in 1979, while in Japan and the major European nations this ratio fell dramatically (for example: from 26 percent to 23 percent in Germany and from 23 percent to 19 percent in Italy).

3. ACRS is a very inefficient way of generating new investment.

First, much of the business tax reduction resulting from ACRS would take the wasteful form of a subsidy for investments which would have been made anyway.

Second, although ACRS would sharply cut corporate taxes, the improved cash-flow from this source is no more likely to be reinvested than revenues from higher sales or from any other source. Especially in the current economic climate of slack demand and low levels of utilization of existing capacity, many

businesses would prefer to spend their windfall tax reductions in relatively unproductive ways (e.g., dividend increases, corporate takeovers, speculation in financial instruments and foreign currencies, etc.).

Third, in focussing on the tax structure, ACRS ignores the key determinant of business investment: firms' expectations about the growth of the economy over the next several years. A company is unlikely to invest in increased capacity unless it expects to be able to sell its expanded output. The sales forecasts of most businesses hinge on expected rates of national economic growth. So to most effectively encourage investment, the Federal Government should be more aggressive in using its fiscal and monetary powers to bring the economy out of the current recession and back to genuine full employment.

As the economist Joseph Peckman points out in an article in the December 22, 1980, issue of Tax Notes, "the major constraint on investment is the decline in demand resulting from the recession which began early in 1980, a recession generated by restrictive monetary policies." He further notes that "a three-year period of recession and catch-up would reduce investment by a third to a half a year's worth of investment. I know of no technique, tax or otherwise, that would raise investment by that amount over the next three years." It is quite likely

that rather than stimulating investment the Administration's economic program of a very tight monetary policy combined with large tax cuts will sharply boost interest rates and thus severely depress capital formation.

Fourth, during the five-year phase-in period, ACRS could actually retard capital spending. Firms would have a strong incentive to delay investment to take advantage of later years' more generous depreciation provisions. Such a delay would lower productivity and slow down the economy's recovery from the recession.

4. By capriciously providing more incentive for some investments than for others, ACRS would encourage misallocation of capital and would tend to lower U.S. productivity.

Under an ideal tax structure the depreciation for an asset in a particular year should be equal to the decline in value of the asset over that 12 months. Treasury Department studies in recent years have given us solid estimates of the magnitude of this actual economic depreciation for the various types of investment goods.

Professor Jorgenson of the Economics Department of Harvard University has compared the value of this economic depreciation with the value of the depreciation allowed under current IRS

rules. Jorgenson found that due to increasingly generous IRS-allowed depreciation the actual effective rate of taxation on the income from capital investment has fallen drastically over the last ten years and is now far below the statutory 46 percent. The average effective tax rate for equipment and structures was 42 percent in 1970, but by last year it had declined to just 25 percent.

Jorgenson's research also found that under current law different classes of assets are taxed at widely varying rates. For example, while the effective tax rate on income from an investment in office machinery is 28 percent, the rate on aircraft investments is only 8 percent. This variation in tax rates indicates that present depreciation rules do not accurately reflect differences in actual economic depreciation. This failure to tax income from all assets at the same rate distorts corporate investment decisions and lowers productivity. In a recent paper, Jorgenson estimates that these distortions reduce the efficiency of investment by a very hefty 20 percent.

A second problem with the current depreciation system is that effective tax rates depend critically upon the inflation rate. An increase in inflation tends to boost effective tax rates, while a decline lowers them. In addition, Jorgenson's research shows that a decrease in the rate of inflation under current law increases

the gaps among effective tax rates for different assets. Thus, ironically, if the nation succeeds in slowing down price increases, we will also be encouraging an even worse misallocation of new investment.

Adoption of the ACRS depreciation plan would not address any of these problems. First of all, ACRS would so accelerate capital cost recovery that the current 25 percent effective tax rate on capital investment would become a 16 percent subsidy. This would cause a massive proliferation of tax shelters as investors make investments whose only virtue is that they shelter other income from taxes. Second, Jorgenson reports that "adoption of the Reagan Administration proposal for capital recovery Owould substantially wideno gaps among effective tax rates for different assets and different industries. This would very significantly worsen the efficiency of capital allocation and would reduce the level of productivity for the U.S. economy."* Third, ACRS would remain sensitive to changes in the inflation rate. In fact, if inflation were to decline to 1960 levels, the subsidy on income from capital investment would shoot up to 79 percent.

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* Dale W. Jorgenson and Martin A. Sullivan, Inflation and Capital Recovery in the United States, Harvard Institute of Economic Research Discussion Paper No. 820, March 1981.

ACRS would have particularly perverse effects in the health care industry. The windfall increase in profits due to ACRS would encourage the expansion of proprietary hospitals, at a time when there are already tco many hospital beds available in the country as a whole. This wasteful expansion will spur inflation in hospital costs and health insurance fees, while doing little to address the problem of improving access to health care for residents of medically underserved areas. Because Medicare and Medicaid reimbursement formulas take depreciation into account, ACRS could also provide hospitals with short-term windfall gains in reimbursements -- which would further encourage excessive expansion and would favor overcapitalized private hospitals over more frugal public facilities. Any new depreciation plan should be carefully drafted to prevent this kind of wasteful increase in spending, or the Secretary of Health and Human Services should be encouraged to use his current statutory authority to prevent this inflationary change in the depreciation methods used in calculating reimbursement rates.

5. <u>ACRS would do little to reverse the post-1973 slowdown in American productivity growth</u>.

Economists have not yet produced a satisfactory analysis of why productivity growth has slowed since 1973. A recent study by Edward Denison, one of the top experts in this field, concludes that this sluggish growth is "disturbing and puzzling" and that "it cannot be explained by any one hypothesis." Productivity

growth depends on a wide variety of factors including: the composition, experience and education of the labor force; the amount of capital and land per person employed; the efficiency of resource allocation; the legal environment; the quality of management; workers' job satisfaction; economies of scale; advances in knowledge; inflation; and energy prices. But even the incorporation of most of these factors in a careful econometric study does not enable Denison to explain all of the recent slowdown.

It is evident that the productivity slowdown is such a complex problem that a simplistic "solution" like ACRS is bound to fail. Denison provides very direct evidence on this point. Not only does his study show that the capital-labor ratio -- which ACRS proponents hope to raise by spurring investment -- is only one of many determinants of productivity growth; the study also shows that, in contrast with a number of the other factors mentioned above, changes in the amount of capital used per worker did not contribute to the post-1973 drop in productivity growth rates. To develop an effective program to stimulate productivity, the Federal Government should fund more research into the sources of the problem and begin to think in terms of a multi-faceted approach which addresses a variety of the many factors which influence increases in productivity.

6. <u>ACRS would be highly inequitable</u>.

Since 1956 the corporate income tax contribution to federal revenues has fallen from 28 percent to 13 percent. Taxes on wage earners have had to rise sharply to take up the slack. Accelerated depreciation along the lines of ACRS would aggravate this regressive shift of the tax burden from business to individuals. Also, a loss of tens of billions of dollars of business tax revenue would probably force further cuts in social programs aiding America's poor, elderly, minority and working people.

Within the business community itself, the benefits from ACRS would be very unevenly distributed. Big firms in profitable and capital intensive industries -- such as communications, oil and utilities -- would reap the largest gains. Because only firms which are showing a profit would benefit from ACRS, it would do little to revitalize key U.S. industries such as steel and auto.

Smaller, labor-intensive businesses would also receive minimal tax relief. Yet it is precisely the small business sector which is in the greatest need of capital, which reinvests very heavily back into its own enterprises and which creates most of the new jobs in the U.S. economy. A well-structured plan to stimulate investment and employment would provide considerably more assistance to small business than does ACRS.

Finally, the distribution of tax relief under ACRS would discriminate against the most needy parts of the country. Since most new investment occurs in Northern suburbs and in the Sunbelt, ACRS would favor suburbs over the central city and growing areas over declining areas. As Congress recognized in designing UDAG, programs to stimulate investment should be targeted; they should only provide incentives for investing in specific areas which are experiencing high levels of joblessness.

AN ALTERNATIVE TAX CUT

AFSCME believes that the bulk of the 1981 tax cut should consist of a reduction in the Social Security tax burden. This could take the form of an income tax credit for a portion of Social Security payroll taxes paid this year. Both employers and employees could receive a part of such a credit. It should be refundable, so that low-income individuals and low-profit or no-profit businesses could share in the benefits. State and local governments and non-profit institutions should be eligible for special payments in lieu of the tax credit.

From the macroeconomic point of view, a large discretionary tax cut in 1981 is essential. Tax increases (including hikes in the Social Security tax rate and base, inflation-induced increases in personal income taxes, and higher windfall profits tax revenues) are expected to push federal tax collections up sharply this year. At the same time, cuts in social programs are likely to restrain growth in federal spending. The net result of revenues growing faster than expenditures will be a very sharp rise in "fiscal drag" -- the contractionary impact of the federal budget on the economy. To allow the projected 1981 tax boosts to come into effect without any offsetting tax cuts, at a time when the economy is slowly coming out of a recession, would be irresponsible federal fiscal policy. But the proposal outlined in the paragraph above has a number of major advantages over other tax cuts which the Congress is currently considering.

A Social Security tax credit would be an effective countercyclical tax cut. Because it would be incorporated into the income tax withholding schedules, the credit would immediately begin to boost disposable income and promote an economic recovery.

A payroll tax cut would provide a strong stimulus to employment. Like the President's proposals, a payroll tax cut would raise employment by stimulating demand. But a payroll tax cut has another employment-stimulating mechanism not found in Reagan's

tax reduction package. By rebating part of employers' Social Security tax payments, it would reduce the cost of labor -- and thereby induce business to hire more workers.

Because it would lower labor costs, a Social Security tax cut would also be an important weapon in the fight against inflation. According to a Congressional Budget Office estimate, a 10 percent payroll tax cut would reduce the 1981 inflation rate by 0.2 percentage points. This slower rate of increase in prices would moderate wage demands and lead to further declines in the inflation rate in future years. By contrast, Reagan's proposed cut in personal income tax rates would spur inflation by boosting aggregate demand without lowering production costs.

It is important to note that this proposal would not impair the financial integrity of the ailing Social Security System. An income tax credit for Social Security taxes paid would temporarily reduce income tax revenues. It would not affect payments into the Social Security trust funds; in particular, the 1981 rate and base changes designed to boost Social Security tax revenues will be implemented as planned.

Although it would not cut Social Security revenues, this kind of a tax cut would begin to respond to the fears of many of us that the Social Security tax burden is too high. Over the

past 25 years, the share of total federal revenue derived from regressive payroll taxes has jumped from 12 percent to 31 percent. The large increase in Social Security taxes has shifted an unfair share of the federal tax burden onto the shoulders of low- and moderate-income workers. Relief from the sharp 1981 increase in this payroll tax burden is the least we can offer the hard-pressed American worker.

Because it targets relief on those who bear the regressive Social Security tax burden, this proposal is much more progressive than the uniform reduction of personal income tax rates suggested by President Reagan. Under this proposal, the three-fifths of the taxpayers who earn less than $20,000 would get only 18 percent of the personal income tax relief. This same group would receive 33 percent of the tax reduction resulting from a rebate of a portion of employees' Social Security contributions. And while a payroll tax rebate would provide a wealthy individual with a fixed maximum tax credit of several hundred dollars, the Administration's proposal has no upper limit. In fact, President Reagan's plan would give the super-rich who earn more than $200,000 per year an average tax break of $19,000.

A reduction in payroll taxes would also provide significant tax relief to business -- especially to small business, which

tends to be labor-intensive. Many small businesspersons have indicated that they need payroll tax relief more than accelerated depreciation.

Finally, this proposal would provide significant fiscal relief to state and local government. The Social Security Administration projects that state and local governments will pay approximately $8.5 billion in Social Security taxes in 1981. State and local governments are experiencing extreme financial stress because of the combined effects of inflation and unemployment. Fiscal relief is essential if these governments are to be able to continue to provide the social services which are badly needed during times of economic hardship.

The case for quick action on a substantial tax cut is compelling. This tax cut should be designed to reduce inflation, spur employment and concentrate tax relief on the sectors of society which are truly feeling the pinch of stagflation: smaller, labor-intensive businesses; fiscally stressed state and local governments; and low- and middle-income workers. Therefore, AFSCME urges this Committee to adopt a tax cut which provides relief from the high and rising burden of Social Security taxes.

We do recognize, however, that this Committee may instead opt for a modification of the personal income tax schedules.

Any such changes should be structured to provide a large share of the total tax relief to workers earning less than $20,000 annually. This could be achieved through rate reductions concentrated in the lower brackets plus large hikes in the standard deduction and earned income tax credit -- which have been severely eroded by inflation in recent years.

AFSCME strongly opposes reducing the maximum tax rate on unearned income from 70 percent to 50 percent. This proposal undermines the principle of taxation according to ability-to-pay, which is the foundation of the progressive income tax. In addition, it represents a regressive multi-billion dollar tax break for the very wealthiest segment of society. We also oppose raising the ceiling on the amount of interest income which can be excluded from the personal income tax. Substantial evidence indicates that such action will have little effect on the level of personal saving and really represents only windfall tax relief for the rich.

On the business tax question, AFSCME believes that targeted federal tax incentives, grants, loans, loan guarantees and other forms of assistance can play a key role in promoting the expansion of private-sector job and investment opportunities. But federal planning is necessary to most efficiently integrate the use of these tools with education, training, and other public-sector

economic development initiatives. Rather than granting wasteful across-the-board business tax cuts, the Federal Government should exercise judgment in dispensing its largess. This will help ensure that: (1) taxpayer dollars are not merely transferred to private businesses as a windfall reward for actions which these firms would have undertaken even without federal incentives and (2) economic development funds to spur job creation are tightly targeted on the most distressed areas of the United States.

Thank you for the opportunity to present our views on these questions.

APPENDIX I

Projected FY 1986 State Corporate Income Tax Revenue loss which which would result from using ACRS depreciation rules.

| | Loss to State in FY 1986 (In millions) | | Loss to State in FY 1986 (In millions) |
|---|---|---|---|
| Alabama | $ 81 | Mississippi | $ 48 |
| Alaska | 420 | Missouri | 100 |
| Arizona | 88 | Montana | 34 |
| Arkansas | 62 | Nebraska | 43 |
| California | 1862 | Nevada | * |
| Colorado | 82 | New Hampshire | 47 |
| Connecticut | 183 | New Jersey | 369 |
| Delaware | 30 | New Mexico | 34 |
| District of Columbia | 34 | New York | 753 |
| Florida | 276 | North Carolina | 217 |
| Georgia | 178 | North Dakota | 27 |
| Hawaii | 37 | Ohio | 384 |
| Idaho | 32 | Oklahoma | 67 |
| Illinois | 570 | Oregon | 132 |
| Indiana | 133 | Pennsylvania | 640 |
| Iowa | 103 | South Carolina | 114 |
| Kansas | 111 | South Dakota | * |
| Kentucky | 118 | Tennessee | 147 |
| Louisiana | 185 | Texas | * |
| Maine | 34 | Utah | 30 |
| Maryland | 123 | Vermont | 17 |
| Massachusetts | 326 | Virginia | 144 |
| Michigan | * | Washington | * |
| Minnesota | 283 | West Virginia | 24 |
| | | Wisconsin | 231 |
| | | Wyoming | * |

* Does not have a state corporate net income tax.

SUBMITTED STATEMENT OF THE
AMERICAN FEDERATION OF LABOR & CONGRESS OF INDUSTRIAL ORGANIZATIONS
TO THE SUBCOMMITTEE ON TAXATION & DEBT MANAGEMENT OF THE
SENATE FINANCE COMMITTEE ON GROUP LEGAL SERVICES -- S. 1039

June 10, 1981

The AFL-CIO is pleased to support S. 1039, a proposal that would allow the continuation of group legal service plans as a non-taxable employee fringe benefit. Unless this measure is adopted, current law will be sunsetted at the end of this year.

The 1976 Tax Reform Act provided that for a period of five years amounts contributed by an employer to a qualified group legal services plan for employees or their families should not be taxable to the employee. In addition, services received or any amounts paid under such a plan as reimbursement for legal services were similarly excluded from the employee's income.

The AFL-CIO has long opposed piecemeal changes in the law, aimed at taxing the fringe benefits of American workers. For example in 1979, a resolution was adopted at the AFL-CIO Convention calling for a continued moratorium on Treasury regulations that would reverse the current tax-free status of employee fringe benefits (copy attached).

The number of group legal services plans has grown dramatically as a direct result of the action taken by the Congress in 1976. In 1975, there were only about 75 employer-related legal service plans -- in 1980, there were 400 such plans covering about one million employees. The protection afforded by such plans is essential to assure the delivery of legal services to employees of moderate means. Considering the uncertainty surrounding the fact that the 1976 law was passed as a measure with limited duration, the growth of legal services plans over the last five years has been

remarkable. These plans have worked but their continued growth will be halted unless positive action is taken by the Congress before the end of this year.

Given the current state of the American economy, the continued delivery of legal services to American workers is even more important now than it was in 1976.

The AFL-CIO urges prompt passage of S. 1039, to provide permanent tax-free status for group legal services plans.

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THIRTEENTH CONSTITUTIONAL CONVENTION OF THE
AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

## Taxation of Employee Fringe Benefits

### SUBSTITUTE RESOLUTION NO. 61

*(This resolution covers the substance of Resolutions Nos. 61, 202.)*

In August 1977, in response to controversy surrounding Treasury and IRS proposals for rules regarding the taxation of employee fringe benefits, the AFL-CIO Executive Council opposed "piecemeal changes in regulations, aimed at taxing some of America's lowest paid workers . . ." and urged concentration on assuring that those of great wealth "pay their fair share of the tax burden."

Late in 1977 the Congress enacted legislation preventing the IRS from issuing any new regulations until 1980. That issue remains unresolved and legislation is now pending to extend the prohibition on IRS action.

The AFL-CIO supports this pending legislation which would prohibit IRS action until Congress establishes necessary statutory guidelines and urges that such guidelines be based on principles such as:

1. Common sense "de minimus" rules that assure no unreasonable record-keeping, administrative, or tax burdens.

2. Limited benefits, generally and historically available to employees, such as discounts for retail store employees, should not be taxed.

3. Benefits provided by the employer that are necessary to the performance of workers' duties or are provided for the employers' convenience, such as uniforms, should not be taxed.

4. Present statutes, which expressly grant exemption under limited circumstances for benefits such as qualified pension plans, group life insurance, employee death benefits, educational assistance programs, moving expenses, and meals or lodging, which are provided for the convenience of the employer, should continue.

Finally, we insist that any measures to change current practice be considered within the context of an overall program of tax justice—a program which fully addresses the tax avoidance opportunities of the wealthy and the corporations and does not add to the already unfair share of the tax burden borne by workers.

STATEMENT OF AMERICAN HORSE COUNCIL, INC.
ON
TAX REDUCTION PROPOSALS
IN
ADMINISTRATION'S ECONOMIC RECOVERY PROGRAM
FOR
HEARINGS BY THE COMMITTEE ON FINANCE
MAY 20, 1981

The American Horse Council, Inc. ("AHC"), appreciates this opportunity to express its views on the Administration's tax proposals.

AHC is a trade association which represents over 140 breed registries and horse-related organizations, as well as thousands of individual horsemen.

AHC supports the Administration's goals of reducing the rate of increase in Federal spending and reducing Federal income taxes. AHC also supports the basic objectives of the Administration's "10-5-3" Accelerated Cost Recovery System ("10-5-3") -- to provide simplified and accelerated cost recovery for depreciable property used in a trade or business. However, there are some aspects of the 10-5-3 proposal which present problems for horsemen, and there are other proposals which would simplify and improve the tax law for those engaged in the horse business.

MODIFICATIONS TO 10-5-3 FOR "USED" LIVESTOCK

The 10-5-3 proposal would place horses in the

five-year recovery period. It would not modify the existing tax rules which deny the investment tax credit to horses.

Under the current ADR guidelines, breeding or work horses may be depreciated over a period of from 8 to 12 years. However, the ADR lives are not mandatory for all taxpayers, and a taxpayer may elect to use a shorter life where the facts and circumstances can justify it. This is frequently done with older breeding horses and work horses, because the actual useful life of these horses may be substantially less than 8 years or even less than 5 years. For example, a 14-year-old or older broodmare or stallion would normally be depreciated over a 2- or 3-year period.

The useful lives of race horses under current guidelines set out by the American Horse Council range from 2 years to 6 years, with 3-year-old race horses having a useful life of 3 or 4 years. There is no ADR guideline class for race horses.

Unlike many other types of depreciable property, a large percentage of race horses and breeding horses which are purchased for business use are purchased as used property.

The 10-5-3 proposal would result in the lengthening of the recovery period for many racehorses and for used breeding and work horses. Although it would speed up the method of recovery somewhat (by allowing a 200% declining balance approach as opposed to a maximum 150% declining balance approach allowed under present law), the overall rate of the writeoffs would still be somewhat slower. Furthermore, since horses are not allowed the investment tax credit, there would be no trade-off with an increased credit as there would be in the case of other assets with extended lives under 10-5-3. The consequence is that horse owners in many situations may well be worse off under the 10-5-3 system than under present law.

One solution to this problem would be to expand the 3-year class to include used livestock, including horses.

Allowing the investment tax credit on the purchase of horses would also, for the most part, eliminate the problem of treating used livestock differently from new animals under 10-5-3 provided the present limitation of allowing only up to $10,000 of credit on the purchase of used property is removed in the case of livestock. (The reasons for extension of the investment tax credit to horses are discussed below.)

Alternatively, if an approach to depreciation reform similar to the "2-4-7-10" approach approved last year by the Senate Committee on Finance were adopted, the problems with lengthened recovery periods for horses would appear to be solved. Under "2-4-7-10", breeding and work horses would go into the 4-year recovery class and there would be no need to distinguish between new and used livestock. Although it is not clear under the proposal, it would appear that race horses should go into the 2-year class.

## 10-5-3 TRANSITIONAL RULES

Many owners of race horses will be seriously disadvantaged by the provision in the 10-5-3 proposals which would generally provide that tangible personal property for which no asset depreciation range was in effect on December 31, 1980, is to be treated as if the ADR lower limit were nine years and that if such property is acquired in 1981, the cost recovery period is nine years.

Under the 10-5-3 proposal, when fully effective, most tangible personal property (including horses) would be recovered over a five-year period under an accelerated method of depreciation (roughly equivalent to use of the double declining balance method switching to the

sum-of-the-years'-digits method) regardless of whether the property is new or used when acquired.

However, these cost recovery periods are subject to transitional rules. In general, the transitional rules for most tangible personal property provide that, in the case of property acquired in 1981, the recovery period is the lesser of nine years or the ADR lower limit in effect of December 31, 1980. This recovery period is then reduced by one year in each succeeding year until all tangible personal property is depreciated over five years.

The transitional rules also provide, however, that in the case of five-year property (most tangible personal property) for which no asset depreciation range was in effect on December 31, 1980, the ADR lower limit shall be considered nine years. Since no asset depreciation range was in effect for race horses as of December 31, 1980, this rule generally requires that the costs of race horses acquired in 1981 be recovered over a period of nine years. This extended recovery period would apply even though under present law the cost of most race horses would ordinarily be recovered over a period of three or four years.

This rule may be mitigated to some extent by the

rule which permits a taxpayer to elect recovery over a five-year period for up to $100,000 of the adjusted basis of property otherwise subject to the phase-in rule. However, for substantial numbers of taxpayers, this $100,000 rule will not provide significant relief.

In considering the appropriateness of the five-year period and of the transitional rule, it should be noted that, for most property which is given an increased life under 10-5-3, the effect of the deceleration of deductions is offset, at least in part, by increases in the investment tax credit. However, under existing law, horses are not eligible for the investment tax credit and the Administration's proposal in its present form would not address this problem.

Furthermore, the adverse impact of this transitional rule is exacerbated by the fact that, under the bill, it would apply to property which is acquired before the date of enactment of the bill but after December 31, 1980.

It is recommended that property which is not covered by the ADR system and which, under present law, can be depreciated over periods of five years or less should not be subject to the transitional rules, but rather should be

subject to cost recovery over no more than five years beginning in 1981.

## INVESTMENT TAX CREDIT FOR HORSES

All livestock except horses are presently eligible for the investment tax credit. Denial of the investment tax credit for investment in horses is inconsistent with the fact that investment in horses, like investment in other productive assets, makes significant contributions to our economy. Breeding, training, racing and showing horses are very labor intensive businesses. Farms engaged in breeding horses for the race track employed 80,000 people in 1980 to produce approximately 50,000 foals. Similarly, the breeding of horses for shows also involved a high ratio of employees. Although figures for the showing industry are less accessible, it is estimated there were 145,000 persons employed on breeding farms engaged in raising show animals last year.

The breeding and raising of horses is only a portion of the total employment generated by the horse industry. There are 350,000 people licensed to work at race tracks, and another 231,000 work during horse shows. These figures include only those people working directly in the racing and

showing industries. There are additional tens of thousands employed in support industries.

The 8.2 million horses in the United States play an integral part in present day agriculture and the industry infuses billions of dollars into the agricultural economy. In 1980, hay, straw, oats and other agricultural products valued at $4.5 billion were used by horses. Horses are the single largest consumers of oats grown in the U.S., and the production of hay and other crops represents a significant income source for farmers.

While horses are used for recreational purposes or are involved in competitions in this country, exports during 1980 came to over $200 million, contributing to the vital export balance generated by American agriculture. Much of the export trade results from the dominance of the U.S. blood stock industry. Recognizing the quality of the horses produced in this country, foreign buyers have played an increasing role in the sale of quality American blood stock.

It should also be noted that horse farms make an important contribution to the quality of life in America. Many breeding farms are located on the fringe of urban areas and the economic structure of horse breeding is capable of

supporting these operations on land which would otherwise be under severe development pressure. Thus, the existence of these farms helps to preserve important open space adjacent to major population centers.

Horses also make substantial financial contributions to society. Horse racing produced nearly $700 million in direct parimutuel taxes in the 30 States which have legal horse race wagering. Racing also produced more than $1 billion dollars in Federal, State and local taxes. Horse shows in 1979 contributed $27 million to charitable organizations plus local admission taxes and Federal, State and local payroll taxes.

There is no reason why the Internal Revenue Code should discriminate against horses and no other form of livestock. No reason was given in the legislative history as to why horses were excluded from eligibility for investment as tangible property used as an integral part of a farming business when other livestock were made eligible for the credit in 1971.

In addition to ending an inequitable exclusion, providing investment tax credit for horses would produce significant benefits. Although prices for top quality

yearlings and breeding stock have increased during the past few years, there has not been a corresponding rise in demand for moderate quality horses, despite a growing demand for both show and racing animals. Many race tracks suffer at the present time from a shortage of horses, which results in smaller fields in their races. Figures clearly demonstrate that smaller fields result in less bettor interest and, thus, fewer wagers. This results in diminished wagering at the track and a corresponding loss of revenue for the track, horse owners and the States which have racing. By making horses eligible for investment credit, there would be a new incentive for the production of the moderate priced horses which are needed to sustain all kinds of competitive events.

The American Horse Council strongly supports S. 450, a bill which would make up to $100,000 of a taxpayer's annual investment in breeding and work horses eligible for the investment tax credit. We applaud Senators Matasunaga, Boren, Huddleston, and Ford for sponsoring this bill.

In 1978, the Senate adopted an amendment making breeding horses eligible for the credit. Unfortunately the amendment was not adopted by the conference committee. During consideration of that amendment, the Treasury Department agreed that there was no policy reason for

denying the credit on the purchase of horses

AHC recognizes that it may be appropriate to limit the amount of credit which could be claimed with respect to a single horse. Thus the AHC would support a provision, such as the one contained in S. 450, which would provide that only the first $100,000 of cost with respect to one horse would quality for the credit. This "per horse" limitation would limit the total amount of credit to $10,000 in cases where a horse is acquired by a syndicate or partnership -- as well as in cases where a horse is acquired by an individual. Such a limitation would provide a strong incentive for the production of more racing and showing stock in the price range where such incentives are most needed.

AHC suggests that the Committee also consider extending the investment tax credit to all horses used in a trade or business, not just breeding or work horses. Since introduction of S. 450, many horsemen around the country have commented that investment in other types of horses, such as race horses and show horses, also has favorable economic effects and the $100,000 "per horse" limitation is adequate to prevent windfalls. Also, if the per horse limitation discussed above is retained, the $100,000 of

investment "per taxpayer" limitation need not be retained. A bill which incorporates AHC's suggestions is H.R. 3150, which is sponsored by Representatives Guarini, Holland, Duncan and Schulze.

AHC believes that the provisions extending the investment tax credit to horses should be made a part of the broad cost recovery program and these provisions should be retroactive to the same extent that other changes in depreciation and the investment tax credit are retroactive.

REDUCTION IN HOLDING PERIOD FOR LIVESTOCK

Under present law, gain from the sale of cattle and horses held for draft, breeding, dairy, or sporting purposes qualify for long-term capital gains treatment only if the cattle or horses are held for at least 24 months. All other capital assets and depreciable property used in a trade or business qualify for long-term capital gains treatment if they are held for one year (except certain commodity futures which quality for long-term capital gain if the holding period is at least 6 months).

The holding period for cattle and horses held for these purposes was extended to 24 months by the Tax Reform

Act of 1969 in order to prevent "tax shelter" investments in livestock.

The Tax Reform Act of 1976 provided additional and more effective rules to prevent the use of farming activities as a tax shelter. The farming syndicate rules prevented investors in farming activities from deducting many prepaid items, and the at risk rules prevented taxpayers from deducting losses in excess of the amounts they have at risk in farming activities.

The changes made by the 1976 Act are much more effective in limiting farm tax shelters than the provisions of the 1969 Act, and AHC believes that these provisions of the 1976 Act are sufficient in themselves to protect against the abuses Congress sought to eliminate in 1969 by enacting the 24-month holding period for most cattle and horses.

Thus, in operation, the 24-month holding period discriminates against investments in cattle and horses (when compared with other capital assets or section 1231 property) for taxpayers in the business of racing, breeding, or showing horses (or of breeding and raising cattle) without being needed to prevent tax-motivated investment. Accordingly, AHC recommends that the holding period for

cattle and horses held for draft, breeding, dairy, or sporting purposes be reduced from 24 months to 12 months.

REPEAL OF WITHHOLDING ON GAMBLING WINNINGS

Section 3402(q) of the Internal Revenue Code, which was added in 1976, requires that, under certain conditions, a person making payment of gambling winnings must deduct and withhold 20% of the payment. In determining whether winnings are subject to withholding, winnings are divided into three categories based on the type of wagering transaction.

Winnings from state-conducted lotteries are generally subject to withholding under this provision if the proceeds from the wager exceed $5,000. Winnings from wagering transactions other than state-conducted lotteries are generally subject to withholding if the proceeds of the wager exceed $1,000. However, for wagers at parimutuel pools with respect to horse races, dog races, or jai alai, withholding is required only if the proceeds from the wager are over $1,000 and at least 300 times as large as the amount wagered. (Winnings from bingo, keno games and slot

machine plays are not subject to withholding under this provision.)

This provision was enacted with the purpose of assuring compliance with the tax laws. However, experience has demonstrated that the provision has a number of undesirable effects, and the additional degree of compliance (if any) with reporting of gambling winnings for income tax purposes may well be outweighed by these other considerations (coupled with the time and expense of obtaining refunds by taxpayers who were subject to withholding but who did not have any tax liability arising from their overall gambling transactions).

There are three principal reasons for repealing this Code section. First, it has induced otherwise law-abiding citizens to patronize illegal gambling activities whose operators do not comply with the withholding rules. Second, it has caused a reduction in State revenues from parimutuel wagering. Third, in operation, the so-called withholding provision actually constitutes, in effect, a 20% excise tax on the average citizen who is lucky enough to win on a longshot, "exotic" bet at the race track. Since the IRS takes the position that gambling losses are an itemized deduction and cannot be offset against gambling winnings

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directly, persons who use the zero bracket amount (or standard deduction) are unable to offset gambling winnings with gambling losses. Also, the IRS accounting standards for substantiating offsetting losses are so burdensome as to deter all but the most stalwart taxpayers.

The reasons for recommending repeal of this provision are set forth in more detail in Attachment A, a paper entitled "Withholding of Race Track Winnings -- A Position Paper".

We would also like to discuss in more detail a related problem. As it stands now, withholding applies to parimutuel payouts of over $1,000 if the odds are at least 300 to 1. On the other hand, winnings from State lotteries are subject to withholding only if the payout is over $5,000. Winnings from parimutuel pools with respect to horse races, dog races, and jai alai should not be subject to a more stringent withholding threshold than other forms of gambling -- and statistics tend to indicate that an even higher threshhold may be justified for parimutuel pools. According to statistics based on Treasury's study of 1977 Gambling Winnings, the average winnings for recipients of Form W2-G varied directly with adjusted gross income (AGI) class, and in each class with AGI of under $50,000 the

winnings were less for taxpayers who used the zero bracket amount. Thus, in the AGI range of less than $10,000, the average gross winnings were $1,955 for all taxpayers and $1,737 for nonitemizers; in the $10,000 to $20,000 AGI class, the average gross winnings were $2,440 for all taxpayers and $2,106 for nonitemizers. By contrast, the average winnings of taxpayers in the $50,000 and over AGI class was $11,868. Of the taxpayers in the under $10,000 AGI class, 68.2 percent did not itemize deductions, and in the $10,000 to $20,000 class, 40.9 percent did not itemize deductions. Thus, these low income taxpayers did not have an opportunity to offset gambling losses against gambling winnings. It is submitted that this provision coupled with the IRS position that gambling losses must be taken as an itemized deduction and the IRS rules on substantiation of such losses are unfair, especially to low income individuals who do not itemize.

## REPEAL OF THE EXCESS DEDUCTIONS ACCOUNT PROVISIONS

AHC recommends that the so-called Excess Deductions Account Provisions (Sec. 1251 of the Code) be repealed.

The Excess Deductions Account Provision was added to

the Internal Revenue Code by the Tax Reform Act of 1969. Under this provision, the taxpayer was required to add farm losses above certain amounts to an Excess Deductions Account (EDA) if such excess losses were incurred in tax years beginning after 1969 and prior to 1976. On subsequent sales of farm property, any gain on the sale which otherwise would qualify as a long-term capital gain would be treated as ordinary income (recaptured) to the extent of the balance in the EDA. The EDA would be reduced by amounts so recaptured as well as by ordinary income from farming activities recognized in years after an addition was made. Although EDA recapture applied to most farm property on which capital gain could be recaptured, it did not apply to gain on sale of depreciable farm real property.

The 1976 Tax Reform Act provided that no additions were to be made to an Excess Deductions Account after 1975, but it left all existing accounts in place (subject to reductions in later years due to recapture or recognition of farm income). The basic reasons for terminating the additions to the Excess Deductions Account were the extreme complexity of Section 1251 and the inclusion in the 1976 Act of other provisions which Congress deemed more appropriate to curb tax shelters.

Although it is not clear from the legislative history why Congress did not completely repeal the EDA, it may be that such action was not taken because it was felt that it would be a windfall to persons with large amounts in such accounts.

However, leaving this provision on the books continues for a relatively limited number of people the extreme complexity which was one of the principal vices of Section 1251. It seems unfair to leave this provision in effect for those few taxpayers who happened to have farm losses durng that limited 5-year period. Further, it has the effect, for purposes of determining the accuracy of the EDA account, of leaving all the years 1970-1975 open for farm taxpayers. Furthermore, there is no indication that any significant amount of recapture has occurred under this provision in recent years. The fact that there is an amount in an account does not necessarily mean that there will be recapture since the account may be reduced by ordinary income from farming activities or may never be recaptured because no appropriate long-term capital gain from farm property would be realized.

With each year that passes from 1975, the administrative problems with the provision also increase

significantly. It will be more and more difficult for taxpayers to keep up with the necessary records -- and it is quite probable that some taxpayers will not know how much is in their EDA account or even that one exists. The audit problems increase for IRS agents to audit EDA accounts as time goes on since tax returns for earlier years may not be available.

Consequently, AHC recommends that this provision be repealed. AHC thinks that such a repeal would remove a potential complicating factor for many farm taxpayers without having a significant effect on revenues.

"The withholding of race track winnings is the biggest boon to illegal gamblers since the invention of the point spread system."

WITHHOLDING OF RACETRACK WINNINGS--A POSITION PAPER

On May 18, 1977, the Internal Revenue Service began requiring pari-mutuel operations--race tracks, off-track betting and jai alai frontons--to withhold 20% of winnings over $1,000, provided the odds were at least 300-1. The rationale behind this, although unsubstantiated by any concrete evidence, was that bettors who were lucky enough to win large amounts at long odds were failing to report those winnings on their income tax returns, or were using so-called ten percenters to fill out IRS report form 1099 when they won bets of that nature.

The Treasury Department and the Internal Revenue Service, in imposing withholding on the pari-mutuel industry, originally estimated that revenues from this provision would exceed $500-million; but they later reduced those estimates--some two days later, as a matter of fact--to a slightly more realistic $110-million. In calculating these estimates, however, both IRS and the Treasury Department failed to take into consideration a number of factors which render this provision economically impotent (for instance, the revenue estimates of $110-million apparently represented the amount of money which was expected to be withheld and

did not take into consideration the fact that losses could be used to offset this figure, possibly reducing anticipated revenue by as much as 80%; the remaining 20% does not necessarily represent new revenue, since taxes were also being paid under the old system of reporting; and finally government revenues will be further reduced by defection of bettors to illegal sources which could further reduce the revenues to government). As a consequence of the latter, withholding is also highly dubious in terms of anti-crime value. As a matter of fact, the principle objection most of the pari-mutuel industry has toward the withholding or race track winings is in the area of its advantages to illegal sources of wagering.

Among the reasons the withholding of race track winnings as required by Section 3402(q) of the Internal Revenue Code is counterproductive are:

(1) Withholding is economically unproductive for the Federal Government and disastrous for the states with pari-mutuel operations.

The 31 states with legalized wagering on horse racing[(1)] derived a record $714,629,120 in direct pari-mutuel taxes from the industry in 1976. Dog racing[(2)] accounted for an

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(1) Pari-mutuel horse racing is conducted in 30 states, while Connecticut has no horse racing but holds off-track betting on races in New York.
(2) Greyhound racing is conducted in 13 states, 10 of which also have horse racing.

additional $106,682,228 to bring racing's total <u>direct</u> contribution to state governments in 1976 to $821,311,348.

In 1977, however, following the imposition of withholding on race track winnings during the last 7 1/2 months of the year, combined state revenues from horse and dog racing showed a decline from the previous year for the first time since 1959, when the industry began keeping such figures. In 1978, the first full year of withholding, combined state revenues declined an additional $18,063,173 to $801,138,465[(3)]. While it may not be <u>entirely</u> causative, most experts in racing attribute a major portion of the $20-million decline in state revenues to the imposition of withholding.

Although that money represents only the tip of the iceberg--it is more than matched by property and payroll taxes, admissions and concession taxes, sales taxes on breeding fees and equipment, et cetera--it represents a highly significant contribution to the states which benefit from racing. A large percentage of these funds, for example, are earmarked for schools, hopsitals, roads, programs for the aged and other programs of social significance.

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(3) See attached excerpts from the National Association of State Racing Commissioners' <u>1978 Statistical Summary of Pari-mutuel Racing</u>.

When you take the money out of the hands of the bettors, as you do under the current withholding provision; or when you drive them away from the legal sources into the hands of the illegal bookmakers, as you do under the current withholding provision, there can only be one result:

Less money is bet with the legal sources;

Therefore, less money goes to the state or local government;

Therefore, less money is available for the aforementioned programs, such as schools, hospitals, etc.;

Therefore, the states will have two choices--raise taxes or seek replacement of those funds from the Federal Government.

The American Horse Council measured the effects of withholding on pari-mutuel wagering for the first year, ending May, 1978. The total value of the payoffs subject to withholding was approximately $330-million and the amount withheld was $66-million. However, the effect on the total betting stream vastly exceeds $66-million when one considers that money at the track is recirculated an average 3.5 times. Thus, it is estimated the total negative effect on handle to be approximately $230-million in one year. Obviously, fewer dollars available for rewagering will result in a reduction of taxes that go to the states and dollars that go to the race tracks to pay expenses, payrolls and purses. During the first fiscal year (May 18, 1978-

May 18, 1979), direct state government revenue was reduced by $17-million and industry revenue by $26-million(4).

As far as race tracks are concerned, withholding almost claimed its first victim. Charles Town in West Virginia has been seriously affected. In January, the racing industry, which contributes more to Jefferson County, West Virginia than any other single industry, through employment and economic stimulation, was about to close. Charles Town was a pioneer of exotic wagering and relied on trifectas and big exactas over the years to attract bettors. This kept people coming through the turnstiles. But the track's drawing card nearly spelled its demise. 20% tacked on to the state's takeout made the long trip to West Virginia exceedingly unattractive to many bettors who put large sums through the windows, and they stopped going to the races. Charles Town's handle plummeted and it appeared early this year the track would be forced to close. At Charles Town in 1978 approximately $1.5-million was lost to the industry and went to the federal government in the form of withholding. It is somewhat ironic that attendance and daily revenues also fell by <u>20%</u> in the first year of withholding. The track operating loss was approximately $250,000. If the track were to close permanently nearly $5-million in revenue to the state would also be lost. There is a point where taxation of the pari-mutuel dollar ceases to raise revenue

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(4) See attached summary of payoffs subject to withholding.

and becomes destructive, as Charles Town clearly shows. If the state legislature had not agreed to give up a portion of its share, Charles Town would be out of business today.

(2) Because of the very nature of pari-mutuel wagering, withholding of race track winnings is confiscatory.

Of every dollar bet at every race track or jai alai fronton across the country, an average of 17 1/2 cents is taken out to provide revenue to the state, to pay the performers and to provide for a place to conduct the event.

Thus, only 82.5% of any money bet is returned to the bettor and there can be no net tax liability because, for every winner there must be offsetting losers.

Under present regulations a bettor must file a 1099 form for any ticket worth $600 or more on a $2.00 wager and if the bettor wins more than $1,000 at 300 to 1 odds, the net proceeds are withheld at a rate of 20%. Although very few bettors are net winners during a given year, losses from the other bets which were made prior to or after the withholding transaction are not taken into consideration, and the vast majority of bettors are therefore entitled to a refund. [Preliminary results of an American Horse Council study of bettors who had payoffs subject to withholding in 1978 have shown that 84.9% of the respondents wound up the year in the red on their pari-mutuel activity and, as such, were entitled to recoup the money which had been withheld.]

To get a refund on the withheld monies, however, the

taxpayer must itemize deductions and give up the standard deduction. Since most individual taxpayers use the standard deduction, giving up this deduction is a big penalty to pay for the majority of them. In the AHC study, 50.6% of the respondents who were entitled to a refund either could not afford to give up the standard deduction, or were unable to substantiate their losses, so the withholding tax amounted to nothing more than a 20% excise tax on their winnings.

Even if the taxpayer does itemize, IRS rules make it exceedingly difficult for him to claim losses and get his refund. There are no clear cut guidelines on record keeping, and yet IRS has rigid accounting requirements which must be met before it becomes satisifed that the bettor has proven his losses. In actual practice it is so difficult for the taxpayer that most do not bother to claim their lossses, leaving the government with windfall tax revenue.

(3) Withholding increases the advantages illegal bookmakers have over legal operations, and therefore, ultimately accrues to the benefit of organized crime.

The Final Report of the Commission on the Review of the National Policy Toward Gambling states clearly and unequivocally, "The Commission believes that the expansion of the withholding concept as it applies to pari-mutuel wagering will not raise additional revenue to the Government . . . however; the likely impact of the requirement's driving previous legal participants to illegal games is of

great concern unless, of course, Congress specifically intended to increase the competitive advantage the illegal games presently maintain over their legal counterpart."(5)

This point has been reemphasized by Congressman Dan Rostenkowski who said in a recent speech that withholding of race track winnings is "aiding illegal wagering activities, while reducing state revenues from horse racing."

Again, from the Final Report of the Gambling Commission, "...Existing Federal tax policies make effective competition with illegal bookmakers impossible."(6)

There are certain natural advantages which tend to encourage bettors, especially big bettors, to deal with illegal bookmakers:

(a) Illegal sources accept telephone bets, whereas the vast majority of legal sources are prevented by law from doing so;

(b) Illegal sources provide credit for their customers whereas all pari-mutuel systems are prohibited by law from doing so;

(c) Illegal sources do not report large winnings to the Federal and/or State governments, which legal sources are required to do.

By requiring 20% withholding on certain pari-mutuel winnings at legal sources, the Federal Government has

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(5) See attached excerpts from "Gambling in America. The Final Report of the Commission on the Review of the National Policy Toward Gambling", created by Congress in the Organized Crime Control Act of 1970 (P.L. 91-452).
(6) Ibid.

created the single greatest incentive yet to bet with illegal bookmakers. Convenience and credit are adequate incentives, yes, but taking a bettor's money away is the surest form of emphasizing the advantages of the illegal gambler.

In order to put a few derelicts out of business, therefore, the Federal Government has embarked on a policy of great benefit to illegal bookmakers and, through them, to organized crime.

(4) Withholding, as structured under Section 3402(q) discriminates against the most prominent, most productive forms of wagering.

While withholding is required on race track winnings if the net proceeds are $1,000 and the odds are 300-1, winnings from state lotteries are subject to withholding only on amounts in excess of $5,000, and casino games are not subject to withholding at all.

The Gambling Commission Report states:

"Additionally, the exclusion of games such as keno, bingo, slot machines and all casino gambling from any withholding requirement is, at best, arbitrary. At worst, it appears Congress has once again formulated a clearly discriminatory practice against selected gambling industries based on what is apparently a very inexact estimate of anticipated revenue."

SUMMARY: The withholding of certain race track winnings has proven counterproductive for numerous reasons, chief among them:

(1) Withholding is economically counterproductive and is a major cause of a $20-million decline in direct pari-mutuel revenue to the racing states during the past two years.

(2) The nature of pari-mutuel wagering and IRS rules for substantiation of losses have combined to produce what is, in effect, a 20% excise tax on race track payoffs for nearly 60% of the bettors who are entitled to a refund of the money that was withheld from them.

(3) Withholding has minimal effect on so-called "ten percenters" and may, in fact, drive legitimate bettors into the hands of illegal bookmakers.

(4) Withholding, as currently imposed, discriminates against the most productive forms of wagering in terms of state revenue, which are in the neighborhood of $800-million a year.

Therefore, we strongly urge you to support the repeal of Section 3402(q) of the Internal Revenue Code.

For further information contact:

Arnold Kirkpatrick
Executive Secretary
Racing Advisory Committee
American Horse Council
1700 K Street, N.W.
Washington, D.C. 20006
(202) 296-4031

# TOTAL GREYHOUND AND HORSE RACING REVENUE TO STATES (1959-1978)

| Year | Revenue |
|---|---|
| 1978 | $801,138,465 |
| 1977 | $819,201,638 |
| 1976 | 821,311,348 |
| 1975 | 766,730,183 |
| 1974 | 650,684,516 |
| 1973 | 605,945,628 |
| 1972 | 569,753,462 |
| 1971 | 567,777,744 |
| 1970 | 539,742,764 |
| 1969 | 508,545,672 |
| 1968 | 468,077,649 |
| 1967 | 432,076,514 |
| 1966 | 424,252,115 |
| 1965 | 402,705,421 |
| 1964 | 379,914,405 |
| 1963 | 343,228,047 |
| 1962 | 313,438,030 |
| 1961 | 287,920,639 |
| 1960 | 280,090,399 |
| 1959 | 262,810,999 |

Statistical Summary prepared by
the National Association of
State Racing Commissioners, 1978

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# TOTAL REVENUE TO GOVERNMENT

Statistical Summary prepared by the National Association of State Racing Commissioners, 1978

| State | TOTAL REVENUE TO GOVERNMENT ($) Total | Thoroughbred | Harness | Qtr. Horse | Mixed | PERCENT INCREASE OR DECREASE Total | Thoroughbred | Harness | Qtr. Horse | Mixed |
|---|---|---|---|---|---|---|---|---|---|---|
| Arizona | 2,893,669 | ✓ | | ✓ | 2,893,669 | +10% | ✓ | | ✓ | +10% |
| Arkansas | 7,914,436 | 7,914,436 | | | | +17% | +17% | | | |
| California | 115,697,431 | 85,513,930 | 11,530,526 | 10,848,624 | 7,804,351 | +3% | +4% | -10% | +11% | +5% |
| Colorado | 2,061,483 | 1,633,250 | | 428,233 | | +8% | +6% | | +14% | |
| Connecticut-OTB | 8,657,244 | ✓ | ✓ | | 8,657,244 | — | | | | — |
| Delaware | 4,997,774 | 678,197 | 4,319,577 | | | -14% | +23% | -18% | | |
| *Florida | 18,305,863 | 15,778,201 | 1,827,848 | 99,816 | | -21% | -19% | -30% | -60% | |
| Idaho | 445,030 | ✓ | | ✓ | 445,836 | +21% | ✓ | | ✓ | +21% |
| Illinois | 73,899,698 | 37,012,497 | 36,887,201 | | | -2% | -4% | +9% | | |
| Kentucky | 14,960,379 | 11,484,588 | 3,295,489 | 180,302 | | +12% | +14% | +9% | -30% | |
| Louisiana | 12,843,913 | ✓ | | ✓ | 12,843,913 | -6% | ✓ | | ✓ | -6% |
| Maine | 860,391 | | 860,391 | | | -16% | | -16% | | |
| Maryland | 22,277,706 | 16,701,781 | 5,575,925 | | | +15% | +11% | +29% | | |
| Massachusetts | 14,696,133 | 11,728,319 | 2,967,814 | | | -22% | -21% | -25% | | |
| Michigan | 27,089,556 | 14,072,825 | 12,949,856 | 66,875 | | +4% | +4% | +4% | +16% | |
| Montana | 130,674 | ✓ | | ✓ | 130,674 | +16% | ✓ | | ✓ | +16% |
| Nebraska | 7,487,765 | ✓ | | ✓ | 7,487,765 | +9% | ✓ | | ✓ | +9% |
| Nevada | 8,700 (E) | ✓ | | ✓ | 8,700 | — | | | | — |
| New Hampshire | 7,197,353 | 4,912,572 | 2,284,781 | | | -3% | -37% | -8% | | |
| New Jersey | 21,071,979 | 12,707,522 | 8,364,457 | | | -40% | -46% | -27% | | |
| New Mexico | 2,924,393 | ✓ | | ✓ | 2,924,393 | +12% | ✓ | | ✓ | +12% |
| New York | 102,664,964 | 53,979,084 | 48,575,596 | 109,284 | | -7% | -7% | -6% | -80% | |
| New York-OTB | 130,645,453 | 88,838,909 | 41,806,544 | | | +.09% | +9% | -13% | | |
| Ohio | 21,344,761 | 12,400,889 | 8,867,637 | 76,255 | | +13% | +.21% | +36% | +428% | |
| Oregon | 2,258,830 | ✓ | | ✓ | 2,258,830 | -20% | ✓ | | ✓ | -20% |
| **Pennsylvania | 32,063,697 | 18,861,987 | 13,201,710 | | | +6% | +10% | +1% | | |
| Rhode Island | 913,193 | 913,193 | | | | -1% | -1% | | | |
| South Dakota | 202,257 | ✓ | | ✓ | 202,257 | +10% | ✓ | | ✓ | +10% |
| Vermont | 14,301 | | 14,301 | | | — | | — | | |
| Washington | 6,627,098 | ✓ | | ✓ | 6,627,098 | +10% | ✓ | | ✓ | +10% |
| West Virginia | 10,008,340 | 10,008,340 | | | | -10% | -10% | | | |
| Wyoming | 7,385 | | | 7,385 | | +9% | | | +9% | |
| *Total | 673,863,831 | 404,924,600 | 203,430,653 | 11,816,764 | 52,293,906 | -4% | -6% | -4% | -11% | +22% |

*Total revenue includes additional miscellaneous revenue of $587,818 from all horse tracks, greyhound tracks and jai-alai frontons.

**Figure for harness includes $4,710,387 to Philadelphia School District

Statistical Summary prepared by the National Association of State Racin Commissioners, 1978

# GREYHOUND RACING IN THE U.S. 1978

| State | Racing Days | Number of Races | Attendance | Daily Average Attendance | Pari-Mutuel Turnover ($) | Daily Average Turnover ($) |
|---|---|---|---|---|---|---|
| Arizona | 492 | 7,028 | 1,176,192 | 2,391 | 97,678,139 | 198,533 |
| Arkansas | 112 | 1,634 | 1,056,755 | 9,435 | 106,046,767 | 946,846 |
| Colorado | 355 | 5,122 | 1,245,388 | 3,508 | 121,804,108 | 343,110 |
| Connecticut | 276 | 5,413 | 1,034,783 | 3,749 | 98,489,050 | 356,844 |
| Florida | 1,805 | 29,952 | 8,938,093 | 4,952 | 714,869,809 | 396,050 |
| Massachusetts | 510 | 6,120 | 1,976,571 | 3,876 | 176,267,475 | 345,623 |
| New Hampshire | 560 | 8,631 | 1,306,364 | 2,333 | 112,677,541 | 201,210 |
| Oregon | 85 | 935 | 570,957 | 6,717 | 46,355,486 | 545,359 |
| Rhode Island | 145 | 2,532 | 502,600 | 3,466 | 49,103,296 | 338,643 |
| South Dakota | 269 | 3,105 | 463,108 | 1,722 | 32,378,574 | 120,366 |
| Vermont | 102 | 1,314 | 203,336 | 1,993 | 14,610,422 | 143,239 |
| West Virginia | 300 | 4,450 | 623,533 | 2,078 | 62,782,040 | 209,273 |
| Mobile County, Ala. | 240 | 3,960 | 670,529 | 2,794 | 64,204,272 | 280,018 |
| Greene County, Ala. | 250 | 3,300 | 503,838 | 2,015 | 48,902,680 | 195,611 |
| Totals | 5,501 | 83,496 | 20,272,047 | 3,685 | 1,746,169,659 | 317,428 |

*Figures do not include charity or scholarship days.

# REVENUE TO GOVERNMENT AND STAKES AND PURSE DISTRIBUTION

(STATE, COUNTIES, CITIES, SCHOOL DISTRICTS, ETC.)

| State | Total Revenue | % Increase Decrease | Track Licenses ($) | Occupational Licenses ($) | Pari-Mutuel Taxes ($) | Breakage ($) | Admission Taxes ($) | Misc. ($) | Total Money Distributed ($) |
|---|---|---|---|---|---|---|---|---|---|
| Arizona | 5,493,558 | +9% | – | 7,272 | 5,475,080 | – | – | 11,206 | 2,764,505 |
| Arkansas | 6,867,599 | +4% | 33,600 | 7,913 | 6,362,806 | 410,241 | 52,739 | 300 | 2,159,350 |
| Colorado | 6,519,818 | +8% | – | 5,368 | 6,513,960 | – | – | 490 | 2,929,832 |
| Connecticut | ? 534,718 | -17% | – | 8,066 | 7,879,124 | 201,139 | 135,146 | 311,243 | 2,473,959 |
| Florida | 56,468,122 | +9% | – | 60,558 | 52,235,278 | 2,438,711 | 956,869 | 776,706 | |
| Massachusetts | 15,187,885 | +8% | 96,300 | 3,640 | 14,462,206 | 449,367 | – | 176,372 | 4,574,308 |
| New Hampshire | 8,619,006 | -6% | 178,793 | 7,925 | 7,960,783 | 257,460 | – | 214,045 | 3,168,706 |
| Oregon | 2,812,872 | -1% | 18,750 | 4,388 | 2,711,226 | – | – | 78,508 | 1,009,350 |
| Rhode Island | 3,100,269 | +105% | – | 1,490 | 2,946,258 | 100,203 | 51,693 | 625 | |
| South Dakota | 2,497,406 | +5% | 6,500 | 6,939 | 2,403,205 | 79,302 | – | 1,460 | 916,582 |
| Vermont | 944,727 | -42% | 380 | 3,856 | 852,530 | 24,397 | – | 63,564 | 441,285 |
| West Virginia | 3,619,883 | +87% | 45,000 | 9,927 | 3,488,741 | – | – | 76,215 | 1,796,078 |
| Mobile County, Ala. | 5,359,983 | +5% | 200 | 5,220 | 5,136,342 | 119,219 | 65,824 | 33,178 | 1,738,732 |
| Greene County, Ala. | 2,048,790 | +294% | 1,000 | 6,725 | 1,966,344 | – | 74,571 | 150 | 1,333,384 |
| Totals | 128,874,634 | +8% | 380,523 | 139,285 | 120,393,883 | 4,080,839 | 1,336,842 | 1,744,062 | 25,305,991 |

## PAYOFFS SUBJECT TO WITHHOLDING

(May 18, 1977 to May 18, 1978)

| | Number of Forms | Total Value of Payoffs | Amount Withheld |
|---|---|---|---|
| THOROUGHBRED | 73,115 | $134,284,979 | $26,856,996 |
| HARNESS | 39,013 | $ 79,701,009 | $15,940,202 |
| QUARTER HORSE | 2,720 | $ 6,042,202 | $ 1,208,440 |
| JAI ALAI | 7,687 | $ 15,559,526 | $ 3,111,905 |
| GREYHOUND | 39,911 | $ 49,698,429 | $ 9,939,686 |
| OTB | 24,430 | $ 44,270,920 | $ 8,854,184 |
| TOTALS | 186,876 | $329,557,065 | $65,911,413 |
| Minutes to Process | x5 | | x 3.49 |
| | 934,380<br>÷60 | Reduction in Total Handle---- | $230,030,831 |
| | | | x .0722 |
| Man Hours to Process | 15,573 | Reduction in-----<br>Govt. Revenue | $ 16,608,226 |
| | | Reduction in Track Revenue (.0615)---------- | $ 14,146,869 |
| | | Reduction in Horsemen's Revenue (.0518)-- | $ 11,915,597 |
| | | | $ 26,062,466 |
| | | TOTAL LOSS--- | $ 42,670,692 |

## AMERICAN IRON ORE ASSOCIATION
## STATEMENT TO THE COMMITTEE ON FINANCE

Hearings on the Administration's Tax Reduction Proposals
(May, 1981)

The American Iron Ore Association is a trade association representing companies which mine more than 95% of the iron ore produced in the United States and Canada, as well as a large percentage of iron ore produced in the free world. This statement is submitted in response to Chairman Dole's April 13, 1981 announcement of public hearings on the tax reduction proposals contained in the Administration's program for economic recovery.

### ECONOMIC RECOVERY PROPOSALS

Timely Scheduling of Hearings

In view of our nation's desperate need for immediate improvement in productivity and for increased rates of saving and capital formation, Senator Dole has made a very appropriate decision in not delaying these hearings until after the Committee on Ways and Means and the House have finalized their deliberations and have voted upon a tax bill. Our support of this decision to accelerate Finance Committee hearings on the tax reduction proposals, however, goes hand-in-hand with a recommendation that Congress abide by the Administration's recommendation that various other tax proposals be considered as part of a second tax package after the critically needed tax reduction legislation is in place. There never should be a short-circuiting of the public hearing process regarding any significant proposal to amend tax legislation in other unrelated areas.

Encouragement to Cut Spending

Our Association views favorably the economic package of the Reagan Administration as evidenced by its proposals for reductions in federal spending that are meaningful in amount and widespread in application. We recommend resistance to the already emerging pressure from segments of the population for exemption or relief from the impact of these reductions on a multitude of existing governmental programs. Only by reducing the rate of growth of federal spending can the disastrous inflationary forces at work in the U.S. economy over the past several years begin to be diminished. A reduction of inflation, coupled with greater productivity and

improvement in the economy, should certainly relieve the pressure for maintaining the present level of government spending.

Support for Tax Rate Reductions

In like manner, we favor proposals for across-the-board reductions in individual income marginal tax rates to take place over a three-year period. The Economic Recovery Tax Act in this aspect of its provisions will provide increased incentives to savings that will be less subject to the erosion of inflation. More importantly, the eventual reduction of the maximum rate of tax on so-called unearned income to 50% and the companion effect of reducing the maximum capital gain tax rate to 20% will inevitably encourage investors to shift nonproductive tax shelter investments to those that will contribute to increased productivity of U.S. industry and labor, an increase critical to our ability to compete effectively with other industrial nations around the world. When the level of individual tax rates no longer encourages current consumption over savings, this reinvigorated opportunity for investors to preserve more of their earnings for the long-term benefit of their families and communities also will bring about additional invested capital in new and technologically sophisticated machinery and equipment.

Support for Accelerated Cost Recovery System

Subject to three specific recommended modifications which are discussed below, the American Iron Ore Association strongly supports the proposed Accelerated Cost Recovery System (ACRS) to become effective no later than March 11, 1981. We have long advocated a capital cost recovery system which is simple in its application and flexible in its use as a replacement for the present Class Life Asset Depreciation Range System (ADR), and we believe ACRS satisfactorily meets the fundamental objective of terminating the obsolete concept of useful life depreciation. A very important feature of the system is the accelerated rates of recovery which should greatly reduce the cost of capital as well as create an incentive to reinvest in productive assets.

We are very much concerned, however, about the mandatory deductions required under ACRS. The iron ore industry - - - being cyclical in nature because of its dependence upon the steel industry - - - is fearful that the mandatory deduction feature might discourage certain major capital investments during periods of lessened activity and profitability. Although the net operating loss

carry-over period is extended under ACRS, we would prefer the flexibility feature contained in H.R. 1053 which permits discretionary use of the maximum allowable deductions.

Another provision in H.R. 1053 allows deductions to begin when costs are paid, a feature we prefer over the ACRS placed-in-service and progress expenditure rules. We recommend such a provision under any system in which the concept of useful life is no longer a factor in determining depreciation. This modification is particularly important in mine construction projects involving new or expanded operations which require long periods of time to complete.

Finally, it is noted that ACRS does not apply to property used predominantly outside the United States. This restriction would apply to property owned either by a foreign branch or a foreign subsidiary of a U.S. corporation. Although the ACRS write-off period for foreign assets is similar to the write-off period provided under ADR, ADR does permit the use of accelerated methods of depreciation. Under ACRS only straight-line depreciation is permitted. Consequently, the use of accelerated methods with respect to foreign assets in determining U.S. tax calculations has the effect of decreasing the annual disparity between the depreciation allowed in the U.S. as compared to the depreciation allowed in a foreign country. Where the foreign country capital recovery allowance provides for rapid rates of recovery compared to the 10 and 20 year straight-line recovery allowances as proposed under ACRS, the disparity as between years will result in generating excess foreign tax credits due solely to timing differences and not to economic reasons.

The greatest disparity arises when the capital recovery allowances are more generous like those found in Canada or the United Kingdom. In Canada, for example, the annual capital recovery allowance is 100% of the expenditures incurred with respect to investments in developing a new mine or in a major expansion of an old mine. On routine mining industry investments, the allowance is 30% computed on a declining balance. The manufacturing industry, likewise, is allowed to recover its investments equally over two years. Similarly, in the U.K. investments may be expensed in the year incurred or, unless the taxpayer elects otherwise, such investments may be recovered under a rate schedule provided by statute.

We recommend, therefore, that all assets, domestic and foreign, should be subject to a similar recovery allowance under the Accelerated Cost Recovery System.

## OTHER RELATED RECOMMENDATIONS

As noted previously, the American Iron Ore Association supports the President's request that a second tax bill be enacted this year to deal with a wider variety of matters. However, inasmuch as there presently is not a clear indication as to the number of tax bills to be produced or the scope of proposed tax legislation to come forth from the House of Representatives, we feel obliged to suggest consideration of three other related and important topics involving capital formation. (Keeping in mind the Chairman's wishes to move forward expeditiously on the tax aspects of the President's economic program, we will not now address several less pertinent, but nonetheless important, matters which have been the subject of previous testimony by the American Iron Ore Association.)

### Repeal the Minimum Tax on Corporations

The first related topic of importance to the iron ore industry concerns the heavy burden of minimum tax which is being borne by our member companies. Testimony presented to this Committee on past occasions by the American Iron Ore Association, most recently during the hearings of April, 1976, has pointed out the onerous impact this tax has on corporate enterprises carrying on iron ore mining operations. Present circumstances in our industry, coupled with the implementation of other provisions of the Internal Revenue Code, have compounded the undermining impact of the minimum tax on our member corporations. At a time when there is widespread focus on ways to stimulate capital formation in basic industries, we believe it would be a mistake not to repeal the minimum tax as it applies to corporations. Such repeal is also conceptually harmonious with the President's economic objectives.

In 1969, the Committee on Ways and Means was justifiably concerned about certain high income individuals who paid little or no income tax. As a means of dealing with the problem, that Committee proposed in its bill a "limit on preferences" for individuals only. This concept was designed to assure that financially able individuals would include in taxable income at least one-half of their total economic incomes. The Ways and Means Committee concept did not survive in the Senate; and unfortunately, there was substituted in the Senate the general framework of minimum tax as we know it today. Without benefit of analysis or hearings, corporations were unexplainably

made subject to a newly developed minimum tax formula, although they were never a part of the perceived individual income tax abuses. And yet, one major contributor to low individual taxes in relation to economic income, which was identified as a preference item by Ways and Means Committee, was not even included in the legislation as enacted. That item is tax exempt interest.

Thus, eleven years after enactment, we continue to have a law that taxes organizations and activities not intended to be taxed and at the same time does not reach a type of income that was definitely intended to be taxed. The American Iron Ore Association believes it should not at this time judge the pros and cons of the tax exempt interest issue or any other aspect of the minimum tax as it applies to individuals, but it does believe it has an obligation to point out why the application of minimum tax to corporations is illogical and inappropriate. (Although the corporate minimum tax raises only modest sums for the U.S. Treasury, statistics indicate that most of the burden falls on a limited number of capital intensive companies which are engaged in the mining and primary metals industries.)

The iron ore industry is extremely capital intensive, and capital formation incentives are desperately needed. Congress has long recognized the extraordinary needs of the mining business, and as a result the Internal Revenue Code provides for the outright deduction of exploration and mine development costs and for a percentage depletion deduction as a measurement of the value of capital invested in natural resource deposits being permanently exhausted. In addition, due to very heavy investment in plant and equipment by the iron ore industry, cash flow arising from depreciation and the investment tax credit has also been a vital contributor to our economic survival.

In spite of the importance of the foregoing provisions to cash flow in the iron ore industry, however, it has been our experience that the minimum tax contradicts and frustrates the very objective of such provisions. This is because the minimum tax is applied at the rate of 15% on the excess of preference items (which include percentage depletion) over regular income taxes paid after application of available tax credits. Consequently, the corporate tax problem results not only from the presence of so-called preference items (which we believe is a misdirected concept as it

applies to the active conduct of a mining operation in corporate form) but also from the erosion of the regular tax as a result of tax deductions and credits which were designed to function undiminished as business incentives. These business deductions and credits are established cornerstones of the U.S. income tax system. Ironically, in the case of a marginally profitable or loss corporation engaged in a capital intensive industry, the minimum tax appears in its most sinister form as an imposition of "income" tax on a base not comprised of income.

It is in the national interest to promote a healthy natural resource industry and to minimize our reliance on foreign sources for critical raw materials. This point is generally recognized and accepted. Two recent Congressional reports in which this message is reconfirmed are "Report on U.S. Minerals Vulnerability: National Policy Implications" by the Subcommittee on Mines and Mining and "The Ailing Defense Industrial Base: Unready for Crises" by the Committee on Armed Services, both issued in 1980. Suffice it to say, the existence of the corporate minimum tax as a further drain on the cash flow of natural resource companies represents a serious obstacle to this very critical national objective.

As a concluding reason for repeal of the corporate minimum tax, we again refer to the Administration's proposed ACRS which provides for an acceleration of capital cost write-offs to stimulate cash flow and, in turn, capital formation. As previously stated, we strongly recommend enactment of ACRS with certain modifications. But we also want to point out the negative impact its adoption will have on existing corporate minimum taxpayers as a result of increased current income tax deductions. Repealing the corporate minimum tax as it applies to corporations will enable the capital intensive industries to realize the same stimulating impact from ACRS as other business taxpayers.

Improve the Investment Credit

The Administration's tax proposals are designed to aid in the restoration of America's industrial vitality. Such a program should take into account the economic forces which have had a particularly damaging effect upon capital formation in the mining industry and its related basic metal industries.

One ravaging force has been inflation in the cost of capital goods. For example, during the 1970 - 1979 period, the Commerce Department's price index of capital goods used in mining rose 182% as compared with a concurrent rise in gross national product of only 84%. New project costs in the mining industry were growing on average at more than three times the relevant inflation rate during this period - - - among the highest for any basic industry group.

In addition to these general inflationary effects, many of the member companies in the iron ore industry have in recent years undertaken plant expansions and have had to incur substantial expenditures for governmentally mandated equipment. These factors, giving rise to a substantial increase in available investment credits, have occurred at a time when income levels have not been adequate. Consequently, there has been an accumulation of unused tax credits in the iron ore industry as the result of abnormally high capital expenditures in a time of depressed earnings. This circumstance has prevented affected companies from becoming full participants in an important tax incentive for reindustrialization with respect to which they have already taken positive action. We are optimistic that the present condition of depressed earnings is only temporary, but it is also noted that enactment of ACRS will serve to compound the present blockage of potential cash flow from the generation of investment credits. Accordingly, we ask that consideration be given to ways in which utilization of available credits might be accelerated at least for the short term.

For the long term, we continue to support liberalization of the investment credit as a meaningful tax incentive to stimulate capital formation and to enhance our nation's productive capacity. In testimony of prior years we have advocated increasing the credit rate, and we were pleased to see the increase to 10% made a permanent feature of the Code. Contemplation of further rate increases in the future as a means of attaining important national objectives should, in our judgment, remain a viable option under appropriate circumstances.

Improve the Tax Treatment of Pollution Control Expenditures

The area of governmentally mandated pollution control expenditures also causes considerable concern to the American Iron Ore Association. We note that the Administration's proposal contains no specific provision relating to governmentally mandated expenses. Such

expenditures have further lowered our industry's profitability and reduced its ability to effectively compete with foreign producers. Accordingly, we urge your support of an amendment to the tax laws relating to pollution control expenditures that would provide for immediate expensing and for an expanded definition of the term "pollution control". In light of the increasing financial demands which face our industry, we believe the justification for such an amendment is compelling.

The iron ore industry has invested and will continue to invest heavily in modern equipment to increase efficiency and productivity. Nontheless, we have been unable to generate internally sufficient capital to meet our needs, thus reflecting the harsh realities of the overextended economic slump and the financial burdens created by environmental costs. Environmental expenditures generally do nothing to increase productivity, yet such costs far exceed the level originally envisioned. It, therefore, seems prudent and appropriate to ease the burden of future pollution control expenditures by establishing a more realistic and beneficial tax treatment. Immediate expensing of pollution control facilities would go a long way toward easing the financial burden imposed upon our industry's efforts to help make our nation pollution-free.

Immediate expensing of pollution control facilities without investment tax credits, however, will not be as beneficial as amortizing such costs over five years with investment tax credits. Therefore, considering the extremely large additional capital expenditures for pollution control which are anticipated during the next several years as mandated by present law, we also strongly recommend the continued application of a tax credit for environmental control expenditures. Such a credit can be fully justified on the basis of the need for governmental aid in achieving the social goal of cleaner air and water.

It is further noted that foreign operators often do not have to bear the same heavy level of environmental costs as do their U.S. counterparts. Thus, a pollution control tax credit for eligible expenditures would also help maintain the competitive position of inherently healthy organizations whose ability to compete in the world market has in part been eroded by such expenditures, and it would enable U.S. industry to absorb without further economic detriment the projected increases in these non-productive, government-mandated costs of pollution control.

A stable and economically sound domestic mining industry is vital to this nation's economic health and national security. We believe a carefully drawn and specifically targeted tax credit for pollution control expenditures would help considerably in achieving this goal. This proposal is also in accord with the recommendations made by President Reagan's Task Force on the Environment which urged extensive use of tax credits and faster depreciation schedules for implementing the Administration's environmental program.

Finally, the definition of pollution controls as interpreted by the Internal Revenue Service is too restrictive. It should be clarified legislatively that pollution controls for tax purposes include equipment which prevents pollution in addition to equipment which reduces pollution. There is no logical distinction for different treatment afforded the aforementioned equipment, both having identical ultimate goals.

STATEMENT OF
C. JACKSON GRAYSON, JR., CHAIRMAN
AMERICAN PRODUCTIVITY CENTER
SENATE FINANCE COMMITTEE
May 22, 1981

## INTRODUCTION

On February 5, in his address to the nation on the economic crisis facing the country, President Reagan indicated his acute awareness of the productivity problem in the United States. He emphasized his determination to reverse the alarming downward trend in productivity. In particular, he stated that he would soon propose a comprehensive tax program which would include accelerated depreciation as one method of dealing with the productivity issue. On March 10, 1981, this legislation was introduced in the House of Representatives as H.R. 2400 and in the Senate as S. 683.

This statement discusses proposed tax changes aimed at increasing productivity.

The discussion is grouped under five headings:

I. Overview and General Conclusions

II. Capital Cost Recovery and Related Proposals

III. Research and Development Tax Incentives

IV. Other Savings and Investment Proposals

V. Summary

## I. OVERVIEW AND GENERAL CONCLUSIONS

The basic question is:

> "It is desirable to stimulate productivity growth in the United States. If certain changes are made in the tax code, will these bring about a significant increase in productivity? That is, significant enough (a) to overcome the revenue loss to the Treasury, (b) to outweigh any inflationary stimulus that may be caused by these changes, and (c) to generally help restrain inflationary forces in the economy."

The simple answer is, "We really don't know for sure."

There is generally believed to be a positive relationship between tax reductions, savings, investment, and productivity. Lowered taxes will lead to increased savings and investment which, in turn, will lead to increased productivity.

While I concur with the general policy of lowering taxes to stimulate savings and investment to increase productivity, there is no empirical evidence specifically demonstrating the direct relationship between tax policy and productivity.

There are statistics which show that there has been a general positive relationship in the United States and in other nations. <u>But -- and this is a very important point -- none of these linkages is automatic, nor are they necessarily sufficient to produce the productivity growth that this nation needs</u>.

It is my opinion that it is potentially disappointing, even dangerous, to build national productivity improvement goals on tax changes alone.

It is possible that tax changes could lead to a low response in savings. Increased funds in the hands of individuals could lead to increased consumption and/or speculative or non-productivity-increasing investments.

Increased funds in business hands could lead to low-return and short-term investments without high or long-term productivity yields.

Why would the public and business do this?

(1) Because they do not believe that inflation will be licked. Because they are uncertain about the long-term ability and determination of the Administration and Congress to cut spending, decrease government regulations and reduce "stop-go" economic policies.

(2) Because of habits of recent years that have grown up in business to invest more in product than process improvements, to focus more on short-term rather than long-term productivity improvements, to neglect product quality, and to forget the human element in business -- the necessity for employee involvement, reward systems, and training.

(3) Because of the adversarial relationships that have developed between business and government, between

managers and employees, and between unions and business.

In this kind of an environment, it is difficult to conceive that a simple relationship exists between tax changes, investment and productivity.

On the other hand, tax changes can lead to increased incentives to work and save and greater investment in productive assets which, in turn, can lead to productivity improvement.

The point is that these relationships are not automatic, nor are they sufficient. For a successful linkage, they depend on other factors as well, and unless these other factors are also attended to simultaneously, the response from tax change to productivity improvement may not occur.

These "other factors" that must be addressed in concert are:

(1) A cessation of "stop-go" economic policies;

(2) Reduced government spending;

(3) Reduced government regulation;

(4) Improved productivity in government agencies;

(5) Improved national and international productivity measures;

(6) Improved coordination and cooperation between the private and public sectors around productivity improvement; and

(7) Improved and increased activity by private sector organizations to improve productivity.

If explicit programs in these areas are announced and visibly get underway in 1981, will the proposed tax changes likely produce significant improvements in productivity? My answer is, "Yes."

There is some inferential evidence that there are relationships between these factors. Examples include the Kennedy tax cuts and the productivity growth that we experienced in the 60's; the relationship between investment and productivity in our history and in other nations; the slowing of returns to capital and our slowing productivity growth; and so on. There are many studies and reports that infer relationships, but they are sometimes correlations without causal linkages, or they occurred in another nation, or in a different economic situation.

The world is not like it was in the 1950's and 1960's, or before the OPEC cartel. Our inflation rate is unprecedented, our economy is heavily regulated, our capital stock is old, our labor-management relationships are often adversarial, our managers have tended to focus too much on the short-term and our expectations about the future economic conditions are vastly different than in previous years.

Even if we had empirical studies definitely establishing linkages in the past, extrapolating them to the present and the future would be highly suspect.

Keep in mind also that there is not one factor that causes productivity growth, but many. The reason that "investment" is so often singled out is that it seems the easiest to measure and control, and seemingly the most subject to public policy intervention. But this heavy preoccupation, almost solely with investment generated by tax cuts, can easily lead to neglect of the other factors -- particularly human factors -- and to overlooking the differences between industries and firms.

Many industries do not obtain productivity improvements from investments in physical capital. More and more people are working in information jobs with lower capital inputs, and some are more dependent on materials productivity.

But, none of this is to say that taxes should not be changed in an attempt to stimulate productivity. I do recommend certain changes which are discussed in the succeeding sections.

To preview my recommendations, they are as follows:

(1) The Jorgenson-Auerbach First Year Capital Cost Recovery Proposal. It's greatest impact on productivity growth would be felt if it were installed immediately. Less preferable would be for it to be phased in over a period of years, which may be economically or politically more acceptable, but will have less impact on investment stimulus.

(2) The 10-5-3 proposal. If Congress does not adopt the first year recovery system, the Capital Cost Recovery Act (10-5-3) should be enacted. If there is a need to break this proposal into parts, then my ranking as to maximum short-run impact on productivity would be 5-3-10.

(3) Research and Development. Since innovation can play an important role in boosting productivity, significant R & D tax incentives should be enacted such as the Senate Finance Committee's proposal for a 25 percent incremental R & D tax credit.

(4) Other Proposals. Other incentives for savings and investment such as a larger capital gains exclusion or a larger exclusion for interest and dividends would be beneficial.

## II. CAPITAL COST RECOVERY AND RELATED PROPOSALS

There are several cost recovery proposals under consideration in Congress. The leading ones are:

(1) President Reagan's Accelerated Cost Recovery System.

(2) The Capital Cost Recovery Act, commonly referred to as "10-5-3" or the "Jones-Conable" Bill.

(3) The Simplified Cost Recovery System formulated by the Senate Finance Committee in 1980.

(4) The First Year Capital Cost Recovery proposal.

Each has the objective of causing faster recovery of investments in plant and equipment.

The belief is that if business increased its cash flow by a faster recovery of investment, the rate of return on capital will rise. More investments will be made, leading to greater productivity. This position is also advanced because of the negative impact that inflation has had on the recovery of capital when historical book values, and not replacement costs, are used for tax purposes.

A. Accelerated Cost Recovery System

In general; President Reagan's proposal provides a depreciation system with five recovery periods of 18-15-10-5 and 3 years for most business assets which would be phased-in over five years beginning January 1, 1981. Under this formulation, certain autos and light trucks plus machinery and equipment used in research and development activities will be written off in three years according to an accelerated schedule. An investment credit of six percent will also apply to this class. All other outlays for machinery and equipment, including public utility property with present guideline lives of eighteen years or less, are assigned to a five-year class. The full ten percent investment credit will be allowed for this class. Factory buildings, retail stores, and warehouses used by their owners, and public

utility property for which present guidelines exceed eighteen years will be written off over ten years. As under present law, the ten percent investment credit applies to public utility property in this class, but is not generally available for real property.

Also under the President's proposal, "audit proof" lives are prescribed for other classes of real estate. Non-residential structures not included in the ten-year class and low-income rental housing will be written off in fifteen years by the straight-line method. This treatment applies to each building as a composite. Other residential structures for rental, such as apartment buildings, will each be written off, as a composite, over eighteen years according to the straight-line method.

B. Capital Cost Recovery Act

Another proposal to increase business investment and boost productivity is the Capital Cost Recovery Act, commonly referred to as "10-5-3" which was introduced by Representatives Jim Jones (D-Okla.) and Barber Conable (R-N.Y.) on January 22, 1981 (H.R. 1053).

This bill provides a three-year write-off with a six percent investment tax credit for the first $100,000 of annual investment in autos and light trucks. Most equipment would be recovered over a five-year period and be eligible for a ten percent investment tax credit. Non-residential structures would be eligible for a ten-year write-off.

C. The 1980 Senate Finance Committee's Simplified Cost Recovery System

Last year, in an effort to reduce the impact that the 10-5-3 approach would have on the federal deficit, the Senate Finance Committee formulated a recovery system with categories of 2, 4, 7, 10, 15 and 20 years. Under this proposal, equipment investment would be assigned to one of four categories corresponding to recovery periods of two, four, seven, and ten years. Most property now eligible for the Asset Depreciation Range (ADR) system would be assigned to a useful life category that is at least forty percent shorter than its current mid-point useful life. The bill also would introduce "open-ended accounting," in which all assets in each category are lumped together for depreciation purposes, and would modify the investment tax credit.

The Finance Commtttee's 1980 proposal also provides several new "audit proof" elections for real property. First, a taxpayer may elect to depreciate structures over a period of twenty years using the straight-line method and composite depreciation. Second, a taxpayer may elect to depreciate low-income rental housing over fifteen years using the straight-line method and composite depreciation. Third, certain "owner-occupied" business structures can be depreciated over a period of fifteen years using the 150 percent declining balance method.

In a recent study,[1/] the Congressional Budget Office used three econometric models to simulate the impact of the 2-4-7-10 depreciation proposal on the level of business fixed investment, output, and productivity. The simulation results are contained in the following table.

THREE ECONOMETRIC ESTIMATES OF THE IMPACT OF THE SIMPLIFIED COST RECOVERY SYSTEM (1981-1985 Annual Averages)

| Area of Impact | DRI a/ | Chase b/ | Wharton c/ |
|---|---|---|---|
| Business Fixed Investment Equipment (increase in billions of 1972 dollars) | 8.5 | 1.8 | 1.9 |
| Structures (increase in billions of 1972 dollars) | 3.0 | 0.9 | 0.8 |
| Level of Real GNP (percent change from baseline) | 0.8 | 0.3 | 0.5 |
| Level of Productivity (percent change from baseline) | 0.6 | 0.3 | 0.3 |

a/ Data Resources, Inc.

b/ Chase Econometrics, Inc.

c/ Wharton Econometric Forecasting Associates, Inc.

SOURCE: Congressional Budget Office

1/ "The Productivity Problem: Alternatives for Action," Congressional Budget Office (CBO), January, 1981.

Under the DRI model, it is estimated that the Simplified Cost Recovery System would produce an average annual increase of $11.5 billion in the level of real business fixed investment during the 1981-1985 period. The Chase and Wharton model simulations show much smaller gains of $2.7 billion. The DRI model suggests that the average annual level of productivity would increase by 0.6 percent while the Chase and Wharton models estimate productivity gains of 0.3 percent.

Increases in productivity from 0.3 percent to 0.6 percent per year are significant and, thus, make this type of proposal worth pursuing from a productivity-improving viewpoint. At the same time, however, these results illustrate the importance of implementing a comprehensive National Productivity Program. The effect of any single proposal may seem relatively insignificant. Under a comprehensive National Productivity Program, however, the cumulative effect of many separate proposals to improve productivity could be substantial.

D. First Year Capital Cost Recovery System (Jorgenson-Auerbach Proposal)

Under the First Year Capital Cost Recovery System, taxpayers would receive just one depreciation deduction for a given asset and that depreciation deduction would be taken in the year the asset is placed in service. Under the proposal, the allowable deduction would represent the present value of future

economic depreciation of the asset as well as the value of the investment tax credit.

The First Year Capital Cost Recovery System has two distinct advantages over other depreciation proposals. It provides greater neutrality and thus avoids misallocation of capital. It also provides greater simplicity.

With respect to neutrality, under current tax law an increase in the rate of inflation results in a heavier tax burden on all assets. Current law imposes a greater burden on some assets than others as a consequence of very sizeable differences between capital consumption allowances and economic depreciation. The size of these distortions depends on the rate of inflation, so that inflation undercuts incentives for capital formation and results in serious misallocations of capital. These misallocations blunt the impact of capital formation in contributing to higher productivity and to economic growth.

Since the First Year System results in a deduction in the same year an asset is acquired, capital consumption allowances are unaffected by inflation or by variations in the rate at which inflation takes place. This system accommodates high, moderate, and low rates of inflation without the distortions resulting from the current system. While the First Year System would provide substantial stimulus to capital formation, it would also contribute to improving the allocation of capital. The System would enhance rather than dissipate the impact of a higher rate of capital formation on productivity and economic growth.

The First Year Capital Recovery System also represents a major simplification of our tax law since only one depreciation deduction would be taken for each asset. Taxpayers would not have to make separate annual depreciation computations for each year in the applicable recovery period. Taxpayers would be relieved of cumbersome reporting requirements.

E. Summary

Each of the methods discussed has its pros and cons. Some have more impact on different industries than others. Some are more stimulative in the short-run; others have longer and perhaps more lasting effects. And each has a different impact on Treasury revenues.

My own preference is for the Jorgenson-Auerbach proposal. It has not gotten as much publicity as the other proposals, partly because it seems difficult at first to understand. But when looked at carefully, it is not so difficult and it seems to make more sense conceptually. It could also have the greatest short-term impact on productivity. It has the advantage of yielding tax rates that are equal for assets that differ in durability, and the effective tax rates would not depend on the rate of inflation. Both of these are important advantages.

It also hits the budget the hardest in the first years, but over the longer haul produces more revenue gains. Professor Jorgenson has suggested that if the short-run revenue losses were

unacceptable, the system might be phased-in over a period of years.

In my view, this system is likely to be the most beneficial for productivity -- short and long-term.

The 10-5-3 proposal also has the potential for improving productivity. If it is enacted, I would hope that all of the features would be used, *i.e.*, the 10 and the 5 and the 3. Structures are the least likely to give productivity gains in the short-run, but they are still important for the long-run. And this nation needs to move away from only short-run actions. The greatest short-run improvements are likely to come from the equipment section ("5"). So, the preferred order, if forced to choose, would be 5-3-10 for short-term effects, but the entire 10-5-3 for long-term productivity gains.

The 2-4-7-10 approach has the advantage of impacting federal revenues less in the short-run, and it also has some advantages in terms of administrative simplicity. But it, like the 10-5-3 proposal, also suffers from having different impacts on different industries, and does not directly relate the depreciation deductions to the rate of inflation. Both of the proposals, however, do offer some rough-cut attempts to overcome some of the negative impacts caused by inflation and the use of historical depreciation rates for tax purposes. Both have the potential to increase productivity.

Irrespective of which of these alternatives is selected, the new depreciation system should give taxpayers flexibility to deduct less than the maximum amount allowable in a year. A provision in the 10-5-3 bill provides this flexibility. Without such flexibility, capital formation in certain industries such as mining will be adversely affected because of the impact of larger depreciation deductions on percentage depletion.

As an additional means to encourage capital formation and boost productivity, the minimum tax for corporations should be repealed.

Under current law, corporate taxpayers are subject to a tax equal to fifteen percent of the amount by which the sum of specified tax preference items exceeds the greater of $10,000 or the regular tax liability for the taxable year. Tax preference items include such things as percentage depletion and net capital gain.

The minimum tax is an "add-on" tax that must be paid in addition to the regular tax liability.

The real objective of the minimum tax was to prevent individuals with very high earned income from sheltering this income by means of investments in outside activities. The concern about sheltering earned income for individuals is simply not applicable to corporations.

The minimum tax is constructed in such a way that it impacts most heavily on companies which have preference items,

but which suffer from low profitability. This can be simply illustrated by the example of two companies having exactly the same amount of preference items, one of which is profitable while the other is not. The profitable company will pay enough regular income tax that it pays no minimum tax, while the unprofitable company pays a minimum tax of fifteen percent of all its preference items. Thus, the effects of the tax are regressive. Companies most affected at present by the minimum tax tend to be natural resource companies, including companies in such basic and depressed industries as steel, railroads, coal and hard mineral mining. Many of these companies are forced to pay a minimum tax only because they have little or no profits. For these companies, the minimum tax not only reduces the value of their preference items but also reduces the value of deductions and credits such as those for depreciation and investment. Thus, those companies most in need of the full benefits of tax deductions and investment credits are able to derive less than full benefits therefrom. This is particularly harsh in the case of capital-intensive industries.

In addition, proposals to increase carryback and carryover periods for the investment tax credit, net operating loss and capital loss can help promote capital formation. Greater flexibility such as by allowing businesses to relinquish the three year carryback for capital losses should be added to the depreciation legislation enacted by Congress.

## III. RESEARCH AND DEVELOPMENT TAX INCENTIVES

One of the causes of lagging productivity is the lack of sufficient resources devoted to innovation. For example, according to findings of John Kendrick of George Washington University about forty percent of productivity increases in the U.S. during the past fifty years can be attributed to advances in technological innovation. Yet, total R & D spending in the United States has declined from about three percent of our gross national product in the early 1960s to a little more than two percent now. The following two tax incentives for R & D can help reverse this trend.

### A. Twenty-five Percent Incremental R & D Tax Credit

On January 15, 1981, Senator Danforth (R-Mo.) introduced S. 98 to provide a twenty-five percent tax credit for the amount by which eligible "research and experimental expenditures" for the taxable year exceed the level of such expenditures in the base period. (Generally, a three-year moving average base is used.) This bill is identical to the R & D tax credit approved by the Senate Finance Committee in 1980 as part of H.R. 5829 of the 96th Congress.

Under the legislation, "Research and Development" is generally defined in accordance with Financial Accounting Standards No. 2 (October, 1974).

B. Section 861 Allocations

To prevent double taxation of income, foreign income taxes paid by a U.S. company (or "deemed" paid by its subsidiaries) are allowed as a dollar-for-dollar credit against U.S. income taxes up to the amount of the foreign tax credit limitation. The limitation is computed by multiplying a company's foreign source income by the U.S. income tax rate. Treasury Regulation § 1.861-8 reduces the foreign source income included in the computation by artificially allocating to it a high proportion of research and development expenditures incurred. With a lower limitation, some foreign taxes may not be creditable against U.S. income, with the result that many firms incur an overall tax burden in excess of the U.S. tax rate.

These regulations have an adverse impact on American R & D activities. Some companies have moved some research activities out of the United States, thus putting the U.S. in a position of having to make outbound royalty payments on technology which could instead have been an income source. Other corporations have simply terminated their internal research and development programs.

Congressman James Shannon (D-Mass.), a member of the House Ways and Means Committee, introduced H.R. 2473 which simply excludes domestically performed R & D from the application of Section 861. Under the bill, all domestic R & D which is conducted in the United States is deducted solely from U.S. source

income. No R & D expenses incurred in this country will be deducted from foreign source income. This modest tax change can be an important part of broad national efforts to improve productivity.

C. Summary

In summary, these two R & D tax proposals have the potential to increase productivity.

There are other areas affecting R & D outside the tax system that might also be considered, such as increasing the amount of federal spending on basic R & D, and federal assistance to the diffusion of new technologies.

While the government can provide some assistance in the stimulation of R & D by these actions, the strongest impact on productivity will likely come from private expenditures on R & D. Businesses themselves are more likely to know where the most bang can be obtained for the buck.

Thus, tax proposals to encourage private R & D expenditures should receive high priority. The effect on productivity may not be large in the short-run, but if we are to ever get to the long-run increase that we need, the time to start is now.

IV. OTHER SAVINGS AND INVESTMENT PROPOSALS

Declines in U.S. productivity are often linked to the degree Americans consume rather than save. Americans save

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considerably less of their disposable incomes than the citizens of our industrial competitors and have continued to do so over a recent decade.

Actually, Americans save a considerable portion of their income although not as much as citizens of other industrial nations. For example, the Japanese save approximately twenty percent of their disposable income while Americans save less than eight percent. Declines in productivity growth are more closely tied to the kinds of investments in which savings are held.

In recent years, only a small portion of savings has been invested in plant and equipment of private business enterprise.[2/]

The dearth of personal savings invested in private plant and equipment and the impetus to invest in housing is in large part a function of the rate of return available for different investments. During the past decade, investment in housing has provided one of the highest rates of return available to most savers. On the other hand, rates of return on investment used to finance business have not merely been lower, but in many cases negative. For example, the real value (adjusted for

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2/ U.S. Department of Commerce, Bureau of Economic Analysis, Private Nonresidential Fixed Investment (Net of Depreciation) as a Percent of Disposable Personal Income, 1955-1979:

| | | | |
|---|---|---|---|
| 1955-1964 | 3.48 | 1976 | 2.00 |
| 1965-1973 | 4.92 | 1977 | 2.76 |
| 1974 | 4.49 | 1978 | 3.62 |
| 1975 | 2.00 | | |

inflation) of the Standard and Poor's common stock index has declined to less than sixty percent of its 1970 level.

Several tax proposals are designed to increase the disposable income of Americans by reducing personal income tax rates or taxable income, and hopefully, to increase investment in productivity-improving channels.

A. Reduce Maximum Tax Rate On Investment Income From Seventy Percent To Fifty Percent

One of the best ways to encourage investment and at the same time to eliminate some of the uneconomic tax shelters would be to reduce the seventy percent tax rate on investment income to fifty percent. Current law results in a misallocation of capital in the economy since investments are too often made for tax reasons and not for economic reasons. Congress should encourage persons to place their money in the most productive financial investments.

Under present law, a rock singer can make $10 million a year and be subject to only a fifty percent tax rate. It is counterproductive to turn around and impose a seventy percent tax on a venture capital investment that might develop into the "new Xerox" or the "new IBM." Our tax laws should encourage, not discourage, the development of innovative products and services which create jobs in this country.

B. Tax Exclusion For Specified Amounts Of Interest And Dividends

Under present law, there is an exclusion for the first $200 of combined interest and dividends ($400 for a joint return). This exclusion is in effect for calendar years 1981 and 1982.

An increase in the present savings exclusion would be a very simple and easily understandable method to help reverse the low savings rate in the economy and provide greater fairness to small savers. A savings exclusion cannot be effective unless the average taxpayer fully understands the provision and then proceeds to take advantage of the exclusion.

The imposition of tax on interest earned by small savers is extremely unfair. During periods of double digit inflation, individuals receive a negative rate of return on savings deposits. With an inflation rate of thirteen percent, a bank depositor who earns interest of about five percent actually ends up with a return of minus eight percent. The imposition of tax on this negative return is inequitable. This is particularly unfair for those on fixed incomes such as senior citizens.

A larger exclusion would help prevent large withdrawals of savings from traditional sources like a bank account. Such withdrawals are often reinvested in less traditional sources such as antiques, jewelry, gold and paintings. It is important to prevent large withdrawals of existing savings from banks, savings

and loan associations and the stock market. Funds in an S & L, for example, are needed for home construction. Equity investment is needed to create capital for the expansion and modernization of plant and equipment.

According to IRS data, about forty percent of the tax returns with adjusted gross incomes below $20,000 reported no interest or dividend income. This amounts to twenty million tax returns. Many taxpayers who file these returns would be encouraged to save more by substantial savings exclusions in the tax law.

C. Increased Capital Gains Exclusion

The Senate Finance Committee's 1980 tax cut bill raises the capital gains exclusion from its present level of sixty percent to seventy percent for noncorporate taxpayers. The bill also reduces the maximum rate of the alternative minimum tax from twenty-five percent to twenty percent. In the case of corporations, the alternative capital gains tax rate would be reduced from twenty-eight to twenty percent.

On January 6, 1981, Senators Malcolm Wallop and Daniel P. Moynihan introduced legislation (S. 75) to provide a seventy-five percent capital gains exclusion for individuals.

These proposals would encourage equity investment and strengthen the stock market. A strong stock market allows established companies to sell additional stock at attractive prices

and thus helps companies avoid an overreliance on debt financing. At today's interest rates, this allows corporations to save substantial annual interest payments. By keeping companies out of the debt market, it eases the upward pressure on interest rates, lessening inflationary pressures.

D. Incentive Stock Options

Last summer the Senate Finance Committee approved an amendment offered by Senator Packwood (R-Ore.) to provide an "incentive stock option" which would be subject to taxation in a manner similar to earlier tax rules on restricted and qualified stock options. Thus, there would be no tax consequences on the exercise of the "incentive stock option" and the employee would be eligible for capital gains treatment when the stock is sold. In addition, no business tax deduction would be allowed to the employer corporation at any time with respect to the option. Under the amendment, the stock option plan must meet numerous requirements in order to qualify for this advantageous tax treatment. The amendment adopted by the Senate Finance Committee would have applied to options exercised after December 31, 1980.

Senator Packwood (R-Ore.) and Senator Bentsen (D-Texas) reintroduced this proposal (S. 639) on March 5, 1981.

The objective of the proposal is to give corporations a mechanism to allow management to share in the profitability of

the firm. This would be an incentive for management to boost company earnings and productivity. (Parallel tax treatment should be provided for "restricted stock plans" since these plans would help achieve the same objectives.)

Legislation to provide favorable tax treatment to stock options should apply to existing plans for several reasons. First, treatment of existing plans would immediately end the inequity that results under current law when people who exercise options and purchase shares have to pay tax, at ordinary income rates, on whatever "increase" there has been, even though they have actually realized no income. Second, if a stock options provision were to provide nonrecognition treatment only for options granted after enactment, the value of all existing option plans would be seriously diluted. Such dilution could contribute to an undesirable spate of job hopping in industries using stock option plans to attract and keep top managers. Third, treatment of existing plans will result in an immediate net gain in revenue to the Treasury. Companies which elect to convert their existing stock option plans to fit within the parameters of "incentive stock options" would give up the offsetting deduction they now receive when an employee buys the stock (exercises the option) and pays a tax (on the difference between the option price and the market value of the stock).

Proposals To Expand Energy Investment Tax Credits

In 1978, Congress enacted a series of targeted tax incentives to help achieve national energy objectives. However, some of these incentives were drafted so narrowly that they have not achieved their purpose. Accordingly, on March 19, 1981, Senator Malcolm Wallop (R-Wyoming), chairman of the Energy Subcommittee of the Senate Finance Committee, introduced S. 750 to expand the business energy tax credits. Congressman Cecil Heftel (D-Hawaii), a member of the House Ways and Means Committee, introduced the same bill in the House, H.R. 2640.

The objective of this legislation is to help industry meet the high cost of energy-saving investments which can help reduce U.S. dependence on imported oil. Last year alone the U.S. imported about $60 billion of crude oil and we are dependent on foreign sources for about 35 percent of our oil consumption.

The major impediment to investments in industrial energy efficiency is not technology or know how, but capital. Most of the low-cost industrial energy conservation measures have already been adopted. The significant energy savings of the future will come largely from heavy capital expenditures in energy-efficient plant and equipment. Much of America's investment capital is already directed by Government mandate into investments that insure environmental quality and worker safety. In many cases, the little discretionary capital that is left over

is allocated to projects that offer a quick payback or an improved market position. Hence, energy conservation or conversion investments must compete with a long list of investment options, and in many cases energy-efficiency improvements are deferred.

The very high rate of return demanded by many firms for the type of investment in which energy savings is usually categorized is a major deterrent to such investments. The high "hurdle rates" frequently cluster around thirty percent after taxes. Companies base the high "hurdle rates" on the judgment that conservation measures do not have the strategic impact of a new product or additional capacity, and that they are easily postponed -- this, despite the very low risk involved in energy-saving investment.

F. Proposals To Withdraw Foreign Tax Credit Regulations

The proposed regulations attempting to redefine creditable foreign income taxes, which were published on November 17, 1980, in temporary form, create serious policy problems in terms of capital formation and should be withdrawn.

Under these proposed regulations, all tax payments made to a foreign government by a mineral company might be non-creditable if the tax on mineral companies imposed by the host country varies only slightly from the tax imposed on non-mineral companies. Complete denial of the foreign tax credit reverses long-standing U.S. tax policy. The concept of a foreign tax

credit was enacted originally as part of the Revenue Act of 1918 in order to prevent double international taxation. The proposals are inconsistent with sixty years of administrative practice.

The tax proposals would hamper capital formation and conflict with our nation's energy and mineral policies. Furthermore, the proposals would add significant uncertainty to our tax laws to the detriment of both taxpayers and the Internal Revenue Service.

Due to the adverse consequences of these regulations in terms of capital formation and other areas, they should be withdrawn.

G. Reduction in Estate Tax Rates

A reduction in estate tax rates can help reduce the serious drain on private capital that frequently occurs under current estate tax provisions. Accordingly, Congress should enact S. 395, the Wallop-Boren-Byrd estate tax bill, which includes a provision to reduce estate tax rates across-the-board by 10 percent.

The original objective of the estate and gift tax laws -- to prevent the unreasonable accumulation of wealth -- is simply not applicable to family-owned farms, ranches, and other closely-held businesses. In fact, many family enterprises have to be sold to large corporations to be able to meet the estate tax liability.

Excessive estate tax rates have a negative impact on the formation of capital which is vital for a viable and healthy agricultural and business economy. There is little incentive for a farmer, rancher or other businessman whose operation is capital-intensive to expand the business to make it more efficient and productive when such expansion will increase the amount of the estate tax and possibly cause a partial or total liquidation on the death of the owner.

H. Summary

The short-run effect on productivity from raising the savings or investment rate by any of these tax methods is not likely to be large. It takes time for the pattern of saving, investment, and productivity improvement to work its way through the system. The greatest short-run impact on productivity would probably be had by changing the composition of saving, i.e., by causing people to shift away from real estate, durable goods, and speculative investments toward productivity-improving financial assets.

However, the long-run impact on productivity could be large by changes in both the rate and composition of savings. And, for this reason, the time to get started is now.

## V. SUMMARY

Tax changes in the areas of capital recovery, R & D, savings and investment can help improve productivity.

However, the relationship between tax changes and productivity improvement is complex and not automatic. It is true that increased savings and capital investment generally are associated with higher productivity, both in our own history and in other nations. It is generally true that reduced taxes can lead to higher savings and investment. However, none of these relationships automatically flow from one to the other, particularly in the economic and social environment in which these tax changes are proposed.

Because of the lack of hard data and research on this linkage, I recommend that research be commissioned as soon as possible. This will not be the last time that these questions are raised. Such research should not only be macroeconomic, but also microeconomic, with data, surveys, and observations from the firm and industry levels.

It is my recommendation that the tax changes discussed in this statement be enacted. But with equal emphasis, I also urge that these changes be done only if there are other significant actions taken in both the private and public sector to cause these potential productivity gains to be realized. Otherwise, there would be revenue losses, coupled with zero or low productivity gains -- the worst possible results.

To increase the probability that all of these actions (including the proposed tax changes) have the maximum chance to improve productivity, I strongly recommend that there simultaneously be created a "President's Council on Productivity" to coordinate and stimulate public policies in the area of productivity improvement with similar actions by the private sector.

Testimony of Jerry Leatham, President of the American Warehousmen's Association Before the Senate Finance Committee Hearings on the Administration's Tax Reduction proposals, May, 1981.

Mr. Chairman: The American Warehousemen's Association is pleased to have the opportunity to testify on S.683 and the tax reduction proposals in the Administration's program for economic recovery.

The members of the American Warehousemen's Association are the owner-operators of public or merchandise warehouses. The primary function of the public warehouseman is the handling, processing and distribution of goods for its commercial and industrial accounts. Not merely a storage place for goods, the public warehouse is an integral part of the system by which goods are economically and efficiently distributed.

As owner-operators of small family-owned businesses, the members of AWA support the President in his efforts to moderate inflation and increase productivity and real growth in the economy. The basic provision of S.683 for accelerated cost recovery provides a much needed stimulus for capital investment in all sectors of the economy. We are particularly concerned, however, with the unequal treatment the bill proposes for building depreciation between private and public warehousing. The bill provides for a 10-year accelerated rate for warehouses which are used by their owners for the storage and distribution of the owners' goods.

The public or merchandise warehouse, owned and operated by AWA members, which store and distribute goods for industrial and commercial accounts are considered not to be owner-occupied and are included in the 15-year straight-line depreciation rate.

The bill sets two different rates of depreciation for two identical types of structures. Both are owned and operated by the taxpayer and both perform the same functions. The taxpayer in both cases makes the capital investment. The only difference is that the public warehouseman does not take or have title to the goods.

The bill as interpreted puts the AWA member at a significant disadvantage. For comparison, on a warehouse costing $1,000,000 the difference in cash flow based on 15-year straight line versus 10-year accelerated is $33,334 in the first year and $89,335 over ten years.

We believe that both private and public warehousing should be treated equally, and urge your support for a 10-year accelerated rate for both public and private warehousing. The 1245 recapture provision of the bill for the 10-year rate does not cause the public warehouseman much concern. The AWA member retains his warehouse structure rather than selling it and building a replacement. The warehouseman does construct additional warehouses as the market demand increases.

The Public/Merchandise Warehouse

The public warehouse is an integral part of the system by which goods are economically and efficiently distributed. A standard textbook in the field of distribution, Bowersox, Smykay & LaLonde, Physical Distribution Management, page 225, (rev. ed. 1968), describes the function of the public or merchandise warehouse as follows:

"The distribution warehouse contains goods on the move. Because the operation is essentially a break-bulk and regrouping procedure, the objective is to efficiently move large quantities of products into the warehouse and customize orders of products out of the warehouse."

The companies using public warehousing include major corporations as well as smaller companies. Public warehouses provide companies with the distribution capabilities and flexibilities without having to make the capital investment in warehouse structures. The distribution services provided include: receiving goods in carloads and distributing them in smaller quantities to local jobbers or retailers; issuing negotiable and non-negotiable receipts; and providing recoopering, marking and separation of varieties. Warehouse services allow companies to keep spot stocks for their customers, to equalize production by steadily absorbing manufacturer's output and reduce time lags in distribution from the point of origin.

In the distribution pipeline, the public warehouse and the private warehouse have the same critical function in the orderly and efficient movement of goods.

To set different rates of depreciation creates artificial distinctions which only serve to further the inefficiencies and inequities in the tax code. We strongly urge you to maintain tax neutrality between like functions.

The American Warehousemen's Association looks forward to working with the Committee as it proceeds with the tax legislation. We are grateful for the opportunity to be heard.

## Statement of the American Textile Manufacturers Institute

### THE TEXTILE INDUSTRY SUPPORTS THE ADMINISTRATION'S ECONOMIC PROGRAM

The U.S. textile mill products industry (Standard Industrial Classification code 22) employs close to 900,000 persons, ships $48 billion of product per year, consists of over 5,000 companies (both small and large businesses), and is located in nearly every state. Nearly a quarter million cotton farmers and wool growers look to the U.S. textile industry as their chief source of revenue - and their only stable customer country.

This is America's oldest manufacturing industry, but this does not mean it is ancient, out of date or inefficient. Some of its equipment is old and technologically obsolete (about 27% of it according to a recent survey) but much of it is brand new, exceptionally efficient and the latest "state of the art." That same survey reveals that over 30% of the textile industry's capital spending is for automation.

The U.S. textile industry is deemed the world's most efficient producer and, as such, one of the world's lowest cost producers. The textile industry's growth in productivity has been about four percent per year for the past twenty years, more than twice the U.S. manufacturing average. To be sure, the industry is not sitting back. It is fighting, scratching and scrambling for improvement, utilizing every bit of its addmittedly meager resources.

But much more can be done. By speeding up allowable depreciation schedules while maintaining the investment tax credit and by embracing the features of the President's revenue program, we believe the economic results will be beneficial to the U.S. economy. Our arguments relating to the U.S. textile industry as set forth below are, we think, persuasive.

1. Heavy Commitment to Capital Investment

The textile industry is currently spending about $1.6 billion a year for new facilities in the U.S., most of which is for equipment as opposed to structures. The textile industry is an old industry in which there are many multi-story buildings which generally call for the construction of a new on-the-ground addition in order to accommodate high speed machinery. Furthermore, about 40% of a green field textile project involves the cost of the building. New buildings are generally single purpose designed for the technology to be utilized in that structure and are not as adaptable for subsequent use as has previously been the case. Last year its expenditures consumed about 90% of the industry's retained cash flow. The last five year average was 82%.

| Year | Capital Spending (1) | Retained Cash Flow (2) | Expenditure % of R.C.F. |
|---|---|---|---|
| 1976 | 1.05 | 1.38 | 76% |
| 1977 | 1.26 | 1.43 | 88 |
| 1978 | 1.38 | 1.81 | 76 |
| 1979 | 1.50 | 1.93 | 78 |
| 1980 | 1.62 | 1.81 | 90 |
| | | Average . . . . | 82% |

Sources: Column (1): Bureau of Economic Analysis, U.S.D.C.
Column (2): Federal Trade Commission. Profits after taxes and after dividends, plus depreciation.

Significance: The industry's investment is growing, its commitment is obvious in that it tends to spend every available dollar. Investment, together with working capital requirements, does consume every available dollar.

2. Productivity Growth is Strong and Persistent

The textile industry, recognizing the fiercely competitive nature of the market place where million dollar orders hinge on price differences of as little as a quarter cent per yard of cloth, has done everything possible to raise its productivity. During the last two decades that growth has averaged 4% a year. This has been far greater than the U.S. economy as a whole and manufacturing industries in particular.

PRODUCTIVITY[1/] GROWTH PER YEAR

| | Textile Mill Products | U.S. Manufacturing |
|---|---|---|
| 1960-70 | 3.7% | 2.8% |
| 1970-79 | 4.2% | 2.8% |
| Total | 3.9% | 2.8% |

[1/]Output per person-hour

Source: Textile: ATMI
U.S. Manufacturing: Bureau of Labor Statistics

a) Significance: The textile industry has done more than most manufacturing industries to fight inflation through productivity gains. During the ten-year period through 1980, textile prices have gained only 71% against a U.S. industrial commodity jump of 150%.

b) Significance: The result of the above productivity growth is to place the U.S. at the top of the world in textile production efficiency.

RELATIVE OUTPUT PER HOUR WORKED

<table>
<tr><th></th><th>Spinning</th><th>Weaving</th></tr>
<tr><td>United States</td><td>100</td><td>100</td></tr>
<tr><td>Hong Kong</td><td>52</td><td>49</td></tr>
<tr><td>South Korea</td><td>45</td><td>43</td></tr>
<tr><td>Taiwan</td><td>46</td><td>44</td></tr>
<tr><td>West Germany</td><td colspan="2">87</td></tr>
<tr><td>Japan</td><td colspan="2">74</td></tr>
<tr><td>United Kingdom</td><td colspan="2">56</td></tr>
</table>

3. <u>Capital Expenditures are Required by Regulations and Economics</u>

Approximately 20% of the textile industry's capital expenditures this year are for pollution control, safety and health, and energy conservation. Most of these outlays are non-productive in the sense that they do not enhance the industry's output per hour worked. This is not to say they are not necessary, desirable, or economically justified. We do not know how much of the 20% is directly the result of federal, state, and local regulation, but it is substantial.

The textile industry allocates the highest percentage of its investment to safety and health equipment than any other manufacturing industry (i.e., 8.3%).

Further, the textile industry will allocate a higher percentage of its outlays for energy conservation than any other U.S. industry this year (i.e., 8.4%). The textile industry is one of the ten large energy users targetted by the Department of Energy for reduced energy usage. The industry has already increased its usage efficiency by 16% since 1972, the D.O.E.'s benchmark year. Further increases can be expected.

The future holds potentially large expenditures to reduce cotton dust in its mills, and to reach noise standards that may be promulgated. The aggregate investment requirements for just these two regulatory areas will many times exceed present annual expenditures for <u>all</u> investment needs.

4. <u>Inflation in Equipment Prices and Inflation in Technology Siphon Off Capital Funds</u>

There has been growth in the textile industry's earnings in past years but depreciation allowances suffer from the echo effects of older equipment installed years ago at much lower values.

EFFECT OF EQUIPMENT INFLATION ON CASH FLOW

| Period | Retained Earnings | Depreciation Charges | Textile Retained Cash Flow | Textile Machinery Price Index 1967 = 100 | Real Purchasing Power Million $1967 |
|---|---|---|---|---|---|
| | - - - - | $ Millions | - - - - - - | | |
| 1966-70 | 1816 | 2845 | 4661 | 105.4 | 4422 |
| 1971-75 | 2037 | 3917 | 5954 | 135.6 | 4391 |
| 1976-80 | 3555 | 4805 | 8360 | 192.5 | 4343 |
| increase | +96% | +69% | +79% | +83% | -2% |

Sources: First three columns: FTC
Price Index: BLS

The tabulation above shows how the textile industry's real purchasing power has diminished in spite of a 79% rise in retained cash flow. The two percent decline in real buying power does not tell the full story, however, because today's technologically competitive loom has a much higher price tag because of its high degree of sophistication. In short, today's investment is a completely different order of magnitude than fifteen or twenty years ago. Today, it is not unusual to find a new mill costing as much as $400,000 - $500,000 per operating position (with a four shift, seven day operation required of that facility, the investment works out to about $120,000 per employee).

Modification in our tax laws can do much to permit the industry to expand its investment in latest equipment technologies, to offset sharply rising costs of that equipment, to meet regulatory requirements and to assure a strong international competitive posture.

5. Textile Income Tax Rates are High

The textile industry has among the highest effective federal income tax rates of any manufacturing industry. This results largely from the fact that the industry doesnot have the opportunity to claim tax offsets such as the foreign tax credit and investment tax credits claimed by others. Based on 1977 I.R.S. information, profitable textile companies paid 38.7% of their taxable income as income tax. For total manufacturing, the figure was 30.7% in that year. The chief difference is in the foreign tax credit.

6. Some Foreign Countries Allow Faster Depreciation

Much has been accomplished tax-wise over the years to shorten allowable depreciation rates and to bring them more in line with overseas depreciation rates. Some of our chief industrial competitors, however, still permit faster writeoffs.

For America to be more competitive in international commerce, our tax laws need to be changed to enhance that competition. Faster depreciation is one way, investment incentives are another. With faster depreciation, however, it is necessary to maintain the full investment tax credit. Current capital recovery bills do that, but the phase-in method will inevitably delay the full impact on new investment.

PERCENTAGE OF COST THAT CAN BE RECOVERED IN
FIVE YEARS - GENERAL MACHINERY & EQUIPMENT

| | | | | | |
|---|---|---|---|---|---|
| Australia | 50% | W. Germany | 56% | Netherlands | 73% |
| Belgium | 67% | Italy | 95% | U. K. | 100% |
| France | 85% | Japan | 76% | U.S.A. | * |

Source: Arthur Andersen & Company

The proposed capital cost recovery system will permit 100% recovery in five years, after full phasing, which should permit considerably improved modernization in the U.S.A., assuming market growth.

*Too variable to calculate.

Statement of H.E. Bond
Chairman of the Tax Committee
ARCO Coal Company

Introduction

My name is H.E. Bond. I am Chairman of the Tax Committee, of the National Coal Association, and President of ARCO Coal Company. We appreciate this opportunity to express our views with respect to the tax aspects of the President's proposal as it relates to the coal industry.

The membership of the National Coal Association consists primarily of producing coal companies, whose operations comprise over half of the production in the United States. In addition, we number in our membership equipment manufacturers, railroads, coal exporters, consultants, and other coal-related industries.

My comments will be directed only to the Capital Cost Recovery System (ACRS) as proposed by President Reagan. NCA fully supports the ACRS proposal.

There is an urgent need for incentives to encourage capital investment in the coal industry. We believe this could best be accomplished by allowing shorter tax lives for all production machinery and equipment and buildings, through the ACRS. We also strongly support the provision in the ACRS proposal that would permit depreciation on long term construction projects to commence as the "construction costs are being incurred" instead of having to wait until the project has been completed. In this time of high interest rates and high construction costs, this provision is desperately needed.

Capital Requirements of the Coal Industry

Most energy forecasts and studies call on the coal industry to double annual production by 1990 and triple production by the end

of the century. These studies did not take into account the unexpected increase in demand in the export market. Nevertheless, we believe these goals are realistic and can be accomplished provided the financing is available for the necessary huge investment in machinery and equipment.

There is presently an overcapacity to produce in our industry. This is due primarily to certain restraints placed on the burning of coal which hopefully will be eased. Notwithstanding this temporary current overcapacity, we are optimistic about the future of the industry; a future that will require huge capital outlays.

By conservative estimates, the coal industry will require at least $46 billion between now and 1990 and over twice that much by the year 2000 to meet capital investment requirements. These amounts are inordinately in excess of the current total industry capitalization of almost $15 billion. An additional $36 billion will be required for the supporting transportation infrastructive. These estimates are stated in current dollars.

While capital costs may vary according to the terrain and the depth of the seam, it is generally accepted in the coal industry that the capital cost to install a new deep mine exclusive of the cost of coal is over $50 per ton of annual production. These figures do not include the substantial administrative costs prior to start-up, such as securing permits, surveys, feasibility studies, and other related costs. Thus, a medium-sized mine, with a capacity of one million tons a year, represents well over a $50 million capital expenditure by the time it actually begins commercial production. These new mines will mean thousands of more

jobs for miners. In terms of capital requirements, approximately $330,000 of investment will be required for each new mining employee.

Production costs are also skyrocketing. Total industry production costs increased nearly 100 percent during the period 1972 to 1980. The cost of machinery alone was up over 100 percent during that period.

The foregoing discussion on the capital needs of the industry illustrates why it is critically essential to the coal industry to obtain funds of a magnitude never before required by our industry.

ACRS and the Coal Industry

I earlier stated our full support for the concept of ACRS. However, we believe certain minor constructive changes would prove highly beneficial to the program. By making the system mandatory, and allowing no flexibility with respect to its use, a hardship would result for some taxpayers. It would appear that this overall accelerated depreciation program did not take into account the unique situations that exist for the extractive industries, and particularly the coal industry. ACRS as proposed is mandatory, and although it carries with it the increase of the net operating loss and investment credit carryover periods to 10 years, it still does not, unfortunately give relief to the coal industry's situation.

As you know, the percentage depletion deduction for a coal property (in simplified form) is 10% of gross revenues but not to exceed 50% of net income. The maximization of percentage depletion over the life of a property would require that the same limiting factor apply in each tax year, i.e., the 10% or the 50% limitation.

The further acceleration of depreciation, as ACRS would do. would reduce income in the early years and increase it in the latter years of a property's life. Thus in the early years available depletion would be reduced due to the 50% limitation and in the latter years the 10% limitation might not provide sufficient depletion for the greater net income in those years. Overall less percentage depletion would be used during the life of a property.

Various tax strategies such as aggregations of properties, etc., might be used to correct some of the imbalance of available and useable depletion over the life of a property, but we believe the bottom line effect of this ACRS on the coal industry is not what the Administration intended.

There are many ways to remedy this situation but the simplest and perhaps the least controversial would be to provide for a flexible capital recovery system, so that the taxpayer could claim less than the maximum amount allowed under ACRS and provide for a carryforward.

The leadership of both the Senate Finance Committee and the Ways and Means Committee have stated that any depreciation changes would be effective no later than March 11, 1981. This is encouraging However, I would urge the Committee to favorably consider making any changes effective January 1, 1981. Any other effective date would mean that the taxpayer would operate under two different depreciation systems during the same tax year. This would result in considerable administrative confusion. The two and a half months should not have a major revenue impact.

CONCLUSION

In closing, I wish to reiterate the need to update and expand, not only the productive capacity of the coal industry, but the entire national industrial complex. Tax incentives are a tried and proved tool to acomplish this end. We urge this Committee and the Congress to take favorable action on the Accelerated Cost Recovery System as soon as possible, and provide for a January 1, 1981 effective date.

Attached to my testimony as an addendum are three technical comments concerning the ACRS.

ADDENDUM

1. The bill appears to have an anomaly regarding land improvements for industrial buildings. For instance, an industrial warehouse would receive a ten year life under Sec. 168(c)(3)(A)(i). However, the parking lot for such facility would appear to have a 15 year life under Sec. 167(r)(1)(B)(ii). This seems incongruous.
2. In view of the fact that simplification was one of the objectives of ACRS, the methods of computing the first and last year allowances for the 15 and 18 year life assets (Sec. 167(r)(6) & (7)) seems unnecessarily complicated. The precise day any asset is placed in service is certainly arguable. It would appear that a half-year convention, or at least a monthly calculation, would be appropriate as opposed to the daily calculation.
3. Under ADR, the mining industries' foreign assets are allowed a ten year accelerated write-off. However, ACRS penalizes the mining industry by limiting mine asset write-off to ten years straight-line.

Statement of

The Associated General Contractors of America

Presented to the

Committee on Finance

United States Senate

April 20, 1981

On the Topic of

The Economic Recovery Tax Act of 1981

AGC is:

* More than 30,000 firms including 8,400 of America's leading general contracting firms responsible for the employment of 3,500,000-plus employees;

* 113 chapters nationwide;

* More than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utility facilities;

* Approximately 50% of the contract construction by American firms in more than 100 countries abroad.

The Associated General Contractors of America (AGC) represents more than 30,000 firms including 8,400 of America's leading general contracting companies which are responsible for the employment of more than 3,500,000 employees. These member contractors perform more than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utility facilities. We appreciate this opportunity to submit written testimony regarding the important issue of capital formation generally, and The Economic Recovery Tax Act of 1981, specifically.

The Associated General Contractors of America has pledged its complete support of the Administration's entire economic package of spending and tax cuts. This support is predicated on the belief that the proposed tax incentives, the lifting of regulatory burdens from all industry. and reduced federal spending will benefit the entire U.S. economy.

AGC strongly supports The Economic Recovery Tax Act of 1981 and firmly believes that it will be a major step toward overcoming the existing obstacles to capital formation and will greatly help this country regain its productive and economic superiority.

For many years now, our nation's tax laws have encouraged consumption and seriously discouraged savings and investment. Nowhere is this fact more evident than in the area of capital formation. Consider depreciation as an example. Under present depreciation tax laws, the owner of a productive asset is allowed to deduct from his tax liability a percentage of the value of that asset until it is worn-out. At the end of that time, the

asset will presumably be worthless and the owner will have to replace it with a new asset. The theory behind allowing the owner to deduct a percentage of the asset's value over its "lifetime" is that the money saved in reduced taxes will supposedly enable the purchase of a new asset when the old one wears out. In practice, however, the tax savings realized under current law are so inadequate that there is little or no incentive for a business to replace its outmoded plant, machinery and equipment with new assets even though those new assets could greatly increase the productivity of that business. The reason for this inadequate cost recovery is two-fold. First, because of inflation, the money a business receives back in tax deductions is worth less and less in real terms each year. Second, by the time a business has recovered the cost of its investment through depreciation, the replacement equipment it must buy invariably costs far more--sometimes two to three times more--again due to inflation. Consequently, depreciation under current law has proved to be an inefficient capital cost recovery tool.

Another capital recovery tool which also proved inadequate under current law is the 10% investment tax credit. Simply stated, it allows the owner of eligible property to reduce tax liability by an amount equal to 10% of the cost of the capital asset if the asset is held for at least seven years. If the asset is held for five to six years, only two-thirds of the 10 percent investment tax credit is allowed, and if the asset is only held for three to four years, a mere one-third of the 10 percent investment tax credit is allowed.

The problem is obvious. In order to qualify for the full 10 percent investment tax credit, a business must declare that the "useful life" of the asset is at least seven years, even though in reality, it may be only five years. If the business declares that the "useful life" of the asset is five years for depreciation purposes, the business will automatically lose the full benefit of the investment tax credit. Consequently, the business is either forced to choose the full investment tax credit and give up quick depreciation of the asset or opt for more rapid depreciation at the expense of losing the full investment tax credit. To say the least, this conflict greatly minimizes the potential for capital cost recovery.

The Economic Recovery Tax Act of 1981 would eliminate this conflict and would provide many positive investment incentives:

1) It would accelerate the depreciation of various productive assets thereby enabling business to recover its capital costs in such a way as to permit reinvestment in new, more productive capital assets even in times of high inflation;

2) It would eliminate the impractical and complicated "useful life" concept and Accelerated Depreciation Range (ADR) system and replace them with simplified schedules which all business, large and small, could understand and use;

3) It would eliminate the "facts and circumstances" test of current depreciation laws which gives rise to uncertainty among taxpayers and replace it with simplified

tables that would add certainty to the tax laws for large and small businesses alike;

4) The Economic Recovery Tax Act of 1981 treats the investment tax credit as an issue separate and apart from the depreciation issue. Therefore, using the intended incentives of one does not require sacrificing the advantages of the other;

5) Although The Economic Recovery Tax Act of 1981 may cause an initial revenue loss to the Treasury, it is fully expected that investments in capital assets induced by this legislation will raise the nation's productivity. This, in turn, will create new jobs, supply will rise to meet demand and inflation will be curbed. The resulting tax revenues from increased employment will minimize, if not negate, the revenue impact of this proposal.

AGC supports the entire economic package of the Reagan Administration. We have pledged full support for federal budget reduction proposals, which include at least $18.2 billion in construction cutbacks. We have done so in the conviction that the tax package and regulatory relief action of this Administration will provide the economic stimulus to develop the overall economic recovery we all need so desparately.

The total economic package is needed, and at the earliest possible date, including the tax measures covered specifically in this statement of our Association's position.

## Statement of Edward A. Crooke, Vice President and Secretary, Baltimore Gas & Electric Co.

The Baltimore Gas and Electric Company (Company) appreciates the opportunity to express its views concerning the tax reduction proposals in the administration's program for economic recovery. We agree a tax revision bill should be enacted in 1981, and that it should be aimed at increasing individual savings, encouraging capital investment and improving the productive capacity of the country.

Of course, the liberalized tax depreciation provisions now under consideration would assist business in expanding and modernizing its facilities. However, we also believe S. 141, introduced by Senator Bentsen on behalf of himself and Senator Baucus, meets all of the above goals and should receive favorable consideration.

Reinvested dividends under current law are now taxed, after exclusions, as ordinary income in the year paid. Under H.R. 654, a stockholder could elect to defer income taxes on dividends reinvested in original issue stock -- with an annual limit of $1,500 for a single taxpayer and $3,000 for a joint return. In effect, taxation would be deferred until the shares of stock so acquired were sold. Enactment of such a proposal would be of substantial benefit to our stockholders and also would aid the Company in acquiring essential equity capital.

About 17,500 of our common stockholders, or 19.6% of the total holders, are now participating in the Company's dividend reinvestment plan. The median number of shares held by these participants is less than 200 shares per holder and represents an investment of about $4,000 at the present market price of the stock. Under the existing tax law, other stockholders who might desire to invest in our common stock are discouraged from doing so as income taxes, at a high rate of tax on unearned income, must be paid currently even though the dividends are reinvested.

The deferment of taxes would stimulate far greater participation in original issue dividend reinvestment plans. Of course, the primary beneficiary of this legislation would be the stockholder. It would encourage him to make regular small increases in his investments in an economical manner. From an equitable standpoint, he would then be in a comparable tax position with the recipient of a conventional stock dividend, who pays no tax upon receipt of the dividend. Furthermore, the proposed change would be a desirable step in the partial reduction of the double tax on dividends. In addition, customers of public utilities would also benefit from the lower capital costs incurred by utility companies as such costs are included in the development of rates for service.

There is a growing awareness in the country of the need to encourage capital formation, and this proposal is directly on target with that goal. Capital-intensive companies, such as in the public utility industry, would benefit from the increased flow of funds from dividend reinvestment plans to assist in the financing of necessary replacement or expansion facilities. Greater participation in dividend reinvestment plans would tend to help in the battle against inflation by the use of reinvested dividends to finance production facilities rather than cash dividends to satisfy consumer demands.

On behalf of the stockholders and the Company, we urge that the dividend reinvestment proposal as embodied in S. 141 be included in any tax reduction bill.

STATEMENT OF
STANLEY I. BREGMAN
COUNSEL FOR
THE TRUCK RENTING AND LEASING ASSOCIATION
THE AMERICAN CAR RENTAL ASSOCIATION
AND
THE COMMITTEE FOR EFFECTIVE TAX INCENTIVES
BEFORE THE
FINANCE COMMITTEE OF THE UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

My name is Stanley I. Bregman and I am Counsel for the Truck Renting and Leasing Association (TRALA) which is a national trade association comprised of firms engaged in the renting and leasing of trucks in the United States.

TRALA's membership ranges in size from smaller companies with fewer than ten trucks to the large nationally-known firms including Ryder Truck Rental, Inc.; Avis Leasing Corporation; Rollins Leasing Corporation; Saunders Leasing System, Inc.; Ruan Leasing Company; and Lend-Lease. The industry which TRALA represents provides in excess of one million vehicles representing more than ten percent of all the trucks operated in this country.

The American Car Rental Association (ACRA) is a national trade association for firms which provide daily automobile rental services to commercial businesses and the general public. These car rental companies include the large and familiar names in the industry as well as many small and medium independent car rental companies which do business in virtually every city of the United States. Total membership exceeds 1,600 companies.

The Committee for Effective Tax Incentives (CETI) is comprised mostly of businesses engaged in the renting and leasing of motor vehicles.

All three of these organizations believe in the objective of eliminating the discrimination in our tax laws against short lived assets and of creating 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.

To eliminate the present discrimination in our tax system it is vitally important that qualified tangible property held one year receive an adequate investment tax credit, and we would support any legislation that will assure this is accomplished. We believe the Administration proposal meets our goal.

The Administration's proposal for accelerated depreciation coupled with investment tax credit treatment for short lived assets 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 environment. This proposal we also believe will have a beneficial impact on the truck and automobile manufacturing industry. This will be done by:

1. Stimulating purchases of new vehicle fleets,

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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. Strengthening the operation of related small commercial enterprises,

7. Strengthening the motor vehicle manufacturing sector and related industries.

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 an investment tax credit structure as in the Administration's proposal 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 of 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 leasing industry, the investment tax credit provision of the Administration's proposal will increase the availability of these benefits.

By encouraging new rental and lease vehicle purchases the investment tax credit provisions of the Administration's proposal 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 cost of fuel-efficient diesels, however, 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 Administration's proposal 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 operation costs.

An improved capital cost recovery system will, moreover, lower costs and thus 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. 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.

We believe that the Senate Finance Committee bill reported out last session of Congress was deficient in one aspect. That was its treatment of the investment tax credit for shorter lived assets.

The bill was deficient by having a spread of two and three years between steps for the investment tax credit. A disincentive would thus be created to early replacement of assets. Under the Finance Committee bill, if useful life is

less than two years, no credit would be allowed and existing law recapture rules would apply.

Although the purpose of the investment credit is to encourage modernization of equipment, recapture may actually cause business to retain assets beyond the period that would be economically appropriate. As an example, a business which would ordinarily turn a truck or fleet of trucks over after three years would probably hold off and not turn them over until four years. Also, fleet owners of automobiles who turn their cars over usually between 15 and 18 months would be encouraged to hold them for two years.

We believe that the treatment of investment tax credits on an annual basis is a more practical approach, and would go further in achieving the goals of encouraging new investment, increasing productivity, and reducing inflation. The investment tax credit treated on an annual basis will stimulate the purchase of new vehicle fleets thus creating more business for American automobile and truck manufacturers and bring more energy efficient motor vehicles into the American economy. It should be noted that for many businesses and especially small businesses, the investment tax credit is much more an incentive for investment than accelerated depreciation.

Several cost recovery proposals have been structured to provide limitations on the depreciation and investment tax credit incentive so that the present value of the tax benefits from depreciation and the investment tax credit would not

exceed the tax benefit that would be available from current expensing. These proposals, as presently structured, impact shorter-lived asset categories by limiting the amount of investment tax credit rather than limiting the depreciation.

If a limitation is deemed necessary, the proposals should be modified to favor the investment tax credit over depreciation liberalization for shorter-lived assets. Dollar for dollar, on a present value basis, the investment tax credit provides greater incentive than accelerated depreciation. This is so because the investment tax credit has a direct impact on reported earnings for financial purposes, whereas tax referral derived from accelerated depreciation must be reported as a deferred tax liability. In addition, a structure favoring investment tax credit would particularly benefit small business corporations whose tax rates are lower than 46 percent.

Any capital cost recovery proposal can be modified to accomplish this desirable result.

If a "2-4-7-10" cost recovery approach were used, the 7-year and 10-year categories would be permitted to use depreciation based upon the double declining balance method. The 2-year and 4-year categories would be limited to the use of straight line depreciation. This would permit the allowance of a full 10 percent investment tax credit for the 4-year, 7-year and 10-year categories and a 5 percent investment tax credit for the 2-year category while meeting the targeted limitation. ITC recapture would be structured as follows:

| Asset Held | ITC Retained |
|---|---|
| Less than 1 year | 0 |
| 1 year | 2-1/2% |
| 2 years | 5% |
| 3 years | 7-1/2% |
| 4 years | 10% |

If "3-5-7-10" cost recovery approach were used, the 10-year and 7-year categories would be permitted to use the double declining balance method of depreciation. The 3-year and 5-year categories would be limited to the 150 percent declining balance method. This would permit the allowance of the full 10 percent investment tax credit for assets in the 5, 7 and 10-year categories and a 6 percent credit for assets in the 3-year category, while meeting the targeted limitation. ITC recapture would be structured as follows:

| Asset Held | ITC Retained |
|---|---|
| Less than 1 year | 0 |
| 1 year | 2% |
| 2 years | 4% |
| 3 years | 6% |
| 4 years | 8% |
| 5 years or more | 10% |

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 that tangible property qualified under present law held one year be eligible for an adequate and equitable investment tax credit, and recapture be done on an annual graduated basis such as in the Administration's proposal.

TESTIMONY OF EDMUND G. BROWN, JR., GOVERNOR OF CALIFORNIA

BEFORE THE SENATE FINANCE COMMITTEE

MAY 28, 1981

This is an exciting and critical time in the formation of business tax policy for the United States. The tax changes you are now considering can be compared in scope and magnitude only to those enacted during the early 1950s. Because of our short-term fiscal crisis, with a large deficit a probability, a tax cut must be carefully fashioned to meet short-term constraints while contributing to our long-term economic goals.

At the same time, we must recognize the limitations of broad tax reform to accomplish our economic goals. The U.S. economy is currently undergoing a major restructuring due to fluctuating energy prices, the maturing of technologies developed 10 to 20 years ago, and increasingly fierce international competition in both basic and advanced industries. This restructuring will occur with or without a tax cut, but it is in our national interest to hasten this restructuring and influence the final shape of our economy with a thoughtful tax program. To survive and maintain our quality of life we must encourage, rather than impede this process. Government plays a critical role in this process by focusing spending only where necessary, by making its policies predictable, and by passing appropriate tax policies; government can further economic development rather than impede it. However, such a tax policy should be put in context of broader economic policy in which emphasis shifts from conservatism to entrepreneurial risk-taking and from imitation to innovation in the development of new products. Any tax policy, if not accompanied by these actions by the private sector will be insufficient to meet the economic challenges of the remainder of this century.

In addition to the general lowering of personal income taxes and the reform of depreciation allowances already before you, I would like to discuss two specific measures which deserve your support. If we are to maintain our competitive edge, we as a nation must invest in science and engineering research and development. Study after study has shown that the largest single contributor to increases in productivity has not been more capital of the same kind or more labor of the same kind, but has been technological advances and increases in human knowledge.

S. 98, coauthored by Senators Danforth and Bradley (parallel to H.R. 1183 authored by Representative Shannon and H.R. 1539 authored by Representative Pickle) would provide for a 25% tax credit for increases in research and development spending by private firms. H.R. 1864, authored by Representatives Shannon and Pickle, would provide for a 25% tax credit for business contributions to universities for research. Both proposals are needed because basic and applied research are undertaken by both universities and businesses. Taken together, these measures should provide a much-needed stimulus to private investment in research and development.

The 25% Incremental Research and Development Tax Credit

S. 98, providing for incentives for research and development conducted by businesses is critical for a number of reasons:

First, our companies cannot compete internationally if only given more capital through tax cuts. No matter how effective the proposed reductions in personal income tax rates, they will not bring U.S. savings in line with Japanese or German savings rates. To keep up, we must be concerned with the quality of our investment. In particular, we must seek to add new capital for plants and equipment which are technologically superior and resource efficient.

Second, many companies are living off research and development undertaken five and ten years ago. In many industries, the new product cycle simply takes that long. If companies are not encouraged to increase their current spending in this area, the present rapid pace of corporate innovation will slow dramatically.

Third, the proposed "10-5-3" depreciation schedule taken alone discriminates against rapid innovation. For firms in industries with rapid technological change, the 5-year write-off for equipment is too long and will actually impose a higher tax burden. In contrast, those industries with little technological change, which consequently have write-off periods for equipment far in excess of 5 years, will benefit the most. It would be preferable to provide innovative firms with some protection against increases in write-off periods; but in the absence of such a provision, a research and development tax credit can limit the bias against innovation.

Fourth, this provision will benefit both mature and cutting edge industries, both new and old firms, and both small and large companies. It is not special interest legislation designed to aid a few high-technology companies in California. I am sure you are all aware of the successful revitalization of the Massachusetts and North Carolina economies which is occuring

around technology based firms. More importantly, no U.S. industry can hope to compete in the future simply by using additional capital to duplicate itself -- all must compete by being the first to innovate and the first to bring new products and processes to the world market. This holds as true for the auto and steel industries as it does for the electronics industry. By providing incentives only for increases in research and development, this bill focuses only on future investment in research and development and does not favor those industries which in the past have concentrated on research and development.

25% Tax Credit for University Contributions

This nation has long depended on its public and private universities to carry out the long-term basic research needed to sustain private technological advances. Many of the current high-technology industries are directly linked to basic advances made at leading universities ten to thirty years ago. The proposed 25% tax credit for business contributions to university research is a vital complement to incentives for research and development within private businesses for several reasons.

First, in this period of limited public resources and amidst cuts in the National Science Foundation budget, a clear need exists to encourage the private sector to make long-term investments in basic university research. In California, I am attempting to do this by instituting a program of matching grants for business and government contributions to microelectronics research at the University of California. A Federal tax credit will further encourage participation in such programs across the country.

Second, the United States faces a shortage of engineers and scientists which is reaching alarming proportions. It is in this area that a comparison with the Japanese is quite telling. Out of 10,000 citizens in Japan, there are 400 engineers and scientists; while in the United States, there are 70. Out of the same 10,000 persons in Japan, there is one lawyer, while there are twenty lawyers in the United States. This shortage will become even more acute when the increased military budget begins to attract scientists and engineers out of civilian research and development. Increasing the research and development funds available to universities can only help in this regard.

Revenue Cost and Public Return

I am sure that you are all concerned about the effect of these tax credits on the federal deficit. In fact, each of these proposals carries an initial cost which is quite modest relative to the overall tax package now being considered. While I realize

that each public dollar must bear close scrutiny, if the current academic studies are accurate, there is no tax reform available to you which has a higher public return than increasing investment in research and development. Taken together, the two research and development tax credits will have an initial revenue cost of just over $600 million in 1982, and $1 billion in 1985. In contrast, the tax cut proposed in Kemp-Roth will cost $10 billion in 1982 and $59 billion in 1985. Such a revenue loss is indefensible in light of the national interest in innovation. If enacted, these research and development tax credits will focus private management on long-term investment, on the quality of investment, and on the neglected supply-side of the economy -- human knowledge. Broad based tax cuts will not accomplish these goals.

Stimulating Entrepreneurial Behavior

In addition to these critical measures, I would like to briefly discuss two other proposals which would increase our nation's entrepreneurial efforts: the restoration of incentive stock options and a targeted reduction in capital gains taxes.

Until recently, a decisive incentive for inducing promising entrepreneurs and managers to leave the security of large firms to take the risk of founding or joining new firms was the incentive stock option. Such options were occasionally subject to abuse, so that Congress acted to eliminate them. If targeted to new and small firms, where they can serve as a major incentive to innovation, I believe that favorable tax treatment for incentive stock options should be reinstated. S. 689, authored by Senators Packwood and Bentsen, is a step in the right direction.

We have all observed the tremendous response of the nation's investors to the 1978 across-the-board reduction in capital gains tax rates. The area of greatest response, and greatest value to the economy, is in venture capital. In California, I am proposing to stimulate venture capital by eliminating state taxation of capital gains arising from new long-term investments in small California companies. I believe that there is also room for further targeted reductions at the Federal level. While there is no single bill which goes as far as desirable, S. 889, coauthored by Senators Roth, Long, Bentsen, and Wallop, which would cut in half the tax rate on gains from investment in small technology based firms, is an important first step.

Conclusions

You now face the task of fashioning U.S. business tax policy for years to come. If new tax policy legislation is enacted which stimulates research and development and is accompanied by more entrepreneurial private management, the United States will emerge from current difficulties ready to compete in the world economy. If this opportunity to focus the tax structure on innovation is missed, we run the serious risk of providing major tax benefits indiscriminately with insufficient preparation for the future. I urge all members of the Senate Finance Committee to support the research and development tax incentives outlined here today.

STATEMENT OF VINCENT W. GARRETT
PRESIDENT, CHANCELLOR CORPORATION

SUBMITTED TO

COMMITTEE ON FINANCE, UNITED
STATES SENATE

It has been recognized for some time that the fate of this nation's economy turns on the ability of industry to attract a sufficient amount of investment capital. Without it, employment and real wages will grow slowly, if at all, and inflation will continue. The capital necessary to turn our economy around must be found in the private sector.

It is now generally agreed that tax policy plays a key role in the development of capital formation. It would be naive to believe that a tax system simply raises revenue. Where the tax falls - on whom and how much - are far more important questions than a simple recitation of the sum total of revenue collected. The revenue code can and is used to skew expendable income towards savings, investment, or consumption. Unfortunately, our present system taxes savings and investments far more heavily than it taxes consumption.

Recognizing both the need for new capital investments and the current bias in our tax system against the formation of such new capital, the President's tax proposal represents a giant step forward in the recovery of our economy by an increase in the spendable income of the private sector after taxes. In addition, it removes some of

the tax dissentives to saving while at the same time providing positive tax incentives to invest directly in our economy.

<u>Role of the Leasing Industry</u>

Over the last twenty years, a branch of the financial services industry has emerged to play an ever increasing role in our economy. The leasing industry, especially the leasing of equipment, has come to represent a new form of capital formation. Estimates of the total amount invested in equipment leasing now range into the trillions of dollars. Two of the major weapons that our tax systems have used to promote the retooling of industry are the investment tax credit and the allowances for depreciation. Both are designed to reduce the initial aftertax cash outlay necessary for industry to replace existing equipment and provide the incentives for expansion. However, it must be recognized that non-refundable credits and tax deductions will operate as an incentive to invest only if industry can take advantage of the tax credits and tax deductions. If a weakened or recessionary economy has already reduced industry's profits to a level that results in little or no tax liability, then the offering of additional tax benefits will be of no value.

The leasing industry has provided the instrumentality by which the tax benefits unusable by industry may be passed to the leasing company or even to private investors. A succession of Congresses and Administrations have recognized the benefit of this

passthrough. It permits the intent of Congress to be carried out even though the intended recipient of the tax benefit is not in a position to take advantage of it.

**ECONOMIC RECOVERY TAX ACT OF 1981:**
**Preference Items and Leased Property**

The cornerstone of the President's Economic Recovery Tax Act of 1981 is the increase in the depreciation rate schedule. Liberalizing the depreciation rate together with the investment tax credit provisionswill be powerful incentives for industry to retool and grow. However, these incentives will only work if industry and investors can take advantage of them. Industries in need of recovery are often industries with a very diminished ability to invest new capital and because of declining incomes cannot take advantage of new tax benefits. The private individual, on the other hand, provides a huge and vital pool of investment capital. But like industry, if the individual cannot take advantage of the new tax incentives of a liberalized depreciation schedule, then the President's program will not attract new investment capital and may even discourage present sources of capital.

The minimum tax provisions of present law provide that, for non-corporate lessors, only the excess of accelerated depreciation over straight line depreciation, using the mid-range of the ADR system, on leased personal property is a tax preference item. The

President's plan would change this and generally make a greater percentage of the accelerated depreciation allowances on leased personal property subject to the application of the minimum tax. Both S. 317 (introduced by Senator Bentsen) and H.R. 1053 (introduced by Messrs. Conable and Jones) are very close to the provisions of present law.

For example, under present law a taxpayer choosing to depreciate any number of assets having a five year life available (to be the largest group under the President's Plan) with a mid-range of six years would have a very significant increase in Preference Amount (See Exhibit One for Detail):

| | Current Law | President's Law |
|---|---|---|
| Preference Amount as % of Equipment Cost: | 16.68% | 43.75% |

This increase from 16.68% to 43.75% is a 262% increase. The net result of the President's plan will be to discourage capital investment by individuals to the leasing industry. This drying up of the pool of private investment capital will not only hurt the leasing industry but also the manufacturing industries that have come to rely so heavily on leased equipment.

Because this result is so contradictory to the President's announced policy, we believe this change in law in the President's

bill is an inadvertent drafting error. We urge, then, that the language in Section 205 of the Economic Recovery Tax Act of 1981 be amended to read "been depreciated using the straight line method over the recovery period used for depreciation" (lines 1 & 2 pg. 63) and the balance of (12)(A) deleted.

Retroactive Concept Disruptive

The uncertainty of the final nature of Tax Legislation in 1981 makes the acquisition of property by owners, lessors, and lessees an economically risky proposition. We urge that any legislation enacted contain language allowing the taxpayer to continue to use current law for the year 1981 at the taxpayer's option for property acquisitions made in 1981.

## EXHIBIT ONE

### ASSUMPTIONS

#### CURRENT LAW

Asset depreciable over five years
ADR mid-range is six years (Excess of Straight Line is Preference)
Accelerated Depreciation Elected: 150% DB to SL.
Half Year Convention Elected

#### PRESIDENT'S PLAN

Asset depreciable over five years
Excess of Straight Line over eight years is Preference
Half year convention mandatory

### EXAMPLES

| | CURRENT LAW<br>150% Declining Balance to Straight Line | | | PRESIDENT'S PLAN | | |
|---|---|---|---|---|---|---|
| Year | Deprec | 6YrSL | Pref Amt | Deprec | 8YrSL | Pref Amt |
| 1 | 15.00 | 8.83 | 6.67 | 15.00 | 6.25 | 8.75 |
| 2 | 25.50 | 16.57 | 8.83 | 22.00 | 12.50 | 9.50 |
| 3 | 17.85 | 16.67 | 1.18 | 21.00 | 12.50 | 8.50 |
| 4 | 16.67 | 16.67 | 0.00 | 21.00 | 12.50 | 8.50 |
| 5 | 16.67 | 16.67 | 0.00 | 21.00 | 12.50 | 8.50 |
| 6 | 8.33 | 8.33 | 0.00 | 0.00 | 12.50 | 0.00 |
| | | | 16.68 | | | 43.75 |

Preference is increased 262%.

WRITTEN STATEMENT
OF THE
COGENERATION COALITION, INC.
ON THE
ADMINISTRATION'S ECONOMIC RECOVERY PROGRAM
BEFORE THE
SENATE FINANCE COMMITTEE
MAY 28, 1981

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The following written statement for the record is filed on behalf of the Cogeneration Coalition, Inc. on the tax aspects of the Administration's Economic Recovery Program. The program, which was unveiled by the Administration on February 18, 1981 and supplemented on March 10, 1981, has been the subject of hearings before this Committee from May 13 through May 21, 1981.

The Cogeneration Coalition, Inc. (Coalition) is a non-profit organization comprised of interested natural gas utilities, industrial users, industrial equipment manufacturers, and engineering and construction consulting firms. The Coalition has also established advisory relationships with other public interest groups and national trade associations. The Coalition supports the provision of necessary financial and tax incentives to promote the utilization of cogeneration technology and the removal of unnecessarily restrictive federal barriers to the development of cogeneration nationwide.

Cogeneration is one of the foremost technologies for the efficient use of energy currently available in the United States. It involves the sequential production of electricity or mechanical shaft power and some other useful form of energy (usually heat or steam) from the same energy source.

Introduction

The Cogeneration Coalition strongly supports the business investment tax provisions of the Economic Recovery Program recently introduced by the Administration. As this Administration has recognized:

> One of the major tasks facing the U.S. economy in the 1980's is to reverse these trends (of declining investment and productivity) and to promote more capital investment. To combat the decline in productivity growth, to hasten the replacement of energy-inefficient machines and equipment, to comply with government mandates that do not enhance production, we must increase the share of our nation's resources going to investment. A Program for Economic Recovery (February 18, 1981), p.15.

Inflation and our inefficient and outdated capital cost recovery allowance system have combined to lower the after-tax real rate of return on capital investments by business. These impacts have been specifically reflected in the decision-making process for capital investment in energy efficiency improvements such as cogeneration equipment.

Therefore, the Coalition strongly supports the Administration's recommendation to provide an accelerated cost recovery system for machinery and equipment and certain structures based on various class lives: 10 years for long-lived public utility property, factories, stores and warehouses; 5 years for all other machinery and equipment, except long-lived utility property; and 3 years for autos, light trucks and capital costs for research and development.

## Investment Patterns in Business Energy Efficiency Improvements

Consideration of this legislation as well as other legislative proposals currently before this Committee provide a unique opportunity to focus on major issues associated with the development of increased energy efficiency capabilities by industry. The modifications in the proposed accelerated cost recovery system would extend to investments in cogeneration equipment. Such equipment would fall into a 5 year class life under the program, except for long-lived public utility property, and qualify for the full 10% investment tax credit.

Such an approach recognizes the continuing need to promote energy efficiency by business, while recognizing the important contribution made by industrial energy conservation activities since the Arab oil embargo. During 1973 through 1978, industrial energy use decreased by 12% per unit of output, while on a comparative basis residential and commercial use increased 1% per capita. This increase in the more efficient use of energy has been relatively less capital-intensive than projected capital requirements for increasing energy efficiency within industry during the 1980's. These capital requirements for the upcoming decade will be substantial, and this legislation establishes an important correlation between an awareness of the capital-intensity of such investment, and the need to provide appropriate financial incentives through the tax system to encourage the pursuit by industry of energy efficiency improvements.

However, the companies and energy users with the greatest incentive to conserve the use of oil, natural gas and electricity are also the very same companies and users which lack sufficient capital to take full advantage of readily available energy efficiency technologies. Further, these companies or users face a greater burden of competition within domestic or international markets compared with other similarly situated companies and users.

As a matter of national energy and tax policy, energy efficiency should be given high priority. It is the most effective and high-yield investment that can be made on a short and mid-term basis to achieve national policy objectives associated with displacing foreign oil import. In many respects, the Economic Recovery Program fails to consider the importance of energy related issues to ensure the necessary economic recovery of this nation.

Current discussion focusing solely on the use of market mechanisms to provide proper price signals to energy consumers as the new cornerstone of national energy policy is somewhat misleading. Such an approach fails to recognize the important investment impediments which exist in achieving this goal. Even if the marketplace provides appropriate incentives and price signals, serious capital shortfalls exist which are not being addressed. Therefore, many existing energy efficiency technologies such as cogeneration for industrial, commercial, and multi-family residential uses are not being deployed in sufficient numbers. This occurs because such investments are too

capital-intensive even though they may yield attractive returns on investment. Further, with limited capital resources available, other capital projects are demanding a higher call on available capital within companies.

Based on recent surveys conducted by Resource Planning Associates, investments in cogeneration are viewed as ancillary investments since the required capital is not related to increasing production by industry. Thus, the minimal acceptable return on investment can reach 25% with economic paybacks required of four years. These requirements also reflect the level of risk perceived as well as the position that while such investments can improve overall profits, they are not essential to the company's continuing operation. Resource Planning Associates, Inc., Potential of Cogeneration in Pacific Gas & Electric's Service Area Between 1980 and 1990 (December, 1980).

Finally, cogeneration investments do not entail the development of new technologies. Instead, such business energy efficiency improvements focus on the need for extensive retrofit of existing facilities, modifications to existing processes, and the acquisition and installation of major new energy efficient plants and systems. The promise of long-term economic paybacks for such investments are not sufficiently attractive at this time to justify the investment of limited capital resources in such projects. As energy costs increase for oil, natural gas and electricity, historical trends have indicated that the amounts of available capital for business energy efficiency improvements decreases.

Thus, it appears that additional federal incentives are necessary to increase investment in energy efficiency plant and equipment to achieve long-term energy policy goals associated with major displacement of oil. In this regard, the Administration's plan is an important first step in providing policy recognition of this national requirement.

Conclusion

The Cogeneration Coalition, Inc. supports this Committee's efforts to focus attention and discussion on the need for increased business productivity and investment. In this regard, we strongly support the leadership exhibited within this Committee and by the Administration and respectfully hope that these efforts will continue on an accelerated basis during the 97th Congress.

The Coalition also respectfully urges the Committee to maintain recognition of the need to consider other tax approaches to spur increased energy efficiency investments such as continuation and expansion of the business energy investment tax credits. We respectfully request that the Committee consider at the appropriate time the Industrial Energy Security and Incentives Act of 1981 (S.750) recently introduced by Senator Malcom Wallop on March 19, 1981, and co-sponsored by a substantial number of members of the Senate. This bill provides a comprehensive approach for dealing with the issue of improving industrial energy efficiency, including the public interest benefits associated with increased use of cogeneration. A summary

outline of recommendations with detailed explanation of these issues is enclosed with this written statement.

We thank you for the opportunity to submit this written statement for the record and stand ready to provide additional information or assistance which the Committee may desire.

Respectfully submitted,

Michael J. Zimmer

Washington Counsel,
Cogeneration Coalition, Inc.

Cogeneration Tax Legislation

The following is a summary of different features of cogeneration tax legislation supported by the Cogeneration Coalition, Inc.:

Cogeneration Tax Credit

1. Amend the current business energy tax credit for cogeneration equipment provided in the Windfall Profit Tax Act of 1980 as follows:

   - modify the definition of cogeneration equipment to insure that mechanical cogeneration qualifies for this tax credit, as well as cogeneration equipment that uses energy sources such as solar, biomass, and geothermal energy.

   - increase the amount of the business energy tax credit for cogeneration equipment from 10% to 20%.

   - extend the termination date for the business energy tax credit for cogeneration equipment from December 31, 1982 to December 31, 1990.

   - make the business energy tax credit available for cogeneration equipment installed in new facilities as well as modification or retrofit of existing facilities.

   - make the business energy tax credit for cogeneration equipment available for the total costs of the cogeneration system installed.

   - ensure that the business energy tax credit for cogeneration equipment is available for oil and gas-fired equipment installed in a cogeneration facility that qualifies for an exemption from the prohibitions of the Powerplant and Industrial Fuel Use Act of 1978.

   - remove the current exclusion against public utilities qualifying for the business energy tax credit for cogeneration equipment, which is characterized as public utility property.

   - require the Department of Treasury to promulgate proposed regulations to implement these modifications within 90 days after the date of enactment, and to promulgate final regulations within 270 days after the date of enactment.

Cost Recovery Allowances

2. Provide for more rapid cost recovery allowances for business investments in energy conservation equipment for cogeneration facilities modeled after the Capital Cost Recovery Act (S. 1435 and H.R. 4646), particularly regarding Class II property (five year depreciation for equipment and other tangible personal property).

Industrial Development Bonds

3. Establish the eligibility of cogeneration equipment for tax-exempt financing through the proceeds of industrial development bonds. Thus, the industrial development bond exemption in the Code should be made available for any cogeneration equipment that is eligible for the expanded cogeneration tax credit provided in this legislation.

August 1, 1980

WICKWIRE, GAVIN & GIBBS, P.C.
ATTORNEYS AT LAW
SUITE 804
1828 L STREET, N.W.
WASHINGTON, D.C. 20036
202-887-5200

VIENNA, VIRGINIA
8250 BOONE BOULEVARD
FOURTH FLOOR
VIENNA, VIRGINIA 22180
703-790-8750

LOS ANGELES, CALIFORNIA
(WICKWIRE, GAVIN & GIBBS)
ONE CENTURY PLAZA, SUITE 4290
2029 CENTURY PARK EAST
LOS ANGELES, CALIFORNIA 90067
213-552-7910

DETAILED EXPLANATION
of
COGENERATION TAX LEGISLATION

The following is a detailed explanation of the different features of cogeneration tax legislation supported by the Cogeneration Coalition, Inc.:

Cogeneration Tax Credit

The Windfall Profits Tax Act of 1980, which was recently signed into public law (P.L.96-223), provided the establishment of a business energy investment tax credit for cogeneration equipment. This non-refundable tax credit in the amount of 10% is in addition to the current investment tax credit of 10% for such equipment, and is available through 1982. Cogeneration equipment means property which produces steam, heat or some other form of useful energy (other than electricity) for industrial, agricultural, commercial, or space heating purposes, and which also produces electricity in the same energy consuming system.

To qualify, cogeneration equipment must be installed in connection with a boiler or burner at an existing facility and must result in an expansion in the facility's cogenerating capacity (including the start of cogenerating activity). To qualify for this energy credit, the annual use of an oil or natural gas fuel in the systems must be less than 20% of all fuel used each year and must be limited to use as a startup, backup, or flame stabilization fuel.

The major restrictions on this existing tax credit for cogeneration equipment diminish its effectiveness, and preclude use of the tax credit as a comprehensive incentive for the aggressive development and expansion of cogeneration facilities. The current tax credit should be amended to promote a comprehensive scheme for the short and mid-term development of cogeneration as a matter of national energy and tax policy.

## Critical Modifications

The current business energy investment tax credit for cogeneration equipment in the Windfall Profits Tax Act should be amended as follows:

1. Modify the definition of cogeneration equipment to ensure that mechanical cogeneration qualifies for this tax credit, as well as cogeneration equipment that uses energy sources such as solar, biomass and geothermal energy.

2. Increase the amount of the business energy tax credit for cogeneration equipment from 10% to 20%.

3. Extend the termination date for the business energy tax credit for equipment from December 31, 1982 to December 31, 1990.

4. Make the business energy tax credit available for cogeneration equipment installed in new facilities as well as modification or retrofit of existing facilities.

5. Make the business energy tax credit for cogeneration equipment available for the total costs of the cogeneration system installed.

6. Ensure that the business energy tax credit for cogeneration equipment is available for oil and gas-fired equipment installed in a cogeneration facility that qualifies for an exemption from the prohibitions of the Powerplant and Industrial Fuel Use Act of 1978.

7. Remove the current exclusion against public utilities qualifying for the business energy tax credit for cogeneration equipment, which is characterized as public utility property.

8. Require the Department of Treasury to promulgate proposed regulations to implement these modifications within 90 days after the date of enactment, and to promulgate final regulations within 270 days after the date of enactment.

## Definition of Cogeneration

Initially, the definition of cogeneration equipment contained in Section 48(1)(14) of the Internal Revenue Code must more closely reflect cogeneration as the sequential production of electrical or mechanical energy and useful heat from the same primary energy source. The current cogeneration tax credit is only available for cogeneration equipment that produces electricity and some other form of useful energy. <u>It must be noted that cogeneration equipment which produces mechanical energy can provide a similar increase in the efficiency of energy use.</u> This current discrimination against mechanical cogeneration should be rectified by making the business energy tax credit for cogeneration equipment available

for equipment which produces either electrical or mechanical power. This has also been most recently recognized by the Federal Energy Regulatory Commission in its Final Rule establishing the provision of an exemption from incremental pricing for mechanical cogeneration as well as electric cogeneration. (Docket No. RM80-62, 45 Fed. Reg. 71787; October 30, 1981) Inclusion of mechanical cogeneration would also provide better capabilities to maximize the energy conservation potential of cogeneration. Mechanical cogeneration is projected to fully constitute one-third of the conservation potential for cogeneration in major U. S. industry.

## Amount of the Tax Credit

Many knowledgeable observers have agreed that the business energy tax credit for cogeneration equipment should be increased beyond its current level of 10% to provide the appropriate and necessary incentive to spur investments in cogeneration systems. It should be noted that some sources have indicated that the business energy tax credit should be raised as high as 40% to stimulate the optimal amount of cogeneration development. In this respect, GAO indicated that the current 10% business energy investment tax credit for cogeneration facilities was insufficient to serve as an appropriate investment incentive.

## Expiration Date

The current business energy tax credit for cogeneration equipment will expire after December 31, 1982. There is a limited possibility for an extension through 1990 for certain property where the taxpayer has affirmatively committed to such investment by December 31, 1982. At a minimum, any new tax credit established under this legislation should be available for the period through December 31, 1990, while providing a further extension for projects where the taxpayer has affirmatively committed to the investment at the end of that period. Such an extension of the cogeneration tax credit is necessary for two critical reasons:

1. The tax credit will not achieve its maximum impact and benefit until the Treasury Department issues final regulations to implement the credit. Uncertainty will exist with respect to forecasting and planning until necessary regulations to implement these provisions are issued.

2. Once implementation of the credit occurs by the Treasury Department, there should be a substantial period of time available for industry and utilities to plan long-range projects relying on the availability of the credit. Based on current forecasting requirements, it can take as much as five years or more for a cogeneration project to move from the initial conception stage and feasibility studies into final construction. In that respect, most of the expenditures for which the credit will be claimed probably occur close to the end of that five year period. Thus, the credit should be available for the substantial period of time necessary to develop the cogeneration facilities.

## Applicability to New Facilities

The current business energy tax credit for cogeneration equipment is limited to equipment installed in an existing industrial or commercial facility. However, new facilities are generally better-suited to cogeneration than the retrofitting of existing facilities. New facilities can be constructed from the outset to avoid numerous technical problems which are faced in the modification and retrofit of existing facilities. Thus, the business energy tax credit for cogeneration equipment should be available regardless of whether it is installed at a new or existing facility.

## Total Cost Coverage

The current business energy tax credit for cogeneration is limited to equipment which increases a system's capacity to produce electricity or useful energy, whichever is the secondary energy output of the system. The credit should be extended to cover the entire cost of an energy system which includes cogeneration equipment. Specifically, the credit should also be available for any pollution control equipment or loading and handling equipment required in connection with the cogeneration facility. This would recognize major concerns which exist that environmental restrictions will be a significant impediment to the development of cogeneration projects.

## Oil and Gas-Fired Equipment

Current restrictions on use of oil and gas in cogeneration facilities in order to qualify for available federal tax incentives must be reexamined to consider:

1. Only large sized cogeneration facilities possess the economics of scale and capital costs to utilize coal.

2. For the small and medium size cogeneration facility, the only reasonable and available fuel choice is oil and gas in the interim.

3. Use of oil and gas in a cogeneration facility incurs increased efficiencies in use of these fuel inputs over use of such fuels in separate facilities.

4. Use of oil and gas in the interim can provide an important bridge or transition to synthetic fuels derived from wood, lignite, etc., for the long-term in cogeneration facilities.

GAO has recognized that a balanced cogeneration program should include provisions for some oil and gas-fired cogeneration facilities. The FERC has recognized that: "the legislative history, Congressional intent, and national energy policy support the use of oil and gas in cogeneration facilities." Finally, DOE has recognized that a balanced

mixture of oil and gas-fired cogeneration facilities (as well as facilities using other fuels) could produce energy conservation savings of close to 4 quads in the 1990's.

Therefore, the energy tax credit for cogeneration equipment should be granted for certain oil or gas-fired cogeneration systems. Specifically, the tax credit should be provided for oil or gas-fired cogeneration systems that have been granted an exemption from any of the prohibitions of the Powerplant and Industrial Fuel Use Act. For smaller facilities not subject to the prohibitionary features of the FUA, relief from the oil and gas limitation should be provided for such facilities where they operate at certain efficiency levels, or achieve a specified level of energy savings.

Public Utility Property Exclusion

The Energy Tax Act of 1978 created a number of business energy credits to supply a tax incentive for taxpayers to conserve energy and to convert from the use of oil and natural gas to alternative forms of energy. However, public utilities were excluded from the class of taxpayers eligible for such tax credits.

The provisions of the bill would delete the application of Section 48(1)(3)(B) of the Internal Revenue Code with respect to energy property used by public utilities for cogeneration facilities. The application of Section 48(1)(3) with respect to other forms of public utility property would remain unchanged. To make this and other business energy tax credits useful, the December 31, 1982 termination date should be extended to December 31, 1990 for these business energy tax credits as provided elsewhere in the bill.

Although a provision providing energy tax credits for public utility property was originally contained in both the House and Senate versions of the Energy Tax Act of 1978, this provision was deleted in the Conference Committee on the Act. The reasons for the deletion, while apparently based in part on the belief that the energy tax credits are not cost-effective with respect to public utilities (which are otherwise required to construct or to convert to coal facilities), did not take into account the stimulative effects the credit would have upon needed acceleration of conversions as well as new plant construction.

The end result of this most recent examination of the utility property exclusion during consideration in 1980 retains the exclusions under present law, and also makes public utility property ineligible for the energy credit on new types of property added in that bill, i.e. biomass property and cogeneration property, except for qualifying hydroelectric energy property. This most recent action is effective for qualifying investments after December 31, 1979.

## Treasury Regulations

Because of delay and uncertainty fostered by inordinate reluctance by the Treasury Department to issue proposed regulations for the business energy investment tax credits from the Energy Tax Act of 1978, a time schedule for implementing regulations is proposed. Under the provisions of this bill, the Department of Treasury would be required to promulgate proposed regulations to implement these modifications within 90 days after the date of enactment, and to promulgate final regulations within 270 days after the date of enactment.

## Cost Recovery Allowances

More rapid cost recovery allowances for business investments in energy conservation equipment for cogeneration facilities should be provided modeled after the Capital Cost Recovery Act (H.R. 1053) particularly regarding Class I property under the Act (ten year depreciation for buildings and their structural components) and Class II property (five year depreciation for equipment and other tangible personal property).

Thus, strong support is offered for proposals to increase capital formation through the comprehensive approach provided under the 10-5-3 plan for capital cost recovery. The benefits of this plan would directly accrue to cogeneration facilities owned and operated by either industry or public utilities through a reduction in the period for depreciating industrial electric and steam generating and distribution systems (currently from 17.5 to 26.5 years) or a reduction in the period for depreciating utility electric and steam production and distribution equipment (currently from 22.5 to 33.5 years).

## Industrial Development Bonds

This section would establish the eligibility of cogeneration equipment for tax-exempt financing through the proceeds of industrial development bonds. Thus, the industrial development bond exemption in Section 103 of the Internal Revenue Code should be made available for any cogeneration equipment that is eligible for the expanded cogeneration tax credit in this legislation. In this regard, it should be noted that the "double dipping" rules contained in Section 48(l)(11) of the Internal Revenue Code would prevent any potential duplication of benefits as a result of this suggested extension of the industrial development bond exemption to cogeneration equipment.

The availability of industrial development bond financing would provide an important incentive to the private sector, as well as provide necessary encouragement to governmental units and other tax-exempt groups which do not derive any benefit from business energy tax credits.

Finally, this provision would also specifically clarify that a cogeneration facility would satisfy the public use requirements of Section 103(b), even if the entire output of the facility is used by a single industrial or commercial user. This modification is totally consistent with the current treatment of pollution control equipment under the Code, and would ensure that the exemptions for industrial development financing provide the maximum range of benefits to cogeneration.

STATEMENT SUBMITTED BY
COOPERATIVE FOOD DISTRIBUTORS OF AMERICA
FOR SENATE FINANCE COMMITTEE CONCERNING
PROPOSED INCOME TAX LEGISLATION

Cooperative Food Distributors of America (CFDA), a nonprofit corporation functioning as a national trade association with its office located at 1910 "K" Street, N.W., Washington, D. C. 20006, respectfully submits this statement for the purpose of requesting your Committee to consider for inclusion in the income tax legislation which you will soon be drafting of certain provisions which are of direct concern to our members and their member-retailers.

I.

INTRODUCTORY STATEMENT

CFDA's members consist of approximately 67 retailer-owned wholesale food distributors operating approximately 85 warehouse distribution centers throughout the United States. These food wholesalers are owned by some 28,000 independent food retailers whom they supply with a wide variety of food and grocery products.

The basic objective of each of the wholesale organizations having membership in CFDA is to purchase food and grocery merchandise on a volume basis at the most economical prices obtainable and to resell such merchandise to their respective member-retailers. The typical member of CFDA operates on a cooperative basis in accordance with the provisions of Section 1381 through 1388 (subchapter T of the Internal Revenue Code), and distributes the profits earned by it to its member-retailers in the form of patronage dividends in proportion to the quantity or value of purchases made from it by each member-retailer.

Fundamental to the principle of operating on a cooperative basis is that all of the member-retailers be entitled to receive patronage dividends in a nondiscriminatory manner from their wholesale organization. Each member-retailer then reports his share of the wholesale organization's profits as distributed to him in the form of patronage dividends and pays federal income tax thereon.

CFDA recommends the adoption of three legislative changes in the Internal Revenue Code which it feels are necessary and appropriate in order to enable its members and their member-retailers to be able to compete effectively in today's economic climate and thereby allow consumers to continue to benefit from the cost savings which can ultimately be realized by them as a result of the economies to be achieved from the distribution of food and grocery products through the retailer-owned system. These three legislative changes consist of the following:

(1) inclusion in the proposed 10-5-3 depreciation legislation of alternative options which would permit retailer-owned organizations and others who might not be able to achieve the intended benefits of 10-5-3 to elect to use longer periods of time for depreciating their assets and the avoidance in any such legislation of any discrimination between owner-occupied and leased structures;

(2) simplification and modification of certain LIFO rules which now deter retailer-owned food and grocery wholesalers from adopting the LIFO method of accounting for inventories;

(3) extension of the time limit for making patronage dividend distributions of additional taxable income resulting from a determination of income made more than 8½ months after the end of the distributing corporation's taxable year.

The discussion which follows describes the problems which retailer-owned food and grocery wholesalers are concerned with in the case of each of the above tax situations and sets forth CFDA's recommendations for legislative changes to alleviate them.

II.

RECOMMENDED CHANGES IN PROPOSED
10-5-3 DEPRECIATION LEGISLATION

Problem:

If a retailer-owned food and grocery wholesale firm were required to use a 10-5-3 depreciation method for all of its owner-occupied buildings, its machinery and equipment, and its motor vehicles as proposed in both H.R. 1053 (the Capital Cost Recovery Act) and the Accelerated Cost Recovery System included in the President's tax legislation, it would have depreciation deductions in the early years of the lives of such capital assets which would significantly reduce its taxable income and also its patronage dividend distributions to its member-retailers during such years. Thus, because the member-retailers would receive substantially reduced or perhaps no patronage dividend distributions during the depreciation period, the incentive for the retailer-owned organization to make significant investments in capital assets would be diminished--a result which would be directly opposite to that intended by Congress.

Also, the leading proposals incorporating 10-5-3 depreciation would require stores and warehouses used by their owners to be written off over 10 years but would require that stores and warehouses occupied by lessees be depreciated over a longer period of 15 years. Although CFDA recognizes that the underlying purpose of such proposals is to encourage investment by owner-occupants and correspondingly to discourage investment in rental real estate by those investors primarily seeking a tax-sheltered vehicle for some of the funds which they have available for investment purposes, CFDA feels that such a discrimination between owner-occupied and leased structures would work to the distinct disadvantage of smaller business firms. The smaller firms particularly need the assistance of those investors who can lease to them the necessary physical structures for their stores or warehouse space because they are frequently unable to make the large capital outlays which larger firms can make.

Moreover, the owners of retail stores having membership in grocery and other types of retailer-owned wholesale organizations often find it desirable, for estate planning and other reasons, to separate

the ownership of their operating businesses from that of the real estate occupied by such businesses. For example, the family retail business may be structured in corporate form with shares of its stock owned by several members of the family (including the children who hope to be able to preserve the business and continue to operate it after the death or retirement of their parents), while ownership of the real estate is retained by the parents who lease it to the corporation operating the business and thereby realize rental income which can help to satisfy their economic needs during their retirement years.

Suggested Solution:

Any 10-5-3 or similar depreciation method adopted by Congress should provide for alternative options under which a taxpayer would be permitted to elect to depreciate a particular asset over a longer period than that which would be provided under the basic 10-5-3 method. In order to provide the maximum potential incentive for investment in assets which would otherwise qualify for the 10-5-3 treatment, it is submitted that separate elections of longer depreciation periods should be permitted on an asset-by-asset basis. Thus a corporation such as a retailer-owned food and grocery wholesaler investing in both a new warehouse and in a new piece of warehouse equipment in the same year could elect to depreciate the warehouse over a period of perhaps 30 years and at the same time use the 5-year period of depreciation provided for the equipment under the 10-5-3 method.

The allowance of an election to use a longer period of depreciation than that provided for under 10-5-3 for a particular asset would not only provide the flexibility desired and needed by some types of taxpayers such as retailer-owned food and grocery wholesalers but would also benefit the U. S. Treasury in that it would, to the extent any such optional period of depreciation were elected, receive additional tax revenues during the early years of the useful life of the asset.

With regard to leased structures, it is suggested that the same types of options as to the depreciation period should be permitted as are permitted in the case of owner-occupied structures. Any loss to the Treasury which might possibly result from such uniform treatment of leased structures and owner-occupied structures would probably be more than offset by the increased revenue which the Treasurer would realize if taxpayers were given the option of depreciating their capital assets over longer periods of time than those prescribed under the basic 10-5-3.

III.

RECOMMENDED CHANGES IN LIFO RULES

Problem:

In order to take advantage of the LIFO method for valuing inventories, corporations such as retailer-owned food and grocery wholesalers

operating on a cooperative basis are required to use a set of pools for LIFO purposes which often are different from the allocation units or pools into which they normally divide their inventories for the purpose of determining and allocating patronage dividends.

In addition, all taxpayers are now required, as a condition for electing LIFO, to restore inventory write-downs so that beginning inventory in the year of change is reflected at cost. Sometimes this restoration can create a substantial amount of income to be taxed during the year of change.

Furthermore, the development of a LIFO index, as required under the present LIFO rules, can be costly and time-consuming for a taxpayer, and is particularly disadvantageous to food and grocery firms which must operate with rapid turnovers of a large quantity of low profit margin products.

Another feature of the current LIFO rules which particularly affects corporations operating on a cooperative basis arises from the creation of annual additions to the LIFO reserve which cannot be distributed as patronage dividends because the current year's addition is not includible in the cooperative's income. If the members or patrons of the cooperative were never to change, such additions could be distributed upon the liquidation of the cooperative organization, but since members and patrons change continuously, it would be appropriate for the increases in the LIFO reserve allocated to a member or patron who ceases to do business with the cooperative to be distributed to such member or patron at the time the member or patron's business with the cooperative ceases. However, it is likely that under the present LIFO rules such a distribution would terminate the LIFO election for the remaining members of the cooperative.

Suggested Solution:

The following legislative changes are suggested in order to alleviate the foregoing problems which retailer-owned food and grocery wholesalers now experience with the LIFO rules:

(1) a cooperative should be permitted to adopt LIFO pools which conform to the cooperative's allocation units for the purpose of distributing patronage dividends;

(2) provision should be made for a 10-year period over which income arising from the restoration of inventory write-downs upon the adoption of LIFO can be spread;

(3) a taxpayer should be permitted to use, at its option, either an internally developed index or an externally developed index such as the Consumers Price Index or the Producers Price Index in order to reduce the administrative burden to which a taxpayer must be subjected if he is required to develop his own LIFO index;

(4) corporations operating on a cooperative basis should be allowed to allocate each year's increase in the LIFO reserve to their members or patrons in the same manner that they allocate the patronage dividends which they distribute to their members or patrons without such action having the effect of terminating the LIFO election for the remaining members of the cooperative. In the case of nonmember patrons, such a corporation should also be permitted to distribute to such patrons on a current basis the addition to the LIFO reserve allocated to them. In the case of a member of the cooperative, distribution of the portion of the LIFO reserve which has been allocated to the account of such member should be permitted at the time his membership terminates without any adverse effect on either the cooperative or its remaining members insofar as the LIFO election is concerned. This would be equitable since it would allow cooperatives and their members to receive the benefits associated with the LIFO method but would also require the immediate payment of the tax on his share of the LIFO benefit by a member or patron for the year in which he receives his distribution of such benefit.

## IV.

## RECOMMENDED CHANGES IN TIME LIMIT FOR MAKING PATRONAGE DIVIDEND DISTRIBUTIONS OF ADDITIONAL TAXABLE-INCOME

Problem:

Section 1382(d) of the Internal Revenue Code requires that a patronage dividend distribution which is deductible by a corporation operating on a cooperative basis and includible in the gross income for tax purposes of a member or patron of the cooperative must be made no later than the 15th day of the 9th month following the close of the taxable year during which the amount distributed was earned by the cooperative. However, situations frequently occur in which the Internal Revenue Service, upon an examination of the cooperative's tax return, determines that the amount of patronage-sourced income realized by the cooperative during the year for which the return was filed should be increased.

Examples of situations in which such a determination of additional taxable income may occur include those in which the Internal Revenue Service determines that an item of income should have been included in the taxable income of a cooperative for an earlier year than the year in which the cooperative considered it to be taxable income and those in which the cooperative has claimed an expense deduction (e.g., an addition to the bad debt reserve) in excess of what the Internal Revenue Service determines to be reasonable. In addition to increases in income occurring as the result of Internal Revenue Service examinations, the cooperative itself may discover at a later date that, through an accounting error, it failed to include all of its patronage-sourced income in its gross income on the tax return filed by it for a particular year.

Because of the payment period limitation prescribed by Section 1382(d), it is usually too late for the cooperative to distribute

such additional amounts of income to its members or patrons as deductible patronage dividends, with the result being that the cooperative must pay income tax on an amount which it would not have had to pay tax on if the correct amount of patronage-sourced income of the cooperative had been known prior to expiration of the prescribed payment period. This in turn creates the following additional problems:

(1) should the additional tax payment be charged against patrons for the year for which the cooperative's gross income has been increased or against patrons for the year in which the tax payment is made by the cooperative?

(2) if the allocation should be made to patrons for the year for which the cooperative's income has been increased, how does the cooperative allocate to a patron who is no longer a member of the cooperative or who no longer has an account with it the share of the cooperative's additional tax payment which should be borne by such patron?

(3) are the cooperative's patrons entitled to deductions from their respective gross incomes (or at least to setoffs reducing the amount of patronage dividend income to be included as part of their respective taxable incomes) for the portions of the cooperative's additional tax which are allocated to each of them?

(4) instead of allocating the additional tax paid by it among its patrons, should the cooperative instead charge such tax to its unallocated tax paid reserves?

Suggested Solution:

It is submitted that, except in the case of fraud with intent to evade tax or a willful failure to file an income tax return within the time prescribed by law, a cooperative organization should be allowed a special payment period within which to make a deductible patronage dividend distribution to enable it to avoid the tax liability which would otherwise be imposed upon it in cases where its patronage-sourced income for a given year is increased as a result of an adjustment made by the Internal Revenue Service or as a result of an accounting error on the part of the cooperative. This could be accomplished either by an appropriate amendment to Section 1382(d) of the Internal Revenue Code or by an amendment adding a new Section 1384 to the Code which would authorize the cooperative to obtain a deduction for a distribution of the additional income no later than 8½ months after the end of its taxable year in which the addition to income is made, without regard to the fact that the addition relates to an earlier taxable year.

Such an amendment could also provide for the issuance of regulations by the Secretary of the Treasury setting forth the procedure to be followed by a cooperative in order for it to become entitled to receive a deduction for an additional patronage dividend distribution made by it within the special payment period. The amendment could

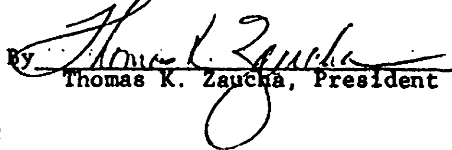
further provide that no such deduction can be obtained unless the patronage dividend distribution for which the deduction is claimed would have been eligible for deduction under Section 1382 of the Code if it had been made within the regular payment period as currently prescribed by Section 1382(d).

CONCLUSION

CFDA believes that the inclusion of changes in the Internal Revenue Code to alleviate the problems faced by retailer-owned food and grocery wholesalers and their member-retailers which have been outlined above is essential in order to enable such wholesalers and their member-retailers to be able to compete effectively under the highly inflationary conditions which characterize today's economic climate. It is our further belief that the adoption of such changes will at the same time benefit the consuming public by means of the additional economies which the changes recommended by CFDA can enable the wholesalers and retailers participating in the retailer-owned food distribution system to achieve.

Respectfully submitted,

COOPERATIVE FOOD DISTRIBUTORS
OF AMERICA



By Thomas K. Zaucha, President

Dated: May 19, 1981

STATEMENT OF WILLIAM H. DEMPSEY
PRESIDENT, ASSOCIATION OF AMERICAN RAILROADS

Mr. Chairman and Members of the Committee:

My name is William H. Dempsey. I am President of the Association of American Railroads, with headquarters in Washington, D.C. The Railroads which are members of the Association operate 92 percent of the line-haul mileage, employ 94 percent of the workers and provide 97 percent of the freight revenues of all railroads in the United States.

The Association of American Railroads testified on behalf of the railroad industry at this Committee's hearings last year. We supported efforts to improve depreciation allowances in the proposals then before the Senate, including the so-called 10-5-3 and 2-4-7-10 bills. We continue to support proposals which will accelerate depreciation and facilitate greater capital formation. As a very capital-intensive industry, improved depreciation methods are vital to the future of an efficient national rail system.

We cannot, however, support provisions for depreciating rail track structure as presently proposed in S. 683 by the Administration. This approach alters the treatment of railroad track which was contained in these earlier capital recovery proposals. It would also reverse tax accounting practices used by the railroads since the Federal income tax went into effect

and repeal a law passed by Congress just last December.

Public Law 96-613, passed by the Congress on December 13, added to Section 167 of the Internal Revenue Code, a new sub-paragraph (r) codifying the Retirement-Replacement-Betterment (RRB) method of depreciation of railroad track structure for tax purposes. Prior to enactment of this legislation, the RRB method has been recognized by this Committee and the Congress by inclusion in Sections 48(a)(9) and 263(f) of the Internal Revenue Code. The RRB method had also been accepted in every court in which it has been considered, including the Supreme Court, as an appropriate method of accounting for depreciation of railroad track serving clearly to reflect income for Federal tax purposes. The Treasury Department in Revenue Rulings (67-22, 1967-1 CB 52; 67-145, 1967-1 CB 54; and 67-285, 1967-2 CB 7) held the method to be appropriate for accounting for depreciation of track structures. Despite the foregoing long-time acceptance of this method, prior to last year's legislation, the Code itself did not expressly authorize use of the RRB accounting practice as an acceptable method of depreciation for Federal income tax purposes.

This bill, which was ultimately enacted into law, was introduced by Chairman Dole in June 1979, and co-sponsored by Senators Bentsen, Boren, Danforth, Heinz, Talmadge, Packwood, Wallop, Baucus, and Durenberger.

I would like to remind the Committee what this accounting method is, why it became necessary to seek last year's legislation, and why we were shocked to see that it is proposed in the Administration's bill to repeal the law the Congress passed last December.

At the outset, let me emphasize that the recent codification of RRB did not cause any revenue loss to the Treasury nor did it affect present or proposed regulations of the Interstate Commerce Commission or Securities and Exchange Commission.

For over 75 years, antedating the imposition of the Federal income tax, the railroad industry has depreciated its track under the RRB method of accounting prescribed by the Interstate Commerce Commission (ICC).

Under this method when additions to the track structure, such as new branch lines, are installed, the cost is capitalized. No depreciation is allowed on account of the capital investment until the branch line is either retired from service or its components are replaced. When the useful life of a 120-lb. rail, for example, is exhausted and it is replaced by a new 120-lb. rail, the cost of the new "replacement" is deducted as a depreciation expense. If the 120-lb. rail is replaced by a 130-lb. rail, the old rail is retired at the current cost of a new 120-lb. rail, and the difference between the amount and the cost of the new 130-lb. rail is capitalized as "betterment." When the track is taken up and not replaced, the track is "retired" and the amount lodged in the capital account representing the original cost plus subsequent "betterments" is deducted as depreciation expense.

The RRB method is a conservative method of reporting operating results. It is much like the last-in, first-out (LIFO) method of accounting for inventory, in that it is more sensitive to inflation than a ratable depreciation method based on historical cost because the current cost of replacing track

in kind is treated as a cost of operation. Because track components have long service lives, use of the RRB method tends to offset much of the inflationary cycle in contrast to a ratable method, which also recovers only original cost but over long periods of time. Thus we are talking about a matter of a "timing difference."

The industry became gravely concerned in 1979 because the RRB method came under review, for reasons other than Federal income tax, by the ICC and the SEC. The treatment of our track expenditure for regulatory purposes currently depends on the ICC accounting rules. A change in these accounting rules to provide for a ratable method of depreciation could significantly increase income for ICC purposes by reducing the current charge on account of depreciation expense. Industry specialists were concerned that such a change might cause the Internal Revenue Service to seek a similar change in the accounting for depreciation for tax purposes, even though financial accounting frequently requires the use of different depreciation methods than is allowed for tax purposes. The resulting reduction in depreciation expense would increase reported income and, consequently, Federal income taxes.

Ironically, a change in the accounting method would produce an illusory increase in income for book purposes, without any increase in cash receipts from railroad revenues. In fact, the cash flow from railroad earnings would be seriously reduced by the additional tax payments at both Federal and state levels. Given the insecure financial posture of the railroad industry, this cash drain would strike a disastrous blow to many railroads

which currently have insufficient earning and borrowing power to finance the replacement and upgrading of their track.

RRB is not attractive for use by any other industry because it permits no cost recovery for an entire life cycle of the asset or until it is replaced. To benefit from the RRB method requires that the taxpayer would have no recovery of his investment for the entire life of a newly acquired asset. When an industrial enterprise computing its federal income tax on any ratable method of depreciation places new plant or equipment in service, an allowance for depreciation commences immediately. The capital cost is recovered during the initial life cycle through depreciation in a period shorter than that which is available de novo under the RRB method.

In the recently passed Railroad Deregulation bill, the Congress found that earnings of the railroad industry are the lowest of any transportation mode and are insufficient to generate funds for necessary capital improvements. Furthermore, it was stated that by 1985, there will be a capital shortfall in the railroad industry of between $16 and $20 billion dollars.

The industry submitted testimony at this Committee's hearings last summer on the advisability of tax incentives for capital formation. This Committee is aware, I believe, of the needs of the railroad industry in this regard. I will not repeat this testimony but will merely state that this is no time to risk the possible diversion of very substantial sums from the industry to the Treasury.

The condition of its track is a matter of continuing

concern to the entire industry. The heavy increase in coal traffic generated by a national energy program which demands conversion to coal will increasingly necessitate ever greater track expenditures. Many railroad mortgages automatically create liens against after-acquired property. Generally speaking, the industry can create new debt only to acquire rolling stock, but cannot borrow to upgrade and maintain its track structure and therefore must rely on internally-generated cash flow. The inadequacy of sufficient cash resources has been the major reason for the development of deferred maintenance on some key segments of our national rail system. To reduce cash flow by requiring the use of ratable depreciation for tax purposes would be decidedly counterproductive.

Further, equity supports the retention of the RRB method. The only asset to which this method applies -- track -- is the counterpart of the asset supplied by public funds to competing modes -- highways, airports, harbors, channels and wharves. Any charges exacted for use of such facilities are currently deductible. To require the railroads to use their own capital and then to delay recovery of that capital over a long period would compound the inequity. The cash shortfall could only be recouped through increased freight rates, where competitively feasible, and lower service quality where higher rates are not possible.

The RRB method of depreciation, used consistently for tax purposes since the inception of the Federal income tax laws, clearly reflects income. As stated above, it has been recognized consistently by the courts as an appropriate method of depreciation

and has been accepted by the Internal Revenue Service and the Treasury Department. This consistent use is, in itself, an essential element in establishing that revenue is clearly reflected. The AICPA, in support of the RRB codification, reviewed the application of the method and concluded:

> "We believe that this legislation is warranted to formally recognize, as an acceptable method of depreciation, a procedure which is a historical tax practice of long standing in the industry. In general, we feel that accounting methods in any industry that have been acceptable for many years should be interfered with as little as possible. Resistance to such changes is helpful to tax simplification and stability. In addition, an effort to change the depreciation method for the common carrier industry would, we believe, be contrary to the important goals of stimulating capital investment and encouraging transportation which is consistent with energy conservation and development."

The continuation of RRB for tax accounting drew strong support last year from the financial community, the accounting profession, economists, rail shippers, the Transportation Association of America and the Interstate Commerce Commission. To our knowledge, none of these interests have changed their views.

We must object to Treasury's use of this major tax bill to repeal Section 167(r), so recently enacted by the Congress. Simply put, we are opposed to the stated provisions of S. 683 affecting depreciation of rail track because they would cause major increases in tax liabilities for many railroads, at least in the initial transition years. This consequence is hardly consistent with the main thrust of the bill, which is to liberalize depreciation and thereby increase investment in capital assets.

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The proposed provisions relating to RRB were apparently drafted by Treasury officials without any input from the affected railroads. We are unaware of any comprehensive study made by the Treasury to ascertain the financial results of the proposal to eliminate RRB on the 25 railroad systems comprising over 90 percent of the industry.

As drafted, the proposal offers no guidance on what types of track expenditures would be capitalized and what types of expenditures should be expensed. Each and every time in the past decade when a change from RRB has been explored, this critical question has been raised. It has remained unresolved, and this proposal does nothing to allay our fears on this score.

What track expenditures will be expensed in one year and what proportion will be written off over five years is obviously a primary determinant in calculating whether a changeover will be practical or whether it will cause huge losses to the industry. Hundreds of millions of dollars hang in the balance. Absent knowledge of IRS's future interpretations, the process of evaluating the effects of a changeover becomes highly speculative and sure of litigation. In this uncertain environment, it is no wonder railroads oppose change from a tried and understood system to one that is so uncertain.

Similarly, the changeover could cause very significant losses in investment tax credits by the railroads under the proposed scheme of depreciation.

Finally, the treatment offered most industries under this proposal gives faster depreciation schedules than presently

exist and phases in those improvements over five years. For railroad track, the bill would require slower write-off periods for the majority of track expenditures and implements those adverse changes immediately in the first year. While some track expenditures could be depreciated much faster, the one-year changeover would cause huge cash losses in the initial years. Even if the other defects were remedied, a less costly transition seems imperative. The hope of long-run gains will be of little solace to some railroads if they cannot maintain at least their current, beleaguered, financial posture until those gains materialize.

We do not believe all of these defects can be cured in a short time, even if the Administration was to commit itself to accepting all of the necessary remedies. And we are not sanguine about the satisfactory resolution of these issues, given the many years some have laid unresolved. In any event, an agreement on these points would mean that the legislation would have to be substantially rewritten and expanded to cover these legitimate concerns. It would be more prudent, we believe, to exclude RRB from this legislation and deal with it at a later date, _if_ these issues can be dealt with in a fair and non-injurious manner to the railroad industry.

Since we first became aware of the Administration's intent to repeal RRB, we have had several discussions with Treasury officials. They indicate that they would like to see railroads switched to a more conventional system of track accounting for tax purposes and believe such a system could be fashioned to

produce greater benefits to the industry, similar to the overall improvements they are seeking in this legislation for other industries.

Last year we pledged to work with the Treasury Department to find such a system. We remain willing to cooperate with Treasury to develop an alternative that provides more incentives for capital formation than does RRB. But the present proposal provides less incentives and would cause dramatic, initial losses to a number of major railroads.

We respectfully request that the treatment of RRB be retained in the form contained in either the original 10-5-3 proposal (reintroduced by Senator Heinz as S. 287), or the 2-4-7-10 proposal (reintroduced by Senator Bentsen as S. 317 and Senator Long as S. 394). In the alternative, the elective treatment accorded the unit-of-production method in S. 683 should be accorded to the RRB method.

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STATEMENT OF FORD MOTOR COMPANY TO THE
COMMITTEE ON FINANCE, UNITED STATES SENATE
RELATIVE TO ITS CONSIDERATION OF
TAX ASPECTS OF THE PRESIDENT'S ECONOMIC PROGRAM
ON MAY 19, 1981

Ford Motor Company welcomes the opportunity to comment to the Finance Committee on the Administration's program for economic recovery. We support the Administration's economic proposals in general and its tax proposals in particular. The Administration and most other segments of opinion recognize that present depreciation and other capital formation aspects of the Tax Code are insufficient to meet the country's need for increased productivity and jobs.

We have a few suggestions concerning the tax measures proposed by the Administration through its Accelerated Cost Recovery System (ACRS) which are discussed in some detail below. They relate to the investment tax credit, the cost recovery period for special tools and the treatment of foreign assets.

Investment Tax Credit

Proposal. Ford favors making investment tax credits available to all businesses, regardless of profitability, either by a current payment in cash, or by an extended carryback period.

Purpose of the ITC. It is quite clear that the investment tax credit is an incentive in the tax law designed by Congress to promote investment in modern machinery and equipment so as

to increase productivity and provide jobs for the country's work force. Precisely the same purpose would have been served had Congress originally provided for an incentive payment from the Treasury entirely apart from the tax system. The credit was not enacted until 1962, so it obviously had no part in the determination of classical net income. Depreciation is the traditional method of recovering investment in business property. The history of the ITC established its purpose as an economic regulator--it was suspended, reinstated, repealed, re-enacted and subjected to numerous rate changes, all intended to meet the economic goals of the moment.

How the ITC Can be Made More Effective. Ford supports utilization of the ITC by all businesses when earned, regardless of profitability, through treating otherwise unuseable ITCs as a refundable overpayment of tax ("refundability"), or by permitting their use as a credit against past tax payments on a basis more extensive than the 3-year period provided by present law ("expanded carryback"). The reason for this position is that the ITC is not now achieving, across a significant spectrum of American business, its intended purpose. The situation of the automobile industry illustrates the need clearly. At present, if Ford purchases a new machine, it must pay 100¢ on the dollar, whereas GM, our chief competitor, pays only 90¢ after application of the investment tax credit. Most other auto companies are similarly disadvantaged compared to GM.

The air transport industry, steel, railroads and other important basic industries, because of low profitability, cannot use all of their investment tax credits and have "solved" this problem, in part, by turning to leveraged leasing, which is an economically inefficient device to transfer the ITC to others, with some part recovered as reduced rentals.

If the ITC is to achieve its purpose, then it seems to us that it must be made refundable, or otherwise available, to those large sections of basic industry which presently experience its intended incentive effects only in small part, if at all; i.e., autos, airlines, steel, railroads, mining, and paper.

Revenue Aspects of Refundability. Revenue cost to the Treasury is a proper consideration in evaluating any proposal affecting the tax law. The estimated ongoing benefit to the automotive industry of ITC refundability could be an aggregate cash flow gain in the range of $250 million per year so long as the depressed state of the industry continues. The all-time loss to the Treasury would be much less, however, since most of the credits should, in any event, ultimately be used by the industry as the result of restored profitability during the authorized carryover period. The end loss to the Treasury, therefore, would be largely in terms of cash flow--not the full amount of the credits. As to unused excess credits from investments in prior years, the revenue loss could be

limited if it were considered impractical to allow their full current availability. "Feedback revenue" resulting from the use of refunded ITCs would further diminish their cost. The Treasury should have no financial objection to refundability, since a Treasury spokesman recently stated that the Treasury's projected cost of investment tax credits was always based on the assumption that they would be fully used.

Refundability Not a Bailout of Failing Businesses. Some opponents argue that refundability would be a Government handout to inefficient and failing businesses which should be allowed to die under our market system. This contention requires consideration of the industries that would now profit most from refundability: automotive, airlines, steel, railroads, mining, and paper. These are strong industries that are essential to our continued national well-being. Although depressed, they are not failing. A further answer to these opponents is that in order to earn 10¢ of credit, one must invest $1.00 in machinery and equipment. It is hardly likely that anyone will invest $1.00 in a failing business in order that it may receive 10¢ of investment tax credit. That is to say, the investor providing the $1.00 will do so only after judging that the company is not failing.

Cash Payments Under the Tax Law. There is much to be said for the viewpoint of those who believe that the tax law should be used for raising revenue rather than for the pro-

motion of public policy goals. The fact is, however, that the tax law is used extensively for this purpose. Illustrative are tax deductions for charitable contributions, general and targeted jobs credits, deductions for the conservation of historical structures, exclusion of benefits and allowances for military personnel, and credits for energy conservation.

Leveraged Leasing. Spokesmen for the leveraged leasing industry have argued that refundability is unnecessary because much of the benefit can be realized by the user of qualified ITC property through "leveraged leasing." The existence of the leveraged leasing industry is a strong argument for ITC refundability or expanded carryback. Leveraged leasing is an inefficient method of passing only a portion of the credit to a business which would receive the full amount if there were a tax liability against which to credit it--or, if there were refundability. Through the leasing device, the full credit is taken by the lending company with part of it being passed back to the substantive business as a rent reduction. The balance goes to the leveraged leasing company in the form of profits and overhead. This appraisal is confirmed by the article entitled "Leveraged Leasing: Is It Really Necessary?" by George Brown in the Equipment Financing Journal for January/February, 1981. Mr. Brown, President of Babcock & Brown, an investment banking firm specializing in leveraged leasing, makes clear that the procedure is a contrived and inefficient

method of doing indirectly what Congress should permit by direct authorization.

Expanded Carryback of Investment Tax Credits. The most efficient and feasible alternative to refundability of ITCs would be to extend the present 3-year carryback period to 10 years and possibly increase the percentage of tax liability against which the credit could be applied. The expanded carryback would, as to Ford, have substantially the same effect as refundability. It would also satisfy any "philosophical" objection to refundability of those who argue that there should be no such benefit from the Government unless there has been an equal or greater tax payment by the recipient.

There are a number of legislative precedents for extended carrybacks, among which are the 10-year carryback for product liability losses, the 10-year carryback for losses of financial institutions, the 10-year carryback losses of a Bank for Cooperatives and the now repealed provision for a 5-year carryback of losses sustained by a taxpayer for which certification had been issued under the Trade Expansion Act of 1962.

Industry Position. The Motor Vehicle Manufacturers Association, composed of Ford and other domestic manufacturers of motor vehicles, has urged that the ITC be made currently available to all in the industry without regard to profitability. The Association, like Ford, strongly supports improvement in

capital formation through the tax system, and views ITC refundability as a meaningful and complementary improvement to ACRS.

Special Tools

Special tools (dies, jigs, fixtures, patterns, gauges, etc.) are a very large part of total automotive investment in capital goods. Their special character and short life are recognized under present tax law, which allows a 3-year average recovery period. The Administration's ACRS does not recognize their unique character and lumps them in a 5-year category with very long-lived property of such enterprises as steel, atomic power plants, other public utilities and supertankers, while allowing them only the same 10% ITC. The result is clearly discriminatory compared to such long-lived property, and gives very little improvement over their current tax treatment. The economics and equity of ACRS would be better served if special tools were assigned to the 3-year category and given the full 10% investment tax credit.

Foreign Asset Depreciation

The proposed depreciation treatment of foreign assets would be less favorable than under current law because of a proposed extended straight-line depreciation system. Special tools would be particularly hard-hit by this treatment since it would compound the depreciation loss resulting from their being moved from a 3-year recovery period to the 5-year category,

as discussed above. We are not suggesting that foreign assets be given the same treatment as domestic property, but we do urge that they be accorded depreciation no less beneficial than at present. This would provide adequate safeguards for the Treasury while avoiding what we understand to have been an unintended penalty.

Conclusion

Ford favors making investment tax credits available to all businesses because this would extend at least part of the benefit of an expanded capital formation system to those who, through low earnings or losses, could not otherwise use their investment tax credits. Even with refundability or expanded carryback these depressed businesses would remain competitively disadvantaged because of their inability to use increased depreciation deductions. Ford has earned its investment tax credits by buying modern machinery and equipment. We are pressing for ITC refundability or expanded carryback in order that we may use the cash flow represented by these credits to help finance the immense ongoing investment in capital goods which is essential to our future profitability and the country's welfare.

2 Winnifred Street
Bay Shore N.Y. 11706
May 21,1981

Robert E.Lightizer
Senate Finance Committee

Dear Mr.Lightizer

I would like this statement to be included in the record. With tax relief the theme of this administration, any act of levying a tax on fringe benefits is unthinkable. Gentlemen, the past four years of double digit inflation has eroded the economic stability of this nation.

Gentlemen, I implore you to intervene on my behalf and thousands of my colleagues, to ban any IRS proposal for taxation the fringe benefits of air transportation personnel. I hope by being sympathic to my positon, you will do everthing in your power to defeat this proposal.

Sincerely

George D. Hitt

## Statement of Luis L. Granados, Legislative Counsel, the ESOP Association of America

Mr. Chairman, my name is Luis Granados. I am the Legislative Counsel of The ESOP Association of America, and I appreciate the opportunity to share our views on the President's tax bill with the members of the Committee today. The ESOP Association is the national trade association of companies with Employee Stock Ownership Plans, or "ESOPs." Our 500 members are dedicated to the spreading of this exciting new concept that holds the potential of dramatically improving the performance of the American economy. As the name implies, the ESOP is a plan for providing corporate employees with shares of stock in the companies for which they work. Typically, the stock is provided at no cost to the employee. Today I will address subjects different from those discussed at the Committee's hearings last summer.

The attention of the nation is now focused on the Congress, and in particular upon this Committee, as you grapple with the vexing problem of how to cut taxes in such a way as to improve our national rates of productivity and investment and thereby restore vitality to the economy. There is little disagreement over the need to achieve these goals. The trouble is that all of the proposals for stimulating investment and productivity, Republican and Democratic alike, suffer from a pronounced skewing of their benefits toward the upper end of the income scale. We do not share the paranoid view that this is some sort of attempt by the evil capitalists to "rip off" working people and the underprivileged. Rather, we view these proposals as the logical consequence of a widely-accepted but utterly false premise. That premise, simply stated, is that capital investment is the exclusive province of the well-to-do. The only way to increase investment, so the theory goes, is to cut taxes for the rich, so they will have more to invest. It is not hard to see why everyone assumes that premise to be true. After all, statistics show that 1 percent of the American people own over half of all individually held stock, and 6 percent of the people own almost three-quarters of it. But the most important thing I have to tell the Committee today is that the premise itself is wrong. There are ways to increase the investment of average working people, and the ESOP is one of them. The ESOP creates a substantial capital stake for each of its participants, and it does so according to the non-discrimination rules of ERISA to provide all the assurance necessary that workers of all income scales within the firm will get a chance to become capitalists.

A hundred years ago, America was faced with the problem of how to finance the opening of the West. One alternative would have been government ownership of the land, with millions of civil servants hired to till it. That is the socialist alternative, which we wisely rejected. Another alternative would have been simply to sell it to the highest bidders, which undoubtedly would have resulted in the carving up of the West into vast feudal baronies owned by a handful of wealthy Easterners or Europeans. The owners then would have hired millions of serfs to work the land, people anxious to find any kind of income to support their families, people never given a real chance to become owners of the land.

Instead, thanks to the wisdom of President Lincoln, we developed the Homestead Act of 1862, giving every American the chance to become an independent capitalist. The result was an economic boom of unheard-of proportions, propelling America from insignificance into a position of world economic leadership. And we did all that without <u>any</u> inflation.

Today, this Committee faces the same three alternatives in deciding how best to stimulate the financing of our new industrial, or some would call it post-industrial, frontier. One alternative is government ownership; I trust that this Administration has the good sense to see the pitfalls in that approach. The second alternative, which unfortunately seems to be embodied in both the Administration's proposal and in the leading Democratic alternatives to it, is to give tax breaks to the wealthy so that they can invest in projects to employ millions of "wage-serfs" seeking to support their families in any way possible, who have never been given the realistic chance to become owners of the projects themselves. The ESOP Association believes that we should recognize the wisdom of President Lincoln, and develop an "Industrial Homestead Act", structuring tax reductions in such a way as to cut millions of American workers in on a "piece of the action" of the capital expansion that we need over the remainder of this century. The ESOP presents a practical, non-adversarial way to do just that. Before his election, President Reagan had spoken out in favor of such an "Industrial Homestead Act" to stimulate ESOP financing. We haven't heard much about it since, but we hope the prodding of this Committee will refresh his recollection of a plan that has always enjoyed strong bi-partisan support.

Furthermore, even aside from considerations of justice and equity, there are some very practical reasons to include ESOP provisions in this tax bill if what you are doing is trying to improve productivity. Study after study has borne out the common-sense notion that when you give a worker a meaningful piece of the action in the company for which he works, he will become more profit-conscious, and will improve his productivity. The best such study, done by the Survey Research Center of the University of Michigan, indicated that when you compare firms with substantial ESOPs to similar-sized firms in similar industries, the ESOP firms have profitability rates 50% higher. That study also showed that the key determinant of profitability is how much of the company the employees own. The higher the percentage owned by the employees, the higher the profitability.

Mr. Chairman, the President claims that his accelerated depreciation program will improve productivity by making it tax-advantageous for firms to purchase more new equipment. He is probably right. But he is also missing something — the human factor of productivity. The shiny new machine isn't going to produce very much on the days its operator shows up for work drunk. Or on those days when a green trainee is trying to work it, because the man who used to work it quit and went somewhere else.

Not long ago I heard a noted economist say that his profession could explain about half of the decline in productivity growth as a failure to modernize equipment, but that he could not explain the other half. I believe that anyone who knows people who punch a clock every day could give him a clue. More and more these days, the wage-serfs — especially the younger ones — just don't seem to give a damn. The ESOP is not the total answer to this problem; but it is a part of the answer. We cannot expect workers to care about productivity if there is nothing in it for them. And we cannot expect a tax plan that fails to take this into account to do very much about productivity — no matter how many shiny new machines it generates.

How, then, can Congress amend this tax bill to bring about not only more investment, but more broadly-owned investment, to make our economy more just and more productive? I would commend to your attention the "Expanded Ownership Act of 1981," to be introduced shortly by Senator Russell Long. This bill, which is an enlarged version of the "ESOP Improvements Act" already introduced by Mr. Frenzel, contains a number of provisions that will accomplish this objective at minimal cost to the government:

1. It makes the additional tax credits for TRASOPs provided by IRC Section 46(a)(2)(E) permanent. These credits are now scheduled to expire at the end of 1983, which would be extremely unfortunate. They have provided millions of working people with at least a taste of ownership, and they deserve to be continued.

2. It establishes a "payroll-based" tax credit of up to 1% of participants' compensation for contributions to a TRASOP. This would equalize the tax treatment between capital intensive and non-capital intensive firms, and allow millions more workers to obtain the advantages of the TRASOP.

3. It would amend the TRASOP provisions to permit a distribution of stock to continuing employees (without regard to the present 84-month rule) in the case of the divestiture of a subsidiary or division by the parent corporation maintaining the TRASOP. This would correct a technical problem which has denied TRASOP benefits to many workers.

4. It provides a deduction for cash dividends paid on employer stock held by an ESOP or TRASOP if those dividends are distributed in cash to the participants. It would also treat these distributions as dividends for purposes of the present dividend exclusion. I can think of no step the government can take to make the ESOP work better in terms of motivating employees to improve productivity. It is one thing to tell a worker that he is going to get some stock someday, but it is much more effective actually to pay him a substantial dividend on that stock, based on the company's profit performance. Companies that choose to compensate their employee-owners with dividends rather than strictly with wages should not have to suffer a tax penalty for doing so.

5. It permits charitable treatment for gifts and bequests to ESOP for purposes of the income, estate, and gift tax laws. Many owners would like to leave something to the people who helped them to build their fortune, but the tax laws effectively prohibit them from doing so. This provision would correct this injustice, and probably create millions of independent capitalists in the process.

6. It would exclude from current taxability the first $25,000 of a lump-sum distribution from an ESOP, treating it instead as long-term capital gain upon subsequent sale of the stock. If we are to pursue a conscious policy of broadening capital ownership, then it does not make sense to tax it away as soon as the person receives it! This provision would help to rectify this problem.

7. It would allow "legitimate" nonvoting common stock to be acquired from a shareholder who had held it for at least two years, thus making the ESOP a more flexible device for firms which are partly capitalized with nonvoting stock.

8. It would increase substantially the contribution limits for employer contributions to an ESOP. These limits not only hinder the growth of employee ownership, but they have the unfortunate effect of occasionally cutting back the size of the regular pension plans that a company with a large ESOP can have.

9. It would end the current discrimination in the tax law in favor of conglomerate mergers and against sales of businesses to ESOPs, by permitting "tax-free rollover" of the gain on the sale of small business stock to an ESOP. An owner who trades his shares for conglomerate shares is not taxed at all, until such time as he sells the conglomerate shares acquired in the deal; but if the owner chooses to sell his shares to an ESOP, even if he goes ahead and reinvests the proceeds in another small business, he still must pay the full capital gains tax right away. That is not sound tax policy, and this bill would correct it.

10. It would permit a Subchapter S corporation to set up an ESOP. There is no justification for the present law's prohibition against such a transaction.

11. It would permit the ESOP to "assume" an owner's estate tax liability, in return for an equivalent amount of stock from the estate. The ESOP then would have the right to pay the tax in installments over a several-year period, just like estates can under IRC Sections 6166 and 6166A. This provision should actually result in a revenue gain for the government, both because the installment payment period is shorter than that of Section 6166 and because the ESOP, backed by a corporate guarantee, will frequently be a more reliable source of payment than will the widow or other family members who have no interest in keeping the business alive. This one proposal would stimulate the creation of thousands of new ESOPs, at no additional revenue cost to the government.

12. It would permit a mandatory "cash-out" of ESOP benefits (without the right to demand stock) when 100% of the employer's stock is owned by the ESOP or where the corporation's charter or by-laws limit ownership of stock to current employees. Congress ought to be encouraging firms to structure themselves in this way, and not effectively preventing them from doing so by prohibiting "call" options in these cases.

13. It would revise the present "put option" provisions to require a 60-day option period following distribution and another 60-day period in the following period. Current put-option law is too generous to terminating participants, which only works to the detriment of the participants who remain in the plan.

14. It would make it easier for banks to set up ESOPs, by taking into account the legal restrictions they are under involving repurchase of their own stock. Participants in such plans would still be entitled to cash distribution rights.

15. It would clarify the treatment of ESOPs under "cafeteria plans," enabling more employers with such plans to extend ESOP benefits to their workers.

As I said at the outset, I appreciate the opportunity to share these thoughts with the Committee today. You have an extraordinary opportunity to seize upon the ferment in economic thought and move ahead with a bold program of broadening the ownership of productive capital. At the very least, a part of the tax bill before you should be devoted to improving the atmosphere for broadened ownership in America today. I hope that you will make the most of your opportunity.

**WRITTEN STATEMENT OF CARL E. HATHAWAY
PRESIDENT HATHAWAY & ASSOCIATES, LTD., SUBMITTED TO
THE SUBCOMMITTEE ON SAVINGS, PENSIONS AND INVESTMENT
POLICY OF THE UNITED STATES SENATE COMMITTEE ON FINANCE.
MAY 18, 1981.**


SUMMARY SHEET

Tax Deferral of Reinvested Dividends (S. 141 and H.R. 654) is focused legislation which effectively and simultaneously addresses the following problems in this manner.

Problem: Lack of individual savings and investment - Americans save an average of only 5.6% of their income, while the French save an estimated 15.5%, Canadians 10.3%, West Germans 13.2%, Britons 15.0% and Japanese a healthy 26.0%.

Solution: The legislation:

is a direct stimulus for individual savings and investment - dividends must be automatically reinvested and not used for consumption, thus the effectiveness is essentially guaranteed;

benefits the small shareholder - is not a "fat cat" bill; and,

increases participation in dividend reinvestment plans which in 1979 provided nearly $2 billion in common equity, approximately 24% of all equity capital raised. (Estimated effect of enactment of this legislation is a two-to-three fold increase in participation.)

Problem: Deterioration of corporate balance sheets - the ratio of corporate long-term debt to short-term debt continues to decline, reaching a record low of 2.6 to 1 in 1980. The interest expense of corporations equalled a record high 45% of net profits before taxes in 1980, as compared with only 14% for the 1960's.

Solution: The legislation:

is an instantaneous, direct, cost-effective means of creating much needed equity capital that will aid in improving corporate balance sheets by reducing the burdensome reliance on debt capital;

is targeted legislation - the benefit accrues to those companies that need external equity the most to improve their financial condition, it would particularly help a wide range of companies including those in capital intensive industries; and,

would begin to eliminate both the tax bias favoring the issuance of debt rather than equity and the double taxation of dividends.

Problem: The inter-relationships between inflation, declining savings, and productivity rates produce financial instability, high unemployment levels, and unsatisfactory economic growth.

Solution: The legislation:

will lead to increased investment and productivity by U.S. corporations, create new jobs, and thereby be a help in the control of inflation;

has broad based support from labor, pensioners, industry, economists, rating agencies and regulatory bodies; and,

currently has over 160 sponsors or cosponsors in the United States Congress.

## DIVIDEND REINVESTMENT PLANS ARE AN EFFECTIVE STIMULUS FOR INDIVIDUAL SAVINGS & INVESTMENT

Hathaway & Associates, Ltd.[1] believe the best individual incentive before the Congress which will result exclusively in increasing personal savings and the supply of equity capital is the tax deferral of reinvested dividend proposal (S. 141 and H.R. 654). That is, an individual can only receive a tax benefit if the dividend is automatically reinvested in an original issue dividend reinvestment plan (DRP).

DRP's allow the participants to automatically reinvest their cash dividends in common shares of the company. The shareholder notifies the company of a willingness to participate in the plan, and then instead of receiving cash dividends, the shareholder receives an equivalent value of common stock. This provides a simple, convenient, systematic method for investors to increase their equity investment in the company. Since the expenses incurred for original issue plans are commonly absorbed by the company, DRP's are also an inexpensive means of individual investment.

1 Hathaway & Associates, Ltd. is engaged in the management of large sums of pension monies for major U.S. industrial corporations. Mr. Carl E. Hathaway and Mr. Stephen K. Laird are the principals of Hathaway & Associates, Ltd. Both Mr. Hathaway's and Mr. Laird's entire business expeirence prior to the formation of Hathaway & Associates on April 1, 1981 was with the Morgan Guaranty Trust Company of New York. Together they had thirty-three years of involvement with the management of employee benefits funds. Mr. Hathaway had been Senior Vice President in charge of pension investments at Morgan since 1969. Mr. Laird had been a Vice President and group head of Morgan's research department. The Morgan Bank's pension assets under management aggregated $18 billion at the end of 1980 and represented the largest sum of ERISA type monies managed by a single organization.

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Many companies have added several additional attractive features to their plans. These plans issue stock through DRP's at a discount from the market price, typically five percent (5%). In addition, many plans permit investors to contribute limited amounts of additional cash to the plan, typically $25 to $1,000 per quarter.

Because of the relatively high transaction costs associated with small investments, most cash dividend payments to individuals have historically been used for consumption rather than investment. By eliminating the transaction costs and making the reinvestment of small dollar amounts of dividends automatic and convenient, new issue DRP's encourage small investors to increase their savings and investment. In addition, by channeling these funds from consumption into investment, the plans have an anti-inflationary effect on the economy.

## DRPs WORK

Dividend reinvestment plans have proven to be a popular investment vehicle. During the past five years, investment in DRP's has nearly quintupled. In 1979 alone, nearly $2 billion in new equity capital has been raised through DRP's (Chart A). This amount represents 24% of all new common stock issued that year. Chart B illustrates that over the past five years, dividend reinvestment has grown to be a significant source of new equity capital. It has increased from 5% of all common equity issued in 1975 to over 24% in 1979.

An immediate significant result of the tax deferral proposal is that it would increase the flow of reinvested dividends into existing dividend reinvestment plans. Nearly 200 companies currently have original issue plans with more than two million investors participating. Enactment of the legislation would encourage other corporations requiring common equity capital to form these types of plans and it is reasonably estimated that participation in the plans would increase two to three fold.

DRP's BENEFIT THE SMALL SHAREHOLDER

DRPs have a particular appeal to small investors who constitute the vast majority of current participants. A recent survey of several companies having DRP's indicates that over 75% of all participants hold fewer than 200 shares of the company's stock (see Chart C). In fact, at General Telephone & Electronics (GTE) 93% of all participants own 200 shares or less (see Chart D).

Conversely, participation among investors with large shareholdings is very modest. Of registered GTE shareholders owning more than one thousand shares, only six percent participate, and they comprise less than one-half of one percent of the total plan participants. By limiting the deferral to $1,500 per individual and $3,000 per joint return, the proposal does not provide a new tax benefit to the high-bracket taxpayer. These investors can currently minimize their taxes by investing

in low dividend/high growth companies or in tax-exempt securities.

## DRP's WILL IMPROVE CORPORATE BALANCE SHEETS

The capital structure of U.S. industry is weaker now than at any time in history. In the 1980's there will be an extraordinary demand for equity capital to meet future requirements and to offset the huge amounts of debt incurred by industry in the 1970's.

There is little dispute that the current flow of investment funds into the United States industry is inadequate -- whether measured by comparison to the savings rate in other industrialized natures such as Japan or measured by the historical percentage of GNP or any other method. There has been a severe lack of equity investment in the U.S. over the past several years (see Chart E). This increased reliance on the use of debt capital has deteriorated corporate balance sheets to record lows. Increased dividend reinvestment will significantly help to alleviate this very serious deficiency.

DRP's have important advantages for the issuing companies. The relatively low issuance costs of DRP stock make the plans the most cost-effective means of raising common equity capital. The plans provide a relatively stable, assured, and continuous flow of new equity capital, thereby enabling companies to reduce the number and size of public equity offerings and the associated downward pressure on the market price. The market

has demonstrated an ability to accept a small steady stream of new common stock without a significant impact on the market price while an equivalent number of new shares issued at one time in a public offering could result in a significant decrease in the stock price.

By strengthening their equity base, DRPs provide a means of improving the competitive capabilities of these companies. The benefits of the improved capital base have been noted by several credit rating agencies, including Moody's Investors Services, Inc., Standard & Poor's Corp., and Duff and Phelps, Inc., who have stated that the use of DRP's could lead to improved credit ratings for the firms. An improved credit rating results in a lower cost of debt for the company which in turn results in lower cost for the goods and services produced. This would contribute to reduced inflation, increased productivity, and improved internatonal competitive strength.

In addition to the credit rating agencies, the National Association of Regulatory Utility Commission (NARUC) has also endorsed DRP's because of the favorable long-term impact they feel it will have on the cost of capital.

DRP's BENEFIT THE NEEDIEST CAPITAL USERS

Double digit inflation has increased the debt problem for all companies, especially those in capital intensive industries. For these companies the demand for equity capital is exacer-

bated by a continuous need for external capital, high cost of capital and the investor's demand for large cash dividends.

Capital intensive industries have suffered from a declining equity/debt ratio in recent years. These industries include public utilities, airlines, banking, primary metals, etc. The erosion of corporate balance sheets to record lows coupled with low profitability has resulted in these industries experiencing increased difficulty in raising their ever increasing external capital needs to maintain and improve service and increase productivity.

Capital intensive industries provide the basic strength of America's industrial infrastructure, and equity is the supporting beam in their financial strength. Therefore, greater availability of external equity capital is critical in order to provide the revitalization needed to increase productivity, meet service demands, and counter foreign competition. Because of the difficulty in obtaining external equity capital, these industries have been forced to limit capital investment, or finance significant segments of their needs through debt. This increased debt burden has increased the riskiness of these companies and has contributed to depressed equity prices. As a result, nearly all bank and public utility stocks are currently selling below book value.

DRP's will provide equity, particularly to these capital-intensive industries, which is the most assured method of increasing productive assets in the U.S.

## TAX LAWS DISCRIMINATE AGAINST CASH DIVIDENDS

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 Roger G. Ibbutson and Rex A. Sinquefield, it was shown that dividends provided more return to investors than they received through price appreciation. Unfortunately, the tax code discriminates against dividends in favor of capital appreciation.

Traditionally investors in the stock of most capital intensive industries have sought a high dividend yield. Because of the substantial portion of shareholders who invest in these type of securities for income rather than capital gains, many of these companies have always maintained a high dividend payout ratio. Thus, while a non-capital intensive company may provide a return to investors through growth - on which taxation is deferred until sale and then based on capital gains rates - the return on investment of stockholders of capital intensive companies, in the form of dividends, is taxed as ordinary income.

This discrimination is seen most clearly by comparing the after tax return of stockholders who receive only stock dividends which are not subject to immediate taxation, with that of stockholders receiving the same equivalent cash dividend which is subject immediately to ordinary income tax rates. This situation has been exacerbated by the "tax bracket creep" caused by continued inflation and the lowering of the capital

gains tax rate. The theoretical calculations in Chart F 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.[2]

Other successful industrialized countries against which we compete in the world marketplace recognize the importance of dividends in their tax code. Chart G demonstrates how Japan and West Germany, known for their high rates of savings, 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 incentives 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. 141 and H.R. 654, 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 not received in cash.

The concept goes even one step further. Not only does it eliminate discrimination, it actually places the choice of the

2 In the case of Citizens Utilities, Inc. which has both stock and cash dividend paying stocks, it has been found that the stock dividend paying security sells at a premium to the cash dividend paying security.

type of dividends a stockholder wants to receive in his or her hands. This allows the stockholder to decide, based on individual circumstances, whether they will receive a regular cash dividend or automatically reinvest this dividend, similar to a stock dividend.

These increased investment alternatives should improve the attractiveness of equity securities and thus encourage additional individuals to become shareholders. It will also reduce the cash flow burden which is a severe problem for many capital intensive companies. In fact many utilities are currently paying out 80 to 90% of their current new income. It is currently estimated that enactment of this legislation would result in a 10 to 20% increase in the price of common stocks offering such plans.

## DRP's INCREASE EQUITY INVESTMENT, PRODUCTIVITY AND JOBS

Equity investment, as opposed to other forms of investment, has a far greater impact on increasing total productive assets because of the associated multiplier effect. 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. A study by Robert R. Nathan Associates concludes the legislation would:

1. Double dividend reinvestment in new issue stock.

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.

---

## DRP's HAVE BROAD BASED SUPPORT

The proposal has wide support from a wide cross-section of the U.S. population. Labor unions, pensioners, and stockholders have all strongly supported this legislatior. A listing of the major organizations and associations endorsing the tax deferral of reinvested dividend legislation (S. 141 and H.R. 654) is as follows:

American Association of Retired Persons
American Bankers Association
American Council for Capital Formation
American Gas Association
American Society of Corporate Secretaries
Building and Construction Trades Department, AFL-CIO
Business Roundtable
Committee for Publicly Owned Companies
Duff and Phelps, Inc.
Edison Electric Institute
International Brotherhood of Electrical Workers
International Union of Electrical, Radio and Machine Workers
International Union of Operating Engineers
Laborers' International Union of North America
Moody's Investors Services, Inc.
National Association of Regulatory Utility Commissioners
National Investor Relations Institute
Standard and Poor's Corporation
Stockholders of America
U.S. Chamber of Commerce
U.S. Independent Telephone Association

In addition, over 160 members of the U.S. Congress are currently sponsors or cosponsors of this legislation.

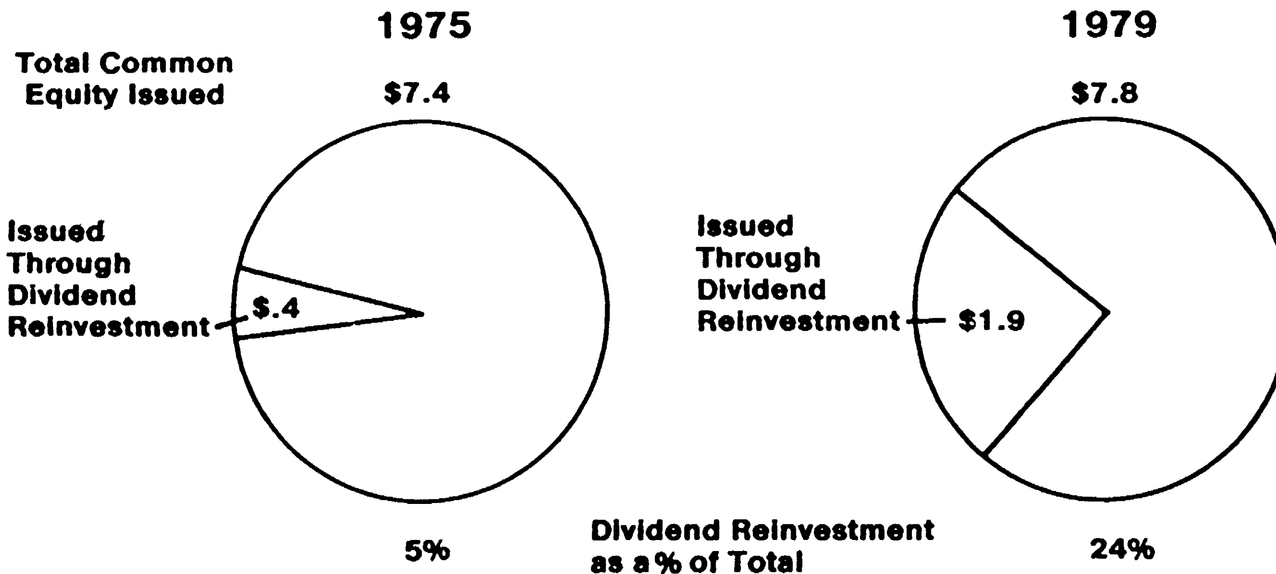
## CONCLUSION

The widespread use of DRP's offers a potential source for a substantial portion of the common equity capital which industry will need in the future. This potential can be easily and effectively utilized through enactment of the tax legislation embodied in S. 141 and H.R. 654. This legislation would give a tax benefit to individuals by treating shares acquired under DRP's essentially the same as conventional stock dividends. The proposal is direct, focused and efficient. It is direct because it generates common equity capital, the basis of any economic expansion, and represents instantaneous formation of new capital. It is focused because it proportionally allocates this common equity to those sectors of the economy where it is most sorely needed, i.e., capital intensive industries. Its efficiency has been documented by the Nathan Associates study which projects the generation of net additional tax revenues within three years of enactment.

CHART 3

# DIVIDEND REINVESTMENT AS A SOURCE OF COMMON EQUITY CAPITAL

($ in Billions)

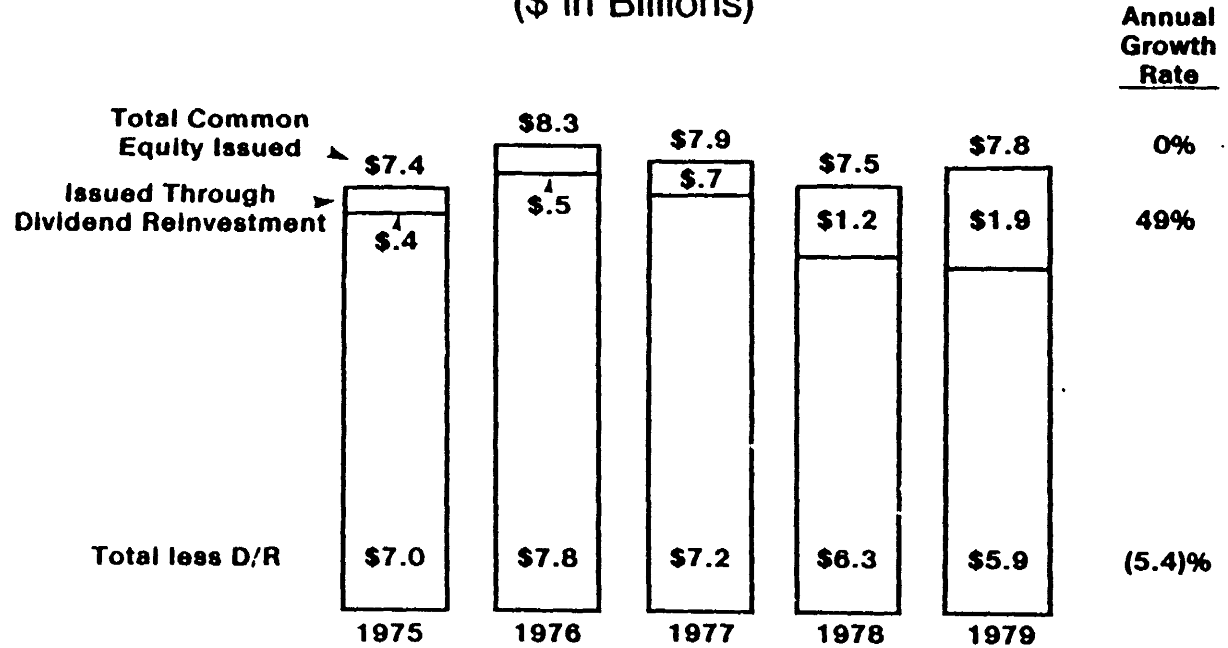



SOURCE: Federal Reserve Bulletin
Salomon Brothers

CHART B

# DIVIDEND REINVESTMENT as a SOURCE OF COMMON EQUITY CAPITAL

($ in Billions)




| % From Dividend Reinvestment | 5.4% | 6.0% | 8.9% | 16.0% | 24.4% |
|---|---|---|---|---|---|

SOURCE: Federal Reserve Bulletin

CHART C

ILLUSTRATION OF PARTICIPATION BY
SMALL SHAREOWNERS IN DIVIDEND
REINVESTMENT PLANS

| | PERCENT OF PLAN PARTICIPANTS OWNING 200 SHARES OR FEWER |
|---|---|
| AMERICAN ELECTRIC POWER COMPANY | 61% |
| AMERICAN TELEPHONE AND TELEGRAPH COMPANY | 80% |
| CENTRAL MAINE POWER COMPANY | 79% |
| CENTRAL TELEPHONE & UTILITIES CORPORATION | 66% |
| CINCINNATI GAS & ELECTRIC COMPANY | 74% |
| CONTINENTAL TELEPHONE CORPORATION | 85% |
| DUKE POWER COMPANY | 88% |
| GENERAL TELEPHONE & ELECTRONICS CORPORATION | 93% |
| NEW ENGLAND GAS AND ELECTRIC ASSOCIATION | 76% |
| NIAGARA MOHAWK POWER CORPORATION | 69% |
| SOUTH CAROLINA ELECTRIC & GAS COMPANY | 60% |
| UNION ELECTRIC COMPANY | 83% |
| UNITED TELECOMMUNICATIONS, INC. | 81% |
| SIMPLE AVERAGE OF 13 COMPANIES | 76% |

CHART D

Two bills are currently before Congress (H.R. 654 and S. 141) which could have significant impact on GTE Shareholders. These bills propose the deferment of taxes on dividends reinvested in new issue dividend reinvestment plans (such as the GTE Plan). Under such proposals, no federal income tax would be incurred by shareholders on dividends automatically reinvested (up to $1,500 annually per individual) until the stock purchased with the reinvested dividends is sold. Any gain on the sale would then be taxed at the lower capital gains rates. In effect, the stock received as a result of reinvested dividends would be regarded, for tax purposes, as essentially the equivalent of a conventional stock dividend with similar tax consequences.

Enactment of this legislation would be most beneficial to the investor and is a direct, focused, cost-effective means of encouraging capital formation. It promotes the creation of new equity in those sectors of the economy where it is most crucially needed, while generating additional tax revenues for the Treasury in the long run. As a result, this legislation will create jobs, improve productivity, reduce inflation and increase economic activity.

ADDITIONAL INFORMATION CONCERNING THE GTE SHAREHOLDER SYSTEMATIC INVESTMENT PLAN MAY BE OBTAINED BY WRITING TO GTE SHAREHOLDER SERVICES INCORPORATED, P.O. BOX 158, NORTH QUINCY, MASSACHUSETTS 02171, OR CALLING (TOLL FREE) (800) 225-5160, OR FOR MASSACHUSETTS RESIDENTS, (800) 972-5094. FOR RESIDENTS OF ALASKA OR HAWAII, (800) 225-5440

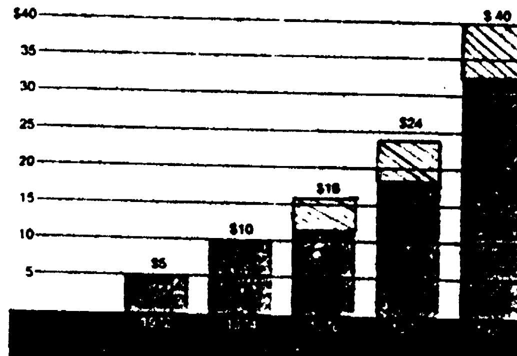
**Shareholder Participation**

| | Shareholders | Plan Participation | |
|---|---|---|---|
| Shares Held | Registered Shareholders | Participants | Percent Participation |
| 1-100 | 342,119 | 95,671 | 28% |
| 101-200 | 75,445 | 10,110 | 13 |
| 201-600 | 59,349 | 6,393 | 11 |
| 501-1,000 | 17,040 | 1,707 | 10 |
| 1,001-over | 7,829 | 445 | 6 |
| Total | 501,802 | 114,326 | 23% |

Participants owning 200 shares or fewer 105,781 / Total Participants 114,326 = 93%

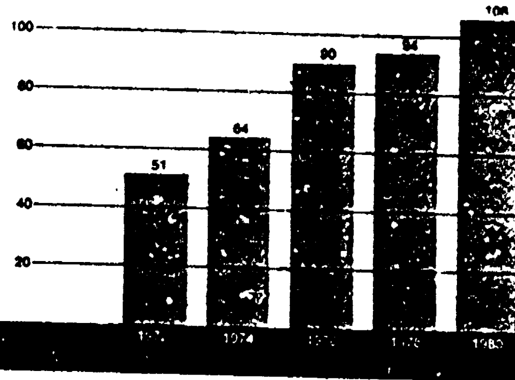
As of January 1, 1981, a total of 114,326 or 23% of all registered GTE shareholders were participating in the plan. The plan is particularly popular among small investors who represent 93% of all participants.

**Annual Investment**
**(Dollars in millions)**




The average annual growth rate is 27%. Approximately 80% of the 1980 investment is from the reinvestment of dividends and the remainder is from optional cash payments.

**Average Shareholder Participation**
**(Participants in thousands)**




The average annual growth rate is 10%.

649

CHART E

## 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 | $104.6 | 72.4% | $31.0 | 21.5% | $8.9 | 6.2% | $144.5 | 100% |
| 1976 | 132.5 | 69.7 | 53.2 | 28.0 | 4.3 | 2.3 | 190.0 | 100 |
| 1977 | 139.6 | 62.5 | 79.7 | 35.7 | 4.0 | 1.8 | 223.3 | 100 |
| 1978 | 152.1 | 62.3 | 92.3 | 37.8 | -0.1 | -0.1 | 244.3 | 100 |
| 1979 | 160.1 | 60.8 | 107.8 | 41.0 | -4.7 | -1.8 | 263.2 | 100 |
| 1980 | 158.0 | 59.8 | 95.7 | 36.2 | 10.6 | 4.0 | 264.3 | 100 |

SOURCE: SALOMON BROTHERS

84-165 O—81——42

CHART F

# TAX LAWS DISCRIMINATE AGAINST COMPANIES PAYING HIGH CASH DIVIDENDS

## 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

CHART G

# COMPARATIVE TAX TREATMENT OF DIVIDENDS*

| Country | Special Corporate Tax Rate on Dividends Paid | Personal Tax Credit or Exclusion on Dividend Income |
|---|---|---|
| **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 |
| **Non-Supportive of Capital Formation** | | |
| United States | None | Exclusion—First $200 ($400 joint) of dividend income |
| Great Britain | None | None |

*Treatments shown are those generally applied to dividends paid by local companies to residents of the countries listed

Statement of the Intergraph Corporation,
Huntsville, Alabama

Roland Brown, Vice President for Finance

Mr. Chairman, the Intergraph Corporation is pleased to offer testimony on behalf of legislation which, while minor in its revenue impact, would remove a substantial obstacle to the performance of research and development by companies receiving tax exempt financing through industrial development bonds. Specifically, we are concerned that the Internal Revenue Service treats research and experimental costs as capital expenses for the purposes of the $10 million limit on such expenditures by companies using IDBs. (See Treas. Reg. §1.103-10(b)(2)(b)(ii)(e).) We believe that this treatment serves as a serious disincentive to R&D by small American companies and denies the most innovative, high technology companies access to the favorable financing provided by IDBs.

Intergraph manufactures, sells and supports computer graphics systems. These systems use computer technology to facilitate design and drafting processes for customers engaged in architecture, engineering, construction, mapping or geoglogical activities. Using our systems, a customer can design and evaluate site plans, structures, structural systems, land use and resource management plans, energy exploration plans, in addition to normal data management and retrieval functions. By providing for full evaluation and manipulation of two-and three-dimensional figures, Intergraph systems allow users to do in hours, work that would otherwise involve weeks of manual drafting, computation and planning. At our main facilities in and around Hunstville, Alabama, and in other locations in the United States and throughout the world, we employ more than 700 people. We had sales exceeding $50 million in 1980.

Ours is a highly competitive, rapidly evolving business. In order to stay in the forefront of our industry -- an industry in which this Nation leads the world -- we must constantly improve our products. We must develop new software -- computer programs -- to create new applications, new kinds of images, and to manipulate and evaluate them in ever more useful ways. We must develop new hardware to display, store and retrieve our work. In order to do this, we spend a large share of our income on research and product development, as much as $10 million this year alone.

And it is this need for research which creates our problem with IDBs, a problem shared by American companies which seek to keep pace with and advance technology today. Under the "small-issue exemption" of section 103(b)(6) of the Internal Revenue Code, a business receiving IDB financing may not have more than a total of $10 million in capital expenditures within the bond-issuing jurisdiction in the 6 year period beginning 3 years prior to the issue date. The $10

million cap applies to all of a company's capital expenditures in that 6 year period, whether or not the specific expenditure was financed with the proceeds of an IDB.

The Internal Revenue Service has held that expenses for research are "capital expenditures" within the meaning of this provision. IRS has taken this position even though section 174 of the Code expressly permits research and experimentation costs to be expensed, rather than capitalized. In other words, because of section 174, R&D costs are generally permitted to be treated as expenses, except if considered in the IDB context, in which case they are treated as capital expenditures.

This ruling has serious consequences for research by American industry. Those companies which build, renovate or expand their facilities through the use of IDBs must avoid or curtail their research expenditures for a six year period in order to stay within the $10 million limit. Even more seriously, the small firms that are on the cutting edge of this nation's innovation and productivity, are effectively denied the advantage of tax-exempt financing. For if a firm spends a large share of its budget on R&D, it cannot afford to finance its capital facilities -- land, plant and equipment -- through an IDB.

In our case, for example, we are operating facilities financed with recent IDB issues amounting to $5.45 million at interest rates ranging from 7.75% to 9%. If we undertake our normal amount of research at any time in the next three years, the bonds will lose their tax-exempt status and the interest rate will revert to 2% over prime. You can easily see how this creates a powerful discentive to undertaking the research that our company, that American industry as a whole, needs.

Beyond its impact on research, the current rule creates a severe bureaucratic burden for businesses. While section 174 was intended to end and should have ended the need for

companies to separate their R&D capital expenses from normal operating expenses, thereby avoiding repeated audits and challedges on this point, these problems arise all over again in the IDB context. A business which receives financing from an industrial development bond must analyze all of its expenditures in the preceding 3 years, separating out research, and must segregate research expenditures for the subsequent 3 years as well. Furthermore, because a company's determination on this point can be challenged by IRS, the bond's tax exemption remains uncertain, and the door is opened to continual litigation.

There is a simple solution to this problem. Congress can amend the Code to provide that research and experimental costs which are treated as expenses not chargeable to capital account pursuant to section 174 will also not be considered capital expenditures for the purposes of the "small-issue exemption." This will permit firms such as ours, which depend heavily on research and innovation, to benefit from tax-exempt financing. It will also permit companies using IDB financing to carry out normal research and product development activities. And it will carry out the intent of Congress when it created section 174, by removing the uncertainty and administrative burden which results from attempting to separate research "capital expenditures" from ordinary expenses.

Senator Moynihan has introduced a bill, S.768, to amend section 103(b)(6) to provide that research and training costs not be considered capital expenditures. With one change, this legislation would correct the problems created by the current IRS position. That change would make the provision apply to all research and training costs paid or incurred after the effective date, rather than only to costs relating to bonds issued after the effective date. The value of this approach is that it will immediately remove the disincentive to research by companies already operating under IDBs. We are not urging that the provision be made retroactive, validating expenditures already incurred or permitting tax exemption for bonds already ruled taxable, but only that the provision be made effective in a manner that will immediately encourage firms to undertake R&D.

We realize that there is controversy over the question of whether the Congress will enact one or two tax bills this year. Without speaking to that point, we would only note that to the extent you include measures to assist small businesses or promote research and development in a tax bill, the measure we are advocating is appropriately included. The current IDB treatment penalizes innovative

producers and small concerns. A manufacturer, particularly one in the highly competitive, new technology fields, must constantly improve and develop his product, spending substantially for research. Yet that manufacturer thereby runs into the capital expenditure limitation. Similarly, while a national corporation has considerable latitude to allocate or disperse its research activities in such a fashion as to avoid hitting the expenditure limitation within any one jurisdiction, a small business located in a single area has no such leeway.

In summary, we would urge the Congress to exclude research expenses from the capital expenditure limit relating to industrial development bonds. By doing so, you will encourage the productivity and growth of American industry and reduce the paperwork and bureaucratic burden on business.

INGAA

May 21, 1981

Honorable Robert J. Dole
Chairman
Committee on Finance
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Dole:

The Interstate Natural Gas Association of America (INGAA) is a trade association representing all of the principal interstate natural gas transmission companies in the United States. On behalf of INGAA, I want to record our support for the basic thrust of S. 683, the Economic Recovery Act of 1981.

The member companies of INGAA bear the responsibility for delivery of adequate supplies of gas for the ultimate use of industrial enterprises and homeowners on a nationwide basis. The discharge of this responsibility, currently and unquestionably with ever growing urgency into the future, requires that our member companies undertake extensive capital commitments. These large-scale investments relate to liquefied natural gas terminals and facilities, maintenance of a high level of gas exploration activities, construction of new pipeline systems into remote geographic regions, such as North Slope, Alaska and establishment of commercial-scale synthetic gas plants. A liberalized "cost recovery" plan such as that in S. 683, one which essentially provides enhanced cash flow by means of expanded capital cost recovery deductions, will encourage and facilitate our companies in their efforts to insure the adequate supply and delivery of gas. Accordingly, we very much urge the adoption of the type of program for the business sector set forth in President Reagan's proposal.

With respect to S. 683 itself, there are a number of meritorious specific features to the bill, which we believe will serve well to achieve its objectives:

(1) The depreciation or recovery computation is quite simple due to yearly percentages established by law and the elimination of the need to estimate salvage value.

(2) A provision requiring "normalization" of the amount of the recovery deduction in excess of depreciation allowances as measured under current law is included in the bill and is drafted in such a way as to retain the relevance and viability of past interpretations by I.R.S. and various regulatory authorities.

(3) The election out for public utilities from the qualified progress expenditure rules for recovery property and section 167(r) property is a beneficial planning tool. It should be clarified, however, to provide that if the election is made there can be no imputation by a regulatory agency that the qualified expenditure rules were applicable. It should be further clarified as to whether the election out also applies to the Investment Tax Credit where the QPE rules are no longer elective.

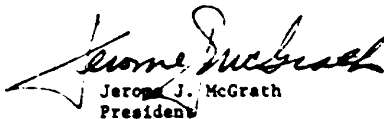
(4) The 18-year ADR class life dividing line for 10-year and 5-year public utility property is reasonable in that it seeks to provide a telescoping of the depreciation recovery period for public utility assets that is approximately proportionate to that provided for capital assets used in other industries and enterprises.

(5) The retention and favorable change in the qualifications for modification of the investment tax credit provision will enhance long range business plans which have been made based upon total after tax expenditures. As it relates to the natural gas industry the investment tax credit was intended by Congress to serve as an aid to the expansion of gas supplies and essential public utility facilities. The industry has calculated its long range capital needs with full reliance on the continuation of an investment credit of at least 10%. As recently as 1978 Congress permanently set the investment credit at 10%; any proposal to reduce or eliminate the investment tax credit would only serve to erode the taxpayers confidence in the stability of tax policy as well as seriously handicap the ability of the private sector to effectively budget long range capital outlays.

With regard to the personal income tax concepts raised by S.683, our association is in agreement that a reduction in the maximum marginal tax rate on so-called unearned income would contribute to a much needed increase in the rate of saving. However, it is our view that such a reduction, whatever its benefit, is in itself not sufficient to meet the problem of depressed savings and should be considered along with other worthwhile measures. Among such additional provisions would be an increase in the exclusion amount for dividends and interest, and enlargement of the capital gains tax exclusion ratio.

INGAA sincerely appreciates this opportunity to share its views with you and the Committee. We stand ready to assist you in any way we might be able in your deliberations on this legislation and the important issues raised by it.

Very truly yours,



Jerome J. McGrath
President

STATEMENT OF
THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS
ON
THE TAX ASPECTS OF THE PRESIDENT'S ECONOMIC PROGRAM
PRESENTED BY
WALLACE R. WOODBURY
TO
THE COMMITTEE ON FINANCE
OF THE
UNITED STATES SENATE
MAY 27, 1981

## STATEMENT

### I. INTRODUCTION

My name is Wallace R. Woodbury, Chairman of the Board, Woodbury Corporation, Salt Lake City, Utah. I am Chairman of the Tax Subcommittee of the Government Affairs Committee of the International Council of Shopping Centers (ICSC), and I submit this testimony today on behalf of the members of the International Council of Shopping Centers.

The ICSC is a business association of approximately 10,000 members consisting of shopping center developers, owners, operators, tenants, lenders and related enterprises. ICSC represents a majority of the 22,000 shopping centers in the United States.

It is estimated that more than 5.9 million people are regularly employed in shopping centers and that several hundred thousand more are annually engaged in new construction. The rippling effect of shopping center development on employment in related businesses, including display advertising, maintenance and cleaning, legal and accounting, and the manufacture of goods sold in the centers, is considerable.

It is estimated that in 1980 shopping centers accounted for 41 percent of total U.S. retail sales. By the beginning of the next decade (1990), the shopping center share will likely range between 48 percent and 53 percent. In current dollar value, U.S. shopping center retail sales reached a level of $386 billion in 1980.

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

## II. ECONOMIC ISSUES

The members of ICSC believe that the most pressing domestic issue facing the United States is the building of a healthy economy for the 1980's: an economy based on growth, with reduced inflation, interest and unemployment rates. Such a growing economy is the basis for the fulfillment of all the domestic hopes and plans of our people, and, indeed, of our strength and reputation around the world. To that end, ICSC supports the goals of President Reagan's economic recovery plan to reduce the rate of increase in both federal spending and taxes. With President Reagan, ICSC believes that the achievement of the goal of a healthy, stable and productive economy requires the enactment of substantial tax reductions this year to reduce significantly the size of the projected increase in taxes.

Any tax cut adopted must be addressed to reducing the current high inflation, interest and unemployment rates by increasing investment incentives and capital for the productive elements of the economy.

One sector of the economy that should have a high priority in a tax cut is the real estate industry. Inflation and high interest rates have had a dramatic and negative effect on employment and activity in this vital industry.

The real estate industry is composed almost totally of small firms. Sixty percent of all construction firms and eighty percent of all real estate service firms have four or fewer employees. This makes the industry unusually susceptible to changes in economic conditions, financial climate, the tax code and other public policies. During the past, those factors have combined to retard the growth rate of all areas of real estate.

The various sectors of the real estate industry are interrelated. For example, shopping center development and rehabilitation follow very closely new housing starts and rehabilitation, and the development and location of housing and job-related real estate such as office buildings, retail stores, and industrial facilities continually interact with one another. In a recent study conducted by the ICSC Research Department, the total square footage of annual U.S. shopping center construction starts (1970 to 1979) was correlated with annual U.S. housing starts (1969 to 1979). Results indicated that 95 percent of the variation in shopping center construction starts could be statistically "explained" by changes in the level of housing starts.

All the elements of the real estate industry are suffering from the current bias and penalties in the federal tax code against real estate rehabilitation and construction which discourage capital formation and investment.

What is needed as a part of this year's tax cut is a comprehensive reworking of the current federal tax policy regarding real estate to eliminate the inhibitions against capital formation and investment, and to enact provisions that will encourage and allow all of the sectors of the real estate industry to produce the strutures and facilities necessary to provide the housing, retail facilities and job sites that will be needed in the 1980's.

## III. THE CAPITAL DRAIN RESULTING FROM PAST TAX LEGISLATION

Since the health of the real estate industry and its ability to compete for investment capital is predicated upon a delicate balance of many factors, it is crucial that the Internal Revenue Code contain provisions which encourage capital investment and productivity in the industry. Unfortunately, tax laws enacted over the last two decades have had a dampening effect on capital investment and productivity.

A comparison of the tax provisions in effect eighteen years ago with the provisions presently in effect will, we believe, dramatically indicate how the tax laws have both reduced the supply of and increased the demand for investment capital in real estate.

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

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

In stark contrast to the tax provisions described above, the commercial real estate industry is now faced with the following rules: non-corporate construction period interest and taxes must be capitalized and amortized over a prescribed number of years. Also, many shopping center and other real estate developers have substantial limitations on the amount of mortgage interest that may be currently deducted once the project is placed in service. Although accelerated depreciation has not been entirely eliminated, present rules limit the maximum rate to the 150 percent declining balance method, and the accelerated portion is subject to a tax preference surtax of 15 percent.

In addition, cumulative depreciation deductions in excess of straight-line are again taxable upon the sale of the project at ordinary income rates to the extent of gain, regardless of the holding period. Moreover, the rules regarding the taxation of capital gains have undergone substantial change, and, even with the recent reduction, there has been an increase in the effective tax rate on such gains.

In addition, capital flow in the real estate industry has suffered from the unfair and unrealistic treatment by the Treasury and the IRS of the depreciation and component depreciation lives taken by the industry, and by the less advantageous depreciation methods made available to real estate as compared to the methods made available to other kinds of property.

For example, investment in personal property is fostered by more rapid depreciation methods. For such property depreciation lives are more realistically scheduled and the ADR system provides shorter optional lives which permit rapid write-offs. The law, on the other hand, provides different standards for real estate.

In addition, increased "investment tax credits" applicable to certain personal property purchases, but not to real estate, have provided further disincentives to real estate investment.

It is also very disconcerting to note that the depreciation periods for retail buildings advocated by the Treasury and the IRS significantly exceed the depreciable lives which the shopping center industry studies indicate are, on the average, claimed. A representative sample group of 89 shopping centers owned by ICSC members established that shopping centers useful lives range from 22 to 29 years and that there is a median initial tax life of 26 years and a mean initial tax life of 27 years for shopping centers.[1/]

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1/ Touche Ross & Co., DEPRECIABLE LIVES OF SHOPPING CENTERS, The International Council of Shopping Centers, 1976.

This is significantly lower than the 50 year life which IRS Revenue Procedure 62-21 requires for retail buildings, and the 35 years suggested by the Treasury in 1976 for retail buildings having 50,000 or more square feet of indoor floor space on contiguous parcels of land.

In addition to the guidelines for depreciation advocated by the Government, we find that our members are spending an increasing amount of time and effort fighting against unreasonable calculations of useful lives in the IRS audit process. This involves the unnecessary expenditure of great amounts of unproductive time by both taxpayers and revenue agents. This results in increased costs of operation and lost opportunities for the taxpayer and the inefficient use of IRS personnel.

## IV. TAX CUT PROPOSALS AND COMMENTS

Any tax cut legislation enacted this year to eliminate the penalties and bias against real estate investment and to provide reasonable inducements for investment and capital formation in the real estate industry should contain the following significant changes in the current tax treatment of real estate:

A. Depreciation reform. The current depreciation rules should be revised to provide for a set, audit-proof depreciation recovery period of reasonable length with no change in the current section 1250 depreciation recapture rule.

B. Current deductibility of construction period interest and taxes. The bill should provide for the current deductibility by individuals of construction period interest and taxes by repealing present section 189 of the Internal Revenue Code which requires the amortization over a 10-year period of all construction period interest and taxes involved in the construction of real property by individuals, but not by corporations.

C. Interest on real estate investment indebtedness. Section 163(d) should be repealed to the extent that it limits the deduction of interest on real estate investment indebtedness.

D. Ordinary and necessary business expenses paid or incurred prior to realization of current income. At the present time, the IRS seeks to disallow current deductions for ordinary business expenses incurred prior to realization of income. The Code should be amended to assure the current deductibility of these expenses.

E. President's tax proposals - miscellaneous provisions. Certain amendments to S. 683 should be made to clarify provisions relating to qualified progress expenditures, the investment credit recapture on section 48(g) real property, the minimum tax, the net operating loss carryover and accounting for "earnings and profits."

A. Depreciation Reform

In order to make more equitable the treatment of depreciation for the real estate industry, we favor a system that would reform the present depreciation system as follows:

1. Establish a set capital cost recovery period for depreciation for all real property in place of the current system of requiring the establishment of a useful life by the facts and circumstances test.

2. Set the recovery period for depreciation at a reasonable length which is shorter than currently provided for under Treasury guidelines and currently generally taken in the industry.

3. Make no change in the current section 1250 recapture rules for real estate.

4. Provide a "safe-harbor" for property placed in service before January 1, 1981 (or the effective date of any depreciation reform legislation), whereby,

a. if the useful life used by the taxpayer is 30 years or more, the Internal Revenue Service may not assert a longer useful life for depreciation purposes, and

b. if the useful life used by the taxpayer is between 20 and 30 years, the IRS may not assert more than a 25 percent increase in that useful life. In no case may the useful life asserted by the IRS exceed 30 years.

The "Economic Recovery Tax Act of 1981" (S. 683 and H.R. 2400) which will implement President Reagan's proposed Accelerated Cost Recovery System (ACRS) will accomplish most of the depreciation reform measures which ICSC believes necessary. Only the "safe-harbor" rule is not included in ACRS.

ACRS will eliminate the need to establish the useful life of real property by placing leased commercial real property and low income housing in a 15 year depreciation recovery class, and conventional residential rental properlty is an 18 year depreciation recovery class.

ICSC supports a 15 year depreciation recovery class as a reasonable recovery period for most real estate. Low-income housing traditionally has been allowed faster write offs than other real estate, and ICSC would support the continuation of such a policy on a reasonable basis.

ICSC neither advocates nor opposes the shorter life provided in ACRS for owner-users of real property used for industrial and distributive purposes, and will not object if such a shorter life appears justified to the Congress.

As to classes of real property with 15 years or longer "capital cost recovery periods," ACRS will make no change in the current section 1250 recapture rules.

A depreciation rule embracing our four criteria would simplify the tax code and greatly reduce the costs of its administration. It would insure consistency and predictability and eliminate audit disputes between taxpayers and the Internal Revenue Service concerning the useful life of real property. This would free revenue agents to work on higher priority matters.

Inclusion of a "safe-harbor" rule for existing real property would have the similar effect of reducing audit disputes.

A set recovery period of 15 years will stimulate capital formation and investment, and contribute to economic growth through enhanced activity and the modernization of the nations capital plant.

ICSC strongly supports the continuance in the law of the current section 1250 depreciation recapture rules for real estate. Section 1250 provides for the recapture (the taxation at ordinary, rather than capital gain, rates) of the accelerated portion of depreciation over straight line on the sale of real estate. Under section 1250, real estate depreciated by the straight-line method is not subject to recapture on sale.

B. Current Deductions of Construction Period Interest and Taxes - Section 189

Section 189 of the Internal Revenue Code, enacted as part of the Tax Reform Act of 1976, is highly discriminatory in requiring a taxpayer other than a corporation (which is not a subchapter S corporation or a personal holding company) to capitalize real property construction period interest and taxes. The amount capitalized must be amortized over a period which began with 4 years in 1976 and will be extended to 10 years when the provision is fully phased in. Since the amortization is phased in over a 7-year period, the full 10-year amortization period will not be fully effective in the case of commercial real estate until 1982, and will not begin to apply to low-income housing at all until 1982. Thus, although this provision has already had an adverse effect upon the real estate industry, the full impact of the provision has not yet been fully felt.

This provision has the effect of draining capital from the real estate industry since interest and taxes are real, out-of-pocket expenses which have to be paid whenever due. By forcing individuals who develop real estate to capitalize these true "out-of-pocket" costs rather than allowing current deductions as permitted to others with "business interest" expenses, section 189 increases the required capital for non-corporate taxpayers to develop real estate.

It further discriminates by permitting the corporate developers of competing facilities the unlimited deduction of such expenses. This inequity is magnified by the extremely high interest rates encountered today.

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Section 189 is highly inflationary in that the developer-landlord typically recovers in higher rents any such increased costs of development.

In light of the adverse consequences which section 189 now has on most real estate development, and soon will have on low-income housing, we urge the early repeal of section 189 retroactive to its original effective date. Repeal of section 189 will equalize the treatment of interest and taxes, which are actual out-of-pocket expenses, between real property construction and other industries. Repeal also will remove the discrimination created by the section against individuals and in favor of corporations which construct real property.

Repeal of section 189 will have a limited impact on revenues according to data compiled by the National Association of Realtors and presented to the Committee in their testimony on March 24, 1981. These figures indicate that the current expensing of construction period interest and taxes will result in revenue reductions of $0.8 billion in each of 1981, 1984 and 1985, $0.9 billion in 1982, and $1 billion in 1983.

C. Deductibility of Investment Interest

Enacted in 1969, section 163(d) of the Internal Revenue Code provides an exception to the general rule that a taxpayer itemizing his deductions may deduct all the interest paid or accrued within the taxable year on his indebtedness. Section 163(d) was amended further by the Tax Reform Act of 1976 to impose dramatically more significant limitations on the deductibility of interest on investment indebtedness and "net-leased" business income property indebtedness by non-corporate taxpayers, by limiting such deductions to $10,000 plus the amount of net investment income and the amount of excess net-lease out-of-pocket expense.

Section 163(d) works harshly because it operates to deny a deduction for a real cash outlay, which, prior to its enactment, was traditionally recognized as a

deductible expense. The harshness has become even more severe because of the present extremely high interest rates. Application of the rule produces a taxable, artificial, paper gain. This adverse and unfair tax effect is a disincentive to investment in the real estate industry.

Section 163(d) is discriminatory in that it applies to individuals, but not to corporations. Moreover, wealthy individuals who have large amounts of investment income and net-leased section 1231 income from other investments can avoid its impact.

Unfortunately, not so wealthy, new entrepreneurs cannot avoid the provision's adverse tax effects. Those entrepreneurs consequently suffer greater development costs and greater capital requirements than their more wealthy competitors, and are therefore discouraged or prevented from entering into otherwise economically viable real estate developments.

In addition, the investment interest limitation is difficult to understand and has proved impossible to be equitably and uniformly administered.

According to data released by the National Association of Realtors in their Testimony presented to the Committee on March 24, 1981, repeal of this disincentive to investment in real estate will reduce revenue by $0.1 billion in each of the next five years, which is partially offset by the aggregate costs incurred by taxpayers and government in administration.

We believe that this unfair, complicated, and difficult-to-administer rule should be repealed.

D. Ordinary and Necessary Business Expenses Paid or Incurred Prior to Realization of Current Income

It is generally held that trade or business expenses are currently deductible under section 162 of the Internal Revenue Code only after a business has started to perform the ultimate activities for which it was organized. Prior to that time, the

activity or business is not considered the conduct of a trade or business. With regard to shopping center and other real estate developers and partnerships, the IRS has taken the unfair position that the ultimate activities are not begun until the premises are occupied by retail tenants or otherwise until regular rentals come in.

Therefore, this rule generally precludes the current deductibility of many otherwise deductible expenses incurred during the investigatory, start-up and "high-risk" development stages prior to the commencement of regular rental income.

This rule is patently unfair in that it disregards the most risky business period of development which is necessarily a major part of the business purpose of a developer of rental income property. The rule also discriminates in favor of corporations, which are deemed to commence business upon commencement of corporate activity.

In the Miscellaneous Revenue Act of 1980, Congress attempted to remedy the situation by providing that qualifying business startup or investigatory expenses paid or incurred after July 29, 1980, may, if the taxpayer so elects, be amortized over a period of not less than 60 months. ICSC believes this to be an inadequate solution to the problem.

We urge that section 162 be amended to provide that a taxpayer would be able to deduct currently amounts paid or incurred in connection with, or during the period of, the acquisition, development, construction or erection of all real property, unless it should be properly capitalized.

The costs incurred are actual, not paper, expenses and as such should properly be deductible. The IRS position that a trade or business does not begin until regular income is realized from the property is particularly harsh with regard to shopping center developers since much of their activity occurs before rents are received from center tenants. Clearly, the "trade or business" of a developer begins prior to the time he realizes income. Furthermore, there is no valid reason to create a distinction between corporate and non-corporate taxpayers with respect to their expenses.

V. President's Tax Proposals - Miscellaneous Provisions

Several provisions of the President's tax proposals which will be implemented by the Economic Recovery Tax Act of 1981 (S. 683) should be clarified or modified as follows:

A. Qualified Progress Expenditures.

From our reading of S. 683, it is our impression that a taxpayer has the option of whether or not to apply the special qualified progress expenditure rules. However, the bill is ambiguous on this point.

We believe S. 683 should be amended to provide specifically that a taxpayer may elect to apply the special rules. To force a taxpayer to use the special qualified progress expenditure rules may be detrimental, particularly during phase-in, where the recovery periods are shortened on an annual basis.

B. Investment Tax Credit.

S. 683 needs to be amended to clarify many points with regard to the treatment after December 31, 1980 of 15-year real property for purposes of the substantial rehabilitation investment tax credit under section 48(g) of the Internal Revenue Code. Among the unresolved issues in the present draft of the bill are whether the special qualified progress expenditure rules will apply with regard to the substantial rehabilitation of 15-year real property, and whether the investment tax credit recapture will be eliminated when the rehabilitated property has been held for 5 years.

S. 683 provides that both the qualified progress expenditure rules and the rule that there is no recapture after the property is held for 5 years apply to 10-year real property which has been substantially rehabilitated. We believe there should be no distinction between the 15-year and 10-year property on this point.

C. Minimum Tax.

i. S. 683 provides that the present minimum tax preference items of accelerated depreciation beyond straight-line on real property (section 57(a)(2)) and on leased personal property (section 57(a)(3)) will not apply to 3-year, 5-year and 10-year property.

Although the bill appears to do so, it should state in a clear fashion that no part of the depreciation on 15-year and 18-year property will be considered a tax preference item under section 57(a)(2) (accelerated depreciation on real property).

ii. S. 683 will create a new preference item, applicable only to individuals, electing small business corporations and personal holding companies, which will equal in amount the difference between the recovery allowance for all leased 3-year, 5-year and 10-year property, excluding real property, over an assumed straight line depreciation amount. For purposes of this computation, the assumed straight-line depreciation period is twice the "recovery allowance" period. For 10-year personal property, the assumed straight-line life is 20 years.

We do not see any reason why this new preference item should be limited to only individuals and certain corporations. This is an unjust discrimination like that found in section 189 and should be eliminated.

In addition, we believe S. 683 should be amended to provide that the assumed straight line depreciation period should be the lesser of twice the "recovery allowance period" or the ADR life, in order to avoid increasing the amount of tax preference.

Making these modifications will remove unreasonable disincentives to capital investment, and, at the same time, restrict the minimum tax to its intended purpose of assuring that some income tax is paid by all taxpayers.

D. Net Operating Loss Carryover.

S. 683 will extend the net operating loss carryover from its present limit of 7 years to 10 years. In order to provide a greater incentive to capital investment, we believe that an unlimited net operating loss carryover should be provided.

E. Earnings and Profits.

S. 683 would require cutting the "recovery allowance" by 50 percent in determining "earnings and profits." This requires unnecessary accounting adjustments.

We recommend that the straight-line "recovery allowances" on real property not be considered as accelerated depreciation. Accordingly, we urge that such adjustments in determining "earnings and profits" be limited to personal property and such real property as to which "accelerated depreciation methods" have been utilized.

## VI. Conclusion

ICSC believes that the President's economic program as implemented by the depreciation reform provision of S. 683 represents a responsible and positive step toward improving incentives and capital formation for the real estate industry, and urges the Committee to adopt these provisions of S. 683 after the incorporation of our proposals as discussed above.

Thank you for allowing us to present our views today.

**STATEMENT OF**
**DOUGLAS A. FRASER, PRESIDENT**
**INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE AND AGRICULTURAL IMPLEMENT WORKERS OF AMERICA, UAW**
**TO THE**
**COMMITTEE ON FINANCE,**
**U.S. SENATE,**
**ON THE TAX ASPECTS OF THE PRESIDENT'S ECONOMIC PROGRAM**

**April 30, 1981**

I welcome the opportunity to present the reaction of the UAW to the Administration's tax cut proposals. We believe they should be set aside: they are grossly inequitable, they reduce federal government receipts to an unacceptable level, and they are not grounded on tenable economic assumptions. The UAW urges this Committee to write a new tax bill which preserves federal finances, distributes the tax relief in a progressive fashion to individuals, and selectively to business.

The UAW agrees with the need for some tax relief for individuals. The combined effects of higher income and Social Security taxes and rapid inflation have eroded the purchasing power of working people to an extent unprecedented in the last two decades: real spendable earnings show a decline of 13 percent in the last three years. In aggregate terms, the lag in the growth of disposable income has prompted consumers to dip into savings and/or acquire more debt at an unsustainable rate in order to maintain their standard of living. This combined with continuing monetary stringency increases the possibility of yet another economic slowdown.

The need for across-the-board tax relief for corporations is much less obvious. A selective approach should be used. Corporations as a whole have not been suffering from any "bracket creep" due to inflation: the corporate share of the federal income tax bill has steadily decreased from 26 percent in FY 1977 to 21 percent in FY 1980. While that has not stopped business from clamoring for tax cuts, the argument that a heavy tax burden is hampering corporate investment is less than persuasive. During the 1970s when corporations complained of being overtaxed, plant and equipment spending rose to 10.5 percent of gross national product from 9 percent

in the 1960s. It is true that capital per worker declined after 1973; but that was due to the large influx of people into the labor force, mostly into marginal jobs in service industries where capital requirements are small rather than to any feature of the tax system.

When we look beyond the totals and examine the economy sector by sector, we are aware that pockets of need for federal government aid to corporations do exist. Those are the needs which should be addressed, with measures tailored to address them adequately, and at the least cost to the Treasury.

We are extremely concerned about the magnitude as well as the distribution of the tax cuts proposed for the next three fiscal years and beyond. The loss in revenue would severely and permanently curtail the federal government's ability to allocate resources to the needy, to public investment, to education, health care, and other functions. That cannot be allowed to happen: public essentials should not be abandoned in order to finance a shaky, inequitable economic experiment.

## Personal Taxes

The Administration's justification for its plan to cut individual tax rates by 30 percent over three years assumes that people will work more and save more as their disposable income increases; and that the increased savings will translate into higher investment, more jobs, and faster productivity growth. But, the Administration is assuming far too much of a saving "bang" from each "buck" of taxes cut; specifically, Treasury Secretary Regan asserted that " between one-half and two-thirds of the personal tax cut is expected to be put into savings." 1/ Even among the Administration's friends there is no agreement that anything like this will happen: Chairman Volcker, for example, stated that "that kind of prediction goes somewhat outside the range of historical experience." 2/ Moreover, a recent CBO report 3/ concludes that measures which raise the overall saving rate do not have an effect on the capital stock or on productivity for a number of years, because a substantial portion of the savings gets allocated to nonproductive or speculative ventures such as the purchase of gold and other precious metals, of "collectibles," of real estate, etc.

The counterpart of the Adminstration's overestimate of the response of savings and investment to the massive tax cuts proposed is its underestimate of their inflationary impact. Although there are many sectors where capacity is woefully underutilized, the increased demand in many other sectors would represent an opportunity to enlarge profit margins, and price changes would be either maintained at current rates of increase or accelerated.

The skewed impact of the 30 percent cut in tax rates on the income distribution would enlarge the gap between the well-off and the moderate income earner. This is especially apparent when the effect of inflation as well as that of the proposed tax cuts is taken into account. For example, assuming a 35 percent increase in nominal income between 1980 and 1984, a head of a four-person household earning the national median of $20,000 in 1980 would make $27,000 by 1984, and the marginal tax rate on his or her taxable income (assuming 23 percent deductible expenses) would remain at 21 percent. Meanwhile, a similar household at twice the median income and comparable deductions would be favored by a drop in the marginal tax rate from 37 percent to 32 percent; at three times the income, the drop would be 49 percent to 40 percent.

Not enough attention has been paid to the combined impact of income and FICA taxes on people's paychecks. When the Social Security tax increases of last January 1st are factored in, upper-income taxpayers are shown to be even more favored by the Regan proposal than when only income taxes are taken into account, a result due to the regressive nature of the Social Security taxes.

Tax relief in the Reagan plan totally bypasses those earners who due to low wages and/or family circumstances do not pay income taxes. About 15 million poor workers are paying Social Security taxes 14 percent higher than three and a half years ago but would get absolutely nothing out of the Administration's proposal.

We urge this Committee to enact a personal tax cut designed to compensate for the loss in purchasing power of wages and salaries, and to make it retroactive to

January 1st, the date of the last round of Social Security tax increases. The tax cut should take the form of a refundable income tax credit equal to a specified percentage of the individual's Social Security tax. The level of 20 percent proposed by the AFL-CIO seems adequate to us. This alternative would focus relief on those taxpayers who need it the most, as seen below in the comparison between the Administration's proposal and the tax credit proposal:

**Reduction in Income Taxes***
**1980-IV to 1981-IV**

| Income | Administration's Proposal** | Refundable 20 Percent Social Security Tax Credit Proposal |
|---|---|---|
| $ 10,000 | $ 52 | $134 |
| 20,000 | 228 | 266 |
| 40,000 | 648 | 395 |
| 50,000 | 956 | 395 |
| 100,000 | 1,840 | 395 |

* Annualized, four-person family, one earner, 23 percent deductible expenses.
** At first full year rates.

We also agree with the AFL-CIO that the refundable income tax credit should be extended to employers, at a level of five percent of Social Security contributions paid. At the same time, we favor phasing out the maximum taxable base for determining employer contributions so as to achieve full taxation of employers' payroll.

In addition to the enactment of tax cuts for calendar 1981 along the lines just described, we urge this Committee to provide for further tax relief starting in January 1982, but the additional amount should not double the Social Security credit for 1981. Such a move would avoid the need for another retroactive cut sometime in 1982. That is our reason for proposing such action now; we believe it would be a mistake to legislate tax cuts that will begin in 1983 and 1984, as proposed by the Administration.

**Tax Cuts to Business**

The Accelerated Cost Recovery System (ACRS) or "10-5-3" proposed by the Administration should be discarded by this Committee in favor of more targeted, less costly incentives.

This Committee has already heard criticisms of "10-5-3" for the massive drain of funds it would impose on the Treasury; the wasteful allocation of a large proportion of those funds to profitable corporations that would have invested at the same level anyhow; the lack of public policy strings attached to the relief; the flood of tax shelters that it would facilitate. We strongly subscribe to those views.

Although ACRS is touted as relief for the effects of inflation on the cost of replacing assets, it provides no linkage between the rate of inflation and the speed of depreciation it affords. Thus, actual tax relief could vary widely not only across industries but in conjunction with the course of inflation. If this Committee believes that there is a negative impact of inflation on investment which must be addressed, it should take a look at alternatives to "10-5-3" which really take that impact into account. But whatever the form of the investment stimulus, attention should be paid to its impact on various industries, communities and regions.

We are particularly interested in the impact of "10-5-3" on the auto and parts industry for which most of our members work, as their jobs and income overwhelmingly depend on the health and prospects of the industry.

The auto industry and its suppliers constitute one of the most important industrial/commercial complexes in the U.S. economy. In a good year, this complex directly employs 1.5 million people. On average, every job in auto creates 2.3 additional jobs in steel, rubber, glass, textiles and other industries. In 1979 the automobile industry used 21 percent of the steel consumed in the United States, more than 50 percent of the malleable iron produced, 34 percent of the zinc, 12 percent of the primary aluminum, 13 percent of the copper, and 60 percent of the synthetic rubber.

For two full years now, the U.S. automobile industry has been operating at levels usually associated only with the worst 2-4 months of a major recession. Domestic vehicle sales at a level 30 percent below 1978, over 1,600 dealer bankruptcies in just 18 months, plant closings in double digits, shift eliminations and unprecedented levels of Midwestern unemployment all reflect its disastrous situation.

However, the auto industry is not a sunset industry; instead, it is poised to record substantial productivity gains, assuming it can generate the required resources to continue retooling and that appropriate import policies allowing it to recapture a significant amount of its lost market share are implemented.

Given the present circumstances, the auto industry is favored relatively less than other sectors by "10-5-3". A 1979 study by the Treasury Department 4/ determined that with respect to depreciation of plant and equipment used by the industry, the average recovery period for machinery and equipment in auto is about 5.8 years. This would decline to 5 under ACRS, while the reduction for "all industries" would decline from 10.2 to 5 years, making investments in other industries relatively more attractive than in auto. Moreover, motor vehicle manufacturers are now allowed a guideline depreciation period of 9.5 years for regular assets, and of 3 years for special tools. Under "10-5-3", both categories are included in the 5-year class. During the phase-in period, the recovery period for special tools is immediately increased from 3 years up to 5, so that there might even be an increase in the tax liability of the companies which show a profit during the first and second years that the new depreciation system is put in place. This would add to their financial burden at a time when they are facing major capital outlays.

As as a result of slumping sales, many companies in the motor vehicle and parts industry have reported losses of enormous magnitude — both in absolute and relative terms — and are hampered by a shortage of cash flow in their efforts to retool their facilities for production of the smaller, more fuel-efficient vehicles which are already on their drawing boards. The "10-5-3" proposal would give little or no relief to these companies.

The most objectionable feature of "10-5-3" is its bias favoring the erection of plants and structures. A tour of any older industrial city shows that there is no scarcity of buildings; rather, the problem is that many buildings stand vacant or house outmoded equipment. "10-5-3" would act as a powerful incentive for business to close older plants — accelerating urban deterioration. Many would relocate in low-wage areas. Short of that, it would strengthen the stance of employers who use the threat of abandonment of their present facilities to wrest economic concessions from their workers and their communities.

We urge this Committee to enact a plan for business tax relief which (a) helps those of the nation's basic industries which are in trouble or at a crucial stage in their development, and (b) revitalizes economically distressed areas. A first step should be to make the investment tax credit refundable, thus putting all companies in the same position vis-a-vis the cost of their investment regardless of their current profitability. Measures bestowing greater tax relief to companies in industries which are of strategic importance to the nation should be devised. The criteria used here should encompass regional stability, national security, number of jobs, growth potential, and impact of unfair trade practices of foreign companies.

The UAW has already asked Congress to consider several tax related measures to help the auto industry, such as tax credits for the purchase of a new car, a scrappage bounty to speed up the retirement of old cars, and a higher, refundable tax credit for certain investments used to produce motor vehicles.

I also urge this Committee not to lose sight of the fact that historically the major constraints on investment have been the restraints in demand resulting largely from the cyclical nature of our economy. There is no tax measure that can raise investment by the same amount that is lost in each recession. For example, it has been estimated that the tax cut of 1964 increased real nonresidential fixed investment by about $6 billion in the 1964-1967 period over and above what it otherwise had been;

while in the previous four recessionary or low growth years, investment was reduced by a total of $15 billion. The best way to secure adequate investment and productivity increases is to avoid recessions, by planning for balanced and healthy economic growth.

This is exactly what the Administration's economic program does not do. Instead, it relies on "throwing money" at the problems, and on old theories which have been shown not to work before. If implemented, these will not pull America out of chronic unemployment, deficient productivity growth, and high inflation, but will succeed in redistributing income and wealth in favor of the rich at the expense of the working people and the poor.

FOOTNOTES

1/ Daily Executive Report, January 27, 1981, p. LL-4.

2/ Business Week, February 16, 1981, p. 22.

3/ "The Productivity Problem: Alternatives for Action," January 1981.

4/ As reported by then Treasury Secretary William Miller in testimony before Congress, October 22, 1979.

## Statement of Brian O'Connell, President, Independent Sector

I am Brian O'Connell, President of INDEPENDENT SECTOR. I am grateful for this opportunity to submit testimony for the record on S. 170.

INDEPENDENT SECTOR is a new organization, just over a year old, created to preserve and enhance our national tradition of giving, volunteering, and not-for-profit initiative. We have 295 Members, including 159 national voluntary organizations, 83 corporations and 53 foundations. The Voting Members are organizations with national interests and impact in philanthropy, voluntary action and other activity related to the independent pursuit of 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 is the successor organization to NCOP and CONVO.

I am here today to testify in support of the Charitable Contributions legislation. INDEPENDENT SECTOR strongly supports this measure which would allow all taxpayers to deduct charitable gifts from their taxable income, whether or not other deductions are itemized. Senators Daniel P. Moynihan (D-NY) and Bob Packwood (R-OR) introduced S. 219 on January 20, 1981, in the Senate. Similar legislation had been introduced in the House (H.R. 501) on January 6, 1981, by Congressmen Richard A. Gephardt (D-MO) and Barber Conable (R-NY).

The measure has already gained considerable bi-partisan support in the House where a majority have co-sponsored the legislation; 253 are co-sponsors, including 118 Democrats and 135 Republicans. In the Senate, 26 members have co-sponsored, including 14 Democrats and 12 Republicans. Eight of the Senate co-sponsors are on the Senate Finance Committee. In addition, a majority of the House Ways and Means Committee have co-sponsored the legislation.

The legislation had major bi-partisan backing in the 96th Congress, with 255 House members and 43 Senators co-sponsoring the measure. In addition, the Senate Finance Committee voted 13 to 4 to include the bill as part of its tax cut proposal. It was the only amendment, out of 90, which was chosen by the Committee to be added to its basic tax cut package.

Included with this testimony are several editorials and other articles from newspapers around the country attesting to the grassroots interest in the legislation.

Impact of the Legislation on Giving

Will the Charitable Contributions legislation, in fact, do what it sets out to accomplish? Recent studies support the conclusion that the Charitable Contributions legislation will increase charitable giving more than the amount lost to Treasury.

In testimony before the Senate Finance Committee in January of 1980, Dr. Martin Feldstein, Harvard University Professor of Economics stated:

> "The statistical evidence indicates that the stimulus is substantial: Each 10% reduction in the price of giving induces an increase of about 13% in the amount of giving.
>
> The analysis shows that the legislation would raise giving by about $3.8 billion (at 1975 levels) while reducing tax revenue by about $3.2 billion. The extra giving represents a 13% increase in total contributions."

Before the same hearings, Charles T. Clotfelter, Associate Professor of Public Policy Studies at Duke University, stated:

> "Because it would allow non-itemizers to deduct charitable contributions in calculating taxable income, the legislation would create an incentive to give by reducing the net 'price' of giving."

Michael Boskin of Stanford said,

> "I believe that it is sensible legislation for a number of reasons. First, it will add substantially to charitable giving in sectors of our economy in a manner that is extremely efficient relative to alternative methods for doing so."

R. G. Penner of the American Enterprise Institute said,

> "With regard to the current charitable deduction, I have no doubt that giving would fall drastically if it were eliminated."

Importance of The Legislation to Taxpayers of Modest Means

This legislation will be of greatest help to the very taxpayers who will be affected most by the Administration's proposed $20 billion in budget cuts to social welfare, health, education, and related services. The measure will benefit the lower and middle income groups almost exclusively. The wealthy already receive tax benefits for their charitable gifts. Enactment of this measure will give a real and tangible tax cut to those who need it most; average working people. The Joint Committee on Taxation has determined that 83% of the revenue loss to the Treasury, if H.R.501/S.170 is enacted, will go to taxpayers with incomes under $30,000. Almost 60% will go to those with incomes under $20,000.

It is also this group of middle and lower income taxpayers which contributes by far the largest share of the funds given to charity. Of the $47 billion contributed to charity from all sources in 1980, about half was contributed by individuals with annual incomes under $20,000. It is only fair to give this group, which contributes so substantially to charity, a tax break for their charitable contributions similar to that enjoyed by the wealthy.

Tax Policy and Charitable Contributions

The President and many of the people here with him and with the new Congress believe that more public services should be delivered by voluntary organizations. Even without this conviction, it is likely that we are headed for a period of large Federal budget cutbacks, when Government will look to voluntary organizations to pick up the slack.

It is possible to open significantly the serving roles of individual citizens and their nonprofit organizations. The first step is to stop the Treasury Department from using its tax authority to capture money that should go to these voluntary groups. Treasury officials say that the drain from voluntary organizations was never intended but, in the face of tight Federal budgets, it is not the right time to correct this error.

This position absolutely contradicted a principle of the Carter Administration, which advocated citizen involvement and service. It would be utterly untenable in a Reagan Administration. If any President wants to stimulate greater private-sector activity, his Treasury cannot be allowed to engage in unfair competition with voluntary organizations - with, for example, church related day-care centers, Jewish homes for the aged, or Salvation Army service centers.

Historically, tax policy has encouraged the deduction of 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 that is to be fostered. In the last 10 years, however, this principle has been seriously undermined.

To simplify the income-tax system, the Government has increased the level of the standard deduction five times since 1969. In 1979, about 75 percent of all taxpayers used the standard deduction. This reduced incentives for giving among enough taxpayers to represent a loss of more than $1.5 billion to voluntary organizations in 1980. That 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 - that's all the money raised in 1980 by all United Way campaigns.

A recent Gallup survey revealed that in every tax bracket, taxpayers who itemized gave at least twice the amount of non-itemizers. The ratio is 3 to 1 in the $15,000-to-$20,000 income category.

The Charitable Contributions legislation is designed to offset both the inadvertent change of tax policy and the loss of dollars. The bills would, in essence, remove charitable contributions from the standard deduction and again allow all Americans to deduct their gifts. Contributions are not like other deductions. The others all represent expenditures that serve the taxpayers - interest payments, for example. The charitable contributions serves society.

Even the term and concept of standard deduction are no longer relevant. It is now called the "zero bracket amount" and is largely a vehicle for tax reductions. The Treasury acknowledges that the "zero bracket amount" no longer contains fixed dollars or percentages for the separate deductions.

The charitable contributions bills are designed only to redress the Government's significant undercutting of contributed income. It is hardly sensible or fair for the Government to capture money that should flow to voluntary groups, or for Treasury to espouse big government at the expense of pluralism, when the Government is trying to transfer responsibility back to private agencies. They cannot have it both ways, and neither can the country.

Americans of all philosophical and political persuasions are intellectually committed to our country's unique degree of voluntary action, but we assume this pluralism will continue without planning to ensure that it will.

A study conducted by The Urban Institute and released on May 15, 1981, indicates that giving to voluntary organizations would have to increase by 144% between 1981 and 1984 to offset the effects of direct cutbacks to the voluntary sector and a 10% average inflation rate. (See attached report, The Federal Government and The NonProfit Sector: Implications of the Reagan Budget Proposals.)

Private philanthropy and voluntary organizations cannot be expected to cover a significant proportion of the proposed cuts, and, unless immediate steps are taken to stimulate giving, will not even be able to come close to covering the direct losses to the voluntary institutions themselves.

The Charitable Contributions legislation would increase contributions by an estimated $4 to $6 billion a year. That would expand personal giving by 12%. Even if the Government were to lose a like amount -- estimates are that the loss would be far less -- the total would represent only a fraction of 1% of Federal expenditures.

For a society turning to voluntary organizations to compensate for government cutbacks, a 12% expansion of funds voluntarily contributed is a sensible first step in the right direction.

Concluding Statement

Enactment of this legislation is the right thing to do. It is right because it redresses the Government's significant undercutting of contributed income. It is right because it gives a tax break to taxpayers of modest income who have the major source of philanthropic dollars in this country. And it is right because it gives a tax break to those taxpayers who will bear the brunt of the Administration's proposed cuts in funding for a variety of social welfare and other programs.

On behalf of the 295 Members of INDEPENDENT SECTOR, I urge you to include the Charitable Contributions legislation as part of this Committee's tax bill.

# Hurting Voluntary Agencies

By Brian O'Connell

WASHINGTON — Ronald Reagan and many of the people here with him and with the new Congress believe that more public services should be delivered by voluntary organizations. Even without this conviction, it is likely that we are headed for a period of large Federal budget cutbacks, when Government will look to voluntary organizations to pick up the slack.

This heightened interest in voluntary initiative is welcome. But it is important not to give a false impression that voluntary organizations can substitute for the necessary role of the Government in a vast array of public services, such as public welfare and the enforcement of civil rights. It would be a disservice to President Reagan and the public to exaggerate what voluntary organizations can do, or what Government should not do.

Still, it is possible to open significantly the serving roles of individual citizens and their nonprofit organizations. The first step is to stop the Treasury Department from using its tax authority to capture money that should go to these voluntary groups. Treasury officials say that the drain from voluntary organizations was never intended but, in the face of tight Federal budgets, it is not the right time to correct the error.

This position absolutely contradicted a principle of the Carter Administration, which advocated citizen involvement and service. It would be utterly untenable in a Reagan Administration. If any President wants to stimulate greater private-sector activity, his Treasury cannot be allowed to engage in unfair competition with voluntary organizations — with, for example, church-related day-care centers, Jewish homes for the aged, or Salvation Army service centers.

Historically, tax policy has encouraged the deduction of 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 that is to be fostered. In the last 10 years, however, this principle has been seriously undermined.

To simplify the income-tax system, the Government has increased the level of the standard deduction five times since 1969. In 1979, about 75 percent of all taxpayers used the standard deduction. This reduced incentives for giving among enough taxpayers to represent a loss of more than $1.5 billion to voluntary organizations in 1979. That 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 — that's all the money raised in 1979 by all United Way campaigns.

A recent Gallup survey revealed that in every tax bracket, taxpayers who itemized gave at least twice the amount of non-itemizers. The ratio is 3 to 1 in the $15,000-to-$20,000 income category.

Charitable-contributions legislation (supported by 44 Senators and 255 Representatives in the last Congress) is designed to offset both the inadvertent change of tax policy and the loss of dollars. The bills would, in essence, remove charitable contributions from the standard deduction and again allow all Americans to deduct their gifts. Contributions are not like other deductions. The others all represent expenditures that serve the taxpayers — interest payments, for example. The charitable contribution serves society.

Even the term and concept of standard deduction are no longer relevant. It is now called the "zero bracket amount" and is largely a vehicle for tax reductions. The Treasury acknowledges that the "zero bracket amount" no longer contains fixed dollars or percentages for the separate deductions.

The charitable-contributions bills are designed only to redress the Government's significant undercutting of contributed income. It is hardly sensible or fair for the Government to capture money that should flow to voluntary groups or for Treasury to espouse big government at the expense of pluralism when the Government is trying to transfer responsibility back to private agencies. They cannot have it both ways, and neither can the country.

Americans of all philosophical and political persuasions are intellectually committed to our country's unique degree of voluntary action, but we assume this pluralism will continue without planning to ensure that it will.

The charitable contributions legislation would increase contributions by an estimated $4 billion a year. That would expand personal giving by 12 percent. Even if the Government were to lose a like amount — estimates are that the loss would be far less — the total would represent only a fraction of 1 percent of Federal expenditures.

For a society rapidly learning the practical limitations of big government and turning to voluntary organizations for help, a 12 percent expansion of funds voluntarily contributed is a sensible first step in the right direction.

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*Brian O'Connell is president of Independent Sector, an organization that is concerned with "our national tradition of giving, volunteering, and not-for-profit initiative."*

THE WASHINGTON STAR 1/26/81

# Short-Form Heroes

Among the quiet American heroes whom President Reagan hailed in his inaugural address were the "individuals and families whose taxes support the government and whose voluntary gifts support church, charity, culture, art and education." Unfortunately, the easier the government has made it to pay taxes, the harder it has become to contribute to nonprofit causes and institutions.

The same tax code that encourages giving by allowing us to deduct contributions from our income base also — and inadvertently — discourages it. The unlikely villain in this piece is the standard deduction. Over the last decade, it has more than tripled; today two-thirds of all taxpayers opt for the short form rather than the tedium of itemizing their deductions. And if you don't itemize, you can't deduct charitable contributions.

The effect on voluntary giving hasn't been surprising. In the same decade that has seen the standard deduction raised half a dozen times, the percentage of their income that people contribute has steadily declined — a $5 billion drop in all. It's bad enough that colleges, symphony orchestras, and rescue squads have suffered for the sake of our convenience on April 15th; even worse is how the standard deduction appears to be transforming charity into an activity only of the rich.

American philanthropy has maintained its effervescence because we've always been a nation of *individual* givers. Corporations and foundations, their logos affixed to the public television programs we watch, may be the most visible contributors to the nonprofit sector, but nearly 90 per cent of the giving in this country actually comes from individuals. In Europe, where philanthropy is less pluralistic, more institutional and seigneurial, there's a surprisingly widespread resentment of charitable acts that we rarely experience in this country.

But the standard deduction may be pushing us toward the European pattern. Eight out of 10 people who take the standard deduction are middle and lower-income taxpayers. It's these same eight who have less incentive to give — and who provide American philanthropy the individualism, local spirit, and flair for experimentation that have staved off stodginess. The more charity has to rely on the wealthy two out of 10 — and on institutions which can hire tax lawyers to manage their giving, and PR firms tastefully to hype it — the more likely are our bubbly, adaptive voluntary associations to lose their distinctive American fizz.

Mr. Reagan has wasted no time in reminding us that the services we expect from government have grown out of hand. He also appears determined to ask for a tax cut. These two themes dovetail nicely in a bill sponsored in the House by Reps. Richard Gephardt and Barber Conable, and in the Senate by Patrick Moynihan and Robert Packwood. If taxes are going to be cut, there's hardly a more attractive way to proceed than with what they propose: allowing people who take the standard deduction also to deduct their charitable contributions.

Under this plan, it's been estimated that the Treasury would lose about $2.2 billion a year in revenues. At the same time, voluntary groups — which often could do a better job providing some of the services now delivered via Washington — stand to make about $5.7 billion a year. And best of all, the tax cut would be progressive, helping most the low and moderate-income heroes who take the standard deduction and whose support the voluntary sector most needs.

Monday, December 22, 1980 THE CHRISTIAN SCIENCE MONITOR

# If Uncle Sam turns stingy, charities will turn to *you*

By Marshall Ingwerson

Boston

Who supports those who can't support themselves in the United States?

The answer many people would give is the federal government, through welfare programs, endowments to the arts, and various other grants to states, cities, people, and institutions.

But it appears likely that more people and programs will be counting on corporations and individuals for support in the coming years as Uncle Sam, as well as the major private foundations, become precarious sources.

This means that a growing share of what are now government programs will fall to nonprofit organizations – the "third sector" of the American economy – according to experts both in and outside nonprofit organizations. And the future of this third sector lies, increasingly with private contributions.

"If you're going to cut back government spending, then you've got to give people the incentive to give," suggests Jeffrey Lant, a consultant on management and fund raising for nonprofit groups. "We need to inculcate the individual spirit of philanthropy."

Inflation and the stock market have hobbled the wealthy foundations, and business corporations recently have overtaken them as contributors to worthy causes. "Corporate potential," says Steve Delfin, a spokesman for United Way of America, "is largely untapped."

But individuals still account for 90 percent of charitable contributions – overshadowed only by the government with its own social programs and $20 billion-to-$40 billion more each year in grants to others.

And federal largess to nonprofit programs, a lifeline to many of them, is still an open question under new Washington leadership. The so called third sector is waiting for clues – and expecting lean times.

"No one knows explicitly what's going to happen when Reagan gets in power," Mr. Delfin says. "But based on what we know of Mr. Reagan's philosophies, he's for decentralization of these things." This means, he explains, federal budgets will be cut and

voluntary, community agencies will have to take up the slack in providing services.

If the federal Head Start program is pared down in next year's budget, for example, a greater share of child care will fall to nonprofit day-care centers, Delfin notes, just as the demand for these centers is already straining resources.

It is human services – especially those for less articulate constituencies like children – that stand to lose most as corporations take over the domain of the independent foundation and the federal fist tightens, consultant Lant forecasts.

Institutions like museums and colleges tend to have sound corporate connections and will fare better, he says. Lant is adamant on one point: "Nobody gets a corporate nickel unless you're connected."

And local arts programs are "always last on the list," Lant says. Corporations favor funding large-scale "glamour projects" for their wide public-relations appeal.

Overall, Lant concludes, "All innovation will suffer" as corporations tend to concentrate their funds on the programs they know.

Meanwhile, the central effort in the nonprofit sector is to build individual contributions.

A charitable contributions bill awaits the 97th Congress.

According to Brian O'Connell, president of the Independent Sector, the bill would allow the roughly 70 percent of American taxpayers who use short forms to deduct contributions without having to shift to the longer tax form. It would mean $3 billion less in tax revenues, Mr. O'Connell figures, but it also would boost giving totals 15 percent, or $6 billion. Both President-elect Reagan and the Republican platform favor the bill.

The Independent Sector was formed last March as an organization of nonprofit groups, both contributors and receivers. Its message to Americans, according to Mr O'Connell: "If they want a society that has alternatives for social welfare, then they have to support them."

And to support them, Jeffrey Lant says, Americans need tax incentives. The Reagan administration, he says, "needs to make it easier for people to give."

THE BOSTON GLOBE THURSDAY, MAY 14, 1981 13

# Helping charity – and the taxpayer

**JEFFREY L. LANT**

America's more than 500,000 nonprofit organizations, particularly those in the human services where Reagan Administration budget cuts will be severely felt, have a fine opportunity to help themselves. But they'll have to act by the first week of June, when the House Ways and Means Committee finishes its tax work for the session.

Ways and Means is considering legislation allowing taxpayers to deduct charitable contributions regardless of whether they take the standard deduction. At present, taxpayers who use the short form or do not itemize deductions are not credited for their charitable contributions. Thus a gift of $100 to a nonprofit day-care center costs the full $100. The same gift by a taxpayer in the 40 percent tax bracket who itemizes his deductions costs $60.

There has, of course, always been this discrepancy, but the impact was less significant when fewer people used the short form. Since 1969 the Treasury has raised the standard deduction five times to simplify the tax system. As a result, less than 25 percent of all taxpayers itemize deductions.

The effect on charitable giving is hardly surprising. The more people using the short form, the fewer making charitable contributions and the smaller the contributions. A recent Gallup Poll shows that itemizers in the $10,000-$15,000 income bracket in 1978 contributed an average of $324 to charity, compared with only $249 for non-itemizers. When all income brackets are considered, the mean average contribution of itemizers was $652 compared to only $210 for non-itemizers.

In 1978 a movement arose in Congress to reverse that trend. The movement is currently spearheaded by Reps. Richard A. Gebhardt (D-Mo.) and Barber Conable (R-N.Y.) and Sens. Robert Packwood (R-Ore.) and Daniel P. Moynihan (D-N.Y.). Each year their bill (HR-501 and S-170) creeps a little closer to passage as the leading arguments against it have been dealt with.

The chief of those arguments has been its potential cost in lost federal revenue. Supporters of the legislation, using figures provided by Harvard economist Martin Feldstein, admit that it will cost the Treasury about $4.8 billion a year. However, they say that the benefit to public charities will be about $5.7 billion yearly, a figure that goes some of the way toward making up the $20 billion in Reagan-promoted federal budget cuts.

Increasing citizen support of civic organizations and broadening public participation is, of course, a hallmark of the Reagan philosophy. Thus it is no surprise to learn that both the President and the Republican platform endorse this legislation. Moreover, in the House and Senate the legislation has attracted broad bipartisan support: 108 House Democrats and 112 House Republicans are sponsors: 12 Senate Democrats and 12 Senate Republicans, too.

There seem to be two obstacles:

1) Liberal Democrats fear that the anticipated loss in federal revenue under this legislation might imperil favored social programs which the President's measures have already adversely affected. They have thus withheld their support. The Massachusetts congressional delegation, for instance, despite the wealth of nonprofit organizations in this state, has hung back.

Proponents counter the objections of the liberals by citing the incalculable advantages to be gained in encouraging more people to support public charities and nonprofit organizations, a benefit only a bill of this kind can provide.

2) Despite the high-blown Republican rhetoric in favor of this bill, there has not been a notable push from the White House for its passage.

At this juncture, nonprofit organizations can help themselves first by urging the recalcitrant members of the Massachusetts congressional delegation to support this legislation and, second, by urging House Speaker Thomas P. O'Neill and Rep. Daniel Rostenkowski (D-Ill.), chairman of Ways and Means, to do so. Unless they act, an important measure capable of mitigating the sting of the budget cuts on nonprofit organizations will be shelved until another Congress assembles.

*Jeffrey L. Lant is president of a Cambridge-based firm assisting nonprofit organizations.*

OCTOBER, 1980

## *Business Mirror*

By JOHN CUNNIFF
AP Business Analyst

# America's Independent Sector

NEW YORK (AP) — You are familiar with the business sector. You are aware of the government sector. But you probably do not even recognize this sector of American life, or if you do, cannot name it:

It is one of the largest influences in American life, but as one commentator said, some of the simplest statistics about it are not collected, scholars rarely study it, teachers seldom teach about it.

It consists of a vast array of vital entities such as colleges, churches, voluntary hospitals, philanthropic foundations, symphony societies and research centers devoted to the general welfare.

It's members are private and nonprofit, but they operate for the general welfare and spend more than $80 billion a year. And they depend on donations of 50 million Americans to continue their work.

This is the independent sector. "We believe passionately in it," said Brian O'Connell. It is, he said, a creative force, an outlet for free expression, a voluntary movement, a uniquely American development, and an alternative to business and government, the two other sectors.

He fears, however, that it is often overlooked, as unknown in some respects as the dark side of the moon, although in his view it not only represents the American people but IS the American people.

To be overlooked is not just difficult to underfand, he comments, but injurious too, particularly since institutions of the independent sector depend on contributions for health and survival.

In the past decade, he said, giving is down 10 percent, and at least part of the reason is a consequence of the sector's poor recognition.

O'Connell is president of the six-month-old Independent Sector — the organization and the sector share the name — so named by members who seek to be more clearly categorized as the third sector of society.

Business isn't the guilty one, said O'Connell, former director of the Mental Health Association. Last year corporations gave a record $2.3 billion, exceeding foundation contributions for the first time.

He doesn't place blame directly on individuals either, because they continue to provide 90 percent of charitable and philanthropic giving. In fact, O'Connell declares, neither does he blame government.

Still, he concedes, the federal government has created a problem, one that is related to the third sector's lack of recognition. It was done inadvertently, he said. The intent was to help, not hinder.

The source of the damage appears to be the Internal Revenue Service code relating to charitable, tax-deductible contributions. Six times in the past eight years the standard deduction has been increased, until it is now $3,400 for a married couple, compared with $1,000 in 1970.

Itemization is better for those who depend on contributions, according to O'Connell. He refers to a survey showing itemizers contribute three times as much to charity as those who take the standard deduction.

Now, says O'Connell, almost every independent sector organization, large or small, community-based or nationwide, religious or secular, "is faced with the prospect of having to curtail its activities."

Increases in the standard deduction, he maintains, parallel the percentage declines in giving. But small percentage declines, he emphasizes, can and have amounted to hundreds of millions of dollars.

And so, as one of its first pieces of business, the Independent Sector — the foundations, the corporations that give, and the major voluntary organizations — are seeking a change in the tax law.

They are supporting two bills, S.219 and H.R. 1785, which would authorize taxpayers to itemize and deduct charitable contributions regardless of whether they also take the standard deduction.

As O'Connell sees it, nobody in government really intended to deprive or endanger the independent sector, and the strong support the bill has received in Congress suggests that others too feel the same way.

To O'Connell, who has spent a lifetime in the independent sector, it means more than the preservation of existing institutions.

"One of our most basic jobs" he says, "is to keep open the freedoms that lead to new causes."

Taxes

# Bill Shows Charity to Non-Itemizers

By Kathleen Burns

A bill to permit charitable deductions for taxpayers that don't itemize has been introduced in both the House and Senate with bipartisan support.

Senate sponsors include Sen. Robert Packwood, R-Ore., and Sen. Daniel Moynihan, D-N.Y. On the House side, proponents include Rep. Barber Conable, R-N.Y., and Rep. Richard Gephardt, D-Mo.

Under the current law, an estimated 72 percent of all taxpayers elect the standard deduction. Thus, they are not eligible to deduct charitable contributions from their gross income.

"During the past decade, Congress has raised the standard income tax deduction on six occasions, from $1,000 for those filing jointly to $3,400," said Gephardt in a press conference. "No one questions the benefit this has brought to million of American families who take advantage of a device which saves countless hours in the preparation of their tax return, without increasing their tax liability."

But if you can't deduct it, you'll think twice before giving it away, the legislators maintain.

"Recent studies reveal that the average contribution of those who itemize is three times the average for non-itemizers," Gephardt said.

According to a recent Gallup Poll, those that itemized on their tax forms in 1978 who were in the $10,000 to $15,000 bracket contributed $324 in donations compared to $249 for those that took the straight form. In the $15,000 to $20,000 bracket, the averages were $652 for those that deducted and $222 for those that didn't. In the upper brackets from $20,000 to $50,000, those itemizing gave $658 to charity compared to those that didn't who contributed $281.

Independent Sector, a Washington-based umbrella group representing 250 of the country's largest charitable organizations, said that passage of such a bill would increase donations to charitable causes by an estimated $5.7 billion annually versus the projected $2.2 billion loss to the U.S. Treasury.

About 83 percent of the tax savings would go to families with incomes under $30,000, on projections from Harvard University economist Dr. Martin Feldstein.

The organization had considered the merits of a tax credit but rejected it in favor of the tax deduction. Independent Sector pointed out that tax credits are, in effect, rebates or a return of government money to a taxpayer.

"This makes the government, not the taxpayer, the contributor to public charities," the organization stressed. It further noted that "Organizations which rely heavily on large contributions (hospitals, for example) as against those which rely on innumberable small contributions from all segments of the population (e.g. United Way) would suffer badly" under the tax credit scheme.

Don Foley, an aide to Gephardt, said the current administration is expected to support the bill since the proposal was initially endorsed by the 1980 Republican Party Platform. In his inaugural address, president Reagan also called attention to the "individuals and families whose taxes support the government and whose voluntary gifts support church, charity, culture, art and education."

Statistically, an estimated 90 percent of the charitable giving in this country is done by individuals rather than through philanthropic groups.

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# To Help Private Giving

Robert Akerman

SINCE THE U.S. economy is moving toward a record proportion of gross national product going into federal government programs through taxation, those who believe in the free enterprise system see a necessity for some kind of tax reduction.

One issue which divides them, however, is the matter of timing--do you cut federal spending first, to avoid a bigger inflationary deficit, or do you cut government revenue through tax reduction in the hope that it will force cuts in spending?

And another point of debate is whether to push for general tax cuts or to give priority to carefully targeted cuts that stimulate especially desirable types of economic behavior.

These two issues are somewhat interconnected, since the belief that it is important to avoid a bigger deficit will also lead to greater concern about priorities as to the substance of tax cuts.

As far as economic factors are concerned, I take the position that we should begin with tax cuts that stimulate personal savings and business investment. This reflects a concern for both limiting the deficit and doing the most to spur productivity.

But, for social reasons, there are other tax concessions that ought to have high priority. A good example of the sort of tax reform we ought to enact as soon as possible is to extend the right to make a deduction for charitable giving to those who do not now itemize deductions in preparing their tax return.

When noted reformer John Gardner (of Common Cause fame) and the conservative Heritage Foundation agree on something, it has to be significant. And Gardner, now head of an organization called Independent Sector, is in full agreement with the Heritage Foundation that we face a crisis in charitable giving due to defects in the tax laws. In a study of "Philanthropy in America," the Heritage Foundation had pointed out that while donations to charity appear to have risen dramatically since World War II, actually the pace has slackened since 1970—especially if allowance is made for the factor of inflation. If dollars given to charity are adjusted into the real value of those dollars, contributions from foundations and charitable bequests have in fact declined.

A major factor in discouraging charitable donations has been the effort by the government to simplify the tax code by encouraging the use of the standard deduction. Since 1970 the proportion of taxpayers using the short form has increased from 50 percent to about 70 percent. As Heritage Foundation puts it, "When a taxpayer takes the standard deduction, he receives no tax break for any charitable contributions he makes. If he gives $100 to his church or a local college he cannot deduct any part of the gift from his taxable income. Thus, the cost of the gift to him is $100. If, on the other hand, he were to itemize and is in the 40 percent tax bracket, the deductible gift would involve a net cost to him of only $60."

There are several points to be noted about this situation. First, it obviously discourages private charitable giving to some extent. Organizations in the "Independent sector" about which John Gardner is concerned estimate that this trend in the tax system has cost them some $5 billion in just seven years between 1970 and 1977.

Second, although the drive to simplify the tax laws has been called a "reform," the present set-up gives the wealthy person who itemizes deductions a benefit that is not given to the low- or middle-income taxpayer who does not itemize because he or she doesn't have enough other deductions to justify it.

Third, it should be realized that while government gains revenue from this unfair deterrent to private giving, society does not gain a benefit. More of the burden for philanthropic activity simply is shifted to government when charitable and educational institutions have less revenue to do their jobs. Indeed, those who believe that private action is inherently preferable to government action will view this trend as an actual detriment to a free society.

I think we should give serious consideration to the proposal to allow a special deduction for charitable donations by all taxpayers. It should be done as soon as possible. And because there are so many socially and economically desirable actions which can be encouraged through careful revision of the tax laws, it would be a shame to rush into massive across-the-board cuts which are not precisely targeted to encourage responsible private behavior.

Jacksonville, Sunday, May 3, 1981

# *Congress needs a push on charitable giving policy*

One of the painful aspects of making out a personal income tax return is the knowledge that many others are paying less because they are more skilled in the art of dodging.

Tax policy is like the law that forbids sleeping under bridges. It applies equally to millionaires and vagrants. In spite of the seeming evenhandedness, this law doesn't restrict the activities of millionaires perceptibly but it plays havoc with the lifestyle of vagrants.

Or perhaps taxes are more aptly compared to the rain in the poem which says it falls upon "the just and unjust fella, but more upon the just because the unjust hath the just's umbrella."

Congress now has before it a straightforward tax amendment that would benefit the good causes in American life. It would be equal not only in name but in reality.

The 96th Congress, to its shame, let this amendment die. The 97th can, and should, revive it.

The amendment would have allowed taxpayers to deduct the charitable contributions they made during the year whether or not they take the standard deduction.

As things now stand, taxpayers must make a choice between itemizing or taking the standard deduction. They can't do both.

Taking the standard deduction greatly simplifies tax preparation but it also reduces the motivation for charitable giving.

Charitable giving in the United States has suffered from the greatly increased usage of the standard deduction, which has risen sharply over the past nine years.

There are estimates that this increased usage of the standard deduction has resulted in a decrease in charitable giving over this nine-year period by about $5 billion.

Yet, U.S. tax policy should be encouraging the charitable giving that supports thousands of nonprofit organizations whose work relieves government — and thus the taxpayer — of a great burden.

They support youth work, hospitals, schools, work with the handicapped, the fight against disease, day care and help for the elderly. They are the nuclei around which gather millions of volunteers.

The dollars thus spent offer the greatest possible return in the form of actual good works.

The estimated annual cost to the treasury of this measure would be about $2.2 billion, a fraction of the proposed tax cut but a natural part of that tax cut.

The estimated annual return to the organizations of the nature of those that belong to Jacksonville's United Way would be a yearly $5.7 billion.

States and communities across the nation are seeking ways to help compensate for the loss to good causes that will be sustained as a result of the budget cuts in the offing. This is an obvious and productive move along that line.

Two proposals that would effect this change are now in Congress.

One is H.R. 501 sponsored by Rep. Richard Gephardt, D-Mo., and Rep. Barber B. Conable Jr., R-N.Y. The other is S. 170 with Sen. Daniel P. Moynihan, D-N.Y., and Bob Packwood, R-Ore., as sponsors.

The proposal died last year and it may well die this year, despite its obvious merit, unless a showing of public support is made.

It is time the American people involved themselves in tax policy and demanded changes that will help create a more humane America instead of letting it be dictated by a narrow range of informed, but often selfish, interests.

STATEMENT OF JOHN K LAMB, CHAIRMAN, COMMITTEE ON LEGISLATION, BUSINESS ADVERTISING COUNCIL, INC.

Our members are following the news coverage of the upcoming legislation on taxes. We feel that it will be mutually beneficial for us to communicate the views of our membership.

The need of all business, and especially small business, is for greater working capital. This need can be met through encouraging investment and allowing retention of earnings for working capital. Inflation alone in recent years has created a requirement for additional working capital just to carry the annually increasing cost of inventories, accounts receivable, wages and benefits, regulation, and other overhead items, as well as federal tax bracket creep. To correct this capital deficiency, we urge your support of:

1. Immediate reduction of corporate income taxes on earnings under $250,000 to permit retention of earnings for working capital by small business which needs it most. We follow the small business trade associations' recommendations on the bracket structure.

2. Immediate reduction and eventual elimination of capital gains taxes to encourage investment.

3. Reduced taxes on interest, dividends, and other returns on invested capital to a level not to exceed earned income.

4. Accelerated depreciation up to a $250,000 asset value. Access to unlimited amounts would result in unequal treatment, benefiting corporate giants which could soak up huge amounts of the tax expenditure to the extent of reducing the other tax reductions which we seek.

Although many of our members would personally benefit from Kemp-Roth personal tax cuts, we agree that business tax cuts (suggested above) should begin right away, and that those for individuals should be delayed.

We support the concept of supply-side economics, and believe that you recognize that past federal tax policies which have hurt small business resulted from theories now proven to be erroneous and which should be reversed.

Small business - 14,000,000 strong - are the most intensive employers of labor. Support of our positions should provide an immediate increase in employment, and for the longer term, a greater supply of goods produced more efficiently to combat inflation, and a more competitive USA.

Some support earmarked for small business seems important to assure our citizens that ours is not a government by, for, and of big business.

## STATEMENT OF EUGENE LERNER, PROFESSOR OF FINANCE, NORTHWESTERN UNIVERSITY'S KELLOGG GRADUATE SCHOOL OF MANAGEMENT

My name is Eugene Lerner. I am a Professor of Finance at Northwestern University's Kellogg Graduate School of Management. I want to address the question of the tax treatment of dividends that are reinvested by shareholders in the companies that they own. Specifically, I urge that the taxes on these reinvested dividends be deferred until the shares that are purchased are sold.

This committee hardly needs to be reminded that the high interest rates that prevail have weakened the financial position of many companies. While these firms could in the past borrow money to expand and replace their plant and equipment, this option is no longer available. The high interest rates and extremely difficult money market conditions have limited their access to the debt capital market.

The inability to finance capital expenditures has direct repercussions upon both the productivity and employment levels in the country. Productivity is directly linked to the amount of capital that a worker has at his or her command. And employment levels are intimately tied to the volume of capital expenditures. Unless capital expenditures increase more rapidly, the continued deterioration of productivity is likely to continue and the level of economic activity is likely to continue to be sluggish.

How then is the Gordian knot to be cut? How are the firms to finance their required capital outlays?

The answer must inevitably be that new capital expenditures will to an ever larger extent, have to be financed with equity.

There are, however, a number of practical problems with this resolution of the problem. First, investors want a current return on their investment in the form of current dividends. This does not mean that rational investors have an obsession with dividends and would not be willing to substitute capital gains for current dividends. However, with interest rates high, the price of publicly traded shares have not increased nearly as fast as inflation. To maintain their returns, investors have been compelled to look more and more toward their dividends that they receive.

Second, because of the need to keep dividends high and growing, firms have not been able to keep their dividend payout ratios at low levels. Rather, many firms have been compelled to increase their payout ratios. More and more firms now have higher dividend growth rates than earnings growth rates.

Finally, the high interest rates, which have lowered stock prices, have prevented firms from selling new equity issues to prospective investors at favorable rates. Even though a firm may like to finance its plant expansion and replacement with an equity issue, it may be reluctant to adopt this course of action if it results in the price of existing shares falling or if it forces the firm to adopt a nonsustainable sequence of future dividend payments.

It is not certain that there is any solution to the problem of the financing of new equipment short of halting the inflation. But a more liberal attitude toward the dividend reinvestment question would be a step in the right direction.

The adoption of a tax deferral program on reinvested dividends would let shareholders make the decision for themselves in a more unbiased way as to whether they wanted current dividend income or future capital gains. As the law now reads, a person must pay taxes on the dividends that he reinvests in the company. As a result, the investment not only does not return any cash at all but actually costs the investor something because he or she must pay taxes on a cash flow that was never actually received.

Were the legislation under consideration passed, some investors would opt to have their dividends reinvested in the company. While they would not then receive any current income, they would not be penalized by having to pay taxes on a cash flow that they never actually received.

In short, the proposed legislation is a step in the direction of helping firms replace and expand their capital by letting them raise equity capital on more attractive terms than now exist. The legislation would be an important step toward both increasing productivity and creating more jobs. Both of these developments are necessary if the nation is to fight the twin evils of inflation and stagnation.

I strongly urge the adoption of legislation that will postpone the taxes on reinvested dividends.

Testimony of Thomas McDermott, Co-Chairman of the Government Affairs Committee, American Supply Association, Before the Senate Finance Committee Hearings on Administrations's Tax Reduction Proposals, May, 1981.

Mr. Chairman: The American Supply Association is greatly concerned about the future of this year's tax bill and is glad to have this opportunity to inform the Committee of the views of individual plumbing-heating-cooling-piping wholesalers, whom we represent.

First, let us say that ASA enthusiastically endorses President Reagan's view that the economy needs sufficient tax stimuli to spur renewed capital formation throughout every sector of our economy. As small business people, we strongly support the kind of individual tax cuts proposed by the President -- because so many small businesses are unincorporated and individual tax cuts translate into business tax cuts for many in our industry. The American Supply Association recognizes that some will have differences on the details of the cut; however, we urge the Committee to stand by the President's principal aims and take whatever steps are necessary to ensure that the bulk of the President's package on individual cuts stays intact.

Second, we strongly support the 10-5-3 proposal for accelerated depreciation. We have testified before this Committee in the past in support of accelerated depreciation and we were delighted to have the President endorse this approach in the first round of tax revisions. We would have preferred to have seen a reversal of the _Thor_ decision, as well as revision of the elements of FIFO and LIFO that we consider unwieldly and counterproductive; yet, we understand the reasons behind a lean, first tax bill followed by a second bill that we would hope will encompass comprehensive revisions of the inventory rules.

ASA therefore strongly endorses the principal thrust and many of the details of the President's tax program. We are committed to its speedy passage and want nothing to jeopardize its enactment.

Yet loyalty to the President's program and a concern for the construction industry also requires us to outline our single most important misgiving: ASA believes that the future looks so bleak for the construction industry that, if immediate steps are not now taken through this tax bill, we face serious and negative economic consequences in the months ahead.

Witnesses have already presented the Committee with ample statistical data on these problems: production for 1980 was down 26% from 1979 and 57% over a two-year period; sales are declining and inventory is building; and there is a shortage of money to lend, with thrifts reporting net new money down 29% from 1979 and 75% from 1980. ASA is dependent on the construction industry, yet so is our entire economy. We believe that steps must be taken to increase savings and promote construction -- and that these steps can begin with prudent use of the proceeds of the individual tax cuts suggested by the Administration. ASA believes that we must link tax cuts with incentives to save and we believe that these savings can be advantageously and productively used to purchase housing.

ASA has therefore joined Congressman Tom Petri (R-Wisc) in developing HR2968. The bill combines many of the features that have been discussed before this Committee, yet places them in a tight, integrated package incorporating tax principles familiar to every American.

- a 25% tax credit up to $250 ($500 on a joint return) on interest and divident income;

- universal taxpayer eligibility for Individual Retirement Accounts;
- an increase in the maximum IRA contribution to $2,000, but allowing another $2,000 tax-free contribution by taxpayer's spouse;
- a $15,000 withdrawal for purchase of a principal residence, with the tax consequences spread over three years;
- a $15,000 withdrawal to finance a child's education expense; and
- a bonus of 14% for lower income savers holding their IRA contributions in the account for 7 years.

The first focus of the bill is quite clearly to stimulate the desire of taxpayers to save, rather than to continue to spend on consumables. The Individual Retirement Account has already proven a popular vehicle for saving, so popular that members of the Administration and this Committee have already voiced their support for expanding IRA's -- both in terms of eligibility and in terms of the annual tax-free contribution. Its long-range goal of providing a mechanism for saving towards retirement comes at a time when Social Security becomes more obviously inappropriate to bear the full burden of retirement.

The Petri bill, however, makes the IRA a more versatile savings vehicle. Those who now maintain IRA accounts, but who wish to purchase a retirement home, may do so. A young family finding it increasingly difficult to buy a first home may use an IRA, thereby accumulating savings at a faster rate. [Note that statistics show only one taxpayer in eleven now has the financial wherewithal to purchase the median-priced U.S. house as a first home.] And, others who simply wish to upgrade their living conditions may do so with the aid of their IRA.

Spending of this sort is productive and fits clearly within the administration's goals for this tax cut. Having additional new money available through the thrifts and of having new buyers in the housing marketplace will go a long way towards improving a housing industry that sits at the very hub of our economy.

ASA is proud to take a lead position in advancing legislation for its industry. We are comfortable with the knowledge that these are not parochial interests, but reach out to the hopes and aspirations of every American. The American Supply Association will have a great deal more to say about this legislation in the days and months ahead, and we appreciate having the Committee's time and attention as we articulate our views.

1125 Fifteenth Street, N.W.
Washington, D.C. 20005

Mortgage Bankers Association of America

Thomas T. Shealy
*President*
*Mortgage Bankers*
*Association of America*
202-861-6501

May 27, 1981

Honorable Robert Dole
Chairman
Committe on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

On behalf of the Mortgage Bankers Association of America (MBA), I should like to offer these comments for record of the hearings recently held by the Senate Finance Committee on the Administration's tax cut proposals. MBA, the trade association of this nation's mortgage lending industry, supports the Administration's proposed personal income tax cuts, but only if they are accompanied by appropriate cuts in government spending. We believe this is necessary to avoid fueling current inflationary pressures. In addition, MBA believes that certain amendments to current tax laws are needed to encourage long-term savings and new investment. Such encouragement will foster additional capital formation that will increase America's productivity rate and reduce inflation.

Toward these ends, MBA supports the following:

1) an increase in the current deduction for interest and dividend income from $200/400 to $1,000/2,000;

2) an increase in the current deduction for contributions to an individual retirement account (IRA) from $1,500/1,750 to $2,000/2,250, and a broadening of the IRA coverage to include all taxpayers;

3) a reduction in the tax rates on "unearned" income to eliminate the unfair tax burden that results from applying the highest tax rate to income from savings and investment, and which acts as a disincentive to long-term savings; and

4) tax provisions regarding commercial and multifamily income property that provide for:

   a) a maximum depreciation period set by law that would allow reasonably prompt recapture of investment;

   b) restoration of the deductibility for construction period interest and taxes;

c) elimination of the current limit on investment indebtedness; and

d) permission to treat business expenses incurred prior to the opening of commercial properties as current deductions rather than requiring that they be capitalized.

## TAX INCENTIVES FOR SAVINGS

The housing need during the 1980s is projected to be the greatest in U.S. history. Nearly 41 million persons will reach the prime home-buying age of 30 during the 1980s, 10 million more than reached that age during the 1970s. Many housing analysts feel that annual housing starts of 2 million will be necessary to satisfy this demand. A shortage of affordable funds for mortgages kept starts at less than 1.3 million in 1980, and starts are likely to be no higher than 1.3 million this year.

The key factor in meeting projected housing needs will be an adequate supply of affordable funds for home mortgages. In the past, the housing and mortgage finance industries have depended upon the personal savings of millions of Americans to supply the necessary funds for home mortgages. However, personal savings can no longer be counted upon as a dependable, stable source of funds for mortgage lending in part because the rate of personal savings is so low. For 1980, the rate was just above 5.5 percent, well below the 8.5 percent average experienced in the first half of the 1970s. Unless there is an increase in the rate of personal savings, it will be extremely difficult to secure affordable mortgage financing to meet America's housing needs.

We believe that tax incentives for savings will not only cause a substantial increase in the personal saving rate, but are necessary for such an increase to occur. The structure of the current tax system discourages savings. Interest income from savings is added to a taxpayer's wage or salary income and is consequently taxed at the taxpayer's highest marginal tax rate. By imposing such a high, effective tax rate on income from savings, particularly in an environment of rapid inflation, any natural propensity to save is discouraged. President Reagan's program for cutting personal income taxes, which MBA supports, provided appropriate reductions are made in government spending, will not change this tax treatment of interest income. Marginal rates will be reduced but interest income from savings will still be added to a taxpayer's wage or salary income and taxed at the taxpayer's highest marginal tax rate.

Broadening the eligibility requirements for tax-deductible contributions to IRAs and increasing the maximum IRA deductions, and increasing the current $200/400 interest exclusion from personal income taxes will stimulate new savings and provide a more stable longer term source of capital, particularly for depository institutions. In turn, this will make more money available for mortgage lending by these institutions, to the benefit of the homebuying public.

## REAL ESTATE INVESTMENT TAX REFORM

In addition to removing impediments to savings in current tax law, we also urge the Finance Committee to do the same for real estate investment, particularly in multifamily housing. The demographic factors mentioned earlier will create a large demand for new multifamily rental housing and commercial facilities with corresponding capital requirements. Unless impediments to investment contained in current tax law are removed, the real estate industry will be hard pressed to meet these capital requirements during this decade and beyond.

There are four broad areas that we believe the Committee should examine carefully in order to identify and remove impediments to investment:

Depreciation This area currently is marked by constant disputes between taxpayers and the IRS over what constitutes the useful economic life of a structure. MBA believes that a minimum, reasonable, and certain limit should be set for all structures. Such an approach would encourage investment and eliminate expensive and lengthy taxpayer-IRS disputes without incurring a large revenue loss for the government.

Deduction of Construction Period Interest and Taxes Section 189 of the Code requires interest and taxes paid during the time of construction to be amortized over ten years. This provision works a hardship on owners, particularly during times of extremely high interest rates. The construction period expenses for interest and taxes are a significant element in the cost of a real estate project. The industry guideline is that construction period interest paid will total roughly the interest rate paid times one-half the cost of the building Thus, for example, a $20 million structure with 14 percent construction financing will incur a construction period interest expense of roughly $1.4 million. Requiring this expense to be capitalized and recovered over ten years, in inflationary times, means that owners not only must wait for the tax relief, but also will receive it in dollars that have less purchasing power than those invested during the construction period. We urge the Committee to repeal Section 189 of the Internal Revenue Code and permit the deduction of construction period interest and taxes as an expense in the year they are incurred.

Interest on Investment Indebtedness A third area that should be examined carefully by the Committee is the limitation on deduction of interest on investment indebtedness by individuals and partnerships imposed by Section 163 of the Internal Revenue Code. Successful real estate developments are often highly leveraged. During times of high inflation, with interest rates at record levels, debt service may exceed income by a wide margin for the initial years of operation. The cost of the money used to finance the acquisition of real estate is a necessary and ordinary business expense. There is no economic reason for limiting the deduction of interest investment expense by individuals and partnerships, and MBA urges the Committee to repeal this section.

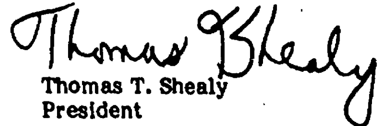
Deduction of Pre-Opening Expenses Owners of commercial facilities and, to a lesser extent, multifamily projects incur expenses prior to the time they are

operating as a business. The Internal Revenue Service, by regulation, has required these expenses to be capitalized rather than deducted as current expenses. These types of expenses are not acquisition or construction expenditures of the type that are traditionally amortized. They are necessary and ordinary business expenses even though they are incurred prior to the time the business is a formally operating entity. We recommend that the Committee add appropriate language to Section 162 of the Internal Revenue Code that will specifically define such expenses as currently deductible trade or business expenses.

The removal of current tax law impediments to savings and investment that we have identified will stimulate residential and commercial construction in the coming decade. This action will assure that America's needs for housing and for energy-efficient and productive commercial facilities will be met.

We appreciate the opportunity to submit our views and would be pleased to furnish additional information if requested.

Sincerely,



Thomas T. Shealy
President

TTS/dw

National Association of Federal Credit Unions · 1111 N. 19th Street Arlington, Virginia 22209 · 703/522-4770

May 27, 1981

The Honorable Robert Dole
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Chairman Dole:

We, at the National Association of Federal Credit Unions (NAFCU), respectfully submit this statement for the record of the May 13-21, 1981 hearings of the Senate Committee on Finance concerning the Reagan Administration tax cut proposals. NAFCU is the only national trade association exclusively representing the interests of our nation's federally chartered credit unions. There are 12,708 Federal credit unions throughout the country whose 26.3 million members hold more than 36.6 billion dollars in savings.

We appreciate the opportunity to provide the Association's views as you consider the tax aspects of the President's economic recovery program. The tax policies being explored by this Committee will have a substantial impact not only on our nation's consumer-owned and operated credit unions, but upon every American citizen.

Administration officials have expressed the view that the proposed three-year, 30 percent tax cuts will promote a substantial increase in savings. However, this does not appear likely, considering the rate of savings among Americans for the past several years, and the absence of incentives to save. The average rate of savings in 1980 was only 5.6 percent. In comparison, the savings rate in the early '60's, when the economy was thriving, was also at a low of 6.0 percent. NAFCU believes that the lack of savings in this country is a result of an overall policy which encourages consumption and discourages saving.

We fail to see how an across-the-board cut in personal income taxes will change consumer attitudes toward saving. It will simply spur consumer spending or provide funds to reduce bills which have accumulated during periods of high inflation rates. Incentives to save are needed to convince consumers to become savers.

NAFCU believes that savings incentives must be included in the tax bill to be passed this year. By simultaneously legislating tax cuts and savings incentives, the Administration would stimulate new savings. On the other hand, we believe if the tax cuts are passed and the savings incentives are postponed, consumers will continue

traditional spending patterns and the Congress will have lost an excellent opportunity to reverse this trend.

Current problems involving dependence on the Social Security system and lack of adequate retirement income reflect the failure of Americans to save for their retirement. It is time for the Congress to make saving make sense by rewarding saving, and encouraging consumers to plan for their retirement years. We believe that this Committee can help build renewed faith in the value of saving.

## TAX INCENTIVES TO SAVE

In the past, the National Association of Federal Credit Unions, with the welcome support of many members of Congress and of 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. But, to stimulate saving Congress must go much further in providing meaningful savings incentives.

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 England, 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, the savings rate in the United States has dropped to the lowest of all industrialized nations in the western world. The current rate of savings is down to 4.7% of disposable income. This rate, which has remained consistently low over the past two years, reflects a continued decline in the consumer attitude toward saving.

One must ask why it does not make sense to save in this country today. The symbiotic partnership of inflation and the U.S. tax code discourages the prudent consumer from saving. Earnings are first taxed as income to the recipient. When income is saved the savings are reduced in value by a high inflation rate, an insidious hidden tax. Then the yield on what has been saved is taxed once again. As a result, the individual often receives a negative return on savings. Therefore, there is little real incentive to save, while spending is immediately forced by price escalation and further encouraged by an inflationary mentality which assumes that what is expensive today will be more expensive tomorrow.

The probability of tax cuts tremendously increases the urgency to reverse the trend of a diminishing rate of personal savings. We urge this Administration to remove the tax on interest and dividends so that the tax cuts will result in stimulation of productivity and saving.

INDIVIDUAL RETIREMENT ACCOUNTS

Inflation has taken its toll on the elderly, while pressures on the Social Security system and private retirement plans point to the need for additional sources of retirement funding. 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 constructive 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 (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 IRAs to many working Americans. IRAs 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 be then extended to borrowers in the form of consumer and mortgage loans.

Specifically, S. 243, introduced by Senator Chafee, a distinguished member of this Committee, proposes several changes in this structure to make these accounts much more attractive to both the consumer and the financial institution. To expand the eligibility requirements so that all wage earners would have access to these tax-deferred accounts would prompt new savings that would benefit our society now and retirees in the future.

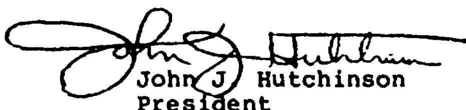
The National Association of Federal Credit Unions supports the Administration in its efforts to provide tax cuts. Simultaneously, however, we urge Congress to include incentives for savings so that the tax cuts do not result in further inflation. We,

therefore, endorse prompt action by Congress to expand and make permanent the tax exclusion for interest and/or dividends.

In addition, we strongly urge the expansion of eligibility criteria for Individual Retirement Accounts as an effective incentive to prompt new savings. The exclusion for interest and/or dividends will reward those who are already saving, and the expansion of IRAs would provide 60 million more workers with a new savings opportunity, and open a whole new source of savings deposits.

I thank the Committee for the opportunity to present the views of the National Association of Federal Credit Unions. If you have any questions regarding our position, please feel free to contact Dick McConnell, our executive vice president.

Sincerely,



John J. Hutchinson
President

## STATEMENT OF DENIS R. ZEGAR, DIRECTOR, GOVERNMENT SERVICES, NATIONAL AMERICAN WHOLESALE GROCERS' ASSOCIATION

Mr. Chairman, we appreciate the opportunity to present to you the views of the National-American Wholesale Grocers' Association (NAWGA) on vital tax issues now under review by your committee.

NAWGA is a non-profit trade association of grocery distribution companies that provides programs in technical, educational, and government services on behalf of its nearly 400 wholesale grocers. NAWGA members operate over 850 distribution centers nationwide, serving independent grocery stores and foodservice establishments throughout the Nation. NAWGA members' annual sales volume approaches $50 billion, accounting for roughly one-third of the Nation's grocery supply distributed through such centers.

American business, including wholesale grocers, is facing one of its greatest challenges in decades. Congress and the Administration must directly confront two of America's most pressing economic problems; namely, declining productivity and the loss of competitiveness in the world economic community. These problems can be linked directly to inadequate capital investment. Inflation and inadequate capital accumulation have contributed to aging and increasingly inefficient plants and equipment. Inflation increases the cost of capital and produces significant economic pressures for increased cash flow to support higher levels of investment in inventory and receivables to maintain the same level of business activity.

As short-term financing becomes more costly due to tight monetary policy, the wholesale food distributor's ability to leverage capital is significantly reduced. This limitation directly impedes needed business expansion, delays necessary machinery and equipment replacement, and significantly hinders the replenishing of depleting inventories which artifically increase in value as a result of inflation.

The most painful affect of inflation on wholesale distributors is its contribution to capital erosion, reduction of liquidity, overstatement of profits, and overpayment of taxes. This inability to retain capital and the fact that the wholesale grocery industry ratio of net profits to net sales averages less than one percent places the distributors of our Nation's food supplies in an extremely vulnerable financial position.

In order to preserve and promote a healthy food distribution system and to encourage new initiatives as well as the expansion of the private business sector, NAWGA generally supports the thrust of the Administration's economic recovery proposal as it relates to reducing government spending and balancing the federal budget. Only then can the proposed business tax measures reasonably be expected to stimulate America's economic recovery.

BUSINESS TAX REDUCTIONS

Any tax reduction needs to be directed toward the immediate improvement of our Nation's production by increasing the incentives to save and invest. The stifling of our Nation's productivity growth is reflected in a large federal deficit and a lower standard of living. Slow growth in productivity increases the cost of production and inflation which leads to higher federal outlays and interest payments.

CAPITAL COST RECOVERY

In order to stimulate capital investment and savings, NAWGA urges Congress to support the 10-5-3 accelerated depreciation approach so that business can invest in new plants, equipment, and machinery. There is an urgent need for wholesale grocers to depreciate their fixed assets over a shorter period of time and on the basis of replacement costs rather than useful life. NAWGA also believes that owner-occupied and leased buildings should be treated "equally" and placed under Class I ten year life and accelerated depreciation.

While NAWGA supports the 10-5-3 proposal, certain industry dynamics mandate that Congress adopt the original 10-5-3 which allows the taxpayer to deduct all or any portion of the allowable recovery deduction in any recovery year. A taxpayer could increase or decrease the amount deducted at any time while the statute of limitations was still open. In addition, any unused recovery deductions could be carried forward indefinitely.

The President's proposal eliminates this important feature and substitutes a provision extending the carryover period for Net Operating Losses (NOLs) and Investment Tax Credits (ITCs) from 7 to 10 years.

While 10-5-3 should not be structured to assist long-term unprofitable or distressed firms, neither should its accounting techniques be constructed in such a way as to compress large deductions in lean years, thereby increasing long-term uncertainity

over future capital investment. If our goal is to provide incentives for long-term capital investment in plant and equipment, then we must not artifically mandate deductions for firms making large capital investments during periods of low profitability. "Flexibility" allows each firm to recover its investment at the particular rate that is most advantageous.

There are two other areas where NAWGA urges action: the LIFO method of inventory valuation and further corporate rate reductions.

NAWGA supports simplified inventory pooling requirements by allowing the taxpayer to use LIFO inventory pools according to customary business classifications and the use of regularly published government indices to measure price change for value LIFO pool.

We also support the further reduction on corporate rates as proposed in S.394 or S.360. Such reductions will further add to wholesale grocers' working capital thus reducing the need to borrow expensive money in the capital markets.

We are confident that if Congress provides the proper climate for business growth, we will once again see lower interest rates, lower inflation, increased employment, and an overall healthier economy.

## STATEMENT OF THE NATIONAL CATTLEMEN'S ASSOCIATION, JAMES P. HARPER, VICE CHAIRMAN, TAX COMMITTEE

Proposed Tax Reductions

S. 683

"Economic Recovery Tax Act of 1981"

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THE NATIONAL CATTLEMEN'S ASSOCIATION strongly supports the proposal to cut taxes and to redirect the tax system toward encouraging capital formation and investment as a part of an overall program to curb inflation and spur the economy.

One of the major problems facing this Nation today is the built-in bias in the tax structure against savings and capital investment. The errors of focusing on taxing income and investment are evidenced by lack of productivity, heightened unemployment, raging inflation, unstable interest rates, and an alarming decline in the competitive world position of U. S. industry and business.

Agriculture, and the livestock business in particular, in its capital-intensive position, shares heavily in the ills of discouraging capital formation through the tax system.

AUGUST 5, 1980, STATEMENT

Attached is the Statement of the NCA submitted to the Committee on August 5, 1980, relative to Tax Cut Legislation. In said Statement, the Association urged passage of legislation which would:

(1) Reduce income tax rates for all taxpayers;

(2) Index income tax exemptions, deductions and rates to reflect inflation;

(3) Simplify depreciation rules and provide for accelerated depreciation;

(4) Expand investment tax credit to include all buildings, structures and facilities used in agricultural production;

(5) Amend the alternative minimum tax provision to permit investment tax credit to be applied against such tax;

(6) Exempt farm licensed trucks from the Federal highway use tax;

(7) Exempt livestock trailers from the Federal excise tax;

(8) Permit the deduction of "fringe benefits" by proprietorships and partnerships; and

(9) Reduce Social Security taxes and amend the Social Security laws with respect to agricultural employees and permit retired farmers and ranchers to participate in the management of their rented farm and ranch properties without being subject to the self-employment earnings tax and without having Social Security benefits reduced or eliminated.

Each of the recommended amendments listed above is expanded upon in the body of the Statement.

CURRENT PROPOSAL BEFORE COMMITTEE

With respect to the current proposed legislation now before the Committee, the Association wishes to stress the following additions and/or changes:

Investment Tax Credit Should be Applied to Alternative Minimum Tax Liability

Farmers/ranchers are often forced during years of low income or loss to sell breeding animals and/or land for cash flow purposes. Such a move can make them subject to the alternative minimum tax, even though the farm/ranch operation itself has generated no income. In fact, the alternative minimum tax can come into play even if a taxpayer has no "preference income." For taxpayers with substantial amounts of investment tax credit, this tax can exceed the regular tax liability

even if the taxpayer has neither capital gains nor itemized deduction preferences.

To correct this problem, the NCA strongly recommends that investment tax credit be applied against any alternative minimum tax. Also, net operating losses from other taxable years should be allowed as a deduction against alternative minimum taxable income to make the alternative minimum tax provision equitable in recognizing said losses.

For additional comments on this issue, see page 8 of the August 5, 1980, Statement.

Investment Tax Credit Should Be Expanded

In the interest of enhancing capital formation, the Association urges that investment tax credit be expanded to include all buildings, structures and facilities used in agricultural production.

For additional comments, see page 7 of the August 5, 1980, Statement.

$100,000 Limitation on Used Property Should be Lifted

The current $100,000 limitation for investment tax credit has a stifling effect and should be removed. As a result of inflation, this amount will now cover not more than one used tractor and accompanying machinery. In addition, the disparity between new and used property should be ended.

Cost Recovery Problem for Used Property (Livestock)

The "10-5-3" Accelerated Cost Recovery proposal contained in the legislation before the Committee would disadvantage taxpayers purchasing depreciable used livestock. The NCA, therefore, urges that such animals be allowed into the next lower category, at the election of the taxpayer.

Cost Recovery Proposal Adverse
For Hogs, Sheep and Goats

Farmers/ranchers who raise hogs, sheep or goats would be disadvantaged under the "10-5-3" proposal since these taxpayers can depreciate their animals over a period of 5 years or less under current law. The proposal would adversely impact hogs, in particular, since the ADT mid-point for these animals is now 3 years.

Other Tax Cut
Recommendations

For other tax cut recommendations, please refer to the attached Statement of the NCA submitted to the Committee on August 5, 1980.

ESTATE AND GIFT TAXES

The Association strongly favors the complete repeal of estate and gift taxes. These taxes are a serious deterrent to capital formation and adversely affect the orderly transfer of farm/ranch property from one generation to the next. This traditional transfer has made a significant contribution to Agriculture's enviable gains in productivity by assuring the continuation of economically viable operating units and by setting the stage for trained operators and work forces to be in place on a continuous basis.

At the very least, this Congress should proceed to phase down the tax rate, increase the unified credit, provide for an unlimited marital deduction, increase the annual gift exclusion, and, particularly, to solve the problems which have arisen in the practical implementation of the Special Use Valuation provision (Section 2032A of the Internal Revenue Code).

SUMMARY
OF
STATEMENT
of the
NATIONAL CATTLEMEN'S ASSOCIATION

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"Taxflation" has imposed a cruel and devastating blow to our nation's economy, robbing it of growth and vitality. From the wounds inflicted, there has resulted a decline in productivity, a reduction in capital investments, an increase in interest rates and heightened unemployment. These ills need immediate and effective medication, which the National Cattlemen's Association ("NCA") feels can be provided by enactment of tax cut legislation.

NCA urges passage of such legislation which would: (1) reduce income tax rates for all taxpayers; (2) index income tax exemptions, deductions and rates to reflect inflation; (3) simplify depreciation rules and provide for accelerated depreciation; (4) expand investment tax credit to include all buildings, structures and facilities used in agricultural production; (5) amend the alternative minimum tax provision to permit investment tax credit to be applied against such tax; (6) exempt farm licensed trucks from the Federal highway use tax; (7) exempt livestock trailers from the Federal excise tax; (8) permit the deduction of "fringe benefits" by proprietorships and partnerships; and (9) reduce Social Security taxes and amend the Social Security laws with respect to agricultural employees and permit retired farmers and ranchers to participate in the management of their rented farm and ranch properties without being subject to the self-employment earnings tax and without having Social Security benefits reduced or eliminated.

NCA submits that passage of such legislation would have a positive and beneficial effect on inflation, interest rates and other facets of our economy. Such legislation would also result in a broader and more equitable restructuring of the present tax system and would spur capital investment and create economic growth in Agriculture and in the rest of our nation.

## STATEMENT OF JAMES L. POWELL, CHAIRMAN, TAX COMMITTEE, NATIONAL CATTLEMEN'S ASSOCIATION

ADVISABILITY OF ENACTMENT OF TAX CUT LEGISLATION EFFECTIVE IN 1981

National Cattlemen's Association Supports Enactment of Tax Cut Legislation Effective in 1981

The National Cattlemen's Association ("NCA") strongly supports enactment of tax cut legislation this year to be effective in 1981. It is the position of NCA that the enactment of such legislation would have a beneficial and positive effect on inflation, interest rates, capital improvements and other facets of the economy.

According to Tax Foundation, Inc., inflation is robbing the American taxpayer of increases received in earnings. Referring to the adverse effect caused by this "taxflation", the Tax Foundation observes that even taxpayers fortunate enough to have a 14.5% increase in earnings in 1980 will have less dollars in their pockets and that the Federal government will end up receiving an unlegislated revenue boost.*

With earnings in the agricultural sector of our country at a low ebb because of the present cost-price squeeze, Agriculture has been particularly affected in a detrimental manner by double digit inflation which has caused the evaporation of dollars needed for capital investment and improvement.

In light of "taxflation" and its harmful effects on our nation's economy and well being, NCA respectfully urges that

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* Monthly Tax Features, Volume 24, Number 6, June-July 1980.

consideration be given to the passage of tax cut legislation which would be addressed to a number of issues, including: reducing income tax rates; indexing of income tax rates to reflect inflation; providing for accelerated depreciation; allowing investment tax credit on farm buildings; amending the alternative minimum tax provisions; exempting farm trucks from the highway use tax; exempting livestock trailers from the excise tax; permitting the deduction of "fringe benefits" by proprietorships and partnerships; and reducing the social security taxes. These changes, NCA feels, would result in a broader and more equitable restructuring of the present tax system and would spur capital investment and create economic growth in Agriculture and in the rest of our nation.

Tax Rates Should Be Reduced

Not only for Agriculture, but for all individuals and corporations, a broad based reduction in income tax rates would have a favorable effect. Such an across the board reduction in tax rates would act as a needed prod to our economy while improving productivity, helping reduce unemployment and permitting more funds to be invested in capital and assets. With more persons employed, a larger base for producing additional tax revenues would result.

Specifically, NCA submits that a further reduction in the current capital gains tax rates, which were recently reduced in the 1978 Revenue Act, would have an effective and noninflationary stimulus on the economy. A provision which

would provide for delayed taxes on reinvested capital gains would be particularly welcomed and beneficial. Such modifications of the capital gains rules would be especially helpful to Agriculture because of its highly capital intensive nature which requires large investments in land, breeding livestock and other capital assets.

NCA offers no precise guidelines as to the amount of the reduction in income tax rates for all taxpayers, but would suggest that such reduction be significant and not less than the current rate of inflation to achieve the goals of providing more funds for capital investment and reducing the amount of unemployment while at the same time placing a damper on the runaway double digit inflation which has been experienced in recent years.

Income Tax Exemptions, Deductions And Rates Should Be Indexed To Reflect Inflation

Closely aligned with NCA's proposal to reduce income tax rates for all taxpayers is the one to index income tax exemptions, deductions and rates to a reliable measure of the value of the dollar so that the Federal government's share of a taxpayer's income and wealth can be increased only by overt Congressional action.

Depreciation of the value of this country's currency has had many destructive effects. One of the most harmful of these is the way it has fed the appetite of the Federal government for an ever-increasing share of the nation's wealth. By reducing the relative value of tax exemptions and deductions and increasing the total number of dollars

subject to higher rates under our present graduated income tax system, inflation has permitted the Federal government effectively to increase the tax on both capital and income without the benefit of public debate and discussion. NCA feels this has had a negative effect and the "taxflation" which has resulted has actually taken away dollars which farmers, ranchers and others could otherwise have invested in their businesses.

Indexing federal income tax exemptions, deductions and rates to a reliable measure of the value of the dollar could bring an end to this adverse trend of "taxflation" and could, combined with a current income tax rate reduction, cause an added impetus to our economy in future years. Indexing would also have the salutary effect of encouraging business expansion and growth since taxpayers will have the assurance that additional income produced by capital investment will not receive a disproportionate bite in federal income taxes. Furthermore, indexing would result in greater flexibility on the part of agricultural and other business operations to retain the amount of increased earnings represented by inflation in their businesses, which would be reflected in increased employment and greater productivity.

Depreciation Rates Should Be Accelerated And Depreciation Methods Simplified

Present depreciation requirements and procedures adversely impact on farmers, ranchers and other closely held businesses because of their inherent complexity and deleterious impact

on capital formation. The complexity issue is especially troublesome to small or medium sized operators who typically do not have professional accounting or legal assistance available to them. In addition to the simplified classification of property and the need for accelerated rates, it would also be beneficial if the salvage value rule under present law was eliminated and no distinction was made between new and used property.

Provisions such as contained in S.1435 (Capital Cost Recovery Act of 1979) and S.231 would be most beneficial. These bills would accomplish many of the above referenced objectives. For example, salvage value would be disregarded in computing depreciation. Under present law, salvage value may be reduced by up to 10% of the basis of personal property, other than livestock, which has a useful life of 3 years or more. There is no justification to retain this exclusionary rule for livestock especially since depreciable livestock are now subject to the depreciation recapture rules of Section 1245. Also, permitting farms, ranches and other closely held businesses to use a simplified but shortened straight line depreciation table would result in significant benefits. The depreciable lives of 5 years for farming assets (compared to an average of 10 years under the Class Life System) and 12 years for farm buildings (compared to 25 years under the Class Life System) would be advantageous to cattlemen and others engaged in agricultural pursuits. However, farmers and ranchers who raise hogs and sheep which

usually have depreciable lives of less than 5 years would be disadvantaged by this proposal. Accordingly, such persons should be allowed to depreciate their hogs and sheep over a period of less than 5 years, as under current law.

NCA also supports the concepts embodied in S.935 which would, except for elevators, single purpose agricultural structures and qualified rehabilitation facilities, permit depreciable property which qualifies for investment tax credit to be depreciated over a useful life of 5 years. This would be an elective provision and taxpayers could decide whether the shorter period of depreciation would be advantageous, considering the fact that if it were elected, the bonus first year depreciation which applies to tangible personal property with a useful life of 6 years or more would not be available. Further, this bill would reduce the amortization period for pollution control facilities, which are becoming more commonplace in the cattle business and in Agriculture in general, from 60 to 24 months and would repeal the amount of such amortization which is currently treated as a tax preference subject to the minimum tax. Both of these provisions would be beneficial.

In short, a simplified depreciation system together with an acceleration of the time period within which depreciation can be claimed would have a favorable effect on agricultural and non-agricultural businesses.

MARK M. SINGER, STATEMENT OF PRESIDENT
NATIONAL FOOD BROKERS ASSOCIATION
ON
S. 683
BEFORE
THE SENATE
FINANCE COMMITTEE
MAY 15, 1981

Mr. Chairman and members of the Committee, my name is Mark Singer. I am President of the National Food Brokers Association, which is a national nonprofit trade association composed of over 2470 food broker firms.

Food brokers are independent sales representatives performing essential sales functions and related services for a number of different manufacturers (average is 23) of food, grocery or related products. Food brokers sell on terms set by the manufacturers they represent to wholesale buyers, wholesalers and supermarket firms, both chain and independent. It is estimated that our members in total represent over 60,000 salespeople to carry out their important role in food distribution.

## SUMMARY OF POSITION

The National Food Brokers Association (NFBA) has always directed its efforts toward helping food broker firms improve their productivity, efficiency and continuity in a rapidly changing economic climate. During the past decade, business operating costs have been adversely affected by the rate of inflation and restrictive federal tax measures.

NFBA supports President Reagan's comprehensive program to reduce the growth of government spending and the proliferation of federal regulations. President Reagan's tax program, as proposed in S. 683, attempts to attack the adverse consequences of restrictive federal tax laws.

NFBA also supports President Reagan's efforts to reduce individual and business taxes in order to relieve the effects of inflation and to contribute to economic growth.

NFBA supports:

1. Allowing faster capital cost recovery by establishing 3 year recovery for automobiles, 5 years for other machinery and equipment, and 15 years for office buildings;
2. Increasing the percentage of property eligible under the 3 and 5 year property categories for the 10 percent investment tax credit;
3. Reducing corporate tax rates and raising the current corporate surtax exemption from $100,000 to $150,000, and later to $200,000;
4. Lowering individual taxpayer rates 10 percent for the next three years to offset the effects of inflation and escalating social security taxes.

NFBA cannot urge strongly enough that substantial tax reductions to offset the ravishing effects of inflation and social security tax increases are needed not only to help small business firms such as our members, but to foster a revitalized economy.

Capital Cost Recovery

S. 683 establishes new rules for capital cost recovery in place of present complicated methods for depreciation. NFBA supports the proposal for recovering the cost of automobiles over 3 years, other machinery and equipment over 5 years, and office buildings over 15 years.

Financing of automobiles, office equipment, and office buildings presents a substantial burden for food brokers attempting to meet capital needs in the inflationary economy. Inflation aggravates the problem further by having to depreciate equipment and buildings over periods of time that do not permit recovery of costs fast enough to generate the expansion or replacement.

The alternative for small concerns, such as food brokers, unable to generate capital financing internally is to seek financial assistance from the capital market. High interest rates inhibit food broker access to financing and restrict their attempts to acquire those assets necessary for efficient operations.

NFBA believes the simplified categories for capital cost recovery in S. 683 deserve Congress' support and are a step forward enabling food brokers to generate internally more financial resources for replacement and expansion of business property.

Investment Tax Credit

S. 683 would increase the percentage of the cost or basis of property eligible for the 10 percent investment tax credit. Sixty percent of 3-year recovery property and 100 percent of 5-year and 10-year recovery property would be eligible.

Next to employee salaries, automotive expenses are the biggest factor in food broker operating costs. A food broker's average sales area covers over 130,000 square miles. An average of 20 automobiles are used by a food broker firm. Also, instead of each manufacturer having his own large sales force requiring automobiles and gasoline supplies for these vehicles, the food broker can be considered an economical car pool, using far less gasoline and other expensive automobile services.

NFBA recommends that the percentage of cost of automobiles eligible for the investment tax credit be increased to 100 percent. This would be an added incentive for business to invest in automobiles and revitalize our economy.

Corporate Tax Rates

Revising corporate tax rates is another priority recommendation for small business concerns that are not capital intensive. Food brokers are not capital intensive, but are labor intensive. Food brokers' operating expenses for salaries and fringe benefits exceed 60 percent. Reduction in corporate tax rates would enhance the cash flow and capital liquidity of small business. Relieving the financial pressures on small firms imposed by inflation and taxation on corporate taxable income will encourage growth and development. NFBA supports some reduction in corporate tax rates and raising the corporate surtax exemption from $100,000 to $150,000, and later to $200,000.

Individual Tax Rates

It has been more than two years since individual tax rates have been revised. In the last two years, the Consumer Price Index has in-

creased over 25 percent. Federal receipts from individual income taxes increased almost $60 billion. Social security tax receipts increased almost $35 billion. Lowering individual taxpayer rates 10 percent for the next three years would offset the effects of inflation and escalating social security taxes.

Approximately 25 percent of NFBA membership is firms operating as partnerships and sole proprietorships. Reducing individual income taxes would provide relief for this segment of the business community.

NATIONAL FOREIGN TRADE COUNCIL, INC.
10 ROCKEFELLER PLAZA • NEW YORK, N. Y. 10020 • (212) 581-6420
WASHINGTON OFFICE: 1835 K STREET, N.W. • WASHINGTON, DC 20006 • (202) 887-0278

May 21, 1981

Honorable Robert J. Dole
Chairman
Senate Finance Committee
U.S. Senate
Washington, DC 20510

Dear Mr. Chairman:

The National Foreign Trade Council, a non-profit organization whose membership comprises a broad cross-section of over 650 U.S. companies with highly diversified interests engaged in all aspects of international trade and investment, enthusiastically supports the Administration's Capital Cost Recovery Proposal contained in S.683. The Council endorsed the Capital Cost Recovery Act of 1979 (H.R. 4646) when it was first introduced nearly two years ago. We urged the Congress at that time to speedily enact that legislation and we again urge Congress to adopt Capital Cost Recovery legislation. We believe today, as we believed two years ago, that America's economic condition requires urgent attention. American plant and equipment is becoming more obsolete every day, our productivity is continuing to decline and American performance in the world marketplace continues to deteriorate. Increasingly, foreign goods such as automobiles and steel, are capturing a larger share of our domestic market. This is in part attributable to declining plant and equipment investment.

To overcome our economic problems American business needs to invest in more efficient plant and equipment. But there must be an improvement in capital formation in the United States to provide the funds needed to make the necessary investment. We believe the capital cost recovery provision contained in S.683 will make a very substantial contribution toward providing American busniess with the necessary funds to invest in more efficient plant and equipment. That investment will help us improve our productivity and reduce inflation. Since S.683 will help American business generate funds internally, some of the pressure on the capital market should be eliminated, reducing the risk of a financial crisis, and contributing to an eventual reduction in interest rates.

We believe it is now important to separate recovery of plant and equipment costs from a useful life concept. High inflation rates deter investment in assets where recovery may be spread over a decade or longer. Recovery of original costs against inflated dollars overstates taxable income thereby increasing taxes and reducing the cash flow needed for investment in plant and equipment with ever-increasing costs. A shorter recovery period, as provided for in S.683 will shift investment to productive assets where it is needed since inflation rates and historic useful lives will be less important considerations. In addition, many small businesses, which have found the current ADR system too complex, and are burdened by a heavy record keeping load, will appreciate the simplicity of the capital cost recovery provisions.

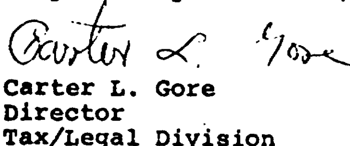
We endorse the three year recovery period for assets used in research and development provided for in S.683. We believe that U.S. research efforts have lagged in recent years due to higher costs. Certainly faster cost recovery on research equipment is directionally sound. More, however, must be done to encourage our R & D effort. For example, we have requested that the Treasury review the extremely complex section 861-8 regulations on R & D expenses which deny an effective tax deduction for a larger number of taxpayers.

The Council endorses the investment credit provisions of S.683. The investment credit remains a very important incentive for investing in more efficient plant and equipment.

One problem which adversely affects our members is the treatment of foreign assets in S.683. The capital cost of property used predominantly outside the United States would be recovered using the straight-line method of depreciation over extended recovery periods. Many of our members have found that this produces a result far less advantageous than current law, and we believe enactment of the foreign asset provisions of S.683 would adversely affect foreign investment, the U.S. position in international markets, and our balance of payments. Therefore, we urge that S.683 be amended to give foreign assets the same capital cost recovery treatment as assets in the U.S. By maintaining such tax neutrality we believe funds will be invested in the most efficient and productive manner.

Finally, we believe S.683 is urgent and we endorse the Administration's request for speedy enactment of this legislation. It is our hope that controversial proposals requiring time consuming debate are not added to this bill.

Respectfully submitted,



Carter L. Gore
Director
Tax/Legal Division

84-165 O—81——47

Summary of Statement
of
The National Housing Partnership

Senate Committee on Finance Hearings on
The Tax Aspects of the Economic Recovery Act of 1981

May 20, 1981

The National Housing Partnership is seriously concerned that the Administration's tax proposals will severely limit, if not entirely eliminate, investment in low-income housing. Under the President's program, the equality of tax treatment granted to both residential and commercial real estate creates a severe disadvantage for the production of low-income housing. Because government-assisted rental housing is restricted as to cash earnings and resale, and because appreciation is usually limited, low-income housing must maintain its favored tax status in order to remain competitive with other real estate investments. In order to continue the availability of adequate housing for all our citizens, we strongly recommend that any tax reduction bill include the following provisions:

1. Low-income housing should continue to be eligible for accelerated depreciation but with a 15-year useful life, effective immediately.

2. With respect to low income housing, only depreciation in excess of straight-line should be subject to recapture, as under present law.

3. Excess depreciation should no longer be treated as a tax preference for purposes of the 15% add-on minimum tax.

4. Construction period interest and taxes should continue to be currently deductible for low-income housing. We encourage permanently deferring the provision of I.R.C. Section 189, which phases-in the capitalization of such costs beginning in 1982.

5. The new Section 195 of the Code should be modified to make it clear that the business of real estate begins when construction or rehabilitation begins.

6. The maximum cost eligible for 5 year amortization of rehabilitation expenses should be increased to $40,000 from $20,000 per unit in order to keep pace with inflation.

7. Several provisions designed to encourage the rehabilitation of housing are currently scheduled to expire on December 31, 1983. These provisions should be made permanent.

8. A clear distinction should be maintained between investment in the construction or rehabilitation of property, and the mere buying and selling of used properties.

9. The definition of low-income housing should be revised to take into account changes in federal programs and to clear up certain ambiguities with respect to state and local programs.

10. Projects completed or under construction between January 1, 1981 and the date of enactment of the new tax bill should be eligible to elect either the new or the old law rules. Providers of low-income housing need certainty that rules at least as favorable as present law will be available.

The real production of low-income housing has been nearly cut in half — from approximately 120,000 units per year to between 60,000 and 70,000 — by reason of the recently approved budget cuts. Our recommendations will not involve significant additional revenue losses to the Treasury. However, they will permit the continuation of the low-income housing industry as a productive and essential segment of our economy.

STATEMENT OF
THE NATIONAL HOUSING PARTNERSHIP

Senate Committee on Finance Hearings on
The Tax Aspects of the Economic Recovery Act of 1981
May 20, 1981

The National Housing Partnership ("NHP") is seriously concerned that new tax proposals, such as the Administration's tax bill, will severely limit — if not completely eliminate — investment in low-income housing.

WHO IS NHP?

NHP is a unique organization created to perform a public mission with funds invested by private citizens. The organization was formed pursuant to Title IX of the Housing & Urban Development Act of 1968, which stated:

> it is the policy of the United States to encourage the widest possible participation by private enterprise in the provision of housing for low and moderate income families.

Although neither NHP nor National Corporation for Housing Partnerships ("NCHP"), its General Partner, is an agency or establishment of the United States Government, three of NCHP's Directors are appointed by the President with the advice and consent of the Senate. NCHP is required by law to submit an Annual Report to the President.

The National Housing Partnership is a developer and manager of government-assisted multifamily housing for persons of low and moderate income. In its twelve years of existence, NHP has been responsible for the production of over 50,000 units of multifamily rental housing in 40 states, the District of Columbia and Puerto Rico. In recent years over one third of our annual multifamily housing production has been devoted to the rehabilitation of blighted structures in urban areas. Historic structures have been renovated for residential use, as have obsolete schools and industrial buildings.

In marshalling private resources pursuant to its Congressional mandate, NHP has taken a major leadership role in the low and moderate income housing industry. One of its pioneering functions has been its role as an innovator in the development and construction industry. Another major initiative has been the creation of a management division to overcome the lack of federal focus on project maintenance. With over 27,000 units under direct management, this management company has become one of the nation's largest and most successful managers of government assisted housing, with an outstanding record of maintaining a quality living environment for the residents of the units under its supervision.

EFFECT OF BUDGET CUTS IN HOUSING PROGRAMS

The real production of low-income housing units has been nearly cut in half — from approximately 120,000 units per year to between 60,000 and 70,000— by reason of the recently approved budget cuts. However, as explained below, it appears that the adoption of the President's cost recovery proposal (the

Accelerated Cost Recovery System, more commonly called "10-5-3") would make substantial further reductions in the production of low-income housing units.

NEED FOR SPECIAL TAX INCENTIVES

In order to raise the capital necessary to finance the production of low income housing, NHP sells a portion of the equity interest in its projects to private investors, in the form of limited partnership interests. Private capital has been attracted to this endeavor primarily because of the unique tax benefits conferred by previous Congresses. In the areas of accelerated depreciation schedules, the phase-out of depreciation recapture, and the ability to deduct construction period interest and taxes, Congress has secured a favored tax position for investors in low income housing.

That favored status must be maintained because government assisted rental properties are subject to specific legal restrictions as to cash earnings, and resale may be prohibited for 20 years or more. These properties may be perceived to have much more limited potential for appreciation than other real estate investments.

Although the President's Economic Recovery Program appears to recognize the need to maintain a special status for low income housing, the Program does not go far enough to provide adequate incentives for low income housing. Under the Program, low-income housing is allowed an 18 year recovery period, with a three year phase-in to 15 years. Commercial facilities such as office buildings, shopping centers, and hotels would also be eligible for a 15 year recovery period with a 3 year phase-in. Non-subsidized housing would be depreciable over 18 years. (Also, the cost of certain owner-occupied industrial

structures could be recovered over a 10 year period using a very accelerated rate.) During the 3 year phase-in period, low income housing would be at such a competitive disadvantage that it might disappear. Furthermore, because all property would be restricted to the straight line method, the advantage previously granted to investors in low-income property through accelerated depreciation and the phase-out of recapture would no longer exist.

In addition to the effects of the President's proposed changes, the existing Section 189 of the Internal Revenue Code will further curtail the special tax advantages of low-income housing by requiring that, beginning in 1982, construction period interest and taxes will no longer be fully deductible.

RATES OF RETURN ON INVESTMENT

The President's Program would make significant reductions in the rates of investment recovery during the critical first five years on investments in low income property. (Investment recovery for this period is highly significant in making an investment decision.) In addition, the President's Program would cause investments in low income housing to be substantially less attractive when compared with competing real estate investments. Both of these comparisons suggest that there will be a substantial diversion of funds from low income housing. (See attached rate of return and investment recovery comparisons.)

One competing investment with substantial new advantages is non-residential real estate. The proposed rules for non-residential real estate produce a dramatic improvement in the relative rate of return over the treatment available under current law when compared with low-income housing. The tax benefits that would be available to office and commercial buildings would become fully

comparable with subsidized housing. Taking into account the greater potential for resale, cash flow, or refinancing of non-residential real estate, it becomes evident that low income housing would be at a severe disadvantage in its ability to attract private investment dollars.

Similarly, although the President's proposal would continue to provide somewhat greater tax benefits for low-income housing than for market rate residential property, the differential is slight. Furthermore, when even a modest rate of appreciation is applied to the investment in market rate housing, the differential is completely negated.

Several aspects of the President's proposal seem to encourage artifically accelerated sales and resales of property, for the sole purpose of creating an improved depreciation schedule for the new owner. The lack of differentiation between new and used property, and the absence of recapture may well result in rapid and inflationary turnover of commercial and unsubsidized residential property. By contrast, low income residential property is usually subject to legal restrictions regarding use, sale and refinancing. As a result, its competitive position as an investment would be even further reduced.

RECOMMENDATIONS FOR TAX INCENTIVES

In order to maintain adequate incentives for investment in low and moderate income housing, NHP recommends that the tax reduction bill include the following provisions:

(1) Low-income housing should continue to be eligible for accelerated depreciation but with a 15-year useful life, effective immediately.

(2) With respect to low-income housing, only depreciation in excess of straight-line should be subject to recapture, as under present law.

(3) Excess depreciation should no longer be treated as a tax preference for purposes of the 15% add-on minimum tax.

(4) Construction period interest and taxes should continue to be currently deductible for low-income housing. We encourage permanently deferring the provision of I.R.C. Section 189, which phases-in the capitalization of such costs beginning in 1982.

(5) The new Section 195 of the Code, which now permits a 60-month amortization of start-up expenditures, should be modified to make it clear that the business of real estate begins when construction or rehabilitation begins. This is consistent with the recent Court of Claims decision in Blitzer v. U.S.

(6) The maximum cost eligible for 5 year amortization of rehabilitation expenses should be increased to $40,000 from $20,000 per unit in order to keep pace with inflation.

(7) Several provisions designed to encourage the rehabilitation of housing

are currently scheduled to expire on December 31, 1983. These provisions should be made permanent:

a. Provision for 60-month amortization of expenditures to rehabilitate low-income rental housing.

b. Provision for 60-month amortization of expenditures to rehabilitate certified historic structures.

c. Provision for accelerated depreciation of certain substantially rehabilitated historic property.

d. Provisions limiting the tax benefits available in situations involving the demolition of historic property.

(8) A clear distinction should be maintained between investment in the construction or rehabilitation of property, and the mere buying and selling of used properties.

(9) The definition of low-income housing should be revised to take into account changes in federal programs and to clear up certain ambiguities with respect to state and local programs.

(10) Projects completed or under construction between January 1, 1981 and the date of enactment of the new tax bill should be eligible to elect either the new or the old law rules. Providers of low-income housing need certainty that rules at least as favorable as present law will be available.

While our recommendations are directed toward the President's "10-5-3" proposal, we have the same concerns about any other capital cost recovery proposal which might come up for consideration. Whatever proposal is adopted, it is imperative that the depreciation rules and other related tax provisions for government-assisted low-income housing be signifantly more favorable than those for other forms of real property. Without adequate tax incentives, investors simply will not put their equity capital into government-assisted low-income housing -- where the return on investment is limited by government regulations, resale is restricted, and residual value is questionable. Without this equity capital, NHP and others will no longer be able to build low-income housing.

The recently approved budget cuts in federal spending programs have already reduced the number of future government-assisted projects by nearly one-half. We therefore submit that our recommendations will not involve significant additional revenue losses to the Treasury.

Vacancy rates for rental housing are at extremely low levels. The conversion of rental units to condominium forms of ownership, and the decline in the construction of new rental housing units has severely restricted the supply of rental housing for low and moderate income families.

We support the President's goal of encouraging investment in productive areas of our economy. We simply wish to emphasize that the provision of adequate housing for all of our citizens is an essential and productive use of our resources. And it is our feeling that an incremental advantage must be maintained for low-income housing, or the supply of such housing will vanish.

## COMPARISON OF INVESTMENT RETURN

### CURRENT LAW

| | | | | | |
|---|---|---|---|---|---|
| TYPE | Low Income | Unsubsidized | Unsubsidized | Commercial | Commercial |
| TAX BRACKET | 70 - 28 | 70 - 28 | 70 - 28 | 70 - 28 | 70 - 28 |
| DEPRECIATION | SYD - Comp. | SYD - Comp. | SYD - Comp. | 150% - Comp. | 150% - Com |
| CONSTRUCTION INTEREST | Deductible | Capitalize | Capitalize | Capitalize | Capitalize |
| START DATE | 1981 | 1981 | 1981 | 1981 | 1981 |
| SALE DATE | 2000 | 2000 | 2000 | 2000 | 2000 |
| APPRECIATION RATE | 0 | 0 | 2% | 0 | 3% |
| INVESTMENT RECOVERY - 5 YRS | 113.8% | 113.5% | 113.5% | 98.6% | 98.6% |
| RATE OF RETURN - 20 YRS | 19.5% | 18.2% | 21.7% | 13.3% | 19.7% |

### PRESIDENT'S PROPOSALS

| | | | | | |
|---|---|---|---|---|---|
| TYPE | Low Income | Unsubsidized | Unsubsidized | Commercial | Commercial |
| TAX BRACKET | 50 - 20 | 50 - 20 | 50 - 20 | 50 - 20 | 50 - 20 |
| DEPRECIATION | SL - 15 | SL - 18 | SL - 18 | SL - 15 | SL - 15 |
| CONSTRUCTION INTEREST | Capitalize | Capitalize | Capitalize | Capitalize | Capitalize |
| START DATE | 1981 | 1981 | 1981 | 1981 | 1981 |
| SALE DATE | 2000 | 2000 | 2000 | 2000 | 2000 |
| APPRECIATION RATE | 0 | 0 | 2% | 0 | 3% |
| INVESTMENT RECOVERY - 5 YRS | 77.4% | 67.8% | 67.8% | 78.8% | 78.8% |
| RATE OF RETURN - 20 YRS | 10.5% | 8.5% | 15.1% | 10.5% | 18.1% |

### NHP RECOMMENDATIONS

| | | | | | |
|---|---|---|---|---|---|
| TYPE | Low Income | Unsubsidized | Unsubsidized | Commercial | Commercial |
| TAX BRACKET | 50 - 20 | 50 - 20 | 50 - 20 | 50 - 20 | 50 - 20 |
| DEPRECIATION | SYD - 15 | SL - 15 | SL - 15 | SL - 15 | SL - 15 |
| CONSTRUCTION INTEREST | Deductible | Capitalize | Capitalize | Capitalize | Capitalize |
| START DATE | 1981 | 1981 | 1981 | 1981 | 1981 |
| SALE DATE | 2000 | 2000 | 2000 | 2000 | 2000 |
| APPRECIATION RATE | 0 | 0 | 2% | 0 | 3% |
| INVESTMENT RECOVERY - 5 YRS | 116.6% | 77.4% | 77.4% | 78.8% | 78.8% |
| RATE OF RETURN - 20 YRS | 19.0 | 10,5 | 16.3 | 10.5 | 18.1 |

#### ASSUMPTIONS

1. Description of Investment - This analysis assumes an investment of $800,000 (with a mortgage of $3,200,000) and a one year construction period, in three similar structures, each used for different purposes: a) low-income apartment building
   b) unsubsidized apartment building
   c) commercial office building
   Construction and financing factors are held constant in each case, in order to highlight other elements. (It is recognized that these essential factors will vary in practice.)

2. All tax brackets shown at maximum rates, including 15% minimum tax, where applicable.

3. Sale proceeds for low income project shown at $1.00 over mortgage balance. Appreciation rate on other residential and commercial property applied to investors contribution plus mortgage assumed as part of basis.

4. Net annual benefit after 5 years equals total tax benefits divided by investor contribution. No appreciation assumed.

5. Cash distributions assumed to commence in sixth year, at maximum allowable distribution net of administrative fees for subsidized apartments, 4% for unsubsidized apartments and 8% for the commercial building.

STATEMENT OF DAVID W. GODFREY, CHIEF EXECUTIVE OFFICER, HART STORES, INC.

Summary of Principal Points

1. NMRI is a major retail trade association, whose member companies do business in 48 of the 50 states and have gross sales in excess of $50 billion per year. NMRI member companies serve a broad cross-section of the American public and, for this reason, have an extraordinary concern with the overall health of the American economy.

2. Although the retail trade industry is one of the largest business sectors in the American economy, creating many new jobs, and the combined industry constitutes one of the nation's largest employers, the retail trades are among the most heavily taxed segments of American business.

3. NMRI supports, in general, the overall thrust of President Reagan's tax proposals because NMRI believes that these proposals will create jobs, increase productivity, and will thereby help NMRI customers maintain their current standard of living.

4. NMRI strongly supports the accelerated capital recovery system and, particularly, the 10-year useful life for commercial real estate. NMRI also supports strongly the proposed 5-year useful life for other business equipment. NMRI believes that these provisions will benefit the retail trades, as well as other segments of the American business economy. They will also help American business to remain competitive with foreign companies whose governments today generally allow much more rapid capital recovery for business than does the current U.S. tax law.

My name is David W. Godfrey. I am the Chief Executive Officer of Hart Stores, Inc. of Columbus, Ohio. I am also Chairman of the National Mass Retailing Institute, on whose behalf I am testifying today. The National Mass Retailing Institute ("NMRI") is a trade association consisting of over 110 major retail stores operating in 48 states. The member-companies have annual sales of over $50 billion.

I am here to urge the enactment of a major part of President Reagan's economic plan, Title II of S. 683, which contains the Administration's proposal for Accelerated Capital Recovery (ACR). We urge that the bill be enacted in its entirety as introduced, subject to one relatively minor amendment, which is discussed later in my statement. My comments address the overall effects of the proposal on our national economy, but I ask the Committee to take note of the special interest of NMRI in the provision allowing a 10-year capital recovery period for commercial real estate. We also strongly support the 5-year write-off which is proposed for most types of business equipment.

The Committee is well aware of the difficult state of the American economy today. Inflation has become a constant drain on our economic resources; it plagues business and the consumer alike. Interest rates remain at levels that would have been unthinkable only a few years ago. Our rate of unemployment is a national tragedy.

The cumulative effect of our economic problems on business has been disastrous. Capital markets are chaotic. The rate of increase in productivity of American industry is the lowest of any major Western economy. Investment in American industry is also far lower than most of our Western economic partners. Personal savings are at almost unprecedentedly low levels. Our trade balance, as well, is in serious straits as industry after industry finds itself unable to compete with foreign competition not only in the world market, but here at home. We look at these facts with frustration because it is clear that the productive ingenuity of American business is being strangled by economic barriers that Government has been unwilling in the past to attack forthrightly. Indeed, the principal result of economic policies in the past decade has been to move the Nation closer to economic stagnation.

America's retail industry has always been a vital part of its economic system. It brings to market a major part of the product of American industry -- almost $800 billion in annual sales. One out of every six Americans today is employed in the retail sector. Between 1948 and 1977, employment in the retail and wholesale trades has increased 105 percent, compared with 25.8 percent in manufacturing. And between 1965 and 1976, employment in general merchandise retailing increased 31.6 percent, compared with 23.2 percent in total employment increases nationwide. A healthy retail sector provides employment in

the inner city and is a source of income for many part-time and semi-skilled workers, such as students, older persons, and married women returning to the work force. In short, our retail industry is a major source of employment and an area of critical economic activity. The interest of retailers in the current movement toward change in national economic policy is therefore clear.

We are encouraged that the new Administration has taken prompt steps to deal with our economic problems. At the root of President Reagan's approach is the realization that we can no longer look to increased taxes as a substitute for growth. If our citizens are to have a more secure economic future, we must begin to revitalize our economic system. The short-term solutions that have been the mainstay of Governmental action in the economic sphere must give way to long-term solutions that will increase our national wealth, not merely slow the rate at which we as a nation grow poorer. We agree that the time for stop-gap measures has run out. We agree with the President that the work of turning our economy around must begin. And we believe that it must begin now.

The Administration has proposed actions on a very wide front in the economic area. Many measures are before the Congress. But there are certain keystones to the economic program. One of these is the proposed change in depreciation schedules for business property, widely known as the "10-5-3" plan. There are many good reasons for

taking a hard look at our current depreciation rules because they have become inadequate to perform their intended purpose, the stimulation of continuing growth in business. A fundamental problem, of course, is that current depreciation schedules are not realistic -- they do not reflect the rapidly rising cost of replacement structures and equipment. The unfortunate result is that investment in new plant and equipment is discouraged. Businesses are forced to make do with existing structures and equipment beyond the period when replacement would be advisable because capital recovery rates are out of step with economic realities.

In terms of the competitive posture of American industry on world markets, current depreciation schedules have become sadly outmoded. It is no secret that the dominant position of American industry, enjoyed for so long, was the result of continued innovation in our production methods. Today, we find ourselves being beaten at our own game. While the average capital cost recovery period in nations such as Japan, Germany, France, Sweden, The Netherlands and other major western competitors averages less than 10 years, the period in the United States averages 15 years. It is no surprise, then, that American industries are struggling to keep up with their counterparts abroad. The time has passed when we can attribute the cheaper price of imported goods to lower costs of labor overseas. The plain fact is that overseas producers enjoy tax systems that enable them to compete aggressively with their neighbors. American industry does not.

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The Department of Labor announced recently that the rate of inflation, based on statistics for the month of March, is now 16 percent. We believe that a large contributor to continued high inflation -- and to the failure in the past to control it -- is the declining rate of productivity in the United States today.

Much of this can be laid directly to the inability of our businesses to put into use the most modern equipment available. The statistical evidence is, we believe, compelling. In 1979, the Joint Economic Committee reported that productivity in the United States between 1972 and 1977 increased by 0.7 percent. By contrast, West Germany and Japan averaged annual productivity increases during this period of 3.5 percent; in France, the average figure was 3.1 percent. Even in Great Britain, in the midst of economic problems more serious than our own, average productivity increases were 1.2 percent annually.

Unless American business can match wage increases with increases in productivity by use of new plant and equipment, continued inflation is inevitable. Current depreciation schedules are a major part of the problem. As retailers, we are deeply concerned with this subject because, in our view, continued low increases in rates are a prescription for diminished buying power of our customers.

The Commitee is certainly aware that the problems that arise from an outmoded system of capital recovery are not limited to industries that need new plant and equipment to conduct their businesses productively and profitably.

The industries that provide new plant and equipment suffer as well. Demand for new construction is diminished, for example. And businesses that provide new technological equipment for industrial and commercial uses cannot thrive when it is uneconomic for their customers to make purchases of replacement goods.

The Administration's proposal for Accelerated Capital Recovery, as embodied in S. 683, is responsive to the problems we have identified in the existing depreciation system. We support enactment of this legislation in the form proposed by President Reagan.

If enacted, the ACR proposal will replace a complicated scheme of depreciation deductions that costs taxpayers and businesses millions of dollars each year in bookkeeping and accounting costs. Other proposals we have looked at would simply replace one cumbersome system with another.

The Administration proposal is a far-sighted one. The system it provides will not only respond to the immediate problems of particular industries in America today, but will remain viable and sensible long after these immediate problems have been overcome. We believe this is a critical point, because the actions that are taken by Congress and the Administration now must do more than move the Nation in a new direction. They must provide a direction that we can continue to follow in the future.

ACR will provide American industry with a basis for resuming a truly competitive position in world and domestic markets by boosting productivity. Our industries can begin stepped-up programs for replacing outdated plant and equipment to increase the value of each employee. In the retail sector, we are particularly supportive of the proposed 10-year recovery period for commercial real estate. If enacted, that provision will permit us to begin the process of expanding and improving our retail outlets, warehouses, and other commercial facilities. We also strongly support the 5-year recovery period for business equipment. We believe the 5-year period is both more realistic and easier to administer than the complex depreciation system used today.

We do have one comment with respect to the proposed legislation. The bill appears to draw a distinction between owner-used commercial real estate and commercial real estate which is leased by the user. We believe that such a distinction is unwarranted. The leasing of real estate for commercial use is a common and legitimate business practice. The availability of 10-year capital recovery for leased real estate would provide a substantial benefit for many businessmen because the availability of the credit to the lessor would almost certainly result in lower rents for the lessee. If the Committee is concerned that leased real estate might be used as a tax shelter by individuals, we recommend that this problem be attacked directly, rather than by penalizing the legitimate business use of such property. One possible

approach, though not necessarily the only approach, might be to provide that in the case of leased property, the Accelerated Capital Recovery System would not be available to non-corporate lessors. This would prevent the use of the Accelerated Capital Recovery System by individuals for tax shelter purposes, but would enable all businesses to receive the benefits of accelerated capital recovery.

Ours is, of course, a very competitive industry and a capital recovery system that permits ongoing modernization would be a key element in price containment. We are anxious, too, to continue to act as a major provider of job opportunities throughout the United States. Accelerated Capital Recovery will enable us to meet that objective. We believe firmly that these beneficial results can be duplicated in other industries.

Accelerated Capital Recovery can also contribute to an improvement in the state of our capital markets. Investors have little incentive to participate in business activity that is not profitable. But as the effects of Accelerated Capital Recovery are felt, we can expect the profit picture for business to improve. We are hopeful that other actions proposed by the President will have their intended effects of increasing the availabilty among the public of investment capital. Combined with increased attractiveness of business investment, the result we would hope to see would be a return to orderly capital formation.

The retail industry has a strong interest in the state of our economy as a whole. The economic health of the

industries whose products we sell and of the consumers we depend on redounds to our benefit. NMRI member stores are largely discount operations who sell to a broad cross-section of the American public, but particularly to middle and working class Americans. It is not too much to conjecture that from time to time almost everyone patronizes a NMRI member retail outlet. For this reason, NMRI has a strong interest in programs which stimulate the American economy, create jobs, and allow our customers to maintain their standard of living.

But there are particular concerns that we have as well. First among these is the fact that retailers as a group receive proportionately less benefit from business tax incentives than other major industries. This is so because much of our investment is in commercial real estate, a class of capital investment that has long depreciation periods. As a result, the retailing industry pays among the highest effective federal tax rates of any major business group. This has been the case for a number of years. We are looking to the Administration's 10-year real estate depreciation proposal for some relief from this situation.

We believe that the consuming public will benefit from enactment of this proposal. Retailers are anxious to pass on quickly even small increments in their profitability in the form of lower prices. In many areas of retailing, after all, a difference of even a few dollars in the price of a product translates into a competitive edge. Additionally, we see in this proposal a chance to lower our energy costs.

It is well recognized that new building stock offers the greatest opportunity for energy efficiency. The price of retrofitting is still too high in most cases to be considered cost-effective. A capital recovery system that would enable retailers to replace old facilities would be an important positive influence on our energy conservation efforts. The benefits to the public are obviously significant. In this area, as well, we are confident that other industries will be able to take advantage of energy efficiency opportunities that present themselves only when plant and equipment are replaced.

We urge the Congress to join the Administration in beginning a restructuring of our national economy. The Accelerated Capital Recovery proposal is a major step that will enable the Nation to begin reducing taxes, stemming inflation and unemployment, and stimulating investment and economic growth. We hope the Congress will move quickly to enact Title II of S. 683.

## Statement of the National Retired Teachers Association and the American Association of Retired Persons

### I. INTRODUCTION: THE TAX CUT MUST BE A VIABLE COMPONENT OF THE ECONOMIC RECOVERY PACKAGE

The National Retired Teachers Association and the American Association of Retired Persons have a combined membership of 12.5 million people over the age of 55. All recent contacts with our members have proven to us that the greatest concern of this nation's older population is inflation. The inflation problem is threatening the viability of all retirement income structures, and for the older person it is making life increasingly difficult. Our Associations urge the Finance Committee to use the tax policy tool it possesses to help correct this inflation problem.

The future tax cut package needs to be consistent with the goals of reducing inflation and increasing productivity and economic growth. While the tax cut should compensate individuals somewhat for the rising levels of taxation, it must also reward and encourage productive activity. Above all, the tax cut must not be so large as to jeopardize the opportunity to balance the budget in the short run.

The Associations are concerned that a tax reduction bill may be developed that, rather than serving to reduce inflationary pressures, may add to them in the short term. If Congress passes the Administration's tax package, the federal budget will not be balanced until 1984 -- and this would only happen if some

very optimistic economic assumptions hold or if further potentially unacceptable budget cuts are made. The Finance Committee should reject the Administration's approach and instead cautiously draft an anti-inflationary tax bill.

## II. COMMENTS ON THE TAX ASPECTS OF THE ADMINISTRATION'S ECONOMIC PROGRAM

The Administration has suggested that Congress pass a tax bill which would contain two essential elements: A "10-5-3" capital cost recovery plan for business and a 30 percent rate reduction over three years for individuals. The Administration estimates that the revenue loss (prior to expected feedback) from these proposals will be $148 billion in 1984, and it will continue to accelerate in the years following. The Associations feel that both elements of this plan involve far too large a revenue loss commitment for the near future. The potential inflationary consequences of this proposal represent -- in our view -- too great a risk.

As organizations firmly committed to the objective of reducing inflation to tolerable levels in the near term, we have strong reservations as to the efficacy of the Administration's overall economic program, including its tax cut component. Our concerns are as follows:

1. The Administration's total economic recovery package fails to address specifically the

wage/price spiral. We do not agree with the argument that a dramatic reduction in the federal budget will cause inflationary expectations, and therefore the wage/price spiral, to abate. We feel that the wage/price spiral is firmly embedded in the economy and needs to be specifically addressed through a rigorous incomes policy.

2. Tax reductions comtemplated will not be directed toward savings and investment. Although tax rates will be reduced, no clear signal is given to the taxpayer that it would be to his or her advantage to save and invest. In fact, all present policies which encourage consumption, as for example, the deductibility of interest expenses, would remain in place and no new saving incentives are considered. On the business side, although the 10-5-3 proposal could stimulate much needed investment, we question the cost-effectiveness of that approach as well as its equity implications for various businesses.

3. To the extent that the tax cut is not saved, it will be consumed. The inflationary implication of a large increase in consumption must be considered ominous.

4. Even if there would be a long-term revenue feedback from the Administration's proposals, the short-term federal deficit could destroy all anticipated gain. While our Associations support careful budget-cutting activity, we do not wish to see these reductions necessitated in the future by a fiscal crisis. Such a crisis could occur if the planned tax decreases are fully implemented. Furthermore, if the expenditure side cannot be reduced in line with the revenue side, the goal of capital formation for the private sector may be frustrated by government borrowing.

Because of the magnitude of these concerns, we cannot accept the tax policy approach undertaken by the Administration. Instead, we think that a carefully crafted bill, responsive to the present economic situation, is needed.

## III. RECOMMENDATIONS: DESIGNING A TAX CUT BILL THAT MEETS THE DEMANDS OF THE PRESENT ECONOMIC CIRCUMSTANCES

### A. The Tax Cuts Must be Moderate so that the Budget Can be Balanced Over the Business Cycle

The Associations believe that as a priority matter, actions should be taken to bring the budget into balance and to keep it in balance over the course of the business cycle. Although this action

alone will not eliminate inflation, it is a necessary element of a comprehensive anti-inflation strategy. A budget in balance will take pressure off of the other anti-inflation strategy components such as a restrictive monetary policy and an incomes policy designed to reduce the wage/price spiral.

We are concerned that the Administration's anti-inflation program, with its heavy reliance on fiscal policy, is not broad-based and comprehensive enough to be effective. The potential for lasting damage to the economy if this program fails is very real. Given that there are other complementary means which ought to be utilized in the general effort to control the inflation rate, we do not believe that the risk involved in enacting the Administration's tax package is worth taking.

The Associations would prefer that this Committee commit itself to designing tax reductions, the magnitude of which are reasonably related to anticipated reductions in federal spending. While the economic consequences of a tax cut can cause revenue feedback to the Treasury, it is highly unlikely that a large tax cut can pay for itself in the present inflationary environment. Tax policy should instead be designed to balance the budget over the business cycle. The federal government would then have a reduced impact on capital markets and this would allow increased private sector investment.

B. The Tax Bill Should Contain Savings and Investment Incentives

Despite the fact that marginal tax rates will be lowered under the Administration's tax plan, it is unlikely that the plan will lead to large increases in the nation's savings rate. What looks like a reduction in marginal rates to the economist also looks like a rebate to the individual. Under the Administration's plan, this would be particularly true at the upper income levels, where most of the real tax savings will take place. A middle income person confronted with a tax reduction in an inflationary environment will probably be inclined to spend a good deal of it. At the upper incomes levels, some additional amounts could be saved. However, since marginal rates remain high, particularly for unearned income, the upper income person would still have a large incentive to seek nonproductive tax shelters.

To address the need to encourage people to save, the Associations believe that the upcoming tax cut bill should contain actual savings incentives. In determining the type of savings incentives that would be preferred, the Committee should endeavor to adopt tax policy so that it complements sound retirement income and retirement savings goals.

In determining a sound retirement income strategy, "self-help" planning efforts should be emphasized. Because social security alone cannot provide an adequate retirement income

for the next generation of elderly persons, these persons need to be encouraged to save for their own retirement, while they are still young and are still in the labor force.

Unfortunately, a number of tax code provisions presently prohibit potential "self-help" measures. Employees who contribute to their qualified pension plan do not presently receive a deduction for those contributions. Additionally, anyone who is a participant in a qualified pension plan is prohibited from utilizing an Individual Retirement Account.

The limitation on tax benefits for retirement savings leads to less capital available for the economy as well as an increased reliance by individuals on government programs for retirement income. Also, in the case of IRA eligibility rules, current tax law creates tremendous inequities. We have received much correspondence from members of our Associations who "participated" in qualified pension plans, yet who never vested. Many seem to have wanted 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.

The Associations also feel that because the past decade, with its high and rising rate of inflation, has witnessed a rapid reduction in the value of the elderly's savings, Congress should take action to compensate retirees. As an equity measure, and to

further encourage others to save for retirement, the Associations support an exemption from taxation (beyond that provided in last year's Windfall Profits Tax legislation) of interest and dividend income for those who are 65 and over. Our initial recommendation is that the exempt amount for people over 65 be set a $500 ($1,000 for joint returns).

In reviewing the legislation before this Committee, we have determined that one bill, S. 243, sponsored by Senator John Chafee, does accomplish the goals of encouraging people to save and compensating elderly savers for the effects of inflation. We believe that these provisions should be a central element in the tax cut package.

C. The Finance Committee should Seriously Consider the Effectiveness and Value of Tax Expenditures

The Associations feel that room for a tax cut needs to be made through a reduction in the growth of federal spending. However, because the growth of federal spending as a percent of GNP has not been very large over the past ten years, and because there is a perceived need to increase defense spending, we cannot rely solely on budget cuts to finance tax cuts. In fact, in recent testimony before various Committees, our Associations have expressed concern about the effects on low income elderly people of some of the Administration's proposed cuts in Medicaid, low-income energy assistance, food stamps, social services, and legal services. The substantial benefit cuts in the Medicare program, which were recently approved by this Committee, cause additional concern - particularly because such increased cost sharing has not been accompanied by any meaningful effort to limit provider reimbursement and contain health costs in general. Clearly, some sacrifices need to be made elsewhere if we are to be able to equitably afford periodic and significant reductions in tax burdens.

The Associations suggest that while federal spending may, in fact, have been hemorrhaging, a similar process is taking place in the tax base. The revenue loss from tax expenditures has been rising at a rate of 14 percent a year since 1975, while the annual rate of increase in direct federal outlays has been around 11 percent over the same time period. Figures released by the Joint Committee on Taxation indicate that by 1982 tax expenditures will be nearly 2-1/2 times their 1968 level in real terms, and they are expected to continue to increase in the future.

In its present form, the tax code subsidizes economically inefficient behavior through the use of tax expenditures. For example, a person can deduct the interest paid on consumer debt. On the other hand, had that person saved to make the purchase, he or she would have had the interest income taxed, even if the yield was less than the rate of inflation. While we think that affirmative savings incentives should be a part of the tax code, they will lose some of their desirable economic potential if consumption continues to be subsidized by tax policy to the extent it is today.

Given our concerns about balancing the budget and encouraging savings, it seems far more effective to lower tax rates through a reduction of both budget and tax expenditures rather than through the creation of a large federal deficit. Also a thorough review

of tax expenditure items will create a far more equitable approach to rate reductions than will relying on budget cuts alone.

Because this is a time in which we are carefully reviewing areas in which government is ineffective, we urge this Committee to use this opportunity to take a hard look at the inefficiencies caused by the tax code. This effort should produce a less inflationary, more productive and fairer tax cut package.

IV. CONCLUSION

While our Associations have a number of items to pursue to achieve equity for elderly taxpayers (our Legislative Program for 1981 in the tax area is included as an Appendix), the main concern of the elderly in this tax debate involves economics. The tax bill must help solve the nation's inflation and productivity problems.

We do not feel that the Administration's response to these concerns is adequate. As we have outlined in this statement, there is strong reason to believe that the approach taken by the Administration may lead to more inflation and more economic adversity.

The Associations believe that the Finance Committee should have a number of goals in mind when considering a tax bill. First, balancing the budget over the business cycle should be a priority, and the size of the tax cut must reflect this goal. Second, the tax reduction bill should actively encourage and reward savings and investment. Finally, consideration should be given to reducing select tax expenditures, particularly those that unduly subsidize consumption and that serve no clear cut or useful economic objective.

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APPENDIX: 1981 NRTA-AARP LEGISLATIVE PROGRAM -- TAX POLICY SECTION

The Associations will pursue a number of objectives in the tax policy area. The first is equity for the elderly. The amount of federal taxes paid by the elderly must be as fair and unburdensome as possible. This objective should be consistently applied among subgroups of older people.

The second objective is economic. Tax policy ought to be used to help direct the economy along paths which would lead to a reversal of current trends of low or no productivity growth, declining rates of saving and investment, and extraordinarily high rates of inflation. At the same time, unemployment rates must be restrained and optimum, real GNP growth rates restored and maintained. Certainly, a reversal of these trends is essential to strengthening government income support programs, promoting the growth and security of private pensions, and providing for the great numbers of elderly persons who have inadequate incomes.

The third tax policy objective is to encourage "self-help" retirement planning efforts. Because social security alone cannot provide the elderly with an adequate income, people need to be encouraged to save for their own retirement.

Often these objectives combine so that a policy position that is clearly beneficial for the elderly is also beneficial for the economy and conducive to retirement

saving. For example, the nation's economic problems are attributable, in part, to the decline in the rate of savings and investment. Yet the tax structure promotes consumption and discourages savings. Not only has this bias against saving hurt the elderly, who tend to be savers, but it has also hindered the nation's economic progress and inhibited the accumulation of savings and other income producing investments for retirement.

Although current tax policy tries (without much success) to encourage some retirement savings by providing a deduction of up to $1,500 ($1,750 if a spouse is included) for contributions to an Individual Retirement Account (IRA), a worker can only utilize an IRA if he is not a participant in a private pension plan. This restriction effectively eliminates half of the private sector work force from IRA eligibility. Moreover, workers who are thus ineligible for IRA's may also end up with no private pension benefit, if they fail to stay on a job long enough to acquire a vested right to one. Persons in this latter situation reach retirement with neither an IRA account nor a private pension benefit.

To deal with this situation, the Associations support a two-pronged strategy: provide compensation for inflation losses to those who can no longer save and encourage those who can save to do so. First, the $200 ($400 for joint returns) interest

and dividend exclusion, which was enacted in 1980 and which is to be effective in 1981 and 1982, should be made permanent. Additionally, because the elderly must often draw down their savings account principal for living expenses and because of the effect high inflation has on the value of savings accounts, the amount of the exclusion should be increased to at least $500 ($1,000 for joint returns) for persons age 65 and over.

Second, to encourage whose who can continue to save, existing savings mechanisms, such as IRA's (and also Keogh plans) and private pension plans, should be strengthened through tax policy. Employees who participate in a public or private pension plan should be given the option to contribute to either the plan or an IRA. A tax deduction should be provided for these contributions, and the deductibility limits that were set in 1974 for amounts contributed to IRA's should be raised considerably and then indexed to reflect the effect of inflation. In addition, tax credits should be available as an alternative to tax deductions to help reach lower income people, who might not necessarily respond to a deduction approach.

Another matter of concern involves recent proposals that would subject one-half of a person's social security benefits to federal income taxation. The Associations are strongly

opposed. A further tax on retirees is uncalled for in these present inflationary times. Most of the elderly who would find their income tax liability increased as a result of this proposal, are by no means high-income individuals. Furthermore, arguments in support of these proposals that the tax treatment of social security benefits should be modeled on the present tax treatment of pension payments are not persuasive. Social security, as it exists today, is simply not a pension; it is a form of social insurance. Because social security benefits are very different from pension payments, equivalent tax treatment is inappropriate.

To enhance equity among retiree subgroups, the tax relief available to retirees living on taxable (non-social security) forms of retirement income should be increased and made comparable to that accorded recipients of social security. Presently, the tax relief available to public employee (non-social security) retirees under the Tax Credit for the Elderly (TCE) lags far behind the tax advantages automatically available to social security recipients. To remedy this inequity, legislation ought to be enacted to increase and automatically cost index the maximum amounts that can be taken into account in computing the credit, so that these amounts are equivalent to, and keep pace with, average annual social security payments. In addition, the "adjusted gross income limits" currently applied

ought to be removed or substantially raised to make the credit available to more elderly taxpayers.

Other tax equity measures that the Associations recommend include the following:

First, a tax credit should be provided for the residential day-care expenses incurred for elderly dependents.

Second, widows, widowers and single elderly individuals should be allowed to qualify as a head-of-household and to use the preferential tax rates.

Third, the earned-income tax credit should be made available to elderly workers by broadening its eligibility rules to include individual workers, even though they have no children in the home.

Fourth, the one-time exclusion of gain from the sale of a principal residence by persons age 55 or over should be rolled back to taxable years beginning after December 31, 1977.

Fifth, the age at which an IRA account must be distributed should be increased from age 70½ to 75.

Sixth, the double taxation of dividend income should be eliminated.

Seventh, the $15,000 adjusted gross income phase-out of the "sick-pay" exclusion should be increased at least in the case of two-member family units.

Eighth, an automatically increasing measure of tax relief should be targeted for those elderly income components that are relatively fixed, like private pension benefits and interest from savings accounts.

Because of the adverse economic effects they will prompt, the large payroll tax increases that are scheduled under current law should be at least partially rolled back. Payroll tax increases raise the cost of labor (relative to capital) and thus add to both inflation and unemployment. In place of these planned increases, limited amounts of "general revenues" ought to be introduced into the social security programs on a temporary basis. However, the Associations will not support any plan which would derive those general revenues from a value-added tax. Such a tax would significantly increase the tax burden of the elderly and aggravate the wage and price spiral which is contributing greatly to current levels of inflation.

As tax cut proposals are considered, such as lower tax rates on capital gains or more rapid depreciation for plant and equipment, their compatibility with the nation's economic objectives will serve as the critical test of Association support, especially where they involve no direct increase or decrease in tax liability for the elderly. For example, the Associations will not support massive tax cuts if

they are potentially inflationary.

As a means of handling the special problems elderly taxpayers face in preparing their federal income tax returns, Congress in 1978 created the "Tax Counseling for the Elderly" program. Given the success of the program to date and the increasing complexity of the tax laws, the program ought to be expanded significantly. At the same time, a serious effort should be undertaken to simplify the tax code.

**Statement Submitted by the**
**National Savings and Loan League**
**on the President's Economic Program**
**to the**
**Committee on Finance**
**United States Senate**
**May, 1981**

The National Savings and Loan League appreciates this opportunity to offer our comments on the President's proposals for accelerated cost recovery for business investment.

The savings and loan industry, accounting for over $625 billion in assets, has a great deal at stake in seeing that the goals of the President's business tax proposals are realized. The savings and loan industry's future is dependent upon a stable, growing economy with a low rate of inflation. Without a significant reduction in the rate of inflation and the accompanying stable and low level of interest rates, the savings and loan industry, which is attempting to restructure itself, will face a very difficult next few years. The President's proposals can help create an economic environment which will help achieve these goals.

It is important that these business cuts be accompanied by the proposed budget cuts, however. While in and of themselves, the tax proposals will increase investment and assure some higher measure of economic growth, if federal government spending is not reduced at the same time, the short-run impact could be to exacerbate inflationary pressures and aggravate expectations of future inflation rates. We believe these adverse effects can be avoided if the budget reductions are adopted, and we are very pleased that the Congress has been receptive to those proposals.

The purpose of the President's tax proposals in the business area is to provide an incentive to invest in capacity building alternatives, which should increase productivity because of increased capital/labor ratios, thereby reducing inflation. Simplicity is also a goal of these proposals.

The proposals provide for a three-year recovery period for cars, light trucks and depreciable personal property unused in connection with research and development; a five-year recovery period for equipment and machinery as well as some long-lived utility property; and, a ten-year recovery period for certain owner-user buildings and public utility property with a midpoint lifetime greater than eighteen years.

The President's proposals also affect the tax treatment of buildings by establishing shorter recovery periods. Commercial and

low-income residential rental buildings would be depreciated over a fifteen-year period, while other residential rental properties would be depreciated over an eighteen-year period, both on a straight-line basis. We would like to comment briefly on the President's proposals as they affect residential buildings. We believe the President's other depreciation proposals will have the desired effect--the inducement of investment which will lead to the beneficial economic effects we discussed above. However, the proposals on buildings are complex and need to be reviewed carefully. We are particularly concerned about the incentives provided for commercial vis-a-vis rental buildings.

Multifamily Rental Buildings

Under present tax laws, multifamily rental buildings are allowed to take advantage of accelerated depreciation; while under the President's proposals, only straight-line would be permitted. Another change proposed from present law is that component depreciation not be permitted. Under component depreciation, faster write-offs can be obtained, depending upon the useful lives assigned to the various components of the entire building such as the air-conditioning system. There are two advantages to the President's proposals, however. First, owners do not have to concern themselves with recapture, nor do they have to estimate salvage value.

Our point is that there are offsetting impacts here. Some parts of this proposal will have a positive effect, while others will be negative. This would not be so important except that rental construction in this country is significantly depressed. Vacancy rates for multifamily rental units are close to all-time lows. High interest rates have had a very adverse effect on the "economics" of rental projects, and investors have sought other, more lucrative alternatives. A number of analysts have indicated that even greater benefits than exist under present law, benefits which used to exist, are needed in order to stimulate rental construction. While we would not disagree with that, we do realize that all sectors of the economy need to be looked at carefully. We would request that the Committee and its staff look closely at this proposal to determine its impact.

We in the savings and loan industry assign a very high priority to these economic proposals. As we have indicated, as much as any other industry, we are dependent upon a stable and growing economy. Much of the debate about the share of credit going toward housing as opposed to other investments would dissipate in a healthier economic environment with higher rates of savings. That is why, except for the question of a potential negative impact on rental dwellings, we support the business incentives provided in the Administration's proposals. We also believe that additional incentives, especially on the savings side, are needed in order to assure a quick recovery. We will discuss those shortly.

The President's economic program, including the spending and tax cuts, is aimed at economic revitalization, and we strongly support this goal. To be a competitive, productive nation, we must take steps to stimulate capital formation and to revitalize basic entities in our economy.

Housing and Reindustrialization

We want to emphasize that the housing industry is a key sector of our economy and that a sound reindustrialization plan for the United States must include strong and stable housing and housing finance industries.

Discussions of this subject have assumed that incentives for revitalization of plant and equipment of basic industries are pitted against incentives for housing. This is not the case in our view, and we are not arguing for a privileged incentive for housing at the expense of other sectors of the economy. Increases in industrial production and productivity, a redress of trade imbalances, and reduction of unemployment are obviously necessary for a vigorous economy.

It is cricical that any reindustrialization program include the housing sector. The construction and rehabilitation of housing, multifamily as well as single family, provides jobs and demands for products which involve virtually all sectors of our economy. Demand for construction materials involves jobs in the steel, lumber, clay products, and heavy equipment industries, for example, and the demand for finished consumer goods associated with housing are too numerous to mention.

In addition, the availability of workers and resources for other nonrelated industries depends on an adequate supply of affordable, livable housing in surrounding communities.

Therefore, the Congress as a part of its tax program must face the issue of appropriate tax policy to assure a healthy housing and home finance industry in the future.

Savings Incentives

Increasing the savings rate in the United States is a critical national priority. The facts on current rates of savings and investment speak for themselves. Last month, savings and loan associations experienced the biggest outflow of net new savings in recent history. The $2.3 billion outflow in March resulted in a first quarter performance of a negative $800 million in net new savings. This compares to $1.55 billion in the first quarter of 1980, $10.1 billion in the first quarter of 1979, and $7.5 billion in the first quarter of 1978. Thus, it is clear that the current experience is significantly lower than in previous periods. In addition,

preliminary indications are that the month of April will be as bad as March. Unless action is taken to control inflation and to increase incentives for savings, we in the savings and loan business will be unable to continue our role as home finance lenders. Since we are the primary source of home finance in this country, this would mean that housing opportunities would be denied to many Americans.

Priority consideration should be given to expansion of the Individual Retirement Account concept. This program can be built on an already existing structure that is in place and that has worked successfully. The IRA contribution amount should be increased, eligibility should be extended to all wage earners regardless of participation in a qualified pension plan, and the spousal account should be modified accordingly. Many members of this Committee have introduced legislation which encompasses these goals and which should be given serious consideration.

Expansion of IRAs would serve two pressing social and economic needs. First, this action would be a useful weapon in countering inflation by encouraging additional savings instead of consumption. Secondly, the universal IRA account would widen the options of the consumer in saving for retirement and provide a positive incentive for people to plan ahead during their income-producing years to assure security in retirement.

The Urban Institute, under contract to the Federal Home Loan Bank Board, has been doing some very interesting work in projecting the impact of expanding the IRA program on savings flows. While their work is still in the preliminary stage, we believe you would be interested in what they have found so far. The Institute used 1978 as the base year because data were readily available, but the projections can be applied to other years.

Assuming that there is some positive interest sensitivity of savings, i.e., as real interest rates increase, households will increase their amount of savings, the expansion of the IRA program will result in increased savings flows. Depending on the assumptions used regarding the level of that interest sensitivity, the Institute estimates that with universal IRAs and an annual contribution limit of $3,000, savings flows would have increased by $28 billion to $55 billion over what they would have been in 1978. Since the actual amount of funds saved was $140 billion, this represents an increase of between 20% and 39%. While the 39% estimate may seem high, the Institute notes that this assumes all families eligible use the fully allowed amount of $3,000.

In order to verify these estimates, the researchers at the Institute analyzed the experience of retirement savings plans (RSPs) in Canada, which have been authorized since 1957. Under the RSP, any household, whether it belongs to a pension plan or not, can contribute to a tax-exempt retirement account. The Canadian experience offers

some useful insights. Based on their analysis of the Canadian experience, the Institute researchers predict that a universal IRA with a $3,000 limit would have resulted in between $10 billion and $21 billion in additional savings in 1978. While this is lower than the other estimates, they are relatively similar. These dollar figures represent an increase of between 7% and 14% in 1978 savings levels.

Thus, the available evidence and research indicates that expansion of IRA eligibility limits and universality would at least raise savings by approximately 10 percent and perhaps more. Since a significant portion of this increase would go to thrift institutions, mortgage lending would also increase substantially, which is sorely needed. According to the Bank Board, S&Ls now hold $7.5 billion in IRAs, or approximately 1.5% of total S&L deposits. Increasing IRA deposits would be especially suitable for mortgage lending because generally they are long-term deposits.

By the encouragement of savings and investment, the modified IRA represents an efficient tax deferral that can be combined with President Reagan's tax cuts to provide benefits to the consumer while achieving national goals of increased savings and investment.

The savings situation, however, is so critical that we believe you may need a variety of incentives to reverse the current trend of dissavings.

A multi-faceted approach to this problem may indeed be in order if we are to overcome the current bias in our tax code which has taught people that it is better to spend than to save in an inflationary economy. These expectations will not easily be reversed, and it will likely take sustained lower levels of inflation to accomplish this reversal.

We, therefore, urge this Committee to consider enactment of a program to give the widest options to the individual saver so that he or she will be encouraged to increase savings no matter what the individual circumstance. Such a program could include supplemental IRAs, exemption from taxes for interest earned and possibly some innovative tool like the tax-exempt savings certificate.

The tax-exempt savings certificate could be offered by depository institutions for a limited maturity, perhaps three to five years. The maximum yield which could be offered would be tied to a specific index, such as 75% of the Treasury 3- or 5-year rate. The proceeds of these certificates would then be directed to mortgage loans. This certificate would have specific benefits in addition to increasing the rate of savings. It would help to lower the current high mortgage interest rates, helping to bring homeownership within the grasp of more families, especially first-time buying young families. It would also stimulate the home building and construction

industries, increasing employment and productive capacity with concomitant increases in tax revenues. Finally, it would provide a mechanism to assure continued viability of certain regulated depository institutions in these difficult economic times. We would urge the Committee to explore this idea and give it full consideration in the coming weeks.

Revision of Income Tax Treatment for S&Ls

There are a number of issues in the tax code relating to savings and loans that are in need of revision. The following list is certainly not all inclusive, but represents some "equity" issues which we believe are consistent with the President's economic program and which should be considered for inclusion in any tax legislation enacted this year.

- Repeal of IRS Revenue Ruling 80-274 relating to tax treatment of annuity contracts with reserves based on segregated asset accounts. Revenue Ruling 80-274 prohibits the tax deferral for an individual who purchases an insurance annuity from an insurance company with the insurance company's proceeds to be held at a financial institution. These annuity contracts, known as investment annuities, have been used by insurance companies and financial institutions for a number of years. They have proven to be a very successful means of encouraging individual savings, and therefore, capital formation.

  Revenue Ruling 80-274 is totally at odds with the goals of the Administration and the Congress in terms of its adverse effect on savings and capital formation. It is an example of increased government regulation and a reversal of longstanding policy upon which the financial industry and individuals have relied.

- Extend full investment credit to savings and loans. Most businesses are allowed a credit equal to 10% of the cost of certain depreciable property against the first $25,000 of tax liability and 60% of the liability in excess of $25,000. For savings and loans this credit is reduced by half. Savings and loans should receive equal tax treatment with other businesses.

- Elimination of the bad debt allowance as a preference item subject to minimum tax. This would remove the current penalty against savings and loans when reserves are increased. Build-up of reserves should not be penalized because they are needed for sound operation of savings and loans.

- Revision of the IRS regulations on operating loss carrybacks for thrift institutions. In the Tax Reform Act of 1969, Congress reduced the bad debt allowance of thrift institutions from 60% of taxable income to 40% over a ten-year period. It also extended the net operating loss carryback (NOLC) for such institutions from three to ten years.

The Report of the House Ways and Means Committee on HR 13720, the 1969 tax bill, provides this statement of the reasons for the extension of the NOLC:

> Your committee believes, that, notwithstanding a larger tax liability because of these changes in the bad-debt reserve deductions, there will still be reserves consistent with the proper protection of the institution and its policyholders in the light of the peculiar risks of long-term lending on residential real estate which is the principal function of these institutions. Furthermore, to provide for unusually large losses, your committee has extended the net operating loss carryback from 3 to 10 years for all financial institutions, which allows the spreading of losses over 15 years--10 years back and 5 years forward. Your committee believes that this is a better means to provide for large unexpected losses than to allow such institutions to build up their reserves tax free.
> (emphasis supplied)
>
> House Report 91-413, p. 125

In 1978, the IRS amended its regulations on the NOLC to require that losses carried back to prior years would have to be reduced by the bad debt allowance applicable for that year. The amendment, however, provided for a ten-year phase-in of this required recomputation by providing that it would only apply to losses carried back to taxable years beginning after December 31, 1977. Thus, the full impact of the revision would not be felt for ten years--that is, until the ten-year carryback period no longer reached back to 1977.

In 1978, the IRS proposed to cut short the ten-year phase-in of this regulation by providing that recomputation would be required for losses carried back from taxable years beginning after December 31, 1977. This was later modified to apply to losses carried back from taxable years beginning after December 31, 1978, but the effect was still to cut short the ten-year phase-in by nine years (since the recomputation would be fully effective for calendar-year taxpayers in 1979 instead of 1988).

At the very least, the full ten-year phase-in should be restored, since the reasons for the ten-year carryback cited by the House Report above--the "peculiar risks of long-term lending on residential real estate"--are the cause of "unusually large losses" in today's economic climate.

We appreciate the opportunity to present the views of the National Savings and Loan League on this important topic. We will be pleased to work with this Committee in any way we can to assure that the needed changes in the tax and spending programs are realized.

# OUTLINE OF TESTIMONY OF THE SMALL BUSINESS LEGISLATIVE COUNCIL BEFORE THE SENATE FINANCE COMMITTEE

MAY 20, 1981

## Finance Committee initiatives sustained small business during the 1970s.

The Small Business Legislative Council commends the Committee for its initiatives in establishing progressive corporate rates, modernizing the estate tax, rolling back capital gains rates, and spearheading depreciation reform.

These developments have been major factors in preserving and encouraging independent enterprise during the difficult 1970s.

## Balanced tax policy needed for 1980s.

As we face such major problems as energy shortages, inflation, and high interest rates in the 1980s, it is even more important that federal tax policy take account of the special needs of the nation's 15 million new small and independent businesses.

## General suggestions.

We welcome President Reagan's initiatives in the budget, tax and monetary areas. The 1981 business tax reductions will probably be the largest in history and their impact will dominate U.S. industry in this decade.

We therefore recommend:

- Information on the proposed distribution of revenue benefits and costs by industry and size of business should be fully developed;
- The overall size of the tax cut should leave a cushion for responsible fiscal policy;
- Business tax reductions should constitute about half of the benefits;
- The reductions should be designed as anti-inflationary wherever possible, in such ways as gearing part of personal tax cuts to offset increases in the social security taxes;
- An appropriate proportion of the cuts should be targeted to the dynamic small business community which accounts for more than three-quarters of new private sector jobs and half of all industrial innovation.

## Specific small business proposals.

An attachment sets forth a series of "options" that would be most helpful to smaller firms across the spectrum of the economy. Also listed are several "off-sets" that could substantially reduce the cost of the legislation. We strongly support depreciation reform, and believe it can be enacted in a form that will accommodate many of the other excellent provisions approved by the Committee last year as a part of H.R.5829, which will make the economic benefits of the bill more widely applicable.

Major small business provisions we support include the following:

- Corporate rate reductions, scaled up to $200,000 in two years (as was approved by the Committee in 1980 as a part of H.R. 5829) and at least $250,000 in the "out years;"
- Direct expensing of the first $25,000 of annual equipment purchases (as in H.R.5829, S.394, and H.R.3202);
- Increase to 25 percent of the rehabilitation credit for 20 year old structures (H.R.5829 and the Long/Bentsen bills, S.317 and S.394);
- Increase of the ceiling for used property eligible for the investment credit to $250,000 (Weicker-Nunn and Bentsen bills, S.360 and S.1140);
- Revision of estate tax limitations and rates to realistic levels permitting continuity of family and closely-held farms and businesses, such as are found in the Wallop-Boren-Bryd bill (S.395);
- A broadened employment credit to take the place of the expiring WIN and targeted jobs credits, which would accord balance in the law for labor-intensive small firms;
- A limited credit for incremental research and development expenditures, further capital gains reductions in some form, and the specialized measures such as are contained in the Long, Bentsen and Weicker bills (S.394, S.1140 and S.360) to spur investment, capital formation and capital retention in innovative new and small ventures;
- The beginning of inventory reforms allowing small business to use LIFO accounting systems to better adjust for inflation;
- Appropriate incentives for savings, so local financial institutions will be able to compete for funds sufficient to extend credit to independent firms, particularly in the construction industry.

In addition, the Committee should explore proposals for increasing outside investment in small firms such as capital gains roll-over, new issue credit, and the small business participating debenture; and it should review regulatory and statutory provisions discouraging re-investment by entrepreneurs in their own businesses, such as the debt-equity regulations and limitation of deductible investment interest.

We believe that balanced legislation of this kind is within the spirit of the President's program and we would welcome the opportunity of working further with all concerned to advance such legislation.

84-165 O—81——50

**APPROXIMATE 5-YEAR TOTAL REVENUE EFFECTS OF SMALL BUSINESS OPTIONS TO 1981 TAX BILL (H.R.2400)**

(1st Order Revenue Impact in Billions of Dollars*)

Fiscal Years 1981 - 1985

| | Five-year total |
|---|---|
| 1. Corporate rate reductions under $200,000 [would increase modestly if level adjusted for inflation beginning 1983.] | - $7.6 billion |
| 2. Depreciation: Equipment | |
| A. Expensing of $25,000 per year, without 1% investment credit [with 1% ITC - $13.7 billion] | - $8.5 |
| B. Increase of Used Machinery Investment Credit to $250,000 would require some adjustment for carryover of property | - $1.2 |
| C. Use of 15 years (for structures) and 10-7-4-2 (for equipment) framework vs. 18-15-10-5-3 -- with 30% of ADR for utilities vs. estimated 50%+ proposal | + $49.8 |
| D. Elimination of depreciation and Investment Tax Credit on Progress Payments of property taking more than 2 years to build | + $6.9 |
| Structures | |
| E. 25% Rehabilitation Credit for 20-year-old structures | - $2.8 |
| F. Would require adjustment if a spread were adopted for structures of "owner operated" businesses | |
| 3. Employment Tax Credit -- Broaden from targeted to general in 1982 | - $10.0 |
| 4. Small Business Capital Formation -- specialized provisions | |
| A. New Issues Credit | - $.076 |
| Rollover -- out of 1 small business, into another | - $3.4 |
| Small Business Participating Debenture | - $6.1 |
| B. Accum. Earnings increase to $250,00, Subchapter S increase to 25 shareholders, Incentive Stock Options, Broker-Dealer Profit Reserve, Remission of diesel excise tax | - $1.3 |
| 5. Credit against income tax for social security increases [If part of individual income tax reductions were measured in this way, small employers and self-employed persons would realize $31.6 billion in tax reductions during this 5-year period.] | zero |
| 6. Capital Gains Tax Reductions to 20% for individuals and corporations [contained in present bill; independent cost about $10.7 billion] | zero |
| 7. Estate Tax Reduction to $600,000 exemption, and related improvements | - $9.8 |
| 8. Inventory reform | |
| A. Resolution of Thor, 10 year spread on tax increased in adopting LIFO system, indexing and pooling | ? |
| B. Cash Accounting at $500,000 of receipts | ? |
| 9. 25% Research and Development Credit | - $2.9 |
| 10. Interest exclusion equal to dividend exclusion, tied to mortgage lending | ? |
| 11. Extend Conservation and Solar Energy Credits to rental property | - $.637 |
| 12. Offset: Elimination of 1st year small business depreciation (§179) | + $1.0 |

| | | |
|---|---|---|
| TOTAL OF ALL OPTIONS: | GAIN | $57.7 billion |
| | LOSS | $54.32 billion |
| PROVISIONAL NET IMPACT | | + $ 3.38 billion |

* Estimates by Small Business Legislative Council from various published sources.
? No existing estimates as of May 18, 1981.

NEWS... *from*


SMALL BUSINESS "AT THE END OF THE STRING" TAX EXPERT TESTIFIES

WASHINGTON, D.C., May 20, 1981 -- "Small business interest rates will soar to 24 percent or more in the next four years," William D. Barth, Managing Partner for Small Business Practice at Arthur Andersen & Co., Chicago told the Senate Finance Committee at a hearing on 1981 tax proposals today.

Representing the National Small Business Association (NSB), Barth noted that with interest rates in the neighborhood of 20 percent for the past year, small business is already "at the end of the string," and a new round of interest-rate inflation would force many thousands of established small companies into bankruptcy and millions of people out of jobs. Mr. Barth cited a projection by Data Resources, Inc. which shows interest rates raising to 4 1/2 points above current levels by 1985. Small businesses borrow at several points above the prime rate.

"Unless the tax bill this year is balanced to include measures which speed the flow of affordable capital to smaller enterprises, we stand to lose a substantial segment of the productive, innovative portion of our economy," Mr. Barth testified. "The results will be catastrophic."

High interest rates, Barth explained, place the greatest burden precisely where it is least able to be borne. Small companies, he noted, have severely limited access to most capital markets, and are therefore faced with borrowing from banks to either expand, produce new products, or resupply existing inventories. "No business can survive without

new capital," he said, "but what we are seeing now is that small business cannot afford either the cost of money or the cost of living without it.

"The proposed strategy is a Draconian solution to what we all agree is the most pressing economic problem today," he said.

Barth told the committee that small businesses will survive only if they share equitably in the benefits of the tax bill now being considered. He showed that the proposed "10-5-3" depreciation reforms will assist the large, profitable, capital-intensive industries, but unfortunately will do little to help most small firms. Depreciation reforms, he noted, will not provide any infusion of capital needed by small companies, since they must first raise and spend money on capital expansion to qualify for the tax benefits.

NSB has submitted to the committee a list of options that could provide small business with a fair share of the 1981 tax reductions.

# # #

For more information, contact David Kramarksy, 202/296-7400

# *National Trust for Historic Preservation*

1785 MASSACHUSETTS AVENUE, N.W. WASHINGTON, D.C. 20036 (202) 673-4000

May 28, 1981

Honorable Robert Dole, Chairman
Committee on Finance
United States Senate
2213 Dirksen Building
Washington, D.C. 20010

Re: S. 683, Economic Recovery Act of 1981-Impact on Historic Properties.

Dear Mr. Chairman:

The National Trust for Historic Preservation is pleased to have this opportunity to give you the private preservation perspective on S. 683 and on related proposals pending before the Committee to increase investment in existing buildings. We have carefully reviewed President Reagan's proposal and analyzed its impact on historic properties. Our evaluation was greatly assisted by a special Advisory Committee on Tax Policy composed of tax scholars and practitioners experienced with the existing tax incentives for certified rehabilitation of historic buildings for commercial and other income producing purposes.

In addition, we have taken into account the needs of historic property owners and investors as identified in Field Hearings held by the Subcommittee on Select Revenue Measures of the Committee on Ways and Means in San Francisco, Boston and Chicago in October of last year. These hearings demonstrated the tremendous interest in investment in historic property rehabilitation as a result of the tax incentives, and they also revealed areas where improvements could be made.

We will direct our comments to the parts of the bill prescribing the Accelerated Cost Recovery System (ACRS) because of its impact on investment in historic resources. I will then discuss, briefly, alternative approaches which have been proposed to increase investment in existing buildings.

Generally, we support efforts to simplify the depreciation rules applicable to real estate by establishing relatively short, audit-proof capital cost recovery periods for real estate investments. Predictable and uncomplicated rules for tax treatment of real estate investments should encourage the direction of more private capital into preservation

of our historic built environment.

Impact of S. 683 on Existing Tax Incentives

The ACRS in S. 683 contributes to simplification of the Internal Revenue Code. Unfortunately, S. 683 appears to have been drafted without regard to historic properties or current incentives for their certified rehabilitation. The bill repeals accelerated depreciation for substantially rehabilitated historic structures under Internal Revenue Code Section 167(o). We recognize that such repeal is incident to the wholesale repeal of authorization for accelerated depreciation of all real property (other that ten-year property) and is not specifically targeted to historic structures. Nonetheless, removal of authorization for accelerated depreciation for substantially rehabilitated historic properties does vitiate Congress' declared policy of providing marginal tax incentives to encourage quality rehabilitation of historic commercial buildings for long term use.

Moreover, the bill weakens the effect of the so-called straight line disincentive under Code Section 167(n), which limits to straight line the depreciation which may be taken on a replacement structure erected on a site formerly occupied by a property listed on the National Register of Historic Places. The proposal leaves intact the demolition disincentive in Code Section 280B, which denies a deduction for losses sustained in demolition of a National Register property.

Recommended Revisions To S. 683 To Maintain Marginal Tax Incentives For Certified Rehabilitation Of Historic Properties

We believe that the Congressional policy of promoting quality rehabilitations of historic, commercial buildings through tax incentives can be reinforced and maintained by two relatively simple amendments to S. 683. These recommended amendments conform with the policy underlying the bill as well as with its statutory framework.

1. Provide A Recovery Period For Certified Rehabilitations Of Historic Structures Of One Half The Otherwise Applicable Recovery Period

We recommend that any legislation specifiying a fixed capital cost recovery period for classes of real estate investment provide, for certified rehabilitations of historic properties, a recovery period of one half the otherwice applicable period. In the case of S. 683, this would mean that accelerated depreciation for substantially rehabilitated historic structures would only be available for owner-user commercial and industrial structures in the ten year category. By performing a certified rehabilitation, such owner-users could reduce the recovery period from ten years to five years. This would be consistent with the policy underlying existing Code Section 167(o).

Under ACRS, depreciation for all real property excluded from the ten year category is confined to the straight-line method. The recovery period for certified rehabilitations of historic structures in these categories would be:

—leased industrial and commercial buildings—7 1/2 years.

--low income housing--7 1/2 years.

--other residential real estate--9 years.

Provision of a recovery period for certified historic structures equal to one half the recovery periods otherwise authorized by S. 683 would maintain, and possibly strengthen, the marginal tax incentives now authorized for rehabilitations of historic structures.

2. Increase Investment Tax Credit For Rehabilitations of Certified Historic Structures By One Half That Otherwise Available For Qualified Rehabilitated Buildings

In addition to a shortened useful life for historic structures, we urge the Committee to increase the existing investment tax credit for Qualified Rehabilitations, if they are also certified rehabilitations of historic structures, form 10% to 15%. We understand from the Department of the Interior that a number of developers have avoided rehabilitations of historic structures and buildings in historic districts and, instead, undertaken Qualified Rehabilitations in non-historic neighborhoods. The apparent reason, in view of the current equal credit for either, is to avoid having to comply with the Secretary of the Interior's certification procedures and having to perform more costly, quality rehabilitation in accordance with the Secretary's standards. We believe a tax credit one half greater than that available for rehabilitation of non-historic structures would maintain a marginal incentive for rehaiblitation of historic structures.

The availability of an investment tax credit is especially important, of course, to the owner-user of buildings, whether large or small. A marginally larger investment tax credit should be an important incentive to the local owner-merchant who our National Main Street Center is encouraging to rehabilitate his building as part of historic central business district revitalization in smaller cities and towns. The income level of the typical owner-merchant, and the local financing arrangements for his rehabilitation, often make the investment tax credit a better incentive than accelerated capital cost recovery.

We must emphasize that we do not believe that an investment tax credit, although marginally larger for certified rehabilitations, should take the place of other capital cost recovery incentives for preservation. Deductions from income for rapid amortization of rehabilitation expenses or for depreciation over relatively short recovery periods as proposed in the ACRS are complementary alternatives to the investment tax credit because they are attractive to taxpayer-investors other than owner-users. In this regard, we are pleased to note that the President's bill retains the election of sixty month amortization of the expenses of certified rehabilitation under Code Section 191. Like a shorter capital cost recovery system, rapid amortization mitigates the real and perceived investment risk due to the unpredictability of costs involved in many rehabilitations. This is especially true where the investors must comply with the Secretary of the Interior's standards for the rehabilitation in order to qualify for the tax incentives.

Finally, we recognize the primary focus of S. 683 is on tax simplification and depreciation reforms to stimulate industrial and commercial investment. Consistent with the recommendatons of numerous witnesses who testified in the October field hearings, however, we believe that extension of the tax credit to certified rehabilitations of historic structures for residential rental should be carefully considered.

Alternative Proposals To Increase Investment In Existing Buildings.

Several alternative proposals to increase investment in existing buidings have been advanced. The most notable are the tax cut proposals approved by this Committee and endorsed by President Reagan last Fall and Congressman Rostenkowski's tax cut proposal announced in Chicago in April. A central element of each is an increased tax credit for rehabilitation of older buildings.

As you will recall, The Finance Committee proposal would increase the tax credit for rehabilitation of older buildings, irrespective of the buildings' significance, to 25 percent of the qualified rehabilitation expense. Mr. Rostenkowski's proposal would provide marginal increments in the tax credit of 15 percent for structures 30 years or older, 20 percent for structures 40 years or older and 25 percent for certified rehabilitations.

The need to provide effective tax and economic incentives to encourage the highest quality rehabilitation possible for properties of historic significance is easily overlooked. We were thus especially pleased to note Mr. Rostenkowski's proposal to provide an additional 5 percent marginal increment for buildings which undergo a certified rehabilitation in strict conformity with the Secretary of the Interior's Standards for Rehabilitation.

However, some members of our Advisory Committee on Tax Policy and historic property redevelopers in contact with the Trust have expressed concern that the proposed five percent marginal increase for certified rehabilitations, by itself, appears to be insufficient to induce developers to incur the additional design and construction costs often associated with a certified rehabilitation. Both the processing time and the compliance with the applicable standards place certified rehabilitations of historic structures at a relative cost disadvantage in comparison with other rehabilitations of older buildings.

Recommendations To Make Alternative Proposals Responsive To Historic Properties

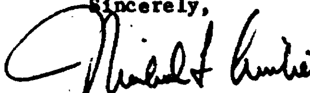
If the Committee elects to pursue a system of tax credits in lieu of the ACRS to stimulate investment in existing buildings, as contemplated in last Fall's Finance Committee proposal and in Mr. Rostenkowski's proposal, we urge the Committee to consider ways to maintain the existing marginal incentive for undertaking a certified rehabilitation. Alternatives might include:

(1) increasing the marginal increment for certified rehabilitations from 5 to 10 percent (resulting in either a 30 percent tax credit for certified rehabilitations or a 10 and 15 percent credit for 30 and 40 year old buildings and a 25 percent credit for certified rehabilitations), or

(2) maintaining the proposed system of incremental tax credits, with a 25 percent tax credit for certified rehabilitations, coupled with a reduction in the useful life for certified rehabilitaions by an appropriate period.

We look forward to working with you to develop legislation that will maintain the system of marginal tax incentives for quality rehabilitations of historic buildings within the overall framework of tax reduction and simplification of the rules governing real estate depreciation.

Sincerely,



Michael L. Ainslie
President

STATEMENT OF
MORTON COLLINS
GENERAL PARTNER, DSV ASSOCIATES
PRESIDENT OF THE NATIONAL VENTURE CAPITAL ASSOCIATION
BEFORE THE
FINANCE SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT
May 8, 1981

Mr. Chairman and Members of this Distinguished Committee:

My name is Morton Collins and I am a General Partner of DSV Associates, which is a $25 million Limited Partnership formed in 1974 for the purpose of venture capital investing. Prior to the formation of DSV Associates, I was Chief Executive Officer of Data Science Ventures, Incorporated, a privately held corporation formed in 1968 for the purpose of venture capital investing. Since 1975, I have been a Director of the National Venture Capital Association, a trade association representing most of the organized venture capital firms in the country, and I am currently President of this Association.

Prior to initiating my career in venture capital, I was the founder and Chief Executive Officer of a computer services company and before that I was a faculty member in the School of Engineering at Princeton University.

## SUMMARY OF TESTIMONY

MORTON COLLINS
NATIONAL VENTURE CAPITAL ASSOCIATION

1. Employee Incentive Stock Options are extremely important in enabling small companies to attract critically needed key management personnel.

2. Stock options are not compensation; they are a method by which employees investing their talents side by side with investors providing money can receive the same benefits and enable small businesses to get started and grow.

3. Stock options will motivate employees to find more efficient ways to perform their jobs. Increased efficiency results in greater productivity. The resulting business growth creates new jobs.

4. Non-qualified options, available under current law, are often combined with Stock Appreciation Rights to yield results for the employee similar to those which would be obtained with Incentive Stock Options. Such programs do not work in young companies when key management personnel are most needed.

5. The Employee Incentive Stock Option proposal will increase Treasury revenues by an amount estimated to aggregate $30 - $60 million annually by 1985.

I am pleased to have been invited to testify here today and I thank the Committee for this opportunity to further explore solutions to the economic problems of the country. Today, I speak on behalf of my own organization, DSV Associates, which when combined with its predecessor has made a total of 51 investments in young high technology companies since 1968. Our sole objective is to provide equity funding and sophisticated management and technical assistance primarily to new, high risk, growth oriented companies. In addition, I speak on behalf of the National Venture Capital Association. The NVCA's membership consists of 105 firms throughout the country which in the aggregate have approximately $4.5 billion invested in small businesses. That $4.5 billion is especially critical as it constitutes the seed capital for the technology industry of this country.

My organization is representative of the venture capital industry as a whole in what it does. While the principal focus tends to be on high technology, often more mundane areas of business are financed by the venture industry. An example of such a company is Federal Express. Federal Express, financed by the venture capital industry has beat the United Parcel Service and the U.S. Postal Service at their own game by provided a service the marketplace needed.

I am appearing here today to urge you to include in the tax package a provision creating Employee Incentive Stock Options. This provision will provide new incentives for individual innovation as well as an increase in Federal tax revenues.

Incentive Stock Options are important in enabling small companies to attract key management personnel. Such a stock option gives the employee the right to buy shares in the company at the current price for a fixed period of time and to obtain capital gains tax treatment on any gain realized from later sale of the shares after the shares have been held for a prescribed period. People leaving large companies with excellent salary and other benefits view the process as one of investing their energies and talents in the success and growth of the small company. These employees become "partners" with the financial investors and it's just as appropriate to offer capital gains treatment to them as it is to investors risking their money. Stock options are not compensation; they are a method by which employees investing their talents side by side with investors providing money can receive the same benefits and enable small businesses to get started and grow.

Incentive Stock Options will motivate employees to find more efficient ways to perform their jobs. Such options only have value to the employee if the price of the company's stock increases. Such increases generally follow increases in the company's sales and profits. This has the benefit of specifically motivating improvement in efficiency. Increased efficiency results in greater productivity and business growth creates new jobs.

"Non-qualified" options, granted under the current law, while better than nothing, are largely useless for inducing innovation and risk taking. The employee is forced to pay tax at ordinary rates on a "phantom" profit at the time of exercise of his option. He must provide the capital in "real" dollars to pay such taxes. While it is possible to construct plans, generally called Stock Appreciation Rights, by which company loans or grants are made available to enable the employee to pay taxes, they do not work in companies that have not yet reached profitability or are cash poor. Generally, it is at this point in the development of a new company that the attraction of key management personnel is most important. If a company is profitable, the use of Stock Appreciation Rights can produce a significant reduction in reported earnings distorting financial statements. In particular, the more that good profit

performance causes a company's stock price to rise, the greater will be the gain to the employee upon exercise of the non-qualified options and the greater will be the Stock Appreciation Rights payment to the employee. Since the Stock Appreciation Rights payments are expenses for financial reporting purposes, the greater the profit performance, the greater the reduction of reported profit. For a small company growing rapidly, such payments can cause significant fluctuations in reported profit which will adversely affect the company's stock price. Therefore, this scheme is mostly useful to large companies with a significant base of profitablility. In any case, it creates an accounting problem of substantial magnitude.

The non-qualified option plus Stock Appreciation Rights is more complex, not less complex than an Incentive Stock Option. A complicated incentive plan is much less effective than a simple one. It's difficult to explain to the employee whom you are trying to motivate a scheme under which he gets an option on which he owes ordinary income at the time of exercise, but that the company will take care of that by paying him some additional money that will cover the taxes. That explanation lacks the simplicity of telling the same employee that he is being granted an opportunity to purchase a number of shares of the company's stock and he will get all the benefits of

ownership even though he does not have to make the cash investment until some time in the future. The qualified option program is simple, straightforward and effective, while the other scheme is viewed by employees as convoluted. Indeed, it is convoluted.

The Incentive Stock Option proposal is a plan which benefits both business and government. Treasury revenues are increased because corporations lose the current front-end deductions achieved with the non-qualified option law. Various groups have analyzed the effect of the Incentive Stock Option proposal on Treasury revenue. The results of these estimates show gains in the second to third year, with the magnitude of the increase reaching $30 - $60 million annually by 1985.

In conclusion, I urge you to include in the tax bill provisions for an Employee Incentive Stock Option Plan. The Packwood-Bentson Bill, S.639 contains the necessary provisions. Inclusion of this bill in the tax package will benefit both business and government.

I thank you for your attention and would welcome your questions.

## Statement of William L. Raby, on Behalf of the American Institute of Certified Public Accountants

As Chairman of the Federal Tax Division of the American Institute of Certified Public Accountants, I am submitting these comments on behalf of our organization, which represents over 168,000 CPAs, many of whom spend a substantial portion of their time in dealing with federal income tax matters.

As part of our presentation, we are submitting copies of two of our recent publications: Statement of Tax Policy #7, Analysis of Capital Cost Recovery Proposals, and Statement of Tax Policy #9, Implementing Indexation of the Tax Laws. Our purpose in this testimony is to summarize and integrate the conclusions of those two publications. Because our space here is limited, I will confine discussion to major points of policy.

The current proposal includes several major tax policy considerations which we have endorsed in the statements referred to above. It would eliminate the concept of useful life in the recovery of capital costs. This is major tax simplification. It would also eliminate the complications inherent in the determination of salvage values of depreciable assets. These are changes which we heartily support.

The proposal also includes substantial individual tax rate reductions as well as changes in capital cost recovery. Strong arguements have been made for those changes, as well as reductions in overall government expenditures. The basic purpose is to increase capital investment and savings and to reduce the level of inflation experienced in recent years.

As a professional group, we do not take a position in favor of specific levels of tax cuts. Nor do we suggest how the tax cuts should be allocated between business and personal components. Those are political decisions as to which we do not take an affirmative position.

In our work with individual clients, however, we have seen how the current high marginal tax rates, especially with regard to investment income, have led individuals

to consider the tax aspects of an investment as often being more important than the economic potential of the investment. This does not necessarily lead to an efficient allocation of our nation's resources.

In dealing with business clients, we have also seen how our tax system introduces distortions into commercial transactions. An obvious distortion concerns the recovery of capital investment. In a time of rapid inflation, our current system of depreciation does not allow a business to recapture the economic value of a capital investment. As a consequence, businesses are taxed on inflated or "phanton" profits. Taxation of inflated profits acts as a barrier to the reindustrialization of the American economy.

The Federal Tax Division has previsouly spoken in favor of the general concept of indexation of our tax system.* In our Statement of Tax Policy #9, Implementing Indexation of The Tax Laws, we deal with the practical aspects of how our tax system should actually be indexed. That document concludes that individual and corporate tax brackets, fixed dollar amounts (such as the various exemptions, deductions and limitations), and the basis of most assets should be indexed. Our ojective in advocating indexation for these items is to preserve the tax structure, as determined by Congress, from distortions—such as "bracket creep" and eroded levels of exemptions—which would otherwise arise from inflation.

I would like to briefly address two arguments frequently put forward against indexation: First, that it signals defeat—giving up the fight against inflation; and second, that it would be an undue complication of our tax system.

We believe that neither argument is persuasive. Indexation is a realistic way of accounting for income and expenditures, for tax purposes, in terms of economic value.

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*See Statement of Tax Policy #6, Indexation of the Tax Laws for Inflation.

Indexation would also curtail the automatic increase in tax revenues which results from inflation. We consider such a result a positive, rather than a negative, effect—removing the ability of the federal government to "profit" from inflation as tax revenues rise at a greater rate than price levels.

As to whether indexation would unduly complicate our tax system, our response has two parts. First, the complexity of indexation is ususally overstated. It is true that for reasons of complexity, we have recommended that some things not be indexed, but it is also true that tax brackets, fixed dollar amounts, and most assets can be indexed in a manner that would add very little complexity to the tax code and almost no additional complexity to the tax forms for most taxpayers.

Second is the complicating factor of change itself. As long as we do not have indexation, we will continue to have periodic "adjustments" of the tax system--ostensibily to compensate for inflation. Such changes complicate planning for both individuals and businesses.

The complexity of indexation could be more than mitigated by making other changes in our tax system. The one I would like to discuss here is the system of open-ended pooled accounts that we endorsed in Statement of Tax Policy #7, Analysis of Capital Cost Recovery Proposals, and in our publication, Tax Recommendations to Aid Small Business. Systems of capital cost recovery based on open-ended pooled accounts were also included in proposals introduced in the last Congress.

Briefly, the difference between pooled accounts and the vintage accounts that we now use is that with vintage accounts each year you establish a new account for each class of assets, whereas with pooled accounts, assets of a particular class are added to the same account year after year, and depreciation and proceeds of dispositions are subtracted from that account.

The advantages of a pooled account approach can include avoidance of the need to maintain vintage accounts, simplicity in accounting for retirements, lessening of the adverse effects of depreciation and investment tax credit recapture when assets are sold, and understandability by persons who are not expert in tax and accounting concepts.

In summary, we believe that a revised capital cost recovery system should be an indexed system based on pooled accounts. Such a system would provide major simplification as compared with presently allowable methods of depreciation.

If there are any points which you or your staff would like to discuss further, the staff and members of the AICPA Federal Tax Division would be happy to do so at your convenience. Our goal is to assist in the development of a simpler, fairer, and improved tax system.

STATEMENT OF
JAMES R. STITES, SENIOR VICE-PRESIDENT
REPUBLIC GEOTHERMAL, INC.

Prepared For

COMMITTEE ON FINANCE
UNITED STATES SENATE
MAY 27, 1981

My name is James R. Stites and I am Senior Vice President of Republic Geothermal, Inc., a company engaged solely in the exploration, development, production and marketing of geothermal resources. Republic applauds the Administration's cost recovery initiatives, as embodied in the Economic Recovery Tax Act of 1981, to stimulate new capital investment. However, a little noticed provision of that Act will have the opposite effect, by severely curtailing investment from the private sector where our company, like many others, derives most of its capital. That provision, Section 203(g) of the bill, would apply the so-called "at-risk" rules of Section 465 of the Internal Revenue Code, which currently limit losses available to certain taxpayers, to the investment tax credits.

The proposal assumes a parallelism between losses and tax credits and therefore would extend the "at-risk" rules governing the former to the latter. This reasoning is fallacious. Congress did not intentionally encourage the loss practices which resulted in the passage of the "at-risk" provisions governing such losses. Section 465 of the code was enacted, after careful study, to correct what Congress perceived to be abuses of existing code sections. On the other hand, Congress enacted the original investment tax credit to encourage the modernization of plant and equipment and subsequently passed energy tax credits to stimulate investment in new alternative (non-oil and gas) energy sources.*/

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*/ See this Committee's report on The Energy Production and Conservation Tax Incentive Act (H.R. 5263) dated October 21, 1977, which states:

> This bill uses tax incentives in an effort to reduce demand for energy, to induce conversion from oil and gas to more abundant energy sources, and to increase U.S. production of a broad range of energy sources. (p.3)

* * * *

[Footnote Continued on Following Page]

However, the investment tax credit sections are fine-tuned pieces of legislative action which do not permit an investment credit where a stimulative effect is not to be expected or desired. Thus, Congress carefully excluded certain property from obtaining investment tax credits: property used by tax exempt organizations and governmental entities, property used outside the United States, property completed abroad or of predominantly foreign origin, certain leased property, public utility property (for purposes of the energy investment tax credit) and others. If a particular investment does not meet the criteria for the intended stimulus provided by the investment tax credit, or if abuses appear, that property, after careful study and documentation, has been carved out of the investment tax credit. There is precedent for such an approach. It would be unprecedented to curtail all investment tax credits across the board, especially when most are producing the results intended by Congress.

This is especially true in the alternative energy area and, in particular, the use by the independent energy sector of the energy tax credits first enacted as part of the Energy Tax Act of 1978. Our industry simply cannot remain viable if the energy tax credits are in any way curtailed. Such an action will prevent us from raising capital in the only market normally available to us: the private investor market.

It is no secret that a company such as ours seldom can command conventional financing from a bank, insurance company, pension fund or other similar source because of the risks perceived by these institutions. Private individual investors are willing to undertake such risks. And Congress clearly chose to subsidize this risk element to encourage alternative energy investment by granting energy tax credits for a prescribed period of time. This policy should not now be changed in mid-stream.

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> The Finance Committee's bill differs significantly from the House-passed energy tax provisions (title II of H.R. 8444) .... The Committee bill takes a different approach and attempts to induce consumers of oil and gas to conserve energy and convert to alternative energy sources through appropriate tax incentives .... The committee believes that conservation, by itself, cannot do the full job of meeting the nation's energy needs; therefore, the committee's bill provides major tax incentives for the production of such new sources of energy as geopressurized methane gas, oil shale, geothermal resources and bioconversion. (p. 6)

Enactment of the energy tax credits permitted smaller, independent energy companies to compete with the giant oil corporations and conglomerates moving into energy areas. Yet the ironic result of this proposal would be to kill off the independent sector and enhance the power of large corporations over alternative energy projects. This curious result stems from the fact that the "at-risk" rules, which the Administration wishes to apply to the independents, do not apply to any large corporations. These large corporations will continue to receive the benefits of all the investment tax credits -- both the regular investment tax credit and the energy investment tax credit.

In sum, if this provision is enacted, the independent energy industry will find it difficult, if not impossible, to raise capital for alternative energy projects. In our case, major geothermal production will not come on line. Given the fact that Congress has encouraged such projects through the granting of tax credits, Congress should reject an attempt to render such credits inoperable.

STATEMENT OF ROHM & HAAS CO., J. LAURENCE WILSON, VICE PRESIDENT, AND JOHN T. SUBAK, VICE PRESIDENT AND GENERAL COUNSEL

Summary

Rohm and Haas Company supports the Economic Recovery Tax Act of 1981 proposed by President Reagan. In particular, Rohm and Haas supports passage of the accelerated Cost Recovery System ("10-5-3") and certain technical amendments including amendments to Sections 103(b)(4)(E) and (F).

Rohm and Haas Company

Rohm and Haas is a medium-sized manufacturer of specialty chemical products (polymers, resins, monomers, plastics, industrial chemicals, and agricultural chemicals). It has over 13,000 employees around the world (9,000 in the U.S.) and facilities or operations in seventeen states: Alabama, California, Colorada, Connecticut, Delaware, Florida, Georgia, Indiana, Kansas, Kentucky, Massachusetts, North Carolina, Ohio, Pennsylvania, Tennessee, Texas and Virginia. In 1980, the Company had sales of $1.725 billion, 63% in the United States and 37% abroad. Most of its competitors are larger chemical companies, many of them located in Europe and Japan.

In General

The Company's prior testimony, dated August 18, 1980* explained the Company's capital needs, the impact of inflation on earnings, valuation of stock, cost of borrowing, capital expenditures, energy and feedstock and research and development.

* Submitted to the House Committee on Ways and Means.

The compelling arguments for the enactment of capital formation incentives remain. Indeed to stay competitive in the world chemical markets the Company's capital requirements are increasing. The existing tax incentives are simply insufficient to maintain the Company's plants.

Specific Comments

For assets presently depreciated in the 7 to 9 year life categories (including chemicals), the initial year of adoption of the Accelerated Cost Recovery System would provide minimal incentive. This is true because the phase in starts at the nearest even year for such assets. Thus, unlike below 7 year assets which immediately receive added incentive through increased investment credit and assets with a 10 year or longer life which immediately drop to 9 years to start the phase-in, the 7 to 9 year assets start the phase-in period by remaining unchanged. Consideration should be given to providing at least an initial one year incentive to these assets. For example, the phase-in could provide for a minimum reduction of 1 year in life for assets presently classified in a 7 year or longer grouping.

Other changes in the tax law which would make capital formation more meaningful would be:

1. Adoption of a more liberal placed in service rule allowing investment credit and depreciation to commence with payments on assets requiring a one year or longer construction period (instead of 2 years).

2. A technical amendment of existing Internal Revenue Code Section 103(b)(4)(E) and (F), offsetting in part the capital drain for mandated environmental expenditures to insure the availability of tax exempt financing for air and water and hazardous waste control facilities. Adoption of the provisions of S 169 introduced by Senator Heinz would accomplish this goal.

Conclusion

The enactment of capital formation legislation is essential for our economy to move forward on a real basis with increased productivity and real economic growth which will in turn reduce inflation.

STATEMENT OF
SCOTT PAPER COMPANY
SUBMITTED TO
UNITED STATES SENATE COMMITTEE ON FINANCE

May 26, 1981

Scott Paper Company is among the oldest and largest manufacturers of consumer and commercial sanitary paper products and printing and writing papers in the United States. Scott employs over 20,000 people in the United States and operates a total of 29 manufacturing and converting operations in this country. Our 3.1 million acres of forest land contribute significantly to our fiber base. Additionally, we are active in the international market with manufacturing affiliates in 20 foreign countries.

The purpose of our testimony is to urge the Committee's consideration of a proposal that deals very specifically with the problems of capital formation and growth. More precisely, we would like to recommend support of a proposal generally known as Investment Tax Credit Refundability, the concept of which is currently addressed in Senator Durenberger's Bill, S. 737, and has previously been the subject of legislation introduced by Senator Long.

Scott believes that it is extremely important to understand when we discuss the idea of Investment Tax Credit Refundability that we are not talking about government bail-outs of companies in the private sector or an artificial propping up of poorly managed firms. In reviewing available records dating back to 1928, Scott has earned a profit in each of the past 53 years. In fact, it is interesting to note that this was true even during the year of the stock market crash in 1929 and the years of the great depression that followed.

The encouragement of capital spending has been a central goal of many legislative initiatives addressed by the Senate Finance Committee over the past 20 years. As a matter of fact, the Investment Tax Credit itself, as originally conceived in 1962, was designed as a

subsidy to encourage capital spending and growth on the part of the private sector. On balance, it has proved a worthwhile program accomplishing many of the goals for which it was intended. The central objective of most capital spending is to increase efficiency and productivity and thereby improve competitive positions. Much of the rationale for ITC comes from a recognition that new investments often have expensive start-up periods before their full potentials are realized.

The paper industry is particularly capital intensive. Just one paper machine easily may cost $200 million today, and a pulp mill producing 800 tons of pulp per day can be expected to require over $300 million of capital investment. Paper machines and pulp mills have more than doubled in cost over the past 10 years.

Our industry, which demands a great amount of energy, has also been hard hit by rising fuel costs. Since 1972, our cost of purchased energy has increased almost six-fold. To meet this challenge, over the past eight years we have initiated expensive energy conservation capital projects which have provided us with a 30% reduction in the useage of purchased energy per ton of product. As a result, today, across the United States, Scott Paper Company has become almost 50% energy self-sufficient. Many of the new capital projects in which we are now involved will further increase our energy self-sufficiency level to 60% by 1985. This is not only good for Scott Paper but also for the country.

Over the past five years our company spent $915 million for new capital projects, expansions, improvements and for energy conservation. In February of this year, we announced that for the next five years our capital spending program will increase to $2 billion, nearly a 120% increase. This is the most aggressive capital spending program in our company's history, a huge undertaking when you consider Scott's domestic sales hit the

$2 billion mark for the first time in 1980. The savings and higher profits from these projects will come, but not overnight.

Our problem, then, simply stated, is that Scott's capital spending currently is increasing at a faster rate than our earnings. It has done so over the last seven years and we expect this will continue to be the case at least until 1985. The result is that by the end of last year we had accumulated approximately $48 million in unutilized Investment Tax Credits. By the end of 1985 this amount is expected to be well in excess of $100 million.

The loss of these credits or even significant delays in receiving them could seriously affect when or if significant portions of our capital spending program are undertaken and completed. This uncertainty may ultimately affect present and future jobs with Scott Paper Company, with the construction trades, and with our regular suppliers. Over the long term it could certainly jeopardize our ability to survive. Further, from an economic standpoint, by linking these credits to a company's profits, it in effect discourages capital investments when they are most needed--during a recession. Refundability would automatically act to provide an incentive for investment in a business downturn where the present system would discourage investment.

For companies like ours with large unused Investment Tax Credits, the prospect of additional credits is no longer an investment incentive. The loss of tax credits or even a long delay in receiving the benefit from these credits acts as a barrier to economic prosperity for our company and others similarly situated. Specifically, if we must continue to pay $1.00 for what others need only pay 90 cents, we are at a real competitive disadvantage. What we are asking for is a program which would provide fair and equitable treatment for all companies,

equalizing everyone's access to Investment Tax Credits on a timely basis. Such a policy would address the crucial element of cash flow, especially in a time of high inflation and high interest rates. For example, a seven-year delay in utilization of Investment Tax Credits at a time when inflation averages 10% or better significantly dilutes the incentive value of the credit.

The shorter term solution to this problem is not accelerated depreciation as embodied in various legislative concepts. Paradoxically, this proposal has a negative effect on those companies most in need of receiving their earned Investment Tax Credits. This is because as depreciation deductions are accelerated and increased, the company's tax liability decreases. Because it is the tax liability upon which the present Investment Tax Credit limitation is based, the lower the tax liability, the lower the amount of credit which can be collected and the greater the amount of credits which go unused. This is not to say we oppose 10-5-3. On the contrary, we support it because of its long term effects and the belief that the time will eventually come when we, like the most profitable companies, will be able to utilize the credits on a current basis. However, we very strongly advocate a "flexibility" feature for 10-5-3 to allow companies to use less than the full amount of allowable depreciation each year. This would prevent excessive depreciation deductions from going to waste. Flexibility, in conjunction with a 100% tax liability limitation, would prevent the permanent loss of earned Investment Tax Credits.

But the solution to our problem and that of many others is a legislative program that is first of all fully equitable for all companies who undertake capital programs, and secondly, constructed in such a manner so as to provide the incentives on a timely basis. Senator Durenberger's Bill, S. 737, is an excellent start on this concept, although we believe that industry groups other than the five specifically mentioned in this legislation should also be

included. Specifically, we advocate a refundable Investment Tax Credit for all companies involved in capital programs.

We recognize some may have philosophical problems with this precise approach. Fortunately there are a number of viable alternatives that we also recommend for your consideration. For example:

1. Extend the carry-back period from the current three years to 15 or 20 years at 100% of the tax liability.
2. Permit the transferability of Investment Tax Credits from those companies who cannot use them to others who can. This, in fact, is currently being done now by use of leveraged leasing. Indeed, an entire industry has sprung up that exists principally for the purpose of permitting one company to sell to another its unused Investment Tax Credits. Regretably, this procedure is very inefficient and, while it can absorb some of the currently generated Investment Tax Credits, it does not solve the problem of the existing backlog. Furthermore, taxpayers should not be required to rely upon this inefficient system to capture tax credits due them.
3. Issue United States Treasury certificates for unused Investment Tax Credits.

Of all these alternatives, the last one, the issuance of Treasury certificates, is perhaps the most attractive from both a technical and societal view and also would appear to have the most favorable revenue impact. In general terms, the government owes any company making a qualified investment in machinery and equipment an amount equal to 10% of the cost of the investment. It is only because the mechanics of this payment have been established within the tax system that a number of companies in several capital intensive industries have not been able to collect the cash due them under this program--despite having made billions of dollars of desirable, qualified investments.

In order to break this logjam of unused credits, we suggest that a mechanism come into play when the tax system fails to permit companies to collect the credits due them. Specifically, we suggest that interest-bearing, 7-year Treasury certificates be issued in a face amount equal to a company's unused Investment Tax Credits which cannot be currently absorbed by the tax system. Such certificates would be freely transferable so that companies could sell them to investors for cash equal to their unused credits.

This system has the advantage to the government of postponing actual payment of the credit to the maturity date of the certificate, 7 years after the year in which the unused credits are generated.

Companies would benefit by being able to cash in their earned, but uncollected Investment Tax credits, thereby restoring equity to the Investment Tax Credit system. All companies would have equal access to earned Investment Tax Credits, and the Investment Tax Credit would once again be an incentive factor in capital spending decision-making.

Scott Paper Company's record clearly demonstrates we are committed to assuring our ability to successfully compete in the 21st Century. We are supporting that goal with $2 billion of capital spending by 1985.

We believe that the idea of Refundable Investment Tax Credits or utilization of one of the alternatives discussed in this testimony is the only pending capital formation tax incentive proposal that can provide any stimulating economic incentives to business enterprises like ours which currently happen not to have sufficient liability for federal income tax to make use of the credits allowed under the existing Investment Tax Credit laws. We can think of no program that would provide a better benefit not only for the country, but also for those companies and industries so essential to our economy.

Scott would be pleased to provide any additional details to the Committee members or staff. Requests for further comment or information should be addressed to either Mr. Jeffrey P. Eves or Mr. Robert A. Ladig, Scott Paper Company, Scott Plaza, Philadelphia, PA 19113. Phone contact: (215) 521-5000.

Testimony of Peter J. Finnerty
Vice President, Public Affairs
Sea-Land Industries Investments, Inc.
On Accelerated Tax Depreciation
For U.S.-Flag Shipping
Before the Finance Committee
United States Senate
May 26, 1981

Mr. Chairman,

Sea-Land Industries Investments, Inc. welcomes this opportunity to testify in support of improved tax depreciation for U.S.-flag vessels.

Our company and its subsidiaries are engaged in various transportation ventures throughout the world. One of our subsidiaries, Sea-Land Service, Inc., is the largest container shipping firm in the world. It also is the only major U.S.-flag liner carrier in foreign commerce that does not receive operating subsidy from the U.S. Government. Nor has Sea-Land ever applied for federal ship construction subsidy or Title XI government guaranteed loans.

As a non-subsidized, American-owned ocean carrier Sea-Land achieved 1980 gross revenues of about $1.4 billion. Since its start 25 years ago, Sea-Land Service, Inc. has grown to an international system that provides scheduled, fully containerized transportation between 122 locations in 52 countries with about 80,000 freight containers and 44,000 truck chassis. Sea-Land's ocean fleet consists of 47 U.S.-flag containerships and 18 smaller, foreign-flag feeder ships. In 1980, Sea-Land added twelve new technology U.S.-flag, energy efficient containerships to its fleet in a $570 million service improvement program.

Sea-Land strongly supports improved tax depreciation for U.S.-flag vessels. In addition, we urge the Committee to include in its tax bill certain other amendments which would make U.S. tax depreciation for vessels competitive - for the first time - with that available in other countries for our foreign-flag competitors.

These amendments for U.S.-flag shipping are justifiable and merited because of the unique, extraterritorial nature of international shipping. Too often, when officials are considering policy changes relating to U.S. shipping they fail to evaluate the matter in its proper international, rather than domestic, setting. If the combination of capital investment/vessel operation cost criteria is not at least competitive with that provided by foreign nations, it is the foreign ship that will move U.S. imports and exports rather than U.S. ships. Our government's failure to watch that critical barometer has

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resulted in a sharp and continuing drop in the U.S. merchant fleet.

The need for internationally competitive U.S. tax depreciation is a vitally important issue. Accordingly, I testified in favor of improved shipping depreciation before the House Committee on Ways & Means on March 19, 1980 on H.R. 4769, again on August 20, 1980 on H.R. 4646, and finally, on April 1, 1981 on H.R. 2456. This year, the issue of improved accelerated depreciation for U.S. shipping and shipbuilding assets has taken on even more importance in view of the Reagan Administration's proposed maritime policy changes and announced massive increases in Naval shipbuilding.

STATUS OF THE U.S.-FLAG FLEET

The U.S. Defense Department finally has awakened to the alarming shrinkage in the U.S.-flag fleet to which they must look for oceanborne support of American forces engaged abroad in any national emergency. The number of American liner companies in 1981 is down to nine from 19 in 1970. The number of liner ships in foreign commerce is down to only 190, many of them older, low productivity, high fuel consuming ships, nearing the end of their useful lives. The U.S.-flag share of liner cargoes has dropped in the last few years from 30 percent to about 24 percent.

Only about two percent of America's vital bulk commodity imports and exports are transported in U.S.-flag vessels. The number of seafaring jobs on U.S. commercial ocean-going ships of 1,000 gross tons and over has dropped from 54,000 in 1966 to just 19,720 in 1980.

The main reason for these startling numbers is the lack of a competitive U.S. Government maritime policy. While reforms of non-competitive regulatory and promotional statutes are necessary, change is urgently needed in U.S. tax depreciation rules for shipping and shipbuilding assets.

In the past, U.S. maritime technology has been pre-eminent in the world. Some U.S. carriers thus far have maintained a competitive position with foreign carriers enjoying a tax depreciation advantage because of previously strong, established U.S. carrier positions in specific trades or because of U.S. innovations and technological superiority. In addition, a select few carriers to date have worldwide capabilities and economies of scale. Regrettably, competitive circumstances have changed. Many foreign competitors now enjoy technological advantages.

Additionally, U.S. carriers must contend with the harsh reality of skyrocketing increases in prices of fuel. With most domestic enterprises, the energy technology against which they compete is about comparable. But in the case of the U.S. liner fleet, foreign competition has a large advantage in fuel efficiency. U.S. ships are primarily powered by steam turbine propulsion.

Foreign vessels, on the other hand, generally have used diesel propulsion plants and therefore enjoy a large and growing cost advantage. There is, consequently, a need to convert U.S.-flag ships to energy efficient diesel power plants as quickly as possible.

To accomplish these changes in the face of intense foreign competition in this highly capital intensive service industry, U.S. carriers must have competitive tax depreciation rules.

AMENDMENTS TO SUPPORT U.S.-FLAG SHIPPING

Appendix I sets forth a draft bill outlining amendments to the Administration's proposal which are intended to help revitalize the U.S. merchant marine through improved tax depreciation. These amendments would improve the Administration's treatment of U.S.-flag shipping and shipyards in several material respects.

First, the bill provides a strong incentive to build in U.S. shipyards by offering U.S.-built vessels a more favorable tax advantage (one year depreciation) than is provided for vessels built abroad (which may be depreciated over five years, as recommended by the Administration). Second, it recognizes the cyclical nature of the international sea transport industry and provides a more flexible basis to claim the depreciation by permitting a carryover to later years.

It also would permit the benefit of the new, competitive depreciation rules to take effect sooner than the Administration's proposal, that is, without the "phase-in" period. The new depreciation schedules would come into effect in 1981 and extend to the entire U.S.-flag fleet, as well as to new investments in vessel construction facilities.

Finally, the measure contains a provision to discourage abuse of these new provisions by imposing a severe tax penalty on any taxpayer that transfers a U.S.-flag vessel that has used these depreciation rules to a foreign registry.

Together, the features of this bill would improve the Administration's proposal by providing needed tax competitiveness for U.S.-flag carriers. The only way a vessel owner may gain any benefit from these amendments is by building and operating U.S.-flag vessels. That is what the bill will create the incentive for investment capital to do.

FOREIGN TAX LAWS

U.S.-flag shipping will increase only if it is competitive in the world marketplace, and improved tax depreciation is one vital element in that equation. Foreign tax laws right now provide significant advantages to our foreign-flag competitors. Appendix II sets forth a detailed comparison of how some major maritime nations provide more advantageous depreciation

rules than the United States. These maritime nations have maintained their competitive edge through such supportive tax policies and other promotional and regulatory advantages.

Other countries with large merchant fleets go even further. Liberia and Panama, as examples, have no tax depreciation because they do not assess income taxes on vessels flying their flag. Allow me to emphasize the point: they are not taxed at all. Thus, while major western nations employ tax depreciation rules superior to existing U.S. depreciation rules, some developing countries are even more competitive by placing no tax burden at all on their vessels. Yet American carriers must compete against all foreign lines in international markets.

It is also important to note that to a growing degree, the competition faced by U.S.-flag carriers is not with other private enterprise entities. Instead, U.S. carriers face maritime nationalism and state-controlled entities which are not profit-oriented. For example, the Soviet centralized economy disguises the nature of aids to their maritime industries. Soviet shipping lines are heavily subsidized to the extent that the capital cost of vessels in the fleet, their depreciation expense, and replacement provisions are not imposed on Soviet carriers, and credit flows to the industry at almost no interest. Thus, the large financial pressures on western vessel operations are absent from Soviet shipping operations.

U.S. NAVAL SHIPBUILDING

Another consideration that calls for passage of the amendments set forth in Appendix I is the need to assist U.S. shipbuilders in equipping their industry to cope with the huge increase in naval construction announced by the Reagan Administration. In order to increase the productivity and reduce the production costs of American shipyards, capital investment is needed immediately, rather than three or four years from now. As Appendix III shows, the Navy shipbuilding program is enormous and it will take long lead times to equip U.S. shipyards even if they begin immediately.

This lead time can be reduced by purchasing certain equipment abroad which is what U.S. shipyards have done to obtain drydocks and fabricating machinery in the past. The Navy is so concerned about the need for increased productivity and shorter shipbuilding delivery schedules that it has considered procuring U.S. naval vessels from foreign shipyards.

When you realize that the Navy program is in the billions of dollars, granting full five year depreciation to shipbuilding assets beginning in 1981 could provide the U.S. Government substantial savings in the cost of Naval ship construction. This change for shipyards could also lower the cost of all commercial vessels built in the United States.

CONCLUSION

In the shipping world of the 1980's, new technical developments, especially energy efficiency, plus a renewed aggressive marketing stance based on flexibility and investment profitability must be employed to enable U.S. shipping to compete head-on with world-wide and heavily nationalized foreign shipping operations. Yet the marginal return on U.S. shipping investment is a growing concern and basic impediment to a strong and expanding U.S. fleet drawing upon private sources of capital.

The goal as we see it is to make U.S. shipping an attractive investment for U.S. investors, and to make U.S. shipping once again a dynamic internationally competitive free enterprise industry.

An obvious method of enhancing investment attractiveness while supporting the competitiveness of U.S. carriers worldwide is the allowance of elective tax depreciation in respect of shipping assets. Such depreciation would not change the amount of a vessel owner's tax liability, but would shift significantly the timing of the liability. This approach has been utilized by several countries, notably the United Kingdom, and has served to promote expansion and upgrading of their national fleets. The real benefit to a shipping company using such method is that value between alternative cash flows under normal depreciation and accelerated depreciation.

U.S. shipping is endeavoring to meet the foreign shipping challenge, but a practical additional tool is needed in U.S. shipping's arsenal. Improved depreciation is that tool. It would provide U.S. shipping with a strong measure of internal control over intense financial pressures with direct and obvious opportunities in respect of U.S. fleet modernization and expansion. This is a necessary and logical step in U.S. efforts to match policies already enjoyed by foreign competitors. It also would help to neutralize basic economic advantages enjoyed by non-western state-controlled fleets.

This proposal is both good for U.S. shipping and for the United States. Our nation's ability to deliver our goods and services to trading partners upon whom the United States is dependent for resources and commercial goods is important in peacetime and vital during a national emergency.

This proposal to modernize a U.S. policy rendered non-competitive by the governments of our country's trading partners is urgent. We respectfully urge the Committee to give it prompt consideration so that the country's shipping and shipbuilding resources can be strengthened.

Thank you for this opportunity to testify in favor of these amendments.

## APPENDIX I
## THE U.S.-FLAG SHIP FAIR COMPETITION ACT OF 1980

A BILL

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, that (a) section 167 of the Internal Revenue Code of 1954 (relating to deduction for depreciation) is amended by redesignating subsection (r) as subsection (s) and by inserting after subsection (q) the following new subsection:

"(r) ALTERNATIVE DEPRECIATION FOR VESSELS AND VESSEL CONSTRUCTION FACILITIES.-

"(1) GENERAL RULE.-Under regulations prescribed by the Secretary, the taxpayer may elect to compute the depreciation provided by subsection (a) attributable to eligible vessels and qualified vessel construction facilities by using the useful life specified in paragraph (2) and a method allowed by subsection (b).

"(2) USEFUL LIVES.-For purposes of this subsection-

"(A) The useful life of an eligible vessel constructed in a U.S. shipyard and placed in service after December 31, 1980 shall be one year.

"(B) The useful life of an eligible vessel not taken into account under subparagraph (A) and qualified vessel construction facilities shall be five years.

"(3) TIME OF DEDUCTION.-An amount paid by the taxpayer with respect to an eligible vessel or qualified

facility will be subject to the allowance under paragraph (1) in the taxable year paid by the taxpayer without regard to the date the eligible vessel or qualified facility is placed in service.

"(4) CARRYOVER OF ALLOWANCE.-In any year the taxpayer does not claim the entire amount of the depreciation allowed under paragraph (1), the unclaimed amount may be carried forward and claimed in any subsequent year in addition to the allowance claimed in that year pursuant to paragraph (1). The deduction for any taxable year may be increased or decreased at any time before the expiration of the period prescribed for making a claim for refurn of the tax imposed by this chapter for such taxable year.

"(5) TRANSITIONAL RULE.-In the case of an eligible vessel, but not including vessel construction facilities, for which an allowance for depreciation under subsection (a) has been claimed for a prior taxable year, the balance in the capital account not yet claimed under subsection (a) may be treated by the taxpayer as property subject ot the allowance of this subsection if the taxpayer so elects, in accordance with regulations prescribed by the Secretary.

"(6) RECAPTURE PROVISION.-If, in any taxable year, any eligible vessel with respect to which deductions were made under this subsection is documented or registered under the laws of a nation other than the

United States, then the taxpayer must include in his gross income for the taxable year, an amount equal to the excess of the accelerated depreciation claimed under this subsection over the depreciation that would have been allowed on a straight line basis over the actual life of the vessel.

"(7) DEFINITIONS.-For the purposes of this subsection-

"(A) ELIGIBLE VESSEL.-The term 'eligible vessel' means a vessel documented, or to be documented, under the laws of the United States that is operated in the foreign or domestic commerce of the United States.

"(B) VESSEL.-The term 'vessel' means a vessel and any cargo handling equipment affixed to the vessel and a container complement not exceeding three times the vessel's capacity.

"(C) QUALIFIED VESSEL CONSTRUCTION FACILITIES.-The term 'qualified vessel construction facility' means an item of real or personal property, excluding land, that is utilized in the construction, modification, or maintenance process of eligible vessels and that was placed in service after the effective date of this subsection.

"(7) EFFECTIVE DATE.-The provisions of this subsection shall apply to taxable years ending after the date of enactment of this subsection."

## APPENDIX II

### CHART I

### AVERAGE CASH FLOW COMPARISON

| Country | Average* Annual Net Free Cash Flow ($ Millions) |
|---|---|
| United Kingdom | $ 115.6 |
| Sweden | 109.5 |
| France | 108.6 |
| West Germany | 106.6 |
| Japan | 103.0 |
| Norway | 101.4 |
| United States | 100.0 |

*The project is the same in each case. The investment is the same and the total project cash flow is the same. The cash flows above show how much cash flow, on average, that would have to be added to the U.S. project to compensate for its cash flow timing disadvantage.

In most maritime nations government assistance programs support shipping. The most obvious form of incentive in major noncommunist maritime nations which seriously disadvantages a U.S. competitor is various methods of accelerated depreciation. These can be greatly in excess of depreciation allowances available to U.S. companies.

## CHART II

### Accelerated Depreciation Techniques

Percentage of Vessel Asset Value
Taken as Tax Depreciation in Each Year

| Year | U.K. | Sweden | France | Germany | Japan | Norway | U.S. |
|---|---|---|---|---|---|---|---|
| 1 | 100% | 30.0% | 31.3% | 48.3% | 32.5% | 12.0% | 13.8% |
| 2 | | 21.0 | 21.5 | 4.7 | 8.4 | 12.0 | 11.9 |
| 3 | | 16.4 | 14.8 | 4.7 | 7.4 | 12.0 | 10.3 |
| 4 | | 16.3 | 10.1 | 4.7 | 6.5 | 12.0 | 8.8 |
| 5 | | 16.3 | 7.0 | 4.7 | 5.7 | 12.0 | 7.6 |
| 6 | | | 5.1 | 4.7 | 4.9 | 7.0 | 6.6 |
| 7 | | | 5.1 | 4.7 | 4.3 | 7.0 | 5.7 |
| 8 | | | 5.1 | 4.7 | 3.8 | 7.0 | 4.9 |
| 9 | | | | 4.7 | 3.3 | 7.0 | 4.7 |
| 10 | | | | 4.7 | 3.3 | 7.0 | 4.7 |
| 11 | | | | 4.7 | 3.3 | 5.0 | 4.7 |
| 12 | | | | 4.7 | 3.4 | | 4.7 |
| 13 | | | | | 3.3 | | 4.7 |
| 14 | | | | | 3.3 | | 4.7 |
| 15 | | | | | 3.3 | | 2.2 |
| 16 | | | | | 3.3 | | |
| Total | 100% | 100% | 100% | 100% | 100% | 100% | 100% |

Curiously, while many countries, again most notably the United Kingdom, allow more liberal depreciation allowances, which has greatly aided expansion of their own fleets, the U.S. has a much greater stake in encouraging fleet expansion. This is due to the worldwide and multifaceted scope of U.S. foreign trade and the need to strengthen our fleet's ability to support the military through ongoing production of highly efficient and technically advanced vessels.

More liberal and competitive depreciation methods in respect of shipping can substantially enhance investments and financial opportunities in respect of the cost of fleet expansion and, concurrently, our country's national defense and international trade.

## CHART III

## QUALITY OF INVESTMENT COMPARISONS*

| Country | Return On Investment % | Net Present Value ( $ Million ) |
|---|---|---|
| United Kingdom | 11.3% | $ 187.9 |
| Sweden | 10.9 | 161.1 |
| France | 10.8 | 155.4 |
| West Germany | 10.6 | 141.9 |
| Japan | 10.3 | 118.1 |
| Norway | 10.2 | 112.2 |
| U.S. | 10.0 | 100.0 |

*Based on typical expansion/improvement type investment in a containerized shipping company. The same investment has been made in each case. The only variable is the type of accelerated depreciation used. For expository and confidentially purposes the results have been normalized so that the U.S. is equal to 100%.

## CHART IV

## VESSEL COST COMPARISON

| Country | Real Cost Per Vessel(1) In Present Value Terms ( $ Million ) |
|---|---|
| United Kingdom | $ 73.7(2) |
| Sweden | 81.8 |
| France | 83.4 |
| West Germany | 87.5 |
| Japan | 94.6 |
| Norway | 96.4 |
| U.S. | 100.0 |

(1) Equal to the original cost of the vessel less the discounted value of subsequent depreciation cash flows.

(2) If the full benefit of the U.K.'s depreciation regulations is taken in the first year of operation the cost falls to $68.2.

THE WALL STREET JOURNAL,
Friday, March 27, 1981

APPENDIX III

# Larger Naval Expansion Than Disclosed With Rise in U.S. Shipbuilding Is Mulled

By WALTER S. MOSSBERG
*Staff Reporter of* THE WALL STREET JOURNAL

WASHINGTON—The Pentagon is considering a larger naval expansion plan than it has publicly disclosed, and is weighing a greater federal role in shipbuilding to carry out such a buildup.

According to a letter from Defense Secretary Caspar Weinberger to Sen. John Tower (R., Texas), chairman of the Senate Armed Services Committee, defense officials are considering a naval shipbuilding program that could expand the Navy's fleet to as many as 700 ships by 1995 from about 450 currently.

If such a target is adopted, it would represent a much larger Navy than the 600-ship fleet announced publicly early this month by Navy Secretary John Lehman.

In addition, the letter – which wasn't made public – says the government may have to step in to help shipyards carry out the fleet expansion. Among the possible government moves suggested by the Defense Secretary in the letter is a resumption of some ship production in federally owned yards.

Other possibilities cited include a suspension of competitive bidding on ship jobs, giving shipyards legal priority for obtaining raw materials and parts, and federal funds for recruiting and training shipyard workers.

In the letter and in an interview, Mr. Weinberger stressed that he and the President haven't made a final decision on the desired size of the fleet. He also said he hopes to avoid, if possible, a big government role in shipbuilding.

But he conceded that the 600-ship figure is mainly "a symbol, an indication of our intention" and that "it may well be that more ships are required." The exact number, he said, would depend on Soviet moves and budget limitations.

## Private Yards

In the interview, Mr. Weinberger also said "I'd infinitely prefer that we leave the task up to the private yards," which he hopes will expand capacity sufficiently to do the work.

However, he said, "I think we need a great deal more shipbuilding capacity," and he cited his unhappiness over the pace and quality of the submarine construction work being done by General Dynamics Corp. "I'm interested in more quality and speed," he said.

Thus, he said, "we aren't limiting ourselves" to relying on an expansion and improvement in private-yard capacity.

Pentagon officials have conceded that even expanding the fleet to 600 ships would require a great effort and could present personnel problems. The Navy is already short of the minimum number of senior sailors needed to run comfortably today's fleet. Any expansion beyond 600 ships would make these problems worse.

Mr. Weinberger's letter was written to transmit to Sen. Tower a study comparing U.S. and Soviet shipbuilding capabilities that was ordered by the Senate Armed Services Committee last year.

According to a summary of the study attached to the letter, the study considered requirements for constructing a Navy of varying sizes, up to 800 ships.

The summary refers to the 600-ship Navy, which the administration has cited as its goal, as a "base case." But the letter indicates that Mr. Weinberger is considering a larger fleet of up to 700 ships, the study's "intermediate case."

## Building Pace

To reach the 600-ship fleet, the study says, about 20 ships a year must be built, on average, over a 10-to-15-year period. To reach the 700-ship fleet, about 33 ships a year must be built.

In Mr. Reagan's proposed budgets for fiscal 1981 and 1982, shipbuilding would be raised to between 20 and 30 ships a year.

According to the summary of the study, the shipbuilding industry can adapt to naval expansion, given about four years of lead time to expand its labor force and sufficient certainty that the program would be carried out.

But the summary says some of the government's naval shipyards, which haven't built any new ships since 1972, would have to be used to meet the 700-ship goal. Four of the seven Navy yards are believed capable of building new ships if necessary.

The summary also says that "to guarantee a timely response by the industry will require government actions that suspend full dependence on market forces."

The summary suggests that Navy yards might take over the building of all nuclear-powered ships, and that federal actions should be taken to "cause increases in commercial ship demand." The summary suggests cargo preference laws to mandate the use of U.S. ships and increases in federal shipbuilding subsidies.

Mr. Weinberger ended his leter to Sen. Tower by declaring that "if we are to achieve the naval forces, merchant marine and shipbuilding capacity commensurate with our national security interests, we must pursue some of the policy options that are outlined in the attachment to this letter."

STATEMENT OF THE

SECURITIES INDUSTRY ASSOCIATION

TO THE

SENATE FINANCE COMMITTEE

UNITED STATES SENATE

MAY 28, 1981

Mr. Chairman and members of the committee, the Securities Industry Association appreciates the opportunity to participate in the committee's hearings on tax reduction proposals.

SIA represents over 500 leading investment banking and brokerage firms headquartered throughout the United States which collectively account for approximately 90% of the securities transactions conducted in this country. The activities of SIA members include retail brokerage conducted on behalf of 30 million individual shareholders, institutional brokerage, over-the-counter market making, various exchange floor functions and underwriting and other investment banking activities conducted on behalf of corporations and governmental units at all levels. Because of their role in the capital markets, SIA members are in a position to recognize the impact of tax policy on investment decisions by corporations and investors.

## Introduction

The recent deterioration of the nation's economic health has spawned a consensus that new tax policies are imperative to ensure vigorous and stable future growth. U.S. economic growth as measured by real GNP has been on a downtrend, averaging almost 5% in the 1960s and about 3.7% in the 1970s. Moreover, years characterized by negative growth are becoming more frequent. The decade of the '70s was marked with two recessions, culminating in three years of negative real economic growth.

In 1980, with the beginning of a new decade, the nation's economic ills were underscored by one of the sharpest quarterly drops on record -- a 9.9% drop in real GNP. Despite the acuteness of this decline, inflationary pressures have so far proven intractable. Inflation set a 12.4% annual pace in 1980, less than 1 percentage point below the unprecedented 1979 rate. These two consecutive years of double-digit inflation were the first time in history in which inflation in the U.S. was higher than the average of all industrial countries.

Labor productivity gains declined precipitously in the '70s. The increase in average annual productivity, more than 3% in the 1947-65 period, slowed to slightly over 2% between 1965-73, dropped to under 2% in 1974-77, and has been negative for the past three years. Among the factors determining productivity is the quality of physical capital. The percentage of plant and equipment considered outmoded at year-end 1980 for some of America's key industries reached as high as 42% for railroads, 34% for rubber manufacturers, and 28% for the automobile industry (see Table 1).

Table 1

Percent of Plant and Equipment
Industries Considered Outmoded

| Industry | Outmoded as of Year-End: 1980 | 1978 |
|---|---|---|
| Iron & Steel | 26% | 26% |
| Electrical Machinery | 10 | 11 |
| Autos, Trucks & Parts | 28 | 17 |
| Rubber | 34 | 25 |
| Petroleum | 10 | 4 |
| Railroads | 42 | 10 |
| Electric Utilities | 3 | 10 |

Source: McGraw-Hill

Trends in the average annual growth rates of real non-residential investment offer much of the explanation for the antiquation of our industrial base. This rate was over 4% in the 1949-73 period and has fallen sharply to only 2.4% in the 1974-79 period. Any increase in investment must be accompanied by an increase in savings, for it is savings that provides the wherewithal for the updating of plant and equipment and the implementation of new, advanced technologies. The reduced level of savings and inadequate level of capital investment in the U.S. are closely intertwined and have been major factors in the decline of productivity and loss of international competitiveness. Savings as a percentage of disposable income has dwindled from 8.0% in 1970 to 5.7% in 1980. Recently released statistics show that savings in early 1981 continued at a depressed rate.

## International Comparisons

The loss of our once-preeminent international competitive position has cost dearly in terms of lost production, lost jobs,

and costly imports. In international comparisons of key indicators of economic progress, the U.S. does not fare well. The U.S. ranks last by far in terms of productivity growth.

Table 2

| | 1979 Manufacturing Productivity Gain Percent Increase | Percent Change in Annual GNP Growth Per Employee 1973-1980 * |
|---|---|---|
| Italy | 8.7% | 1.9% |
| Japan | 8.3 | 3.5 |
| France | 5.4 | 2.7 |
| West Germany | 5.2 | 3.1 |
| United Kingdom | 2.2 | 0.4 |
| United States | 1.5 | 0.0 |

Source: U.S. Labor Department, Bureau of Labor Statistics and OECD
* Forecast values for 1980.

The U.S. last-place showing in terms of productivity gains is echoed in terms of savings and investment. Personal savings is an essential link to corporate capital formation; a low level of savings precludes a high level of capital investment and severely limits productivity gains.

Table 3

| | Real Investment as % of Real National Output 1/ | Savings as % of Disposable Personal Income 2/ |
|---|---|---|
| Japan | 23.5% | 20.1% |
| Canada | 17.4 | 10.5 |
| France | 16.3 | 15.6 |
| United Kingdom | 15.4 | 15.1 |
| West Germany | 15.6 | 14.5 |
| Italy | 14.4 | 23.8 |
| United States | 10.9 | 5.7 |

Source: OECD and U.S. Department of Commerce.

1/ Data is 1974-79 for Germany and U.S.; 1974-78 for Italy, Japan and United Kingdom; 1974-77 for Canada and France.
2/ Data is 1980 for U.S.; first three quarters of 1980 annualized for France, West Germany, United Kingdom and Canada; 1978 for Italy and Japan.

The savings rate of six major countries far exceeds the U.S. rate of only 5.7%. (See Table 3.) In the '70's, the U.S., France and Germany experienced a decline in the savings rate. The U.S. rate dropped by a considerable 29%, while the French rate fell by 6.6% and the West German rate dipped only 2.7%. Moreover, real investment as a percentage of total output in these countries is impressively higher than that of the U.S.

The conclusion to be drawn is that we must enact legislation to rekindle U.S. investment and productivity. Tax legislation is one of government's most important tools to attain these objectives. The following reviews several of the numerous policy changes that have been proposed. In the final analysis, those policies that add the most in terms of investment and productivity while costing the least in terms of government deficits are the most desirable.

## Individual Tax Cuts

We believe the American people deserve tax reductions to offset, in part, increases in rates resulting from "bracket creep" and increases in payroll taxes. We claim no expertise in determining the size of such tax cuts. But savings and investment will more effectively be fostered through selective measures aimed specifically at removing tax disincentives.

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The improvement in the investment atmosphere following the capital gains tax cut in 1978 is a prime example of the beneficial impact of direct targeting. To stimulate our sagging savings and investment rates, further cuts in capital gains taxes and a reduction in the maximum tax on investment income from 70% to 50% would be more effective than personal tax reductions. The President's program of reducing personal tax rates by 10% over the next three years would lower the maximum tax on investment income to 50%. But even if Congress decides to adopt the President's multi-year plan, some investment may be delayed until full implementation in 1984. This possible hurdle could be avoided by an immediate end to the distinction between "earned" and "unearned" income.

## Capital Cost Recovery

Business has also been a victim of our present tax structure. Companies are writing-off assets based on historical costs, while profits may reflect only higher inventory values. Annual depreciation charges may be less than half the cost of productive capacity consumed. Using historical cost figures to calculate tax liabilities is a major impediment to capital formation and distorts reported earnings.

Investors are well aware of the deterioration in the quality of reported earnings. The price/earnings multiple of the DJIA has declined from 19 at the end of 1960 to 8.4 recently. With internal cash flow no longer sufficient to renew and expand plant and equipment, and with the equity markets unreceptive until very recently, corporations were forced to turn repeatedly to the debt

markets. The ratio of new debt raised to equity raised was 1.32 in the 1956-60 period and has escalated to an estimated 3.33 in the 1976-80 period. Moreover, the high level to which inflationary expectations have pushed interest rates in recent years has caused many corporations, shut out of the long-term debt markets, to turn instead to costly short-term debt arrangements.

These problems could be alleviated by a capital cost recovery program of the sort proposed by the President and this committee last year. However, neither capital cost recovery nor an increase in the investment tax credit will fully solve our capital formation dilemma. These measures are targeted at the more established and larger segments of U.S. business, but would do nothing for the plight of small, developing enterprises which create a disproportionately large share of new jobs. The capital problems of small business can best be treated by tax measures aimed at encouraging individual investment and risk taking.

## Savings and Investment Incentives

This nation's depressed level of savings and investment is one of the most urgent problems to be addressed by policy makers. There are numerous tax proposals specifically designed to stimulate savings and investment and correct this nation's economic problem. Selective measures aimed at removing tax disincentives can effectively and efficiently foster savings and investment.

## Results of the 1978 Capital Gains Tax Cut

Of the many tax measures proposed to encourage savings and investment, the recent documented track record of the 1978 capital gains tax cut is encouraging. The Revenue Act of 1978 reduced the maximum effective capital gains tax rate for individuals from about 49% to 28%. That tax cut was both effective and efficient. The effectiveness can be found in the overall improvement in the investment climate since passage of the Act, despite adverse economic conditions that would tend to negate such improvement. As for efficiency, original projections of large revenue losses have been revised downward several times and the current estimates show that additional capital gains tax revenues were generated in 1979 with the reduction in capital gains tax rates.

### Revenue Effect

The inhibiting effect of capital gains taxation on the investment process is most pronounced in the 34% decline in total gains reported in the 1969-70 period which followed a substantial increase in the capital gains tax. The amount of capital gains reported inched up at an average annual pace of 5.8% in the 1969-77 period, in part reflecting illusory gains due to inflation. In striking contrast, reported gains soared 40% from $51.5 billion to $72.1 billion from 1978 to 1979 when the capital gains tax cut became effective. (See Table 4.)

Table 4

Taxes Paid on Capital Gains Income
(Individuals Only, $ Billions)

| Year | Total 1/ Gains | Taxes Paid on Capital Gain Income |
|---|---|---|
| 1969 | $31.4 | $4.4 |
| 1970 | 20.8 | 3.0 |
| 1971 | 28.3 | 4.3 |
| 1972 | 35.9 | 5.6 |
| 1973 | 35.8 | 5.3 |
| 1974 | 30.2 | 4.3 |
| 1975 | 30.9 | 4.5 |
| 1976 | 39.0 | 6.2 |
| 1977 | 45.9 | 7.3 |
| 1978 2/ | 51.5 | 8.1 |
| 1979 2/ | 72.1 | 10.1 |

Office of the Secretary of the Treasury
Office of Tax Analysis

1/ Net long-term gain in excess of short term loss plus short-term capital gain.

2/ Based on Preliminary Data.

Recent evidence of the offsetting effects of increased capital gains realizations on revenue loss is startling. The Treasury Department's original "static" loss estimate from the 1978 capital gains tax reduction was about $2.5 billion. This estimate was not based on actual data but on past trends prior to the capital gains tax cut in 1978. However, the initial analysis of the Treasury of tax returns actually filed for 1979 indicated that capital gains tax receipts were down only $100 million from that projected for 1979 before the capital gains tax cut in 1978 was enacted. More importantly, the most current data available to Treasury indicates that actual revenues generated from capital

gains taxes are up $2.0 billion in 1979 over 1978 and are about $1.7 billion more than projected before the 1978 tax cut. Thus, the 1978 capital gains tax cut actually generated additional tax revenues in 1979.

Shareownership

Individual shareownership, reported in the New York Stock Exchange Shareholder Census, has risen and fallen in concert with tax policy changes on investment income over recent years. While no one factor accounts for the investment behavior of individuals, the after-tax return on investment is a prime consideration. Between 1970 and 1975, shareownership dropped 18%, coinciding with increased taxes and reduced returns that resulted from 1969 tax policy changes. However, between 1975 and 1980, individual shareownership rose to 29.8 million, almost completely recovering the loss of the prior 5 years. Moreover, the average individual investor is younger, less affluent and holds less stock than in prior years.

The number of new investors is striking compared with prior periods. Between 1965-70, 5.3 million new investors were reported and in the 1970-75 period, only 2.2 million. However, between 1975-80, a significant 6.5 million individuals became shareholders for the first time, an increase of almost 200% over the 1970-75 period. More impressive still is that the number of new shareowners picked up dramatically after the more favorable tax treatment of capital gains. In the 4-year period from January 1975 to December 1978, the number of new shareowners was growing at an average monthly pace of 86,000. Between the 1 1/2-year period January 1979 and June 1980, the number of new shareowners jumped 51% to an average monthly increase of 130,000.

Stock Market Indices

Equity investment over the 1970s lost its long-held position as the traditional hedge against inflation. Investment funds increasingly flowed into real estate, metals, art, and other tangibles. Yet, in the 1979-80 period, two years characterized by persistent double-digit inflation, unprecedented high levels of interest rates, and the deterioration of the financial position of many corporations, the stock market indices recorded significant gains.

Table 5

Percentage Gains in Stock Market Indices

| Period | S&P 500 Index | NYSE Common Stock Index | AMEX Market Value Index | NASDAQ Index |
|---|---|---|---|---|
| 12/78 - 12/79 | 12.3% | 15.5% | 64.1% | 28.1% |
| 12/79 - 12/80 | 25.8% | 25.7% | 41.3% | 33.9% |

While the S&P 500 and NYSE Common Stock indices made notable gains in 1978-80, the increases registered by the AMEX Market Value and NASDAQ indices are most impressive. These latter two indices represent the stocks of smaller capitalized companies, the value of which increased a substantial 132% on the AMEX index and 72% on the NASDAQ Index between 12/78 and 12/80. The individual investor traditionally focuses his attention on the smaller companies, hoping for significant growth in such companies, which would be reflected in higher share prices and capital gains when sold. Moreover, of particular importance given our present economic condition, these small, developing enterprises create a disproportionately large share of new jobs.

Initial Public Offerings and Venture Capital

The increased value placed on the stocks of smaller companies has led to a market atmosphere conducive to the initial public offerings of many lesser known companies. From 1969 through 1975, following increased capital gains taxes, initial public offerings by small companies and the capital raised through those offerings virtually disappeared, declining an incredible 99%. When passage of the 1978 Revenue Act was imminent in the second half of that year, initial public offerings jumped to about 3 times the first half's level and $250 million in new equity capital was raised in 46 offerings. Although there was a dramatic 63% increase in the 1977-78 period, the amount of new capital raised in 1979 and 1980 was even more striking. In 1979, 81 public offerings were made amounting to $506 million. In 1980, 237 initial public offerings came to market, raising $1.4 billion in new equity funds.

New capital raised by venture capital firms also picked up noticeably in late 1978, rose to a relatively high level in 1979, and surged in 1980. This new capital allowed venture capital firms to substantially increase disbursements to $1 billion in 1979 and is estimated at $1 billion in 1980 -- 2 1/2 times the pre-1978 level.

Impact of Various Tax Proposals

Despite the recent criticisms of econometric models, they are useful in indicating the direction and the relative impact of various tax proposals on the economy. One of the reasons for the inaccuracy of macroeconomic forecasts in the last few years is

that most models are based on the economic experience of this country since World War II. However, economic conditions in the last few years have been very dissimilar to that of earlier decades. Thus, we have very carefully monitored our simulations.

DRI has been engaged in research to incorporate the tax and economic developments since the capital gains tax cut in 1978 in their quarterly economic model of the U.S. This research provides for a more comprehensive analysis of the response of savings, consumption and the holdings of household assets relative to changes in after-tax returns. Dividends and stock prices are also related to the after-tax returns on savings with stock prices influenced by expected after-tax returns on equity (proxied by the expected earnings per share).

The revised model contains new specifications for the impact of after-tax returns on personal savings, and the impact of changes in the taxation of investment income (capital gains, interest and dividends) on household holdings of assets, consumption, investment, dividend payout ratios and stock prices. No less than seven different categories of consumption are impacted by changes in taxes on investment income. Household holdings of corporate bonds, deposits, commercial paper, mortgages, and assets are affected by changes in the taxation of investment income as is household debt. Projections of both consumption and household holdings of assets are improved, especially in the most recent periods, using these new factors.

An example of how these changes affect the model follows. Lower capital gains taxes increase the after-tax return on equities. This raises stock prices and reduces the cost of

equity financing, thereby stimulating investment. Households spend more because of their increased wealth resulting from higher stock prices. At the same time, they also have a greater incentive to save because of higher after-tax returns on equities. Finally, dividends decline because shareholders prefer to take profits in lower taxed capital gains rather than higher taxed dividends. These reinvested earnings lead to higher long-term earnings growth.

All of these relationships are incorporated in the new DRI model, thereby eliminating the need for assumptions about changes in stock prices and dividend payout ratios with modifications in taxes on investment income. Work is continuing on the new specifications so current estimates should be interpreted as suggestive rather than final.

Macroeconomic Impact

Two comprehensive bills aimed at broad-based modifications of U.S. tax policy have been introduced recently. These are the President's proposal for across-the-board personal income tax cuts and capital cost recovery allowances and the Senate Finance Committee's 1980 tax bill. That bill included personal tax cuts, capital cost recovery allowances and specific proposals aimed at increasing personal savings and investment. In addition to these major proposals, there have been several thoughtful bills introduced by members of this committee aimed at stimulating savings and investment specifically.

Together with DRI, SIA has simulated the impact on the economy of the two comprehensive bills as well as five other

proposals. The simulations include: (1) the President's program containing both tax and spending proposals; (2) last year's Senate Finance bill; (3) an increase in the interest and dividend exclusion to $1,000/$2,000 as embodied in S. 492; (4) an increase in the capital gains exclusion to 75% as incorporated in S. 75; (5) a reduction in the maximum tax on investment income to 50% which is included in S. 936; (6) an increase in IRA limits and eligibility as provided for in S. 243; and (7) a dividend reinvestment program of $1,500/$3,000 as contained in S. 141.

Because of their comprehensive scope, both the President's program and last year's Senate Finance Committee bill greatly overshadow the five smaller proposals in terms of absolute impact on the economy. The Senate Finance bill tends to be more efficient than the President's proposal in generating additional investment, since it provides for more directly targeted tax stimulus to investment. Although both these proposals cost about the same over the 1981-83 period in terms of real federal tax receipts and revenues -- about $63 billion, the Senate Finance Committee bill would add about $104 billion in real GNP as compared to about $43 billion for the President's proposal. In terms of real investment, the Senate Finance Committee bill would add about $37 billion, while the President's proposal would generate about $15 billion. (See Table 6.)

SIA supports both of these proposals relative to not implementing changes to the tax code. Of the two, the Senate Finance Committee bill is preferable, in general, in that it has a more desirable impact on the economy in terms of stimulating economic growth and investment relative to the cost in federal tax receipts.

Table 6

Absolute Changes in Selected Variables
Under Various Tax Proposals
(1981-83, $ Billions)

| | Real GNP | Real Investment | Real Personal Savings | Real Consumption | Real Federal Tax Receipts** |
|---|---|---|---|---|---|
| President's Proposal* | $ 42.7 | $ 15.2 | $ 33.4 | $ 39.9 | $(62.9) |
| Senate Finance Bill | 104.1 | 36.8 | 29.8 | 65.2 | (63.7) |
| Increase in Interest/ Dividend Exclusion to $1,000/$2,000 | 51.0 | 9.0 | 32.9 | 45.4 | (33.0) |
| Increase in Capital Gains Exclusion to 75% | 4.8 | 0.8 | 2.9 | 4.2 | (0.5) |
| Reduction in Maximum Tax on Investment Income to 50% | 7.6 | 1.4 | 4.4 | 6.5 | (1.9) |
| Increase in IRA Limit Eligibility | 6.4 | 1.2 | 4.0 | 5.2 | (3.5) |
| Dividend Reinvestment Program $1,500/$3,000 | 3.4 | 0.7 | 6.3 | 3.3 | (5.2) |

* Includes spending and tax proposals
**With feedback effects

Targeted Proposals

Each of the five specifically targeted proposals generates additional investment and savings. The increased interest and dividend exclusion to $1,000/$2,000 has a much larger magnitude than any of the other proposals in terms of generating growth, investment and savings. However, it is considerably more costly than any of the other proposals as there is an estimated $33 billion loss in real federal tax receipts and revenues over the 1981-83 period.

Increasing the capital gains exclusion to 75% has a very positive impact on the economy while very little tax revenues are lost. Over the 1981-83 period, real GNP, investment, savings and consumption increase by $4.8 billion, $0.8 billion, $2.9 billion and $4.2 billion, respectively. At the same time, real federal tax revenues decline by only $0.5 billion, as increased realizations, resulting from lower capital gains taxes, almost offset completely the impact of lower rates on capital gains.

Lowering the maximum tax on investment income to 50% also has beneficial results for the economy. Real GNP, investment, savings and consumption increase by $7.6 billion, $1.4 billion, $4.4 billion, and $6.5 billion, respectively. Over the 1981-83 period, real federal receipts fall by only $1.9 billion. In estimating the impact on federal revenues for this proposal, we relied on the initial static revenue loss provided by the Treasury of $4.6 billion, which fails to take into account any change in investment patterns from tax shelters and tax-exempt activities to taxable instruments which would be subject to a lower effective rate. In addition, efforts expended in escaping federal taxes completely through the subterranean economy would be curtailed. Thus, although the econometric simulations of the benefits of lowering the maximum tax are helpful in providing guidance for policymakers, we believe the figure of $1.9 billion may actually be an overestimate of the impact on losses to the federal tax coffers.

We analyzed the impact on the economy of an increase in IRA limits and eligibility as included in S. 243. This provision has several desirable effects on the economy by increasing growth,

investment and savings. At the same time, federal revenues drop by a modest $3.5 billion. A dividend reinvestment program of $1,500/$3,000 also has some desirable effects in creating further real growth, investment and savings. However, its estimated tax revenue loss of $5.2 billion exceeds that for IRAs and is considerably higher than that for a reduction in the maximum tax on investment income, or an increase in the capital gains exclusion.

Efficacy Ratios

Because of the very different magnitudes of the tax proposals being discussed, we have developed an efficacy ratio to measure each proposal's relative efficiency and effectiveness (Table 7). The figures should be interpreted: how much additional activity is created per dollar of tax revenue lost. For example, lowering the maximum tax on investment income to 50% generates $4.51 of real GNP in 1982 per dollar of tax revenue lost, while $4.85 would be generated in 1984.

In relation to the tax revenues lost, the 1980 Senate Finance Committee bill, the increased capital gains exclusion and the lowered maximum tax on investment income are highly efficient. All of these rank high in generating additional real investment and real savings per dollar of tax revenue lost in 1982 and 1984. In general, all of the targeted proposals are relatively efficient in stimulating personal savings. Nevertheless, the increased capital gains exclusion to 75% and the reduction in the maximum tax on investment income to

50% have higher ratios than the other targeted proposals. In terms of generating additional real investment or savings, these proposals are not quite as large in absolute magnitude as others. However, because of the modest revenue loss of these two proposals, they have a very high efficacy ratio when the amount of savings and investment generated is compared to any loss in federal tax revenues. In conclusion, the modeling results confirm our intuitive belief that "directly targeted" proposals are much more efficient in stimulating savings and investment than across-the-board personal income tax cuts alone.

Table 7

Efficacy Ratios of Various Tax Proposals*

| | Change in Real GNP Per Dollar of Tax Revenue Lost | | Change in Real Investment Per Dollar of Tax Revenue Lost | | Change in Personal Savings Per Dollar of Tax Revenue Lost | | Change in Real Consumption Per Dollar of Tax Revenue Lost | |
|---|---|---|---|---|---|---|---|---|
| | 1982 | 1984 | 1982 | 1984 | 1982 | 1984 | 1982 | 1984 |
| President's Proposal | 0.65 | 0.87 | 0.23 | 0.34 | 0.45 | 0.61 | 0.63 | 0.77 |
| Senate Finance Bill | 1.53 | 4.80 | 0.54 | 1.81 | 0.40 | 2.70 | 0.92 | 3.00 |
| Increase in Interest/ Dividend Exclusion to $1,000/$2,000 | 1.96 | 1.73 | 0.33 | 0.33 | 1.04 | 1.32 | 1.66 | 1.64 |
| Increase in Capital Gains Exclusion to 75% | 14.13 | 4.47 | 1.25 | 1.91 | 9.30 | 6.42 | 11.81 | 1.17 |
| Reduction in Maximum Tax on Investment Income to 50% | 4.51 | 4.85 | 0.55 | 1.71 | 2.27 | 4.87 | 3.27 | 3.79 |
| Increase in IRA Limit Eligibility | 2.52 | 1.84 | 0.47 | 0.23 | 1.36 | 1.92 | 1.93 | 1.72 |
| Dividend Reinvestment Program $1,500/$3,000 | 0.76 | 0.62 | 0.18 | 0.16 | 1.18 | 1.20 | 0.71 | 0.78 |

* Ex-post concept and total tax revenues lost. These ratios are estimated using total tax revenues lost and include feedback effects.

## International Tax Treatment of Capital Gains and Dividend and Interest Income

While the 1978 Revenue Act was a welcomed step in reducing capital gains taxation, compared with rates in 10 major foreign countries, the resultant 28% maximum tax on long-term gain in the U.S. is the second highest of the major industrial countries. A recent study prepared by Arthur Andersen (see attached) for SIA shows that only the United Kingdom has a higher maximum tax on

capital gains. Moreover, six of the ten foreign countries exempted capital gains from taxation entirely. Only Canada includes a greater percentage of long-term gain in taxable income than does the U.S. In Canada, however, there is no holding period required for long-term capital gains treatment and the maximum tax rate on income is 43% as compared with 70% in the U.S.

The Arthur Andersen study also reviewed the taxation of dividend and interest income. Compared with ten major foreign countries, tax rates in the U.S. again ranked among the highest. Regarding the taxation of dividend income, only the Netherlands has a higher maximum effective rate than the U.S. While Japan has a maximum marginal rate of 70%, the same as the U.S., many Japanese residents can avail themselves of the 20% taxation under "at the source" rules. In addition, seven of the ten countries studied have adopted some type of integration system to reduce the burden of double taxation of corporate earnings at both the corporate and shareholder level. Moreover, both Belgium and France have measures specifically designed to encourage portfolio investment in stocks. In considering the taxation of four chief sources of interest income, three of the ten foreign countries have maximum tax rates slightly exceeding 70%. However, two of the three have interest income exclusions which also exceed the $200 individual exclusion in the U.S. The seven other foreign countries have tax rates substantially lower than the U.S. Eight of the ten foreign countries have special exclusions, allowances, and rates, in many cases significantly more generous than the current dividend/interest exclusion in the U.S.

## Conclusion

The U.S. economy, as well as the world economies, has undergone very dynamic changes since World War II, thus rendering demand-oriented policies ineffectual in curing supply-side problems. Traditional policies of stimulating demand are but short-term remedies for long-term ills. Without increased savings and investment by both corporations and individuals, the U.S. faces the prospect of stagnating growth.

Tax policy which encourages savings and investment directly provides a stronger stimulus than reductions of individual rates alone. The 1978 capital gains tax cut established an impressive record for effectiveness and with no revenue cost. We believe a further cut in the capital gains tax and a reduction in the maximum tax on investment income would continue to produce beneficial effects on savings and investment and the nation's economy.

STATEMENT OF WILLIAM B. REED
PRESIDENT OF SOUTHERN COMPANY SERVICES, INC.
ON THE ECONOMIC RECOVERY ACT OF 1981 (S. 683)
TO THE COMMITTEE ON FINANCE
UNITED STATES SENATE
May 26, 1981

Mr. Chairman and Members of the Committee:

These comments are submitted on behalf of The Southern Company, the parent firm of four investor-owned electric utilities operating in the southeastern United States. These companies are Alabama Power, Georgia Power, Gulf Power, and Mississippi Power, collectively referred to as the Southern electric system. Directly and indirectly, the Southern electric system provides electricity to more than nine million people in most of Alabama, Georgia, southeastern Mississippi, and northwestern Florida. The Southern Company's common stock is the most widely held electric utility stock in the nation and is one of the 10 most widely held corporate stocks in America.

We are especially concerned with the problem of capital formation because the electric utility industry is the most capital intensive of all industries in the United States. Electric power companies are currently responsible for about one-fifth of all plant investment and construction expenditures made by the nation's businesses. Electric utilities account for one-third of all new long-term corporate financing and approximately half of all new-issue common stock marketed in the United States.

In support of its construction program, the Southern electric system currently anticipates the expenditure of $4.7 billion over the next three years, and we expect to raise a substantial portion of these funds through the sale of first mortgage bonds, preferred stock, and new common stock.

We firmly believe that a tax cut properly designed to stimulate capital formation is essential and should be enacted. The Economic Recovery Tax Act of 1981 (S. 683) would provide much needed capital. Specifically, the Accelerated Cost Recovery

System (ACRS) would begin to improve the financial condition of American business. However, if the intended benefits of this legislation are to be fully realized by the electric utility industry, the following modifications are essential:

1. Investment tax credits must be used before applying the ACRS allowance.
   We urge that the legislation be amended to provide that investment tax credits must be fully utilized by an electric utility before the ACRS deductions are permitted. This amendment would ensure that the economic benefits of investment tax credits are fully realized by an electric utility and its customers. Further, if this suggested modification is adopted, the Treasury Department's estimate of lost tax revenues from the electric utility industry, due to ACRS, would be substantially reduced.

2. ACRS deductions based on expenditures for construction work in progress (CWIP) should be available to electric utilities only to the extent that these expenditures are included in the rate base for rate-making purposes.
   Inclusion of CWIP in the capital cost available for recovery under ACRS, when it is not included in the rate base for rate-making purposes, would create tax deductions which have no relationship to current revenue. From a rate-making standpoint, this mismatch would decrease current revenue and would be inconsistent with the objectives of ACRS. Additionally, such tax deductions would create a tax normalization reserve which could be deducted from the rate base, even though CWIP is not included in the rate base.

   We are particularly interested in seeing this modification adopted because the majority of the regulatory agencies for the Southern electric system do not include CWIP in the rate base.

3. Section 203(d) of S. 683 should be deleted.
   This section, an amendment which relates to limitations on investment credit for certain regulated companies, would affect these companies adversely.

Normalization provisions under the present Code -- Section 46(f) -- provide for a sharing of investment tax credit benefits between customers and stockholders. The proposed amendment, 203(d), would end the sharing of these benefits. This amendment would lead to a substantial loss of tax revenues and would deny significant economic benefits to the electric utility industry. Indeed, the effect would be to subvert the very purpose of the bill, which is, after all, to encourage capital formation.

Though not officially a part of the administration's initial legislative program for economic renewal, this committee eventually will have under its consideration S. 141 -- a bill which would allow stockholders to defer the payment of federal income taxes on dividends which are reinvested in new shares of common stock.

Approximately 85 percent of Southern Company stockholders own fewer than 500 shares and receive $800 or less in dividends annually. Many of our individual stockholders have written to us supporting tax incentives, such as those offered by S. 141. The sentiment of those letters was echoed in the findings of a recent survey of our individual stockholders conducted by Louis Harris and Associates. The results of the survey indicate that the number of stockholders who take part in our dividend reinvestment program -- currently 25 percent -- would double if taxes on reinvested dividends were deferred.

Moreover, tax-deferred dividend reinvestment would alleviate the immediate burden of double taxation of corporate earnings and provide additional encouragement for long-term capital formation. We solicit your support for S. 141.

Stimulation of capital formation through tax incentives is needed to ensure adequate electric service for the expanding economy of the Southeast. There can be little question that capital formation will benefit both the Southern electric system and our customers.

I urge this Committee on Finance to take favorable and prompt action on S. 683 with the modifications we have recommended, as well as enactment of S. 141.

I thank this Committee for the opportunity to submit these comments.

# STATEMENT OF THE TAX COUNCIL ON TAX ASPECTS OF THE PRESIDENT'S ECONOMIC PROGRAM TO THE COMMITTEE ON FINANCE UNITED STATES SENATE

May 13, 1981

The Tax Council is a non-profit business membership organization concerned with federal tax policy. Our members represent a wide range of business enterprise including heavy and light manufacturing, energy, mining, transportation, public utilities, consumer products and services, retailing, public accounting, banking and other financial services. Since its inception in 1967, The Council has emphasized the benefits accruing to all sectors of our economy from increases in our nation's stock of capital and has consistently advocated a tax structure that would encourage capital formation and preservation.

The Tax Council makes the following recommendations on the tax aspects of the President's economic program:

(1) We strongly endorse the proposed accelerated cost recovery system to become effective no later than March 11, 1981.

(2) We strongly endorse the proposal to reduce marginal rates of individual income tax on a permanent, across-the-board basis.

Because other business organizations have taken the lead in consideration of the details of the depreciation reform program, most of this statement is devoted to the proposed individual income tax reductions.

## Accelerated Cost Recovery System

The proposed ACRS depreciation reform would revolutionalize depreciation practice in this country doing away with all but a vestige of the cumbersome

"useful life" determinations and significantly accelerating recovery periods. The system would be mandatory and, compared to the present, of relatively simple application eliminating the need for over 100 ADR classifications. The adoption of the proposal would put the U.S. in the forefront of industrialized nations with respect to capital recovery policy and help reestablish a more competitive position with regard to our aggressive trading partners. Because deprecation allowances provide the bulk of funds for business investment, a major move to liberalize depreciation practice is essential to providing a better climate for an increased rate of productive investment. The Council believes that the ACRS proposal is the best approach to do the job.

Individual Rate Reductions

The President's proposal to reduce marginal rates by 10% across the board for three consecutive years beginning in mid-1981 would be the first overall rate reduction since 1964. So it's obviously way overdue. This cannot be emphasized too strongly. We have increased exemptions, upped the zero bracket amount, brought in the earned income and many other credits, set up the maximum tax, jiggled the brackets a bit, liberalized capital gains treatment somewhat, but done nothing since 1964 to reduce the crushing load of high rates across the board.

Most of the public discussion of, and reaction to, the President's proposal here has centered on its likely economic effects--on savings and the budget. The Administration claims that the prospect of permanent rate cuts would elicit a very high savings/investment response, high enough to more than offset the additional federal debt involved in the short-term enlargement of the budget deficit due to the tax cut. This is important because otherwise the issuance of additional debt will either crowd out private investment or be monetized by the Federal Reserve or both.

In dollar terms, the distribution of the Administration's individual tax reductions would be in close proportion to taxes paid, with the largest dollar cuts going to the $30,000-and-over income groups. However, the Administration maintains that the savings/incentive effect on marginal rate cuts would be spread throughout the entire income spectrum--that additional dollars in tax relief even at the lowest rates will contribute significantly to overall savings even if they are used solely to reduce consumer debt.

In our view, it cannot be "proven" one way or another whether or not such a policy will achieve the desired result in encouraging savings or be partly dissipated in inflationary pressures. No matter what econometric model is used, decisions will have to be made mainly on the basis of circumstantial economic evidence and policy judgements.

Certainly, the 1964 tax reduction was a success in achieving its objectives as real growth increased and built a better revenue base. The sharp cut in the top marginal rate from 91% to 70% under the 1964 Act was definitely a work and investment incentive for upper-income groups. Income taxes collected from those earning $50,000 or more rose dramatically in 1964-1965. There was a similar pattern in the 1920s when high marginal rates of World War I were reduced under the prodding of Treasury Secretary Andrew Mellon. Also, the increase in the capital gains exclusion to 60% under the Revenue Act of 1978 appears to have had an immediate and positive effect on investment and capital mobility.

Now, of course, the Administration proposal would reduce the top rate to 50% over three years and in the process reduce the top effective rate on long-term capital gains to 20%. After 1983, there would be no distinction between earned and "unearned" income. In our view, except for extraordinary circumstances, no taxpayer should have to pay more than 50% on a marginal dollar of income and

that a policy so limiting the reach of the tax collector will not really cost the Treasury a penny.

The stultifying effect of high marginal rates is by no means confined to the very top of the income scale. Mostly due to inflation in the ten-year period ending in 1977, the number of returns subject to 36-48% marginal rates ballooned fourfold to almost 5 million or 7% of the total. Even after the 1978 legislation, which widened tax brackets and reduced some rates in the middle, a 39% marginal rate on single taxpayers cuts in at only $23,500 of taxable income. The prospect of permanent reductions of rates throughout the graduated bracket structure by any logic must have a significant effect on work and savings incentives.

There are, of course, other tax measures to stimulate personal savings, and a number of proposals here have been considered by this Committee. Some of them apparently could have quite substantial effects on savings, perhaps even at somewhat lower revenue cost per dollar of additional savings generated than across-the-board rate reductions. However, those proposals which typically project the highest incentive to savings are apt to be either targeted to very specific groups or involve new complications in the Tax Code or both.

In The Tax Council's view, the graduated rate structure of the income tax and its interaction with inflation remains the single most serious obstacle to individual savings and investment. The simplest and most equitable way to deal with this is to cut marginal rates across the spectrum. The President's proposal for 10% per year rate reductions certainly meets this objective. And while we cannot say with any precision how the specific scheduling of rate reductions will impact on the economy, we believe the proposal is sound in design and should be adopted in the context of the critical expenditure restraint program now underway in the Congressional budget process.

If Congress decides to modify the individual rate reduction proposals, we would strongly urge it to retain the central objective of lower rates for all taxpayers. It would be better to stretch out the schedule of rate reductions than to adopt a series of fractionalized savings incentives in the name of minimizing initial impact revenue cost.

* * * * * * * * * * *

In The Tax Council's view, depreciation reform and individual rate reductions are certainly not the only major tax issues we need to address. Along with other organizations, we have own list of tax problems that need to be alleviated. But we agree with the Administration that depreciation reform and individual rate reduction are the priority issues and should be addressed now in this bill. It would be quite detrimental to the economy and all taxpayers to get bogged down in a lengthy consideration of other matters, as pressing as some of the claims may be. Finally, it should be remembered that with lower individual tax rates many of these other matters just may be somewhat less pressing.

STATEMENT OF JEFFREY H. TOLL, C.P.A.

UNITED STATES SENATE FINANCE COMMITTEE
PRESIDENT REAGAN'S ADMINISTRATION'S TAX CUT PROPOSAL

I have spent the past seventeen (17) years as a Certified Public Accountant, rendering accounting, tax consulting, and management services to a varied group of individuals, small partnerships, and closely-held family business corporations. My clientele represents the smallest economic unit within the American business community. As a result, I believe that I have had an opportunity to observe, at close hand, the economic, emotional, and psychological reactions of small businesses to the current United States tax laws. Since I do not represent any special interest or organization, I have requested to appear before you today in order to provide you with some insight as to the problems and probable effects of the Administration's proposed individual and small business tax cuts. The small retail businesses, manufacturers, physicians and attorneys that I represent, may not individually be considered any major factor in this country's economy, but when taken as a whole, they represent a major segment of this country's economy and contribute the largest share of tax revenues.

The Reagan Administration's proposed tax reductions for corporations and small businesses, especially relative to more rapid depreciation write-off of fixed assets and increased investment tax credits, represents an excellent first step in revitalizing our presently sagging economy. With the advent of double-digit inflation over the last several years, the proposed higher limits of income before the imposition of the maximum 46% Corporate Income Tax, and the increased allowable accumulation of retained earnings before subjectivity to the penalty tax for accumulation of excess retained earnings, are most welcomed changes which have been long overdue. With the inflated profit dollars of past years, many smaller business organizations were becoming subject to the maximum corporate tax rates without having the true purchasing power to make the necessary investments for expansion, research and development, and possible contingencies.

Although the business and corporation tax reductions are excellent, they represent only one (1) segment of this nation's economy and will not fully produce the desired effects unless they are properly combined with similar individual tax reductions. The economic activity of this

country is not controlled or determined by business entities, corporations, banks, or other intangible organizations but rather the corporation and business entities are controlled and run by individual people and it is these people who make the decisions. I believe this is an important factor when the emotional and psychological considerations of these people are considered; it is their perception of the economy, the government, and the tax structure that determines their decisions.

As a result of continued inflation over the past decades, and especially the double-digit inflation of the past several years, every individual in this country has been thrown into substantially higher tax brackets. In effect, the result of this inflation has been a tremendous increase in the effective constant dollar percentage tax rates paid by all individuals in this country. When this fact is coupled with the higher costs of basic human necessities relative to energy, housing, and transportation, the average American has been economically squeezed to a point where his frustration level is possibly at an all-time high. If this situation is allowed to continue without drastic action, even Union workers, bus drivers, and garbage collectors will

approach or enter the 50% tax bracket. You must also remember that in addition to the Federal Income Tax, each individual is paying substantial local, City, and State Income Taxes which in many instances pushes the individual's top tax rates well beyond the 50% range.

The Administration's planned 10% per year tax reduction for individuals, over a three (3) year period, will, at the very best, merely maintain and hold constant present effective US individual income tax rates. Unless there is a substantial reduction in the true and effective inflation rate to below 10% per year, there will be no real reduction of effective US income tax rates with the Administration's present plan. The freezing of individual income tax rates at their present level will not lessen the public's frustration with government, the economic climate, or with our present tax collection system. The result over the past years of the ever-increasing Federal tax burden, as a result of inflation, has been to "turn off" a large segment of this country's population. Those individuals who are producing the most for society, as evidenced by their higher incomes, are now unwilling to continue to work and invest in order to produce more income when the net result is that for their

efforts they receive substantially less than 50% of the net proceeds for their labors. As a result, many individuals who are high achievers and are contributing substantially to our society are being penalized for their efforts and are, at the present time in ever-growing numbers, unwilling to make those contributions. A substantial case can be made for the fact that the bulk of the individual American taxpayers in the middle to lower income brackets are the "economic slaves" of this government. The progressive income tax system, as a result of inflation, has become so oppressive as to turn off a large segment of this country's high achievers who are not satisfactorily rewarded net of taxes for their economic efforts. The result of this most unfortunate situation is that ever-growing numbers of our population are being forced to join the underground or hidden economy. The resiliency and stamina of the American people is such that they shall survive economically, and are presently being forced to join the underground economy as a matter of absolute economic necessity. This emotional and psychological reasoning on the part of the average individual pervades even the non-50% tax bracket taxpayers. This is evidenced by the fact that I have observed many Union employees unwilling to work extra hours or days, even

at double time, because of the substantial amounts of taxes that are withheld from their pay for working these extra hours. It is my personal opinion that a large segment of American creativity, ingenuity, and inventiveness has been castrated by a tax system which has become oppressive and rewards only those individuals who do not produce and do not contribute. A balance of import versus export of technology has substantially shifted and I am led to believe that we are now a net importer of technology as opposed to our previous position of being an exporter of technology. To a degree, many of the problems faced by our automotive, steel, and railroad industries are a direct result, in part, to the individual's lack of incentive to produce and contribute to our society, be he a high paid corporate executive, an inventor, or an assembly-line worker.

The Administration must stimulate investment, rekindle the lamp of inventiveness, and encourage the rebirth of our American free enterprise spirit by removing the roadblocks presently contained in our individual income tax system. The Administration must provide real, effective, individual tax reductions in order to change the psychology and thinking of the individuals who make up this society and who control its business enterprises and corporations. At the

present time, there is too little incentive, too little economic reward for high productivity, substantial risk-taking, and a sincere effort to do a good job. As a result of inflation and our progressive tax rates, we have unintentionally removed the key driving element to the American free enterprise system, which is the incentive to an individual to contribute and participate in the economic benefits derived therefrom.

I would humbly and most sincerely request that this Committee consider both now and for the future, a substantial permanent reduction of individual income tax rates significantly below the bracket percentages now in existence. I would suggest that the 1960's be used as an average base period for determining the true net effective tax percentages and that once the changes are made, the bracket amounts be changed annually and tied to inflation. I would further suggest that the increasing or decreasing of the tax bracket amounts be changed automatically, by law, and tied to the Consumer Price Index. The benefits would be immediate and substantial to the government and would pervade every area of this country's economic activity because we would rekindle the spirit of free enterprise, and provide the necessary economic incentives to our population to produce,

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create and work. Rather than overheat the economy and lead to additional inflation, I believe a substantial individual income tax cut of a permanent nature would do more to help balance the Federal budget through larger tax receipts than any other single action that could be taken. There is too little incentive for the average individual to produce, create or work as a result of our present tax system, especially when combined with the present unemployment benefits and welfare benefits that are available. We have inadvertently removed the economic carrot which made America the greatest nation on the face of this planet. It is unreasonable and pretentious to assume that the average individual will work and create if, as a result of his efforts beyond a certain point, he will receive less than half of the fruits of his labor, while the other half is used by a welfare oriented government to provide benefits and monies to those individuals in this society who are,more often than not, not producing. We are rapidly approaching the point of no return and cannot afford to "turn off" any more of our citizenry with the present confiscatory tax system.

STATEMENT OF PAUL J. TIERNEY, PRESIDENT,
TRANSPORTATION ASSOCIATION OF AMERICA
BEFORE THE SENATE FINANCE COMMITTEE
ON THE TAX ASPECTS OF THE PRESIDENT'S ECONOMIC PROGRAM
May 15, 1981

My name is Paul J. Tierney, and I am President of the Transportation Association of America (TAA), which is located at 1100 17th Street, N.W., Washington, D. C. 20036 (202 296-2470). 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 transport interests work together in TAA's National Cooperative Project to develop policy positions designed to provide the strongest possible U.S. transportation system under private-enterprise principles.

The views that I am expressing in this statement on the tax aspects of the President's economic program 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 the Association's Cooperative Project, and the expression of support or non-opposition to them by all eight panels, the proposals were formally adopted by the 115-member TAA Board of Directors. This Board also represents a cross-section of top executives in the transportation sectors mentioned above. A current roster of the Board is attached to this statement.

Strengthening the U.S. Economy

TAA is in complete agreement with the goal of the Administration to strengthen the U.S. economy through stimulation of productive capital investment so that we can reduce inflation, put people to work in long-lasting and meaningful jobs, conserve energy, and enable American business to compete more effectively in both the domestic

and foreign marketplace. In order to do this, we must replace our outmoded capital equipment and facilities; and one quick way to do this is through tax incentives.

However, careful consideration should be given to any proposed tax incentives to make certain that they don't replace existing ones that can do a better job in stimulating capital investment for certain business groups, or that do not place other such groups in a worse competitive position. These points will be discussed later in this statement, especially with respect to the mandatory feature of the Administration's 10-5-3 accelerated depreciation proposal and the proposed elimination of the railroads' method of depreciating track.

The importance of commercial transport carriers to the U.S. economy should be obvious, although at times these carriers' services to the general public are taken for granted. Yet, without their services the American economy would not function effectively. Commercial carriers handle over 75 percent of all the intercity freight moved in this country (in terms of ton-miles) and about 16 percent of all the intercity travel (in terms of passenger-miles). U.S.-flag air carriers also handle approximately 40 percent of overseas international travel by American citizens (in terms of expenditures).

If American business is to be modernized and made competive in the world market, the transportation services that are essential for supplying raw materials for production and for distributing our finished products to consumers must also be modernized. Our nation has long had the advantage of both freight and passenger mobility so essential to an advanced economy, and any loss of this mobility will prevent the revitalization of our economy that all of us agree is needed.

Transport Capital Needs

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 or worn out equipment with more productive but very costly equipment.

The industry's efforts have not been too successful. To illustrate, in 1950 commercial 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 7.5 percent in 1970. While a further decline to 5.1 percent in 1977 appears to have been reversed -- in large part because of liberalization by Congress of the investment tax credit eligibility for airlines and railroads -- the overall commercial transport share increased to only 5.6 percent in 1980.

Unfortunately, the capital formation problem of the transportation industry has worsened, as for other industries, because of inflation. Long faced with high labor costs and continued pressures for increased wages/fringe benefits by powerful unions, the commercial transportation industry also has been forced to face the problem of rapidly rising fuel costs -- which for the airline and maritime industries are of nearly equal impact to labor costs. Unfortunately, the transportation industry is virtually 100 percent dependent on petroleum-based fuels, with no cost-effective alternative fuels expected to be available in reasonable volume for at least a decade.

Further compounding the problem is the mandatory compliance, regardless of the carriers' 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 has squeezed net income of many carriers 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 generating and attract ng capital. These needs are very sizeable. This fact has clearly been brought out in the recently published report of the National Transportation Policy Study Commission entitled "National Transportation Policy Through the Year 2000" This report, the result of a comprehensive study mandated by the Congress, devotes a complete chapter to transport

capital requirements. One of the tables in this report (page 172) lists transportation capital needs for the period 1976 through 2000. Shown below are the average annual capital needs for commercial carriers for this period, using 1975 dollars, based on low-growth and medium-growth scenarios. Because of the recessionary pressures of the U.S. economy during recent years, the high-growth scenario data are not shown. Also, for more realistic analysis, the 1975 figures in the report, while shown below, have been increased to reflect the 47 percent increase in capital equipment price levels between 1975 and 1980.

Average Annual Capital Needs of Commercial Modes
For the Years 1976 Through 2000
(In Millions of 1975 and 1980 Dollars)

| | Low-Growth Scenario | | Medium-Growth Scenario | |
|---|---|---|---|---|
| | $1975 | $1980* | $1975 | $1980* |
| Airlines | 3,622 | 5,324 | 6,237 | 9,168 |
| Bus (Intercity) | 79 | 116 | 88 | 129 |
| Oil Pipelines | 870 | 1,279 | 1,057 | 1,554 |
| Railroads | 4,864 | 7,150 | 9,596 | 14,106 |
| Trucks (For-Hire) | 3,048 | 4,480 | 4,562 | 6,706 |
| Water-Foreign | 568 | 835 | 806 | 1,185 |
| Domestic | 654 | 961 | 1,023 | 1,504 |
| Totals | 13,705 | 20,145 | 23,369 | 34,352 |

*Computed by increasing 1975 figures in source by 47% to reflect the increase in capital equipment price index from 1975 to 1980, as per "Economic Indicators", Joint Economic Committee of Congress, February, 1981, page 22.

Data Source: "National Transportation Policies Through the Year 2000", National Transportation Policy Study Commission, Final Report, June, 1979, page 172.

While there may be disagreement over the above figures for various modes of transport, the fact that all commercial transport modes were able to generate or attract only an estimated $11-12 billion in 1980 for expenditures for new plant and equipment -- per official Department of Commerce data -- indicates a significant investment gap. To meet the NTPSC's annual capital needs figure for even the low-growth scenario for 1980, over $20 billion should have been spent.

At this point, it should be emphasized that the figures above are capital needs as developed by an impartial study. Individual carrier groups have developed their own data, often under different assumptions. For example, the railroad industry has estimated that realistically it may only spend about $4.3 billion per year over the next six years for capital requirements. Although the railroads' needs are much greater than $4.3 billion, they are constrained by insufficient cash flow. They estimate that under present tax laws the internally generated cash available for capital expenditures will only cover 15 to 20 percent of such an outlay.

Oil pipelines estimate their annual capital needs at over $1 billion through 1986, mostly for expansion purposes. U.S.-flag ship lines in the foreign trade estimate capital needs of $490 million a year through 1986, assuming continuation of an additional 50 percent in the form of construction differential subsidies that the Administration wants to discontinue. Domestic water carriers, which do not receive such subsidies, estimate annual capital needs of $430 million. The scheduled airline industry estimates annual capital needs of $4.8 billion throughout the 1980's. Commercial truck lines say they will need more than $3 billion a year for tractor-trailers alone, while intercity bus lines should replace about 1,200 buses a year at a unit cost of more than $100,000.

The transport capital needs are obviously sizeable, and the unit costs of transport equipment can range from $30,000 to over $50 million. Generating or attracting such huge sums will be most difficult, as experienced in the past.

PRESIDENT'S 10-5-3 DEPRECIATION AND INVESTMENT CREDIT PROPOSALS

The Administration's proposals to help business stimulate capital formation in the personal property area stress two major changes. One would apply a simplified, but mandatory, accelerated depreciation schedule, with most personal property depreciated over 5 years; but with cars, light trucks and R&D equipment depreciated over 3 years and

long-lived "public utility" equipment over 10 years. The other proposal would liberalize the investment tax credit eligibility rules for short-lived equipment.

TAA has very clear policy positions relating to both of these tax-incentive proposals, as we should like to describe as follows:

10-5-3 Accelerated Depreciation Incentive

TAA has long advocated the use of accelerated depreciation as one means of helping transport companies to replace their equipment. This has proved particularly beneficial to carriers with very costly and long-lived equipment, such as railroads and water carriers. During periods of inflation, particularly as experienced in this country during recent years, the cost of replacement equipment rise so quickly that only a fraction of their costs is covered by depreciation allowances. To illustrate, from 1970 to 1980, the average costs of capital equipment, according to the Department of Commerce, increased by 114 percent (index rose from 112.0 to 239.5). Even if a piece of equipment were depreciated fully over 10 years, the allowances would have returned less than half the cost of the equipment replacing it.

The TAA Panels studying various capital formation tax-incentive proposals unanimously supported the 10-5-3 approach, such as in the Administration's tax package, and the TAA Board formally adopted in 1980 the following policy:

> "Rapid Depreciation - Capital Recovery Allowances - The Internal Revenue Code of 1954 should be amended to provide liberalized depreciation of capital assets. An example of such liberalized depreciation could be the establishment of three classes of depreciable property with the time frame for depreciation as shown below:
> Class 1: Buildings and structural components of buildings...depreciate within 10 years; Class 2: Recovery property not taken into account under Class 1 or Class 3...depreciate within 5 years; Class 3: Automobiles, taxis and light-duty trucks...depreciate within 3 years.
>
> "The full amount of the investment should be recovered under applicable schedules of depreciation and salvage value should be ignored.
>
> "Existing methods of accelerated depreciation should continue to be allowed."

As clearly indicated, the above policy supports the 10-5-3 approach, as well as the Administration's proposal to allow recovery of "the entire cost of property, including salvage value." However, the last paragraph of this policy specifically questions the wisdom of mandating the use of 10-5-3, as proposed by the Administration, as a replacement for present rules for depreciating personal property. While we recognize the complexity of the present rules and the Administration's desire to simplify them, we do not believe such a drastic change should be made in an across-the-board manner without consideration of those companies that stand to gain very little, or possibly be worse off, from the standpoint of capital recovery through depreciation.

The transportation industry contains many companies that 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 other incentives, such as investment tax credits, many transportation companies will find the resulting legislation of little or 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.

We have been advised by several of our member carrier groups that this would be the case for their particular industries. The faster write-offs under 10-5-3, it has been pointed out to us, will be of little benefit to carriers which are marginally profitable, unprofitable, or that experience wide cyclical variations in profitability and have very heavy demands for capital investment, such as commercial airlines. Our railroad members advise that the replacement of their retirement-replacement-betterment accounting by 10-5-3 will reduce the amount of funds available for track outlays. The trucking industry, we are told, would benefit only marginally from 10-5-3, since its principal assets

-- trucks, tractors and trailers -- already have relatively short useful lines.

TAA, therefore, supports the adoption of 10-5-3 accelerated depreciation as another acceptable option but opposes its mandatory use as the only method of depreciating personal property. Since the objective is to stimulate productive capital investment, which certainly should include commercial transport capital outlays, we believe that other depreciation methods doing a better job in this respect should be continued.

Retirement-Replacement-Betterment Accounting

An example of an existing method of depreciation that has proved to be effective in stimulating capital outlays in the transportation field is retirement-replacement-betterment accounting in the railroad field for track structures (rail, ties, ballast, and fasteners). R-R-B has long been used in the railroad industry for this single purpose, and its use has been endorsed by the Interstate Commerce Commission, and the courts, including the U.S. Supreme Court. Last year, Congress codified the use of the R-R-B method for tax accounting purposes, in Public Law 96-613. This legislation was supported by TAA, based on the following policy formally adopted by the TAA Board last year:

> "Retirement-Replacement-Betterment Method of Accounting - The Internal Revenue Code should be amended to provide that the retirement-replacement-betterment method of accounting is an acceptable accounting method."

Under the R-R-B method of accounting, the cost of additions is capitalized. Depreciation is not allowed until the addition is either retired from service or its components are replaced. For example, when the useful life of a 120-lb. rail is exhausted and it is replaced by a new 120-lb. rail, the cost of the new replacement is deducted as an expense. If heavier rail is used for the replacement, the additional cost of the rail is capitalized as a betterment. When the rail is taken up and not replaced, the original cost of the rail plus subsequent betterments is retired and deducted as a depreciation expense.

The advantage of such an accounting method is that it gives railroads a greater opportunity to assume the heavy cost burden of track through their cash flow, an important consideration because external funds are ve difficult to obtain for this purpose. While the application of 5-year, or even 10-year, depreciation would certainly be far better than straight-line depreciation over the long lives of track, neither would stimulate rail track replacements and betterments as much as R-R-B. R-R-B, it should also be noted, would not be beneficial to other business groups because for a complete life cycle of a depreciable asset no recovery of their investment would be allowed.

While some railroads have maintained their track in excellent condition, and upgraded key portions of it, many railroads have not been able to do so because of their poor financial status. As a result, we still have many sections of poor track that require slow orders. With about 70 percent of all rail freight traffic being interlined over the tracks of two or more railroads, it is important to reduce the amount of poor track so that it does not offset many of the operational benefits of the good track. Continuation of R-R-B accounting will improve the chances of railroads to maintain their track in satisfactory condition. Therefore, TAA recommends that provisions in the Administration's tax proposals that call for repeal of R-R-B be deleted.

Investment Tax Credit

Last year, a TAA spokesman stressed to your Committee the great importance of the investment tax credit to the transportation industry. He pointed out that it has proved to be an effective 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.

While we believe more recognition should have been given to the ITC in the Administration's tax package--because of the great potential to stimulate capital formation and outlays through liberalization of its use--we fully support all but one of the ITC changes being proposed. These include allowance of the full 10 percent ITC for all eligible 10-year and 5-year recovery property (vs. a 7-year minimum at present); and a 6 percent ITC for all eligible 3-year recovery property (vs. 6.67 percent for lives of 5-6 years and 3.33 percent for lives of 3-4 years).

This change in ITC eligibility rules certainly is in the right direction. We would prefer, of course, to apply the full 10 percent ITC for property having a tax life or cost recovery period of three or more years. Such a change would simplify both the ITC eligibility and recapture rules. A dollar spent by a carrier for shorter-lived equipment can, in our opinion, be as productive as a dollar spent for other equipment.

Another change in ITC eligibility rules being proposed is supported by TAA. It calls for extending the 7-year present carryover period to 10 years. This should be very helpful to the transportation industry, and particularly to its less profitable segments. We hope and expect it will increase the low percentage of ITC utilization by this industry.

On the negative side, however, we oppose the proposal to extend the "at-risk" rules to the investment tax credit and thus limit the amount of the ITC that can be applied for property financed with non-recourse loans. If the goal of the ITC proposals is to stimulate investment in productive equipment, we should point out that a sizable amount of transport operating equipment, particularly rail freight cars, has been placed into service through such limited-risk financing. TAA, therefore, believes that no such change should be made in present ITC eligibility rules.

OTHER WAYS TO STIMULATE TRANSPORT CAPITAL FORMATION

If the nation's transportation industry is to provide the kind of services that are needed throughout the 1980's, it must have immediate access to large sums of capital for replacement of equipment and facilities, and to provide additional capacity to handle the increased demand for these services.

Much of the transportation equipment that could be made available, provided the necessary investment funds can be generated or attracted, offers major technological advances that promise significant fuel and other savings.

The airline industry is an excellent example, with new generation jet transports offering fuel savings of 30 percent or more compared to present comparable transports. These savings will be possible, in part, because of the lighter-weight composite materials being used, but also because of major improvements in aircraft engines. Yet, the acquisition costs are tremendous. To meet minimum demand requirements, and to replace aircraft with ages over 18 years, through 1984, the commercial airlines say they should have placed orders for $22 billion worth of new aircraft; yet their spotty profit situation in recent years has enabled them to place only $13 billion worth. Since new transport aircraft are currently costing an average of $21 million each -- with many of them costing more than twice that amount -- it doesn't require too many orders to impose a $1 billion capital burden on a single carrier.

Two other modes of transport that are expected to expand capacity sharply during the 1980's are the railroads and inland water carriers. Both will be asked to handle what prognosticators agree will be increasing demands for freight cars and barges to move heavy volumes of both coal and grain.

As already noted, the transport capital needs of these and other modes are far in excess of what they can generate or attract without additional tax incentives. The 10-5-3 depreciation and modest investment tax credit changes

proposed by the Administration, while helpful if the former is not made mandatory, simply will not do the job for the transportation industry.

TAA, recognizing this problem, has therefore developed a package of additional capital formation tax-incentive proposals designed to stimulate the volume of investment required for the nation's transportation industry and its equipment suppliers. These include several changes to further liberalize rules on utilization of the investment tax credit, to allow capital constructive funding for the inland waterway industry, and to permit ICC-regulated motor carriers of freight to write off the value of operating rights purchased in past years but now made virtually valueless because of recent opening of entry into this field of transport.

Finally, TAA believes that regulated transport modes should not be denied the benefits of capital formation tax incentives through actions by regulatory agencies. Each of these proposals will be discussed separately as follows:

ITC Refundability

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 to use incentives based on tax write-offs. 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 are due, with any excess credits refunded to the corporate taxpayers. 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 investment stimulus from a tax package that only allows larger tax depreciation deductions or 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, and trucking companies), and automotive and other manufacturers of transport equipment. Making the ITC refundable would provide an 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 enterprises. 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. For very costly transport equipment such as transport aircraft, this 10 percent could be quite significant.

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. An example of such a condition is the railroad industry, where many carriers with little or no taxable incomes have found that their competitive position relative to other carriers has worsened because of their inability to utilize present capital formation tax incentives.

In response to the question of whether refundability would reward inefficient firms, we should like to answer that the objective is to stimulate productive capital investment in areas vital to the nation. This, in turn, should increase jobs and taxable personal incomes that should recover the temporary losses to the Government for its maximum-10 percent share of the total costs. Also, it would enable all transport companies that serve the general public to share in this tax incentive and thus lessen the chances that direct U.S. financial assistance will later be needed to help pay for far more than 10 percent of a carrier's capital costs.

Transfer or Sale of ITC's

Another way to stimulate transport investment 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 or sale of earned but unusable ITC's would eliminate much of the large volume of credits lost today by transportation companies. By being able to market them for investment purposes, they should be in a better position to purchase equipment outright, and the equipment users would not have to abandon the benefits of ownership. Purchasers of the ITC's would in turn have to use them for investment purposes to obtain any tax write-offs.

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.

Capital Construction Fund

The Capital Construction Fund (CCF) concept now applicable to deep-draft U.S.-flag vessels has proved to be very successful in stimulating investment capital in the maritime industry. It is an effective method of funding the construction and acquisition of eligible vessels under Section 607 of Title VI of the Merchant Marine Act of 1936 (46 U.S.C. 1177 et seq.). This incentive has been successfully used for construction of U.S. ships and deep-draft barges operating in the foreign trades as well as on the Great Lakes and between non-contiguous domestic states.

In essence, the law embodies the concept whereby owners may allocate any portion of net income derived from operating eligible vessels into a Capital

Construction Fund that is specifically earmarked for the sole purpose of building, converting, or acquiring marine vessels of authorized types. Income deposited into the CCF, whether from vessel operation or sale, or from interim investment, is not taxable unless withdrawn. No depreciation deduction is allowed for ships financed from the CCF.

By deferring Federal income tax liability, the net effect of the CCF is to facilitate capital formation for ship acquisition in the maritime field. Legislation (H.R. 2821) has been introduced in the House of Representatives to extend this capital formation tax incentive to shallow-draft towboats and barges, with the proviso that existing CCF funds be ineligible for use to acquire or construct such shallow-draft vessels. Future earnings derived from towboat and barge operations under the proposed extension could be deposited in the new CCF to the extent elected by the owners.

TAA supports the extension of this tax incentive for transport capital formation to the inland waterway transport industry as a proven and effective way to stimulate investment in operating vessels.

Amortizing Motor Carrier Operating Rights

From an investors' standpoint, one important factor long used in judging the eligibility of an ICC-regulated trucking company's financial credit standing was the scope of its operating authority. Under a controlled-entry regulatory doctrine characteristic of this industry until passage of the Motor Carrier Act of 1980, such authorities had sizeable value -- both in terms of actual dollars and for credit security purposes. During this long span between 1935 and 1980, when this doctrine was in effect, carriers purchased operating rights as a way to expand and to enter new markets. Many carriers had to borrow funds to pay for these purchases. According to our member trucking firms, the total value of these purchased rights exceeds $360 million.

Passage into law of the 1980 Act has taken away this backing for motor carrier financing. In some instances, it has decreased carriers' access to equity capital. These facts have been substantiated by our investor members who have long been strong financial backers of this industry. Also, those motor carriers with remaining debt on the cost of purchasing operating rights will find it more difficult to compete for investment funds with other carriers not so burdened.

Recognizing that the devaluing of these purchased operating rights has been done beyond the control of the affected carriers, and without cause on their part, the policymaking Panels in the TAA Cooperative Project agreed that some form of restitution should be made. Accordingly, with the support of the TAA policymaking Panels, the Association's Board last year adopted the following policy in support of allowing any motor carriers adversely affected by the 1980 Act through loss of the value of their purchased operating rights to amortize them for tax purposes.

> "Amortization of Motor Carriers Operating Authorities for Income Tax Purposes - The Internal Revenue Code should be amended to permit over a period of not more than three years the amortization of the aggregate adjusted bases of motor carrier operating authorities for tax purposes."

In action taken just recently, the Financial Accounting Standards Board, (FASB), which we understand is the rulemaking body of the accounting profession that is recognized officially by the SEC, ICC, and other government agencies, has directed all affected motor carriers to make a full, one-time and immediate write-off their operating rights for book purposes in the year 1980. By taking such action some carriers become in technical default on loans because existing loan covenants may be violated. Since the value of such purchased rights has represented a very sizeable percentage of the total book value of

many motor carriers -- exceeding 50 percent in some instances -- such an accounting write-off without reimbursement reduces sharply these carriers' net worth and thus makes it difficult to attact investment funds.

In line with the action taken by the FASB, and in fairness to the affected motor carriers, TAA believes that legislative authority should be given for tax relief to them through tax write-offs of any losses from devalued operating rights over a period not to exceed three years.

Normalization

To assure that federally regulated transportation companies are not wholly or partly denied the full benefit of capital formation tax incentives enjoyed by other businesses, TAA believes that 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 services, valuation of property, deletion of deferred taxes from a rate base, or by any other means.

In 1964, Congress passed legislation that barred 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 ratemaking (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.

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Summary of TAA Views

TAA appreciates the opportunity to express its views on the vital policy issue of capital formation through tax incentives, as they should apply in the transportation field. We believe that because adoption of the 10-5-3 accelerated depreciation method would be beneficial only to portions of the transportation industry and its suppliers, it should be made optional and not be a mandatory replacement of other forms of accelerated depreciation now authorized by law. In this respect, TAA particularly urges continuation of railroad retirement-replacement-betterment accounting for track. We strongly support the proposed recovery through depreciation of the entire cost of property, including salvage value.

TAA supports the proposed liberalization of investment tax credit eligibility for shorter-lived equipment, but it believes other more effective changes should be made to increase the use of ITC's. These include the adoption of the refundability concept, so that the use of ITC's for capital formation is available to all transportation companies, and formal authorization of the right to sell or transfer ITC's. TAA favors the extended carryover period from 7 to 10 years; however, it does not favor extension of the "at-risk" rules to the ITC because this could dry up a source of investment funds for transport equipment.

TAA believes inland water carriers could generate capital for needed shallow-draft vessel acquisitions through the expansion of the existing Capital Construction Fund for maritime deep-water carriers. It also believes that ICC-regulated motor carriers of freight, now faced with heavy losses because of the loss in value of operating rights under new regulatory reforms, should be able to write them off for tax purposes over a three-year period.

Finally, TAA believes that Congress should again make it clear that regulatory agencies should not prevent carriers under their juridiction from receiving the benefits of capital formation tax incentives through rate pass-throughs, adjustment in the rate base, or other means.

STATEMENT OF THE UNITED STATES BREWERS ASSOCIATION, INC.


Summary

The United States Brewers Association urges the adoption of the Administration's program as soon as possible. It would provide our members with the funds necessary to offset inflation, maintain employment, and expand production. However, it should allow flexibility as to the amount of depreciation deductions that a company may take in any one year.

Should the Finance Committee devise proposals of its own, the following items should be favorably considered:

1. Extension of the NOL and investment credit carrybacks to 10 years;

2. A more equitable phase-in for 7- to 9-year property than that proposed by the President;

3. Additional incentives for expenditures incurred to rehabilitate or retrofit existing facilities;

4. Clarification of the definition of a "special purpose structure" which will qualify for the investment credit;

5. A simplified system for treatment of gain or loss on the sale of property;

6. Allowance of a meaningful tax incentive for research and development;

7. Allowance of construction period depreciation deductions to be taken without regard to a two-year construction period threshold; and,

8. Adoption of the provisions of S. 169 to allow the unproductive cost of the elimination of air or water pollution to be financed by tax-exempt bonds as was Congress' original intent.

United States Brewers Association

The United States Brewers Association, Inc., (USBA) the nation's oldest continuously incorporated trade association, is composed of companies engaged in all phases of the production of malt beverages. Together, its members account for approximately 75 percent of total U.S. malt beverage production.

Today, there are 42 domestic brewers in business in the United States, operating 81 plants. In 1980, the United States produced over 194 million barrels of beer and ranked number one in the world as a producer of beer. Germany, our closest competitor, produced less than half of United States production, with only 80 million barrels of beer. The total value of brewery sales in 1980 was $9.3 billion at the brewery level, $15.5 billion at the wholesale level, and approximately $28 billion at the retail level.

The brewing industry is a successful employer, employing approximately 47,000 persons directly, whose salaries, wages, and supplementary fringe benefits exceed $1.5 billion. These figures do not include the employees of the close to 5,000 beer wholesalers, who employ approximately 75,000 people, with a payroll in excess of $1.3 billion, or the over 350,000 persons dependent on beer for employment in retail outlets selling malt beverages in the United States.

The brewing industry is a prime consumer of United States agricultural products. In 1980, it consumed 5.2 billion pounds

of malt, 1.6 billion pounds of corn, and 790 million pounds of rice, together with 43 million pounds of hops, with an aggregate value of $1.1 billion. Miscellaneous agricultural products on the order of 540 million pounds, including barley, sugar, syrup, and soybeans, which had an additional value of over $60 million, were also purchased. Finally, the aluminum, glass, and paper industries regard it as one of their principal customers. There is not a state in the country which is not affected by the brewing industry, whether as producer, seller, or purchaser, but most particularly as a taxpayer.

The Reagan Administration's Cost Recovery Program

The USBA is pleased that many of the changes in our tax laws which we urged this Committee to adopt in our 1980 testimony have been incorporated in the Administration's tax plan, particularly the "10-5-3" program of cost recovery. The high rate of inflation has made present capital cost recovery periods inadequate. A manufacturer is unable to recover its capital costs and provide for the replacement of equipment at substantially inflated costs. If a brewer cannot adequately recoup its investment through tax deductions, it has no choice but to raise its beer prices, a move which only leads to further inflation. It is also an undesirable alternative from the brewer's perspective because price increases make the brewer less competitive with more expensive foreign beers.

Furthermore, there is no incentive under current law for a company to retrofit an existing plant or purchase a used plant and retrofit it for production, when it can only obtain straight-line depreciation on the building over a period of at least 20 - 30 years. The alternative -- component depreciation -- entails extremely burdensome record-keeping requirements. These are very important concerns to the USBA's membership because many brewers are at the point where aging plants require rebuilding or retrofitting.

The 10-5-3 method of cost recovery offers the dual advantages of simplicity of use and capital cost recovery periods short enough to provide real incentives for business capital investments. All other alternatives (such as 2-4-7-10 adopted by this Committee last year and the present values' deduction recommended by Dr. Jorgensen and others) are founded on complicated concepts and provide inadequate incentives. None of the systems put forth to date offer both of the advantages of the Reagan Administration's proposal.

For these reasons, the USBA fully supports the President's program. If the Committee modifies the Administration's proposals, it should provide for more capital cost recovery and not less.

Specific Comments

1. Flexibility

The Administration's proposal would not impact on all of our members equally. Like every other industry in the United

States, the brewing industry is comprised of successes, partial successes, and struggling companies. Just as with every other industry in the United States, no single solution can be expected to be of equal applicability to all the members of our industry. Therefore, we support the Administration's cost recovery plan with the proviso that taxpayers should have the flexibility to elect to claim less than the full depreciation allowance permitted and to carry forward the unused allowance to any future year. In this regard, we cite the Jones-Conable bill -- H.R. 1053. The mandatory application of the Administration's accelerated cost recovery plan could result in even greater net operating losses for some businesses, already in a negative posture, rendering meaningless the plan's extension of the net operating loss carryover period to 10 years.

2. <u>Net Operating Loss and Investment Credit Carrybacks and Carryovers</u>

Under current law, § 172 of the Internal Revenue Code provides that a net operating loss (NOL) may be carried back to the three preceding taxable years and forward to the seven succeeding years. Section 46 of the Code includes a similar provision for an unused investment credit. The Administration's proposal would extend the carryover provisions of §§ 46 and 172 to ten years. We would applaud such a change, similar to the one which we urged last year in our testimony before this

Committee. However, we wish to reemphasize that, if the Administration's cost recovery proposal is not amended to allow some flexibility as to its use by the taxpayer, even the ten year carryover period will prove insufficient to permit struggling companies to benefit from the faster recovery allowances. If the Administration's plan remains mandatory, the carryback periods under §§ 46 and 172 should also be extended to ten years.

3. Phase-in Period

Certain equipment used by members of the USBA currently has a lower ADR life of from 7 to 9 years. Under the phase-in provisions of the Administration's proposal, the purchase of such equipment would result in little or no tax reduction in the first year of the program. In order to encourage more rapid capital formation, all classes of assets should receive at least a one-year reduction in class life to start the phase-in period. This would provide 7 to 9 year life property with some immediate incentive. Other class lives already receive immediate incentive -- below-7-year-life property from an increased investment credit and longer-than-9-year-life property from an immediate reduction in life.

4. Special Purpose Structures

The IRS has adopted a very restrictive interpretation of § 48(a)(1)(B)(i), dealing with the applicability of the

investment credit to special purpose structures, i.e., "property . . . used as an integral part of manufacturing [or] production. . . ." Thus, many special purpose structures employed by members of the USBA, such as brew houses, have been denied qualification for the investment credit by the IRS, despite the Congressional intent, that such facilities qualify for the credit, as expressed in 1971 when the investment credit was re-enacted. The Committee should amend § 48(a)(1)(B)(i) to clarify that special purpose structures qualify for the investment credit when they are so integrally related to manufacturing, production, etc., that they could not be economically converted to any other use. A structure could not be economically converted to any other use if it could be demonstrated by the taxpayer that: (a) it is the practice in the industry not to convert such a structure to any other use; (b) the cost of removing all the machinery and equipment which the structure was initially designed to house would exceed the cost of reconstructing a similar structure without such machinery or equipment; or (c) that the structure would not be economically useful for any purpose other than for housing the machinery and equipment for which it was designed. The amendment should be effective retroactive to 1971 to make it clear that such has always been the Congressional intent.

5. Depreciation Recapture

Under the Administration's proposal, gain or loss would be recognized on the sale or other disposition of equipment, and

that portion of the gain reflecting prior allowable depreciation would be recaptured as ordinary income, according to the rules of § 1245. In this respect, the provision adopted by this Committee last year is preferable. Under that provision, neither gain nor loss would generally be recognized on the sale or other disposition of an asset. Any gain would simply reduce the balance of the recovery account, or loss increase its balance, with any negative balance recaptured as ordinary income.

6. Property Used for Research and Development

Under the Administration proposal, tangible § 1245 property used in connection with research and development would be 3-year property eligible for a 6 percent investment credit. Such a classification would provide no better tax treatment for such property than it would receive as 5-year property entitled to the full 10 percent investment credit. Property used in connection with research and development should be 3-year property and, in addition, qualify for the full 10 percent investment credit.

7. Construction Period Depreciation

The Administration's proposal would allow depreciation deductions to be taken as progress payments were made during the construction period of an asset. However, a company could only avail itself of that provision if the asset under construction had a normal construction period of at least 2 years.

In this respect, the Jones-Conable 10-5-3 proposal would be preferable, because it would provide for the taking of construction period depreciation without regard to a two-year construction period threshold. This rule removes the disincentive for efficient construction contained in a two-year rule.

8. S. 169

The USBA urges this Committee to amend § 103 of the Code in the manner provided for in S. 169, a bill introduced by Senator Heinz. S. 169 would provide that industrial development bonds would bear tax-exempt interest if the bond proceeds were used to construct facilities or finance processes which either prevent the creation of pollutants or prevent their release to the environment. Under the restrictive interpretation of § 103 currently employed by the IRS, only those end-of-pipe facilities which prevent the release to the environment of already existing pollutants qualify as "pollution control facilities" and, thus, for tax-exempt financing under § 103(b)(4)(F). The IRS has used this restrictive interpretation to deny tax-exempt financing for equipment used by members of the USBA, such as dust control equipment and spent grain liquor evaporators. Such a restrictive reading of § 103(b)(4)(F) is not only unwarranted, but it is also detrimental to our environment and our economy, because it limits the availability of tax-exempt financing to the less effective and frequently more expensive end-of-pipe technology.

SUMMARY STATEMENT OF DAVID M. RODERICK
CHAIRMAN, UNITED STATES STEEL CORPORATION
AND MEMBER OF THE BOARD OF GOVERNORS, UNITED WAY OF AMERICA
BEFORE THE
SUBCOMMITTEE ON TAXATION & DEBT MANAGEMENT GENERALLY
OF THE SENATE FINANCE COMMITTEE

January 31, 1980

United Way of America supports the Moynihan-Packwood bill (S. 219) to allow all taxpayers a deduction for their charitable gifts whether they itemize or not because it accomplishes two beneficial purposes. It reduces taxes for those who need it most -- moderate income Americans. (Almost 80 percent of the benefits go to families with adjusted gross incomes of less than $30,000.) Secondly, charitable giving to institutions supported by these Americans is increased by an amount larger than the tax revenue losses.

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

Approval now of the Moynihan-Packwood bill is more critical than ever. The six increases in the standard deduction since 1969 have eroded the giving base. While simplifying filing for many lower and middle income people, these increases have also inadvertently eliminated the tax incentive to give for over seven out of ten people.

In 1970, 48 percent of all taxpayers itemized deductions, just over 25 percent did so in 1979. If rewards for giving go primarily to those in the upper income brackets the charitable deduction may soon be seen as a tax loophole for the rich.

The result of the dramatic drop in the number of taxpayers itemizing has been a corresponding drop in charitable contributions. According to recently revised giving estimates by the American Association of Fund-Raising Counsel, in 1970, 1.99 percent of personal income was contributed to non-profit organizations. In 1978 that figure was down to 1.92 percent. Had Americans continued to give as much of their personal income to charities as they did in 1970, contributions would have been $1.2 billion higher in 1978.

A recent Gallup survey of 1978 charitable donations indicated that people who itemize personal deductions on federal income tax returns give significantly more than those who take the standard deduction. This is true in every income bracket.

Failure to pass the Moynihan-Packwood proposal will result in forcing the charities to look to the rich for support. This trend is dangerous because without broad support, public charities will lose their viability and democratic base.

Money a person gives away to charity should not be considered as income for purposes of determining the federal tax due. It is a way of channeling money into socially desirable paths and encouraging people to participate in voluntarism.

STATEMENT OF
DAVID M. RODERICK
CHAIRMAN, UNITED STATES STEEL CORPORATION
AND MEMBER OF THE BOARD OF GOVERNORS
UNITED WAY OF AMERICA
BEFORE THE
SUBCOMMITTEE ON TAXATION & DEBT MANAGEMENT GENERALLY
OF THE
SENATE FINANCE COMMITTEE

January 31, 1980

Mr. Chairman, I'm David M. Roderick, Chairman of the Board of United States Steel Corporation. President of United Way of Allegheny County, Pennsylvania and a member of the Board of Governors of United Way of America. I am pleased to have the opportunity to appear before this Subcommittee today to offer testimony in support of the Moynihan-Packwood bill, S. 219.

This bill to allow taxpayers a deduction for their charitable gifts whether they itemize or not is essential to maintaining a strong voluntary sector. United Way of America endorses this change in our tax laws because it will accomplish two beneficial purposes. First, it reduces taxes for those who need it most -- moderate income Americans. Almost 80 percent of the benefits go to families with adjusted gross incomes of less than $30,000. Secondly, charitable giving to institutions supported by these Americans is increased by an amount larger than the tax revenue loss. For these reasons, we believe the Moynihan-Packwood bill is sound public policy.

America has always relied on voluntary organizations to meet community needs. The broad range of organizations represented here yesterday

and today is in itself testimony to the fact that the private non-profit sector reaches into almost every field of human interest. It supports an incredible variety of institutions including symphonies, museums and libraries, religious organizations, health clinics and hospitals, colleges and universities -- and civic and social service organizations such as the Salvation Army, 4-H Clubs, United Ways, day care centers, half-way houses and co-ops. Taken together, they constitute an indispensible part of American life. This is a phenomenon unique to our country.

From 1962 to 1964 my family and I lived in France. I am dismayed about the fate of private charities and philanthropic giving in that country and other Western European nations. The people there have come to view charity as the responsibility of government and government alone. Donations by wealthy individuals or foundations, no matter how altruistic the motivation, are seen as elitist and self-serving. In many cases contributions for worthy purposes are simply not accepted or are argued over for years.

There is justifiable fear in our own charitable community that America may soon follow the path of these western European states. During the last decade we have seen an erosion in the giving base. The increases in the standard deduction since 1969 have enabled millions of taxpayers in the lower and middle income brackets to switch to the standard deduction. While this has simplified filing for many, it has also inadvertently eliminated the tax incentive to give from over seven out of every 10 taxpayers. Whereas in 1970, 48 percent of all

taxpayers itemized deductions, just over 25 percent did so in 1979. Importantly, the largest portion of itemizers is the wealthiest segment of our population. If rewards for giving go primarily to those in the upper income brackets, are we not in danger of following the sad example of those countries that now frown on philanthropy?

The results of the dramatic drop in the number of taxpayers choosing to itemize has been a corresponding decline in charitable contributions. According to recently revised giving estimates by the American Association of Fund-Raising Counsel, in 1970, 1.99 percent of personal income was contributed to non-profit organizations. In 1978 that figure was down to 1.92 percent. Now seven one-hundreths of a percentage point may not sound like much, but in 1978 alone, it equalled $1.2 billion dollars. Had Americans continued to give as much of their personal income to charities as they did at the beginning of the decade, contributions would have been $1.2 billion higher in 1978.

A recent Gallup survey of 1978 charitable donations indicated that people who itemize personal deductions on federal income tax returns give significantly more than those who take the standard deduction. This is true in every income bracket. On average, itemizers contribute three times the amount contributed by non-itemizers. There is no doubt that a tax incentive -- or lack of one -- is an important determinant of the amount a person donates to charity, and may even be a factor in whether he or she gives at all.

Now, for a moment, I would like to discuss not dollars, but what they make possible. The purpose of our organizations is not to amass

dollars but to orovide services. That takes money, of course, but it is vitally important for all of us to remember that we are here today because many of our neighbors in our own communities have very real unmet needs.

As a volunteer in the United Way movement I am priveleged to be part of the largest charitable fundraising, planning and allocations organization in the world. Today there are over 2000 local United Way organizations throughout the United States. In 1978, total contributions exceeded $1.3 billion.

United Ways are not service delivery agencies. The money collected by United Way campaigns is allocated to member agencies skilled in providing basic human needs.

The United Way family consists of many familiar agencies like the Red Cross, YMCA and YWCA, Scouting, and other organizations. Some agencies -- neighborhood centers, day care programs and senior citizen centers -- are not familiar nationally, but are well known in the communities they serve. Hundreds of smaller service and neighborhood organizations, not affiliated with any national association, also depend on United Ways for support.

Now let me say that if Congress does not accept the Moynihan-Packwood proposal, United Ways will survive. The large universities, musuems and other long-standing institutions will survive also; but many of the financially fragile entities so important to American

life, such as local community organizations, day care centers, co-ops and the like may well go under. Those that remain will be continually caught in the dilemma of having more and more people to serve with fewer and fewer resources -- especially since federal, state and local budgets are drastically cutting back public dollars for social services, education and the arts.

In closing, let me tell you why I endorse this bill as a businessman as well as a volunteer.

U.S. Steel Corporation is a major employer of people and the health and welfare of our employees and of the communities in which we operate is of the utmost importance to our business success. Our employees must be able to come to work, to perform conscientiously and to go home to satisfying personal lives with family and friends. It is important that parents have quality day care centers for their young children, after school programs like scouting, recreational programs at the Y, visiting home nurses to care for an ill or elderly family member, and counselling services when emotional or family problems arise. Without these services to rely on, our absentee rate would be affected, as would job performance -- and our work-force would be generally less dependable. Communities need the services non-profit organizations provide. Directly or indirectly they enrich all of our lives every day. Passage of the Moynihan-Packwood bill will help ensure their continued viability and preserve this most unique aspect of American life.

Thank you.

# Private Charity Going Out of Style In West Europe's Welfare States

New York Times
Sunday, July 2, 1978

By JONATHAN KANDELL

Special to The New York Times

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

The donation was never accepted. And, in fact, the would-be recipients admonished the King for even attempting as a private individual to fulfill what was considered in modern-day Sweden a function of the government.

Increasingly in Western Europe, philanthropy is acquiring a bad name. Leftists assert it delays the expansion of government-controlled social benefits and softens popular attitudes toward private wealth.

Even moderates are voicing disapproval of what they call the elitism of philanthropists' and their foundations' dispensing large amounts of money and patronage without the controls of electoral mandates or the accountability of government bureaucrats.

### Charitable Groups Are Numerous

In sheer numbers, West European charitable associations seem impressive enough. There are 120,000 in Britain, 32,000 in the Netherlands, 19,500 in Switzerland, 15,000 in Sweden, and 4,000 in West Germany. But most of them are small and exist in name only. Fewer than 3 percent still make sizable donations. Public sentiment that philanthropy should be the responsibility of governments has forced thousands of small charities to depend increasingly on funds from state and local authorities.

The refusal of West European governments to allow tax deductions for large individual donations has reduced the number of tycoon-philanthropists of the sort that achieved fame before World War II. Even those wealthy persons who continue to contribute often find that the publicity surrounding their donations can boomerang.

Last March, for example, Marcel Dassault, the aircraft manufacturer and reputedly one of the richest men in France, decided to finance an indoor swimming pool for his constituents in Beauvais, a district he represents as a conservative Gaullist legislator in the National Assembly.

The mayor, Walter Amsallem, a Socialist, inaugurated the pool with some acid comments as the 86-year-old Mr. Dassault stood by.

"To give ourselves over to patronage, consigning our fates to the powerful and the rich, seems to us contrary to the spirit of the republic and of democracy," said the mayor. "We should have preferred action by the nation, the fruits of efforts by the whole community, eliminating charitable practices that degrade those who benefit from them."

It is doubtful that Mr. Dassault even heard the rebuke. He was caught up in a shouting match with some Communist councilors, hurling abuse at him from across the pool. "My workers are the best paid in France," Mr. Dassault yelled.

"And I also was once poor before I was successful."

Less raucous, but no less controversial, has been the case of Pierre Guerlain, 72, the perfume manufacturer, whose offer to donate 10,000 acres of lake and land for a wildlife reserve was approved after four years of negotiations with the French Government.

His credentials as a nature lover were never questioned—he was once administrator of the World Wildlife Fund. But bureaucrats reportedly held up the bequest for fear that it would give Mr. Guerlain a windfall of publicity or set off rumors that be had been given a tax break. Mayors in some of the communities bordering the preserve felt that the Government should reserve the option of eventually using the land for housing.

In Sweden, where popular feeling against private philanthropy probably runs highest, there have been few recent cases of large private donations.

"I would say that sort of philanthropy is suspect nowadays," said Lars Bergstig, information secretary in the Budget Ministry. "Even among wealthy people, there is a feeling that you don't become popular by giving away money, by establishing a grant or foundation in your name."

### Sweden Allows No Tax Deduction

Nor would a philanthropist in Sweden be allowed a deduction from his taxable income for a charitable donation.

"In the past, philanthropy was an important substitute for social benefits for the poor," said Mr. Bergstig. "But we've had such a fast buildup of public welfare services since the end of the war. All political parties now believe that philanthropy should be the function of the state and local communities. And the mentality of Swedes today is that if you need money for disease research or support for the arts, you go straight to the Government. After all, isn't that why we pay all those taxes?"

According to Mr. Bergstig, many of the thousands of small charitable trusts that still exist can no longer fulfill their original aims.

"There are five to ten small trusts in Stockholm alone that specify that their money should be spent for the moral improvement of wayward women," he recalled. "Can you really imagine giving away money for that in Sweden today? Then we have old charitable funds to make it possible for young people to go to a university or study abroad. Well, the Government more than takes care of that nowadays.

"The trouble is that even if there are no longer recipients who qualify for many of the old charitable funds, no new legislation has been passed to alter their provisions. It just would not be worth the controversy."

### Tax Exemptions Exist in Britain

In Britain charities are exempted from income tax, corporation tax and capital gains. But individual donors are not. And in recent years, most of the charities have had trouble raising money or maintaining their endowments.

"Operating and administrative costs continued to rise and inflation persisted in eroding the value of capital," stated a report last year by the charity commissioners for England and Wales. "These trends impinged adversely on the ability of charities to sustain existing programs and to start new ones, from their own resources and also on the ability of the public to subscribe fresh funds."

Increasingly, British charities depend on government financing. Earlier this year, a survey by the Charities Aid Foundation, an umbrella group for many voluntary organizations, disclosed that only 40 percent of donations to British charities came from individuals, wills, trust funds and corporations. Government grants covered most of the rest.

### Trend Toward Statutory Funding

"It would be naive to suppose that charities which are effectively dependent on statutory funding will be left with the freedom of initiative any longer than it suits the convenience of the state," said Redmond Mullin, assistant director of the Charities Aid Foundation.

This view was also put forward in a report last year on philanthropy by the National Westminster Bank, but with a slightly different perspective:

"In recent years there has been increasing political interest in charities, and their attractive, tax-sheltered status must have played a role in this. Some charities such as private schools or hospitals are seen as havens of wealthy privilege that enable the rich to buy certain services at a cut price; others are attacked on the ground that they launch political propaganda under the guise of charitable activity."

### State's Role Does Not Resolve Issue

But a government monopoly of philanthropy, as has occurred in the patronage of the arts in Britain, has not put an end to the controversy.

In the United States, businesses are allowed to give away up to 5 percent of their income, free of tax. In Britain, business gifts to the arts are free of tax only if the Government determines that they are part of actual business or advertising expenses. As a result, private donations account for only $1.8 million a year, or less than 1 percent of total patronage for the arts.

But the Government, particularly at the local level, tends to donate its money to the more conventional artistic activities that are free from public controversy, according to advocates of private philanthropy.

The stringent tax laws against potential private art patrons have also been blamed for the large-scale outflow of works of art abroad. Neither the museums nor the Government are able to match offers by foreign collectors for paintings put up for sale by their British owners.

A PARTIAL LIST OF AGENCIES & SERVICES RECEIVING UNITED WAY ALLOCATIONS

American Diabetes Association
American National Red Cross
American Social Health Association
Arthritis Foundation
Big Brothers
Big Sister
Boys Clubs
Boy Scouts
Camp Fire Girls
Catholic Charities
Child Adoption Services
Child Guidance Clinics
Day Care Centers
Epilepsy Foundation of America
Family Counseling Services
Foster Care of Children
Girls Clubs
Girl Scouts
Homemaker—Home Health Aide Service
Homes for Dependent and Neglected Children
Hospitals
Information and Referral Services
Inner City Projects
Legal Aid Services
Leukemia Society of America
Mental Health Services
Medical Clinics
National Association for Mental Health
National Association for Retarded Citizens
National Association of Hearing and Speech Action
National Council on Alcoholism
National Council on Crime and Delinquency
National Cystic Fibrosis Research Foundation
National Easter Seal Society for Crippled Children and Adults
National Hemophelia Foundation
National Kidney Foundation
National Multiple Sclerosis Society
National Recreation and Park Association
Neighborhood Centers and Settlements
Planned Parenthood Services
Residential Treatment Centers for Children
Salvation Army
Services for the Aging
Services for the Handicapped
Services for Unwed Mothers
Summer Camps
Temporary Shelters for Children
Travelers Aid
United Cancer Council, Inc.
United Cerebral Palsy Association
United Seamen's Service
United Service Organizations (USO)
United Way Planning Organizations
Urban League
Visiting Nurse Services
Volunteer Bureaus and Voluntary Action Centers
Volunteers of America
YMCA
YWCA
YMHA
YWHA

STATEMENT OF 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 MAY 13, 1981

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 345,000 customers who reside in 94 incorporated 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. 141 in any tax cut proposal.

Let me start by saying that Kansas City Power & Light Company strongly supports the approach outlined in S. 141 which would defer current Federal income 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 facilities, thus creating employment opportunities which would lead to a strong economy. The proposal would also encourage individual savings to provide a supplemental income during retirement years.

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 and a half years ago, the Company adopted an original issue dividend reinvestment plan in an effort to raise needed equity capital. At present, there are some 4,300 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 $6,700. The amount currently being reinvested by common and preferred stockholders, in the aggregate, is $4,325,000 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. 141 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 funds at an economical cost, which savings will ultimately benefit its customers.

We strongly urge the inclusion of the provisions of S. 141 as part of any tax reduction program.

STATEMENT OF LAWRENCE W. WHALEN, JR., PRESIDENT, THE BERKLINE CORP., ON BEHALF OF THE SOUTHERN FURNITURE MANUFACTURERS ASSOCIATION AND THE NATIONAL ASSOCIATION OF FURNITURE MANUFACTURERS

Mr. Chairman, members of the Committee, I am Lawrence W. Whalen, Jr., President and Chief Executive Officer of the Berkline Corporation, Morristown, Tennessee, a leading furniture company. My comments before the Committee represent the views of my company, as well as The Southern Furniture Manufacturers Association (SFMA) and the National Association of Furniture Manufacturers (NAFM). The combined memberships of these two associations represent all but a very small fraction of the U. S. furniture sales which total over 9 billion dollars annually.

Thank you for this opportunity to testify about the Administration's tax reduction proposals. Hopefully, you will find constructive suggestions in my remarks. I will try to answer any questions you may have.

Although I am not an economist by profession, I am seriously concerned about the current state of the economy and the direction it has been taking in recent years. I am aware, of course, of the necessity for your committee to often deal in macro-economic terms and concepts. It is because of that fact that I especially appreciate this opportunity to testify.

What are the effects of the present tax laws on small business and manufacturers - particularly furniture manufacturers?

The domestic furniture industry is largely composed of small, family-owned, highly competitive manufacturers. Put in another way, this is a low-profit, extremely fragmented industry having little access to

traditional equity markets. The stock of those few publicly-owned furniture companies generally brings such a low price that it is impractical to use stock offerings for the purpose of raising capital. Typically, furniture manufacturers rely heavily on depreciation to generate needed investment capital. However, the industry is now at a cross-road. And the question is - will the defenders of the status quo unwittingly cause this highly competitive domestic furniture industry to become the auto industry of the future?

For too many years now, the forces of strong demand just for working capital, unprecedented inflation, costly regulations, high interest rates and a woefully inadequate depreciation scheme have been working in concert to the disadvantage of the domestic furniture manufacturer. It is my firm opinion, and that of the leadership of the two associations, as well, that the President's more rapid depreciation proposal represents a long overdue beneficial tax reform. While other business tax reform proposals might be helpful in the future, I do not choose to comment on them at this time.

The Administration's depreciation formula would be of great help to the furniture industry's capital formation problems; and funds becoming available through such a formula would have a largely non-inflationary impact on our economy.

In my testimony I have dwelt on the need for reform in the depreciation area, because I am a businessman and because of the positive effect

depreciation reform would have upon the furniture industry. However, the NAFM and SFMA have, through formal resolutions, supported the President's entire economic package, and I endorse that support.

In conclusion, let me say that as was true with many segments of the U. S. economy in recent years, the domestic furniture industry experienced little real growth, if any. However, there is now irrefutable evidence demonstrating that by approximately 1983, given a healthy economy, the demand for furniture will mushroom beyond our industry's present production capacity. This highly competitive domestic industry wants to meet this demand, but it must have Congress' expeditious assistance. We urge passage of the President's depreciation formula. Without it, the domestic furniture industry, in its present form, will be unable to finance the necessary increase in production capacity, and non-domestic manufacturers then, unquestionably, will take advantage of this industry's inability to meet the coming increased demand.

Thank you very much.

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