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EFFECT OF TAX LAW ON AMERICAN COMPETITIVENESS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

OCTOBER 5 AND 19, 1987

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CONTENTS

OPENING STATEMENTS

COMMITTEE PRESS RELEASE

MONDAY, OCTOBER 5, 1987

Public Witnesses

MONDAY, OCTOBER 19, 1987

Public Witnesses

APPENDIX

Alphabetical Listing and Material Submitted

COMMUNICATIONS

EFFECT OF TAX LAW ON AMERICAN COMPETITIVENESS

MONDAY, OCTOBER 5, 1987

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
COMMITTEE ON FINANCE,
Washington, DC.

The subcommittee met, at 9:03 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the subcommittee) presiding.

Present: Senators Baucus, Roth, and Danforth.

[The press release announcing the hearing and an opening statement of Senator Roth follow:]

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT TO HOLD HEARINGS ON THE EFFECT OF TAX LAWS ON AMERICAN COMPETITIVENESS

WASHINGTON, D.C.—Senator Max Baucus (D., Montana), Chairman of the Senate Finance Subcommittee on Taxation and Debt Management, announced Monday that the Subcommittee will hold two hearings to explore the impact of the U.S. tax code on America's international competitiveness.

The hearings are scheduled for Monday, October 5, 1987 and Monday, October 19, 1987, both beginning at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

"There is growing concern about this country's declining international competitiveness," Baucus said. "Increasing our basic economic productivity is crucial to America's competitiveness, and that is where the tax code comes in."

"Our tax system affects virtually every aspect of our economy. But we have very little understanding about how our tax system affects competitiveness. These hearings are designed to begin to develop this understanding."

"Restoring our competitive edge requires many steps," Baucus said. "One is reforming our trade laws. A second is getting the federal budget deficit under control. And third is making the American economy more productive."

"The first two hearings will provide a broad overview of the relationship between tax policy and international competitiveness, as well as a comparison of the U.S. tax system with those of our major economic competitors," Baucus said. "Later, we will examine how our tax system affects specific elements of competitiveness, including the cost of capital, education and training, and worker-management relations."

"All too often," said Baucus, "Congress is forced to focus on the immediate problem at hand. These hearings are intended to focus, instead, on serious, long-range problems for which there are no easy answers."

Witnesses for these hearings will appear by invitation only.

STATEMENT OF SENATOR WILLIAM V. ROTH, JR.

SUBCOMMITTEE ON TAXATION AND DEBT MNANGEMENT

October 5, 1987

I am pleased to be here today to discuss a topic which I believe the Finance Committee has too often overlooked in recent years in the efforts to produce legislation. The effect of the tax system on U.S. competiveness will become even more critical as our nation struggles to compete in the emerging global economy. There are several issues which I hope can be examined during the course of the hearing today, and October 19th. In discussing these issues, I am hopeful that the witnesses will comment on the tax systems of our major trading partners, and the relative advantages and disadvantages that exist for the U.S. under our tax system.

The issue of major concern to me is the effect of our tax treatment of capital investment. A second concern is the dismal level of both public and private savings. I believe both of these issues are related to how our tax system treats investment and savings.

However, the matters that I believe are most urgent for Congress to consider are the tax treatment of U.S. companies doing business abroad. It is time for a permanent solution to the Section 861-8 R&D allocation problem. It is inconceivable that after a decade of deferring the effective date on these punative regulations, the solution last year was to require U.S. companies with foreign operations to allocate 50% of their domestic R&D expenditures to income earned abroad. To talk about "making America more competitive" while increasing the overall tax liability of these companies, and creating an incentive to move domestic R&D abroad seems to be the classic case of Congress saying one thing and doing something else.

Another such issue is the treatment of export financing interest. While Congress has spent the last nine months trying to eliminate the barriers imposed by foreign countries on U.S. exports, it has failed to examine the deterrent it created in last year's tax legislation which has increased the difficulty for medium-sized U.S. exporters to finance export sales. Senator Baucus, Senator Moynihan, and I have proposed legislation which will eliminate the barriers which exist for U.S. owned foreign banks that provide export financing for these U.S. exporters. The problem exists due largely to a combination of unwise and ill-considered changes made in the 1986 tax reform bill to provisions governing the U.S. tax treatment of foreign source income.

U.S. exporters finance the purchase of goods by foreign buyers by having U.S. financial institutions provide the financing. This is accomplished by the U.S. bank lending money to the foreign buyer in exchange for the buyer's note, known as a trade receivable. This is the cross-border border lending which supports U.S. exports. The problem is many countries impose a gross witholding tax on interest income which a bank earns from lending to foreign importers of U.S. goods. Since the time many years ago that the United States first imposed a tax on the worldwide income of U.S. taxpayers, banks have been permitted to take a tax credit for the full amount of the gross witholding taxes paid to the foreign government. Unfortunately the 1986 tax reform act places stringent new limits on the amount of foreign tax credits which can be taken against U.S. income.

The 1986 Tax Reform Act changed the tax treatment of interest earned by U.S.-controlled foreign financial institutions in two significant ways. Generally, such interest is no longer entitled to deferral, and it is no longer permitted to be averaged with other foreign income for foreign tax credit purposes.

First, the 1986 Act replaced the overall foreign tax credit limitation with a "basket" approach. Under the new rules, a separate foreign tax credit limitation must be computed for each basket of income. While some of the designated baskets make the traditional distinction between "active" and "passive" income, others segment certain types of active income by line of business, e.g. banking, manufacturing, insurance, etc.

The second major change in the treatment of foreign source income was the elimination of foreign tax "deferral" for certain types of "active" income, including overseas banking activities. Previously, a foreign bank could finance the sale of export products of both related and unrelated persons and the profits therefrom would not be subject to a U.S. tax until distributed to the U.S. shareholders as a dividend.

In making these changes in the foreign tax credit and deferral, Congress provided for a limited exception to the rules for income derived from the financing of related party exports. Thus, income earned by the financial arm of a U.S. manufacturer's own exports would be exempt from the new foreign tax credit baskets and the elimination of deferral.

Unfortunately, the export finance exception is so narrowly drawn that it applies only to the financing of exports by related parties. This effectively means it applies to financing provided by foreign subsidiaries of exporters, but not the financing provided by unrelated financial institutions, the primary potential source of export financing. Worse, even among related parties, the export financing exception does not apply to the financing of inventory, but only "non-inventory" items. For example, a loan made by the foreign subsidiary of a U.S. exporter to the exporter's customer for the purpose of purchasing the exporters product would not qualify for export finance treatment, even though such a transaction would appear to lie at the heart of the export finance exception.

If related party financing of inventory items does not qualify, and unrelated party financing does not qualify, it would seem appropriate to ask, what sort of export financing does qualify? Apparently, the answer is very little, if any.

At a time when Congress is laboring to improve our nation's trade deficit, and the competativeness of U.S. manufacturers in world markets, we ought not be creating obstacles through the tax system that make it unprofitable for U.S. banks to provide export financing for our manufacturers. If Congress truly wants to stimulate exports, the export finance exception should be amended to cover unrelated party financing. Technically, such an amendment would permit interest earned from the financing of U.S. exports by unrelated parties-- that is unrelated companies in the financial business-- to continue to benefit from deferral, and to have that interest allocated to a "good" basket for foreign tax credit purposes.

The decline of U.S. foreign markets, savings, and investment in our infrastructure is well chronicled in the press. Our manufacturers correctly charge that this country has never recognized that our trading partners have aggressive export financing policies that make needed credit available at concessionary or highly favorable terms. For there to be a renewed interest by U.S. banks in financing exports, there must be an economic basis for it.

Trade financing is a sophisticated and often risky venture. Medium-sized companies, or even larger companies with limited export volume, either cannot or will not allocate sufficient financial and human resources to finance an export sale either directly or through a related person. Without an unrelated party exception, even if the U.S. exporter could utilize the foreign tax credits generated by the export financing, the costs and the risks associated with the financing negate the profits from the sale. The personel costs related to employing the necessary financial specialist to structure the transactions is prohibitive for most middle-market companies. Moreover, the exporter must have the financial strength to justify carrying a the account receivable on its balance sheet. In reality only a few exporters have sufficient annual export volume to justify these out-of-pocket personel expenses, and to warrant taking the associated risks.

The bill we have introduced would amend the export financing provisions to exempt income derived from both related party and unrelated party export financing activities from the more restrictive foreign tax credit limitation and deferral rules. Our tax law should not include an export financing rule that discriminates against unrelated party transactions. Any benefit derived from the amendment will be directly linked to expanded export financing activities. This is because only the income derived from export activities will be eligible for the exemption from the burdensome new rules governing the foreign tax credit and deferral. This legislation will increase sales for our U.S. exporters, generating an increase in income tax revenues to the Treasury, and helping reduce our trade deficit.

In closing, I would like to again thank the Chairman for holding these hearings, and I look forward to the comments of the invited witnesses.

OPENING STATEMENT OF SENATOR MAX BAUCUS

Senator BAUCUS. The hearing of the Subcommittee on Taxation and Debt Management will come to order. Before I begin, I would like to say a few words about the agreement reached over the weekend between the United States and Canada concerning the tentative Free Trade Agreement.

I have not finished studying the terms of the agreement, so at this time, I can't address it in detail. However, I think it is important that both sides understand where Congress stands on any free trade agreement, be it with Canada or whomever. No free trade agreement is worth its salt if it isn't fair, and no agreement can be fair if it doesn't address the major concerns of both countries.

A fair free trade agreement with Canada would be a major step forward, not just for the United States and Canada, but for most of the free trading world.

But any agreement that tries to gloss over the real concerns of the American people cannot be considered fair or free. America is not going to let itself be taken advantage of. That isn't being protectionist; it is being pragmatic, responsible and realistic.

I caution both administrations from engaging in cheerleading tactics to build support for the agreement. Congress will judge this package on its merits, not on promotional posturing. Only after Congress has the opportunity to review the specifics will it be able to determine whether this agreement is free or if the American worker and consumer is being asked to pay a high price for what amounts to a political deal.

It is my hope that the terms of the agreement will bear out the enthusiasm of the administration, but of course, in the final analysis we will look at the fine print, we will look at the dotted "i"s and crossed "t"s to determine whether, in fact, this agreement is fair.

Moving on, today's hearing is the first of a series that this subcommittee will hold to consider the impact of the U. S. tax system on America's international competitiveness. I know that some people say that competitiveness is a political fad, a buzz word that means everything to everyone and consequently, means nothing.

But criticizing the word won't make the problem go away. If it were that easy, we wouldn't be here today. It is absolutely true that America's economic role is changing. You can call it anything you want, but the change is there. It is real, and it is frightening.

From 1980 to 1986, America's trade deficit worsened over 34 percent per year, and the trade deficit is only part of the story. Thirty years ago, Americans produced over 40 percent of the world's GNP. Today, we produce less than 30 percent.

Thirty years ago, Americans owned 26 of the world's top 30 corporations; today, we own only 15. The rate of private domestic investment has fallen to less than 5 percent, the lowest level in postwar history. American kids are falling behind in international scholastic exams.

The result is lost sales, lost jobs and a declining standard of living. The average 50-year old worker today takes home less real income than he did in 1973. During the 1950s, U. S. workers' pay rose an average of 2.5 percent per year. In the 1980s, it has actually fallen by three-tenths of 1 percent.

So what do we do about all this? Part of the answer is reforming our trade laws. The Finance Committee has done its part, and I hope we will soon work out a conference agreement that tightens up on unfair trade practices without resorting to protectionism.

We also must reduce the Federal budget deficit. The message has become monotonous. Every reputable economist tells us that deficit reduction is the key to our international economic performance. Yet the politics of deficit dodging persist. It has to stop.

Later this week, we will begin assembling another reconciliation package. Nobody likes to cut spending and raise taxes, but it is important for this committee to meet its target and keep driving the deficit down. We cannot continue to borrow to our standard of living; we have got to start earning it.

In addition to reforming our trade laws and reducing the budget deficit, we have got to solve the productivity puzzle. In the end, we have to produce our way out of the trade deficit. But every one of our major competitors is increasing its productivity faster than we are, every one. In the case of Japan, almost three times faster.

I wish we could pass a bill that mandates higher productivity, but we can't. Many of the changes that must occur simply can't be legislated. They require new attitudes in our boardrooms, in our classrooms, and on our factory floors.

However, the Federal Government is not just a passive observer. In some cases, Federal policies can also have a profound impact and that is where today's hearing comes in. The Federal tax system raises $800 billion a year; it creates incentives and disincentives that affect the way we behave as investors, as business managers, as workers, and as consumers.

So how does our tax system affect our ability to sell American goods and services in world markets? Some people say it doesn't matter at all, because exchange rates adjust to offset any change in our Tax Code. Others invoke competitiveness as a euphemism to defend their favorite tax break.

The truth is: At this point, we really don't understand that relationship between taxation and our international economic standing. When we debate a tax provision, we have revenue estimates; we have distribution charts; and we may argue about whether the Japanese or Canadians give some industry a bigger tax break than the United States does.

But we don't have the solid analytical tools we need to understand how the tax laws we pass will affect the ability of American companies and workers to sell their goods internationally. These hearings are designed to begin to provide those tools.

We will begin with two days of general hearings. Today, we will hear from some of our nation's leading experts on competitiveness. They will discuss what American companies must do to become more productive and how taxes affect them.

On October 19, two weeks from today, we will hear from leading economists and tax experts who provide an overview of other countries' tax systems and discuss the basic characteristics of ours.

After that, we plan to have four more hearings on how the tax system affects specific aspects of productivity. First, there will be a second round of hearings that will focus on management horizons, the problem created by short-term thinking about long-term problems. We will also focus on the takeover phenomena, incentives for bonus compensation and stock ownership incentives.

The second hearing will focus on education and training; the third on the cost of capital; and the fourth will focus on the taxation of U.S. companies operating abroad.

Let me make one final point: I am approaching these hearings with an open mind. There are many questions to consider, including the general effect of the tax system, the effectiveness of tax incentives and the utility of income versus consumption taxes. Hopefully, we can address these questions forthrightly and build the base of knowledge we need to develop so that we have tax policies to keep America competitive in the 1980s, the 1990s and beyond.

Our first witness is Mr. Ed Pratt, who is Chairman and Chief Executive Officer of Pfizer of New York. Mr. Pratt, we are very happy to have you here, and please proceed.

STATEMENT OF EDMUND T. PRATT, JR., CHAIRMAN AND CHIEF EXECUTIVE OFFICER, PFIZER, INC., NEW YORK, NY

Mr. Pratt. Thank you very much, Senator and good morning.

It is my understanding that although all those issues that you mentioned are ones that we as a company and the business community in general have discussed and tried to cope with and understand better, the main thrust of my testimony this morning is to be the impact of the U.S. Tax Code on international competitiveness.

My name is Edmund T. Pratt, Jr. I am Chairman and Chief Executive Officer of Pfizer, Inc., which is a research-based pharmaceutical company with worldwide sales of $5 billion, of which about one-half are from foreign operations. In all, we operate in 140 nations and have a manufacturing presence in 65 of them. I also serve as Chairman of the Emergency Committee for American Trade, the ECAT, I am Co-Chairman of the Business Round Table and serve on its Trade and Investment Task Force, and I am also a member of the President's Advisory Committee on Trade Negotiations.

ECAT is an organization formed in 1967 to support measures which expand international trade and investment. Its members are major exporters and investors in foreign markets. The 60 corporate members of ECAT have combined annual worldwide sales in excess of $700 billion, and they employ more than five million people.

While ECAT will formally testify before this Subcommittee on October 19th, my comments relative to the pending trade legislation reflect the views of Pfizer as well as those of ECAT members.

At the outset, Mr. Chairman, I certainly want to commend you for holding these hearings at this time. The topic, the effect of the tax laws on international competitiveness, is both timely and critical to the future of our economy.

As we are all painfully aware, the United States not only became a net debtor nation in 1986; it became the world's largest debtor. Despite a significant realignment in the value of the dollar, the U.S. trade deficit remains unmanageably high, and we are becoming increasingly dependent upon foreign capitol to finance our Federal budget deficit and balance of payments deficits.

We cannot minimize the seriousness of such current economic realities. To meet the challenge they present, our business, labor and government leaders must continually scrutinize current policies and practices for their impact on our ability to compete abroad and, where appropriate, take the necessary, frequently difficult steps to improve our international economic position.

As you suggest, some of the steps the government must take are readily apparent. One is the enactment of new trade legislation. Another is a reduction of the U.S. Federal budget deficit, and a third area, which is the subject of this hearing, is tax policy and its role on fostering a more productive and competitive U.S. economy.

Before turning to the issue of tax policy, let me comment briefly on the pending trade bill and the Federal budget deficit. The U.S. business community strongly supports the passage of a trade bill that will promote U.S. competitiveness in the world marketplace. At the same time, we recognize that changes in our trade laws alone cannot possibly bring about a rapid or significant improvement in either our trade or balance of payments deficits overnight.

The trade bill is not a panacea for the resolution of our trade problem. Nevertheless, the passage of a trade bill which provides a broad grant of presidential negotiating authority for participation in the Uruguay round of Multilateral Trade Negotiations is essential if we are to preserve and improve the international economic system under which the U.S. and its trading partners have benefited throughout the post-war era.

We further believe that trade reform, which requires an affirmative Presidential response to serious injury findings and findings of unreasonable, unfair or unjustifiable foreign trade practices, will go a long way toward improving the U.S. economic position in the global economy.

International rules provided under the framework of the GATT influence the global environment in which today's international business must compete. They provide stability and promote worldwide economic growth. Existing GATT rules and disciplines governing trade must be approved, improved and expanded to include new economic issues, such as services trades, foreign direct investment and intellectual property protection, which are critical to international businesses.

For a research-based pharmaceutical company, like Pfizer, the assurance of adequate worldwide protection of intellectual property, especially patents, is critical if we are to continue the necessary R&D investments to bring to the marketplace new drug discoveries which benefit people all over the world.

The budget deficit. Turning briefly to the budget, I believe there is a direct link between the U.S. trade deficit and our huge Federal budget deficit. Bringing the Federal budget deficit under control and back on a downward path is perhaps the most important step the Congress could take to help tackle our economic problems and to improve the outlook for a higher standard of living over the long term.

I am hopeful that we are moving in the right direction with the recently signed legislation strengthening the goals of the Gramm-Rudman Deficit Reduction Act.

On tax policy, as this Committee well knows, considerable debate still surrounds the impact of the sweeping tax reforms enacted last year on U.S. international competitiveness. Some are of the view that the Tax Code has minimal effect on the ability of U.S. businesses to compete either at home or abroad. I strongly disagree. To the extent tax policies affect capital formation and technological innovation, they have a direct impact on the productivity of our work force and the cost and quality of U.S. goods and services.

Moreover, to the extent U.S. companies bear a tax burden not shared by their foreign competitors, they will obviously be placed at a competitive disadvantage in world markets.

As you probably know, I was not an advocate of the tax reform movement that ultimately produced the sweeping tax changes contained in the 1986 Tax Act. I believed then, and still do, that the pre-1986 Code, albeit complex and imperfect, did not arise, nor operate, in a vacuum. Specific provisions of the Tax Code were crafted over several decades to influence economic behavior.

While some were based on traditional tax principles, others were designed to promote legitimate public policy objectives, such as capital investment, technological innovation or the provision of broad-based health, retirement and educational benefits for our work force.

Nonetheless, now that the 1986 Tax Act, which, I might add, is far from simple, is in place, it must be carefully scrutinized for its impact on U.S. competitiveness. While I am hardly an advocate of perpetual tax change, I nevertheless believe that where potential adverse affects can be demonstrated, further modifications must be considered.

The private sector recognizes that a tax regime cannot guarantee the success of U.S. businesses. At the same time, it certainly should not be allowed to serve as an impediment to our effective competition in the world marketplace.

Let me comment briefly on a few areas where I believe the tax policies adopted in the 1986 Tax Act could have an impact on our international competitiveness, and, therefore, warrant your careful review.

These are capital formation, technological innovation and the ability of U.S. companies to penetrate foreign markets through foreign direct investment. Each is a barometer of our competitiveness.

First, capital formation. Pfizer is not a major capital-intensive company. Therefore, I have somewhat different experience from those in the steel industry, for instance. I do know that many members of the business community are concerned over the impact of the 1986 Tax Act on capital formation in the United States.

While some provisions of the Act, notably, the significant reduction in tax rates, should have a favorable effect on the overall cost of capital in the economy, others, such as changes in the depreciation systems and the repeal of the investment tax credit, would have a significantly negative impact.

To the extent the tax law increases the cost of acquiring capital equipment in this country, it could further impair the ability of many U.S. companies to expand and modernize plants and equipment and manufactured goods that can be sold competitively in world markets.

This would tend to diminish the international competitiveness of U.S. companies and workers and further increase the vulnerability of U.S. companies and their employees' jobs to imports. In fact, the more favorable cost recovery systems in other industrialized countries may actually provide a positive incentive for U.S. companies to manufacture goods abroad rather than in the United States.

It may be too soon to determine the net impact of tax reform in this area, but I would recommend further careful scrutiny of the capital formation issue in the context of these hearings.

Technological innovation. I think we would all agree that a major factor affecting U.S. international competitiveness is technological innovation, which has been the source of the U.S. comparative advantage in the past and must be for the future. Our Federal tax system can and does have an impact on the willingness of American firms to devote resources to research and development and to the expansion of the U.S. technological base.

It is only through such investment that the U.S. can hope to develop and produce the new and better products and services that will become the source of our competitive edge in the future.

Global competition in R&D is formidable. Although the United States has a large R&D effort in absolute terms, indeed the largest, on the basis of its share of Gross National Product developed to civilian R&D, the U.S. ranks lowest among the big five industrial nations.

Therefore, the challenge facing R&D-intensive companies, such as Pfizer, is formidable. My company will spend about $400 million on research this year. This is about four times the amount spent ten years ago. From 1980 to 1984, the pharmaceutical industry as a whole doubled its R&D investments in the United States.

But this is an inherently risky and very expensive business with many dry holes, and, I might add, a business which is not aided by uncertain Federal tax policies that can lead to underinvestment in commercial research.

Of particular concern in this area is the fact that Congress has yet to enact a permanent solution to the section 861-8 R&D allocation problem.

As you well know, Mr. Chairman, Section 861-8 requires U.S. companies with foreign operations to allocate a portion of their domestic R&D expenditures to income earned abroad. While highly complex, the net effect of this is to increase a company's overall tax liability and to create a disincentive to the performance of R&D in the United States and an incentive to move such activities overseas. The adverse consequences for the U.S. technological base hardly need elaborating.

I know that you, Mr. Chairman, have been a major proponent of legislation to permanently repeal the Section 861-8 R&D regulations and played a leading role earlier this year in developing a compromise proposal that has the support of the Administration, industry and members of this committee. A permanent solution to the 861 problem is long overdue, and it is my sincere hope that the compromise proposal will be enacted this year.

In a similar vein, a permanent solution of the R&D credit issue should be a major priority. The uncertainty created by periodically expiring provisions unnecessarily deters needed R&D investments.

U.S. foreign investment. U.S. foreign direct investment is a direct measure of the ability of American firms to penetrate foreign markets that cannot be effectively reached by U.S. exports. The benefits of such investment to the U.S. domestic economy are substantial.

Approximately 40 percent of all U.S. manufactured exports represent sales to U.S. subsidiaries abroad. Repatriated earnings exceed some $70 billion, increasing the pool of domestic capital for investments in the United States.

Regrettably, this positive contribution of U.S. overseas investment is frequently overlooked. When I testified on the President's tax reform package in 1985, I expressed the strong opposition of the international business community to the proposed changes in the U.S. taxation of income earned abroad.

While the Congress rejected the President's proposal to impose a per country foreign tax credit limitation on U.S. companies with operations abroad, the final act contains equally burdensome provisions that undermine the integrity of both the foreign tax credit and deferral of foreign earnings and taxes on those earnings until they return to the United States.

First, while ostensibly retaining the overall limitation, it requires companies to artificially segment income earned abroad by type or line of business and to calculate the foreign tax credit separately for each basket of income. This penalizes diversification and ignores the highly integrated nature of our international businesses.

That the United States is the only country in the world to tax foreign earnings in this fashion is testimony enough to its potential anti-competitive effect.

Second, the recent Tax Act eliminates foreign tax deferral for a number of active businesses, such as banking, shipping and insurance. Again, this is a major departure from traditional U.S. international tax policy that foreign earnings should not be taxed until actually repatriated to the United States and will result in a tax burden not shared by our foreign competitors.

Similarly, in another unprecedented attack on deferral of taxation, the 1986 Act would subject U.S. subsidiaries abroad to the new rules governing passive foreign investment companies. These rules, which were originally intended to apply only to individuals participating in overseas investment funds, were expanded at the last minute to cover U.S. subsidiaries abroad.

This could subject many active manufacturing operations to a loss of deferral and significantly add to the tax burden of such U.S. companies. I do not believe this result was intended by Congress, and it must be rectified if adverse competitive consequences are to be avoided.

As you know, the 1986 Act provides for a very limited exception to these burdensome new foreign tax rules for certain types of export financing. Congress did so in the express recognition of the potential anti-competitive impact the changes might have on U.S. export trade.

It is my understanding, Mr. Chairman, that you and Senator Roth, I believe, have entered legislation to significantly broaden this exception to cover all export financing activities. I certainly commend you for this initiative and hope that the Congress can act on the proposal this year.

If we are to begin closing the trade deficit, we obviously must expand U.S. exports. It is difficult enough to compete against the aggressive export promotion policies of our foreign competitors. We cannot afford to lose sales due to the unavailability of adequate financing on competitive terms.

Moreover, we must not overlook the fact that for every $1 billion in exports, between 20,000 and 25,000 new American jobs are created.

In conclusion, obviously, I have touched upon only a few of the many issues that this subcommittee will consider in its examination of tax policy and U.S. international competitiveness. In closing, however, I wish to reiterate my view that tax policy can and should play a legitimate role in fostering a more productive and competitive economy.

The specific proposals I have mentioned regarding section 861 and export financing are prime examples and warrant favorable congressional consideration. That concludes my comments. I would be pleased to respond to any questions.

[The prepared statement of Mr. Edmund T. Pratt follows:]

STATEMENT OF

EDMUND T. PRATT, JR.

Mr. Chairman and Members of the Subcommittee, my name is Edmund T. Pratt, Jr. I am Chairman and Chief Executive Officer of Pfizer, Inc. -- a research-based pharmaceutical company with worldwide sales of $5 billion of which about one-half are from foreign operations. In all, we operate in 140 nations and have a manufacturing presence in 65 of them.

I also serve as Chairman of the Emergency Committee for American Trade (ECAT), am co-chair of the Business Roundtable, serving on its Trade and Investment Task Force and am a member of the President's Advisory Committee on Trade Negotiations. ECAT is an organization formed in 1967 to support measures which expand international trade and investment. Its members are major exporters and investors in foreign markets. The 60 members of ECAT have combined annual worldwide sales in excess of $700 billion, and they employ more than 5 million people. While ECAT will formally testify before this subcommittee on October 19th, my comments relating to the pending trade legislation reflect the views of Pfizer as well as those of ECAT members.

At the outset I want to commend you, Mr. Chairman, for holding these hearings at this time. The topic -- the effect of the tax laws on international competitiveness -- is both timely and critical to the future of our economy. As we are all painfully aware, the United States not only became a net debtor nation in 1986, it became the world's largest debtor. Despite a significant realignment in the value of the dollar, the U.S. trade deficit remains unmanageably high and we are becoming increasingly dependent upon foreign capital to finance our federal budget and balance of payments deficits.

We cannot minimize the seriousness of such current economic realities. To meet the challenge they present, our business, labor, and government leaders must continually scrutinize current policies and practices for their impact on our ability to compete abroad and where appropriate, take the necessary, frequently difficult steps, to improve our international economic position.

As you suggest, some of the steps the government must take are readily apparent. One is the enactment of new trade legislation. Another is a reduction in the U.S. Federal budget deficit. A third area, which is the subject of this hearing, is tax policy and its role in fostering a more productive and competitive U.S. economy.

Before turning to the issue of tax policy, let me comment briefly on the pending trade bill and the Federal budget deficit.

TRADE LEGISLATION

The U.S. business community strongly supports the passage of a trade bill that will promote U.S. competitiveness in the world market place. At the same time, we recognize that changes in our trade laws alone cannot possibly bring about a rapid or significant improvement in either our trade or balance of payments deficits overnight.

The trade bill is not a panacea for the resolution of our trade problem. Nevertheless, the passage of a trade bill which provides a broad grant of Presidential negotiating authority for participation in the Uruguay Round of Multilateral Trade Negotiations is essential if we are to persevere and improve the international economic system under which the U.S. and its trading partners have benefited throughout the post-war era. We further believe that trade reform which requires an affirmative Presidential response to serious injury findings and findings of unreasonable, unfair or unjustifiable foreign trade practices will go a long way toward improving the U.S. economic position in the global economy.

International rules provided under the framework of the General Agreement on Tariffs and Trade (GATT) influence the global environment in which today's international businesses must compete. They provide stability and promote worldwide economic growth. Existing GATT rules and disciplines governing trade must be improved and expanded to include new economic issues, such as service trades, foreign direct investment, and intellectual property, which are critical to international businesses. For a research-based pharmaceutical company, like Pfizer, the assurance of adequate worldwide protection of intellectual property, especially patents, is critical if we are to continue the necessary R&D investments to bring to the market place new drug discoveries which benefit people all over the world.

THE BUDGET DEFICIT

Turning briefly to the budget, I believe there is a direct link between the U.S. trade deficit and our huge Federal budget deficit. Bringing the Federal budget deficit under control and back on to a downward path is perhaps the most important step the Congress could take to help tackle our economic problems and to improve the outlook for a higher standard of living over the long term. I am hopeful that we are moving in the right direction with the recently-signed legislation strengthening the goals of the Gramm-Rudman Deficit Reduction Act.

TAX POLICY

As this committee well knows, considerable debate still surrounds the impact of the sweeping tax reforms enacted last year on U.S international competitiveness. Some are of the view that the tax code has minimal effect on the ability of U.S. businesses to compete either at home or abroad. I strongly disagree. To the extent tax policies affect capital formation and technological innovation, they have a direct impact on the productivity of our work force and the cost and quality of U.S. goods and services. Moreover, to the extent U.S. companies bear a tax burden not shared by their foreign competitors they will be placed at a competitive disadvantage in world markets.

As you know, I was not an advocate of the tax reform movement that ultimately produced the sweeping tax changes contained in the 1986 Tax Act. I believed then and still do that the pre-1986 code, albeit complex and imperfect, did not arise -- nor operate -- in a vacuum. Specific provisions of the tax code were crafted over several decades to influence economic behavior. While some were based on traditional tax principles, others were designed to promote legitimate public policy objectives such as capital investment, technological innovation or the provision of broad-based health, retirement, and educational benefits for our work force.

Nonetheless, now that the 1986 Tax Act (which, I might add, is far from "simple") is in place, it must be carefully scrutinized for its impact on U.S. competitiveness. While I am hardly an advocate of perpetual tax change, I nonetheless believe that where potential adverse effects can be demonstrated, further modifications should be considered.

The private sector recognizes that a tax regime cannot guarantee the success of U.S. businesses. At the same time it certainly should not be allowed to serve as an impediment to our effective competition in the world market place. Let me comment briefly on a few areas where I believe the tax policies adopted in the 1986 Tax Act could have an impact on our international competitiveness and therefore warrant your careful review. These are capital formation, technological innovation, and the ability of U.S. companies to penetrate foreign markets through foreign direct investment. Each is a barometer of our competitiveness.

Capital Formation

While Pfizer is not a capital intensive company, and thus I cannot speak from personal experience on the issue, I do know that many members of the business community are concerned over the impact of the 1986 Tax Act on capital formation in the United States.

While some provisions of the Act, notably the significant reductions in tax rates, should have a favorable effect on the overall cost of capital in the economy, others such as the changes in the depreciation systems and repeal of the investment tax credit could have a significantly negative impact.

To the extent the tax law increases the cost of acquiring capital equipment in this country, it could further impair the ability of many U.S. companies to expand and modernize plants and equipment and manufacture goods that can be sold competitively in world markets. This would tend to diminish the international competitiveness of U.S. companies and workers, and further increase the vulnerability of U.S. companies and their employees' jobs to imports. In fact, the more favorable cost recovery systems in other industrialized countries may actually provide a positive incentive for U.S. companies to manufacture goods abroad rather than in the United States.

It may be too soon to determine the net impact of tax reform in this area, but I would recommend further careful scrutiny of the capital formation issue in the context of these hearings.

Technological Innovation

I think we would all agree that a major factor affecting U.S. international competitiveness is technological innovation, which has been the source of the U.S. comparative advantage in the past and must be for the future. Our Federal tax system can and does have an impact on the willingness of American firms to devote resources to research and development and to the expansion of the U.S. technological base. It is only through such investment that the U.S. can hope to develop and produce the new and better products and services that will become the source of our competitive edge in the future.

Global competition in R&D is formidable. Although the United States has a large R&D effort in absolute terms, on the basis of its share of the Gross National Product devoted to civilian R&D, the U.S. ranks lowest among the big five industrial nations.

Therefore, the challenge facing R&D-intensive companies, such as Pfizer, is formidable. My company will spend about $400 million on research in 1987. This is about 4 times the amount spent 10 years ago. From 1980 to 1984, the pharmaceutical industry as a whole doubled its R&D investments in the United States.

But this is an inherently risky, and very expensive business with many "dry holes" -- and, I might add, a business which is not aided by uncertain Federal tax policies that can lead to under-investment in commercial research.

Of particular concern in this area is the fact that Congress has yet to enact a permanent solution to the Section 861-8 R&D allocation problem. As you well know, Mr. Chairman, Section 861-8 requires U.S. companies with foreign operations to allocate a portion of their domestic R&D expenditures to income earned abroad. While highly complex, the net effect is to increase a company's overall tax liability and create a disincentive to the performance of R&D in the U.S. and an incentive to move such activities overseas. The adverse consequences for the U.S. technological base hardly need elaborating.

I know that you, Mr. Chairman, have been a major proponent of legislation to permanently repeal the Section 861-8 R&D regulations and played a leading role earlier this year in developing a compromise proposal that has the support of the Administration, Industry, and members of this committee. A permanent solution to the 861 problem is long overdue and it is my sincere hope the compromise proposal will be enacted this year.

In a similar vein, a permanent resolution of the R&D credit issue should be a major priority. The uncertainty created by periodically expiring provisions unnecessarily deters needed R&D investments.

<u>U.S. Foreign Investment</u>

U.S. foreign direct investment is a direct measure of the ability of American firms to penetrate foreign markets that cannot be effectively reached by U.S. exports. The benefits of such investment to the U.S. domestic economy are substantial. Approximately 40% of all U.S. manufactured exports represent sales to U.S. subsidiaries abroad. Repatriated earnings exceed some $70 billion, increasing the pool of domestic capital for investments in the United States.

Regrettably, this positive contribution of U.S. overseas investment is frequently overlooked. When I testified on the President's tax reform package in 1985, I expressed the strong opposition of the international business community to the proposed changes in the U.S. taxation of income earned abroad. While the Congress rejected the President's proposal to impose a "per country" foreign tax credit limitation on U.S. companies with operations abroad, the final act contains equally burdensome provisions that undermine the integrity of both the foreign tax credit and deferral.

First, while ostensibly retaining the overall limitation, it requires companies to artificially segment income earned abroad by type or line-of-business and calculate the foreign tax credit separately for each basket of income. This penalizes diversification and ignores the highly integrated nature of our international businesses. That the United States is the only country in the world to tax foreign earnings in this fashion is testimony enough to its potential anti-competitive effect.

Second, the 1987 Act eliminates foreign tax deferral for a number of active businesses, such as banking, shipping and insurance. Again, this is a major departure from traditional U.S. international tax policy that foreign earnings not be taxed until actually repatriated to the U.S. and will result in a tax burden not shared by our foreign competitors.

Similarly, in another unprecedented attack on deferral, the 1986 Act would subject U.S. subsidiaries abroad to the new rules governing passive foreign investment companies. These rules, which were originally intended to apply only to individuals participating in overseas investment funds, were expanded at the last minute to cover U.S. subsidiaries abroad. This could subject many active manufacturing operations to a loss of deferral and significantly add to the tax burden of such U.S. companies. I do not believe this result was intended by Congress and it must be rectified if adverse competitive consequences are to be avoided.

As you know, the 1986 Act provides for a very limited exception to these burdensome new foreign tax rules for certain types of export financing. Congress did so in express recognition of the potential anti-competitive impact the changes might have on U.S. export trade. It is my understanding, Mr. Chairman, that you and Senator Roth are considering legislation to significantly broaden this exception to cover all export financing activities. I commend you for this initiative and hope that Congress can act on the proposal this year. If we are to begin closing the trade deficit, we must expand U.S. exports. It is difficult enough to compete against the aggressive export promotion policies of our foreign competitors. We cannot afford to lose sales due to the unavailability of adequate financing on competitive terms. Moreover, we must not overlook the fact that for every $1 billion dollars in exports, between 20,000 and 25,000 new American jobs are created.

CONCLUSION

Obviously, I have touched upon only a few of the many issues this subcommittee will consider in its examination of tax policy and U.S. international competitiveness. In closing, however, I wish to reiterate my view that tax policy can and should play a legitimate role in fostering a more productive and competitive economy. The specific proposals I have mentioned regarding Section 861 and export financing are prime examples and warrant favorable Congressional consideration. That concludes my comments. I would be pleased to respond to any questions.

Senator BAUCUS. Thank you very much, Mr. Pratt. First of all, I want to thank you for taking the time to appear this morning. I know that you have another engagement out of town that you partially canceled in order to come to this hearing. We appreciate that very much.

Mr. PRATT. Thank you.

Senator BAUCUS. I note that we are joined by the distinguished Senator from Delaware, Senator Roth, who is also extremely interested in this subject. In fact, I think he is partly responsible for your presence this morning.

Senator Roth, do you have a statement or a few comments you would like to make at this time?

Senator ROTH. Thank you, Mr. Chairman.

First, I do want to congratulate you for holding these hearings on what I think, in many ways, is the most important problem facing this country, that is, our competitiveness in world markets.

I am particularly grateful to Mr. Pratt, who, as always, has given us a very perceptive and incisive statement as to what needs to be done. I want to thank you for coming here today, even though it meant cancelling of some other very, very important engagements on your part.

Mr. Chairman, I do have a statement, but rather than take the time of the subcommittee reading that, I would ask that it be included as if read.

Senator BAUCUS. Without objection.

Senator ROTH. And I will wait. Thank you.

Senator BAUCUS. Thank you. Mr. Pratt, before I begin the heart of the matter here, I am wondering if you have had a preliminary chance, to look at the tentative Free Trade Agreement that the United States and Canada have reached, particularly insofar as it affects the pharmaceutical industry in this country?

Mr. PRATT. I have heard only sketchy outlines of it, Senator. From what I have heard, I am disappointed. The pharmaceutical industry has a particular problem with our Canadian friends in that, in essence, they fail to have an adequate patent law in Canada for pharmaceuticals which is, in our judgment, truly an outrageous thing for a developed nation. They are only developed nation in world that has done that. We have been negotiating with them for about six years to try to get it rectified.

I would say up front that I don't believe I have ever run into a thoughtful member of the Canadian Cabinet who hasn't agreed that what they did was not right; it should be changed. For that reason, they have been working on legislation for a number of years to try to restore protection of our intellectual property rights in Canada, and that bill has been stalled in their Parliament.

We were always led to believe by both countries that one of the key factors in any free trade agreement would be bringing their intellectual property protection in line with what we have in this country as part of becoming unified free trade area.

Early indications are that they have stopped considerably short of that in the proposed agreement, but I haven't seen the details yet, so I don't know for sure.

Senator BAUCUS. Could you quantify the degree to which unfair trade practices, at least as your company and industry are concerned adversely affect America's competitive position? What portion of the problem do you think it accounts for?

Mr. PRATT. Of course, it varies all over the place. That particular item in Canada, for example, would be almost 100 percent of the problem as far as our industry and its ability to compete in Canada is concerned. On the broad sweep of all of international trade, unfair trade practices, I think, by most of those who have tried to estimate them are usually assigned a quite a bit lower role, more in the 10- or 15- or 20-percent range.

Senator BAUCUS. Do you agree with that at all?

Mr. PRATT. I really have a hard time, without studying all of the kind of data that was produced, coming to a judgment. I suspect it is not the major item. I would think that is right, yes. I guess I say that mainly because up until about, oh, the early 1980s, the trade balance was acceptable; it was only about 1982 that the trade balance really went completely to pot in this country. The unfair trade practices in some countries have increased since that time, but they really couldn't have been responsible for the tremendous change.

So it is a significant factor, and I don't know; maybe it isn't too important whether it is 20 percent or 30 percent or 40 percent. It is a factor which needs to be dealt with, and in some countries, like Canada in our case of course, it is a critical factor.

Senator BAUCUS. On that point, a lot of people in this country say, "If only we have an even playing field, we can compete fairly and squarely with other countries."

The observation, frankly, is not very thorough. That is, to say that there is an even playing field assumes that other countries operate and live by the same rules and the same attitudes and the same cultural preferences as we do.

To carry it further, it is to impose our value system, our society, our governmental balance or lack thereof between the industry and the public and private sectors on them.

My question, then, is: If you agree that other countries have systems, economic systems and cultures and attitudes so different from ours, that it is not ineffective to impose our value system on them, because we will be unable to do so; that is, that the assumption of an even playing field or the cry for an even playing field is really not very accurate and it is missing the mark.

I wonder if you could comment on that.

Mr. PRATT. I think I always assumed an even playing field meant something a little different than you were suggesting, Senator. I think all of us who do business in the international field, which most major American companies do, realize that we will never be able, nor do we think we should, nor have we suggested that we should impose our standards of living and the way we go about things—our culture—on other countries.

I agree with you that would be unrealistic. I think what we meant by a level playing field is that, and all I think that statement means when it is said by an American businessman, is we have the GATT, for example. We have the GATT and other international forms of regulations to deal with the issues. Once you leave your country and get into international trade, there needs to be a common set of rules under which we operate for trade and international economic activity to go on effectively.

In that framework, all the nations of the world, in negotiating and in developing the rules of the GATT and other similar international bodies, have created a body of law and regulation which is presumed to create a balanced, level playing field for international trade to take place.

I think what the businessman means when he says, "Let me have an international level playing field," is that he is convinced that the framework of rules are not followed as appropriately as they should be by some companies and countries; they violate the rules and thereby take advantage of the situation and that, indeed, our nation has probably allowed this to happen in the past years when, because of our great economic strength, we could afford to wink at it.

The average businessman now feels that with the change in the economic situation, we cannot afford to let other nations violate of agreed upon international trading rules to their own advantage and to our disadvantage. I personally don't see anything arrogant in American companies saying in that context that we need a level playing field. If we are two companies competing for business in a third country, for example, or two countries competing for business in a third country, why, if we are playing with completely different rules and they have subsidized financing arrangements which affect the cost of their products then, it is, of course, impossible, in today's circumstances for an American company to compete.

That kind of a level playing field I think even the foreign country would want if he felt he was being discriminated against.

Senator BAUCUS. Speaking of taxation, as you know, some people think the Tax Code really has not that much effect on U. S. competitiveness as long as we have a stable tax system, as long as businessmen know what it is, they can work around it and deal with it, as long as it is a fixed target and not changing all the time.

You seem to think that the incidence of taxes and the various ways it affects business activities does have a very direct affect on American competitiveness. Would you please give some examples of how 861 or the R&D tax credit or the problems of export financing directly affect your firm or your industry? Just flush that out a little bit and just give us some ideas of the degree to which the tax system, our American tax system, as a practical matter does, in fact, affect your company or your industry.

Mr. PRATT. Let me give a little background first. I think in the first place, you have to say that we didn't go out of business when the 1986 Tax Act was passed, even though we thought a number of the factors were negative to business. We don't immediately have a huge surge in success or profitability when certain tax advantages are built into the Code, so in the short term, it is true that almost anything that happens to you may not have a dramatic, immediate effect.

But let me give you a few examples. In the long term, business decisions are, in some respects, fairly simple. We consider various courses of action. We compute the result on the profits of our company as we look into the future, and based on what looks to be a desirable mathematical result, we make a decision. Other factors go into it, but the numbers really are a key part of the decision.

To give you an extreme example, the country of Ireland and Puerto Rico have revolutionized business and growth of businesses in their country through tax policy. There are plenty of examples that exist that a dynamic tax policy can turn things around.

I think most people feel that a great deal of the successful, highly-risky ventures into drilling for oil, for example, are strongly impacted by tax policy. There are examples all over the place of that, where tax policy can have a clearly evident affect on economic activity.

There are those who argue—and that was the basis of the 1986 Tax Act—that tax policy shouldn't be used for this, that it ought to be used to collect taxes and not to do other things. I think, and I argued at the time, that that is unrealistic and ignores the whole trail of history.

All nations in the world use tax policy to try to affect economic activity, and they do that by creating incentives or disincentives for business activity.

Senator BAUCUS. One can also point out that the tax policy has had a positive effect on the housing industry, the real estate industry.

Mr. PRATT. Absolutely. In our industry, for example, we are a worldwide company; we have research operations in a number of countries, and we have them there for a number of reasons. It is to our benefit as a company and to our ability to perform on a world basis to tap the brain power of other nations other than our own, and in order to do that, we have created a worldwide research capability.

So we have decisions we can make as to where we increase our research expenditures. If the tax laws of this nation make it more attractive for us to do research abroad than to do it here, even though that is not a 100-percent swing, if it is a meaningful swing, as we consider, over the years, investment after investment, there will be an inevitable move toward putting more abroad and less here.

It is that sort of thing that happens, and the same thing with manufacturing plants. We have built several plants in Puerto Rico that might have been built in this country. We did that because there was a tax advantage to us, deliberately created by Puerto Rico and supported by this country, to create a needed economic result in Puerto Rico.

So there are countless examples where, for instance, companies like ours will get in and out of businesses based on the economic return, which is partially determined by the incentives that may or may not be given to making capital investments.

Senator BAUCUS. Thank you very much.

Senator Roth.

Senator ROTH. Thank you, Mr. Chairman. Let me start out by saying that, Mr. Pratt, you are one of the few business statesmen, and I use that word carefully. Last year when the tax legislation was before this Congress, I was a little shocked by the fact that many business people seemed to be either for or against a proposal depending upon what impact it had on the bottom line of their company.

Now, I can understand their concern, but looking at it from a national perspective, that was rather shortsighted. I congratulate the fact that you, for having the courage to oppose the legislation, because you didn't think it was in the country's national interest. You maintained your opposition even though you had been advised the tax package would reduce your company's tax liability. I think we need more of that kind of industrial statesmanship.

Mr. PRATT. Thank you, sir.

Senator ROTH. I would also like to reinforce what you had to say about research and development, patents and trademarks, capital formation, and I would add savings, as being critical factors in developing what I call a favorable environment for growth in this new world marketplace.

R&D has never been more important than it is today. The country that is most innovative, will excel; manufacturing and marketing are no longer the most critical factors.

Mr. PRATT. Senator, I have felt so strongly about that that I have spent a good deal of the last four or five years making speeches and meeting with Congressmen and members of our Administration to build a growing understanding of the critical nature of protection of our intellectual property rights.

That term wasn't even understood two or three years ago, and yet it became one of the major issues for discussion at the Punta del Este meeting and the GATT, and it is on the GATT negotiation agenda, due to the push that a number of us have made in that area.

I believe that, in this new economic situation, the United States finds itself in different circumstances from what we had for the last 40 years after World War II where, at the beginning, we dominated everything.

In many areas of competition, we no longer have a comparative advantage. We have well-trained, highly-motivated labor in many other countries who work probably as effectively as our people, and some people think more so, at a fraction of the wages that we pay.

These people do not work in a plant with no equipment; they have the latest equipment in many of these developing nations, with highly-motivated, low-paid employees. There are lots of industries in which, under those circumstances, we are going to find it very difficult to compete. That is the way it is supposed to be. Different nations have different comparative advantages.

What, then, is our comparative advantage? It has seemed to me very clear that the most critical comparative advantage this nation has is our innovation, our creativity, the money we spend on research, our history for innovation, and that the future of our economic strength will have to come from that field.

So yes, I think it is more critical than it has ever been and is, indeed, the most critical single factor we have to work with.

Senator ROTH. One of my principal initiatives in the recent Trade Bill was to provide language in the area of intellectual property rights. I can think of nothing more important in the next GATT round than pushing actively and succeeded in the area of worldwide patents and trademarks.

Mr. PRATT. If you believe what I just said about the importance of this to us, you can only come to that conclusion. That is why I am particularly concerned about what happened in the Canadian discussions.

Senator ROTH. One of my concerns, and I know it is yours, too, is what we did last year in the area of the tax treatment of income earned from the financing of exports.

Do you have any figures that would dramatize to what extent you think the changes in the tax law hurts our efforts to reduce the trade deficit? I have a bill, as you know, I introduced last week, S. 1747, to try to make some modifications to what I think were the ill-conceived changes of last year.

While I have no official revenue estimates yet, let us assume than an amendment is going to cost something like $50 million annually in tax revenue if we make these exceptions that we proposed in the bill.

How can we justify that kind of tax expenditure when we have, as you know, a very serious deficit which you rightfully believe has to be reduced? Can the static revenue analysis methodology being used by Congress accurately reflect the spillover benefits to our economy in providing favorable tax treatment to U.S. banks operating overseas providing financing for our U.S. exporters?

Mr. PRATT. I think there is some question about that, how or whether they can adequately reflect it. I know we think, on many issues of tax policy, they have not adequately measured long-term impact of things done upfront. We would certainly want to try to help you with that and to build, as best we can, our estimates.

I quoted one or two figures. For every $1 billion of increased exports, we create up to 25,000 jobs in the United States, and the economic impact of that is tremendous, as you can well expect and well understand.

It is true that you here in the government have the same problem we have in industry. When things are difficult in business or even when they are not difficult, there is always the pressure of spending a minimum amount in order to create the maximum profit.

But you need to spend that right amount in order to invest in the future of your business and in order to create opportunity for sales and for growth. We would think that certainly this particular example is one that, while we can argue for keeping government expenditures to a minimum, we think this is the kind of an expansion that ought to pay off.

We believe it does. There, obviously, are some expenditures of government funds or reductions of taxation which are productive and do pay off more than their cost, and we would believe that is true in this case. We will do the best we can to help you to develop supporting analysis in that regard. We are convinced that it is the case, and in any event, it is certainly the kind of thing that all of our competitors are doing.

It is another negative in the competitive game if you reduce to any extent the availability of financing, which is one of the strong factors. As more products get similar and as the world develops, that tends to happen. We have competitive products in every field.

Many, many times who gets the business is determined by who makes the best financial proposal.

So these are important factors in addressing what we all agree is one of the critical issues we have: an unsustainable export balance problem in this country.

Senator ROTH. Mr. Pratt, do you think it would be beneficial to U.S. trade if foreign banks were permitted to finance exports of U.S.-made goods, whether or not the manufacturer is related to the bank?

Mr. PRATT. Well, yes. I don't think whether the manufacturer is related or not really has anything to do with it. We need to create as much available financing as we can to help stimulate our exports. I think we have foreign-located banks which are owned by American organizations which have funds that can be used for this purpose, and would be certainly stimulated to do so if they didn't have to pay a tax penalty in order to carry out that function.

It seems like it is a self-defeating part of the law at a time when everybody agrees we need to do anything reasonable to help stimulate exports.

Senator ROTH. In many ways, aren't the ones we are hurting the most medium and small business who depend upon that financing.

Mr. PRATT. Absolutely. That is true. That is why it really doesn't make any sense for just a related company, to be able to have this advantage, because it is, in many cases, other companies who could benefit from it most, as you point out.

Senator ROTH. It is my understanding that last year, there were at least four or five U.S. manufacturers operating overseas banks which could have provided related-party and unrelated-party export financing.

Several of these banks have since been sold. Pfizer Bank was not one of them. Given the changes made in the 1986 Tax Bill, will your offshore bank provide export financing to U.S. exporters? What activities will that bank engage in in lieu of export financing?

Mr. PRATT. It is very difficult. As a matter of fact, it is quite possible that with the constraints and the disadvantages put on the bank by the change in the tax law that it might not even survive.

As you say, other banks have already been sold and we might be forced to do the same thing, as well, and of course, we can do that, but it would be too bad, because here is a resource that should be useful in addressing one of the main problems that we are sitting here talking about.

It would be another example, going back to an earlier discussion, of what can happen through tax policy. There is no question about the fact that if the tax law permits us to do this, I can assure you, a sizable amount of the funds of that bank will inevitably find their way into that kind of business. That would profit us and also profit the companies whose exports are thus stimulated.

Senator ROTH. As we look at what was done last year in the Tax Code, an exception was made, purportedly to help the financing of some related party exports. However, because of the unrelated party limitation, plus the fact that favorable treatment would be permitted for only related party transactions and only if it was the financing of non-inventory items, in fact, the exception is almost a nullity; isn't that correct?

Mr. PRATT. It astounds me. It is beyond me how that could have developed, and I guess these are the kind of things that come out when you have a huge revolution in tax policy done under great pressure. This obviously, I assume, has to be some kind of mistake in the framing of the bill, because it accomplishes nothing.

I didn't even realize that until recently, and it is kind of mind-boggling. I think you are absolutely right. The way it is now written, it is no exception; it does not meaningfully permit the banks to use those funds to finance any exports.

Senator ROTH. I have one more question, Mr. Chairman.

Going back to the impact tax policy has on conduct of taxpayers, would you agree that tax policy can also promote savings on the part of the taxpayer, as well as influence action from the standpoint of investment in housing and so forth?

Mr. PRATT. I certainly do. I think sometimes you wonder, when you hear the kind of challenges that are made about the ability of tax policies to affect things, whether those people don't prepare their own tax returns, because all of us who deal with the Tax Code of the United States find ourselves doing things to take advantage of the way the tax law is written.

All you have to look at is what happens in Wall Street when the law changes and a whole new type of investment starts to blossom because people immediately see the impact of that tax effect. So the evidence is there very clearly, I think, for everybody to see, Senator.

Senator ROTH. I am mystified by the number of people that would come before this Committee and subcommittee and argue that tax policy makes no difference on the savings and yet at the same time, they will come and argue in every other area that it would help promote conservation of houses and so forth and it seems to me purely contradictory.

Mr. PRATT. On that point, certainly I would never say that we run our whole business for tax reasons; of course not. We try to build plants and we try to get into products that serve a market that we see. Tax doesn't dominate everything we do. I certainly don't want to give that impression.

But tax has become such a major factor in everybody's P&L statement, that it has to have a big impact, as do labor rates and the other things, and tax is one of the largest single items of expense that they have, and so of course, it has to have a major effect on what happens.

Senator ROTH. I want to thank you, Mr. Pratt, for taking the time to be here today. Your testimony has been very helpful.

Mr. PRATT. Thank you, sir.

Senator BAUCUS. Thank you very much, Senator Roth.

On the last point, Mr. Pratt, why are personal savings rates in this country falling as a percent of GNP? Some argue that the Tax Code does not have much effect; that is, whether people save or not is cultural; it is attitudinal; Americans just don't save. They like to consume. We are on this big party after the Second World War. We are having a good time. We like to spend and consume; more deferred self-gratification, the Tax Code doesn't affect it.

Mr. PRATT. I would only point out one example of that. When the Congress passed the 401-K regulation to try to stimulate saving, almost everybody in our company went into that program and started saving money. It really achieved the objective, and I think there are a lot of examples like that.

Again, it is not the only thing. Certainly, the relative standard of living; the state of the economy; how much funds a person has available for discretionary use, all these have an effect on how much you save, and the cultural background of the nation certainly is important in it, too.

I have always thought, and I have seen analyses on this, that it is really not fair to compare just saving in this country with Japan and other nations when, indeed, putting funds into a home and other things which are assets of a different type tend to be larger in this country and need to be included in the equation.

Senator ROTH. You think more savings would help improve America's competitive position?

Mr. PRATT. Excuse me?

Senator BAUCUS. More personal savings, more national savings would help improve America's competitive position. Do you agree with that statement?

Mr. PRATT. The need for capital is critical to a nation which wants to compete competitively, that wants to compete in the international scene, and capital comes from savings. So to that extent, yes, I have to agree with it, certainly.

Senator BAUCUS. What do you think about this merger mania? There are a couple of points of view on this. Some suggest, in fact, an example, Mr. Tom Peters, who was unable to appear because of a snowstorm in Vermont, has written "Two and a Half Cheers for T. Boone Pickens".

Mr. PRATT. I am glad he is snowed in. [Laughter.]

Senator BAUCUS. You may wish he were not snowed in, because he will be here in two weeks, and you won't be here to present the contrary view.

Mr. PRATT. Yes, I would like to comment on that.

Senator BAUCUS. His point, obviously, is that T. Boone Pickens and the other raiders, Drexel, Burnham, the Millikins of the world, have forced American big corporations to be leaner and tougher and meaner; they are too bloated; it gets rid of all the fat and so on. That is basically the argument.

Then, on the other hand, there are those which point out that takeovers force American management to become more and more short-term its orientation; look at the quarterly reports; set a defense mechanism so you are not taken over, and that hurts our competitiveness. What do you think?

Mr. PRATT. It is terribly upsetting to me that you would even ask that question, because to me, the truth is so obvious that it astounds me that some people seem to be taken in by the likes of Boone Pickens.

If you look at what Boone has ever accomplished, or any of the raiders, what they have ever built, what new products they have ever created, what organization they have created, what kind of success they have ever developed in running anything, for them to go around the country making that kind of a statement, I think, is probably as good an example of the big lie as we have anywhere in the world.

The American business community is not against unfriendly takeovers, per se. Many companies have made direct offers to shareholders in an effort to bring together two companies that they thought could make a stronger organization.

It is the abusive takeover that is destructive, that takeover which is made with no thought of creating a stronger company, but by ripping a company asunder and the communities in which it lives and the employees that it has and selling it in order to pay for the cost of buying it, out of which nobody gets anything but the takeover artist. It is hard for me to see how this could have been allowed to go on this long.

I think it is an outrageous derogation of our competitive capability in this country. Unfortunately, those companies who fight it off have to largely destroy their competitive strength in order to do so.

So it is a negative event no matter how it comes out. Good Year is a good example; the kind of things the over-leveraging and other various defensive steps is a situation where the rules obviously need changing. I would only rest on that.

Fortunately, again, I think, Senator Roth, I knock on wood, because maybe nobody is safe, but I have no reason to believe that my company, because of its particular financial situation, is particularly vulnerable here, but to me, it is a tremendous negative to the competitiveness of this country, and indeed, many managements are spending their time and their efforts in trying to fend off these pirates rather than, indeed, in building.

As you pointed out, how, indeed, can you work? How can you invest in research? How can you make gambles in going into new products when, if your profit drops down a little bit and your PE goes down, you are a sitting duck for somebody who comes in to "save America from your mediocre management."

I think it is an absolute outrage, and we have got to do something about it fast.

Senator BAUCUS. Thank you.

Mr. PRATT. Is that clear? [Laughter.]

Senator BAUCUS. I have obviously pushed a button.

Mr. PRATT. I am glad you asked the question. [Laughter.]

Senator BAUCUS. Thank you, Senator Danforth?

Senator DANFORTH. Mr. Pratt, good to see you, as always.

Mr. PRATT. And you, sir.

Senator DANFORTH. I have no questions, and I will not make much of a comment lest whatever I say might sound like sour grapes.

It seems to me that if we were considering measures that would reduce our competitiveness in international markets, tax measures that would reduce our competitiveness in international markets, a very good place to start for kind of a handbook of anti-competitive tax policy would be the tax bill that we passed in 1986.

I think that what we did in that bill was to go down the list of everything that we could conceivably do to hurt competitiveness. First of all, we decided that the be all and end all of tax policy was to reduce rates, thereby putting more cash in the hands of the consumers, which, I suppose, is a fine thing to do.

But in order to get the money to reduce those rates, we cashed in virtually everything that we could cash in that had an effect on savings, on capital formation, on plant modernization, on research, and on education.

We cashed in capital gains differential, for example; we cashed in the investment tax credit; we made depreciation less generous than it had been. The IRAs, which Senator Roth was the great champion of, were cashed in. The R&D tax credit was sunsetted and reduced.

And on education, it was as though we had consulted a computer for everything that we had done to encourage education and then systematically reduced or got rid of those things: interest on student loans, no longer deductible; scholarships and fellowships, taxable, in part; gifts of property to colleges and universities covered by the alternative minimum tax; tax-exempt borrowing by universities, especially the great research private universities, capped.

All of these things we did in order to worship the shrine of low rates, and no politician can criticize low rates. They are fine, but I think that the net effect of that Tax Bill was to significantly weaken our competitive position. I don't know if you want to respond to it, but that is my comment for the day.

Mr. PRATT. I would, Senator. I would just like to say this: That as the chairman mentioned earlier, I have a very important meeting that I had to miss to come down here, and it was worth coming to hear you say that, because you have said exactly what I think about it. I said at the time we were discussing, debating the bill and I testified, and I just couldn't agree more.

I think we have to start again, and I hate to say it, and rethink those issues again.

Senator DANFORTH. Would there be any support for doing that? I mean, my thought is that we have done it and it is very hard to undo it at this point.

Mr. PRATT. I am afraid that is so. But we can start small, I guess. The critical nature of the competitiveness challenge is also one that is strong in everybody's view. It is true that a sizable part of the business community supported that Tax Bill, and there was a lot of debate that led up to that. My own view is that that was so because at the time the bill was better than it had been previously, and I believe they thought they had better support before it got worse.

I thought it was a mistake then. You are right; there are a number of members of the business community who wouldn't agree with my view on that, but there are a lot who would, and I suspect there are going to be more and more as we see the impact of it on competition. Subsequently, I think the atmosphere will allow the process to start and grow in potential to make those changes.

I hope so. I think it is going to be critical.

Senator DANFORTH. The following question is not appropriate to the hearing, but I am wondering if you have any knowledge, sufficient knowledge about the details of the Canada-United States. Free Trade Agreements to have a view on it.

Mr. PRATT. I was asked that before, and I will say quickly again, I think most of us in the business community thought a really fair, balanced agreement between the United States and Canada would be a good thing and a good further move towards free trade in the world, an example for others and all those things.

So if, indeed, we could have eliminated all tariffs between us; had equivalent access to investment opportunities in both countries; equal protection of intellectual property rights and, indeed, made us almost as one country when it comes to trade and economic activities, that would be a wonderful idea. If we could achieve reasonable steps towards that, it would be a good idea.

But if we made an agreement just to make an agreement—and there was a lot of political pressure involved here to have an agreement—and if as a part of that agreement we end up where what we got didn't equal what we gave up, then it is not a good agreement, and I don't know enough about it to know that.

I made the point that I suspect in many respects, it will be that my industry and others, particularly my industry, may be the ones who are going to be less favored. I hope that is not the case, but the early indications I have is that we have a very special and serious problem on protection of intellectual property. The Canadians avoided patents for drugs, which is an outrageous thing for a member of the developed group of nations to do in the world. It is a tremendously bad example for the rest of the world for countries we are trying to lead toward an increase in protection of intellectual property rights.

Just the quick word I have gotten is that we went into that agreement, the discussion, with one objective being to get an equivalent protection of intellectual property in Canada as we give them in this country, and what I have heard so far is one of those disturbing-sounding things that on intellectual property, particularly relative to our industry, the agreement was to agree to work toward a conclusion.

If that is so, then, of course, it has been a loss for us. I hope that is not the case.

Senator DANFORTH. Thank you.

Senator BAUCUS. Mr. Pratt, one final question. We have to get to the next witnesses very quickly. What is your view of the Glass-Stiegel Act? There are many who point out that Japanese capital costs are lower, in part because the banks take such a heavy position in companies in Japan, and therefore, the banks are able to hang in there for the longer term and that means that even though there is much heavier debt/equity ratios, that the cost of that debt to the company is less.

I am curious whether you think that it is time for the United States to rethink the Glass-Stiegel Act and perhaps figure out ways to amend it, change it, repeal it as one way to help reduce capital costs in this country.

Mr. PRATT. Now it seems to me you are getting into that area you started off your comments with Senator, about differing cultures and ways of doing business in different countries. It has long been understood that the Japanese have a very different approach toward capitalizing their companies, which, indeed, allows them to have to pay less concern to profitability. They are seeing a good example up in the automobile industry now where they have hung in there with pricing far lower than they should have versus the change in the value of the yen, and a lot of major Japanese automobile companies are losing money.

Senator BAUCUS. And also keeping the same R&D expenditure.

Mr. PRATT. Exactly, and so yes, they do have advantages there. In a sense, it is another kind of unequal playing field, not level playing field, but more of the kind that you talked about, one that is hard to cope with because we are talking about different cultures in the different countries.

I think, to the extent that things like that are clearly determined to be and have become a significant factor, we have to consider them. If we can't change them, we are going to have to do something to adjust to an advantage like that if we determine it is really meaningful.

I am not familiar enough with the details of it to know whether that is a significant enough one that we would have to change our own approach to financial management and financial institutions or not, but it certainly justifies a good look by your committee.

I would, on the Glass-Stiegel Act, say one thing. I do happen to be on the Board of Chase Bank, and the commercial banks in this country, of course, have a problem of their own in that everybody is getting into banks, even Pfizer, in a special way, and yet the banks are still limited in many respects into the things they can get into.

I think the banks have had a very rational claim there that when you take one side of regulation away and leave the other side in, you may well be putting our commercial banks in a largely untenable position, and we certainly don't want to do that.

I think the whole impact of the Glass-Stiegel Act is one that definitely justifies a serious look.

Senator BAUCUS. Thank you very much. Unless you have more questions, Senator Danforth, Mr. Pratt, thank you very, very much. I appreciate your taking the time again. Thank you.

Our next witness I mentioned today, Tom Peters, as I mentioned, is snowed in, but he will be able to be here at the next hearing's time.

Our next witnesses are Mr. Bruce Scott, and Dr. Pat Choate. I would like both of them to come up together.

STATEMENT OF BRUCE R. SCOTT, PAUL W. CHERINGTON PROFESSOR OF BUSINESS ADMINISTRATION, HARVARD BUSINESS SCHOOL, COAUTHOR, INDUSTRIAL PLANNING IN FRANCE AND COEDITOR, U.S. COMPETITIVENESS IN THE WORLD ECONOMY, BROOKLINE, MA

Senator BAUCUS. Another witness scheduled today, Tom Peters, unfortunately, as I mentioned earlier, is snowed in. He is unable to come, but he will be here for our hearing in two weeks' time. Dr. Scott, I know you have got an 11:20 plane?

Mr. SCOTT. Yes, sir.

Senator BAUCUS. Is that correct?

Mr. SCOTT. Yes, sir.

Senator BAUCUS. Do you have a car waiting?

Mr. SCOTT. No; public transportation.

Senator BAUCUS. We will get you out there.

Senator DANFORTH. Public transportation.

Senator BAUCUS. Why don't you begin? Then we will follow with Dr. Choate.

Mr. SCOTT. Thank you. I do not have a prepared statement. I just have a few notes by way of introduction. The question of U.S. competitiveness is my area of study at school. Part of the reason I don't have that statement is I am in the process of trying to write a book that says a competitive United States might look like, and I am staying with that.

Let me go back to the definition, because I think that is worth a reminder in view of what you have just been talking about. I think it is important to keep in mind is that the basic indicator of whether you are competitive or not is not the trade balance but real incomes or standard of living over a period of time. That is what the game is about.

The trade balance is important because it indicates that you are borrowing rather than earning your standard of living. In addition you have to ask: Are we making adequate provision for the future? In that context, you have to ask: Are we financing our public and private commitments from current incomes?

Well, the answer is no, we are not financing either from current incomes, current consumption or our public sector commitments that is where the trade balance and the budget deficit come in. But they are not the basic measures of what the game is about: the basic measure is incomes or standard of living.

As to incomes, the standard that we are going to be driven to over a period of time is to aim to raise our incomes along with or at about the same pace as the countries that we think of as major competitors.

I had an exhibit which I hope you have a copy of, and maybe Senator Danforth. I think if you look back at the income per person over the last 35 years, as shown on that exhibit, it is absolutely obvious what is happening. It is also apparent that it is working much the same as the Young Commission tried to point out back in 1985: Other countries' incomes have been rising much more rapidly than ours.

That exhibit is in 1985 dollars. If you put that in 1987 dollars, France, Germany, the Netherlands have gone right past us in terms of absolute incomes. The Japanese are equal to the United States If we are going to solve the trade deficit the way so many of us seem to think, by a further reduction in the value of the dollar, and redraw that graph based on a dollar of 1990 or 1992, you are talking about the major countries with which we compete having incomes that are going to be 20 or 30 percent or more above the American level.

So over a span of about 20 years, we have gone from having, perhaps, a 40 percent advantage to being 20, 30, or maybe 40 percent behind. That is the basic measure of what is going on, and I think the question, for you here, is to say: If that happens, are we going to be another England that says we have to deal with this relative decline by curtailing one after another the international commitments, most of which have a cost and/or by reducing domestic programs? In addition, we should expect that we are going to have growing distributional problems within the country, and asking how we will deal with them.

The other exhibit that I think is important is what is happening to earned income. Earned incomes in this country have been going down since 1973. We now have 14 years of decline in real terms, both before tax and after tax. That is shifting the distribution of income away from people who work to people that own property that are collecting rent or interest. We have got the highest share of the population at work ever, which helps the average. But if I said capability to earn a rising standard of living, it is clear that it has been deteriorating since the mid-sixties.

If I contrast that reality with our perception, there is a big gap. One statement that has had a very significant positive impact was the President's comment earlier in the year, but let me recall for you what he said. He said, in his State of the Union Speech, "It's often said that America is losing her competitive edge, but that won't happen if we act now."

I think the Young Commission which reported to him two years earlier was right on the mark when they said it is perfectly obvious that the U.S. competitive position has been in decline for 20 years. We are a country in competitive decline. It is not that we are going to prevent something if we act now; the question is whether we can recognize what has been going on for the past 20 years.

I would like to raise the question whether something can happen that is like what Rachael Carson did for the concern about toxic substances and the environment when she published that book called "Silent Spring".

That led to a whole new body of regulations, and a new regulatory agency, as the obvious parts; but I really think it also led to a consensus that there was a problem where something needed to be done. You had grass roots organizations; the one I think of, obviously, is the Sierra Club, but all sorts of organizations picked this up and became a constituency that was concerned.

Maybe the other measure of what happened was the school system from kindergarten through graduate school began teaching about the significance of the environment. If I ask where are we on competitiveness, I would say we are still arguing about whether the issue exists. We have a President who would say "it won't happen if we act now." Competitiveness is still not factor in policymaking; this administration has not been able to acknowledge that the problems exists.

Mr. Pratt was talking about that with you a minute ago, Senator. He was saying if you were considering competitiveness, we did the opposite, in many respects, in public policymaking last year. I don't think there is any equivalent in the country to the Sierra Club and the other organizations that became a constituency concerned about it. I would pick up the major business leaders in this, as well. I do not believe they have become an effective constituency for competeveness. I think it is just a very disappointing set of circumstances that there is no equivalent business group effectively raising public consciousness on this issue.

Finally, I think the most obvious part of it is: It is nowhere in our educational system, whether it is kindergarten, grade school, high school, or most universities. You can take a major in economics almost anywhere in the country, and you will never encounter competitiveness as an issue at all. Even in some of our most high-priced universities, including some of those that are way up there in the Northeast, it is not on the agenda anywhere in our school system at this stage.

I make two other comments of a general nature. One, I think we have to recognize we have an implicit industrial policy and that it has been utterly non-competitive. The most subsidized industry in the United States has been housing and real estate. That is number one in the tax code. One positive thing that happened in 1986 was to reduce that tax subsidy, and it was reduced by taking down marginal rates which reduces the value of any kind of a tax subsidy. Another positive element was to end many of the tax shelters, including those in housing.

For me, the big plus in the 1986 Tax Bill is cutting down the favoritism to a sector which doesn't have to compete with anybody abroad. It has been an extreme example of ignoring international competition that the most favored sector would be one that doesn't export and doesn't have to deal with import competition at all.

I think the 1986 Tax Act, I will also say, has a very significant, at least symbolic change in ending the deductibility of interest on the credit card and on consumer installment lending. But you created a loophole which allows us to do it on our "home equity."

As a country, we have to recognize that this is simply a non-competitive way to think. We have to begin to think about the sectors exposed to foreign competition and at least have them on a level playing field with housing, and other sheltered domestic sectors such as retailing.

Let me turn to your question: Can tax policy influence competitiveness? I think the answer is an obvious yes. But it is not a panacea, and I would just take two of the examples that Mr. Pratt gave to illustrate that.

Puerto Rico and Ireland have tried to manage themselves as tax shelters. The number one attraction has been in the one case, to get inside the United States system without having to pay corporate income tax and the other, to be in the European Community without having to pay an income tax. Both of them have tried to have the tax attraction as the cornerstone of their industrial policy.

It has been a gross failure in both cases. It has been used as a substitute for trying to go through and ask: Are my wage policies, educational programs and other policies and institutions competitive?

Both of them have used tax policy to avoid dealing with economic reality, and in both cases, you end up with very high rates of unemployment; unaffordable social programs, and in Ireland, you are now up to pretty close to 20 percent unemployed. Even a total tax holiday is not enough to get people to come to a country where so many other things are so obviously mismanaged.

They have been doing what many of the Third World countries have in terms of borrowing. But it is not a real substitute in any sense for doing other things right, and I think what we need to do is to begin to do some of the things you are talking about over here, on your flip chart. But first, I think it is important to begin to think of ourselves as people that produce as well as consume. Our tax codes essentially subsidize people to consume, it has ignored their role as producers. It has subsidized them to borrow and ignored the saving, even with your Keoughs and all the rest of it. I think part of the reason it has had so little impact is you could go borrow the money at the same time and have a tax subsidy on the interest.

In addition, I think we need to think about the real economy versus the paper economy. Tax policy ought to be at least considering what are the incentives for producers versus consumers, savers versus borrowers, and the real economy versus the paper economy, as well as whatever else you are going to do in the area of trade policy.

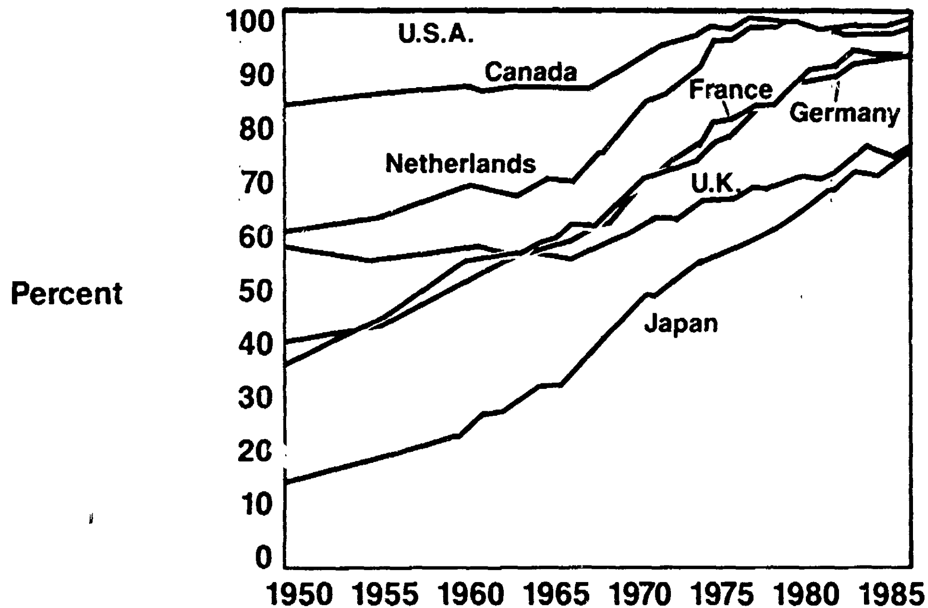
Thank you.

Senator BAUCUS. Thank you, Dr. Scott.

Dr. Choate.

U.S. Competitiveness

Real Gross Domestic Product Per Employed Person, Selected Countries, 1950 - 1985.



Source: Council on Competitiveness Based on (USA=100). Department of Labor, Bureau of Labor Statistics.

STATEMENT OF DR. PAT CHOATE, DIRECTOR, OFFICE OF POLICY ANALYSIS, TRW INC., AND CHAIRMAN, CONGRESSIONAL ECONOMIC LEADERSHIP INSTITUTE, MAYPEARL, TX

Dr. CHOATE. Thank you very much, Mr. Chairman. With your permission, I will submit my formal statement for the record and summarize.

Senator BAUCUS. So ordered.

Dr. CHOATE. The thrust of my testimony this morning is that America is experiencing a very real economic decay, and much like dry rot, that decay is being masked. It is being masked by the good economic statistics that we are seeing now in the short term: employment, a booming stock market, and low levels of inflation.

But when we take a look over a longer period of time, ten or 15 years, what we find is that our industries are losing major positions in global markets. I list 18 major industries in my testimony. This is off of a list, I think, that could include for dozens of additional industries.

Moreover, when one takes a look at these losses in terms of market position, what we find is, it is across the board. It is in manufacturing; it is in services; it is in high tech; it is in agriculture and agri-industry.

If we were able, for example, to take our economy and do an autopsy on it, I think that we would truthfully be able to say that there has been no single cause of this decline, this economic dry rot, but it has really been death by a thousands cuts.

In a very real sense, I think that competitiveness is a code word that suggests that as there is no single or simple cause for this decline, neither is there any simple or single solution; rather, a package of measures are required.

In my mind's eye, there are five sets of measures that are most important, and they run fairly closely, but a little different to the issues on the chart that you have there.

One of those measures is how do we deal with the extraordinary Federal budget deficits? I strongly agree with Senator Danforth and his comments about the tax bill and the lack of regard and concern that was given to competitiveness.

My concern for the longer term is that when the Federal government does begin to address this Federal deficit and make substantial reductions is that we keep in mind the lessons that should have been learned in 1986.

The second major set of issues are antiquated United States trade policies. It is my view that U.S. trade policies are trapped in the time warp of the 1940s and 1950s and simply don't recognize the differences in economic systems in the world.

The third set of measures concern the slow commercialization of our technology. We have a wonderful capacity in this country to create research and technology, and we have fallen behind in our ability to commercialize it.

The fourth package of measure is: How do we deal with the work force that has gone from being the best industrial work force in the world in the fifties and in the sixties and the forties to what I now consider to be a second-rate industrial work force overall, because they are undereducated; they are underskilled; and they are undermotivated.

Then the final measure, and the bulk of this testimony concentrates on this, is the short view of American business. I found it very interesting to note in Saturday's Washington Post a survey that had been released by Opinion Survey, that a majority of the American people say that they are concerned about the short-term views of American business.

The Conference Board's recently released report of corporate executives attitudes indicates that a majority believe the major obstacle they face in managing their business are the relentless pressures that they face for quick results and short-term earnings.

In my mind's eye, I think that there are two different sets of pressures: one for big business and one for small business. Both are real and both are pernicious.

For big business, the principal focal point, the principal set of pressures for quick results and short-term earnings for the short view comes from what is happening in the capital markets. Specifically, I pulled together some numbers that illustrate this point, and I have them in the back of my testimony in charts.

I must be candid with you, I was a bit surprised. Since I last looked at this situation a couple of years ago, the situation has deteriorated.

The first thing that we find is that we have had a major shift in who does the trading on the New York Stock Exchange. In the fifties and sixties, trading was dominated by individuals. What trading in the financial institute is dominated by financial institutions. They do upwards of 90 percent of all of the trades, though they own only 35 percent of the stock.

More importantly, what we increasingly find is that the institutions are engaging in large volume transactions, these 10,000-share blocks or more. This is a massive movement of money. On the second chart, I trace that in 1965. There were an average of nine large-block transactions a day; that is 10,000 shares or more.

By 1980, there were 528 a day. In 1986, there were 2,600 per day, over the past six years, we have had a 500 percent increase. What is happening is a hypermovement of our capital in financial transactions.

As a consequence, the total value of the New York Stock Exchange is now turning over not every six years or so, as it was in the sixties; but now at the rate of every 19 months.

When one goes back and takes a look at ownership, what you find is that of America's 200 largest operations, 50 to 60 percent of their stock was held by institutions. These CEOs and corporations recognize, as Mr. Pratt was suggesting: That there are raiders who that are engaged in three types of transactions. There are the arsonists, who will put a stock into play for the movement or for green mail; there are financial restructurings, some of which have real merit; and then there are the longer-term mergers.

Increasingly, the financial institutions are becoming the arms merchants in these wars, creating high turnover of capital. Those corporations that think and act long term place themselves at risk of having their corporations attacked and their companies taken over.

What this means is that very few companies in this country have either the earnings or the stock prices that will permit them to both meet these short-term demands and at the same time be in a position to invest in new research, modern facilities and improvments in their work force.

For small business, the primary difficulty that they have is finding long-term debt, long-term capital to support their activities. Even with the explosion of venture capital fundings that have occurred over the past ten years, venture capital funds provide only 1 percent of the money for new business; 99 percent comes from savings, families, friends, from collateralizing personal assets.

Equally important, when most of these small businesses find themselves at a point when they need longer term money and they go to a bank, they have to personally collateralize the loan. It is nothing more than an extension of their personal assets.

What we also find is the overall preponderance of the commercial loans that are made to these institutions are due in less than one year. These firms, a vital segment of our economy, cannot think and act long-term if they are having to operate on one-year money or less than one-year money.

What we require are the ways and means to shift tens, if not hundreds of billions, of dollars in the private capital market to these firms. I am suggesting that what we need is something analogous to the secondary mortgage market in housing but for industrial mortgages for those types of loans that can be collateralized by real assets and real property.

So in summation, what I am suggesting is that we require a package of measures. Much of what is needed can be done through tax policy. You take some steps that can relieve pressures for quick results and enable the capital markets to focus more on long-term investment than on short-term financial actions. This can create an environment for the businesses in which they can make investments or capital, technology, and worker training.

Thank you.

[The prepared statement of Dr. Pat Choate for the record follows:]

Statement

of

Pat Choate

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

Thank you for inviting me to share some thoughts with you on the issue of U.S. competitiveness. In fairness to you and my employer, TRW Inc., I emphasize that the views I offer do not necessarily represent any position other than my own.

AMERICA'S ECONOMIC DRY ROT

Almost two decades ago, the French writer Jean-Jacques Servan-Schreiber predicted in The American Challenge that the United States would be so economically advanced by 1980 that it would "stand alone in its futuristic world -- hold a monopoly of power," dominating Western Europe in every basic area where power matters: culture, politics, the military, and economics.

But the American challenge failed to materialize. In the years following publication of Servan-Schreiber book in 1968, it was American industry that lost position in the world marketplace. This decline occurred in industries where U.S. firms were long considered invulnerable: advanced computers, semiconducters, aircraft, machine tools, telecommunications, pharmaceuticals, scientific instruments, industrial chemicals, engines, turbines,plastics, steel, automobiles, synthetics, insurance, engineering services, banking and many others.

America's startling and humbling losses are an insidious form of economic decay. Much like dry rot, they are only partially visible -- masked by inflation, unproductive mergers, profitless growth, and clever financial manipulation. And like dry rot, the economic decay -- evident in lost market share, lagging reinvestment, and waning technological supremacy -- is spreading, undermining the foundations of one industry after another.

Because this economic decline has no single source, simple or quick remedies are impossible. What is required is a package of actions, large and small, applied over a period of many years. In devising these measures, attention to five basic issues is particularly critical: the extraordinary federal budget deficits; antiquated U.S. trade policies; the slow commercialization of American technology; a work force that is undereducated, underskilled, and undermotivated; and the short view of American business.

This morning I will limit my comments to the issue of why business tends to favor the present over the future and suggest some ways that federal policies, particularly those on taxes, can reduce this bias.

A DESTRUCTIVE OBSESSION

Fast results and short-term earnings have become the obsessive goal of too many American companies. The pursuit of these objectives diverts resources from investment in modern plant and equipment, research, technology and training to clever financial manipulations. It sacrifices market share to high quarterly earnings. And it discourages workers from making long-term commitments to companies.

By ceding the future to the present, American firms have greatly reduced their capability to cope with foreign competitors whose actions are shaped by long-term perspectives. It is the short view of American business, more than anything else, that threatens the long-term vitality of our economy.

If business is to take a longer-term focus, it requires an economic environment that permits and encourages long-term action. The creation of such an environment hinges on a reduction in the two principal pressures for short-term performance: the demands of investors for immediate returns, regardless of longer-term consequences; and the inability of small business to secure long-term money.

Short-Term Pressures on Big Business -- Control of America's major corporations has steadily shifted from individual investors to financial institutions -- pension funds, insurance companies, foundations, investment companies, educational endowments, trust funds, and banks. This shift has far-reaching consequences, because individuals and institutions invest in the stock market for sharply different reasons; individuals are primarily investors looking for long-term performance; institutions are pursuing short-term profits. Thus, just when U.S. business needs to be making long-term investments to meet global competition, the new owners -- the institutions -- are pressing for quick results.

Institutions now hold so much equity and are such a powerful presence in stock markets that most corporations are at the mercy of their demands. The raw economic power of institutional investors can be measured in two ways; their stock holdings and their willingness to get rid of stocks that fail to produce quick earnings.

Institutional stock holdings have risen rapidly over the past three decades. By the mid-1980s, institutions held more than 35 percent of all equities listed on the New York Stock Exchange (NYSE), double their share in 1960. By 1990 they are expected to own half. Already, institutions have half to two-thirds of the stock of the nation's 200 largest corporations.

Yet their biggest impact comes not through mere ownership but through the growing pace of their transactions. In 1953, when institutions controlled about 15 percent of the equities listed on the NYSE, their trades constituted a quarter of stock market transactions. Today, institutional trades constitute almost 90 percent of transactions (chart 1).

As a result of such hyperactive trading, the fundamental focus of the stock market has been transformed from long-term investing to short-term speculation. This shift can be gauged by both the rising volume of large-block stock transactions (10,000 shares or more) by institutions, and the quickening pace at which the entire value of stocks listed on the NYSE is traded.

The exchange reports a two decade trend of steady increases of large-block transactions, and they are overwhelmingly by institutions. In 1965 there were, on average, only nine large-block transactions a day, constituting 3 percent of the daily volume of the market (chart 2). By 1980 the average number had risen to 528 per day. Over the past seven years, the number of large block trades increased by 500 percent, soaring to an average of 2,631 per day in 1986, half of the total volume on the NYSE.

Because institutions own such a large share of all stock, and trade that stock so zealously, there has been a sharp increase in the turnover rate of the entire NYSE (the pace at which the total value of stocks listed on the exchange is traded). In 1965, when individual investors dominated market transactions, the turnover rate was roughly 16 percent a year. By 1986, it was 64 percent (chart 3). At the 1965 rate, it would take six years for the entire value of the stock market to turn over, but today it takes less than 19 months.

In the speculative, short-term-oriented equity markets that now exist, only a few American firms, such as General Electric, IBM, General Motors, and Exxon have sufficient profits and assets to make the commitments that long-term global competitiveness requires without sacrificing shorter-term earnings. Most companies are obliged to focus their efforts and resources on results that can bolster the price of their stock. Corporate executives know what happens when their stock is undervalued -- they are likely to face a hostile takeover. Most managers also realize that even if they can fend off an unwanted takeover, as Martin Marietta and Phillips Petroleum did, the company can be seriously harmed in the process, as both of them were.

The hyper-speculation of financial institutions and their relentless demands for short-term results are undermining the performance and imperiling the survival of U.S. companies and the national economy by fostering several harmful phenomena:

- The unproductive "paper entrepreneurship" that Robert Reich describes -- the speculative mergers and takeovers, "greenmail", and inflation of corporate earnings through accounting transactions.

- The increased use of firms' capital for buybacks of their own stock to make it less attractive to raiders.

- Corrosion of the venture capital market. Pension funds and institutions now provide more than a third of all venture capital. Because of their insistence on short-term results, venture capital funds are being transformed from providers of long-term money and technical support to speculators demanding quick results .

- The shift of research and development from long-term efforts that can produce major breakthroughs to short-term "safe" projects that can produce quick results. The National Science Foundation reports that a growing number of businesses are directing their research toward minor refinements of existing technologies, rather than major technological breakthroughs. Yet it is the real breakthroughs such as microelectronics, computers, and xerography that have created entire new industries and significant improvements in older ones, as well as major bursts of productivity and competitiveness.

The preoccupation of corporate executives with the short term is heightened by the way they are compensated. Most companies respond to, and thereby reinforce, the unrelenting pressures for short-term performance by basing pay and promotion decisions primarily on immediate financial results, such as quarterly earnings and sales. Research at the University of Rochester's Graduate School of Management indicates that in any given year, firms whose stock performance ranks in the top 10 percent will increase executive pay by a real 5.5 percent, while firms whose stock performance ranks in the bottom 10 percent will cut executive pay by

4 percent. Not surprisingly, when corporate leaders were asked in a recent survey about their single overriding objective as chief executives, 51 percent said, "creating shareholder value." Only 18 responded that their top priority was to become the market or industry leader.

Clearly, what most companies require are compensation systems that link pay to the long-term performance of the firm. This can be done in many ways such as through ESOPs. Additional options are also required. One that holds some potential is what I term the Pay Incentive Plan.

It would require that federal law on stock options and income tax be altered to allow managers and workers to take part of their pay as stock and part in cash and benefits. The cash and benefits would be taxed as they are now. The stock would not be taxed until it was sold.

The tax on the sale of stock would apply to the entire sale price but would be assessed at a sliding scale -- the longer the stock was held, the lower the tax. This voluntary plan would produce clear incentives for managers and workers alike to take long-term views -- that is, support investment in modern plant, equipment, technology and worker training that might reduce quarterly earnings in the short-term, but would lead to greater competitiveness and higher stock values in the longer-term.

Institutional investors adhere to a short-term trading focus because they are expected to get quick results. Fund managers are judged on the basic of quarterly, even on monthly earnings. A recent survey of 308 of the nation's largest institutional investors found that when selecting stocks, only 4 percent considered the quality of the company's products -- normally a sound gauge of a firm's long-term competitiveness.

When the trend toward greater institutional ownership got underway three decades ago, it was viewed as a stabilizing influence: most observers assumed that institutions would eschew short-term speculation in favor of longer-term investment. That potential still exists. Indeed, the institutions' vast pool of capital does represent a major national asset, but only if their managers take a more patient view of investments and returns.

Capturing this potential will require a change in the economic rules so that long-term investment becomes more attractive to financial institutions. This means, first, that federal regulations should be modified so that managers of financial funds are compensated not solely on the basis of transaction costs or management fees, but also according to some measure of the long-term performance of a fund.

A second step in creating an economic environment that favors long term investment over short-term financial speculation and transactions would be to impose a federal tax on financial institutions' short-term trading profits. Ideally, such a tax would be high on quick profits, but decline sharply, perhaps to zero, over time.

A tax on short-term trading profits would force money managers to concentrate on a firm's long-term prospects -- its capital investment, research and development, worker training, management and global position. As short-term speculation becomes less profitable, participation in speculative corporate raids and greenmail will also become much less attractive.

Not least of all, creating an economic environment that favored long-term investment over short-term speculation would likely to boost the returns of institutional funds. Even though institutional money managers annually collect more than $6 billion in management fees and commissions, they are inept speculators. In the bullish stock market of the past five years, had most workers and their firms invested their pension funds in government or corporate bonds or a stock portfolio based on the S&P's 500, for example, they would have done better than almost three-quarters oftheir money managers and paid fewer commissions in the process.

In sum, if the speculative spirits of money managers can be dampened, then big business can take a longer-term perspective.

Short-Term Pressure on Small Business -- Because most small businesses are privately owned, they are immune to the pressures of the stock market. Because they have difficulty securing long-term debt financing, however, small businesses are forced to operate with a short-term orientation.

Contrary to popular belief, the much-publicized explosion of venture capital has done little to provide such funds. Venture capital and government loan funds combined are the primary source of capitalization for only 1 percent of the nation's small business entrepreneurs.

More than seven of every ten Americans starting up a small business rely on their personal savings and loans from family and friends. When small businesses do rely on banks and commercial lender for monies, most of the loans are personally collateralized and are thus an extension of personal resources.

Today, more than half of small business loans from banks and commercial sources are due in less than one year. Obviously, it is extremely difficult, if not impossible, for a small business to think long-term in the face of such immediate repayment pressure.

What small business needs is a mechanism that can help infuse more long-term, affordable capital. The model for providing these monies is the secondary market for residential mortgages.

Prior to the New Deal, banks and savings organizations were unable to tie up much of their capital in long-term mortgages because there was no secondary market in which they could sell a mortgage should they require liquidity. Before financial institutions could channel significant long-term investment into housing, therefore, mechanisms were needed to overcome this problem. To meet this need, the federal government created secondary market organizations, such as the Federal Home Mortgage Corporation.

These organizations helped create a secondary market in housing mortgages by purchasing individual mortgages from local financial institutions, bundling many of these small mortgages into a large mortgage-backed security, and then selling this new, liquid financial instrument to pension funds, banks and other investors. The local institution which initiates the mortgage gets most of their funds back, money which can then be reinvested, plus a fee to service the mortgage it sold.

As with housing five decades ago, the secondary market for industrial mortgages is limited now. Before major financial institutions can channel major amounts of their funds into long-term small business financing, they require a mechanism that can package many small business loans into a broadly backed, large security that can be traded.

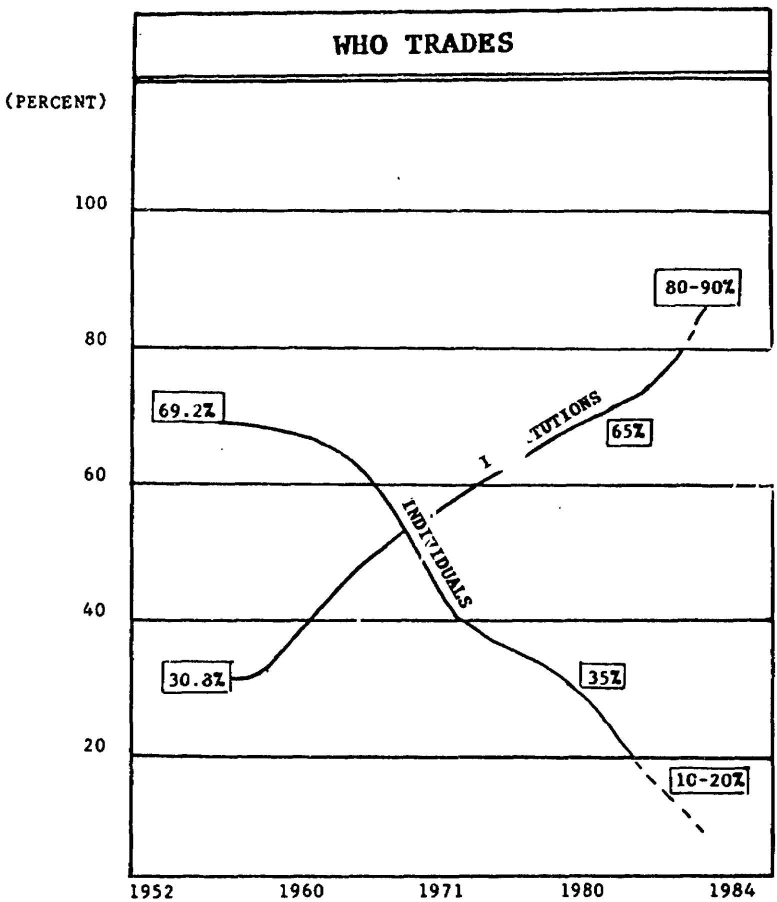
As the federal government created a secondary market mechanism for housing mortgages, it needs to create a similar mechanism for industrial mortgages. These mortgages would be backed by real property and other assets. Enabling local banks and other commercial credit organizations to make standarized long-term loans of five, ten, and even fifteen years to small business would reduce many of the short-term pressures that constrain these firms today.

CONCLUSION

The American economy still has all the ingredients for strong, competitive growth. Yet mounting pressures by financial institutions for quick results and short-term earnings and the inability of small business to secure long term financing are shackling the capacity of business to improve its global competitiveness. As a result, America's remaining economic advantages, and thus our economic future, are quickly slipping away.

Thank you. I look forward to your questions and comments.

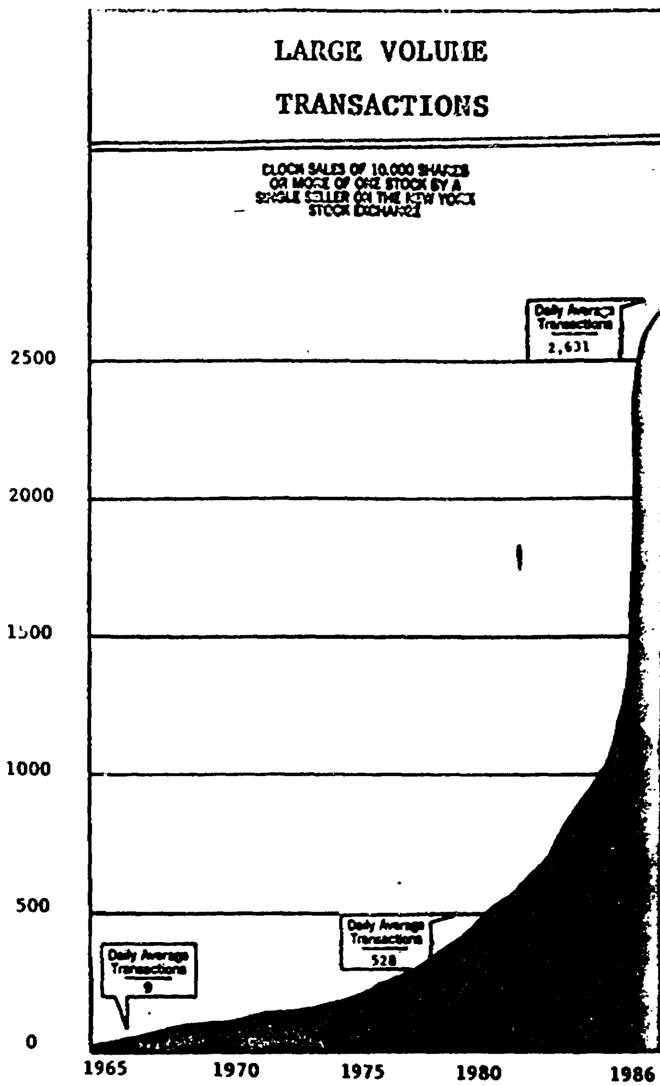
CHART 1



SOURCE: "Fact Book 1987", The New York Stock Exchange, Businessweek August 13, 1984.

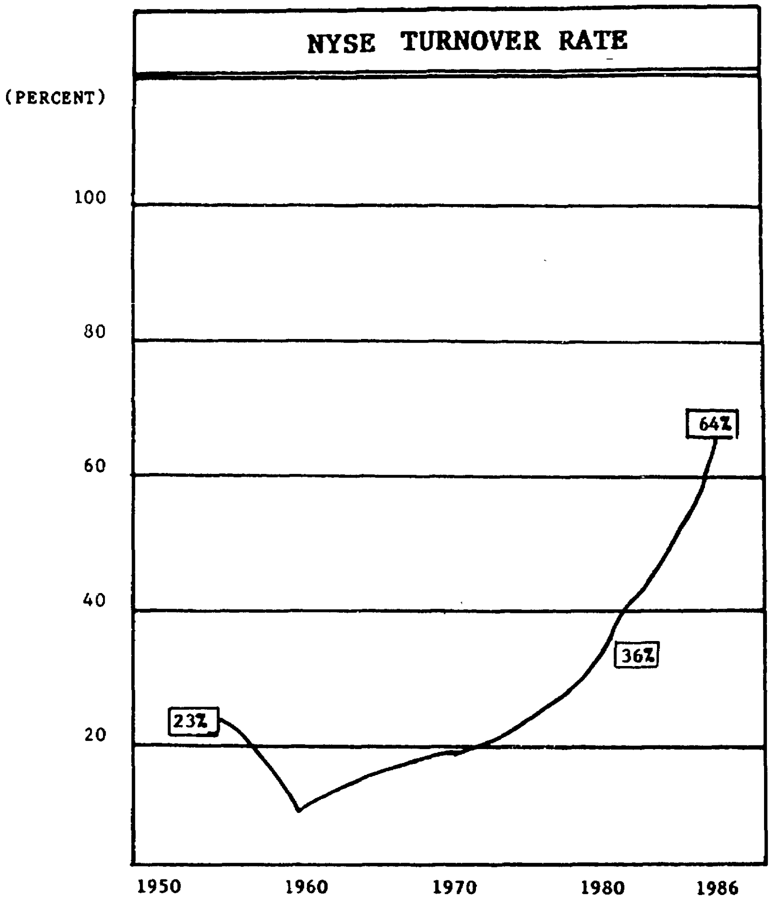
NOTE: 1984 figures are estimates from an August 13, 1984 Businessweek article.

CHART 2



SOURCE: "Fact Book 1987" The New York Stock Exchange

CHART 3



SOURCE: "Fact Book 1987" The New York Stock Exchange

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Senator BAUCUS. Thank you both very much. I would like to focus, if we can, on this long-term, short-term problem and see what kinds of incentives Congress might enact that would make some sense here. It is very complicated, as you well know. For example, today, the best business schools in this country still turn out MBAs who tend to go to Wall Street and want to make a financial killing, because that is where the big bucks are.

In addition, there are many who say, and I agree, that there are too many lawyers in this country, and there are too many financial analysts in this country; there is too much attention to rearranging the balance sheets and there is not enough attention to giving sufficient incentives to the engineers and the products people so that we build a better product rather than a better tax break, for example.

The questions obviously revolve around what we can do in this country to change the incentives so that there is a greater reward for going into products and engineering, design and development, rather than into finance and investment banking or the securities industry or what-not.

Then there is the question of how we can help managers of businesses, particularly publicly-traded companies, to think longer term? What do we do about these quarterly reports or what do we do about institutional funds churning.

There is the whole host of questions here, and we are just beginning to scratch the surface because a lot of this is, as people say, cultural and attitudinal. But still, we can probably address that. We should try to address the culture and the attitudes to help us think in the longer term.

I am just curious about what more specific ideas you have to help encourage our country to change the time frame within which we look at gratification so that it is a little longer term rather than short term.

You say we have a thousand cuts. What are a few of the bandages if you will, that begin to stop some of these cuts so that we start to turn this thing around?

Dr. CHOATE. I guess my first observation is I don't believe that it is cultural. I believe it is a natural reflection of the legal and tax environment that has been created, so I think it is possible to take the issue on straightforward.

I think that there would be three basic sets of actions: One, I think that much of the transactions on the stock markets on the churning are created, first, because many of the principal institutions that engage in that churning pay no taxes. In other words, there is no incentive to think and act long term. There is no time dimension that is placed in there, in a differential.

Senator BAUCUS. So you would have some penalty tax of some kind?

Dr. CHOATE. Yes, I would. What I would do, just as you slow down traffic in a parking lot by putting in a speed bump, I would urge, do urge, that the Congress consider and place a tax on the pension fund and other financial institutions trade for profits made, let's say, within some time period four months, five months or six months, that can go to zero after that. It is only the question of introducing the time element. That is one thing.

The second thing, I think, that needs to be done is to encourage if not require greater linkages between the compensation of institutional fund managers and the performance of the fund.

In November 1985, the SEC made it possible to create pay-for-performance systems. It is my understanding that no more than 5 percent of the funds now use those measures, that is essentially based upon the size of the account that is done; in other words, it is a gross number.

In other words, I think if you set up longer-term pay-for-performance incentives, like where you would give more pay for a three-year period of time or make a portion of that pay, you would change some of the incentives of the fund managers in addition to having a different environment.

The third thing I think that is required is that we perhaps need to find ways to encourage more pay-for-performance systems of managers of corporations and workers altogether. Now, many approaches are offered, and you see some of the models in ESOPs, for example.

I would think that one way to do this might well be to, in effect, modify the tax code to say that individuals could elect, on a voluntary basis, to take part of their compensation as stock; that that stock would not be taxed when it is received but only when it is sold; a very high rate if it is sold immediately, but let that rate decline over time. In other words, it is almost a reverse capital gains tax.

I happen to like capital gains tax. I think they do make a difference in people's thinking. So what I am suggesting there is there are three measures that I think begin to address it very directly, and those can be structured in a manner where they give much greater precedence to the future over the present.

Senator BAUCUS. Dr. Scott? Do you care to respond?

Mr. SCOTT. Yes. I would certainly agree with two of those three. I think it would be very constructive if you consider a penalty tax on short-term gains. I think it would be constructive if it were a big one, but, I mean, just anything as a penalty tax on short-term gains. I think it is absolutely essential that it apply to the institutional investor as well as the individual. They are not paying anything on the trading, and that is part of what is diverting everybody in that area.

Senator BAUCUS. Then what happens is the labor unions say, "You are just going to increase the pension funds costs."

Mr. SCOTT. I think that is trivial, I really do. I think that is trivial. I think the notion of those incomes that you are talking about is also something that people in the labor unions and the rest of the economy ought to be able to understand.

Part of the reason the graduates are drifting to Wall Street is, at least in our case, the starting pay is two and a half times what it is if you make a product or a service. Our graduates are part of a market economy. The pay to go to Wall Street starts now, really, at those rates.

Senator BAUCUS. How do you turn that around?

Mr. SCOTT. You turn it around by market forces there, Mr. Chairman. One of the ways to do it is to cut down some of those incentives for the quick-buck trades. We are graduating a lot of folks who are good at that stuff, and if the starting salaries are in six figures, somebody that takes a real product or an ordinary service simply cannot compete for those salaries. So you have the top of the class migrating to Wall Street.

I think that is the same thing Pat is concerned. It is a gross distortion of where these people are going. I think another thing, I don't think you can do this in a Federal sense, is to say that there ought to be some minimum holding period for voting stock. I think states have to do that. They are the ones that charter corporations, and they can do that the same as they do to be a resident to vote. They could say, you have got to hold the stock three months or six months or whatever else it is before you vote the securities.

I think, unlike Mr. Pratt on this thing, that much is of what is going on in Wall Street with the takeovers has a healthy aspect to it. It offends the people that are there in control right now, and that what one wants to do is not to stop it, but to slow it down. A voting requirement would slow it down. It would make it more difficult, but it would not stop it.

For example, let me just ask you to think about this. I don't believe anybody in the pharmaceutical industry has been bothered by this stuff. Almost nobody in electronics has, either. The parts of our industrial system that are high on the R&D spending tend to have high values in the stock market for their companies, and they have not been bothered.

Boone Pickens, so far, has not gone after, as far as I know, either pharmaceuticals, electronics, any other part of the economy that is high in the R&D. What they have gone after is oil, minerals, forest products and foods. The bulk of it is concentrated in those areas, and they are all low-growth areas where people have had excess cash flow and have been unwilling to turn the cash flow back to their shareholders.

That invites the kind of outside attacks that have come. A lot of it is also being invited by people that pursued strategies of unrelated diversification, built a corporate overhead to manage the unrelated diversification, which reduced the value of the company.

Much of this is being financed by selling off unrelated pieces, getting rid of the corporate overhead and making yourself an emphatically more competitive business, and I don't think you want to stop that. I think you want to try to find a way to reduce some of these things without stopping them.

Senator BAUCUS. Your time is short. I have gone over my time, so let me get to Senator Danforth, who may wish to ask you personally a few questions.

Senator DANFORTH. First, Mr. Chairman, I think that this hearing is a very good one, and I think that the testimony of the witnesses is excellent.

What happened in 1986 in this Committee was not only did we get infatuated with the idea of low rates, but—do you have to leave?

Mr. Scott. I have got two minutes. I have got an 11:20 plane.

Senator BAUCUS. We have got a car out there for you. Paul is a fast driver, so you can get there.

Senator DANFORTH. I will just make a brief statement and you don't have to respond. In fact, you can leave now if you feel like it.

Mr. SCOTT. I will, because I have got a class I have got to teach. That is the problem. Excuse me.

Senator BAUCUS. Thank you very much.

Mr. SCOTT. Thank you.

Senator DANFORTH. I think what happened was not only did we get infatuated with low rates, and who can quarrel with that, but also, I think that the Finance Committee, after several years of passed bills, became turned off at the idea of attempting to micromanage the economy by a lot of little complexities that were put in the Tax Code.

Some of those measures backfired. Some of them were silly. Some of them had counterproductive effects on the economy. We created a situation, for example, where every dentist had to own a barge or a piece of a barge, even though there was a glut in barges.

Why do that? So I think we reacted to that. I think that my concern is that in trying to redress the problems that we have created for competitiveness we again come up with attainable laundry lists of little deals and try to put them in the Internal Revenue Code, and it is just more fussing around, more finetuning.

I don't think we do a very good job of finetuning here. I think that what we do is created inequities and create a sense of unfairness in the Internal Revenue Code when we offer just a whole host of minuscule incentives for people to do little things, and that if we address this problem, which is, obviously, a real problem, what we should do is to do it in a very big way.

We should think boldly; we should think in terms of tax policy, writ large, from the standpoint of international competitiveness. So my thought would be that I don't know, Dr. Choate, Mr. Scott, and others who are interested in that, Senator Baucus, might attempt to put together a philosophy of pro-competitiveness and put together a large package. Should we, for example, start thinking about a value-added tax? We do that on and off. Is that part of it?

Should we reinstate the capital gains differential? Should we have specific savings incentives? We are not going to have a tax bill, I don't think; maybe we will in the reconciliation, a technical correction, something like that, but a big, big tax bill, there is really no stomach for it unless somebody comes forward and says, "Here is a major philosophy of tax policies which pursuant and here are various components that would go into a very big approach."

So that would be my thought. I have to say that, I mean, if all we are going to do is to provide a disincentive for people to turn over investments or pension funds to turn over investments, I would doubt that that would lead to competitiveness.

I would think that it would take a whole spectrum of both spending policies and tax policies. The spending side, obviously, has to be addressed. I mean, what we have done in our budget cuts is to focus on that portion of the budget that deals with the future of the country, the domestic, non-entitlements, discretionary programs in the areas that have been cut.

So that would be my thought, that maybe you, Dr. Choate, could convene a kind of a convention of long-term strategists and come up with a mega-program that would really do something conscious.

Dr. CHOATE. I agree with you, I think, very much. To reverse the decline that we have experienced over the past 20 years, I think it is going to require a commitment at least as great as what we had as a people to clean up the environment, and it will have to be at least that sustained.

Into the question of what would be the substance of that, which it is a major national effort; it reflects a major national commitment, it, I believe, comes back to this five cluster of measures that I had mentioned in the first part of my testimony: the deficit; the technology commercialization, which is one of our competitive constraints; the question of how do we take this work force whose performance is really slacking off and how do we really give them the boost that they need, the educational skills and the motivation, and then, of course, this question of trade policy.

In my mind's eye, this next GATT round is not going to make a great difference in our global trade because of the points that the chairman was mentioning earlier, that we are dealing with cultures that are not anglo-American in nature. We can try to advance anglo-American concepts with Japanese as long as we wish, and it is not going to make a great deal of difference, period.

Then finally, I think that this short-term view is really crippling our businesses. Whether it is real or not, whether they feel it or not, it is distorting the behavior of decision-makers in business because they feel deeply threatened. And those threats are not, I think, illusionary in many cases. They think their companies will be attacked.

The question in each of those five clusters, is how do we view it through a prism of competitiveness, our ability to earn a higher standard of living and not lose our position in the global marketplace, and is, I think, your suggestion.

Within each those clusters, there is dozens of measures. It seems to me that the opportunity that we have is over the next year, year and a half or so, before we got into the next recession, whenever that will be, 1988, 1989, 1990, is to begin to identify some of those measures and then when the concern moves to national attention, to be in a position to implement some of those that can be put in during that time with the type of sweeping reforms as occurred in 1986 with the Tax Act.

Now is a period of, I think, agenda bill, just as you are suggesting.

Senator BAUCUS. I think you have a good point, Jack. The only question that comes to my mind is this: It is clear that Congress doesn't have the stomach to tinker with the Tax Code this year or next, and you will only pass a tax bill if there is some good, solidly convincing cohesive rationale behind it, a new look, so people can see further down the road how passage of this bill or a series of bills is going to lead to enhanced economic growth for most of the country.

The slight danger of that approach, though, is that there is no panacea. Japan didn't became a world power by passing a single major bill. Japan became a world power by working on the margin a step at a time, just working, working, working for a slight little improvement over what it had before, and that is certainly true in its processing technologies, for example, so the answer is probably somewhere in between.

We have got to keep working a step at a time. There is no magic panacea here; at the same time, we must develop a new attitude, a new rationale to some degree, so that we can begin to make those extra efforts to in a cumulative way that are effective and helpful.

It is a real problem. I, frankly, think we have an opportunity here during the Presidential season. It is my strong hope that as we have these hearings to try to come up with some ideas, as we will later on in these hearings, that the Republican and the Democratic Presidential candidates, either generated here or elsewhere, begin to address this basic, fundamental problem.

I think it is an issue of patriotism and pride; is it not really national flag waving and so forth, but also is so that we pay more attention to quality, so "Made in America" is the badge of pride again, so the Japanese, in the extreme, buy American products.

All I am saying is it is complicated, but it is my hope these with these hearings, we are going to start to, begin to dig down a little more deeply into the heart of the matters so we can find solutions to all this.

Dr. Choate, I want to thank you very much.

Dr. CHOATE. Thank you, Mr. Chairman.

Senator BAUCUS. I appreciate your testifying.

Senator BAUCUS. Our next witnesses are Mr. Corey Rosen and Robert Loughhead. Mr. Rosen is the Executive Director of the National Center for Employee Ownership, Oakland, California, and Mr.—is it Loughhead; is that right?

Mr. LOUGHHEAD. Loughhead.

Senator BAUCUS. Mr. Loughhead is the CEO of Weirton Steel, which is a West Virginia company which has pioneered, certainly, and is prized for its aggressive development of his ESOP.

STATEMENT OF ROBERT L. LOUGHHEAD, CONSULTANT, WEIRTON CORP., WEIRTON, WV

Senator BAUCUS. Mr. Loughhead, why don't you proceed?

Mr. LOUGHHEAD. I was to be accompanied by a certain individual whose absence, I suppose, will become more clear to me later. I am the panel, so I guess what you see is what you get.

Senator BAUCUS. Thank you. Proceed.

Mr. LOUGHHEAD. At any rate, I am pleased to speak with you today. I am Robert Loughhead. I was the first President of Weirton Steel Corporation. I served in that capacity as the Corporation's Chairman, President, and Chief Executive Officer until July 27th of this year, when I retired. I presently serve in a consulting capacity and will do so at least until the end of this month.

I would like to make it clear that the views that I express this morning are those of Weirton Steel Corporation and, more particularly, they are the views of Mr. Herb Elish, who is the President, Chairman and Chief Executive Officer of Weirton and who has succeeded me.

To give some background, Weirton Steel Corporation came into existence July 11, 1984 as the nation's largest ESOP. It was created through the purchase of the assets of the Weirton Steel Division of the National Steel Corporation for just under $400 million.

Weirton has been profitable now for 15 consecutive quarters, which is every quarter of its existence. In the year 1984, its first year of existence, it earned some $60 million and earned about $61 million in 1985, followed by some $46 million in 1986. For the first three quarters of this year, its earnings are somewhat in excess of $90 million, and the fourth quarter will also show excellent results.

I could probably tell you about how much that is going to be, but the lawyers and accountants have threatened to kill me if I don't stop doing that, so at least suffice it to say that we will have the best year in the history of the corporation. Sales are about $1.3 billion and shipments are some 2.5 million tons annually.

From a zero base at January 11, 1984, Weirton has built its net worth which, in this case, is employee-owners' equity, to some $200 million, and about $35 million has been distributed to employees, owners in profit sharing and there will be a substantial distribution made for this year, as well.

We concur that restoring American industry's lost competitiveness is of paramount importance to the future of our nation. Perhaps the condition of the steel industry in this country makes a very strong case in that regard.

Obviously, the Weirton story is an exception to the general story of the American steel industry, which, as you know, is a story of devastation to companies that are losing billions of dollars and laying off thousands of employees and, more importantly, yielding ground in the competitive struggle for domestic and global markets.

It might be instructive to examine briefly some of the reasons why Weirton has been able to come to grips with some of those powerful changes battering the steel industry. Although Weirton does face some very difficult problems, it is today in a very excellent position to emerge from the turbulence of today as a success story in a troubled industry.

I should point out that Weirton does not rank by any means among the giants in the steel industry in terms of size. It is currently the nation's seventh largest steel company, but it is worth noting that it is the 65th largest privately owned company in America, and it is the nation's 266th largest industrial corporation.

It is still America's largest wholly employee-owned manufacturing company, and finally, it has the distinction of being the largest industry in the State of West Virginia.

Basically, Weirton is a producer of flat-rolled steel products serving such markets as service centers, appliances, the automotive industry, the pipe and tubing manufactures, construction, containers, packagers and the mining industry, a rather broad range of markets, and our products include hot-rolled, cold-rolled and galvanized sheets and tin plate, tin-free steel and Black Plate.

Weirton currently has about 8,300 employees. Its facilities combine both the contemporary and state-of-the-art. Capital spending to achieve the much-needed modernization and refurbishment is averaging some $60 million per year, and that rate will increase substantially in the near future because there are several major programs on the drawing boards at the present time.

To go back a little bit, earlier in the recession which struck the domestic steel industry at the outset of this decade, employers at Weirton faced what was a very crucial decision. They were presented the opportunity to acquire the company and operate it under an Employee Stock Ownership Plan or face the rather grave consequences of a gradual shutdown by the owner.

Quite courageously, I think, Weirton's management and union leaders worked together negotiating a buy-out of the company. The negotiations took about two years, but ultimately, the employees acquired the company, and on January 11, 1984, assumed 100 percent ownership and began operating Weirton Steel as an independent, freestanding corporation.

Since assuming that ownership, Weirton's employees, again, labor and management, have become a veritable case study, I think, in proving that "working together works". They found more and more ways to reduce costs and have improved productivity and improve quality.

I think, most importantly, they have learned that it is better to look for ways to get along and stop looking for ways to get even, and they have made money while they are doing it.

That latter lesson has really not yet been learned, I don't think, by labor and management in this country. Without the ESOP legislation, however, much of it introduced by retired Senator Long, it is virtually certain that Weirton Steel Corporation would not exist today. And the Weirton community of some 26,000 people who depend on that steel company for their livelihood, either in the whole community would not exist or it would be in the same deplorable state that a lot of steel towns find themselves in today.

The Weirton steel ESOP has made it possible to avoid such things as shattered lives and shattered families and wrecked careers and, most importantly, we have been able to avoid the lost opportunities for young people to go on to higher education.

If you would see the benefits of making it possible for people to help themselves through hard work and dedication and commitment, you have only to go to Weirton West Virginia and look about you.

ESOP was a solution for Weirton because employees were willing to give up something in the short term in exchange for the opportunities of ownership and a stake in the future. It should be pointed out, however, that Weirton Steel had all the elements that are essential for a successful business to start with, such as the history of profitability a good quality reputation, good facilities, loyal customers and excellent skills, both in labor and management.

I think too often, ESOPs have been identified with efforts to save failing plants that, in fact, don't have the capability to stand and to remain viable as a freestanding business. The real success stories of ESOPs, and there are many of them, are those cases where employees have truly become owners and have acquired a forum for their ideas and have become part of the system and have proven that that labor and management can work together and produce successful businesses. I think that is the true legacy and really the original intent of the ESOP legislation.

It seems to us that there are yet some additional ways where ESOP-related legislative actions can contribute to America's battle to improve productivity and quality and competitive positions, and of course, the Baucus amendment is, I think, a creative example of ways in which tax legislation can contribute toward efforts to improve competitiveness in American industry through the expanded use of ESOPs.

An earlier considered amendment to allow an additional deduction for contributions to a 401-K plan if an equivalent amount were to be invested in the stock of a company is an excellent example of a way that employees might give up something in the short term or incentive increases or give up wages in exchange for stock and greater rewards in the future. I think that reducing current costs and adding to future equities certainly are appropriate ways to fight the battle of regaining competitiveness.

There has been a great deal written and some things said here this morning about the huge takeovers and consolidations, which, in the final analysis, create no new products, no new jobs, no improved competitiveness, but they do create huge debt and heavy interest burdens. I think rather than creating a gift to shareholders from taxpayers by virtue of huge interest deductions, it might be appropriate to deny the deductibility of some of that interest unless at least a partial ESOP were included.

The key point here is this could ensure involvement by the principal constituency that has to make the new business work, namely, the people who are doing the jobs. In the whole field of incentive depreciation, it seems, too, that an opportunity for expanding the ESOP could well exist.

With the tax reforms having canceled the investment tax credit and pretty much revising the rules of accelerated depreciation and folding all that into incentive depreciation, it seems that considering denying some part of incentive depreciation, particularly where takeovers are involved, unless at least a partial ESOP were included, might be worthy of consideration.

I don't think there can be any question that to some extent, high employment costs, certainly in the steel industry, have made it more difficult for companies to compete in global markets. I think as part of the effort to make American industry more competitive globally, getting employees to accept something such as stock in lieu of wage increases might offer real unique opportunity.

The concept is, I think, good both in the near term for business and the long term for employees. For example, at Weirton, employees were willing to give up 20 percent of current wages and fringes to obtain an equity position and profit sharing and stock which is now valued at some $51 per share.

I think the tax advantages presented by an ESOP do really not, in any significant way, add to the pressure of the Federal deficit. If you were to look at the Weirton example, for instance, if those 8,300 persons who are now employed, together with the thousands of persons who depend on the company for existence, such as suppliers and merchants of the city and other areas, one can hardly imagine the impact on Federal programs if all those persons were on some sort of welfare rolls or other programs.

So they are creating a product; they are adding value; and the value that they added that to goes into the commercial stream certainly gives rise to a lot of tax being paid downstream from that manufacturing company.

I think in the ESOP, Weirton found a workable solution to its principal problem, and that problem was survival and the opportunity for survival. Their circumstances are improving, in large part, because employee ownership provides an incentive to sell; it provides an incentive to seek excellence; and it provides an incentive to proceed and try to get the rewards of owning a business.

The company is becoming cost competitive, and I think that is really at the heart of what we are talking about in terms of American industry becoming competitive, both domestically and globally. I don't think American industry has any hope of competing globally unless it can first become competitive from a cost standpoint.

I would be happy to entertain any questions you might have.

[The prepared statement of Robert L. Loughhead follows:]

TESTIMONY OF
ROBERT L. LOUGHHEAD

SENATOR BAUCUS AND THE DISTINGUISHED MEMBERS OF YOUR SUBCOMMITTEE, I AM VERY PLEASED TO SPEAK WITH YOU TODAY.

I AM ROBERT L. LOUGHHEAD. I WAS THE FIRST PRESIDENT OF WEIRTON STEEL CORPORATION SERVING IN THE CAPACITY OF CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER FROM 1983 UNTIL JULY 27TH OF THIS YEAR WHEN I RETIRED. I AM PRESENTLY SERVING THE CORPORATION IN A CONSULTING CAPACITY.

THE VIEWS THAT I SHALL EXPRESS THIS MORNING ARE THOSE OF WEIRTON STEEL, AND MORE PARTICULARLY, THEY ARE THE VIEWS OF MR. HERB ELISH, THE NEW CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF WEIRTON STEEL CORPORATION.

WEIRTON STEEL CORPORATION CAME INTO EXISTENCE ON JANUARY 11, 1984, AS THE NATION'S LARGEST ESOP. IT WAS CREATED THROUGH THE PURCHASE OF THE ASSETS OF THE WEIRTON STEEL DIVISION OF NATIONAL STEEL CORPORATION FOR JUST UNDER $400 MILLION.

WEIRTON STEEL CORPORATION HAS BEEN PROFITABLE FOR FIFTEEN CONSECUTIVE QUARTERS - EVERY QUARTER OF ITS EXISTENCE. ITS EARNINGS REACHED THE LEVEL OF $60 MILLION IN THE YEAR 1984 - FOLLOWED BY $61 MILLION IN 1985, AND $46 MILLION IN 1986. EARNINGS FOR THE FIRST THREE QUARTERS OF 1987 WILL EXCEED $90 MILLION, AND THE FINAL QUARTER OF THE YEAR WILL SHOW EXCELLENT RESULTS. THE CORPORATION'S SALES ARE ABOUT $1.3 BILLION, AND SHIPMENTS ARE IN EXCESS OF 2.5 MILLION TONS ANNUALLY. FROM A ZERO BASE AT JANUARY 11, 1984, WEIRTON STEEL CORPORATION HAS BUILT ITS NET WORTH (IN THIS CASE EMPLOYEE-OWNERS' EQUITY) TO SOME $200 MILLION DOLLARS. APPROXIMATELY $35 MILLION HAS BEEN DISTRIBUTED TO THE EMPLOYEE-OWNERS IN PROFIT SHARING, AND A SUBSTANTIAL DISTRIBUTION WILL BE MADE FOR THE CURRENT YEAR.

WE CONCUR THAT RESTORING AMERICAN INDUSTRY'S LOST COMPETITIVENESS IS OF PARAMOUNT IMPORTANCE TO THE FUTURE OF OUR NATION. PERHAPS THE CONDITION OF THE STEEL INDUSTRY OF AMERICA MAKES A VERY STRONG CASE IN THIS REGARD.

OBVIOUSLY WEIRTON STEEL CORPORATION IS AN EXCEPTION TO THE GENERAL STORY OF THE AMERICAN STEEL INDUSTRY - A STORY OF DEVASTATION - OF COMPANIES LOSING BILLIONS OF DOLLARS, LAYING OFF THOUSANDS OF EMPLOYEES, AND YIELDING GROUND IN THE COMPETITIVE STRUGGLE FOR DOMESTIC MARKETS.

IT MAY BE INSTRUCTIVE TO EXAMINE BRIEFLY SOME OF THE REASONS WEIRTON STEEL HAS BEEN ABLE TO COME TO GRIPS WITH THE POWERFUL FORCES OF CHANGE BATTERING THE STEEL INDUSTRY. AND WHY WEIRTON STEEL, EVEN THOUGH IT, TOO, FACES DIFFICULT PROBLEMS, IS IN AN EXCELLENT POSITION TO EMERGE FROM THE TURBULENCE OF TODAY AS A SUCCESS STORY IN A TROUBLED INDUSTRY.

WEIRTON STEEL DOES NOT RANK AMONG THE GIANTS OF THE STEEL INDUSTRY IN TERMS OF SIZE. IT IS CURRENTLY THE NATION'S SEVENTH LARGEST STEEL COMPANY. IT IS WORTH NOTING, HOWEVER, THAT WEIRTON IS THE 65TH LARGEST PRIVATELY-OWNED COMPANY IN AMERICA AND THE NATION'S 266TH LARGEST INDUSTRIAL CORPORATION. IT IS ALSO AMERICA'S LARGEST WHOLLY EMPLOYEE-OWNED MANUFACTURING COMPANY. FINALLY, IT HAS THE DISTINCTION OF BEING THE LARGEST INDUSTRY IN THE STATE OF WEST VIRGINIA.

WEIRTON IS A PRODUCER OF FLAT-ROLLED STEEL PRODUCTS SERVING SUCH MARKETS AS SERVICE CENTERS, APPLIANCES, AUTOMOBILE AND TRUCKS, AGRICULTURE, PIPE AND TUBING, CONSTRUCTION, ELECTRICAL EQUIPMENT, CONTAINER, PACKAGING, AND MINING.

WEIRTON'S PRODUCT LINES INCLUDE HOT ROLLED, COLD ROLLED, AND GALVANIZED SHEETS; AND TIN PLATE, TIN-FREE STEEL, AND BLACK PLATE.

WEIRTON HAS ABOUT 8,300 EMPLOYEES. ITS FACILITIES COMBINE THE CONTEMPORARY AND STATE-OF-THE-ART. CAPITAL SPENDING TO

ACHIEVE MODERNIZATION AND REFURBISHMENT AVERAGES SOME $60 MILLION PER YEAR. THIS WILL INCREASE IN THE NEAR FUTURE.

EARLY IN THE DEEP RECESSION WHICH STRUCK THE DOMESTIC STEEL INDUSTRY AT THE OUTSET OF THIS DECADE, THE EMPLOYEES OF WEIRTON STEEL FACED A CRITICAL DECISION. THEY WERE PRESENTED WITH THE OPPORTUNITY TO ACQUIRE THE COMPANY AND OPERATE IT UNDER AN EMPLOYEE STOCK OWNERSHIP PLAN OR FACE THE GRAVE CONSEQUENCES OF GRADUAL SHUTDOWN BY THE OWNER.

COURAGEOUSLY, WEIRTON'S MANAGEMENT AND UNION LEADERS WORKED TOGETHER ON NEGOTIATING A BUYOUT OF THE COMPANY. THE NEGOTIATIONS REQUIRED ABOUT TWO YEARS. ULTIMATELY, THE EMPLOYEES ACQUIRED THE COMPANY, AND ON JANUARY 11, 1984, ASSUMED 100% OWNERSHIP AND BEGAN OPERATING WEIRTON STEEL AS AN INDEPENDENT FREE-STANDING CORPORATION.

SINCE ASSUMING OWNERSHIP OF THE COMPANY, WEIRTON'S EMPLOYEES (LABOR AND MANAGEMENT) HAVE BECOME A VERITABLE CASE STUDY IN PROVING THAT "WORKING TOGETHER WORKS." THEY HAVE FOUND MORE AND MORE WAYS TO REDUCE COSTS; THEY HAVE IMPROVED PRODUCTIVITY AND QUALITY; THEY HAVE LEARNED THAT IT IS BETTER TO LOOK FOR WAYS TO GET ALONG THAN TO LOOK FOR WAYS TO GET EVEN; AND THEY HAVE MADE MONEY.

WITHOUT THE ESOP LEGISLATION APPROVED BY THE CONGRESS, MUCH OF IT INTRODUCED BY THE RETIRED LOUISIANA SENATOR, RUSSELL B. LONG, IT IS VIRTUALLY CERTAIN THAT WEIRTON STEEL CORPORATION WOULD NOT EXIST TODAY. AND THE WEIRTON COMMUNITY OF 26,000 PEOPLE, WHO DEPEND ON THE STEEL COMPANY FOR THEIR LIVELIHOODS, WOULD EITHER NOT EXIST OR WOULD BE IN A DEPLORABLE ECONOMIC CONDITION LIKE MANY STEEL TOWNS ACROSS AMERICA. THE WEIRTON ESOP HAS MADE IT POSSIBLE TO AVOID SHATTERED LIVES AND FAMILIES, WRECKED CAREERS, AND LOST OPPORTUNITIES FOR YOUNG PEOPLE TO GO ON TO HIGHER EDUCATION.

IF YOU WOULD SEE THE BENEFITS OF MAKING IT POSSIBLE FOR PEOPLE TO HELP THEMSELVES THROUGH HARD WORK, DEDICATION, AND COMMITMENT, YOU HAVE ONLY TO GO TO WEIRTON, WEST VIRGINIA, AND LOOK ABOUT YOU.

ESOP WAS A SOLUTION FOR WEIRTON STEEL BECAUSE EMPLOYEES WERE WILLING TO GIVE UP SOMETHING IN THE SHORT TERM IN EXCHANGE FOR THE OPPORTUNITIES OF OWNERSHIP AND A STAKE IN THE FUTURE.

IT SHOULD BE POINTED OUT THAT WEIRTON STEEL HAD ALL THE ELEMENTS THAT ARE ESSENTIAL FOR A SUCCESSFUL BUSINESS: SUCH AS, A HISTORY OF PROFITABILITY, A QUALITY REPUTATION, GOOD FACILITIES, LOYAL CUSTOMERS, AND EXCELLENT SKILLS IN LABOR AND MANAGEMENT. TOO OFTEN, PERHAPS, ESOPS HAVE BEEN IDENTIFIED WITH EFFORTS TO SAVE FAILING PLANTS THAT DO NOT, IN FACT, HAVE THE POTENTIAL FOR VIABILITY AS FREE-STANDING BUSINESSES. THE REAL SUCCESS STORIES OF ESOPS (AND THERE ARE MANY) ARE THOSE CASES WHERE EMPLOYEES HAVE TRULY BECOME OWNERS; HAVE ACQUIRED A FORUM FOR THEIR IDEAS; HAVE BECOME PART OF THE SYSTEM; HAVE PROVEN THAT LABOR AND MANAGEMENT CAN WORK TOGETHER AND PRODUCE SUCCESSFUL BUSINESSES. THIS IS THE TRUE LEGACY, AND INDEED THE ORIGINAL INTENT, OF THE ESOP LEGISLATION.

THERE ARE YET ADDITIONAL WAYS, IT SEEMS TO US, WHERE ESOP-RELATED LEGISLATIVE ACTIONS CAN CONTRIBUTE TO AMERICAN INDUSTRY'S BATTLE TO IMPROVE PRODUCTIVITY, QUALITY, AND COMPETITIVE POSITION.

THE BAUCUS AMENDMENT IS A CREATIVE EXAMPLE OF WAYS IN WHICH TAX LEGISLATION CAN CONTRIBUTE TOWARD THE EFFORTS TO IMPROVE COMPETITIVENESS OF AMERICAN INDUSTRY THROUGH THE EXPANDED USE OF ESOPS.

THE EARLIER PROPOSED AMENDMENT TO ALLOW A DEDUCTION FOR ADDITIONAL CONTRIBUTIONS TO A 401-K PLAN IF AN EQUIVALENT AMOUNT WERE TO BE INVESTED IN STOCK OF THE COMPANY IS AN EXCELLENT

EXAMPLE OF A WAY FOR EMPLOYEES TO GIVE UP SHORT-TERM WAGE OR INCENTIVE INCREASES IN EXCHANGE FOR STOCK AND GREATER REWARDS IN THE FUTURE. REDUCING CURRENT COSTS AND ADDING TO FUTURE EQUITY CERTAINLY ARE APPROPRIATE WAYS TO FIGHT THE BATTLE OF REGAINING COMPETITIVENESS.

MUCH HAS BEEN WRITTEN ABOUT THE HUGE TAKEOVERS AND CONSOLIDATIONS WHICH CREATE NO NEW PRODUCTS, NO NEW JOBS, NO NEW MARKETS, AND NO IMPROVED COMPETITIVENESS, BUT RATHER CREATE HUGE DEBT AND HEAVY INTEREST BURDENS. RATHER THAN CREATING A GIFT TO SHAREHOLDERS FROM TAXPAYERS BY VIRTUE OF HUGE INTEREST DEDUCTIONS, IT MIGHT WELL BE APPROPRIATE TO DENY DEDUCTIBILITY OF SUCH INTEREST FOR TAX PURPOSES UNLESS AT LEAST A PARTIAL ESOP WERE INCLUDED. THIS COULD ENSURE INVOLVEMENT BY THE PRINCIPAL CONSTITUENCY THAT MUST MAKE THE BUSINESS WORK - THE PEOPLE DOING THE JOBS.

IN THE ENTIRE FIELD OF INCENTIVE DEPRECIATION, IT SEEMS AN OPPORTUNITY FOR EXPANDING THE ESOP CONCEPT EXISTS. WITH TAX REFORMS HAVING CANCELLED THE INVESTMENT TAX CREDIT AND REVERSED THE RULES OF ACCELERATED DEPRECIATION, FOLDING IT ALL INTO INCENTIVE DEPRECIATION, DENYING SOME PART OF INCENTIVE DEPRECIATION, PARTICULARLY WHERE TAKEOVERS ARE INVOLVED, UNLESS AT LEAST A PARTIAL ESOP WERE INCLUDED, MIGHT BE WORTHY OF CONSIDERATION.

IT IS TRUE, TO AN EXTENT, THAT HIGH EMPLOYMENT COSTS (CERTAINLY IN THE STEEL INDUSTRY) HAVE MADE IT MORE DIFFICULT TO COMPETE IN GLOBAL MARKETS. AS PART OF THE EFFORT TO MAKE AMERICAN INDUSTRY MORE COST COMPETITIVE GLOBALLY, GETTING EMPLOYEES TO ACCEPT STOCK IN LIEU OF PAY RAISES MAY OFFER A UNIQUE OPPORTUNITY - BOTH IN THE NEAR TERM FOR BUSINESS AND IN THE LONG TERM FOR EMPLOYEES. EMPLOYEES AT WEIRTON WERE WILLING TO GIVE UP 20% OF CURRENT WAGES AND FRINGES TO OBTAIN AN EQUITY POSITION - PROFIT SHARING AND STOCK NOW VALUED AT $51 PER SHARE.

THE TAX ADVANTAGES PRESENTED BY AN ESOP, IN OUR VIEW, DO NOT ADD PRESSURE TO THE FEDERAL DEFICIT. WERE THE 8,300 EMPLOYEES OF WEIRTON STEEL ADDED TO THE ROLLS OF THE UNEMPLOYED, TOGETHER WITH THE THOUSANDS OF OTHER PEOPLE WHICH DEPEND ON THE COMPANY FOR SUSTENANCE, SUCH AS SUPPLIERS AND MERCHANTS OF THE CITY AND OTHER AREAS AS WELL, ONE CAN HARDLY IMAGINE THE IMPACT ON FEDERAL PROGRAMS TO PROVIDE FOR THEM AND THEIR FAMILIES.

IN THE ESOP, WEIRTON FOUND A WORKABLE SOLUTION TO ITS PRINCIPAL PROBLEM - THAT OF THE OPPORTUNITY FOR SURVIVAL. THE COMPANY'S CIRCUMSTANCES ARE IMPROVING - IN LARGE PART BECAUSE EMPLOYEE OWNERSHIP PROVIDES AN INCENTIVE TO EXCEL, TO SEEK EXCELLENCE, AND TO WIN THE REWARDS OF OWNING THE BUSINESS.

WEIRTON STEEL IS BECOMING COST COMPETITIVE, AND THAT IN ITSELF IS AN IMPORTANT CONTRIBUTION TO AMERICA'S DRIVE TO BE COMPETITIVE IN THE INDUSTRIAL ARENA.

Senator BAUCUS. Thank you, Mr. Loughhead.

I want to tell you of a personal experience I have had, just two of them. One of them is whenever I go to the ESOP convention, I am just very impressed with the energy in the room. Those who are associated with ESOPs, I think, are more innovative, have more energy than a lot of other folks. You can just feel it when you walk into the room. I think that is constructive.

Mr. LOUGHHEAD. That is because they had to be, because that was the essence of what it was all about. When Weirton was faced with that decision of perhaps no jobs and no community in February 1982, all they had was people and their ideas and their dreams and their hopes.

Such things and money and machinery and all that came later. They started out with just dedication of people, and I think that has survived.

Senator BAUCUS. That ties into my second experience. I do something I picked up from Senator Graham. When he was Governor of Florida, and he still does this, he takes out about one day a month and just works a different job.

I began doing that about nine or ten months ago. A few weekends ago I was home, in my state. I worked at an aluminum smelter half a day as a general laborer doing odd jobs and the other half on the pot lines. I mention this because this is a smelter that has converted to an ESOP about two years ago, and it has become profitable now for the first time in a long time. Of course, the aluminum prices are up a little bit.

But second, you talk to the employees and ask them how they like their jobs compared with years earlier; you are stunned with how much they like their jobs now compared with earlier years. That is, they say, "Now management listens to us. We have got an idea how to do something a little bit better, they listen to us, and it works; big change in attitude."

Based on all I have heard and seen about ESOPs, I very firmly believe that they have a big role helping to encourage productivity.

Mr. LOUGHHEAD. I sometimes get accused of being almost evangelistic about it, but I think the point that you make about the attitudes that you observed on the part of the persons who now own a part of the company is the key, and the reason for that is not so much that they have a certificate that represents part of the ownership of the company; it is because as a result of that, they have had to find ways to become involved and ways for their ideas to be used, and management has had to respond and implement those suggestions.

I think that one of the major problems in American industry is at the end of the day, after all the strategic planning has been done and all of the studies have been made, I think that in American industry, perhaps the one thing that we forgot is people. There is a tremendous storehouse of knowledge out there in the minds of all the people who have been doing these jobs for all these years, and it hasn't been used for the simple reason that they have never been asked. If they have been asked, they probably haven't been listened to.

That is really the essence, I think, of making the ESOP contribution work.

Senator BAUCUS. If it has worked so well for Weirton, why haven't other firms organized along the same lines?

Mr. LOUGHHEAD. They have. There are a number of ESOPs and many successful ones. I think one of the reasons it hasn't been used as widely is there were some early abuses. The ESOP legislation originally intended for it to be used in a way for persons to become true owners in a par and equity position.

It was used, in some cases, by entrenched managements and investors in order to enhance the liquidity of their stock and it somehow gained perhaps a bad reputation in the early stages, but it has been used.

In the notable failures, such as Raft Packing and Hyatt-Clark, I think the reason for those failures is simple: There was never a commitment between labor and management to find ways to get along. The individuals were more concerned about what was in it for them.

I think you will see it being used more and more.

Senator BAUCUS. I would like you to comment, if you could, too, on just the changing nature of American manufacturing markets in that, at least as many commentators say, that the companies today are going to have to down size or pay more attention to specialty markets.

Do you agree with that analysis or not?

Mr. LOUGHHEAD. I agree to this extent: I think that is going to happen in a lot of the basic manufacturing industries. I think it is happening in the steel industry, and I think it is good. I think you are going to see the steel industry, perhaps in the next several years, looking more like it looked at the turn of the century before a lot of the large consolidations took place.

You may see a lot of large facilities in and out, part of a big corporation, become freestanding corporations, not necessarily ESOPs, but perhaps, and I think you are going to see the industry smaller and more fragmented and more specialized.

Senator BAUCUS. What is driving that?

Mr. LOUGHHEAD. I think what is driving it is that persons in Pittsburgh or persons in Birmingham can't speak well to the interests of somebody in Chicago or California. I think that is what drove the elimination of patterned collective bargaining. I think it gets down to the basics of persons in a particular location knowing what is best for them and doing what they can do best. I think that may drive that even more in the future.

Senator BAUCUS. I suppose that happens; that driving force is operative in most industries, not just steel.

Mr. LOUGHHEAD. I think so. I think so.

My associate is present.

Senator BAUCUS. Before we turn to your associate, do you have any other general ideas about how to make America more competitive? You sat patiently listening to other witnesses and listening to the various Senators. I am curious whether anyone said anything that kind of got under your skin that you would like to comment on or whether you have any other ideas.

Mr. LOUGHHEAD. There was one thing that wasn't said that got under my skin, and it is true in a lot of the large, basic manufacturing companies and that is that neither labor nor management wants to step up to the microphone and admit that they have done a very poor job at the bargaining table over the last three decades, and they have. Because they have created obligations for which they cannot now pay. They are playing fast and loose with pension funds now because funds aren't there to pay obligations that were promised at the bargaining table, and that is being dealt with to some extent.

But we are never going to become competitive globally unless we do something about what has happened to employment costs in at least a few of our basic industries which put them so far out of line with other industries in this country and other countries, as well. That is seldom said before the microphone.

Senator BAUCUS. Why did representatives of management and organized labor reach those agreements, then, at the time?

Mr. LOUGHHEAD. Two reasons. In both the auto industry and the steel industry, and in the machinery and equipment industry, in those years, going back 15 or 20 years, the threat of a strike was so, so great and the loss of markets to then encroaching foreign imports was so great that I think they were really forced; and, of course, the government became a third party at the bargaining table sometimes and a third party in setting prices.

I think all those things came into play, and management agreed to things it shouldn't have agreed to, hoping that they would find a way to pay for it in the future and they simply didn't, because there wasn't a way to pay for it.

Senator BAUCUS. Thank you very much, Mr. Loughhead.

Mr. LOUGHHEAD. Loughhead, as if I were an attorney.

Senator BAUCUS. I am sorry. I am very sorry. Could you please stay? Do you have the time for a couple of minutes?

Mr. LOUGHHEAD. Yes.

Senator BAUCUS. We may have more questions we want to ask.

The next witness is Mr. Corey Rosen. Corey is with the Employee Stock Ownership Association; is that correct?

STATEMENT OF COREY ROSEN, EXECUTIVE DIRECTOR, NATIONAL CENTER FOR EMPLOYEE OWNERSHIP, OAKLAND, CA

Senator BAUCUS. Okay. Corey, why don't you go ahead.

Mr. ROSEN. Thank you. I apologize for my last-minute arrival. I spent the past half an hour on Constitution Avenue, so I have had some time for further thought.

It is a pleasure to be asked to address you this morning. I am Executive Director of the National Center for Employee Ownership in Oakland, California. Established in 1981, the Center is a private, non-profit membership, research and information organization. We are not a lobbying organization and draw all of our support from members, workshops and the like.

As you know, traditionally, the Tax Code has been used to promote economic competitiveness by providing incentives for capital investments in research and development. As you also know, there is considerable controversy about whether these incentives have the desired effect.

I am not qualified to comment on that, but our organization has done extensive research on a very different approach to competitiveness, one that the Tax Code also encourages and one that seems to be working: Employee ownership.

America is a country rich in capital, rich in capable and educated people, rich in natural resources and rich entrepreneurial drive, but we are not so blessed in the way we organize people. Our reward systems do little to motivate workers, and when they are motivated, do little to give them a chance to act on that motivation.

Repeated national opinion polls tell us that workers do much less than they themselves say they can do. But the economists tell us just getting people to work harder really won't solve the problem. I agree.

The issue is not give getting more work out of people, it is getting more work out of organizations. In a typical company today, when an employee hears a complaint from a customer, sees a problem on a production line, has an idea to create a better product or knows a way to make something better or faster, that employee has little motivation to share that information with fellow employees or supervisors, and supervisor have little incentive to listen.

Even if employees are well-motivated, the structures in which they could act on this better knowledge rarely exist. Moreover, few companies act on the well-established principle that a group's collective expertise is better than any one individual's. All of us have particular skills in areas of special knowledge. When faced with a problem, if we pool these, we can come up with a better solution.

These principles seem like common sense and, indeed, they are supported by a great deal of research. Researchers on Japanese companies, for instance, have consistently found that it is differences in the way the Japanese use people, not differences in capital structure, that account for their remarkable performance.

Companies have long-established patterns of power, expectations and rewards, however, that tend to trap people in more traditional, hierarchial ways of doing things. To move companies in a different direction, there need to be incentives to make it worthwhile.

The market provides some of these clues, but obviously, not enough. That is why tax incentives to move in this direction can be so valuable. Let me talk about one of those, incentives for ESOPs.

There now are about 8,000 non-tax credit Employee Stock Ownership Plans in the United States covering about eight million employees. In 1974, when the first tax incentives for ESOPs were passed, employee ownership was virtually unknown. Just last week, the 11,000 employees of Avis became 100 percent owners of their very profitable company, and the 9,000 employees of the equally profitable Charter Medical were told they would become owners of two-thirds of that company.

Clearly, tax incentives have helped spur ESOPs, but has that been worthwhile? According to the GAO, the total amount spent on non-tax credit ESOPs, since their inception, has been about $1 billion.

While we cannot quantify how much this has produced in terms of overall economic performance, we can say that companies clearly do better with ESOPs than without them.

We looked at 45 ESOP firms for at least five years before they set up their plans and five years after. We then measured their sales and employment growth rates relative to their competition during this time.

Finally, we subtracted their before figures from their after figures to obtain a net difference attributable to employee ownership. In other words, if a company were growing 1 percent per year faster than its competitors prior to setting up its ESOP and 5 percent per year faster after setting up its ESOP, the net difference attributable to employee ownership would be 4 percent per year.

In fact, on average, that is about what we found. ESOP companies grow 3.5 to 3.8 percent per year faster with their ESOP than they would have without it. Put differently, in eleven years, an ESOP firm will create 50 percent more jobs than it would have if it did not have an ESOP. And these are good jobs, jobs that offer people an ownership stake in their company. Isn't that ultimately what the goal of economic policy is, to create more jobs?

We also found that the ESOP companies with the foresight to combine ownership with a high level of employee participation grew even faster. The most participated ESOP firms grew 11 to 17 percent per year faster than the least participative firms.

Unfortunately, only about 25 percent of the ESOP companies are very participative, but the percentage is growing, and ESOP companies certainly appear to be doing more along these lines than non-ESOP companies. I can't resist adding, since Bob Loughhead is sitting next to me, that the example that Weirton has provided over the last three years of the impact of the combination of ownership and participation has been one of the principal reasons why we have seen more and more employee ownership companies moving in that direction and, indeed, why we have seen a number of companies move in the direction of employee ownership.

It would be good if we could find a way to give more of the ESOP tax incentives to these most participative firms, but frankly, I cannot imagine how that would be done. Despite that, the overall effect of ESOP tax incentives does appear to be impressively positive.

The results of this study are described in more detail in the article, "How Well is Employee Ownership Working?" by myself and Michael Quarry in the current issue of the Harvard Business Review. I would like to ask that that article be included in the record.

Senator BAUCUS. It will be included.

Mr. ROSEN. The image of employee ownership is often one of employees desperately trying to rescue failing firms or managers using an ESOP to fend off a hostile takeover, or clever tax attorneys creating a kind of elaborate sham that does not really benefit workers.

Frankly, these things do happen. But the vast majority of ESOPs, 96 percent, according to the GAO, require no employee concession and, according to our research, almost all ESOPs are set up in healthy, profitable companies.

Employees clearly benefit from ESOPs. The typical employee in a typical plan, we have found, accumulates $31,000 of stock in just over ten years. We think the country benefits, as well, in that ESOPs are one way we can use tax incentives to make life better for all of us.

I hope, however, that the committee will consider the lesson from this to be not just that the ESOP tax incentives appear worthwhile, but that other incentives for other kinds of gain sharing and employee involvement programs could also prove effective.

We have a great deal to gain by improving organizational performance. We have even more to lose by focusing only on capital and not on people.

I would like to just add, I just came from a press conference where we just announced that there is overwhelming popular support for employee ownership. We just released a national public opinion poll in which we found, among other things, that by a 57 to 30 margin, workers would be willing, and these are workers in all companies, not just employee owned companies, would be willing to give up their next wage increase for a share in their company.

Senator BAUCUS. That is very interesting. Thank you very much, Mr. Rosen.

Mr. ROSEN. Thank you.

Senator BAUCUS. I am wondering if both of you could comment on more traditional ways to help management and employees to work together so that they are working less in a confrontational, adversarial relationship, but more in a cooperative, productive way.

I read somewhere that the goal of Japanese corporate managers is not the greatest return for shareholders; it is not the greatest return on an asset; rather, it is what is best in the long-term interest of the firm's employees. I don't know whether there are many ESOPs in Japan. I suppose there really aren't.

It is more of a cultural, attitudinal proposition in Japan, and also, because the Japanese executive is so much less mobile. That is, they tend to start, work their way up in the firm and have a no lay-off policy in the main, although there are some exceptions to that.

But they work with a firm; they grew up with the firm; they know their firm, and they know if they manage according to what is the best in the long-term interest of the employees, that the productivity is going to more likely go up and increase with more attention to quality, because it almost becomes a family unit; and it will stick together.

I assume that there are no ESOPs in Japan, but we are a different country from Japan. We have a different culture. I further assume that ESOPs are a way to attempt to accomplish some of the same results in a different culture; that is, our culture compared with that in Japan.

I am wondering if both of you could, again, give us some more ideas as to how to encourage more cooperative, less adversarial, more productive sorts of arrangements.

Mr. LOUGHHEAD. I suppose it wouldn't come as any surprise to you to learn that the whole thing starts with communications and starts with open, honest communications. You have probably read in a thousand annual reports which some chief executive officer said, "People are our most important asset," but if you go talk to one of the workers in that CEOs plant who wants to produce a quality product but it can't because he doesn't have the tools or he isn't communicated with or no one trusts him or no one thinks he knows anything, you find out how wide that gap is.

I am convinced the only way to close that gap is with open, honest communications, and that has to start at the top. Nothing will happen unless the CEO is willing to demonstrate personally and visibly that he is going to be involved in communications and he is going to be involved directly with the work force and all the employees.

It starts with open, honest communications, and if you aren't willing to make that kind of commitment as a CEO, then you would be better off staying in your office because you will probably do less harm.

If you talk about the Japanese example, and there has been a lot said about that today, about their having a different culture and so forth, but if you look back to World War II and the end of World War II and then the situation Japan found itself in, I am absolutely convinced that the reason they have gotten themselves in a position to dominate so many world markets is that they made a commitment to quality; they said, "If we are ever going to amount to anything as a nation, we are going to have to produce a quality product," whereas previously, the words "Made in Japan" was synonymous with inferior quality, and now it is synonymous with superior quality. That came about through commitment, and that commitment extended down through working with people, and there, the Japanese term is that every man is a manager, and they were committed to getting the ideas of people who were doing the jobs, using those ideas and finding ways to improve productivity and quality.

They sing company songs before they start to work. We never got to that point in Weirton. I probably would have had difficulty agreeing on which songs to sing, but I have seen people in Japan cheering just at the end of a safety meeting because they made a commitment and they are willing to do what is best for the common good, and that has not always been the trait of American labor and management, but it needs to be, and it starts with communication.

Senator BAUCUS. What can the Congress do, if anything, about that? One can say communications is key; that ESOPs are generally a good idea; that a company wants to make a commitment to quality; that, sure, capital is important, but the human element is more important in the firm. It is really up to the firm to either do that or not to do that. There is not a lot Congress can do.

Mr. LOUGHHEAD. It is, but I think those kinds of things are best and most easily accomplished within the framework of employee ownership. That gives a good base to start with, and I think that anything that we can do to expand that employee ownership and to give more recognition to persons who have been doing their jobs and the people who ultimately have to make things work. People have to make things happen, not machines.

I think anything in the legislative vein that does aid and abet and extent the concept of ESOPs is going to provide an environment where that sort of thing can grow.

Mr. ROSEN. I would agree with that. The experience in Japan with the growth of quality circles, for instance, which now, I am told, have extended beyond just large companies to a system of participation in virtually all Japanese companies, was almost unknown in the early 1950s. It spread not because the government intervened in some way, but because a few companies started it and they set up an information organization to trade ideas, and eventually, everybody did it because that became the competitive thing to do.

I suspect that that is going to have to be the case here, too, that we are going to have to learn, American companies are going to have to learn, through the marketplace, ultimately, whether this is the way to go or not. It certainly seems to be.

So that is kind of a discouraging view about what can Congress do to encourage this, but I do think there are some things that Congress can do. As I indicated, for instance, I think that supporting employee ownership and other kinds of gain-sharing programs is one way to kind of get employees' foot in the door that they are more partners in the company. At the same time, aside from tax incentives, I think Congress can use its pulpit to preach these ideas, particularly through the Labor Department; the Federal Mediation and Conciliation Service, and other labor-management type organizations that could spend more of their resources or be given more of their resources to promote these concepts which, frankly, they haven't done very much of, and particularly haven't done much of anything to promote the notion of employee ownership.

We spend lots of money promoting export and promoting all sorts of things we think business should be doing. We spend very little money promoting the ideas of participation and labor-management cooperation and that sort of thing.

So I think that that is not a tax-base incentive, but it is something that the government can do. Ultimately, though, I think that it is going to have to occur in the marketplace and that the best that Congress can do is to provide incentives for innovations like employee ownership that encourage that kind of labor-management cooperation and innovative thinking.

But I cannot imagine a way; perhaps there is one, but I certainly haven't thought of one, in which you could give a tax incentive for treating people more like partners in a company.

Senator BAUCUS. Other than Japan, what about South Korea or other Asian countries or Brazil, other countries that are coming on like gangbusters? Do they have ESOPs? To what degree does the government help in those countries, encourage this kind of sharing?

Mr. ROSEN. The United States is really the only country that has made any substantial commitment to employee ownership on a policy level. There is some movement in this direction now in Canada, the United Kingdom, Australia, but it is very limited.

The United States is clearly the leader in employee ownership of any country in the world, and certainly, the leader in providing incentives for it. I think that other countries that have done well in terms of outperforming the United States recently have been able to take advantage of different cultural norms about how people are to participate in their companies and how workers are treated, and we just don't have those.

We have a sort of military approach toward organizing companies based on lines of authority and pyramids and things like that that is really inimical to the kind of high performance that we are seeing in companies like Weirton, as well as a number of Japanese companies.

Senator BAUCUS. Is the rate of R&D higher in ESOP companies compared with non-ESOP companies, as a general rule?

Mr. ROSEN. No. The rate of technological adaptation is the same, and as best we can tell, ESOP companies are not more likely to invest more or less. Their investment policies, their R&D, their machinery, all those kinds of things are pretty much the same. The reason they do better is they use people better.

Senator BAUCUS. Do you agree, though, that the R&D rate in this country is too low?

Mr. ROSEN. I think all of those things are problems, but it seems to me that we have tried to address the issue of improving our economic performance entirely by focusing on incentives for research and development and incentives for capital investment, and it seems to me that the evidence that those incentives ever produce investments above what would normally occur is, at best, mixed, and, it seems to me, mostly negative.

There doesn't seem to be any overwhelming impact of those tax incentives, even if those are desirable things for companies to do. The tax system isn't getting them to do it; the market gets them to do it or not do it. And one of the reasons the market isn't getting them to do it is that the market is made up of shareholders who don't have the interest of the long-term performance of the company at heart.

Who would? Either you have an entrepreneurial company that is privately-owned, or you have a company owned by the employees, because they are not that concerned about how much dividend they get in the next quarter or whether their stock goes up relative to other companies in the next quarter or the next year. That is nice and important, but their basic economic interest is in the long-term performance of the company and, hence, the security of their job.

So when the company comes in and says, "Should we spend money on something that is going to reduce our year-end profits but is going to improve our competitiveness in market position," employee shareholders would say, "Yes," whereas public shareholders probably say, "No."

Mr. LOUGHHEAD. I can only use the Weirton example, but I might cite an example that ties in very closely with what he has said. Weirton is a very large producer of tin mill products, tin plate, the second largest producer in this country.

In the last 4 years, I dare say Weirton Steel Corporation has spent more money advertising and putting together product development facilities to the point where almost every new innovation that has taken place in tin plate tin manufacturing in the last four years has originated in Weirton.

That has cost a lot of money that could have been on the bottom line. I doubt very much if that decision had to be made in a boardroom in Pittsburgh rather than down in Weirton where the facilities are, I doubt that it would have been made. I think it would have flown to the bottom line rather than being used in product development.

Weirton has become recognized as the premier producer of that product by virtue of the fact that it committed itself to research and development.

Senator BAUCUS. Do you have any other views about the long-term, short-term problem in this country? That is, can you think of any legislative incentives that might help encourage a little longer term view of management, any of you? Some talk about penalizing short-term gains.

Mr. LOUGHHEAD. I was thinking about that whole concept as I sat here this morning. While I don't have specifics, I do think this: I heard people talking about the import problem and dealing in the current terms of the import problem, and if we could have applied a long-term view to the import problem 20 years ago rather than having to deal with it now, things would be different.

A lot of industries have been charged with not having invested, not having modernized. If you look back to the late sixties and early seventies in my industry, when they should have been modernizing, there is a good reason why they didn't: Their markets were being taken away from them, often by illegal actions on the part of foreign producers. The reason they didn't invest was because the market wasn't there and you aren't going to invest in a market if, by the time you get the production facility finished, your market has been taken by someone else.

I think that the long-term versus the short-term view that you are espousing and that we need to develop is absolutely right on target, because had we done that two decades ago, things would be a little bit different, I think, in the manufacturing industry.

I am not for "fortress America" and barriers at the coastline, but I do think that ultimately in this country, you have to make a decision to what portion, what participation in the markets of this country you are going to allow foreign producers to share, and in exchange for that, you must get commitments from them to open their markets.

Senator BAUCUS. Do you think government has a role in helping encourage longer term thinking in addition to trying to encourage other countries to play fair? Is there an additional governmental role to help encourage the long-term view?

Mr. LOUGHHEAD. I believe there is a role there for government. I think there is an appropriate role there, just as in the vein that Corey was talking about, what government may do to aid and abet the ownership concept.

I think there is an appropriate role for government because in many cases, that problem is going to be resolved by dealing with governments and not with companies abroad, and therefore, I think there is a role for government to play.

Mr. ROSEN. For instance, if you wanted to really move in that direction, one of the reasons that Japanese companies are more market-oriented than short-term profit oriented is that most of their financing comes from debt and not equity.

Senator BAUCUS. What about that?

Mr. ROSEN. In the United States, the flip side of that is true. A lot of institutional investors own a lot of equity. I don't think that managers are that concerned about individual shareholders and their short-term concerns so much as they are about institutional investors churning their investment. You could remove tax incentives for the non-taxability of gains from institutional investors who don't hold their investments for more than a certain amount of time, or you could change the way in which debt and equity are treated in terms of their returns on an after-tax basis to investors to encourage more debt and less equity.

But I suspect that would be a rather difficult sell.

Senator BAUCUS. Mr. Loughhead, do you agree with both of those points?

Mr. LOUGHHEAD. I think they are worth considering. Yes, I do agree.

Senator BAUCUS. Okay. Well, I want to thank you both very much. You have been very instructive, very helpful.

This is, as I said, the first of a series of hearings, a very complex matter but, I think, one that has to be addressed. You have both been very valuable contributors to it. Thank you very much.

Mr. ROSEN. Thank you.

Mr. LOUGHHEAD. Thank you.

Senator BAUCUS. The hearing is adjourned.

[Whereupon, at 11:45 p.m., the subcommittee was recessed, subject to the call of the chair.]

EFFECT OF TAX LAW ON AMERICAN COMPETITIVENESS

MONDAY, OCTOBER 19, 1987

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:20 a.m. in room SD-215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the subcommittee) presiding.

Present: Senator Baucus.

OPENING STATEMENT OF HON. MAX BAUCUS, U.S. SENATOR FROM MONTANA

Senator BAUCUS. The subcommittee will come to order.

Today we continue a series of hearings studying the effects of the United States tax system on America's ability to compete in international markets. In our first hearing, this committee heard from some of America's leading experts on competitiveness. They stated that American industry is losing its position in the world marketplace.

We learned that too many of America's business leaders have turned their attention away from making and selling a better product. The long-term perspective of developing market share has been exchanged for the myopia of quarterly profits and losses. But the decline in America's industrial strength is not solely the fault of our business leaders. We in Government must shoulder some of that responsibility. For too long, we have passed legislation that affects business without considering whether it would help or hurt businesses' ability to compete, particularly in the international arena.

I came away from that first hearing convinced that we need to understand much better just how tax policy affects the ability of U.S. business to compete. Today we are going to hear answers to that question. Our witnesses will describe the nature of the relationship between taxes and competitiveness. They will also suggest alternatives to our present form of income-based taxation.

Some of these suggestions will involve some form of consumption-based tax, such as a value added tax. I am not yet convinced that a VAT is feasible or desirable; but as I said when I opened these hearings, I am approaching them with an open mind.

Some of the ideas presented here will be novel. Some of the ideas presented may be controversial, but it is important to discuss new ideas. If our current tax system really does tie America's hands and feet, we should replace it with something that helps rather than hinders our competitiveness.

Today I would like to focus on two fundamental questions about tax policy. First, should the United States consider changing the basis of its tax system from income to consumption? If so, how should such a new system be structured?

Second, do tax-based economic incentives and disincentives actually modify the behavior of businesses and investors? If so, what kinds of incentives will best help us to compete?

Today we have a very distinguished group of economists to help us as we consider these questions. First, we will hear from Victor Kiam, President and Chief Executive Officer of Remington Products. Mr. Kiam represents the entire domestic electric razor industry because Remington is the only remaining U.S. producer. His fame stems in part from his television commercials, where he tells us he liked the razor so much he bought the company; but since he brought Remington in 1979, he has tripled its sales and more than doubled its market share. Along the way, he even managed to get Remington listed as one of the 100 best companies to work for in America.

He is an American entrepreneur in the best sense of the term. Mr. Kiam, we are very pleased to have you with us and look forward to your statement.

STATEMENT OF VICTOR K. KIAM II, CHIEF EXECUTIVE OFFICER AND PRESIDENT, REMINGTON PRODUCTS, INC., BRIDGEPORT, CT

Mr. KIAM. Thank you very much, Senator.

Senator BAUCUS. I must say, too, that as I was watching the first World Series game Saturday night, I was very pleased to see you on one of your commercials.

Mr. KIAM. Did I strike out?

Senator BAUCUS. No, no. You scored. [Laughter.]

Mr. KIAM. Good. I think this hearing is very appropriate because the United States today is involved in an economic global conflict. There is no longer free trade but controlled trade. Tax and fiscal policy are key ingredients and are intertwined, but these policies are also affected by many other forces, including political and social factors.

The key element is the monetary value relationship of currencies under the current quasi-monetary free market. The strength of the dollar, due to fiscal and tax policies, have made U.S. products and services noncompetitive.

Controlled values of some nations' currencies vis-a-vis the U.S. dollar makes U.S. products noncompetitive and gives the other countries tremendous economic advantages.

Tax policies of other nations vary widely: export manufacturing credits; lower corporate tax rates; exorbitant import duties and even embargoes; and VAT tax structures and implications of these structures for the benefit of export.

And overriding it all is the availability of profits for reinvestment in businesses. Until the last decade, the strength of the U.S. economy and efficiencies of manufacturing that existed have provided an insulation for American-based companies so that fiscal and tax policy were not critical to the success or failure of an American enterprise or the American economy. Today, the United

States is involved in an economic war, and we have not planned for this evolution; nor have we investigated or utilized tax structure and fiscal policy to increase the competitiveness of American products in the world marketplace; nor has much of the Government fiscal planning considered what effect that planning would have on the basic manufacturing infrastructure of the United States.

We must change from a consumptive society to a productive society. We are establishing a legacy of debt and debt financing for our children and grandchildren. The spendthrift approach of our Government has permeated our entire society with individuals and entities leveraging with debt.

Savings rates are low, and debt assumptions of corporations weaken them in the world marketplace. It is time that we do restructure the tax policies and, more importantly and in conjunction, the fiscal policies of this country.

Senator BAUCUS. Thank you very much, Mr. Kiam. As I hear you, you are essentially saying that the Federal budget deficit and, to some degree, the increase in private debt are very big disincentives to American businesses. As a businessman, do you see that to be the case? That is, is it very difficult for you to conduct your business in a competitive way with the Federal deficit as high as it is and because of increases in private debt?

Mr. KIAM. I think what has happened is that, in the last seven years, we have seen the greatest deterioration in manufacturing and productivity in the United States in the history of our country, and I think it evolved from the fiscal policy and the overall governmental strategy. We, as a nation, embarked on a plan to increase military spending, reduce taxes, maintain a great deal of our social services, but obviously there was a cutback there; but the net result was enormous debt.

We went, as you so well know—and all of us now realize—from the largest creditor nation to the largest debtor nation in a short span of some seven years. During this period, the manufacturing sector of the United States was forgotten. In all the planning by the Government, nobody—it seems to me—considered the fact that the result of the policy that was undertaken would be an aberration in the currency value that was established for the dollar. So, from the period of 1981 until 1986, the dollar was in essence 40 to 50 percent overvalued. This virtually reduced the ability of American companies, American farmers, anybody dealing in the foreign sector to export; but more importantly, it opened our market to a flood of imports because American companies could not compete due to the strength of the currency and the weakness of foreign currencies.

Senator BAUCUS. On that point right there, could you give us some idea of the degree to which the high dollar a couple of years ago very much hindered your efforts to sell Remington razors overseas. And then, I would like you to address the degree to which, with the lower U.S. dollar now, you are able to regain the lost market share or even expand.

That is, how much did the high dollar hurt and how much has the lower dollar helped?

Mr. KIAM. Let me use an example, Senator. In 1981, the value of the British pound—the British are somewhat excluded from the impact of verbalization—it is usually directed at Japan and the Far East. So, using Britain as an example is a good one because they have a very open trade policy, and you are permitted to sell your product there without any restraints whatsoever.

In 1981, let us assume that our shaver cost was $9.60. The value vis-a-vis the pound of the U.S. dollar was $2.40 to the pound, which meant that our shaver in Great Britain cost our U.K. company four pounds. Now, we only have one manufacturing facility; that is in Bridgeport, Connecticut. We don't have overseas manufacturing in any other country of electric shavers.

So, our British company purchased the shavers from us at four pounds, and we would sell them at wholesale for about seven pounds 50 pence in the U.K. market; and the shavers would retail at prices of £11, £12. All of a sudden, the aberration of the dollar occurred. No longer was the ratio $2.40 to one pound, but it dropped as low, interim trading-wise, to $1.03; but in 1985, the average was $1.20 to the pound.

Because of productivity increases and incentives here, our prices to manufacture the shaver did not increase one penny, we continued to sell our shaver to Great Britain at $9.60. The only difference was that it now cost eight pounds.

In order to maintain the same percentage markup, we would have had to sell that shaver for some 14 or 15 pounds. The competitive factors in the marketplace precluded that.

It was very difficult to go up even one or two pounds. So, we would go up to, say, 10 pounds. We now had two pounds to operate our company, or roughly 20 percent gross profit, as opposed to 45 percent previously. What do you do?

Initially, we continued to run advertising because that is the life blood of our business in an effort to maintain our market share there, which at the time had been around 26 or 27 percent. We did that for three years, and we produced enormous losses to our company. For a company our size, our overseas businesses suffered $4 million of losses in 1985. Now, that doesn't sound very large but, when you realize it was a $7 million swing and a huge percentage for the size of our company, we realized we had to do something.

The alternative was to raise prices, which would have made us noncompetitive, or to reduce advertising. We suffered for three years without reducing advertising, hoping that the policies of the United States would change and that the system would be reestablished on an orderly basis. Unfortunately, since that didn't happen, we cut our advertising about 75 percent and got our company to a break-even point.

Our market share suffered, and we went down to 16 percent market share, as our competitors continued to spend since their gross profit was not affected.

Senator BAUCUS. All right. Now that the dollar is down, are you able to regain that market share?

Mr. KIAM. This is the first time that we will see. We are spending this fall at the rate that we were spending before. The dollar is down; it has recovered, but it is not at the same level. It is at one pound, 66 pence this morning.

We hope to regain market share. It is very difficult, which is why in the United States today, in spite of the fact that the currencies have been restructured, you don't see the Japanese companies, the Korean companies, the Taiwanese companies, the German companies raising prices because market share is the life blood of a business; and you are willing to suffer losses to maintain that market share.

That is why the old philosophy of the J curve no longer holds. We are the largest consumptive area in the world; and therefore, to have a posture in this country is vital to every nation.

Senator BAUCUS. Now, there are some economists in this hearing room. Why don't you explain to them why the J curve doesn't work?

Mr. KIAM. I am not an economist. I am just a businessman——

Senator BAUCUS. But you are on the front line.

Mr. KIAM. You know I can't live by theory. I have to live by sales. The reason that I think that the old precepts no longer hold are twofold. One, there are sophisticated financial instruments today that can protect companies in the short term for a year to a year and a half; and many—not many—almost all companies so do. At the end of that period, you have to decide what you are going to do.

Well, I had dinner last night with the chairman of a very fine store in the United States, a specialty store, Bonwood Teller; and I asked what had happened to the prices of apparel. Now, apparel is a peculiar animal because there there are a lot of small manufacturers, and they are unable to take advantage of some of the financial instruments.

Their price increases—the Italian shirts, the fancy name things—have gone up anywhere from 25 to 30 percent in wholesale price to the purchasers here. In the sophisticated areas such as in our business—appliances or in automobiles or electronics—the price increases have measured about five percent because these companies do not want to lose the market share that they have gotten here.

In some fields, we no longer produce at all. I don't believe that we make any television sets any more in the United States. If they raise prices sufficiently, somebody in the United States is going to go back into business.

I do not believe in the current philosophy that a value added tax, for example, or more importantly a less valued dollar is going to result in high inflation because of rising prices because I think the world has changed; and we base the future on the past. And in the past, we felt and it was so indicated that if we were to have a low value, that foreign products would flood this country at higher prices; and, therefore, we would get into an inflationary spiral.

I don't think that is true because I think what would happen is that American companies, American manufacturers, American entrepreneurs, would go into these fields that have been precluded from them and that we would have even more competition at perhaps some slightly higher price, but not a great deal.

We have lost too much to manufacturing overseas.

Senator BAUCUS. What you are saying, as I hear you, is that because the dollar went up so high a few years ago, it made it very difficult for U.S. manufacturers to export overseas. And now the dollar is down, so it is going to be other manufacturers overseas that got market share in the United States when the dollar was so high, and they are going to cut down to the bone as much as they can to maintain market share in this country.

Mr. KIAM. The other thing, too, Senator, is that so many American companies opened up overseas plants during this period.

Senator BAUCUS. Right.

Mr. KIAM. And a lot of these plants were predicated on exports. In other words, they got concessions provided; so much of their manufacturing went to export.

Senator BAUCUS. Right.

Mr. KIAM. Those plants are doing the exports that the U.S. companies should be and would have been doing from the United States.

Senator BAUCUS. Now, you are implying though that the Government has something to do with all of this. That is, it was Government policy that led to the very high U.S. dollar a few years ago?

Mr. KIAM. Yes, sir.

Senator BAUCUS. And you are also implying that—as I hear you—Government should not do that any more. How can Government not do that any more?

What should we be doing here in the Congress? What should we be doing to prevent the runup on the dollar again, which very much hurts U.S. manufacturing?

Mr. KIAM. I think there is a conscious effort to now have a more controlled world monetary relationship. The Group of Five met in September of 1985 and began to formalize controlled currencies, but there seems to be a feeling in this country right now that the dollar should not be allowed to drop any further. And I think we are arbitrarily holding that dollar up because we need foreign investment in this country to fund the debt that we ourselves are not willing to face.

Senator BAUCUS. So, you are implying that if we get the Federal deficit down significantly, there would be less need to try to attract that foreign investment, and that would be a big help?

Mr. KIAM. Oh, I think it would be a big help for that, but it also, I think, would make a much more salutary world for my children and my grandchildren who are going to have to suffer the debts that this free-spending older group have created within the last 10 years.

Senator BAUCUS. So, you are saying that the Federal deficit is a main cause of some of the economic dislocations that American business has been facing?

Mr. KIAM. Oh, I definitely think so.

Senator BAUCUS. Now, would you therefore then agree to a greater effort of the Government to reduce the deficit more quickly than appears to be the case? That is, would you reduce the deficit more than the $23 billion that we may reduce it by this year?

Mr. KIAM. I don't know if my information is correct, but I read an article coming down on the plane this morning in the Wall Street Journal. This may be erroneous, but from what I inferred in that article, the reduction was from the debt of a year ago. Now, if we come in with a deficit of $150 to $160 billion this year, compared to the deficit of last year, according to what I read it seems to me that you don't have to reduce the debt at all because you have got the $23 billion reduction from the prior year.

If we keep spending $150 billion a year more than we take in, we are going to put ourselves in the same position as some other countries are today, which is we are unable to fund our debt because nobody is willing to advance further loans; and what we are going to do is impact the standard of living of our population.

Over the last 12 years, the standard of living in the United States of the average citizen has dropped one percent a year—eight-tenths of one percent.

Senator BAUCUS. So, you think we should go further?

Mr. KIAM. I think we have got to start setting the standard for the nation. We have become a materialistic nation. Individuals are saying: What is in it for me? The Yuppie generation, as we hear it; the 90-day wonders you discussed in your opening remarks. We have gone from an investing futuristic society to 90-day wonders, and in so doing, we are creating an atmosphere throughout the United States among individuals that we should spend more than we take in because what is the difference?

You know, if we had a marketplace, for example, for our food today, if our dollar was cheaper, our farmers could be more competitive. We might be able to then reduce some of our subsidies to our farmers, which would reduce the debt, instead of funding our farmers' problems by asking them not to grow produce and then purchasing for them and keeping abnormal price supports.

Now, that is only one segment of the society, but we are doing this throughout our society.

Senator BAUCUS. Back to the deficit, would you as a businessman advocate more spending cuts and perhaps more income raised?

Mr. KIAM. Yes, I would do both. I would try to get our economy in balance or certainly in a much closer balance than it is currently, and I would take every step possible.

Senator BAUCUS. Standing back, as sort of a statesman/businessman, does it make much difference as you see our economy whether those are mostly in spending cuts or revenue raised or 50/50. As a businessman, as you take a long-term view of our nation's economy, does it make much difference to you as we cut that deficit more than what that mix is?

Mr. KIAM. Yes. I think that the social services of this country have been curtailed to a degree. I am sure that there are savings that could be engendered, but I think we have reduced them about as far as we can. I am hopeful that there will be some evolution in the negotiations with the Russians that will allow us a respite in our military spending; but I am not privy to the information and, therefore, you have to go on the recommendation of the authorities to the best extent you can.

So, the best way to get this in balance is to take the hard step—and I know it is very unpopular, and a politician can't say it but I can—to tighten our belt and increase taxes.

Now, I disagree that we should have an income tax increase because I think what we have done in the last tax bill has been very beneficial to the economy. I think that what we should have is a consumptive tax. We are an overconsumptive society; we are living beyond our means.

The United States reminds me today of Great Britain in the 1960s; and I think we have to get the focus of each individual that they must live within their means, and I think this can be accomplished. It doesn't have to be a wholesale value added tax. I think we can start off—at least the psychology will be implanted—by having a luxury tax that we had during the Second World War, where you taxed jewelry, you taxed nightclubs, and you taxed restaurant bills over a certain amount, so that those people who have the largest disposable incomes will be affected. These are not necessities of life, and I think that is an approach.

And of course, we should continue to look at every area of governmental expense that could be cut.

Senator BAUCUS. What are some of the provisions, though, in the last Tax Act that did help American business in the best sense of the term? You said that the last Tax Reform Act was good in some respects. What were those respects?

Mr. KIAM. I think that the reduction of the corporate tax was really critical, particularly to a widespread group of businesses. The prior tax, with the tax shelters, aided a few companies, largely capital goods companies that bought and sold tax credits; but for a company like ours, the reduction of the tax gives us more capital to invest. And when you consider that we are up against some companies that operate in countries with very low tax rates, I would like to point out that the Hong Kong corporate tax rate is 18.5 percent maximum tax. Now, incidentally, our tax policy allows a U.S. company to manufacture in Hong Kong, ship that product anywhere in the world including the United States, and pay no tax to the United States as long as it doesn't bring the money back to the United States, which means that if Company X had a Hong Kong facility and let's say they were a competitor of Remington, and Remington is in Bridgeport, up until the last tax law, if we both made $1 million, the Hong Kong company would have—let's see, it is 18.5 percent—$815,000, and I think I am right on that calculation, to invest. We would have had $500,000 to reinvest; the balance, we would have had to borrow, which just increased our debt.

We have to look at providing the capital for American institutions. We are a private company, so I can speak freely. I think the investor's psychology today is short-term gain instead of looking down the road five years. So, the last tax really helped corporations, and it will help us as the time proceeds.

Senator BAUCUS. That point is interesting because some suggest—and I think one or two of the witnesses will testify on this later this morning—that reducing the corporate rate in exchange for the investment tax credit and stretching out depreciation schedules has the effect of favoring old investment at the expense of new investment. That is, if we kept the ITC and stretched out depreciation and retained the corporate rates, that would be an incentive for new investment—new buildings and new equipment—whereas lowering the corporate rate and so forth tends to allow a high rate of return on old investments.

I guess I want to ask you that question from two points of view. One, I guess that is my own theory, whether you agree with that or not. Second, as a businessman, what effect do lower rates have—

with repeal of ITC and stretched out depreciation—on you as an American businessman operating in America?

Mr. KIAM. On the first point, Senator, I think we have a few too many office buildings, salmon farms, Arabian horse farms around the country. I think if that had been put into more constructive areas, this society would be a heck of a lot better off. So, those people who have said the investment tax credit and the shelters that existed under the prior law were better, I would certainly argue with them.

Senator BAUCUS. On that one point, let's assume that we cut down on the shelter, the paper loss problem, but still kept the ITC, how would that have an effect?

Mr. KIAM. I think that is important. I don't think that would affect us to a great degree; but if we could really set up the procedure so that the tax laws encouraged companies—manufacturers, medical equipment makers—to build for the future and invest in capital equipment. Yes, but that law would have to be very, very carefully refined so that we didn't have leasing companies springing up with enormous deductions available up and down the line, and so that this became a business unto itself.

I agree with you. There are two things in the last tax law that I think perhaps should be looked at. Even though it won't affect us, I do think it is worthwhile for many companies to compete around the world. The second tax change that I would make is make a differentiation between short term and long term gains. I think that last point was probably one of the worst features of the new tax law.

Senator BAUCUS. That is eliminating the capital gains?

Mr. KIAM. Yes, because all we did was stimulate the 90-day wonders.

Senator BAUCUS. Some suggest, though, that the presence of the capital gains differential accounts for about 50 percent of the complexity of the whole——

Mr. KIAM. I think it depends on the way you concentrate but if you set up a standard where, no matter what you buy or what you sell, you get a capital gain at the end of a year, what I see is that I would encourage people to hold longer. So, I would see a reducing capital gains based on an annual holding period—for example, short-term could stay at 28.

Senator BAUCUS. How many other businessmen would agree with that, do you think?

Mr. KIAM. Gee, I don't know.

Senator BAUCUS. What is your guess?

Mr. KIAM. I am an entrepreneur. I say what I think, and I can't tell you what the consensus would be. Anyway, Senator, I believe consensus opinion leads to mediocrity.

Senator BAUCUS. I agree with that. What other long-term standards should we look at? You mentioned sort of a sliding scale on capital gains, depending upon the length of time it is held. Do you think it is worth our while to look at other incentives that encourage longer term thinking, for example, incentives for bonus systems, profit-sharing systems? Are there some other ways to encourage a longer view of the world?

Mr. KIAM. I think we ought to reestablish more incentives for savings. I think the last law reduced it. Of course, it all has to be balanced with revenue so you have to be very careful in what you say we are now going to stimulate, but I think the ESOPs, the Keogh plans, the profit sharings that have come into existence do offer a shelter through savings.

And I think the provisions of the 401(k) also have been beneficial and certainly the last one. A lot of these things are counterproductive for me personally, but I just think the reduction of the levels that are allowed in these programs are what they were designed to be—these various plans like 401(k)—so that top management can't dominate these plans. They are really designed for the future savings of the workers.

But the more we can do to encourage savings the better off we are because of the low savings rate in this country, where we are only saving three percent of after-tax income, as compared to Japan which was 15 percent.

It is interesting, Senator, that as part of our policy of getting our dollar value lowered, we have to beat up people like the Japanese to reduce their savings rate. We have gone on a whole crusade to increase consumption in Japan.

Senator BAUCUS. We are doing the same with the Germans.

Mr. KIAM. Yes, of course. You know, frugality is something that we really should pride ourselves on; and we have said to them, well, you be like us. You be profligrate like we are—profligate, I guess that is.

Senator BAUCUS. The first one sounds a little more accurate.

Mr. KIAM. Yes, but I think we have to tighten our belts. Now, as far as other taxes, I think what we have to do is to see how this new tax system works. I think the 17 and 28 percent tax base for individuals is very similar to what has existed in Hong Kong for years, and that has produced a very buoyant society and certainly a society of entrepreneurs. Hong Kong, with a population of about six million people, I think is the sixth or seventh largest exporting country in the world—or exporting area—they are not really a country any more.

And it has stimulated, I think, a great drive; and I think if we change these rates dramatically, it does lessen the incentive. I know that there is also a feeling that people who make an awful lot of money should be perhaps taxed at a heavier rate than is now contemplated. I think that might go against the capitalistic system because I think that is what our country has stood for, and I think that is what drives a lot of the individuals who have really built this country.

In the last eight or nine years, you know, employment here has gone up, not through the employment level of large corporations, but it has been small and medium sized businesses. Therefore, this new tax law that we just passed has on broad measure stimulated the activity. I know it's true for myself now—I used to think Uncle Sam was a partner, and we were 50/50, so what the heck? Maybe we will spend a little more in advertising; Uncle Sam is paying half of it.

I think a lot more carefully now that Uncle Sam is paying less, and he will be paying less next time. So, I think the more that you can take Uncle Sam out of our business, the more we are going to run the business as well as we can for the profitability of the business.

Oh, sure, there were a couple of things. I think I mentioned one earlier in another discussion, and that was this expense reporting system where a company pays 20 percent of travel expense for meals. If you are sitting in a lonely hotel room in Macon, Georgia and you go down to the local motel and you spend $10.00, $2.00 of it is not deductible. But if you go out to the Four Seasons and you entertain and you spend $500.00, you get the same 20 percent disallowance. I think that is grossly unfair. I think there should be a limit on how much you can spend—I don't care what it is, whatever is fair—on entertainment, and that is it. And it is so much person; and anything over that, you spend 100 percent at the expense of the corporation.

Senator BAUCUS. Now, you said that we consume too much in this country. There are a lot of folks looking at that last Tax Act who say that the effect of that is to tilt us more toward consumption in this country. There is a tendency of that Tax Act to encourage more consumption in this country and to discourage more savings and investment. Do you agree with that or not?

Mr. KIAM. I disagree with that. I don't think it has any effect one way or the other because the prior tax certainly didn't benefit the average person. It benefitted the wealthy much more, where you would go into your shelters and you would get your tax credits; but the individual——

The last tax law perhaps impacted the IRAs and the Keoghs to a greater extent, but I think that people——

Senator BAUCUS. The argument is to lower the ITC or stretch out depreciation, cut back in IRAs and Keoghs; on the other hand, it did begin to cut back on the deduction of some consumer interest expense.

Mr. KIAM. That was a very, very wise decision—that last one—and I think that anything you can do to establish the philosophy that will trickle down if the U.S. Government will establish the philosophy of a pay-as-you-go program rather that mortgaging the future for individuals as well as for the U.S. Government, I think that will go a long way to change the psychology of the country.

I think the average person looks at his own affairs and says, well, what the heck? The U.S. Government is running up this enormous deficit every year; I will go into hock because I can always pay it off in the future even if something negative happens.

I think that we should, looking at our society, start to tax the consumption of people; and I wouldn't recommend an across-the-board tax because I think we can try it. You don't have to go whole-hog, but I don't see why—except from the restaurant union, perhaps, if you started a tax luxury meals or the jewelry workers of America—there is always a pressure group—but actually the items that you would tax if you put on a luxury tax, I think, if you analyzed it from my estimation, and I have done some analysis of this, over 80 percent of it would be imported products.

If you taxed expensive perfumes, taxed expensive jewelry, the costume jewelry—which is all we make here today really; all of the others are imported—we don't make hardly any perfumes here.

But all of the luxury goods today, the things that people seem to think are the epitome of success or the epitome of quality or image, are imported. So, in essence, you would be helping the balance of trade if you did put in a luxury tax.

Senator BAUCUS. One final question here. You have an American company with no overseas production, but sell overseas. To what degree is your business hurt by unfair foreign competition? Is that a big factor or is that an insignificant factor?

Mr. KIAM. There are two types of competition overseas. There is the up-front competition and there is the hidden in unfair competition. On the up-front, we are not hurt that much because the countries that do that are not the largest consumptive countries in the world.

Senator BAUCUS. They have the greatest subsidies and tariffs that are up-front and direct?

Mr. KIAM. That is correct; however, these countries are now the ones that are running the greatest trade surpluses. Korea. We are an embargoed product. Korean shavers come into the United States with no duty. We are not allowed to sell shavers in Korea unless we purchase product for export from Korea of an equivalent amount. Now, that law only went into effect a year and a half ago. Up until then, we were completely embargoed.

We pay duties in such countries as Taiwan and in the Philippines of 129 percent on our products going into that country. In South America, we are embargoed unless we manufacture down there. We just can't sell in certain countries unless——

Senator BAUCUS. It sounds like those are significant.

Mr. KIAM. They could be. Unfortunately, we don't know because, unless we open a plant down there, we won't find out. They could be significant—yes—the totally up-front barriers.

Now, the Japanese have not affected our shaver business, but there was an instance there where we had the opportunity to take a product which was made by a competitor—it was made by Clairol, and it was a Clairol foot fixer, which is a massager; you come home at night and you plug it in, and you massage your feet; it has warm water. The Japanese declared that was a medical device and insisted that a doctor inspect every single one of them. And at that rate, we would go broke because a doctor would charge for a house visit for each Clairol foot fixer.

Senator BAUCUS. There must be a lot more podiatrists in Japan now.

Mr. KIAM. Pardon me?

Senator BAUCUS. There must be a lot more foot doctors inspecting all of them.

Mr. KIAM. Oh, yes, but we didn't hire them because we couldn't afford to bring the product in; but there are some hidden barriers that are indigenous to the various countries. In Japan, the barrier is the distribution system, which is a five-tier distribution system which is something that you have to cope with; and most American companies find it very difficult and, in the consumer product field, most of them would end up with large Japanese trading companies that have the distribution system, but they get about this much attention. They get a tiny bit of attention.

We opted to go ourselves in the entrepreneurial way, and we have been selling through agents, distributors, wholesalers, and retailers.

Senator BAUCUS. You found a way to avoid the distribution system there?

Mr. KIAM. No. We have had to go right through it, and it has priced our product way up.

Senator BAUCUS. How are you doing then in Japan?

Mr. KIAM. I think this year we may break even for the first year in five years. We have suffered losses since we have been there. We started from scratch.

Senator BAUCUS. And you think it is basically an unfair distribution system, that is, it is unfair to you?

Mr. KIAM. You can't say that. This is their distribution system, and you have to fit.

Senator BAUCUS. You just have to deal with it?

Mr. KIAM. You just have to deal with it. Now, take Germany, for example. There, they have policies which would be considered unfair in the United States, but native to their nation, there is nothing you can do about it. We have something here called Robinson-Patman, which means you can't discriminate between types of accounts, et cetera.

In Germany, if I think you are a good account and I like you, I just give you something for your support. Now, we are going into Germany with our own little company. We have a major competitor there. The major competitor gives rebates to the retailers that carry their product based on their support of some five to seven percent of the turnover that they do. Now, the major retailer says, hey, mister—I mean, the major competitor says: Mr. Retailer, if you purchase Remington, I don't think that you are going to be supporting Braun, which is the brand that is over there. Now, if you are a retailer doing, say, a half a million dollars worth of the entire Braun line and collecting $30,000 a year in rebates—pure profit—are you going to put in Remington and do $15,000 in total sales and perhaps lose the rebate?

Now, there is nothing we can do about it. That is the practice of the German marketplace. We have to live with it.

But those are some of the things that exist in nations that aren't so-called up-front barriers; they are the hidden barriers to us doing business in those countries.

Senator BAUCUS. As I hear you, you say that even though they are hidden barriers, with an almost maniacal dedication to hard work and imagination and creativity, you can find a way to sell?

Mr. KIAM. You have to. Otherwise, I find that you can't survive in this world. But what we are looking at, if you look at the world as a total, you see the nations that today are more successful, have more stability than we do, and these are the savings nations. The nations that have been spendthrift like us are the nations that we are now worried about, that they can't pay their bank debts.

So, I think it is a hard decision for legislatures to make, but we have to bring our economy back into balance. And the question you asked earlier: Should it be additional cuts in the Government—in the social services or defense—or additional taxes, I don't think it is a question of where you get it; you must get it.

We have a Federal Government today that is really a leverage buyout with junk bonds.

Senator BAUCUS. Well, you used those junk bonds, didn't you?

Mr. KIAM. No, sir. I did something that was a pure leverage buyout in which the combination of ingredients was a small amount of equity, the seller took back paper, and I had bank debt for the assets that I acquired. In 1981, I believe it was, or 1982, we were paying 23.5 percent interest and our debt-to-equity ratio was 50 to one, and we survived; but we survived by cutting every single place and watching every penny. And that is what I think the Government has to do. I would ask you, sir: How much has the expenditure for Congress been increased in the last ten years—the overhead for every Senator and Congressman in Congress? Why don't we have a cutback to the level we were ten years ago?

We can survive.

Senator BAUCUS. Frankly, not only would we survive, but I suspect we might do a lot better.

Mr. KIAM. I think so. And look at the other aspects of our Federal Government. Let's start cutting to the bone. Let's start running the Federal Government as though it were a turnaround, as though it was a leverage buyout, because it is. And I don't want to see my grandchildren not enjoying the same level of life that I do, and we have got to make some hard decisions.

Senator BAUCUS. That is a good point to end this discussion on. I very much agree with you. I mean, the bottom line really is that we have to live within our means; and the sooner we do that in this country, the better off we all are going to be. That is what, I think, this comes down to. Mr. Kiam, you have been a very helpful witness. I want to thank you very much for taking the time and also for obviously giving a lot of thought to what you were going to say; and we all appreciate it very much. Thank you.

Mr. KIAM. Thank you, sir. I might add, as a last thing, I think the monetary relationship in the future is really critical to restoring American manufacturing. The relationship between the currencies—that is what we constantly have to look at.

Senator BAUCUS. So, you are basically saying that if that can be stabilized, without all these swings, that that would make a big difference, too?

Mr. KIAM. That is right, and we can't allow certain countries to continue to mold or fix their currency at an abnormal rate.

Senator BAUCUS. The Taiwanese talk to us about that all the time.

Mr. KIAM. I am sure they do.

Senator BAUCUS. Thank you very much, Mr. Kiam.

Our next witness is Dr. Larry Dildine, who is a partner at Price Waterhouse. Dr. Dildine is an expert on international taxation, and we thank you very much, Dr. Dildine, for appearing before us. We are much obliged.

[The prepared written statement of Mr. Kiam follows:]

PRESENTATION BEFORE THE SUBCOMMITTEE ON ECONOMIC STABILIZATION

by

Victor K. Kiam II, President

Remington Products, Inc.

March 10, 1987

I am grateful for the opportunity to present the views of Remington Products and myself to the Subcommittee relative to the trade posture of the United States in the international marketplace. I come here not only as the president of Remington but also as the only lobbyist for the U.S. electric shaver industry, as Remington is the U.S. electric shaver industry.

Remington Products, Inc. manufactures all of its shavers in a plant in Bridgeport, Connecticut, sells in the United States, and exports to 163 countries, albeit very small amounts to a great number of these.

The last 4 or 5 years were probably the most deleterious period in the history of the United States for the manufacturers and sellers of American made products both at home and abroad. The most important reasons for these events have been the inflated value of the U.S. Dollar and the lack of a coherent trade policy, which have made U.S. products less competitive against foreign-made products both here at home and in the world marketplace. This, coupled with unfair trade practices, has put all American industry at a disadvantage. This, in turn, has resulted in shrinking profitability with less financial resources for capital spending by American companies to meet competitors in the future. The aberrant value of the Dollar coupled with a lack of a fair and coherent trade policy have inflicted great and sometimes fatal damage to U.S. manufacturers.

Over the last eight years since I took over a then failing company after a leveraged buyout, Remington has witnessed the vagaries of the international marketplace probably as much as, if not more than, almost any company in the United States.

First, the U.S. market. In 1979 Remington had a 19% share of total unit shaver sales in the United States. In 1983 Remington had a 40% share of the men's market, and 56% of the ladies' market. How did this come about? Because in 1979, I set policy that Remington was to dramatically reduce the price of its shavers to the American consumer, improve profitability for future growth, and maintain the excellent quality of the Remington shavers. In 1984 an independent test by CONSUMER's REPORT declared our Remington XLR 3000 shaver as "top rated," and stated "An American-made model was a standout." This rating remains today and is a proud tribute to Bridgeport, Connecticut workers. Incidentally, Remington is listed in the book, THE 100 BEST COMPANIES TO WORK FOR IN AMERICA, and is the only leveraged buyout so mentioned.

Beginning in 1984, Remington's growth plateaued and Remington was inhibited from further growth by two factors. Norelco, the dominant shaver brand, purchased Schick, the third leading shaver brand. Norelco, which is part of N. V. Philips of Holland, one of the world's largest corporations, engaged in a pincer movement with Schick, aimed at Remington. Because of its belief that this purchase was unlawful and violated the Sherman Antitrust laws. Remington, at great expense, took on the $27 billion international Dutch enterprise, N. V. Philips, and the suit is still pending. The Attorney General of the State of Connecticut joined as amicus curiae in Remington's private legal action against this violation of our antitrust laws--a violation designed to destroy the only viable competition and, therefore, put Remington out of business.

The second factor is the strategy of the U. S. Government - a strategy of inflating the dollar to attract capital to fund an ever growing debt which the Administration was unwilling to alleviate through other means. This was highlighted in a speech I made prior to the meeting of the Group of Five in September 1985. That speech is being submitted in writing to this committee as part of my presentation.

Today, the aberration of currency values has been corrected to some degree with certain countries. However, there still are countries who maintain fixed rates with the U. S. dollar because of their controlled currency, and these are among the countries with which we have serious trade imbalances.

It will take time to correct the errors of the past. The trade debacle of the last five years will not be corrected short term through a rapid change in currency values. There are too many sophisticated financial instruments today that protect over the short run. The inflated value of the dollar lasted almost five years, and now many U. S. industries and companies have left these shores so that exports that normally would be present from the U. S. no longer exist.

The Administration has been an unknowing accomplice in an attack by Norelco (Philips), the dominant brand with their foreign-made Norelco and Schick shavers. For example, the best selling Norelco (Philips) shaver was at the same price point as Remington's best selling shaver - $29.98. As the dollar increased in value, Philips reduced its price to $26.49 and Remington matched that drop. The dollar decline continued and Philips reduced their price to $18.98. There was no way Remington could match that price. It was decided to maintain the price, increase advertising, reduce capital spending, and, of course, reduce profits. The situation became so desperate for Remington that in addition to our pending antitrust action against Norelco, we filed a petition with the International Trade Commission for relief. While we were being hurt at home, the inflated value of the dollare was also hurting us overseas. Due to the false high dollar, our margins overseas were squeezed, advertising had to be reduced or prices increased. We were in danger of losing our most valuable commodity, market share. We tried to solve this problem on a country-by-country basis as best we could, but it has been impossible to compete profitably. But what about other practices? Practices of foreign nations regarding American-made products which exacerbated our problem. Let me list a few of the barriers, unfair practices, that face American products today. You will note that most of these barriers are in countries that have enormous trade surpluses with the United States.

1. Korea, Taiwan, and much of South America have either high import duties or embargoed the import of electric shavers and other products into their countries, while being permitted to bring in their shavers into the United States duty free or at a preferential rate. Especially disturbing was our experience in Venezuela, where we completely lost our investment in advertising because the oil crisis precipitated an embargo on the importation of shavers.

2. In Germany Remington was substantially precluded from selling shavers by the major brand, Braun, through a system of rebates to the dealers through whom Remington was trying to sell. In my view, this course of action would have been considered to be an unfair trade practice in the United states and a violation of Robinson Patman.

3. In Japan relatively small U. S. manufacturers, such as Remington, cannot enter in any significant way unless they distribute through a well financed Japanese company. In spite of this, we started our own company which after five years of losses, we expect to be operating in the black this year. About three years ago, we obtained the rights to distribute the Clairol Foot Fixer in Japan, to help cover our overhead, but were quickly dissuaded from the venture when the authorities required that we retain a doctor to inspect every single unit.

4. In France, we once again faced the vagaries of politics and the worldwide financial markets. Some years ago, we decided to invest in advertising in France, where, as in Germany, TV commitments must be made in October for the advertising for the following year. Shortly after, President Mitterand announced price controls at the wholesale level. This, coupled with the rise of the U. S. dollar, placed us in a situation where the more shavers we sold, the more we could lose.

5. It would be virtually impossible for us to export to India due to the domestic contents requirements.

6. In Nigeria, we had a situation which demonstrates the need for export credit insurance or guarantees for American-made goods exported abroad. Since no such credit insurance was available here, we had to export our shavers through our subsidiary in the United Kingdom, where we could obtain credit insurance of up to 90% of the total value of our shipments to Nigeria. The insurance proved critical, because we were never paid by the Nigerian Central Bank, even though we had a letter of credit, and we could only collect through our insurance in England. We had to add value in England of approximately 30% to conform.

The cost of shipping our shavers from England was much higher than it would have been if we could have shipped directly from the United States. Providing for export credit insurance or guarantees here would aid U.S. exports and would enable us to export directly to Nigeria and other countries where similar problems exist.

Recommendations

1. Currencies which have already shown some adjustment cannot be allowed to radically swing back to where they were, in the near term. There were five years of aberration already on one side of the pendulum. There must now be a long term period of currency stabilization and equalization on a trade related basis.

2. Those countries which control their currencies to maintain a quasi parity with the dollar must face retaliation if governmental pressures are not sufficient. I recommend an across the board currency equalization tax, a standard percentage levied on all products emanating from that country and imported into the United States. This tax can be adjusted based on performance on a continuing basis.

3. We should set into motion a means of insuring shipments to countries in which payment is questionable due to the internal financial structure of the institutions (I refer you to my Nigerian example) or because of political or military disturbances.

4. Lastly, we must remember that we are not involved in world trade. We are involved in economic global conflict with each nation's government trying to raise the standard of living of its populace.

In the speech which was given on September 10, 1985, before the Southern Governors Association, and which I am submitting to your Subcommittee, you will find additional specific recommendations for regressing the trade imbalances of countries that, either arbitrarily restrict product or arbitrarily control their currencies, in order to maintain an unfair trade relationship with the U.S. This causes favorable trade balances for them and increased standards of living for their population at the expense of the American people.

Remington is a small unique company. We don't have overseas manufacturing which can be utilized to adapt to changing currency relationships or changing tariff or quotas. If we had been a public company over the last few years, I don't think I would be here addressing you today because I think I would have been forced out by irate shareholders who wondered why we remained in the U.S. It has cost us millions of dollars to remain a U.S. based manufacturer but we would not run from our native habitat or displace our loyal, dedicated employees.

Thank you for permitting me to address you today.

VICTOR KIAM'S SPEECH
51ST ANNUAL MEETING - SEPTEMBER 10, 1985
SOUTHERN GOVERNORS' ASSOCIATION

I am delighted to be with you at the 51st Annual Meeting of the Southern Governors. I am particularly pleased because I am a native son having grown up in the Bayous of Louisiana. I have traveled not only all the states of the South, but I have been to nearly every nook and cranny of our great country. In just one generation we have seen your area of the country burst forth as a real land of opportunity, growth and optimisim. You, the chief executives of these Southern states have worked to build up your industries, universities, support your entrepreneurs, and clear the way for businesses to grow. Your states have created an environment that offered opportunity without controls and restrictions. So it is a pleasure for me to be here today to discuss the concerns I have as a business executive and entrepreneur as to the current national situation and direction in the area of international trade..to point out the problems and offer suggestions for correction.

It is indeed fitting that the topic of this year's meeting is "The South Going Global." But, unless we recognize that we, as a nation, are at risk today in the international trade area, we won't be going anywhere. Instead, we'll be taken to the cleaners by other more aggressive countries. And, the hard work that you, Governors, and your predecessors have done to build your states' financial positions in manufacturing and services will be quickly undone. I have thought about what southern states can do to improve their international trade posture. Today I beleive you are being as effective as possible. Most of you have developed a U.S.P. for your states -- your unique selling proposition that sets your state apart. If not it is a mandatory objective in the highly competitive environment in which you operate.

The main principle for success is to plan long-term. Long-term relationships are much more important in foreign lands than here. Don't expect short-term successes. Constant attention and interest is a necessity to attract investment.

For those states where political control may change, a bi-partisan approach should be undertaken to assure continuity. The approach cannot be widespread but must be pinpointed to the most logical countries based on your U.S.P. A full-time staff with responsibility and account ability should be employed, rather than consultants. Nemawashi, prepare the ground for planting -- watch it grow -- piano, piano slowly, slowly. There can be no short-term goals. And look for the entrepreneurs! They are the creators, the builders.

President Reagan has said "This is the age of the entrepreneur." Yes, this is the age of the entrepreneur -- it has always been the age of the entrepreneur. Each year more jobs have been created by...more patents have been issued to...small entrepreneurial businesses, than to large corporations. You are representatives of southern states, but you cannont control the economic climate or national direction. We, as a nation, are not engaged in international trade, we are in a struggle of economic global conflict. First, there is the broad struggle between the communistic countries and the socio-democratic societies. In this area there is no question that we are winning. Secondly, within the socio-democratic sphere there are nationalistic rivalries as each nation's government tries to raise the standards of living of its citizenry. It has to be said about our nation's trade situation: we are in trouble, we are on a rudderless ship, (many have said we are on the Titanic) and unless we correct our course, we will flounder on the seas only to curse at the shore and discover we have become a second class debtor nation. In point of fact we are there now. This year the United States became a debtor nation for the first time since 1914. This is not a trend we want to see continue for future generations to confront. Our balance of trade deficit has ballooned from $36 billion in 1980 to a projected $150 billion in 1985.

I do not beleive that the spirit of an entrepreneur need reside only in a business person. That feeling of trying new approaches, different strategies, anything to make something work better is the essence of an entrepreneur and the basis for any successful person. It has been the spirit of this country for most of its short life. It has guided us through civil upheavals, world wars and nationwide depression. While it is evident that such an attitude has fired your spirit to try new approaches in these southern states, it seems to be lacking on a national level. That spirit of the entrepreneur was the underpinning for even greater national productivity and creativity which has led our country to an unbroken string of international trade surpluses for more than 80 years.

That same spirit drove me in my own efforts to turn around the performance of the company I bought, Remington. We are a microcosm of our country. We manufacture in the United States with no overseas plants and export to the world. Remington has a favorable balance of trade of $16 million. Together with the enthusiasm of our management and employees, we have re-established a famous American name brand as a domestic competitor and a challenger in 31 foreign markets. We investigated many different approaches to the problems we faced and kept trying different ways until we were successful. Throughout this ordeal -- and that is the only way to describe a turnaround venture -- I knew we could make a quality product in America and tell our customers that it was "Proudly Made in the U.S.A." I never thought for one second that American workers had to take a back seat to foreign employees and I would not let that happen. We are pleased that CONSUMER REPORTS ranked our rechargeable MicroScreen Shaver the top-rated shaver and noted that surprisingly it was American-made. Our factory employees earn $9.84 an hour against the national average rate of $9.45. As the only U.S. shaver manufacturer, we are competing against foreign companies who pay 75 percent of our national average rate in Germany, 67 percent in the Netherlands, and 50 percent in Japan -- only $4.73 and hour. We have company-wide profit sharing and everyone has individual incentive plans, including the factory area. We have no blue collars, no white collars -- only the Remington collar. I am terribly proud that Remington -- the smallest company listed -- is included in the book, THE 100 BEST COMPANIES TO WORK FOR IN AMERICA.

I want Governor Jim Martin of North Carolina to know that there are employees in his state who join me in saying "Proudly Made in the U.S.A." These North Carolina employees make the travel cases for the Remington shaver and took production and jobs that had previously been in Taiwan. They are great workers, Governor, and their product is tops -- and it's 100 percent

American-made. And unlike Coke's initial approach, Remington has developed a sportswear line that will be introduced this Christmas by major national retailers "Proudly Made in the U.S.A." -- in Alabama, Kentucky, Florida and Tennessee.

After purchasing Remington through a leveraged buyout, I had to restore Remington's U.S. manufacturing base. I was adamant that Remington remain a U.S. company -- albeit the last U.S. manufacturer of electric shaver products. While I was able in just three years to double Remington's share of the U.S. electric shaver market, I realized I had to quickly improve our export sales. America is no longer a self-sustaining market for many consumer items. It is not for electric shavers, we are in a global environment. Successful businesses simply have to sell in foreign countries to continue their growth and maintain production cost efficiencies. Foreign sales become even more important as foreign manufacturers aggressively market here in our own backyard. I travel around the world twice a year to implement this policy. Your own industires recognize this. For instance, in Louisiana, Texas, and South Carolina, one manufacturing job in eight is export related. Simply put, America's business market is now and must always be international in scope.

You, as Governors, have recognized this. Your states are taking actions to spur on their entrepreneurs -- technology centers, university support, and tax breaks are examples. And with your own overseas offices and trade missions you can help these businesses grow toward foreign markets. These are meaningful actions on your part and I applaud your own entrepreneurial activities to promote your states and your products.

In fact, you are becoming so competitive that if I were to announce that I planned to relocate a business with a thousand employees and was looking at a possible southern location, I wonder if I could make it out of this room with my suit intact. Each of you are well-equipped to compete with your neighbors. But one thing you or your states cannot do is compete without regard to our nation's trade policies or lack thereof. Every business in each of your states is at risk today in the international global conflict because our nation lacks an international trade policy. Business leaders need certainty about their business environment in order to make planning and investment decisions. As a business executive, I know I can look to our states and local governments and gauge levels of support in terms of taxes, employment and development assistance. But when I look to Washington for fundamental direction as to our international trade policy, what I see is almost total anarchy. We are, indeed, a nation at risk. We are told that our national policy is free trade/anti-protectionism. I agree wholeheartedly with that thesis, but where is the nation's trade leadership? In the White House, where it belongs? No. It has been abdicated by inaction and inattention. Our national leadership has been unwilling to undertake bold new initiatives and has repeatedly called up the spector of Smoot-Hawley. Congress is trying to assume the leadership role, and with what result? More than 300 protectionist bills have already been introduced. There seems to be protectionist legislation for every major and even many minor industries. This is not leadership. In point of fact, this once again evidences my conviction that our nation's trade policy must emanate not from Congress but from the White House, the executive branch of our government. But with effective policy that recognizes the changed environment in which American workers and businesses must exist and compete.

What is the executive branch of our government doing about our dismal state of affairs vis-a-vis international trade? It seems we have 25 federal agencies that deal with our trade policy. They spend more time shoving each other around than they do developing and implementing a coordinated trade policy. The results then become obvious. The 535 Senators and Congressmen try to takeover at the helm of our trade ship when they should more properly be manning the oars.

Instead of a coordinated trade policy which would recognize the current situation and be structured to correct it, all I see is chaos. I see congress assuming a leadership role -- a role abdicated by the White House. Yes, anarchy governs our international trade direction and America's economic competitve position worsens and worsens.

A small example. Our British company paid Remington L4 for the micro-shaver in 1980. Now, with no rise in manufacturing costs, the price paid is L8. How can we still be competitive.

No Governor in this room would allow the anarchy that characterizes Washington's trade policy apparatus to exist in his or her state's agencies. You wouldn't because you know your industry and finance are ultimately at risk.

Yet our current practice of having no trade policy in Washington means a flood of imports, both fairly and unfairly traded, blocked exports, and a push of our own home-based industires to off-shore status. Can your state attract investment when you are competing with much lower wage rates compounded by enormous overseas advantages of deflated currencies and advantageous nationalistic tax laws as well as hidden subsidies. Something has to be done, done now, and done carefully, but urgently. And it has to be bold and creative. I would like to offer three suggestions.

The first suggestion: this nation must have a trade policy and it must come from the White House. The President must address this issue and pound out a sensible and supportable policy, a policy which gives you and me a sense of direction. This policy, I beleive, should have three basic components.

First, we have been talking too long in this coutnry about the lack of reciprocal market access for U.S. exports. While we talk, our trading partners continue to increase their product shares in our markets while effectively blocking out our products in theirs. Congress acted and has provided the administration with adequate enforcement tools. The administration must launch a series of investigations against countries which impose unfair barriers on the import of U.S. products. We have been patient too long. Either get our "Proudly Made in U.S.A." products into overseas markets or face the inevitable consequence of losing the slogan "Proudly Made in U.S.A."

Second, the Administration on its own initiative -- and the President has taken the first steps -- should launch a series of complaints against dumped and unfairly subsidized imports. The Administration's initiating such actions -- as opposed to relying on the enforcement of our unfair trade laws by industry

-- would be unprecedented and send strong signals that our market, while being an open market, is open only for fairly-traded products. Why must U.S. industry act alone and have to bear the burdens and costs of keeping open our markets?

Third, today many foreign industries do not need to dump or take advantage of domestically available subsidies to be competitive in this country. They have the advantage of the overvalued dollar. This situation must be corrected. The dollar needs to be realigned by getting our own federal budget in order. In the interim, the administration must be prepared to help U.S. industries that are being clobbered by increaseing levels of foreign imports. The administration had better recognize these increasing levels and be prepared to act and provide the interim relief our trade laws provide. I am not asking the President to reject his policy of free trade. I'm asking him to be realistic about the conditions facing our industries today as they struggle to compete. It does no good to say "Sorry" and watch our industries go off-shore. If they are in need of interim, short-term breathing room and the result of any temporary releif is long-term competitve equalibrium with imports -- let them have it.

My second suggestion is straightforward. The President, backed up by American businesses and the Governors, must say no to the surcharge proposals coming from Congress.

The surcharge proposals are based on quick-fix remedies for individual industries or against individual countries. They will surely invite reciprocal action and benefits will go to the few that shout the loudest and they will be only short-term probably for the most inefficient and least competitive industries.

Why just quotas on automobiles or limitations just for textiles?

Reference has been made to the disastrous effects to "free trade" of protectionist measures such as Smoot-Hawley.

In the present economic global conflict there really isn't "free trade." G.S.P. nations completely block imported products from the U.S. in exchange for our open door policy. L.D.C. countries operate in the same manner. Export subsidies and hidden barriers abound and other nations control the value of their currencies.

We have truth in labeling, truth in packaging, and truth in lending -- what we need is <u>TRUTH IN TRADE.</u>

But an import surcharge fo individual industries or companies is not a long-term solution -- it's the opposite: it marches us backward. Currency is the major obstacle to America's remaining a viable factor in the international trade arena.

Since the end of Bretton Woods, the value of trade related goods and services between nations has fluctuated with the monetary policies of nations -- not solely on the inherent value of the item themselves. Trade is at the mercy of governemntal fiscal policy, all too often based on political aim. The United States is the defender of the socio-democratic political systems. To this end, its current policy results in an expenditure of 7 - 8 percent of its gross national product for defense. It's <u>protected</u> industrialized partners spend from one percent of

G.N.P. in Japan to 3 - 5 percent in Europe for defense, and the current U.S. fiscal and tax policy does not allow for budget balance.

To finance this fiscal gap, funds must be attracted to this country. As interest rates are increased well beyond levels necessary to balance a purely domestic economy, the dollar soars. As a result other nations receive the greatest incentive to their trade -- in effect a currency subsidy.

It isn't poor work ethic or higher labor rates that are sinking the American economic ship, it's the U.S. Government's financial subsidy of foreign products. How much is that subsidy? 40 percent.

A 40 percent subsidy to imports -- a 40 percent barrier to exports. That is the increase in the value of the dollar since 1980.

We have supported nations throughout the world, we are the protection of the "free world."

We must make sure that the long term economic health of our nation and the future standard of living of our society is not destroyed.

In my final suggestion, I call upon the President, the Congress and the Governors to support a trade equalization program -- not a protectionist program -- but, I want to repeat, -- a trade equalization program. This country needs a trade policy which seeks to eliminate non-trade related influences on trade relationships -- a trade equalization program. The concept is directly tied to correcting artificial imbalance. I would suggest that an equalizing system of currency surcharges be developed which are pegged to a particular base -- to the value of the U.S. dollar -- and based on bilateral relationships. Such a system would provide a base value for the dollar to be compared with foreign currencies. An import surcharge would be imposed according to differences in valuation and adjusted on quarterly, semi-annual or annual time frames.

For example, the Japanese Yen should be at 190-200 to the dollar, yet it is artificially at the 240-260 level. But it is not. Why? Yesterday's WALL STREET JOURNAL might provide a clue. I quote. "The accepted wisdom in Tokyo financial circles is that the capital-outflow problem is an interest-rate problem. As long as U.S. bonds yield 10.5 percent and Japanese bonds earn 6.5 percent, money will flow out of Japan into the U.S. and the major reason for the four-point spread in interest rates is the large U.S. Budget deficit."

"Higher interest rates in Japan could stem the tide of capital outflow thus strengthening the Yen. But Japan's economy could be hurt by rising rates at home. 'We want to lower the interest rate,' says Mr. Kaneko of the ministry of finance.

This is just one example of a worldwide monetary climate -- self or national protection -- pure protectionism. A specific surcharge could be imposed of, for example, 20 percent on all imports from Japan to eliminate the artificial devaluing of the Yen to the dollar and its improper influence on trade. This would mean that if an item had zero duty it would become 20 percent. If the currency had 10 percent duty it would become 30 percent. If the currency values became more equivalent, the surcharges would be reduced or eliminated. Here, the surcharge would serve a balancing purpose -- the elimination of artificial monetary influences on established trading relationships. Let's demonetarize trade.

Unless we take such a step -- a trade equalization program -- our American manufacturing infrastructure will be shattered. We have become a nation of businesses and governements fascinated with the short-term solution. We have been all too unwilling to face the long-term problems and address their solutions. The risk is that even if a business is showing a profit today, it is probably not able to invest in capital improvements, R & D or advertising to maintain a competitive edge in international markets over the long haul. We simply cannont allow our manufacturing capacity to erode or be pushed off-shore. Two million manufacturing jobs have disappeared over the last 14 and a half years. And the American farmers, although the most productive in the world, cannont overcome the vagaries of currency resulting in a dramatic decline in the U.S. farm trade surplus. We will beocme a nation whose main commerce will be to serve the needs of others -- a service society. In other words, once again we will become a colony. You can show your support for immediate actions by alerting your Congressman and Senators to your fears of alarm of the present and the future, a coordinated effort is needed to effect action and change.

Another area in which corrective action should be taken immediately for trade equalization is a revision of the tax laws in the international arena. There have been many proposals for a restructuring of the U.S. tax system but nowhere in those proposals is there any reference to changing the outdated but existing tax code that permist U.S. companies to produce overseas for lower tax rates than they would pay if they were U.S.-based. For example, if Remington, located in Bridgeport, CT, makes $41 million pre-tax it would pay $500,000 in taxes. If Remington moved to Hong Kong, the total tax ould be $170,000 providing the company with an additional $330,000 in working capital and cash flow.

Tax laws promulgated in the late 1940s to assist U.S. companies to become multinational are no longer an asset but a liability. Example: In 1984, a public Florida company in our field earned $300,000 pre-tax last year, but paid $641,000 in taxes. Reduced by adjustment and allocations of foreign earnings at a lower rate.

Let's review our taxation structure, not only for U.S. individuals and domestic corporate tax rates, but in the international sphere as well. These laws must be changed to keep American companies and American jobs at home.

Your see, today we are involved in more than mere international trade. We are involved in global economic conflict. Improving our position in this area cannot occur with bandaids or with fingers in the dike. We must establish a coherent trade policy that looks at the realities of the world situation, the status of the United States of America in the world and the numerous relationships we have with each of our foreign trading partners -- our friends whom we support in so many ways.

We can no longer espouse free trade without fair trade and without a trade policy that gets us there. It is time for Congress to stop posturing, the White House to start acting.

The worst situation we can face is not to act to develop an effective, a competitive international trade policy and organization. A wrong decision can be spotted and changed. An entrepreneur makes mistakes but he or she quickly retools and moves on. Let's face it, our competition is proving very adept. Our failure to decide only perpetuates this drift at the same time our international competitors continue to penetrate -- and penetrate aggressively -- our markets.

I have placed before you three suggestions, as well as specific recommendations. You can agree or disagree with them in their entirety or as component parts of a whole. However, we must take action. We must have trade leadership and we must have a sense of direction. It is about time that I, as a businessman, and you, as Governors, sought measures to bring some order to the nonsense that is our country's -- yours and mine -- foreign trade policy and organization. It is time to shout that the U.S. trade policy stands before us stark naked. We cannot wait any longer, for this nakedness is yours and mine also.

Thank you very much.

STATEMENT OF DR. LARRY DILDINE, PARTNER, PRICE WATERHOUSE, WASHINGTON, DC

Dr. DILDINE. Thank you, Senator Baucus. It is very much a pleasure for me to be here this morning. I want to talk to you specifically about tax policy and its relationship to America's international competitiveness.

I am head of a group of tax economists in Price Waterhouse who do consulting here in Washington for a variety of clients, but I appear this morning here as a witness invited on my own behalf and will not necessarily be representing the views of any of my clients or of my firm.

The term "competitiveness" has come into prominence in the last few years as a symbol for a variety of problems that seem to persist in the U.S. economy. These problems include slow growth in productivity, the decline in the manufacturing sector relative to services and the associated dislocation of workers, our large international trade deficit, the shrinking world market share in certain manufactured products, slow growth in real living standards as compared especially to Western Europe and Japan, and our rapidly increasing external debt.

All of those problems have at one time or another been associated with the idea of international competitiveness, and all of these problems are related. Yet, it seems to me that the wide range of these concerns has caused the competitiveness debate often to become unfocused and sometimes to degenerate into slogans.

So, for today's purposes, I think we need to narrow the competitiveness issue to those few key sectors that are most related to or might be altered by the structure of the U.S. tax system. And I would suggest that we focus the discussion of taxes and competitiveness on three specific areas.

Let's look at how the tax law affects productivity, how it affects technological innovation and capital expansion, and how it affects the cost and quality of manufactured goods in particular.

You should understand first that promoting exports probably will have very little to do with reducing the trade deficit. The trade deficit is not primarily a failure to compete in world markets. It results primarily from our national propensity to borrow abroad, rather than to save at home. The Federal Government is a very large contributor to this condition. Government dissavings—that is the Federal budget deficit--wipes out a large share of the relatively small amounts that we save privately.

Thus, much of our capital expansion must be funded by borrowing from abroad. When we borrow, we will necessarily import more than we export, which means incurring a trade deficit. If reducing the trade deficit is an objective, nothing is more important than reducing Government borrowing.

Federal tax policy can influence what we export, but as compared to budget policy, the structure of the U.S. tax law has relatively little to do with the overall U.S. trade balance.

Also, I think it is clear that a tax incentive or disincentive is only one of many international economic policy tools. Education and training policies, basic research programs, tariffs and other trade policies, monetary policies, and budget policies all need to be coordinated with tax policies to improve the U.S. competitive position.

To date, the conclusion of most research on the international economics of tax policy concludes that tax structure changes can be important in specific areas of international trade and finance, but tax influences can easily be overwhelmed by changes in Government borrowing or the value of the dollar or changes in U.S. interest rates, protectionist trade policies, and the like.

It also seems to me that the competitiveness issue is really about manufacturing for export. It is true that our resource-based industries and agriculture are still important in world trade. Also, the service sector can create new jobs and some services may be exported. But I believe that fundamentally the concern for competition is a concern that a strong U.S. economy must have a strong export-oriented manufacturing sector, especially in technologically advanced products.

Now, as a professional tax policy analyst, I think it is important to ask quantitative questions about the international implications of tax policy. Just as we have become accustomed to evaluating the revenue consequences of tax law changes, or the distributional consequences, or the effects on domestic costs of capital or effective tax rates, we ought to also be looking at the quantitative effects on international economic variables.

Just after the Tax Reform Act passed last fall, we were visited by some colleagues from Sweden who asked me specifically what international economic policy lay behind the Tax Reform Act. And I had to say that, as far as I could tell, having followed the discussion and the markup and so on very closely, there really wasn't any international economic policy behind it.

There were quantitative revenue targets that were clear. Tax rate targets were clear. Distributional targets were clear. But no international economic targets were clear.

Often, revenue considerations came to dominate larger economic policy questions, even when revenue amounts in particular provisions were relatively small. We always had numbers for revenue effects, and that was appropriate; but we rarely had any analysis of trade, technology, or capital flows to go with them.

There is a tendency for tax policy to be controlled by effects that we think we can measure, even when other consequences are more important.

So, if we are really concerned about international economic objectives, it seems to me four quantitative questions should be asked regarding proposed tax policy changes.

First, what is the effect on U.S. productivity, capital investment, and economic efficiency? Second, what is the effect on trade flows? Third, what is the effect on direction or magnitude of international investment flows? And fourth, what is the effect on technological innovation in U.S. goods and services and in production methods?

Let's look at each of these in turn.

First, productivity and efficiency. If tax policy is to promote U.S. growth, we should promote the growth of businesses we do best. For the most part, these are best chosen by markets. A neutral tax policy among industries will promote efficiency. Fortunately, quantitative estimates have been made of tax burdens by industry sectors, and these studies—based on technique of cost of capital analysis—have been getting increasingly more sophisticated. These studies have generally come to the conclusion that tax burden on U.S. businesses was raised somewhat by tax reform, but also that the tax burden across industries was made considerably more uniform.

Uniformity in taxes on domestic production will help to make our domestic economy more productive and efficient, but the higher corporate tax burden will also restrain our productivity enhancing investment in plant, equipment, and research. Both of these findings are significant for U.S. productivity and efficiency.

Now second, what is the effect on trade? Trade policy can also alter the terms of trade, that is, the relative prices of traded goods in the international economy. And it can influence the location of economic activity among countries. Taxes or tax benefits that affect costs in any particular trade-oriented industry can have a significant and lasting impact on the terms of trade.

When tax costs are raised, the response may be to export less of the product, import more, or move domestic production offshore. Here again, recent empirical work has estimated the effect of tax policy changes on trade. Studies, for example, by the staff of the International Trade Commission have estimated that most price increases due to the Tax Reform Act were modest.

Most manufacturing industries will experience a small increase in prices, on the order of seven-tenths of one percent. Certain industries will even have been affected positively by the tax law. It is estimated, for example, that increased domestic output as a result of the change in the tax law last year might include leather and footwear, apparel, computers, and aircraft. Again, however, these changes are relatively modest, and that is the basic conclusion of most of the studies in that area.

The third area that should be quantified to the extent possible is the effect of any tax policy change on international investment flows. We need to look at each tax law change and consider whether it increases capital inflow, which in the short run will be accompanied by an increase in the trade deficit, or whether it causes an increase in capital outflow, which would in the short run tend to reduce the deficit. Again, there is good economic work being done at the Treasury Department and elsewhere on this subject that suggests that the Tax Reform Act would result in some short run capital outflow leading to a short run improvement in the trade balance. Over a longer period of time, because we have raised the tax cost of investment, the Treasury analysis suggests a two to three percent reduction in the U.S. stock of plant and equipment and, consequently, some long-term harm to the U.S. trade position.

I should emphasize that all the quantitative studies are certainly not definitive. We need to do more research in all these areas. But it is important to note that quantitative analysis does exist. It is being performed, and these studies do not get nearly enough attention or support.

Fourth, I think we ought to look at technological innovation in the United States and consider in particular what tax policy has to say about the ability to do research and development.

Probably the one aspect of tax policy that has had relatively little analysis is in areas of specific foreign tax provisions. These provisions can be very important for particular industries and for particular kinds of products. We have now what I would call a patchwork of rules: source rules, transfer pricing rules, cost allocation rules, antitax haven rules, and foreign tax credit rules. These have been put together and changed often over many years. Many of them were changed in the last tax law; a few of them are being looked at again this year; and it seems to me that it is time to take a look at all of them together and try to rationalize them.

Let me just go directly to a couple of conclusions that I have reached from thinking about this subject.

First, I believe it would be very useful, as I just said, to review systematically the patchwork of foreign tax provisions that now exist. To some extent, tax reform and accompanying rate reductions actually made dealing with the foreign tax provisions more difficult. These provisions should be rationalized to reflect a coherent policy and should be tested for their effect on trade, innovation, and capital flows in addition to revenue and equity concerns.

Second, the importance of closing the Federal budget deficit cannot be overemphasized. If increased taxes must be part of the solution, the nature of such increases should be consistent with our international economic goals. The policy should be to avoid further damage to innovation and modernization in the U.S. traded goods sector.

Thank you. That concludes my remarks.

Senator BAUCUS. Thank you very much, Dr. Dildine.

The first question I have is: What is most important from the point of view of this committee? Would it be raising revenue and maybe cutting some spending to reduce the Federal budget deficit, thereby encouraging less public dissavings in this country? Is that number one?

Dr. DILDINE. I think it is number one. I think realistically we are going to have to do both. Clearly, it seems to me, you should look at the outlay side first, but there are a number of areas that it is very difficult to do very much about. The deficit looms as the major problem in this whole area.

Senator BAUCUS. But as an economist, you think the highest priority should be reducing the Federal budget deficit?

Dr. DILDINE. Yes.

Senator BAUCUS. In order to increase savings, our national savings rate in this country?

Dr. DILDINE. Yes. Right.

Senator BAUCUS. Greater savings and———

Dr. DILDINE. So that we no longer have to borrow massively from abroad. It is a very insidious effect, but over a number of years, we will surely find ourselves in the position where we own less and less of the capital that we use for production; and more and more of the income from it is going to be going abroad.

Senator BAUCUS. Now, does it make any difference that we in this country have a unified budget, have a statement of receipts and expenditures, and we don't have a balance sheet or an income statement and so forth?

Dr. DILDINE. Right.

Senator BAUCUS. I know all the problems of evaluation and so forth. But, if we did, assuming we could handle that reasonably well, does it make any difference to you if we don't have those kinds of national statements, rather just a statement of receipts and expenditures? Some suggest that this thing is all skewed. What is the big deal here?

Dr. DILDINE. Yes.

Senator BAUCUS. What is your reaction to that?

Dr. DILDINE. I don't want to belittle the difficulties of doing a capital budgeting for the United States. That would be a very difficult task.

Senator BAUCUS. Yes.

Dr. DILDINE. But I think anything that could cause us to look ahead more, to be more concerned about longer term consequences of policy would be a good thing; and that is certainly what you use the capital budget for.

Senator BAUCUS. Let's say we were to move to a capital budget. Would that have any effect on your judgment that still we have to both reduce our expenditures and increase our receipts in order to make our country more competitive?

Dr. DILDINE. Without one, it is very hard to say exactly what it would show; but in conjunction with our national accounts for the private sector, looking at a Federal capital budget would probably show the same growing debt burden.

Senator BAUCUS. If we have to increase revenue then, in your judgment are there better ways to raise revenue than some others in view of enhancing America's competitive position?

Dr. DILDINE. Certainly, there are.

Senator BAUCUS. What are they?

Dr. DILDINE. In general, the most important objective, if you have to raise revenues, is to raise them as uniformly across the economy as you can. Here, I guess may be the only place that I find myself disagreeing with Mr. Kiam.

You really don't want to be in the business of picking out what kinds of consumption are good and what kinds of consumption are bad, whether I should like this kind of consumer good or that kind of consumer good.

Senator BAUCUS. But you agree there should be some sort of raising of revenue?

Dr. DILDINE. If we are going to be concerned about saving and we need to find more revenue, perhaps we ought to look at consumption-based taxes. And I think, if we are going to do that, we ought to make them as uniform and low rate as possible.

Senator BAUCUS. Some say a consumption tax, though, is inflationary. If you have an across-the-board consumption tax, then oops, up go prices; and that is not a good thing to have.

Dr. DILDINE. It certainly isn't, and some price increases probably would be a short-run effect. That suggests that nothing here can be done really fast. We have got ourselves in such a deep hole that we are not going to get out of it overnight. Once again, the inflation problem could be minimized by being careful about phase-ins and transitions.

Senator BAUCUS. Some say that a consumption-based tax is too regressive. We have a high payroll tax in this country; it is just another regressive tax.

Dr. DILDINE. That is true, and perhaps at the same time, we need to look again at our income taxes and make some counter balancing adjustment there.

Senator BAUCUS. I am sorry—you are suggesting what?

Dr. DILDINE. I am suggesting that if we go to a consumption-based tax, we might at the same time want to reinvestigate the distributional consequences of the income tax and try to bring about a balance there.

Senator BAUCUS. Is there any merit, other than a consumption tax, in your view, to other kinds of incentives, targeted investment incentives or in savings incentives? Would that help or hurt?

Dr. DILDINE. I have suggested that. One of the things that we might target is research because there is clearly a public benefit to that.

Senator BAUCUS. R&D. You mean an R&D tax credit?

Dr. DILDINE. Yes, of course we do that already. We have probably a more favorable tax system toward research than most of our competitors. I think we ought to be careful to maintain that. Otherwise, I very much agree with the previous witness that we ought to be careful about targeting anything. It is important for the country to save more.

It is important for the country to become as aggressive in research and innovation as we can be, but I would not like to see the Congress or this committee picking out particular kinds of investments to channel our saving into; and that is one of the problems you run into with targeted investment incentives. The markets, I think, are better at choosing those than tax law is.

Senator BAUCUS. So, you are basically saying that to raise revenue, we should do it with a consumption tax. What do other countries do that we can borrow from or utilize ourselves in their tax structure that affects their competitiveness?

Dr. DILDINE. There is another thing they do, and this is going to be controversial with some of my colleagues who perhaps follow me. Another thing that most other countries do is they find some way to integrate the corporate and individual income tax. They find some way to reduce the double taxation of corporate earnings or even to eliminate them in large part. We have actually, in the last year or so, gone the wrong way. We actually in many instances stiffened the double-tier tax that we have.

It would seem to me that one thing we want to look at—again, thinking entirely in terms of the long run—is some form of integration of the corporate and individual income tax.

That, and doing away with investment tax credits—all those things like that—in the short run, have some costs because they tend to give some benefits right up front to old capital and old decisions. But in the longer term, I think they are important for getting ahead with doing business with less interference from the tax consequences.

Senator BAUCUS. What is the major argument against that? You said you think some of your colleagues think it is a bad idea.

Dr. DILDINE. I think you made reference before to the concern about taking off the investment tax credit, that it somehow rewards old investment as compared to new. And that may be true for a while, but it seems to me that it is more important to get the tax system as much out of the way as possible in business decision-making; and over a period of years, low tax rates, a uniform tax base, and a tax that does not make a large distinction between whether you are doing business as a corporation, whether you are doing it here or abroad as a corporation, whether you are doing it as a partnership or whatever entity will help to make us more competitive. I think the tax system ought to be getting out of the way of business choices as much as possible.

Senator BAUCUS. One of the subsequent witnesses suggests that unearned income for foreigners—that is, unearned income in our country—should be taxed. Now, it is not. Would that be a good idea?

Dr. DILDINE. I am not sure what the reference is to, but as I said before, I think we have haphazardly built up our laws about how we tax foreigners doing business in the United States and U.S. companies doing business abroad and the relationships between them. We built those laws up in a kind of crazy quilt, and I think you could look at a number of specific provisions that give anomalous effects of that sort. We really ought to do a study to rationalize those and see if they can be made more consistent with our international economic goals.

Senator BAUCUS. You heard Mr. Kiam. He was just adamant in talking about the wild fluctuation in exchange rates, and it is just killing him.

Dr. DILDINE. Yes.

Senator BAUCUS. I remember hearing about two years ago, I think, Helmut Schmidt speaking downtown. He said something that really struck me at the time, and it may have something to do with this problem. He said: Countries don't like fixed exchange rates because it forces them to do what they should be doing. It is politically easier for a government to get off the fixed exchange rates because the fixed rate system forces the countries to address some economic difficulties in their own countries. So, it is easy for a country to want to do so. Maybe that is part of the problem here. Maybe if we moved to a floating system, they could decide, what the heck, let things float and people could take care of themselves, which makes it less likely that we as a country would address the basic economic fundamentals in this country.

I guess my basic question is: What should this Government do to address Mr. Kiam's problem and the problem that I think most American exporting industries have?

Dr. DILDINE. Yes.

Senator BAUCUS. There is this big runup of the U.S. dollar. How do we prevent that from happening again?

Dr. DILDINE. Again, at the risk of sounding like a broken record, I am going to agree entirely with what he said. I think the most important thing we can do is to reduce the Federal Government's deficit. Insofar as the argument about the fixed exchange rates is concerned, I am not so sure they would help. It certainly would cause a government to take action, but the actions that it might take are not always the healthiest ones. In a fixed-exchange environment, you very often wind up having to do things with exchange controls or with tariffs or with other kinds of protectionist policies.

What we have done now, though, is we have failed to live up to the requirements of a floating exchange rate world.

Senator BAUCUS. You are saying a balanced budget. Is that what you are saying?

Dr. DILDINE. Yes, that is what I am saying.

Senator BAUCUS. It all comes down to that?

Dr. DILDINE. Congress is right now talking about $23 billion to be raised for this year, $12 billion of that in taxes.

Senator BAUCUS. Right.

Dr. DILDINE. We are talking there about an amount that is clearly within the range of estimating error for one year. If it helps, it can't help very much. It seems to me that to be serious about deficit reduction takes a lot more than that.

Senator BAUCUS. How much further do you think we could go in reducing the deficit so as not to give our economy too much of an adverse jolt? 30 percent more? 20 percent more?

Dr. DILDINE. Yes, I thought the idea of doing it over four or five years in a ratable way made a certain amount of sense, but we keep putting off the first year. That is basically what seems to happen.

Senator BAUCUS. I don't know what all this means, but I just had my office check; and the Dow Jones is trading down at 10:00 a.m. 94 points.

Dr. DILDINE. Oh.

Senator BAUCUS. So, this whole conversation is certainly relevant, but I don't know how it is relevant.

Dr. DILDINE. I don't think anybody knows, from day to day, how it is relevant; but if we look back from now six months, and see that that turned out to be a permanent adjustment or even the beginning of a downturn, maybe we will have found that the deficit problem we have been postponing for several years now finally needs to be addressed.

Senator BAUCUS. Thank you very much, Dr. Dildine. I appreciate it.

Dr. DILDINE. Thank you.

Senator BAUCUS. Our next witnesses are a panel, Dr. John Makin, who is the Director of Fiscal Policy Studies and Resident Scholar of the American Enterprise Institute; and Dr. Gary Hufbauer, Wallenberg Professor in International Financial Diplomacy of the School of Foreign Service at Georgetown University. Gentlemen, thank you very much for coming today. Why don't we begin with Dr. Makin and then hear Dr. Hufbauer?

Dr. MAKIN. Thank you.

Senator BAUCUS. You can tell us what all this means in view of the big drop in the market.

Dr. MAKIN. I am going to have to leave the room for a minute.

Senator BAUCUS. I think we all are. [Laughter.]

[The prepared written statement of Dr. Dildine follows:]

Larry L. Dildine, Ph.D.

Price Waterhouse
Office of Government Services
Washington, DC

I. Introduction

Good morning, Senator Baucus and members of the Subcommittee. It is a pleasure to speak with you today on the role of tax policy on America's international competitiveness.

My name is Dr. Larry Dildine. I head the Tax Economics Department of Price Waterhouse here in Washington. We are a group of professional economists and tax policy specialists who perform economic studies and provide consulting services to clients on a wide variety of tax policy and tax compliance matters. I appear today, however, as an invited witness on my own behalf and will not necessarily represent the views of the firm or our clients.

Today, I would like to cover three topics, which I hope will contribute usefully to discussions of international tax policy issues. First, I want to consider the true meaning of the term international competitiveness. Second, I would like to propose a set of criteria we can use to measure the effect of taxes on competitiveness. Third, I will consider briefly the structure of some other countries' tax systems, as compared with ours.

II. "Competitiveness": The Main Issues

The term "competitiveness" has come into prominence in the last few years as a symbol for a variety of problems that seem to persist in the U.S. economy. These problems include: slow growth in productivity; a decline in the manufacturing sector relative to the services sector and the resulting dislocation of workers; our large international trade deficit; our shrinking worldwide market share in certain manufactured products; the slow growth in our real living standards relative to many other countries, especially in Europe and the Far East; and our rapidly increasing external debt. All of these problems are related and, yet, the wide range of these concerns has caused the "competitiveness" debate to become unfocused and sometimes contradictory. For today's purpose, we need to narrow the "competitiveness" issue to those few key factors that are most related to, or might altered by, the structure of the U.S. tax system.

I suggest that we focus the discussion of "taxes and competitiveness" on three specific problems:

1. Productivity -- the means to keeping down the cost of quality exports and improving our standard of living;

2. Technological Innovation and capital expansion, which are essential to increasing U.S. productivity and raising the quality of U.S. goods for export;

3. The Cost and Quality of Manufactured Goods, which directly determine the health of the U.S. manufacturing sector in a global economy.

You should understand, first, that promoting exports probably will have very little to do with reducing the trade deficit. The trade deficit results from our national propensity to borrow from abroad rather than to save at home. The Federal government is a very large contributor to this condition. Government dissaving, i.e. the Federal budget deficit, wipes out a large share of the relatively small amounts that we save privately. Thus, much of our capital expansion must be funded by borrowing from abroad. When we borrow, we will necessarily import more than we export, which means incurring a trade deficit. If reducing the trade deficit is an objective, nothing is more important than reducing government borrowing. Federal tax policy can influence what we export, but, as compared with budget policy, the structure of the U.S. tax law has relatively little to do with the overall U.S. trade balance.

Also, I think it is clear that a tax incentive or disincentive is only one of many international economic policy tools. Education and training policies, basic research programs, tariffs and other trade policies, monetary policy, and budget policy all should be coordinated with any tax policies designed to improve U.S. competitiveness. To date, the conclusion of most research on the international economics of tax policy is that tax structure changes can be important in specific areas of international trade and finance, but tax influences can easily be overwhelmed by changes in the value of the dollar, changes in U.S. interest rates, protectionist trade policies, and the like.

It seems to me that the "competitiveness" issue is really about manufacturing for export. Yes, our resource based industries are still important in world trade and, yes, the service sector can continue to create new jobs and, yes, some of our services may be exported. The U.S. increasingly supplies financial, communications, technical and business services to the world. But, I believe that fundamentally the concern for "competitiveness" is a concern that a strong U.S. economy must have a strong export-oriented manufacturing sector, especially in technologically advanced products.

III. Analyzing the Effect of the Tax Structure on U.S. Competitiveness

As a professional tax policy analyst, I think it is important to ask quantitative questions about the international implications of tax policy, just as we have become accustomed to evaluating the revenue consequences, or the distributional consequences, or the effects on domestic "cost of capital" and "effective tax rates." A Swedish colleague who visited last fall asked me what international economic policy lay behind the Tax Reform Act. I had to say that as far as I could tell there wasn't any. There were quantitative revenue targets, tax rate targets, and distributional targets, but no international economic targets. Often, revenue considerations came to dominate larger economic policy questions, even when revenue amounts were relatively small. We always had numbers on revenue effects, appropriately, but we rarely had any analysis of trade, technology, or capital flows. There is a tendency for policy to be controlled by effects that we think we can measure, even when other consequences are more important.

Four quantitative questions should be asked regarding proposed tax policy changes that affect the international economy:

1. What is the effect on U.S. productivity, capital investment and economic efficiency?

2. What is the effect on trade?

3. What is the effect on the direction or magnitude of international investment flows?

4. What is the effect on technological innovation in U.S. goods, services, and production methods?

To promote U.S. growth we should promote the growth of businesses we do best. For the most part, these are best chosen by markets. A neutral tax policy, as among industries, will promote efficiency.

Fortunately, quantitative estimates have been made of tax burdens by industry sectors. The starting point for these estimates is to estimate changes in the "user cost of capital", a technique pioneered by Dale Jorgenson and Robert Hall and practiced with ever-increasing sophistication and detail by academics, private tax consultants, and the excellent professional economic staffs of the Congress and Federal policy agencies. For example, a recent study by Donald Rousslang of the International Trade Commission reviewed the effect of Tax Reform on the cost of capital of 77 industries. He concludes that TRA will "increase the cost of capital to most U.S. industries ... However, the law will reduce substantially the existing industry differences in marginal effective tax rates."[1]

Cost of capital studies generally show the tax burden on U.S. business to be higher after tax reform, but more uniform. Uniformity in tax rates on domestic production will help to make our domestic economy more productive and efficient. But, the higher corporate tax burden will restrain our productivity-enhancing investment in plant, equipment, and research. Both of these findings are significant for U.S. competitiveness.

2. What is the effect on trade?

Tax policy can alter the terms of trade, i.e. the relative prices of traded goods in the international economy, and it can influence the location of economic activity among countries. Taxes (or tax benefits) that affect costs in any particular trade-oriented industry can have a significant and lasting impact on the terms of trade in its products. The response may be to export less of the product, import more, or move domestic production offshore.

Here again, recent empirical work has estimated the effect of tax policy changes on trade. Rousslang estimated that most price increases due to TRA-induced increases in capital costs are modest: most manufacturing industries experience a small increase in prices (less than 0.7 percent), and two industries which have been affected by import competition, footwear and leather products, actually could experience price decreases. Several industries are estimated to increase domestic output, due either to increasing exports or reducing imports. These included: leather and footwear, apparel, computers, and aircraft. Again, however, the changes are relatively modest, generally in the range of one percent.[2] The conclusion of modest changes in relative prices is also supported by research conducted by Jane Gravelle of the Congressional Research Service.[3]

3. What is the effect on the direction or magnitude of <u>international investment flows</u>?

The question here is whether tax provisions alter the after-tax return on U.S. offshore investment, in such a way as to influence capital inflow or outflow. For example, encouraging the repatriation of foreign income to U.S. parent companies would result in a capital inflow, while provisions that discourage foreign investment in the U.S. would result in a capital outflow. Capital flows will have a counterpart in trade flows.

Some capital flow effects of tax reform have been estimated by Harry Grubert and John Mutti, of the Department of Treasury's Office of Tax Analysis.[4] Their analysis uses a general equilibrium model to estimate simultaneously the effect of TRA'86 on sectoral output, trade, and capital flows. Grubert and Mutti estimate a short run capital outflow, leading to an improvement in the trade balance of some $8 billion per year in the short run, but also a small increase in the trade deficit ($1 to $2 billion) in the long run, because the increased stock of U.S.-owned capital abroad will generate greater investment income and finance more imports. Overall, the U.S. stock of plant and equipment is estimated to be reduced by some 2 to 3 percent, due to reduction of investment incentives, the corporate minimum tax, and the uniform capitalization rules. Assuming mobility of capital, the authors conclude that "a relatively modest change in the tax on U.S. capital income at the business level can have a significant [positive] effect on the trade balance in the short run, and can lead to a visible long run change [decline] in the capital stock."

I should emphasize that the authors of all of these quantitative studies will be among the first to say that their results are not definitive. The data, research on taxpayer behavior, and modeling techniques all need to be improved. In particular, we need to turn our analytical tools to the analysis of the more complex and specific international tax provisions, such as the foreign tax credit limitations. My main point here is that quantitative analysis does exist, especially with regard to the broadly applicable tax provisions, and this analysis is getting better all the time.

4. What is the effect on technological innovation in U.S. goods, services, and production methods?

Research and development of innovative products and production methods is clearly one of the most important keys to our international economic viability; and research is an economic activity that is particularly susceptible to the influence of tax policy. For example, it is estimated that the combined effect of Tax Reform changes (rate reduction and reducing the R&D tax credit) would likely result in making R&D relatively more costly than before. In this regard, a paper by Cordes, Watson, and Hauger presents evidence that U.S. tax reform generally increased the cost of R&D, although the increase was less than for other types of investment. They estimate that "corporate tax rules that directly affect R&D under new U.S. tax law continue to be more favorable than corresponding rules under either Japanese or West German tax law." However, "the effect of tax reform as a whole is to worsen the relative tax treatment of U.S. high technology firms as compared to their Japanese and West German counterparts."[5] It is not clear that this result is what Congress intended.

As I said before, the specific income tax provisions that apply to foreign income and investment deserve much more analytical attention than they receive. These provisions include the source rules, transfer pricing rules, cost allocation rules, anti-tax haven rules, and foreign tax credit rules. Let's look at a couple of these.

Probably the most important impact of TRA '86 on multinational companies stems from the interaction of the corporate tax rate reduction and the foreign tax credit limitation. U.S.-based companies with operations in high-tax countries (such as most of Europe and Japan) will be very likely to find themselves in the position of having excess foreign tax credits. Grubert and Multi estimate that 70 percent of U.S. multinationals (weighted by gross income) will now have excess credits.

A U.S. company with excess foreign tax credits may now seek to expand in the U.S. instead, or to locate or expand operations in a low-tax country in order to reduce its average foreign tax rate. Also, foreign-based multinationals with U.S. manufacturing operations will generally encounter higher taxes in the U.S. Depending on the amount of credits allowed by the home country, the higher U.S. taxes on business may discourage foreign investment in the U.S., leading to an increase in the capital outflow.

Another example of tax provisions that appear to have conflicting objectives are the section 861 R&D allocation rules. The regulations, as currently written, clearly overallocate U.S. R&D expenses to foreign affiliates, which has the effect of reducing the available foreign tax credits. The U.S. is the only major country that reduces foreign tax credits by such an allocation. As a result, these allocation rules partially offset the tax provisions encouraging R&D, thus hampering the efforts of U.S. firms to invest in productivity-enhancing technology.

I should add at this point a comment about the "hidden tax" of complying with the tax changes affecting U.S. companies competing in the international marketplace. It may have been unintended by Congress in developing the TRA, but it is clear that companies will face a major burden in complying with the allocation rules for interest and other expenses, the basket limitations, and other extremely complex provisions of TRA '86. Conscientious taxpaying companies will have an extremely difficult time complying with the international provisions; smaller companies may find the burden overwhelming. I want to emphasize that companies don't always object to the principles of these provisions, but that the ensuing paperwork burden is out of proportion to the additional revenue generated by the changes.

IV. A Brief Look at Some Other Countries' Tax Systems

U.S. competitiveness is often compared with the relatively fast growing economies of Europe and the Far East, notably West Germany and Japan. One should ask whether the tax systems of these countries provide any insight into their ability to increase productivity, manufactured exports, or technological innovation. First, let's examine the structure of the tax systems of Japan and West Germany.

The attached chart shows total tax (federal, state, and local) as a percent of GDP in the U.S., Japan, and West Germany, for 1980 and 1985. The total tax burden in the U.S. is much closer to Japan, which has the lowest overall tax burden of the three countries, than it is to Germany which is the highest. The other major European countries have overall tax burdens in the range of Germany, or higher.

In general, the composition of taxes are perhaps more similar among these countries than is often perceived. The Japanese tax system is similar to the U.S. system. Social Security taxes in Japan are about the same proportion of GDP as in the U.S., as are consumption taxes. Consumption is taxed in the U.S. through sales taxes, excise taxes, and customs duties. Japan does not have sales taxes, but total excise taxes are about the same proportion of GDP. Neither country has a Value Added Tax. In both the U.S. and Japan, total taxes on income, profits, and capital gains are about 13% of GDP, but Japan has an integrated corporate/individual income tax structure that treats the corporate tax as a withholding tax with credits to shareholders for the tax component of dividends. This integration feature accounts for some of the apparently lower ratio of individual to corporate taxes in Japan.

Germany's tax structure differs in several ways from the U.S.[6] Social Security (payroll) taxes are higher (13.8% of GDP), and German consumption taxes are higher, principally because of VAT revenue of 6% of GDP. Germany does have a small net wealth tax, but, in comparison, U.S. taxes on property are about 2.7% of GDP. In both Germany and the U.S., income taxes represent approximately 13% of GDP, with 10 - 11% from individuals and 2 - 3% from corporate taxpayers. Like Japan, Germany has a form of corporate tax integration -- a lower rate on corporate dividends and a credit to shareholders.

What can be said about the role of these tax structures on competitiveness? In international comparisons of the cost of capital, the U.S. is generally found to have relatively high costs of capital which tend to discourage capital expansion and the use of new technology.[7] The higher capital cost is mainly because of our low supply of savings, rather than taxes. Comparisons of the taxation of income from capital performed by Hulten, by Shoven and Tachibanaki, and by Ando and Auerbach have shown that the U.S. and Germany have historically had relatively high tax rates on capital compared to Japan[8]; and Tax Reform will cause the U.S. rate to increase.[9] The existence of corporate tax integration and the greater use of consumption based taxes are important reasons for the lower taxes on capital in Germany and Japan.

V. Conclusion

I would like to conclude my testimony with two general recommendations for your consideration. First, I believe it would be very useful and illuminating to review systematically the patchwork of foreign tax provisions that now exists. The rules for royalties and other inter company prices, the income source rules, the anti-tax-haven rules, the cost allocation rules, the foreign tax credit limitations, etc, are largely uncoordinated, sometimes contradictory, and extraordinary complex. Tax reform and rate reduction have only made matters worse. These provisions should be rationalized to reflect a coherent policy and should be tested for their effect on trade, innovation, and capital flows, in addition to revenue and equity concerns.

Second, the importance of closing the Federal budget deficit cannot be overemphasized. If increased taxes must be part of the solution, the nature of such increases should be consistent with our international economic goals. The policy should be to avoid damage to innovation and modernization in the U.S. trade sector.

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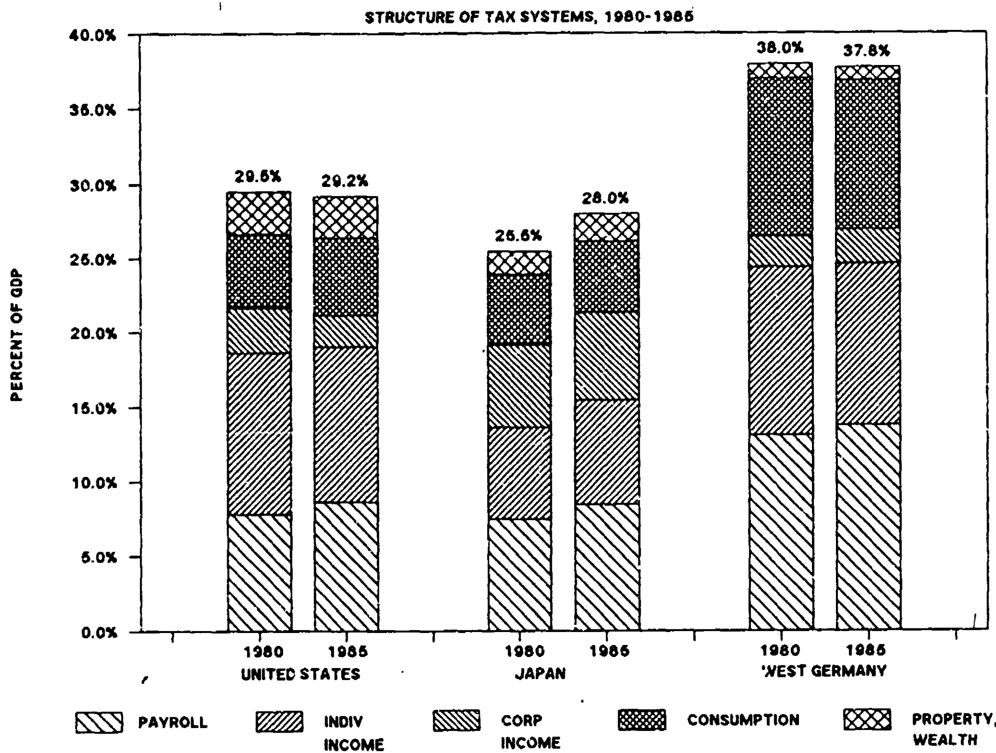
US, JAPAN, WEST GERMANY



Source: OECD Revenue Statistics, 1965-1986

STATEMENT OF DR. JOHN H. MAKIN, DIRECTOR, FISCAL POLICY STUDIES AND RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Dr. MAKIN. Senator Baucus, I am very pleased for the opportunity to be here to talk about taxation and American competitiveness. Let me try to put in perspective what I think is the main reason we are here today, and that really is what I view as one of the things that happen that is a major historical accident, a combination of events that began early in the 1980s and brought about some changes in world markets that made it very difficult for American companies to compete.

In 1981, as we all know, Congress passed an historic tax reform bill that sharply reduced the tax burden on various forms of capital and also sharply reduced the overall tax take, although projections at the time varied.

There were some modifications to the bill in 1982, but by and large, the incentives for capital formation were left in place. At the same time that the Congress here was contemplating these major changes in American tax law, Japan was contemplating a major change in its foreign exchange control law. Up until 1980, Japan had a very stringent law which effectively prevented most capital outflows from Japan.

In December of 1980, with some pressure from the outside but largely due to a consensus reached inside Japan, the foreign exchange control law was modified in such a way that large capital outflows from Japan were feasible.

So, we had then developing a situation where, in the United States, we passed tax measures that stimulated particular kinds of investment. We put into place a tax system that implied a very high level of Government dissavings, that is, we had lower tax rates. And so, we of course also increased spending.

The Federal sector of the U.S. economy was set off on a major dissaving path, and the private sector was set off on an investment spree. And this began to appear not in 1982 because we were in a recession, but in 1983 and in 1984 investment began to pick up very sharply.

So, in the United States, you had major changes in policy that created a tremendous draw for capital. In Japan, you had a huge reservoir of savings that had largely been channeled to domestic uses until the passage of the Foreign Exchange Control Act late in 1980.

But as the pull from U.S. capital markets increased because, as we moved into the period with rising deficits, very expansionary fiscal policy, we were also in the course of controlling inflation. So, at least until 1982-1983, monetary policy was quite unaccommodated. So, you had a surge of demand in the United States, relatively tight money.

The floodgates in Japan were lifted, and the savings flowed out of Japan with a tremendous force that pushed the dollar up very strongly. So, the dollar appreciated tremendously until 1985, as we all know.

Now, the problem here was from the standpoint of American competitiveness although there was some progress on the capital cost side, and the incentives to invest were uneven.

So, from the point of view of American competitiveness viewed from capital—from the point of view of capital—you had some drop in the cost of capital for some forms of investment; but in order to improve competitiveness when you cut the cost of capital, you have also got to increase the productivity of capital. If you put into place tax measures that encourage investment that wouldn't otherwise have been undertaken, in effect you put into place incentives for relatively low productivity investment.

So, you had a drop in the cost of capital, a drop in the productivity of some investment, and at the same time, the macroforces—that is, the large Government dissaving in the U.S., expansionary fiscal policy, and the surge of saving in from Japan—caused the dollar to appreciate tremendously so that a lot of the investment that was undertaken was not undertaken, especially in American manufacturing, with the view that the dollar would reach 260 yen, that is, with the view that it would be very difficult to compete with Japanese products at home and abroad.

So, everything as it turns out—and it wasn't something by design; it was a collection of events—that made it very difficult for American manufacturers to compete as we moved into an expansion that normally would be very good for those manufacturers.

In some cases, it was; but in some cases, it was a very mixed and uneven expansion. This has been often a term that has been used to characterize the expansion.

So, as Mr. Kiam and other witnesses have mentioned, some of the American manufacturers moved abroad to get around the exchange rates.

Now, if you look at American competitiveness over the long period in terms of the performance of American factors, a study that we have just completed at American Enterprise Institute suggests a gradual deterioration of competitiveness that has continued at an uneven rate since 1960, which is when we started our search.

But if you adjust the competitiveness for exchange rates, there was a very sharp deterioration of competitiveness brought about by the sharp depreciation of the dollar from 1982—sorry, a sharp appreciation of the dollar—from 1982 to 1985. Since then, the turnaround in the dollar and its sharp depreciation have more than compensated for the steady loss in American competitiveness; and ultimately, our manufacturers I think will find themselves able to compete in world markets.

We are in for what is currently a rather painful adjustment right now in the foreign capital markets and the U.S. capital markets because—again, as other witnesses have suggested—the terms on which the rest of the world is prepared to accommodate a very high level of American net borrowing are getting worse; and that is reflected in the sharp drop in the bond market and the parallel sharp drop in equity markets.

We ask: What can we do now? And how can we get out of this? Yes, it is going to be necessary to try to reduce the budget deficit. I think I would prefer to see measures on the spending side, and I think it is necessary, if something significant is to be done on the spending side, to take a sharp look at what are currently mandated entitlements and adjust the rate of growth of those entitlements.

The simple fact is that the entitlement programs were put into place in the 1960s when prospective growth of the American economy was viewed at four percent. We have indexed those entitlements, that is, we have not allowed inflation to cut into their real value, which is an attractive social goal. The question is: If the economy underperforms and it turns out that we cannot afford the entitlements without sharp increases in taxes that would impair our competitiveness, should we adjust the rate of growth of the entitlements?

You raised the question, Senator Baucus: What about the balance sheet accounting approach to looking at the American budgetary situation? Arthur Anderson completed a study in 1986 of the 1984 budget deficit on a balance sheet account adjusted basis; and although the deficit as we normally measure it in 1984 was $180 billion, they estimated that the actual deficit was more like $330 billion——

Senator BAUCUS. How much?

Dr. MAKIN. $330 billion, when you adjusted for the very large unfunded liabilities of the Social Security System.

You know, another way to deal with this is to suggest that a very rough rule of thumb to calculate the budget deficit to reflect the major unfunded liabilities is simply to omit payroll taxes from current revenue, that is, simply do not count the payroll tax, which is earmarked for the Social Security System as current revenue. You get pretty close to the figure that Arthur Anderson suggested, and you also follow the practice that is currently followed in Japan.

When Japan reports its deficit, it is a deficit that does not include as revenues the receipts on the payroll tax on the rationale that the money is already spent because prospective aging of the population is going to put very heavy demands on the tax system in the future if contracts implied by the Social Security or the Social Insurance Program are going to be satisfied.

Senator BAUCUS. I just want to understand that point.

Dr. MAKIN. Yes.

Senator BAUCUS. Japan does not report payroll taxes? Does that have the effect of increasing its deficit?

Dr. MAKIN. Yes.

Senator BAUCUS. So, if we did not also, then our deficit would be much greater?

Dr. MAKIN. Yes. Let me make a last comment about the possible changes in the Tax Act of 1986 from the standpoint of enhancing competitiveness. We conducted a fairly extensive simulation study of the effects of the Tax Act, I guess, just after its form became final. Our major finding was that there were some significant gains to the economy from a more even distribution of tax burdens, but that the major weakness of the system was a lack of indexing for provisions related to income from capital, that is, provisions that would affect investment. Capital gains tax rates are not indexed. There is no indexing provision for the reevaluation of depreciation or inventories.

And our simulation suggested that if inflation were to go to the seven to eight percent range from the three to four percent range, the losses in terms of higher tax burdens on income from capital would wipe out the gains from the increased neutrality of the system. So, the major vulnerability of the Tax Reform Act of 1986, I think, is perhaps its vulnerability to higher inflation rates.

Senator BAUCUS. Thank you, Dr. Makin. Dr. Hufbauer?

[The prepared written statement of Dr. Makin follows:]

By John H. Makin, Resident Scholar and

Director, Fiscal Policy Studies

Mr. Chairman, I am pleased to appear before this distinguished Senate committee to discuss the impact of tax policy on American international competitiveness.

My appearance today is timely as I have, as part of AEI's research program in international aspects of fiscal policy, just completed a study of the competitiveness of the American manufacturing sector with that of Japan. This study provides an operational definition of competitiveness and yields a number of conclusions about the effects of tax policy on American international competitiveness.

Defining Competitiveness

American international competitiveness is the ability of American firms to sell their products in world markets priced at or below the prices of comparable products produced abroad. This definition can be made operational by remembering that the essential determinants of the cost of producing goods are the productivity of factors employed in the production process and the costs of those factors. A country's international competitiveness is determined by the ratio of its factor productivity to factor cost relative to the same ratio for other nations. Such ratios need to be specified for both capital and labor. The measure of competitiveness may also be adjusted for the effect of exchange rate changes.

Three Findings on American vs. Japanese Competitiveness in Manufacturing

Before moving to a discussion of the direct effect of tax policy on competitiveness, it is useful to consider three main conclusions from AEI's competitiveness study. These conclusions concern the competitiveness of American labor and capital and, overall competitiveness for the past two decades.

The study's first conclusion is that the competitiveness of American labor deteriorated gradually from 1960-86. In the manufacturing sector, the ratio of American labor productivity to real labor compensation fell relative to the same ratio in Japan at an average rate of 0.8% per year. Over 26 years, that compounds to a loss of 23%. That decline was most pronounced during the 1973-79 post-oil crisis period. The deterioration in competitiveness of American labor was not as bad as the relatively slow growth rate of labor productivity would suggest. However, it was slower growth of real wages (measured by overall compensation per hour in manufacturing) that tended to offset some of the loss of competitiveness due to slower growth of labor productivity.

The 1979-86 period saw the slowest deterioration in the growth of American labor productivity relative to Japan's. The relatively slow growth of the productivity of American labor was partly offset by slower growth of labor compensation in the United States, resulting in a modest, 0.8% annual deterioration of U.S. labor competitiveness vis-a-vis Japan during the 1979-86 period.

The fact that slower growth of labor compensation helped to reduce the net deterioration in the U.S. productivity vis-a-vis Japan is, of course, not good news. In effect, the relatively slow growth rate of U.S. labor productivity put a cap on the growth rate of labor compensation in the United States. The only worse outcome, from the standpoint of U.S. competitiveness, would have been an even more rapid growth rate of overall labor compensation in the United States. Such an outcome, given the relatively slow growth rate of U.S. labor productivity, would have required an even more painful adjustment to achieve competitiveness.

The pressure to improve competitiveness of American labor, given the conflict between pressure for higher wages in the U.S. and the constraint imposed by relatively slow growth of American labor productivity, has led some in Congress to attempt to mandate higher wages abroad. Aside from being unenforceable, such proposals amount to an open admission that American labor can only be made competitive by making foreign labor less competitive. Proposals for backward movement in the world economy to accommodate uncompetitive American labor are unbecoming and selfish for an economy which ought to be providing positive leadership for the world economy.

The study's second conclusion relates to the competitiveness of American capital vis-a-vis Japan's. Here the data is less reliable than in the labor sector but some estimates are available and should not be ignored. Also, it is in the capital sector where tax policy can have the greatest effect on competitiveness so it is important not to overlook capital productivity and capital cost when assessing overall international competitiveness.

A comprehensive study by Maddisson (1987) finds that productivity of capital grew at a negative rate for all industrial countries between 1973-84. However, the negative growth rate of U.S. capital productivity, -0.47% per year, was the slowest and was considerably slower than Japan's -3.41% per year. As a result, the competitiveness of U.S. capital was enhanced relative to Japan even after adjustment for changes in the relative cost of capital.

Based on a study by Ando and Auerbach (1987), the U.S. cost of capital relative to that in Japan changed only moderately over periods for which data is available after 1968. The U.S. cost of capital did rise relative to that in Japan during the 1973-79 period. This is because accelerating inflation in the U.S. pushed up the tax burden on income from capital due to an absence of inflation-indexing of capital gains, inventory valuation and depreciation allowance. This effect was somewhat mitigated by the absence in the U.S. tax code of inflation-indexing on interest income and expense which in turn resulted in negative real interest rates for many U.S. borrowers.

The third major conclusion of the competitiveness study concerns overall U.S.-Japan competitiveness and the effect of exchange rate changes in compensating for changes in the competitiveness of labor and capital. On net, as already noted, U.S. factor competitiveness deteriorated during most of the 1968-84 period. The deterioration appears to have been worst in the 1973-79 period after the first oil crisis. Viewed factor by factor, U.S. labor competitiveness deteriorated by more than U.S. capital competitiveness improved.

The typical response to a deterioration in overall U.S. factor competitiveness was a real depreciation of the dollar against the yen. Real depreciation measures the depreciation of the dollar in excess of the difference between U.S. and Japanese inflation rates. Typically, the larger the deterioration in factor competitiveness, the larger the real dollar depreciation.

Between 1973-79, the period of sharpest U.S. factor competitiveness deterioration (-2.2% per year), the dollar depreciated at a real rate of 5.1% per year. This was sufficient to leave the U.S. with a current account balance in 1979 and a current account surplus in 1980 and 1981.

The pattern whereby real dollar depreciation offset gradual deterioration of U.S. factor competitiveness was reversed after 1981. While a gradual deterioration of U.S. factor competitiveness continued, the dollar appreciated sharply from 1981-85. The exchange rate movement accentuated rather than offset the typical deterioration in U.S. factor competitiveness.

The sharp real appreciation of the dollar and the attendant loss of exchange-rate-adjusted U.S. factor competitiveness resulted from an unusual combination of events. First, a large increase in American federal budget deficits combined with American monetary restraint to push up real interest rates. Second, unusually high American real interest rates coincided with a major change in Japan's foreign exchange control law. The new foreign exchange control law, allowing much freer overseas investment by Japanese investors, went into force in December, 1980. At the very time that U.S. real interest rates were at record levels, Japanese investors, with a very large pool of accumulated saving, were permitted to expand their international investments. There followed a massive increase in capital outflows from Japan that caused an unusually sharp real depreciation of the dollar against the yen.

Based on an examination of Japanese capital inflows to the U.S., the adjustment was largely completed by 1986. The slowdown of that adjustment coupled with a divergence in inflation rates between the two countries resulted in an depreciation of the dollar against the yen beginning early in 1985. That depreciation accelerated in 1986 and went well beyond the depreciation indicated by relative inflation rates in the two countries.

In view of the path of changes in the competitiveness of American factors of production and the sharp real depreciation of the dollar since 1985, it is likely that the competitiveness of American factors of production has been largely restored to a normal, long-run path. Indeed, it may ultimately be the case that the dollar has over-depreciated relative to a stable, long-run path for the exchange rate.

Tax Policy and Competitiveness

With these broad conclusions about the path of American international competitiveness as prologue, it is possible to draw some conclusions about the potential impact of tax policy on competitiveness. The impact is usually analyzed in two ways. The first is to consider its effects on the cost of capital and thereby, upon investment as a means to enhance competitiveness. The second involves the effect of tax policy on saving and the subsequent impact upon interest rates, exchange rates, investment and capital formation.

The most powerful impact of tax policy on international competitiveness, especially for a nation with the lowest saving rate among industrial countries, is most likely tied to a possible effect on the national saving rate rather than the possible effects on the cost of capital. However, if the tax system is poorly indexed for inflation, especially concerning provisions affecting the cost of capital, it is possible that an acceleration of inflation by increasing the tax burden on capital income can harm competitiveness.

The definition of factor competitiveness as the ratio of factor productivity to factor cost at home relative to abroad suggests that changes in tax policy can enhance competitiveness if they reduce the cost of capital without reducing the productivity of capital. If, however, tax policy is employed to encourage investment that would, in the absence of tax incentives, be uneconomic, competitiveness is unlikely to improve.

This somewhat paradoxical conclusion follows because reduction of tax burdens on capital to a point that encourages projects that would not be undertaken without special tax treatment results by definition in capital expenditures that produce below average or even negative changes in the productivity of capital. If the percent reduction in the productivity of capital is greater than the percent reduction in the cost of capital, then, unless the same reduction occurs abroad, capital competitiveness is diminished.

The best way to change tax policy in order to enhance American competitiveness is not to employ tax incentives to stimulate investment directly but, rather, to encourage investment by removing existing disincentives for saving. A higher level of saving puts downward pressure on interest rates which, in turn, encourages investment and capital formation without putting upward pressure on the exchange rate. Faster growth of the capital stock raises labor productivity and thereby enhances the ability of American firms to compete internationally.

It is critical to remove disincentives to save as a way to stimulate investment indirectly rather than trying to do so directly. The saving stimulation strategy results in lower interest rates and easier credit conditions that induce investment without the higher interest rates and stronger currency that results from direct investment incentives. Direct investment incentives are self-defeating by virtue of the fact that such stimulation raises real interest rates and strengthens the currency, thereby undercutting the ability of firms to sell the products produced with the new capital.

Stimulation of saving moves everything in the right direction by easing credit market conditions tending instead, to produce currency depreciation rather than appreciation and enhancing the competitiveness of American products both through a lower exchange rate as well as through more productivity of American labor.

A number of studies including a recent one by Douglas Bernheim and John Shoven at Stanford University and by John Shoven and myself in this year's

<u>Contemporary Economic Problems</u>, published by the American Enterprise Institute, have found that domestic credit market conditions have a far larger effect on the cost of capital, and thereby on investment, than tax systems. The pre-1987 American strategy of employing tax measures to stimulate investment can be characterized as an attempt to overcome American credit market conditions unfavorable to investment that arose from a combination of a tax system biased against saving and a high level of direct government dissaving as manifested by large and persistent budget deficits.

There are two ways to remove the bias against saving in the American tax system. The first, less radical approach, would be to stay with an income-based tax system and move toward reduction of the double taxation of saving implicit in that system by changing the tax treatment of interest income and expense. The most feasible step would be that proposed in the Treasury's Tax Reform plan of 1984 to tax only real interest earning and to allow deductibility only of real interest expense. While a precise indexing formula would be complicated, there are various ways to design a simple indexing formula that would remove 80% of the saving disincentives associated with full taxation of interest income and full deductibility of interest expense.

Some have argued [See Friend and Hasbrouck (1983)] that there exists no evidence to support the claim of Boskin (1978) and Summers (1981) that higher after-tax returns for savers will--other things equal--cause them to increase saving. The drop in U.S. personal saving rates during periods of high interest rates in the 1980s is frequently cited as anecdotal evidence of the unresponsiveness of saving to higher after-tax returns.

A recent AEI study by Makin (1987) suggests that the "elasticity pessimism" with respect to the responsiveness of saving to interest rates may be unwarranted. A re-estimation of the responsiveness of saving to higher interest rates controlling for pension funding behavior that biases downward the measured responsiveness of saving to higher interest rates resulted in a 0.4 elasticity--virtually identical to Boskin's 1978 estimate. This finding implies that tax measures aimed at raising the after-tax rewards to savers can raise the saving rate.

A more radical, but superior and ultimately simpler, approach to the problem of eliminating the double taxation of saving implicit in income tax would be to adopt a consumption based tax system of the type outlined in the U.S. Treasury's 1977 Blueprint for Tax Reform. I recognize that such a radical approach is unlikely to follow quickly on the heels of a major tax bill like that enacted last year. However, the compelling economic logic for a consumption tax in a country with one of the world's lowest rates of saving will remain.

The consumption tax is essentially aimed at elimination of the double taxation of saving. As such, the welfare gains obtainable with a consumption tax are highly sensitive to the responsiveness of saving to interest rates. The findings, discussed above in Makin (1987), are consistent with achievement of substantial welfare gains attributable to introduction of a consumption tax.

Broader Perspective on Saving and Competitiveness

Numerous discussions about American saving behavior, American competitiveness and the means to change both with a consumption tax lead to some broader thoughts about America and Americans that might usefully be interjected here. Do we really want what we say we want? Remember that saving, whether aimed at enhancing competitiveness, or any other goal, is the portion of current output set aside to provide for an increase in future consumption. More saving means using less of our resources to satisfy current needs and setting aside more resources to satisfy future needs. A country that saves more or consumes less is likely to be better able to compete in world markets simply because less demands are being placed upon its resources to satisfy current consumption. Therefore, it is able to offer current goods on better terms in exchange for larger claims on future goods. Japan is obviously such a country.

The combination of a low level of private saving in the United States and a high level of government dissaving means simply that Americans and their government are choosing to provide for less of an increase in future consumption. In fact, during most of the 1980s we have been "dissaving", meaning that we are providing for a modest reduction in future consumption. It remains to be seen whether this is a temporary phenomenon related to a post-1973 reduction in our long-run growth rate or a fundamental, attitudinal change about the future on the part of most Americans.

Dissaving is a rational and normal response to a temporary slowdown in the growth of income provided that the slowdown is reversed within a reasonable time and followed by an acceleration above the trend of growth that provides for the restoration of capital to its pre-slowdown level. As we approach our fifteenth year of the post-1973 slowdown in real growth there is considerable concern that other than being a temporary aberration, the slowdown in growth is permanent and should be adjusted to by some downward shift in spending patterns.

It is also useful to remember that, by international standards, America has always had a relatively low saving rate. The fact that long-run American economic growth, particularly before the 1970s, has been impressive has been related to the discovery of new frontiers both geographic and technological.

In short, "something has always turned up" to keep American growth at a high level. However, now that the American capital stock has expanded to a point where its full employment requires not only sales to domestic markets but also substantial sales in international markets, the terms on which we produce our goods at the margin must be competitive with those offered by producers abroad. This new reality is what has generated the pressure for more American competitiveness and the increased introspection as to how to get it.

It is unlikely that a change in American tax policy will be sufficient to qualify as the "something" that turns up to fully restore or enhance our competitive position. To some extent, restoration of American competitiveness and enhancement of American saving is already underway by virtue of a sharp depreciation of the American dollar. Those who emphasize the effect on the American trade deficit of a weaker dollar emphasize its expenditure-switching effects. Just as important are expenditure-reducing effects whereby currency depreciation operates to restore equilibrium by reducing domestic absorption of resources. A weaker currency produces a higher price level that absorbs the purchasing power of existing financial assets such as money and near-money and cuts the purchasing power of wages. If labor works harder to restore real wages then its productivity and the nation's competitiveness improve. If, in an attempt to restore the real purchasing power of assets, saving increases and the higher level of saving creates a lower real interest rate and a higher level of investment, competitiveness improves again. The higher investment operates to increase the productivity of labor and thereby, international competitiveness. In the interim, higher saving reduces requisite capital inflows and thereby coincides with a lower trade deficit.

Other Options

There do exist alternatives to the consumption tax measures mentioned above. A tariff, or a tax on imports, can be viewed as a selective consumption tax that is a tax on goods imported for consumption. The difficulty with such a tax is that it is also levied on imported investment goods and thereby tends to be partially self-defeating.

There is one thing that the Congress could do to obtain more revenue while potentially making American consumers better off. This would be to eliminate all import quotas and replace the quotas with an equivalent tariff. Existing arrangement, such as the auto import quota with Japan, amount to asking the Japanese please to place a tax on American consumers and keep the revenue for themselves. The quota method also means that American consumers fail to receive the benefits of any productivity improvements which, in the absence of import quotas, would make more products available to American consumers at a lower price. Removal of import quotas would also eliminate a pattern of uneven taxation of imported products implicit in the quota arrangements. If all quotas were removed and replaced by a uniform five percent import tax, the revenue potential, according to CBO estimates, would be about $85 billion over five years.

STATEMENT OF DR. GARY C. HUFBAUER, WALLENBERG PROFESSOR IN INTERNATIONAL FINANCIAL DIPLOMACY, SCHOOL OF FOREIGN SERVICE, GEORGETOWN UNIVERSITY, WASHINGTON, DC

Dr. HUFBAUER. Thank you for inviting me. Senator, we have reached a fundamental consensus in America that we should tax ourselves, at the Federal level, at about 20 percent of the gross national product and we should spend about 24 percent. I believe that only a crisis will turn us around in terms of our thinking, and perhaps the stock market is the announcement of that crisis.

When thinking changes on this fundamental consensus, the stage will be set for repairing the Federal budget. And my guess is that we are talking about cutting public expenditures in the order of $70 billion annually and raising taxes on the order of $80 billion annually. Before turning to taxes, let me offer a short word on cutting expenditures.

To me, sequestration has the flavor of a line item veto, but it is not quite there. I would very much approve of a line item veto for the President who takes office in 1989. Let us try the idea, on an experimental basis, for two years to see how it works.

Now, let me address the tax side. How can we deal with the tax side of repairing our Federal budget?

Broadly, there are three avenues. First, raising personal taxes by broadening the base and raising the rates. Second, introducing a series of consumption taxes, for example, excise taxes, national value added taxes, and user fees for Government services. And third, raising corporate income taxes.

If one assesses the "political ugliness" of these three, it is just about the reverse of the order in which I have listed them. In other words, personal taxes are probably the most ugly and consumption taxes, the second most ugly. In a way, then, corporate taxes win the beauty contest. That is unfortunate from a competitiveness standpoint because the challenge in the years ahead, as we repair our fiscal revenues, will be to raise taxes in a way that does not further weaken the business sector of America. To me, the way to do this is to emphasize consumption taxes.

Let me talk very briefly about the impact of the tax system on competitiveness in the international context.

I think there are two main channels of influence. First, the impact of the tax system on domestic savings and the external deficit; and second, the impact of the tax system on the so-called "cost of capital."

Taking first the connection between taxation and savings, my belief is that a decrease in the Federal deficit of $1.00 will, after a few years, reduce the external deficit by 25 to 35 cents. The improvement is not dollar for dollar, but it is a very significant.

In order to get that improvement, the key thing is to increase taxes and not to increase expenditures, in other words, to actually cut the budget deficit. For the primary benefit, it doesn't much matter how the Federal deficit is cut. It could be cut by raising personal taxes; it could be cut by raising consumption taxes; or it could be cut by raising corporate taxes.

But there is a very important secondary effect of how the tax system is changed in terms of national savings. Briefly, it seems to me that an increase in personal taxes or an increase in consumption taxes will not have much effect on national savings. An increase in business taxes will have a very substantial adverse impact on business savings: I would say about 50 cents on the dollar would be a good approximation.

So, if we repaired the Federal revenues by raising corporate taxes, we will help in one sense but will hurt in another, because business savings will correspondingly fall.

Let me turn to the second aspect of the tax structure and competitiveness, and that is the cost of capital. Previous witnesses have correctly emphasized how important this is, how we already suffer by comparison with Japan, and how a further increase in corporate taxation would worsen our position.

The government can do two things to address the cost of capital problem. One, of course, is to deal with the budget deficit, which we have already talked about. This addresses the cost of capital by bringing down real interest rates. The second thing the government can do is avoid new taxes that place a further burden on business firms by slashing their depreciation allowances or by raising their tax rates.

By contrast with higher corporate taxes, an emphasis on consumption taxes is desirable because consumption taxes do not raise the cost of capital.

Let me just stop there, Senator, and say that a gratifying feature of the present debate on the tax side of the Gramm-Rudman-Hollings Act is that the new taxes so far discussed would not burden U.S. competitiveness. The taxes are in the direction I have talked about.

Senator BAUCUS. The taxes that are presently being considered?

Dr. HUFBAUER. The taxes that are presently being considered by the Senate Finance Committee.

Senator BAUCUS. Right.

Dr. HUFBAUER. And I think that is commendable, and I hope that the same spirit carries forward in the years ahead.

Senator BAUCUS. Thank you very much, both of you.

[The prepared written statement of Dr. Hufbauer follows:]

Testimony by
Gary Hufbauer
Wallenberg Professor of International Finance
Georgetown University

In 1980, Ronald Reagan demonstrated that talk of cutting Social Security benefits was politically hazardous. In 1986, Walter Mondale showed that a good way to lose votes is to talk higher taxes. Both lessons will be remembered in 1988. Thus, the Presidential fiscal debate may very well focus on "waste, fraud and abuse", rather than the serious questions of major expenditure cuts and large tax increases.

As a result, the President elected in 1988 will probably take office without a mandate to repair the federal revenues. Quite possibly, the budget gap will not command serious Presidential attention until bad events befall the U.S. economy, for example:

(1) A jump in the rate of inflation, say to 7 percent annually;

(2) A dramatic increase in interest rates, say to 12 percent on long-term Treasury bonds;

(3) A dollar crisis of substantial proportions, say an abrupt fall of 20 percent.

I am not a pessimist. But I believe that at least two of these bad events will visit the United States before 1990. In a period of economic crisis, the stage could be set for a significant cut in public expenditure -- perhaps by $70 billion annually -- and for substantially higher taxes -- in the order of $80 billion annually. How should the tax side of this painful package be accomplished? Broadly speaking three avenues are available:

(1) Raise personal taxes, through a broader base and higher rates.

(2) Introduce taxes on consumption, for example, higher excise taxes on alcohol and tobacco, a national value added tax, or higher "user fees" on a wide range of government services.

(3) Raise corporate income taxes, again through a broader base and higher rates.

New taxes are never popular, but there are degrees of unpopularity. Higher personal taxes would, I think, be most unpopular, and higher corporate taxes would be least unpopular. This "ugly contest" suggests that much of the additional revenue might be raised from the corporate sector.

While politically understandable, that outcome would be most unfortunate from the standpoint of America's place in the league of world competition. If the United States tax system is not going to hamper America's competitive resurgence, most of the required new revenue should come from taxes on consumption -- for example, higher taxes on alcohol and tobacco, value added taxes, and higher "user fees" for airports, waterways, and national parks. In these remarks, I shall try to explain why.

The tax system affects the international competitiveness of the U.S. economy through two important channels:

-- First, by its impact on domestic savings and hence the U.S. external deficit;

-- Second, by its impact on the cost of capital.

Higher corporate taxation would impair U.S. competitiveness on both counts. By contrast, higher consumption taxes would have little effect on U.S. competitiveness.

1. Taxation and Domestic Savings

Any increase in public revenues which is not absorbed by higher public expenditures (a most important proviso!) will decrease the federal budget deficit. A decrease in the federal budget deficit will in turn reduce the current account deficit. This reduction will not be dollar for dollar, but the figure might be 25 to 35 cents of current account improvement (after a period of 2 or 3 years) for each dollar decrease in the budget deficit. For these purposes, it does not much matter whether the tax increase takes the form of personal taxes, consumption taxes, or corporate taxes. So long as government revenue goes up, and public expenditures do not rise, the budget deficit will go down, and the current account deficit will shrink.

But the type of tax increase does make a difference to savings in the private sector of the U.S. economy. If taxes are raised in sensible ways, then private savings will not be badly damaged. If taxes are raised in foolish ways, then private savings will suffer. Private savings are just as important as public savings in correcting the domestic savings gap and closing the current account deficit. Indeed, as Appendix A shows, the growth of the external deficit in the 1980s was as closely related to the drastic fall in household financial savings as to the mushrooming federal budget deficit.

These are two main sources of private savings in the U.S. economy: households and businesses. Judging from the experience of the 1980s,

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American families do not save a larger fraction of their income when marginal tax rates decline or when tax incentives are offered for pension plans. Indeed, in the 1980s, the measured personal savings rate fell considerably.[1] I conclude that taxes are much weaker than other economic forces in determining personal savings rates.

Consumption taxes would have little adverse affect on national savings. Consumption taxes are collected by business firms (or the government, in the case of user fees), but they are largely passed on to consumers in the form of higher prices. If anything, higher prices might cause some households to postpone consumption and increase their savings.

On the other hand, business savings are sensitive to tax changes. Historically, business firms save about half their after-tax profits and distribute the other half. When taxes take a larger share of profits, less money is left in the pool of business savings. The Tax Reform Act of 1986 will probably increase U.S. corporate income taxes from about 2.4 percent of GNP in 1986 to about 3.4 percent in 1990. This escalation will generate about $120 billion of new revenue over the years 1987 through 1991. My guess is that -- true to past experience -- about half of this new revenue will be reflected in lower business savings. Another increase in corporate taxation in the 1990s would further erode business savings.

Table 1 presents a scenario of corporate and national savings under different tax regimes. A jump in corporate taxes back to a marginal rate of 51 percent could raise about $80 billion. But about half of this gain would come out of business savings. Thus the net increase in domestic savings might be only $40 billion. By contrast, an $80 billion increase in consumption taxes would probably improve domestic savings by the full $80 billion.

TABLE 1. Domestic savings under alternative tax regimes. Estimates for 1990, billions of dollars.

	Law under Tax Reform Act of 1986 (base case)	51% Corporate tax used to help balance the budget	Consumption taxes used used to help balance the budget
Gross national product	5600	5600	5600
New consumption taxes	-	-	80
Corporate profits before tax	380	380	380
All corporate taxes	160	240	160
Corporate profits after tax	220	140	220
Retained corporate profits (50% of after-tax profits)	110	70	110
Corporate depreciation allowances	190	190	190
Gross corporate savings	300	260	300
Change in gross corporate savings (compared with the base case)	-	-40	--
Change in government savings by (compared with the base case)	-	80	80
Net change in domestic savings (compared with the base case)	-	40	80

Sources: Value Line Investment Survey, Selection and Opinion, New York, March 6, 1987.

Estimates by the author.

2. Tax Structure and the Cost of Capital

The second element in the international competitive equation is the cost of capital. Peter Drucker, surveying the world economy, reached an important conclusion:[2]

> The cost of capital will thus become increasingly important in international competition. And this is where, in the last ten years, the United States has become the highest-cost country -- and Japan the lowest. A reversal of the U.S. policy of high interest rates and costly equity capital should thus be a priority for American decision makers.

In the 1990s, direct labor costs will shrink as automation sweeps across the factory floor. Likewise, raw material costs should continue their post-1980 decline owing to material-saving technology. The conclusion is inescapable: capital costs will increasingly distinguish one industrial competitor from another.

Government policy can do two things to reduce the cost of capital. First, it can reduce the budget deficit and bring down interest rates. Second, it can avoid new taxes that would increase the cost of capital to U.S. business. The technical details of the cost of capital calculation are contained in Appendix B. Without delving into those details, the broad message is clear. Corporate tax rates should not be raised and allowable depreciation rates -- especially on equipment -- should not be cut. That brings us back to consumption taxes as the best way to avoid increasing the cost of capital.

A further virtue of consumption taxes should be noted. Because consumption taxes are considered "destination taxes" under GATT rules, they can be "adjusted" at the border. The fact that a value added tax (VAT), for example, can be "adjusted" at the border means that the VAT can be imposed on imports and rebated on exports. Hence the introduction of a VAT will leave export prices expressed in dollars unchanged. Meanwhile, the price of imports, like the prices of goods made and sold domestically, will rise by the amount of the VAT. All in all, then, a VAT causes no change either in export or import price relations that would harm the U.S. trade balance. By comparison, higher corporate taxes would put U.S. firms at a disadvantage in the world marketplace and worsen the trade deficit because, under GATT rules, corporate taxes cannot be adjusted at the border.

As I said earlier, no taxes are popular. Consumption taxes are no exception. Moreover, a fairness issue will arise if corporate taxes remain unchanged while consumption taxes are increased. Here are two suggestions for addressing the fairness issues. No doubt additional ways can be found that would not harm the U.S. competitive position.

(1) Place a cap on true mortgage interest deductions at, say, $20,000 per person per year ($40,000 per couple) and $250,000 per lifetime ($500,000 per couple). There is no reason why the national pool of savings should be artificially drawn by a tax subsidy into the luxury housing market.

(2) Enact a requirement that high net worth individuals and families (e.g. those with assets exceeding $5 million per person or $10 million per couple) periodically appraise their assets at current market values (say every 5 years), and pay capital gains tax accordingly.

3. Tax Policy until 1990.

I have offered broad prescriptions for the direction of tax policy when circumstances compel drastic measures. What about policy during the interim years? My suggestion is to follow the Oath of Hippocrates:

> The regimen I adopt shall be for the benefit of my patients according to my ability and judgment, and not for their hurt or for any wrong...

In these times, it would be wrong to impose taxes that undercut the ability of U.S. corporations to compete in world markets. Recent examples of such wrongs include:

(1) The elimination of the investment tax credit for equipment outlays.

(2) The reduction in the R&D tax credit.

(3) The change in the 1986 Tax Reform Act that limited the foreign tax credit which U.S. banks may claim when they finance U.S. exports.

Even now, similar adverse changes are threatened. For example, there has been talk of a change that would require U.S. firms to pay more tax on their export earnings.[3] Such a change would have a pronounced adverse effect on U.S. exports. This and kindred tax measures should be avoided.

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1. In 1981, personal savings were 6.2 percent of personal income. In 1986, the figure was 3.3 percent. Economic Report of the President, January 1987, Tables B-25 and B-27.

2. Peter F. Drucker, "The Changed World Economy", Foreign Affairs, Spring 1986, p. 781.

3. See Gary Hufbauer and Arthur Hammond-Tooke, "U.S. Export Competitiveness and Source-of-Income Rules", A Report Prepared for the Export Source Coalition, Washington, D.C., October 1987.

APPENDIX A.
Components of Domestic Financial Savings, 1978-1986.

As Alan Blinder points out, net domestic financial savings can be divided into three components: net household savings (household savings minus residential investment), net business savings (business savings minus nonresidential investment), and government savings (federal, state, and local taxes minus government expenditures at all levels). Allowing for statistical errors, total net domestic financial savings (or deficit) must equal the current account surplus (or deficit). As table A-1 shows, American net household savings since 1980 have taken just as big a dive as government savings.

Table A-1. Components of Domestic Financial Savings, 1978-1986.
Billions of current dollars.

Year	Household[a]	Business[b]	Government[c]	Total[d]
1978	-19	11	0	-8
1979	-21	12	12	3
1980	14	27	-35	6
1981	37	-2	-30	5
1982	49	61	-111	-1
1983	-22	112	-129	-39
1984	-13	26	-102	-89
1985	-49	75	-136	-110
1986	-103	97	-142	-148

Source: Alan Blinder, "It's Time to Put an End to the Borrowing Binge", Business Week (May 4, 1987), p. 22.

Notes:
a. Excess (deficiency) of personal savings over residential investment.
b. Excess (deficiency) of business savings (including depreciation allowances) over business investment.
c. Excess (deficiency) of taxation (federal, state, and local) over government spending.
d. Allowing for statistical errors, the total equals the current account surplus or deficit.

APPENDIX B
The Cost of Capital

The standard Hall-Jorgenson formula for the cost of capital contains five main elements:[1]

-- First, the monetary outlay for the capital asset, either physical assets or a body of knowledge.

-- Second, the cost of raising financial capital.

-- Third, the rate of economic depreciation experienced by the capital asset.

-- Fourth, the rate of taxation of corporate profits.

-- Fifth, the investment tax credit and the present value of depreciation allowances permitted for tax purposes.

A simple version of the formula for the cost of capital is:

$$(1)\quad c(1 - t) = q(r + d - p)(1 - k - tz)$$

In formula (1):

c is the user cost of capital, namely the amount of money which, if received as an annual taxable rent, represents the minimum compensation necessary to make it worthwhile to hold the capital asset, taking into account the tax aspects and other features of asset ownership.

t is the marginal corporate tax rate (i.e. the statutory rate).

q is the price of the capital asset.

r is the corporate discount rate which reflects the average cost of raising debt and equity capital.

d is the annual rate of economic depreciation of the capital asset.

p is the annual rate of price inflation applicable to the capital asset.

k is the investment tax credit, expressed as a percent of the price of the capital asset.

z is the present value of depreciation allowances permitted for tax purposes, expressed as a percent of the price of the capital asset (in a present value calculation, future year depreciation allowances are discounted by the corporate discount rate).

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1. Robert E. Hall and Dale W. Jorgenson, "Tax Policy and Investment Behavior", American Economic Review, vol. 57 (June 1967), pp. 391-414.

Senator BAUCUS. You both seem to generally agree that we have to increase the national savings in this country, and the biggest dissaver is the Federal Government. So, that means the more the Federal budget deficit is reduced, the more that helps. Is that right? Is that number one to both of you?

Dr. HUFBAUER. Absolutely.

Senator BAUCUS. And as I hear you, too, you are also saying there are ways to cut that Federal budget deficit. Dr. Makin, you suggest we address the spending side first, primarily entitlements; and I guess, Dr. Hufbauer, you suggest some kind of a mix, but I am not sure exactly the degree to which the mix between spending and revenue makes much difference to you.

Let me just ask this one question of both of you, particularly you, Dr. Makin. The tables I have seen show that the incidence of total taxation in America on a per capita basis, compared to other countries, is actually quite low, that is, about where Japan is. Other countries—West Germany, for example—have somewhat of a higher total incidence of taxes. Now, if that is the case and if we in America are spending a lot more than we are taking in, I guess it is your point that taxes in America on a per capita basis should remain as low as they are, that is, close to Japan's low per capita incidence, but that we should reduce the deficit by primarily addressing spending—that is, keep the low taxation rate about the same, about where it is right now. Is that right?

Dr. MAKIN. Let me add to that a little bit.

Senator BAUCUS. Yes.

Dr. MAKIN. I think we have done an awful lot of emphasis on the taxation of capital versus the taxation of labor. I am convinced that the current tax treatment of income from capital is adequate with the important proviso that we are vulnerable to higher inflation, increasing the tax burden on capital; and I think that that should be addressed. I think that is the key thing that we ought to do with respect to the tax burden on capital.

I think the important distinction here is the tax treatment of spending now versus spending later, that is, consumption versus saving. An income tax system is not the natural state of affairs, although everyone has one. An income tax system taxes saving twice. If you are a country with the world's lowest private saving rate and have a high level of Government dissaving, you certainly ought to give some serious consideration to removing the double taxation of saving, the point there, of course, being to reinforce my earlier testimony that to be competitive it is far more productive to encourage saving than to encourage investment.

You encourage saving that creates a situation where interest rates are lower and thereby encourage investment, rather than by pushing the investment directly and causing interest rates to be pushed up.

Now, of course, all of the things you do, and some economists would argue that it really doesn't matter what you do because world capital markets are so highly integrated that everything will be washed out, that is true to some extent. But I certainly think that the important thing to do on the tax side is to encourage people to spend less now and to put aside more for later.

And the important thing to do on the spending side is to address the programs that make up 70 to 80 percent of total spending.

Senator BAUCUS. Sure. Now, on the tax side, though, what kinds of private incentives do you think we should enact or at least address to encourage more private savings?

Dr. MAKIN. There is the whole-hog consumption tax approach, such as the blueprints approach.

Senator BAUCUS. Right.

Dr. MAKIN. There is perhaps a correction that could be done within the context of the income tax, and that would be to follow the Treasury I provisions on interest income and expense, where the objective is not to tax the inflationary portion of interest income and not to deduct for——

Senator BAUCUS. Right. You think those are two approaches we should pursue?

Dr. MAKIN. Yes.

Senator BAUCUS. Dr. Hufbauer, do you agree with that?

Dr. HUFBAUER. I would stress very strongly the wisdom of consumption taxes. We have been through an episode for many years now of trying to encourage personal savings by liberalizing IRA accounts and lowering marginal tax rates and so forth. As far as we can tell from the statistics, personal savings are not going up; indeed, they are going down. I won't say that personal savings are falling because of the tax system, but I believe that the personal tax system has a weak impact, as presently constituted on savings. The way to deal with this problem is with a sledgehammer; and consumption taxes are that sledgehammer.

Senator BAUCUS. Now, there are various kinds of consumption taxes. There is a value added tax. There is a transfer tax. There are all kinds of consumption taxes. I would like to ask the two of you which of those variations seems to make the most sense?

Dr. HUFBAUER. I will leap in. I believe that the start should be higher excise taxes on "sin" goods, as they are often called.

Senator BAUCUS. Alcohol?

Dr. HUFBAUER. Alcohol and tobacco and a few luxury items.

Senator BAUCUS. Right. Start there.

Dr. HUFBAUER. Start there, but we are probably talking $10 to $15 billion there, and my view of the revenue repair called for on the tax side is about $80 billion—not right away, of course, but over a four or five year period. So, that leaves a yawning gap. I would certainly fill part of that gap with a greater emphasis on Government user fees for services rendered—the airport and waterway type of fees which are familiar. Maybe that provides another $5 billion. That still leaves a yawning gap.

And then I come to a value added tax. I realize the value added tax is not popular. I realize it has many administrative difficulties, and it is not a simple tax. But I am quite impressed that this is the direction most industrial countries are going, and I believe it is one of the fairer types of consumption tax.

Senator BAUCUS. Japan doesn't have one.

Dr. HUFBAUER. Japan is trying to introduce one. Nakasone did try to introduce it; and of course, that created big political difficulties for him. I think they will introduce it in the next——

Senator BAUCUS. Canada is apparently looking at it, too.

Dr. HUFBAUER. Canada is looking at it. I believe the value added tax is the way to go; but obviously, many people have to be persuaded.

Senator BAUCUS. Dr. Makin?

Dr. MAKIN. I guess I would disagree with Gary. I should reveal that, as a cigar smoker and a brandy drinker, I can't condone the "sin" taxes; but I think, too, you can argue against the excise tax on the grounds that it is a narrow and selective base.

So, my first choice would be a comprehensive consumption based tax where essentially you set up an accounting system, such as that laid out in the blueprints for tax reform, where there is no corporate income tax. Individuals are taxed only on what they consume. Capital spending is expense, but there is no deduction for interest expense. It is a relatively simple system, but it is radical; but I think it would be exactly what we need.

It would give us the revenue and address the inner temporal issue that I am concerned about, that is that we need to look at how much we spend now versus later. Second could be a value added tax that I think ought to be introduced in a revenue neutral context, simply because it is rather dangerous to talk about a value added tax without that discipline. Once you have it in place, then you can look at your revenue needs again; but if you are going to generate a lot of money with a value added tax, it is going to be very difficult for this committee and the Ways and Means Committee to resist everyone coming in and saying, well, since you are going to have this money, give it back to us, in one way or another.

So, a revenue neutral value added tax would be my second suggestion.

The third suggestion would again be to try to——

Senator BAUCUS. But by revenue neutral, you mean it doesn't go to additional spending?

Dr. MAKIN. That is right.

Senator BAUCUS. All right, but not revenue neutral in the ways we raise revenue; you want additional revenue?

Dr. MAKIN. No.

Senator BAUCUS. Or lower some other taxes?

Dr. MAKIN. That is right. Lower tax rates.

Senator BAUCUS. Oh, lower rates? Lower the corporate and individual rates to offset some kind of value added tax?

Dr. MAKIN. Yes.

Senator BAUCUS. Right. That doesn't raise any revenue.

Dr. MAKIN. That is right.

Senator BAUCUS. It doesn't lower the deficit.

Dr. MAKIN. That is right, but again, it does address the problem of spending now versus spending later; and I would suggest that if that were done in conjunction with some very careful look on the spending side at very rapidly rising outlays in some of the entitlements areas, that would be my first best. If the only way you are going to get the deficit down is to earmark some of the revenue for the value added tax for deficit reduction, I think it is second best because it is dangerous because it is very difficult to resist the pressure from people who see additional tax revenues and come in and say: Well, now that you have some additional revenue, you should do more for me.

Senator BAUCUS. You would earmark it in some way? Put it in some kind of a trust fund?

Dr. MAKIN. We both know that is very difficult to do.

Senator BAUCUS. Yes.

Dr. MAKIN. That is why my first choice would be just to keep it revenue neutral.

Senator BAUCUS. Has the dollar gone down as far as it should go? You seem to think so, Dr. Makin. Dr. Hufbauer, if I heard you correctly, you think not?

Dr. HUFBAUER. No. I think the Treasury Department made a very bad mistake in agreeing in February at Louvre and then repeating this agreement at the September IMF meetings to keep exchange rates approximately where they were and have been in 1987—using the yen and the Deutschmark as reference points, at 140 yen to the dollar and at 1.80 Deutschmark to the dollar.

I think those rates are keeping the dollar much too high, that is, 15 to 25 percent too high. From this weekend's remarks by Secretary Baker, I think he is coming around to my view. I find that very gratifying. The result of the level of exchange rates that the Treasury has agreed to is to put very great pressure on the U.S. bond market and the stock market because there are a great many institutional investors who have a pervasive conviction—like the one I have stated—that the dollar is too high. So, why continue to hold dollar assets if you think that there is going to be another 15 to 25 percent correction?

Senator BAUCUS. Why do they think the dollar is too high?

Dr. HUFBAUER. Because the pace of the external deficit correction is too slow. In nominal terms, of course, there is no correction this year; in fact, we are going to have a slightly larger current account deficit this year than last year. In real terms, making an adjustment for prices on imports and exports, we have a small correction—$10 to $15 billion. That rate, $10 to $15 billion, is too slow. It means an accumulation of foreign claims on the U.S. economy of at least $700 billion by the early 1990s. The financial markets are doubtful that there are foreigners who want to acquire that many additional dollar assets in that period of time; hence, the pervasive feeling that I mentioned.

Senator BAUCUS. But the net effect of that is, if I hear you, that U.S. dollars are not low enough yet from a mathematical or arithmetic point of view. A lower U.S. dollar, it seems to me, is going to mean a lower standard of living. It makes imports more expensive. Therefore, the working man's dollar that he gets today goes less far. It encourages domestic manufacturers to raise prices to meet the higher prices of imported products. That makes the U.S. working man's dollar go even less far.

The bottom line to all of this is the American standard of living in real terms.

Dr. HUFBAUER. That is what it amounts to.

Senator BAUCUS. And if the dollar keeps coming down even further, you are saying the American standard of living should come down even further, it seems to me.

Dr. HUFBAUER. I agree with you, Senator. We have been living beyond our means. All of us have been living beyond our means.

The overvalued dollar is a manifestation of living beyond our means.

Dr. MAKIN. I don't want to leave the suggestion that I think the dollar will not go lower. I did say that it has gone far enough probably to correct the competitiveness problem in manufacturing. I think I agree with what Gary says. On a portfolio basis, it is going to go lower, for the reasons that he mentioned, for the reasons that are related to Japan's expansion. Our Treasury Department was very pleased when Japan agreed to expand fiscal policy, apparently forgetting that easier fiscal policy drives up interest rates. And if you have higher interest rates in Japan and you peg exchange rates, you will have higher interest rates in the United States.

Senator BAUCUS. Do you have any reaction to Mr. Kiam's point that there is no J curve?

Dr. MAKIN. I can certainly understand his skepticism. I, for a long time, have argued that the J curve is very flat when you start off with imports twice exports. And if you do the mathematics, it takes a great deal of quantity change to overcome the price change. So, the J curve is certainly long and flat. The other thing that I am afraid we have overlooked is that there are two things that a weaker dollar does. One is to switch spending, and the other is the thing that you mentioned, Senator Baucus, that is, it makes Americans worse off, and so they spend less on imports.

The point is that it is not necessarily fun to get rid of a trade deficit or painless. A trade deficit is a symptom of too much spending, and one way to get rid of it is to cut spending. So, it is difficult to deal with that politically, but I am afraid that is one of the things that we are discovering now.

Senator BAUCUS. Would you suggest that Congress enact any kinds of incentives to try to move some of American businessmen's and individuals' thinking about a little bit longer time frames? The consumption tax is some of that, but in addition, do you think we should look at the suggestion of Mr. Kiam, namely that some kind of a differentiation between capital gains and ordinary income and just lower tax incidence the longer the asset is held, for example? Someone even suggested a securities transaction tax, a minor tax, just to prevent churning. Others suggest incentives for bonus payment systems. Are there kinds of incentives that you think we should address to encourage longer term thinking?

Dr. MAKIN. I am very skeptical that there is much that the Congress can do to cause businessmen to change their time thinking.

Senator BAUCUS. Should we? Answer that question first.

Dr. MAKIN. All right. I think you have already—not you—but I think the Congress has already done some things to shorten the horizon by changing the Tax Code very frequently. And I think that once we settle on a Code, we ought to stick with it so that the planning horizon naturally lengthens. Second, the world has not been kind to businessmen or any of us who would like to have a stable horizon since 1973; there have just been tremendous changes in relative prices and uncertainty, although it seems that businessmen elsewhere have dealt better with them.

But I am not sure that there is anything that the Congress can do. I don't like the idea of the capital gains provision because that gets complicated, and it leads to a lot of attempts to offset the effect of the regulation in the private sector. I think primarily predictable policies——

Senator BAUCUS. Let me interrupt here. I have talked to a lot of businessmen. There is a recent survey by the American Business Conference, which is a group of mid-sized American businesses, which confirms this, namely those companies that don't have to pay as much attention to the quarterly reports because they are not publicly held tend to sell better overseas because they can more easily incur the up-front market development costs and hang in there for the longer run in order to, over the long haul, be successful. Whereas, to a significant degree, it is companies that are publicly held and are slaves to the quarterly reports and look at the short-term basis that makes it harder for them to develop those up-front costs for the longer term.

I just think there must be something to this that perhaps we should try to help address. You don't think so?

Dr. MAKIN. I certainly can't argue with people who are actually out there doing business. I agree that there is a problem. The question is: Is it possible to design some legislation to do something about it? And that is where I am skeptical because we don't quite have a firm handle on exactly what the problem is other than that people feel that they are a slave to their quarterly reports. You know, that may be the case; but what do you do legislatively to address that?

Senator BAUCUS. I don't know what you do about it either. All I know is that, in Japan for example—and this isn't really directly relevant—but in Japan, there are no hostile takeovers in Japan under Japanese corporate law unless the target board of directors unanimously agree.

Dr. MAKIN. Let me suggest that if borrowing becomes less attractive, as it would with a consumption tax or as it would with a different treatment of interest expense, highly leveraged corporate takeovers would be less likely. So, that might help.

Senator BAUCUS. All right. I have no more questions. Thank you very much. I appreciate it.

Dr. MAKIN. Thank you, Senator.

Senator BAUCUS. All right. Our next witnesses include a panel of Dr. Lawrence Summers, Professor of Economics at Harvard University; and Dr. Alan Auerbach, who is Professor of Economics at the University of Pennsylvania.

Before we begin, I will give you a report of the stock market. At 10:00 a.m., it was down 95; at 10:30 a.m., down 105; somewhere between 10:30 a.m. and now, it was down to 210. At 10:50 a.m., it was down 153, and now it is down at 140. I don't know what all that means, but perhaps you can tell us. Dr. Summers, why don't you begin?

STATEMENT OF DR. LAWRENCE H. SUMMERS, PROFESSOR OF ECONOMICS, HARVARD UNVERSITY, CAMBRIDGE, MA

Dr. SUMMERS. Thank you very much, Senator Baucus. The stock market is driven largely by imperatives of its own, at the frequency of day-to-day fluctuations, like the ones that we are seeing; but the decline in its value from the high level in August is symbolic of the decline that we will all face because America has lived beyond its means for the last six or seven years.

The subject of today's hearing is tax policy in American competitiveness. The other speakers have ably reviewed the competitiveness problems we find ourselves in, both the very substantial trade deficit of $150 billion and the long term productivity slowdown. It is well known that America saves much less and grows much less rapidly than Japan. It is less well known and more sobering that our saving rate over the last 16 years has been about 80 percent of the saving rate of Great Britain, and our productivity growth rate has correspondingly been about 80 percent of the productivity growth rate of Great Britain.

Senator BAUCUS. National saving rates?

Dr. SUMMERS. National saving rates and correspondingly productivity growth has been slower.

Senator BAUCUS. Say that again. Eighty percent of Great Britain's?

Dr. SUMMERS. Great Britain's national saving rate and productivity growth rate have been about 80% of ours. You can see that on the chart that is included about halfway through my testimony. Figure 2, which follows page 4, illustrates the point.

Poor American competitiveness, both the short run trade deficit problem and the longer run problem of slow American growth, surely has many causes. Unfair trade practices do play some role, and those who fault American management must be right to at least some extent.

But there is little that public policy can do if managers have the wrong attitudes, if workers have the wrong attitudes; and in any event, however well our managers managed and however well our workers worked, we would be at a very substantial disadvantage as long as our national saving rate was two percent, as it was last year, and averaged less than three percent, as it has for the last five years. We are saving less than one-fifth of what Japan is as a nation.

It is that low national saving rate that I regard as the key to our competitiveness difficulties.

There is no question that reducing Federal budget deficits by raising taxes or reducing spending is the most potent and reliable means of increasing our national saving. Reducing Federal deficits would contribute substantially, very close to dollar for dollar, to increasing national saving. Federal deficits over the last five years have drained about two-thirds of the saving that has been produced by the private sector and the State and local sectors of the economy. There is no measure, other than reducing Federal deficits, whose effects we can predict with nearly the same degree of confidence and whose potency is similar to reducing Federal deficits as a device for increasing national saving.

I should say in that regard that the outcome—the forecast for Federal deficits—on a rational basis is almost certainly significantly worse than the figures that the Congress regularly studies. I say that in two senses. If one looks at the Congressional budget resolutions passed in April of the last seven years, one finds that in every single year the Congressional budget resolution has been too optimistic about the deficit. It will not surprise you that that optimism has been substantial, averaging about $50 billion a year.

What I found more sobering studying the figures in the CBO report was that that optimism is not primarily due to the fact that Congress did not make the spending changes it said it would, but the $32 billion a year on average has been due to excessively optimistic economic and technical assumptions. The decline of 10 percent in the stock market this morning at one point suggests to me that it is very likely that the economic assumptions on which the Congress is now operating are too optimistic.

What should be done? I think it is clear that what is needed is an increase in taxes. Let me say that I am supportive of the idea of a national consumption tax in a value added form to increase national savings. I think that is the place where you can get a lot of revenue and where you can get it without interfering with incentives.

Let me use the rest of the short time that I have available to highlight six other smaller measures which would raise revenues and, at the same time, have incentive effects but incentive effects that I think would be working in the right direction for competitiveness, not the wrong direction for competitiveness.

First, taxing cigarettes and alcohol would not interfere with anything good and would significantly reduce mortality costs associated with tobacco and alcohol and, in so doing, reduce health insurance premiums, reduce disability days, and contribute to reduction of labor costs for American employers.

Second, improved tax enforcement through doubling the rate, which would only bring it back to its level in 1976, would raise a significant amount of revenue. Some estimates suggest as much as $25 billion; I think that is too high, but I think $15 billion is a reasonable target. And you can say one thing about the underground economy in the United States: it may do some importing——

Senator BAUCUS. It may do what?

Dr. SUMMERS. It may do some importing, but it almost certainly does very little exporting, and taxing it more effectively would be a contribution to improving competitiveness.

Third, taxing advertising in the same way we tax other investments. If I buy a piece of machinery, for tax purposes I have to depreciate that machinery over time. If I make an advertisement for my product, I am permitted to write that investment off in the year that I make it. Taxing advertising more fully by requiring that it be amortized over time would contribute to neutrality, would discourage a form of investment whose principal effect is to redistribute wealth between companies rather than to create new wealth, and would discourage consumption and increase the incentive to save.

Fourth, taxes on financial transactions, such as the transactions tax that Speaker Wright has proposed, would divert resources from rent-seeking activity on Wall Street into more productive activity. I was recently in Japan and learned that in Japan it is the students from the bottom of the business school classes who go to work for investment banks and from the top of business school classes who go to work for major manufacturing firms.

Senator BAUCUS. Are they paid less in Japan at investment banks?

Dr. SUMMERS. Relatively speaking, somewhat less, yes.

Fifth, a tax on gasoline would raise revenue, would not discourage exports, and would encourage energy conservation, which would contribute to reducing oil imports. Unlike an oil import fee, however, it would not burden the many companies who use energy as an intermediate product in their export businesses.

Finally, sixth, the one target for taxation that I would have thought was most politically attractive was foreigners. The Congress in 1984 repealed the taxation of interest income earned by foreigners. Taxing the interest income earned by foreigners on bonds issued by U.S. companies or certificates of deposit issued by U.S. banks could raise up to $5 billion. It would be equitable; there is no reason why wealthy Latin Americans whose capital is fleeing their own nation should pay less in taxes than American housewives on their savings accounts. It would contribute to the foreign policy goal of discouraging capital flight from nations that are having problems, and it would contribute to competitiveness by reducing the capital inflows that are holding the dollar up above any sustainable level. By reducing the value of the dollar that would contribute to revitalizing American manufacturing.

Those six measures, taken together, would raise about $50 billion, and they would have incentive effects that would be working all in the direction of competitiveness. There is not a necessary trade-off between incentives and tax increases. These are tax increases that would have incentive effects, and those incentive effects would work in the right direction. Thank you.

Senator BAUCUS. Thank you. Dr. Auerbach?

[The prepared written statement of Dr. Summers follows:]

Lawrence H. Summers
Professor of Economics
Harvard University

My name is Lawrence H. Summers. I am a professor of economics at Harvard University and a research associate of the National Bureau of Economic Research specializing in the economics of tax policy. I am pleased to have this opportunity to present my views on the relationship between tax policies and international competitiveness. The United States may once have been able to afford the luxury of setting tax rules on the basis of domestic considerations. But the last few years have made it painfully apparent that the need to improve our international competitiveness should now condition all our international economic policies.

In my testimony today, I shall first highlight the crucial short and long run dimensions of our current competitiveness problem. Second, I will discuss its causes, focusing on the problem of low national saving which I believe is the aspect of our competitiveness problem that is most amenable to government action. Third, I will discuss possible tax measures that could make a significant contribution to increasing national saving and competitiveness. Fourth, I suggest that the Congress will have to carefully track the effects of the 1986 Tax Reform Act on manufacturers involved in international trade. Several provisions of the 1986 Act worked to tilt the playing field against these firms. Finally, I suggest that the time may be at hand for a thorough re-evaluation of American tax rules governing international transactions.

The American Competitiveness Problem

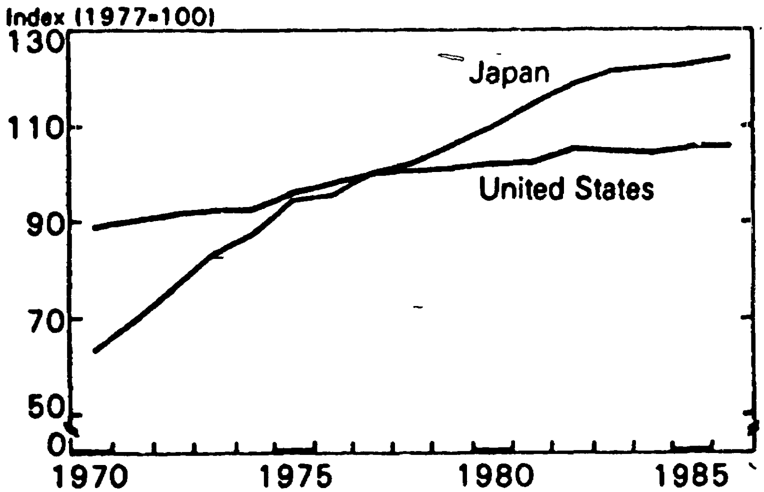
The most visible manifestation of American competitiveness problems is the large trade deficit that we have sustained in recent years. It is expected that this year's gap between merchandise imports and exports will exceed $150 billion. In 1986, American export earnings covered less than 80 percent of the cost of American imports. This fraction is lower than the corresponding share for Brazil even during the 1970s when it was rapidly accumulating foreign debt. Despite the significant decline in the value of the dollar--to levels near those that prevailed in 1980, when the American current account was approximately in balance--it now seems unlikely that the trade deficit will approach zero any time soon. This reflects a variety of factors including stagnation in the world economy, the special problems of Latin America, and continued poor American productivity performance.

The trade deficits that we have suffered in recent years are just the most visible manifestation of a much deeper American productivity problem. While the United States maintained approximate balance in its trade accounts throughout the 1970s, given our lagging productivity growth, this could only be accomplished by accepting a declining real exchange rate, stagnation in real wages and living standards, and reduced rates of profit. As Figure 1 demonstrates, real average hourly earnings in the United States are barely higher today than they were in 1970. In contrast real wages have increased tremendously in Japan. Firms suffered along with their employees during the 1970s as evidenced by the 49 percent decline in real stock prices during the 1970s.

The experiences of the 1970s and 1980s are two sides of the same coin. During the 1970s, we maintained balanced trade by sacrificing growth in standards of living. In the 1980s, we have enjoyed improved living standards but only at the expense of huge and unsustainable foreign borrowing Restoring American competitiveness and making it possible for workers to enjoy improved

Figure 1

Real Compensation Per Hour in Manufacturing



Note: Figure is from Paul R. Krugman and George N. Hatsopolous, "The Problem of US Competitiveness in Manufacturing", New England Economic Review, January/February 1987.

standards of living without foreign borrowing will require improving our rate of productivity growth. Over the period, 1973-1986, American productivity grew at a 2.3 percent rate compared with 5.6 percent in Japan, 3.5 percent in West Germany and 2.9 percent in Great Britain. Raising our relative productivity performance is the primary challenge facing economic policy at the present time.

Diagnosing Competitiveness Problems

American competitiveness problems have many sources. There is no question that foreign trade barriers inhibit some US exports. However, there is no evidence that trade barriers have increased in the last few years, as our trade deficit has soared. In my judgment, critics who attack the short term focus of American management and its preoccupation with financial performance rather than product quality are almost certainly correct. And American trade performance would certainly be better if the rest of the world had enjoyed as strong a recovery from the worldwide 1982 recession as we have. But the most important cause of the US trade deficit is our low national saving rate. Fortunately, while the American government can have only a limited impact on foreign trade practices or the attitudes of American management, there is a great deal it can do to increase our national saving rate.

Table 1 illustrates a basic economic identity. A country's current account deficit is arithmetically equal to the difference between its national saving and investment rates. Nations like the United States that invest more than they save borrow funds from abroad. The only way that the foreign funds can come into the country is for us to import more than we export. Similarly, Japan

Table 1

National Saving, Investment and the Trade Balance

(as a percent of GNP)

	Japan			United States		
Year	Net National Saving	Net National Investment	Current Account Balance	Net National Saving	Net National Investment	Current Account Balance
1975	19.4%	19.9%	-0.5%	2.8%	2.1%	0.7%
1980	18.3%	19.5%	-1.2%	4.4%	4.2%	0.2%
1981	18.5%	18.6%	-0.1%	5.3%	5.2%	0.1%
1982	17.9%	17.5%	0.4%	2.0%	2.0%	0.0%
1983	17.0%	15.5%	1.5%	2.0%	3.2%	-1.2%
1984	18.2%	15.7%	2.5%	4.5%	7.1%	-2.6%
1985	16.7%	13.0%	3.7%	3.2%	6.2%	-3.0%
1986	***	***	***	2.0%	5.5%	-3.5%

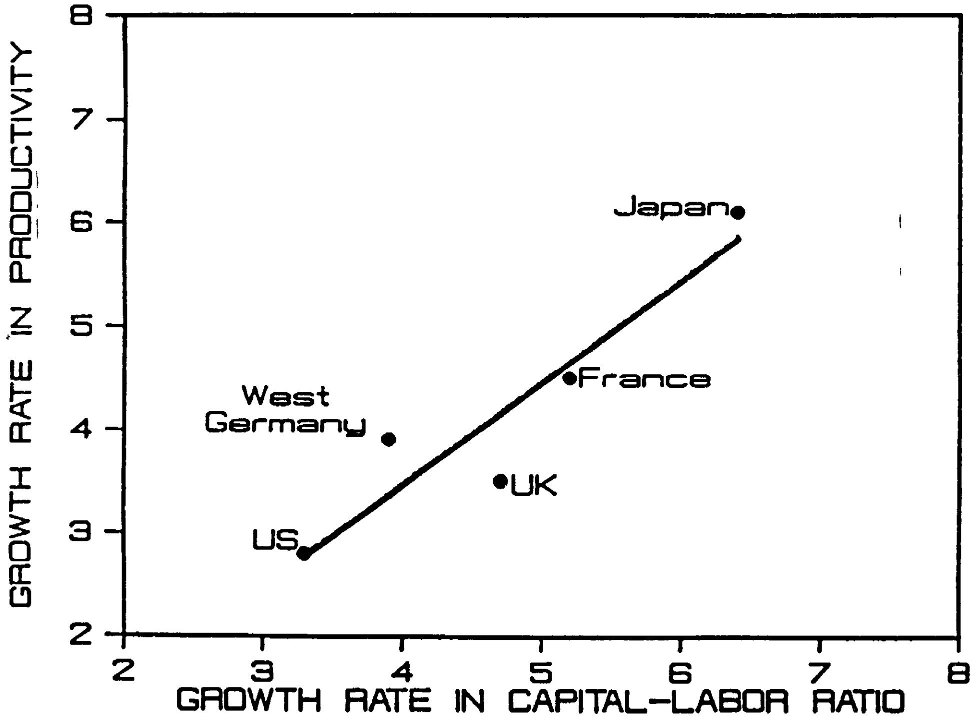
Note: Table presents net national saving, net national investment, and the trade balance as a percent of gross national product. Data are from OECD, Quarterly Income Accounts, various issues, Tables 1a and 4 for the United States and Japan. Japanese data for 1985 are annualized first quarter estimates. Japanese data for 1986 are unavailable. Differences between savings minus investment and the trade balance are due to net capital transfers and statistical discrepancies in the OECD accounts saves more than it invests and so runs chronic current account surpluses. Comparing the figures for the 1970s or early 1980s with the figures for 1986, it is apparent that reduced national saving is primarily responsible for the deterioration in our current account.

As long as our national saving rate remains below 3 percent, as it has for the last several years, we will face a cruel choice between continuing to borrow from abroad, with the attendant trade dislocations, and cutting back our net investment rate from its current low level. Figure 2 illustrates that our relatively low rate of investment in plant and equipment is a major reason for our poor productivity performance over the last 15 years. Even the British have increased their capital-labor ratio almost one-third faster than the United States and have reaped corresponding productivity benefits. France, West Germany and Japan have all enjoyed even greater growth in capital-labor ratios and productivity.

It is important to understand that low national saving is a root cause of other barriers to US competitiveness. For a number of years in the early and mid 1980s, American producers were unable to compete because of the strong dollar. The lasting effects of exchange rate misalignments that dislodged American producers from their traditional markets are still being felt. The appreciation of the dollar during the early 1980s was the result of capital inflows caused by low American national saving and the resulting high real interest rates. While monetary factors have caused the dollar to decline substantially since February of 1985, it remains at a level where trade balance is impossible. Bringing about trade balance will require increases in American national saving that will, as a side effect, reduce the value of the dollar.

Figure 2

GROWTH RATE IN PRODUCTIVITY AND CAPITAL-LABOR RATIO
IN MANUFACTURING
(1970-1986)



Source: "Presentation on Competitiveness."

It is often suggested that a high cost of capital inhibits American investment and encourages American managers to focus on short term returns. As Table 2 illustrates, the cost of capital in the United States is indeed much higher than in Japan. Given their costs of capital, an American manager would be willing to invest $.37 in return for a dollar six year from now, compared with $.66 for a Japanese manager. The primary reason for the differential in costs of capital is that huge Japanese saving increases the supply of capital in Japan, driving down its cost. On the other hand, our low rate of national saving makes capital scarce and drives up its cost.

Even if American management improves, and even if trade barriers to American exports are eliminated, American producers will labor at a competitive disadvantage as long as the United States saves much less of its output than our principal competitor nations. Raising national saving should be a major priority for economic policy in coming years.

Increasing National Saving

The most potent and reliable way to increase national saving is to reduce Federal deficits. As Figure 3 illustrates, Federal borrowing has absorbed a large and increasing share of private saving, and so has depressed our national saving rate. In 1986, dissaving by the Federal government absorbed two-thirds of the saving generated by other sectors of the economy. At a time when personal and corporate saving are declining, we can ill afford a continuation of huge Federal deficits.

While the Federal deficit declined sharply between 1986 and 1987, the

Table 2

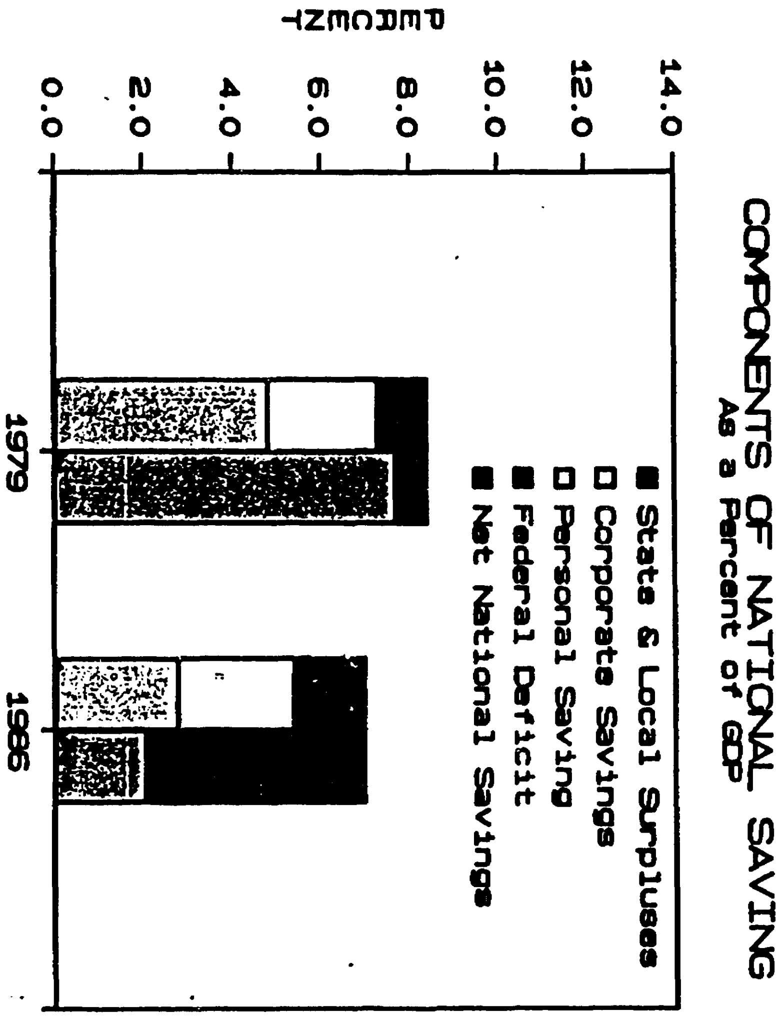
The U.S. Cost of Capital Problem

1985

	Real Interest Rate	Price-Earnings Ratio	Cost of Capital
United States	6.6%	8.5%	12.9%
Japan	3.2%	3.8%	8.4%

Note: Table is from George N. Hatsopoulos and Stephen H. Brooks, "The Gap in the Cost of Capital: Causes, Effects and Remedies", in Technology and Economic Policy, ed. Ralph Landau and Dale Jorgenson (Cambridge, MA: Ballinger, 1986). Prcice-earnings ratios are from statistics published during 1985 in Capital International Perspectives.

Figure 3



Source: "Presentation on Competitiveness."

decline was largely a reflection of transitory factors. As a consequence, current projections call for increasing Federal deficits in coming years. There is every reason to expect that even these bleak forecasts are too optimistic. The economic and technical assumptions embodied in each of the last seven First Congressional Budget Resolutions have been too optimistic by an average of $32 billion. Projections of outyear budget deficits have been even more overoptimistic.

It is unrealistic to expect that economic growth or spending reductions will be sufficient to eliminate Federal budget deficits. After five years of cyclical expansion, it is very likely that the economy will go into recession sometime in the next several years. There is also a serious risk that reductions in foreign capital inflows will lead to significant further increases in interest rates, exacerbating budget deficits. After 7 years of budget cutting, all of the easy spending cuts have been made. Current projections already call for a cessation of growth in real defense spending. A bi-partisan consensus opposes cutbacks in Social Security. Relative to GNP, Federal spending, aside from interest, defense and Social Security has been rolled back to its level in the mid-1960s. While spending cuts will be difficult, pressures are building for new spending programs in a number of areas.

These considerations suggest that a significant increase in Federal tax revenues will almost certainly be necessary if national saving is to be restored to a satisfactory level. The challenge for policy will be to choose tax measures that do not interfere with competitiveness by reducing incentives to save and invest. Two broad approaches are possible--the enactment of a national consumption tax or piecemeal reforms that increase various taxes that do not burden international competition.

Broad based consumption taxes, such as a value added tax, a national sales tax or a business transfer tax offer the possibility of a substantial increase in government revenues and little interference with economic growth. Even a 3 percent value added tax would raise about $70 billion in tax revenue each year. It would also work directly to reduce excessive consumption and so to increase national saving and competitiveness. Because a value added tax would apply to imported but not to exported goods, it is possible that it would temporarily improve the trade balance before wages, prices and exchange rates fully adjusted to its presence.

Critics have argued that consumption taxes would be "money machines" that fueled increased government spending. Given the present enormous budget deficit, Congress is unlikely to dedicate any large portion of a tax increase to new spending programs. If excessive spending were seen as a critical problem, we could legally dedicate tax revenues to deficit reduction by modifying the provisions of the Gramm-Rudman legislation.

The other major argument against consumption taxes holds that they are regressive and unfair. Any regressivity problems with consumption taxes could be attenuated by taxing luxuries at high rates and exempting certain necessities. A consumption tax might also be combined with increases in personal exemptions for low income taxpayers, and increases in top rates under the income tax. But it is important to understand that in reality consumption taxes are much less inequitable than is usually asserted. First, individuals with low income but high consumption have in most cases suffered only temporary declines in income. On a lifetime basis, consumption taxes are much more progressive than they appear when evaluated on an annual basis. Second, consumption taxes are shelter proof. Anyone who lives well has to pay them. There is no way in which the rich can avoid consumption taxes except by making all of their income available to investors--an outcome we surely want to encourage. Third, there is a basic question of how we should measure well-being in assessing progressivity. A strong argument can be constructed that is fairer to tax people on what they withdraw from society, as measured by their consumption, than on what they contribute to society, as reflected in their income.

Neither the "money machine" nor the regressivity argument seem to me sufficient to outweigh the competitiveness benefits of major new consumption taxes. But it is unlikely that such a tax will be enacted in the immediate future and even if a consumption tax were to be enacted, there would be significant lags in its implementation. In the meantime, there are a number of ways to raise tax revenues while at the same time promoting international competitiveness:

* Restoring taxes on cigarettes to their 1952 level (in real terms) and increasing alchohol taxes could raise more than $10 billion annually. It would also reduce employers' labor costs for absenteeism, disability and health and life insurance. It has been estimated that increased cigarette taxes alone would avert several hundred thousand deaths each year.

* More extensive efforts at tax enforcement like those that have been introduced in a number of states could raise some of approximately $80 billion annually lost to tax non-compliance. By forcing people out of the "underground economy" that may import but surely does not export, improved tax compliance would also contribute to competitiveness.

* Requirements that firms amortize their advertising outlays for tax purposes would raise several billion dollars annually. It would also reduce the current tax bias towards promotional outlays, and away from productivity enhancing new investment. An additional virtue of reduced advertising might well be an increase in our anemic personal saving rate.

* A 10 cent a gallon tax increase would raise $9 billion a year and at the

same time encourage energy conservation. Unlike a general oil import fee, it would not burden the many companies that use energy product as an intermediate good in their production.

* Taxes of 1/2% on the transfer of stocks and other securities could raise $5-10 billion a year. They would also encourage a reallocation of talent away from the zero sum game of buying and selling paper assets and into the positive sum game of production. Turnover taxes would have only a negligible effect on long term investors but would bear heavily on short term traders. They might help overcome financial markets preoccupation with short term performance.

* Taxes on portfolio income earned by foreigners in the United States could raise about $5 billion a year and at the same time promote competitiveness by reducing capital inflows.

Taken together, this package of competitiveness enhancing tax increases could raise up to $50 billion annually without touching the 1986 tax reforms. Additional revenue could be raised by returning to the tradition that the highest income taxpayers should have the highest marginal tax rate. Piecemeal reforms that do not interfere with firms and workers who are facing fierce competition from overseas thus do offer the prospect of meaningful deficit reduction without the introduction of major new consumption taxes.

Many people see a trade-off between the adverse effects of budget defiicits and the adverse effects of tax increases. This is highly misleading. Deficits must be financed sooner or later. If taxes are not increased soon, even larger tax increases will be necessary to finance interest payments in the future. The choice we face is not between deficits and painful budget balancing measures. Running deficits only postpones and magnifies the painful adjustments that will ultimately be necessary.

While reducing the budget deficit is by far the most constructive step that the Federal government could take to increase national saving, there is some scope for tax policies to spur private saving. The available statistical evidence suggests that IRA incentives were effective in stimulating saving. Most contributors had only relatively small liquid asset holdings and so their contributions represented new saving rather than merely transfers of funds. The fact that almost half of IRA contributions were made near the last possible moment evidences the responsiveness of consumers to the advertising blitz that IRAs cause financial institutions to mount.

Further stimulus to national saving could come from appropriately designed tax incentives for employee stock ownership and profit sharing. Compensating workers partially in the form of stock rather than cash might well induce them to save, particularly if payments were treated as a bonus and tied to their employers profitability. A number of analysts have suggested that firms' extensive use of bonuses may contribute to the high Japanese saving rate. The beneficial effects on saving of employee ownership would be enhanced if employees were required to hold their firm's stock for some minimum period before selling it.

Tax Policy and Investment

Increasing national saving is necessary but not sufficient for restoring our international competitiveness. It is also necessary to provide adequate incentives for plant and equipment. In this regard, I have serious reservations about certain provisions of the 1986 Tax Reform Act. By eliminating the investment tax credit and scaling back accelerated depreciation allowances, I fear that the 1986 Act will raise the cost of capital and reduce productivity enhancing investments in new equipment. The adverse impact of reduced investment incentives will far exceed the rather speculative neutrality benefits associated with the 1986 reforms of the corporate tax.

The 1986 Act is projected to increase corporate tax revenues by $125 billion over five years. But this figure understates its impact on new investment. The tax bill would raise corporate revenues much more but for the fact that the corporate rate is reduced from 46 to 34 percent. This rate reduction has the primary effect of reducing the tax rates on the profits that firms will earn on their past investments that are already in place. On the other hand, the elimination of the ITC and changes in depreciation rules will have their primary impact on new investment, where incentives do have potent effects.

The combination of reduced investment incentives and corporate tax rates embodied in the the 1986 Act is often defended on grounds of neutrality. In fact, it will tilt the playing field against capital intensive manufacturing industries--the industries that are most exposed to international competition. Investments in intangibles--advertising, marketing, and other components of good will all receive the ultimate in accelerated depreciation, expensing. Although these outlays yield a stream of benefits over time, just like capital investments, firms are permitted to write them off in the year that they are undertaken. For example, the large expenditures incurred by Coca-Cola in developing and marketing New Coke can all be expensed. In contrast, outlays on new equipment must be amortized over time for tax purposes. The resulting tax bias towards intangible investments and industries that rely most heavily on them has been exacerbated by the 1986 Act.

Federal budgetary problems almost certainly preclude the reintroduction of major new investment incentives at the present time, unless a means of paying for them can be found. One approach that deserves careful consideration, particularly if the economy goes into recession would involve restoring the investment tax credit and raising the corporate tax rate. Such a policy combination would benefit exposed manufacturing industries and would encourage all industries to undertake new investments rather than simply reaping profits from past outlays.

International Tax Policies

Over the last five years, the United States has moved from being the world's largest creditor nation to being the world's largest debtor. Many projections now call for foreign claims on United States assets to exceed American claims on foreign assets by a trillion dollars in the early 1990s. This profound change in our role in the international economy necessitates a reevaluation of elaborate rules governing the taxation of international transactions. Tax rules that may have been appropriate when American investment abroad far exceeded foreign investment in the United States are now in urgent need of reform. It is high time that the United States started to seriously tax portfolio income earned by foreigners on their American investments.

Tax legislation enacted in 1982 and 1984 and especially in the Tax Reform Act of 1986 has eliminated many domestic tax inequities. But the Congress has perpetuated a major inequity in the tax code and sacrificed a potentially significant revenue source by continuing to allow foreigners to earn tax free portfolio income from certain investments in the United States. Some recent legislation has actually moved in the wrong direction--the 1984 repeal of the 30 percent withholding tax on corporate interest paid on portfolio investments held by foreigners has made it even easier for foreign residents who are not U.S.

citizens to escape taxation on income generated within the United States. This provision augments long-standing rules exempting from U.S. income taxation bank interest paid to nonresident aliens and capital gains on portfolio transactions of nonresident aliens. Various tax treaties further reduce the taxation of American capital income earned by residents of some countries.

Given our large Federal budget deficit, it is inevitable, and probably desirable in the short term (in order to prevent interest rates from rising even further) that we borrow from abroad, even though such borrowing reduces the competitiveness of American firms in international markets. But there is little reason for American tax policy to tilt the incentive to save and invest towards foreigners and away from domestic residents. Increasing taxes on foreign capital income would reduce the foreign demand for dollars, and lead to a much needed further decline in the value of the dollar. This in turn would improve our international competitiveness by making American goods cheaper relative to foreign goods.

Tax fairness is an additional reason for changing current laws. Wealthy foreigners who invest in large certificates of deposit from American banks in order to evade taxes and avoid financial uncertainty in their own countries pay no U.S. tax on the interest they earn. There is no reason why foreigners who use the United States as a safe haven should not be charged for the privilege, when Americans who deposit small amounts of money in the same banks pay income tax on the interest they earn.

The Latin American debt crisis has been greatly exacerbated by the several hundred billion dollars of capital flight out of the debtor countries. Much of the flight capital has been deposited in American bank accounts offered by the very banks that press for government assistance in collecting their debts. Capital flight from troubled situations is inevitable, but there is little reason for us to offer preferential treatment to those seeking to avoid taxation in Latin America, particularly when it exacerbates the growing debt crisis.

The principle argument against taxing foreign capital stresses the importance of the free flow of international capital. This argument confuses the interests of the financial institutions that are eager to profit from complex international transactions, with our national interest. While the efficient allocation of production around the world is important in contributing to the health of the worldwide economy, international trade in paper assets is a zero sum game--no wealth is created by such trade. By causing exchange rate volatility that interferes with trade in goods and services, it may actually hurt overall economic performance. It is ironic that while exempting foreigners' portfolio interest from tax, the United States offers no relief on foreign direct investments in plant and equipment. Eliminating this disparity would increase economic efficiency and improve our international competitiveness.

While the recent Netherlands Antilles episode illustrates the potential disruptions caused by abrogation of treaty protection with respect to outstanding obligations, existing tax rules and treaties can be changed by Congress with respect to obligations that will be issued in the future. Indeed, most of our tax treaties allow either party to withdraw after giving six months notice. Mutual forbearance in international taxation was desirable at a time when America was a huge creditor. It will no longer be in our interest in an era when foreigners invest much more in the United States than we invest abroad.

Conclusion

Low national saving is a primary cause of our competitive difficulties on international markets. The most potent and reliable means of increasing national saving is reducing Federal deficits. In all likelihood, this will require increased tax collections. Fortunately, there are tax policies that can raise revenue without interfering with incentives to work, save and invest. These include consumption taxes as well as a variety of more specific measures targetted at tilting the playing field towards socially productive activities.

STATEMENT OF DR. ALAN J. AUERBACH, PROFESSOR OF ECONOMICS, SCHOOL OF ARTS AND SCIENCES, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA

Dr. AUERBACH. Yes, thank you, Senator Baucus. Let me start by saying that I think, given the vagueness of the term "competitiveness," it is useful to tell you at least how I interpret it. I think it is important to point out that there are really two concepts that people have in mind. One is the short-run idea of competitiveness, which means maintaining a sufficient demand for tradeable commodities, particularly manufacturing in this country. But in the long run, there is a different notion, which is one you have highlighted this morning, which is maintaining a high and improving standard of living through having a high enough savings rate and rate of economic growth.

Both of these notions of competitiveness are important, but the policies that may be appropriate for the achievement of each may differ; and one should keep them distinct in one's mind in thinking about policies.

Let me turn first to the short-run problem. Despite today's performance of the stock market, the U.S. economy today is hardly moribund. We have had a very prolonged expansion. There is no problem with insufficient aggregate demand in the Keynesian sense. What is bothering everybody and what the short-run competitiveness problem is about is the composition of demand. As a Nation, we have been devoting more and more of our resources to production of goods outside of the manufacturing sector while, at the same time, maintaining a high level of manufactured goods purchases by having a very large trade deficit in that area.

Most of the merchandise trade gap in 1986 was represented by net imports of consumer goods and automobiles.

Now, I think there are serious concerns which I won't address that might attend a significant shift away from manufacturing in a permanent sense, and many people have focused on that. But I believe it is premature to address those concerns because, whatever other problems we have at the moment, the shift away from manufacturing should not be seen as a permanent one. And here, as I detail it in my comments, it is an issue of national income identities.

The current trade deficit is not going to last forever. It may be very painful to get rid of, but eventually it will disappear. Of course, how it disappears depends on what kinds of policies we enact; but it must disappear because eventually we are going to have to start paying off the foreign debt that we have been accumulating. And when we do, just like underdeveloped countries that are currently having debt problems, we are going to have to earn foreign exchange to pay off these deficits to foreign countries; and to do that, we are going to have to run trade surpluses in the future.

And these surpluses must be generated by increasing exports and decreasing imports in the industries that are sensitive to trade. As I show in Table 1, attached to my comments, virtually the only area where a change as big as the one that is going to have to occur in the United States could happen is in the manufacturing sector. People often think of some of the other industries as being ones that are very important for trade, and they are.

Agriculture, for example, continues to provide a small surplus in the trade sector. Services also are currently in trade surplus in the United States. However, the level of trade in each of these areas is tiny compared to the level of exports and imports in manufacturing.

For example, agriculture exports in the U.S. last year were less than $30 billion, and service exports were less than $17 billion, compared to a merchandise trade deficit overall of about $150 billion; and the surpluses in each of those areas were considerably smaller even than the level of gross exports. The big deficit is in manufacturing. The big level of exports is in manufacturing. And the big level of imports is in manufacturing.

So, it is simply a matter of seeing that this is the only place where the improvement could come. That tells me that, eventually when it happens, it is going to happen in manufacturing. Now, as I said already, how the adjustment occurs depends on many factors.

There has been some discussion of the J curve this morning, and it is quite clear that, although I say the trade deficit will eventually disappear, it needn't disappear soon and it needn't disappear when the dollar is at 140 yen; it may be at 100 yen.

It could be a very, very painful experience for the U.S. and the dollar may be very low and purchasing power may be very low. I don't have to say what the cause of this deficit has been. It has been said by every other speaker this morning. The trade deficit has appeared because the U.S. has run an enormous budget deficit, and private savings did not respond.

In order to finance the deficit, one of three things had to happen. Either private savings had to increase, which it did not; foreign saving had to increase to supply some of the funds being demanded by the Government; or domestic investment had to decline substantially. Now, what in fact happened was that most of the needed funds were supplied by foreigners, which led to very large capital inflows, the other side of which is the very large trade deficit we developed.

But it should be understood that, had the foreigners not supplied the funds that were needed by the Government—the need for which was generated by the Government—it would have had to be supplied domestically, and it wasn't supplied by private savings, so it would have had to be supplied by domestic investment. We should, therefore, understand that if the policy we are currently following, which is to do nothing about the structural problem of the budget deficit—not enough, in my opinion—if we continue to follow that and the trade deficit does begin to disappear, what is going to disappear along with it is domestic investment.

There is just no way around it. If we don't save more as a nation, if the Government doesn't save more, if we privately don't save more, and eventually, foreigners stop supplying the capital we need, then it is going to come out of domestic investment, which is not exactly a rosy picture even though it may be good for export-sensitive industries.

Just to sketch what the remainder of my written comments are about, I then go on to talk about the long-run problem which, as you said, is really one of our standard of living. And whatever our problems in the short run, and even if our trade deficit disappears, if we continue to save less as a nation, including the Government, we are going to have less in the future to finance the standard of living which we seek to achieve.

I then talk about a couple of proposals. Now, of course, there have been many tax issues and tax policies discussed this morning. I chose to highlight two because these are policies—fairly important policies—which I have heard discussed many times in this context. One is investment incentives, and here my point is that, once you distinguish the short-run from the long-run problem of competitiveness, one could make a good case—and other speakers this morning have—for having investment incentives for long-run purposes. If the cost of capital is too high, that may be the right thing to do in order to encourage domestic investment; but that is not going to help the short-run competitiveness problem.

It is definitely not going to help trade-sensitive manufacturing recover its export share because, to the extent that the cost of capital is lowered, there is going to be an overwhelming increase in capital inflows caused by the strong investment incentives. Many people feel this is part of what happened in the early 1980s after the passage of the Economic Recovery Tax Act of 1981.

So, investment incentives may be a good thing, but they are not the right thing for the short-run competitiveness problem.

The other point I wanted to make was that, as far as a value added tax goes, a value added tax should be seen—and I guess I will disagree here with what John Makin said earlier—in my view, a value added tax should be seen as a beneficial tax policy toward the competitiveness problem because of the revenue it raises, and secondarily because it is a tax on consumption. But I think the argument, which I have heard people outside of this hearing make, that a value added tax is good for competitiveness because it only taxes imports and doesn't tax exports is fallacious. In a world of flexible exchange rates, I don't think that competitiveness would be maintained.

The primary benefit from the value added tax comes from the revenue it raises. A secondary benefit comes through the fact that it is a tax on consumption, rather than a tax on savings.

There are many other policies that can be considered, but taxes that don't increase national savings, either through the private sector or directly through increasing Government revenue, are going to leave us with the problem. If we want to increase exports in one industry, we are either going to have to decrease exports somewhere else or we are going to have to decrease private domestic investment, neither of which is likely to be an attractive alternative. Just for example, if we look for policies to increase exports in manufacturing without doing anything about our national savings problem, it is either going to hurt domestic investment or it is going to kill industries like agriculture, which have already suffered substantial losses in the size of their export share in the last five years.

Thank you.

Senator BAUCUS. Thank you, gentlemen, very much.

[The prepared written statement of Dr. Auerbach follows:]

TAX POLICY AND INTERNATIONAL COMPETITIVENESS

by

Alan J. Auerbach
Professor of Economics, University of Pennsylvania and Research Associate, National Bureau of Economic Research

October 19, 1987

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to offer my views on the role of tax policy in helping American business meet foreign competition. Given the vagueness of the term "competitiveness", it is important to begin by telling you how I interpret it. In the short run, it means keeping the world prices for American-produced goods in line with the prices of goods produced abroad, in order to maintain sufficient demand for the tradeable commoditites we make. In the long run, it means establishing a rate of savings and economic growth that permits a high and improving standard of living.

Both short-run and long-run competitiveness are important, but the policies appropriate for the achievement of each differ. Though some policies may encourage both long-run and short-run competitiveness, there are others that have opposite short-run and long-run effects. Still other policies that are purported to encourage competitiveness would do so neither in the long run nor the short run. I will try to indicate which policies fall into each category, after discussing the nature and source of competitiveness problem.

The Competitiveness Problem

The Short-Run Problem

The U.S. economy today is hardly moribund. We have had a five-year expansion since the recession of the early 1980s, and the aggregate unemployment rate is lower than at any time since the late 1970s. There is no problem of insufficient aggregate demand in the traditional Keynesian sense. It is the composition of demand that causes concern.

As a nation, we are devoting a greater fraction of our domestic resources to the production of services and a smaller fraction to the production of manufactured goods than during the recent past. Since 1979, for example, real value added in manufacturing has grown at an annual rate of 2.2 percent, while the growth rate of services has been 4.0 percent. Yet American consumers are still managing to maintain a high level of manufactured goods purchases. This difference between domestic production and domestic consumption is explained by our large merchandise trade deficit. In 1986, imports of manufactured goods exceeded exports by roughly 130 billion dollars, with most of this gap being accounted for by net imports of consumer goods and automobiles.

Of immediate concern because of this shift in domestic production is the replacement of manufacturing jobs by jobs that may require lower, or at least different skills than those of the industrial workers laid off. Beyond this, some worry that the service industry cannot give rise to the degree of productivity growth to which we have been accustomed in the past. While each of these concerns might justly attend a significant permanent shift away from manufacturing in this country, I believe it is premature even to address them seriously. There is every reason to believe that the U.S. manufacturing sector will be healthier in the coming years. This is not based on faith or even on complicated econometric models, but on some very basic economic reasoning.

The current trade deficit simply cannnot last forever. Eventually, our nation must begin to pay off the foreign debt we have accumulated to finance the trade deficits of the 1980s. To do so, we must earn foreign exchange by running trade surpluses. These surpluses must be generated by increasing exports and decreasing imports in our trade-sensitive industries. Assuming we do not substantially curtail oil imports or attract many more foreign tourists, this leaves few industries in which we have the capacity for a substantial increase in net exports.

Table 1 gives an industrial breakdown of the U.S. trade balance in 1986. Although it is an industry currently producing a trade surplus for the U.S., agriculture alone is simply not big enough to provide most of the necessary adjustment: exports of agricultural products in 1986 were under 30 billion dollars, compared to a trade deficit of nearly 150 billion dollars. Likewise, though we are also a net exporter of services, the growth in service exports is likely to provide little of the needed surplus. In 1986, private service exports were barely 17 billion dollars. Manufacturing as a whole must expand to produce an increase in net exports, although there will still be winners and losers among specific industries based on their relative abilities to meet foreign competition.

How this adjustment occurs depends on many factors, including the fiscal and trade policies we adopt. In the present environment, the falling dollar is shouldering the entire load. Without additional policy intervention, the low (or lower) dollar will eventually make American goods cheap enough compared to foreign goods to close the trade gap. Measured in foreign currencies, the gap has already begun closing, but it is impossible to predict how low the dollar must go or how long it will take for the trade gap to close. The most recent trade statistics, reported last week, indicate that the adjustment process has far to go.

The short-run problem then is not one of accommodating a shift from traditional industries, but of expediting the trade adjustment that must eventually occur.

Sources of the Short-Run Problem

To understand how to deal with this problem, it is helpful to clarify how it arose. Beginning in the early 1980s, the federal government began a period of massive dissaving in the form of budget deficits that averaged 4.9 percent of GNP between 1983 and 1986. There has been no offsetting increase in saving by the private sector. In fact, private saving as a fraction of GNP has been lower during the past several years than it was in the late 1970s. This decline in national saving required either that the use to which this saving is put, domestic investment, decline or that additional resources be obtained from abroad. To a significant extent, the latter occurred, pushing the value of the dollar up and driving the U.S. trade deficit up to unprecedented levels.

It is useful to reiterate that the funds needed to finance the deficit had to come from a combination of three sources: increases in private domestic saving, reductions in private domestic investment and increases in net capital inflows. Given the lack of additional saving, neither of the remaining alternatives is attractive. The increased captial inflows have distorted our allocation of productive resources away from trade-sensitive industries. But avoiding this would have denied funding for a substantial amount of new investment.

As long as the budget deficits remain, so will this need for funds. But the source of funds will soon change, even if the budget deficits remain. As foreign investors become less willing to supply additional funds to the U.S., more funds must be generated domestically. In a process that is already underway, this reduction in capital inflows will evenutally solve the short-run competitiveness problem by depressing the value of the dollar. But who will fund the federal budget deficits? If the private sector does not save much more, it will have to invest much less. The consequences of this choice are at the heart of the long-run competitiveness problem.

The Long-Run Problem

In the long-run, the dollar will find a level that lets U.S. producers sell their commodities abroad. If this level is not 140 Yen to the dollar, it may be 100 Yen to the dollar. The real issue is the standard of living we achieve. If, as a nation (including the public sector), we continue to save very little, we will suffer in two ways. First, we will have less national wealth to finance future consumption expenditures. Second, to the extent that domestic investment is financed by domestic saving, this reduction in wealth will be absorbed by the domestic capital stock, reducing labor productivity and depressing the dollar. There may be further negative repercussions if, as some have argued, technological innovation is tied to the accumulation of new capital goods.

The potential long-run problem, therefore, is one of insufficient national wealth accumulation and productivity growth. Neither of these problems was created in the 1980s, as the low levels of saving and productivity growth of the 1970s indicate. But the problem has worsened in recent years. The rate of productivity growth is still depressed and the national savings rate has gone down. Some have argued that the failure of private savings to increase is an indication of greater confidence about future productivity, but I see little evidence to justify such confidence.

The Role of Tax Policy

If we take no action, the short-run competitiveness problem will "solve" itself, but in a very painful manner, as the U.S. dollar stays very depressed at least until our exports recover and, very likely, substantial domestic investment is crowded out by the lack of available funds. An increase in the national savings rate would lessen the harshness of this adjustment by making more funds available for investment and, if achieved via a reduction in private consumption, reducing the demand for foreign consumer goods. An increase in national saving would also deal directly with the long-run competitiveness problem.

The fiscal policy most likely to produce an increase in national saving is a tax increase, which would increase government saving by substantially more than it would reduce private saving. Consumption oriented tax increases would probably increase national saving the most per dollar of revenue raised. I am much more doubtful about the efficacy of other policies that have been suggested.

Investment Incentives

The tax treatment of investment has changed remarkably often in the last six years, with no consistent policy direction. After the introduction of substantial accelerated depreciation benefits in 1981, the tax code has been amended several times to reduce these benefits, most recently be the Tax Reform Act of 1986. The 1986 act achieved a more rational tax treatment of business income, but at a substantial cost. By lowering the corporate tax rate and reducing investment incentives, particularly the investment tax credit, it shifted the tax burden from old to new investments, inducing windfalls for the owners of existing assets and discouraging new investment. This negative outcome is especially unfortunate because the positive aspects of the business tax changes could have been achieved without it.

A reinstatement of some form of investment incentives, perhaps through a rearrangement of corporate tax liabilities, is worthy of consideration to help solve the long-run competitiveness problem. One must weigh the potential benefits against the costs of continuing to change the tax law on a regular basis. But investment incentives should definitely not be seen as a solution to the short-run competitiveness problem. Indeed, they would make the problem worse than it already is.

As I indicated above, the source of the short-run problem is that a reduction in national savings has been compensated for by an inflow of foreign capital, inducing a large trade deficit. The problem will gradually disappear as capital stops flowing in and investment, rather than exports, begins to absorb the brunt of the shortage of domestic funds. Investment incentives will act to offset this transition by increasing domestic investment by more than they increase domestic saving. Overall, they will cause the trade deficit to increase in the short run.

Some might argue that this worsening of the aggregate trade deficit would be accompanied by a shift in the composition of our exports, with capital intensive industries expanding because of their improved position relative to to other industries. Another look at the recent trade statistics in Table 1 indicates how unrealistic a position this is. The majority of our exports and imports, and the bulk of our trade deficit, are attributable to sales of durable and nondurable industrial and consumer goods, the products of capital intensive industry. Our other export sectors are simply not large enough to bear the large reduction in exports that might result from an increase in capital inflows. Nor is it even clear that this would be a desirable outcome. Agricultuie, for example, is already suffering. Agricultural exports have fallen from 43.3 billion dollars in 1981 to 26.9 billion dollars in 1986.

One must conclude that it is not possible to improve the short-run competitive position of capital intensive U.S. industries through the use of investment incentives, even if such incentives are desirable from a longer term perspective. The validity of this argument does not hinge on the behavior of foreign governments or the cost of capital in foreign countries. In particular, one cannot logically support investment incentives in the U.S. as a response to a lower cost of capital in Japan or elsewhere.

The cost of capital may indeed be lower in Japan, or at least it may have been lower during the recent past. My colleague Albert Ando and I concluded in a recent study that the return to capital in Japan over the period 1967-83 was nearly six percentage points lower than in the U.S. over the same period, suggesting a substantially lower cost of capital.

This does not mean we should use tax policy to lower the cost of capital here. First of all, as I have already indicated, this would not help the short-run competitivenesss of U.S. industry. Second, our findings also suggest that the lower Japanese capital cost is not the result of investment incentives or other favorable tax treatment of corporations. It very likely is due in part to the domestic absorption in Japan of a very high rate of private savings. Indeed, there is evidence that, as Japanese capital markets have become more open in recent years, this has spurred an outflow of capital from Japan to the United States, perhaps reducing the difference in the cost of capital between the two countries but at the same time supporting the dollar and worsening the U.S. trade balance. The statistics reported in Table 2 show that Japanese capital inflows to the U.S. were negligible in the early 1980s, but have grown quite rapidly in recent years, at a greater rate than flows from Europe or the rest of the world. Like investment incentives in the U.S., the opening of foreign capital markets may ultimately be beneficial but is not a solution to the short-run trade problem.

The Value Added Tax

The imposition of a value added tax might help American business to be more competitive, but not for the reason popularly given. It is often said that a destination-based value added tax would spur exports and discourage imports because it would apply only to goods sold in the United States. Hence, imports would be taxed upon entry to the U.S. and exports would receive a rebate of the tax upon exit. Yet this analysis ignores the flexibility of exchange rates. An appreciation of the dollar could entirely offset the effects of the tax, and this is the likely outcome, particularly if the tax is seen as a permanent one. (A very large and temporary VAT could, conceivably, improve the trade balance by causing domestic consumers to defer purchases of both domestic and foreign goods until the tax were removed.)

The value added tax would help the competitiveness problem, not primarily because of its structure but because of its revenue. A consumption based value added tax would raise roughly 20 billion dollars per percentage point.

Thus, a value added tax of a few percentage points would make a substantial contribution to reducing the deficit and increasing national saving. Because it is based on consumption, the tax would probably depress private saving by less than other equal yield alternative tax increases. But the main benefit of the tax would be lost if it were used simply to reduce other taxes. Moreover, without a complicated scheme of exemptions and rebates, it is a fairly regressive tax.

Conclusions

I have argued that the major role for tax policy in solving the short-run and long-run components of the international competitiveness problem is through its ability to increase national savings by reducing the federal budget deficit. Investment incentives, though perhaps desirable from the long-run perspective, would worsen the trade problem in the short run. A value added tax would help only indirectly through its revenue effects on national saving. Though I have not dealt with them, one could conceive of policies aimed at helping very specific industries with their short-run trade problems. But it should be remembered that without increasing national saving, it is impossible to increase the net exports of one industry without decreasing those of others or reducing domestic investment.

TABLE 1

The Composition of U.S. Trade, 1986
(billions of dollars)

	Exports	Imports	Balance
Goods and services, total*	270.0	417.2	-147.2
Agriculture	26.9	21.5	5.4
Energy	8.2	38.1	-29.9
Travel & transportation	31.0	41.1	-10.1
Services	17.2	6.6	10.6
Capital goods, consumer goods and other industrial materials and supplies	168.4	299.2	-130.8
All other, including balance of payments adjustments	18.2	10.6	7.6

*Excludes U.S. government transactions and payments of income on foreign assets in the U.S. and U.S. assets abroad.

All statistics taken from March 1987 Survey of Current Business, except for agriculture imports, extrapolated from January - November total given in the 1987 Economic Report of the President, Table B-97.

TABLE 2
Capital Flows into the United States
(billions of dollars)

Year	EEC	Japan	All other countries
1982	28.8	-2.4	61.5
1983	30.8	7.2	43.7
1984	43.8	13.7	35.3
1985	60.6	31.9	34.6
1986	97.1	52.9	63.3

Source: Survey of Current Business, March, 1984-87.

Senator BAUCUS. How far would each of you go in reducing the Federal deficit further this year?

Dr. SUMMERS. I would favor some kind of serious commitment to reducing the Federal deficit $40 billion a year for each of the next three years.

Senator BAUCUS. Dr. Auerbach, do you agree? Does that sound about right?

Dr. AUERBACH. It is easier for me to make the statement since you have to raise the taxes, but that sounds about right to me. It strikes me that the word that Larry just used, "commitment," is what is important in the sense not only that taxes are being raised, but it represents a long term commitment to keep taxes up to close the deficit in fairly short order.

Senator BAUCUS. That would be about a 50/50 mix between spending cuts and revenue raised? Or would you have a different mix?

Dr. SUMMERS. I think that that decision is properly one based on what elected officials feel in the public's good we need, rather than economic performance. My own personal assessment would be, given the backlog of unmet needs that have accumulated over the last seven years, that it would probably be better for it to be more than 50/50 on the tax side.

Senator BAUCUS. "Unmet needs" mean investments?

Dr. SUMMERS. Investment in the infrastructure, in education, the kinds of things that people talk about when they talk about a competitiveness.

Senator BAUCUS. Right.

Dr. SUMMERS. A budget of things to do rather than things to undo.

Senator BAUCUS. How about you, Dr. Auerbach?

Dr. AUERBACH. I basically agree with that point.

Senator BAUCUS. What you are saying then, to some degree, you are disagreeing with the President? The President is saying no new taxes, without getting into the semantic argument of what is taxes and what is not taxes.

I hear you saying that this country has to raise some revenue if it is going to get the Federal deficit down, and it has to get the Federal deficit down if it is going to increase savings and investment so we can be competitive.

Dr. AUERBACH. I think that is right. One of the points I would like to second, that Larry made, is that there are a number of taxes, such as excise taxes, the real value of which have gone down. Excise taxes are tiny as a Government revenue source compared to what they were 10, 20, or 30 years ago.

Senator BAUCUS. What are some big items there? Which ones stand out most?

Dr. AUERBACH. I think the gasoline tax, the cigarette tax; these are taxes that are unit taxes. There are many excise taxes that are in terms of cents per unit as opposed to per dollar of sales. And what has happened over the years is that the fraction of the sales price represented by the tax in many of these commodities has gone down over the years because the taxes have not been raised as the prices of these commodities have gone up.

It wouldn't raise a lot of revenue, but I think one of the things that we have discovered since the 1981 Act, which necessitated raising of revenue subsequently, is that there are a lot of little things which, if the deficit is painful enough, can be taxed. And some of these things are things that we have taxed in the past and let the base erode.

Dr. SUMMERS. Let me just make the point that I think, in talking about the deficit or tax increases, we frequently get it wrong in an important sense. The discussion is couched in terms of: Which would be worse for the economy—the deficits or tax increases? That is not the choice. We have to pay for our spending, anyway. The question is whether we gain by deferring a tax increase, and the case that increasing taxes to pay interest 10 years from now will be less detrimental to the economy than increasing taxes today has certainly not been made.

So, I think the President gets it wrong in focusing on the adverse effects of a tax increase, unless the plan is to repudiate the national debt. Taxes will be raised to cover all the spending that we are doing. The only question is when, and I don't see any advantage to postponing the necessary tax increase to the future.

Senator BAUCUS. That is to say that the dampening effect on the economy of raising revenues now is not nearly so great as the dampening effect of the economic problems we have because we are not paying our bills, that is, because we are not saving enough and lowering our productivity.

Dr. SUMMERS. I think that is right. And whatever problems there are associated with tax increases, we are not avoiding; we are only postponing.

Senator BAUCUS. And you both seem to be saying that when we raise revenue, there are better ways of raising it, too. That is, there are the excise taxes, the consumption kinds of taxes, which you think are better for the economy than, say, taxes on income.

Dr. SUMMERS. Let me say that, in my view, I think that a national value added tax would be a tax that would minimize incentive effects, would minimize interferences with incentives and to save. I think the six measures that I listed go one better than that. They would have incentive effects, like all taxes do; but they would have incentive effects that would work in the right direction towards diverting people into activities that would be competitiveness promoting. That is why I would start there.

Senator BAUCUS. Start with the six?

Dr. SUMMERS. I would start with the six.

Senator BAUCUS. Yes. You heard me ask the question earlier of other witnesses about the degree to which we should try to encourage a longer term view in private and public thinking in this country. Do you have any suggestions?

Dr. SUMMERS. I think there are two levels to that. One is the cost of capital here is substantially greater than the cost of the capital in Japan. An American businessman given the American cost of capital will invest a dollar that will yield a return six years from now; and he expects to get $2.80 back in six years. A Japanese businessman will do it if he expects to get $1.50 in six years.

So, the cost of capital has an important effect in creating the apparent myopia. Beyond that, I think the taxes on transfers, which would discourage short-term trading, would also contribute to reducing the pressure to produce profits instantly and would enable businessmen to take the longer view.

Senator BAUCUS. Some argue that that forces some to trade offshore, to go to other markets. Even if it does, is that a problem? What is your reaction to that argument?

Dr. SUMMERS. First of all, my reaction would be sort of threefold. First, if some of that business went offshore, and our guys who are doing that now decided to go into making products, that wouldn't be an altogether bad thing, in my view. Second, undoubtedly some of it would go offshore. I just spent a few months in London. They have such a tax, and some of it goes offshore; but by no means does all of it go offshore. Companies still want to be listed on the London stock exchange, not the Cayman Islands stock exchange.

And as a consequence, they raise revenue with the tax and, to some extent, discourage short-term trading. So, I do not think that there would be a large-scale diversion abroad. The third thing is that, if you look across, there are similar taxes, not just in Britain, but in Japan, and in a number of other countries. This is a place where other countries would follow the United States.

The problem for most other countries was that the stuff would go to the United States. So, I think that would not be a critical objection.

Senator BAUCUS. Doctor, what causes the higher real capital costs in this country?

Dr. AUERBACH. Can I comment on that? I have actually done some research on that, which I have cited in my comments.

To say that it is higher, is probably correct. To say that it has anything to do with corporate taxes is not correct. And to suggest that it could be alleviated by giving investment incentives to American firms is also not correct.

Senator BAUCUS. A lot of them seem to think so, though.

Dr. AUERBACH. I understand that.

Senator BAUCUS. The first witness at our first hearing made that point.

Dr. AUERBACH. I think there are two points here. One is that, even if it were true, giving investment incentives would not help the short-run competitiveness problem. It is really an issue of what we should do for the long run. The evidence is that there is a lower cost of capital in Japan, but it is really because people who are saving are receiving a lower rate of return from the corporations, not because the corporations are able to give them more per dollar earned because of any kind of investment incentives. One asks why savers are accepting a lower rate of return. I don't really know.

Japan has an enormously high savings rate, and there is evidence that, until recent years, a lot of what was saved in Japan had to stay in Japan. That is, people have also complained that the capital market in Japan has not been open to capital going in and out. Now, that may be true. There is actually evidence if one looks at flows from Japan to the United States in recent years that, compared to other countries with more open capital markets like the EEC, capital has been flooding into the United States from Japan; I don't think there is any disagreement about that.

That, to me, is evidence that there has been a general relaxation in recent years of capital controls, implicit and explicit, in Japan, letting capital come to the United States. In the long run, I think what that will do is lead to an equalization of the cost of capital, which is probably a good thing. In the short run, it is clearly not helping the short-run competitiveness problem because those capital flows are one of the things that led to pushing up the dollar.

Senator BAUCUS. You are saying that in the long run U.S. businessmen shouldn't worry too much about——

Dr. AUERBACH. In the long run, we should worry about the cost of capital because——

Senator BAUCUS. Because the more the markets are open, the more investors are going to——

Dr. AUERBACH. In the long-run consideration, we should worry about openness of capital markets, and perhaps about investment incentives for our own purposes but not because of whatever is done in Japan. Could I just make a comment on the issue of corporate horizons?

Senator BAUCUS. Sure.

Dr. AUERBACH. The point was made that hostile takeovers are pretty well absent in Japan. I think the threat of a hostile takeover has good effects and it has bad effects; the bad effects have been highlighted, but the potential good effects should not be lost sight of either.

Senator BAUCUS. I agree with that. Why do you suppose that the Japanese are willing to incur lower real term returns in addition to the closed capital markets?

Dr. SUMMERS. I think the main thing is that they have a stronger desire to save. That means there is more supply of savings. When there is more supply of saving, that supply and demand—the basic propensity for private saving in Japan is much greater than it is here. It is hard to know why that is. One reason is undoubtedly cultural. The very limited evidence that is available suggests that the Japanese Americans in the United States save more than average in the United States. So, I think part of it is just cultural.

I think that culture is supported by a number of institutions of large-scale saving programs, which encouraged tax-free saving. And I think it had its principal effect not because the rate of return was a little higher, because you exempted the taxes, but because of the incentives it created for financial institutions. There is a saying that life insurance is sold, not bought. In Japan, representatives of savings banks go visit people every month and try to persuade them to locate their savings account there.

Senator BAUCUS. Doesn't Japan, though, have a federal budget deficit?

Dr. SUMMERS. Because of Japan's huge private saving rate, their government is able to absorb some of that saving and still have more left over than most other countries.

Senator BAUCUS. If Japan can get away with a fairly significant public debt, which is made up of huge private savers, does that imply that maybe our Government or we in our country should, yes, cut the budget deficit but also work very hard to try to encourage much higher private savings in this country?

Dr. SUMMERS. I agree with the basic impulse behind your question. Many of the figures on Japanese government debt overstate it substantially because they don't take account of the fact that there are large trust funds of social security.

Senator BAUCUS. We talked about that this morning.

Dr. SUMMERS. And the net is a good deal smaller, once you take account of those trust funds. I think we should try to raise private savings in the United States. It would be better if we knew how better.

Senator BAUCUS. How do we?

Dr. SUMMERS. My reading of the evidence is that the IRAs were successful and were becoming increasingly successful.' The first couple of years, many people moved monies from one account into the IRA account, but at some point, it became an effective marginal incentive. The average American contributing to IRAs had only $8,000 in liquid assets. So, you can not keep contributing year after year at about $8,000. Eventually, it starts to become a marginal incentive.

The Canadian comparison is very interesting. In the early 1970s, Canada introduced a system, and they called them RRSPs that are substantially more generous than IRAs were. And if you look at the savings rates between the United States and Canada, they moved very much in parallel. And then, following the Canadian introduction of those programs, the large advertising blitzes that followed, Canadian savings rose quite sharply relative to U.S. savings.

Senator BAUCUS. I have noticed that Canadian savings rates have risen sharply, but the personal——

Dr. SUMMERS. Yes. I have studied that comparison fairly closely, and I think that is the principal factor. Another one is that there is no interest deductibility for housing in Canada.

Senator BAUCUS. That is right.

Dr. SUMMERS. A second measure that I think would contribute to private saving is something—and I do not have a particular structure in mind here—in the ESOP related area. If one encouraged bonuses, that is workers being paid a part of their compensation in the form of profit-sharing or perhaps shares in the companies they work in, the evidence in Japan is that one of the reasons for their high saving rate is that a significant fraction of workers' pay comes in the form of bonuses. So, one aspect of it is just making the payment in the form of bonuses that come slightly irregularly to contribute to saving.

The second aspect of it is that, once you are giving shares in the company to workers, you have the option of requiring that, in order to be tax favored, the shares not be sold for two years or three years—some period. And that, of course, has the effect of, in a sense, turning a component of salary into a type of enforced saving. And I think that might also be effective in spurring saving.

But I should tell you that these types of things, while I think they have some effect, are using the Tax Code to serve objectives and go against the philosophical perspective that the Congress adopted in the 1986 Tax Reform Act.

Senator BAUCUS. Does that make it right or wrong?

Dr. SUMMERS. I would support a set of measures along the lines I have just described, and I think the level playing field mentality ran amuck somewhat in the 1986 Tax Reform Act because we ended up tilting the playing field away from the future. I wouldn't worry about it, but it is important to know what you are getting into.

Senator BAUCUS. Right. Dr. Auerbach, I saw you shaking your head.

Dr. AUERBACH. Yes. I disagree with some of the things that Larry said, although it is a disagreement of emphasis rather than on basic points. The most important point, which he did mention but I don't think he stressed enough, is that we are much less able to affect private savings than we are to affect public savings.

Senator BAUCUS. Let me ask something on that point. I don't know whether it is significant at all, but years ago Japan had big carrots and big sticks in the area of saving. I mean, you had to have 50 percent down to buy either a house or some large consumer product. In addition, their savings accounts were tax exempt. I don't know what all else; but anyway, there were definite carrots and sticks. Maybe the culture required that, and maybe they would have done that anyway; but nevertheless, the law did help enforce savings and encouraged savings.

Everyone says that there is no evidence that American laws have any effect on savings; and I know that and I tend to agree with that, but still I see what happens in Japan.

Dr. AUERBACH. If I were asked to come up with a policy to affect individual saving, I would lean much more heavily toward curtailing interest deductions than I would toward reinstituting IRAs. The evidence on IRAs is most charitably characterized as mixed.

Senator BAUCUS. So, you agree more with the pain of principal than the pleasure of principal?

Dr. AUERBACH. It is a question of who is paying this immediately and who is paying this further down the road. We are all going to experience pain if we don't do something about increasing national savings. Larry said that the IRAs were successful and becoming more so. I would agree with the second but not the first point.

The worst kind of IRA system would be one in which it was introduced and then taken off and then introduced again and then taken off because the effect it would have would be to just keep giving people an opportunity to put their accumulated liquid assets into tax-free accounts and perhaps even borrow to do so. It is true that a sustained system of that sort would be better, but I think better still would be some sort of reduction in the ability of consumers to deduct the full portion of their nominal interest payments.

Senator BAUCUS. I am sorry. What was your last point?

Dr. AUERBACH. There was some discussion earlier, for example, in Treasury I of allowing only a partial deduction for interest payments, the real component; and that was jettisoned because of the complexity issue. But we now have a situation where, as interest rates start to creep up, the interest deduction is going to become even more attractive than it is right now to people who are borrowing to purchase homes because of the favorable tax treatment on the income side.

Senator BAUCUS. So, you would reduce the home equity loan deduction?

Dr. AUERBACH. Something in that area, yes.

Senator BAUCUS. Dr. Summers, I wonder if you could just briefly expand your point about taxing income of foreigners—income earned in the United States? I remember that provision in the Code that you mentioned, but I have forgotten why we did what we did.

What is the argument against going back and taxing that, just income earned in the United States? It sounds like a good idea to me; what is the argument against it?

Dr. SUMMERS. My understanding is that the principal objection is of two types. One, it is argued that we don't want to interfere with international capital mobility, and especially we don't want to interfere with international capital mobility at a time when we need to have all our big debts financed. Those are essentially the two arguments.

We want to have capital flow to wherever it is most efficient, and we don't want to tax it when it crosses international borders. If the country of origin wants to tax the capital income, that is fine; but we shouldn't tax the capital income. That is the argument.

My reaction and the argument also says that in many cases American investments abroad are taxed; and when Americans hold CDs in foreign banks, that those are being taxed favorably. So, we should provide similar treatment here.

Now, my reaction to those arguments would be, first, whatever rules were right at a time when there was far more capital of Americans flowing out than was flowing in need to be reevaluated at a time when there is far more capital flowing in than is flowing out. Second, if one looks at the source of what a lot of this money is about, it is hot money seeking short-term returns of a kind that destabilizes exchange rates, and in some cases it is flight capital from debtor countries. And that is not especially a type of capital flow that we wish to encourage.

Third, there is an irony in the fact that we tax foreign direct investment on a basis similar to the basis that we tax American companies, and it would seem that, if anything, we wanted to give the break to the people who were building plants here, rather than for the people who are purchasing CDs here. But I think the basis for what the Congress did was a concern about the free flow of capital.

The other thing was that the provision that was repealed in 1984—this is probably a more important effect actually—was less sweeping in what it taxed than what I just advocated, and in fact, raised almost no revenue because it was very easily circumvented through The Netherlands Antilles. And people thought that the spectacle of these rules being circumvented through The Antilles was unappealing.

Senator BAUCUS. Have you read the monthly cover story a few weeks ago of Pete Peterson, the article on the morning after? Frankly, that article really struck me. Do you tend to agree with it or not?

Dr. SUMMERS. Yes.

Dr. AUERBACH. Yes. It wasn't exactly light reading, nor did it leave me with a very good feeling; but I thought it was a fairly clear statement of the problem that we have and can't be said often enough.

Senator BAUCUS. Do you agree, Dr. Summers?

Dr. SUMMERS. I thought, yes. To tell you the truth, at the moment I read it, I thought in talking about collapsing markets and so forth it was perhaps slightly too apocalyptic; but in light of the events of the last few days, I would withdraw even that minor criticism.

Senator BAUCUS. What is the good news?

Dr. AUERBACH. The good news is that the economy is healthy, and many of the concerns that often attend a discussion of a tax increase such as pushing down aggregate demand and leading to higher unemployment is less of a concern now than it would have been three years ago, I think.

Senator BAUCUS. In terms of higher employment?

Dr. AUERBACH. In terms of the short run, traditional Keynesian concerns about insufficient aggregate demand, having a tax increase, increasing savings, reducing demand, and throw people out of work. The people who are out of work now are people in trade-sensitive industries. And the overall unemployment rate has come down quite substantially—gradually and substantially—in recent years.

Senator BAUCUS. Even though that is true, the real income of the average American family isn't going up and has not been. Then you get the question of how you define those unemployment figures. A lot of families now, the husband and wife both work at part-time jobs, at mobile jobs, and it is at lower paying jobs.

Dr. AUERBACH. As you said, with the low rate of national saving, a falling dollar, and a very low degree of productivity growth, we just don't have the capacity to have increasing real incomes. And we can do very little about that in the short run.

Senator BAUCUS. What do we do about the problems addressed by Pete Peterson—that you both addressed—namely, the huge public dissavings, a net debtor nation by far and growing, and low growth rates of productivity? It seems to me that is not very good news.

Dr. AUERBACH. No, it isn't very good news, but perhaps if it is more publicly understood that the problem is not something in the distant future but is happening right now, then there may be the will to accept, or really to recognize that our standard of living has to decline.

Senator BAUCUS. Are there any economists who disagree with you and Mr. Peterson?

Dr. AUERBACH. Excuse me?

Senator BAUCUS. Are there any economists that would disagree generally with your general view that we have just been talking about this morning?

Dr. SUMMERS. Senator Baucus, there is no proposition that you cannot find an economist to support.

Senator BAUCUS. I know about the right hand and the left hand, but just generally?

Dr. SUMMERS. I think that this is a case where the economics profession would speak with a rare degree of relative unanimity in feeling that two percent national saving was not nearly enough and represented a serious problem and that it was important to do something about it.

Senator BAUCUS. All right. We are going to end on this very sobering note. The tape is behind—I don't know how far behind—oh, it is one hour behind. The Dow now shows down 142; the volume is 270 million shares at this point. So, that is what is happening.

The hearing is adjourned.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

STATEMENT OF THE

AMERICAN PETROLEUM INSTITUTE

ON

THE IMPACT OF THE U.S. TAX CODE

ON AMERICA'S INTERNATIONAL COMPETITIVENESS

OCTOBER 5 AND 19, 1987

INTRODUCTION

The capacity of any business enterprise, foreign as well as domestic, to effectively compete in world markets is directly influenced by the operation of the tax laws of its home country. For many companies, performance is largely measured by their success in attracting and effectively utilizing capital, and this in turn depends to a significant degree on the tax treatment of capital and capital assets. A company's performance is also dependent upon the extent to which its home country's foreign tax laws enhance or inhibit its ability to compete with foreign companies. Section I of this paper discusses the U.S. tax regime relating to capital formation, with emphasis on two points: one, the dramatic changes in this area made by the Tax Reform Act of 1986 (the Act); and, two, the Windfall Profits Tax (WPT). Section II examines the foreign provisions of the Internal Revenue Code (Code), also emphasizing the effect of the Act.

I. CAPITAL FORMATION

The Act

The ability of domestic companies to compete internationally is significantly affected by the way the tax system treats capital formation. In that regard, the changes to the U.S. tax system enacted in the Act were a major step backward. While billed as "revenue neutral," the Act shifted $120 billion of tax burden from individuals to the corporate sector. Lower rates of tax were enacted, but the benefits of such reductions for capital intensive industries such as oil and gas were far exceeded by repeal or substantial curtailment of investment incentives.

Some of the most disappointing features of the Act were its changes to the depreciation system. Investment in new plant and equipment is influenced by capital cost recovery rates. For investment in exploration and production facilities, the new, slower ACRS depreciation schedule provides only 79% present value of allowances compared to 82.5% under prior ACRS (100% present value if the investment tax credit is included). Refining facilities and water transportation equipment fell to 72% present value while the present value of marketing facilities and pipelines dropped to 57%.

The extension of recovery periods under the new ACRS with no provision for indexing resurrects all of the problems of inflationary erosion of capital values which led to enactment of ACRS in the first place. The loss of ITC compounds the problem since, under prior law, it acted in part as a surrogate for indexing so that there was full recovery of real or replacement costs. (Pre-Act ACRS provided only about 90% recovery of real or replacement costs at 5% inflation.)

The optimum recovery system is, of course, current expensing of capital outlays. Currently expensing capital outlays means that the internal rate of return before and after tax is the same, thus eliminating taxes as an investment consideration. Current expensing also avoids the necessity of an inflation adjustment, and provides the government with as much or more tax revenue over the project life as any of the other cost recovery mechanisms at comparable rates. At a minimum, a cost recovery system should be indexed for inflation so that the real investment outlay is recovered.

The uniform capitalization rules, which require construction-period interest expense and other indirect costs attributed to new investment to be capitalized and recovered over the life of the asset or as an inventory cost, also delay cost recovery and further burden new investment. Additionally, there are new administrative costs associated with the accounting changes and the recordkeeping requirements now in place that impose an added burden on taxpayers.

The slower recovery rates and disregard of inflation in the new ACRS and capitalization of interest and other indirect expense result in a significant reduction of return on new investment, increase in the cost of capital, and elimination of a number of otherwise viable projects. These results, in turn, could place downward pressure on business spending, economic growth and employment.

Capital intensive industries such as oil and gas are disadvantaged relative to labor intensive industries. In general, new entrants, companies in a growth mode, or companies attempting to revitalize are disadvantaged by the Act changes. The increased cost of capital exacerbates the effect of oil price declines on domestic exploration and production, and will result in increased reliance on foreign oil.

Comments with respect to capital formation are not complete without review of the corporate alternative minimum tax (AMT). The new AMT tends to magnify the intrusion of the tax system into the investment decision process, impede economic growth, and risk a reduction in new business investment. Once a taxpayer is subjected to the AMT, the internal rate of return and present value of the net cash flow on each new project are reduced. Many projects could lose their economic viability and be scrapped. On the other hand, current projects that are operating at a loss can be subject to the AMT under the current law.

Once the AMT is triggered, marginal effective tax rates over the life of a project rise and the present value marginal effective tax rate could exceed statutory rates by an even wider margin. Rather than neutralizing the effects of taxes on investment, the AMT magnifies the distortion inherent in the regular corporate income tax and thrusts the tax system further into the investment decision process.

The basic flaw in the underlying rationale for the AMT is the fact that with few exceptions the alleged corporate "preferences" simply involve the issue of <u>when</u> costs should be deducted rather than <u>whether</u> such costs should enter into the computation of taxable income. Virtually all so-called corporate preferences are clearly costs incurred in earning taxable income and should be deducted in determining any tax intended to be based on net income.

In essence, the AMT is simply a parallel income tax structure with capital cost recovery rates that are much slower than those used under the regular corporate income tax. No effort is made to determine the most rational or efficient recovery period for costs which generate multiperiod income, or to adjust any of the "norms" to reflect the impact of inflation. The AMT simply substitutes a slow and ill-conceived capital cost recovery rate as the "norm."

Another flaw in the AMT system is the limitation on the use of foreign tax credits. The denial of full use of these credits to offset AMT liability is tantamount to double taxation.

Planning uncertainty for projects that extend beyond 1989 is increased due to the AMT "preference" relating to book income/earnings and profits. The book income preference, which is unlike other preferences in that it does not operate to replace a previously taken deduction, basically requires that 50 percent of the amount by which a taxpayer's book income exceeds its adjusted regular taxable income plus other preferences be added to the AMT income base. This will evolve in 1989 into a preference based on current earnings and profits under rules yet to be prescribed. The problems of the 1986 Act are compounded by further changes which the Congress is considering. One proposal, which is part of the House passed reconciliation bill, raises the book income preference to 100 percent. This change if enacted would make it more difficult to compete on an international level.

In addition, the AMT rate is entirely too high -- almost 59% of the regular corporate rate. An AMT at that level ceases to be an alternative which applies only to those few taxpayers that make excessive use of so-called "preferences" and is likely to become the general rule applicable to a majority of taxpayers.

Furthermore, the prior corporate minimum tax law contained fewer preferences. Under the Act Congress both broadened the AMT base <u>and</u> increased the rate -- from 30% of the maximum regular tax rate to nearly 60% of the maximum regular tax rate. Prior to the Act, the AMT was set at 30% of the maximum regular corporate tax rate (15/50) -- a far more reasonable level. To be consistent with the prior law ratio of minimum tax to corporate tax, the present law should provide an AMT rate of 10%.

As a response to the reduction in corporate tax rates contained in the Act there is a growing trend by major foreign industrial nations to likewise reduce their tax rates. The obvious purpose of these actions by foreign governments is to preserve the competitive advantage for their nations' industries over U.S. companies. The enactment of the AMT has resulted in furthering the economic disadvantages of American companies against foreign competitors in both U.S. and foreign markets. While an exact measurement cannot be made, the natural result would be an increase in foreign imports and a reduction in U.S. exports.

Finally, another way in which the tax system affects competitiveness is the overall investment climate it fosters. The Act has increased the cost of capital and U.S. industry's tax administrative burden, and additional changes to the income tax system at this time will only serve to further handicap decision makers. Uncertainty about various aspects of the tax law, such as cost recovery methods and rate changes, tends to cause investment decisions to be postponed, thus slowing domestic economic activity. Confidence in the permanence of various aspects of the income tax system neutralizes, to some extent, the intrusion of the tax system into investment decision making and such confidence should be nurtured.

<u>The WPT</u>

An important and positive step that Congress could take to help shrink the U.S. trade deficit and improve the competitiveness of domestic businesses is repeal of the Crude Oil Windfall Profit Tax. This excise tax is imposed on domestic, not foreign, oil and thus acts to seriously weaken the U.S. trade situation.

The windfall profit tax (WPT) has contributed to the string of huge monthly foreign trade deficits. But for this tax, the nation would now be producing more of its own oil; oil imports and U.S. payments for foreign oil would be correspondingly lower. The tax has been on the books for seven years. Given the response of domestic production to economic incentives over that time, API estimates that domestic oil production is now close to 1 million barrels a day lower than it would have been without the tax.

Although total revenues from the WPT have been much less than what was originally estimated, the tax has nonetheless represented a significant disincentive to domestic exploration and production. And, even though under current depressed industry conditions little or no WPT is being levied, the tax poses a disincentive to both present and future investment because it limits the potential profitibility from any future increases in oil prices.

The negative influence of the WPT occurs in two ways. First, the WPT imposes an economic disincentive on new production, thus making many new domestic oil exploration and production projects unattractive. For example, more intensive development of existing fields (infill drilling, secondary recovery operations, pressure maintainance operations, and workovers, e.g.) is especially sensitive to the WPT. These projects have offered and continue to offer considerable opportunity for near term supply response. Thus, continuation of the tax would result in less domestic production and an inevitable increase in oil imports. Second, because of the high risk nature of the business, internally generated cash flow, rather than borrowings, must provide a major source of exploration and production capital. This cash flow is generated largely by income from existing production (e.g., Tier 1 old oil) that must carry the principal burden of funding new projects. However, the WPT extracts the largest cash flow penalty from this production. This design flaw of the WPT decreases the pool of capital available to fund exploration and development by reducing the cash flow generated by existing production.

Additionally, the very structure of the WPT with its different tax rates and adjusted base prices fosters distortion in investment decisions. For example, in today's environment and over the foreseeable future, any WPT that is due will be from Tier 1 crude oil. A barrier is thus erected to new investment on Tier 1 properties and otherwise recoverable reserves are left in the ground. The trend toward shutting in wells is exacerbated by continuation of the tax. Repealing the WPT would do away with these artificial distinctions, and reduce such misallocations of resources.

API estimates that the current annual cost of compliance to taxpayers is approximately $100 million, exclusive of audit costs. This cost to taxpayers is in addition to the cost to the government. The IRS estimates that last year alone it processed 4 million original Forms 6248, which must be produced and filed for all transactions even if no WPT is due. It is simply a drain on public funds to continue a tax that costs the government more to administer than it returns in revenues.

Since President Reagan accelerated and completed decontrol in 1981, domestic crude oil has been produced and sold in direct competition with crude oil from other producing nations. Domestic crude oil prices have been determined by the forces of the world market. Because the market in which the domestic petroleum industry now operates is working, with prices both rising and falling in response to supply and demand, there is no reason to continue the tax surrogate for the price controls in effect a decade ago. That the market works is shown by the price collapse which occurred when worldwide production exceeded worldwide demand. Continuing the WPT disadvantages the domestic petroleum industry without accomplishing the purposes for which it was enacted.

These circumstances have been recognized by the Administration. As stated by then-Assistant Treasury Secretary Roger Mentz in his February 4, 1987, testimony, "Even if crude oil prices again rise to levels that would generate significant profits for domestic oil producers, such profits would, in no way, be considered 'windfall' profits. This is because a return to a profitable situation for domestic oil producers would be the result solely of market conditions (here and abroad) and not the result of the government lifting an artificial price barrier, as was the case when the tax was first imposed."

Action to bolster domestic oil production is urgently needed, because U.S. oil production is declining while consumption is increasing. From early 1986 through mid-1987, U.S. oil production fell by more than 800,000 barrels a day while over the past two years consumption has increased by a similar amount. Should these trends continue, by year's end the United States will have increased annual oil imports by almost 2 million barrels a day over just two years ago. That increasing reliance on foreign oil will send billions more dollars overseas in oil import payments and put continual pressure on this country's foreign trade deficit.

Congress can address the trade problem directly by immediately repealing the windfall profit tax on domestic oil production. That action will improve our trade balance by adding new domestic oil production, thus restraining oil imports and putting downward pressure on oil prices.

II. FOREIGN TAX PROVISIONS

As in the realm of capital formation, the Act should be a primary focus of inquiry into the effects of the foreign tax provisions of the Code on the ability of U.S. businesses to compete internationally. However, several comments regarding the Code's foreign tax provisions generally, aside from the changes made by the Act, should be made before proceeding. First, basic to our concept of federal income taxation is that U.S. corporations are subject to U.S. income taxation on a worldwide basis. The U.S. is by no means the only nation employing this principle, but it is worth mentioning that a number of other countries have not adopted this theory. To the extent that U.S. companies compete in third countries with companies from countries not on the worldwide system (e.g., countries which tax on a "water's edge" basis, such as France), they compete at an obvious disadvantage.

Second, the U.S. Government maintains a historic and growing bias against tax deferral of income earned by foreign subsidiaries. This bias finds substance in the subpart F provisions of the Code which, even without the Act, are unparalleled in their reach and sophistication vis-a-vis the tax laws of other countries. U.S. multinationals competing against foreign multinationals in third countries are therefore greatly handicapped, even where the foreign multinational's home country employs a subpart F type approach.

Third, six major tax revisions, each involving significant foreign changes, have been made during the last ten years. Moreover, Congress is currently considering a number of foreign amendments in the reconciliation package. Aside from whether any of these revisions are justified in a pure tax sense, there is no doubt that the sheer frequency and volume of these changes has created an extremely unstable business planning environment, as alluded to in the capital formation section. At a time when stated government policy is to encourage U.S. companies to penetrate foreign markets to redress the trade deficit, this aspect of U.S. tax policy encourages the opposite.

The Act

Congress has been commended for its decision to reduce U.S. individual and corporate income tax rates. However, as stated previously, rate reductions were achieved primarily by increasing U.S. corporate income taxes by $120 billion over the ensuing five years, thereby substantially diminishing the ability of U.S. companies in general, and U.S. oil companies in particular, to effectively compete with foreign companies. This $120 billion shift in tax burden to the corporate sector was accomplished in no small part through changes in the foreign tax area. For example, the Act significantly changed the rules for allocating and apportioning deductions for interest and other indirect expenses for purposes of determining the foreign tax credit. One aspect of this change is that U.S. multinationals are no longer entitled to the same U.S. tax treatment of interest expense as allowed foreign multinationals with similar operations.

Specifically, the Act requires that interest expense be allocated and apportioned to domestic and foreign source gross income on the basis of the domestic and foreign assets of all members of the U.S. tax consolidation as if all such members are a single taxpayer. Inconsistently, interest expense of foreign affiliates is not subject to this rule. This new requirement, which is based on the so-called fungibility of money theory, effectively denies full U.S. tax relief to U.S. multinationals for expenses actually incurred in connection with their U.S. operations.

To illustrate, assume that a U.S. multinational (M) owns a domestic subsidiary (S) which produces oil in the United States. M produces oil through a branch in a foreign country. Assume also that S borrows funds from a U.S. bank to fund its U.S. oil activities and that M's foreign oil activities are adequately funded by equity capital. The Act requires that S's interest expense to the bank be allocated and apportioned to domestic and foreign source gross income on the basis of the domestic and foreign assets of all members of the U.S. tax consolidation. Therefore, part of S's interest expense is apportioned to M's foreign source income, reducing M's foreign tax credit limitation.

If, in the above example, S were a foreign subsidiary, none of its interest expense would be allocated and apportioned to M's income. That interest expense of a foreign subsidiary may not be allocated to income of its U.S. parent (in contrast to the requirement that U.S. interest expense of domestic affiliates must be used to offset foreign source income of domestic <u>and</u> foreign subsidiaries) is inconsistent with the fungibility principle, and is unfair. In keeping with the fungibility concept, interest expense of foreign subsidiaries <u>should</u> be allocated to income of U.S. affiliates.

U.S. multinationals are further disadvantaged by the recently issued proposed regulations implementing these new interest allocation rules. The proposed regulations selectively ignore the general fungibility theory, to the advantage of the Treasury, in at least one instance where there is no basis to do so and where the effect is extremely harmful to U.S. companies. The proposed regulations require a "direct tracing" of a U.S.

company's interest expense to its foreign source interest income in situations where the U.S. company borrows from 3rd parties and has outstanding loans to its foreign subsidiaries. This direct tracing has the effect of reducing the amount of the U.S. company's foreign source income and, potentially, its foreign tax credit. Regulations implementing the Act should reflect the intent of Congress, as clearly indicated in the legislative history to the Act, and should not be revenue driven.

Another foreign provision significantly changed by the Act is the Code section which sets out the mechanics for calculating the foreign tax credit limitation. Under the limitation provision, the amount of foreign tax credits that can be claimed against U.S. tax on foreign source income is limited by a fraction, the numerator of which is the taxpayer's foreign source income. The higher the numerator of the fraction, the higher is the potential credit. Under pre- Act U.S. tax law, to avoid "averaging" of credits, five separate limitation fractions were calculated, determined on the basis of five separate income categories. To further curtail averaging, the Act expanded the old law separate interest income category to include all passive income, and added several new categories. These separate foreign tax credit income categories, as well as the special foreign tax credit limitation for oil and gas extraction income, necessitate the computation of a minimum of ten separate foreign tax credit limitations. Further, because the Act imposes a separate per-company foreign tax credit limitation on dividends from certain "non-controlled" foreign corporations, many U.S. multinationals must compute hundreds of separate foreign tax credit limitations. Calculation of the foreign tax credit is further complicated by many of the other rules contained in the recently issued proposed regulations implementing the amendments to the foreign tax credit provisions made by the Act.

No other taxing jurisdiction requires its multinationals to make so many computations to determine creditable foreign taxes. Averaging of high and low foreign taxes paid on income generated abroad is permitted by foreign tax jurisdictions, whereas the U.S. foreign tax credit provisions effectively require U.S. multinationals to compute the foreign tax credit limitation on an item-by-item basis. This level of complexity adds significantly to administrative costs and reduces the effectiveness of the foreign tax credit as a tool to avoid double taxation. This diminishes the capability of U.S. multinationals to compete in foreign markets with foreign companies, where it is usually the case that foreign competitors operate in a more favorable tax climate.

The Act also significantly changed the rules regarding the recapture of losses incurred in foreign countries, the effect of accumulated deficits in earnings and profits of a U.S.-owned foreign subsidiary on current earnings and profits of the subsidiary, the recognition of foreign currency gains and losses, and many other provisions. Though to a lesser degree than with respect to interest allocation and the foreign tax credit limitation rules, these changes also serve to substantially increase the tax costs of U.S. multinationals doing business in foreign jurisdictions, further affecting the profitability of U.S. multinationals.

CONCLUSION

In summary, although the Act reduced corporate income tax rates, it also substantially reduced the ability of U.S. multinationals to compete in U.S. and foreign markets. In plain terms, U.S. companies often are required to pay a double tax (tax to the U.S. and tax to the foreign country only partly creditable against U.S. tax or not creditable at all) where foreign companies with similar operations pay tax at most only once. The short-term increase in tax revenues gained from U.S. multinationals by the Act will result in long-term revenue losses as the profitability of U.S. multinationals decreases due to their inability to compete effectively at home and abroad.

BARRETT SMITH SCHAPIRO SIMON & ARMSTRONG

Dear Senator Baucus:

We are writing this letter (a) to alert you to certain provisions of the Internal Revenue Code of 1986 (the "Code") which, we believe, substantially inhibit the export of certain U.S. manufactured products (particularly commercial aircraft), thus aggravating the U.S. trade imbalance; and (b) to respectfully request that legislation should be enacted to eliminate these export-disincentive tax provisions.

The export-disincentive tax provisions referred to above are contained in Section 168 of the Code, which sets forth the rules related to depreciation of property. Under Section 168 of the Code, property that is used by a domestic entity is generally subject to more favorable depreciation allowances than property that is used by a foreign entity. For example, a commercial aircraft that is owned and used by a domestic entity is depreciable over a seven-year period (using an accelerated method of depreciation). See Code Section 168(b), (c) and (e). By contrast, a commercial aircraft that is owned by a domestic entity and leased to a foreign entity in a standard leveraged lease transaction (which qualifies as a "true lease" for Federal income tax purposes) will generally be depreciable over a period equal to 125% of the lease term (possibly as long as 20 to 25 years) using the straight-line method of depreciation (even if the aircraft is registered with the FAA and operated to and from the U.S. with a regular degree of frequency). Code Section 168(g)(3) and (h).

Although Section 168 of the Code distinguishes between property that is used by a domestic entity and property that is used by a foreign entity, it generally does not distinguish between U.S. manufactured and foreign manufactured property. Thus, a foreign manufactured commercial aircraft that is used by a domestic entity will be depreciable over a seven-year period (using an accelerated method of depreciation), whereas a U.S. manufactured aircraft that is owned by a U.S. lessor and leased to a foreign airline (in a standard leveraged lease transaction) will generally be depreciable over a period of from 20 to 25 years (using the straight-line method of depreciation). This result is highly anomalous. The existing discrimination in the tax laws against property that is used by a foreign entity is all the more surprising in light of the genuine, and often expressed desire of the United States to stimulate exports and improve its balance of payments position.

The tax discrimination against aircraft used by foreign entities originated in the "Tax Reform Act of 1984" (the "1984 Act"). Prior to the enactment of the 1984 Act, foreign airlines financed the acquisition of many U.S. manufactured aircraft by entering into leveraged lease transactions with U.S. institutional lessors. The 1984 Act's changes in the depreciation rules effectively eliminated this means of financing the acquisition of U.S. manufactured aircraft by foreign airlines and, thus, significantly increased the economic cost of U.S. manufactured aircraft to foreign airlines.*

While it can be argued that U.S. trade policy should not be subsidized under the tax law (as it was in the DISC provisions), it does not follow that U.S. tax law should be used to gratuitously shoot our trade policy in the foot. The elimination of the long-standing tax provisions which permitted leveraged leasing of U.S. aircraft to foreign airlines had the practical effect of raising the export price above the domestic price of the product.

There is clearly no basis for objection by our trading partners in the GATT for permitting foreign airlines to acquire U.S. aircraft through leasing, and there is every reason to do this in the light of reduced Export-Import funding.

The notion that U.S. manufactured long-range jet aircraft such as the Boeing 747 (for which foreign airlines are now the biggest customers) face no effective foreign competition seems incredibly short-sighted. Even if this were true, it would not justify raising the export price through the tax law, which inevitably tends to depress sales that benefit U.S. employment and the balance of payments. No one has shown that the market for these aircraft is price inelastic, and those who know the market best argue persuasively that it is not.

Furthermore, U.S. domination of the world market for commercial jet aircraft is no more secure than U.S. domination in computers or micro chips was once thought to be. European interests already claim a substantial share of the world market in wide-bodied jets.

Sales of long-range jets which are leased for use by foreign airlines unquestionably strengthen the ability of U.S. manufacturers to compete in all phases of the market financially and in terms of product and service commonality which airline customers regard as important. There would seem to be no occasion to discriminate against such sales in the tax law.

It is respectfully requested that, in order to eliminate the current discrimination in the tax laws against U.S. exports, legislation should be enacted to provide that property that is manufactured in the U.S. and leased to a foreign entity should be subject to the same depreciation allowances as is property that is used by a domestic entity.

Please feel free to call the undersigned if you have any comments or questions regarding this submission.

Very truly yours,

William C. Clarke

William C. Clarke

Jack Miles

Jack Miles**

cc: Laura Wilcox
Hearing Administrator

Mary McAuliffe
Minority Chief of Staff

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* The 1984 Act substantially reduced the tax benefits available with respect to property leased to tax-exempt organizations, such as colleges, municipalities, government departments and foreign entities not subject to U.S. tax. This change in law followed a series of highly publicized sale-leaseback transactions involving domestic tax-exempt entities (e.g., Bennington College and the U.S. Navy). Because most foreign airlines are exempt from U.S. taxation, based upon reciprocal exemptions extended to U.S. flag airlines in foreign countries, the sponsors of the 1984 Act lumped foreign airlines together with U.S. tax-exempt entities. It is submitted that leveraged leasing of U.S. manufactured aircraft operated by foreign airlines raises different issues of tax policy than sale-leaseback transactions involving domestic tax-exempt organizations, and it raises a whole dimension of U.S. trade policy which is not present in those transactions.

** The undersigned have represented foreign airlines in leveraged leasing of U.S. aircraft.

STATEMENT OF

THE BANKERS' ASSOCIATION OF FOREIGN TRADE

RELATING TO EXPORT FINANCING INTEREST

* * *

The Bankers' Association for Foreign Trade (BAFT), which has been in existence since 1921, is a trade association of money-center, regional, and smaller banks dedicated to promoting international trade and finance. Its U.S. voting members compromise virtually all U.S. banks actively engaged in international banking and trade finance. BAFT is pleased to have an opportunity to present its views to the Subcommittee on the crucial issue of the Internal Revenue Code's impact on U.S. trade finance.

From an international competitiveness standpoint, one of the greatest concerns of BAFT's U.S. members is the treatment of tax credits earned by U.S. banks for gross withholding taxes (those in excess of 5 percent) which they pay to foreign governments. In the trade finance context, these withholding taxes are imposed on gross interest income paid to U.S. banks on loans to foreign borrowers which finance the importation of U.S. goods and commodities.

BAFT's members have spent the year since the 1986 Tax Reform Act (TRA '86) became law analysing the impact that the new foreign tax credit separate limitation for high withholding taxes is having upon the ability of U.S. banks to finance the exports of U.S. businesses. BAFT has concluded that the TRA '86 has indeed had a negative impact on trade finance, and therefore respectfully recommends a change in the 1986 Tax Reform Act. Specifically, BAFT urges an amendment to IRC Section 904(d)(2), which creates an exception for export financing interest in the case of the separate foreign tax credit limitation for interest subject to high withholding taxes.

THE SCOPE AND IMPORTANCE OF TRADE FINANCING

Financing is a critical competitive component in nearly every export sale. Intense foreign competition requires U.S. exporters to quote an "all-in" price to foreign buyers of U.S. goods and commodities that includes financing costs. U.S. exporters have therefore turned to their U.S. bank lenders to provide this crucial financing component and to assume the associated foreign buyer credit risk. Money-center, regional, and smaller banks, however, have been discouraged from attempting to meet this need for competitive trade financing because of several factors, including the damaging effect which the 1986 Tax Reform Act has had upon the treatment of U.S. bank cross-border lending income. This in turn has hurt U.S. prospects for increased trade and has exacerbated the U.S. trade deficit; the result has been lost business opportunities and lost profits for U.S. exports, and lost jobs for American workers.

The foreign tax credit limitation rules of the 1986 Tax Reform Act have worked against U.S. exporters by making it impossible for them to provide export financing on terms as competitive as those offered by banks of other major industrial countries. The tax laws of countries such as Germany, Japan, France and the United Kingdom continue to provide deductibility of foreign withholding taxes on such transactions on terms generally similar to those available to U.S. banks prior to the changes made by the 1986 Tax Reform Act.

In a sample survey, BAFT found that a decline in the trade financing activities of U.S. banks had commenced at the same time that new restrictions on the use of foreign tax credits by U.S. banks were being adopted in the House Ways and Means Committee in the fall of 1985 as a part of tax reform. Although U.S. banks financed approximately $6 billion worth of U.S. exports in 1986, the interest from which was subject to high withholding taxes, that figure represented a reduction of between 50 to 100 percent from 1985 levels. That dramatic decline has continued in 1987.

The problem of U.S. banks in connection with financing U.S. exports has been highlighted in the financial press in the last six months. Lengthy newspaper reports have focused on the reduction in the ability and willingness of U.S. banks to finance exports for a number of reasons --- including the reduced ability to claim the foreign tax credit on trade finance loans due to the high withholding tax limitation. As it impacts trade finance, the key problem with the separate limitation for high withholding taxes is that virtually all of the countries to which U.S. companies export impose such taxes.

ADVERSE IMPACT OF FOREIGN TAX CREDIT CHANGES ON EXPORTS

U.S. banks are no longer able to offer competitive financing in support of U.S. exporters because of the separate limitation on interest subject to high withholding taxes. The competition from foreign exporters and their lenders will not allow U.S. banks to pass the additional costs along to foreign buyers.

In an example attached hereto, the loss of the full use of foreign tax credits earned on a typical trade finance transaction involving the purchase of a $5 million machine results in an <u>increase of over 75 percent in the interest rate on the financing</u>. Just as the price of that machine must be competitive when the same or similar goods are offered by other prospective sellers, the cost of the financing associated with that sale must also be competitive. (2 other examples attached)

Because the nations which are our principal foreign trade competitors do not impose similar limitations on the use of tax credits earned by their banks, American banks alone are faced with the choice of offering uncompetitively expensive financing packages, absorbing additional costs which make export financing unprofitable, or abandoning export financing altogether. Unfortunately for our nation's trade competitiveness, the latter has been the only realistic option for too many U.S. banks.

Fifty foreign countries impose foreign gross withholding taxes for interest paid to U.S. lenders. The U.S. also imposes such a tax at a 30 percent rate, unless the rate has been reduced by an income tax treaty. (The U.S. Treasury has been notably unsuccessful negotiating tax treaties with developing nations, which buy more than one-third of U.S. exports.) When a U.S. bank makes a cross-border loan to a buyer in a withholding tax country to purchase goods, the bank becomes liable for the withholding tax on the interest income earned on the loan.

Under the U.S. tax law prior to the TRA '86, U.S. banks were able to take a full foreign tax credit for gross withholding taxes paid abroad on interest they received. While taxation systems differ among countries, the pre-TRA '86 foreign tax credit for withholding taxes was comparable to the current treatment of such taxes by our major export competitor countries.

Under the TRA '86 if a foreign withholding tax on interest exceeds 5 percent, the interest income and tax credits are subject to the special high withholding tax limitation. (On average, foreign withholding taxes range from 10 to 30 percent.) These credits cannot be used to the extent they exceed the U.S. rate of tax on net income. These disallowed credits thus substantially increase the costs of cross-border lending by U.S. banks to high withholding tax country borrowers. These additional costs must be absorbed by the U.S. bank or paid by the borrower in the form of higher financing costs.

EXPORT FINANCING INTEREST EXCEPTION

When the 1986 tax bill Conference Committee considered the new separate limitation for interest subject to high withholding taxes, it recognized that a financing problem might be created for U.S. exporters. In response to this concern, it created an exception for export financing interest income. Unfortunately, this exception is drafted so that only manufacturers, growers, processors, or a related party (e.g., a captive finance subsidiary) may obtain the benefit of the exception. U.S. banks are ineligible to receive the preferred treatment granted by the exception because they are barred by federal law from being manufacturers, processors, etc., or "related to" such entities. As a result, and key to BAFT's concerns, this provision has been of virtually no use to U.S. exporters. Although some large U.S. manufacturers have finance subsidiaries which are able to make trade financing deals for their parent companies, the vast majority of U.S. businesses still must look to U.S. banks to provide trade finance. It is this problem which is addressed by BAFT's proposal. It would enable unrelated parties, such as U.S. banks, to receive export financing interest and treat it as financial services income for foreign tax credit purposes. While the problems created by the separate limitation for high withholding tax interest still remain for the majority of cross-border loans made by U.S. banks, this particular and important problem for U.S. exporters would be cured by this legislation.

Finally, the assumption made by some that adoption of this legislation would reduce tax revenues and further exacerbate the budget deficit is incorrect. If U.S. banks continue to be unable to finance U.S. exports, there will be fewer U.S. exports, less U.S. production, fewer U.S. jobs, and less overall tax revenue. Conversely, enactment of BAFT's proposal would boost exports, raise production, create new jobs, and increase tax revenues.

CONCLUSION

The trade financing problem created for U.S. exporters and their bankers by the TRA '86 foreign tax credit rules would be corrected by adoption of the BAFT proposal. Trade financing is critical to the growth of U.S. export, which in turn is vital to increased U.S. production and jobs. Allowing U.S. banks to get back into the trade finance business is thus crucial to our national economic trade interest.

1986 Tax Reform Act - Foreign Tax Provisions
Exclusion of U.S. Banks from Export Financing
Example: $5.0 million U.S. Manufactured Product

	Old Law		New Law			
			Competitive Rate of 8.0%		Pre 86 TRA Profit Rate of 9.75%	
Income						
Cash interest	$300,000		$300,000		$368,000	
W/H Tax Receipts	100,000		100,000		121,000	
	400,000	(1)	400,000		489,000	(2)
Expense						
Interest (1)	(375,000)		(375,000)		(375,000)	
	(5,000)		(5,000)		(5,000)	
	(380,000)		(380,000)		(380,000)	
Income before taxes	20,000		20,000		109,000	
Income Tax Expense						
Foreign Tax	(100,000)		(100,000)		(121,000)	
U.S. Taxes before tax credit (3)	(7,000)		(7,000)		(37,000)	
Foreign Tax Credit	100,000	(4)	32,300	(5)	62,000	(5)
Total Taxes	(7,000)		(74,700)		(96,000)	
Income (loss) after taxes	$13,000		(54,700)		$13,000	

Assumptions and Notes

(1) Terms: 5.0 million loan at gross interest of 8.00 percent for 1 year; Brazilian withholding tax withheld at 25 percent on gross interest; cost of funds is 7.50 percent.

(2) Rate must be increased from 8.00 to 9.75 percent to maintain pre 86 TRA profit.

(3) Tax Rate - 34 percent

(4) Under pre 1987 tax rules, the U.S. tax on all of the Bank's foreign source net income exceeded foreign taxes paid on such income. Thus the $100,000 of foreign taxes was fully creditable against the U.S. tax.

(5) Maximum allowable foreign tax credit:

	A	B
Gross Income	$400,000	$489,000
Expenses per U.S. tax rules	305,000	305,000
Net foreign income - U.S.	$95,000	$184,000
U.S. tax at 34 percent	$32,300	$62,000
Maximum foreign tax credit	$32,300	$62,000

4/3/87

1987 Tax Reform Act (TRA) - Foreign Tax Provisions
Financing Export Trade
One Specific Loan Financing the Export of Coal

Terms

Loan of $3,546,029 at gross interest rate of 9.39% (libor floating) for a term of 181 days. Brazilian income tax withheld of 25% on gross interest. 1988 U.S. income tax rate of 34%. Cost to fund floats with libor (6.4%).

Financial Statement Profitability Impact

	Old Law Competitive Rate of 8%	New Law Competitive Rate of 8%	Pre 86 TRA profit Rate of 12.30%
Gross interest income	$166,400	$166,400	$218,081
Expense Incurred (Excluding Income Tax)			
Interest expense	(113,657)	(113,657)	(113,657)
All other (including overhead)	(16,843)	(16,843)	(16,843)
Pretax net income	35,900	35,900	87,581
Income Tax Expense			
Foreign income tax expense	(41,600)	(41,600)	(54,520)
U.S. Income Tax Expense:			
o Before foreign tax credit (34% of $35,900)	(12,206)	(12,206)	(29,777)
o Foreign Tax Credit **	41,600	2,829	20,400
Net Income (Loss) after taxes	$23,694	$15,077	$23,684

** Calculation of U.S. Credit for Foreign Income Tax Payments

Gross Income	[NOTE	$166,400	$218,081
Expenses "determined under tax rules"	A]	(158,080)	158,080)
Foreign income taxable in U.S.A.		8,320	60,001
U.S. tax @ 34%		2,829	20,400
Maximum foreign tax credit	$41,600	2,829	20,400

NOTE A: Under pre 1987 tax rules, the precredit U.S. tax on all net income earned abroad exceeded foreign taxes paid on such income. Thus, the $41,600 foreign taxes on the above transaction would be fully creditable toward the U.S. tax liability. Also, under pre 1987 tax rules, expenses attributable to the $166,400 of foreign sourced income would be $129,8C Due to new methods to allocate and apportion expenses, the "attributable" expenses are approximated at $158,080.

EQUIVALENT YIELD COMPUTATIONS FOR FOREIGN LOANS
5/4/87

ASSUMPTIONS:

Interest Rate on Loan	9.00%
Cost of Funds Rate	7.50%
Principle Amount of Loan	1,000,000

	Old Law 46%	New law 34%	Repriced under New Law
Gross Yield	90,000	90,000	94,358
Cost of Funds	(75,000)	(75,000)	(75,000)
Pre-Tax Earnings	15,000	15,000	19,358
Federal Income Tax	(6,900)	(5,100)	(6,852)
Foreign Tax Withheld	(9,000)	(9,000)	(9,436)
Net Income Before FTC	(900)	900	3,340
Foreign Tax Credit	9,000	4,760	4,760
Net Income After Tax	8,100	5,660	8,100

The foreign tax credit limitation will be equal to the U.S. tax liability of the separate basket which requires a special allocation of all expenses.

We estimate the effect of the new foreign tax credit limitation as follows:

Foreign Tax Credit Limitation Under New Law:

$$\frac{\text{Australian loan}}{\text{Consolidated Bank Assets - Tax Exempt Assets}} \times \text{Consol. Bank Interest Expense} = 57,000$$

+

Allocated Non-interest Expense = 19,000

Total Allocation of All Expenses 76,000

Foreign Tax Credit Limitation
(90,000 - 76,000) x 34% 4,760

A Statement by the Research and Policy Committee of the Committee for Economic Development

TAX LEGISLATION AND COMPETITIVENESS

U.S. tax laws can exert a powerful influence, either positive or negative, on the international competitive position of U.S. goods and services in the global marketplace. As we stated in the policy statement Tax Reform for a Productive Economy (1985), U.S. tax policy as applied to the taxation of foreign income should be sensitive to avoiding unreasonable and detrimental burdens on international trade, particularly when our major trading partners do not impose similar burdens on their own multinational firms.

The tax legislation of 1986 contains a series of provisions relating explicitly to the international operations of U.S. firms. It is widely acknowledged that these provisions were developed with little attention to their likely effects on international competitiveness. We are concerned that these provisions could have serious adverse effects on the competitive position of U.S. firms. Here are several examples of provisions that particularly concern us.

- New separate provisions eliminating low-taxed passive income and a number of other separate categories of income from the averaging mechanism in computing the overall foreign tax credit. The result is a considerable loss of flexibility for some multinationals.

- Changes in the method for allocating interest, research and development and other expenses to offset foreign income, resulting in losses of deductions that will both increase costs for international companies and militate against research and development investment in this country.

- The introduction of the concept of a superroyalty that requires multinationals to include in their U.S. taxable income amounts that are commensurate with the income attributable to intangible properties originated in the United States.

- Foreign tax credit limitations on dividends of joint ventures or of subsidiaries in which U.S. corporations own a minority interest.

To avoid potential damage to the U.S. competitive position in world markets, we recommend an early review of the recent revisions in the tax treatment of foreign operations of U.S. firms that takes the U.S. competitive position into careful account and such modifications in the new provisions as may be appropriate in light of this review.

There is also a broader question about the likely effects on comparative capital costs, investment, and international competitiveness of the basic provisions of the new tax law relating to capital investment, such as the elimination of the investment tax credit, changes in depreciation rules, and lower and broader-based general tax rates.

While we are not suggesting near-term efforts to change the basic provisions of the new income tax law so soon after its passage, the impact of the 1986 tax legislation on capital costs and on investment needs to be carefully monitored, especially insofar as its effects on the international competitiveness of U.S. firms is concerned. Should evidence of harm to U.S. competitiveness be discovered, the Administration and Congress should be prepared to take appropriate remedial steps.

The issue of competitiveness also arises in connection with proposed measures to increase taxes in order to help reduce the federal budget deficit. We believe that the deficit-reduction program required to strengthen U.S. international competitiveness must include revenue increases. Such increases should be linked to forceful and enduring expenditure reductions. However, the <u>net</u> impact on competitiveness will depend importantly on the <u>types</u> of revenue-raising measures that are chosen. **Hence, we continue to urge that effects on international competitiveness be given very careful attention in conjunction with the choice of revenue-raising measures that may be adopted.***

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* See memorandum by **William T. Eorey**, page 91.

Page 64, WILLIAM T. ESREY, with which JACK BENNETT and LEIF H. OLSEN have asked to be associated.

While substantial further progress must be made in restraining Federal spending, there is also an urgent need to plan intelligently, now, for future measures to raise revenue. In the current circumstances of the U.S. economy, it seems clear that future revenue-raising efforts ought to avoid adding to existing burdens on saving, investment, and the business sector, and at the same time should be sensitive to possible negative consequences for U.S. international trade performance. In this regard, a thorough review of the value-added tax, and its possible suitability for the U.S. economy, seems timely. An in-depth study of the V.A.T. (or of any other potential major tax proposal, for that matter) should marshall the knowledge, experience, and resources of the private business sector as well as of the academic community and the U.S. Treasury Department. By such cooperative research efforts, the potential implications for all areas relevant to our nation's long-term economic health should come to light. In this way, perhaps we can avoid making substantial shifts in tax burdens without the benefit of a longer-term analysis of the probable results.

Page 66, JAMES Q. RIORDAN, with which RODERICK M. HILLS and ELMER B. STAATS have asked to be associated.

I think we should have made clear that the revenue raising measure that would have the least unfavorable impact on international competitiveness would be a consumption tax (e.g., a value-added tax). GATT permits such a tax to be imposed on imports. It does not need to be imposed on exports. Most of our industrialized trading partners have such a tax.

Page 71, RODERICK M. HILLS

The discussion of the LDC debt problem is simplistic and suggests solutions that may only aggravate current problems. As written, the section unreservedly endorses 'expanded lending' and states that the United States should welcome 'a Japanese equivalent of the Marshall Plan.' A Japanese Marshall Plan would only serve to further retard U.S. economic interests and unrestrained lending can only exacerbate or postpone the inevitable. As written, the section is far too 'breezy' to be included in an otherwise thoughtful economic analysis.

(4)

Special Report

How well is employee ownership working?

Corey Rosen and Michael Quarrey

Ever since 1974, when Congress enacted the first of a series of tax measures designed to encourage employee stock ownership plans (ESOPs), the number of employee-owned (or partially owned) companies has grown from about 1,600 to 8,100, and the number of employees owning stock has jumped from 250,000 to more than eight million.[1] Employee-owners publish the *Milwaukee Journal*, bag groceries at Publix Supermarkets, roll tin plate at Weirton Steel, and create high-tech products at W.L. Gore Associates. How well are these companies doing?

Underlying worker ownership is a radically democratic, Jeffersonian ideal – one we strongly endorse. Every American wants to own some property, to have a stake. We all want to know that we are working "for ourselves."

Still, the ultimate test of employee ownership is how well ESOPs affect corporate performance. If the only way to keep a company competitive is to distance employees from the managerial prerogatives of ownership, so be it. When a ship sinks, it is no consolation to the surviving hands that they own a piece of the wreck.

The ultimate test of employee ownership is how well it affects corporate performance.

We have recently completed a major study of ESOP companies that should put an end to talk about wrecks. Not only have workers gained financially, but we can prove that ESOP companies have grown much faster than they would have without their ownership plans. We have found, moreover, that ESOP companies grow fastest when ownership is combined with a program for worker participation. A synergy emerges between the two: ownership provides a strong incentive for employees to work productively, and opportunities for participation enhance productivity by providing channels for workers' ideas and talents.

Corey Rosen is executive director of the National Center for Employee Ownership, a nonprofit research and membership organization in Oakland, California. With Katherine J. Klein and Karen Young, he has written Employee Ownership in America: The Equity Solution *(Lexington Books, 1986). Michael Quarrey, formerly projects director of the National Center for Employee Ownership, is the author, with Corey Rosen and Joseph Blasi, of* Taking Stock: Employee Ownership at Work *(Ballinger, 1986).*

How do ESOPs work?

The tax incentives have proven so attractive to companies, it's little wonder that the number of ESOPs has grown. The 1986 tax reform act has only made ESOPs more agreeable. Businesses can still deduct contributions to ESOPs from corporate income taxes. If an ESOP buys stock in a closely held firm, the owner can defer taxation on the sale. Other laws – there have been 17 in all – allow an ESOP to borrow money and use the loan to buy company stock; the company can make tax-deductible contributions to the ESOP to pay off the loan. The 1986 act permits banks to continue to deduct 50% of the interest income they receive from ESOP debt. Estates of owners of closely held companies can exclude 50% of their taxable income from a sale to the company's ESOP, up to a maximum benefit of $750,000.

Nor is it particularly difficult for a company to set up an ESOP. You begin with a trust fund. You then contribute new shares of company stock to the plan or contribute cash – again, this is tax deductible – for the ESOP to buy existing stock. You can help the ESOP borrow to purchase either kind of share.

Employees, meanwhile, acquire a gradually increasing right to company shares through vesting. For example, if an employee is qualified to receive 100 shares after seven years, he or she will receive, say, 20 shares after three years, 70 shares after five years, and so on. They are entitled to receive the entire cash value of their stock at separation or retirement.

While it is true that some ESOPs have been used as a last-ditch effort to save failing businesses, prevent hostile takeovers, or even induce employees to make wage concessions, the U.S. General Accounting Office reports that such cases account for only about 3% of all company plans. Only about 8% terminated pension plans to create their ESOPs, and about 40% of all ESOP companies have at least one other kind of retirement plan. Of the more than 100 ESOP companies we have studied, only one had required wage concessions; managers at the rest said their wage and benefit packages were competitive quite apart from the ESOPs.

By and large, then, ESOPs are started for the purposes Congress intended – such as allowing employees to become owners of profitable, closely held companies when a principal owner retires (such cases account for about half of all plans) or as an additional employee benefit. The typical ESOP owns a 10% to 40% interest in the company, with 10% to 15% of the plans owning a majority. At least one-third of all plans will eventually afford workers the chance to acquire a controlling interest. And companies, public and private, have instituted ESOPs for other positive reasons – to borrow capital, to divest subsidiaries, or simply to buttress a corporate commitment to having workers share in managerial decisions.

How do we judge performance?

Nearly all previous studies of employee ownership have found that ESOP companies do respectably well.[3] Unfortunately, all these studies look at ESOP companies only *after* the plans have been set up. As a result, it has been impossible to say whether employee ownership is the cause of better corporate performance or simply that the more successful companies were the ones to set up plans in the first place.

We determined to avoid this ambiguity in our research. In 1986, we studied 45 ESOP companies, looking at data for each during the five years before it instituted the plan and the five years after. We might well have simply compared pre-ESOP figures with post-ESOP figures for each company. But this could prove misleading. Suppose the business climate had brightened – which it did for many industries – during the latter five years? Could the gains be credited to ESOPs? You can't tell how the Yankees are doing merely by comparing this year's stats with last year's. You have to consider the team's standing among other American

League teams. (Weirton Steel, perhaps the most familiar ESOP company – which we excluded from our study because it could not meet our ten-year requirement – registered impressive gains after adopting its plan in 1984. Were the gains due to an industrywide recovery or to changes within the company?)

We decided to compare the performance of ESOP companies with the performance of other similar companies. The pivotal year remained the one in which the companies' ESOPs took effect. But we were careful to consider company performance in the context of industry trends. Of the ESOP companies we studied, 20 were from an earlier survey for which we had sufficient data; we excluded companies that had had ESOPs from the start. To provide an adequate sample, we looked at an additional 25 companies. We then chose at least five comparison companies for every ESOP company from *Dun & Bradstreet*, for a total of 238. These were comparable to the ESOP companies in terms of business line, size, and, where possible, location. We excluded from our ESOP sample companies with business line combinations for which there were no comparison companies.

ESOP companies grow faster

Once we had our two samples, we collected data on sales and employment growth. We then compared the growth rates of each ESOP company with its five or more comparison companies, calculating the differences in performance before and after the ESOP was established.

If an ESOP company's growth was consistent and significantly higher than its comparison companies' growth, we ascribed this to the "ESOP effect." An ESOP company might well have outperformed the comparison companies before it set up its ESOP. We registered an ESOP effect only if the company's performance was even more impressive after it set up its plan.

The results of this analysis proved striking. During the five years before instituting their ESOPs, the 45 companies had, on average, grown moderately faster than the 238 comparison companies: annual employment growth was 1.21% faster, and sales growth, 1.89% faster. During the five years after these companies instituted ESOPs, however, their annual employment growth outstripped that of the comparison companies by 5.05%, while sales growth was 5.4% faster. Moreover, 73% of the ESOP companies in our sample significantly improved their performance after they set up their plans.

The data couldn't be clearer: companies do better after setting up ESOPs.

Incidentally, it would obviously have been preferable to judge the performance of ESOP companies by profit, not growth. Failing companies can grow – at least for a while. But most of the companies in our sample have remained closely held, and we knew in advance that unvarnished profit statements would not be available to us. The next best thing, we reckoned, was to look at growth over a sustained period. Again, we looked at only stable companies whose performance we could track for a minimum of ten years.

Finally, we wondered if there might be other factors involved in setting up an ESOP that might account for improved performance – a change in management, perhaps, or an extraordinary use of ESOP tax breaks. We tested for these and other factors and found no relationship.

(6)

Added value of participation

The data show that ESOPs exert a positive influence on corporate performance But the question remains whether any one aspect of employee ownership can be thought the key to higher productivity.

When we looked at the ESOP companies alone, our most interesting finding was the impact of worker participation Regardless of company size, or the size of employee contributions, or even the percentage of the company owned by the ESOP, the most salient correlation was between corporate performance and workers' perceptions of their managers' attitudes toward worker participation. ESOP companies that instituted participation plans grew at a rate three to four times faster than ESOP companies that did not. Also impressive was the correlation between performance and the actual routines of participation – for example, the number of meetings held in which workers and management could develop corporate plans and resolve difficulties

One virtue of these data is that they are intuitively satisfying Most people work better when they enjoy what they're doing. Our data suggest that employees enjoy their work most when they feel they have some say about the conditions of their work day. At Cost Cutter Stores, a grocery chain based in Bellingham, Washington, the mere establishment of an ownership plan raised employee expectations about their role in the company, forcing management to get employees more involved After a series of meetings between management and employees, managers began interviewing employees one-on-one The productivity of Cost Cutter has gone up so much that Associated Grocers, which measures such things for its members, reported that the company was "off its charts" Cost Cutter executives are the first to say that the transition to a different and more participative management style was difficult and would not have been made without the impetus provided by employee ownership

Or consider, once more, Weirton Steel In 1984, Weirton's 7,000 employees bought the company to keep it from closing. As 100% owners of a steel mill (which could be worth $1 billion in good times), Weirton's workers suffered from no lack of entrepreneurial spirit Weirton set up intensive three-day training programs to teach employees to run employee involvement teams on their own, it installed television monitors throughout the plant to keep employees informed of developments, and it shares detailed financial and production data, good and bad, with employee-owners After 3½ years, Weirton now employs 8,500 people and has made a profit for 14 straight quarters, a record unmatched among integrated steelmakers '

Given these findings, companies might well decide they should implement participation programs without necessarily ceding ownership to workers. That conclusion would be unwarranted. Data on participation's impact on non-ESOP companies is at best mixed, while ownership alone has a modest but important effect Ownership and participation together have considerable impact There is no escaping the conclusion that American workers sense a difference between working for their own benefit and merely being employed for the company's benefit, a difference between participation by right and participation at the sufferance of managers

Having a stake

Clearly, feeling like a participant is critical to a worker's greater contribution to a company after it establishes an ESOP But it is important not to define participation too narrowly For a worker to feel like a participant-owner, there must be a tangible financial benefit and a process of consultation, not just abstract prestig

In 1985, we conducted a study of 108 randomly selected ESOPs, looking at how much workers had profited from them during the previous four years The average contribution was the equivalent of 10.1% of workers' pay, and the average annual gain in stockholders' equity was 11.5% (compared, incidentally, with about 6% for the Dow Jones industrial average during that time)

Using these figures and applying conservative assumptions about how quickly workers' shares are vested, we calculated that an employee making the 1983 median wage of $18,000 would accumulate $31,000 over the next 10 years and $120,000 over 20 years

This may not sound like a great deal of money. Yet in 1983, the median net financial assets of a family at retirement, aside from home equity, amounted to only $11,000 Americans are clearly not in the habit of saving Of course, by putting aside 10% to 15% of their yearly pay into other retirement or forced savings plans, workers could accumulate a sum equal to the value of ESOP shares. But *would* they elect to put this much aside?

And if ESOPs are a hedge against feeling strapped at retirement, they matter as much to workers for the way they can improve life before retirement We surveyed 2,800 employees in 37 representative ESOP companies across the country While our data show clearly that employees react to ownership primarily in financial terms – the larger the annual company contribution to their accounts, the more motivated they claim to be – workers nevertheless say they cherish the demonstrated commitment of management to worker ownership and participation.

In fact, such basics as company size, lines of business, and workforce characteristics do not affect employee attitudes much. Not even employee voting rights correlated with higher morale, though in about 15% of private ESOP companies employees can vote their shares on all issues (By law, employees in private ESOP companies must be able to vote on issues involving sale, liquidation, relocation, or merger In public companies, workers have the right to vote on all issues.)

Again, employees are enthusiastic about companies that engage their ideas and talents, whether in an informal open-door meeting with the president or at a random meeting with a supervisor. The best companies, they say, regularly hold sessions in which managers and workers can thrash out problems. But employees attached little importance to the formal trappings of corporate control, such as having representation on the board.

Workers may well appreciate the money they get by owning company stock. But their enthusiasm won't do much for corporate performance unless it can be channeled into creative enterprise. Employees ought to feel that they can share new ideas, devise new ways to work together more efficiently, take on responsibility for customer satisfaction.

The lessons for management are clear. Give employees an opportunity to acquire a significant share of the company and develop opportunities for them to participate as owners. This course is remarkably effective, remarkably exciting, and remarkably different from the one the vast majority of American companies travel.

References

1 In her article "The Attack on Pay," HBR March-April 1987, Rosabeth Moss Kanter correctly cites our book (with Joseph Blasi), *Taking Stock: Employee Ownership at Work* to the effect that 11 million workers have participated in stock ownership plans. That number includes the 3 million workers who had participated in payroll stock ownership plans (or PAYSOPs), which were not intended to encourage ownership and were in any case eliminated by the 1986 tax reform act.

2 See, for example, Michael Conte and Arnold Tannenbaum, *Employee Ownership* (Ann Arbor: University of Michigan Survey Research Center, 1980); Thomas Marsh and Dale McAlister, "ESOP's Tables," *Journal of Corporation Law*, Spring 1981, p. 612; Matthew Trachman and Corey Rosen, "Report to the National Venture Capital Association of the Relationship of Employee Ownership and Corporate Growth in High-Tech Firms," unpublished paper, 1985.

3 For an earlier look at Weirton Steel, see William E. Fruhan, Jr., "Management, Labor, and the Golden Goose," HBR September-October 1985, p. 131.

STATEMENT OF

LARRY R. LANGDON

DIRECTOR OF TAX AND DISTRIBUTION

HEWLETT-PACKARD COMPANY

FOR THE EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. Chairman, and members of this distinguished committee, my name is Larry R. Langdon. I am the Director of Tax and Distribution of Hewlett-Packard Company, headquartered in Palo Alto, California. I am appearing on behalf of ECAT, the Emergency Committee for American Trade.

Description of Hewlett-Packard and ECAT

Hewlett-Packard is a major designer and manufacturer of electronic products and systems for measurement and computation. During its last fiscal year, Hewlett-Packard Company and its subsidiaries had sales of $7.1 billion, about 46% of which were to customers outside of the United States. Worldwide R&D expenditures last year were $824 million, or 11.6% of sales. About 90% of HP's R&D was conducted in the United States. HP exported from the United States products with a value exceeding $1.4 billion, and is ranked by Fortune and Business Week as among the top ten or fifteen exporters, even though HP is ranked 51st in overall size on the "Fortune 500" list. Hewlett-Packard has over 82,000 employees worldwide, of whom about 53,000 work in the United States.

I am appearing before you this morning on behalf of the Emergency Committee for American Trade.

ECAT is an organization formed in 1967 to support measures which expand international trade and investment. Its members are the leaders of 60 large U.S. firms with extensive overseas business interests. They are among the largest U.S. exporters and investors in foreign markets. The sixty members of ECAT have combined annual worldwide sales in excess of $700 billion, and they employ more than five million people.

International Competitiveness

As you know, John Young, Hewlett-Packard's president and chief executive officer, chaired the President's Commission on Industrial Competitiveness. The Commission's report is one of the most thoughtful and thorough analyses of factors affecting the international competitiveness of U.S. companies.

The Commission on Industrial Competitiveness defined "competitiveness" in the following way:

> *Competitiveness is the degree to which a nation can, under free and fair market conditions, produce goods and services that meet the test of international markets while simultaneously maintaining or expanding the real income of its citizens.*

One primary conclusion of the Commission was that competitiveness is affected by a range of factors, no one of which predominates. Obviously the strength or weakness of the dollar, the size of the federal budget deficit, inflation rates, monetary policy, trade laws, tax policies, and many other factors all have an impact on our competitiveness. Thus, improving our international competitiveness will require action on a broad range of issues, not just one or two. Certainly the trade legislation now being considered by the Congress is of critical importance, as are efforts to reduce the federal budget deficit.

Impact of Tax Laws on Competitiveness

U.S. tax policies undoubtedly influence our international competitiveness. I thank you for the opportunity to discuss some of the particular aspects of the U.S. tax laws that impact our competitiveness in both positive and negative ways.

Rate Reduction

ECAT endorses wholeheartedly the significant cut in corporate income tax rates by the Tax Reform Act of 1986. I would like to stress that every effort should be made to preserve these low rates. Low tax rates clearly help our competitive position.

It is important to remember, however, that the Tax Reform Act imposed a major tax increase on corporations through base broadening and elimination of major incentives for investment. Future tax legislation should provide a balanced treatment between individuals and corporations, since additional after-tax income for corporations generally finances investment while additional after-tax income for individuals tends to finance consumption.

Incentives and Disincentives for Technological Innovation

R&D is the lifeblood of high-technology companies in the electronics industry. However, R&D is critical to such industries as pharmaceuticals, aerospace, defense, and to many others. Technological advances are applied by other industries and services, such as automobiles, banking, and telecommunications, thus having great effects on the productivity of many sectors of the economy.

The speed of technical change and the need for significant R&D expenditures to keep pace with this change are illustrated by a characteristic of HP's sales. Year after year, over half of HP's total worldwide revenues are from products released within the current and two previous years. Producing new products at such a rapid pace demands a large R&D effort, and federal tax policies should encourage the R&D necessary to enable U.S. companies to compete in high technology markets.

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Extending the R&D credit through 1988 was a positive development and ECAT encourages the Congress to make the R&D credit a permanent feature of U.S. law. The additional resources which could be channeled to R&D efforts over a period of years with a permanent R&D credit in place clearly would add to our ability to compete.

The Tax Reform Act rules place equipment used in R&D in the five-year category under the modified ACRS depreciation rules. Moving such equipment to the three-year category would be appropriate as a further inducement to utilize the most modern equipment in conducting R&D.

The R&D allocation rules under section 861-8 of the Income tax regulations create a tremendous disincentive for U.S. companies with foreign operations to conduct R&D in the United States. These rules are complex, but in essence they disallow a tax deduction for a portion of a company's R&D conducted in the United States. Therefore, the current regulations create an incentive for a company to move its R&D activities outside of the United States. Mr. Chairman, you and Senator Wallop have been leading proponents of legislation to repeal the 861-8 R&D regulations, and have played key roles in developing a compromise that is supported by the Administration, the Treasury Department, industry, and members of the Finance Committee and Ways and Means Committee. ECAT and Hewlett-Packard Company greatly appreciate your efforts in this area. A permanent resolution of this issue is needed. We hope the compromise which is included in both the House and Senate bills currently under consideration will be adopted this year so that the significant disincentive for conducting R&D in the United States caused by the 861-8 regulations would be substantially reduced.

Drs. Martin N. Baily and Robert Z. Lawrence, both Associate Fellows of the Brookings Institution in Washington, D.C., completed a study earlier this year entitled "Tax Policies for Innovation and Competitiveness." Their study concluded that the "case for government programs to stimulate commercial R&D rests on sound analytical grounds," because society tends to underinvest in commercial R&D. Their study also concludes that aggregate R&D spending in the United States is 7% higher than would have been expected without the credit, leading to a GNP in 1986 that was $8 billion to $13 billion higher than it would have been. The study cautions against imposing regulations which raise the costs of performing R&D in the United States.

Having a tax code that promotes the conduct of R&D in the United States is critical to the long-term economic health of the United States economy. R&D has spillover effects on the whole economy. It is also key to providing a high standard of living for the American people. It is harder for the United States to compete in certain world markets in which low-cost labor is an important factor. If we lower wages here to compete, our standard of living will fall. With technological leadership, however, we can create additional jobs and a higher standard of living.

The U.S. has been a technological leader in the past. U.S. tax laws should provide permanent, favorable rules which provide positive incentives for conducting R&D in the United States, so that this leadership will be maintained in the future, as well.

Another important consideration is that manufacturing jobs most often are created near the location where R&D is conducted. Thus, by encouraging R&D, we will promote manufacturing as well.

Our competitors around the world have recognized the importance of R&D incentives in their tax systems. For example, Australia recently provided for a 150% tax deduction for R&D expenses. Japan has had a 20% R&D tax credit in place since 1966. The U.K. permits a current year tax deduction for machinery, equipment and buildings used for R&D. Canada has three special provisions to encourage R&D: (i) a 150% deduction for current R&D, (ii) a 150% deduction of capital expenditures on R&D undertaken in Canada, and (iii) an investment tax credit (which is generally 10%) for both current and capital expenditures.

A decade or more ago, HP, like most U.S. companies, almost automatically located important R&D facilities in the United States for non-tax reasons. But more recently, the opportunities for locating facilities abroad have increased substantially. Decisions on locating R&D facilities are now subject to much closer scrutiny. In this environment, tax considerations, including major disincentives such as the Section 861-8 R&Dregulations and the lack of a permanent R&D tax credit play a role in company decisions.

In 1980, an internal study conducted by HP concluded that it would be economically advantageous on an after-tax basis to increase the portion of our worldwide R&D effort conducted outside the United States. Instead, partly because of the moratorium on R&D allocations under Section 861-8 and the R&D tax credit were enacted, we have increased our domestic R&D expense from $327 million in 1981 to $739 million in 1986. If these two legislative provisions which favor the conduct of R&D in the United States are not made permanent or extended, the analysis might again favor the location of R&D offshore. In fact, this result could be more compelling now than in 1981 because of favorable R&D incentives enacted since 1981 in other countries and the foreign tax credit rule changes in the United States.

<u>Exports</u>

The U.S. tax laws have for over 60 years had a provision that treats part of the profit on exports as foreign source income, sometimes called the "title-passage" or "export source" rule. This rule is only of benefit to exporters with substantial foreign tax liabilities, either directly or indirectly through foreign subsidiaries. The export source rule was actively debated during tax reform and was, practically speaking, preserved for companies that export products from the United States, including such exporters as Hewlett-Packard Company and most other ECAT member companies.

The Conference Report directed Treasury to conduct a study of the source rule, which has not yet been completed. However, a study recently completed by Gary Hufbauer, Wallenberg Professor of Economics at Georgetown University, and Arthur Hammond-Tooke concluded that repeal of the export source rule would lead to a reduction of exports of between $3.9 and $5.4 billion and would lead to a loss of jobs in the United States of between 115,000 and 160,000. These are very serious consequences. ECAT urges Congress to retain this provision of critical importance to exporters.

Mr. Chairman, we also want to acknowledge the role you and Senator Chafee have played in sponsoring a bill to have the study of the source rule conducted by the Department of Commerce and Special Trade Representative, as co-authors with the Department of Treasury, to be sure that trade and competitiveness factors are taken fully into account in the study, to avoid a focus on technical tax policy issues.

The impact of repealing the source rule will be to increase taxes on exports, by an amount that will vary from company to company. For most companies, however, the marginal tax rate on exports will increase substantially. Thus, if this provision of the tax law that currently encourages companies to manufacture in the United States and to export is eliminated or curtailed, companies will find that the relative tax costs of manufacturing outside the United States rather than in the United States will be reduced, thus creating an additional reason to increase manufacturing outside the United States.

One other important provision of U.S. tax law which encourages exports, the Foreign Sales Company ("FSC") rules, clearly should be retained.

Export Financing

As you know, the 1986 Tax Reform Act provides for a very limited exception to these burdensome new foreign tax rules for certain types of export financing. Congress did so in express recognition of the potential anti-competitive impact the changes might have on U.S. export trade. It is my understanding, Mr. Chairman, that you and Senator Roth are sponsoring legislation to significantly broaden this exception to cover all export financing activities. I commend you for this initiative and hope that Congress can act on the proposal this year.

If we are to begin closing the trade deficit, we must expand U.S. exports. It is difficult enough to compete against the aggressive export promotion policies of our foreign competitors. We cannot afford to lose sales due to the unavailability of adequate financing on competitive terms. Moreover, we must not overlook the fact that for every one billion dollars in exports, betwen 20,000 and 25,000 new American jobs are created.

Capital Formation

The Tax Reform Act of 1986 enhanced the ability to earn and improve corporate profits by reducing the corporate tax rate.

The changes to the depreciation rules, while a reasonable compromise, certainly provide lower incentives for capital investment than the depreciation regimes of many of our major trading partners, particularly after the elimination of the U.S. investment tax credit.

International Provisions of the Code -- Deferral, Double Taxation

The provisions of the Internal Revenue Code that deal with the taxation of the international activities of U.S. companies have for years been governed by two general principles -- first, the deferral of taxation on income of foreign subsidiaries, with exceptions for tax haven activities (Subpart F), and, second, the use of an overall foreign tax credit to avoid international double taxation.

The provisions of the Tax Reform Act of 1986 in these two areas are of great concern with regard to our international competitive position.

The United States not tax the income of foreign corporations until returned to the United States. This is commonly referred to as "deferral." Subpart F embodies certain exceptions to deferral. The underlying theory of Subpart F is that income earned in passive transactions between related parties is potentially abusive. Active, unrelated party transactions are subject to deferral and they should be -- that is, real businesses conducting real international operations should not be taxed currently on funds they have not received.

ECAT historically has been opposed to the elimination of deferral.

The concept of deferral was severely eroded by the Tax Reform Act of 1986, which reduced the Subpart F threshhold from 10% of gross income to the lower of 5% of gross income or $1 million. Many of Hewlett-Packard's foreign manufacturing and sales operational subsidiaries have historically maintained cash balances that will generate more than enough interest income to exceed these minimum amounts, without any tax avoidance motive whatsoever. Under the new rules, there will be current U.S. taxation of this income. Furthermore, the purpose of the de minimis rule, to avoid added complexity where there is no significant tax avoidance purpose, will be frustrated since any income exceeding the new threshhold will be treated as a current dividend for U.S. tax purposes, even if there is not an actual distribution of profits.

The passive foreign investment company ("PFIC") rules adopted by the Tax Reform Act of 1986 also severely curtail the deferral concept. The PFIC rules, which apply to controlled foreign corporations ("CFC's") already subject to Subpart F, would essentially end deferral on operating income for CFC's making the Qualified Electing Fund election. The mechanics of the PFIC rules are fairly complicated, but making CFC's subject to the PFIC rules was a fundamental attack on the concept of deferral that should be reversed.

Our principal foreign competitors do not tax the earnings of their foreign subsidiaries nearly as aggressively as the United States taxes foreign subsidiaries of U.S. companies. Some countries, such as France and the Netherlands, generally exempt foreign source income from taxation altogether. Others utilize the overall limitation or other measures which achieve the same result. For example, Japan taxes foreign source income but foreign tax credits are computed under an overall limitation with "tax sparing" treaties with many countries. Tax sparing treaties permit foreign tax credits to be claimed in Japan even though no foreign taxes were paid. Germany (by treaty) and Italy (by dividend exemption) also allow for significant exemption of foreign source income. Belgium exempts most foreign source income, and any foreign source income subject to tax can be offset by foreign tax credits computed under an overall limitation. Even in the United Kingdom and Canada where per country limitations are employed, averaging of high and low foreign tax rates still can be legitimately achieved.

The Tax Reform Act of 1986 also causes major concern about the avoidance of international double taxation. The many new "baskets" established for purposes of computing the foreign tax credit limitation will result in a major erosion of the overall foreign tax credit limitation concept and create much greater likelihood that U.S. based companies will be subject to international double taxation. Complexity in U.S. taxation for foreign subsidiaries will grow geometrically.

The basket approach artificially divides the foreign income of a worldwide business, with the objective of increasing U.S. taxes on foreign income, not to protect U.S. taxation of domestic income. For example, establishing both a passive basket and a high-tax basket prevents identical categories of income from being averaged together, which seems designed only to increase U.S. taxation of foreign income.

The separate basket approach has been justified by stating that calculating foreign tax credits based on the overall, or average, foreign taxes paid is an abuse. This sentiment was unanimously opposed when offered in justification for the per country proposal.

Income From Imported Property ("Runaway Plants")

In the current effort to raise taxes, one provision which the House Ways and Means Committee has adopted, but which the Finance Committee has not, would end deferral on "profits on imported property." More specifically, this provision would tax currently in the United States income earned by foreign subsidiaries on manufactured products that are used or consumed in the United States. Also, these earnings and any other income, such as royalties and interest attributed to such earnings would be subject to a separate foreign tax credit limitation.

ECAT and Hewlett-Packard Company are both emphatically opposed to such a provision.

We are opposed because it places U.S. based companies at a significant competitive disadvantage; it virtually repeals deferral, a fundamental principle of U.S. tax rules; and it may have unintended consequences because it reflects a total misapprehension of the global nature of international economic competition.

The House Budget Committee report acknowledges that this tax would apply to imports from U.S.-controlled foreign subsidiaries, but would not apply to Japanese or European-controlled subsidiaries and other foreign corporations. Hewlett-Packard, has a foreign subsidiary which owns a factory in Malaysia down the street from a factory owned by a Japanese company. Under the House provision, Hewlett-Packard would be subject to current U.S. tax at a 34% rate on profits from products sold to the U.S. market, while the Japanese company would not be subject to any tax. Furthermore, because of a tax sparing treaty between Japan and Malaysia, the Japanese company could repatriate profits back to Japan free of any tax, while under current rules, Hewlett-Packard would be subject to U.S. tax on such dividends. The Japanese company would have the advantage of either greater after-tax profits to invest, or the ability to retain profit margins while lowering prices to obtain U.S. market share.

The erosion of such a long-standing principle of U.S. tax law is philosophically wrong. To abandon this principle without debate of the issues because it may be a politically viable way of raising revenue is most inappropriate when the proposed repeal will affect so profoundly the multinational sector of the U.S. economy, which is the source of the vast majority of U.S. exports. Also, there has been no demonstration that U.S. companies are systematically shifting manufacturing jobs outside the United States to avoid U.S. taxes to such a degree that the current rules that help Hewlett-Packard and other ECAT members to compete internationally should be rewritten to our detriment in the hopes of counteracting some activities that comprise a tiny portion of the real economic activity of America's major international companies.

As I indicated earlier, Hewlett-Packard is a net exporter from the United States by a wide margin. Yet, in an effort to be competitive internationally, we generally manufacture in one factory for the worldwide marketplace, whenever possible. (Exceptions to this approach may exist for certain of our products which have high volumes, and in certain countries, particularly in Latin America, where we need a manufacturing presence in order to sell anything at all in the local marketplace.) Furthermore, in other industries there is frequently no choice whatsoever about foreign locations, when raw materials or other special factors are present in the foreign location.

In this context, the House provision could set up tax consequences which could make it advisable for Hewlett-Packard to shift a greater percentage of our manufacturing out of the United States than we would shift back into the United States in order to avoid the impact of this rule. This might occur because the full gamut of actual and proposed changes to the U.S. tax rules that apply to our international transactions may make it more desirable for Hewlett-Packard over time to balance imports and exports on a country-by-country, particularly in the current international trade climate. U.S. tax rules which cut down on our flexibility and incentives to export from the United States could lead to this more balanced result, which would be contrary to the result we presume the proposed policy changes of recent years seek to achieve. Furthermore, the additional U.S. tax costs of this rule, which <u>no</u> foreign competitor would be required to match, might in the future force U.S. companies to manufacture in two places products that are today manufacturer in only one place. The duplication of costs involved in such a situation would increase the price of our products, clearly making them less competitive.

Let me emphasize that I have been discussing possibilities. What will actually happen in the short term will be affected more by current investments in plant and equipment, as well as obligations to our employees in both the United States and foreign locations, than by the marginal impact of U.S. tax laws. In the longer term, however, this proposal, if enacted, could prove counterproductive at best.

GATT Treatment of U.S. Tax System

ECAT is also concerned with the issue raised regularly by Congress relative to the trade effects resulting from different GATT treatment of direct taxes, such as income taxes, compared with indirect taxes, such as sales or value-added taxes. The latter may, under GATT, be rebated on exports and added to imports, but no such so-called border adjustments are allowed by GATT on direct taxes. The U.S. relies far more on direct than indirect taxes compared with many other countries, and is thus, in the view of many analysts, disadvantaged in trade by the difference in GATT treatment. Section 121 of the Trade Act of 1974, as amended, called for "the revision of GATT articles with respect to the treatment of border adjustments for internal taxes to redress the disadvantage to countries relying primarily on direct rather than indirect taxes for revenue needs," and this is repeated again in Section 105(b)(2)[M] of the Senate version of this year's trade bill as a principal objective of international trade negotiations.

Conclusion

Obviously, I have touched upon only a few of the many issues this Subcommittee will consider in its examination of tax policy and U.S. international competitiveness. In closing, however, I wish to reiterate my view that tax policy can and should play a legitimate role in fostering a more productive and competitive economy. The specific proposals I have mentioned regarding Section 861 and export financing are prime examples and warrant favorable Congressional consideration. That concludes my comments. I would be pleased to respond to any questions.

SENATE FINANCE COMMITTEE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

Hearings on the Impact of the U.S. Tax Code on America's International Competitiveness

U.S. owned multinationals compete with foreign owned multinationals in three arenas - the U.S. domestic market, the market where the foreign competitor is incorporated, and third country markets. The 1986 Act damaged, in differing ways, the ability of U.S. companies to compete in each of these three markets.

A. Competition in the United States

U.S. multinationals compete in the United States with domestic corporations owned by foreign multinationals and with purely domestic corporations. Changing the rules for allocating and apportioning deductions for interest, overhead, state income and franchise taxes, charitable contributions, etc., from the former separate company basis to the new consolidated basis affected companies differently. U.S. multinationals are effectively denied full U.S. tax relief for expenses actually incurred in connection with their U.S. operations merely because they happen to own stock in corporations doing business abroad. Their competitors are not so affected.

For example, U.S. subsidiaries of U.S. multinationals compete with U.S. subsidiaries of foreign multinationals in exploring for and developing petroleum reserves in the U.S. Under former law the financing costs of the competitors would have been identical both before and after tax. Under the new law, however, the after-tax financing costs of the U.S. owned companies were increased, whereas those of the foreign owned companies were not. U.S. tax policy should not give foreign owned corporations an arbitrary competitive advantage over U.S. owned corporations.

In addition, repeal of the investment tax credit (ITC) and the Accelerated Cost Recovery System (ACRS) and extensive new requirements that costs be capitalized rather than expensed made it more difficult for U.S. manufacturers to compete with foreign businesses in supplying U.S. markets. Importers benefit from the reduced tax rates but are not affected by the negative impact on capital recovery.

B. Competition in Foreign Host Countries

Foreign subsidiaries of U.S. companies compete in foreign host countries with local companies. All are equally affected by the tax laws of the host country at the corporate level. Under the 1986 Act, however, the United States taxes the earnings of the U.S. owned companies at the shareholder level more harshly than foreign countries do.

The 1986 Act greatly expanded the subpart F rules which tax U.S. shareholders currently on the undistributed earnings of their foreign subsidiaries, whereas foreign shareholders are generally not taxed until earnings are distributed.

The 1986 Act created double taxation at the shareholder level by allocating certain expenses to the foreign affiliate for U.S. tax purposes which are not deductible for foreign tax purposes. Foreign countries do not permit affiliates of U.S. companies to deduct interest, state taxes and other expenses incurred by other members of the U.S. group, so the new allocation rules effectively mean that such expenses are not deductible anywhere in the world. Some categories of income such as shipping, are not taxed in many foreign countries, but will bear full U.S. residual tax under the new separate basket rules. Incredibly, the new tax law fails to recognize that the only way U.S. companies can do business in many foreign countries is to accept local partners with an interest of 50% or even greater. Putting each such business venture into a separate foreign tax credit basket enormously increases workload, complexity and double taxation for U.S. owned companies which are not incurred by foreign owned companies. Collectively these fundamental changes in how the United States taxes income earned abroad substantially handicap U.S. companies trying to compete with foreign companies in their host countries.

C. Competition in Third Country Markets

U.S. corporations compete with foreign corporations in third countries in two ways -- by exporting from their respective home countries, and by doing business in or trading among third countries.

1. U.S. Exports

The ability of exporters from the United States to compete with exporters from other countries was damaged by the repeal of the investment tax credit and the accelerated depreciation rules. The increased cost of capital for U.S. firms will lead to less investment in new plant and equipment within the U.S.

2. Doing Business in Third Countries

Subsidiaries of U.S. multinationals competing in third countries with subsidiaries of foreign multinationals suffer many of the disadvantages described in Section B above. The U.S. shareholder will be taxed currently on active business income which other countries do not tax until it has been distributed. The U.S. shareholder must divide the income of its subsidiary into nine or more categories, and assign expenses and foreign taxes to each category according to arbitrary and complex tax accounting rules. It must maintain books and records and do multiple calculations which serve no business purpose. If despite all this the subsidiary prospers and is sold at a gain, the gain may be treated as U.S. source income even though 100% of the value of the company arose from foreign operations. Gain may also be treated as "passive" even though the value arose from the active conduct of a trade or a business.

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Mobil Corporation

150 EAST 42ND STREET
NEW YORK NEW YORK 10017 5666

JAMES Q. RIORDAN
VICE CHAIRMAN
CHIEF FINANCIAL OFFICER

November 13, 1987

Hon. Max S. Baucus
706 Senate Hart Office Building
Constitution Ave. and 2nd St., N.E.
Washington, D. C. 20510

Dear Senator Baucus:

It is very positive to have hearings on the impact of taxation on the competitive position of the U.S. Although it was not possible to give full consideration to competitive impacts during an effort like the 1986 Tax Reform Act, these issues will be with us in the future and it is very helpful to have a continuing dialogue. Reference was made to the importance of this problem in the recent CED statement "Toll of the Twin Deficits", an excerpt from which is attached.

We have also attached a submission which touches on various aspects that should be considered in assessing the competitive position. The issue is much broader than imports and exports because we also want U.S. multinationals to be fully competitive with foreign multinationals in doing business anywhere in the world. Unfortunately, a number of the changes that have been made in recent years in the Internal Revenue Code impinges on the competitive position of U.S. companies in comparison with foreign companies. As a result, a European multinational has an edge over a U.S. multinational in doing business in the Western Hemisphere, the Eastern Hemisphere, or both.

It is not just the Federal tax law which has damaged the competitive position of U.S. multinationals. Certain state tax systems, for example the California unitary tax, also favor foreign multinationals over U.S. multinationals. I would hope that in future hearings you would consider the international competitive aspects of state taxation.

We have not tried to cover aspects which are of particular concern to oil companies. These we understand have been discussed in a paper submitted by the American Petroleum Institute. Instead we have tried to give a paper on a proposed structure for analysis to make sure all aspects of international competition are considered.

Sincerely yours,

James Q. Riordan

James Q. Riordan

cc:
Ms. Laura Wilcox w/atts.
Ms. Mary McAuliffe w/atts.

Statement of the

Machinery and Allied Products Institute (MAPI)

"The Effect of Fiscal Policies on U.S. Competitiveness"

Introduction

The Machinery and Allied Products Institute (MAPI) is a nonprofit policy research institute with some 500 member companies representing a wide range of industries in the manufacturing, communications, and transportation sectors. Remaining competitive in an era of global markets is a continuing challenge for such companies. For some time the U.S. industrial sector has suffered a gradual erosion of its competitive edge over foreign competitors. In some industries, many businesses have suffered adversely from the significant import penetration of U.S. markets.

Throughout the industrial sector, U.S. businesses have responded to the competitive challenge by improving the efficiency of operations and reallocating their capital and labor resources to higher value-added activities. U.S. manufacturing is in a stronger position now than it was at the beginning of the decade./1 Manufacturing still produces the same proportion of Gross National Product (GNP) as it did 25 years ago and manufacturing employment is rising again after a substantial decline during the 1981-83 recession. But unless the Congress and the Administration adopt fiscal policies that encourage more rapid innovation, many businesses in the industrial sector will increasingly encounter difficulty competing in world markets. If this occurs, the real income of U.S. workers and the ability of government to finance widely supported programs to assist other groups in society will be threatened.

MAPI, therefore, welcomes the Subcommittee's initiative to improve public understanding of the importance of fiscal policies in responding to the competitiveness problem. The Institute is pleased to have this opportunity to present its views on why there is an urgent need for government to adopt fiscal policies that will permit U.S. industry to compete more successfully against its foreign rivals.

Productivity: The Key To Restoring U.S. Competitiveness

A good indicator of the competitive position of a business or industry is what it costs to produce a unit of output compared to the unit costs of its competitors. Obviously in an era of global markets, it is not possible, nor economically desirable, for every U.S. industry to be the low cost producer. To maximize its competitive position, the U.S. industrial sector should seek to maintain a cost advantage in the high value-added industries typically requiring intensive use of plant and equipment, innovative technology, and relatively high skilled labor. For the U.S. economy to remain competitive, it must constantly move capital and labor resources out of industries in which it is a relatively high cost producer and into those industries that have relatively low unit production costs and a high value-added in production.

1/ "Manufacturing Is Alive . . . And Changing!," MAPI Memorandum G-214, April 1987.

Many private sector actions can improve business' unit cost position. Improved business investment decisions, greater attention to the quality and marketing of its products, and more efficient management of personnel are the responsibility of business. Public policy reforms can also affect the comparative cost position of U.S. industry. For example, strengthening our trade policies to encourage other countries to permit U.S. exports into their markets and protection of U.S. industry from foreign unfair trade practices and from infringement of U.S. intellectual property rights are important. Reforming regulatory and products liability policies that unnecessarily raise the cost of production in the United States would also improve our competitive position. But the most important role for government is to provide the fiscal policy environment that will encourage industry to innovate and improve its productivity performance.

Since labor is one of the most important inputs in production and U.S. compensation costs are higher, and in some cases significantly higher, than in almost all countries, we must have a higher level of productivity than our competitors if our unit costs of production are to be competitive. In the past we had higher productivity levels than any of our foreign competitors and, indeed, for the entire private business sector we still have a productivity level advantage. In manufacturing, however, many other countries have, for at least 20 years, consistently surpassed our productivity growth rates. The cumulative result has been a significant convergence of productivity levels among industrialized countries. For some industries, a similar convergence has occurred between the United States and rapidly developing countries like South Korea and Taiwan. In fact, it is estimated in several studies that, on average, Japan's manufacturing productivity level matched the U.S. level around 1980./1

In the future, if the United States is to enjoy a high standard of living and continue to be a leading economic power, our government's fiscal policies must stimulate productivity growth in the private sector. No one private or public sector action will enable U.S. manufacturers to match or surpass the productivity growth rates of its leading competitors. Many studies, however, confirm that the single most important determinant of productivity performance is the rate of capital investment--investment in both research and development and in new plant and equipment.

Insufficient Investment and Loss of U.S. Competitive Leadership

An increase in investment in new plant and equipment contributes to productivity improvement in two related ways. First, a larger quantity of capital increases productive capacity which allows potential benefits from economies of scale. Second, increased investment typically improves the quality of industry's stock of capital as the latest innovations are incorporated into the new plant and equipment. These technological changes allow industry to produce a given level of output with fewer inputs and to reduce unit costs of production.

1/ "U.S. International Competitiveness and Government Mandating of Employee Benefits," MAPI Memorandum G-213, March 1987.

<u>A Low Rate of Investment in Plant and Equipment Hurts Our Comparative Productivity Performance</u>

An increase in the rate of investment in new manufacturing plant and equipment will not only increase the quantity of capital available to U.S. workers, but it will produce significant improvements in productivity as innovations in technology are spread rapidly throughout the industrial sector. A high rate of investment at this stage of the innovation process is crucial if U.S. industry is to remain competitive in global markets.

When compared to the performance of its major competitors, the U.S. investment in plant and equipment has also been low. The large U.S. economy obviously invests a greater amount of capital than any of its competitors but if over a period of several decades other countries invest a higher proportion of their resources than we do, on average, the <u>quality</u> of their stock of plant and equipment will be greater than that of U.S. plant and equipment, since a higher proportion of their manufacturers will have adopted state-of-the-art technology.

The amount and quality of equipment and production facilities per worker is crucial to improving the productivity of the workforce. Indeed, several studies conclude that the rapid increase in capital available to manufacturing in other countries is the major reason for the gradual convergence of manufacturing productivity levels between the United States and its competitors./1

As shown in Chart I, for several decades, proportionately, our major competitors, including more recently South Korea, have been channeling significantly more of their resources to investment in plant and equipment than has the United States. Since almost all other countries have a cost advantage in labor inputs, this is likely to give them an advantage in unit costs of production.

<u>More R&D Needed As Basis for Future Technological Advancement</u>

A strong technological base, the result of successful R&D, is a necessary prerequisite for improved production processes and for the development of new products. Investments in R&D and in new plant and equipment are, of course, complementary in improving productivity. The addition of new plant and equipment not only increases the amount of capital available per worker, it also increases the quality of that capital.

The contribution of R&D to improved productivity performance is substantial, accounting for perhaps 8-16 percent of U.S. productivity growth during

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1/ See for example, J. R. Norsworthy and David H. Malmquist, "Recent Productivity Growth in Japanese and U.S. Manufacturing" in William J. Baumol and Kenneth McLennan, <u>Productivity Growth and U.S. Competitiveness</u> (Oxford University Press, New York, 1985), p. 58.

the postwar period./1 Estimates of the average rate of return to businesses that invest in R&D are also very high--generally in the 30 percent range and, according to a study of 18 manufacturing industries, variations in R&D spending explained 88 percent of the variation in exports among these industries./2 Clearly, an increase in private sector investment in R&D will increase the competitive position of the U.S. industrial sector.

The high average rate of return to those who invest in R&D is only part of the total return from the investment. Other firms as well as the public benefit because those who invest in R&D are usually unable to capture and protect all the benefits from their research. Because the total return to society from R&D investment is greater than the return to the businesses making the actual investment, the government has a justifiable role in developing specific policies that encourage the private sector to invest more in R&D. The high societal rate of return to R&D also places a responsibility on government to increase its direct expenditures on R&D provided that the results of successful R&D are made available for commercial production.

The United States is now spending a larger share of its GNP on R&D than we did in 1975, but we still are below the 1967 share (Chart II). One of the weaknesses of our R&D expenditure level is that, compared to other countries, much of our R&D is not directed at commercial applications. While, as shown in Chart III, we spend about the same proportion of our GNP on R&D as do the other major industrial countries, the proportion spent on civilian R&D in the United States is much smaller than in those countries. There is, of course, some beneficial spillover from our large expenditures on military R&D to commercial civilian production. In the long run, however, our major competitors are likely to have an advantage in the international markets since a higher proportion of their R&D is designed to produce results for purely commercial purposes.

A higher rate of investment in R&D and in new plant and equipment may not be sufficient to ensure that in the long run the U.S. industrial sector retains its competitive leadership in world markets, but it is a necessary requirement if we are to achieve this important goal. Current government fiscal policies are not providing the environment that will maximize private sector investment in either R&D or new plant and equipment. Since there is a fairly long lag between increased investment and the beneficial effect on the competitive position of U.S. industry, it is important that fiscal policy reforms be initiated promptly.

Fiscal Policies for Restoring Competitiveness

Fiscal policy can affect the rate of investment through federal budget policy and specific tax policies. If large federal budget deficits raise real rates

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1/ Estimate based on results of following studies: Leo Sveikauskas, "The Contribution of R&D to Productivity Growth," Monthly Labor Review, March 1986, pp. 16-20; and Zvi Griliches and Jacques Mairesse, "Productivity and R&D at the Firm Level," in Zvi Griliches, ed., R&D, Patents, and Productivity (National Bureau of Economic Research Conference Report, Chicago, IL, 1984), pp. 339-374.

2/ George N. Carlson, "Tax Policy Toward Research & Development" in Ralph Landan and N. Bruce Hannay, ed., Taxation, Technology and the U.S. Economy (Pergamen Press, New York, 1981), p. 72.

of interest and the tax policy reduces after-tax profits, it will be impossible for U.S. industry to match the rate of investment of its competitors.

Chronic Government Dissaving Will
Retard Capital Investment

Unless the current federal budget deficit (i.e., dissaving) is offset by an increase in personal and corporate saving or by a decline in U.S. investment abroad and/or continued borrowing from foreigners, investment by U.S. industry is likely to decline. If the economy is operating at relatively full employment and domestic savings cannot be increased to finance government dissaving, real interest rates will rise. This will result in two possible consequences for investment. As the federal government bids up the cost of funds needed to meet its expenditure obligations, capital investment by the private sector may be "crowded out." At the same time, the higher rates will attract an inflow of foreign capital, thereby increasing the value of the U.S. dollar which in turn will produce a larger trade deficit. The adjustment mechanisms are to some degree substitutes for one another. Since 1983, however, the large federal budget deficit has not "crowded out" private investment because the high rates of net foreign investment have mitigated upward pressure on interest rates. In fact, private investment has remained slightly above the trend since the mid-1960s. This is because a decline in U.S. investment abroad and an increase in foreign investment in the United States has been financing the U.S. government's budget deficit and has allowed the United States to consume more than it produced, but at the cost of a huge trade deficit.

In the long run, however, the inevitable decline in the inflow of foreign capital will make it difficult to maintain the current rate of capital investment without sacrificing expenditures on government programs. The U.S. excess of consumption over production has already affected the composition of federal budget expenditures. For example, in 1976 interest on the debt accounted for 7 percent of federal expenditures; by 1986 it was 14 percent. Unless the federal budget deficit is reduced substantially, a larger proportion of federal revenue will be required to service government debt and foreigners will be less willing to continue lending to the United States, making it likely that interest rates will rise and U.S. investment in plant and equipment will be reduced.

Tax policies to stimulate R&D and lower the cost of business investment in plant and equipment represent an important part of a strategy to improve the long-run competitive position of U.S. industry. MAPI believes a number of reforms should be considered, but that any revenue loss from greater tax incentives for investment must be offset by federal expenditure reductions and, to the extent necessary, by tax increases that do not discourage saving or investment in new plant and equipment.

The Current R&D Tax Credit Should Be
Made Permanent and Strengthened

The 1981 Economic Recovery Tax Act (ERTA) introduced an incremental tax credit of 25 percent for certain qualifying research and development expenditures which exceed a base level. This tax credit provision was only temporary and scheduled to expire by 1986. With the passage of the 1986 Tax Reform Act (TRA), the R&D tax credit was extended for an additional two years, through 1988, albeit at a lower marginal rate (20 percent), to allow further time for evaluation.

All economists agree that without government incentives, the private sector will not invest sufficiently in R&D. There is less agreement on what kind of government incentives should be used to increase R&D investment. The R&D tax credit, particularly as it is currently formulated, is not perfect and even while improvements can be made, using tax policy to increase R&D investment also has weaknesses. However, most of the alternatives, such as direct government expenditures to stimulate applied R&D for commercial purposes, have more serious problems than the tax credit approach. Fortunately, most analyses of R&D policy indicate that the R&D tax credit, even with its problems, has been a relatively cost-effective stimulus to R&D spending.

The general consensus, based on three separate surveys of the available literature conducted by the Congressional Research Service, the Joint Economic Committee, and the Congressional Budget Office, appears to be that the R&D tax credit has had a small, but statistically significant, impact on R&D spending./1 This is not surprising given the temporary nature of the credit, the limited amount of time it has been in effect, and its small and variable size. Further, the credit is relatively cost effective. During the latest tax year for which we have data, July 1984-June 1985, the amount claimed for the R&D credit was less than $1.6 billion--equivalent to only 1.5 percent of taxes paid by U.S. business before credits. If estimates are correct and the price responsiveness of R&D spending is approximately unity, i.e., an additional dollar of R&D spending results for each dollar of tax revenue lost,/2 then the tax credit appears to be a good investment given the high societal rate of return to R&D.

We feel that the tax credit can be made more effective with the following changes:

- <u>Make the R&D Tax Credit Permanent</u>--One reason for the apparent small effect of the tax credit on business expenditures is the fact that in both the 1981 ERTA and 1986 TRA, the credit is provided only as a temporary measure. Most R&D projects have longer time horizons than those provided in either of these provisions. If a company is considering a new R&D program, a tax credit scheduled to expire at the point where expenditures begin to increase does not provide much of an investment incentive.

- <u>Change the Base</u>--The current design of the base can lead to perverse effects, actually discouraging R&D investment that could otherwise have occurred. If a firm in any year is not going to invest in R&D at a level exceeding the average of the preceeding three years, it will only be reducing the value of future credits by investing in any R&D that year. The purpose of using the three-year moving average as a base is to encourage ever-increasing amounts of investment by the firm. We believe that

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1/ See Martin Neil Bailey and Robert Z. Lawrence, "Tax Policies for Innovation and Competitiveness," Council on Research and Technology, April 3, 1987, pp. 37-42, for a review of the relevant studies.

2/ <u>Ibid.</u>, p. 20, fn.7.

this is not the correct goal. The credit should be designed to provide incentives to the firm to maintain its investment in R&D at a level higher than its historic level. To this end, the base for the incremental credit should be the average of the firm's R&D expenditures for the three-year period, 1978, 1979, and 1980, adjusted annually for inflation.

- Restore the Credit to 25 Percent--Even with the credit set at a 25 percent level, the United States will be giving less preferential treatment to R&D than do its major trading partners.

Tax Policy Should Provide a Greater Stimulus to Investment in New Plant and Equipment

The greatest contribution to productivity growth is associated with the diffusion of successful innovations throughout industry. The rate of diffusion depends importantly on industry's cash flow position and the rate of return from investment in new plant and equipment. Tax policies that reduce the cost of investment through depreciation of capital assets prior to their obsolescence in competitive markets and through other policies that increase after-tax cash flow are essential to increasing the rate of capital investment.

A number of the tax policy goals of the 1986 Tax Reform Act were desirable. Lower marginal tax rates for individuals and a slight shift in personal taxes toward reducing the high penalty on saving versus consumption were clearly desirable. Similarly, the move toward greater neutrality in the corporate tax treatment of earnings among industries may ultimately improve the efficiency of allocation of resources in the economy. Unfortunately, these benefits were made at a net cost to saving by curtailing tax preferences that encouraged saving and provided incentives to invest in R&D and in potentially innovative economic activities.

Despite some benefits derived from the 1986 Act, MAPI reiterates its view, expressed in testimony prior to the passage of the 1986 Act,/1 that the current tax code's continuing penalty on saving and the shift of some $140 billion of the tax burden to business over a five-year period, in order to attain the goals of general rate reduction and revenue neutrality, will reduce in the long run the ability of the industrial sector to remain competitive in world markets.

MAPI continues to believe that any changes in the current depreciation treatment of plant and equipment should be in the direction of a more rapid writeoff of plant and equipment. In addition, if we are to encourage innovation, it is essential that the tax treatment of capital gains fully reflect real gains rather than nominal gains. In the long run, the failure to index tax rates in the case of capital gains will have an adverse effect on investment. Additionally, capital gains rate preference should be restored so that such gains are not taxed as ordinary income.

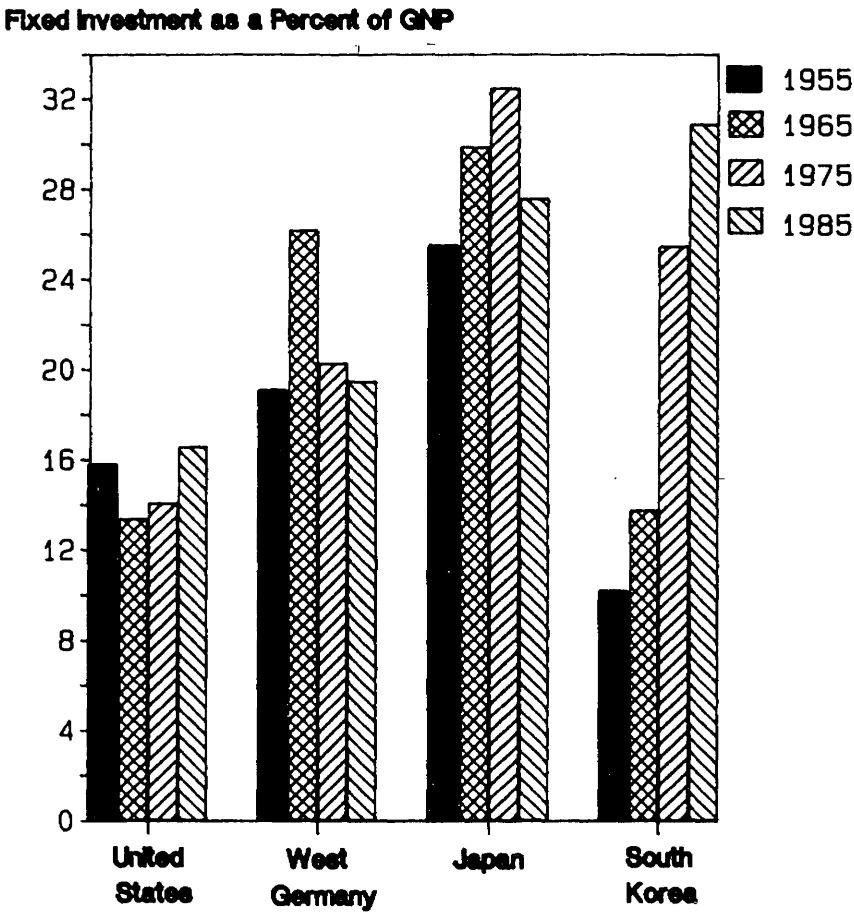
1/ MAPI Testimony Before the Senate Committee on Finance, February 6, 1986, Executive Letter L-686.

Conclusion

In the absence of other actions, the adoption of tax incentives to increase investment in R&D and plant and equipment could reduce federal tax revenues, in the short run at least, making it more difficult to reduce the federal budget deficit. To the extent this is the case, the appropriate policy would be to reduce government expenditures and/or raise taxes on consumption in order to make the U.S. economy more competitive and to avoid burdening future generationn of Americans with additional costs of servicing the national debt.

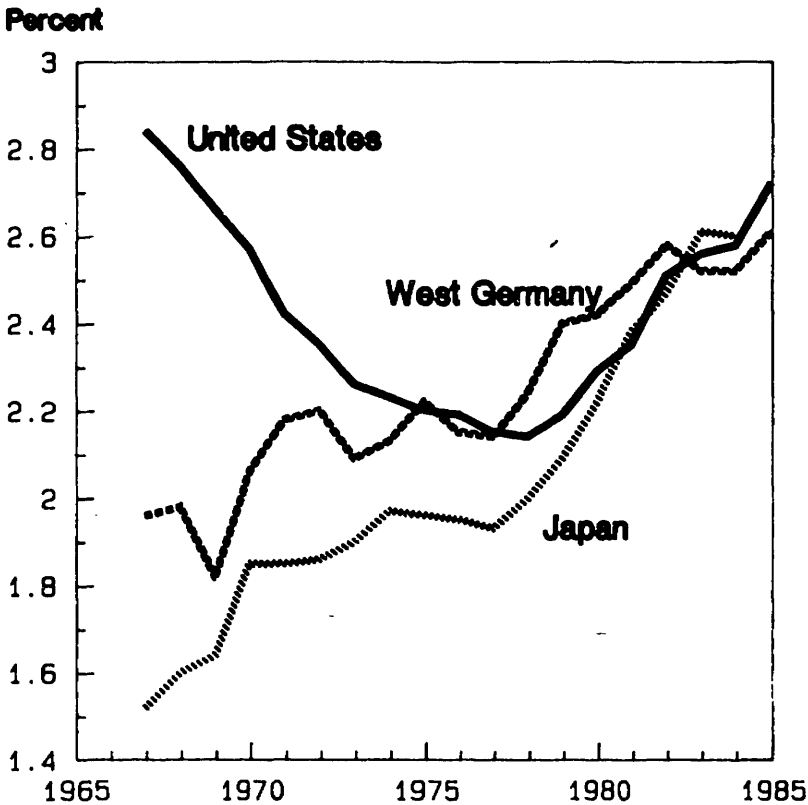
The risk of a recession is greater if the reduction in the federal deficit is accomplished solely through tax increases. Output would fall and the incentive to invest in new plant and equipment would decline. The federal deficit should be eliminated over a period of several years so that there is no sudden change in effective demand. MAPI believes that the first phase of a budget reduction strategy should be a reduction in the rate of growth of federal purchases of goods and services. There should be a moratorium on new social programs that increase government expenditures. All government programs, including entitlements, should be examined for cost effectiveness and all should share in reducing government expenditures. Raising taxes to reduce the budget deficit may be necessary, but if that is the case it is in the public interest in the long run that the burden fall on consumption rather than on saving and on individuals rather than on business. Unless fiscal policies recognize the importance of stimulating savings and investment, the industrial sector will face increasing difficulty in competing in world markets.

Chart I
International Investment Comparison
1955–1985



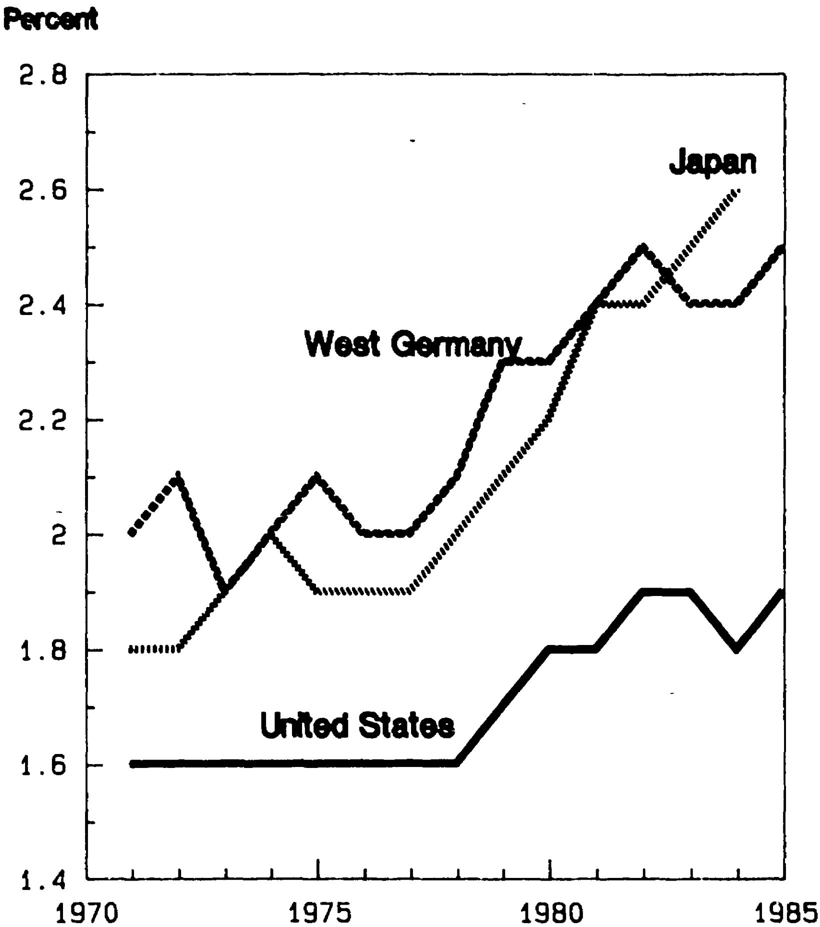
Source: International Monetary Fund

Chart II
Total R&D Expenditures as a Percent of Gross National Product by Country



Source: National Patterns of Science and Technology Resources 1986, National Science Foundation

Chart II
Civilian R&D Expenditures as a Percent of Gross National Product by Country



Source: National Patterns of Science and Technology Resources 1986, National Science Foundation

EMPLOYEE OWNERSHIP, EMPLOYEE PARTICIPATION, TAXES AND ECONOMIC COMPETITIVENESS

Corey Rosen
Executive Director
National Center for Employee Ownership
Oakland, California

Mr. Chairman and members of the committee, it is a pleasure to be asked to address you this morning. My name is Corey Rosen and I am executive director of the Nati al Center for Employee Ownership. Established in 1981, the Center is a private, non-profit membership, research, and information organization. We do not lobby, and draw all of our support for members, workshops, publication sales and other information activities.

As you know, traditionally the tax code has been used to promote economic competitiveness by providing incentives for capital investments and research and development. As you also know, there is considerable controversy about whether these incentives have the desired effect. I am not qualified to comment on that, but our organization has done extensive research on a very different approach to competitiveness, one the tax code also encourages, and one that seems to be working: employee ownership.

America is a country rich in capital, rich in capable and educated people, rich in natural resources, and rich in entrepreneurial drive. But we are not so blessed in the way we organize people to produce all they can. Our reward systems do little to motivate workers, and when they are motivated do little to give them the chance to act on that motivation. Repeated national opinion polls tell us that workers do much less than they themselves say they can do.

But, the economists tell us, just getting people to work harder really won't solve our problems. I agree. The issue is not getting more work out of people. It is getting more work out of organizations. In a typical company today, when an employee hears a complaint from a customer, sees a problem on a production line, has an idea to create a better product, or knows a way to make something better or faster, that employee has little motivation to share that information with fellow employees or supervisors. And supervisors have little incentive to listen. Even if employees are well-motivated, the structures in which they could act on this better knowledge rarely exist.

Moreover, few companies act on the well-established principal that a group's collective expertise is better than any one individual's. All of us have particular skills and areas of special knowledge. When faced with a problem, if we pool these, we can come up with a better solution.

These principles seem like common sense, and, indeed, they are supported by a great deal of research. Researchers on Japanese companies, for instance, have consistently found that it is differences in the way the Japanese use people, not differences in capital structure, that account for their remarkable performance. Companies have long-established patterns of power, expectations, and rewards, however, that tend to trap people in more traditional, hierarchical ways of doing things. To move companies in a different direction, there need to be incentives to make it worthwhile. The market provides some of these clues, but, obviously, not enough. That is why tax incentives to move in this direction can be so valuable.

Let me talk about one of those: incentives for employee stock ownership plans (ESOPs). There are now about 8,000 non-tax credit ESOPs in the U.S., covering about 8,000,000 employees. In 1974, when the first tax incentives for ESOPs were passed, employee ownership was virtually unknown. Just last week, the 11,000 employees of Avis became 100% owners of their very profitable company and the 9,000 employees of the equally profitable Charter Medical were told they would become owners of two-thirds of that company. Clearly, the tax incentives have helped spur ESOPs.

Has that been worthwhile? According to the GAO, the total amount spent on non-tax credit ESOPs has been about $1 billion. While we cannot quantify how much this has produced in terms of overall economic improvement, we can say that companies clearly do better with ESOPs than without them. We looked at 45 ESOP firms for at least five years before they set up their plans and five years after. We then measured their sales and employment growth rates relative to their competition during this time. Finally, we subtracted the "before" figures from the after figures to obtain a net difference attributable to employee ownership. In other words, if a company was growing 1% per year faster than its competitors prior to its ESOP, and 5% per year faster after, the net difference would be +4%. In fact, on average this is about what we found -- ESOP companies grow 3.5% to 3.8% per year faster with their ESOP than they have without them. Put differently, in eleven years, an ESOP firm will create 50% more jobs than it would have if it did not have an ESOP. And these are good jobs, jobs that offer people an ownership stake in their company. Isn't that ultimately what the goal of economic policy is, to create more good jobs?

We also found that the ESOP companies with the foresight to combine ownership with a high level of employee participation at the job level grew even faster. The most participative ESOP firms grew 11-17% per year faster than the least participative ESOP firms. Unfortunately, only about 25% of the ESOP companies are very participative, but the percentage is growing, and ESOP companies certainly appear to be doing more along these lines than non-ESOP companies. It would be good if we could find a way to give more of the ESOP tax incentive to these firms but, frankly, I cannot imagine how that would be done. Despite that, the overall effect of ESOP tax incentives does appear to be impressively positive.

The results of this study are described in more detail in the article "How Well is Employee Ownership Working," by myself and Michael Quarrey in the current (Sept/Oct 1987) issue of The Harvard Business Review. I would like to ask that that article be included in the record.

The image of employee ownership is often one of employees desperately trying to rescue a failing firms, or managers using an ESOP to fend off a hostile takeover, or clever tax attorneys creating a kind of elaborate sham that does not really benefit workers. These things do happen, but the vast majority of ESOPs -- 96% according to the GAO -- require no employee concessions, and, according to our research, almost all ESOPs are set up in healthy, profitable companies. Employees clearly benefit from ESOPs. The typical employee in the typical plan, we have found, accumulates $31,000 in stock over just ten years. We think the country benefits as well, and that ESOPs are one way we can use tax incentives to make life better for all of us.

I hope, however, that the committee will consider the lesson from this to be not just that the ESOP tax incentive appears worthwhile, but that other incentives for other kinds of gainsharing and employee involvement programs could also prove effective. We have a great deal to gain by improving organizational performance; we have even more to lose by focusing only on capital, and not on people.

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