INCENTIVES FOR ECONOMIC GROWTH

HEARINGS

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

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CONTENTS

ADMINISTRATION WITNESSES

PUBLIC WITNESSES

PUBLIC WITNESSES—Continued

COMMUNICATIONS

ADDITIONAL INFORMATION

APPENDIXES

INCENTIVES FOR ECONOMIC GROWTH

MONDAY, MAY 16, 1977

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
GENERALLY OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:30 a.m. in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. (chairman of the subcommittee) presiding.

Present: Senators Long, Harry F. Byrd, Jr., of Virginia, Hansen, and Packwood.

Senator BYRD. Nine-thirty having arrived, the committee will come to order.

Before the witnesses begin their testimony, I would like to take this opportunity to welcome each of the witnesses to this first day of hearings before the Subcommittee on Taxation and Debt Management Generally. The hearing today is the first in a series of 4 days of testimony on the topic of incentives for economic growth.

[The press release announcing these hearings follows:]

[Press release, May 6, 1977]

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT ANNOUNCES HEARINGS ON INCENTIVES FOR ECONOMIC GROWTH

Subcommittee Chairman Harry F. Byrd, Jr. (I., Va.), announced today that the Subcommittee on Taxation and Debt Management will hold hearings on May 16 and 17, 1977, and June 13[1] and 14, 1977, on the relationship between taxation and economic growth.

The hearings will begin at 9:30 A.M. in Room 2221, Dirksen Senate Office Building.

Senator Byrd stated that the hearings will examine the effect of tax policy upon the growth of the private sector of our economy.

Witnesses before the Subcommittee are to focus upon those proposals which they consider as the key to providing for greater business growth and higher employment.

Senator Byrd, in announcing the hearings, noted that capital formation proposals were put forth in general terms by the last Administration and were discussed in connection with the Tax Reform Act of 1976. Hearings on this general subject were held early in 1976 before the Subcommittee on Financial Markets of the Committee on Finance.

Since then, he said, the Administration has indicated a strong interest in acting on the problem.

The Treasury Department plans to submit recommendations in the fall.

Senator Byrd stated that Congdess, and the Subcommittee in particular, must become more involved in this subject if Congress is to have a significant role in the formulation of policy in this area.

"We need to explore the range of current proposals, focus on those which merit serious consideration, see how they would work, and analyze the ramifications—who's going to be hurt and who's going to be helped."

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[1] Date subsequently changed to June 15, 1977.

In announcing the hearings, Senator Byrd expressed a desire that witnesses concentrate on what they consider to be the two or three most important proposals to encourage economic growth and employment.

"One thing to be avoided is for business to present the Subcommittee with a shopping list of proposals."

Senator Byrd said that he wants to give special attention to the views of the small business community. "The impact of the current proposals on small businesses, incorporated and unincorporated, should be carefully considered."

We ought to immerse ourselves in the specifics of these proposals now, so that the Congress and the Administration will have ample opportunity to study the views presented."

The hearings will begin with presentations by Daniel Brill, Assistant Secretary of the Treasury for Economic Policy, and Alan Greenspan, former Chairman of the Council of Economic Advisers, in order to set the stage.

The Subcommittee will then hear from spokesmen representing small business and business generally. In the second two days of hearings, the Subcommittee will receive testimony from present Administration officials and leading economists, academicians and "public interest" groups.

The following witnesses have been scheduled to testify on the first two days (May 16 and 17):

Daniel Brill, Assistant Secretary of the Treasury for Economic Policy; Alan Greenspan, former Chairman, Council of Economic Advisers; Council of Small and Independent Business Organizations; Small Business Legislative Council; National Association of Small Business Investment Companies; American Council for Capital Formation; Securities Industry Association; American Bankers Association; and National Savings and Loan League and U.S. League of Savings Associations.

An announcement concerning witnesses for the second two days of hearings will be made in the next few weeks.

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

Witnesses scheduled to testify must comply with the following rules:

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

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

(3) The written statements must be typed on letter size paper (not legal size) and at least 75 copies must be submitted by the close of business the day before the witness is scheduled to testify.

(4) The witnesses will be allowed 15 minutes for their oral presentation.

Written Testimony.—Other persons interested in presenting their views to the Subcommittee are urged to prepare a written statement for submission and inclusion in the printed record of the hearings. These written statements should be submitted to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, on or before July 1, 1977.

Senator BYRD. During the past several years, the American economy has been confronted with the unfortunate phenomena of high levels of inflation and high levels of unemployment. There is now a growing concern that American businesses are not making the necessary investments in plant and equipment to sustain the future growth of the American economy and to provide jobs for American workers.

This view is backed by statistics which show that, from 1966 to 1976, approximately 19 million workers entered the labor force. Yet during the same period the growth rate in the amount of private plant and equipment has declined.

Many proposals are now being advanced as solutions for the low rate of growth in the American economy. These proposals involve changes in our present tax laws relating to businesses. Some of these proposals, if they were adopted, would involve a comprehensive change in our current system.

The purpose of these hearings is to permit the business community to present their views on what is needed. I hope that the witnesses who will be testifying will avoid the temptation of giving the subcommittee a shopping list of proposals.

Instead, it is the subcommittee's hope that the witnesses will concentrate on the two or three measures that they consider to be the most important in encouraging economic growth and development.

The hearings are designed to present a balanced program of all points of view, including the administration, big business, and the small business community, this latter being of special concern to me.

In formulating a tax policy to encourage business investment, it is important that this significant segment of our economy will not be overloooked.

The hearing will begin with the testimony of Mr. Daniel Brill, Assistant Secretary of the Treasury for Economic Policy.

I welcome you, Mr. Secretary; we are pleased to have you and you may proceed as you wish.

STATEMENT OF HON. DANIEL BRILL, ASSISTANT SECRETARY OF THE TREASURY FOR ECONOMIC POLICY

Mr. BRILL. Thank you, Senator. Good morning.

Perhaps, if it meets with your pleasure, I will not read the document that I submitted, but summarize it and leave the opportunity then for us to have a further dialog on some of the issues that are involved.

As I look at the problem of capital formation and the implications for the economy, it seems to me that we are involved in coping with both short run and longer run problems, both of which have at their heart the need for a faster rate of capital formation.

In the short run, we have the problem of a slowing in rate of growth of productivity, a phenomenon that has bewildered many economists, including myself. We do not have the answers for this development. For the longer run, we have the need for a capital base that can sustain a full employment economy, our objective by the end of this decade.

In the short-run productivity problem, all the measures of productivity indicate a very substantial decline since about 1969. If one plotted the growth of productivity over the postwar period, a roughly 3.3 annual growth line would have covered the annual figures very precisely up until 1969. Since then, we have seemed to have been falling far behind the long-term growth trends in productivity.

There have been minor fluctuations reflecting the usual cyclical variations in economic activity, and special developments, such as the impact of the energy crisis, but the problem still remains that we are far below our long term growth trend in this very important aspect of economic activity.

The result has been constant upward pressure on prices, with compensation moving in general at about a 7.5- to 8-percent advance while national productivity has been growing at about 2 percent. This relates very much to the 6-percent underlying rate of inflation, with which we seem to be plagued.

The decline in the rate of growth in productivity has been related to many, many problems—the entrance of less skilled workers into the labor force, the shorter workweek, a number of other factors.

Personally, I think that one of the important considerations—although there is not unanimity among the economic profession on this—is the slowing in the growth of capital formation. The figures that we have been able to put together on the amount of capital per worker show that in the past decade the growth in the amount of capital, after correction for inflation, has been somewhat less than half that of the decades preceding the 1970's.

I think that this is one of the important elements in describing why we have had a slowdown in productivity.

Senator BYRD. What are you going to do about that?

Mr. BRILL. If it is true sir, that the problem is in significant measure a slowing down of the rate of growth of capital, then we have to look at everything we are doing in the way of government regulations and laws that inhibits the growth of capital.

Foremost among these, of course, is the tax structure. The question is: What can we do to revise our tax structure in such a manner that it will contribute to capital formation?

The criteria that we have been applying in the Treasury in a mammoth study now underway, on the ways in which the tax structure should be reformed, are: First, simplification, which we feel is a highly desirable objective, to permit individuals to understand what it is that they are being required by their Government to report.

The second consideration is equity—all forms of income being treated equally; all sizes of businesses being treated equally, equitably; different income classes being treated equitably.

The third criterion is that of economic effectiveness, particularly in promoting capital formation.

There have been a number of proposals over the years to modify the tax structure in order to achieve this latter objective. These were spelled out in very succinct form in the report of the Joint Committee on Taxation last year which analyzed the variety of proposals. As I indicated in my prepared statement, sir, this is not virgin territory that we are discussing. This has been very thoroughly studied from a number of perspectives.

The various proposals involve such modifications of the tax structure as: Integration of the forms of returns paid by corporations; equal treatment for dividends and interest payments, or various modifications of this proposal.

There is another class of proposed modifications which have to do with manipulating the investment tax credit which has been changed from time to time by the Congress and possibly could be revised again.

Senator BYRD. What is your view as to the present rate of the investment tax credit? Has it got to a point beyond which it would not be desirable to go, the 10 percent?

Mr. BRILL. Desirable is a hard term to answer. Desirable in the sense: Does it have effectiveness beyond the 10 percent in producing the results claimed?

There is quite a variety of views in the economics profession, as I am sure you are aware, on the efficacy of the investment tax credit.

Senator BYRD. What is the administration's position on the investment tax credit at the current rate?

Mr. BRILL. We feel it should be considered in the context of total reform, not to look at it individually as a separate item, but what role it can play in the context of the total change in the tax structure.

Senator BYRD. Do you think it would be appropriate to go above 10 percent?

Mr. BRILL. If there were no other change made in the tax structure—which I do not think is a very realistic assumption—then I think that should be given consideration.

Senator BYRD. You mean to go above it?

Mr. BRILL. Yes, sir. Under the condition that no other change was made in the tax structure.

If, on the other hand, we are looking at the subject of total reform, then I am not sure that I feel that the investment tax credit would be as important a prod to investment as some of the other changes under consideration.

I find it difficult to answer with respect to one form of tax, if we are in the process of discussing a major reform in the tax structure.

Senator BYRD. As one who favors the investment tax credit, also as one who originally did not favor it, it seems to me that it is important, No. 1, that we, the Congress and the administration, that we reach a determination as to whether it is wise or unwise to have an investment tax credit and roughly the rate at which it should be, and then begin to leave it alone, rather than to repeal it, put it on, repeal it, put it on, as we have consistently done for years.

Would you be inclined to think that we ought to try to reach a conclusion and then basically leave it alone?

Mr. BRILL. I think the problem with varying the investment tax credit is the uncertainty that it induces in the business community in making investment decisions.

Senator BYRD. That is very important.

Mr. BRILL. It is indeed.

I faced that problem myself in trying to estimate the prospective return on an investment to a company with which I was affiliated, with respect to what the after-tax return would be, given the various possibilities that might prevail with the investment tax credit.

On the other hand, I think the important issue, Senator, is whether we are considering one tax in isolation or considering a total package. It is our hope that, no later than this summer, we will be able to present to the Congress a complete package in which the investment tax credit can be viewed in the context of a total change in the entire system.

Senator BYRD. Let me ask you this. I realize this could vary from business to business, but looking at business as a whole which is the more important, the investment tax credit or a more liberalized depreciation rate?

Mr. BRILL. Looking at it from the viewpoint of business, it would depend upon whether we are dealing with a capital intensive industry——

Senator BYRD. That is right. Recognizing the differences in businesses, but in order to reach a broad approach, what would be the most helpful to most businesses?

Mr. BRILL. I would think of an option that falls outside of the particular range that you just indicated, that would be a reduction in the corporate rate overall as probably being the most important contribution that tax reform can contribute to the business sector.

Senator BYRD. I think that is a very important point that you raise. Do I take it from the way that you answered the question, then, that if there were to be a reduction in the corporate rate, that both the investment tax credit and a more liberalized depreciation schedule probably would not be considered?

Mr. BRILL. We are not at the stage where we say we have the finished package, even combination of packages. But that is what we are looking at, alternative combinations. If we can combine in one package a set of tax reforms which will achieve certain objectives such as more equal treatment of various sources of income and a reduction in the overall rate for corporations and individuals, then other specific measures, such as an investment tax credit or juggling of depreciation allowances become less valuable to both the recipients and to society as a whole.

It is a matter of trying to visualize what is most useful in the context of combinations that become a specific package.

Senator BYRD. I take it, then, that the prime consideration in developing this package, the prime consideration, is to reduce the overall tax rate?

Mr. BRILL. Our consideration is economic effectiveness in addition to simplification and equity. By economic effectiveness, we mean particularly the extent to which a given tax structure will enhance the possibility of getting greater capital formation.

Senator BYRD. You are talking now about the corporate income tax?

Mr. BRILL. Corporate and individual income tax.

Senator BYRD. In this context, we are really dealing now with the business tax. What I was trying to get your viewpoint on was what could be done in the corporate field?

I realize, of course, that it would work hand in hand with what is done in the individual field, but am I correct in assuming from your earlier statement that, insofar as business is concerned, the contemplated tax package will be built around a reduction in the corporate rate?

Mr. BRILL. At this stage of our study, I would say this has a very high priority. Whether that will turn out to be the keypoint in the final package as it is presented—it is much too premature for me to be able to predict that.

We think of the various incentives and methods of approaching the problem of inducing a higher rate of business investment that a reduction in the total rate has very great economic potential.

Senator BYRD. What two or three steps could Congress take to be the most effective in encouraging capital formation?

Mr. BRILL. Are you including in that, sir, what Congress does about the tax package or are you talking outside of the area of taxes?

Senator BYRD. I am speaking primarily in the tax field.

Mr. BRILL. It would seem to me that the adoption of a tax structure by the Congress of a tax structure that is going to have the characteristics of inspiring capital formation and having a degree of stability that is now being changed with each new session of the Congress, I feel this would be very important, a major contribution in establishing the kind of environment that the businessman can plan in.

Overall, you realize that most major capital projects that an average business is contemplating requires planning and investment over an extended period. It would be very difficult to plan if first one is not sure by the time the project is onstream what the tax framework would be under which the income generated by this new plan will be taxed.

I think that the ability to plan in a more certain framework is very important for business. That applies also to the general environment.

You asked whether I had reference to action that Congress could take outside the field of taxes. I think that it is first and foremost important to establish a sound economic environment so that businesses feel that by the time the equipment that they have put in place is producing, there will be markets for the products that they are producing. That involves congressional actions to help stimulate the economy but also congressional support of actions that will diminish the rate of inflation.

Senator BYRD. How important is our fiscal policy?

Mr. BRILL. This is what contributes to the environment in which businessmen feel that they can plan ahead. I think President Carter's determination to achieve a balanced budget by fiscal year 1981 is an important element in establishing the environment that should be reassuring and establish business confidence.

I think that this is a part of the area outside the specific field of tax structure that I had in mind.

Senator BYRD. I certainly agree with that. I think that is very important.

I have been concerned that, while the administration rhetoric has been about a balanced budget, the recommendations of the Administration have been to increase spending substantially over what it was prior to the new Administration's taking office.

It seems to me that you are going in two different directions at one time.

Mr. BRILL. It looks at the moment as though our budget deficit for the current fiscal year will be running anywhere between $15 and $20 billion below the last full fiscal year of the preceding administration.

Senator BYRD. Let us come to fiscal 1978. You will find that it will be the second highest, or maybe the highest, in history. It will be substantially above this year's, will it not?

Mr. BRILL. As the figures now stand, yes, it will be above this year, but it will be below the $66 billion deficit in fiscal year 1976.

Senator BYRD. By a hair, $65 billion versus $66 billion—$64.65 billion, if you want to be precise. That is what Congress has just passed last week.

Mr. BRILL. As I recall our specific unified budget number was $58 billion. I do not have that with me at the moment, but that was the number, I think, that Mr. Lance was using.

If I am in the right range—and I am checking on it—it was $58 billion. That was the official projection for fiscal year 1978.

Senator BYRD. Is that the figure that the Congress passed last Friday?

Mr. BRILL. No, sir.

Senator BYRD. All right. Is that not the figure that you are likely to get?

Mr. BRILL. When you say the Congress, I did not realize that it had gone through both committees.

Senator BYRD. The conference report on the budget was approved Friday. It is a very high figure.

In developing this tax package that you are speaking of, Mr. Secretary, how much input will business and private individuals have in revising the tax package?

Mr. BRILL. We hope that hearings such as this will provide us with the background. We will be having hearings with various groups. We have a Small Business Advisory Committee to the Treasury which will be meeting with our tax officials.

We very definitely want to get as much input as we can from all groups.

Senator BYRD. What is the timetable for submitting the proposal?

Mr. BRILL. The original timetable was to submit the report to the Congress by October 1. We are accelerating that. I do not have a specific date. It will be some time during the summer, or very early fall. We cannot, at this juncture, pinpoint the date.

Senator BYRD. One of the reasons for concern is over adequate capital in the energy area. Can you supply the committee with estimates of the cost to our economy of the various parts of the President's energy program?

Mr. BRILL. The cost to the economy, did you say?

Senator BYRD. Yes.

Mr. BRILL. In broad terms, yes, it is possible for us to evaluate. As you may know, the estimates of the package as a whole is that it would have relatively small effect on our real gross national product, because the taxes raised by one element of the program are very often rebated to the economy through another set of actions, so that the net impact should be minimal.

There will be some impact on prices because the program does rest on using the market mechanism to reduce consumption of our most convenient, but least producible, sources of energy; oil and gas.

But I can provide you with some estimates of what this involves.

Senator BYRD. The estimates which I have seen have varied a great deal. President Carter had one estimate and Mr. Lance had a substantially higher estimate.

One of the Members on the Senate floor had a greater and higher estimate.

Of the two, what is yours?

Mr. BRILL. I do not happen to have my file with me on that subject, but as I recall, my estimate of the impact on the price measures, if that is what you are referring to, is the one that has had the widest variety of estimates. The energy package without the standby gasoline tax, will probably add 0.3 to 0.4 percent to the price index over the next 2 to 2½ years, and then drop back somewhat.

If, in that period, the gasoline tax were triggered, that would prevent the fallback at the end of this 2-year period and the price measures would continue to contribute to roughly less than 0.5 percent per annum to the price index.

Senator BYRD. Does the administration view the capital formation proposals as a means to solve an economic problem; namely, the problem of too low capital to achieve our goals, or a means to work out some form of tax reform?

Mr. BRILL. We regard tax reform as a partial solution to the economic problem. Our interest in particular forms of the modification of the tax structure is to achieve an answer to the problem of why we are not getting enough capital.

Senator BYRD. How much emphasis would you place on the need to encourage personal savings as part of a capital formation package?

Mr. BRILL. The experience I have had in studying the problem of personal savings suggests to me that there is not very much that can be done directly to encourage a higher level of savings in total. It is possible, through various incentives, to induce a change in the form of saving, but not through various tax measures, to change the total amount of savings.

That has been the experience in this country. It also has been the experience in most other countries. What induces the change in the total volume of savings is what really happens in the total economy, not as a result of specific tax measures.

Senator BYRD. Could you supply for the record the depreciation rates for the major industrial nations?

Mr. BRILL. Yes, sir.

[The following was subsequently supplied for the record:]

Average declining-balance depreciation rates for manufacturers in five major industrial countries

	Percent
United States	14.7
West Germany	11.5
France	18.4
United Kingdom	56.7
Japan	16.0

Senator BYRD. Realizing that the administration is not prepared at this time to make its recommendations on the subject, could you outline what you feel to be the alternative choices the administration will have in putting together this package?

Mr. BRILL. The alternatives from which to choose are extremely wide, because this is an area in which there has been very extensive work and analysis done, both in the Congress and in the administration, and by individual economists.

I believe that the broad categories of modification of the tax structure were laid out in the report prepared by the Joint Committee on Taxation last year in which they listed as I recall, six major areas of possible change.

The first one was the possibility of integrating dividend and interest income, the integration of the corporate and person tax in part or in whole.

The second was a more specific technique of the investment tax credit.

The third was the adjustment of the depreciation allowances.

The fourth general approach was reducing the corporate tax rate.

The fifth, as I recall, was the possibility of applying the price indexes to adjust the value of capital to take account of inflation.

Then there was the matter of changing the reduction for operating losses and capital losses.

There are at least six broad categories of modification that can be made, and various alternatives within each of those, the approach that we are using is one of looking at various combinations to see which is likely to achieve the objectives of simplification, equity, and enhancement of capital formation.

Senator BYRD. If you were going to choose one or the other, what would be your preference, looking at it from the point of view of the Nation as a whole and business as a whole? The investment tax credit, or a liberalized depreciation?

Mr. BRILL. I find it difficult to answer the question in isolation.

If you are talking about no other change in the tax structure other than choosing——

Senator BYRD. That was one of the alternatives you mentioned a moment ago, a change in the depreciation rate.

Mr. BRILL. Yes.

I would say if no other changes were made, I think that most economists would feel that the investment tax credit probably has a greater impact on inducing investment, but I may say that some of the empirical work that I have seen come up with very different conclusions.

Professor Eisner has one set. Professor Brimmer has come up with alternative results.

Senator BYRD. You have not reached a conclusion in your own mind?

Mr. BRILL. No, sir, I have not.

Senator BYRD. Senator Long?

Senator LONG. I was just thinking about some of the problems that you have to contend with. One is the fact that, down there in your Department, nobody knows how to handle a computer. The reason I say that is your people keep looking at revenue estimates. For example, you proceed on the theory that when you have a 48-percent corporate tax and a 70-percent personal income tax on what is left, that you are going to get for the Government 84.4 percent of what is earned by a company and that the individual will be left with 15.6 percent.

Now, as a practical matter, it does not work out that way. Nobody in his right mind wants to take all the risk inherent in investing his money in an enterprise if he gets 15 cents out of a dollar of earnings. All of the facts show that it does not work out that way, either. They will put their money in the tax exempt bonds rather than put it in a corporation.

Of course, they would earn less than they would on taxable bonds, but after taxes, they will earn a lot more. Some businessmen told me just over the weekend—I had a chance to make a speech before the business council and a man who has been very successful all his life said, can you explain to me why anybody in his right mind would want to put any money into bonds? The depreciation in the value of the capital is not overcome by the income that you get, and when you consider taxes, it is even worse. So his attitude would be, if you have some money that you need to invest, you had better put it in land or put it in something where that would tend to offset the erosion of inflation, so at least you would make something over and above your investment.

Now the administration is trying to work out some tax reform proposals. They say we have to reduce this silly, ridiculous rate—the combination of the 48 plus the 70, which works out to 84.4-percent tax rate. We are going to cut that down some and we are going to give a credit for the taxes that were paid at the corporate level. They will come in here showing a great big revenue loss in their estimates on the theory that people actually are investing their money when they are only able to keep 15.6 cents out of a dollar earned, and they will also come in with an estimate that will assume if you let a person keep more than 15.6 cents on a dollar, it is not going to stimulate the economy.

You and I know that something has to be wrong. There has to be an error for the simple reason you are not making any money with that kind of a deal. Nobody in his right mind is going to trade with you that way. He is going to find a way to leave his money in the corporation, until the stock goes up in value, and then he will sell the stock, or liquidate the company and take a capital gain.

But you can do all you want to try to find a way to tax that income. People are not going to do business that way. They will find another way to do business or quit doing business.

If a businessman cannot keep half of what he has, if he cannot keep anymore than 30 percent of what he earns, he is going to find some other way to do business. He just feels it is outrageous, unfair. He is being treated viciously by his government. He is going to find some other way to do business.

The result is when you bring down something that would tend to correct some of those ridiculous assumptions under which we have been proceeding in the past, you show a big loss of revenue, when, in fact, there is no revenue loss at all.

For example, when we repealed the investment tax credit we were supposed to pick up $5 billion on the theory that that was a tax incentive, which in fact, it was. But we did not pick up any $5 billion, we lost $5 billion, because the economy slowed down.

Then when we put it back on, we were supposed to be losing about an equal amount. We did not lose anything; we made some on that.

We repealed it again on the same assumption, that we were going to make money. We lost about the same amount we thought we were going to make. We put it back on again and assumed we were going to lose about $7 or $8 billion. Instead, we made the same amount.

How long is it going to take you down there to change those assumptions so that when you do something that encourages business people to do something that stimulates the economy you would make the computer cough up the answer which the economy actually comes up with? That is, that with the proper incentive, people will make their investments and the Government makes money. With no incentive, people do not make any money.

When is somebody down there going to have the courage to tell these people they have been wrong, wrong, wrong and wrong. When are you going to make your estimates come out right for a change?

I learned long ago that computers do not think. I had that impression, but they do not. All a computer can do for you is when you push a button, it can come up with an answer that was programed in to begin with.

Your people down there at the Department, do they think that the computers do the thinking?

Mr. BRILL. No, sir.

Coming, as I do, from a computer company, I am very well aware of the old adage that is repeated so often in the industry, garbage in, garbage out. The computer is not responsible for the garbage that is put in. But if you put it in, that is what you get out.

Senator LONG. Your people have yet to look at these facts. They are trying to explain why the computer comes up with the wrong answer time and again. They are trying to explain why their estimates are wrong. They are trying to explain why it is that they have never yet been able to conclude that the investment tax credit makes money for the Government. Yet they still have the investment tax credit down as a $9 billion loss. If you repeal it, you will not pick up revenue; you will lose $9 billion.

We have been through that four times; repealing and reinstituting. Do you think you can teach those people down there with the computers to look at the facts of life?

When you provide a businessman with an incentive, you can anticipate that business people will take advantage of it. When they take advantage of it, the Government makes money because it provides more production, it reduces the drain on welfare and unemployment insurance, it brings in payroll taxes by making taxpayers out of nontaxpayers. Even though you don't collect at the same rate that some ambitious English-style Socialist thinks would be a good thing for America, at the same time, collecting at a lower rate, you collect a lot more money.

Mr. BRILL. I do not know, Senator Long, if you have had the opportunity of seeing the program yesterday at noon when Secretary Blumenthal was on "Issues and Answers." One of the questions was specifically addressed to the problem that you are raising. It was put in a somewhat different framework, as to how you can meet the President's objective of not losing any tax revenues and still have effective tax reform?

The Secretary's answer is exactly the one that you were suggesting. If we get the right kind of tax reform that provides an incentive for business that will result in increasing revenues. That is, you do not lose revenues if you have a program that is structured to provide incentives that businessmen will want.

I know what the problem is, in being on the other side, of trying to establish for a company what the objectives should be. My own creed is, if I cannot return to my shareholder the amount that he would get by buying a tax-exempt security and then going home and sleeping at night and not worrying about whether I was a good business executive, I do not belong in that job.

Basically, the problem is that we have to provide some reward for risk and we have not been getting enough risk-taking in American society. That is showing up in the declining rate of growth in capital formation.

Senator LONG. Here is another thing that I think we ought to be thinking about before we make our decision. We are told if we transfer about $15 billion of "general revenues" into the social security trust fund we will be using the income tax for social security rather than using the social security tax for that purpose, or at least to the extent that we transfer it from the general fund.

I cannot buy that for a simple reason. The income is actually not covering the other expenses of Government. The way it is now, over in the Federal funds area, we are in the red by $65 billion. So the income tax is not raising enough money to put something over in the social security fund. It is not raising enough to cover the deficit in the other Federal funds.

When someone is talking about using general revenue, they are not talking about anything but printing press money. What we are covering the cost of daily Federal operations with now is printing press money. When you do that, that gets to be inflationary, and I hope we are not going to find it necessary to start this thing of using the printing press to try to pay social security benefits.

It seems to me, with the deficit to pay for foreign aid and the welfare and the general activities of Government, that that ought to be enough.

Can you see where we have any surplus of money from the income tax to pay into the social security fund?

Mr. BRILL. I believe that the deficit of the size that we have is a function of the worst recession in the economy since the 1930's. As we are able to achieve a more satisfactory rate of economic activity we ought to be reducing that deficit.

Earlier, Senator Byrd was pointing out that the estimates for next year's deficit is quite large. We hope that the economic recovery, which now seems to be resuming, will permit us to have even higher levels of revenues and bring that deficit down.

But as you say, it is a deficit. We are still in excess of our outlays over receipts.

Senator LONG. It just seems to me—and I am not going to ask you to take issue with the President or the other parts of this administration, but it seems to me that it is bad enough to have us running a deficit in the Federal funds. We ought to make these trust funds carry themselves.

My thought is we should either cut back the benefits or raise the taxes in those areas rather than having everything in this Government leaning on the printing press dollar.

If we do too much of that, you know as well as I do that after awhile you just have to keep adding zeroes every month so you start printing $1 bills, and then it is $10 bills and then it is $100 bills and after awhile you greet yourself coming back.

With all those zeroes you put on a piece of paper, it is not worth the paper it is printed on. You do not want to get us in that situation and we do not either, do you?

Mr. BRILL. No, sir.

Senator LONG. Thank you very much.

Senator BYRD. If I may say so, Mr. Chairman, your view is too sound to be accepted by the Congress and the Treasury Department.

Senator LONG. Don't blame the Treasury Department for some of these foolish things.

Senator BYRD. They come up and testify for them and urge the Congress to do something. I think that they ought to be sharing the blame. When they come to testify before the Congress, they ought to give their own true views. They could say that they cannot go counter to their boss, but I think they are obligated to give their true views.

Senator LONG. If they come down here and say the President is wrong, they might as well bring their resignation with them. They would be out of a job.

Senator BYRD. I think that is one trouble with Government. There are too many people in Government who are there only for a job and not willing to run the risk of losing their job by giving the people the facts.

Anyway, like you, I do not want to blame the Treasury Department too much.

Senator Hansen?

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

Let me say to the distinguished witness that I am pleased to be here to hear his testimony. It was interesting to me to read in the Outlook section of the Washington Post, Sunday, a summary of a paper or some comments written by Peter Jay, the envoy-designate to the United States.

He was talking about the failure of popular democracy. He points out some very elementary facts that most of us understand. If a democracy is to work, it works in all systems: how we elect, how we try to find out what the people want, how we talk to people of different views. Those of us whose view seems more to agree with the majority of the electorate eventually get to Congress and we try to implement those things that people are talking about.

He questions, I gather, whether the system can work and he gave some alarming facts that indicate that it is not working very well in Great Britain.

In that same section was an advertisement placed by a group, I am certain, of distinguished Americans. I scanned the list; I did not read every name.

Apparently they are from one end of the country to the other calling upon the President to keep his campaign promises. I am not saying that he has not. Apparently, those persons whose names were attached to that ad believe that he hasn't.

They called for a number of things, including more jobs for everybody and equalization of taxes, tax relief for lower- and middle-income people, tax reform and inflation control.

Some of the things, it seems to me, are contradictory—that we cannot have.

I mention those two articles I read because they seem to reflect even greater merit upon the observations that you have made here today.

It is a tough thing. It is a tough operation for any politician trying to secure his reelection to tell the people what he believes to be the truth as contrasted to what they might want to hear.

I happen to come from a State, Wyoming, that is a major oil and gas producer, and I am supposed to be down at an Energy Committee meeting right now, but I wanted to be here because I think what you have to say and what Alan Greenspan has to say, among other witnesses, is very important.

Whether we are going to be able to convince most Americans that certain things have to be done or not is the real test that we will face in these coming months.

I find nothing in the President's energy message that encourages me to believe that we are going to do anything more than demagog an issue that has been demagoged for 6 years, that I know of. We first started talking in 1971 about putting together an energy policy.

During that period of years, our dependency on foreign sources of supply has grown steadily. Now we are importing about 50 percent of the oil that we use. We use to talk about how serious it would be if we had another embargo.

At that time, the time of the last embargo, we were importing about a third of the oil that we used. Today, we are importing about half of it. The balance of payments problem has become very serious. It has taken a lot of money out of this economy and it contributes, significantly, I think to the overall rate of inflation.

I am one of the few politicians who say we ought to decontrol gas and oil. I think that it would be better to create more American jobs.

I need not underscore the dependence of industry upon oil and natural gas. Everyone who went through last winter knows perfectly well what happens to jobs where there is no fuel.

Yet, because the oil companies have a very bad name, because everyone knows everyone in the business wears a black hat, it is a very easy thing for politicians to get up and demagog this issue and say, we are going to keep a cap on oil prices because we do not want to hurt poor people.

Senator Long tells a good story about the lady who came into the little grocery store and wanted to buy a dozen eggs and she asked what they cost. The merchant said they are 40 cents a dozen, and she said, the merchant down the street sells them for 30 cents a dozen.

He said, why don't you go down there and buy them?

She responded that the fellow is out of eggs, and he says—the merchant with whom she is talking—well, if I were out of eggs, I would sell them for 20 cents a dozen.

I like to tell that story. I do not tell it as well as Senator Long does, but it needs to be told because that is exactly what we are doing in energy.

We can talk about how we are going to keep the prices down. We have done a good job doing that. We have also done an excellent job of curtailing domestic production.

There are those persons that recognize that oil and gas are finite resources. The thing we fail to consider is the volume of sedimentary rock that exists on the Outer Continental Shelf, the rock which has not been explored in the lower 48 States, the reserves, and the potential for oil and gas development that we have in Alaska. There is a whale of a lot more of cubic miles of sedimentary rock yet to be explored.

I have no doubt at all but that we are going to run out. I do say that there is enough potential there for development if we will give this domestic industry the encouragement that it needs. That means a chance to make a profit and the expectation of the profit. We can minimize our dependence on these foreign sources of supply to give us the leadtime we need to get on with some other forms of energy that can make up the difference.

I say this now, because not only is there the chance of another oil boycott, but there is also the great danger, and a growing danger, with the emergence of the Russian Navy as the No. 1 force in this world and the far greater number of Russian subs than there are American subs. American vessels will become particularly vulnerable to the Soviet presence in Africa, because Russian subs are moving down both sides of that continent.

If their subs were not enough to pose a real threat to that tanker fleet which has to go around the Cape of Good Hope every 15 minutes, because 15 percent of the Free World's petroleum sources are in the Persian Gulf area, they will have a land base there too. There is no doubt at all that they can control the sea lanes for a thousand miles.

So I think it is an extremely serious situation. I think we have been demagoged on the tax issue. We have done everything but recognize that if we want to increase the standard of living—you pointed this out very clearly in your testimony here—we must give workers a tool, and we have not done it. We have not put investments back into industry comparable to the number of new workers that we have placed in industry.

And whether or not—I think Peter Jay summarizes it very well—whether or not we can rise to that degree of objectivity which will give us the opportunity to make the right choices remains to be seen. It is sure a longtime past the time when we can afford any demagoguery. There will be plenty of it floating around there in the next few months.

Mr. Chairman, I share your view about how important it is to put money back into industry so that we can continue to achieve our objectives.

Whether we can do that or not is the test.

Thank you for your testimony.

Senator BYRD. Thank you, Senator Hansen.

Senator Packwood?

Senator PACKWOOD. Mr. Brill, on page 3 of your statement, you refer to the greater productivity increase in the last decade to 1.5 percent. Is that true that is the worst, or the lowest, productivity increase for any of the industrialized nations of the world, including Germany and Japan?

Mr. BRILL. I am not sure offhand. I have a feeling in this decade that it would probably rank at the bottom, but not necessarily as the worst.

Senator PACKWOOD. Could you give me the figures on that? I am under the impression that it is the worst, including Great Britain.

Mr. BRILL. That is the exception I had in mind. Perhaps with this time period, you are right. I can find out.

Senator PACKWOOD. If you could get them to me personally, I would appreciate it.

[The following was subsequently supplied for the record:]

TABLE.—TRENDS IN MANUFACTURING PRODUCTIVITY IN THE MAJOR INDUSTRIAL COUNTRIES, AVERAGE ANNUAL RATES OF CHANGE

Country	1956–66	1966–75
United States	2.8	1.6
Canada	3.9	3.6
Japan	8.9	8.8
Belgium	n.a.	8.1
Denmark	4.8	7.6
France	5.2	4.8
West Germany	6.1	5.2
Italy	6.0	5.2
Netherlands	5.2	6.9
Sweden	5.9	5.4
Switzerland	n.a.	4.9
United Kingdom	3.4	3.0

Source: U.S. Department of Labor, Bureau of Labor Statistics, Office of Productivity and Technology. Based on estimates for 1975.

Senator PACKWOOD. Thank you, Mr. Chairman.

Senator BYRD. Just one or two brief questions, Mr. Secretary. We might as well put in the exact figures we have on the deficits.

The OMB estimates for fiscal 1978 projects a deficit of $57.9 billion which is the figure you gave. The congressional budget resolution which was approved last week projects a deficit of $64.65 billion, which can be rounded to $65 billion for fiscal year 1978.

Now, you have mentioned integration of personal and corporate income tax. How would that be done, if that is to be one of the recommendations?

Mr. BRILL. There are a number of alternative ways of proceeding with integration. One way is to simply attribute to individual taxholders all of the income of corporations, just pass it through to them as though corporations were comparable to noncorporate enterprises.

Senator BYRD. Am I correct, is that not what the AFL–CIO has recommended?

Mr. BRILL. I do not know their recommendation, sir.

Senator BYRD. The Americans for Democratic Action? Have they recommended that?

Mr. BRILL. I do not know.

Senator BYRD. What is your view on that?

Mr. BRILL. We are right in the midst of studying that. I am not in a position where I could express a view, a preference, for one or the other.

Senator BYRD. I am not asking for your view as to a preference. I would like to have your view as to whether or not that is a logical thing to do.

Mr. BRILL. Yes; it is logical but it has certain deficiencies in it, because it does raise problems for individuals who will find themselves being taxed at a rate on income that they have not received.

Senator BYRD. Is that fair?

Mr. BRILL. No; I do not think that it is fair. One has to be sure that individuals have the income in hand in order to pay the taxes that are being levied on them.

Senator BYRD. The average corporation pays what percentage of its profits in dividends?

Mr. BRILL. Roughly in the 30's.

Senator BYRD. A person, whether it be a man, widow, or whomever it might be, who owns shares of stock in that corporation, would be paying a tax on 100 percent, yet would be receiving a dividend of only 30 percent.

Mr. BRILL. As I say, one of the deficiencies in that approach is that an individual would be paying taxes on income accrued, but not necessarily paid to him.

Senator BYRD. In your judgment, is that a sound approach?

Mr. BRILL. No. You asked whether it was logical. I said that there is a logic to it. I am not saying that it is equitable or fair.

Senator BYRD. I gather from what you say that you personally do not regard it as a sound approach?

Mr. BRILL. Under that criteria, requiring people to pay taxes on income they have not received, no, I do not regard it as a fair approach.

Senator BYRD. The Americans for Democratic Action, Senator Long tells me, have advocated that approach. I agree with you. I do not think it is fair or reasonable at all.

Mr. BRILL. I find it rather difficult myself to be in that position.

Senator BYRD. If a person, whoever it might be, owns a share of stock, you tax him on 100 percent of the profit of that corporation, yet they receive only a 30-percent dividend. I do not know how you will get people to buy stock on that basis.

What other approach would there be?

Mr. BRILL. There is the possibility of allowing corporations to deduct, to treat dividends the same as interest.

Senator BYRD. What do you think of that?

Mr. BRILL. It answers one objective. It makes it equally advantageous for a corporation to finance through equity as against debt. That has been a problem.

I think I indicated in my paper one of the problems of financing through debt. We have created a debt-heavy financial structure that inhibits the kind of venture capital approach that we need in our society.

We are not accustomed to debt-equity ratios of the kind you find in some other societies, like Japan, where, for entirely different reasons, they are able to finance in a 25 or 30 to 1 debt-equity ratio. That is not acceptable here.

We find it has resulted in a tilt of the tax structure toward debt financing, and is indeed an inhibiting factor on the formation of capital. Therefore, an action that would move payment of dividends and interest into closer consonance would be favorable from the viewpoint of aiding the corporate balance sheet.

Senator BYRD. How else can you integrate?

Mr. BRILL. There are a number of variations where, instead of requiring or instead of permitting the dividend payment to be deducted by the corporation and treat it simply as you would interest expense. There is the approach of allowing the individual to receive the dividend, but then have a tax credit for the amount of the tax that the corporation has paid.

Both of these approaches have technical problems. Both of them have some advantages. I am not technically proficient enough to indicate which is preferable, but I think that the basic objective of both approaches is to make the payment of interest and payment of dividends a more equal choice by corporations under the tax code.

Senator BYRD. One final question.

What three steps in the tax field do you think Congress should take to be the most effective in encouraging capital formation?

Mr. BRILL. When our proposals are submitted to the Congress, I would hope they will be given very thorough examination. But I think the general approach that we are taking should be encouraged. That is the desire to develop a tax structure which will be conducive to capital formation.

Senator BYRD. That is broad. Could you not give us two or three concrete suggestions that you think would be the most concrete ways that we could achieve that?

Mr. BRILL. Yes. I really think that hearings such as those you are conducting right now are very important to get all the views—and there are contrary views.

I alluded earlier to the fact that economists are not in agreement. That is not unusual; economists generally are not in agreement, but there are many people who have different views, not only economists, businessmen, labor leaders, agricultural leaders. All of them have their views on what is best, not only for their own group but their views on what is needed for the country.

I think we should be getting these views, getting them on the table and getting an assessment of how various alternatives can meet the objectives, keeping in mind that there are multiple objectives; the objective of simplification and equity have to be balanced with economic effectiveness.

Senator BYRD. I think so. That is the objective of these hearings, to be helpful—helpful to the committee and to the administration and the Congress—in formulating new programs and policies in the tax field.

I might point out that I have found my talk with you in my office tremendously interesting. You devote a great deal of attention and time to your mail. As a result, you realize that there is a great diversity of viewpoints throughout this great country of ours.

I just want to commend you for the many hours and the tremendous amount of time that you do put on your mail. I spend much time on my mail. It encourages me to know that you, in your position as Assistant Secretary of the Treasury, find it helpful.

Mr. BRILL. It does, sir.

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

[The prepared statement of Mr. Brill follows:]

STATEMENT OF THE HONORABLE DANIEL H. BRILL, ASSISTANT SECRETARY OF THE TREASURY FOR ECONOMIC POLICY

Mr. Chairman and Members of this distinguished committee: It is indeed a privilege to appear before this Committee today to lead off a discussion of the problems of incentives for economic growth, particularly incentives to increase the rate of capital formation so essential for sustaining economic growth.

In addressing these issues, we all recognize, of course, that we are not invading virgin territory. The problem has been the subject of intensive examination by economists, lawyers, business and labor leaders and by officials in the Executive and Legislative Branches of government over an extended period.

Having followed the course of these discussions over the years, from several different perspectives, I am encouraged by the growing coalescence of views on some key aspects of the problem. I think it fair to say that there is today, much wider acceptance of the theses that:

(a) there is a need to accelerate the rate of growth of our capital stock;

(b) government policies—not only the general tools of economic stabilization, such as monetary and fiscal policies, but also regulatory and tax policies—play a key role in determining the rate of capital growth;

(c) encouraging the rate of capital growth involves, importantly, the removal of impediments in the saving/investment process as well as the development of new inducements to higher levels of saving and investment.

Before turning to aspects of the problems on which there is less agreement, let me address what I think are the principal factors underlying these three generally accepted theses.

Recognition of the need to accelerate the rate of capital formation has been spurred, in recent years, by increasing evidence that productivity in the U.S. economy has deviated significantly below the earlier long-term growth trend. Ultimately, the increase in real returns to the factors of production, that is, the possibility of raising everyone's living standards, depends on the growth of output per unit of input. This sets the limit for our society as a whole. Disturbingly, in the past decade, the rate of gain in productivity has slowed significantly, limiting the possible growth in living standards and contributing to upward pressure on prices.

A substantial growth in productivity, averaging 2.9 percent annually in the nonfarm business sector, was a major contribution to the low inflation rate of the 1956–66 period. The data for the last decade, however, indicate that productivity increased at an average of only 1.5 percent per year. For the private sector as a whole, labor productivity growth was slightly more rapid because of a continued shift of employment out of agriculture into the nonfarm sector, where labor productivity is higher. However, a significant decline is equally evident for the private sector as a whole.

Of course, the decade of the mid-1950's through the mid-1960's was a period of rapid economic growth, terminating in a year of exceptionally high resource utilization. In contrast, the latest decade includes two severe recessions, and terminates in a year of low resource utilization. But even after adjustment for cyclical influences, it appears that the secular rate of productivity growth slowed perceptibly after 1969.

This slowdown in productivity growth has been attributed to a variety of causes—reduction in the workweek, slower growth in productive capital per worker, shifts in the composition of output to low productivity sectors, shifts in the composition of the workforce toward workers with less experience and fewer skills, and to a miscellany of other causes. For the most recent years, the drop in productivity after 1973 can be explained by the impact of the energy crisis, and the subsequent rebound in productivity in the past two years to the normal cyclical effects accompanying the economic recovery that began in early 1975. But these fluctuations have occurred around a level far below the long-term trend growth rate extrapolated from the experience of the 1950's and 1960's.

It is clear that no one factor satisfactorily explains the slowdown in productivity gains. But I am persuaded that the slower growth in the capital stock per worker has been one of the most important factors. I should hasten to emphasize that this has not been so much the result of a slowing in the rate of growth in the capital stock *per se*. There is some evidence that in recent years, the capital stock has grown at a somewhat slower pace than earlier, but the principal factor in the declining capital/labor ratio since 1969 has been the sharp acceleration in the growth of the labor force. In other words, we haven't been creating the tools of production as rapidly as we have been creating workers willing to use them. The amount of capital per member of the labor force grew by 3 percent per annum in the first two postwar decades. So far in the 1970's, the amount of capital per worker has grown at only half that rate.

The implications of such a trend are disturbing, not only for the effect on inflation of reduced productivity but also for the substainability over the longer term of an adequate growth rate for the economy as a whole. The benchmark study of the capital requirements of the U.S. economy, undertaken by the Department of Commerce two years ago, concluded that to assure a 1980 capital stock sufficient to meet the needs of a full employment economy, business fixed capital investment would have to absorb some 12 percent of real GNP in the second half of this decade. So far into the period, that is, in 1975 and 1976, fixed investment has been less than 10 percent of real GNP, so the gap to be filled in the remaining years would require an even faster rate of growth in additions to our capital stock than was postulated in the study.

In summary, then, we need more capital formation, both to restore productivity to the growth track of the 1950's and 1960's and also to provide the tools of production for a full employment economy in the 1980's.

What private and public policies can facilitate the needed growth in capital formation? The answer was best put, in my judgment, in a report issued last October by the Fifty-first American Assembly, when a distinguished group of academic, business, labor and government leaders met to consider the capital needs of the United States. The final report of the Assembly noted: "The single most important means of encouraging investment expenditures is to combat economic instability and inflation."

Wide fluctuation in economic activity induce excessive caution in investment decisions. After all, whatever else may be done to increase the cost effectiveness of new investments, entrepreneurs have to have confidence that a market will be there for the products that will be produced in the plants in which they are investing. Instability in the economy breeds uncertainty, and uncertainty diminishes investment propensities.

Inflation and expectations of inflation are also adverse to investment. Businessmen no longer rush to accelerate expansion plans to "beat the price rise"; the experience of recent years has taught that by the time a new facility launched in the feverish atmosphere of inflationary momentum is likely to come on a stream, a post-inflation recession will probably have dried up the intended market. And consumers have long displayed the wisdom of reducing major outlays when inflationary forces gather momentum.

The major contribution of public policy to capital formation, then, is the creation of a stable and noninflationary economic environment. The Carter Administration has expressed its dedication to this objective. The actions taken by the President to date to insure noninflationary growth, and the President's commitment to pursue this course into the ftuure, should provide confidence to businessmen and consumers that the economic environment will be propitious for capital formation.

There are, in addition to the pursuit of macroeconomic policies conducive to investment, specific policy areas addressing the capital formation problem. Principal among these is the tax structure. As this Committee knows, the Treasury has under way a major reexamination of our tax system, with the view to proposing to the Congress significant revisions. That study is not yet comlete. However, it will be submitted sometime this summer or early fall; every effort is being made to reach conclusions as soon as possible.

Over the years, there have been many proposals for modifying the tax structure to enhance incentives for adding to our capital stock. The excellent study prepared by the Joint Committee on Taxation, released last month, classifies these proposals under six broad headings: proposals for the integration of corporate and individual income taxes, investment tax credits, modification of depreciation allowances, changes in the corporate tax rate, deduction of losses, and indexing for inflation. Each of these approaches, individually and in various combinations, is being carefully assessed.

The criteria that are being applied in the Treasury's evaluation of all revision options relate to three general considerations: simplification, equity and economic effectiveness, particularly in enhancing capital formation. The need for simplification is self-evident to anyone who has struggled through the preparation of an income tax return. It is only about a month since many of us have had to suffer through this annual exercise in frustration. But the complexity of the return is a function of the complexity of the law; simplification of the law will permit the design of a form more easily comprehended by the bulk of taxpayers.

The need for equity is also self-evident. Our tax system is unique in the extent to which it depends, successfully, on the voluntary participation of those subject to the system. That success can be maintained only if all taxpayers are convinced that the burden is being shared on an equitable basis. Equity considerations require correction of imbalances in the present tax structure that may be penalizing one form of income-generating income as against another, individual taxpayers as against businesses, small enterprises as against larger firms.

The need for an economically effective system, particularly one that facilitates capital formation, is evident from the analysis advanced earlier as to the economy's need for an accelerated rate of investment. One aspect of the tax structure with particular relevance to the problems of adding to our capital stock is the impact of taxes on the form of financing new investment. Our financial system is justifiably renowned for its capacity, scope, richness of form and resiliency. It functions with remarkable efficiency in gathering the savings of the public and transforming these into the means of financing private investment. Nevertheless, there is concern that the availability of financing—in both appropriate amount and form—is, or could become, an impediment to the necessary growth in our capital stock.

One fundamental problem is the tilt of the system toward financing through debt instruments. Savers appear, in general, to prefer acquiring financial assets of fixed nominal value and fixed income return—a preference that persists despite the postwar erosion in the purchasing power of fixed-value claims. Moreover, our present tax system encourages the financing of investment through debt instruments.

Over the longer run, this is not the ideal arrangement; there are limits to which it is prudent or even feasible to pile increasing amounts of debt on a very slowly growing equity base. A debt-heavy financial structure increases the vulnerability of the business enterprise to cyclical fluctuations in income. It limits the venturesomeness of investment, for lenders cannot in good conscience underwrite the risks appropriate to an equity participant. And it inhibits economic growth because growth depends very much on willingness to risk investment in new products and new processes.

Moreover, the emphasis on debt financing raises particular problems for smaller and newer enterprises, which often lack the track record necessary to attract adequate amounts of financing from lenders, and must therefore fight for access to pools of equity financing.

Many proposals have been advanced to modify the tax structure in order to achieve more even-handed treatment of alternative means of financing investment. These proposals are all under active study.

As the Committee can well imagine, such a comprehensive assessment of the tax structure as is now under way is no mean task. Within each broad category of tax modification proposals mentioned earlier there are many variants to be pursued. There is a decided lack of unanimity among economists as to the economic "pay-off" of the various alternatives, and reasons for these differences in view must be explored. Foreign experience with some of the alternative approaches must be evaluated in terms of their possible relevance to U.S. problems. The relationship of the various alternatives to the tax measures and innovations incorporated in the National Energy Plan must be assessed.

Finally, the consistency of various alternatives must be established with the Administration's goals of reduced unemployment, reduced inflation and a balanced Budget by fiscal year 1981. I might note, in concluding, that achievement of these goals depends importantly on maintaining a high rate of growth in investment over the balance of the decade. The Committee can be assured, therefore, that the tax revisions recommended will contribute to this objective.

Senator BYRD. The next witness is one who has been before this committee many times, one in whom the committee has a high regard, and one in whom the committee has great confidence, and the committee is most pleased to welcome back Mr. Alan Greenspan, the former Chairman of the Council of Economic Advisers.

I want to welcome you, Mr. Greenspan, both on behalf of the committee and on behalf of myself. I am personally very pleased to see you again. I appreciate your coming here today. You may proceed as you wish.

STATEMENT OF ALAN GREENSPAN, FORMER CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. GREENSPAN. Thank you very much, Mr. Chairman, especially for those kind words.

To save the committee time, I would like, if I may, to briefly outline the content of my formal statement and request that the full document be submitted for the record.

The issue which I think is critical to these hearings—and perhaps to national economic policy more than most of us are aware, is the need to create improved incentives for capital investment in this country.

If one looks across the spectrum of the major industrial countries of the world, what strikes you most is the extraordinary shortfalls that now exist with respect to real investment, not only in the United States, but also in virtually every industrialized country in the world.

We are increasing our investment rates at the moment, but even as we are doing that, they are still far less than what we would normally expect, granted the levels of economic activity, granted the levels of capacity utilization, granted the levels of profitability.

Clearly, something is wrong. My suspicion is that this deficiency in investment, and therefore, in real income growth, is caused by a massive increase in uncertainty.

Senator BYRD. A massive increase?

Mr. GREENSPAN. A massive increase in uncertainty, a shortfall, a failure, deterioration in business willingness to invest, particularly in longer lived capital assets. The reasons for this, Mr. Chairman, are, I think, fairly obvious but the solutions are not.

First, it is clear that inflation and the great instability that it has generated, both in this country and around the world, has increased the risk premiums employed in evaluating projections of future profitability. Most business investors, and most corporate planning committees have a sense of instability and frenetic activity about the future that, requires that they increase the prospective rate of return on any new facility in which they will invest.

In a sense, the required rate of return has obviously risen, and risen quite signficantly, which means that any particular project that is evaluated for investment must look a lot better than it used to before business will invest in it.

Second, we have had a dramatic increase in regulatory change. There are two ways of looking at this question. One is, to look at the costs of the new regulations as they embody themselves in the costs of production. This is a calculable number and one which I do not believe very greatly inhibits capital investment. It does in part, but not greatly.

What does, is the rapid changes in regulation and the uncertainly that most businessmen feel about what new regulations will be put in place.

The most recent example, in my view, is the proposal put forth by the current administration with respect to energy regulation. It is stated, I think in many respects probably correctly by the administration, that the incentives built in to their recommendations with respect to the expansion of crude oil supply are probably quite significant; they say that there will be, in a sense, free market prices for a number of types of so-called new oil.

It you read the regulations, that is what it says.

The problem, however, is that most everyone has become sufficiently sophisticated to know that if you have a regulatory apparatus in place whose legislative requirement is to make regulations, it is also in the business of making them and changing them and making new ones. It is indeed the rare, regulatory apparatus which creates a whole series of regulations and then self-destructs.

Therefore, even though it is true at the moment that we are looking at a proposed set of regulations that creates large incentives for a number of various types of oil projects, the risk that those regulations will change before the investments were put in place, certainly before the returns have been derived from those investments, is perceived as very large.

Parenthetically, I find it rather odd, if the administration is willing to bite the major bullet on the oil issue, namely proposing oil product prices go to world market levels through taxation, why it does not argue for full decontrol.

If you eliminate the regulatory apparatus through decontrol, then you remove the latent uncertainly that these regulations will be easily changed.

This is a very major issue which I do not believe has been sufficiently focused on. This energy proposal has in it essentially world oil prices for consumers, and very substantial taxation to do so. Even though I would not necessarily approve of this, but if the administration had recommended complete decontrol and 100-percent taxation on old oil, they would get the same tax revenues, the same prices for consumers, and very substantially increase the incentives, merely because the regulatory apparatus would be disengaged in the process of decontrol.

I choose this particular example, Mr. Chairman, because we do not realize, I believe, that we are moving toward more and more uncertainly creation within the Federal Government, through continuously changing regulation. I fear that rather than resolve the major energy problem in this country we will impede it. Increasing rather than decreasing regulation is the wrong way to go.

It may well turn out that there is in fact—very little in the way of crude oil reserves still to be discovered.

But granted our problems, we cannot afford not to turn every single knob that we can find to enhance our capacity to achieve these additional reserves.

The concern we have of oil companies' profits is an issue I do not think we can afford. Energy policy in this country should be largely, if not wholly, focused on what is good for this country, what is good for our economy, what is good for the American people, not what is good or bad for the oil companies.

Assailing oil companies and oil company profits, it is a luxury that I think we, as a people, cannot afford. There is too much at stake here to be concerned whether something is good or bad for the oil companies. The criteria should be whether it is good or bad for the American economy and the American people.

Senator BYRD. I think so. If you broaden the scope beyond the energy question, beyond the oil company problem, let me ask you, what two or three steps in the tax bill do you think the Congress could take which would be the most effective in encouraging capital formation?

Mr. GREENSPAN. First, Mr. Chairman, we must be careful in looking at taxes that the major force which could destroy capital investment is inflation and, if, in the process of constructing our fiscal policies, we inadvertently create large deficits, we will find whatever policies we have in the tax area will be self-defeating.

Every policy must be in the context of gradually reducing the budget deficit to remove the inflationary imbalances and the pressure that Federal borrowing has on the capital markets, which would, more than anything else, undercut any strength in the capital investment area.

Having said that, I would say that the most important thing that should be done is to cut the corporate income tax. It is a far more important thing to do than a number of the other proposals that we tend to get involved with with respect to trying to enhance capital investment.

I do think the investment tax credit is a valuable tool and I do agree with your view that whatever we do with it, let's stabilize it and not continually change it.

One change, if we could make it, and lock it in place, which would be helpful, would be to remove the bias which now exists in the investment tax credit toward enhancing investment in short-lived as distinct from long-lived assets. Because of the flat 10 percent credit, it turns out that it unduly enhances incentives to invest in 5-year assets and for longer lived assets it is a gradually diminishing force.

Since the major element in the recent shortfall in capital investment is in long-lived assets, I would suggest that the committee take a close look at having the investment tax credit rising with the life of the asset to neutralize this bias toward short-term assets.

The last economic report of the Ford administration's Council of Economic Advisers attempted to outline this problem and showed in a table the biases which are inherent in the existing tax law. That would be the only significant change, sir, that I would recommend in the investment tax credit, and I certainly hope that thereafter there would be a tendency not to further alter this valuable vehicle.

Finally, there would be unquestionably, great advantages in accelerating depreciation which, I think, results in spurring investment about as much as an investment tax credit considering dollar-for-dollar revenue loss. With respect to the issue of eliminating the double taxation on dividends the so-called integration question, I fear the term "integration" is getting to be used in much too general a way.

How one creates integration very critically affects the impact.

The major thrust of this type of legislation should be, in my view, to basically improve corporations' capacity to invest and I would tend to focus more on the issue of the deductibility of dividends in a manner similar to the reduction of interest in order to avoid a very marked imbalance between debt and equity.

There is however a major problem with that, Mr. Chairman. In a sense, if you keep the corporate tax rate where it is and you allow dividends to be deducted, you tend to impose a 48-percent tax on undistributed earnings. This might create a much larger amount of dividends than is, in fact, a sensible thing for a corporation to do.

Integration is also used to mean imputing all corporate income to shareholders. But in the context of the top-70-percent bracket, it probably overtaxes incentive when it is passed on, especially for those who are in the upper-income brackets.

I would therefore say that one thing which should be thought of in terms of this type of integration is to reduce the 70-percent rate to the 50-percent rate and, tax earned and unearned income at the same rate, at which point it would then make sense to go to full integration in the sense of treating a corporation, and taxing it, as though it were an unincorporated business, or a Subchapter S corporation. If so, you would then not get the problem to which Senator Long alluded earlier in these hearings; namely compounded a 48-percent rate with the 70-percent rate.

Ideally I would opt for full integration, but as a part of that, I think it would be necessary to reduce the highest marginal tax rate for it to be effective as an incentive creator in the capital investment area.

Senator BYRD. Summing up your remarks, I judge that you feel that the greatest long-range threat to our economy is inflation?

Mr. GREENSPAN. Yes, sir.

Senator BYRD. On the question of integration of personal and corporate income tax, it seems to me that this is an immensely difficult matter to work out. I would like to see something accomplished in that field. I have never been able to get my mind clear as to just how we could realistically accomplish it.

No. 1, we would have to rule out the recommendation of the Americans for Democratic Action that you would tax the individual stockholder on the total profits of the corporation. As I understand, the way that would work—assuming 30 percent of the profit is distributed—if a person were entitled, under the present system, to a $300 dividend on which that person would then pay tax, that individual would be taxed on a $1,000 dividend and still only receive $300.

That would be totally impossible, would it not?

Mr. GREENSPAN. Mr. Chairman, if earned and unearned income are both taxed at 50 percent and some means for corporate withholding of taxes on dividends could conceivably be worked out, then the problem would be much more easily handled.

There is no question if you have a situation where you maintain a 70 percent maximum marginal rate there is an undue and excessive burden on individual taxpayers. The purpose of integration is to enhance capital investment not impede it.

Senator BYRD. In regard to the investment tax credit versus a more liberalized depreciation schedule, if you had to choose between the two, which would you prefer?

Mr. GREENSPAN. At this particular stage, if the choice were, for example, increasing the investment tax credit or accelerating depreciation, I would tend to opt for the latter, largely because the investment tax credit, by its nature, tends to be focused on shorter lived assets, while the incentives that we need now are in the long-lived assets that includes heavy construction. Accelerated depreciation, would enhance investment in the areas where I believe we need it the most. One of the problems that I do have with the investment tax credit, even though I do support it wholly, is this bias toward short-term investment and its failure to cover the full spectrum of capital investment, both plant and equipment, whereas, accelerated depreciation, would act to cover both and to tend to move incentives into longer lived assets.

Senator BYRD. Thank you.

Senator Long?

Senator LONG. Thank you very much for your statement.

Senator BYRD. Senator Hansen?

Senator HANSEN. Mr. Greenspan, some people have recommended that there is an unfairness, inherent unfairness, in the capital gains tax for the sale of an asset held—it used to be 6 months, now it is 9 months, and then we go to 12 months next year.

There have been some who suggest that there should be a declining scale of taxes applied that will reflect the increased period of time over which an asset is being held.

What are you views on that?

Mr. GREENSPAN. Senator, let me answer the question in a broad way.

I believe we have been moving, in the last number of years, perhaps by inadvertence more than with purpose, of increasing taxes on capital investment, and on incentives. It is by no means an accident that we are now running into concerns with respect to capital investment shortfalls and its effect on growth and standards of living of the American people.

I would not focus solely on any specific tax, but clearly we are gradually removing the tax preference on capital gains. The marginal rates are now up to close to earned income rates.

If we had, for example, the type of implied indexing that you suggest on capital assets, that would clearly move us back, in many respects, to where we used to be and improve the incentives for longer term investments. That is the direction in which we should be going.

If we could alternately, or in addition, treat earned and unearned income equally and reduce the maximum rate of taxation to say, 40 to 45 percent, while eliminating the capital gains tax preference completely, we would probably be moving in the right direction.

What I am concerned about is not any particular tax. Yet, it would be desirable to index capital gains, other things being equal. Indexing capital gains and simultaneously, eliminating tax preferences on capital gains would also be useful as a tradeoff.

I am inclined to support anything that reduces the tax on capital gains and anything that reverses the direction that we have been inadvertently and unfortunately following.

Senator HANSEN. Thank you very much. I have no further questions.

Senator BYRD. Thank you, Senator Hansen.

Mr. Greenspan, would you list for the record the current sources of capital available to business for investment?

Mr. GREENSPAN. First of all, most businesses start with their internal cash flow which, as you know, Mr. Chairman, has been declining. I should say its growth rate has been declining in recent years, along with what I am sure is a decline in the rate of return on facilities.

Second is, the equity market. The volume of financing tends to move up and down with the market value of securities; and here too, for reasons that I outlined at the beginning of my presentation, the factors creating uncertainty in capital investments have also created similar risk premiums for equities.

Price-earnings ratios have fallen, which is another way of saying that the rate of discount on expected future earnings has risen so the same force that has inhibited capital investment has inhibited the market value for stocks, and as a consequence, the cost of capital to corporations.

Finally, there are debt issues that have been, to a greater and greater extent, the source of capital for investment in this country.

We have unduly increased that debt rate. Rising debt-equity ratios have probably been a factor in causing a greater sense of instability in the business community and a factor which probably tend to accelerate inflationary pressures.

Senator BYRD. Is there a shortage of capital or only a shortage of investment, due, perhaps, to a lack of business confidence?

Mr. GREENSPAN. I do not think there is a true shortage of capital. There is no physical shortage. It largely depends on the willingness to invest in the future.

In essence, there is no shortage of capital. There is a shortage of confidence.

If confidence were restored, we would have all of the capital invested that we conceivably would want and many of the problems which now assail this economy would, in my view, disappear.

Senator BYRD. The key word is confidence?

Mr. GREENSPAN. That is right.

Senator BYRD. How much emphasis would you place on the need to encourage personal savings as a part of the capital formation package?

Mr. GREENSPAN. I am inclined to agree with Assistant Secretary Brill that the aggregate amount of savings per se is very difficult to alter in a useful way. This is why I have always thought that the major action that the Federal Government could take to enhance savings for the private sector would be to reduce the Federal deficits which directly drain savings from the personal sector. Also needed is to reduce very large, off-budget financing and the large guarantee programs. We do not place these guarantee programs in the budget, but they have precisely the same effect in absorbing private savings and reducing the amount of savings available to the investment sector, as does direct Treasury borrowing.

Similarly, all the regulations that require corporations to invest in, say, pollution control equipment drain savings. The effect on savings is the same as the Government borrowing those funds and lending them to the company to make that investment.

Rather than thinking in terms of enhancing personal savings, I think the focus should be on reducing the direct drain on overall savings coming from the Federal sector and the indirect drain which it imposes through guarantees and regulations. In that respect, it can do more to create increased private savings available for capital investment for economic growth.

Senator BYRD. In that connection, a corporation in Virginia whose manager came to see me last week, earns roughly $3.6 million. It has been ordered by the Government to convert to coal, and the estimate of the cost to do that is $30 million, about 10 years' worth of profits.

I would think that a corporation faced with that choice would have a pretty difficult time staying in business, would it not?

Mr. GREENSPAN. Yes, sir.

Senator BYRD. What we need to do is create additional job opportunities rather than eliminate job opportunities, yet we are faced with a need to convert from oil to coal.

When you add up all of those factors, where is the priority line in that area?

Mr. GREENSPAN. First of all, as I said earlier, Mr. Chairman, one thing that I think can specifically assist in the resolution of this problem is decontrol of crude oil at the well. If we decontrol, many of the applications that are moving toward the use of oil and gas will, of necessity, begin moving toward coal, not because it is mandated by the Federal Government, but because it is a far more sensible approach in meeting company requirements.

I am not saying you are going to solve all of our problems that way. I do not think, in fact, that you will. It is unquestionably a particular policy option that has very great effectiveness that we are not using, and to try to resolve our energy problems with our most important policy vehicle out of use is making it exceptionally difficult and forcing us to come up with types of solutions just alluded to.

I do not think that you can, in fact, mandate that sort of situation.

Senator BYRD. If you decontrol oil and natural gas, that would not, in itself, eliminate the need of conversion to coal.

Mr. GREENSPAN. What it would do is price oil, coal, and gas in a way that users will move toward coal. I have heard a number of people in the business community say there is no way to reach our necessary coal production goals without such changes, and without some rethinking of the types of environmental regulations that we have.

We have a very serious energy problem, in my view. What we are trying to do is resolve it in ways that give us a very low probability of actually solving it. If we were to have some changes in environmental legislation and were to move toward decontrol in a phased manner on oil and natural gas, the incentives to create much higher levels of coal production will be there. Because of the differential in reserves that now exists, it is quite likely that coal would become a far cheaper fuel than oil or gas in which case you would tend to get a market increase in the consumption of coal and hence in the profitability of mining. And the solution of the particular problem that you raise, would not need mandation by the Federal Government to switch from oil to coal. It would be in the interests of the companies to do so.

Senator BYRD. If you were charged with formulating capital formation proposals aimed at helping small to medium sized corporate and nonincorporated businesses, what would be your recommendation?

Mr. GREENSPAN. Aside, sir, from the general recommendations with respect to tax policies I do subscribe to making permanent the lower first bracket rate on smaller corporations. Moreover, I found in talking to a number of small businessmen, the greatest problem for them is the very large amount of regulation to which they are required for adhere.

Many of them do not have the means, or the particular accounting firms or large tax lawyers that the large corporations have to deal with this. They are overburdened with regulation which essentially inhibits their willingness and their incentives to expand.

I have run into situations in which some of the regulations that have come from Washington for several small businesses were too obscure for the individual to understand. He may be a good businessman, in the type of product he is in, but he is not a lawyer. They do not know what to do.

They obviously want to adhere to the law in every way that they can. They do not know how to do it, and this, in my view, if it continues, will undercut this very vital segment of our economy.

So simply, I would say a simplification and reduction of regulation, especially for small business, will do more to enhance expansion and investment in small establishments than anything I could think of.

Senator BYRD. I was talking the other day with a very able individual who has had a bit of experience in the tax field. He feels that in regard to depreciation that a business should have the right to set its own depreciation schedule and to write off the equipment—speaking of the equipment right now—in 1 year, if that business desires, or to write it off over a longer period of time.

Would that, from the point of view of the Government as well as the point of view of the business, would that be a practical or reasonable thing to do?

Mr. GREENSPAN. The only sensible thing a businessman should do, if confronted with those options, is to write it off immediately. The only reason he might not is that he might not want to make his reported earnings to shareholders reflect it.

But I find that, a rather irrational point of view. While I would certainly be in favor of as short a schedule of depreciation as possible, I do not think, as a practical matter, that you can leave it to the businessman's full discretion, because any sensible businessman would then choose—provided he has a tax liability—to write it off immediately. If he does not, it is for nonsensible reasons.

Senator BYRD. Of course, if he writes it off in a very short period, in 1 year, 2, 3, or 4, then of course, then his tax liability after that will substantially increase.

Mr. GREENSPAN. However, what it amounts to is that he has, in a sense, an interest-free loan from the Federal Government owing to a delay in his tax liability.

You will find, if you go through the arithmetic, that it will always pay to continuously defer taxes, even though the absolute dollar amount that is paid will, if legislation does not change, be the same. You are saving the interest on the loans to pay the taxes earlier.

Senator BYRD. Do you feel that the depreciation rates are currently set at the right rate, or should they be liberalized?

Mr. GREENSPAN. I think they should be more liberalized. It is evident when you run into an inflationary period such as now, there is a tendency for depreciation to lag. I think some acceleration would be clearly desirable.

Senator BYRD. But not to the extent of a 1-year depreciation?

Mr. GREENSPAN. I will say this—if you had that, it would be a major boon to capital investment, but you would have a huge revenue loss in the process. That is a tradeoff that we must make.

Senator BYRD. Do you happen to have any information as to how the new schedule in Canada is operating? I understand it can be written off in 2 years.

Mr. GREENSPAN. They have an acceleration that I am not familiar with. I do think the tendency that the tax system is moving toward, indexing individual income tax rates and accelerating depreciation, is clearly something which we should be moving toward.

The indexing question has been discussed more and implemented less than I think most any proposal I have seen in years.

Senator BYRD. To get back to the question of integration, if an integration proposal is to be adopted, do you feel we should compensate for the revenue losses? Do you feel that some of the present provisions in the tax law, such as the tax credit, investment tax credit, should be eliminated?

Mr. GREENSPAN. At this stage, Mr. Chairman, I would be reluctant to move in that direction. In the name of sustaining capital investment, it depends obviously on the type of integration we are talking about. If it turns out that we are looking at full integration and reduction in the upper brackets, then I think on net balance it may well be advantageous.

But you would have to have some very significant, offsetting advantages to capital investment for that to be a tradeoff which would enhance investment in the country.

Senator BYRD. If you had a choice between integration, which would involve eliminating many of the tax benefits that businesses now have, or modifying the existing tax system, namely a reduction in the corporate income tax itself to provide for greater investment without integration, which do you think would be the sounder approach?

Mr. GREENSPAN. I would opt, at this stage, if capital investment was my sole purpose to emphasize a cut in the corporate tax. I would, for example, be very much inclined to move toward some acceleration in depreciation and would prefer that the investment tax credit be embodied into an overall corporate tax reduction.

There are a number of statistical studies that suggest that that would actually be negative to capital investment. It might be at the margin but the overall distortion that is reduced by having high corporate tax rates come down would work in the other direction.

I would be more inclined to the removal of various preferences and reducing the rate as a vehicle that would tend not so much to increase aggregate investment, but direct it in the areas where it does the most good.

Senator BYRD. Would you have a figure where you would care to indicate under those provisos what would be an appropriate figure to reduce the tax rate?

Mr. GREENSPAN. You are talking about the corporate tax rate?

Senator BYRD. Yes.

Mr. GREENSPAN. If you realize, Mr. Chairman, that the direct, immediate Federal revenue loss will be a little more than over $1 billion per percentage point, we could drop the corporate rate very substantially, say, by 10 percentage points. The actual final revenue loss would be significantly less than the immediate, and it certainly would act to restore a good deal of the business confidence which has been eroded in recent years.

It could be one of those rare corporate tax cuts that actually would not lose revenue. That was an essential argument of the Kennedy administration when they introduced their tax legislation. I think they were proved right at the time.

Subsequent analysis indicates that their tax program which reduced the tax on capital and on investment was not a revenue loser, and if we could take the principle of the legislation which the Kennedy administration introduced and applied it to the current period, we might well find that we could reverse this erosion in capital incentives.

Senator BYRD. One final question.

In regard to depreciation, would a more liberalized depreciation policy work somewhat like the investment tax credit; namely, if an asset is fully depreciated at the end of a short period of time, would that have the effect of encouraging business to replace that equipment more quickly and thus create additional business activity at the other end?

Mr. GREENSPAN. It might, in some cases, Mr. Chairman. In general, it probably would not.

The reason that it would not is that most sophisticated analysis within companies does not look at a particular piece of equipment from the point of view of the books, so to speak, whether or not depreciation has or has not pertained, but what does it cost to produce item x with the existing facility and what does it cost if you replace the facility wholly independent to what the books show with respect to depreciation or net book value.

As a consequence, the main thrust of accelerating depreciation is largely to move the cash flow on new investment up front, where it is more likely to be an incentive to new investment.

It may be, however, as you say, that there are some companies which would consider the fact that investment is already written off as a reason to move ahead on new investments. I suspect that they would largely be in the minority.

Senator BYRD. As a general proposition, that would not be a very viable way of stimulating economic activity?

Mr. GREENSPAN. Not for that purpose. Accelerated depreciation is, but not because in itself writing off something quickly would create new investment incentives.

Senator BYRD. Thank you very much, Mr. Greenspan. I appreciate your being here today.

Mr. GREENSPAN. Thank you very much, Mr. Chairman. It is always a pleasure to testify before you, sir.

[The prepared statement of Mr. Greenspan follows:]

STATEMENT BY ALAN GREENSPAN, PRESIDENT, TOWNSEND-GREENSPAN & CO., INC.

It is a pleasure to appear before this subcommittee today to discuss the incentives needed for economic growth in the years immediately ahead. In recent years, I have often stressed, before this committee and other committees of the Congress, the critical importance of enhancing incentives for capital investment in this country. If we fail to do so, our chances of achieving a noninflationary full employment economy by the early 1980's are, in my view, remote.

Much of what I'm going to say this morning will be in way of review. Much has been covered in recent annual reports of the President's Council of Economic Advisers. I regret that little has changed over the past two years in the diagnosis of the factors behind the shortfall of private capital investment or in policy measures to alleviate it. I compliment this committee in attempting to focus attention on the issue of incentives for economic growth. It unquestionably is one of the most important policy issues this government will confront in the years immediately ahead.

We are in a period when we would expect aggregative capital investment to be rising markedly. Instead, we find that investment is lagging badly behind what one would ordinarily project at this stage of the business cycle. I should like to review the reasons for this and, by so doing, indicate the types of actions that governments can take to enhance the growth in private capital investment.

The primary reason for lagging investment is the heightening of uncertainty in the business outlook that has occurred since 1970. As we all know, other things being equal, the greater the uncertainly, the greater becomes the rate of return required on new investment to compensate for that uncertainty, and the fewer the number of projects which will qualify. As a result, anything which acts to heighten uncertainty will have a depressant effect on capital spending.

It is, of course, very difficult to prove that a decline in business confidence or an increase in risk premiums is responsible for the failure of investment to rise as much as might have been expected, for example, during the current recovery. This difficulty results partly from our inability to directly measure the uncertainty or accurately assess the expectational factors and the environment within which long-term investment decisions are made. Most evidence for the view that business confidence remains poor is qualitative. One quantitative indicator of the expectations affecting business investment which was presented in the last Economic Reportof the President is the market value of a corporation's stocks and of net interest-bearing debt relative to the replacement cost of its assets. If, for example, assets are valued in the market significantly above their replacement cost, corporations will be encouraged to invest in new equipment and thereby create capital gains for the owners of their securities. On the other hand, if assets are valued below their replacement cost, corporations which sell new securities to buy new capital goods may be creating capital losses for their security holders. In the latter case we can infer that the cost of capital has arisen relative to the average profitability of past investment projects and that new investment will be discouraged. Of course, at the margin the expected rate of return on a significant number of potential new investments will remain above the cost of capital, even though existing assets on average are valued below their replacement cost. Thus, even if the market value of a firm fell below the replacement cost of its assets, this would not mean the end of investment incentives. It would be especially inappropriate to draw such conclusions from estimated aggregates composed of heterogeneous corporations.

Nevertheless, it is probably safe to infer that the almost continuous decline in the ratio of the market value of nonfinancial corporations to the replacement cost of their assets during the last few years is an indication that investment incentives are much lower currently than in the second half of the 1960s. Even allowing for the possibility that the high values of the ratio in the 1960s reflected some temporary overconfidence in the evaluation of future returns, the significant downward trend is an indicator that a lack of confidence may be a factor holding back long-term investment commitments now.

Another indirect measure of the decline in business confidence is the evident growing reluctant on the part of companies to expand capacity.[1]

Typically, as operating rates rise the need for new capacity, is seen by companies and, with a lag, the rate of capacity expansion in the economy begins to move higher. At low rates of operation, the incremental addition to capacity is relatively small and primarily reflects rounding out and modernizing expenditures, rather than plant expansion. However, at some point, referred to by some as the "trigger" point, the rate of capacity expansion as a function of operating rates begins to accelerate. Over the period 1954–69, the trigger or inflection point for manufacturing appears to have been around 85% of capacity. Below that point, the rate of capacity expansion would increase by

[1] I am indebted to my colleague M. Kathryn Eickhoff for the following analysis.

less than 0.15% for every 1% increase in operating rates; above the trigger point, capacity accelerated to nearly ¾% for every 1% rise in operating rates.

In 1970, the demand function for new capacity appears to have shifted downward, followed by a further downward shift in late 1973. As a result, the trigger points appears to have shifted upward to approximately 87% capacity. At low rates of operations, approximately 1% per annum less capacity appears to be coming on stream than would have been expected in the earlier period. However, at higher operating rates the shortfall may be more nearly 2% per annum. Unless the forces which caused the demand function to shift downward can be reversed, that is, unless the level of uncertainty can be significantly reduced, serious problems would appear in prospect. (One, of course, is shortages.)

Although other reasons undoubtedly could be thought of, the following factors stand out as important contributors to the higher level of uncertainty over the last several years. First, and by far the most important, is the higher rate of inflation and the fear of an increasing rate of inflation in the year ahead. Second is our experience with wage and price controls and the ongoing concern of business that if, or when, inflation does accelerate in the future, it is only a question of time before controls are once more imposed. The third is the seemingly inexorable rise in the degree of regulatory intrusion into business activity and the rapid acceleration recently in the rate at which changes in the regulatory environment have been occurring.

An inflationary environment makes calculating expected rates of return on new investment far more difficult. Profit calculations are affected by the rise in price both from the cost and the price side. Even if overall profits advance in line with the rate of inflation, no single producer can be certain that his profits will rise similarly. It will depend upon how much his costs rise relative to all other prices in the economy and whether or not he can raise his price correspondingly. As a result, the dispersion of profits among producers increases as the rate of inflation climbs.

The evidence suggests that this dispersion of profits has a far greater effect, negatively, on rate of return calculations than the overall rise in profits has, positively. In effect, a much higher rate of future discount is applied to inflation-generated profits than to those accruing from a noninflationary business environment. The longer the effective life of a prospective investment, the more adverse the effect is apt to be because the greater uncertainty attached to projections of inflation into the future. Accordingly, inflation not only introduces greater uncertainty into rate of return calculations, but it also acts to skew the investment pattern towards shorter-lived projects on which the uncertainty is less.

Relative prices in our economy are continuously changing as market forces act to balance supply and demand over both the long- and short-run.

The imposition of wage and price controls in 1971 demonstrated that a controls system locks the economy into the pattern of relative prices that exists at a single point in time, i.e., it stops the ongoing adjustment of relative prices from continuing and perpetuates the existing disequilibria. What then follows is an attempt to alleviate the worst inequities by allowing some changes to occur. This creates further distortions. Low profit margin goods, for example, begin to disappear from markets. This creates a greater demand for substitutes which have a relative price advantage or higher profit margin, a demand which, in short-run, the economy may not be capable of meeting. Ultimately, the system breaks down and prices rise rapidly as the market attempts to restore more nearly equilibrium conditions.

While it is clear that the existence of such controls greatly increased uncertainty in the early seventies, one might think that sufficient time has elapsed since they were removed to eliminate this element of uncertainty. Unfortunately, although controls were removed, the economy has been continually threatened with their reimposition. And in this regard, it makes no difference whether the threat is of voluntary or mandatory controls. Under present circumstances, unless the problem of inflation is solved, it is only a question of time before some exogenous force once again causes prices, at least temporarily, to spiral upwards. The probability that the present Administration would allow market forces to control such a situation appears, in the view of most businessmen, small. Thus, business continues to factor in controls as an element of uncertainty in projecting future prices and profits.

In recent years, business regulation has escalated sharply in the area of environmental and health protection. Increasingly, EPA and OSHA regulatory changes have directly affected investment. Typically, such changes increase the cost of facilities significantly. However, this, in itself, is not the worst problem. (So long as costs are calculable, higher costs reduce, but do not stop, investment.) Far worse for capital investment decisionmaking is the fact that regulations may, indeed will, change in the future, but in a presently unknowable way. As a consequence, future costs of meeting regulations cannot be calculated.

To some degree, companies could conceivably be protected from this problem by "grandfathering" regulations. A plant built today could be required to meet all presently existing laws, but would be immune from future changes. No matter how seemingly prohibitive the cost associated with existing laws, it would be calculable and would therefore permit projects whose rates of return were sufficiently high to move ahead.

One major problem with instituting such an approach in the environmental area is how to handle the situation in which a previously unknown, but toxic, substance is produced by a plant. The public would have to be protected in such an event and the potential liability would be presently unknowable. However, if investment is to move forward, investors need to be protected from the possibility of presently unknown hazards suddenly wiping out their investment. Most obvious solutions imply a degree of government intrusion in the ongoing life of an investment which is also harmful to investment. Thus, this is a problem whose dimensions are only beginning to be perceived and one which is apt to be difficult to solve in a wholly satisfactory manner.

A major new source of regulatory uncertainty would occur if the broadened form of regulation embodied in President Carter's recent energy message is enacted. Such control must lead to increasing uncertainties with respect to the profitability of energy production, as well as the availability of various forms of energy in the future under potential allocation. Even if the Administration is correct that freeing so-called "new, new" oil from regulation is more than adequate to create incentives for exploratory drilling and development, uncertainty would develop from the operation of such a regulatory apparatus in that today's regulations almost certainly will not be tomorrow's. A regulatory agency's basic purpose is to make regulations, and to *change* them. The regulatory body which makes regulations and then self-destructs is too mind-boggling a notion to contemplate.

Hence, a prospective oil producer cannot know with any degree of surety that currently uncontrolled oil will not fall back under controls. The existence of an ongoing body whose daily purpose is to review price regulations, clearly raises the probability of such an occurrence.

* * * * * * *

One inference from the foregoing is that a direct stimulus to investment, such as a corporate tax reduction would provide, could hasten the restoration of business confidence. Another is that measures which would help reduce the risks of substantial changes in the regulatory climate over the normal life of fixed assets would also raise investment. Above all, a reduction in inflation and the risks it creates is essential. Such measures would help to offset the uncertainties which are still restraining investment and would make up for the recent slow growth of productive capital.

Senator BYRD. The next witnesses will be Bruce G. Fielding, secretary, Council of Small and Independent Business Organizations; Mr. Edward Pendergast, Small Business Association of New England; and Dean Treptow, chairman of legislative affairs, Independent Business Association of Wisconsin.

Welcome, gentlemen.

STATEMENT OF DEAN TREPTOW, CHAIRMAN OF LEGISLATIVE AFFAIRS, INDEPENDENT BUSINESS ASSOCIATION OF WISCONSIN

Mr. TREPTOW. Thank you, sir. My associates have designated me as lead-off speaker here today.

My name is Dean Treptow, I am a banker as a profession, president of an independent bank whose primary business is serving the needs of small business. In fact, I consider myself a small businessman.

A major function of government is the redistribution of capital. All too frequently this redistribution is accomplished with a very short-term perspective which results in a simplistic taking from areas of abundance, at a particular point in time, and giving to areas of deficiency.

I am most bothered by the seeming inability of our tax planning to recognize the long term impacts on the economy. We seem to have a propensity to cure immediately today's symptoms while completely ignoring the imputed future costs of these actions.

As regards small business, I am far less concerned with how the tax codes treat us relative to large business, than I am with the tax codes tendency to strangle off small business, endangering survival, stifling innovation, and in the end, precluding economic contribution over the long term.

I will not take your time by extolling the numerous virtues of small business in our free enterprise economy. I am certain that you have heard them all before. In any event I have never heard serious objection to the arguments that small business benefits the consumer by product innovation and reduced pricing through competitive activity. I believe we all agree that the small business sector of this country has given this economy its best bargain for a long time. It being my impression that we have reached agreement on this point, then I think we are overdue for reexamining our tax impact on small business, that restrict its ability to better serve our economy.

Frequently, our tax codes are not unlike the dairy farmer who for fear of current revenue loss, milks his cow dry to the detriment of the newborn calf standing at her side. Eventually the bawling calf is starved out of existence, there is no perpetuation of the herd and no future generations to perpetuate the stream of income.

Capital is the milk that nurtures business activity. People who do not possess it call it wealth and ask that it be redistributed. The employer of capital, a business entity, regards it in its true nature, as an indispensable resource which supports growth in sales, research and development, competitive practices, and payrolls. In almost every type of business, it is possible to develop firm ratios between capital employed and jobs available.

The next point that I would like to make is that sources of capital for all businesses are retained earnings from operations, and outside investment. If either of these are in sufficient quantity, then they can be supplemented with borrowed money.

Small business differs from large business in our economy, in that it must rely primarily upon retained earnings to support its growth. Outside equity capital is relatively less available to small business than it is for large business and the extent of this condition is becoming greater each year.

The reasons for this are numerous. Among them are the facts that small businesses are inherently more risky from an investor's viewpoint than large businesses, simply because they tend to have shorter track records, have less ability to control their markets and thereby their pricing and profit margins and in any equity offering, must bear the same expensive and exhaustive securities regulations that apply to large businesses.

The conclusion is that it should be a matter of public policy that small businesses be enhanced by an increased ability to retain the earnings that they have created out of their own productivity. This differs sharply from an appeal for external governmental support. Our appeal is to government.

To view the taxing of small businesses with a longer range perspective that would diminish the tax impacts in the short term in return for the creation of larger and stronger small businesses in the future, would result in a greater tax base later in the life cycle of a business, both directly from corporate income and directly from increased payroll taxes on people employed.

The most significant tax factor affecting retained earnings, in my opinion, is the corporate income tax. During the vital years of startup, early growth and research, outside equity investment is probably totally excluded and capital must come exclusively from internal cash flow and borrowing.

Congress recognized this in principle 39 years ago, when it exempted a company's first $25,000 in earnings from the full 48-percent tax rate. Two years ago, after 429 percent of inflation had made that $25,000 all but irrelevant, Congress raised this exception to $50,000. This exemption still is not adequate for modern needs.

We need to reduce the tax rate on the lower levels of corporate earnings so as to allow that corporation greater strength to sustain it in its early years. Specifically we recommend that the corporate surtax exemption be increased to $150,000. The payoff for government will be a higher survival rate of small businesses who will pay corporate income taxes over a longer time period and most likely in greater amounts due to their increased ability to develop markets, competitive positions, and conduct research.

Small businesses are labor intensive and as they are able to enhance cash flow by reduced tax burdens in their early years, they will employ more people and the Government will get the added payoff of increased payroll taxes and greater economic stability from higher levels of employment.

The SBA task force on venture and equity capital in its report issued a few months ago, supported this contention when it said that allowing small business to use a larger portion of their earnings would be "the most direct and effective step that can help small business."

Recovery of cash invested in capital assets is the next most important step to enhancing small business growth. Writing off depreciable assets as a tax deductible expense is an important method that small business does use to increase internal financing.

Every dollar deducted as an expense increases cash available by the amount of the tax savings. These writeoffs have long been permitted, but they are presently permitted over too long a period to give the required benefit.

The staff of the Joint Committee on Taxation in their "Tax Policy and Capital Formation" report, prepared for the House Ways and Means task force on capital formation, supported the well-known economic fact that growth in the labor force is directly tied to capital investment. This same report goes on to point out that businesses will only purchase capital goods if they lead to a combination of increased revenues, reduced costs and tax advantages whose net value, when expressed as a yearly percentage of the cost of the capital goods, exceeds the cost of the funds raised to finance the investment.

More favorable tax treatment obviously raises the aftertax return expected from acquisition of new capital assets. The logic then becomes as follows. permitting more rapid depreciation of capital goods, enhances cash flow of business which makes increased capital investment more attractive which in turn leads directly to higher productivity and greater employment. This whole issue becomes more important when we consider what inflation has done to the replacement cost of equipment.

It is not at all uncommon that a piece of equipment purchased for $10,000 7 years ago will require $20,000 to replace that identical piece of equipment at today's prices. The concept of depreciation allowances was to permit a company to establish cash reserves for equipment replacement and in an inflationary economy the present guidelines result in an almost prohibitive cash flow deficiency.

The third area of concern to me in our tax codes as regards small business, is capital gains treatment. Investment in capital stock of a small business is unique from a similar investment in larger corporations and that the stock investment is not liquid by virtue of an active secondary market.

This renders equity investment in small business less attractive than investment in larger businesses; accentuates the equity investment problem I have already described.

This could, in part, be rectified by making small business investment more attractive by changing tax treatment of capital gains on investments in small business.

We recommend that an investment in small business be exempt, in fact, be exempt from capital gains treatment on sale of that investment if, in fact, the proceeds of this investment are reinvested in the equity of another small business within 1 year.

The concept is directly analogous to the deferral of capital gains on investments in a personal residence. This concept becomes more credible in our minds, if in fact we regard capital investment as a resource necessary for business productivity, so long as it is being employed in the small business sector as a resource.

Why, then, should government take a share of this investment simply when its employment changes from one small business company to another, particularly when the owner has not benefited by cash in his pocket or increased liquidity.

The final areas of concern that I would like to address is the double taxation of corporate income. This is the current situation in which a corporation pays Federal income taxes on its total operating income and then upon payment of dividends, the stockholder pays another tax upon the dividend received.

By virtue of my earlier arguments that retained earnings is essential to a small business and thereby we can assume that that small business will be likely to pay minimal dividends, and if we also agree that outside equity investment is relatively unavailable to small businesses as compared to large corporations, then this issue should be of relatively little significance.

It does become important, however, when we consider the various proposals currently receiving attention for integration of corporate and individual income taxes. It is these proposals for tax change that cause me the greatest concern.

Inherent in most of them is a rate of taxation on retained earnings that is higher than the rate of taxation on dividends. This, I believe, will give the larger publicly held and stock exchange listed firms a competitive edge in the marketplace versus the smaller business entity. The publicly held firm would be able to look to outside capital investment to support its needs at a relatively lower tax rate than would the small business relying almost exclusively on retained earnings for its growth, if that small business had to pay a higher tax rate on retained earnings than existed on dividends.

Retained earnings, as I have stated previously, is the foundation of the small business, and it needs to have a favorable tax situation on those earnings.

I thank you very much for this opportunity to present my recommendations and opinions on tax codes as they affect small business in our economy today.

Senator BYRD. Thank you, sir.

I might say that you began your statement by mentioning the change in the surtax exemption from $25,000 to $50,000 which I agree with you, it certainly has been very helpful to small business. It should be said for the record that Senator Gaylord Nelson from your State and a member of this committee was very instrumental in bringing that about.

Mr. TREPTOW. I am very pleased to hear you say that.

Senator BYRD. You ended your statement by discussing retained earnings. Would it be correct to say that if the retained earnings law and regulations are too severe, too limiting, it forces small business to sell or merge with big business who are not faced with that problem?

Mr. TREPTOW. That is correct. I am very concerned about that issue.

Senator BYRD. I happen to be one of those who feel that what we want to do in this country is encourage larger numbers of small businesses rather than having business in whatever field it might be, concentrated in a few companies.

Mr. TREPTOW. This is one of the strongest arguments we like to make before all of our congressional contacts that we have, that small business does enhance competitive activity. Clearly we are really not asking for a subsidy from government. We are asking for an opportunity to retain a little bit more of what we, ourselves, have produced to strengthen the small business formations.

Senator BYRD. I have a note here that Senator Nelson is at a hearing in the House of Representatives. He is trying to get here.

Mr. Fielding?

STATEMENT OF BRUCE G. FIELDING, SECRETARY, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. FIELDING. I am Bruce G. Fielding, an officer and director of the National Federation of Independent Business (NFIB). Our organization represents one-half million small and independent business men and women throughout the Nation. I also am the owner of my own accounting business. In addition to these functions, I am one of two members representing the public on the Commission on Federal Paperwork.

Most of my 24 years in the practice of accounting have been devoted to assisting small business persons, ranging from the sole proprietor with no employees to the small corporate employer with less than 100 employees. During this time, it has become very evident that Congress has generally failed to recognize the need to distinguish between small business and large business in the areas of taxation.

Senator BYRD. Where do you draw the line? When does the small business cease to be small and become a large business?

Mr. FIELDING. We like to think of large business as being publicly owned. Our definition of small business with regard to qualification of membership in our organization is an independently owned organization that is not dominant in its field.

Senator BYRD. Do the other two panelists concur on that?

Mr. TREPTOW. I would concur. We become hung up so often in statistical numbers, number of employees, value of assets, and so forth. The truly qualifying factors are not controlling markets and having an entrepreneurial charter in ownership and management.

Mr. PENDERGAST. Another limitation might be if they have more than 500 employees under any of those definitions they are definitely not a small business. You could have a privately held company not dominant in its market with more than 500 employees. I would certainly consider that a large business.

Mr. FIELDING. I would like to emphasize again that the Congress has failed to distinguish between the difference between small business and large business in the areas of taxation. In the very areas where it has recognized this difference, it has discriminated against the small, unincorporated business.

A prime example of this is the area of tax rates. The maximum tax rate in the corporation, as we all know, is 48 percent. A small, independent business, unincorporated business, the earnings can be taxed at a rate of 70 percent.

For example, an individual with $35,000 of business income pays approximately $8,000 of Federal income tax. By incorporating, the combined individual and corporate taxes would be approximately $6,000. This is a savings of 25 percent, an inducement to incorporate, but an artificial inducement.

Last year, the Council of Small and Independent Business Associations that we call COSIBA, proposed, as a part of its Small Business Growth and Job Creation Act of 1976 that unincorporated businesses be allowed to calculate their tax as though they were incorporated. It is a simple provision and would not require extensive administrative or reporting requirements.

This provision would tend to equalize the tax on small businesses and would eliminate the necessity of incorporating just to minimize taxes.

Senator BYRD. May I interrupt you there? That is, in essence, subchapter S corporations?

Mr. FIELDING. Yes.

This again, is alleviating the small business person from the expense of incorporating to minimize taxes. Why should an individual have to incorporate? In a subchapter S corporation, you would still have the expense of incorporation.

Senator BYRD. Your idea is to put an unincorporated business in the same category as a subchapter S corporation but not having to go through the expense of incorporating.

Mr. FIELDING. I am trying to put it in the same tax rate. An unincorporated business should pay taxes at the same tax rate as a corporation. A subchapter S corporation pays taxes at the same rate as an individual.

What we are after is the lower rates.

Senator BYRD. You are reversing it.

Mr. FIELDING. We want the lower rates for unincorporated businesses.

Mr. PENDERGAST. At one time, subchapter K used to allow the partnership to be taxed as a corporation. This would do the same thing for individuals.

Mr. FIELDING. Subchapter K was very complicated, very restrictive, and did not work. This is a simple provision that we feel would work.

Senator BYRD. You answered earlier that what you wanted was to put individuals in the same category as a subchapter S corporation. I see now that your response meant to refer to subchapter K not S. Thank you.

Mr. FIELDING. Another area of discrimination is the provisions dealing with retirement plans. Contribution limitations, vesting requirements, investment opportunities, and the limitation on trustee selections all discriminate against smaller firms. These are basic options which are vital to the owners of businesses in order to encourage them to create retirement plans which are not available to the unincorporated employer.

Why this particular distinction between incorporated and unincorporated businesses? Could it be that Congress and the Internal Revenue Service have determined that the unincorporated business person cannot be trusted and should pay higher taxes? But if he or she incorporates, we have an entirely different ball game with a much more liberal set of rules.

Senator BYRD. What is the rationale?

Mr. FIELDING. So many people in Washington think small business is a mom and pop operation—there is nothing wrong with the mom and pop. Small business is the backbone of this country.

NFIC would like to recommend to Congress that there should be separate provisions in the Internal Revenue Code for all voluntary plans with less than 100 participants. These provisions would be the same for all forms of business entities.

There would be no distinction between a sole proprietor, partnership, subchapter S corporation, or the normal corporation. We would also recommend that there be no dual jurisdiction with respect to these small voluntary plans. The IRS would have exclusive authority. The provisions would also be geared to simplification and reduction of administrative and reporting requirements.

Senator BYRD. Why do you pick 100?

Mr. FIELDING. 90 percent of the plans have less than 100 participants and prior to ERISA, DOL actually did not come into effect, as far as jurisdiction was concerned, until there were more than 100 employees, so we have used that as a cutoff. It is not a magic number.

Senator BYRD. How is the Federal Paperwork Commission getting along?

Mr. FIELDING. I have had to buy two new cabinets since I became a member so that I can file all of the things that they send me to read.

Senator BYRD. Is there any progress being made?

Mr. FIELDING. I think so. We had some specific examples of progress in the area of ERISA, certain recommendations that the Internal Revenue Service has accepted. We have had a very good study on OSHA. We made many specific recommendations on OSHA as to how paperwork could be reduced.

We have had absolutely no cooperation that I know of from the Department of Labor in implementing these suggestions. It is a stumbling block over there. There is a little bit of turf protection going on.

We have also come out with equal opportunity recmmendations. We are in the process now of finalizing our study of the impact of the paperwork burden on small business which will be quite a revealing study.

Senator BYRD. How about the Department of Health, Education, and Welfare? What kind of cooperation are you getting there?

Mr. FIELDING. I believe that we have a great deal of cooperation.

Senator BYRD. The superintendent of schools in my State is complaining bitterly about the tremendous volume of questionnaires that they have to fill out.

Mr. FIELDING. The thing that appeared to me as an observer, as a kind of layman in this whole area, our recommendations are well founded. There are a lot of justifications and we have had a lot of cooperation, but no implementation, and that is the thing I fear so as the Commission goes out of existence, which it is scheduled to go out October 3rd.

When it renders its final report to Congress, that will be another bound report which will go on somebody's shelf and become the basis for somebody's Ph. D. thesis.

Senator BYRD. That is the trouble with this whole situation in Washington. The tendency to continue in the direction that a particular bureau has been going for many years and that means more and more forms and paperwork.

I would like to see your Commission succeed. I would like to see the executive branch put it into operation when you complete your work.

Mr. FIELDING. For example, Senator, your Senate passed a resolution recently that requires an impact report on all legislation, but I have not seen any impact reports. I do not think there have been any.

Somebody has to implement them. There has not been any implementation. I would love to see the cost of the impact of the reporting requirements of the recent job tax credit act.

Senator BYRD. I think you are quite right. I believe the Senate just passed the legislation of which you speak. I do not know that there has ever been a chance to implement it. I think it should be implemented.

Mr. Pendergast?

STATEMENT OF EDWARD H. PENDERGAST, CPA, REPRESENTING THE SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND

Mr. PENDERGAST. My name is Edward Pendergast, past president of the Smaller Business Association of New England and currently chairman of the Federal Legislative Committee.

I would like, Mr. Chairman, for expediency's sake to have my statement entered into the record rather than read it in detail.

I would like to make some comments on what has been said by my two friends, also some of the feeling—I guess I have to categorize it as outrage—with some of the comments that I have heard this morning before my two friends had the opportunity to speak, from the lack of understanding of what is going on and the problems of business, and small business particularly.

We had one allusion by the former Chairman of the Council of Economic Advisers to the complexity of tax laws and regulations being one of the most significant problems that small business has to deal with. One little paragraph from my testimony gives some indication of my agreement with that certainly, although I will emphasize that a lot more has been done than in his discussion.

I think that Congress must realize that it poses at the peak of a rule-making mountain, trembling down the slope of bureaucracy. Legions of civil servants bring an action. By the time the pebble has come to rest, a landslide of related rules and regulations has tumbled upon the population below. The small businessman is being crushed by an avalanche of words.

Just to give you an example, the discussion today about whether we should have the investment tax credit compared to depreciation liberalization—I think the word is depreciation simplification, which is much more important than that. Let us discuss the ADR, one section of the regulations issued by the Internal Revenue Service, one sentence. This is the sentence. It is on page 4 of my testimony.

"In the case of eligible property first place in service in the taxable year of election (and not otherwise properly excluded from an election to apply this section) the taxpayer may not compute depreciation for any of such property in the asset guideline class under a method not described in section 167(b)(1), (2), (3), or (k) unless he (1) computes depreciation under a method or methods not so described for eligible property first placed in service in the taxable year in the asset guideline class with an unadjusted basis at least equal to 75 percent of the unadjusted basis of all eligible property first placed in service in the taxable year in the asset guideline class and (2) agrees to continue to depreciate such property under such method or methods until the consent of the Commissioner is obtained to a change in method."

That is regulation 1.167(a)-11(b)(5)(v)(a).

Senator BYRD. Can anybody interpret that?

Mr. PENDERGAST. No small businessman can. That is why every tax reform act gets called the Accountants' and Lawyers' Relief Act.

I guess I would have to follow the lead of both Congress and the Internal Revenue Service in the interpretation of most of the other agencies of Government.

Senator BYRD. I think you are right.

Mr. PENDERGAST. We talked about the first $200,000 of assets being expensed in effect. I understand that in England, and to a lesser extent Canada, we have full expensing in the apposition of fixed assets in England and the significant rash of additional investment in capital assets as contrasted in the testimony by the Assistant Secretary of the Treasury for Economic Policy and the former Chairman of the Council of Economic Advisers.

The latter, when you ask him if acceleration of depreciation would increase the purchase of capital assets, then contradicted himself and said—I think he used the term "sophisticated facilities analysis" whatever that means, makes their decisions independent of the Tax Code. That is the offset to any exclusion referred to if you allow the opportunity to extend the acquisition of capital assets.

I agree with my friends and all the elements they have spoken about. I would like to emphasize and add maybe a couple of small items that I think may be beneficial to many small businesses, one is to allow a surtax exemption carryover so a corporation who makes no income 1 year and $100,000 the next year would be in the same position as the company that would earn $50,000 the first year and $50,000 the second year.

Under the present law, he has a penalty that he ends up paying some $13,500 because he happened to have his income on a cyclical basis.

Another item that I might ask to eliminate is the accumulative earning tax, as you eliminated the stepped-up basis in 1976. The reason is, it is seriously abated by anything that deterred the generation of additional capital.

I think that ERISA should be amended to encourage pension fund managers to invest in small businesses.

Senator BYRD. How do you do that?

Mr. PENDERGAST. You eliminate the prudent man law to some extent, maybe for 5 percent of the total investment of an investment portfolio, if they are invested in small businesses. The prudent man law is scaring the living daylights out of pension fund managers. They are not going to invest in small businesses.

Another way you can do it is to require any pension fund assets in excess of a certain figure to have a certain percentage of their assets to be invested in certain qualified small businesses.

Senator BYRD. I agree with the objectives you are trying to achieve. I just have some trouble with setting aside the prudent man rule.

Mr. PENDERGAST. I am not suggesting it be set aside, just that you mitigate it.

Senator BYRD. Insofar as this one aspect is concerned.

Mr. PENDERGAST. If you set it aside to the extent of 5 percent, for instance, of pension funds for assets in excess of $10 million, you would put a tremendously significant injection of additional capital into small business.

There is no new capital coming into small business, as you know from the statistics, and they are clearly outlined in the report of the SBA Task Force.

I ought to tell you, when I hear talk about integrating between the corporate tax and the individual tax, if this is done without some offsetting advantage for small business, it will be disastrous. Small businesses do not pay dividends.

One-tenth of 1 percent of the corporations, according to the last statistics of the Treasury Department, pay 75 percent of the dividends; 90 percent of the smaller corporations with assets under a half million dollars pay 6½ percent of the dividends. Clearly it is going to go to 1,000 companies that get recorded in Fortune twice a year—Fortune's 500 and Fortune's second 500.

Senator BYRD. You do not favor integration of the corporate tax?

Mr. PENDERGAST. I just say if it is done without offsetting advantages to small business, it will destroy the small business' ability to attract capital.

Senator BYRD. What do you envision as offsetting advantages?

Mr. PENDERGAST. One would be requiring pension funds investments to be a certain percentage in qualifying small businesses. Another one would be giving significant tax incentives to banks to invest a certain percentage of their loan and investment portfolio in small business.

Senator BYRD. How could you require them to invest? Would that be a good law, to require them to invest in certain companies?

Mr. PENDERGAST. I am not suggesting it is a good law. You asked me, is there a way it could be done. That is a way that it could be done. I think it would be a very difficult law. I think the qualification could be done with some SBA type of confirmation of the investment just as there is now with SBA confirmation of a loan program or certain guarantees.

Senator BYRD. You are inviting the Federal government to come into the business sector.

Mr. PENDERGAST. I do not think the SBA has come into the business sector and is operating any businesses. If anything, they have been criticized when they have made loans to companies and not given them enough management assistance.

Senator BYRD. I thought I understood you to say that the SBA would draw up a list from which pension funds——

Mr. PENDERGAST. That is not what I meant to imply. What I meant would be similar to an SBA loan program where a company would apply for a loan from the bank. The SBA has to approve that loan as well as the bank. The investment could be handled in the same way.

I would like to point to two other things about the integration problem. One, I understand that there has been a paper released by the Joint Committee on Internal Revenue suggesting a method for computing integration. I also understand that a publicly held company has made an analysis of that. They found out for every $100 worth of dividends they would pay to the shareholders, the shareholders would receive a $56 tax credit.

I think that the impact of that needs to be looked at very, very closely before anything is done.

The second issue is that in 1973, in Taxes Magazine, there was an article discussing the effect of integration in England and France, and in neither country was there a significant increase in capital investment.

So we may be trying to accomplish something and the end result may not be what we expect.

Senator BYRD. The purpose is to get away from the double taxation, which I assume would be the purpose of it.

Mr. PENDERGAST. I think the idea of double taxation sounds so dirty, it is a little like apple pie, motherhood, and the American flag. It is very difficult to be opposed to it.

Senator BYRD. You would find most Members of Congress favor the double taxation.

Mr. PENDERGAST. I think that Senator Long, when he was here earlier, indicated to the Assistant Secretary that the double tax is more of an allusion than a fact in many instances.

The Treasury quotes 86 percent rates, whatever figures he was referring to; in fact, when you calculate it out, that is not what they are paying. The effective tax rate for corporations is nowhere near—the large corporations—is nowhere near as high as the 48 percent figure that you would expect.

There are many, many corporations that have never paid a dividend. Some of the largest corporations in the country have never paid dividends, so there is no double tax there.

Most of the small businesses, as I pointed out, do not pay any dividends. There is no double tax there.

The double tax is sometimes more of an illusion than fact.

Mr. TREPTOW. Senator, if I may intercede on that issue?

I am concerned about double taxation, particularly in the larger corporations. I am sure they are, and in fact, should be concerned about the issue of double taxation with the small business community. It may be a very small issue.

If you look at the spectrum of business organizations on the very small end, you have the sole proprietorship, not a partnership, not formally organized—it is a man doing business in some form. There is no double taxation or integration problem there. His earnings are just taxed on the personal tax scale.

We go to subchapter S as the next step in the spectrum. That is a similar situation. I can defer to Mr. Fielding's comments in that area.

As we move up the ladder of sophisticated organizations, we ultimately get to the publicly held corporation and the large, publicly traded organization where double taxation is at issue.

The whole issue is of relatively small importance in the small business community unless we create a situation where, on one hand, the small business which relies almost entirely on retained earnings to support his capital investment and his working capital, as opposed to a larger organization which can tap outside equity capital for that funding.

If we create an integration formula in which taxes retain earnings relatively high compared to the taxation on outside equity investment, then I am concerned about Government intervention having skewed the competitive factors around to the disadvantage of small business.

That is my primary concern.

Senator BYRD. What you are saying, insofar as small business is concerned, double taxation is not a major factor?

Mr. TREPTOW. Only the cures for larger business would be a disadvantage.

Senator BYRD. I think that double taxation is something that Congress should address. There is, in many, many cases double taxation, and it is severe. But you say that for many of the small businesses, that is not a real problem.

Mr. FIELDING. We are getting back to the very premise of my dissertation, recognize the difference between small and large business.

Why do we have to have one law that encompasses both? If we are going to recognize that double taxation should be eliminated or minimized, let's recognize that that is not a part of small business. If we are going to say, this is what we are going to do to publicly held corporations, let's not impose the same restrictions on small business. Let's have a different interpretation of the double taxation problem.

If we cannot get input into the Treasury Department as small business people, when you look at the people in the Treasury Department formulating that policy, I do not think there is one in there who has ever met a payroll. You are not going to get the distinction that we so vitally need.

Mr. PENDERGAST. In the report of the SBA Task Force there are four specific suggestions of what can be done to attract additional capital for the small businesses.

One, to help extend the SBA assistance in longterm borrowing. The second is to strengthen the small business investment companies which you will hear about later today.

Third is to make institutional funds more available for small business as to what I was referring to as the prudent man rule was concerned.

Four, give small business better access to the public securities market.

Senator BYRD. Incidentally, Senator Bentsen from Texas has a bill, S. 285, which proposes to exempt 2 percent of investments from the Federal prudent man rule.

Mr. PENDERGAST. He is obviously a clear-thinking man, Mr. Chairman.

Senator BYRD. He is a clear-thinking man, a very able and splendid Senator and a good businessman along with it. But in my own mind I have not reached a conclusion on his bill. I have not talked with him about the wisdom of exempting trustees from the prudent man rule, but it is something that will be considered by the Congress.

Insofar as small business is concerned, as between liberalized depreciation rates and investment tax credit, I asume liberalized depreciation rates would be more beneficial?

Mr. TREPTOW. Speaking as a banker, and based on the experiences of most of my customers, I would emphatically say an accelerated depreciation is the preferable route, if we had to make a choice between the two.

Senator BYRD. You would prefer the accelerated depreciation?

Mr. TREPTOW. That is correct. It has a longer term impact than the investment tax credit.

Mr. PENDERGAST. My only plea on that, that I would like to make on bended knee in front of the Senate and the House, is when and if they pass a law they do not add another layer of complexity to the law dealing with depreciation. Just give us a nice simple law—not written by the Under Secretary of the Treasury for Tax Policy either, please.

Senator BYRD. A nice simple law has not come out of Washington in a long time.

Mr. PENDERGAST. The House Ways and Means proposal for job creation tax credit was so much simpler than the administration's bill that was in evidence that things can be a little simpler. Every response I get to simplicity is, that is too difficult for us. It causes a wealth of lawyers to spring up and add reasons why it cannot be done. I think probably as a paraphrase of things American—I would say, why can it not be done? Let's get it done.

Senator BYRD. As a result of every so-called tax reform law we have had, the tax system has become more complicated and more complex and requires more and more lawyers and accountants.

Mr. PENDERGAST. In my testimony, Mr. Chairman, I said something that is really dramatic evidence of taxpayer's revolt. As a law gets to a point where it is so complex it cannot be dealt with, it will be repealed by its being ignored.

Bruce Fielding was with me with the National Federation of Independent Businesses. They took a survey of their members with inventories of $100,000 or less. These are members who should be reporting on the accrual basis because inventories are an income-determining factor. Over 50 percent of them are ignoring that and filing on a cash basis. They took the law in their own hands and passed a new law without your knowledge, a very simple one.

Senator BYRD. I would see why they would want to do it. But I would not particularly recommend that course of conduct.

Mr. PENDERGAST. We are suggesting in one of our proposals last year that you allow people with inventories of $100,000 or less to expense it rather than get them involved in inventory-taking procedures.

Senator BYRD. I am not going to the merits of it. I am just commenting that they might incur difficulties with the Internal Revenue Service.

Is one of the reasons for the scarcity of investment capital that investors are being more prudent today than in the past?

Mr. FIELDING. I would say disenchanted.

Mr. PENDERGAST. I think that the main reason is the Federal Government and the municipal governments have absorbed significant amounts of available capital.

Senator BYRD. You are quite right. I think that gets back to the unsound way in which the Government handles its finances. The more the Government goes to the money markets, the greater deficits, the more Government borrows money to finance the debt, the less money there is going to be for small business, large business, individuals, or anybody else. I think it is important to realize this, which so many Members of Congress do not seem to realize.

Mr. TREPTOW. A good example of that is what happened in 1974 when interest rates reached record peaks and Treasury was in direct competition with the private savings sector. Many people with relatively small savings learned how to buy $1,000 Treasury bills, particularly when the 9 percent issue came out in August 1974.

Once having learned those ropes and knowing they can buy Treasury issues now issued, and continuing to be issued, in relatively small denominations for the small saver, they put Government in competition with the private sector and private enterprise in a way that has never been precedented before.

Senator BYRD. Not only that, Government gets the first opportunity.

Mr. TREPTOW. That is right.

Senator BYRD. Everybody else comes in behind Government. I do not think you will get interest rates down until you get Government spending under control.

Mr. TREPTOW. Amen.

Senator BYRD. In fiscal year 1978 we are going to have the second largest deficit in the history of the United States. How important is Government policy as being a reason for the lack of funds for new business ventures?

Mr. TREPTOW. I think it is a significant factor. I sense a great increase in the frustration, perhaps discouragement, of people who have been in small business for some time, as well as those who are thinking about organizing them. The complexity of regulation today is absolutely fantastic.

My associates have referred to that already, and other speakers this morning have. The compliance is a frightening thing.

In my own business, in banking, for example, much of the recent legislation in the consumer area has changed credit standards quite drastically because the fear of compliance—or noncompliance, I should say, is great in my industry and it is within all industry in regards to various types of regulation.

I also think that the general tax burden and the inability to obtain attractive returns on that investment as was referred to by both Mr. Brill and Mr. Greenspan this morning, I think, are significant factors for lack of business growth and a deterrent to new investment.

Senator BYRD. Do you feel that you do have, or will have, sufficient access to the decisionmaking process going on today in the Treasury Department.

Mr. FIELDING. Absolutely not.

Senator BYRD. No?

Mr. FIELDING. We have a Small Business Advisory Committee, 19 of us, who did work with the Internal Revenue Service. It was a very effective committee, Senator. In fact, we can be traced directly to saving $90 million a year in annual reporting fees in regard to ERISA just because we were there and able to talk to them and point the way out, this is the way it should be done.

Now that we are going into the area of reducing advisory committees, the committee has been eliminated and supposedly is going to be absorbed by the small business advisory group within the Treasury Department. Absolutely nothing has happened. We cannot even seem to get any word, yes, no, or why. If we do not have that, we have nothing.

Senator BYRD. The Assistant Secretary of the Treasury testified this morning that Treasury is in the process of developing a new tax program. Has small business, as such, had an opportunity for input into that process?

Mr. PENDERGAST. He said also, Mr. Chairman, in his testimony, that they were going to give access to small business; in essence he admitted that they had not in the Small Business Advisory Committee they are establishing.

There was in place, when he came in, a Small Business Advisory Committee which had supposedly been merged with the Internal Revenue Service Advisory Committee. The new one has not been organized.

From his testimony, I understand they are planning to submit the legislation this summer. They will probably get the advisory committee organized in the fall. Then, 6 months after the law is passed, they will ask us what we think of it.

I think it is very distressing.

Senator BYRD. Do you feel, as representatives of small business, that you have access to all the facts and figures necessary to formulate recommendations in the tax field?

Mr. TREPTOW. It is a very difficult problem for us. There are a great many of us who have been active on behalf of small business who are doing this on the evening and weekends and without professional staffs because one of the characteristics of small business is we do not have internal resource people within our businesses devoted to the study of tax impacts and of tax regulation.

Even in our trade organization, which we represent here, we really do not have the resources that can do this. It relies on individuals finding time outside of their normal business activity to do this.

When it gets particularly in the area of tax impact studies, the frustration to me is the first answer from Treasury, is this proposal will result in the immediate reduction of Federal revenues by x dollars. There is no consideration given to the secondary increases in revenue from all of the succeeding factors that will result.

You cut the corporate income tax. Sure, there is going to be an immediate revenue loss. Never can we get an immediate consideration from the sophisticated models that we know are available in Government as to what is going to happen to employment and sales of capital goods and so forth that will result in increased revenues to Government.

This is what I was referring to by a necessity for a longer term, more in-depth view into the impact. We do not have the resources to do it. We think the Government should do the whole side of this thing, not just one side, saying, get lost, fellows. This is going to cost x dollars.

Senator BYRD. In conclusion, would one of you attempt to briefly summarize the greatest needs and the biggest problems of small business today?

Mr. FIELDING. I think you could say capital, discriminatory tax laws and product liability.

Product liability has become an increasing factor in small business. The insurance premiums are going out of control and forcing small businesses to terminate.

You look at a business—I had one client. Their premiums for 1 year went from $5,000 to $65,000. Their profits for the previous year were only $30,000. They ended up with a nice loss the following year. It is an impossible situation. It is becoming a very difficult situation with which to cope.

Mr. PENDERGAST. In summary, all we ask for is simplicity and equity; no more, no less.

Mr. TREPTOW. I agree.

Senator BYRD. Thank you, gentlemen, very much.

[The prepared statements of Messrs. Fielding and Pendergast follow. Oral testimony continues on p. 61.]

STATEMENT OF BRUCE G. FIELDING, DIRECTOR AND SECRETARY, NATIONAL FEDERATION OF INDEPENDENT BUSINESS; COMMISSIONER, COMMISSION ON FEDERAL PAPERWORK

Mr. Chairman, I am Bruce G. Fielding, an Officer and Director of the National Federation of Independent Business (NFIB). Our organization represents one-half million small and independent businessmen and women throughout the nation. I also am the owner of my own accounting business. In addition to these functions, I am one of two members representing the public on the Commission on Federal Paperwork.

Most of my twenty-four years in the practice of accounting have been devoted to assisting small business persons, ranging from the sole proprietor with no employees to the small corporate employer with less than one hundred employees. During this time it has become very evident that Congress has generally failed to recognize the need to distinguish between small business and large business in the areas of taxation. However, in these areas in which it has recognized the difference, it has discriminated against the small unincorporated business.

The present tax system used in the United States has a serious, negative impact upon the nation's small and independent business community. It consistently discriminates against small and medium size businesses, undermining vigorous and healthy competition, stifling growth, smothering small firms under a mountain of paperwork and theratening the continuation of a strong and viable independent business sector.

The complexity of the tax code, by itself, discriminates against small business. Small firms simply cannot afford to employ the horde of expert lawyers, accountants and tax consultants used by large corporations to exploit and take full advantage of every beneficial provision of the code. This conclusion has been documented by the Senate Select Committee on Small Business, whose Chairman Gaylord Nelson, stated in testimony last year before the House Ways and Means:

"Our hearings have demonstrated that the complex capital recovery provisions of the Internal Revenue Code unduly favor large corporations. Accountants and other experts who prepare tax returns for smaller firms say that independent businesses tend to use straight-line depreciation almost exclusively because they are not willing or able to cope with the more complex capital-recovery devices."

Large corporations are able to use the provisions of the code to pay a reduced effective tax rate. As a class, the 100 largest corporations in the U.S. paid an effective tax rate of between 25 percent to 30 percent over the past three years, while eight of these with earnings totaling $843 million paid no corporate income tax in 1974. On the other hand, many small and medium sized firms may pay through the nose, up to twice the effective tax rate paid by the largest corporations. The result of this is a decided competitive advantage for big business. (See SEC Quarterly 10K Form data surveyed by Congressman Charles Vanik and also FTC Quarterly Financial Reports surveyed by Senate Select Committee on Small Business.)

Small firms cannot grow and create jobs without capital. The supply of investment capital is relatively scarce and small business is in fierce competition with our industrial giants for a share of the shrinking investment dollar.

A business can create growth capital for four ways—

By borrowing or incurring debt;

By selling stock or an equity interest in a business;

By recovering capital already invested; and

By retaining profits.

Banks are extremely reluctant to lend to most small firms. Their funds are reserved for and allocated to their best, least risky customers—large corporations. Even if a small business is able to convince a bank that it is a good risk, it will be forced to pay dearly for its money. While big business can borrow at, or close to the prime rate, small firms must pay substantially more for their loan. So much for borrowing or debt financing.

Who would risk buying stock in a small business? According to Senator Nelson and the Senate Select Small Business Committee, very few small companies are able to raise capital in this manner. In 1974 only nine small businesses were able to float stock issue and during the first half of 1975 not a single small firm was successful in raising capital through the sale of its stock.

As I noted earlier in quoting Senator Nelson, small firms are not particularly successful in being able to recover the capital they have already invested, because the captial recovery system in the tax code "unduly favors large corporations." This leaves only the retention of profits as a feasible method of generating the capital needed to fuel small business growth.

The present corporate tax rates are 20 percent on the first $25,000 in taxable income, 22 percent on the next $25,000, and 48 percent on all taxable income over $50,000. And, as noted earlier, many small firms pay an effective tax rate up to 50 percent. This system is not conducive to generating the amount of capital needed by small business to expand and create jobs.

It is also important to note that 86 percent of all U.S. businesses are unincorporated, but most of the recent beneficial changes in the tax code have been limited to corporations. Individual tax rates, which are paid by unincorporated businessmen, are higher than the tax rates paid by incorporated businesses. Again, this gives giant corporations an unfair competitive advantage and reduces the amount of after tax revenue available for reinvestment by the small businessmen.

The Internal Revenue Code makes several inequitable distinctions between unincorporated and incorporated businesses. As noted above, the rates of taxation are a prime example. The maximum corporate rate is 48 percent while a sole proprietor could be taxed at a maximum rate of 70 percent. An individual wth $35,000 of business income pays approximately $8,000 of Federal income tax. By incorporating, the combined individual and corporate taxes could be reduced to $6,000. This is a saving of 25 percent, and an inducement to incorporate.

Last year the Council of Small and Independent Business Associations (COSIBA) proposed, as part of its "Small Business Growth and Job Creation Act of 1976" (H.R. 13687), that unincorporated businesses be allowed to calculate their tax as though they were incorporated. It is a simple provision and would not require extensive administrative or reporting requirements. This provision would tend to equalize the tax on small businesses and would eliminate the necessity of incorporating just to minimize taxes.

Another area of discrimination is the provisions dealing with retirement plans. There the inequities are so obvious that they "cry out" to be corrected. Contribution limitations, vesting requirements, investment opportunities and the limitation on trustee selections all discriminate against smaller firms. These are basic options which are vital to the owners of businesses in order to encourage them to create retirement plans which are not available to the unincorporated employer.

Why this particular distinction between incorporated and unincorporated businesses? Could it be that Congress and the Internal Revenue Service have determined that the unincorporated business person cannot be trusted and should pay higher taxes? But if he or she incorporates, we have an entirely different "ball game" with a much more liberal set of rules.

NFIB would like to recommend to Congress that there should be separate provisions in the Internal Revenue Code for all voluntary plans with less than 100 participants. These provisions would be the same for all forms of business entities. There would be no distinction between a sole proprietor, partnership, subchapter S corporation, or the normal corporation. We would also recommend that there be no dual jurisdiction with respect to these small voluntary plans. The IRS would have exclusive authority. The provisions would also be geared to simplification and reduction of administrative and reporting requirements.

Some other examples of discrimination are administrative restrictions by IRS with respect to selection of fiscal years, the deductibility of medical expenses and group life insurance premiums for the business owners.

These inequities force the successful unincorporated business to incorporate. This is an artificial device. Incorporation should be based upon sound business decisions and not for the sole purpose of minimizing taxes.

As mentioned previously, there has been a failure by Congress and the IRS to recognize that consideration should be given to the practical ability of small businesses to cope with the intricacies of the Internal Revenue Code and its related regulations, rules and reporting requirements.

An outstanding example of this tunnel vision was the development of an annual retirement plan return (Form 5500). The proposed form was to be used by all employers regardless of whether they had one employee, or 100,000 employees, and regardless of whether their plan had $1,000 or $1,000,000 in assets. The burden that this proposed return would have imposed upon small plans, which comprise approximately 90 percent of all plans, was in the magnitude of $135 million annually.

Many small businesses cannot afford professional assistance in the preparation of their tax returns and the maintenance of their accounting records. Therefore, when they try to cope with the same laws which apply to IBM or General Motors, they make errors and, in many cases, they violate laws and regulations unintentionally. Why should the small business person have to understand the academic nicety of the "accural" basis of accounting or the necessity of capitalizing certain indirect expenses so that the ending inventory of work-in-progress precisely reflects his costs? The Internal Revenue Code, "one law for all", not only imposes a relatively costly burden on small business, but also imposes a costly enforcement burden on IRS. Both of these problems could be overcome through the adoption by Congress of a concept set forth in the 1976 COSIBA "Small Business Growth and Job Creation Act": Allow all businesses whose ending inventories are less than $200,000 to report their taxable income on a "cash" basis. Eliminate the compulsory "accrual" basis and all of its complicated interpretations. The temporary losses in revenue to the Treasury Department would be recovered in future years as the "cash" basis merely defers taxes.

The Tax Reform Act of 1969 gave birth to the "Assets Depreciation Range" systetm (ADR). One of the main benefits of this Act was to allow a greater depreciation write-off in the year in which an asset was acquired. However, in order to qualify for this bonus, the taxpayer is confronted with a maze of rules and regulations. This has caused the ADR system to become almost the exclusive tool of large companies. The system is written and geared for large companies. Congress could have allowed small companies an election that any asset purchased within the first 182 days of the taxpayer's fiscal year, could be depreciated for a whole year and any asset purchased subsequently, could be depreciated for ½ year.

In conclusion, Mr. Chairman, I would like to make it clear that many of the options proposed and discussed by the Ways and Means Task Force on Capital Formation in its recent report do not address the problems of small, independent business. In many cases they are simply not beneficial and some of the suggestions, such as ending the taxation of corporate dividends, could prove harmful.

These are some of the areas in the tax code that concern the small business community. There are, of course, more, but the tax writing committees are starting to look at small business matters and we are confident that once these inequities are known they will be corrected.

We are especially pleased that you, Chairman Byrd, are holding these hearings and we are grateful for the opportunity to appear before you and your Committee. We need more help from Congress and feel that this type of hearing is very important since we see little concern for small business in the Department of Treasury.

Thank you.

PREPARED STATEMENT OF EDWARD H. PENDERGAST, CPA, REPRESENTING THE SMALLER BUSINESSS ASSOCIATION OF NEW ENGLAND

Mr. Chairman, thank you for the opportunity to present the views of the Smaller Business Association of New England on the problems of small businesses when dealing with the federal tax laws and the Internal Revenue Service.

INTRODUCTION

Small businesses, generally considered to be those employing 500 persons or less, comprise 97 percent of all businesses in the United States. As reported by the Small Business Administration, more than one-half of all business receipts are generated by their operations. Perhaps more importantly, they employ more than one-half of the United States business work force.[1] Commencement and

[1] Report of the SBA Task Force on Venture Equity Capital for Small Business, US Small Business Administration, January, 1977.

expansion of new small businesses each year add significantly to the growth of our economy. This stimulant, coupled with the fact that small business is demonstrably labor intensive, means that when small business flourishes, the problem of unemployment is reduced. Further, it is recognized that the cutting edge of technological innovation is honed to its sharpest by small businessmen who must "build a better mousetrap" simply to survive. I am a volunteer representative of thousands of small businesses located across the Northeast from the industrial cities of Connecticut to the islands off the northernmost tip of Maine. My constituency is hard working, inventive in the best Yankee tradition—and frustrated.

The tax laws and their implementation seem to inhibit healthy growth of small business. Part of this is due to the basic cost of complying with tax laws not increasing proportionately with size. As a result our federal paperwork and regulatory burdens fall disproportionately on small business. When compliance becomes too difficult or too expensive, there will be a revolt. If lucky, it will be a quiet one. Bruce Fielding from the National Federation of Independent Business who is testifying here today can amplify on one example. NFIB surveyed its members with less than $100,000 of inventory. The tax laws require them to use inventory values when calculating taxable income. The survey results were that over half were reporting income on a cash basis. The law is impractical and unenforceable. The taxpayer equals with his actions the laws that are unworkable.

SUMMARY

The small businessman desires a simpler tax structure. Rules, forms and procedures adopted to implement the tax laws can add unnecessarily to the complexity he faces. The small businessman desires fewer opportunities for controversy with the IRS. Further, he believes that legal issues under the tax laws should be resolved without protracted litigation.

I would like to concentrate my testimony on three areas that impact small business. The first area is the Internal Revenue Code itself, followed by the implementation by the Internal Revenue Service and finally the specific issue of the proposed elimination of double taxation on dividends.

DISCUSSION

The Internal Revenue Code, regulations, ruling, procedures, forms, and court cases create a dense thicket of tax rules even for the specialist. To the average small businessman without employees having tax expertise this maze can appear almost impenetrable. Compliance costs are burdensome in terms of after tax net profit, and the smallest of the small businesses must frequently apply the same knowledge and effort to follow the rules as his larger competitors.[2]

SUGGESTED CHANGES IN THE INTERNAL REVENUE CODE

Depreciation of physical assets

One area of significant concern to small businessmen is the allowance for depreciation provided under code section 167. A little over ten pages of the code and 100 pages of regulations are devoted to setting forth the complex rules on this subject. In an inflationary economy it is vital for the small businessman to have the opportunity to recover the cost of physical assets as rapidly as possible through depreciation deductions. In 1971, in an effort to minimize disagreement with taxpayers over the useful lives and repair of assets, the Treasury Department adopted the class life ADR System. This reduction of controversy purpose is started in the Section 167 ADR (asset depreciation range) regulations.

The theory of ADR is excellent. By and large it permits more rapid write-offs of costs related to productive assets than would otherwise be the case under

[2] A standard bound edition of the Internal Revenue Code with nine by six inch pages is over 2,100 pages long. Final and proposed regulations exceed 6,000 pages. IRS Revenue Rulings and Revenue Procedures published weekly in the Cumulative Bulletin number many thousands, and finally, a welter of court cases in the Tax Court, Court of Claims, Federal District Courts, Federal Appellate Courts and Supreme Court of the United States fill over 100 volumes. (*See Internal Revenue Code* including 1976 amendments, *Income Tax Regulations* as of March 18, 1977 (3 volumes) both published by Commerce Clearing House, Inc.) A well-known tax information service in 1977 expanded its 7 volume loose leaf service on the Federal income tax law to 28 separate volumes. *Tax Action Coordinator*, Research Institute of America.

conventional tax depreciation rules. But the implementation of this program has been characterized by such obtuse language, sporadic but frequent changes, complexity and high cost of administration that the typical small businessman has been unable to take advantage of it. Revenue Procedure 72-10 which was adopted by the IRS to implement the ADR System has been amended no less than 22 times by additional Revenue Procedures since it was promulgated in 1972. The regulations drafted by the Legislation and Regulations Division of the IRS Chief Counsel's office to define this program are so complicated that 25 separate terms require special definitions. The following single sentence from these regulations is characteristic and evidences why small businessmen cannot reasonably be expected to comprehend, apply, and benefit from the ADR program. Many other regulations under section 167 are no less complex.

"In the case of eligible property first placed in service in the taxable year of election (and not otherwise properly excluded from an election to apply this section) the taxpayer may not compute depreciation for any of such property in the asset guideline class under a method not described in Section 167 (b) (1), (2), (3), or (k) unless he (1) computes depreciation under a method or methods not so described for eligible property first placed in service in the taxable year in the asset guideline class with an unadjusted basis at least equal to 75% of the unadjusted basis of all eligible property first placed in service in the taxable year in the asset guideline class and (2) agrees to continue to depreciate such property under such method or methods until the consent of the Commissioner is obtained to a change in method." Regs. Sec. 1.167 (a)-11(b) (5) (v) (a).

Omitting the use of ADR, many small businesses have continued to be harassed by the IRS over such matters as useful lives and salvage values of depreciable assets and repair allowances. The IRS should be encouraged to extend the spirit of ADR in ways that will benefit small businesses. At the very least, for example, the Service should refrain from making meaningless roll-over adjustments for depreciation the sole effect of which is to shift deductions between years.

In addition, we recommend that the small businessman be given the opportunity to eliminate disputes with the IRS over depreciation deductions by following a depreciation method which he can easily understand. Specifically, Congress should allow a deduction for the full cost of the first $200,000 of depreciable personal property and depreciable real property. The timing of this deduction should be totally within the control of the taxpayer; if he wished he could claim a deduction in a particular year of up to $200,000 of such costs.

This proposal will not result in a net revenue loss to the Government. It will simply delay the receipt of tax dollars. It eliminates the need for a small businessman to prepare detailed depreciation records on each item of property which he acquires and reduces potential controversy with the IRS. It also eliminates the present temptation to expense some items because of frustration with the complexity of current depreciation rules and a perceived inability to take full advantage of those rules at a reasonable cost.

Tax rates and the surtax

The surtax exemption which has effectively been raised to $50,000, should be increased to $150,000. Absent this we should adopt a graduated income tax structure. The establishment of $25,000 as the surtax base was in the early thirties. Inflation alone has increased this to over $150,000. In addition, studies have shown that smaller corporations pay a higher effective tax rate than large corporations. For some reason, it becomes extremely difficult to have this legislation adopted and when it is adopted it is only temporary. We of small business do not have the resources to return to battle every year or so about the same issue. We tend to state our case and expect fair consideration. This is an expensive piece of legislation but is so fundamental to the growth of the small and medium size business it must be passed. As an added point, we wish relief for the cyclical business to allow him to carryover unused surtax exemption, giving him a form of income averaging. Under the present laws, a corporation that makes nothing in one year and $100,000 in the second year pays $34,500 in taxes. If the same business made $50,000 each totalling the same $100,000 he would pay $21,000 or $13,500 less although the combined two year income for both is the same!

Capital gains

When a business is sold, the present tax law encourages an exchange of stock for stock to effect a tax free exchange.[3] This shifts capital from small business to large business because the seller does not want to take shares in a smaller non-publically traded corporation so he sells to a large publically held corporation. Under our proposal, he could sell to the small non-publically traded corporation for cash. If the money were reinvested in another qualified small business investment within a specified time the capital gains tax would be deferred until sale of the new stocks. This would not be a revenue loss bill. Its purpose would be to retain capital in the small business sector rather than shifting it to the large business.

Small business stock

Section 1244 allows a deduction against ordinary income of qualified small business stock losses up to $25,000. This should be increased to $50,000 and increase the limit on an offering from $500,000 to $1,000,000 and the limit on the size of the issuer should be raised from $1,000,000 to $2,000,000. The election should be removed and 1244 should become automatic. The present law does not protect small companies without the knowledge of this code section.

Elective versus automatic laws

Many sections of the code require positive assertion through a proper election. In many of these cases the election provision is unnecessary. The Small Business Stock is a good example. Sub-Chapter S election is another. The filing of the return should be the election. The election type of law can trip up the unsuspecting, provides for more paperwork and adds to the income of tax specialists. No doubt many of the elections require separate filings but if not necessary this should be eliminated.

Implementation of law

If Congress deserves criticism in any area it is never clearer than when a law is passed hurriedly requiring prompt implementation. ERISA and OSHA are not the only examples. The Tax Reform Act of 1976, signed on October 4, 1976 could not be digested in time to deal with some of the choices that needed to be made before December 31, 1976. It is little wonder that the humorists call this the Accountants and Lawyers Relief Bill.

Capital formation

Perhaps the greatest economic problem facing our nation is the generation of the capital required to modernize and expand our industrial plant. One important way in which a small business expands its capital is to retain after tax earnings. The small businessman questions whether the IRS fully comprehends and appreciates this fact of business economic life. He sees IRS applying the rules of Section 531—the penalty tax on accumulated earnings—in a heavy handed way.

When the IRS locks onto this issue the taxpayer is faced with coming forward with evidence on the issue of the reasonable needs of the business under largely subjective criteria established in the regulations.[4] In some instance, the taxpayer has been successful in quantifying these criteria through acceptance by the courts of an operating of an operating cycle approach to determine the amount of needed working capital.[5] Generally speaking, however, the broadness of the regulation gives the IRS ample maneuvering room to advance many theories in support of its charge. Faced with an IRS challenge under Section 531 the small businessman is frequently persuaded that it is cheaper in the long run to compromise than to fight the Government's abundance of resources for litigation.

The impact of Section 531 should not be measured only by the results of litigated cases or agreed deficiency assessments. Its full impact must take account of its in terrorem rôle which influences the small business corporation to pay dividends absent solid evidence of business needs in a hesitant economy. As an alternative to dividends, a corporation may adjust compensation to reduce the accumulation of earnings. This practice, however, creates the possibility of another controversy which the IRS pursues with vigor: Was the compensation "reasonable" or "unreasonable" under Section 162?

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[3] Code section 368 incorporate the various types of mergers and reorganizations generally used to effect tax free exchange of securities.
[4] Treas. Regs. Sec. 1.537–2.
[5] See Bardahl Mfg. Corp. 24 TCM 1030 (1965).

The IRS should soften its audit routines under Section 531 and Congress should review the rationale for this section in the light of the Tax Reform Act of 1976 and other changes in the Internal Revenue Code enacted since the tax on accumulated earnings was first adopted in 1939. Most particularly, we believe that the carryover basis rules of Section 1023 and the increase in the minimum tax under Section 56 reduce markedly the need for concern as to whether a shareholder is currently taxed on the income of a corporation. Indeed, the strong sentiment present throughout our land and in Congress itself in favor of some relief for the double taxation of dividends could find an appropriate outlet in the repeal of Section 531 of the Code. This step would certainly serve the twin objectives advocated by small businessmen: Simplification of the tax laws, and reduced opportunity for controversy with the IRS.

COMMENTS ON THE INTERNAL REVENUE SERVICE

ERISA

Since most small businesses are labor intensive, taking a deduction for the amortization of human capital is an important tax minimization method. One form of this deduction is a contribution to a qualified pension plan. As we all know, ERISA[6] radically changed the Internal Revenue Code rules pertaining to such plan.

Your Committee has no doubt been made aware of many of the ambiguities and uncertainties surrounding ERISA which have discouraged the use of qualified plans by small business to protect against the amortization of human capital. We believe that if the IRS, however, had proceeded forthwith to use plain English in the establishment of rules and guidelines for the implementation of this law, many of the law's critics would have been silenced and the program would have moved forward as intended. This history of the announced guidelines, regulations, and forms under ERISA is replete with examples of requirements for establishing an ERISA qualified plan which are baffling in their complexity.[7] Perhaps one of the most striking examples of the IRS penchant for transforming the simple into the complex is found in Revenue Procedure 75-31.[8]

Section 3001(a) of ERISA requires an applicant for a determination letter from the IRS to "provide evidence satisfactory to the (IRS) that the applicant has notified each employee who qualified as an interested party . . . of the application for a determination." In Revenue Procedure 75-31 the IRS proceeded to turn this straight-forward one sentence rule into five tightly packed pages of explanations, instructions, and a sample notice which may be given to employees. A copy of this notice is included in Exhibit A to this testimony. We submit that this notice simply cannot be understood by the average plan participant. In short, it subverts the requirement of Section 3001(a) of ERISA. More importantly for my constituency, if the elaborate notice procedures outlined in Rev. Proc. 75-31 are not followed to the letter, the IRS can summarily return a firm's application for determination as incomplete and the whole notice procedure must be repeated. If the applicant's 1976 tax return has already been filed, and further amendments to the plan are ultimately found to be necessary by the IRS, the firm's initial failure to comply perfectly with the notice procedure may cost it a tax deduction for its 1976 contribution to the plan. Some aspects of ERISA may require complicated administrative rules. However, we fail to see why the IRS cannot adopt simple rules wherever possible to implement this legislation.

The ERISA notice procedure which I have just outlined is an example of the landslide effect of Congressional legislation on the public. Congress reposes at the peak of a rule making mountain. It casts a pebble down the slope of the Federal bureaucracy. Legions of civil servents spring into action, and by the time that pebble has come to rest, a landslide of related rules and regulations has decended on the population below. The small businessman is being crushed by an avalanche of words.

Another problem with the implementation of ERISA is the delay between the effective date of the law and the issuance of necessary regulations. Effective for taxable years beginning after December 31, 1975 a business with self-employed

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[6] PL 93-406, September 4, 1974.

[7] See for example "Employee Benefit Plans: Completing New Form 5301 Poses Some Knotty Problems", Clark R. Byam, Journal of Taxation, November, 1975.

[8] Rev. Proc. 75-31 has its origin in Treas. Regs. Sec. 601.201(0)(3)(xv). It was subsequently modified by Rev. Proc. 75-37 and amplifies Rev. Procs. 72-6, 74-38 & 75-5.

individuals or shareholder employees was placed on more equal footing with a corporation with respect to the type of pension plan which it might adopt. Section 2001(d)(2) of ERISA permitted such a business to have a defined benefit Keogh Plan.

This type of plan permits the tax deductible funding of annuity benefit payments and will result in a larger permissable tax deductible contribution than a standard Keogh profit sharing plan. The theory is excellent. The only problem is that the IRS has not yet issued proposed much less final regulations necessary for the efficient adoption of a plan which qualifies under this Section.

Equally important, from the standpoint of the small businessman, the IRS has not yet issued either a Keogh or non-Keogh prototype defined benefit pension plan.[9] To comply with and take full advantage of the provisions of ERISA for a deduction for the amorization of human capital the small businessman needs a defined benefit plan he knows the IRS will accept as qualified. This will both simplify compliance with ERISA and reduce potential controversy with the IRS.

IRS litigation

One red flag in the Internal Revenue Manual for IRS auditors is the "IRS Prime Issues" list. The Manual describes this list as containing a summary of, "Those issues which present legal questions of major importance in the administration of the internal revenue laws and which have not been tested adequately in litigation. Prime issues are those that the IRS will ordinarily *insist* on litigating and that will not ordinarily be conceded or compromised."[10] Thus, if a small businessman becomes involved with the IRS on a prime issue, he is either forced to concede the amount in question or undertake an inordinately expensive process of resistance. Even if prior litigation has shown the IRS to be wrong in the Tax Court and one or more Appellate Courts, if the Circuit to which a taxpayer's appeal might be taken has not yet decided the issue the IRS will hold fast to its position. The current prime issue list contains several issues important to small businessmen such as whether a personal holding company's dividends paid deduction equals the fair market value or the adjusted basis of property distributed by the corporation as a dividend.

By and large, small business does not have the resources to engage in protracted controversy with the IRS. We believe that Congress should scrutinize the IRS prime issues list, its litigating posture in nonprime issue areas and proposed regulations. All of these interpretative positions are adopted and maintained upon the advice of the Chief Counsel to the IRS in an effort to protect the public revenues. By timely action to change or ratify these positions, Congress could eliminate years of uncertainty and thousands of man hours of both Government and taxpayer time which is consumed in complex arguments over legal rather than factual issues. In short, Congress should cut the Gordian knots as fast as the IRS (or the taxpayers) can tie them.

For example, a taxpayer successfully argued against the IRS as early as 1953 that an employer's contribution of its negotiable demand note to a qualified pension trust gave rise to a deduction in the year the note was transferred.[11] The IRS disagreed and continued to litigate the issue, losing first in the 9th Circuit[12] and then in the 10th Circuit.[13] Undaunted, the IRS finally won the issue in 1976 in the 7th Circuit and was vindicated by the Supreme Court this year.[14]

Even controversies which do not involve a prime issue are often compromised by the IRS on the basis of "litigating hazards."

The small businessman looks at the lengthy and litigation oriented process of establishing tax law with great dismay. He would like the Government to establish its tax collecting rules expeditiously, clearly and fairly. The process should not be weighted in favor of those who can outfight their opponent in court. This intimidates the people I represent.

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[9] Prototype plans have been issued for money purchase and defined contribution plans (Forms 5614 and 5613).

[10] MT–1277–8, November 19, 1974. (Emphasis added.)

[11] Slaymaker Lock Co., 208 F. 2d 313, (3rd Cir., 1953). *Note:* Section 406(a)(1)(B) of ERISA makes such a contribution a prohibited transaction and therefore renders the issue moot for transactions after January 1, 1975.

[12] Time Oil Co., 258 F. 2d 237 (9th Cir., 1958).

[13] Wasatach Chemical Co., 313 F. 2d 843 (10th Cir., 1963).

[14] D. E. Williams Co., 527 F. 2d 649 (7th Cir., 1976); Affd. Sup. Ct. — US — (1977).

IRS administrative positions

The IRS requently provokes controversy by taking administrative positions that are burdensome, unnecessarily rigid and arguably unreasonable. For example, several Internal Revenue Service Centers have taken the position that where an extension request is sent by metered mail instead of postmarked mail, it must be received before the due date for the return. This appears contrary to Treas. Regs. Sec. 301.7502-1(c)(1)(iii)(b) which holds that metered mail documents are timely filed if dated on or before the due date and received thereafter in the same time required for stamped mail.

Another example is Revenue Ruling 76-453 which establishes new tough rules on the withholding of payroll taxes on travel expenses.[15] In essence, the ruling holds that if an employee does not report to his office before visiting the initial client or customer of his day, then travel expenses to that customer's place of business and for the final trip home in the evening are wages subject to withholding tax. The ruling was issued in November, 1976 with an effective date of January 1, 1977. This novel IRS position caused thousands of employers to make changes in payroll and expense reimbursement systems. The impossibility of the initial due date soon become apparent and the implementation of the position was delayed first three months and then six months. The ruling is certain to provoke litigation and cause thousands and perhaps millions of dollars to be spent in efforts to comply, avoid or contest its position. The small businessman resents the unannounced establishment of substantive tax law in the guise of a "Revenue Ruling" which costs him time, money and compliance energy. When the basis of the rule promulgated is questionable, the process appears to be simply a way for the IRS to avoid the notice and public comment requirements of the Administrative Procedures Act.[16]

In the experience of small businessmen, the IRS's selection procedures for the audit of returns are geared to discover returns for examination which will result in additional tax. The complexity of the tax laws together with the limited knowledge and resources of small businessmen to comply with these laws makes it probable that many are overpaying their taxes. The IRS should be compelled to develop selection procedures designed to uncover such returns.

One audit selection procedure currently relied upon heavily by the IRS is the Discriminate Inventory Function (DIF). This procedure requires the establishment of normal amounts for the several deductions which may appear on a return. Computer reading of returns spots those returns with amounts outside of the normal range for further human review. The maintenance of the DIF program requires the IRS to make a random selection of returns for in depth audits under the Taxpayer Compliance Measurement Program. The initials TCMP in a letter from the IRS announcing that a small businessman has been selected to be audited means that he will incur additional expense and administrative downtime before the agent is satisfied. In such an audit no number in a return is sacrosanct and every item is suspect. Since the TCMP is designed to check IRS procedures, small businessmen feel that they should be compensated in some way by the Government for serving as audit guinea pigs. At present, part of the cost of administering the IRS is shifted to those taxpayers unlucky enough to be selected for a TCMP audit.

Extensions of time

Often the IRS takes considerable time to develop a revenue agent's case. The taxpayer is routinely asked to grant extensions of the statute of limitations along the way. When they complete the work, the agent's report is handed to the taxpayer with a cover letter stating that protest must be filed within 30 days. If extensions of time are granted by the IRS, it is with great difficulty. Fair treatment would allow a more liberal approach.

Double tax on dividends

Pressure is building to eliminate the "unfair" double tax on dividends. It would follow that corporations would pay larger dividends. Small businesses must retain their earnings to grow and usually cannot pay dividends.

The obvious result is that more capital would be attracted to the large publicly held corporation and less to small business and savings and loan associa-

[15] IRB 76-47, 6.
[16] 5 USC 552, et seq.

tions. The Report of the SBA Task Force on Venture and Equity Capital for Small Business details the woes of small business in attracting capital. It should be mandatory reading.

Two points might be evaluated. The first shows that a private evaluation of the Joint Committee on Internal Revenue indicated that a corporate dividend of $150 of a certain type of corporation would yield a credit of $56. The 50% or lower taxpayer would not only have no tax but could apply this balance as a credit against other income. The second item needing evaluation is the change that both France and England made in mitigating their double tax. The effect may not have been as anticipated.

Small business need not question whether the double tax should be eliminated, but rather, if it is eliminated or reduced, significant offsetting benefits must be granted small business for survival. Less than that would be the most severe blow that small business has received in some time.

CONCLUSION

Tax laws and their implementation with attendant paperwork have become a burden beyond the comprehension of the average man. One federal tax service, The Bureau of National Affairs, takes up 15 feet of shelf space! It does not even deal with payroll taxes! Every suggestion for simplicity is answered with another layer of law followed by layers of regulations. The tax rates are burdensome enough. Compliance with the law is becoming one of the most expensive necessities in business.

Simplicity and Equity is what small business demands. That is the sum total of our needs. The preceding pages are some steps that may be taken toward that goal. Your help and concern are appreciated.

Rev. Proc. 75-31—Exhibit A

NOTICE

[Describe class or classes of interested parties]

Application is to be made to the Internal Revenue Service for an advance determination on the qualification of the following employee retirement plan:

Name of Plan:
Name of Applicant:
Name of Plan Administrator:
Plan ID No.
Applicant ID No.

The application will be submitted to the District Director of the Internal Revenue at *(address of district office)* for an advance determination as to whether or not the plan qualifies under section *(enter 401(a), 403(a), or 405(a))* of the Internal Revenue Code, with respect to *(initial qualification, plan amendment, or plan termination)*.

The employees eligible to participate under the plan (describe by class):

The Internal Revenue Service (enter has or has not) previously issued a determination letter with respect to the qualification of his plan.

Each person to whom this notice is addressed is entitled to submit, or request the Department of Labor to submit, to the District Director described above a comment on the question of whether the plan meets the requirements for qualification under part I of subchapter D of chapter 1 of the Internal Revenue Code of 1954. Two or more such persons may join in a single comment or request. If such a person or persons request the Department of Labor to submit a comment and that department declines to do so in respect of one or more matters raised in the request, the person or persons so requesting may submit a comment to the District Director in respect of the matters on which the Department of Labor declines to comment. A comment submitted to the District Director must be received by him on or before (date). However, if it is being submitted on a matter on which the Department of Labor was first requested, but declined to comment, the comment must be received by the District Director on or before the labor of (date) of the 15th day after the day on which the Department of Labor notifies such person or persons that it declines to comment, but in no event later than (date). A request of the Department of Labor to submit a comment must be received by that department on or before (date) or, if the person or persons making the request wish to preserve their right to submit a comment to the District Director in the event the Department of Labor declines to comment, on or before (date).

Additional informational material regarding the plan and the procedures to be followed in submitting, or requesting the Department of Labor to submit, a comment, may be obtained at (place or places reasonably accessible to the interested parties).

Senator BYRD. Our next witness is Mr. Herb Krasnow, president, National Association of Small Business Investment Companies. He will be accompanied by Mr. Walter B. Stults, executive vice president.

STATEMENT OF HERBERT KRASNOW, PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES; ACCOMPANIED BY WALTER B. STULTS, EXECUTIVE VICE PRESIDENT

Mr. KRASNOW. Thank you, Mr. Chairman.

I am president of a medium-sized small business investment company, SBIC. I listened to the testimony this morning, and I just about zippered up my pocketbook.

There is much that was said this morning that was tremendously negative in approach. Many positive things are happening in the small business area, which are not understood.

I would like this morning to draw a bit on that.

In 1958, the effective act that started the small business investment company program gave rise to some companies and, 18 years later, there is excellent successs; $3 billion have been invested in the 18-year period. The loss written off by the Treasury has been only $29 million.

On a numbers-only basis it would be quite significant, but probably what is more significant is that a new financial concept has been born. It is called venture capital today. There is a core of tremendously experienced people who have, as their goal, the investment of money in small business, the building up of their small businesses, cycling their money, and then, when they have their profit, taking that money and investing it in other small businesses.

One of our purposes in being here this morning, Walter Stults and myself, is basically to recommend ways where this process may be accentuated so there will be more capital flowing into the small business sector.

Several people spoke of the Task Force of the Small Business Administration. That was created by William Casey under the supervision of Administrator Kobelinski.

I understand reports have been delivered to the staff and to the various Senators of the subcommittee. The report covers many of the aspects that were discussed this morning and there were different groups of people who presented different viewpoints: the viewpoint of the small business, the viewpoint of the underwriting community, the viewpoint of the banking community, the viewpoint of the Small Business Administration itself.

Many of the things that were said today are very well-written in the report and I would very much like to have an opportunity to be of any assistance if there are any aspects there that could yield to more discussion or more detailed recommendations.

In our own trade association, we have also examined how to do the job better. We have come up with a 20-point program which I would like very much to see entered into the minutes. We call it our NASBIC legislative and regulatory program.

There are some tax aspects in there, also some nontax aspects. I am a man who has been in venture capital since 1949, 28 years of my life, the biggest bulk of my life. I am positive that the numbers that are in the prepared testimony that I presented to the committee there are numbers that indicate that the small business community is vibrant, it is large, it is not dying, but it is being discriminated against. Basically what really is needed is first, an understanding of what the small business community really is as against the so-called business community which masquerades as something else again.

And, what are the positive and the negative factors that, in effect, must be looked to because it is not all negative. There are many, many positive factors.

If this committee can focus on the fact that there are two business communities, that the small business community under the SBA standards employs more than 50 percent of the employees of this country and small business may be small but it is not insignificant. That is really the major point.

Not only is this most significant in numbers, but also in its creativity, in the fact that, from a social viewpoint, it is tremendously important to many of us in the United States to have a strong independent sector. There are not too many of us who want to live in a country of big business and big labor and big government. We strive for that independence.

It is a tremendous psychological and emotional factor. It is completely separate and apart from the numbers. There are studies that are a part of the documentation that we have submitted that shows that this creativity performs for the country in a way that big business does not.

We all are emotional and psychological creatures, and many of us have given up opportunities to enlist in the big business areas simply because of those emotional and those creative factors that we treasure. I am one of them. I would not want to be a part of them—not that they do not have a great place, not that they have not been instrumental in making this country many, many things that it is, but there is a vital factor and a vital place for small business in our society. If we can recognize that, then I think my presence here this morning and the presence of many of the other men will be most important.

The specifics will vary. What is very surprising, though, when we talk about the Casey task force report and talk about the Small Business Administration's Advisory Council, talk about the NASBIC program, Ned Heizer will be talking about the National Venture Capital Association, there is commonality. Many, many of the same things are repeated time and time again.

I will not repeat them this morning because they are in my reports and with some study, notwithstanding, they will all come out.

The fact I would like to get across is that in the creativity that lies in our small business sector, there is growth, there is a great deal of pride, there is independence, there is protection for our democratic ideals, and all of these things have a place.

Thank you very much, Mr. Chairman.

Senator BYRD. Thank you, sir.

What two or three proposals—if you were going to boil it down to two or three proposals—would you consider to be the most beneficial to small business?

Mr. KRASNOW. We have many biases that are built into our tax laws. I am a certified public accountant as well as a venture capitalist and a member of a medium-sized accounting firm.

I recognize in this profession—for instance, we have the reorganization provision that permits a small business man to take common stock, or preferred stock in some circumstances, of a larger, publicly owned company. He pays no taxes; taxes are deferred.

That same man may be confronted with a desire to pass the business to his employees. To do that he has to take his sales price, maybe take 50 percent of that, and turn it over to Uncle Sam. Given the same dollar equivalent of merging him with the larger company, turning over his business to his employees, when in the second case it comes to 50 percent of his tax dollars, there is only one way to go.

So we have a bias toward merging smaller, independent firms, into larger, public companies. That, in many, many cases, is antisocial, antidemocratic. It is moving us toward monopoly.

One of the provisions is basically a provision that says, if you will take the money that you get from the sale of your business and reinvest it in other small businesses, we will let you defer the tax just as if you basically were to merge it into a larger company. It is to remove the bias. Tremendously important.

Senator BYRD. What you are saying is that the tax laws are operating in a way which increases bigness.

Mr. KRASNOW. Absolutely. No doubt about that.

Senator BYRD. In many cases, it forces the smaller companies to merge or sell to the larger companies.

Mr. KRASNOW. That is absolutely true, sir, and it happens in many, many ways. That would require not 10 minutes but maybe 3 or 4 hours of discussion, that, in effect, just are antisocial.

I serve on the board of a company on the American Stock Exchange. Friday afternoon after the close of business we bought control of a wonderful growth company, itself an OTC publicly owned company, where, because there was no market in their shares, they sold for cash to this company on the American Stock Exchange. It just is wrong.

In this case, as a member of the board of directors, we are very happy because we have some wonderful men coming into our group and it is going to enhance our profits and all of the things that we look to, but I have to say to you, though, that basically the destruction of these independent companies because they do not get a trading value, good price/earnings ratio, a market because they are too small, is just as bad for our country.

The type of deferral that we talk about in our NASBIC program is tremendously important. We are also in favor of the jobs credit which now, in effect, has been turned back to conference. Here, too, business represents itself in being interested in the investment credit.

The fact of the matter is, big business is much more interested in investment credit; little business, small business, tremendously labor oriented, does not use machinery many, many times.

Accordingly, this jobs credit which now, in effect, has passed both houses is tremendously effective for us and will, in effect, help our unemployment situation as well.

I do not mean to say that basically everything should be done for small business, it is allusory, simplistic, it will not happen.

I say that there should be a greater understanding of the place of small business in our society so that they get evenhanded treatment and are not discriminated upon, either by dollar sign or lack of understanding.

Senator BYRD. Let me ask you this. In 1976, Congress made many changes in the estate and gift tax laws. What has been the effect of these changes on small business?

Mr. KRASNOW. Those changes as to the businessman who accumulates up to $500,000 of net worth have been, and will be tremendous, because they do not force him to divest the family business simply to put aside the estate tax money that he knows his executors will have to provide.

It is one of the more far-reaching changes that we have seen in the small business sector and we had that in our program it is very much to be recommended for explaining the benefits that could be effectuated by that.

Senator BYRD. Mr. Stults, do you have anything to add?

Mr. STULTS. Mr. Chairman, I would like to ask unanimous consent that our program be inserted as a part of the hearing record and that Mr. Krasnow's statement in full be inserted.

Senator BYRD. The committee will be glad to do that.

Mr. STULTS. Mr. Chairman, you were talking about the basket case under ERISA and the fact that you are open minded. I sat here last week listening to the testimony before the Bentsen subcommittee. It was pointed out by witness after witness that pension fund trustees have $455 billion under their control. It is expected, in another 5 or 6 years, that over half of all of the financing in the Nation will be in the hands of these trustees.

The prudent man rule has meant that a trustee has to protect himself down the road from suits filed by any employee covered by a plan who could say "Why did you invest in the Krasnow company at 10 and it went to 5? We are going to sue you."

There would be no similar question about an investment in A.T. & T. or in General Motors. So I would maintain, and other witnesses did last week, that for all of those billions of dollars, that they are now all being invested in the shares of some 200 firms.

Now, I think that has a tremendous stultifying effect on our national economy. A 2-percent basket clause—insurance companies in Virginia and almost every other State in the country have a nonadmitted assets classification of 5 percent—allowing pension fund trustees to put 2 percent of their stocks, of their assets into venture capital pools, into SBIC's and into the securities of small businesses themselves. That is an investment in growth.

IBM grew through investment, by institutional investments, at a time when it was a relatively small company. Xerox, the same way. Control Data the same way. Today none of those companies could have gotten up into the top 100 under the prudent man rule under ERISA.

I just make an urgent plea to you to study the testimony and try to keep this one further factor from concentrating all of the money of the power in this country in some 200 corporate hands. I know you do not want that.

Senator BYRD. I certainly do not. I am certainly in agreement with your objective. I think you make a strong case.

As I said, this is a matter for careful consideration. I have some hesitancy in saying on the spur of the moment that the prudent man rule should be set aside, but I think that something needs to be done to accomplish the purpose that you have in mind.

Mr. KRASNOW. If I could add one word. The major problems today in our world society are concentration of power, concentration of assets and resources in fewer and fewer hands. Walter Stults talked about one piece of legislation designed to create safeguards which inadvertently is acting to concentrate these assets.

There are numbers in all the reports that indicate just how fast that concentration is moving. In just 15 years, in the banking structure, the 10 biggest banks have moved from 20 to 30 percent of the deposits within their confines.

I think that there is nothing more antidemocratic than this trend toward concentration of assets in fewer and fewer hands, and it is in small and large acts, not a single act that this trend can and should be arrested.

Senator BYRD. I think you are so right. Government has tended to encourage that. Government laws and government regulation have tended to encourage the concentration of power, economic power, yet the antitrust laws are supposed to be going in the opposite direction.

Mr. KRASNOW. They have not been as effective as they should be.

Senator BYRD. Beyond the antitrust laws not being as effective as they should be, other laws, particularly tax laws, are forcing more and more concentration.

Thank you gentlemen very much. It has been an interesting and helpful testimony.

[The prepared statement of Mr. Krasnow follows. Oral testimony continues on p. 72.]

STATEMENT OF HERBERT KRASNOW, PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Mr. Chairman and members of the subcommittee: I am Herbert Krasnow, President of the National Association of Small Business Investment Companies whose more than 300 members represent over two-thirds of all the licensed SBICs and minority enterprise SBICs (MESBICs) and about 90 percent of the assets committed to the industry. For the past 15 years, I have served as the founder and President of Intercoastal Capital Corporation, a medium-sized SBIC located in New York.

On behalf of the SBIC industry, I wish to thank this Subcommittee for turning the spotlight on a little-understood economic problem which threatens to hobble the vaunted American free enterprise system: an inadequate rate of capital formation. Unless this trend can be reversed, prices and unemployment will both rise; our productive plant will come increasingly obsolete; independent businesses will not be able to expand or to compete effectively; and new businesses will not be formed.

My testimony will cover two broad but integrally related areas. First, I shall discuss the capital formation problem as it affects small business directly. In this subject area I would like to discuss small business's need for additional internally generated funds as well as its need for more long-term debt and equity capital. Second, I shall briefly discuss the SBIC industry and the role we play in capital formation for small business. In both discussions I have included suggestions for legislation which will, if enacted, help to dramatically improve the economic viability and competitive position of all small business in general and serve to significantly increase the amount of capital flowing into the SBIC industry. The latter is desperately needed in order to provide the capital needed to finance venture and equity needs in the small business sector of the economy.

THE SMALL BUSINESS CAPITAL GAP—INCREASED INTERNAL CAPITAL NEEDS

A small business relies on both internal and external funds for financing and expansion capital. Unfortunately, when scarce debt and equity capital is doled out via the traditional financial markets, small business is always at the bottom of the ladder. For that reason, small business has to rely more heavily upon internally generated funds for its financing. These internal funds come, of course, from after-tax earnings which are becoming more difficult to maintain due to the increasingly hard bite of corporate income, and other taxes.

Our first recommendation gets directly to the problem of inadequate after-tax retained earnings and would graduate specifically the first $400,000 of corporate taxable income for all corporations. The following schedule is recommended:

Taxable income:	*Marginal rate*
	Percent
$0 to $9,999	10
$10,000 to $19,999	12
$20,000 to $29,999	14
$30,000 to $39,999	16
$40,000 to $49,999	10
$50,000 to $59,999	22
$60,000 to $69,999	25
$70,000 to $99,999	28
$100,000 to $149,999	31
$150,000 to $199,999	34
$200,000 to $249,999	37
$250,000 to $299,999	40
$300,000 to $349,999	43
$350,000 to $399,999	46
$400,000 and up	48

As you can see, the current maximum corporate rate would be reached at $400,00 rather than the current $50,000. Although this reduction would help all corporations, it would especially help smaller companies that do not have large taxable incomes and do rely heavily on every dollar they can retain for financial well-being and long-term growth.

An important concept guiding tax policy is ability to pay. The unintended result of present tax law is that those companies least able to pay (small companies) are assessed a greater percentage of their income in Federal taxes. The following excerpt from the 26th Annual Report of the Senate Small Business Committee portrays the problem in very explicit terms:

> Initially, the committee analyzed the Federal Trade Commission Quarterly Financial Reports, which set forth before-tax and after-tax rates of return of manufacturers of many different asset sizes. This yielded a comparison of "effective tax rates" which is set forth below:

COMPARISON OF EFFECTIVE TAX RATES OF MANUFACTURERS OF DIFFERENT ASSET SIZES [1]
[In percent]

Asset size	Profits before Federal taxes	Profits after taxes	Effective tax rate
All manufacturing corporations	16.5	9.675	41.36
Under $1,000,000	14.975	7.30	51.25
$1,000,000 to $5,000,000	17.375	8.575	50.64
$5,000,000 to $10,000,000	18.075	8.70	51.86
$10,000,000 to $25,000,000	16.325	7.95	51.30
$25,000,000 to $50,000,000	15.875	7.825	50.70
$50,000,000 to $100,000,000	16.075	8.225	48.84
$100,000,000 to $250,000,000	17.20	9.275	46.07
$250,000,000 to $1,000,000,000	17.675	9.85	44.27
$1,000,000,000 and over	16.00	10.375	35.15

[1] U.S. Congress, Senate, Select Committee on Small Business, 26th Annual Report, 94th Cong., 1st sess., 1975, p. 85.

Smaller companies are not asking for a handout, a giveaway or a loophole. Small business is willing to pay its fair share—but let's not ask for more than that.

Our second recommendation calls for the adoption of simplified and liberalized depreciation schedules which can be used by small companies that cannot afford to hire sophisticated tax lawyers and accountants to help them avoid taxes via the skillful use of existing depreciation schedules. Adam Smith, the father of economics, professed that a tax should be certain, convenient and economical. While it can be argued that the complicated depreciation schedules in use today meet none of those requirements, the third is the impediment to which I feel compelled to speak. It is simply not economical for a small company to keep the records and hire the staff and counsel necessary to utilize sophisticated techniques to depreciate capital investment. Also, it is not ultimately economical for the federal government to police and enforce these statutes. As we all know, the simpler the tax code is made the easier it is for companies and individuals to comply and the easier and cheaper it is for the IRS to collect.

The third recommendation for small business tax policy change we support is one which we are glad to say has already been passed by both bodies of Congress. It is the job creation employment tax credit which will help provide a much needed incentive for investment in increased employment. Few people realize that Small Business not only generates approximately 43 percent of total Gross National Product but also employs 55 percent of the business workforce. Because small business is more labor intensive than business in general, the Employment Tax Credit is very useful to them and will certainly bring about increased employment.

THE SMALL BUSINESS CAPITAL GAP—LONG-TERM CAPITAL NEEDS

I'd like to now turn to an area in which SBIC managers have special experitse: long-term venture (debt and equity) capital financing for small business. As I mentioned before, I am president of Intercoastal Capital Corporation, an SBIC located in New York, and I have been involved in the SBIC industry nearly since its inception. I am convinced that there is a shocking dearth of long-term capital financing for small business in this country. This problem is, without a doubt, one of the most serious in terms of the long-term vitality of our free-enterprise system. We, at NASBIC, have in the past and hope in the future to play a significant role in providing "lifeblood' venture and equity capital financing for independent small business. That sector has fallen increasingly further behind as ever scarcer investment capital is parceled out in the markets. The capital shortfall to small business is directly traslatable into a loss to the American consumer via reduced product innovation and price competition.

We at NASBIC have just finished a comprehensive review of our industry and have designed a program which will serve to significantly increase the flow of dollars going into venture capital in this country. I would like to request that the NASBIC Legislative/Regulatory Program for 1977 be included as part of the record if it please the chair. Let me stress also that this will not be a mere shuffling of scarce dollars from one sector of the economy to another, but rather an injection of vitality into an area which will earn, in the long-run, a fiscal dividend. This is possible since investment in small, fast-growing businesses generates, ultimately, a greater amount of economic activity which in turn provides greater aggregate wealth for the economy and additional tax dollars for the treasury. For example:

A recent study by Massachusetts Institute of Technology Development Foundation has arresting data on the importance of new companies and new technologies to property and jobs in America. It compares the performance of six mature companies, five innovative companies, and five young high-technology companies. From 1969 to 1974, the average annual contributions of these companies in jobs and revenues shaped up as follows: [8]

[8] U.S. Small Business Administration, "Report of the SBA Task Force on Venture and Equity Capital for Small Business," Washington, D.C., p. 2.

[In percent]

Type of companies	Sales growth	Job growth
Mature	11.4	0.6
Innovative	13.2	4.3
Young high technology	42.5	40.7

Further, one Government study sampled SBIC-financed small businesses and found that those companies achieved annual growth rates of 25 percent for employment, 27 percent for revenues, 27 percent for profits and 35 percent for assets. It must be stressed that these companies are the innovative, high-growth type which have high potential for employment at a time when sustained, excessive unemployment remains one of our country's most severe economic problems.

The availability of financing for small and independent businesses is and should be a high priority for a sound national economic policy. Because of high risk and reduced reward (the latter coming from strict government regulation and oppressive tax policies), however, traditional sources of venture capital financing are drying up. This phenomenon prompted the comment by Thomas Murphy writing in the April 15, 1977 issue of Forbes magazine that: "If Adam Smith could return, I think he'd be upset to learn that in a world's biggest capitalistic country the Government has become the biggest venture capitalist." He was referring to the fact that only the SBA loan guarantee program and the SBA-assisted SBIC program are making financing available to much-in-need small business. He goes on to further explain that:

"Roughly half the American economy is small business. It happens to be the half that furnishes most of the jobs everybody says we need: entry-level jobs for youngsters service jobs for women and something else that you cannot quantify—it finds places for the millions who don't fit the tidy mold at Xerox and the phone company."

To make matters worse, while venture funds are drying up small companies also cannot look to the public markets where they once received a great percentage of their funds. The following is a chart showing the number of new issues sold for firms with net worth of less than $5 million for the period from 1969 to 1975:

	Number of offerings	Total amount (millions)
Year:		
1969	548	$1,457.7
1970	209	383.7
1971	224	551.5
1972	418	918.2
1973	69	137.5
1974	8	13.1
1975	4	[1] 16.2

[1] Ibid., p. 13.

In addition to small businessmen and venture capitalists, high level business and government leaders have addressed the problem of inadequate internal and external capital financing availability. In May of 1976, Treasury Secretary William Simon appointed the Treasury Small Business Advisory Committee on Economic Policy which recommended, among other things, the implementation of 10 specific tax proposals and further study and consideration in several other areas:

"Recognizing that Federal taxation has the greatest adverse impact on capital formation for the bulk of all small independent business, the Committee ranked tax policy as its highest priority. In principle, we support H.R. 13687, the COSIBA small business tax bill, but we have focused on several items which we recommend for adoption or study. The first three items constitute the principal recommendations of the Small Business Administration Venture and Equity Capital Task Force chaired by William Casey."

Specific Treasury Advisory Committee proposals included:

(1) Adjustment of depreciation schedules so that a taxpayer would be permitted to write off any amount up to and including 100 percent of an asset value in the year of acquisition (up to $200,000).

(2) Revision of the corporate rates to graduate the tax at four levels with the maximum rate of 48 percent being reached at a taxable income of $200,000.

(3) Deferral of capital gains tax if the proceeds from an investment in a qualified small business concern are reinvested in another small business concern.

In January the Report of the SBA Task Force on Venture and Equity Capital for Small Business was released. That blue ribbon group, chaired by former SEC Chairman Bill Casey, recommended a number of changes which would significantly help the capital-short small business sector. Their tax recommendations included the following:

Tax laws and regulations

"Increase the corporate surtax exemption from the present level of $50,000 up to $100,000;

"Allow greater flexibility in depreciating the first $200,000 of assets;

"Permit investors in qualified small businesses to defer the tax on capital gains if the proceeds of the sale of a profitable small business investment are reinvested within a specified time in other qualified small business investments;

"Increase the deduction against ordinary income of capital losses in a small business investment made under Section 1244 of the Internal Revenue Code from $25,000 in annual deduction to $50,000, and increase the limit on an offering from $500,000 to $1 million and on issuer size from $1 million to $2 million in equity capital;

"Permit underwriters of the securities of smaller businesses to deduct a loss reserve against the risks inherent in the underwriting and carrying of such securities;

"Revise methods by which revenue impact of tax changes are estimated to reflect revenue gains from the business use of tax savings and the stimulus to capital formation that tax incentives provide."

Expounding upon the lack of external capital available for finance and expansion, the Casey Task Force reported:

"It is alarming that venture and expansion capital for new and growing small businesses has become almost invisible in America today. In 1972 there were 418 underwritings for companies with a net worth of less than $5,000,000. In 1975 there were four such underwritings. The 1972 offerings raised $918 million. The 1975 offerings brought in $16 million. Over that same period of time, smaller offerings under the Securities and Exchange Commission's (SEC's) Regulation A fell from $256 million to $49 million and many of them were unsuccessful. While this catastrophic decline was occurring, new money raised for all corporations in the public security markets increased almost 50 percent from $28 billion to over $41 billion."

Prompted by the deteriorating small business climate and by the disconcerting lack of profitability in the SBIC industry NASBIC produced its 20-point Legislative/Regulatory Package for 1977. I would like to turn now to our industry and the specific tax changes we feel are necessary in order to improve the long-run health and viability of the SBIC industry—changes which, by strengthening SBICs, will ultimately benefit small businesses by strengthening one of their few remaining sources of long-term capital.

THE SBIC INDUSTRY

SBICs are the product of a joint venture between the private and public sectors initiated by the Small Business Investment Act of 1958. SBICs link the efficiency of private enterprise with the financial resources of the Federal Government to provide venture and equity capital financing exclusively for small businesses. Private funds put up by investors are leveraged up to 4-to-1 with long-term money borrowed from the Federal Government at a rate one-eighth of 1 percent above the cost of money to the government. In that manner, funds are made available to small business investors and the Federal government makes a profit in the deal to boot. I might add that all private funds are at risk before the government loses a nickel. This subordinization of private to government capital almost absolutely insures that the individual SBIC will pursue a prudent investment policy. Losses to the SBA have totaled only $29 million over the past 19 years. Over that time, almost $3 billion have been invested in approximately 40,000 small businesses in a total of 50,276 financings.

We are also glad to report that the owners of these companies were deeply grateful to the SBICs for financing their start-up or growth. An SBA survey revealed that more than 90 percent of all portfolio companies had benefitted from SBIC help, most of them to a major degree. Naturally, tensions sometimes arise between an entrepreneur wholly involved in the life of his business and the lender or investor advancing funds to that firm, but the true partnership nature of the relationship between the businessman and the SBIC is supported by SBA's findings that 87 percent of the owners were satisfied with their SBIC dealings and 87 percent said they "would use SBIC assistance again under similar circumstances."

In order to attract the capital needed in the SBIC industry, however, we must increase our profitability. Although the SBIC industry is an active one, with assets near the $1 billion mark, there is much demand for venture and equity capital going unmet. At the NASBIC Annual Meeting in November 1976, SBA Administrator Kobelinski said: "We estimate that small business faces a shortfall in venture and working capital that will average from $7 billion to $8 billion a year over the next decade."

As we all know, capital will tend to flow to where the risk-adjusted rate of return is greatest. Since the venture capital industry is an industry with a good degree of inherent risk, it stands to reason that its return on capital should be higher than in safer investments. That is not the case however, and our SBIC profitability rates have been very modest. Our highest rate of return on invested capital, for example, was 9.5 percent in the year ending March 31 1969. The second highest return, however, was only 6.0 percent in the year ending March 31, 1968. In short, although the SBIC industry is an active and exciting one, its profitability is just not high enough to attract sufficient investment capital.

We at NASBIC feel that the SBIC program is a success. But to fill the needs for venture and equity capital in the upcoming decade, we must expand our activities by making the industry more profitable. The net return to the government from the SBIC industry via taxes paid by the SBICs themselves, portfolio companies made stronger and more profitable by SBIC financial and management assistance, and by the employees of those companies, is highly positive. But in order to expand the industry to help fill the small business "capital gap" we need to provide more incentives to attract additional private funds.

Mr. Chairman, in view of your Subcommittee's jurisdiction over Federal tax policy, I wish to place heavy emphasis on the following three recommendations contained in our Association package. The first would provide an incentive for all investors, individuals or institutions, to invest in the securities of smaller companies. The other two refer specifically to SBIC tax issues which will allow our industry to operate more profitably and to attract more private capital.

1. Defer capital gains taxes when proceeds of the sale of stock issued by a small business are reinvested in an eligible small business concern

The greatest moment in the life of a venture capitalist comes when he is able to generate hard dollars through the sale of his long-held stock (usually about 10 years) of a successful portfolio company. That's the culmination of a promising investment opportunity, proper structuring and pricing, continuous counseling, and an imaginative exit technique on the part of the SBIC manager or other investor. Less exciting, though, is the heavy burden of Federal and State taxation which will take away about 50 percent of the capital gain so generated. There's a contradiction in this situation: the Federal Government has established and encouraged the SBIC program as a matter of public policy to provide capital to small business, but the same Government decimates the flow of such funds through the imposition of onerous taxation.

Undoubtedly, one of the worst threats to the continuation of the free enterprise system is contained in the Internal Revenue Code. Our tax law permits tax-free reorganizations which provide an irresistible incentive for the owners of a successful small business concern to sell out to a major corporation, since there is no immediate tax consequence of such a merger, so long as they take the stock of the big business in return. This provision of the Code lessens competition and compromises the free market system.

To offset this serious danger, NASBIC strongly urges that the tax law be made at least neutral. We propose an amendment to the Code which would encourage further investment in other small businesses. Taxation of capital gains arising from the sale of stock in a business firm which was small when the security was acquired, would be deferred when the proceeds of that sale were reinvested in a small business concern within a two-year period. There is a clear precedent for this amendment, both in the current corporate reorganization section and in the deferral of taxes on the sale of a residence.

2. Allow all SBIC's to pass through their earnings to their shareholders without the imposition of corporate tax

It is our goal to attract different types of investors to the SBIC program. To those who are particularly interested in capital appreciation through the growth of the SBIC, the capital gains provision outlined above is especially attractive. Other investors, though, have the need or desire for current income, so they would be more likely to invest in SBICs which pay regular dividends. At the present time, publicly owned SBIC's which are registered under the Investment Company Act of 1940 may avoid corporate taxes on their earnings so long as they pass through at least 90 percent of their profits to their shareholders. This authority has proven to be most valuable to several of the public SBICs which have increased their private capitalizations regularly over the life of the program.

We believe that all SBIC's should be given this authority whether or not they are publicly owned. Although this position may appear at first blush to contradict our goal of bringing more capital to the program (since earnings will be distributed, not retained), we are certain that the payment of regular dividends will indede attract many millions of dollars of new capital to those SBIC's which are primarily income-oriented and, thus, able to pay such dividends to their shareholders. Present SBIC's will get the new capital they need to grow and new SBIC's will be formed, we are sure, if the passthrough provision is approved.

3. Provide a statutory loss reserve of 10 percent for SBIC's based upon equities, as well as debt securities

No matter how we redesign the SBIC program, one constant will remain: the high level of risk involved in providing financial assistance to new and small businesses. Over the past 18 years SBIC's have grown more skillful in screening out the doomed investments and in protecting themselves against losses, but every SBIC will inevitably have to swallow its share of complete or partial losses. At present, the Internal Revenue Code permits an SBIC to set up a reserve for bad debts based upon its experience, but this authorization is seriously deficient in two respects: first, for an SBIC, the past is no certain guide to the future. An SBIC may be fortunate enough to have minimal losses for 10 or 12 years and then it may have two or three deals go sour in a very short period. We believe it would make good business sense for the SBIC to set aside a reserve to take care of such unexpected losses. The second problem with the current law is that it allows for losses only on loans and not on investments, even though the latter are ordinarily far more risky. The NASBIC proposal then, would have the law permit any SBIC to establish a reserve against losses in an amount up to 10 percent of its total portfolio, both loans and investments. Here again, the change would encourage further equity investments.

These three specific recommendations would make a significant contribution to the profitability of SBIC's and we are certain they would encourage millions of additional dollars to come into the SBIC program, both into existing licensees and into new ones. The major beneficiaries of these changes, however, would be: (1) new and growing small businesses; (2) the Federal Government which would reap greatly expanded taxes from the small businesses assisted by SBIC's and from the new workers employed by those growing firms; and, (3) the economy which would receive new products and services at lower prices through increased competition.

In summation, NASBIC genuinely believes that there is a significant investment capital shortage for small and independent enterprises in the United States today. We are proud of the role SBIC's have played in the financing of small businesses for the past 18 years but feel that there is much more investment of that sort needed. Since purely private sources of venture capital have dried up significantl, in recent years, government-assisted stimulation is necessary. We firmly believe that adoption of the NASBIC Legislative/Regulatory package will be a significant step in the right direction toward closing the equity and venture capital gap, and would encourage the Subcommittee's support in the specific tax areas we have focused upon.

Thank you.

Senator BYRD. The next witness is Mr. E. F. Heizer, National Venture Capital Association.

STATEMENT OF E. F. HEIZER, JR., NATIONAL VENTURE CAPITAL ASSOCIATION

Mr. HEIZER. Good morning, Mr. Chairman. I want to apologize for not having supplied a written statement in advance but we will supply one. I would like to start off by emphasizing several background points and then make three specific tax recommendations.

First of all, so you understand the vantage point from which I speak, I have been a venture capitalist like Herb Krasnow for many years and our firm, the Heizer Corp., is one of the largest firms specializing in financing what we call early stage growth companies. These companies are very small when they start, but they become very large and very important contributors in terms of net new employment and in terms of taxes to the Federal Government.

I might add that I think the Senate and the House, when considering legislation, should keep in mind that the Federal Government owns, in effect, 50 percent of every successful small business.

Senator BYRD. The Federal Government has a bonanza. It has 50 percent of all the profits and does not share in the losses.

Mr. HEIZER. That is right.

Senator BYRD. I think that is an ideal situation.

Mr. HEIZER. We feel that the Federal Government, having that in mind, should be more supportive of the various programs which we would like to see you support.

In that light, we are very pleased, of course, that you are holding these hearings and that a number of us are having an opportunity to express our views to you. I think that a major point that is sometimes missed in this picture is that, over a period of years, our country has gone from where our money and our capital was in the hands of people who built this country and built these businesses and understood what it takes to build businesses and who have the spirit of wanting to help their fellow man and woman get going in business, into the hands of institutions.

The institutionalization of our money, just in my short lifetime, has gone from where the major movement of funds to small businesses came mostly from individuals to where this source of funds is essentially shut off for all practical purposes, or down to a dribble, and where we must look to the institutions for most of our financing.

By institutions, I mean the banks, the savings and loans associations, insurance companies, and the pension funds. It is in these institutions that the typical citizens have their life savings invested. These institutions use their best efforts to prudently invest this money. They are very careful about what they do with it, and therefore, by indirection, that money is—as Herb Krasnow has pointed out—becoming more and more concentrated, not only in terms of fewer and fewer people making the decisions on where that money goes, but also in terms of the types of companies that they will invest in.

What is happening to us as a country is that we are repeating what happened in Europe many years before it happened here, in that the money became concentrated in very few hands and did not flow freely in Europe. It was economic freedom that I think most of our ancestors sought when they came to this country.

Now through indirection, good intentions, but indirection, we now have a concentration of this wealth. I do not personally see much hope for a change in the trend toward this concentration in general terms, particularly if nothing is done about it.

I think what we should do, without causing institutions to violate the prudent man rule is do a number of things to encourage the flow of moneys to new businesses and our proposals will be delivered to you in writing.

I have tried to pick out the three taxation points which I think are most important. The first is to have the ability to reinvest funds tax free from the capital gains tax. The reason we feel this is so important is that there are so few people investing in new businesses that they should be encouraged to reinvest. Those that invest in new businesses should be free to sell the securities in a developed company tax free providing they move those funds again to another young, developing company.

We would suggest a proper definition of what that means. We do not know exactly what the definition should be, but the key point is that the money should go directly into the young company. We are not recommending that this provision apply to securities traded on the stock exchange. The stock exchange is highly important but does not directly build young companies by paying for new plants or startup wages.

Our suggestion that this money be permitted to rotate tax free is simply to preserve the precious resources that are available in this process, to be reemployed in that process.

Incidentally, we do not feel that that is a tax loophole, it is a tax deferment suggested for very good reasons. As Mr. Krasnow pointed out, it will go a long way toward attracting new capital to developing companies and also help avert the trend toward greater and greater concentration of wealth and control in this country.

The second main point would be to allow a tax free passthrough of income between the firms investing in small business and their investors. This would mean that a venture capital firm or an SBIC would be able, if it realized income, to either reinvest the income tax free or pass it on tax free to its investors.

We are recommending that this be a provision applicable to any venture capital or small business investment firm. We might point out that these same tax results can be obtained under present law by forming a partnership, but a partnership involved difficult problems for many venture capital firms or SBIC's.

If it is considered desirable to encourage institutions and individuals to move their money into the business development field, then it should be recognized that firms like ours serve as an intermediary between the investors, on the one hand, and the small businessman on the other and should not face a third level of taxation.

Venture capital firms can meet the prudent man text for the institutions. We do the investment work for them that they do not choose to do and they are not really qualified to do. They recognize the merit of investing through us but do not like the third layer of taxation.

I might also point out that there is another precedent for what we are recommending. The tax legislation accompanying the 1940 act says that if you are a mutual fund investing in publicly traded securities you can pass through your income tax free. Some people say, why then do not all firms, like SBIC's and venture capital firms become 1940 act companies. The answer is that if you do, the regulations that you have to abide by will not allow you to successfully conduct your business. I can emphatically say that you cannot effectively invest money in small businesses and conform to the 1940 act. Therefore, this is not an effective means to avoid the triple taxation that now exists in our field.

Since you cannot operate effectively in the partnership form nor as a 1940 act company in most cases, we feel a new tax provision is needed.

The third recommendation—I mention it third but it may be the most important of all—is to clear up the confusion and inequity that has grown out of the tax legislation a year ago. The House Ways and Means Committee eliminated qualified stock options because, as I understand it, they felt that companies were using qualified plans merely to lower the tax rates of executives and not properly using the qualified plans to build long-term investment positions for employees in their company. In other words, qualified stock options were simply a method of reducing taxes on ordinary income.

There is a lot of truth in this assumption. We addressed the Senate Finance Committee last year on this issue and, thanks to the efforts of the Senate, the House Ways and Means Committee became aware of a new problem that they created by eliminating the qualified stock option and, at the same time, in effect saying that if someone exercised a nonqualified option, they had to pay ordinary income tax at the time of exercise.

The problem that we were trying to point out and that the Senate pointed out to the House was that most small businessmen at the point of exercise are not able to pay a tax because the securities are not liquid and they are not able to realize the income to pay the tax.

What happened was that the law was not changed, but the Treasury was asked to put out a regulation dealing with this problem. In effect, it was suggested that they allow corporate executives of small companies to value the option or warrant that they received at the time that they received it and pay an ordinary income tax on that value, and then later on when they sold the security, pay the capital gains tax on the difference.

That was a good move. All of us very much appreciated what the Senate did to correct that situation. The problem is that Treasury has not released a regulation and there continues to be a great deal of uncertainty in this area.

It is our suggestion that the law be clarified to say that the management of a young company can declare as ordinary income at the time he gets a warrant or stock option, the value of that warrant or stock option. Then let him pay the capital gains tax under whatever law applies to capital gains at the time he sells it or, in the alternative, put in the law a provision that the executives or management or employees of small business may have stock options and if they cannot afford to pay the tax when they get the warrant or options that they may elect, instead of paying tax at that time, to pay the tax at the time of sale rather than the time of exercise. But the longest period of time that they could wait to pay the tax would be 10 years.

We have a number of other suggestions but those three are the ones we feel are most important.

Senator BYRD. Those are the three that you consider to be the most important?

Mr. HEIZER. Yes.

Senator BYRD. Thank you very much, Mr. Heizer. I thank all of you gentlemen.

[The prepared statement and attachment of Mr. Heizer follow:]

STATEMENT OF NED HEIZER

Mr. Chairman, Members of the Committee, Ladies and Gentlemen, I apoligize for not having a written statement prepared in advance but I did not know I was going to testify until last week. We will send you a written copy of my remarks and the official recommendations of National Venture Capital Association.

My name is Ned Heizer (E. F. Heizer, Jr.) I am Chairman and President of Heizer Corporation in Chicago, Illinois.

Heizer Corporation is one of the larger business development or venture capital firms in the United States specializing in the financing and development of early stage growth companies.

In order to encourage the formation of more business development or venture capital firms, I have been active in both the National Venture Capital Association and the National Association of Small Business Investment Companies.

You have just heard from Herb Krasnow, President of the National Association of Small Business Investment Companies.

I am a former President and Chairman of the National Venture Capital Association, which is similar to the National Association of Small Business Investment Companies but which represents the privately financed business development or venture capital organizations as contrasted to government financed SBIC's.

I am currently a member of the Board of Governors of NASBIC and a member of the Advisory Committee to the SBA.

My testimony will be on behalf of all young and growing businesses which have been the backbone of the U.S. economy, but which have had an increasingly difficult time obtaining capital with which to grow.

Most money in the U.S. has been institutionalized in the form of bank deposits, savings accounts, life insurance, and pension funds and is, generally speaking, no longer available to small business due to both the attitude of institutional investors, the so-called prudent man rule and various laws and regulations intended to protect the investors in these institutions.

The individual also has less incentive to invest today in small business due to our tax structure and the lack of liquidity in the stock market for the stocks of even successful small companies. As a result, essentially all of our capital is being channeled into the established companies and, equally disturbing, into the trading of stocks and options rather than into capital formation. It is doubtful that the trend towards the institutionalization of our money will be reversed. It is doubtful that institutions will directly invest in a meaningful way in new business.

Yet it is essential that new businesses be created since they have been and always will be the greatest source of new products and services, net new employment, and net new taxes.

I urge you to read the White Paper of the NVSA entitled "Emerging Innovative Companies—An Endangered Species" (11/29/76) which sets forth some interesting facts and figures supporting this statement. I also urge you to read the Task Force Report on Venture Capital for Small Business—Small Business Administration (January 1977).

It is essential that the government take positive action to encourage a greater flow of funds into new business since the government has done so much through indirection to cut off the flow of funds to new business. One way to do this is through tax incentives.

I would like to outline some specific tax proposals to:

I. Encourage capital formation for new businesses.

II. Permit developing businesses to reinvest more of their cash flow.

III. Provide greater incentives for managers of small business.

In covering these recommendations, I would like to emphasize that tax measures which help big established companies reduce taxes—such as investment tax credit—have limited effect upon early stage development companies—many of which pay little or no taxes.

RECOMMENDED TAX PROPOSALS

I. (First) To Encourage More Investment In New Businesses We Would Like To Make Five Related Proposals:

1. Permit the tax free reinvestment of capital gains providing the proceeds are invested: (*a*) Directly in developing companies as contrasted to the securities or options market, (*b*) within 24 months after sale. This would be a strong incentive to invest in early stage developing companies. This would be a tax deferment, not a loophole.

2. Have a graduated capital gains tax based upon the length of time an investment is held: (*a*) 30 percent for first 5 years, 25 percent for 5th to 10th years, 12½ percent after 10 years; (*b*) 100 percent 1st year, 90 percent 2d year, 80 percent 3d year, etc., down to 10 percent after 10 years.

Either proposal would be fair considering inflation and the obvious tax bunching problems of long-term capital gains.

If such graduated capital gains tax treatment were only available when the investment was made directly in the equity of a company as contrasted to trading in securities or options, this would be particularly helpful to early stage developing companies and capital formation.

3. Extend the Subchapter S type concept to all businesses with amendment so that: (*a*) Companies may carry forward their tax losses (as all may do today); or (*b*) Distribute their losses to their shareholders. This would be a strong incentive to invest in early stage developing companies. The accounting would be easy to do. It would be tax deferment, not a loophole. The money would have to be actually lost to take the deduction.

The deduction could only be taken once by either the corporation if it chose to keep the loss or its stockholders if it chose to distribute the loss.

4. Permit SBIC's and venture capital firms to pass through any gains or losses which they may have to their shareholders similar to mutual funds and partnerships.

This would facilitate the formation of pools of capital with professional management to invest in early stage developing companies.

SBIC's and venture capital firms cannot operate effectively under the 1940 Act and therefore the mutual fund tax pass-through provisions are not available to them and the partnership form also presents many technical difficulties.

5. Remove capital gains from the list of tax preference items. The present law is complicated and unfair and discourages capital investment. Adoption of a graduated capital gains tax would help to alleviate these problems but combined with the elimination of preference rules would be even more effective.

II. (Second) To permit developing companies to reinvest more of their own cash flow we have two proposals:

1. Provide a Job Creation Credit for net new employment of $2100 per net new employee. This could be particularly helpful to rapidly growing small companies if there was a liberal carryforward provision.

2. Eliminate the double taxation of dividends by allowing a company to deduct dividends paid in calculating taxable income. As you all know, a deduction is currently allowed for interest but not for dividends. This works against early stage developing companies which have to raise considerable equity capital in order to grow. It is unsound and not feasible for developing companies to finance themselves with high debt ratios and thus get the interest deduction.

III. (Third) To provide an incentive for the employees of developing companies who sacrifice the higher earnings and security of working for the large, established companies we suggest two proposals:

1. Permit the employee to pay ordinary income taxes on any value which a warrant or option has at the time of grant and then pay capital gains taxes when the underlying security is sold. In other words, there would be no tax upon exercise of a warrant or option but only upon its grant and the sale of the underlying securities

or

2. Permit the employee who cannot afford to pay and therefore does not elect to pay ordinary income taxes on the value of a warrant or option at the time of grant to pay ordinary taxes on the full appreciation in value at the earlier of three dates: (1) the date he elects to pay; (2) the date of sale; or (3) ten years from the date of grant.

To tax employees at the time of exercise when it may be impossible for the employee in a developing company to obtain cash to pay the tax is totally unreasonable. We appreciate the Senate's efforts to correct this problem last fall, although we are disappointed that no formal action has yet been taken by the Treasury to alleviate a serious and oppressive problem.

The National Venture Capital Association and the National Association of Small Business Investment Companies both have issued or plan to issue formal tax revision proposals to enhance capital formation for growth businesses.

We urge you to review these important proposals remembering that the United States Government effectively owns 50 percent of each successful small business with little or no investment (i.e., through the 50 percent Corporate Income Tax) and that these small businesses of today are the big businesses of tomorrow.

Thank you for your attention and I will be pleased to try and answer any questions you may have.

National Venture Capital Association—A Program of Tax Revision Proposals To Enhance Capital Formation for Small Business

The broad objective of the following program of Federal income tax revision proposals is to encourage the formation and growth of new small businesses in order to encourage innovation, to develop technology and to stimulate employment.

This program is presented by the National Venture Capital Association as an addendum to its position paper "Emerging Innovative Companies—An Endangered Species." As discussed in the position paper, these small to medium-sized companies, which make a disproportionately large contribution to job creation and production of federal tax revenues, are denied access to traditional sources of capital at reasonable cost and are either constrained in their growth or penalized for it. The proposals set forth below would increase the availability of external investment capital for such companies, allow additional internal financing of growth through some increased cash flow and allow these companies to attract and motivate key personnel. The impact of this program on federal tax revenues would be more than offset by the benefits of an increase in private sector employment and the future tax revenues generated by increased economic growth.

Capital investment is the most powerful job creator in a free enterprise system, with each dollar of investment contributing several times its value to economic activity and employment. The most meaningful incentive to capital investment is a substantial differential between the rate of tax paid on realized capital gains and that paid on ordinary income. With a sizeable differential, corporations are encouraged to retain and reinvest their earnings in new plant and equipment rather than paying earnings out in the form of dividends because shareholders then prefer such reinvestment and the resulting increased value of their stock as opposed to dividend income. During the 1950's and 1960's when capital gains were taxed at 25 percent and dividends and interest were taxed at rates as high as 91 percent the United States became the most powerful industrialized country in the world. In recent years the differential between capital gains and ordinary tax rates has been decreasing (capital gains rates are now as high as 50 percent for individuals and ordinary income rates are at a maximum of 70 percent) and, logically, we have seen an erosion of capital investment.

Certain of the proposals in the program set forth in this paper seek to restore a substantial differential between capital gains and ordinary tax rates for investments in small businesses with the objective of stimulating investment by shareholders in smaller, growing companies and, in turn, stimulating these companies to expand rapidly and create new employment opportunities. It is only through such a constructive program of tax incentives that the future of our free enterprise economy, and the place of smaller more aggressive companies in it, can be assured.

I. QUALIFIED SMALL BUSINESS INVESTMENT CAPITAL GAINS TAX DEFERRAL

Proposed legislation.—Amend the tax code to provide for a deferral of caiptal gains tax liability arising from the sale of a Qualified Small Business Investment to the extent that the proceeds of the sale are reinvested in one or more other Qualified Small Business Investments within the twenty-four months after the sale. A Qualified Small Business Investment is defined as a security or securities purchased directly from a Small Business. A Small Business is defined as any corporation, partnership or proprietorship having less than 1,500 employees.

Existing Legislation.—Capital gains arising from the sale of securities are taxed in the fiscal year of sale.

Commentary.—There is presently a shortage of capital for Small Businesses which is heightened by the current tax law that provides a disincentive to investors to roll over their portfolios by taking away a portion of the proceeds when a sale is made. A Qualified Small Business Investment capital gains tax deferral would provide proper incentives to investors in Small Businesses to roll over their portfolios more often and to reinvest the proceeds of a sale in other Small Businesses. The federal government would not lose tax revenue under this proposal; it would merely defer receipt of the revenue as long as the funds were being put to a productive and socially desirable purpose.

The enactment of this proposal would also reduce the Internal Revenue Code's inducement to owners of independent businesses to sell out (when they wish to sell out) to large corporations, whose shares are actively traded, in tax-free reorganizations so that they can postpone the capital gains tax on the sale. Under the proposal urged here owners of independent businesses whose investment was made while the business had less than 1,500 employees could sell the business to any buyer or group of buyers for cash and postpone the capital gains tax by reinvesting the cash in another business or businesses that had less than 1,500 employees within the two years following the sale.

II. SLIDING SCALE FOR CAPITAL GAINS TAX RATE FOR LONGER TERM QUALIFIED SMALL BUSINESS INVESTMENTS

Proposed legislation.—Limit the total tax on capital gains realized by any taxpayer on sales of Qualified Small Business Investments (as defined in proposal I. above) to a rate of 30 percent if the investment is held for less than 5 years, 25 percent if it is held for 5 years or more but less than ten years and 12½ percent if it is held for 10 years or longer.

Existing legislation.—Currently capital gains are taxed at 30 percent for corporations and at rates up to 50 percent for individuals with no differentiation in holding period other than that required to qualify as a capital asset.

Commentary.—It requires a considerable number of years and substantial risk to start a business and bring it to a level of sustained financial independence. Adjusting holding periods and capital gains rates with respect to Qualified Small

Business Investments would encourage investors to invest in Small Businesses and to retain their investments in Small Businesses for longer periods and thus reward the financing and continued support of new businesses. These investors would be more interested in capital gains than current income and hence would encourage the businesses to plow back their earnings to achieve greater growth rather than disbursing their earnings to pay greater dividends. The plowing back of earnings by young businesses is an important source of capital investment in this country. The increased capital investment that would result from this proposal would help create thousands of jobs and build the country's tax-base to the point that would more than compensate for the capital gains tax revenues lost. Furthermore, the disincentive to sell a Qualified Small Business Investment after the investment had been held for a lengthy period of time would be substantially reduced.

III. SMALL BUSINESS JOB CREATION TAX CREDIT

Proposed legislation.—Provide a permanent tax credit of $2,100 per employee for each net new employee hired by a Small Business (as defined in proposal I. above) with no limitation on the amount of the credit and with a carryover from year to year for amounts of the credit earned but not yet used to offset tax liability. Net new employment would be defined as the increase in the average number of full-time employees from one fiscal year to the next. Average employees would be computed by averaging the number of full-time employees at each payroll period during the fiscal year.

Existing legislation.—President Carter has just signed into law a tax bill containing a temporary (for the years 1977 and 1978 only) tax credit for employers hired after the employer's payroll has grown 2 percent from the previous year. The employer's normal deduction for wages must be reduced by the amount of the employment tax credit, and there is a limit of $100,000 upon the amount of employment tax credit claimable in either year.

Commentary.—An increase in private sector employment is the only permanent, productive way to solve our country's unemployment problem. A stronger job creation tax credit for Small Businesses would both provide an incentive to young companies to hire additional workers and increase their cash flow (through reduction of tax) to fund business growth. Loss of federal tax revenue should be more than offset by the increased transformation of unemployed workers supported by public assistance into productive, tax-paying private sector employees. There is no reason to put a maximum limit on the amount of the proposed credit that can be claimed in any one year. A $100,000 limit restricts the number of new employees for whom the benefit can be claimed to approximately 50. There is no need to adopt this limit for Small Businesses, which should be encouraged to grow as fast as their businesses permit and which in any event no longer qualify for the proposed credit after they have reached 1,500 employees.

IV. SMALL BUSINESS INCENTIVE STOCK OPTIONS

Proposed legislation.—Amend the tax code to allow a key employee of a Small Business (as defined in proposal I. above) who is the recipient of an Incentive Stock Option, and who does not elect to be taxed in the year of grant on the then value of the option, to defer payment of tax from the exercise date of the option to the earlier of the year of sale of the underlying stock or ten years after the grant of the option. Only key employees of Small Businesses would be eligible to receive Incentive Stock Options. If the option were exercised while the issuing company had less than 1,500 employees, the stock so purchased would be a Qualified Small Business Investment eligible for the benefits of proposals I. and II. above. The taxation of ordinary stock options would not be affected.

Existing legislation.—The Tax Reform Act of 1976 eliminated the Qualified Stock Option. Under current law an employee who elects not to be taxed in the year of grant at ordinary income rates on the then value of a stock option and who subsequently exercises the stock option is taxed in the year of exercise at ordinary tax rates on the difference between the exercise price and the market value at the date of exercise.

Commentary.—Smaller companies depend upon stock incentives to attract and retain key employees as they cannot afford the high salaries paid by larger companies. The current law unduly penalizes key employees of smaller companies who often must sell optioned stock at the time of option exericse in order to pay the required tax, yet are unable to sell the stock obtained from exercising the option due to the limited or illiquid market for the stock. NVCA's proposal does not suggest a reduction in tax (other than as provided by proposals I. and II.) but merely a deferral of the tax until the employee is able to sell his stock to generate cash to pay the tax.

Senator BYRD. This hearing will stand in recess until 9:30 tomorrow morning.

[Thereupon, at 1 p.m. the subcommittee recessed to reconvene Tuesday, May 17 at 9:30 a.m.]

INCENTIVES FOR ECONOMIC GROWTH

TUESDAY, MAY 17, 1977

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
GENERALLY OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to recess, at 9:30 a.m., in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. (chairman of the subcommittee), presiding.

Present: Senators Harry F. Byrd, Jr., of Virginia, and Curtis.

Senator BYRD. The hour of 9:30 having arrived, the committee will come to order.

I would like to take this opportunity to welcome the witnesses for this second day of hearings before the Subcommittee on Taxation and Debt Management on the topic of incentives for economic growth. The purpose of these hearings is to permit the business community to present views about the effect of tax policy upon economic growth and to evaluate various proposals which are now being advanced on this topic.

As I emphasized to the witnesses on the first day of testimony, the subcommittee hopes that the witnesses will avoid the temptation of giving it a shopping list of proposals. Instead, it is the subcommittee's hope that the witnesses will concentrate on two or three measures which they consider to be the most important in encouraging economic growth and employment.

Today's hearings will begin with the testimony of Dr. Charls E. Walker, American Council for Capital Formation.

Dr. Walker, we welcome you again to this committee. You have been before the committee many times in the past. I might say that you have the confidence of this committee to a very high degree, and certainly the confidence of the chairman of this subcommittee to a very high degree. We are pleased that you are with us today.

You may proceed, Dr. Walker, as you wish.

STATEMENT OF DR. CHARLS E. WALKER, FORMER DEPUTY SECRETARY OF THE TREASURY AND CHAIRMAN, AMERICAN COUNCIL FOR CAPITAL FORMATION, ACCOMPANIED BY DR. RICHARD RAHN, EXECUTIVE DIRECTOR, AMERICAN COUNCIL FOR CAPITAL FORMATION

Mr. WALKER. Thank you very much, Mr. Chairman. I appreciate those words and I am very happy to be here.

I am Charls Walker. I am Chairman of the American Council for Capital Formation and I am accompanied by our executive director, Dr. Richard Rahn.

The council, Mr. Chairman, would like to commend you and your colleagues for scheduling these hearings; we believe them to be both timely and highly worthwhile. The council is convinced that this Nation is confronted with an increasingly serious and potentially crippling problem—an impending dearth of the real capital so badly needed to help us restore full employment, contain inflation, and balance our international transactions.

Inasmuch as Federal tax laws are biased strongly in favor of consumption, the saving and investment that promotes and represents real capital formation is impeded. Therefore, the subject is very much in the domain of Congress in general, and the Senate Finance Committee in particular.

Let me say a few words about the American council. Dedicated to productive tax reform that will remove the bias against capital formation in our tax laws, the council is supported by a diverse and fast-growing group of individuals, businesses, and other organizations. With supporters throughout the Nation, we hope soon to increase our effectiveness in educating the public and persuading Congress as to the merits of our case by establishing regional councils. Except for the executive director, the officers of the council serve without pay.

My statement is brief. First, I would like to review some evidence and views as to the existence and size of the "capital shortage." Then, I shall summarize the tax actions that the Senate Finance Committee could recommend to help eliminate that shortage.

Two quantitative estimates deserve mention. In 1975, a study by a distinguished group of economists, sponsored by the Brookings Institution, concluded that this Nation might just skirt the edge of a severe capital shortage—provided we returned quickly to full employment and attained, first, a balance, then a surplus, in the Federal budget. Needless to say, none of these developments seems likely in the near future.

Also in 1975, the Bureau of Economic Analysis of the Department of Commerce concluded that business fixed investment must increase from the 10.4 percent of gross national product of the preceding decade to 12 percent through 1980. It is discouraging indeed that the actual rates are lagging far behind those mentioned.

Turning to expert opinion, I can do no better than cite Secretary of the Treasury Blumenthal, who is both a trained economist and former chief executive of a major corporation. Earlier this year, he put it aptly when he said:

> We do have a capital shortage, in the sense that growth of physical plant and equipment is lagging behind the rate of expansion required to reach a full employment economy.

The Secretary noted that although recent growth rates in the stock of physical capital may be respectable by historical standards, it has not grown commensurately with the labor force.

> In the first half of this decade, the average amount of business capital per worker grew at only half the rate at which it has been growing in the 1950's and 1960's. In other words, we were not providing tools of production as fast as the growth of workers to use them.

This statement should not only convince any impartial observer of the case for far more capital formation, it should also carry home the message that what is at stake is not simply arcane matters that economists like to discuss, but the bread and butter issue of jobs for a growing labor force.

If I might paraphrase the Secretary, he was simply saying that jobs cost money—money in the form of savings to buy or build the tools that workers need.

Skeptics argue that these points can never be gotten over to the typical American. That's not true; in fact, the American people are already deeply concerned about the impending capital shortage, although most people don't think of it in those terms.

Consider, for example, a survey by the highly regarded Cambridge Report in 1976. To be sure, only a fraction of the respondents could come close to defining "capital" and its function in our economy, but 64 percent professed to believe that there is a serious problem involved in raising the dollars needed for business investment in the years ahead.

And, as the Opinion Research Corp.—another highly regarded organization—reported last year, this concern is shared by leaders in Washington. Especially significant are the views in Congress, where 78 percent of those surveyed stated that over the next decade the shortage of investment capital facing U.S. industry would either by very serious—57 percent—or somewhat serious—21 percent.

Before turning to the specific tax measures that will help close the capital gap, I might simply note in summary form some of the reasons that productive tax reform is difficult to achieve, even though the case for it is so strong. As I testified before the full Senate Finance Committee on March 9:

(1) The types of tax reduction necessary to aid saving and investment are criticized by the press and others as mere handouts to corporations and "Fat Cats"; and (2) the Government cannot afford the supposed revenue loss that would result.

Neither of these arguments has merit. Corporate tax cuts are passed on to consumers as lower prices or back to workers and the savers and investors who provide the funds to buy or build the tools needed by our growing labor force. As to revenue losses, experiences since World War II has proved time and again that reducing the excessively heavy tax burden on business—that is, on saving and investment—tends to increase, not reduce, Federal revenues.

This is especially true when, as now, the Nation's economic resources are underemployed, thereby permitting significant increases in output which in turn boost the incomes of both workers and businesses, thereby widening and increasing the size of the Federal tax base.

A few moments ago I handed you a couple of charts. Only the first one is relevant to the discussion I am making here. I thought this morning I might Xerox these and bring them up.

Senator BYRD. May I ask, when you say "a couple of charts"——

Mr. WALKER. There are two charts on one page; I am referring to the one on the lefthand side. These are Federal Government receipts over the past 30 years or so.

This is taken from the Federal Reserve System's historical chart book. I have put some lines in for the three major tax cuts, business and personal, that have occurred since World War II.

Take the 1948 cut at the lefthand side of the chart. Note the surge in Federal revenues in both personal taxes and corporate profits taxes that occurred within 2 years after the cut. To the extent that the reduction was effective in bringing the economy back to acceptable levels of operation, generating higher incomes and profits, that meant more revenue to the Government.

Take again the cut in 1963, and you will recall the investment credit had been put in place a year earlier in 1962. Again, at that time, we had very large estimates of revenue loss on the part of Treasury and congressional staff, but again, the tax cuts paid for themselves, in effect, in terms of revenue, within a very short period of time.

You may recall that I was up here in 1971, as a Treasury official, asking for reinstatement of the investment tax credit and congressional ratification of the Asset Depreciation Range—accelerated depreciation—and also some personal tax cuts. Again, Congress agreed and we had a surge in revenues.

Now, in those instances—particularly the first and the third—the economy was operating with a great deal of slack. At the same time, I think the tax cuts themselves must be given some credit for helping to bring the economy back.

Experience definitely indicates that soundly structured business tax reductions can raise, rather than reduce, revenues.

"PRODUCTIVE" TAX REFORM

Few politicians come to Washington without first promising the home folk that they will work all out for tax reform. They have read in newspaper after newspaper, and have been told over and over again by broadcast journalists, that the U.S. Federal income tax system is shot through with billions upon billions of dollars of tax loopholes just ripe for the closing. Moreover, they believe, the "take" will be so large that the revenue so raised can be used to reduce significantly taxes for those with low or middle incomes.

Not so. After a relatively short time in Washington, newly elected officials realize that the loopholes are nothing of the sort—they represent preferences in the Tax Code which Congress has carefully reviewed time and again. Remaining inequities in Federal individual income tax—which is basically fair—should be eliminated. But truly productive tax reform lies not in time-consuming, contentious and often misguided efforts to plug every so-called loophole; it consists instead of lasting structural changes to serve more effectively the Nation's social and economic goals.

As to the latter, the American Council recommends that your subcommittee give serious consideration to:

Reducing the corporate tax rate;

Liberalizing tax treatment of depreciation of equipment and structures;

Increasing the investment tax credit, easing restrictions on its use, and making it permanently and fully refundable;

Reducing double taxation of corporate dividends; and

Reversing the sharply upward trend in taxes on capital gains.

I shall be happy to respond to questions concerning these various approaches.

Let me simply add in closing that the argument that will be presented in strongest terms against any of these measures is at the same time the weakest—namely, that we cannot afford any significant moves in this direction because of the resulting loss in revenue to the Federal Government.

Speaking professionally, I do not believe that reasonable reductions in the business tax burden would cost the Treasury one red cent in revenue. To the contrary, I think they would sharply boost such revenue for reasons noted earlier.

And, at this particular juncture, the net gain to the Nation's economy could be great indeed. This is because business leaders are almost desperately searching for signals from Washington before committing funds for investment in new plant and equipment—a sector, I might note, that has been unusually slow to respond in what is otherwise a very strong business recovery.

I can think of no better "signal" than lasting and significant tax measures to promote capital formation—in other words, effective steps toward truly productive tax reform.

Thank you very much.

Senator BYRD. Thank you very much, Dr. Walker.

Let me ask you this. Is there indeed a capital shortage or is it really a lack of confidence that keeps the capital hidden, so to speak, unutilized, perhaps is a better word.

Mr. WALKER. I think there is both a "capital shortage" and a lack of confidence. I think it might be useful to break this down in terms of the situation right at the moment—shortrun factors—and the situation over the next two or three decades.

Over the next two or three decades, I think that some fundamental changes are in order, not only in the tax system, but in respect to regulation of business as to what we do, for example in the pollution area. This is vital from a longrun standpoint.

At this juncture, we have not what I would call a crisis of confidence, but we do have insufficient confidence in the business community to generate at this stage of the business recovery the type of capital formation—plant and equipment spending—which we should have.

I do not, as some do, attribute that solely, or even primarily, to the actions of the new administration. With respect to some of their economic policy actions, I applaud them heartily. I think the President has made it very plain that he thinks that inflation must be brought under control if we are going to solve our unemployment problem—and I think he is 100 percent correct.

What we are coming out of is a traumatic decade. We have had ups and downs, almost "stop-go" policies, with results we have noted in other countries for years. As a result, the businessman thinking about committing a sizable amount of money in a risky investment that will only pay off down the road, 3, 4, 5, 8, 10, 15, 20 years from now, depending on the nature of the project, is asking himself, can I be confident that the market will be there when this investment comes to fruition?

His answer is, right now, I cannot be confident.

The other point is, yes, right at the moment, given this stage of the business cycle, there is plenty of financial "wherewithal," a lot of funds, and our economy is capable of generating large amounts of savings that can go into investment—but that flow is impeded by this fear about the future.

Senator BYRD. On the five recommendations that you make with regard to taxes, I assume that the No. 1 priority, if you made a decision yourself, would be to reduce the corporate tax rate.

Mr. WALKER. Yes, sir.

Senator BYRD. The other four would be secondary to that?

Mr. WALKER. Economically speaking, yes. I would like to start devising an entirely new tax system, but we are not going to do that, especially when I read in the paper that the President's proposals may be up here in a matter of weeks. I am concerned about that. I am concerned about how comprehensive and how well integrated those proposals will be.

Senator BYRD. We should take the time to get something well thought out and desirable, rather than rushing through and get something half baked.

Mr. WALKER. I thought that Mr. Carter in the campaign made one of the most sensible statements ever made by a man running for the Presidency. He said, it will take a full year of study before he would send recommendations to the Congress for tax changes, and that is what it needs.

Senator BYRD. I think you are right. How long did it take—you were involved in the Tax Reform Act of 1969?

Mr. WALKER. Reluctantly.

Senator BYRD. That took quite awhile. And the Tax Reform Act of 1976 took pretty close to 4 years, as I recall.

Mr. WALKER. It took quite a long period of time and then the really basic questions that I am referring to here were not treated because attention was taken up with "who struck John," loopholes, that kind of thing, instead of getting into the fundamentals of capital formation. I wish the administration would take more time in going through this whole thing.

Senator BYRD. In advocating a reduction in corporate income taxes, are you not basically saying that the business profits are too small?

Mr. WALKER. I am saying, first of all, when you start asking whether corporate profits are too small or too large, we tend to get into an exercise that, to me, is somewhat fruitless.

Someone takes a period of 10 or 15 years ago and notes where we are relative to then. You get into all sorts of arguments about methodology and what have you.

Much more important is the fact that Secretary Blumenthal points out, and others have pointed out—including the Washington Post and the Congressional Budget Office—the fact that we are putting much too little plant and equipment in place relative to the growth in the labor force.

Corporate profits after taxes, are not high enough. The after tax rate of return on new investment is not sufficiently high to pull those funds into the investment that I am talking about.

Senator BYRD. You have to talk about profits after taxes.

Mr. WALKER. It is what gets down to the bottom line after taxes that makes the difference. I do not argue with people who say that profits are too high or too low, getting back to these fundamental points of tax return and cashflow, even though your profits are high, if you do not have the cash flow——

Senator BYRD. What assurance do we have that the profit will be reinvested in plant and equipment?

Mr. WALKER. In the American system you have to be competitive. If you do not modernize and invest, and your competitor does, you will be left at the starting gate. To prove this, we can go back and check the record. We have dead industries all over the place that failed to keep up with the Joneses in that respect.

Senator BYRD. You have on your list both a liberalization of the tax treatment of depreciation and an increase in investment credit. Do you think it is realistic to seek both?

Mr. WALKER. Let us take the investment tax credit first. It comes under criticism from various quarters. As you know, it was originally proposed by President Kennedy. It has been on and off a couple of times. Now it seems to be accepted, generally, by the public, the business community and the labor community. The credit should be permanent, to reduce uncertainty, and refundable, to be fair.

The tax treatment of depreciation: Two points. We are lagging very, very much behind our competitors abroad. Almost all of them have much more liberal depreciation systems than we do.

Second, we have had a tremendous amount of inflation. A machine that cost $100,000 15 years ago, now worn out or obsolescent, may have to be replaced by a machine costing $500,000. Depreciation reserves obviously are inadequate. We are "underdepreciating" our plant and equipment.

I would argue that both improvement in the investment tax credit and liberalized depreciation are justified.

Senator BYRD. In regard to the investment tax credit, I think, as you have indicated, the most important thing about it is for the Congress to make a decision and leave it alone. We put it on, take it off, put it on, take it off. I do not see how business can operate over a period of time in that fashion.

Now, when you say increasing the investment tax credit, do you mean going beyond the 10 percent?

Mr. WALKER. I would prefer a 12-percent credit, yes.

Senator BYRD. I guess you would probably prefer a 14-percent credit. There has to be a limit on what you can do.

Mr. WALKER. Let me make an absurd statement. I would not prefer a 50-percent credit or a 30-percent credit. When you get up toward 12 or 15 percent, that is where I would start looking very strongly at these other things and say, we have probably gone far enough with the investment tax credit—let's do something on depreciation, maybe something to integrate the corporate and individual tax, and so on.

I would like to see that permanent, and "cleaned up" with respect to restrictions and refundability. I would like to say, "there it is", and look at these other things, such as depreciation.

Senator BYRD. I support the investment tax credit, but I think there has to be a limit to it. I reluctantly supported this past month going from 10 percent to 12 percent. In the future a 10 percent investment tax credit is about as far as I want to go.

Mr. WALKER. Almost as good as 12 percent.

Senator BYRD. If you choose between liberalizing the tax treatment of depreciation or increasing the investment tax credit, what would be your preference?

Mr. WALKER. I would have to see what you are talking about in terms of liberalization of depreciation. If we were willing to bring our system much more closely in line with our major competitors abroad, I would be gung-ho for that as a high priority.

I think that we tend—let me put it this way. I get upset with some tax experts. We are not sure about the ultimate incident of the corporate tax. We have an imperfect system.

But some of these people insist that within the total of this imperfect system, all of the moving parts have to fit together very smoothly. So, you start talking about lives of assets and these very complicated things that keep a lot of people in the Internal Revenue Service constantly at work.

Why not just adopt a simple thing—like 5-year depreciation for equipment and 10 years for buildings? The experts will argue about class lifes and so on. I say, so what? We are trying to promote capital formation. We are trying to simplify it. We should simplify it in the business tax area as well as the individual tax area. Why try to provide "internal" consistency to a business tax system that makes no sense—repeat, no sense—overall?

Why not go further than that? Why not say businesses can write assets off at any rate they want? Have a full "recapture" provision. There would be an interest-free loan, in a sense, but if a business wants to write it off now, it would pay bigger taxes later. I would especially recommend rapid write-offs for publicly mandated investments—that is, for pollution control—that are not going to increase output.

Senator BYRD. I think that an increase in the depreciation rate would be—on an overall basis—more helpful to more businesses than the investment tax credit would be.

Would you be inclined toward that view, or not?

Mr. WALKER. It could be a rather significant move.

You may recall, in the summer of 1961, Secretary of the Treasury Dillon set forth some considerable changes in depreciation schedules having to do with textile industries. A year later, he ordered even more significant changes for industry as a whole.

Early in 1971, we announced, when I was in Treasury, the "asset depreciation range." It was challenged in the courts. You people in Congress were good enough to ratify that on a legislative basis.

All of that has been constructive.

All of that over the last 16 years or so has moved us only a short way. If you are talking about moving us much farther, I would say that would be a very high priority. To many businesses it would be more important than liberalizing the investment tax credit.

Now, to your labor-intensive industries. Item No. 1 is the most important, decreasing the corporate tax rate. They do not have large amounts of equipment to earn the credit or to depreciate.

You have to put all of these things together.

An important point is that we come out with net reduction of taxes paid by business in the short run. Then, given some time, and I would say that the Government would get it all—and more—back. I am very disturbed by discussions which I have had with some Treasury officials and with some Members of Congress, who say, well, if we do one of these five we have to offset that by hitting you harder on one of the other five. I think that is wrong.

Unless this Congress can come up with measures, net reduction in taxes to promote capital formation, then I think the exercise will be futile and even counterproductive.

Senator BYRD. In regard to depreciation, it seems to me in the long-run the Government does not lose by a liberalization of depreciation. It may lose in a particular year, but it will gain in other years. I am very much inclined to liberalizing the depreciation allowance and that would put us more nearly equal with countries like England and Canada. I do not recall what the other countries are doing, but most of the industrialized countries, is it not correct, permit a much higher depreciation, than we do.

Mr. WALKER. Their depreciation recovers the total amount of the investment within a much faster period of time than we have.

Yes, sir. I agree with you very much on that score. People make the argument that business is going to continue to grow, continue to invest, and that there is never quite a catch-up in the revenues that the Treasury is giving up. I think their argument is totally without merit.

The purpose of accelerated depreciation is to get that additional investment and if, in the process, you defer some taxes—well, the deferral of the tax liberalization is to get the investment and capital formation.

Senator BYRD. That tends to stimulate economic activity.

As I see it, it is better to stimulate it that way than to put billions of dollars from the Treasury in boondoggle projects as Congress has been doing and the administrations have been recommending for a long time. I am going to skip No. 4 for a moment and go to No. 5: reversing the sharply upward trend in taxes on capital gains.

I have reached the conclusion that Congress made a mistake in 1969 when it took the course of action that it took at that point. What is the top capital gains rate at the present time?

Mr. WALKER. It depends, sir. When you have to wind in a number of factors—the Federal rate, the minimum tax and a number of other factors. Sometimes the Federal rate, exceeds 45 percent. I have seen statements by some people, experts, that it gets higher when you add State rates. In many States, it can be above 50 percent.

Senator BYRD. We ought to talk, it seems to me, about the Federal rate.

Mr. WALKER. The Federal rate can get above 40 percent. It can approach 50 percent. In other words, we have, in some cases, doubled the maximum taxable rate on capital gains since 1969. It used to be 25 percent.

Senator BYRD. I do not see how it gets up to a figure like that.

Mr. WALKER. I will work out an example for the record.

Senator BYRD. I wish you would and then give another example, leaving out the minimum tax.

Mr. WALKER. All right. We will do both.

Senator BYRD. My impression has been, except for some isolated cases, it works out to about 37 to 38 percent.

Mr. WALKER. That sounds about right. That is an increase of 50 percent of what it was over the 25-percent rate in 1978. It is bound to affect not only capital formation, but the type of instrument used to help capital formation mainly equity stocks, where most of the risk money tends to come from. So, it is doubly deleterious.

Senator BYRD. It has had a negative effect on economic activity.

Mr. WALKER. Yes. I would agree with that through the impact it has on whether individuals, particularly high income individuals, will put their money out at risk, because it has lowered the rate of return.

Senator BYRD. When you get to No. 4, I approve of the principle of trying to reduce, possibly eliminating double taxation. Explain to me how that can be done.

Mr. WALKER. Well, sir, there are several ways. When you say you can't get your mind clear on it, you are part of a large group in this country.

Let me say first of all that intensive studies are underway, particularly in the business community and our own Council as to the various approaches to reducing double taxation.

To make my answer short, let me put it this way: There is no question but what a strong case can be made for some of the proposals on an equity basis, because the tax to the individual stockholder finally can become so high, particularly in those cases where corporations and individuals are paying high marginal rates.

Let me just describe two of the plans that are being discussed now and say a word or two about them.

One plan would permit, or grant, a refundable credit to the stockholder on his individual income taxes, for all or part of the corporate taxes paid on his behalf.

There are some in the business community that will support this approach. But to the extent that a large amount of the funds devoted to business fixed investment come out of retained earnings, to grant the entire tax reduction to the stockholder—although there is no doubt that over a period of time it will make markets better and it will promote capital formation—in the short run that particular corporation has no more money to invest from retained earnings, which is perhaps the major source of new capital formation.

Senator BYRD. It is not disadvantaged by it?

Mr. WALKER. But proponents of this approach say corporations can, since stockholders benefit from a credit, reduce their dividends and thereby increase retained earnings.

Well, I am not so sure whether corporations can reduce their dividends or not. Tax credits or not, that might be unacceptable to stockholders.

Moreover, much of the common stock in this country is owned by tax-exempt organizations—pension funds, foundations and so on, and they have planned payouts in the years ahead.

The tax credit means nothing to them. They could be receiving a reduced income flow in the form of dividends. You have those problems.

Another approach is to permit corporations to deduct dividends paid in the same manner that they deduct interest on debts. This will have the great advantage of reducing the bias in favor of debt financing and help stimulate equity financing. Also, corporations might share some of that by paying out somewhat higher dividends, but not all of the gain. And so, as a consequence, you will have both a shareholder who wants to buy more stock and you will have the corporation with more to invest.

That is not as politically appealing as the stockholder credit, which supposedly benefits individuals instead of corporations.

Secretary of the Treasury Simon, in one sense you might say with the wisdom of Solomon, sent a proposal up in 1975 that would combine the two. Let corporations deduct half of the dividends paid and let individuals take a credit for 50 percent of the dividend that they receive.

I would not be surprised if something down the "middle," like Mr. Simon recommended, might not be the final outcome.

The only other point I would want to make is that some people have said, well, if we go to an integration plan that "costs" $8 billion—and I put "costs" in quotes, since I say that we can recover these revenues over a period of time—then the business community has to give up something among these other five capital formation proposals. I think that is very wrongheaded. That will not give us the type of net stimulus to capital formation that we need.

This is why I am concerned that the administration is talking about getting this proposal up here so soon. This is an area that is undergoing constant analysis. Everytime we look at it, some new factors come in that have not been considered before.

I do not think we are ready to move in this area at this time.

Senator BYRD. You do not think we are ready to move in this area?

Mr. WALKER. I do not think we have thought out fully enough——

Senator BYRD. You just recommended that we move in this area.

Mr. WALKER. I recommend that we do it only in a time frame where we have time enough to think it out. My point was in terms of moving right into it in either June or July. I would still like to get started on all of these as soon as possible.

What is the best approach to integration? That is the question.

Senator BYRD. Do you think the administration is going to recommend one of these proposals?

Mr. WALKER. The indications are that they favor a stockholder credit approach.

Senator BYRD. From a realistic point of view I took that to mean that they would probably recommend a $100 credit, or something like that.

Mr. WALKER. I do not think that is what they have in mind. As Secretary Blumenthal said—incidentally, in his appearance on "Issues and Answers" on Sunday, he made an interesting statement; the press has not paid much attention to it.

Secretary Blumenthal was taken up by reporters who noted that the President said in his recent press conference that his total tax package would be balanced, it would not lose any revenues. Does that mean, Secretary Blumenthal was asked, that any rate reductions will be offset by rate increases?

It was very encouraging when he answered, no, it does not mean that at all. There are some taxes that can be cut—I would say primarily business taxes—which would actually generate revenues. This indicates that Secretary Blumenthal is going to do something that this committee in general, and Chairman Long in particular, has recommended for a long period of time that the Treasury in its revenue estimates of tax actions, take into account feedback, or the stimulative impact on incomes and profits.

Still, so much of the talk is that if we're going to have $8 billion in integration with stockholder credit, or whatever, business has to give up $8 million or so, or a large portion of that, in depreciation, the tax credit, or what have you. That is very disturbing and would be highly counterproductive.

Senator BYRD. It may be disturbing but I am frank to say I do not see Congress taking each of these five points and acting on each of these points.

Mr. WALKER. I do not either. I will say this to you. When the administration comes up with its proposals and it gets to hearings the American Council will be here with specific recommendations.

I would like to see the Congress start moving in all of these areas.

You do not see the Congress doing that. I do not see the Congress doing that. But in order to set priorities I want to know what sort of integration program they propose. I want to know what they want to do about depreciation.

Senator BYRD. Yes.

On the integration proposal, I was rather startled to read a headline that the Americans for Democratic Action recommended the elimination of the corporate income tax. When I read the fine print, I find that they want to charge the stockholder with a total profit of the corporation. What that means is that a person, whether a widow or whomever it might be, normally would be entitled to $300 in dividends which she has been paid, but she is charged by the Internal Revenue with having received $1,000 in dividends.

I do not believe that that is going to encourage investment. It is going to make it impossible for many people to own any securities.

Mr. WALKER. I had exactly the same reaction when I picked up the paper.

Senator BYRD. They knew what they were doing.

Mr. WALKER. They knew exactly what they were doing.

Senator BYRD. Not only the high income taxpayer. As I visualize it, it would play havoc with anybody, regardless of what tax bracket they are in.

Mr. WALKER. It would play havoc, there is no question there. There are probably a few individuals that may be at a break-even point. On balance, it would play havoc.

That emphasizes how difficult it is to get a handle on this whole integration thing when you have several different plans floating around.

Senator BYRD. You have boiled it down to two or three plans, with the third plan being a combination of the two.

Mr. WALKER. I think that is a realistic range. Unless you could put into effect now a long-range plan aimed at phasing out the corporate income tax—people say, oh, my goodness, you want to let the corporations get away without paying taxes. We know the corporations do not really pay the tax. They are surrogate collectors for the Internal Revenue Service. The corporate tax is borne by people.

Unless you could move toward an effective phaseout of the corporate tax and if there is going to be some sort of integration proposal, I think that the Simon approach, among all that I have seen, combining the dividend deduction and the stockholder credit, may have the most merit.

At the same time, I would again emphasize that to me, even the Simon plan, if put in in full at the estimated cost using the old system of revenue estimating, $15 billion or so, if the argument is made that there has to be an offset by raising business taxes in other ways, I would say no, I would not be in favor of it. In fact, I don't think it would "cost" anywhere near that amount—if anything.

Senator BYRD. Thank you very much, Dr. Walker. This has been very interesting and enlightening and we appreciate it.

Mr. WALKER. Thank you, sir.

Senator BYRD. The next witness is Dr. Michael Sumichrast of the National Association of Home Builders, accompanied by Mr. Gordon Smith of Miller and Smith, McLean, Va. I welcome both of you gentlemen. You may proceed as you wish.

STATEMENT OF DR. MICHAEL SUMICHRAST, NATIONAL ASSOCIATION OF HOME BUILDERS; ACCOMPANIED BY GORDON SMITH, MILLER & SMITH, INC., McLEAN, VA.

Mr. SUMICHRAST. Thank you very much. My name is Mike Sumichrast. I am the vice president and chief economist for the National Association of Home Builders.

Just as a short background, I used to be a home builder. I built houses in Australia, New Jersey, Pennsylvania, Ohio, West Virginia. My training was in industrial engineering in Europe. I got a master's degree and Ph. D. degree at Ohio State University in economics. Mr. Gordon Smith is really substituting for his partner, Dave Miller, who is the president of the Northern Virginia Home Builders Association. Mr. Gordon Smith is one of the new breed of builders. He has an MBA from Harvard University and has been actively engaged in construction for the last 3 years in the Washington area.

I want to thank you for giving me the opportunity to present my views in this discussion here today. Some of the things that I am going to say are not necessarily the NAHB policy, but rather my own.

I will limit my discussion to construction, particularly residential construction. I think this is what you would like me to do.

You asked us to concentrate on two or three major, important issues, and I will touch on these. First, let me just state for the record, when you look at the total new construction as measured as value put in place, you can see we were able to capture a smaller and smaller share of the gross national product since the Second World War. Its share is actually even less than it was in the twenties and in the period to just prior to the Second World War.

Since total construction is the largest single portion of private investment, the same thing has happened to that sector. The gross investment was close to 19 percent in 1949, only 14.2 percent in 1976.

Total construction accounted for 10.4 percent in 1929 and dropped to 10.6 percent in 1960 and 9.6 percent in 1970 and 8.7 percent in 1975 and 8.5 percent last year. It was able to capture a smaller and smaller part of the GNP.

Residential construction shows the same trend: 6.3 percent share in 1950; 5.4 percent in 1955; 4.5 percent in 1960; 4.3 percent in 1965; 3.2 percent in 1970; 3.6 percent in 1975; and 3.5 percent in 1976.

The point here is simply that our problems are not necessarily of short duration, but long and of a persistent nature. One of the reasons that the share of the gross private domestic investment and housing and construction has declined is the Government, led by Federal, State, and local government, has taken a larger share of all the goods and services we produce.

The other reason is we have less and less incentive to put money into structures.

There are three items I wanted to mention. One is that probably the most important thing you can do is to provide some degree of stability in construction. This, of course, can only be done if we can obtain better control over the forces of inflation.

Why is this so important to us in construction? Well, first of all, investment in construction is generally long term. Investment in a shopping center goes for many years; investment in a rental project never goes for months, it goes for years, even decades.

To complete a project from conception to actual occupancy takes at least 3 and as much as 6 years.

The uncertainty which we are faced with during the period of this time provides an enormous amount of difficulties in costing up the project, in getting sufficient equity capital, in making it a successful business proposition.

The construction industry generally does not operate well during a period of high inflation. Housing functions only well in a climate of stability.

During the past 55 years we have witnessed 13 major cycles in which the decline in construction was more pronounced than the decline in GNP.

One of the reasons why the share of gross private domestic investment declined—and construction and housing dropped—is that expenditures increased for all three levels of government—Federal, State, and local. Combined, they take a much larger share of all goods and services we produce than ever before.

Another reason is that we have less and less incentive to provide equity capital for construction. Now, let me elaborate on these issues.

Probably the most important issue facing construction is its instability. This carries with it implied risk and discourages investment.

An assessment of the latest two cycles shows that residential construction bore as much as two-thirds of the overall decline in the economy. Thus, the burden was heavily thrust upon one section of the economy—residential construction—although this economic activity accounted for only 4 to 5 percent of the GNP.

The second major issue of capital discouragement in construction centers on Government intervention and regulations. Here the greatest contribution your committee can make is to stop this trend now and make a commitment to try to reverse it. Government intervention has become oppressive: Businessmen find it extremely difficult to function. Government regulations are so costly that they now account for the single largest item of cost increase in housing.

Let me briefly show how this impacts on our industry.

Fifteen years ago in February a group of us purchased a private airport in the Midwest.

We had it annexed to the city, rezoned and models were opened in mid-June. The first 50 families moved in before the end of the year. The cost of the finished lots was about \$2,200–\$2,500; or approximately 14–16 percent of the sales price. Streets were FHA specs, with 8-inch concrete base, 2 layers of 1½-inch asphalt, curbs and gutters, driveway aprons, and 4-foot public walks.

There is no possible way that this would be done again in such a timespan. Three to four years would be a more likely period now.

Time is money and the consumer is paying for that.

There is no way you could do this today for less than \$18,000–\$20,000 per lot.

There are some other things which impact cost and the need for capital.

Risk in building has increased. It is no longer a foregone conclusion that we can build a project or, for that matter, a house. The uncertainty, as well as the waiting and the redtape, costs money.

Local jurisdictions see real estate as a natural target for taxation to solve their fiscal problems. Most of them are in trouble and now they collect revenues up front, before the development starts.

Environmental costs are adding an enormous burden on the ultimate consumer. If people knew what this does to prices, they would revolt.

Probably the most damaging part of the environmental cost, one which we here in Washington are so intimately familiar with, is the sewer moratoria.

This restricts the supply of usable lots and has doubled, tripled, or quadrupled the prices of lots.

This happened at the time when demand for housing was much higher than ever before. The new generation of postwar "babies" is now in the age group where they are ready to settle down and buy a home.

And, they are stunned, confused, and outraged at prices. And, they should be.

For potential customers higher prices mean higher down payments, higher monthly payments, and a higher share of their disposable income for housing. This, of course, is bad news for young first-time buyers. But, it's also bad news for homeowners or renters.

The third major issue facing the construction industry is closely connected to the first issue of instability. It has to do with the inability to tap the capital market for investment needs.

Why is this?

Mainly because a typical builder does not have the benefit of stable earnings such as most large corporations can provide. He is subject to wild swings and his profit and loss statement reflects this element quite well. His "tract" record, upon which lending institutions base their decision to lend or not to lend, cannot and will not demonstrate a good solid straight line of good returns.

This issue may sound peripheral to this hearing, but let me show you why I think that it is quite pertinent.

We are now running a good rate of housing production. Much of this is compensation for the period of 3 bad years which experienced the deepest housing cycles since the Depression.

This high level of activity, of course, will not continue. For one thing we will have higher interest rates and this alone will retard housing starts.

But, more importantly, the structural shifts of capital incentives to build new subdivisions already guarantees a shortage of suitable finished lots.

This is because suppliers of money for land and land development are not available. For instance, the large and significant contribution of REITS in the mid-1960's is no longer there.

Commercial banks are also out of the land acquisition and land development business. Just recently three of the largest homebuilding companies were told by their boards to stay out of the land development business and concentrate on building homes on finished lots.

Why is this happening? Because:

1. Land and land development requires a large amount of capital.
2. The returns on investment in land are too low.
3. The risk is too large.
4. Turnover of capital takes too long—one can get a faster return by building homes or, for that matter, putting it in the savings and loan associations.

As a result, there is little or no capital available for future land development. The only viable alternative is FHA title X. I believe they made less than a dozen of these loans last year.

Finally, there is investment in rental units. I have written two articles on this subject which I would like to include in my testimony. Put simply, the private rental units face major, longterm, and mostly unsolvable, problems.

The underlying factor to all that I have said is instability. This is the function of inflation which in turn is fueled by the inability of our Government to live within their means, as well as an unstoppable proliferation of Government bureaucracy. And this occurs at all three levels, Federal, State, and local. They control not only our pockets, but just about everything we do. Today our industry is being increasingly regulated by decrees dreamed up by bureaucrats who are, in fact, accountable to no one.

The inability to provide surpluses in the Federal budget makes it impossible for the construction industry to have access to sufficient amounts of investment capital. We cannot compete with the Federal Government.

Let me just end up by saying that the reason why I see less and less capital flowing into the construction area in addition to what I have already mentioned. I see no way in the United States in my lifetime to get the private rental market back to where it was in the 1960's. There are too many disincentives we have created over the last 10 years which make me believe that we will not ever build a million private units as was the case in the early 1970's. You will be very lucky if you can get one-half of it.

I foresee a situation 10 years from today where Government will build half of the rental projects.

Senator BYRD. What did we build last year?

Mr. SUMICHRAST. We built 374,000 units.

Senator BYRD. What do you expect this year?

Mr. SUMICHRAST. 448,000; 100,000 of these are section 8 subsidized housing.

That is all. Mr. Chairman.

Senator BYRD. Thank you, sir.

If I may summarize your comments, you feel that, No. 1, the most important thing that the Congress can do is to bring about a stability. In order to do that, steps must be taken to control inflation.

Mr. SUMICHRAST. That is correct.

Senator BYRD. It gets back to really, while it is not your only problem, your No. 1 problem and most important problem is the question of inflation.

Mr. SUMICHRAST. That is correct. You cannot have a mortgage rate of less than 8, 9, 10 percent with 6-percent inflation. With 6- or 7-percent inflation, obviously you are talking about very high mortgage rates for the consumer to pay.

Senator BYRD. My own view is, the way the Government is running deficits now of 6 or 7 percent you are not going to have any 6- or 7-percent inflation. You are going up to 11- or 12-percent inflation.

Mr. SUMICHRAST. The Government should be repaying debts rather than be creating debts, I agree.

Senator BYRD. We have with us Mr. Gordon Smith whose partner, David Miller, is president of the Northern Virginia Home Builders Association. We are very glad to have you.

Mr. Smith, how are things developing in northern Virginia?

Mr. SMITH. Mr. Chairman, I am Gordon Smith. I am substituting for my partner, David Miller.

We are finding, I suppose, in microscopic terms what Mr. Sumichrast has painted a broad picture of. We are finding it difficult to accumulate capital in our industry. I would echo the problem of the extreme fluctuations that occur in our industry. I think they are magnified by the fact that a Federal Government tends to smooth out the business cycle through monetary and fiscal controls which are magnified in our particular industry. When the Federal Reserve tightens up money, this affects our buyers very drastically. It affects our ability to borrow, and we go through massive fluctuations in the business cycle where most other industries—automobiles, for example. If they fall off by 20 percent, everybody gets upset. Our industry falls off by 60 to 70 percent in the same cycle.

It becomes very difficult to plan under those circumstances, and as a consequence, our organization today is planning on a very short-term planning basis. We do not go into long-term projects.

We are anticipating that some time in the future there will be another downturn. We do not know exactly when. We want to make sure that we are very liquid when that occasion occurs. Therefore, we will not buy large land projects. We will not expose ourselves which, I think, from a business point of view and from the point of view of the economy as a whole, is really bad to do. We should be planning for long term. We should be truly entrepreneurial out there, risking our all, but we see the cycles we have been through and we are unwilling to expose ourselves any further.

Senator BYRD. My impression is that we are pricing the young people out of the housing market these days. I do not know how young people in large numbers, can buy homes at the price that they are.

Mr. SUMICHRAST. I would like to submit for the record six articles that I have written on cost in the Washington Star. They will answer the question that you raised. Yes, we have a problem. A major problem is in the area of the regulations and redtape attached to land development, really.

[The following was subsequently supplied for the record:]

[From the Washington Star, Mar. 4 to Apr. 15, 1977]

HOUSING COSTS

(By Michael Sumichrast)

A Series of Articles Dealing with Various Costs: Labor, Materials, Land and Land Development, Financing Codes and Regulations, Overhead, Marketing, Other Expenses, and Profit Price/Income Relationship

LABOR'S SLICE OF UNIT COST CUT SHARPLY

Forty years ago the labor share of the total average price of a new single-family home, surprisingly, was estimated to be nearly twice as high as it is today.

Unlikely as it may seem, labor's share of the direct construction cost today is only about 16 percent. Putting it another way, only 16 cents out of each purchase dollar goes for on-site labor.

Major reasons for the reduced share of labor are:

Increased productivity due to mechanization.

Widespread usage of industrialized methods in construction.

Standardization of construction.

Enormous improvement in the tool industry.

And, ironically, the rapidly increasing cost of construction labor, which has put pressure on builders to use more parts produced in shops or factories and use less and less on-site labor.

Let us examine why we have had a decline in the share of on-site labor:

First, the overall share of hard cost of which labor is a part—the brick, mortar and other costs of the structure—dropped. In 1949, for each dollar of sales price 69 cents was paid for the structure. Today it represents only about 48 cents.

Much of this shift from hard to other costs has been the result of an unusually rapid increase in the share of land cost. Land's share was about 11 percent after the Second World War and is more than double that today.

Since the structure share is now less than 50 cents of each dollar, rather than 69 cents, the labor share also is less. It would be less even if its relation to, say, materials had remained stable. But it did not.

Productivity, of course, has increased in most human activity as the result of industrialization.

Nowhere is this more evident than in agriculture. Twenty years ago we had more than 19,000 farms; today we have 9,000. Employment on them has dropped from 8.4 million to 4.2 million. Still, fewer workers are producing more. Twenty years ago one worker produced enough food for 19.5 persons Today he produces enough for more than 50.

A similar trend has been documented in construction, although obviously it's not as dramatic.

Today much construction is prefabricated. Says Milt Kettler, president of Kettler Brothers in Gaithersburg:

"About 10 years ago we still had carpenters to hang doors. Today nobody does that any more. We get all pre-hung doors. It takes only few minutes to hang them, rather than several hours."

And so it is with most other items. Kitchen cabinets used to be done in the house itself. Roofs were done on site. Door and window headers were laboriously cut and fitted on the decks of the houses.

Today we ship finished cabinets. Two-by-four trusses have replaced heavy 2-by-6-inch or 2-by-8 rafters. Windows come finished; framing is done in a shop and shipped to the site, and so on.

A document written in 1968 by the Building Research Advisory Board of the National Academy of Sciences said it very well: "Industrialization in housing has been progressing over the years, beginning with small elements and advancing in evolutionary stages to ever larger and more sophisticated components."

An enormous push also has been given productivity by the machine and tool industries. It is always amusing to see the expressions on the faces of foreigners—especially those from behind the Iron Curtain—when they first see the tools being used in construction.

They are not impressed by heavy machinery, because most of the construction in their countries is highly industrialized. They use concrete prefabrication and heavy equipment.

For instance, in the USSR most units are highrise, whereas in the United States fewer than 3 percent of all new housing units built are in highrise structures. Most are for-sale single-family units.

But let these foreigners see even such a simple thing as a paint roller, and it makes a lasting impression on them. They are awed by the great variety of small mechanical tools we use, such as sanders, bench saws, grinders, chain saws, drills. Even the well balanced "Stanley" hammer, available in various weights, is observed with respect. All of these help make work easier and faster—and, hence, more productive.

Heavy equipment also has revolutionized our work. For instance, take a look at delivery trucks unloading concrete blocks or bricks. Labor is nonexistent—the driver hoists these gently to the ground. Even the loading of excavated soil is totally mechanized.

The stripping of soil for new developments has become a highly sophisticated science. "The most expensive thing to do is move dirt," according to Boris Lang, a builder in Crofton, Maryland. "So you move as little as possible, and when you have to move dirt you can choose from a wide variety of scrapers to do the job."

Earth-moving machinery used to move at a snail's pace. No more. Now they are high-speed machines, scraping and dumping three times as much earth as they did 20 years ago.

The scramble to use more equipment also is the result of a rapid increase in wage rates, especially those of union labor. In the seven years between 1969 and 1976 the average wages of all construction crafts increased to $10.79 from $5.82 per hour, or 85.4 percent.

In San Francisco, plumbers were getting $16.72 last year, crossing the $15-per-hour line for the first time. Just two years before the average wage was $12.25 per hour.

It's true that residential construction is not highly unionized, and non-union wages are generally lower than those of union workers. But the rapid increase in contract wage rates has had a great impact on attitudes toward the use of on-site labor.

Off-site labor, such as that used in shops, factories and lumber yards, is generally less expensive than labor used on site. This is partly because of the exposure to weather on site, resulting in a shorter and uncertain work week.

What about the future? The immediate future has been spelled out by George Meany, president of the AFL-CIO, insofar as union targets are concerned: Organized labor wants broad new legal weapons to help unionize more workers. Construction will be one of its targets, and the trend will be toward more expensive labor.

What else is coming in construction?

Adoption of the common situs picketing bill. This bill was vetoed last year by former President Ford. The new proposal seems just as tough or even tougher than the one last year. It would help keep non-union companies off construction projects by permitting a single union to picket an entire project.

One of the main reasons for this bill is to extend unionization to types of construction, such as residential, where little or no union labor is being used. The cost in delays plus the shifting to union labor if this bill is passed could be enormous.

Repeal of Section 14(B) of the National Labor Relations Act. This permits states to ban the union shop, which requires new employees to join unions.

New federal legislation will spur unionization of other workers, such as public employees and farm workers.

A minimum wage increase to $2.76 an hour this year under H.R. 3744, now being studied by the House Labor Committee.

Last year's median price of a new home was $44,325, up 12.7 percent from $39,300 in 1975. Five years ago the median price was $27,600, so the jump since then is 60.6 percent. Some of this was due to increase in the size of homes, and some resulted from the large areas of land we required to build new homes. But most of the increase was due to increases in the costs of all the items that go into the building of houses, including the cost of labor.

On-site labor as a percentage of total contract costs [1]

Type of construction:	On-site labor (percent)
Schools	25.8
Hospitals	29.6
Public housing	32.4
Single family housing	20.4
Federal highways	24.6
Multifamily housing	27.9

[1] All of the above exclude cost of land and land development from the total.

Single family housing share including the cost of land and land development

Year:	On-site labor (percent)
1960–61	18.1
1969	16.1

Productivity in construction

Type of construction:	Annual increases (percent)
Private multifamily housing	2.2
Private single family	1.9
Public housing	2.2
Hospitals	1.0
Schools	1.9
Federal highways	1.8
Sewer works lines	2.3
Sewer works plants	2.2
College housing	2.0
Civil works	2.0
Federal office buildings	2.0

Source: Bureau of Labor Statistics.

Materials Take Smaller Share of House Cost

Today the cost of materials, measured as a share of the price of a new single-family home, is only about 30 percent. After the end of World War II this share was estimated to be about 45 percent.

Put another way, only 30 cents out of each dollar we pay for a new home today goes for bricks, lumber, electric wiring, equipment, pipes and other materials vs. 45 cents spent 30 years ago.

One major reason for this relative decline has been the sharp drop in the share of all hard costs—what the house is actually built of, the bricks and mortar, including labor and materials. Last week I examined some reasons for the decline of the labor share to 16 cents from almost double that amount in 40 years. Now I will show what happened to materials, the other portion of hard cost.

The hard cost share 30 years ago was estimated to be about 69 cents of each dollar purchasers paid. Just seven years ago this share was still about 54 cents. Today it is 48 cents.

If hard costs take a smaller share of the buyer's dollar, where has the rest gone?

A larger share of the cost today is going for land. This share was about 11 percent of the price after the war and is more than double that amount today.

Most of this increase is due to three factors: (1) Increased cost of raw land, including farmland, because of high demand. This has been especially true in the last several years. Farmland prices shot up because of a sharp increase in farm incomes; (2) Environmental cost increases involved in land and land development, and (3) Restrictions that limit the supply of usable land, such as no-growth policies and various moratoriums.

Increases in overhead and other costs connected with a much more complicated process of getting a project under way. Costs also are higher because of the longer time required. "Ten years ago, we could buy land and open a model in four to five months in Montgomery County," said Milton Kettler of Kettler Brothers, builder of Montgomery Village. "Today it takes two or three years before we can put a shovel into the ground. The cost of carrying the land over this extended period has increased enormously."

Increases in the share that construction financing takes due to the overall increase in interest rates. This, of course, is caused by inflation. During the Eisenhower era inflation was less than one percent. Inflation at 2 or 3 percent at that time was unthinkable.

Today we accept a 5 to 6 percent inflation rate and keep fueling the price increase by expectation of more rather than less inflation. In a climate of continually larger government deficits, it's no wonder that people are skeptical about bringing inflation down.

Another point to ponder is the fact that risk in building has increased. It is no longer a foregone conclusion that you can build a given project or, for that matter, even one single-family house. The uncertainty, as well as waiting and red tape, costs money.

Many major materials—other than lumber and oil-connected products—have behaved quite well with respect to price.

Many building items—such as paint, plumbing fixtures, heating equipment, water heaters, building blocks, clay tile and insulation board—have increased in the last 20 years at a slower rate than the average for all commodities. Others, such as concrete products, asphalt roofing and millwork, have increased at about the average rate.

Materials that have increased at a higher rate are lumber (more than twice the rate for all commodities), plywood, brass and fittings, and brick. They increased about one-third more than other types of materials.

Since lumber plays a major role in housing costs, comprising between 14 and 15 percent of the price, this alone tended to dampen the decline in the overall materials share. Yet, even with the wholesale price index of Douglas fir, for example, jumping to 282.4 in January 1977 from 87.3 in 1957, the materials share of the sales price still dropped.

Changes in materials, better design and improved engineering have combined to save on the amount of materials we use today.

Many materials have changed only a little, while many others are considerably altered. A brick is a brick, although people who know maintain that brick is better engineered today and is available in greater variety than ever before.

Lumber is lumber; yet finished structural lumber is smooth and easily handled as compared to the rough, unfinished pieces we knew in the past. On the other hand, a 2-by-4 no longer is 2 by 4, but as much as ½ inch less due to the finish.

Walls no longer need 2-by-4s spaced every 16 inches. We have 24-inch spacing where there is no bearing wall. This was made possible by the development of trusses which typically require only one center support. All other walls just "hang" there and don't carry anything. Why waste lumber?

Yes, it's true: We don't have solid doors any more. We use doors that are hollow-core with cardboard inside. They are light and easy to damage, but for inside they serve the purpose—and they are considerably cheaper.

We used to have slate roofs. Now most of our roofs are of asphalt shingles—fast, less expensive, easy to replace, and they come in various colors.

Water lines used to be made of steel. Then we changed to copper. Now we have plastic. Easier to install, lighter and just as good.

What about tubs? Well, we used to use cast iron, then steel, and now we have plastic, including the sides.

Another truism is the fact that walls are no longer plaster, but drywall. This means that walls are thinner, but in single-family houses who really notices? They are considerably cheaper and much faster to install.

We are finding less and less hardwood flooring. How lovely they are to look at. And what a backbreaking job it is to install them.

On the plus side, equipment has changed drastically, and much more is available than we ever dreamed possible. Kitchens are fully equipped. Nobody with any savvy would even try to sell bare kitchens, although some builders overseas still do, even in West Germany.

We now get much more insulation. Glass is no longer single-strength, and therefore has much more insulation value. Furnaces are much smaller, yet much more efficient, as are hot water heaters. A host of other materials such as wallboard, pre-finished panels and cabinets and dropped ceilings did not exist 30, or even 20, years ago.

What about the future? The best judgment available is that the cost push for materials will continue in the next five to ten years, probably at an accelerated pace.

Undoubtedly lumber will get more expensive, because of the political clout of the environmentalists. The most efficient way to harvest lumber is by clear cutting and reforestation.

This is just about out. Pushed by well-meaning but misinformed groups, we are now giving more protection to birds than to people.

Small lumber mills are disappearing. They served in the past as competing forces, helping the market to work better. Now, with several large companies controlling a substantial proportion of production, there is a serious question as to how well the free market really operates.

The anti-pollution issues, especially clean air and clean water, will make it more, rather than less, expensive to produce many materials used in housing construction.

Energy-intensive materials such as insulation, steel, aluminum and plumbing fixtures, as well as petroleum-based products, very likely will increase in price at a higher rate.

We can except further intervention of government at all levels. Tougher housing codes and regulations, more inspections and more red tape instead of less are likely. Naturally, all of this will cost more.

	12-72	12-76	Percent change
Contingencies	$500	$400	−20.0
Heating	2,265	2,690	+18.7
Plumbing	2,022	2,372	+17.3
Electric & Fixture	1,195	1,782	+49.1
Drywall	1,915	2,080	+8.6
Insulation	237	546	+130.0
Ceramic Tile	258	360	+39.5
Flooring	483	595	+23.2
Window Cleaning	110	110	0
Landscape—Shrub	250	269	−7.6
Garage and Patio Door & Garage Door	379	301	−26.0
Roofing	750	927	+23.6
Carpet	830	963	+12.7
Termite Roofing	20	20	0
Sink Top & Vanity	458	534	+16.6
Kitchen Cab	547	754	+37.8
Kitchen Appliances	672	965	+43.6
Mirrors	91	96	+5.5
Concrete, Slab	450	702	+56.0
Concrete Footing	210	316	+50.5
HDWE Contract	260	300	+15.4
Screens	71	71	0
Structl. Stl. & Dmp	242	308	+27.3
KB Inv	215		−100.0
Dir. Pre. Pur. Kbi	350		−100.0
Glazing	50	50	0
Conc. Found Walls	1,277	1,632	+27.8
Truck Expense	270	270	0
Plan Expense	250	250	0
Temp. Services	150	295	+96.7
Misc	250	200	−25.0
Insurance	25	25	0
Permits & Bonds	55	55	0
Surveys	95	95	0
Labor Service	200	60	−33.3
Carpentry, Rough	1,875	3,168	+69.0
Carpentry, Finish	1,725	3,201	+85.6
Labor, Common	650	899	+38.3
Labor, Finish	254	175	−45.0
Labor, Masonry Skill	885	947	+7.0
Labor, Masonry Helper	387	414	+6.9
Excavation	550	589	+7.0
Concrete Driveway	260	510	+96.1
Wrought Iron Railing	75	107	+42.7
Painting	1,207	1,432	+18.6
Masonry Material	575	958	+66.6
Lumber	4,970	6,902	+38.9
Millwork	2,787	3,728	+33.8
Sod & Seed	530	649	+22.5
Payroll Assessment	657	1,064	+61.9
Fence + Humid		215	100.0
HDWE Rough		585	100.0
Alum. Door + Windows		323	100.0
Total hard cost	35,206	46,258	31.4

Note.—"Hard" construction costs of the Stanmor model in 1972 and 1976. These do not include land, land development, marketing, financing, overhead, profit or incidental expenses.

WHOLESALE PRICE INDICES 1957-77 CONSTRUCTION MATERIALS
[1967=100]

	1957 annual average	1962 annual average	1977 January	Percent change: 1957 to January 1977	Percent change: 1962 to January 1977
All construction materials	94.1	93.4	196.7	109.0	110.6
Softwood lumber:					
Douglas fir	87.3	88.1	282.4	223.5	220.5
Southern pine	93.7	89.8	233.6	149.3	160.1
Other	97.6	92.3	292.8	200.0	217.2
Millwork	87.4	90.7	183.4	109.8	102.2
Softwood plywood	118.6	106.3	281.5	137.4	164.8
Prepared paint	90.6	95.0	177.3	95.7	86.6
Plumbing fixtures and brass fittings	92.0	90.6	179.5	95.1	98.1
Vitreous china fixtures	106.6	94.4	163.7	53.6	73.4
Brass fittings	75.1	80.6	179.8	139.4	123.1
Heating equipment	108.2	100.6	162.9	50.6	61.9
Domestic water heaters	108.2	100.5	165.6	53.0	64.8
Concrete ingredients	92.7	97.4	193.1	108.3	98.3
Concrete products	93.6	95.7	187.0	99.8	95.4
Building block	94.6	95.2	174.6	84.6	83.4
Building brick	87.0	92.5	188.2	116.3	103.5
Clay tile	91.6	97.3	157.4	71.8	61.8
Prepared asphalt roofing	110.1	100.0	220.6	100.4	120.6
Insulation materials	109.6	104.1	225.0	105.3	116.1
Insulation board	108.9	105.4	166.2	52.6	57.7
All commodities	93.3	94.8	188.0	101.5	98.3
CPI index—all items	84.3	90.6	175.3	107.9	93.5

Source: Business and Defense Services Administration, U.S. Department of Commerce, Construction Review. Bureau of Labor Statistics, U.S. Department of Labor, Wholesale Prices and Price Indexes. Bureau of Labor Statistics, U.S. Department of Labor, CPI Detailed Report. Data compilation and analysis by NAHB Economics Department

LAND LEADING FACTOR IN HOUSING COST PUSH

Four years ago Kettler Brothers built a two-story colonial house in Montgomery Village, 2,200 square feet in size, and sold it for $61,500. Today that same house sells for $91,650, nearly 50 percent more.

In the same four years the cost of this structure itself—the brick and mortar, or the living space—increased only 31 percent.

What pushed the overall price so high? A leading factor was the increase in land and land development cost—an increase of 103 percent to $19,900 from $9,800.

In addition, there was a 91 percent increase in the cost of construction financing for the house, plus approximately the same increase in costs identified with delays of construction, government red tape and other government intervention.

Kettler is not alone.

Just seven years ago, builder-developer Edward R. Carr of nearby Virginia built a house which was sold for $40,950. Today the same house sells for $80,000. Actually, this house is selling for $74,823. Carr had to drop the single carport and a fireplace from his design in June 1975 in order to get the price under $80,000.

The Story of his house is pretty much what has happened to most new homes in other parts of the nation. Environmental costs have pushed the cost of land and land development so high that today the consumer pays $23,000 for the same lot that in 1969 cost $7,442—one third as much.

A buyer is bewildered by such exorbitant increases.

"People just don't understand what is happening to cost," said Carr. "Eight years ago the share of the land cost was 18 percent. Today it is close to 30 percent."

What is left, of course, is less money for the house itself. Today Carr can allocate only 46 cents out of each dollar of the sales price to the living space. Eight years ago he had 58 cents to build the house—bedrooms, baths, family room, carport, appliances, all the sticks and stones, brick and mortar which go into living space.

So, big deal! What's 12 cents? A great deal. In the house Carr is now selling for $74,823 the difference is $9,236. Put another way, if the structure had remained at 58 percent of the total price, the consumer would have gotten $43,397 worth of space in which to sleep, eat and relax.

But Carr, like most other builders, has to pay today's higher costs of all the nonconstruction items. Therefore, the consumer gets only $84,161 worth of living space. That's $9,236 less.

What this means is that he gets 330 square feet less space than eight years ago, the equivalent of two complete rooms—one 14 by 14 and another 12 by 11.

What brought all this about?

Most local governments are facing fiscal problems. They used to solve these problems by asking the state and federal governments to pay. If this did not work, they had to increase property and other local taxes. A most unpopular decision.

An easier way is to collect revenues up front, before development starts. "Water and sewer fees were $1,530 in 1972 in Fairfax County," said Ed Cook of the Northern Virginia Builders Association. "Now the fees are $2,605."

Environmental costs such as the prohibition of open burning, storm water retention and silt controls add to the costs. In a study of land development in the Rockville area, done by Oyster, Imus & Associates, the direct cost attributable to these items comes to $2,227 per lot.

This figure does not include the added design costs necessary to comply with the new regulations. It does not include such items as curbs, gutters, paving width, increases in inlets, manholes and other things required to "protect the environment."

Environmental delays in construction are another factor in driving up costs.

"It generally took less than nine months to get a subdivision approved and started," said Carr. "Now it takes two or three times as long." The cost of delays has been estimated at $10 to $18 per day per lot. Even at $10, a year's delay means $3,600. This cost is reflected in such items as "overhead."

Sewer moratoriums put a premium on available lots with sewers. In the early 1970s a typical quarter-acre lot north of Bethesda sold for $10,000 to $12,000. Today, if you could find such a lot, it might bring $40,000 to $60,000.

Time really is money. Expanded use of time creates problems which in turn cost money. Said Milt Kettler, "Ten years ago we could sell within three or four months after purchasing the land. With 6 percent interest rates, a $1 million loan cost us, say, $60,000 for one year."

"Today we need 2½ to 3 years to accomplish the same thing. With a 10 percent increase in construction cost, let's say that this means in 2½ years $250,000 in interest expense alone."

A lot of the increased cost cannot be found anywhere in the "hard cost' 'breakdown, or in overall overhead or cost of doing business. Charles Phillips, vice president of Kettler Brothers, said. "There has been a very sharp increase in costs which did not exist several years ago. For instance, you could add $700–$800 per house simply for extra inspections and maintenance of such things as water retention and silt control.

"We have to provide field people to work on dry or wet ponds to keep water from running off, and this must be kept in perpetuity.

"In silt control we not only have to build catch basins, but seed any area which is stripped so that silt is not washed off. Many times we have to seed a whole street if, for any reason, we cannot finish it immediately. Some builders may do this two or three times during an operation."

Another portion of "invisible" cost buried in overhead is the enormous increase in paperwork. "We used to have one piece of paper to sell a house. Now we have a checklist three pages long for our staff," said Phillips.

For potential customers higher prices mean higher down payments, higher monthly payments and a higher share of their disposable income for housing. This, of course, is bad news for young first-time buyers. But it's also bad news for homeowners or renters:

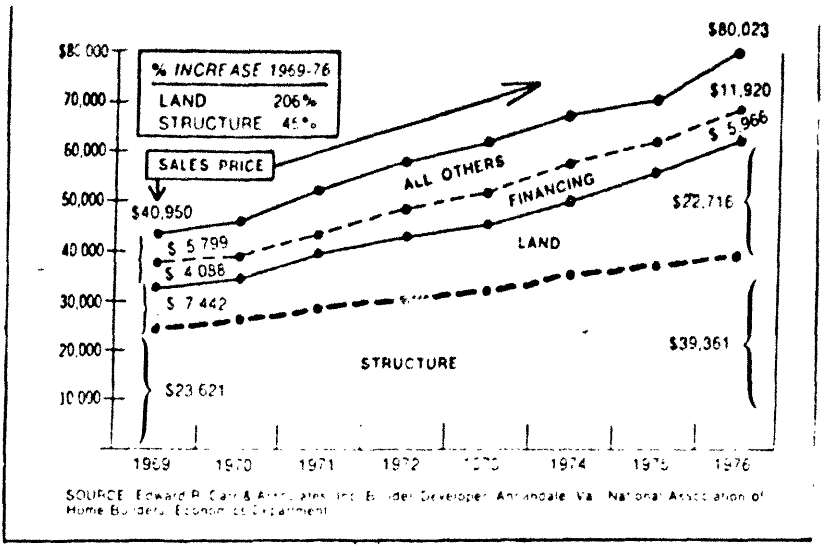
Increases in home prices mean increases in property taxes. So when a house down the street sells for double what was paid for it, don't laugh. The tax assessor will be around soon.

Some people are struck in their present homes. Even if they sell, they probably cannot afford what they would like to live in. In fact, most people could not afford to buy the homes they now live in.

Renters pay, too. As property taxes go up, these increases are passed on to the renters. The requirement of a high rent structure diminishes the appetite of investors who might be interested in a new apartment building and creates a climate for conversion to condos. This does not help renters.

Sales of more expensive houses mean paying higher transfer taxes to the state or county. Again higher selling costs, diminishing the "take" for the average person who wants to use the money to buy a new home.

A nationwide Government Fee Survey being conducted by the National Association of Home Builders shows that not all parts of the country suffer to the same extent from excessive regulatory interference. However, most do.



The increasing slope of the chart lines illustrates the effects of items other than structural costs in doubling the price of a house since 1969. While labor and materials have increased less than 40 percent, land and development costs have tripled, reflecting in part the impact of environmental protection laws.

A builder from Lynchburg, Va., commented, "We are lucky here." Another from Houston said, "Fees are minimal in Harris County. No building codes or building inspection. Government interference is almost nonexistent compared to upstate New York, where we lived until seven years ago."

A builder from Sherman Oaks, Calif., noted, "School fees (we have to pay) have been changed to $500 per student." This builder also sent in a list of more than 30 fees he is required to pay. Among these are a building fee based on dwelling and garage space; a plan check fee—one half of the building fee—a tax of $100 or each bedroom; a seismic tax, and the "Quimby bill—which translates into a dedication of acreage for parks, including land and utilities.

Even in Billings, Mont., a builder reports, "Government fee requirements add up to $1,619 for a typical house I build."

Another from Glenwood, Ill., said, "What you survey (we identified 43 major fee items in the survey) does not cover the 1-1½ years needed for approval, our legal staff, engineering, inspection fees, legal fees to the city, etc."

From Chattanooga, Tenn., a builder wrote, "It is getting to be impossible to work with the planning commission and city and county council. Each day brings a new regulation."

"The cost of a new subdivision is almost prohibitive in our country," wrote a builder from Temperance, Mich. "At the present time it would take three to four years to develop lots. We have water and sewer, but there are practically no new subdivisions being developed because of excessive costs and time involved."

The whole mess was probably best summed up in a short note from a builder in Topeka, Kan.: "It is a ripoff and a pain in the rear."

The consumer is being asked to pay in yet another way. National expenditures to satisfy regulatory standards in the area of environmental, health and safety regulations now exceed 2 percent of the Gross National Product—nearly $40 billion per year. This is as much as we spend in a year to build all single-family housing units—nearly 1.3 million new houses. For the 10 years between 1975 and 1984, it is estimated that compliance in this area will cost us $500 billion.

This estimate, according to former Secretary of Commerce Elliot L. Richardson, does not include "cost of forthcoming regulations—Clean Air Act amend-

ments, toxic substance controls, coke oven standards, the OSHA Standard Completion Project, etc." These will add billions to the cost.

Where does it all end? In the name of environmental protection and consumerism, the consumer is paying exorbitant costs. The consumer should be outraged, and would be if he understand what's happening.

The truth is that the builder also is a victim of the "system." To restore some sanity to the situation let's start with city hall or the county seat or the state house or Congress, where the legislation begins, and try to change the way the regulations are written.

LOTS OFFERED FOR SALE IN MONTGOMERY COUNTY, MD., FEBRUARY 1977

Location	Amount	Square feet
Falls Road	$36,900	20,825
Kensdale	37,500	26,199
Bell Mills	40,000	24,105
Cabin John	25,000	10,500
Oaklyn	32,000	35,591
Farmington	49,500	13,550
Montgomery	58,957	6,050
Bradley	43,990	15,000
Bradley	43,990	17,920
Oaklyn	32,000	42,183
Pomanden	45,000	11,000
Rockville	65,000	[1] 1⅓
Kamotop	130,000	[1] 2
Tara	78,000	[1] 2.6
Tara	57,500	[1] 2.2

[1] Acres

Financing Up to 11 Percent of House Cost

Other than land cost, the most sharply rising construction item in the last two decades has been financing.

The share expended on financing the construction of a single-family house has more than doubled since the end of the second world war. It is now estimated at close to 11 percent of the sales price as compared to about 5 percent in 1949.

This is the money paid to borrow the capital needed to finance actual construction. (See box on the continuation page for definition.)

As I have stressed in previous articles covering labor, materials and land, any increase in the share of the total cost not directly providing bricks and mortar affects the space the customer actually gets for his dollar.

What this means is that 48 cents of each dollar for hard costs gives you only 1,140 square feet of house per $50,000 of the sales price as compared to 1,290 square feet at 54 cents and 1,667 square feet at 69 cents—as was the case in 1949.

In addition to the directly recognizable financing cost, the customer has to pay more for interest indirectly. This comes in the finance charges that all suppliers, subcontractors and other business entities must pay when they borrow money to do business. And all do borrow money for one reason or another.

We don't know how much this adds to the total bill, but the cost must be considerable. It may be as much as the cost directly identifiable by the builders as interest paid.

There are two primary reasons for this increase:

One is the sharp and continual increase in all interest rates. There is no general agreement on the cause of the six-fold increase in interest rates since World War II. The major reason most people accept is the level of inflation.

Historically the "normal" interest rate in the United States has ranged between 3½ and 4 percent. To this "normal" or real rate one has to add the effect of inflation to get a current rate. Thus, when inflation gets to 5 percent, rates would generally be in the 8 to 9 percent range.

Why do we have inflation of 5–6 percent today as compared to, say, less than 2 percent between 1952 and 1965?

There is no general agreement on the answer other than the contributions of high expenditures by government to fight wars, unusually high increases in energy prices and large overall demand for loanable funds by both government and private industry—including the one supporting the mortgage market.

In any case, in the first half of the 1940s short-term interest rates were at a very low level, with short-term yields of bills averaging 0.52 percent. They had increased by 1949 to 1.31 percent.

Compare this to short-term yields topping 9 percent several times in 1973 and last year's three-month bill rates generally yielding over 5 percent.

Those past low levels were maintained by policies established during the Depression and continued during World War II. Low interest rates in the 1946–49 period were accompanied by three budget surpluses.

Since then rates have shown a continual and persistent upward trend. This trend has been accompanied by a trend toward larger federal deficits. Until 1960 surpluses and deficits just about canceled each other out. But between 1960 and 1969 deficits totaled $66.1 billion and surpluses—in one year, 1969, only—were $3.2 billion.

In the 1970–74 period deficits totaled $69.6 billion and for the 1975–77 period the deficit is estimated at about $180 billion.

This year will be the eighth consecutive year of deficit and the 27th post-war year. The estimate of total federal debt for 1977 is at $721.8 billion, up 14.3 percent from a year ago and an increase of $90.5 billion in one year. Interest on the federal debt alone is running at $41 billion, or close to what we spent on all construction for single-family homes last year.

The impact of financing on consumers is particularly drastic during a sharp increase in rates. For instance, between 1970 and 1974 when federal fund rates shot up to an unprecedented 12 percent—and all rates followed—the cost paid for financing a typical home increased nearly 150 percent to $3,917 from $1,580. The share of dollars paid for financing zoomed from 6.5 percent to 10.5 percent.

During the same time the sales price increased 43.5 percent to $37,300 from $24,300.

Much of the new construction financing was tied to the prime rate. Thus when the prime rate was, say, 6 percent, a typical builder would pay 6 plus 2, 3 or more. His project was costed out on the assumption that he would be able to finish the project at the same, or maybe a somewhat higher, rate.

But when the prime rate got up to 8, 10 and 12 percent, many builders found themselves paying rates as high as 14 to 18 percent. Most of them could not continue paying such rates, and the number of bankruptcies catapulted to a new record.

No one gains from bankruptcy, not the customer, bank supplier, subcontractor or builder. Bankruptcy increases the risk in building, and builders must allow for that. So this, too, must be reflected in the cost of housing.

The second major reason for the dramatic increase in financing cost is the substantial lengthening of the time it takes from inception of the project to its finish.

This time frame is stretched by all kinds of restrictions, delays and red tape on local, state and federal levels. Most of the these conditions were nonexistent a decade ago.

I illustrated this situation in my last cost article by quoting Milton Kettler, the co-developer of Montgomery Village. He said that what used to take him three to four months now takes him 2½ to 3 years—and this is merely the basics required to get the project under way.

Buying a piece of land and financing it for a few months at, say, 6 percent is one thing. But, having to carry a piece of land for several years at 10 or 12 percent is a different ball game.

The intrusion by government into private business which resulted in these big cost increases continues even during periods of depressed housing activity. Let me illustrate:

Unemployment is high; there is relatively little housing activity; we are faced with an excess of unsold houses; skilled craftsmen are seeking employment as laborers. One certainly would think that costs would moderate. Wrong. It didn't happen in the past, not even during the most severe postwar housing recession.

There are many reasons for this, and it would take too long to discuss them here. Just let me give you an example of one such item in public financing:

Sales price	Hard cost: Share (cents)	Hard cost: Total	No. of square feet $30 per foot
$50,000	69	$34,500	1,667
$50,000	54	27,000	1,290
$50,000	48	24,000	1,140

NOTE.—This means that 48 cents gives you only 1,140 sq. ft. of house at $30 per square foot of the sales price as compared to 1,290 sq. ft.

The peak in new housing units permitted in Montgomery County was in fiscal 1972, when 11,965 permits for new homes were issued. Expenditures for all inspections (including those for non-residential construction, upkeep and improvement) were $667,961. By 1975 permits had declined more than 90 percent to 1,288 units, but expenditures for inspection increased 80 percent to $1.2 million.

Thus the cost per permit per unit of new housing soared to $936.35 in 1975 from $55.83 in 1972. True, inspections do cover other things in addition to residential construction. Therefore, I have measured the impact of the total budget on total valuation, which includes residential and non-residential, and upkeep and improvement.

This also shows a dramatic change, from $2.44 per $1,000 of construction valuation in 1972 to $7.18 in 1974, dropping slightly in 1975 to $6.99.

A private company could not operate on the same budget, let alone have it increase as it did in Montgomery County, while its production dropped 90 percent. Most private companies would be out of business, or else they would have to reduce their expenditures drastically. But it's apparent that at least one department in Montgomery County did not reduce them.

This, of course, does not get directly into the cost of houses. It does get indirectly into the ever-increasing property taxes. It also indirectly gets into the make-up work of inspectors, delays in approvals and simple paper shuffling.

A prominent builder from Fairfax County said it very well two years ago in a four-page letter to me discussing this problem. He listed 18 major items of local government interference which have contributed to the rapid increase in the cost of housing.

TOTAL EXPENDITURES, CONSTRUCTION PERMIT DIVISION, MONTGOMERY COUNTY, NUMBER OF BUILDING PERMITS ISSUED AND COST OF INSPECTION PER UNIT AND PER $1,000 OF VALUATION OF ALL CONSTRUCTION

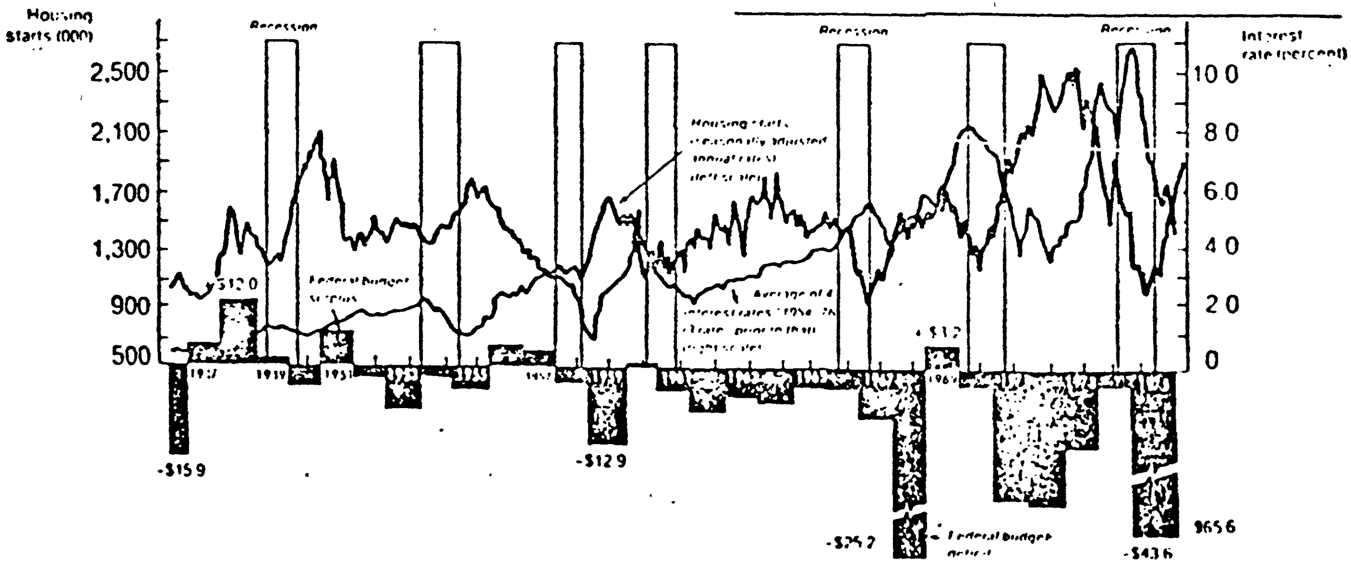
	No. of permits for new homes	Total expenditures for construction permit division	Cost per permit	Cost per $1,000 of valuation
Fiscal year:				
1968	4,988	$310,345	$62.22	$1.92
1969	5,919	340,690	57.56	1.63
1970	7,211	361,710	50.16	1.67
1971	7,886			
1972	11,965	667,961	55.83	2.44
1973	9,707	749,381	77.20	3.14
1974	4,223	1,018,970	241.29	7.18
1975	1,288	1,206,017	936.35	6.99
1976	2,185	1,167,680	534.41	4.27

Source: Montgomery County, recommended budget and public service program. Bureau of the Census, authorized construction, Washington, D.C. area, C-41, various issues.

In addition, he reported: "Our local jurisdiction has been faced with a 50–60 percent fallout in starts. At the same time they have not reduced—and in some instances have increased—their inspection staffs. Each inspector is concerned that he may lose his job and, as a consequence, finds all kinds of items to write up so that he will always appear to be busy.

"In one instance the road inspector told us he was fearful of losing his job and therefore would always find something wrong with our streets which precluded getting our bond released. We felt we were helpless to report this instance to the inspector's superior lest all of the other inspectors in the county inspect our jobs with a vengeance."

The cost of the delays increases the interest paid for borrowed capital, and guess who is paying for it?



Housing starts (000)
2,500
2,100
1,700
1,300
900
500
Recession
Interest rate (percent)
10 0
8 0
6.0
4 0
2 0
0
-$15 9
-$12 9
-$25 2
-$43 6

Too-Strict Codes Cost Thousands

There are those who say that the only good code is no code at all. I disagree, and would dispute also that all stiff codes and regulations promulgated in the last 10 years are bad.

To say they are all bad is nonsense. Some of these codes and regulations are excellent. Some are necessary and some highly beneficial. For instance, smoke detectors save lives. Think what required smoke detectors would mean nationwide in 10 years.

Four-foot sidewalks in new subdivisions provide a safe place for pedestrians and for children to ride their bikes. A 10-inch concrete street base with a 3-inch asphalt topping and concrete curbs and gutters is far stronger than a county specification calling for a heavy stone base and asphalt.

On the other hand, a dead-end street with minor traffic other than that normally terminating there could very well do without such a heavy concrete-asphalt application. Simply put, a 747 could land on this type of surface. Residential traffic warrants less expensive streets.

Too stringent codes and excessive regulations, including too many inspections, increae costs. How much? We don't really know, because costs vary so much from place to place.

A glimpse into this area has been provided by a new National Association of Home Builders survey of builders. It deals with the costs of the 10 most overly restrictive new codes/regulations. We found a range from $1,260 per unit to as much as $3,560 per unit and as much as a whopping $4,500 in the Northeast region.

The codes and regulations governed 79 major areas: 15 in electrical, 14 in fire safety, 9 structural, 12 plumbing, 19 land and land development, 4 miscellaneous. Twelve types of impact analysis were required.

The problem was well summed up by a builder from Virginia: "The home buyer is slowly being regulated out of an affordable home."

A builder from New Jersey said: "New agencies and regulations since 1974 have added $6,000 per house."

The problem seems to be that we are relying more and more on all levels of government to police all phases of the free market economy. It is hard to turn around without some government agency looking over our shoulders.

"I don't think the government should be responsible for protecting everyone from all possible hazards," said a builder from Arizona. Of course it should not, but the government tries very hard to do just that.

The Occupational Safety and Health Administration has contributed its share to costs, confusion and delays. So far, fortunately, OSHA's efforts have been concentrated in non-residential construction, but its inroads have been felt in housing. One builder from Pennsylvania said: "OSHA is, in many respects, the worst of stupidity."

One major problem of codes is that there is little uniformity. Inspectors provide different standards of enforcement. One builder told the NAHB: "We need uniformity on a statewide basis."

On the other hand, we heard: "Indiana is fortunate in having uniform statewide codes with considerable industry participation in the adoption process."

Gordon V. Smith, of Miller & Smith in Fairfax, wrote: "We attempted to hire a handicapped person but found that we could not afford to, since such an individual must be included under our own standard company health plan even though he would have been happy to have the job. He understood our reluctance to include him in our health plan, since this would add about $5,000 per year to the cost of this employ."

Respondents to the NAHB codes/regulations survey listed burning restrictions as the most overly restrictive code. Nearly three-fifths indicated this to be a major problem. The cost per unit, from the consumer point of view, was not all that much—between $90 and $150 per house. But it does provide additional irritation and delays, as well as cost.

Let me list some of the major problems in the order of importance given by builder-respondents:

Burning restrictions.

Ground fault circuit interrupters (outdoor, in bathrooms and on construction sites)

Oversized egress windows in bedrooms.

Mandatory dedication for parks and recreation.

Excessively wide streets.

Sidewalk requirements.
Minimum lot size.
Fire-rated wall and door between garage and house.
Excessive street and access roads requirements.
Setback requirements.
Antisiphon device requirement.
Restriction on Romex electric cable.
Smoke detector requirements.
Extra lighting outlets.
Restriction on use of 24-inch spacing of studs.
Bridging requirements.
Mandatory dedication for community facilities.
Tree ordinance.
Minimum floor space requirement.
Overly restrictive provisions for seismic design.

Now let's look at some examples of how these codes/regulations affect costs.

The old BOCA code allows for stair risers of 8¼ inches. The new code is for an 8-inch riser. This is a minute difference, right? But this minor change requires an extra riser, which means that the stair system has to be deeper. The deeper stair system cuts valuable inches out of some rooms. Also, the extra riser adds to the stairway cost. See the domino effect emerging from a ¼-inch code change?

Virginia now requires a 7 percent grade on residential streets instead of the previous 10 percent. This means more cutting and filling, and fewer trees can be saved. Certainly this change adds cost and is unnecessary on a residential street, not to mention the impact on environment and beauty. The regulation was intended for highways—with speeds up to 55 m.p.h.

Final electrical inspection can be obtained only after installation of all appliances. Many unoccupied houses are needlessly exposed to theft and vandalism. Replacing appliances adds cost and inconvenience.

Each building site now must be tested for soil bearing quality at a cost of $75 per house. Since there is no history of a problem with this in the Washington area, the expense is unnecessary.

Building fees have more than doubled in the last two years. In some instances fees to review engineering drawings cost more now in Fairfax County than it originally cost to have the engineer prepare the drawings.

All these examples demonstrate that, although there is no single major cost item which one could identify as causing his house to increase in cost, together they make a substantial impact on the prices of new units.

Gordon Smith provided a thought-provoking summary on the subject:

"This gives you an idea of the types of added expenses that are continually being placed upon the industry, most of which are questionable upgrading of standards which have served very adequately in the past.

"This continual marginal upgrading adds to costs and prices housing out of the range of a number of families, who then are forced to live in marginal housing that was built under very primitive early codes, and they have very poor electrical wiring, no insulation and inadequate plumbing. Thus it is my contention that these new senseless code requirements are forcing people to stay in outmoded housing which, ironically, adds to their safety and health risks which the code revisions are purported to help."

Why Cycles Hurt Giants the Hardest

On the average, builders of new homes make a little more than 6 percent in net profit before taxes. Their general overhead is another 6 percent of the price, while marketing expenses are a little less than 3 percent.

Within these averages there are wide variations. Some builders make money and some lose. For instance, builders with an annual volume of $500,000 to $1 million show a range from a low quartile of 2.6 percent to a high of 10.9 percent net profit.

Typically, the medium-size builder, with an annual volume of between $1 million and $2 million, makes the least profit, 5.8 percent, and the large-volume builder nets an average of 6.0 percent.

The small builder, with sales of under $500,000, makes the highest profit, averaging 6.5 percent.

He also makes more on the money he puts into the business than the giant builder. His net profit on owner's equity is 35 percent, while the net profit for those with a volume of more than $8 million net return is only 28.3 percent. This is a major reason why the little guy survives the ups and downs of the housing cycle, while giants go broke.

Only big builders have the capacity to invest in equipment and large land tracts for future development and to diversity into other activities. Large investments in land tend to get builders into trouble.

There are exceptions, such as Ryan Homes, which do not hold land or develop it. They buy individual lots and pre-sell their units.

Giants in the industry, on the other hand, work with relatively less of the entrepreneurs' own money than the small builders. This is because they often sell equity shares to the public, while small builders have their own money sunk in the business.

Many of these data come from "The Second Cost of Doing Business," a study done for the National Association of Home Builders in 1975 by the consultant accounting firm of Laventhol, Krekstein, Horwath & Horwath. Some of its conclusions were:

General and administrative expenses seem to decrease as a percentage of sales as volume increases. This decrease can be explained by economies of scale.

Financial expenses are higher for larger builders than smaller ones. (One would have thought it was the other way around.) The explanation seems to be that smaller builders rely more on their own equity, while larger ones tend to have a greater capacity to borrow.

Marketing expenses tend to decrease with the increase in sales volume. This is attributable to the larger builders' ability to use their own staff, maintain models and benefit generally from economies of large volume.

The "current ratio" shows that builders with sales volume of between $4 million and $8 million are the most solvent. They can best maintain their liquidity.

The percentage of net profit on total assets employed shows a downward trend with volume. Ordinarily, increasing volume results in better utilization of assets, but even this apparently has some maximum limitation in terms of volume level.

Now let us put a house together and see how the cost pieces fit at different times. This is illustrated in the following table (1977 figures are for the first quarter):

SHARE OF COST BY MAJOR CATEGORIES

Cost item	1949	1969	1974	1977
Structure	69.0	54.6	48.4	46.7
Land	11.0	21.4	24.6	25.0
Financing	5.0	7.0	10.0	10.8
Other cost, overhead and profit	15.0	17.0	17.0	17.5
Total	100.0	100.0	100.0	100.0

As I pointed out in previous articles in this series, today a substantially smaller portion of the total cost is left for the house—the bricks and mortar—than ever before. Only 47 cents out of each dollar are left for the structure, compared to an estimated 69 cents in 1949.

What do we pay for the structure itself? This is shown in the second table. I broke down the cost for a typical house built in 1972, 1973, 1974, 1975 and in the first quarter of 1977. The sales price in 1977: $45,200.

As you can see, there has been little real change among the individual items over the years. Lumber, millwork and carpentry labor are the three largest components of the hard cost. Plumbing, concrete and masonry are the next group of major items, followed by drywall, wood flooring, heating and electrical work.

This house, of course, could not be built in Washington. As everybody knows, this is one of the most expensive areas in the country. What the data try to portray are the nationwide costs of a typically priced unit.

There are some peculiarities of the housing market affecting costs which I have purposely left out of this series in order to concentrate on relevant cost issues. However, they deserve at least brief mention.

As we have seen, the cost of land has increased disproportionately, for the most part because of decisions of local, state and federal agencies either to limit the usage of the existing sewer systems, because of no-growth attitudes of some communities, because of environmental problems and other planning controls.

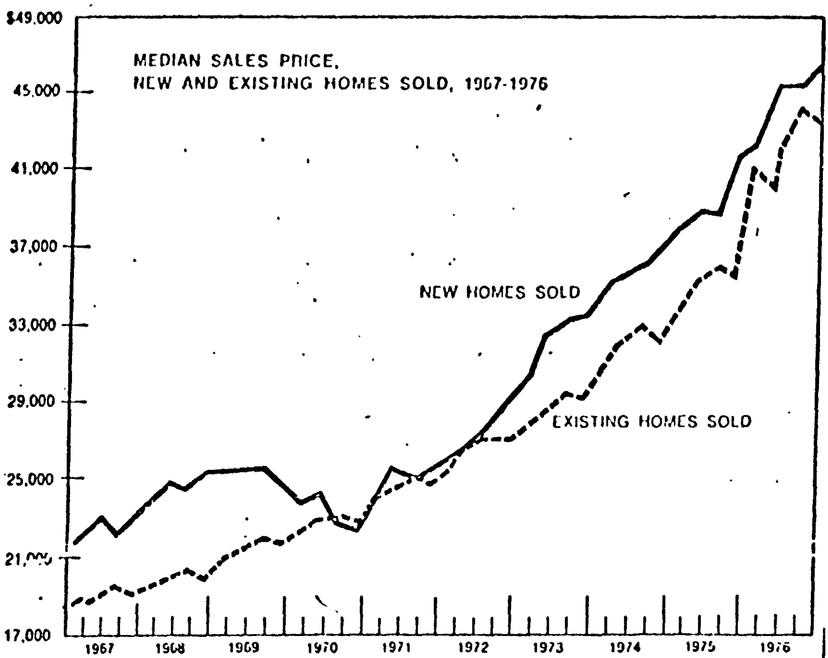
This happened at a most unfortunate time, when the demand for new homes started to accelerate because of the bulge of post-World War II babies entering the market. This demand is substantially above the demand experienced during the 1960s. At that time we could easily be satisfied with an average of about 1.5 million new units annually. We need at least 1.8 to 2 million units through the 1970s.

Another piece of the puzzle of new-housing cost has been the parallel increase in the prices of existing homes. Prices of new homes are interrelated with prices of existing homes.

Hence, if people pay 12 to 15 percent more for an existing house than the previous year, as has been the case in some "good" parts of the Washington area, the prices of new homes—and particularly the price of land in those areas—will follow the same trend.

There are some costs which we cannot do anything about, as they are determined by the prices of all other goods.

The cost of other factors, however, such as land, could be controlled by increasing the supply. There are still others, such as nonproductive fees, charges and environmental costs which add little or nothing to the house, which could be reduced. This would be a great help in stopping the fast rise in overall cost.



SOURCE: U.S. Department of Commerce, National Association of Realtors, prepared by National Association of Home Builders, Economics Department.

	1972 cost	1973 cost	1974 cost	1975 cost [2]	1st quarter 1977 cost [3]	Percent of total			
						1973	1974	1975	1977
Excavation	$226.59	$229.95	$248.43	$274.21	$316.12	1.5	1.4	1.5	1.5
Masonry	1,107.54	932.53	1,157.68	1,258.47	1,393.13	6.0	6.4	6.7	6.6
Concrete	879.94	1,245.08	1,446.35	1,489.23	1,688.64	8.0	8.0	8.0	8.0
Lumber	2,311.53	2,768.46	3,056.00	2,604.05	2,976.23	17.7	16.9	14.0	14.1
Wood flooring	419.91	568.86	753.06	827.90	928.75	3.6	4.2	4.5	4.4
Millwork	1,619.54	1,649.21	1,838.26	2,041.39	2,279.66	10.5	10.2	10.9	10.8
Carpentry, labor	1,741.87	1,708.36	1,837.05	1,908.16	2,131.91	10.9	10.2	10.3	10.1
Roofing	313.93	343.83	456.45	506.19	569.92	2.2	2.5	2.7	2.7
Gutters	118.44	109.01	127.20	137.42	168.86	.7	.7	.7	.8
Lath, plaster and drywall	860.55	873.15	1,055.02	1,067.10	1,203.16	5.6	5.9	5.7	5.7
Tile work	312.95	258.30	313.60	280.04	316.62	1.7	1.7	1.5	1.5
Floor covering	260.77	424.73	605.14	676.25	802.10	2.7	3.4	3.6	3.8
Electric wiring	572.60	606.96	658.13	747.62	844.32	3.9	3.7	4.0	4.0
Lighting	82.68	137.59	167.72	171.30	189.97	.9	.9	.9	.9
Plumbing	1,338.60	1,356.18	1,558.96	1,664.51	1,857.50	8.7	8.7	8.9	8.8
Heating	691.80	746.51	870.69	993.19	1,118.72	4.8	4.8	5.3	5.3
Painting	703.25	661.19	743.37	768.49	886.54	4.2	4.1	4.1	4.2
Insulation	146.95	228.84	285.05	274.46	337.73	1.5	1.6	1.5	1.6
Hardware	241.12	296.24	252.53	307.29	358.84	1.9	1.4	1.7	1.7
Appliances	233.53	217 81	241.61	261.75	295.51	1.4	1.3	1.4	1.4
Incidental cost	274.91	321.92	367.80	386.18	443.27	2.1	2.0	2.1	2.1
Total cost	14,459.01	15,685.71	18,040.10	18,645.20	21,108.00	100.0	100.0	100.0	100.0

[1] Includes labor and materials, but not builder's overhead, profit, financing, marketing, and land costs.
[2] Revised.
[3] Preliminary.

IT ADDS UP—AND HURTS

The main reason why it is becoming more and more difficult to buy a house, or for that matter simply meet all of our financial obligations is that government directly or indirectly takes much larger chunks out of our pockets.

In 1955 a typical American family could buy a new home for $13,700. The breadwinner, meanwhile, worked a total of 6 hours and 30 minutes each week to pay the government.

Today the typical American family must pay $44,200 for a new house. The breadwinner works all day Monday and half of Tuesday each week just to pay Uncle Sam, plus additional hours to pay other "uncles" at the state and local levels.

A better way of measuring the impact of taxation is to compare all government expenditures to total national income rather than take typical family of four.

This shows that federal, state and local government expenditures in 1948 constituted 24 percent of national income (or all of the money we collectively make. In 1955 this share rose to 30.9 percent; in 1966 it reached 34.4 percent; in 1970 it was 39.3 percent, and in 1975 it hit 48.3 percent.

Nearly one-half of all our income is spent on the three levels of government—compared to the one-quarter of our incomes we spent 30 years ago. The major problem in making ends meet is the unmistakable and continual increase of this share year after year.

These changes in housing expenses have been particularly severe since 1970. This, of course, was the result of higher inflation and a rapid increase in federal deficits.

Between 1970 and 1976 both state income taxes and Social Security payments increased at a 15.6 percent annual rate; real estate taxes were up 12.6 percent, and mortgage interest payments were up 11.4 percent annually. Yet disposable income increased by only 6.5 percent.

Last year real estate taxes increased 20 percent; utilities (mainly due to increased fuel prices) were up 20 percent; insurance of homes was up 18.5 percent; mortgage payments rose 14.4 percent; federal income taxes were up 12.5 percent—and disposable income increased only by 7.3 percent.

We keep getting socked with new taxes and increases in existing ones, and finding ingenious new ways to pay for new layers of bureaucrats, new handouts, programs, controls, agencies, bureaus, departments, so-called essential services, more red tape and paper shuffling without anybody seriously considering what this will ultimately do to our "free" economic system.

	Increase	Share of total increase (percent)
Taxes	$4,108	53.6
Mortgage payment—interest	2,222	28.9
Mortgage payment—principal	678	8.8
Utilities and others	672	8.7
Total	7,680	100.0
Increase in disposable income	7,228	
Net loss	—452	

This trend toward more and more taxation is clearly visible in all our daily activities. It is ruining incentives to work. Already it has badly damaged the ability of small and medium-size businesses to operate. Insofar as housing is concerned, it makes it harder and harder for the average person to acquire a house.

It has been said that Americans are more willing than most other nations to be led into slavery through the continual increase of the tax burden. The same people would say other nations would have risen in revolt.

This, of course, is not entirely true. Several other nations, including the Scandinavian countries and Great Britain, have even higher levels of taxation and they have not revolted. Still, their form of government has changed. A large portion of their industry has been nationalized, mostly as the result of the inability of private enterprise to function.

But wait. Isn't the same thing happening in the United States? The influence of government on our ability to buy homes is only one example of the striking changes which have occurred in the last 20 years.

In that time a typical family of four who have purchased a house have seen the following average increases:

State income tax, up 1,235 percent or $352; Social Security, 882 percent or $741; mortgage interest payments, 497 percent or $2,222; real estate taxes, 354 percent or $547; mortgage payments, 322 percent or $2,900; federal income tax, 305 percent or $2,468; hazard insurance, 225 percent or $85; other housing expenses, 209 percent or $205; heat and utilities, 189 percent or $382; price of a new home, 187 percent or $25,600.

Meanwhile, gross income has climbed just 210 percent or $9,298; disposable income, 181 percent or $7,228. But gross income needed to qualify for a loan on a new house is up 219 percent or $14,430.

The cost per square foot of a new home is up 124 percent or $13.95, and the median number of square feet per new home is up 27.9 percent or 381.

Grouping the cost items into four major categories shows the following distribution:

Taxes, up $4,108 or 53.6 percent of the total increase; mortgage payment/interest, $2,222 or 28.9 percent; mortgage payment/principal, $678 or 8.8 percent, and utilities and others, $672 or 8.7 percent.

The total increase in costs is $7,680, $452 more than the increase in disposable income, which came to $7,228.

CHANGES IN HOUSING EXPENSES AND INCOME/ANNUALIZED PERCENT CHANGES

	1955–75	1970–76	1975–76
State income tax	13.8	15.6	10.2
Social security payments	12.1	15.6	8.5
Mortgage interest payments	9.3	11.4	13.1
Federal income tax	7.2	13.8	12.4
Real estate taxes	7.9	12.6	20.5
Mortgage payments	7.5	11.6	14.7
Hazard insurance	6.1	12.0	18.5
Income needed to qualify	6.0	10.4	10.3
Actual median income	5.8	6.9	7.1
Other housing expenses	5.8	10.8	10.5
Heat and utilities	5.5	12.0	20.3
Sales price of new homes	5.4	11.2	12.5
Actual disposable income	5.3	6.5	7.
Annual housing expense	7.1	11.6	14.

This analysis of cost factors affecting home ownership could not measure precisely what has happened over time, because there is no such thing as an "average" house or family.

What I have tried to do is show the relative changes among major items effecting the purchase of new homes during given periods.

The plain truth, simply put, is that although people theoretically might qualify to buy a new home because their income has increased in proportion to the increase in prices of homes, they cannot pay for it. After everyone gets finished reaching into their pockets, there isn't enough left to make the monthly payments. Every day there are more fingers, and the fingers seem to get longer and dig deeper and deeper.

In terms of dollar outlays, or share of total increase, mortgage interest payments constituted the second most important increase among housing expenditures for the 20 year period 1955–75. The average American new-home buyer paid $2,222 more for interest in 1975 than he paid in 1955. Nearly 30 percent of the increase in housing costs and taxes has gone for this item.

The annual interest for the average new-home mortgage in 1955 was $446. Ten years later it was $911. Another 10 years saw the cost nearly triple to $2,668 in 1975, and last year it rose to $3,022. This reflected the higher mortgage amounts (the result of higher priced homes) and enormous increases in interest rates.

Although it may sound unbelievable, the average mortgage rate in 1955 was 4.88 percent. In 1965 it was still only 5.75 percent. In 1976 it reached 8.75 percent.

Stretching out the length of mortgages helped ease the burden. Down payments were cut to make the purchase easier, but this only added to the rising trend of mortgage amounts. A mortgage for an average new home jumped from $9,375 in 1955 to $15,900 in 1960 and to $19,094 in 1970. Then it almost doubled to $34,785 in 1976. Quite a change.

"TYPICAL" FAMILY OF 4 BUYING A NEW HOUSE, 1ST YEAR EXPENSES (SHARE OF INCOME GOING FOR HOUSING EXPENSES)

[In percent]

	Gross	Net
Year:		
1955	18	20
1965	21	24
1970	18	23
1975	22	28
1976	22	29

The third major area of increased annual expense was payment for utilities, maintenance and repairs. This increase has been particularly severe in the last several years because the cost of heating and cooling has increased faster than most other expenses.

The items combined under the housing expense category "utilities and other" increased 8.7 percent a year between 1955 and 1975. However, this category accounted for a 16.8 percent share of the increase in the 1970–76 period, and last year, due mostly to energy cost, this share jumped to 18.9 percent of the $1,230 increase. Taxes accounted for 52.1 percent ($641), and mortgage payments for 29.2 percent ($359) of last year's housing cost.

In spite of soaring increases, last year saw a record number of people buy homes. There were 1.1 million new units started and 3 million existing homes sold.

How is this possible?

One reason is that over the years we have been able to stretch out the length of the mortgage payments. In 1955 the average length of a mortgage was 21.3 years; in 1976 it was 28 years.

Another reason is that down payments have been lowered substantially as a percentage of the loan. In 1955 the loan-to-value ratio was 68.4 percent. In 1976 this was 78.7 percent.

Both of these moves were designed to make it easier for people to acquire homes, and they did. These moves had to be made to counteract the rapid increase in overall mortgage rates.

The third reason is that an "average" family with an "average" income did not buy an "average" house. Last year buyers of a typical new home had considerably more income than the average for all families.

Last year the average family income was estimated to be $14,750. But the incomes of households that bought new homes averaged $21,615, or 46.5 percent higher.

Today's buyer probably has a wife who is working, rather than being the sole provider. In 1955 only 27.7 percent of married women worked. In 1970, 40.8 percent worked, and in 1976 the number reached 49 percent.

Another factor to be considered is that today's new home buyer is more likely to have another house which he can sell, using the equity to buy a new unit. This was not generally the case in the mid-1950s.

Last year only 35 percent of new-home buyers were first-time buyers. An equal number were second-time home buyers; 15.2 percent third-time; 8.2 percent bought a home for the fourth time, and 6.3 percent were buying for the fifth time or more.

Buying a home is a good idea, in spite of the cost and increased expenses. It is a singular protection against inflation as well as a unique means of saving.

In the final analysis, however, one must recognize the fact that rising costs are making it more and more difficult for the average young man, woman or couple to pay for a house.

This is especially true since most people want bigger houses, with more amenities and a larger chunk of land. It is consistently surprising to find, year after year, that people want more rather than less in housing. After World War II a typical dream house contained less than 1,000 square feet. Today it measures slightly over 1,600 square feet.

Today's house must have a family room and 2½ bathrooms. Ten years ago 75 percent of all new homes built had no air conditioning; last year one-half did not have it. In 1970, 62 percent of all units were without a fireplace; last year only 42 percent did not have any. Today only 24 percent of all new houses are without garages, and 53 percent have two or more-car garages. And so on.

Buyers pay a bigger share of disposable income as well as more dollars. This share seemed to level off during the 1960s at about 24 percent of net income. But in 1975 it was up to 27.9 percent. Last year it was estimated to be 28.4 percent. Compare this to the 20.3 percent share in 1955.

Clearly, the problem is not that we don't make enough money. We just don't have enough left in our pay check.

Mr. SUMICHRAST. We are getting into the same area the Canadians are, or Britain or Europe.

Ten, fifteen years ago we could allocate 65 cents of purchasing dollar to build a house. We can no longer do that. We can put aside less than 50 percent for the structure.

Why? Because of all of these crazy things you have to go through. There is no way to fight these. Gordon can tell you some horror stories on this.

Senator BYRD. Mr. Smith, what is the cost of the average home in Fairfax County these days?

Mr. SMITH. I believe the average for new construction is someplace around $62,000 to $63,000.

Senator BRYD. If you go back 10 years it was what, $40,000?

Mr. SMITH. Probably in the mid-thirties.

I have a few different thoughts on that, Mr. Chairman.

We hear a lot of comments that the young family today cannot go out and buy a new house. I would agree with that, and I would raise the question, should they go out and buy a new house, a young married couple? My feeling is their first housing should be an apartment, then maybe a townhouse or a condominium, then maybe a single family.

I know when I grew up you did not dream of owning a house when you were first married. You saved. You did not go on a vacation. You put your money aside, because you knew you wanted to buy a house. You did not go to the theater, you did not do a lot of things.

Senator BYRD. I wasn't considering somebody that young. I consider 40 young.

Mr. SUMICHRAST. People have an alternative. They can buy an existing house. Existing houses are cheaper, other than in Washington. Washington is the only place in the Nation where existing homes are actually more expensive rather than less expensive.

Senator BYRD. As a rule of thumb, what does a building cost per square foot in northern Virginia?

Mr. SMITH. About $30 a foot.

One of our biggest problems is the price of land is taking an increasingly larger portion of the total product. There used to be a rule of thumb in the industry that 20 percent of the cost of the finished project was for the cost of the finished lot.

Now I think in northern Virginia, it is possibly closer to 30 percent. I have seen a couple of cases where the builder spent 35 to 40 percent for a lot cost.

Senator BYRD. Let me see if I understand this. If it were 30 percent, the cost of the lot for a $65,000 home would be $20,000?

Mr. SMITH. That is correct.

Senator BYRD. Is that normal?

Mr. SMITH. You would be very hard-pressed in Fairfax County today to find a lot that would be less than $20,000. It is extremely difficult to find that.

Mr. SUMICHRAST. You cannot find any lot, unless you go way out to Frederick.

Senator BYRD. I was in Williamsburg over the weekend. While I did not go to the new development outside of Williamsburg, some of my friends did. They told me the lots were selling there for about $50,000.

Mr. SUMICHRAST. That does not make sense.

Senator BYRD. Senator Curtis?

Senator CURTIS. I was interested in what you said about subsidized housing. What types of subsidized housing?

Mr. SUMICHRAST. Section 8.

Senator CURTIS. What is the other?

Mr. SUMICHRAST. Section 235.

Senator CURTIS. What is the difference between 235 and 236?

Mr. SUMICHRAST. 235 is for sale housing, 236 is rental.

Senator CURTIS. Have you written any 235's?

Mr. SUMICHRAST. There are no 235's being built now. Less than 1,000 last year. At the peak, there were as many as 330,000 built in a 3-year period, a little over 100,000 a year.

Mr. SMITH. We have never built any.

Senator CURTIS. The program had a lot of problems. There could be, on one side of the street, someone paying for their house in a conventional way with a neighbor with a 235 house with similar income, very similar and the purchaser of the 235 house had a very substantial subsidy.

Mr. SUMICHRAST. That was one of the problems.

The biggest problem with 235, was actually, in the existing houses not in new, where a lot of speculation was done. Detroit was one area where a lot of people made a lot of money and a lot of people were actually put in jail as a result of it.

In the new housing, 235 was a fairly successful program. The problem you mentioned was one of the major problems.

Senator CURTIS. What made it successful? Did poor people actually get them?

Mr. SUMICHRAST. No, not poor. The typical buyer of 235 had an income of about $7,500. The typical public housing income was about $2,200. The typical—203 being nonsubsidized income was about $14,000.

It was about one-half or two-thirds what the typical unsubsidized FHA housing was, only one-half of what the typical family income today for new homes is $21,000. People with medium or average incomes do not buy new homes.

The people have typically double incomes and make more money than the average family makes. The average family income is about $14,750. The people who buy houses do have about $7,000–$8,000 more income.

Senator CURTIS. I was very critical of that subsidizing. It was very expensive for the Government. It was a good bargain for the person who got it, but terribly unfair to their neighbors who had to pay for it in taxes.

Mr. SUMICHRAST. The 235 program was a cheap program compared to 236.

Senator CURTIS. It may have been, but it gave a portion of our people treatment that they did not give to the great number of people who do not buy a house.

Mr. SMITH. Another problem with these particular programs is that they tend to be funded in the down cycle. By the time they work their way through the legislative process and become funded and HUD finally gives the OK on them, we are probably coming out of the cycle and they are used as a stimulus to the economy. They are placed on the industry while the industry has already recovered.

Probably they should be initiated in the legislative process when the industry is at its very peak. When we are at the peak, we know we are going to come to a valley. By the timelag of delay, getting our program involved, it will be a year and a half. That is when you need it the most.

Mr. SUMICHRAST. We expect a decline in production next year. We should be working on to help us do something next year when the interest rates will go up, when the mortgage money will dry up and the construction will start declining.

Senator CURTIS. Thank you, Mr. Chairman.

Senator BYRD. Thank you very much, gentlemen. You have pointed out to us that the housing industry is very important to the economic growth of the country.

Our next witness is Edward I. O'Brien, president of the Securities Industry Association. He is accompanied by Stephen Small, assistant vice president and legislative counsel for legislation.

Please proceed, Mr. O'Brien.

STATEMENT OF EDWARD I. O'BRIEN, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION, ACCOMPANIED BY STEPHEN SMALL, ASSISTANT VICE PRESIDENT AND LEGISLATIVE COUNSEL FOR LEGISLATION

Mr. O'BRIEN. Mr. Chairman, my name is Edward I. O'Brien; I am president of the Securities Industry Association. Accompanying me today is Stephan K. Small, assistant vice president and legislative counsel for taxation.

SIA represents approximately 550 leading investment banking and brokerage firms headquartered throughout the United States which, collectively, account for approximately 90 percent of the Nation's securities transactions conducted in this country. The business of our members includes retail brokerage conducted on behalf of 25 million shareholders, institutional brokerage, over-the-counter market making, various exchange floor functions, and underwriting and other investment banking activities conducted on behalf of corporations and governmental units at all levels.

I wish to commend the committee and its chairman for their decisions to hold hearings on incentives for economic growth. These hearings provide a timely and welcome opportunity to reexamine the effect of the Nation's tax policies on the process of capital formation. Moreover, the hearings permit public comment on various proposals before specific legislation is introduced.

In the thousands of miles that I travel throughout this country each year, I have the opportunity to speak with many investors, large and small, as well as the heads of corporations, institutions, securities firms and salesmen. I am very much impressed with the tremendous interest on the part of citizens of all types on the overall subject of our economy, the need for prudent fiscal budgetary management of the Nation's resources, and the recognition that we need to build our capital and our well-being in the future. There is also a strong tide in favor of providing equity or fairness for the average shareholder who is, by and large, not a person of substantial means. This desire for fairness is, in great measure, reflected in the area of dividend taxation and incentives for investment.

People tell me from across the country that they wish to see some material steps taken to relieve the double taxation of dividends as well as to enable them to share in the country's growth through stock ownership.

We believe that strong and stable growth of the Nation's economy is a prerequisite to the expansion of job opportunities for a growing work force, to the resumption of world leadership in the standard of living enjoyed by Americans and to the availability of a sound tax base for revenues to support needed government services and national defense.

We are gratified to note the growing consensus that such essential economic growth is best achieved through greater capital investment in the private sector. And many regard a major revision of the tax code as it applies to capital formation as the best way to spur the stable economic growth we need. National leaders in both the public and private sector have called attention to the need for Government action to encourage capital investment. Consider the following:

Tax stimulus legislation presently pending in the Congress contains incentives for business to expand hiring.

The Joint Economic Committee published a staff study last year which focused on the need to broaden stock ownership.

Senator Humphrey and Congressman Rostenkowski have introduced legislation (S. 1055, H.R. 5359) which would establish a national policy "to provide sufficient incentives to assure meeting the investment needs of private enterprise."

Treasury Secretary Blumenthal in several speeches has stated that one of the administration's goals will be to encourage increased investment in order to provide jobs and higher productivity.

The House Ways and Means Committee published a Task Force on Capital Formation which recently published a paper, Tax Policy and Capital Formation, discussing a number of approaches to increase investment.

The Americans for Democratic Action have called for elimination of the corporate income tax.

The previous administration published Blueprints for Basic Tax Reform which included as part of one sweeping proposal the integration of individual and corporate income taxes.

Importance of the individual investor. Effective solutions to capital formation must recognize the importance of the individual investor as a source of new capital. I must tell you in candor that I believe that there is a false notion prevalent with respect to shareholders and stock ownership, which seems at least to shy away from tax incentives for individual shareholders as preferential for a segment of our society.

In fact, there are about 25 million human beings who own shares of stock and most of them have made these investments for the long term, for retirement, for the education of their children, or to share in the growth of the country. These 25 million people are, in many respects, in the forefront of our economic system in that they are investing in that system, and they should be encouraged. Certainly, they should not be discriminated against.

Unfortunately, many of the studies of capital formation have practically ignored the investors' role in this process. For example, the report entitled Tax Policy and Capital Formation prepared by the staff of the Joint Committee on Internal Revenue Taxation, restricts its discussion of capital investment to physical capital—plants, equipment, housing—even though it acknowledges a relationship between financial and physical capital. While it is important to focus on plants and equipment, we believe it is equally important to focus on people, who, as investors, are needed to provide the dollars for capital investment.

There are three fundamental reasons for our urging this special emphasis on the individual investor:

Individual investing on a nationwide scale provides broad public support for the system of private enterprise in this country. More, not fewer, Americans should have a direct ownership stake in the success of that economic system. This goal is fully consistent with the economic as well as the democratic political traditions of this Nation.

Individual investing on a wide scale provides a sound means, perhaps the best means, for improving the mobility of capital. Incentives at the corporate level help existing businesses regardless of their needs whereas providing incentives directly to individuals permits their savings to flow wherever the needs and opportunities are most attractive. It is noteworthy that major industrialized countries enjoying greater growth than the United States all provide more favorable capital gains tax treatment than does this country.

Individual ownership, if encouraged, will slow the steady, inexorable trend toward institutional ownership. If ownership of our corporations continues to concentrate in a relatively small handful of giant institutions, our system will become more like that of Japan or Germany and will have lost one of its unique attributes. Economic concentration of this type will have a further negative impact on the ability of credit-worthy but smaller companies to meet their capital needs. A tax system which imposes a greater burden on individual investors than on institutions exacerbates this problem.

Regrettably, a look at the current American shareholder census reveals that the ranks of the individual supplier of equity capital are shrinking. During the first half of this decade, there has been nearly a 20-percent reduction in the number of shareholders. Approximately 6 million individuals have left the equity markets. Today there are only 25 million shareholders compared with 31 million in 1970.

Several factors contributed to this phenomenon: Soaring inflation rates were a severe blow to equity investment, and concern about possible recurrence continues to inhibit investors. Economic policies compounded uncertainty by veering from stimulus to controls and back again. During the early 1970's, the level of personal savings dropped severely. Harsh changes in tax policy accelerated the flight of equity investors and inhibits their return. I shall elaborate on the latter point.

Tax Policy and Capital Formation cites studies showing that "an individual's choice between various assets is quite sensitive to the after-tax yields he expects to receive on the assets" and that "tax incentives for personal saving do not significantly affect the amount of such saving, but do affect its composition." The recent recovery in the level of personal saving has not prompted a return to equity investment. We believe one must look to the treatment accorded equity investment by the tax code for an explanation of this situation.

The erosion of capital gains provisions and the continuation of double taxation of dividends have served to discourage equity investment.

The willingness of millions of Americans to invest depends on a favorable risk/reward relationship. By their mass desertion of the equity markets, millions of Americans have signaled a consensus that the relationship is seriously imbalanced.

There are many factors involved on both sides of this equation—many of which are not solved by legislation. But a singularly important factor, affecting both risk and reward, is amenable to legislative remedy. That factor is the tax treatment of capital gains.

In the past, the United States and other industralized countries have taxed capital gains differently than income. We believe this distinction is sound and economically justifiable. During the last 8 years, however, this distinction has been dramatically eroded. In 1969 the Congress increased the tax rate on capital gains from 25 percent to 35 percent and added capital gains as a tax preference item subject to the minimum tax to raise even higher than the effective capital gains tax rate. Again, in 1976, both the increase in the minimum tax rate plus the reduction in the credit for other regular taxes paid further diminished the positive effects of the capital gains tax. Moreover, in addition to practically doubling the capital gains tax rate—reducing the reward—the Congress has also doubled the element of risk. As a result of the Tax Reform Act of 1976 extending the holding period, by next year an investor will have to remain at risk 1 year before qualifying for capital gains treatment.

In addition to these tax increases—or disincentives—which in themselves could scare off already reluctant investors, current tax policies result in double taxation of corporate earnings paid out to investors as dividends. This situation not only is inequitable to the investor and the corporation, but also has created a dangerous bias in favor of debt over equity financing. Debt now accounts for 55 percent of the total capitalization of all nonfinancial corporations.

Indeed, the double taxation problem is the major focal point of Tax Policy and Capital Formation, which notes that current law "encourages that use of debt finance relative to new stock issues, since interest payments are deductible and dividends are not. More debt increases the risk associated with corporate financial structures because firms must meet higher fixed charges for interest and face greater risk of bankruptcy."

In recent months proposals to address double dividend taxation have attracted considerable attention and support from both the past and present administrations, from members of this Committee and the House Ways and Means Committee, from economists, and from the business community.

The Securities Industry Association has long supported elimination of the double taxation of dividends because we are convinced that simple fairness to those who own American companies demands that, but also, because in our professional judgment, there should not be a bias in favor of one type of security over another when we are advising clients seeking to raise capital.

The selection of a specific method of achieving this end, however, is not a simple process and we recognize it cannot be considered apart from other changes in the tax code.

Nonetheless, we are deeply concerned by those proposals which tie the elimination of double dividend taxation to redefining capital gains as ordinary income. Such a proposal reduces one inequity in the tax code by increasing another. If it is inequitable to impose a double tax on corporate earnings paid out in dividends, it must also be inequitable to impose a double tax on corporate earnings retained and reflected in capital gains. Moreover, such proposals could shut off sources of new capital, imposing the harshest penalties on companies which are new, small or engaging in major expansion vital to employment and long term economic recovery.

Tax policy can be a powerful tool to stimulate the investment necessary to promote long-term economic growth and to achieve public policy objectives. There is little doubt that these goals require increased capital investment. Current tax policy has served to retard investment. Therefore, this Nation needs a new tax policy. A tax policy which is based on the simple and equitable principle that corporate earnings should only be taxed once.

Yet we know that efforts to alter the code will be resisted because it is asserted that the benefits of such changes will go only to a limited number of very wealthy people.

We reject the notion that tax policy which fosters investment is merely "welfare for the rich."

Even with the exodus of equity investors the median stockholder has a family income of just under $19,000.

Millions of lower- and middle-class Americans participate in private and public pension funds which are also major stockholders.

All Americans have an interest in, and will benefit from, the creation of jobs and improved standard of living which can only occur through increased capital investment.

The tax code should not be biased to discourage investment and increase the concentration of equity ownership. We believe that public policy can be furthered by changes in the tax code which will promote investment. We believe that those changes must focus on people—investors—as well as on plants and equipment.

In determining what specific changes in the code are needed, we believe it is necessary to assess the effects of any contemplated change either in the capital gains tax or on the taxation of corporate earnings on the following factors:

Impact on individual investors;
Impact on securities markets;
Impact on mobility of capital;
Impact on corporations, especially those which are expanding and those which are new or small; and
Impact on Federal revenues taking into account the "ripple" effect.
The answers to these very important questions can be derived only after the most careful analysis and study.

I hope you will believe me when I tell you that people are looking to you to help solve these twin problems of providing incentives for investment and eliminating the inequity of the double taxation of their dividends. Most people realize it is difficult to devise the precise balance and in fairness, they rely on experts in and out of government to design the solution. But they do want a chance to build for the future and to be treated fairly with respect to their dividend income.

Finally, then, the Board of Directors of the SIA is committed to provide its collective best judgment in providing answers to the abovementioned questions. On behalf of our member firms and in the interest of the 25 million individual investors they serve, SIA has undertaken a study of a number of specific proposals which are intended to stimulate investment and promote economic growth. We will be happy to share our conclusions with this committee and the Congress at the earliest possible moment.

Senator BYRD. Thank you. You made a good statement.

The question of double taxation, of course, is a vitally important one. I do not believe you indicated how you would solve that problem, or what recommendation you have in that field.

Mr. O'BRIEN. What I indicated, Mr. Chairman, is that we have studied the three proposals which are set forth in the task force paper and we have not reached a conclusion yet for the reason that the matter is under active study. It is a highly complicated one. I have spent hours studying it myself. I do not pretend to know the answers.

We lean toward one that is a partial integration system rather than a full integration system, but that is the very point, that we have begun work and which we would like to furnish to your committee.

Senator BYRD. The committee would be glad to get your view when you have completed your study. I thought in testifying today that you had a recommendation that you wanted to make.

Mr. O'BRIEN. We have a recommendation with respect to the general principle.

Senator BYRD. As a general principle you favor the elimination of double taxation. That is the general principle?

Mr. O'BRIEN. That is correct.

Senator BYRD. I certainly agree with that but we cannot legislate on the general principle. We have to have specifics.

Mr. O'BRIEN. We also made one other point in that testimony today. We lean toward the emphasis on the stockholder relief; namely, the elimination of double taxation and the capital gains question as distinguished from the physical side, which is the investment tax credit and things of that nature.

Senator BYRD. How does the investment tax credit fit in?

Mr. O'BRIEN. I think they are different problems. They are meant to have different incentives.

The only point we wish to make is in the former area.

Senator BYRD. Maybe I missed the point. I do not see what the investment tax credit has to do with the question of double taxation.

Mr. O'BRIEN. I think they are different. I agree with you; they are different. I think each one provides a measure of capital accumulation. I agree with that.

All I am saying, in terms of emphasis, I would like to see that emphasis placed on the elimination of the double taxation of dividends. That is my point.

Senator BYRD. I understand now.

As I understand it, then, while you have not completed your study, you lean toward a tax credit for the stockholder.

Mr. O'BRIEN. In a way it is in the nature of a partial integration of the corporate tax and the individual tax which we would call alternative 1 in the task force study rather than one which would take into consideration taxation of both the dividend as well as the retained earnings on the grounds that it is conceivable that the stockholder, under that latter approach for integration may end up—you used the example yourself with one of the earlier witnesses, he could end up being taxed for a substantially greater amount of dividends than he actually received.

Senator BYRD. Do you advocate that?

Mr. O'BRIEN. I am saying I am leaning toward the former system which is partial integration rather than full integration of the two taxes on the individual and on the corporation. I said what I intend to do is once our study is completed to furnish you with the information on those points.

Senator BYRD. Thank you, sir.

Thank you, gentlemen.

The next witness is Mr. Leif H. Olsen, chairman, Economic Advisory Committee, American Bankers Association.

Mr. Olsen, you may proceed in any way that you wish.

STATEMENT OF LEIF H. OLSEN, CHAIRMAN, ECONOMICS ADVISORY COMMITTEE, AMERICAN BANKERS ASSOCIATION

Mr. OLSEN. Thank you, Mr. Chairman. I have a brief statement. I am going to summarize the statement.

I am Leif Olsen, senior vice president and economist at Citibank in New York and I am chairman of the economic advisory committee of the American Bankers Association, a trade association whose membership includes approximately 93 percent of the Nation's commercial banks. We appreciate this opportunity to testify before your subcommittee on the effect of tax policy on the growth of the private sector of our economy. This is an important issue which has serious implications for the maintenance of the standard of living of all of our citizens. It is also closely tied to the issue of tax reform, and the need to develop an equitable tax system for all of our citizens.

Today, I will make a few brief remarks about monetary and fiscal policy, the effect of tax policy on economic growth in the private sector, and discuss in a general way a few of the key proposed tax changes from the standpoint of this issue only. The American Bankers Association is currently forming a special task force to consider the multitude of issues involved in various proposals for tax reform. This group will consider the specifics of various proposed tax changes, and help the association form positions on them.

I would ask your permission, Mr. Chairman, to submit for the record the recommendations of this task force.

Senator BYRD. We will be very happy to receive them for the record.

[The following was subsequently supplied for the record:]

AMERICAN BANKERS ASSOCIATION,
Washington, D.C., June 30, 1977.

HON. HARRY F. BYRD, JR.,
Chairman, Subcommittee on Taxation and Debt Management, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: This letter is being written as a followup to the testimony of Leif Olsen on behalf of the American Bankers Association before the Subcommittee on Taxation and Debt Management of the Committee on Finance of the United States Senate on May 17, 1977.

At that time you requested our views on the integration of corporate and personal income taxes. This subject was considered very carefully by a special task force on tax reform that has been assembled by our Association. This task force includes members of our Association's Economic Advisory Committee, Bank Taxation Committee, and the Executive Committee of the Trust Division.

We discussed three methods of integration. First, full integration through the elimination of the corporate income tax, and the treatment of all corporate income as if it were earned income of the shareholders. This proposal has too many problems and should not be considered at this time.

Partial integration was discussed in terms of two other proposals. The first would be to allow corporations to deduct dividends paid from their gross income in their determination of taxable income. This deduction would be allowed for dividends paid to domestic tax exempt organizations, but not for these paid to foreign shareholders unless reciprocal treatment were afforded by treaty. The second method would be to allow shareholders to use corporate tax payments on income paid out as dividends as a tax credit against their personal tax liability, after these tax payments have been included or "grossed up" in their personal income. At the current time, our Association cannot take an official position on any of these methods because we do not know what other proposals will be involved in tax reform legislation. Subject to this qualification, our task force reached a tentative consensus in favor of the dividend deduction method for the following reasons:

1. *Simplicity of Administration.*—There would be no need to estimate taxes at the time dividends are paid. Shareholders would not have to be re-educated to include the gross-up in income and take the credit. No problems arise from audit adjustments for past years, partial-year share-holders, or the variations between current and deferred taxes. There would be no necessity of elaborate record keeping to ensure the correct treatment of the credit. The records on foreign shareholders are substantially the same as those that must now be kept for withholding tax purposes.

2. *Incentive to Increase Dividends.*—The dividend deduction approach would provide managers and shareholders with an incentive to increase dividends, thus passing on the tax savings to the shareholders for reinvestment. With a shareholder credit approach, in order for the dividend paying corporation to retain any benefit directly the dividend must be cut, although the shareholder may still receive a higher gross dividend than formerly.

3. *Ease of Phase-In.*—Under a dividend deduction alternative the phase-in is simple, with the burden of keeping up with the phase-in changes falling on professional managers rather than individual shareholders. It would also provide time for a corporation to change its business mix as necessary to accommodate the increasing deduction.

4. *Preservation of Existing Incentives.*—Congress has provided a variety of tax incentives to corporations for purposes seen to be of economic or social benefit to the national interest. With a dividend deduction, these incentives are more likely to be preserved than with a shareholder credit, which might be structured in such a way as to destroy the efficacy of present or future incentives to the extent of dividend payouts.

5. *Enhancement of Capital Formation.*—The dividend deduction approach would generate more capital formation for two reasons. First, the deduction

guarantees a tax savings at the marginal or statutory rate, rather than at some lesser gross-up factor, as might be the case under some forms of shareholder credit. Second, the capital thus formed is automatically reinvested unless dividends are increased; it is likely that somewhat more earnings would be retained than under a shareholder credit system, and thus less would be lost by any propensity of shareholders to spend rather than reinvest dividend income.

In general, we see many advantages to a dividend deduction system although we would not be opposed to a carefully constructed shareholder credit system which took account of the reservations listed above.

We share the concern expressed by many observers about the effects of these proposals on Treasury revenues. Indeed, economic stability will be a crucial element in any program to enhance capital formation. On balance however, capital formation will only be enhanced if the net tax burden on the corporate sector is lightened, and tax incentives are altered to favor capital investment. To accomplish this we urge the Committee to also consider other forms of tax incentives. Areas for consideration might be the investment tax credit, accelerated depreciation, lowering corporate tax rates, and indexing tax rates to account for inflation.

Sincerely,

GERALD M. LOWRIE,
Executive Director, Government Relations.

Mr. OLSEN. The growth and renovation of the capital stock represented by the Nation's industrial plant and equipment, utilities, transportation system and commercial enterprises, is essential to a growing economy. Yet in the first 2 years of the current economic recovery, capital investment has lagged badly.

Part of the reason for the lagging recovery is, of course, the depth of the recession itself. The 18 percent drop in capital spending, like the declines in numerous other sectors of the economy, was the deepest since World War II. The traumas of such a deep recession and the relatively high inflation have caused excess capacity to exist and have bred caution among managers and investors.

The highly cyclical nature of business fixed investment is shown in exhibit III,[1] in which investment is related both to the actual gross national product and potential GNP or the effective capacity of the economy. During this recovery period, only about 8.5 percent of the economy's potential output has been devoted to replenishing and expanding the Nation's capital stock—the lowest proportion since the 1958–62 period.

Another factor inhibiting greater capital investment at this time is the large amounts of unutilized or underutilized capacity in many lines. The average utilization rate in American industry during the first quarter was 81 percent of capacity, up substantially from the recession low of 71 percent but still below the level of utilization which would normally trigger a new wave of capital expansion. In fact, because of increased uncertainties today, including environmental considerations, pollution requirements, safety regulations, et cetera, the trigger point may have moved higher than the 82 to 84 percent level which has normally set off waves of capital expansion in the past.

The basic uncertainty to be resolved before making an investment decision, is, of course, the rate of return that can be earned on that investment. Today's uncertainties over both costs and prices are amplified by uncertainties over regulatory and tax matters. In addition,

[1] See p. 141.

rates of return have been highly cyclical, as shown in exhibit IV.[2]

While the fluctuations in rates of return on net worth in the last quarter century have not been as violent as they were in the thirties and forties, the swings have been wide enough to create periodic delays in investment. The most constructive move toward aiding capital investment would be to provide the policies which would promote a stable economic environment.

Policies which go to extremes, either of stimulus or restraint, often do more harm than good. Moreover, in order to stimulate recovery from recession, government tax policies are adopted which favor consumption over investment, and these generally remain on the books over a number of years and create a continuing bias in favor of consumption over investment.

The conclusion that emerges strongly from this review of the cyclical swings in capital spending is that avoiding recessions is an important way to sustain capital spending. That may sound like an impossibly tall order, but I firmly believe that the frequency and severity of business cycles can be reduced.

The foregoing is simply meant to place the issue of how taxation effects capital investment in perspective by pointing out that changes in the tax law can't be expected to provide a magic solution to the problem posed by the current lag in capital spending. But I wish to emphasize that this does not mean that taxation has no effect on capital spending. On the contrary, it has important effects and a reduction in the heavy burden of taxes on the returns to investment would provide an important stimulus to investment, the economy, and further advances in the general living standards.

In a fundamental sense, investment is made possible because people forgo consuming some part of their current income which is then available to finance the production of capital goods. When these capital goods are introduced into production, the amount of goods and services available to the population is increased. Only by forgoing current consumption, in other words, can we create the means to enjoy higher future living standards.

In our society, the saving that makes investment possible in the private sector is the result of the voluntary decisions of individuals and business managements. Those decisions in turn are strongly influenced by the expected rate of return to prospective investments. People will save, in other words, if offered a sufficient bonus for forgoing current consumption. And the size of the bonus that can be offered depends on the expected return on use of those savings to finance productive investments.

Taxes insert a wedge between the return on the investment and the return to the individual or business investor. Thus, they discourage savings and investment. Lowering taxes on the returns to capital will increase the rate of return to potential investors and stimulate more saving and investing.

The fruits of that investment will benefit the entire society. In discussions of tax policy there is an unfortunate tendency to view corporations as if they were people—as if they pay taxes or benefit from tax relief. In a real sense, only people can bear the burden of taxes. The

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[2] See p. 142.

tax paid by a corporation is borne by the employees, customers and shareholders of that corporation.

In the same vein, changing taxes in a way that increases the after-tax return to business investment will provide real benefits to people, not corporations. And those people will not just be shareholders. They will be the employees of corporations, both the existing ones and the additional ones that will be employed in constructing the investment goods and in operating the new plant capacity once it is installed. And they will also include the customers of those corporations who will be able to purchase products that are relatively less expensive and/or improved in quality because of the improvements in productivity embodied in the additional investment. In short, adequate investment in plant and equipment is vital to the improvement of general living standards. And taxes help to determine whether investment will be adequate.

If I may digress here, the short fall in capital investment that occurs, in time causes a general deterioration in living standards from what otherwise would be the case. This is particularly deceptive because it is not conspicuous on a year to year basis. Only after the passage of, say, 10 to 20 years does it become quite clear.

For this reason, it seems very hard to get policy changes to encourage investment, because it does not appear that anything is happening in the immediate period.

In this context, I would like to make two very general comments about some of the proposals that have been advanced for increasing incentives to capital investment. The first concerns the intriguing proposals for the so-called integration of individual and corporate income taxes. This has a lot of appeal just for the reason I noted earlier—that corporations do not bear the real burden of taxes. Integrating corporate with individual income taxes would bring the form of the law into conformity with the reality of the economics. And it might clear up some of the confusion over just how the burden of the corporate tax is distributed among individuals. Until we eliminate this confusion, we cannot meaningfully come to grips with problems of tax equity.

In addition, the double taxation of corporate dividends inherent in our tax structure creates a bias toward the use of debt in corporate capital structures. This has, in the past, aggravated the problems corporations have experienced in obtaining capital for investment purposes at crucial times in the business cycle.

It is important to keep in mind, however, that integration will only provide a significant spur to capital investment if it is part of an overall program that lowers the tax burden to business investment. Designing a plan that allows, for example, a dividend but then offsets the immediate revenue loss to the Treasury by repealing the investment tax credit or some similar existing provision would not provide sufficient incentive to promote additional capital investment.

Another proposal calls for indexing income taxes to adjust for increases in the price level. In the context of corporate income taxation, this involves adjusting depreciation allowances to take inflated replacement costs into account instead of lower historic costs. By failing to do this, we distort the computation of corporate net income in a way that causes the effective rate of tax on true profit to rise with inflation. In this context, we should not allow ourselves to be misled by focusing only on rates of return expressed in current dollars. Percentage returns that may compare favorably with past rate do not look good at all once we take today's much higher rates of inflation into account.

Also, the general indexing of both corporate and individual tax rates would do much to achieve an equitable distribution of the burdens of inflation among all elements in society. This, in turn, would help to restore business and consumer confidence—a necessary prerequisite to an adequate level of capital investment.

In conclusion, let me reiterate the view that the problem of sluggish growth of capital spending in the current recovery cannot be fully understood without considering the depth of the recent recession. Significant factors bringing on this recession were the high rates of inflation and general instability fostered by monetary and fiscal policies of the Federal Government. Thus the Government can contribute to a revival of capital investment by implementing stable, moderate, monetary, and fiscal policies conducive to noninflationary growth.

Given such policies, tax policies have an important role to play in insuring that the return to investment is sufficient to provide the volume of saving and investment our economy needs to insure a continued improvement in living standards.

Senator BYRD. Thank you, Mr. Olsen. That is a fine statement.

I am interested to note how many witnesses from various segments of the economy emphasize the part that inflation is playing in our economic problems today.

It seems to me that the greatest long range threat to our Nation and the people of our Nation is inflation and the emphasis that you and other witnesses have put on the need to control inflation indicates to me that that is of vital importance if we are going to have sound economic progress for the future.

In regard to the elimination of the double taxation on dividends or integration of corporate and individual taxes, which of the various methods would you recommend?

Mr. OLSEN. I will answer your question but I would also ask if I might reserve a final decision, determination of that, to the work of the task force of the American Bankers Association. My preference would be toward deductibility for dividends paid by taxation so that the dividend payment is treated similarly to that of the interest payment on debt capital by corporations.

But I would ask that a final determination of that—I would like to await the final work of the task force of the American Bankers Association.

Senator BYRD. The task force is working on that?

Mr. OLSEN. Yes.

Senator BYRD. When do you expect to have that?

Mr. OLSEN. I think the record will be open to us for a period of 6 weeks, but we will submit well before that deadline.*

Senator BYRD. It is complex to determine what is the best way to eliminate double taxation. In principle, I agree that we ought to try to eliminate it, but when you come down to specifics, it is difficult.

Mr. OLSEN. It is a very complex issue as everyone agrees and everybody keeps stating, because the double taxation on dividends not only increases the additional burden originating on income in the corporate

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*See p. 440.

sector, but it creates inequities in the impact it has on individuals, depending on their income level and their tax brackets.

For this reason, in some cases, even the tax deductibility of dividends paid might still leave distortions in the way in which the tax impacts on different shareholders, depending upon their income bracket.

Senator BYRD. Let me cite three ways and see if there are other ways that have occurred to you.

One is to give the shareholder a credit. The other is deductibility by the corporation, as you mentioned.

The third way is the Simon proposal, which is a combination of the other two.

Are there other ways that it could be considered?

Mr. OLSEN. The only other way would be if you had full integration of the corporate income tax in which you treated the corporate tax as though it were a partnership and effectively eliminated the double taxation dividends in that fashion.

Senator BYRD. How would the corporation have retained earnings?

Mr. OLSEN. The corporation would be taxed at the same rate as the individual tax. You would have to consider, then, lowering the maximum margin of tax rate for individuals, if this were the case.

Senator BYRD. I am not sure whether I understand what you mean. Do you mean that if a corporation made $10 a share and normally would distribute $3 a share in dividends, under the full integration about which you are speaking, the corporation would distribute the full $10?

Mr. OLSEN. It would not pay taxes, in effect, on what was distributed. It would pay taxes on the income earned at the same rate as though it were a partnership in full integration.

Of the three proposals that were included in the Congressional Task Force Committee, I still would prefer—this is a personal view of mine—the deductibility of the dividends paid by corporations.

Senator BYRD. Under the full integration proposal, would all of the profit be paid to the stockholders?

Mr. OLSEN. No. It would not have to be paid out to the stockholders, no. They could still be retained earnings, but there would not be a tax paid by the corporation and then an additional tax paid by the individual on that portion which is paid out.

Senator BYRD. Then the corporation would pay the tax, the same as it does now?

Mr. OLSEN. Yes.

Senator BYRD. The individual would pay no tax?

Mr. OLSEN. Would pay no tax on that portion which he receives.

Senator BYRD. That would not be your preference?

Mr. OLSEN. No. My preference would be the deductibility. This is on the question of the elimination of double taxation of dividends, yes. To treat the dividend as a deductible, as we do now with interest payments.

Senator BYRD. If dividends were deductible to the corporations, how would this affect small corporations which, generally speaking, do not pay?

Mr. OLSEN. In all corporations, the proportion not paid out in dividends, which are retained in the business, you would presume, would be reflected in an increase in the capital value of the business, either dollar for dollar or in some value, so that there would be an increase in the capital gains proportion of those who retain the retained earnings. That is true today, too.

As it stands now, any businesses that pay out a small proportion of their earnings in the form of dividends and avoid the double taxation, that impacts on the owners of the business, now retained in the business; to the degree that they retain the increase, there is an increase in capital value.

When that capital value is realized, of course, it is taxed as a capital gains.

Senator BYRD. Another way of eliminating double taxation is to have the shareholder assess the total amount of his or her proportion of the profit, and eliminate the corporate tax. It seems to me that that would not be a fair, workable proposal.

If a person is entitled to a $300 dividend which is 30 percent of the profits, then they would be billed by the Internal Revenue for $1,000, even though they received only $300.

That would not work, would it?

Mr. OLSEN. No; it would not. It would create some serious tax flow problems for individual taxpayers.

Senator BYRD. I understand the Americans for Democratic Action advocated such a program. I am not impressed with the soundness of it. It seems to me that this would be totally unsound and totally unworkable and very unfair to a shareholder and would tend to eliminate persons investing in corporations.

Am I sizing that up right?

Mr. OLSEN. I would agree with you.

Senator BYRD. In one of your earlier testimonies to the Congress, you said that we should encourage and reward the efficient management of capital. We should support those Government policies which would enhance such efficiencies while eliminating those that do not.

Could you be a little more specific in saying what policies we should support and which we should eliminate?

Mr. OLSEN. As I was listening to that, I was trying to recall the circumstances under which I presented that testimony.

Senator BYRD. I think this was the Joint Economic Committee last year.

Mr. OLSEN. There are provisions in our tax code which encourage managements to make decisions that are largely induced by tax considerations rather than economic considerations.

One that comes to mind, incidentally, is the treatment of capital gains taxation. Frankly—and this is a personal view again—I have always favored an elimination of the capital gains tax to the degree that capital is rolled over and reinvested again. In other words, to treat all capital gains the same way as we now treat the gains that accrue in the transfer of one home to another home by an individual homeowner.

But whenever capital gains are extracted for consumption purposes, they should be taxes at income rates, treated just as income.

The roll over of capital should not be taxed. Everytime there is a transfer from one capital asset to another capital asset and we tax that, investors frequently take that into consideration and either delay it because of the holding period provided under capital gains taxation, they delay making such transfers.

In some cases, they continue to hold on to an asset long beyond the time when economic considerations would have dictated such a transfer. This tends to make the capital market more inefficient. It tends to make investors make decisions to not transfer to more efficient users because of the concern of the capital gains tax that will occur.

Senator BYRD. Let me see if I understand what you are saying.

If a persons owns 50 shares of A.T. & T., for one reason or another, wants to sell those 50 shares of A.T. & T. and buy 50 shares of ITT, then there would be no gain on the transaction, assuming there would be a gain. They would pay no tax on that gain?

Mr. OLSEN. No tax if the total proceeds of the sale of A.T. & T. were used to purchase additional capital or additional stock in some other enterprise.

Senator BYRD. If the person sold the 50 shares of A.T. & T. in order to buy an automobile——

Mr. OLSEN. The portion of the gain that he withdrew, in effect, to consume goods, would be taxed as income.

This proposal has been made on a number of occasions in the past. Generally, the response has been that it presents a very difficult task to those drafting tax legislation, just exactly how you would go about achieving this.

Senator BYRD. I think so, too.

Mr. OLSEN. I had it in mind, as far as economic effects. The reason I made that statement at the time was that there tends to be, at times, almost an implicit hostility toward the private ownership of capital in the United States, and we are terribly concerned about who owns the capital. I feel, from the standpoint of the welfare of the country as a whole, we should be concerned about how capital is managed rather than how it is owned. I think we do not take that into consideration.

Senator BYRD. I think you are right in at least part, if not all, of what you say. I sense an antibusiness sentiment on the part of the Congress of the United States. I also find among my colleagues in the Congress so many who are not particularly interested in Government financing and business growth because these subjects have no political appeal.

That is one reason why we are in this trouble that we are in.

Mr. OLSEN. This results, unfortunately, from a misconception of what constitutes a business. As I mentioned in my prepared remarks and several witnesses this morning have commented, I think, that it stems from a judgment that a business is—that is a corporation is a person. Somehow you can treat this corporation as adversary. That does not include people, somehow.

But a corporation is, of course, nothing more and nothing less than a combination of capital and people brought together, labor and capital brought together in order to produce goods and services.

Whenever we make policies that adversely affect a corporation in some fashion or limit its efficiency, we are adversely affecting people, all of them citizens and taxpayers of the United States.

Senator BYRD. Given the possibilities of changing the level of dividends, capital gains taxation and individual income tax rates, is there a particular kind of mix that you would suggest?

Mr. OLSEN. The mix that I would like is to see the double taxation on dividends eliminated, and you did not include this, but I would prefer a reduction in the corporate tax rate rather than an increase in the investment tax credit.

Senator BYRD. Do you foresee that if our country continues in the direction that it has been going recently in regard to the Government view of capital that we may well find ourselves in the position that England finds itself in today?

Mr. OLSEN. I do feel that there is a danger, if we continue in the policies that we have had which tend to treat capital and capital investment with a relative degree of hostility and relatively discourage capital formation, that we will, over time, see our standard of living either rise much more slowly than they otherwise would, or actually decline. And I cannot emphasize enough the fruits of those kinds of perverse policies unfortunately do not become readily evident until after the passage of some time, and this is one of the reasons why it is so hard to obtain the kinds of remedies, or changes in strategy, that are required from Congress, because it does not seem to be conspicuous in any one year.

Senator BYRD. It seems to me that it takes Government a long time to learn from clear examples that are available in many areas. When England went to socialism, it went to socialism on the assumption that the average citizen would be bettered by it. We have all found out that the average citizen is much worse off now than he or she had been in the past.

I think the United States has the greatest economic system in the world, if we just do not continue to louse it up. In my view, we are lousing it up.

The tremendous Government, continued regulations, redtape, that business must constantly put up with, has to be paid for. It is paid for by the consumer. It is raising the cost of living.

The Government needs to reverse its thinking in regards to the economic problems as they affect a very important sector of our population.

I do not know how you are going to employ people if you do not have private business to employ them. The Government cannot employ them satisfactorily.

All of that enters into whatever changes the Congress is going to make in the current tax system.

Your testimony has been very helpful. Thank you very much.

[The prepared statement of Mr. Olsen follows:]

STATEMENT OF LEIF OLSEN, CITIBANK, NEW YORK, NEW YORK, REPRESENTING THE AMERICAN BANKERS ASSOCIATION

Mr. Chairman and members of the subcommittee. I am Leif Olsen, senior vice president and economist at Citibank, New York, N.Y., and chairman of the Economic Advisory Committee of the American Bankers Association, a trade association whose membership includes approximately 93 percent of the Nation's commercial banks. We appreciate this opportunity to testify before your subcommittee on the effect of tax policy on the growth of the private sector of our economy. This is an important issue which has serious implications for the maintenance of the standard of living of all of our citizens. It is also closely tied to the tax reform, and the need to develop an equitable tax system for all of our citizens.

Today, I will make a few brief remarks about monetary and fiscal policy, the effect of tax policy on economic growth in the private sector, and discuss in a general way a few of the key proposed tax changes from the standpoint of this issue only. The American Bankers Association is currently forming a special task force to consider the multitude of issues involved in various proposals for tax reform. This group will consider the specifics of various proposed tax changes, and help the association form positions on them.

The growth and renovation of the capital stock, represented by the Nation's industrial plant and equipment, utilities, transportation system and commercial enterprises, is essential to a growing economy. Yet in the first 2 years of the current economic recovery, capital investment has lagged badly. As exhibit I demonstrates, real nonresidential fixed investment not only has recovered less rapidly than the average of previous postwar recoveries, but has been running below even the slowest of any of these earlier recoveries. By the first quarter of 1977, capital investment was only 7 percent higher than it was at the bottom of the recession 2 years earlier. Despite a sizable gain in the lates quarter, the rate of investment has regained only half of the ground lost during the recession.

Part of the reason for the lagging recovery is, of course, the depth of the recession itself. The 18-percent drop in capital spending, like the declines in numerous other sectors of the economy, was the deepest since World War II. The traumas of such a deep recession and the relatively high inflation have caused excess capacity to exist and have bred caution among managers and investors.

Contributing to this caution is the below par performance of profits. Exhibit II shows profits after taxes and after adjustment for inflation. During the past year, corporate earnings have barely kept pace with the rise in prices and still have not quite regained their earlier peak. Throughout the recovery, performance has been decidedly below that for previous postwar cycles. Since after-tax profits are essential prerequisites to investment, providing not only the motivation but the internal funds and the creditworthiness to finance it, this lag in profits is a serious hindrance to a revival in plant and equipment spending.

The highly cyclical nature of business fixed investment is shown in exhibit III, in which investment is related both to the actual gross national product and potential GNP or the effective capacity of the economy. During this recovery period, only about 8½ percent of the economy's potential output has been devoted to replenishing and expanding the Nation's capital stock—the lowest proportion since the 1958–62 period.

Another factor inhibiting greater capital investment at this time is the large amounts of unutilized or underutilized capacity in many lines. The average utilization rate in American industry during the first quarter was 81 percent of capacity, up substantially from the recession low of 71 percent but still below the level of utilization which would normally trigger a new wave of capital expansion. In fact, because of increased uncertainties today, including environmental considerations, pollution requirements, safety regulations, etc., the trigger point may have moved higher than the 82–84 percent level which has normally set off waves of capital expansion in the past.

The basic uncertainty to be resolved before making an investment decision is, of course the rate of return that can be earned on that investment. Today's uncertainties over both costs and prices are amplified by uncertainties over regulatory and tax matters. In addition, rates of return have been highly cyclical, as shown in exhibit IV.

While the fluctuations in rates of return on net worth in the last quarter century have not been as violent as they were in the Thirties and Forties, the swings have been wide enough to create periodic delays in investment. The most constructive move toward aiding capital investment would be to provide the policies which would promote a stable economic environment. Policies which go to extremes, either of stimulus or restraint, often do more harm than good. Moreover, in order to stimulate recovery from recession, government tax policies are adopted which favor consumption over investment, and these generally remain on the books over a number of years and create a continuing bias in favor of consumption over investment.

The conclusion that emerges strongly from this review of the cyclical swings in capital spending is that avoiding recessions is an important way to sustain capital spending. That may sound like an impossibly tall order, but I firmly believe that the frequency and severity of business cycles can be reduced.

What is needed is better management of monetary and fiscal policies by government. A review of the growth of the money supply since World War II shows quite clearly that periods of rapid growth have alternated with periods of much slower growth. And a careful comparison of these swings in growth with the timing of the business cycle shows that excessive rates of increase in the money supply lead to inflation while sharp reductions in the rate of money supply growth lead to recessions. This evidence has been sifted by many, including the Subcommittee on Domestic Monetary Policy of the House Committee on Banking, Finance, and Urban Affairs. It concluded, as others have, that there is a close link between changes in the monetary aggregates and changes in consumer prices and real output. Among their conclusions is the following:

"Both money supply and velocity play important parts in recessions and recoveries. Money supply expansion during and immediately after recession promotes recovery."

It then remains to establish whether the changes in the money supply that foreshadow movements in the economy can be controlled by the Federal monetary authorities. And most would agree that the Federal Reserve has the power to stabilize monetary growth. If they were to do so, I feel certain that business cycle movements would be moderated and therefore pose less of a deterrent to capital spending.

THE ROLE OF TAXES

The foregoing is simply meant to place the issue of how taxation effects capital investment in perspective by pointing out that changes in the tax law can't be expected to provide a magic solution to the problem posed by the current lag in capital spending. But I wish to emphasize that this does not mean that taxation has no effect on capital spending. On the contrary, it has important effects and a reduction in the heavy burden of taxes on the returns to investment would provide an important stimulus to investment, the economy, and further advances in the general living standards. This becomes even more important as capital investment begins to recover more rapidly, as it is likely to do, in the months ahead. This speedup of investment should not be permitted to discourage tax changes to improve capital formation over the long run.

In a fundamental sense, investment is made possible because people forego consuming some part of their current income which is then available to finance the production of capital goods. When these capital goods are introduced into production, the amount of goods and services available to the population is increased. Only by foregoing current consumption, in other words, can we create the means to enjoy higher future living standards.

In our society, the saving that makes investment possible in the private sector is the result of the voluntary decisions of individuals and business managements. Those decisions in turn are strongly influenced by the expected rate of return to prospective investments. People will save, in other words, if offered a sufficient bonus for foregoing current consumption. And the size of the bonus that can be offered depends on the expected return on use of those savings to finance productive investments.

Taxes insert a wedge between the return on the investment and the return to the individual or business investor. Thus, they discourage savings and investment. Lowering taxes on the returns to capital will increase the rate of return to potential investors and stimulate more saving and investing.

The fruits of that investment will benefit the entire society. In discussions of tax policy there is an unfortunate tendency to view corporations as if they were people—as if they pay taxes or benefit from tax relief. In a real sense, only people can bear the burden of taxes. The tax paid by a corporation is borne by the employees, customers and shareholders of that corporation.

In the same vein, changing taxes in a way that increases the after-tax return to business investment will provide real benefits to people, not corporations. And those people won't just be shareholders. They will be the employees of corporations, both the existing ones and the additional ones that will be employed in construcing the investment goods and in operating the new plant capacity once it is installed. And they will also include the customers of those corporations who will be able to purchase products that are relatively less expensive and/or improved quality because of the improvements in productivity embodied in the additional investment. In short, adequate investment in plant and equipment is vital to the improvement of general living standards. And taxes help to determine whether investment will be adequate.

In this context, I would like to make two very general comments about some of the proposals that have been advanced for increasing incentives to capital investment. The first concerns the intriguing proposals for the so-called integration of individual and corporate income taxes. This has a lot of appeal just for the reason I noted earlier—that corporations don't bear the real burden of taxes. Integrating corporate with individual income taxes would bring the form of the law into conformity with the reality of the economics. And it might clear up some of the confusion over just how the burden of the corporate tax is distributed among individuals. Until we eliminate this confusion, we can't meaningfully come to grips with problems of tax equity.

In addition, the double taxation of corporate dividends inherent in our tax structure creates a bias towards the use of debt in corporate capital structures. This has, in the past, aggravated the problems corporations have experienced in obtaining capital for investment purposes at crucial times in the business cycle.

It is important to keep in mind, however, that integration will only provide a significant spur to capital investment if it is part of an overall program that lowers the tax burden to business investment. Designing a plan that allows, for example, a dividend deduction but then offsets the immediate revenue loss to the Treasury by repealing the investment tax credit or some similar existing provision would not provide sufficient incentive to promote additional capital investment.

Another proposal calls for indexing income taxes to adjust for increases in the price level. In the context of corporate income taxation, this involves adjusting depreciation allowances to take inflated replacement costs into account instead of lower historic costs. By failing to do this, we distort the computation of corporate net income in a way that causes the effective rate of tax on true profits to rise with inflation. In this context, we should not allow ourselves to be misled by focusing only on rates of return expressed in current dollars. Percentage returns that may compare favorably with past rates don't look good at all once we take today's much higher rates of inflation into account.

Also, the general indexing of both corporate and individual tax rates would do much to achieve an equitable distribution of the burdens of inflation among all elements in society. This in turn would help to restore business and consumer confidence—a necessary prerequisite to an adequate level of capital investment. In conclusion, let me reiterate the view that the problem of sluggish growth of capital spending in the current recovery can't be fully understood without considering the depth of the recent recession. Significant factors bringing on this recession were the high rates of inflation and general instability fostered by monetary and fiscal policies of the federal government. Thus the government can contribute to a revival of capital investment by implementing stable, moderate, monetary and fiscal policies conducive to noninflationary growth.

Given such policies, tax policies have an important role to play in insuring that the return to investment is sufficient to provide the volume of saving and investment our economy needs to ensure a continued improvement in living standards.

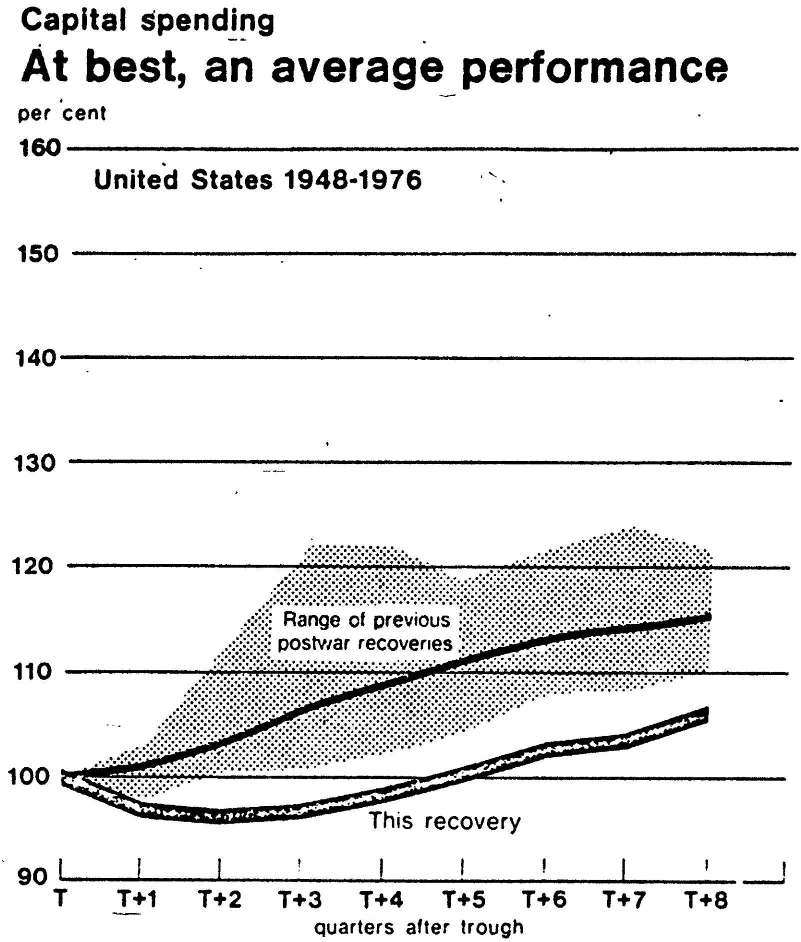

Capital spending
At best, an average performance
per cent
160
United States 1948-1976
150
140
130
120
Range of previous
postwar recoveries
110
100
This recovery
90
T
T+1
T+2
T+3
T+4
T+5
T+6
T+7
T+8
quarters after trough

EXHIBIT 1

Corporate profits
Still trying to catch up

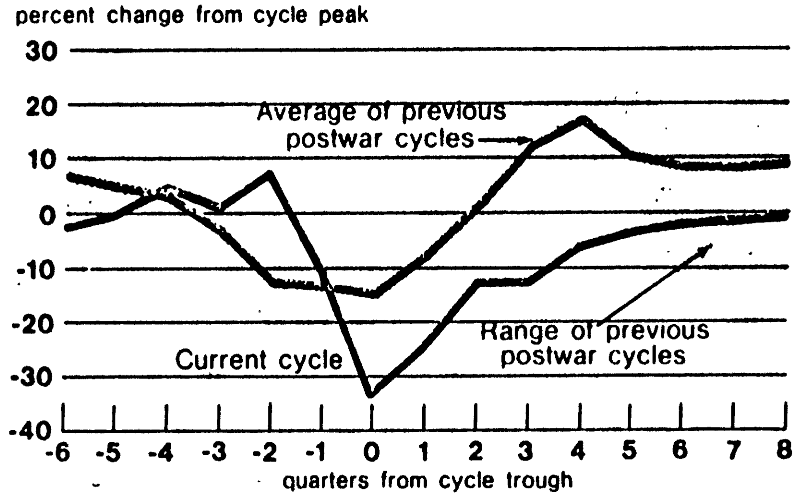


EXHIBIT 2

BUSINESS FIXED INVESTMENT AS A PERCENT OF GNP

1972 DOLLARS

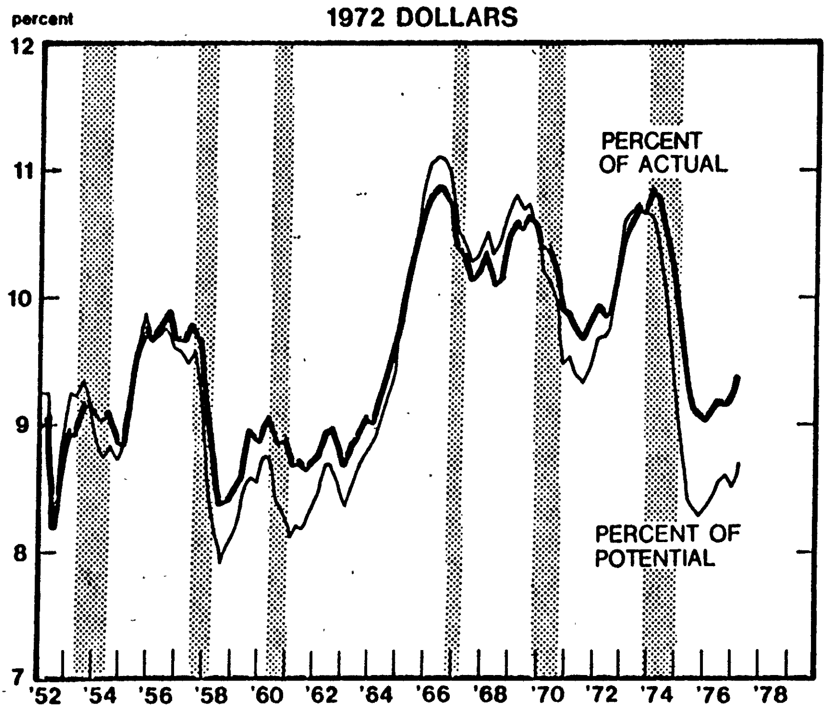
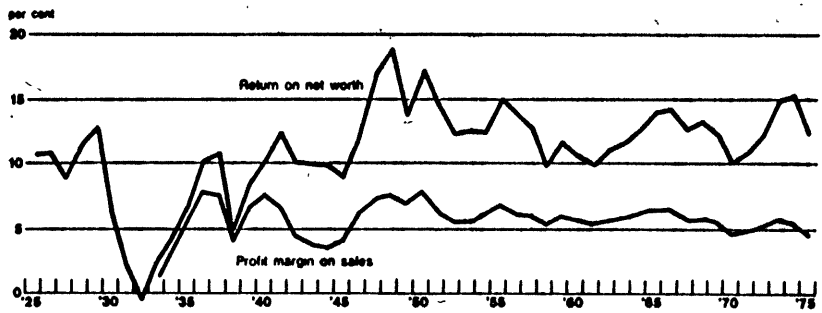


EXHIBIT 3

92-201 O - 77 - 10

Fifty years of manufacturers' profits
How they swung with the business cycle



Compiled by Citibank from published reports to stockholders of leading manufacturing corporations. Profits are after taxes; net worth is measured at the beginning of each year; sales include other types of revenues. Number of firms covered has varied from about 800 in the 1920s to over 2,000 in the early 1970s.

EXHIBIT 4

Senator BYRD. The next witnesses are Dr. Kenneth R. Biederman and Dr. Kenneth J. Thygerson, National Savings and Loan League and U.S. League of Savings Associations.

STATEMENT OF DR. KENNETH J. THYGERSON, CHIEF ECONOMIST AND DIRECTOR OF THE ECONOMICS DEPARTMENT, UNITED STATES LEAGUE OF SAVINGS ASSOCIATIONS

Mr. THYGERSON. Mr. Chairman, my name is Kenneth J. Thygerson, Chicago, Ill. I am chief economist and director of the Economics Department of the United States League of Savings Associations.

The United States League of Savings Associations appreciates this opportunity to discuss with you the broad subject of capital formation and, in particular, incentives for economic growth.

The savings and loan business is concerned primarily with the business of mortgage finance and the ability of our country to adequately house its citizens. Thus, in my comments I would like to address specifically the types of incentives which are needed to encourage economic growth and at the same time assure an adequate supply of capital to house the American people.

As you know, during the recent Presidential and congressional campaigns and more recently in testimony by officials of the Carter administration, we have come to grasp the scope of the capital formation needs of our country. Five major national priorities have been outlined by the new administration—full employment, inflation abatement, environment, energy, and housing, particularly the problem of rebuilding the central cities.

On pages 2 through 16 of my prepared text I consider broadly the need for high-level capital formation to sustain an acceptable rate of economic growth.

To review, we consider in these pages the impact on economic growth and capital formation of first, the fiscal and monetary policy that is the balance of fiscal and monetary stimulus and restraints over the business cycle as we have seen it used over the last decade, in particular, its impact on housing.

Second, we review the impact to sustain the large Federal deficits and their impact on inflation and capital formation.

Third, we review the impact of the changes, the position of this changing Federal spending.

Fourth, we look at the impact of Federal tax expenditures on capital formation, particularly the deductibility of mortgage interest and real estate taxes on housing.

Fifth, we look at the impact of Federal mortgage credit programs such as the Federal National Mortgage Association, Federal Home Loan Mortgage Association, the Farmers Home Administration on Government and their impact of increasing mortgage supply.

Sixth, the particular savings problems of the first-time homebuyers are looked at.

Seventh, we look at the capital needs in housing as they relate to our energy conservation needs and goals.

Several of the analyses included in my complete text is supported by two papers, the first entitled "National Fiscal Policy and Housing" and the second, entitled "The Federal Secondary Mortgage Market: Impact on Specialized Mortgage Lenders."

I would appreciate it if these could be included in the record.

Senator BYRD. They will be included.

[The documents referred to follow. Oral testimony continues on p. 175.]

National Fiscal Policy and Housing

by Dennis J. Jacobe and Kenneth J. Thygerson

Providing adequate shelter for all Americans is a top social priority in the United States. The 1949 Housing Act called for "... a decent home and suitable living environment for every American family," a statement that has been reiterated many times since 1949 and in some sense was responsible for the important 1968 Housing and Urban Development Act and subsequent legislation. This paper analyzes the way fiscal policy is used to achieve the nation's housing priorities. Included is a review of the growth of government spending and a study of the impact on housing of the fiscal-monetary policy mix, federal housing outlays, federal tax expenditures, and federal credit programs.

Total government spending including federal, state and local units increased from 10% of gross national product (GNP) in 1929 to 33% in 1974. A large share of these expenditures can be attributed directly to the federal government whose outlays accounted for 21% of GNP in 1974.

One way this expansion of the federal government has influenced housing is through the fiscal-monetary policy mix. Our analysis of overall stabilization policy disclosed a serious bias in the monetary-fiscal policy mix which has been increasingly adverse to housing in recent years. Large budgetary deficits even after high employment is reached have put undue pressure on monetary policy to correct for the resulting inflation. During periods calling for expansionary policies, the mix has been both favorable and unfavorable to housing although the 1974-75 period suggests that a heavy weighting toward fiscal policy can create demand expansion without bringing about a housing recovery.

Another way federal expansion has influenced housing is through budget allocations. A review of federal allocations to housing indicates that although housing has been given a great deal of lip-service as a national priority, the data does not substantiate this claim. Federal outlays for housing totaled less than 1% of GNP in 1974. Further, the impact these outlays do have actually acts to exacerbate the industry's instability. As a result of this instability in

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housing, the U.S. had far exceeded its cumulative housing goals as of fiscal 1973. Even after the record production declines of fiscal 1974-75, the nation is only modestly below its cumulative target as of fiscal 1975. However, it is clear as of fiscal 1976 that in the next three years (1976-78) total housing production will be far below the nation's 1970 housing goals. This failure to realize our nation's housing goals will take place despite the fact that federal spending is expected to continue to expand to 22% of GNP.

Federal tax expenditures grew rapidly during the late 1960s and early 1970s. Although this form of federal expenditure has decreased in importance in some areas, it has increased in its importance to housing. During the relative instability of the early 1970s, housing tax expenditures have stabilized housing.

Federal credit programs have grown significantly during the last decade (1965-1974). When the size of the federal deficits of the 1970s is taken into account, it is clear that the federal government has been requiring an even larger proportion of the funds available to U.S. credit markets. These trends are projected to continue as federal credit needs reflect increasing deficits in 1976.

Federal credit programs for housing have been a large part of this expansion. Although these programs have increased housing stability by providing subsidized mortgage funds, they have done so at the expense of private intermediaries which is evidenced by the artificial downward pressure on mortgage rates and by the increasing usurpation of the mortgage market by federal agencies. This harmful impact on private intermediaries has a destabilizing effect on housing as private lender uncertainty increases.

The increasing size of federal spending, federal deficits, federal tax expenditures and their changes in composition reveals the increasing tendency of the federal government toward immediate consumption and away from the savings-investment area. This orientation implies the possibility of a capital shortage in the 1980s with obvious related difficulties for housing. Even if a capital shortage is not realized, this orientation in itself has the potential for creating continuing housing instability.

THE FEDERAL BUDGET

Perhaps the easiest of economic laws to substantiate is Wagner's "law." This simply asserts that there is an inherent tendency on the part of government to increase in size and importance.[1] The growth of federal, state and local government in the United States during the past half-century provides empirical proof that this tendency does exist.[2]

In 1929, government revenues totaled $11.3 billion while by 1974 they were $455.0 billion. This represents a 40-fold increase over a period of 45 years with government revenues increasing from a rate of less than $1 billion a month to nearly $1.3 billion a day. The growth of government expenditures has been similar to that of revenues. Between 1929 and 1974 government expenditures

1. Adolf Wagner was a noted German theorist of the 19th Century. See James M. Buchanan, *The Public Finances*, e.g. rev. ed. (Homewood, Ill.: Richard D. Irwin, Inc., 1965), p. 50.
2. Although measuring problems are significant when government activity is being discussed, simple budget data substantiates Wagner's law; see Buchanan, *The Public Finances*, pp. 30-32.

increased 45-fold from $10.3 billion to $460.9 billion. This represents an expenditure increase from $28 million a day in 1929 to $1.3 billion a day in 1974.

Clearly all forms of spending have increased over this span of 45 years. The nation's gross national product experienced nearly a 14-fold increase going from $103.1 billion in 1929 to $1,397 billion in 1974. Real growth of the government sector then is not revealed by revenue and expenditure trends alone. We can envision the real growth of government, however, if we consider the percentages of the nation's total product (GNP) consumed by government. In 1929, government spent 10% of the nation's total product—$1 out of every $10. By 1974, government was spending 33% of GNP or $1 out of every $3—more than a threefold increase in real government size.

Between 1929 and 1974, federal expenditures alone grew from $2.6 billion to $299 billion—a 115-fold increase. This represents better than a fivefold expansion of federal claims on the nation's total product—from 3% of GNP in 1929 to 21% in 1974.[3]

FISCAL POLICY

The growth of government influences housing in many ways. One way housing is affected is through the nation's overall fiscal policy. The relationship between government spending and taxation—the existence of federal budget surpluses and deficits—is usually referred to as fiscal. The overall objective of fiscal policy is to eliminate the gap between aggregate demand and non-inflationary, full employment level of output. The two basic targets of fiscal policy are then price stability and maximum production. Fiscal policy cannot, however, be reviewed in isolation, but must be discussed in the context of overall stabilization policy which rightfully includes monetary policy. Presumably we can have the same overall production with an equally tight fiscal policy and an easier monetary policy or the reverse within some limit. The choice depends primarily on the formulation of our many subsidiary economic goals or targets which are presumably affected differently by the fiscal-monetary mix.

These subsidiary economic goals are at the nexus of the housing debate in so far as it relates to choosing the "appropriate" fiscal-monetary policy mix. It is generally conceded by economists that the policy mix does influence the composition of our economy's output. Housing clearly represents a subsidiary goal that may well be affected.

Although a number of recommendations have been made regarding the role of fiscal policy in meeting our housing goals, unanimity has not been achieved. As one reviews the literature, however, there does seem to be a general concensus of opinion over several issues related to the question of how the fiscal-monetary policy mix influences or should influence the economy and housing expenditures.[4] The major differences occur in the weight given by various

3. Total government expenditures as a percentage of GNP differs from the sum of state and local expenditures/GNP plus federal expenditures/GNP. This is the result of programs such as federal revenue sharing which create double counting problems.

4. *Policy: The Eclectic Economist Views the Controversy*, ed. James J. Diamond (Chicago: DePaul University, 1971), pp. 51-74; Gardner Ackley, "Fiscal Policy and Housing," *Housing*

analysts to the overall importance of these influences. General points of agreement or propositions include the following:

Proposition #1:

The primary goal of monetary and fiscal policy is to produce full employment output with price stability. Housing, while an important subsidiary goal, must be considered only as a secondary concern together with a number of other subsidiary goals such as: 1) the level of interest rates; 2) possible dislocations within the financial system; 3) balance of payments; and 4) effects of stabilization policy on the long-run growth rate of supply in the economy.

Proposition #2

The short-run effects of fiscal policy on the nation's output and employment are generally agreed to be quick and significant. Irrespective of the economic doctrine of the economist, a sharp acceleration or deceleration of government spending are assumed to have fairly strong short-term effects of aggregate demand. Monetariests concede this point, but hold that rises in government spending financed by taxes or sales on bonds to the private sector will eventually "crowd-out" private spending by nearly an equal amount over the long-run.

Proposition #3

The composition of federal spending is assumed to have long-run effects on the rate of supply capacity growth in the economy. That is to say, a fiscal policy that re-allocates resources away from current consumption to investment will alter the long-run growth rate of potential output. Also, fiscal policy can alter the long-run supply of housing by direct expenditures on new housing, rehabilitation, resources going into housing and manpower training.

Proposition #4:

Housing as a credit intensive durable good, is likely to be more adversely affected by a fiscal-monetary policy mix which puts its primary restraining responsibility on monetary policy as opposed to fiscal policy. That is to say, if we have the choice between two fiscal-monetary policy mixes, both of which are assumed to create the same overall aggregate level of demand and similar inflation rate, the policy mix which calls for the more restrictive monetary policy and less restrictive fiscal policy will be the most detrimental to the housing market.

Proposition #5:

Fiscal policy can do little by itself to promote housing goals, but must be coordinated with monetary policy to produce the desired outcome. The objective must be to select a total gross national product-employment target which is consistent with some level of acceptable inflation, then select

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and Mortgage Policy, Federal Reserve Bank of Boston, Conferences Services No. 4 (October 1970), pp. 9-40; Arnold Harberger, David J. Ott, and James S. Duesenberry, "Discussions"; Leonell C. Andersen, "A Monetarist View of Demand Management: The United States Experience," *Review* 53, Federal Reserve Bank of St. Louis (September 1971).

the appropriate combination of monetary and fiscal policy which will achieve the overall output and prime objectives but which also comes closest to achieving the required amount of housing.

IMPACT

Assuming general agreement with the above propositions, we might choose to review the extent to which fiscal policy during the last several decades has favorably or adversely impacted the housing markets. Such an evaluation is difficult for several reasons. First is the problem of the potential lack of coordination between fiscal and monetary policy. Clearly, a particular fiscal policy must be considered inappropriate if it resulted in undesirable output-employment, price, and housing outcomes and such a policy was determined with "perfect knowledge" of the monetary policy actually to be carried out. Unfortunately, fiscal policy can hardly be faulted for an undesirable outcome which occurred because the monetary policy pursued was unexpected or inappropriate. Nor can fiscal policy be criticized for bad forecasting of the outcome of any given policy. Finally, fiscal policy cannot be blamed for adverse housing conditions which are the natural consequence of the pursuit of more important primary or subsidiary goals.

These difficulties make it impossible for us to place blame, but they do not stop us from evaluating policy solely from the more narrow point of view of how the policies pursued affect housing output. In other words, while we might accept the notion that fiscal policy is blameless, we need not reject the temptation to evaluate the policies pursued for the narrow viewpoint of what would have been in the best interest of housing.

This presents another problem, however. Should the fiscal policy chosen be evaluated under the assumption of "full knowledge" of the monetary policy that was pursued? Or conversely, should monetary policy be evaluated under the assumption of full knowledge of the fiscal policy that was pursued? This chicken and egg problem is not easily solved even though most analysts assume monetary policy can be adjusted more quickly than fiscal policy. Nor is the problem of determining what the primary overall output, employment and inflation goals are for any given year. This latter problem is particularly important since housing, as a subsidiary goal, must be considered subservient to these other primary goals.

Given these problems, it is clear that any approach taken to the question of how fiscal policy affects housing must suffer from the criticisms of subjectivity and unrealistic assumptions.

Our approach will be to determine the extent to which fiscal policy has historically tended to foster favorable or unfavorable conditions for the housing market. From the above propositions, particularly propositions #4 and #5, there is general agreement that when fiscal policy assumes too great a stimulative role when expansionary policies are called for in relation to monetary policy, or similarly, where monetary policy assumes too great a restrictive role when deflationary policies are called for as compared to fiscal policy, that housing will suffer adversely. Our effort will be to determine the incidence of these occurrences during the last several decades.

One way of measuring fiscal impact in a full employment framework is the "high" or "full employment budget."[5] The high employment budget is a method of estimating the total revenues and expenditures of government under the assumptions of full employment and some estimate of potential long-run growth in output. Although there are many estimation, weighing, and timing problems associated with its computation, the budget does provide a useful indicator of the direction of discretionary fiscal action by isolating the effect of fiscal policy from the influences of changes in the level of economic activity on the budget data.

From the above discussion, it would appear that fiscal policy could be detrimental to housing under the following conditions:

1) If fiscal policy is stimulative when full employment is approaching or present then there is a tendency for such a fiscal policy to force monetary policy to burden too great a responsibility for slowing the growth in aggregate demand. Such a policy would be detrimental to housing since monetary policy works through the credit markets which is particularly burdensome to the housing sector.
2) If fiscal policy is too stimulative during a period of recession, then monetary policy is unable to ease commensurately as much as if a more balanced fiscal-monetary mix was employed. Such a policy will have a relatively smaller stimulative effect on housing than on other less credit intensive sectors of the economy.
3) If fiscal policy is too restrictive during a period of recession or excess unused capacity, then monetary policy may be forced to be overly stimulative, leading to excessive rises in homebuilding.
4) If fiscal policy is too restrictive during a period of fully utilized capacity, then monetary policy may result in relatively too much in resources being devoted to housing.

The occurrence of these four policy mixes during the last several decades is surprisingly evenly distributed, although through time there is not an equally random occurrence.

The following assumptions are made in analyzing the impact of fiscal-monetary policy mix on housing.

Assumption #1:

It will be assumed first that during periods when the wholesale price index is rising at, near, or above a 5% rate and unemployment is less than or equal to 5% that stabilization policy will be aimed at deflating aggregate demand.

Assumption #2:

It will be assumed that during periods when unemployment is in excess of 5% and when prices are declining or stable that stabilization policy will be aimed at expanding aggregate demand.

5. James R. McCabe, "The Full Employment Budget: A Guide for Fiscal Policy," *Monthly Review*, Federal Reserve Bank of Richmond (May 1972).

PHASES

The quarterly high-employment budget and the annual percentage increase in M_1 (cash and demand deposits in commercial banks) and M_2 (M_1 and time and savings deposits in commercial banks) was evaluated for the period 1950-75. There are four periods when stabilization policy is assumed to be deflationary. There are four periods when stabilization policy is assumed to be expansionary. Each period is also evaluated on the basis of whether the fiscal-monetary mix was favorable or unfavorable to housing. In periods of deflationary goals, a policy weighted in favor of monetary policy is considered negative to housing, while a policy weighted in favor of fiscal restraint would be favorable even though housing would be expected to suffer in either case. In periods of expansionary objectives a fiscal-monetary mix weighted in favor of monetary stimulus is considered positive to housing and vice versa. In both cases, a well-balanced policy is considered neutral.

Deflationary Phases

1) II 1953 - III 1953 (Negative)	Complete reliance on monetary policy to slow economy. Full employment deficit increased stimulus from $9-10 billion.
2) II 1955 - IV 1956 (Negative)	Monetary policy tightened. Balance between monetary and fiscal policy slightly weighted to monetary policy. Sharp tightening of monetary policy and moderate additional restraint of high employment budget.
3) IV 1968 - IV 1970 (Neutral)	Balance between monetary and fiscal policy. Very sharp tightening of monetary and fiscal policy.
4) IV 1973 - II 1974 (Negative)	Balance with emphasis on monetary policy. Moderate tightening of fiscal policy and relatively sharp tightening of monetary policy.

Expansionary Phases

5) II 1954 - II 1955 (Positive)	Sharp expansion of monetary growth and tightening of fiscal policy.
6) I 1958 - II 1964 (Positive)	Monetary policy with the exception of 1959 was progressively more stimulative while fiscal policy remained relatively restrictive.
7) III 1970 - IV 1972 (Neutral)	Sharp easing of both monetary and fiscal policy.
8) IV 1974 - Present (Negative)	Very sharp fiscal stimulus and moderate monetary stimulus.

Our simple subjective analysis indicates:

1) During deflationary phases stabilization policy is heavily weighted toward the use of monetary policy. Rarely does fiscal policy provide sufficient restraint to balance the policy mix. Thus, during periods when deflationary outcome is desired, the fiscal-monetary mix has tended to be adverse to housing.
2) During expansionary phases of stabilization policy, the fiscal-monetary mix has been both favorable and unfavorable to housing.

3) Over the period covered, the tendency has been to use a relatively heavier weighted monetary policy mix during deflationary phases and heavier weighted fiscal policy mix during expansion phases. This is born out by the fact that the only positive fiscal-monetary mix took place during the mid-1950s and early 1960s.

These trends would suggest that housing may have experienced difficulties in recent years as a result of the increased tendency to weigh monetary policy more heavily than fiscal policy during deflationary phases of stabilization policy, and fiscal policy more heavily during expansionary phases. Both tendencies are generally less compatible to a strong housing market and available mortgage credit.

HOUSING OUTLAYS

Another way the federal government impacts the housing market is with its allocation of expenditures for housing. In this regard, housing must compete with other national priorities for funds. As a result, the amount of federal expenditures for housing does reflect at least to some degree the national priority status of housing.[6]

Housing as a national priority fits somewhere in between the foregoing examples. In 1965, federal outlays for housing totaled about one-half billion dollars while by 1974 they were nearly $5 billion—a tenfold increase in nine years. This rate of growth implies that housing has been an increasing national priority over the past decade. This impression is confirmed for the period 1965-1972 as housing outlays increased from 0.4% of total federal outlays to 1.9% and from 0.08% of GNP to 0.4%. However, in 1973 and 1974 federal housing outlays did not meet their 1972 levels representing only 1.75% of total outlays and 0.36% of GNP in 1974. Although housing has been an increasing national priority during the last decade, the trend did not continue upward during 1973-74.

More surprising than this reversal of trend, however, is the overall size of federal housing expenditures. Housing outlays representing less than 2% of total federal outlays—less than 0.5% of GNP—can hardly be seen as reflecting a major national priority.[7]

Goals

In spite of the small size of federal housing outlays, they do hold a significant potential for impacting housing production. Two ways in which the degree of use of this potential can be examined involve housing goals and housing stability. Ideally, the federal government should be capable of adjusting its spending to achieve specified housing production levels which reflect both improved housing for the population and stability in production.

In 1969, the nation's housing production goal was set at approximately 26 million new units over the next decade and a production schedule was estab-

6. *The Budget of the United States Government, Fiscal Year 1976* (Washington, D.C.: U.S. Government Printing Office, 1975), p. 109.
7. *Ibid.*

lished. This goal was revised to 25.5 million new units and 1.0 million publicly-subsidized, rehabilitated units in 1970. Since then a number of studies have been done estimating our nation's housing needs with estimates ranging from 22 to 29 million new units over 10 years.

Attainment of the 1970 production schedule on a cumulative basis was fairly good between fiscal 1969 and 1975. The cumulative target for 1975 was 16.3 million new units while 15.2 million were produced. As of fiscal 1975, the nation has achieved 93% of its target for the period 1969-75.[8] This success, however, has not been achieved in a stable, healthy manner. In fiscal 1971, production was 13% over its target followed by a 25% over-shot in 1972 and 15% over-shot in 1973. Then in 1974 actual production fell 23% below its goal followed by an even more pronounced fall of 55% in fiscal 1975. The sharp declines experienced in fiscal 1974 and 1975 indicate that even with a strong housing recovery in 1976 the nation will be well below its housing goal for the decade.

Another way housing production could be expected to be influenced by federal housing outlays is in the form of subsidized new units. In 1965, 48 thousand new subsidized units were produced representing 3.2% of total new unit production in that year. In 1974, these units totaled 45 thousand—only 3.4% of total production. Subsidized housing units represent only a small share of housing production and thus do not have a major impact.[9] Further, the number of subsidized units produced per year does not reflect a federal government attempt to use this source of impact as a method of stabilizing housing production. If these units were being used to aid housing production, they should increase as production falls below target levels and fall when production exceeds the annual goal. This has not been the case as subsidized production averaged 13.5% of total starts during the boom years of 1971-72 but less than 4.0% during the bust years of 1974-75. As a result, the production of subsidized units actually accentuates housing instability.

This also tends to be the impact tendency of federal housing outlays as a whole. Between 1969 and 1973 as housing production realized rapid expansion, the ratio of federal housing outlays to total outlays increased fourfold. Then as housing production declined swiftly in 1973-74, this percentage also declined. In conclusion, it is clear that any impact federal housing outlays did have on production acted to exacerbate housing instability.

TAX EXPENDITURES

Another aspect of government expansion is reflected by federal government tax expenditures.[10] Tax expenditures is the term used to account for those tax

8. *Estimates of Housing Needs, 1975-1980*, prepared for the Committee on Banking, Housing and Urban Affairs, United States Senate (Washington, D.C.: U.S. Government Printing Office, 1975), pp. 2-4.
9. "Housing Starts," July 1975, Department of Commerce, C20-75-7 (Washington, D.C.: U.S. Government Printing Office, 1975), pp. 4 and 6; and United States League of Savings Associations.
10. Some indication of the widespread use of this mechanism by the federal government is shown by John L. Siegfried, "Effective Average U.S. Corporation Income Tax Rates," *National*

revenues which the federal government does not collect because income subject to tax is reduced by special provisions, credits, deductions, exclusions, and exemptions.[11] For example, the deductibility of medical expenses is generally accepted as a tax expenditure.[12] Total federal tax expenditures for 1967 were $36.6 billion while by fiscal 1974 they amounted to $72.7 billion.

TABLE 1

TOTAL FEDERAL TAX EXPENDITURES[1]
(billions of dollars)

Year	Total Tax Expenditures	Year	Total Tax Expenditures
1967	$ 36.6	1971	$ 51.8
1968	44.1	1972	58.8
1969	46.6	1973-74	72.7
1970	44.1	1974-75	79.3

1. Data for 1967-72 in calendar years and for 1973-74 in fiscal years.

SOURCE: U.S. Department of Treasury; *Special Analyses, Budget of the United States Government, Fiscal Year 1976*, pp. 108,109.

This represents a doubling in less than eight years with the result that in 1974 the federal government expended revenues in this form amounting to almost 6% of GNP. Federal tax expenditures and outlays combined accounted for nearly 40% of the nation's total product in 1974.[13]

Tax Journal 27 (June 1974), pp. 245-259, in his computation of the effective corporation income tax rates for 100 industries in 1963. He found that the average effective tax rate was 39% as opposed to the nominal corporate tax rate for that year of 52%.

Further evidence of the use of tax expenditures is noted in Stanley S. Surrey and William F. Hellmuth, "The Tax Expenditure Budget—Response to Professor Bittker," *National Tax Journal* 22 (December 1969), pp. 528-537; Secretary of the Treasury, U.S. Treasury, "The Tax Expenditure Budget: A Conceptual Analysis," *Annual Report of the Secretary of the Treasury 1968* (Washington, D.C.: U.S. Government Printing Office, 1968); B. I. Bittker, "The Tax Expenditure Budget—A Reply to Professors Surrey and Hellmuth," *National Tax Journal* 22 (December 1969), pp. 538-542; and Barry M. Blechman, Edward M. Gramlich, and Robert W. Hartman, *Setting National Priorities: The 1976 Budget* (Washington, D.C.: The Brookings Institution, 1975).

It is noted in the Brookings' publication that tax expenditures for 1976 would sum $91.8 billion—$21.0 billion in tax subsidies to the corporate sector (44% of corporate tax revenues) and $70.8 billion for individual households (67% of income tax revenues).

11. *Estimates of Federal Tax Expenditures*, prepared by the staffs of the Treasury Department and Joint Committee on Internal Revenue Taxation, Committee on Ways and Means, U.S. Congress, June 1, 1973 (Washington, D.C.: U.S. Government Printing Office, 1973), pp. 1-3.
12. *Special Analyses, Budget of the United States Government, Fiscal Year 1976* (Washington, D.C.: U.S. Government Printing Office, 1975), p. 108.
13. *Economic Report of the President*, transmitted to the Congress February 1975 (Washington, D.C.: U.S. Government Printing Office, 1975), pp. 249-328.

Tax Expenditure Mix

As federal tax expenditures have increased so has the allocation by function. These allocations, however, have not all increased equally, revealing once again changing national priorities. For example, consider the area of income security. Tax expenditures in this area include such items as the deductibility of medical expenses, the exclusion of sick pay, the exclusion of unemployment benefits, and additional exemption given those over 65. In 1967, tax expenditures in this area were an estimated $15.6 billion or 43% of total tax expenditures. By fiscal 1975, tax expenditures in this area totaled $27.2 billion or 34% of the total—a clearly declining tax expenditure priority.

By way of contrast, tax expenditures for state and local government are an increasing priority. This tax expenditure essentially reflects the exclusion of interest on state and local debt and the deductibility of nonbusiness state and local taxes. These expenditures were estimated at $4.6 billion in 1967 and $13.1 billion in fiscal 1975. As a result, state and local tax expenditures increased from 13% of total tax in 1967 to 17% in 1975.

Housing Tax Expenditures

Another way the federal government impacts the housing market is with its use of federal tax expenditures. Once again, housing must compete with other national priorities. As a result, the success of housing in this competition also reveals in part the national priority status of housing.

TABLE 2

HOUSING TAX EXPENDITURES[1]
(millions of dollars)

Function	1967	1968	1969	1970	1971	1972	1973-74	1974-75	1975-76
Bad debt deduction for thrifts	600	660	680	380	400	400	1,000	1,030	980
Housing rehabilitation with 9-year amortization	*	*	*	*	10	15	85	115	95
Excess depreciation on rental housing	250	250	275	255	500	600	480	520	540
Deductibility of mortgage interest on owner-occupied homes	1,900	2,200	2,600	2,800	2,400	3,500	4,870	5,590	6,500
Deductibility of property taxes on owner-occupied homes	1,800	2,350	2,800	2,900	2,700	3,250	4,060	4,660	5,270
Total	4,550	5,460	6,355	6,335	6,010	6,750	10,495	11,915	13,385

1. Data for 1967-1972 in calendar years and for 1973-1976 in fiscal years. Adjustments made to Treasury compilation of what are housing tax expenditures (S&L bad debt deduction included).

*Less than $1 million.

SOURCE: U.S. Department of Treasury; *Special Analyses, Budget of the United States Government, Fiscal Year 1976*, pp. 108, 109.

Housing tax expenditures reveal an uptrend. Included in this area are the deductibility of mortgage interest, the deductibility of property taxes, and the bad debt deduction for thrift institutions. Tax expenditures for housing were estimated at $4.6 billion in 1967 or 12% of the total. By fiscal 1975, these expenditure estimates had increased to 15% of the total or $11.9 billion. Housing is thus an increasing national priority from a tax expenditure perspective.

Goals

As was noted earlier, the U.S. has been fairly successful in achieving its 1970 housing production goals. The level of attainment does appear to be inversely related to the size of housing tax expenditures. As housing production expanded between 1970 and 1972, the size of housing tax expenditures decreased from 14.6% to 11.3% of total tax expenditures. Then in 1972-75 as housing production leveled off and then declined sharply, housing tax expenditures increased from 11.3% to 15.0% of total tax expenditures. These trends indicate that federal tax expenditures for housing have had a stabilizing influence on housing during the volatile 1970s.

FEDERAL CREDIT PROGRAMS

Government also has grown as a supplier of credit.[14] Credit assistance is provided through a number of programs which range from direct loans to private loan guarantees and interest rate subsidies. In 1965, federal credit programs advanced $8.9 billion or 13% of all the funds advanced in U.S. credit markets to nonfinancial sectors. By 1970, credit advanced under federal auspices totaled $17.4 billion while in 1974 it amounted to $26.6 billion. This resulted in federal credit programs supplying 20% of the credit advanced to nonfinancial sectors in 1970 and 15% in 1974.

Another aspect of the federal government's impact on the nation's credit market is reflected when the total funds raised under federal auspices (borrowing for federal credit programs and federal deficits) is compared to the total funds raised by nonfinancial sectors. In fiscal 1965, funds raised under federal auspices were $6.1 billion or 28% of the market total. This percentage increased to 34% in fiscal 1970 as federal funds raised totaled $18.1 billion and 34% in fiscal 1974 representing $25.1 billion.[15] In fiscal 1975, federal credit programs are estimated at more than $31 billion and federal funds raised were projected at $62 billion.[16]

Housing Credit Programs

During the 1970s, the federal government expanded its own mortgage market participation. This was accomplished through legislation fostering the growth of a relatively new form of housing assistance—the federal credit program.[17]

14. *The Economics of Federal Subsidy Programs*, a staff study prepared for the use of the Joint Economic Committee, U.S. Congress (Washington, D.C.: U.S. Government Printing Office, 1972); and *Special Analyses, Fiscal Year 1976*, pp. 82-100.
15. *Special Analyses, Fiscal Year 1976*, p. 83.
16. For 1975 they are projected at 5.6%. See *Special Analyses, Fiscal Year 1976*, p. 366; and *The Budget of The United States Government, Fiscal Year 1976*, pp. 32-37.
17. Several studies of housing and other credit programs have been performed: note particularly

These programs operate through a number of federal agencies. The government has established five major institutions to expand the flow of credit to housing, particularly during times of restrictive monetary policy. They are: Federal National Mortgage Association (FNMA), Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC), Farmers Home Administration (FmHA), and Federal Home Loan Bank System (FHLB).[18]

During the early 1970s federal government utilized several of these agencies to subsidize housing credit through its tandem programs, originated in 1969 to provide mortgage financing for the subsidized 235 and 236 housing programs. Using the National Housing Act, the President authorized GNMA to purchase subsidized housing mortgages at par or at modest discounts. As GNMA issues a commitment to purchase a mortgage, it simultaneously obtains a commitment from FNMA to purchase the mortgage at its free market price. The tandem or piggyback process acts to minimize the impact of tandem programs on the federal budget balance.

In 1971, the tandem program was extended to FHA mortgages insured under unsubsidized programs and to VA guaranteed mortgages. During 1974, a further extension of the concept was made as GNMA was permitted to purchase conventional mortgages. The program grew rapidly between 1971 and 1974, and from 1971 to 1973 GNMA extended new home commitments of $0.8 billion. By contrast, in 1974 alone, GNMA made $7 billion in new commitments.[19]

The increasing importance of these federally-supported agencies is substantiated by the distribution of residential mortgage loans. In 1955 and 1965, these agencies accounted for only about 3% of the mortgage loans outstanding while by 1974 their holding increased to better than 11%.

CONCLUSION

The preceding analysis of federal budget trends of the past half-century, together with the analysis of the related areas of federal tax expenditures, indicates clearly that the federal government is increasingly consumption-oriented. This tendency on the part of the federal government is revealed not only by the simple growth of federal spending, its changing composition, and its changing priorities.

Rudolph G. Penner and William L. Silber, "Federal Housing Credit Programs: Costs, Benefits, and Interactions," *The Economics of Federal Subsidy Programs*, part 5, submitted to Joint Economic Committee, U.S. Congress (Washington, D.C.: U.S. Government Printing Office, 1972).

Also refer to Jack M. Guttentag, "The Federal National Mortgage Association," in George F. Break and others, *Federal Credit Agencies*, prepared for Commission on Money and Credit (Prentice-Hall, 1963), pp. 67-158; Charles M. Haar, *Federal Credit and Private Housing: The Mass Financing Dilemma* (McGraw-Hill, 1960), pp. 74-125; and Henry J. Aaron, *Shelter and Subsidies* (Washington, D.C.: The Brookings Institution, 1972), p. 91.

18. *1975 Fact Book* (Chicago: U.S. League of Savings Associations, 1975), pp. 70-74.

19. George M. von Furstenberg, "The Economics of the $16 Billion Tandem Mortgages Committed in the Current Housing Slump," unpublished (Bloomington: Indiana University), p. 1.

The implications of the consumption orientation of the federal government and thus the nation as a whole can be derived from the fact that housing is an investment good. As immediate consumption increases, the resources available for investment become more limited and the competition for them are more intense. Recent history indicates that housing does not do well as the intensity of competition for funds in the credit markets escalates.

One result of this crunch on funds is the appearance of disintermediation at thrifts. A milder but related aspect is the high cost of funds to all intermediaries. These difficulties have an obviously negative housing impact.

This situation is aggravated further by less direct aspects of the federal consumption orientation. Housing has not been aided by the lack of major energy-related investments and the resulting promise of ever-higher costs. Similar problems can be anticipated if in the future a lack of investment incentives creates shortages of building materials and other housing inputs.

What is worrisome about these trends is that with the allocation of government outlays increasingly oriented toward stimulating aggregate demand, the huge and growing credit needs of the government represent the tapping of our limited nation's credit pool to finance primarily non-durable consumption purchases. The implications of this are clearly detrimental to those credit-intensive durable goods industries such as housing.

92-201 O - 77 - 11

The Federal Secondary Mortgage Market: Impact On Specialized Mortgage Lenders

Dennis J. Jacobe and Kenneth J. Thygerson*

The increased volatility of interest rates during the last decade has resulted in sharp fluctuations in housing starts and sales. These politically undesirable results have provided the impetus for stepped up federal government intervention into the mortgage delivery system. The primary instruments of this intervention have been federal credit agencies. These new governmental responses to promote housing represent a significant departure in the type and impact of the explicit and implicit federal subsidies to the home buyer.

This paper reviews the new efforts made by the federal government between 1968 and 1975 to provide a decent home for every American family. More precisely it examines the changes which have occurred in the form of governmental support given housing and the significant impact of these efforts on the private lenders serving the mortgage market.

S&L Specialization

The fundamental economic role of the S&L is that of a financial intermediary. As such, it gathers savings from the public and invests

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these savings in various assets, mainly residential mortgages. S&Ls are considerably more specialized in their operations than commercial banks. The assets which the S&L is allowed to hold are highly restricted by Congress through either the Federal Home Loan Bank Board and Federal Savings and Loan Insurance Corporation or through the various state regulatory agencies. These restrictions include: (1) geographical limitations on the origination and holding of mortgage loans; (2) percent of asset limitations on the various types of mortgage loans, including restrictions on property type, value of property, and type of borrower; and (3) limitations on allowable types of assets.

As a result of these restrictions the four major attributes of the S&L asset and liability holdings are: (1) S&Ls are very dependent on the relative demands for credit in the residential mortgage market as evidenced by the regulatory constraints which govern their permissible operations; (2) S&Ls bear a significant degree of interest rate risk because of the nature of their asset-liability structure; (3) S&L assets, with the exception of a small proportion of liquid holdings, are relatively unmarketable since it is not possible for S&Ls, due to their low reserve position, to take large capital losses on their mortgages during periods of rising rates; and (4) the liability structure of S&Ls has been confined to short-term maturities -- maturities averaging less than five years.

This short review of S&L structure is suggestive of the dependence of these intermediaries on the residential mortgage market. Because S&Ls, unlike any other depository intermediary, are forced to invest nearly all their assets in mortgages, they are particularly susceptible to forces which change the relative yields on residential mortgages compared to other financial assets. That is, they do not have the asset flexibility to alter their asset structure in response to changing yield relationships.

S&L Taxation

As specialized private mortgage lenders, S&Ls have historically received preferential tax treatment -- one form of federal tax expenditure. In fact, prior to the Tax Revenue Act of 1951 S&Ls were tax exempt. With the passage of this act, S&Ls lost their tax exemption but were given special treatment with respect to their bad-debt reserves and the deduction of interest paid on savings. Specifically, S&Ls were permitted to build-in tax free reserves of up to 12% of their withdrawable accounts.(1)

In 1961, President Kennedy sent a tax message to Congress with a recommendation that the tax provisions dealing with the reserves of S&Ls and some other institutions be reviewed with the aim of assuring non-discriminatory treatment. The result was the Tax Revenue Act of 1962 which permitted an S&L to allocate to its bad-debt reserve only an amount equal to 60% of net income after payment of interest to savers with the remaining 40% being subject to federal corporate taxation.(2)

The trend of increasing S&L taxation continued during the late 1960's and early 1970's. The Tax Reform Act of 1969 substantially increased the federal tax liability of S&Ls as it reduced S&L's allowable additions to loss reserves from 60% to 40% of net income. This act also classified the bad-debt deduction as a preference item and applied a 10% minimum tax to such items.(3) The Tax Reform Act of 1976 further increased S&L taxes by increasing the minimum preference tax.

These tax changes have increased substantially the effective tax rate of S&Ls as is shown in Table #1. During the 1950's and early 1960's, S&Ls were taxed at a 2.0% rate or less. By 1965, this rate increased to 14.4% and reached 25.7% by 1975. Scheduled tax changes provide that this rate will continue to increase through 1979.

TABLE #1

S&L Effective Federal
Tax Rates, Selected
Years 1950-1975

Year	Effective Rate	Year	Effective Rate
1950	0.0%	1967	13.2%
1955	1.5	1968	14.7
1960	0.7	1969	15.8
1961	0.5	1970	18.9
1962	0.4	1971	21.5
1963	12.2	1972	23.5
1964	14.3	1973	24.7
1965	14.4	1974	26.4
1966	13.3	1975	25.7

SOURCE: Federal Home Loan Bank Board.

As a result of these changes, a major pre-1968 source of federally provided private mortgage market support -- mortgage lender tax advantages -- was all but eliminated. How much of this increased tax burden was shifted to savers, home buyers, and S&L shareholders is not clearly discernible. This long-term trend of increasing private mortgage lender (S&L) taxation -- decreasing this form of housing credit tax expenditures -- represents a moderation, if not reversal, of the national effort to stimulate privately financed housing. It also sets the stage for new types of federal government assistance to the mortgage market.

Federal Legislation

During the early post-war era, the government's housing activities maintained a symbiotic relationship with S&Ls. Although many housing acts were passed, most of them dealt with minor changes such as liberalizing FHA and VA insurance and guarantee programs and increasing the activities of the Federal National Mortgage Association (FNMA). Probably the most important reason for the little government activity during this period was the fact that housing did not have any critical problems. The economy during this period was characterized by relative price stability. This resulted in an upward sloping term structure which lasted for almost two entire decades. As a consequence, the private mortgage lending sector, made up primarily of thrift institutions, found it easy to attract funds in the short-term sector and make long-term mortgage loans at attractive spreads.

During the mid-1960's, the economic and competitive environment in which S&Ls operated underwent significant changes. This marked the beginning of the period when private mortgage lenders first experienced the disruptive effects of a dramatic shift in the interest rate structure. This period, from 1965 through 1975, was characterized by the periodic use of restrictive monetary policies resulting in tight credit conditions in the financial markets, and interest rate cycles in which interest rates rose to record levels. Since 1965 these cycles have been widening as on several occasions, short-term rates rose well above long-term rates. These periodic rises in rates and shifts in the term structure from one of upward-slope to downward-slope severly taxed the liquidity, growth, and earnings position of the S&L industry. As a result, housing began to experience a boom-bust cycle.

This situation prompted Congress to develop new ways to promote housing. The Housing and Urban Development Act of 1968 was a landmark piece of legislation which suggested the magnitude of the commitment that Congress was willing to make in the housing area. This act provided for: (1) important new programs to subsidize mortgage interest for low and moderate-income families; (2) the establishment of a special high risk insurance fund for certain FHA mortgages; (3) the conversion of FNMA to a privately owned corporation; (4) the establishment of the Government National Mortgage Corporation (GNMA); and (5) the authorization for the Farmers Home Administration to make direct and insured loans available to low and moderate-income families in rural areas and small towns with interest rates as low as 1%.

Subsequent to the Housing and Urban Development Act of 1968, additional legislation was passed to increase the federal government's role in mortgage lending. This legislation included: the Housing and Urban Development Act of 1969, which created the GNMA's pass-through security programs; the Emergency Housing Finance Act of 1970, which created the Federal Home Loan Mortgage Corporation (FHLMC), provided the authority for FNMA to purchase conventional mortgages, and created the Super-Tandem Plan to enable FHA rates to be subsidized at below market rates; the Rural Development Act of 1972, which liberalized the Farmers Home Administration (FMHA) mortgage lending powers through the elimination of debt limit of FMHA to make non-residential loans in cities with populations up to 50,000; and the Emergency Home Purchase Assistance Act of 1974, which opened the GNMA Tandem-Plan to conventional loans and gave FNMA additional authority to finance its purchases.(4)

As a result of this legislation new federal agencies have experienced rapid growth. FNMA, GNMA, FHLMC, and FMHA now make the traditional FHA and VA programs appear insignificant as is shown in Table #2.

TABLE #2

Housing Related Federal Agencies
Securities Outstanding
December 31, 1976
(Billions)

Agency	Securities Outstanding
Federal National Mortgage Association	$ 30.6
Federal Home Loan Bank Board	16.8
Government National Mortgage Association	34.5
Farmers Home Administration	5.4
U.S. Dept. of Housing & Urban Development	1.8
Federal Homa Loan Mortgage Corporation	2.1
Veterans Administration	1.1
Federal Housing Administration	0.6

SOURCE: U.S. Treasury Department, Office of The Secretary.

The Impact of New Support Methods on S&Ls

The preceding review of housing tax expenditures and credit programs reveals that important alterations in tax techniques used to support the mortgage market were made between 1968 and 1975.(5) In essence, tax advantages given to private mortgage lending institutions to expand housing credit were replaced with a new group of agencies that operate independently of private specialized mortgage lenders. That is, new federal legislation has resulted in supply stimulating subsidies operating around private lenders rather than through them. (see Thygerson 1973). (6)

The impact of this diversion of federal subsidies from thrift institutions has been to place a growth constraint on private lenders. Savings and loan associations must by regulation maintain a specified net worth ratio. The shift in federal housing supply subsidies has reduced the ability of associations to maintain the required net worth ratios for rapid growth in two ways: (1) by reducing after-tax earnings; and (2) by reducing private mortgage lender spreads.

<u>After-Tax Earnings</u>

S&L tax exemptions and special deductions have acted to increase the supply of mortgage credit at any given interest rate. They do this by altering the yield curve faced by S&Ls. Table #3 shows the after-tax net income percentages of S&Ls at various points in time based upon their effective tax rates. In 1950, the net income S&Ls received after-tax was identical to that before-tax while by 1962, the after-tax net income was substantially lower than the pre-tax net income. In 1976, the before-tax net income percentage of 11.4% gave the S&L an after-tax net income of 8.0%.

TABLE #3

Net Income Percentages
of S&Ls Selected
Years 1950-76

Year	Net Income* Before-Taxes	Net Income* After-Taxes**	Difference
1950	24.9%	24.9%	0.0%
1955	22.3	21.9	0.4
1960	15.7	15.5	0.2
1965	13.8	11.6	2.2
1970	10.4	8.2	2.2
1971	13.3	9.9	3.4
1972	15.3	11.1	4.2
1973	14.6	10.4	4.2
1974	10.3	7.1	3.2
1975	8.8	6.1	2.7

* Net income is given as a percentage of total operating income.
** Includes state and local taxes.
SOURCE: FHLBB and U.S. League of Savings Associations.

The reduction of S&L after-tax net income has reduced its ability to pay for savings, particularly at the record interest rate levels of 1973-75. The result has been a decreased supply of funds for housing credit originating from the private sector.

Earnings Spread

Probably the most significant result of federal credit program expansion was the substantial decline in mortgage loan interest rates relative to other long-term debt instruments. Table #4 shows the average rate of AAA corporate bonds, new AAA utility issues, and the spread between these rates over the period 1965 to 1975. These data indicate that there has been a substantial decline in the spread that mortgage rates have had over corporate bonds and utility rates during this short span of years.

TABLE #4

Home Mortgage Interest Rates, and Yields on Corporate Bonds and New Utility Issues

Period	Conventional Loans on New Homes, Effective Interest Rate	New AAA Utility Issues Yield	AAA Corporate Bond Yield	Spread Between Conventional Loan Rate &	
				Utilities Yield	Corporate Bond Yield
1965	5.81%	4.50%	4.49%	1.31%	1.32%
1966	6.25	5.43	5.13	0.82	1.12
1967	6.46	5.82	5.51	0.64	0.95
1968	6.96	6.50	6.18	0.47	0.79
1969	7.81	7.71	7.03	0.10	0.78
1970	8.45	8.68	8.04	-0.23	0.41
1971	7.74	7.62	7.39	0.12	0.35
1972	7.60	7.31	7.21	0.29	0.39
1973	7.95	7.74	7.44	0.21	0.51
1974	8.92	9.33	8.57	-0.41	0.35
1975	9.01	9.40	8.80	-0.39	0.21

SOURCES: Federal Home Loan Bank Board; Federal Reserve Board; Moody's Investors Service.

Although mortgage rates have declined relative to corporate bond rates since the late 40's, the decline has accelerated in recent years. This decline can be attributed to two causes. First, the <u>ex ante</u> risk of a mortgage loan may have been improperly evaluated on the high side in earlier years, causing the return earned on mortgages to be higher than justified given the default losses which occurred. No doubt this hypothesis has merit and accounts for some portion of the decline. The second reason, however, is that the tremendous efforts made by the federal government to attract funds for mortgages through the use of the preferred borrowing position of the government and its agencies has resulted in mortgage credit becoming available at lower rates than would have been the case otherwise.

Hendershott (1974) analyzes this spread between mortgage rates and corporate sales and states his results as:

> Between the fourth quarters of 1975 and 1971 the spread between the home mortgage and bond rates employed in our model fell by exactly one percentage point (1.18 percent to 0.18 percent). The home mortgage rate rose by nearly two percentage points during these six years. The simulation results suggest that the mortgage rate would have been about 3/4 of a percentage point higher relative to the bond rate in the absence of the mortgage support activities of the FSCAs. This accounts for 75 percent of the decline in the mortgage-bond rate spread.(7)

Although this approach differs somewhat from that of Cook (1974), it tends to support Cook's hypothesis that the decline in spread is largely due to the mortgage purchase activities of federal agencies.(8)

More recently, George von Furstenberg in an analysis of the economics of the GNMA Tandem Plan concluded that as a result of Tandem mortgage activities:

> ...the cost of savings capital to the thrift institutions is unlikely to fall on account of Tandem because money market rates are, if anything, raised by the additional borrowing by the U.S. government of its sponsored credit agencies. Thus, the profitability of the thrift institutions may well be affected adversely if below-market Tandem commitment continue to be offered during periods of ample availability of mortgage credit such as 1975 when non-traditional lenders add to the flow of funds into the mortgage market. (9)

The significance of this structural change in rate spreads cannot be underestimated. Since specialized mortgage lending intermediaries must compete for funds against agencies which have a preferred borrowing position, and with other intermediaries who possess broader asset acquisition authorities, it is clear that if they do not earn a commensurate return on their assets they will find it increasingly impossible to grow and generate adequate earnings.

The importance of the preferred borrowing position of the federal agencies should not be underestimated. These agencies have a definite borrowing advantage over the private sector. The spread between privately issued securities and government agency rates averages nearly 100 basis points, except for the short-term maturities where the premium is 25 to 50 basis points.(10)

The significant growth in these agencies and their preferred credit markets also presents additional problems to private mortgage market institutions during periods of tight money. Unlike the major depository intermediaries, these agencies have no constraints in the rates they can pay for funds. Consequently, during periods of tight money, they are in a position to out-compete all private lenders for funds and mortgage loans.

Summary and Conclusions

The changing role of government in the mortgage market has significant and potentially hazardous implications for the private specialized mortgage lending intermediaries. The method of governmental subsidy and support, which consisted of tax advantages given to thrift institutions which support housing, has been largely replaced with support methods that operate independently of the private specialized mortgage lenders. As a result, thrift intermediaries forced to specialize in mortgage loans are receiving far less in benefits to compensate them for the constraints put on their assets and liability structures.

Recent federal programs expanding federal agency actions to support housing pose a significant competitive threat to thrift institutions. This competition is the result of the preferred borrowing position of these agencies. During inflationary periods one particularly harmful effect of expanded government mortgage lending activities has been a sustained and substantial relative decline in mortgage rates as compared to other long-term interest rates. The decline in these rates has acted to exacerbate the earnings problem of S&Ls and seriously weaken their ability to compete for savings against more diversified intermediaries.

These policies also have a bearing on proposals to alter the structure of financial institutions such as those offered by the Presidential "Commission of Financial Structure and Regulations" (1971) and the resulting "Financial Institutions Act of 1975," Senate passed legislation. These proposals call for a limited liberalization of thrift institution asset and liability powers together with the eventual elimination of the Regulation Q rate ceilings and differential advantage now given to thrift institutions over commercial banks.

Clearly, if returns to private intermediation in the mortgage market have declined, there remains a very real question whether thrift institutions, required to specialize in mortgage holdings -- although somewhat less intensively under these proposals -- would be able to pay commensurately competitive rates for savings in a free institutional market environment. If not, as indeed appears to be the case, then ever increasing agency support of the mortgage market may be deemed necessary by our public policymakers. This could be carried to the point of complete socialization of this largest of our domestic credit markets. Such an acceleration of the current trend would not only alter our financial institutional structure, but also the entire financial system. One result might be that a growing number of borrowers, facing relatively higher borrowing cost as they compete against agencies for funds, would look for similar agency borrowing advantages to meet their non-housing borrowing requirements.

NOTES

1. Josephine Hedges Ewalt, History of the Tax Definition of Savings and Loan Associations, 1894-1964, (Chicago: U.S. League of Savings Associations, 1975), p.38.

2. Ibid., p. 44.

3. 1975, Fact Book, (Chicago; U.S. League of Savings Associations, 1975), pp.54-55.

4. See Jack M. Guttentag, "The Federal National Mortgage Association," in George F. Break and others, Federal Credit Agencies, prepared for the Commission on Money and Credit (Prentice-Hall, 1963), pp. 67-158; and Charles M. Haar, Federal Credit and Private Housing: The Mass Financing Dilemma (McGraw-Hill, 1960), pp.74-125: Henry J. Aaron, Shelter and Subsidies (Washington, The Brookings Institution, 1972), p. 91.

5. Both of these methods fall into the general category of a subsidy as defined by the Joint Economic Committee of the Congress of the United States:

> ...the provision of federal economic assistance at the expense of others in the economy, to the private sector producers or consumers of a particular good, service or factor of production. The government receives no equivalent compensation in return, but conditions the assistance on a particular performance by the recipient -- a quid pro quo -- that has the effect of altering the price or costs of the particular good, service or factor to the subsidy recipient so as to encourage or discourage the output, supply, or use of these items and the related economic behavior. The assistance may take the form of:
>
> a. Explicit cash payments;
> b. Implicit payments through a reduction of specific tax liability;
> c. Implicit payments by means of loans at interest rates below the government borrowing rate or from loan guarantees;
> d. Implicit payments through government purchases of goods and services above market price; and
> e. Implicit payments through certain government regulatory actions that alter particular market prices.

92-201 O - 77 - 12

6. Kenneth J. Thygerson, _The Effect of Government Housing and Mortgage Credit Programs on Savings and Loan Associations_, Occasional Paper Number 6, (Chicago: United States Savings and Loan League, 1973).

7. Patric H. Hendershott and Kevin Villani, "The Impact of Governmental Policies on Financial Market and Housing Expenditures," unpublished (West Lafayette: Purdue University, July 1975), pp. 10 and 28.

8. T. Cook, "The Residential Mortgage Market in Recent Years," Economic Review, Sept/Oct. 1974, (Federal Reserve Bank of Richmond).

9. George M. von Furstenberg, "The Economics of the $16 Billion Tandem Mortgages Committee in the Current Housing Slump," unpublished, (Bloomington: Indiana University), p. 1.

10. Thygerson, _op. cit_.

Mr. THYGERSON. Because time is short, I will refrain from developing each of these seven areas of study and move immediately into the discussion of concluding recommendations, which you will find on the bottom of page 16 of my text. The following recommendations we hope and think are consistent with the analyses presented in the first 2 to 16 pages.

The first recommendation is obvious. I think it has been supported over and over again by each of the preceding witnesses. It seems clear to us that the tendency of the Federal Government to run budgetary deficits long after the economy is on the road to recovery has put an enormous burden on monetary policy to control inflation. The trends of the last decade suggest that housing capital has been restricted as a result of the increased tendency to emphasize monetary policy more heavily than fiscal policy during inflationary phases of stabilization policy, and fiscal policy more heavily during expansionary phases. Both tendencies are generally disadvantageous to capital formation and a strong housing market.

Fiscal imbalance is also the primary cause of ever higher rates of inflation and economic uncertainty. The more frequent presence of budgetary deficits stands as our Nation's major hurdle to achieving greater rates of capital formation and faster rates of economic growth.

In this respect, we agree with the statement in the report entitled "Task Force on Capital Formation" which reads:

> The surest way to increase total savings through tax policies is to increase the Federal budget surplus—or reduce the deficit—in periods of high employment.

In reviewing the testimony that I heard earlier today, it seems that one of the central themes that came through when each of these people testified was the fact that economic uncertainty and the volatility of the economy and inflation was probably the single most important detriment to achieving higher rates of economic growth and capital formation in this country.

We certainly suggest that every possible effort be made to achieve President Carter's goal to balance the Federal budget in 1981.

Second, it was shown that the increasing consumption-orientation of Federal expenditures has also been detrimental to capital formation generally, and to housing in particular. The implications of the consumption-orientation of the Federal Government to the Nation as a whole can be derived from the fact that housing is an investment good.

As immediate consumption increases, as a result of fiscal stimulus, the resources available for investment become more limited and the competition for them more intense. Recent history indicates that housing does not do well as the intensity of competition for funds in the credit market escalates.

This is particularly harmful when consumption stimulus is financing the budgetary deficits.

Thus, every effort should be made to review the overall allocation of Government spending to strike a more favorable balance between consumption and investment-oriented expenditures. The increased allocation of Government spending to consumption stimulus should be reversed.

Third, our analysis of Federal tax expenditures indicates that these means are the most favorable for capital formation in housing.

The tax deductibility of mortgage interest and real estate taxes for owner-occupied housing should be maintained in order to assure that our country continues to achieve its enviable position as a nation of homeowners.

Fourth, our study of mortgage credit programs indicates that they are of more limited usefulness in garnering funds for housing. The activities of the major mortgage credit agencies have been shown to merely reallocate the investment in mortgages from private lenders to Government agencies, with no real increase in capital formation. The exceptions to this are the Federal Home Loan Banks which act as a liquidity reserve for savings and loans—thus enabling associations to maintain a very high percentage of assets in mortgages.

We feel that less emphasis should be placed on Federal credit programs, generally, as a solution to capital shortage problems.

Fifth, we recommend that special savings incentives be created for the most victimized segment of the homebuying market—the first-time homebuyer.

S. 664, which provides for establishment of individual housing accounts, has great merit for solving the specific problem of the first-time homebuyer. We strongly urge your consideration of this approach.

The U.S. League of Savings Associations has appreciated this opportunity to present its views to your subcommittee on these issues of such vital importance to our Nation's future economic health. I look forward to your questions.

STATEMENT OF KENNETH R. BIEDERMAN, NATIONAL SAVINGS AND LOAN LEAGUE

My name is Kenneth R. Biederman. I am senior vice president and chief economist of City Federal Savings and Loan Association of Elizabeth, N.J., and was formerely consultant to the National Savings and Loan League in the area of Federal taxation while a member of the economics faculty at Georgetown University.

I am appearing on behalf of the National League, a nationwide trade organization for savings and loan associations.

My comments are basically addressed more specifically to the savings and loans associations than Ken Thygerson's were. I have a lengthy statement that I submitted for the record. I will summarize it here.

Basically the paper looks at three questions:

No. 1, what are the capital needs and requirements of the savings and loan industry?

No. 2, is there now or is there likely to be over the next decade a "capital shortage" or inadequate capital supply for the savings and loan industry within the context of these needs and requirements?

No. 3, what can be done to improve upon the capital needs of the industry?

Very briefly, from the standpoint of savings and loans associations, it must meet by regulation a "net worth"—capital adequacy—test each year at the end of that calendar year. The test is a two factor test, one a function of savings, the other of assets. I have spelled out these two tests in my statement and I will not go over them here. The savings based test, often referred to as the FIR test, has proven to be the more restrictive of the two.

As to the second question of capital adequacy problems in the savings and loan industry as defined by these asset and savings test constraints—I refer you, Mr. Chairman, to table 1 in my statement. Summarizing, at yearend 1976, there were 975 savings and loan associations in the Nation that had net worth-to-savings ratios below this particular 5 percent FIR minimum to which I just referred, constituting over 24 percent of all the associations in the country.

Combined, these associations hold $64 billion of savings capital which at yearend 1976 represented nearly 20 percent of all savings capital in the industry.

This represented a 13-percent increase in 1 year of the number of associations whose net worth-to-savings capital ratios were below the 5 percent FIR requirement, with the amount of savings capital held by such "capital short" associations increasing over 46 percent in 1 year.

I might add, through 1977, even though the industry has been reaping large inflows of savings and there has been a comeback for housing, this particular ratio has continued to fall.

In the following sections, I look at the residential mortgage debt financing demands upon and the corresponding net worth needs of the savings and loan industry in the next decade. I base these on longrange econometric forecasts by Data Research Inc. and an analysis of the Nation's longrun housing needs by the Joint Center for Urban Studies of MIT and Harvard.

The conclusions are: First, savings and loan associations currently are and will continue to experience capital constraints.

Second, such capital constraints will restrict the ability of savings and loan associations to meet the basic housing financing needs as defined by the Joint Center for Urban Studies of this Nation over the next decade.

Third, capital problems facing the savings and loan industry can be directly traced to increasing Federal tax burdens. Mandated increases in the taxation of savings and loan associations over the next 2 to 3 years will exacerbate those problems and further restrict industry growth.

From that standpoint, Mr. Chairman, I would like to submit for the record a summary statement of the study that I did on the tax burden of financing institutions.*

Senator BYRD. It will be received.

Mr. BIEDERMAN. Fourth, the average return on yearend net worth of savings and loan associations has been from 30 to 40 percent below that of other major industrial groups over the past decade.

To the extent, Mr. Chairman, that these groups face tax-induced constraints on capital formation and growth, it should be stressed that similar constraints on the savings and loan industry are as much, if not more, clearly identifiable and related to the tax system.

*The study was made a part of the official committee file.

Thus, if residential mortgage debt financing is to be considered an important facet of investment and capital formation in our economy, I think it goes without saying that some recognition of this must be made in any capital-oriented tax reform package.

From the standpoint of recommendations, Mr. Chairman, we feel that the mortgage interest tax credit proposal, as described in detail in my paper, would greatly help to alleviate existing capital constraints facing the savings and loan industry and would aid significantly in assuring an adequate supply of residential mortgage debt in the future.

Just briefly, the mortgage interest tax credit, as you may recall, was an instrumental part of prior financial reform legislation. It was endorsed by the Treasury of the two previous administrations, and was part of the FINE study principles. We believe that there are several important reasons for supporting the MITC. These are spelled out in my paper, and I will not go into them here. But within the context of these hearings, I think its main benefit would be that the mortgage interest tax credit would increase the availability of funds for financing residential mortgage debt by at least $100 billion over a 10-year period by reducing the net worth constraints which are now, and will continue, to impinge upon the growth of savings and loan associations.

It should be stressed, Mr. Chairman, that tax subsidies such as the mortgage interest tax credit are a more efficient use of tax dollars than direct expenditures in terms of generating supplies of residential mortgage debt. Because of the net worth requirements for every dollar of increase in net worth in the savings and loan association, $20 of the mortgage finance can be provided by these associations. For every dollar that the Federal Government transfers, you get $1 of mortgage finance.

Senator BYRD. You mentioned the need to reduce the net worth restraints. Would you elaborate a little bit more on that?

Mr. BIEDERMAN. Basically, Mr. Chairman, as I mentioned and describe in my paper, savings and loan associations by regulation are required to have a net worth to savings capital ratio of 1 to 20, or put it another way, 5 percent of savings capital ratio must be in net worth. This is a moving average and it has all kinds of details built into it. That is basically the constraint of which I speak.

Senator BYRD. Do you think that is too much restraint?

Mr. BIEDERMAN. From a standpoint of regulation, that is an interesting question. It gets into the whole area of safety for the depositor, safety for the investor, and safety of the financial system. I think clearly the financial system needs some sort of reserves built into it.

The banking system has reserve requirements. The savings and loan system has reserve requirements. There is a lot of debate going on in the industry—is 5 percent the right number? I have no real conclusion on that.

I do feel, however, that there are strong arguments for reserve requirements. Given that there is a need for 5 percent, or some reserve requirement, this does not mitigate the fact that there are problems that I feel are tax induced on the net worth of the savings and loan industry.

Senator BYRD. Speaking of your testimony generally, are you saying basically that what is needed is that the tax burden on savings and loans should be reduced?

Mr. BIEDERMAN. Yes, sir, but there is more to it than that. The very nature of the taxation of the savings and loan industry needs to be changed, again for reasons that I set out in my statement. It seems to me that the way the savings and loan industry is now being taxed does not have key elements of economic efficiency that I think should be built in.

For example, the mortgage interest tax credit, to which I refer, would be an incentive not only for savings and loan associations to continue investment in mortgages, but other financial institutions as well. The incentive would be made a function of interest on mortgages similar to the investment tax credit.

Senator BYRD. Can you translate tax reductions into greater housing, and how?

Mr. BIEDERMAN. Yes; I think you can, Mr. Chairman. As I mentioned, the tax reductions, just from the standpoint of the savings and loan industry alone, would result over a 10-year period in at least $100 billion in increased lending by savings and loan associations alone, using revenue estimates by the Treasury Department.

How this translates into housing depends on the average cost of housing, but it is a significant amount of money that we are talking about. In addition, Mr. Chairman, estimates which have been done by Professor Jaffeer, of Princeton, and others who have researched financial reform and the mortgage interest tax credit have shown that because it will increase the supply of funds into housing, it will have the impact of reducing mortgage interest rates anywhere from 25 to 50 basis points.

It has a 2-factor effect: It increases the supply of mortgage money which will have a positive impact of some amount on interest rates, in terms of lower interest rates, which I think is an improvement over the current tax.

Senator BYRD. Thank you, sir.

In that respect, Mr. Thygerson, am I correct that one of the major points of your analysis is that Federal deficits have adversely affected the housing industry by creating higher interest rates?

Mr. THYGERSON. I think that there is no question about that.

What we perceived over the last decade is the increased tendency during periods when inflation gets high to continue to run budgetary deficits. Thus the impact, the effect is, that monetary policy has to be much more strenuous, much more tighter as a way of moderating inflation and bringing the economy out of an overheated situation, so you have a tendency of getting much higher interest rates, much more volatility in the economy, much more certainty.

Similarly, as in the most recent cycle, we have put a tremendous amount of pressure on fiscal policy to bring us out of the recession.

In my estimation, if we had maintained the same monetary policy that we have maintained in the last 8 years but had registered much less in the way of budgetary deficits, we would have probably received the same recovery, but the mix of the recovery would have been much different. We would have had more plant and equipment spending, more housing spending. We would have had, in other words, a higher rate of GNP going to investment as opposed to consumption.

In the future, we would have had the prospect of a much faster rate of economic growth.

Senator BYRD. On a sounder basis?

Mr. THYGERSON. I think so.

Senator BYRD. In generalizing, what is the interest rate today?

Mr. THYGERSON. It tends to vary quite a bit from as high as 9 percent in California, which is a booming housing market today, to as low as 8.5 in a few cases in Florida which is a capital surplus area, as low as 8.25. On an average, it is about 8.5, 8.75 today for a 30-year conventional mortgage.

Mr. BIEDERMAN. It is interesting to note from the standpoint of capital constraints of which I was referring earlier, that these are regional. For example, the net worth to savings ratio in California is running about 7.3 percent. New York and New Jersey are close to 6 percent. In my own association, in our budgeting for next year, we had to take a very long look at our growth in assets and savings from the standpoint of net worth constraints.

We have reduced the inflow of savings into our association because of capital constraints, and we are not the only association that has done this.

Senator BYRD. In looking ahead 12 to 18 months, assuming no fundamental change in Government policy, would either of you care to forecast what the interest rate might be?

Mr. THYGERSON. Since it is partly my job to do that, we are really quite apprehensive over the outlook for 1978 as we move into the second half of 1978, and are pessimistic to the degree we are pessimistic is involved with the deficits that the budget committees have projected for 1979. That, together with the fact that monetary policy has been very stimulative over the last year with monetary growth rates of the broader-defined money supply in the double digit area of 11 to 12 percent, would suggest that if these policies are continued, the prospect for double digit inflation next year will be very high, and if that were to occur, I would not be at all surprised to see mortgage interest rates that are now in an 8.5, 8.75 level moving in the 10 to 10.5 area where usury ceilings do not prohibit that.

Senator BYRD. It is unfortunate, I think, that so many Members of Congress either are not aware of, or do not appreciate, those figures. Congress has just passed a budget proposal which calls for a $65 billion deficit in fiscal year 1978. That would be the second highest in history, second only to fiscal 1976 which was $66 billion.

I think that you have sized it up correctly. The danger is not going to come in 1977. The danger is going to come a year or maybe as much as 18 months, but more likely a year or 18 months from now; if we do not get the cumulative dificits under control, and I see no evidence that it is being done.

A great buildup has been given to this new budgetary system we have, and I admit that it is better than what we had before, but that is not saying much. It is also true that we have the biggest deficits in history under this new system.

The great problem with the new system is, as a few of us tried to point out when we went to it, is that there is no fiscal discipline involved. There is nothing in the legislation that requires Congress to discipline itself, and I always felt, whether it be an individual, a company or a government, that somewhere along the line there has got to be some discipline or some means of the individual, the company or the Government being disciplined, or we are all going to end up, in the long run, in a very bad situation.

I thank both of you for your testimony this morning and the committee will stand in recess until 9:30 Thursday morning.

[The prepared statements of Messrs. Thygerson and Biederman follow:]

STATEMENT OF DR. KENNETH THYGERSON ON BEHALF OF THE U.S. LEAGUE OF SAVINGS ASSOCIATIONS

Mr. Chairman: My name is Kenneth J. Thygerson, of Chicago, Illinois. I am Chief Economist and Director of the Economics Department for the United States League of Savings Associations*.

The U.S. League of Savings Associations appreciates this opportunity to discuss with you the broad subject of capital formation and, in particular, incentives for economic growth.

The savings and loan business is concerned primarly with the business of mortgage finance and the ability of our country to adequately house its citizens. Thus, in my comments before you this morning I would like to address specifically the types of incentives which are needed to encourage economic growth and at the same time assure the adequate supply of capital to house the American people.

NEED FOR GREATER CAPITAL FORMATION WELL KNOWN

During the recent Presidential and Congressional campaigns and more recently in testimony by officials of the Carter Administration, we have come to grasp the scope of the capital formation needs of our country. Five major national priorities have been outlined by the new Administration—full employment, inflation abatement, environment, energy, and housing, particularly the problem of rebuilding the central cities.

It goes without saying that the solution of each and every one of these problems will require enormous amounts of capital. Creating new jobs requires substantial investments in plant and equipment before a new worker can be put on the payroll. Inflation abatement will require enormous increases in plant capacity, food production, and energy production to insure an adequate supply of goods and services in response to the growing needs of our country. Solving the energy problem will require enormous capital inputs to increase the production of energy substitutes, as well as conservation efforts to decrease our reliance on oil and gas. Increasing coal output, solar energy, and nuclear energy will require mammoth inputs of capital, as does the conversion of business and industry and the consumer from today's limited energy sources to more abundant fuels or solar and wind devices. A clean environment also requires significant capital inputs. Reclaiming land, and cleaning the smoke from coal-burning furnaces are but two examples of the demands on our capital resources necessary to clean our country's environment.

Finally, revitalizing the housing stock of our urban areas and accommodating the housing needs for the household formations anticipated through the mid-

*The United States League of Savings Associations (formerly the United States Savings and Loan League) has a membership of 4,400 savings and loan associations, representing over 98 percent of the assets of the savings and loan business. League membership includes all types of associations—Federal and state-chartered, insured and uninsured, stock and mutual. The principal officers are: John Hardin, President, Rock Hill, South Carolina; Stuart Davis, Vice President, Beverly Hills, California; Lloyd Bowles, Legislative Chairman, Dallas, Texas; Norman Strunk, Executive Vice President, Chicago, Illinois; Arthur Edgeworth, Director—Washington Operations; and Glen Troop, Legislative Director. League headquarters are at 111 E. Wacker Drive, Chicago, Illinois 60601; and the Washington Office is located at 1709 New York Avenue, N.W., Washington, D.C. 20006; Telephone: (202) 785-9150.

1980's, as a result of the baby boom of the last 1940's and early 1950's, will require enormous capital inputs.

Thus, there is no need to belabor the well documented needs for greater capital formation in this country. Several years ago the New York Stock Exchange, The Brookings Institution, Data Resources, Inc., and the National Planning Association all completed extensive studies to answer the question of whether or not our country would face a capital shortage in the years ahead.[1] While the conclusions of these studies differ, each highlighted the role that the Federal Government must play in order to assure an adequate supply of capital. More specifically, each of these studies highlighted the role of fiscal policy, and the impact that budgetary deficits and the use of Government spending have on the ability of our country to generate adequate capital. Each of these studies, for example, assumed substantial declines in Federal budgetary deficits in the years from 1978 through 1984. One of the studies actually assumed a surplus in the Federal Budget beginning in 1980.

The key conclusion to be gained from these studies is that the Federal Government's fiscal policy and the composition of Federal expenditures will probably be the key factor in determining whether or not this country faces a severe capital shortage as it moves to solve the problems of employment, inflation, energy, housing, and environment.

In the few short minutes I have with you this morning, I would like to review the impact on the mortgage market and housing of the fiscal-monetary policy mix, the composition of Government spending, the use of tax expenditures, and the growth of Federal mortgage credit agencies. From this review, I will then develop a series of recommendations designed to encourage capital formation, economic growth, and assure an adequate housing stock.

FISCAL-MONETARY POLICY MIX

Because of the key role that fiscal policy plays in the ability of this country to generate capital, I'm including for the record an article entitled "National Fiscal Policy and Housing" written by Dennis J. Jacobe and myself a year ago and published in "Real Estate Issues" in the fall of 1976. This analysis reviews the role of fiscal policy over the last several decades in determining our country's ability to achieve one of our top social priorities—"* * * a decent home and a suitable living environment for every American family"—as directed by the 1949 Housing Act. This paper includes a review of the growth of Governmental spending and a study of the impact on housing of our Government's fiscal-monetary policy mix, Federal housing outlays, Federal tax expenditures, and Federal mortgage credit programs.

The paper shows that the primary way in which the nation's overall fiscal policy generally influences the economy is through the general level of prices and interest rates. Therefore, the availability of capital to finance housing depends to a large extent on the relationship of Government spending and taxation (i.e., fiscal policy, especially Federal Budget deficits or surplus) to monetary policies. These two economic tools are employed to achieve the overall economic objectives of eliminating the gap between aggregate demand and non-inflationary full employment levels of output. These policies influence the availability of mortage credit for savings and loan associations directly through their impact on the rate of inflation and level of interest rates.

A number of economists assume that it is possible to achieve the same overall production level in the economy with different combinations of fiscal and monetary policies—within some limits. The choice between the alternative monetary and fiscal policy mixes depends primarily on the formulation of many subsidiary economic goals or targets which are affected differently by the alternative fiscal-monetary policy mixes.

These subsidiary economic goals include such important national priorities as:

(1) the level of interest rates;

(2) the possible effects of the various fiscal-monetary policy mixes on the financial system;

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[1] See: Bosworth, Barry; Duesenberry, James; and Carron, Andrew. *Capital Needs in the Seventies* (Brookings Institution, 1975);

Dennis, Robert, *Investment in the Eighties* (National Planning Association Report No. 75-N-2);

New York Stock Exchange. *The Capital Needs and Savings Potential of the U.S. Economy: Projections through 1985* (New York, September 1974); and

Sinai, Allen; and Brinner, Roger E. *The Capital Shortage Near-Term Outlook and Long-Term Prospect* (Data Resources Economic Studies No. 18, 1975).

(3) the impact on our balance of payments;
(4) the effects on the long-term growth rate in the economy; and,
(5) the effects on housing production.

It is this last subsidiary goal that is most directly influenced by savings and loan associations.

The extent to which fiscal policy has contributed to instability in savings and loan operations and the availability of mortgage funds relates directly to the influence of the fiscal-monetary policy mix on the rate of inflation and level of interest rates.

A review of the last fifteen years suggests that Federal deficits are detrimental to savings and loan operations and housing under the following conditions. A very stimulative fiscal policy—characterized by large Federal deficits when we are in an economic upswing and approaching full employment—has resulted in a tendency to force monetary policy to bear too great a responsibility for slowing the growth of aggregate demand in the economy. Such policies are particularly detrimental to savings and loans and mortgage availability because monetary policy works through the credit markets causing interest rates to move to ever higher levels. During such periods tight monetary policy restricts the flow of funds into thrift institutions and substantially decreases the volume of mortgage credit.

This set of conditions—a large Federal deficit continuing long after full employment has been attained—occurred during the Vietnam War years of mid-1964 through mid-1968 and during late 1971 through 1972. In both these instances large Federal deficits contributed to rising inflation, ballooning credit demands, and the necessity for monetary policy to sharply restrict credit growth—both during, and in the months following these periods. This resulted in substantial deposit losses for savings and loan associations and a sharp restriction of mortgage funds in late 1969, as well as during the second half of 1973 and late 1974.

Fiscal policy also can be detrimental during periods of recession. This occurs when large Federal deficits, used to stimulate the economy, reach such levels that monetary policy is unable to ease commensurately to assure a satisfactory increase in money and credit growth. The best example of this situation relates to the large Federal deficits registered during fiscal years 1975 and 1976. During this period, the major burden to stimulate the economy was put on fiscal policy. As a result, the easing of monetary policy during this period was less successful in bringing down interest rates than if the Federal deficits were smaller.

There is a growing bias toward the use of fiscal policy to spur economic growth during recessions while at the same time placing heavy emphasis on monetary policy to slow the economy during periods of rising inflation and low unemployment rates. The increased tendency to do this during the last decade and one-half has been particularly detrimental to the savings and loan business and our nation's ability to maintain an adequate supply of mortgage capital. Relying primarily on fiscal policy rather than monetary policy to bring the economy out of recession has resulted in less savings being available to finance capital goods such as housing. It also has kept interest rates higher than would have been the case with a more balanced fiscal-monetary policy mix.

Similarly, during those periods when fiscal policy has remained in deficit long after the economy has reached full employment, the result has been demand-induced inflationary pressures. This has led to the eventual need for monetary policy to carry too great a burden in slowing down the economy in order to bring inflation under control.

This policy mix places an inordinate burden on the savings and loan business, since associations are unable to cope with the resulting inflation-induced high interest rates. During these periods, open market instruments such as Treasury securities attract money away from savings and loan associations and, therefore, impair the supply of mortgage credit.

Thus, Federal deficits which create these unstable economic conditions have made life almost intolerable for the nation's savings and loan associations at times during the last decade.

INFLATION AND CAPITAL FORMATION

The tendency of our Government to run larger and more frequent budgetary deficits has resulted in higher and more volatile inflation rates. This inflation problem really dramatizes the basic couse of our country's inability to generate adequate capital. High and unpredictable inflation rates stand as the single major enemy to generating greater savings and investment.

The individual who purchases a home and experiences a capital gain only finds that he has received an illusory increase in his wealth. Higher prices for all other goods and services have yielded him no increase in his price-adjusted wealth position.

Moreover, high and volatile rates of inflation, created by fiscal excesses, have resulted in consumer and business uncertainties. Each rise in inflation carries with it the seeds of an economic upheaval. The 1973–74 inflation experience resulted in the worst recession in the post-war period. The result has been greater uncertainty on the part of businessmen and consumers over the potential rewards of investment. Businessmen, worried that a new inflation spiral will occur, are unwilling to invest in new plant and equipment since they anticipate a recession. Consumers, anticipating additional price rises respond by "spending now" rather than "saving for future purchases." The result is less overall capital formation.

All this is compounded by the graduation of individual taxpayers into higher marginal tax rates—which further lessens the desire to save—where capital gains and ordinary income are subject to a bigger tax bite.

Inflation, then, created by fiscal budgetary excesses, remains the primary cause of our nation's capital dilemma.

COMPOSITION OF FEDERAL SPENDING

Another important way in which the Federal Budget directly impacts the capital markets and savings and loan associations is through the composition of Federal spending. The change in the composition of Federal spending is illustrated by the fact that national defense expenditures, which took 45% of national outlays in 1964, represented only 29% in 1974. By contrast, income security programs, which represented 21% of total outlays in 1964, represented a much greater 32% in 1974. This change in national priorities—apart from other considerations—represents, in economic terms, a shift in the orientation of the Federal Budget toward consumption and away from investment.

Expenditures on Federal highways, energy generating equipment, bridges, dams, space programs, and Government-sponsored solar energy research represent long-term investments. In each instance, these investments expenditures." Tax expenditures is a term used to account for those tax revenues which the Federal Government does not collect because income subject to tax is reduced by special provisions, credits, deductions, exclusions, or exemptions.

Housing must compete with other national priorities in the tax expenditure area. As a result, the success of housing in this competition also reveals its national priority status. During the last decade housing tax expenditures have been on an uptrend. Included in this area are the deductibility of mortgage interest and the deductibility of property tax. Tax expenditures for housing were estimated at $4.6 billion in 1967 or roughly 12% of total tax expenditures. By fiscal 1975, these tax expenditure estimates had increased to about 15% of total tax expenditures or roughly $11.9 billion.

This gradual rise indicates that one of the primary tools employed by the Federal Government to encourage homeownership has been through the use of tax expenditures. An analysis of these housing tax expenditures indicates that they represent one of the most successful means used by the Federal Government to encourage homeownership. Because of the success of these tax expenditures, the United States today has one of the highest percentages of homeownership of any country in the world.

FEDERAL MORTGAGE CREDIT PROGRAMS

A fourth impact of the Federal Government on the availability of credit for housing is through their promotion of mortgage credit agencies expenditures." Tax expenditures is a term used to account for those tax revenues which the Federal Government does not collect because income subject to tax is reduced by special provisions, credits, deductions, exclusions, or exemptions.

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FEDERAL MORTGAGE CREDIT PROGRAMS

A fourth impact of the Federal Government on the availability of credit for housing is through their promotion of mortgage credit agencies to support housing finance. During the last decade, the Federal Government has significantly altered the structure of the mortgage market through the encouragement of Federally-sponsored-credit agencies such as the Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, Government National Mortgage Association, and Farmers Home Administration. These credit agencies have substantially altered the flow of funds from the savings markets to the mortgage investment markets.

As part of this testimony, I would appreciate including a recent paper to be presented to the American Real Estate Urban Economics Association entitled "Federal Secondary Market Programs: Impact on Specialized Mortgage Lenders." This paper, by Dennis J. Jacobe and myself, reviews the impact of these credit programs on facilitating investment in home mortgages. The analysis indicates that Federal credit programs have acted primarily as substitutes for private mortgage credit. As Federal credit agencies have grown, private mortgage lenders have lessened their mortgage lending activities by nearly an equal amount.

This review suggests that the Federal credit agency approach to meeting the capital needs in the housing market is one of the least efficient mechanisms available to the Federal Government.

CAPITAL GROWTH IN HOUSING

The discussion of the impact of inflation on savings and investment is particularly evident in the housing market.

This problem has its greatest impact on the first-time homebuyer. The Congressional Budget Office study entitled "Homeownership: The Changing Relationship of Costs and Incomes, and Possible Federal Roles" emphasizes this finding.

The inflexibility in the form of the mortgage document which calls for full amortization at fixed monthly payments has put a growing burden on the first time homebuyers. In addition, the difficulty in saving the downpayment which rises constantly as home prices increase also inhibits the ability of the first time buyer to purchase a home. For these reasons, the U.S. League supported in recent testimony before the Senate Banking Committee Senator Edward Brooke's "Young Families Housing Act", S. 664.

Of particular interest to this discussion is the Individual Housing Account portion of S. 664. (As a tax law change analogous to the Individual Retirement Account, it falls within the jurisdiction of your parent Finance Committee.)

The IHA works to correct a major hurdle of the first time homebuyer—namely, the initial downpayment requirement. As home prices have increased, so have the necessary downpayments. Even if a household is able to support the monthly payment on a mortgage, it may not have saved enough to meet the ncessary downpayment. Thus, young families are precluded from entering today's home market. The Individual Housing Account provision in S. 664 will ameliorate the problem of many households in attempting to save the necessary downpayment for a new home purchase.

As an economic matter, our country's Federal tax system acts as a disincentive to savings. In order to acquire a downpayment, the household must first have enough after-tax dollars to put away in a savings account and then must suffer the consequences of having to pay taxes on interest accrued to those accounts. The IHA successfully eliminates both of these disincentives. First, it provides a deduction of up to $2500 per year on the amount of funds set aside for the Individual Housing Account. Thus, the household is encouraged to save because the amount of such savings comes out of pre-tax dollars rather than after-tax dollars. The incentive is increased further by eliminating the tax on interest credited to funds set aside in the Individual Housing Accounts.

This provision in S. 664 allowing for a buildup of up to 10,000 over 120 months seems to be sufficient to allow most potential new homebuyers to acquire a downpayment sufficient to acquire homes at the average home price in our country.

Importantly, the impact on Treasury revenues is minimized by limiting the IHA to first-time home purchasers.

ENERGY CONSERVATION

Housing, new and existing, also will play a large role in our nation's ability to successfully implement our nation's energy conservation goals. As outlined in President Carter's energy program, additional capital resources will be needed to assure that newly-built homes are more energy-efficient, as well as to retrofit existing homes with energy-saving materials and systems.

The Carter program calls for tax incentives to homeowners who add insulation and invest in solar energy systems, for example. Although the use of the tax system to provide subsidies and incentives has been frequently criticized, it is clear that such incentives do work in many cases, as with the tax incentives to achieve homeownership. Moreover, the tax incentive system is preferable to establishing a bureaucracy to administer direct subsidies or other alternatives which restrict individual choice.

The need for energy conservation and development of alternative energy sources points up the need to expand the sources of capital for these needs. One approach would be the expansion of savings and loan lending powers to include investments in utilities, increases in home improvement lending limits to encourage lending on energy conservation improvements, and greater mortgage instrument flexibility to service existing borrowers desirous of retrofitting their home.

CONCLUDING RECOMMENDATIONS

From our review of the impact of fiscal policy and credit programs on the ability of our country to generate adequate capital to meet our housing needs we can conclude and recommend the following actions:

First, it seems clear that the tendency of the Federal Government to run budgetary deficits long after the economy is on the road to recovery has put an enormous burden on monetary policy to control inflation.

The trends of the last decade suggest that housing capital has been restricted as a result of the increased tendency to emphasize monetary policy more heavily than fiscal during deflationary phases of stabilization policy, and fiscal policy more heavily during expansionary phases. Both tendencies are generally disadvantageous to capital formation and a strong housing market.

Fiscal imbalance is also the primary cause of ever higher rates of inflation and economic uncertainty. The more frequent presence of budgetary deficits stands as our nation's major hurdle to achieving greater rates of capital formation and faster rates of economic growth.

In this respect, we agree with the statement in the report entitled Task Force on Capital Formation which reads, ". . . the surest way to increase total savings through tax policies is to increase the Federal budget surplus (or reduce the deficit) in periods of high employment."

It is suggested that every effort bbe made to achieve President Carter's goal to balance the Federal Budget by 1981.

Second, it was shown that the increasing consumption-orientation of Federal expenditures has also been deterimental to capital formation generally, and to housing in particular. The implications of the consumption-orientation of the Federal Government to the nation as a whole can be derived from the fact that housing is an investment good. As immediate consumption increases, as a result of fiscal stimulus, the resources available for investment become more limited and the competition for them more intense. Recent history indicates that housing does not do well as the intensity of competition for funds in the credit markets escalates.

Every effort should be made to review the overall allocation of Government spending to strike a more favorable balance between consumption and investment-oriented expenditures. The increased allocation of Government spending to consumption stimulus should be reversed.

Third, our analysis of Federal tax expenditures indicates that these means are the most favorable for capital formation in housing.

The tax deductibility of mortgage interest and real estate taxes for owner-occupied housing should be maintained in order to assure that our country continues to achieve its enviable position as a nation of homeowners.

Fourth, our study of mortgage credit programs indicates that they are of more limited usefulness in garnering funds for housing. The activities of the major mortgage credit agencies have been shown to merely reallocate the investment in mortgages from private lenders to Government agencies, with no real increase in capital formation. The exceptions to this are the Federal Home Loan Banks which act as a liquidity reserve for savings and loans—thus enabling associations to maintain a very high percentage of assets in mortgages.

We feel that less emphasis should be placed on Federal credit programs, generally, as a solution to capital shortage problems.

Fifth, we recommend that special savings incentives be created for the most victimized segment of the home-buying market—the first-time homebuyer.

S. 664, which provides for establishment of Individual Housing Accounts, has great merit for solving the specific problem of the first-time homebuyer. We strongly urge your consideration of this approach.

The U.S. League of Savings Associations has appreciated this opportunity to present its views to your Subcommittee on these issues of such vital importance to our nation's future economic health. I look forward to your questions.

STATEMENT OF KENNETH R. BIEDERMAN ON BEHALF OF THE NATIONAL SAVINGS AND LOAN LEAGUE

Mr. Chairman and members of the Committee, my name is Kenneth R. Biederman. I am Senior Vice President and Chief Economist of City Federal Savings and Loan Association of Elizabeth, New Jersey, and was formerly consultant to the National Savings and Loan League in the area of federal taxation while a member of the economics faculty at Georgetown University.

I am appearing on behalf of the National League, a nationwide trade organization for savings and loan associations.

The National League appreciates the opportunity to comment today on the broad questions of tax policy, capital adequacy, and capital formation. Although our comments will be primarily relegated to these issues as they relate to the savings and loan industry, I would like to preface my remarks with a few general comments on the question of capital formation and capital adequacy in the U.S. economy. Technically, the notion of a capital shortage in a market economy is a misnomer in that markets allocate capital at market determined prices, differentiating according to elements of risk and timing. Prices rise during periods of excess capital demand in any given market and fall during periods of capital surplus resulting in an equilibrium allocation of capital in both a physical and financial sense. However, within and between markets there are winners and losers, and often undesirable allocative, distributional, and macro-economic effects. It is not only within the context of temporary market disequilibria that the phenomenon of capital "shortages", or inadequacies, arise.

Macro-related shortages result when the economy experiences less than full utilization of resources due to insufficient private and/or public investment demand. Others who have testified here today, and previously, before this Committee have stressed this notion of capital inadequacy within the context of a less than full employment economy.

Capital inadequacies arise in an allocative sense through both sectoral and regional shortages. For example, an economy can experience insufficient low-cost housing due to a lack of adequate mortgage funds for such housing. It can experience insufficient investment in energy-related areas such as oil and natural gas due to regulatory restrictions on the return to investment. In a regional sense, we currently see capital shortages for housing on the West Coast relative to that in the Northeast. This is reflected in disparities in rates on conventional mortgages of as much as from 75 to 100 basis points between West Coast markets and East Coast markets.

Distributional inadequacies occur when there is excess reliance on debt financing versus equity capital, insufficient private investment, and insufficient capital funds brought on by systems which discriminate against low and middle income savers versus wealthy savers.

Under free-flowing competitive market structures, macro and many allocative shortages or inadequacies would not exist. Imperfect markets, price-wage rigidities, regulation, and taxation do bring about factor shortages and inadequacies with undesirable macro, allocative, and distributional effects. Herein lies the nature of the "capital problem" in the U.S. economy and such problems must be discussed not only on the level of the national economy but within the context of special and industrial considerations.

Turning specifically to the savings and loan industry, the following questions arise:

1. What are the capital needs and requirements of the savings and loan industry?

2. Is there now or is there likely to be over the next decade a "capital shortage" or inadequate capital supply for the savings and loan industry within the context of these needs and requirements?

3. What can be done to improve upon the capital needs of the industry within the context of the issues raised above?

Basically, financial capital (or in the case of the savings and loan industry, net worth) serves three broad-based functions in the financial industry:

1. It helps protect depositors and investors against financial loss;

2. It provides stability within the financial system in order to withstand financial (asset value) loss;

3. It constrains growth in assets and in asset groups. The latter is accomplished both through market constraints on the raising of funds and additional capital, and through regulation.

A savings and loan association must meet a "net worth" (capital adequacy) test each year at the end of that calendar year. The test is a two-factor test and requires that the association must satisfy the greater of:

1. The Federal Insurance Reserve (FIR) plus 20% of scheduled items (which are essentially slow and foreclosed loans). The Federal Insurance Reserve (net worth less accumulated surplus) must equal 5% of savings capital either as of the end of the calendar year or based upon a five-year, end-of-year, moving average. Under the FIR requirement, an association must at least one time in the first twenty-five years of its operation reach an FIR reserve equal to 5% of the ending balance of any given year. Prior to the end of the first twenty years of operation, an association uses a sliding scale FIR with requirements being less than 5% of savings.

2. The sum of certain asset balances times percentages which are assigned to these balances to measure relative asset risk. In addition under this test there are certain reserve requirements against secured borrowings over one year from sources other than the Federal Home Loan Bank system and other designated lenders.

Failure of an association to meet either the asset or the FIR tests can result in regulatory pressure to satisfy these requirements by such methods as:

1. Force the association to reduce the earnings which it pays on savings accounts;

2. Force the association to "shut down" its savings window, thereby restricting growth;

3. Limit the lending of the association in certain categories and/or reshuffle its assets in order to meet the net worth tests;

4. Increase liquidity.

Of these two tests, the FIR has proven to be the most restrictive.

Thus, the constraints which are tied to the net worth (capital) of an association can restrict the association from growing and from carrying out its primary responsibility, which is the financing of home ownership. This is not to quibble with the regulation or the need for such regulatory constraints—this is simply a statement of fact.

Turning to the question as to whether there is a capital adequacy problem in the savings and loan industry, I refer the Committee to Table 1. This table shows the distribution of savings and loan associations by net worth-to-savings capital ratios as of year-end 1975, and year-end 1976. These ratios were determined for virtually all insured savings and loan associations and were prepared by the

Office of Economic Research, Federal Home Loan Bank Board, Washington, D.C. The data show a disturbing trend to which managing officers in the industry are becoming increasingly aware but to which perhaps many policy-makers and analysts outside of the industry are not. As shown in Table 1, 862 associations, or nearly 21% of the total insured, had net worth-to-savings capital ratios below 5% as of year-end 1975. These associations held savings capital of $43 billion, constituting over 15% of all savings capital outstanding in the industry.

TABLE 1.—INSURED SAVINGS AND LOAN ASSOCIATIONS CLASSIFIED BY RATIO OF NET WORTH-TO-SAVINGS HELD AT YEAREND, 1975-76[1]

	Number of associations				Savings capital held			
	Number		Percent of total		Amount (millions)		Percent of total	
Net worth/savings ratio (percent)	1975	1976	1975	1976	1975	1976	1957	1976
Greater than 7 but less than 8	1,873	1,628	46.3	40.5	$122,142	$112,311	44.0	34.3
Greater than 6 but less than 7	646	663	16.0	16.5	55,993	79,045	20.2	24.2
Greater than 5 but less than 6	669	756	16.5	18.8	56,573	71,386	20.4	21.9
Greater than 4 but less than 5	478	555	11.8	13.8	30,918	46,309	11.1	14.2
Greater than 3 but less than 4	212	238	5.2	5.9	8,722	13,321	3.1	4.1
Less than 3	172	182	4.2	4.5	3,324	4,317	1.2	1.3
Total	4,050	4,022	100.0	100.0	277,672	326,689	100.0	100.0

[1] Statistical Division, Office of Economic Research, Federal Home Loan Bank Board, Washington, D.C.

By year-end 1976, 975 associations had net worth-to-savings ratios below the 5% minimum, constituting over 24% of all associations. Combined they hold $64 billion of savings capital which at year-end 1976 represented nearly 20% of all savings capital in the industry. This represents a 13% increase in one year of the number of associations whose net worth-to-savings captial ratios were below the 5% FIR requirement with the amount of savings capital held by such "capital short" associations increasing over 46% in one year.

Those associations whose net worth-to-savings capital ratios are between 5 and 6%, although above the 5% minimum, nonetheless are at a worrysome level from the standpoint of future regulatory capital requirements. Such concerns from a management standpoint are likely to induce actions to restrict growth. In 1976, 43% of all insured savings and loan associations had net worth-to-savings ratios less than 6% compared to 37% in 1975. These associations held 42% of savings capital outstanding as of year-end 1976 compared to 36% at year-end 1975.

One concludes from the data as presented in Table 1 that whereas only a small number of associations have as of yet been unable to meet the 5% FIR requirement because of the five-year averaging technique and because of preventive actions on the part of associations, capital adequacy from the standpoint of meeting future FIR requirements is unquestionably a matter of concern for a growing number of savings and loan associations. This concern must impact management decision and will result in restrictions on growth and mortgage lending, a phenomenon not uncommon in the industry even today.

As to the nature and extent of the capital needs and requirements of the savings and loan industry over the next decade, it is important that first we briefly review the financial nature of the savings and loan industry. Widespread home ownership is at the heart of the American society, and the savings and loan industry is at the heart of home ownership. According to the 1970 census, nearly 40 million homes, or 63% of all residential units, were owner-occupied. Data since that time would suggest that this ratio is presently even higher. As shown in Table 2, mortage lending activity on one-to-four family homes is dominated by the savings and loan industry with the extent of these holdings having steadily increased over the past twenty-five years. The savings and loan industry's $225 billion of such loans at year-end 1975 accounted for over 50% of all such loans outstanding by all lenders. Although this degree of market domination does not hold in the case of multifamily residential dwellings, nonetheless, savings and loan associations are the largest holders of mortgages on multifamily residential properties with a market share which also has been increasing over the past twenty-five years. By comparison, commercial bank year-end holdings in 1975 of one-to-four family home mortgages were 17% of the total market, close to the share held by banks in the mid-50's. Life insurance companies have held a decreasing percentage of one-to-four family home loans, with their current 4% share down from a 20% share in the 1950's. On the other hand, life insurance companies maintain a relatively strong position as to mortgages on multifamily dwellings with a market share of nearly 20%, a position which they have more or less maintained over the past twenty-five years.

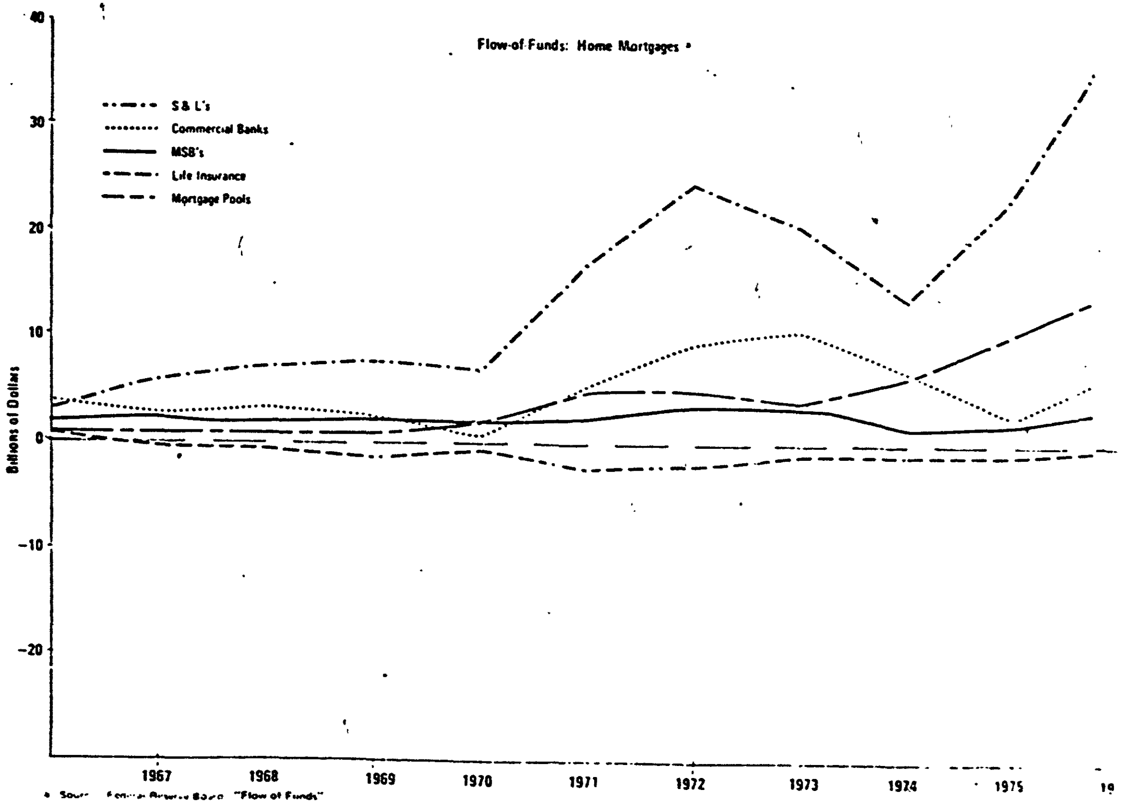
TABLE 2.—HOLDINGS OF RESIDENTIAL MORTGAGE DEBT OUTSTANDING BY SAVINGS AND LOAN ASSOCIATIONS AS A PERCENT OF TOTAL [1]

	1-4 family nonfarm homes [2]	Multifamily residential [2]	Total residential [2]
Year:			
1950	29.0	2.0	24.0
1955	34.0	4.2	29.8
1960	39.2	10.8	35.6
1965	44.2	21.8	40.9
1970	44.6	23.8	41.1
1971	46.2	25.8	42.7
1972	48.4	27.1	44.5
1973	48.8	26.3	44.7
1974	49.0	25.8	44.8
1975	50.1	26.6	46.3

[1] U.S. League of Savings Associations, 1976 Savings and Loan Fact Book; Federal Reserve Board, Flow-of-Funds.
[2] Figures represent saving and loan holdings as a percent of total for each category.

Chart 1 provides a perspective of mortgage lending activity over the past decade by all major intermediaries in the home mortgage area as measured by flow-of-funds data. Since 1974, net lending activity by savings and loans in the home mortgage area has climbed from a recession low of nearly $14 billion in 1974, to an annualized rate of slightly over $35 billion in 1976, an all-time high by any intermediary at any time. Although commercial banks have recently shown a renewed interest in home mortgage lending, they still do not provide a source of funds for home mortgages anywhere near that of mortgage bankers and savings and loan associations. The presence of mutual savings banks has diminished to minuscule proportions in the home mortgage area whereas the posture of life insurance companies of divesting their holdings of home mortgages (which began back in the 1960's) has continued throughout the current decade.

Within the savings and loan industry, the residential mortgage is overwhelmingly dominant in the asset structure and (for historical and regulatory reasons) has guided the fortunes (and misfortunes) of the industry. Currently, mortgage loans constitute 82% of the assets of savings and loan associations. Thus, it can be seen that linked to the question of capital adequacy in the savings and loan industry are the broader issues of financing residential mortgage debt and meeting the housing needs of the United States over the next decade.



* Sour... Federal Reserve Board "Flow of Funds"

As to the extent of the capital requirements which will be facing the savings and loan industry into the mid 1980's, Table 3 provides some figures on the long-range forecast of total residential mortgage debt outstanding and of housing starts, on an annual basis, from 1977 through 1985. The reason for presenting these figures is to develop a feel as to the mortgage financing requirements which lie ahead. As shown in Table 3, the long-range forecast calls for a change in residential mortgage loans outstanding of some $340 billion over the five years ending 1980 and $900 billion over the decade ending in 1985.

During the period 1970–75, savings and loan associations financed 55% of the $200 billion increase in residential debt which occurred. This has been a growing percentage—in 1975, S&Ls financed nearly 70% of new residential mortgage debt. So, if we make the conservative assumption that savings and loan associations will maintain a 55% share of the new residential mortgage debt financed over the next decade, then S&Ls will need to finance around $190 billion of residential mortgage loans by 1980, and nearly $500 billion by 1985.

Historically, the ratio of mortage loans to assets for savings and loan associations has been in the 80 to 85% range, as has savings capital to assets. Assuming that the ratio of savings to mortgage loans remains constant throughout the next decade, then savings capital in S&Ls will need to grow by $190–$200 billion by 1980, and between $490–$500 billion by 1985. Accordingly, net worth in the industry will have to grow by $9.5 billion by 1980 in order to match the 5% FIR requirement, and would have to grow by $25 billion by 1985 for the same reason. Given an ending net worth balance of $19.7 billion in 1975 for all operating savings and loan associations, this would mean a 48% growth in net worth by 1980 over 1975, and a 127% growth in net worth over the decade ending in 1985. These figures translate into average annualized growth rates in net worth of 8.2% and 8.5%, respectively.

TABLE 3.—LONG-RANGE FORECAST OF TOTAL RESIDENTIAL MORTGAGE DEBT OUTSTANDING, AND OF HOUSING STARTS, 1977–85[1]

	Residential mortgage debt outstanding (billions)	Housing starts (millions of units)
Year:		
1977	$705	1.842
1978	776	1.87[illegible]
1979	847	1.831
1980	920	2.032
1981	1,014	2.171
1982	1,112	2.199
1983	1,224	2.231
1984	1,347	2.326
1985	1,481	2.358

[1] Data Resources, Inc., U.S. Long-Term Bulletin, Winter, 1976, table 11.7.

Note: Residential mortgage debt outstanding in 1975 was $579,000,000,000.

Assuming these are reflective of the net worth (capital) requirements of the savings and loan industry over the next decade, then two questions arise:

1. Are these net worth (capital) growth requirements reasonable?
2. Would such a growth in net worth be sufficient?

As to question 1, Table 4 presents the annual change in net worth, and the profit rate, for savings and loan associations from 1955 to 1976. Over the first ten years covered by these figures, net worth in the industry experienced an annual rate of increase of 13%, and an average profit rate of .88%. During the ten-year period ending in 1976, net worth increased at an annual rate of only 8.5% with a corresponding average annual profit rate of .54%. By comparison, the average annual return on net worth of the Fortune 500 industrials was 11.2% from 1956-1965, and 11.8% from 1966-1975. During the decade ending in 1975, the rate of change in return on year-end equity increased 7.9% relative to the previous decade ending in 1965 for the Dow Jones Industrials, and by 5.4% for the Fortune 500. For savings and loan associations, their rate of change in net worth has decreased 25% in the decade 1966–1975 relative to 1956–1965. As is documented and stressed in the ensuing tables and charts, this significant deterioration in the net worth position of S&Ls can be almost entirely attributed to changes in their federal tax treatment.

Off-hand, it would not seem unreasonable that the industry could maintain an 8.2% annual growth rate in net worth through 1980. However, if this growth rate is not exceeded, then it is questionable whether the 1985 net worth goals could be reached since the annual rate of increase in net worth from 1980 to 1985 would have to be nearly 9%.

TABLE 4.—ANNUAL RATE OF CHANGE IN NET WORTH, AND PROFIT RATE; SAVINGS AND LOAN ASSOCIATIONS, 1955–76 [1]

[In percent]

	Annual change in net worth	Profit rate [2]
Year:		
1955	16.9	0.98
1956	15.4	.92
1957	14.0	.86
1958	14.3	.87
1959	14.3	.86
1960	13.4	.83
1961	14.6	.88
1962	14.2	.87
1963	10.6	.64
1964	9.6	.58
1965	10.2	.62
1966	8.5	.45
1967	5.0	.31
1968	7.8	.51
1969	8.7	.57
1970	6.8	.44
1971	10.0	.58
1972	12.3	.68
1973	12.1	.67
1974	8.2	.47
1975	7.2	.40
1976	11.5	.58
Annual rate of increase:		
1955–65	13.0	.88
1966–76	8.5	.54

[1] FHLBB reports.
[2] Additions to net worth/assets.

In addition, there are tax considerations which may further restrict the industry from achieving these net worth growth rates which would be necessary to meet the mortgage debt financing needs referenced in Table 3. Over the ten-year period 1966 to 1975, the average federal tax burden on savings and loan associations was 20.5%. Assuming that the legislated increase in the minimum tax from 10 to 15% occurs in 1978 and that there are no further changes in the federal tax treatment of savings and loan associations thereafter, the federal tax burden of savings and loan associations will average from 26–30% during 1976–1985. Thus, for tax reasons alone, pretax income of savings and loan associations over the period 1976 to 1985 will be reduced, on average, by an additional 6% relative to the period 1966 to 1975. Put another way, if the growth in pretax income were to average the same during 1976 to 1985 as it did from 1966 to 1975, then the growth in after-tax income (net worth) would be about 92% of that in the period 1966 to 1976 due to the higher burden of federal taxes. Thus, pretax income is going to have to grow 8 to 9% faster in the period 1976 to 1985 in order that net worth may grow at the same 8½% rate from 1976 to 1985 as it did from 1966 to 1975.

Assuming that the industry under the existing tax laws were able to achieve an annual rate of growth in net worth of 8½% through 1985, is this sufficient? Recall that the net worth (capital) requirements as set forth above were derived from long-range forecasts of changes in residential mortgage debt. As such, the data in Table 3 say nothing about whether these changes in residential mortgage debt outstanding are commensurate with a desired level of housing and housing finance. Table 3 shows the level of housing starts for each of the ten years which were assumed behind the corresponding levels of residential mortgage debt outstanding. The starts average between 2.07 and 2.09 million units per year.

In a study prepared by the Joint Center for Urban Studies of MIT and Harvard University on the Nation's housing needs over the period 1975 to 1985, a level of housing starts in the range of 2.0 to 2.3 million units per year is projected as necessary in order to meet the basic housing needs of the United States over this decade. Quoting from the study:

"But to meet the country's basic needs for additional housing will still require, on the average, annual production of 2.0 to 2.3 million units per year between 1975 and 19.5. These production levels . . . are a benchmark for establishing a minimum desirable level of housing production to meet middle income market demand. To improve housing conditions for the disadvantaged will require additional measures to help people unable to pay for decent housing, new or old, at market prices." [1]

The net worth calculations above are based upon the assumption of financing a level of housing starts which would be at the lower end of what the Joint Center study has established as the minimum growth in housing starts necessary to finance the basic housing needs of this Nation over the next ten years. In addition, the Joint Center has estimated that as of 1973, there were some 12–16 million existing units of inadequate housing in the United States (see Table 5). Of these, 7 million units were due to physically inadequate and overcrowded housing with the remainder due to excessive rent burdens and inadequate public services.

TABLE 5

Total Housing Deprivation, 1973 [1]

Type of deprivation (nonoverlapping categories)	*Households (in millions)*
Households in physically inadequate units	6.3
Overcrowded households in physically adequate units	0.5
Nonovercrowded households in physically adequate units with high rent burden	6.0
Households in physically adequate units, not overcrowded, without high rent burden, wanting to move because of inadequate public services or objectionable street conditions [2]	4.0
Total households with one or more forms of housing deprivation [3]	16.8
All U.S. households	69.3

[1] Source: Joint Center for Urban Studies, MIT-Harvard, The Nation's Housing: 1975–85, p. 95; tape of the 1973 Annual Housing Survey provided by the U.S. Bureau of the Census.
[2] Public services reported were: public transportation, schools, and neighborhood shopping. Street conditions reported were: street noise; airplane noise; heavy traffic; odors, smoke, or gas; trash or litter in the streets, on empty lots, or on properties; abandoned structures; run-down housing; commercial, industrial, or other nonesidential activities; streets continually in need of repair; inadequate street lighting; street or neighborhood crime.
[3] Households with annual incomes a.. e $11,400 excluded from table.

Given this, assume that savings and loan associations were to finance 50% of the replacement of the existing housing inadequacy over the next ten years; that is, to finance an additional 350,000 units per year over and above the housing start forecasts set forth in Table 3. Since presumably these would be below-average units in terms of quality and cost, assume further that the average cost of these units is set at 75% of the average costs of such construction in 1975 and that these units would increase in cost at an average rate of 7% per year. Assume further that savings and loan associations would finance 80% of the total cost of such units. Thus, the added financing requirements on S&Ls of replacing substandard housing in the United States over the next ten years would be around $115 billion by 1985. By the analysis developed previously, this would imply added net worth requirements for S&Ls over and above those derived above of $5.75 billion by 1985. This would mean a growth in net worth of 156% by 1985 (over 1975), or an average annual rate of growth in net worth for the industry of nearly 10%. Such growth demands on net worth would be quite high under existing tax-regulatory structures, particularly in light of higher taxes which are to be imposed on savings and loan associations in 1978 and 1979.

In conclusion of this section:

[1] Joint Center for Urban Studies of MIT and Harvard University, The Nation's Housing: 1975–1985, pp. 140, 141.

1. The savings and loan industry over the next ten years will find it increasingly difficult to finance the level of home mortgage debt at rates which it has over the first half of this decade; and accordingly,

2. Under the existing tax and regulatory framework, it is unlikely, unless the savings and loan industry were able to enjoy an unbroken period of above-average earnings, that it will be able to finance at present share levels a rate of housing growth at a level that housing experts say is necessary in order to meet the Nation's basic needs for additional housing over the next decade. *At best under these constraints,* the savings and loan industry cannot be expected to provide housing finance much beyond these basic levels.

We now turn to the final question which was posed earlier; that is, given that there exists a capital adequacy problem facing the savings and loan industry, and given that net worth limitations on growth are likely to continue and perhaps grow worse in the future, what can be done to improve upon the capital needs of the industry? Outside of methods which associations themselves might use to increase capital, such as conversion, there are three possible approaches to the problem.

1. The most direct approach would be to change the regulatory restrictions on the capital requirements of savings and loan associations but such a solution first of all is not germane to this committee, which is basically a tax-writing committee; and, second, such considerations are tied into risk and depositor—safety issues which should be dealt with independently.

2. A second approach would be to admit to the growth-net worth constraints as they are and are likely to be on the savings and loan industry and attempt to fill the gap between residential mortgage debt demand and residential mortgage debt supply through increased public housing programs in lieu of private funding. The Budget for FY 1978 calls for some $30 billion in direct, indirect, and off-budget expenditures by the federal government in the housing area. There is considerable debate as to the efficiency of these programs and the desirability of increased intervention of the public sector in the housing area. Within the context of this debate, it is perhaps useful to point out that a $1.00 reduction in the tax burden of a savings and loan association will increase that association's net worth by a corresponding dollar, which under existing capital requirements can support $20.00 of mortgage debt financing. By comparison, that same tax dollar which goes into public coffers can only support $1.00 of direct government expenditure housing programs. In terms of funds directed toward mortgage finance, the former tax-expenditure approach is more efficient.

3. As indicated in Chart 2, and as supported in Table 4, a good portion of the problem of capital-related constraints on growth in the savings and loan industry have been brought on through changes in the federal tax treatment of thrift institutions. Correspondingly, one can look for relief from these problems in the same area, particularly if the results would be a relatively efficient achievement of socially desirable goals, which I submit would be the case.

Profit Rate[1] and Effective Federal Income Tax Rate
All Insured Savings and Loan Associations, 1960-1975

[1] Additions to net worth over total assets

CHART 2

Prior to the Revenue Act of 1951, savings and loan associations and mutual savings banks were exempt from federal income taxation under the premise that since these institutions play an important role in the high national priority of financing residential construction, they should be exempt from taxation. As predominantly mutual organizations, S&Ls more closely resembled non-profit operations, like credit unions, than profit-oriented stock associations, such as commercial banks, which further merited this preferential treatment in the eyes of the Congress. With the continued growth of the industry and associated cries of tax equity and "fair-share" payments by the commercial banking system, Congress terminated in the Revenue Act of 1951 the tax-exempt status of thrift institutions. The provisions of this initial tax bill, however, were so lenient that for all intents and purposes federal income taxation of savings institutions remained virtually non-existent until the Revenue Act of 1962.

With the passage of this Act, Congress legislated major changes in the tax treatment of savings and loan associations. The significance of these changes is apparent from the quantum leap between 1962 and 1963 in the federal income tax burden of the savings and loan industry, (Table 6), and the significant drop thereafter in the growth in net worth (Table 4). The Revenue Act of 1962 primarily impacted the savings and loan industry, leaving mutual savings banks virtually untouched. Nonetheless, S&Ls were permitted under this act to deduct up to 60% of their net income for additions to reserves against bad debts, a deduction which permitted net income to be reduced by 15% to 16% as a consequence of federal taxation.

TABLE 6.—RATES OF FEDERAL INCOME TAX AS PERCENT OF ECONOMIC INCOME, UNADJUSTED:[1] MUTUAL SAVINGS BANKS, SAVINGS AND LOAN ASSOCIATIONS, AND COMMERCIAL BANKS, 1975-76[2]

	(1) Commercial banks	(2) S & L's	(3) MSB's
Year:			
1955	34.2	1.6	1.4
1956	33.8	1.7	.9
1957	38.3	1.5	.6
1958	36.0	1.6	.8
1959	34.2	1.2	.6
1960	37.8	1.0	.7
1961	35.6	.8	.6
1962	33.3	.9	1.1
1963	30.6	16.0	2.2
1964	28.2	14.8	2.7
1965	23.3	15.2	3.4
1966	23.2	16.9	5.6
1967	22.2	13.0	4.7
1968	22.4	18.5	6.2
1969	21.3	15.5	6.4
1970	23.5	18.9	13.2
1971	20.9	21.5	15.7
1972	17.9	23.5	18.5
1973	16.1	24.7	19.3
1974	15.5	26.4	20.3
1975	14.3	25.7	15.4
1976	14.0	25.6	NA

[1] Unadjusted for consideration of regulatory differences.
[2] Internal Revenue Service, Statistics of Income (Source Book); Federal Home Loan Bank Board, Combined Financial Statements; FDIC, Annual Reports.

The second major change in the federal taxation of savings and loan associations occurred in the Tax Reform Act of 1969. This Act reduced the deduction permitted for addition to reserves for bad debts from a 60% level in 1969 to a 40% level in 1979. The current deduction (1977) is 42% of taxable income.

In addition to legislated increases and added restrictions built into corporate tax treatment of thrift institutions by the Tax Reform Act of 1969, a sort of "piggyback" tax on the regular tax was also introduced—the minimum tax. Up until the Tax Act of 1976, this tax was a flat 10% rate applied to the sum of certain tax preference items excluded from the regular income tax, less a $30,000 exemption per taxpayer plus regular income taxes paid net of all credits. The bad debt deduction permitted thrift institutions is among the preference items subject to the minimum tax although not all tax-exempt and deferred-income items are so included. Under the provisions of the Tax Act of 1976, the minimum tax for corporate taxpayers is increased from 10% to 15%, with reductions in the $30,000 exemption. For financial institutions, these provisions become effective in 1978 and for many associations, this again will represent a sizable increase in their federal tax burdens.

As can be seen from Table 6, the upshot of all this tax activity since 1951 is that the federal taxes for savings and loan associations have increased from 1% of their economic income in 1962 and earlier, to 16% in 1969, to an effective rate which for many associations is approaching 30% in the current year. In a matter of some 15 years, the savings and loan industry as a whole has experienced a 25 to 30 fold increase in its effective federal tax burden. The importance of this phenomenon from the standpoint of capital sufficiency in the savings and loan industry is brought out in Chart 2 and Tables 6 and 7 which evidence the relation of rising tax burdens and a falling net worth position.

TABLE 7.—NET WORTH HISTORY OF ALL SAVINGS AND LOAN ASSOCIATIONS FROM 1950 THROUGH 1975 ASSUMING 3 ALTERNATIVE LEVELS OF FEDERAL AND STATE INCOME TAXES—(1) NO TAXES, (2) ACTUAL TAXES, AND (3) FULL CORPO-ATE TAXES [1]

[Dollar amounts in billions]

	Actual yearend		Net worth at yearend assuming 3 tax levels			Net worth as a percentage of— Yearend assets			Yearend savings		
	Assets	Savings	No taxes	Actual taxes	Full corporation taxes	No taxes	Actual taxes	Full corporation taxes	No taxes	Actual taxes	Full corporation taxes
Year:											
1950	$16.9	$14.0	$1.280	$1.280	$1.186	7.75	7.57	7.06	9.14	9.14	8.47
1951	19.2	16.1	1.471	1.453	1.274	7.65	7.57	6.70	9.14	9.02	7.91
1952	22.7	19.2	1.677	1.658	1.366	7.38	7.30	6.10	8.73	8.64	7.11
1953	26.7	22.8	1.927	1.901	1.476	7.21	7.12	5.62	8.45	8.34	6.47
1954	31.6	27.3	2.231	2.187	1.608	7.05	6.92	5.18	8.17	8.01	5.89
1955	37.7	32.1	2.609	2.557	1.770	6.91	6.78	4.80	8.13	7.97	5.51
1956	42.9	37.1	3.018	2.950	1.938	7.02	6.83	4.63	8.13	7.95	5.22
1957	48.1	41.9	3.447	3.363	2.107	7.15	6.99	4.50	8.23	8.03	5.03
1958	55.1	48.0	3.948	3.845	2.303	7.15	6.98	4.30	8.22	8.01	4.80
1959	63.5	54.6	4.524	4.393	2.525	7.11	6.92	4.10	8.29	8.05	4.62
1960	71.5	62.1	5.109	4.983	2.740	7.13	6.97	3.96	8.23	8.02	4.41
1961	82.1	70.9	5.819	5.708	2.998	7.08	6.95	3.78	8.21	8.04	4.23
1962	93.6	80.2	6.716	6.520	3.328	7.16	6.97	3.68	8.37	8.13	4.15
1963	107.6	91.3	7.520	7.209	3.593	6.97	6.70	3.46	8.24	7.90	3.94
1964	119.4	101.9	8.494	7.899	3.920	7.08	6.62	3.40	8.34	7.75	3.85
1965	129.6	110.4	9.510	8.704	4.243	7.29	6.72	3.39	8.61	7.88	3.84
1966	133.9	114.0	10.330	9.096	4.440	7.64	6.79	3.44	9.06	7.98	3.89
1967	143.5	124.5	11.116	9.916	4.599	7.68	6.91	3.33	8.93	7.96	3.69
1968	152.9	131.6	12.236	10.691	4.891	7.92	6.99	3.32	9.30	8.12	3.72
1969	161.1	135.5	13.610	11.620	5.273	8.29	7.17	3.39	10.04	8.58	3.89
1970	176.2	146.4	14.898	12.401	5.574	8.34	7.04	3.29	10.18	8.47	3.81
1971	206.0	174.2	16.820	13.592	6.113	8.04	6.60	3.08	9.66	7.80	3.51
1972	243.1	206.8	19.448	15.240	6.879	7.86	6.27	2.93	9.40	7.37	3.33
1973	271.9	227.0	22.509	17.056	7.825	8.12	6.27	2.98	9.92	7.51	3.45
1974	295.5	243.0	25.135	18.436	8.490	8.32	6.24	2.97	10.34	7.59	3.49
1975	338.4	286.0	27.776	19.776	9.090	8.02	5.84	2.77	9.71	6.91	3.18

[1] Robert R. Dockson, "Comments on Capital Needs of S&L Associations," Second Annual Conference: Change in the savings and loan industry, San Francisco Federal Home Loan Bank, December 1976 (forthcoming).

It is noteworthy that at no time during the debate and the presentation by the Treasury in the aforementioned Tax Acts that any serious consideration was ever given to questions of net worth induced constraints on growth and its potential impact on mortgage debt financing. The issue in 1962 was simply—"Thrifts pay no federal tax—it's time they do, particularly given the relatively heavy burden of taxation borne by commercial banks (at that time)."

In ensuing tax legislation, the issues centered around rate comparisons with non-financial corporations and by attempts to submit "all forms of income to some tax". The links between tax-saving additions to reserves, capital requirements, and industry growth were never made or developed in the debate.

We believe that a major overhaul of the federal tax treatment of thrift institutions is long overdue and would like at this time to endorse the concept of the mortgage interest tax credit (MITC) as proposed in Title VII of the Financial Institutions Acts of both 1973 and 1975. Under this concept, the percentage-of-taxable income method of calculating loss reserves for thrift institutions would be eliminated with further reserve additions on qualifying loans computed under either the percentage of eligible loan or the experience methods presently available to commercial banks. In lieu of this bad debt reserve allowance, we propose a tax credit be granted equal to a specified percentage of gross interest income from qualifying residential mortgages. Essentially, the credit would be a function of interest income on qualifying residential mortgage loans, and the size of the credit would be a function of the percent of such assets which a financial institution or individual has in its portfolio. An incentive effect is built-in since the greater the amount of qualifying residential mortgages which a financial intermediary has, the greater the size of the credit and thereby the greater the amount of the tax benefit. Under this provision, any taxpayer which holds less than 10% of its portfolio in such qualified assets would not be eligible for the MITC.

As to the cost of this proposal, Table 8 provides revenue estimates on the MITC as was reported out of the Senate Committee on Banking, Housing and Urban Affairs in the Financial Institutions Act of 1975. These estimates are net of any revenue gains resulting from the elimination of the bad debt allowance provisions and are similar to the revenue losses under our proposal. They reflect the first order total revenue losses to all taxpayers qualifying under this provision and as such do not account for the increased private and public benefits which would accrue. These benefits are extremely difficult to quantify, which is probably why the Treasury has not done so. Nonetheless, benefits do accrue, they are significant, and they should be recognized.

TABLE 8

Revenue estimate of mortgage tax credit [1]

[Dollars in millions]

Calendar year:	Net revenue loss
1976	$544
1977	618
1978	699
1979	790
1980	872

[1] Source: U.S. Treasury Department, Office of Tax Analysis; mortgage tax credit of 3⅝ percent of interest on qualified assets at 80 percent of qualified assets phasing down to 1½ percent at 10 percent of qualified assets. Revenue losses are net.

As to the benefits associated with this proposal, we submit the following:

1. The MITC would increase the availability of funds for financing residential mortgage debt. Given an average net tax expenditure of $800 million per year, it is estimated that approximately three-fourths of that would accrue to savings and loan associations, or $600 million per year. Over a ten-year period, the MITC would increase the net worth of savings and loan associations by approximately $6 billion relative to the present tax law. Under the FIR (net worth) requirement of 5%, these savings would permit an added growth in assets of $120 billion over this period. Under the assumption that 80% of such funds would go into residential mortgages, an additional $96 billion funds would become available for residential mortgages relative to what would be the case under existing tax law.

2. The mortgage interest tax credit would reduce the net worth constraints which are now and will continue to impinge upon the growth of savings and loan associations. With the mortgage interest tax credit in lieu of the current tax treatment of savings and loan associations, the net worth of S&Ls would only have to grow $19 billion net of the tax benefit accruing from the mortgage interest tax credit in order to provide mortgage debt commensurate with the basic housing needs as described previously. This translates into an annual growth rate in net worth of about 7% net of the tax subsidy compared to an 8½% growth rate under existing tax law. Even if one were to add the financing requirements related to the inadequate housing considerations spelled out earlier, net worth of savings and loan associations, net of tax benefit, would need to increase on an average annual rate of 8½%—high, but reasonable.

3. Third, the MITC would be a move toward reestablishing federal tax equity among competing financial intermediaries. As evidenced in Table 6, the federal

tax burdens of savings and loan associations are currently 70% to 80% higher than that of either commercial banks or mutual savings banks. In a series of studies analyzing the comparative impact of the mortgage interest tax credit and the existing tax treatment of thrift institutions, another Georgetown University economics professor and I showed that under the MITC, the tax burdens of savings and loan associations would be more in line with that of other financial institutions. In additior, this would be accomplished without reducing S&L holdings of residential mortgages.

4. Unlike the current bad debt allowance provisions, the mortgage interest tax credit is anti-cyclical in that it is a function of interest rates rather than profits. Accordingly, it would subsidize most in lean years and least in boom years. Because mortgage funds are least available during periodic credit crunch periods, the mortgage interest tax credit would work toward the alleviation of these shortages and the adverse impact which they have upon the housing construction industry.

5. It has been estimated by various of people who research the economic impact of the MITC (Jaffee, Henderschott, *et. al.*) that it would reduce mortgage rates from 25 to 50 basis points.

6. As pointed out above, the MITC as a subsidy to the private sector would be a more efficient use of tax dollars than the direct expenditure approach in terms of generating supplies or residential mortgage debt.

7. The mortgage interest tax credit will induce other intermediaries to finance residential mortgage debt thereby alleviating the growing dependency upon the savings and loan industry as the overwhelming financier of such debt in the future.

8. It has been recommended by a number of witnesses before this committee and elsewhere that major tax reform in the federal tax treatment of capital is necessary in order to promote capital formation and to insure capital adequacy. These proposals generally follow the line of: (a) increases in the investment tax credit; (b) reduction in the tax rate on corporate profits; (c) the institution of allowances for replacement cost depreciation; and (d) some form of partial or total integration of the tax system. A number of analyses have been conducted as to these proposals, including an oft cited study by Andrew Brimmer and Alan Sinai.[2] One of the primary conclusions of the Brimmer-Sinai paper is that in the absence of an accommodating monetary policy, the housing industry would be adversely impacted by these tax measures both through higher interest rates and through a shifting of investable funds away from mortgage debt finance. The MITC would help offset these effects and should be considered as part of any capital formation tax reform package.

Finally, a few comments on the proposals for integration of the tax system such as have been set forth in the Treasury Department's "Blueprints for Tax-Reform," and elsewhere. Because the various corporate integration schemes have been so tentatively formulated, it is not possible to assess meaningfully the impact of any one upon savings and loan associations. Any integration scheme would need to assess whether it would be appropriate to apply such a system to financial institutions such as savings and loan associations and what allowances would be made for organizational form and regulatory constraints. There are a number of complications which arise because the industry is part stock and part mutual in form. In case of mutual organizations, there are no share-holders apart from the savers. To impute corporate earnings to a saver who would have no right to such earnings would seem to be an unrealistic burden. In addition, there are questions as to net worth constraints on net income distribution imposed by regulation so that any integration scheme would necessarily have to take account of such restrictions. We would strongly urge this committee to carefully assess the impact upon savings flows and mortgage debt of any tax integration proposal. Accordingly, for your consideration, we would like to submit a statement by Leonard L. Silverstein, Tax Counsel for the National Savings and Loan League on such questions of "fundamental" tax reform and integration of the corporate and personal income tax systems.

In conclusion:

1. Savings and loan associations currently are and will continue to experience capital constraints imposed by regulation.

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[2] Andrew F. Brimmer and Alan Sinai, "The Effects of Tax Policy on Capital Formation, Corporate Liquidity, and the Availability of Investable Funds: A Simulation Study" (mimeo).

2. Such capital constraints will restrict the ability of savings and loan associations to meet the basic housing financing needs of the nation over the next decade.

3. Capital problems facing the savings and loan industry can be directly traced to increasing federal tax burdens. Mandated increases in the taxation of S&Ls over the next 2-3 years will exacerbate these problems and further restrict industry growth.

4. The average return on year-end net worth of S&Ls has been 30-40% below that of other major industrial groups over the past decade. To the extent these groups face tax induced constraints on capital formation and growth, it should be stressed that similar constraints on the savings and loan industry are as much if not more clearly identifiable and related to the tax system. Thus, if residential mortgage debt financing is to be considered an important facet of investment and capital formation in our economy, then some recognition of this must be made in any capital-oriented, tax reform package.

5. The mortgage interest tax credit proposal as set forth herein would greatly help to alleviate existing capital constraints facing the savings and loan industry and would aid significantly in assuring an adequate supply of residential mortgage debt in the future.

SAVINGS AND LOAN ASSOCIATIONS AND "FUNDAMENTAL" TAX REFORM, MARCH 3, 1977 FOR NATIONAL SAVINGS AND LOAN LEAGUE BY LEONARD L. SILVERSTEIN, TAX COUNSEL

President Carter, describing the U.S. tax laws as a "national disgrace," has called upon Congress to enact a basic restructure of the federal tax system. The President's commitment to tax revision, in fact, reflects widespread public concern that our tax laws are far too complex and uneven in application. Although the Tax Reform Act of 1976 made a number of changes designed to eliminate so-called tax abuses,[1] the tax code in its present form has now reached heights of complexity.

In light of the foregoing, the Treasury Department is now at work formulating a tax program aimed at simplicity through fundamental structural changes. It is conceivable that this objective may be sought through a broadening of the tax base -that is the inclusion in income of items now ignored or omitted—coupled with a possible lowering of tax rates in all brackets. If the Administration meets its timetable, a tax program will be submitted for public discussion in the fall of 1977, with enactment conceivable in 1978.

Although it is far too early to determine the content of the new program, some indication of the direction of thinking can be derived from comments already made by Assistant Treasury Secretary for Tax Policy, Lawrence W. Woodworth. Further, an important source of technical thinking respecting the form of tax revision reposes in a new Treasury Department document entitled "Blueprints for Basic Tax Reform."[2] issued on January 17, 1977 by former Treasury Secretary William E. Simon. Even though "Blueprints was issued by one administration and is being considered by another, its content is fundamentally technical and nonpolitical. It presents, in a wealth of detail, factors which eventually will be taken into account in the full-scale revision ahead. Several of the Treasury discussion areas have a direct and perhaps dramatic bearing upon the tax treatment both of the savings and loan associations and their savers.

This memorandum will describe certain areas so that the industry may be aware of the general direction of thinking, in order that orientation can be given to appropriate responses.

Despite a myriad of difficulties of implementation, a major objective of the new program will probably be the elimination of the corporate income tax i.e. of double taxation of a corporation and its shareholders. Such a change would have its purpose—the encouragement of more deduction of corporate savings, and the greater use of equity rather than debit for corporate finance.

The Treasury models respecting this "integration" have been framed in terms of a normal closely or publicly held stock company. Accordingly, and thus far, no expression has been given in the study respecting any special rules which

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[1] See, for example, the rules respecting tax shelters under sections 465 and 704 which, however, contain significant exceptions for real estate.

[2] See "Blueprints for Basic Tax Reform" p. 3 et seq. Treas. Dept. Jan. 17, 1977, hereafter referred to as "Blueprints."

would apply to mutual institutions such as savings and loan associations, mutual savings banks, or membership farmer cooperatives.[3] It is also impossible to assess the effect of any corporate integration progam upon stimulus for savings. If, in fact, such a program were implemented and the public at large were thereby induced to invest in corporate equities which, because of the elimination of the double tax would yield a higher rate of return, investment in debt securities and/or savings accounts could, by the same token, be discouraged.

A corporate integration program is being considered under two basic formulations.[4] Under one of these a "comprehensive" income tax, a greater number of items, whether in cash or in kind, which can be regarded as accretion to an individual's net worth would be included in the tax base. Under the second model, "cash flow" tax, the tax base would effectively include all cash items received, but tax would be imposed only to the extent the cash is used for "consumption" i.e. for personal or household expenses and other items of non-business "standard of living" expenditures. Thus, "qualified" investment in savings (or equities) would not be currently taxable until the cash is withdrawn for personal consumption. While the differences between the two models are extensive, this memorandum will consider these models only in relation to the treatment of corporate income.

Under both models, the corporate tax would not exist. All of the corporate earnings would be regarded as having been earned by the shareholders (i.e. the owners of the business). Such a person would be deemed to have received his pro rata share of the corporate earnings. Under the comprehensive tax, the amount of such pro rata share would be added to his cost of stock. Thus, if a shareholder held his shares for a full year in which there were no dividends paid, and sold the shares at the conclusion thereof, the amount of the corporate earnings would be added to the cost of the shares and his gain upon the sale would be reduced by such amount. On the other hand, if, during the year, the corporation paid a dividend in ash, the amount of the dividend would reduce the cost of his shares. His gain on sale, therefore, would be the original cost plus the attributed corporate earnings less the dividend. Similar rule would apply for the purposes of calculation of loss. If the shareholder sold his stock during the year, he would report the difference between his original cost and the amount realized on sale as his share (if any) of the distribution of corporate earnings.[5] Obviously, the imputation to a shareholder of the full amount of his pro rata share of earnings requires an additional infusion of cash with which to pay the tax. This problem would be dealt with in the first instance by imposing a withholding tax upon the corporation, the amount of which would be credited to the stockholder as if paid directly by him. Thus, if $100 of corporate earnings referable to a shareholder were realized during the year, and a corporate withholding tax of $50 were paid by the corporation, a shareholder in the 50 percent bracket, would include in income $100 with a credit, as if he had personally paid $50 and, therefore, would have no tax to pay personally whether or not the corporation distributed the remaining $50 of its earnings. If, in fact, the corporation made a dividend distribution, the shareholder would receive the amount of the dividend without any additional tax. By the same token, if the shareholder's bracket were 70 percent in the foregoing example, he would be required to pay an additional $20 of tax either from remitted corporate earnings or from his own pocket if the earnings were retained. And, conversely, if the shareholder's tax rate were below 50 percent, he could utilize the corporate credit of $50 to reduce tax on income from other sources.

The foregoing system, it is believed, will tend to induce corporations to distribute a greater and greater share of earnings in order to assure that the shareholders will have sufficient funds with which to pay the tax. Furthermore, because the earnings can be distributed without the present dividend burdens of double taxation which now obtain, corporations will, in general, be induced to distribute earnings and seek new capital from new primary offerings of stock. To the extent that corporations would continue to pay additional earnings ot shareholders and new capital from new corporate offerings of equity, activities of a standard industrial corporation may more nearly approximate the activities of intermediate thrift in financial institutions seeking public funds, even in small amounts.

[3] See "Blueprints" p. 3.
[4] See "Blueprints" Chapter 3 and Chapter 4.
[5] See "Blueprints," pp. 71–72.

Under the cash flow version of corporate integration, shareholders would continue to have imputed to them their full pro rata share of corporate earnings. The corporation would, in turn, probably continue to pay a withholding tax, but a shareholder would be taxed only to the extent that he received dividends or other distributions from the corporation and used these amounts for purposes other than the purchase of stock, savings accounts or the acquisition of other financial assets. Under the cash flow approach, only withdrawals from corporations or sales of stock for personal consumption purposes would become subject to tax. Because the cash flow approach subjects to taxation, only purchases of consumer durables and expenditures for personal purposes, it tends to induce the acquisition of financial assets (stocks, savings accounts, and similar items). It should stimulate investment in financial institutions including savings and loan associations.

It is also to be observed that an integrated corporate tax would reduce revenues since it substitutes a single for a double tax. In recognizing this, House Ways and Means Committee Chairman, Al Ullman has suggested that another form of levy must be substituted. While Congressman Ullman has ruled out a sales tax, he has emphasized that, in his opinion, the U.S. is relying far too heavily on the income tax and that other forms of revenue-producing measures are needed. Savings and loan associations may wish to keep this factor in mind, particularly in connection with transactions which include financial transactions.

Since the corporate integration has been so tentatively formulated, it is not possible to assess meaningfully its impact upon the savings and loan associations. Complications arise both in the case of stock as well as federal or other state mutual organizations. In the latter situations, since there are no shareholders apart from the savers, imputatoin of corporate income to a saver who may have no right (other than upon liquidation) to his pro rata share of corporate earnings, would seem to impose upon him an entirely unrealistic corporate tax burden. The problem is further complicated by the restraints upon corporate distributions imposed by federal and state insurance requirements.

Although these considerations are not wholly present in the case of stock associations, it would seem equally inappropriate to impute to the shareholders any portion of the corporate earnings (held in reserve or otherwise) which may, in fact, for regulatory purposes be referable to the savers. It is thus conceivable that any radical change in corporate integration may be entirely inappropriate if applied to intermediate financial institutions such as savings and loan associations.

Because opportunity now exists for submission of individual and industrial views, your thoughts respecting these issues would be welcome, as well as your comments on the many other aspects of the basic tax reform program.[6]

[Whereupon, at 12:10 a.m., the subcommittee recessed, to reconvene at 9:30 a.m. Tuesday, June 14, 1977.]

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[6] Other subjects which are covered involve the treatment of capital gains and losses, the treatment of employee compensation, social security payments, and individual items presently deductible such as medical expenses, charitable contributions, casualty losses, and state and local taxes. Another subject of concern to savings and loan associations, involves the treatment of so-called "imputed rental income" of owner-occupied housing and interest deduction related to the holding of home mortgages. Assistant Secretary Woodworth has indicated tentatively that it is unlikely that any change would be made which would affect the interest deduction for home mortgages.

INCENTIVES FOR ECONOMIC GROWTH

TUESDAY, JUNE 14, 1977

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT GENERALLY
OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to recess, at 9:30 a.m. in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. (chairman of the committee) presiding.

Present: Senators Long, Byrd, Jr., of Virginia, Packwood, and Roth, Jr.

Senator BYRD. The hour of 9:30 having arrived, the committee will come to order. These hearings mark the third day in a series of 4 days of testimony before the Subcommittee on Taxation and Debt Management Generally on the topic of incentives for economic growth.

The subcommittee is fortunate to have with us today a distinguished group of individuals from the economic, academic, and legal communities. Their views about the effect of tax policy on economic growth and business investment will, I am sure, be very helpful to the members of this committee and the Senate in formulating a program to encourage the development of America's productive resources.

In conducting these hearings, the subcommittee is acutely aware that the actions that the Senate will soon be taking in the area of capital formation will have a profound effect on the future well-being of our economy.

The purpose of these hearings is to develop the background information which will be necessary to establish a sound program for economic growth.

Because of the number of witnesses who will be testifying today, each witness will be limited to a 15 minute oral presentation. Each Senator will have 10 minutes to question the witnesses in the first round of questions. Additional questions will follow, depending upon the time limitations.

I welcome each witness and look forward to his testimony.

The first witness will be Mr. Eliot Janeway, an eminent economist, author, columnist and, I might say, friend. I welcome Mr. Janeway, and you may proceed as you wish.

STATEMENT OF ELIOT JANEWAY

Mr. JANEWAY. Senator Byrd, it is a pleasure to be here.

The present burst of interest in capital formation is the outgrowth of a fundamental miscalculation. Until only yesterday, the consensus

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among business and government economists had anticipated a shortage of capital. Today, however, the fact is that the lending institutions are choking on excess liquidity. Consequently, the intellectual embarrassment of the forecasting fraternity is matched only by the operating frustration of lenders looking for qualified and willing borrowers.

Thus, the formation of capital is not the problem; its employment is. It is true that forecasts of future capital requirements, even before adjustment for future inflation, are astronomic. Nevertheless, the present problem in our capital markets is glut, not shortage. And the road to the future leads through the present.

Today's massive ongoing backup of liquidity in the credit reservoir is measuring a dislocation unknown since the Depression decade of the 1930's. Then, though the tragic plight of millions of unemployed and bankrupted families commanded sympathy, the idleness of the money needed to bring them back into the earnings stream was an even greater frustration at the policymaking level.

The unemployment of capital already formed was responsible for the unemployment of people newly ejected from the earnings stream. The same disturbing early warning that announced the failure of the system in 1929 is visible once again: High interest rates amidst a background of easy credit.

Capital already formed is freely available—on a scale signaling economic shrinkage, but for a price assuming expansion. No one felt free to take it in 1929 and no one feels free to take it now.

Providentially, however, today's contrast with that traumatic memory is as reassuring as the parallel is alarming. In the 1930's, the employment of capital emerged as the problem behind the catastrophe after the catastrophe had struck. Today, while time is by no means an ally, it is not too late to solve the problem of idled capital before the more conspicuous problem of idled people can get out of hand.

The answer most commonly advanced in the media for the astronomic accumulation of surplus liquidity is lack of confidence. This strikes me as an easy answer—vague and, therefore, not conducive to suggestions for the remedial actions that are clearly needed.

The letdowns of recent years illustrate the divergence between the ineffectiveness of inflated confidence in starting capital investment moves and the effectiveness of inflated costs in stopping them. Confidence, as expressed in official and prestigious private forecasts, has never run higher. In fact, we are enjoying a full-fledged boom in the capital investment statistics. In the real world, however, a massive strike of capital is one, and it is hardening.

In my judgment, cost, not lack of confidence, is the obstacle to the use of the capital already in place, but not ready to go to work. There is nothing like a projection of black ink on the bottom line to cure a crisis of confidence. By the same token, so long as the bottom line for future projections remains saturated in red ink, no confident claims put forward for capital investment prospects will butter any parsnips or fill any pay envelopes.

Capital investment is commonly taken to be synonymous with economic expansion and corporate health. It is, indeed, so long as it is discretionary in nature and so long as profit is its purpose. But today, an unprecedentedly high portion of such investment as is moving money into the stream is nondiscretionary in nature and noncommercial in purpose.

Moreover, these nonproductive Government-mandated expenditures on capital accounts are growing; while the genuinely expansive commitments which would invigorate the economy and generate tax revenues are at a standstill, if not actually shrinking.

Compliance with the regulatory octopus is the direct cause of these deceptive corporate contributions to the official capital investment totals as they are simplistically computed and uncritically accepted. The dollars mandated for investment to remove nontoxic tannic acid—perfectly tolerable in the form of tea—from exhaust flows given off by old papermills are given equal status with dollars earmarked for the construction of papermills. The money for scrubbers required for existing powerplants is given equal status with the money going into new powerplants.

The indiscriminate jumbling of these two separate and distinct forms of expenditure on facilities is perpetrating the illusion of growth-as-usual and is delaying the recognition of today's strange new reality: Shrinkage, which, instead of enabling industry to conserve cash, is forcing it to waste it.

Worse still, this habit into which we have fallen has entrapped us into an even more dangerous self-deception. Corporations today routinely contract borrowings for the purpose of financing compliance investment in facilities without informing their creditors or their stockholders that no productive assets are being put into place to balance and to carry these liabilities.

It seems clear to me that the Accounting Standards Board has once against been dilatory in meeting its responsibilities. Just as clearly, the disclosure requirements of the securities laws call for the SEC to make up for lost time in requiring publicly owned registered corporations to list their assets as well as their liabilities on a double standard basis: Productive and nonproductive, depending on whether the decision to put them on the books was profit-motivated or compliance-mandated.

Mr. Chairman, I have four concrete suggestions to offer in response to the realistic question formulated in your call for these hearings.

My first suggestion is addressed to this compelling distinction between discretionary investment for productive purposes and nondiscretionary investment dictated by compliance with environmental regulations.

It seems clear to me that the way to rev up the stalled engines of economic expansion via capital investment is, first and foremost, to devise an equitable method of relief for complying corporations from the arbitrary, excessive, and altogether counterproductive state of decrees forcing noneconomic expenditures on corporations. Let Congress recognize these expenditures for exactly what they are: The higher cost of doing business through existing facilities.

The practical tax treatment to give these inflated, nonproductive expenditures is to authorize corporations to expense all mandated expenditures that can be certified as a drag on earning power, and not to add them to the investment account subject to depreciation. The cost of compliance is part of the cost of doing business. No complying corporation can bring any bargaining power to bear, much less any resistance against, any regulatory authority at any level of government. But the taxing authorities can, and the White House will, if it proposes to make its unconditional commitment to balance the budget by 1980 meaningful.

The pragmatic effect of such a simple change in the tax treatment of mandated expenditures would be to force decree-happy regulators to justify carefree cost decisions to the tax-collecting and budgetary authorities from the U.S. Treasury and the White House down to city halls. Once bogus investment in compliance is given tax treatment as the cost it is, the regulatory authorities forcing utility companies to buy redundant scrubbers will be on trial to explain to the President, to the Governors, to the county collectors, and to the mayors how much revenue political grandstand plays will cost and how much priority programing they will displace on the spending side of the budget.

My second suggestion is addressed to the constant inflation of State and local government impediments to the investment process. Revenue sharing is the law of the land. Surely, the Federal Government is entitled to get back some consideration in one form or another for the dollars it put out to the States and cities.

This second suggestion of mine focuses on a Federal agency which commands universal nonpartisan respect: The Federal Bureau of Standards in the Commerce Department. The Bureau of Standards is the common clearing house for new products. It earns its keep by collecting fees, so that enlarging its role will not be a burden on the budget.

The present Secretary of Commerce, Juanita Kreps, commands universal respect for her professional accomplishments and her personification of the expanding role of women in the management of our economy.

My suggestion is that the President and the Secretary ask the Governors, the mayors, and their various regulatory operatives to accept a Federal Bureau of Standards finding as a green light for corporate investment in local jurisdictions for the duration of the present standstill in the economy.

Congress, by virtue of its grant of revenue sharing authority, has a basis for asking the President and the Secretary to make this move. I have discussed its usefulness with OMB Director, Bert Lance—before and since the Dow Chemical Co. made its historic decision to cancel its major investment project in the Sacramento Valley rather than continue to run the gauntlet of endless regulatory agencies with veto power over new investment projects.

No doubt some time will be needed to assess the trend-turning consequences of this cancellation by Dow. It has already influenced Governor Brown of California to reverse his well-known stand against investment expansion. Meanwhile, however, the trend toward shrinkage has already been confirmed by a series of utility company moves to cancel new projects; the expansion of utility investment has been a constant during all past recessions, and it accounts for by far the largest single component of overall investment.

Now that utility companies are joining the cancellation parade, there can be no doubt that the long-standing premises of growth are open to question.

My third suggestion calls for a writeup of net productive assets to the levels of their replacement costs. It calls for recognition of the inadequacy of depreciation allowance against present stated asset values to spur new capital investment.

I do not believe that further liberalization of depreciation allowances or investment credits under present circumstances will call off the strike of capital. Until now, the question of devaluation or revaluation has been limited to the exchange values of the currencies of export-dependent countries. But the United States has the only continental economy in the world with a price, profit, and tax system.

Currency devaluation or revaluation is not now a meaningful question in the United States. The dollar is the only strong currency in the world, despite any trade or payments deficits; it is the world's currency. But revaluation for America's domestic productive assets is overdue. Its immediate effect would be to administer a double shock: To cost the Treasury revenues as the result of a corresponding writeup in depreciation allowances and to reveal the inadequacy of present earnings rates as a stimulus to capital investment.

Admittedly, some legislation would be needed to cushion this twin shock, but the evidence of the marketplace is supporting the judgment that decisions to invest are now being scrutinized in terms of replacement costs rather than depreciated book value. Meanwhile, the reproduction cost yardstick has become a decisive deterrent to investment.

Sooner or later, Congress will find itself forced to face up to the harsh realities involved in an upward revaluation of corporate assets, just as, at long last, it is finding itself forced to face up to the troublesome issue of the double taxation of dividends, on which I have been testifying these past 7 years. Massive revenue losses are involved in both changes. Each will represent a tax levied by inflation on the Treasury.

My fourth suggestion is addressed to the growing concern over the double taxation of dividends. I endorse the push for relief, and of course I recognize the threat it poses to revenue collections. But the danger of a depression poses an even greater threat not limited to revenue collections. In considering the economics as well as the equities of moving on this issue, I hope that the Congress will bear in mind the consideration that any measure which works belies fears of revenue losses.

In this case, Mr. Chairman, I believe that we will see a repeat performance of the statesmanlike exercise initiated by your late, great father as chairman of the Senate Finance Committee. The result of his collaboration with President Johnson in reducing tax rates along with spending rates was an increase of revenue collections. Government adopted the practice of our mass production industries during the classic period of American expansion. It cut the costs of Government and increased its cash take from the public.

Specifically, my suggestion calls for extending to individuals the tax credit now enjoyed by corporations on their receipt of dividends. Presently, only 15 percent of dividend income is taxable to corporations. I see no justification for this double standard.

Admittedly, the revenue cost of an overnight jump to an 85 percent credit for individuals would be prohibitive. But the marketplace anticipates future benefits as appreciatively as it pockets present benefits.

Congress has established a legislative record of tax changes on the installment plan. The effect of granting individuals a first-stage tax credit tied to a corresponding schedule for reducing the deficit would be to enlist a mass constituency benind the President's commitment to balance the budget. The lower the deficit, the greater the dividend tax credit that would be available within the limits of fiscal responsibility.

The parallel effect of a partial extension of the present dividend tax exclusion enjoyed by corporations to individuals would be to enrich net after-tax dividend yields. Dividend yields are already attractive relative to interest rates, but apparently not enough to bring the private investing public back into an active participation in the equity markets.

Granting individuals the right to exclude a significant portion of their dividend income from their tax accruals would have the effect of endowing the stocks of rated corporations with the partial advantages of tax exempt bonds without subjecting them to the obvious limitations.

I have advocated the feasibility, without prejudice to the needs of the Treasury, of dividend tax credits in one form or another since 1970. If my first three suggestions are adopted, and the engines of capital investment are revved up, I have no doubt that the issue of dividend tax credits will be seen as an economy measure to attract capital from the savings reservoir, where it is now stagnating, into the equity market, where a vibrant economy needs to employ it.

Mr. Chairman, I feel prompted to leave a more general problem for your consideration. It relates to a combination of the inequities suffered by the large and amorphous group commonly known as small business people. It is my judgment that the system is paying with burdensome inefficiencies for these inequities. The fact that the savings reservoir is brimming over with a Niagara of liquidity is due in large part to the frugality and the prudence of such people of modest pretensions and substantial means. Our experience of incentives to these people—most notably in the form of tax deferrals on profits taken from homes sold and reinvested in new home building and buying—leaves no doubt that the economy and the Treasury get generous value for consideration given. Why not extend this same incentive to capital gains cashed in and reinvested?

This subject is so big and so important that it calls for special intensive treatment. One good reason it does is implicit in the nature of small business; it is more labor-intensive than big business. When it does well, it creates more jobs with greater life expectancy than bigger businesses need do when their operations pick up. Suffice it for now that the regulatory creep is suffocating the liquidity of smaller businesses and stifling their potential for the growth which, given inflation, is the necessary condition for standing still. In the growth State of Florida, for example, in the hub of the Sun Belt, no less than 23 separate clearances are now required before ground can be broken on a development. This means that the small businesses which, in the main, undertake the developments in this country out of business.

It is my earnest hope that the proceedings of this subcommittee will lead us on the road back to procedures that work. I believe that some special consideration will be needed for businesses below a certain level of capital availability for this to be accomplished.

Senator BYRD. Your time has expired.

Mr. JANEWAY. If I may make one statement. I believe that special treatment is required and justified for smaller businesses, bearing in mind that the smaller businesses—this is in my statement—that smaller business tends, when investing, to employ more labor, because they are more labor-intensive at the outset than the larger corporations.

The cost of doing business today is increasingly prejudicial to the smaller business.

Senator BYRD. Your statement is an excellent one and very provocative. There are so many avenues I would like to explore with you, and I do not know if we have the time to get it all done.

First of all, let me see if I understand, perhaps, your basic thrust, that our country is experiencing today not so much a lack of capital as a lack of confidence on the part of the investing public. Is that your view?

Mr. JANEWAY. A lack of confidence based, however, on the deeper rooted recognition that cost levels make investment uneconomic. There is no way to finance out on discretionary new investment, but the situation is confused because there is a great deal of expenditure by corporation that seems to be investment which, in fact, is mandated cost.

Senator BYRD. Your thought is that the mandated cost, the new investment that really is mandated by the Government and by the Congress, should be written off as an expense of doing business and not depreciated?

Mr. JANEWAY. Yes; this would then turn the regulatory authorities at all levels of Government into claimants against the Treasury and against the Budget Bureau.

Senator PACKWOOD. It also means, if they write if off, it does not become a part of the permanent tax base.

Mr. JANEWAY. That is right.

Senator BYRD. In regard to your fourth suggestion addressed to the growing concern about double taxation of dividends, you have been talking about this for quite awhile now, for about 6 years, I suppose.

Your basic proposal in that field would be to grant to the individual investor the same tax rate on dividends as corporations have on the dividends they receive from other corporations?

Mr. JANEWAY. Yes, sir.

I think that you would see a more productive response from individuals than you would from corporations, though corporations that are able to use the exclusion tend to be liquid and have a reservoir of cash from the asset.

I do not advocate giving the 85-percent dividend credit overnight. I advocate it on an installment plan—say, 15 percent per year—and there are sound, familiar, congressional precedents for this.

If you started out with 15 percent, got into a trading stance with the administration on deficit levels and gave the individual a clear anticipation of what the rate would be in subsequent years, the investor for income, in my judgment, would be very responsive.

This would be timely, coinciding as it would with the need of the economy to finance new energy investment from the private sector.

Here we have an administration—and I am confident that Mr. Lance will verify this tomorrow, although I have not discussed it with him—we have an administration committed, at one and the same time, to a balanced budget and to vast, new expenditures on energy facilities. That can only come from the private sector. If we are to get an energy program off the ground, corporations in the energy field will need vast sums of financing from the equity market.

Even the oil companies, which the market is valuing as "money" companies, face the need, and they admit to it, to raise capital. But the capital is there. What will the price of it be? It will be expressed by the cash dividend part.

If we give a partial 15-percent exclusion to taxability in the first year, with another 15 percent in the second year, utility and oil dividends will become very, very attractive. This will make a great contribution, I think, to diminishing the expectation that only Government can provide energy facilities by expenditures.

Senator BYRD. You stated in your testimony today that the lower the deficit the greater the dividend tax credit would be within the limits of fiscal responsibility. You are tying the reduction in the tax on dividend income to the deficit. How do you do that, as a practical matter?

Mr. JANEWAY. Suppose Congress were to go all the way with the administration and legislate a 15-percent dividend exclusion in the first year, with a contingent followon of another 15 percent in the second year, letting the contingency be tied to the actual borrowing levels of the Government which, in turn, represent the present deterrent to the argument for exclusion.

Senator BYRD. Under your plan, would it not be—that the investor would not know from year to year what his tax would be?

Mr. JANEWAY. He would know that he would get 15 percent the first year. This alone would be mighty attractive, with dividend yields historically favorable as compared to interest rates.

Right now we have a tricky, obscure situation in which a certain number of utility dividends are partially tax free. If you take an 8.5-percent dividend return readily available in the market, and paid by a utility whose dividend is 50-percent tax sheltered now, you are clearly looking at a double-digit dividend return. But no investor now knows from year to year which utility dividend will qualify for the exclusion.

This is clearly attracting private money to the market. Individual investors, not institutions, are buying these securities for the dividends they pay.

Senator BYRD. You say that businesses should be allowed to expense their nonproductive, government mandated investments. In regard to other investments, with regard to business expansion, would you recommend liberalization of the depreciation rate, or would you leave the depreciation rate at the level where it is?

Mr. JANEWAY. In general, my answer would be affirmative to your first question, Senator, but I am bound, I think, in all realism to the present frustrating situation to say that a 2.5-percent increase would not bring out any more capital than it is now because of the markets' insistence at balking at the wide spread between depreciated book value and reproduction costs.

This is why you are now getting a rash of takeover bids in the market. Corporations are deciding it is cheaper to buy than to build. They are willing to pay up for assets already in place. In the Wall Street Journal, day after day, you see a half a dozen takeover bid stories. This will continue to spread.

No one can afford to put into place new investment at anything like what is represented by current depreciated book values.

Senator BYRD. Expensing of nonproductive investments would certainly be a costly program. How much revenue loss to the Treasury would you estimate?

Mr. JANEWAY. I do not see any way to prevent it from losing a good $5 or $10 billion a year, maybe more in the first year.

If Government agencies continue to insist on these productive expenditures, however, they, not the regulatee, would come under pressure to bear the cost burden of the collision between them and the tax collecting authorities, not to mention the budgetary authorities. Corporations are no match for either. Corporations vote "yes."

But we are going on these programs now as if there were no budgetary consequences. I believe, as a practical matter, that most corporations have considerably overstated their tax accruals to the Government.

Senator BYRD. Thank you. My time has expired.

Senator PACKWOOD. How do you tell prospectively what the replacement costs will be?

Mr. JANEWAY. You get construction estimates. Senator, this is the second to third year, certainly the second year, in which industry after industry records an unprecedented high in new investment projects fully paid for on drawing board paper, fully engineered with no ground broken. There has never been such a high ratio of engineering expenditures on the drawing board to actual construction expenditures.

Corporations which formerly were able to do their investing out of their cash flows are now finding that they would have to finance to make new commitments, and they are balking at that because, pure and simple, it's uneconomic.

Senator PACKWOOD. I understand that. I am talking about your third point here in terms of your replacement costs being the basis for depreciation. I think I would agree with you. I am not quite sure how much a replacement of a typewriter will cost me.

Mr. JANEWAY. I meant to suggest that corporations now know, because they have already paid for the cost of the engineering, gotten their blueprints in place, and proceeded to ask for bids to put contracts out, that the cost is prohibitive. It is the cost hurdle of new investment that's stopping projects dead in their tracks.

Senator PACKWOOD. We are not on the same wavelength.

Mr. JANEWAY. How does a corporation know what its replacement costs are?

Senator PACKWOOD. Yes.

Mr. JANEWAY. It gets bids for new projects. Almost all corporations are asking for bids now, and they are not acting on those bids. Most corporations, in my opinion, would not put new facilities where they have present facilities.

Take again the milestone case, Bethlehem Steel in Lackawanna, N.Y., and in San Francisco. For years, Bethlehem has been, admittedly, publicly wrestling with its social responsibilities in a stagnant area, trying to keep that plant going.

Finally, it is giving up. Scrapping it. The same for San Francisco. We have a rate of net scrappage that I think indicates in a pragmatic way that replacement cost is prohibitive and it is cheaper to buy imports commercially than to try to keep pace with the investment process.

Senator PACKWOOD. I have no further questions.

Senator BYRD. Senator Roth?

Senator ROTH. I have no questions.

Senator BYRD. Mr. Janeway, in the endeavor to get relief from the double taxation of dividends, the administration indicates that if that route is taken, perhaps it should be accompanied by the elimination of the favorable tax treatment afforded capital gains.

What would be the effect, do you think, of treating capital gains as ordinary income?

Mr. JANEWAY. Opportunistically, it would help the stock market. It would inhibit decisions to sell stocks. I do not think we need go that far to see a higher stock market.

Senator BYRD. If you eliminated the favorable treatment of capital gains, it would tend to boost the stock market up?

Mr. JANEWAY. People would be inhibited from selling.

Senator BYRD. Would it be wise or unwise to go to such a proposal, namely to tax capital gains as ordinary income.

Mr. JANEWAY. I do not think you need go that far to get the expansive benefits of relief from double taxation.

Now, I ought to add that I took the individual side of the argument. There is the other side of the argument that I am sure you will hear.

Corporations are saying that in order to help capital formation, the dividend payers should have the benefit of the tax credit. I see no chance of making that stick. I think it would sharpen the double standard, and the resentment against it that now exists. I would deplore the abolition of the capital gains tax, or the capital gains spread. I do not think that you would get enough revenue back from the elimination of the spread.

The sophisticated investor who wanted to get money would avoid the capital gains, or the ordinary income rate, by the simple expedient of financing out. He will borrow on his stock or borrow on his statement, get his money out of it without selling, without incurring gains.

Senator BYRD. Am I correct in assuming that you think that it would be unwise to take such a step?

Mr. JANEWAY. Unwise and impractical.

Senator BYRD. Thank you very much, Mr. Janeway.

Mr. JANEWAY. Thank you, Senator.

Senator BYRD. It was very helpful testimony.

The next witness is Mr. Dan Throop Smith, senior research fellow, Hoover Institution on War, Revolution, and Peace, Stanford University.

We are very glad to have you, Mr. Smith. We appreciate your being here.

STATEMENT OF DAN THROOP SMITH, SENIOR RESEARCH FELLOW, HOOVER INSTITUTION ON WAR, REVOLUTION, AND PEACE, STANFORD UNIVERSITY

Mr. SMITH. It is particularly gratifying to be back before members of this committee; having lived with it for 8 weeks at the time of the adoption of the Internal Revenue Code in 1954, I feel quite familiar with these precincts.

I have shortened my prepared statement in the interests of time. I shall omit certain parts and read others.

These hearings on the impact of tax policy on the supply and use of capital are important and timely. I welcome the invitation to appear before you.

My purpose is to indicate some of the broader implications of tax policy on the structure and operation of our economy and our society. The approach is that of political economy. I shall not present an economic model or search for an idealistic tax system which may be destructive of more important values.

As regards the supply of capital, suffice it to say that two apparently contradictory statements always are true. There is always a capital shortage. There is never a capital shortage.

So long as capital is not a free good, that is so long as it is not available to everyone in unlimited amounts, it will have a price. That price is interest. The use of available capital will be limited and directed by that price and by other market and regulatory forces.

Suffice it also to say that productive uses of capital both to increase labor productivity and thereby justify noninflationary wage increases, and to meet public needs in housing, inner city rehabilitation and mass transportation vastly exceed any probable supply.

Any lingering notions about excess savings, a fashionable notion a generation ago when it had some momentary validity in a deep depression, is as bad as a basis for public policy as it is wrong in theory. In the world as it is, capital is socially as well as personally valuable.

One general proposition deserves emphasis before discussion of details of tax policy. The phrase "tax incentives" implies that taxation can be used to give positive encouragement in some way. That is incorrect. Taxation as such is inherently repressive. It may even be destructive.

A provision of tax law may make taxation less repressive. The Congress has wisely included several such features in our law. But so-called incentives should not be regarded as rewards or handouts from the Government. They are, to repeat, merely intended to reduce the inherent repressive effects of taxation in areas where taxation would have particularly adverse effects.

Our tax system conspicuously discriminates against capital and the income from capital. Income which is the only source of new savings and capital is first taxed. Then the income from capital is also taxed. This is double taxation of the most fundamental sort. The most complete relief would involve a shift from income taxation to the sort of cash flow or expenditures tax which is so well analyzed in the recent Treasury publication "Blueprints for Basic Tax Reform."

In addition to removal of discrimination against capital, a cash-flow tax would be fairer in that it would fall on personal consumption from all sources, including inherited wealth and other capital accumulations. A cash-flow tax would make people share with the government for public purposes part of what they spend for personal use, while relieving the double burden on savings which benefit society generally.

The tax would be on a person's drain on resources, whereas an income tax is on a person's claim to resources, even though the claim is not exercised for personal use. Deductions for charitable contributions should, of course, be continued since they do not represent personal use of resources.

A more modest improvement would be some form of relief from the double taxation of dividend income. The successive taxation first of corporations on their profits and then of stockholders on dividends paid from what is left after the corporate tax is clearly double taxation. The fact that savings used to purchase stock come from income which has already been taxed makes the taxation of dividends actually triple income taxation.

The United States is laggard in giving relief in one form or another to this double/triple taxation of dividend income. Even the socialist and labor governments in Europe are moving rapidly to a uniform method of relief by which at least some part of the corporate income tax is allowed as an offset against the shoreholders' tax. This would be the most effective form of relief. Another would be to allow the corporation a deduction for dividends paid. Still other forms of relief have been proposed, each of which has some merit.

Controversy over the type of relief should not be carried to the point where action is postponed. Some form of relief is needed—and needed promptly.

I wrote rather extensively on this subject for a publication this year. I will submit a copy of that article to be included in the record, if I may, Mr. Chairman.

Taxation of capital gains which are reinvested is really a capital levy rather than an income tax. Proposals to tax all capital gains in full as ordinary income would increase the forced liquidation of capital already caused by the existing capital gains tax. Full taxation of capital gains, if applied to reinvested gains, would be both inequitable and economically destructive. I do not use the word destructive lightly.

The concept of capital gains has been constantly strained—even perverted, by devious manipulations to bring ordinary income under the tax definition of capital gains. The Congress has had to be vigilant to prevent abuse. Last year's belated restrictions on artificial accounting losses—often referred to as tax shenanigans—might well have been even more rigorous. Those of us who contend that a tax on reinvested capital gains is a capital levy should be the first to point out abuses.

The substitution of a cash flow for the individual income tax would relieve automatically the tax on reinvested capital gains and at the same time impose full taxation on gains used for personal consumption. Full taxation of nonreinvested capital gains would be both equitable and sound economic policy.

A more modest proposal regarding the taxation of capital gains would be the use of qualified accounts for financial assets as described in the Treasury "Blueprints for Basic Tax Reform." Authorization to use qualified accounts to permit capital accumulation and shifts among capital assets deserves the most serious consideratiton. Its adoption would be the most constructive single change in the individual income tax law short of substitution of full cash-flow taxation.

A second-best modification would be adoption of a sliding scale downward for taxability of realized capital gains, on the presumption that the longer an asset has been held the more likely it is that proceeds of a sale will be regarded as capital and reinvested.

The increase in the capital gains rate in 1976 by a change in the minimum tax and juxtaposition with the maximum tax on earned income, pushing the total rate in some instances to about 50 percent instead of the statutory maximum of 35 percent, will decrease the supply and impede the effective use of existing capital. And the fact that the increase was concealed rather than forthright added to the resentment of those subject to it.

As regards the taxation of business, a value-added tax would be less bad than the present corporation income tax which discriminates against the efficient utilization of our economic resources and distorts so many management decisions regarding capital structures, new financing, new product development, innovation, and risk taking.

Without substantial modifications, under present definitions business income taxation may take more than the total of all funds arising from a constant level of productive activity. Business income taxation under inflation therefore not only prevents economic growth through retained earnings, it can force a contraction of an existing level of activity.

Various projects are underway in the accounting profession and the SEC to modify the concept of income used for financial accounting under continuing inflation. Some of the proposals for current cost, replacement cost, or other revised methods of accounting may be reasonable for tax purposes; others may not. Thus far, no comparable analysis is being undertaken regarding the concept of taxable income under inflation. I urge that a project be started promptly, either alone or in collaboration with the existing ones on financial accounting.

Two unfortunate and somewhat dangerous sentiments seem to have great influence on economic policy, including tax legislation. They may be noted in conclusion.

The first is an excessive egalitarian attitude. The second is a misconception of the extent and function of profits—and resentment at any increase in profits. Both arise from what is sometimes called the politics of envy, arising from what has been referred to elegantly as the revolution of rising entitlements—or less elegantly as meanmindedness.

The egalitarian attitude is carried so far in some theories and ideologies that "welfare" is deemed to be increased even if everyone is worse off, so long as those at the top are pulled down proportionately more than those at the bottom. It is doubtful that this extreme position would find widespread popular acceptance if formally presented in such strong terms. But policies designed to pull down those at the top seem frequently to be adopted intentionally or unintentionally without regard to their adverse effects on everyone, as substitutes for effective means to raise those at the bottom.

Tax reductions of 1974, for example, were based on a totally erroneous belief that progressive income taxation made the burden of inflation proportionately heavier on those in lower tax brackets than on those in higher brackets. The error arose from superficial analysis which measured the effect of an inflationary rise in incomes only on the tax burden itself when what is really significant is the effect of a tax increase on an existing net income.

The significant burden is clearly the impact on net income. This point was, apparently, never even noted in the discussion of legislation for tax relief. Those who were most hurt by the combination of progressive taxation and inflation had reason to be doubly resentful of the fact that tax relief not only passed them by but ignored the reality of their situation. Inadvertently egalitarian legislation is more to be resented than avowed egalitarianism.

Much has been said about the importance of profits as the principal source of new equity capital and the necessary inducement to invest such capital as is available in business activities which are inevitably risky. With higher interest rates existing under the impact of persistent inflation, the levels of profits must be allowed to rise to justify business investment instead of passive investment in fixed-income securities.

The inadequate level of existing profits—and prospective profits—is dramatically revealed by the fact that in many companies, the best and most profitable use of corporate funds is to purchase a company's own stock in the market and retire it. That this is not done more frequently may be evidence of a hope of eventually attaining a profit level which will justify additional investment.

Or it may be evidence that directors and managements think and act in terms of what is good for the company as a separate entity, regardless of the well-being of the stockholders. This is clearly good for the country, in such cases, but stockholders may increasingly realize that partial liquidations of their companies would be more in their individual interests and insist on withdrawal of capital through stock retirement.

Lest this happen to a greater extent than it has thus far, public attitudes and Government policies, including tax legislation, should recognize that both the absolute level and the rates of profits must rise to justify continued access to and investment of new funds in an inflationary economy.

The need for higher prospects for profits is particularly important to justify investment of capital and effort in new business ventures—and to maintain their continued independent existence. New and relatively small independent businesses are a source of much of the initiative in our economy. Even more importantly, they are principal sources of social and political stability and strength in our Nation. In many respects the Congress has made our tax laws less onerous on small business than on larger corporations.

But much more needs to be done. On this subject, as on so many other aspects of tax and economic legislation, we need a broad social and political perspective. Political economy—rather than abstract economic theory or an obsession with maximum productivity—should be the foundation for policy.

An obsession with a concept of income which does not correspond with any concept of income used in corporate law, for trust purposes, for dividend policies by corporations and only in one segment of public finance literature should not be adopted for tax purposes. We should, I repeat, have political economy as the foundation for economic policy.

Thank you very much, Mr. Chairman and members of the committee.

Senator BYRD. Thank you very much, Mr. Smith.

You heard Mr. Janeway's testimony in regard to gradually bringing the tax down to 15 percent. How does that impress you as a way to getting at this problem?

Mr. SMITH. I would do it in a somewhat different fashion. In a technical sense, I would follow the pattern that is being used commonly in the European Common Market by giving stockholders a credit for a part of the corporate tax previously paid.

I believe that would be a fairer way. I strongly support two points that I believe Mr. Janeway mentioned, although I do not have his testimony in front of me as he gave it.

First, I believe that the relief should be at the stockholder level, not a deduction to the corporation. Relief, to repeat, at the stockholder level rather than a reduction to the corporation for dividends paid.

The second point—and I think Mr. Janeway also made this—I would put the change into effect gradually over a period of years, thereby spreading the revenue impact. And I would further say, Mr. Chairman, that if one takes a reasonably long time perspective, I am not talking about decades, I am talking about a few years, I believe that the vitalization, the revitalization of our economy would be such that there would not be a net loss of revenue. A reinvigorated economy, with reinvigorated investment, would so expand the entire tax base, especially if the change were put into effect over time, that one could justifiably claim that there would be a net revenue loss.

Senator BYRD. What would you think of a combination of benefits to the companies and to the stockholders, or do you think it should just be to the stockholders?

Mr. SMITH. I would prefer that it be at the stockholder level, but I have also said at various times that I think that some relief is so important that I would be—I think it would be very unfortunate if controversy over the method were an excuse for giving no relief.

To be more precise on the matter, relief at the corporate level means that different corporations would, in effect, pay a different rate of tax. The mature corporations making large dividend payments already would have a lower effective tax rate, a lower statutory rate, than the new and growing companies.

Believing, as I do, on political, social, as well as economic grounds, that new corporations, small corporations, are important in this country, relief at the corporate level would, in effect, impose a differentially higher tax on the new companies that cannot pay dividends, that are not in a position to tax on the outside.

It is for that reason that I feel that relief at the individual level would be more effective.

A second reason for preferring the relief at the individual level is that I feel reasonably confident—I feel quite confident—that that would have the effect of raising the level of stock prices which, in turn, would remove this present incentive to use corporate funds to retire existing stocks at low price-earnings ratios.

This is not an ivory tower theorizing. IBM recently retired some stock.

Senator BYRD. Is that being done on a widespread basis, would you say?

Mr. SMITH. It is being done on an appreciable basis, and I have talked with a fair number of companies—I am a director of several companies. I am impressed by the fact that management, as I indicated here, is not disposed to do it, but I think the realization on the part of stockholders has grown to the point where there will be very real pressure to do it.

Managements do not like to have a company become smaller, but there are so many marginal activities in most companies that if they slough off this, slough off that, discontinue this or that and use the funds realized to retire stock, stockholders will be better off and they are gradually going to find that out.

Martin-Marietta recently retired some stock.

Senator BYRD. Suppose the trade-off for the elimination of the double taxation of dividends would be to put capital gains in the same category as regular income. Would that be too high a price to pay?

Mr. SMITH. Yes, sir. I am very glad that you asked me that question, so I can give my answer on it. What I would suggest, sir—I had that in my prepared statement—is to make a distinction between reinvested capital gains and capital gains that are not reinvested. I see no reason whatsoever, why capital gains that are not reinvested should not be taxed in full as ordinary income. They are then used for consumption, they are used for personal purposes. Taxation of that does not deplete the supply of capital.

But if the taxation of gains were general and involved anything like present tax rates of ordinary income, it would have two adverse effects. First, it would increase the freezing effect of leaving investments in their present form. If one has security A, which has appreciated greatly, and wants to get security B and there is a tax of 50, 60, or 70 percent on the proceeds of A, a person is not going to submit himself voluntarily to a capital levy to go from investment A to investment B.

Secondly, to the extent that changes are made in investments, the funds taken by tax come out of the capital fund. It is the capital fund of the Nation as well as the capital fund of the individual. That is the reason that I argue very strongly for a differential treatment of reinvested capital gains.

I submit, sir, and I have proposed many times, as one way, the second-best way to do that, would be a sliding scale of inclusion of capital gains taxation. The gains on assets held 1 to 3 years, yes, tax them in full as ordinary income. But when a person has an investment for 5, 10, or 20 years that, I believe, largely will represent funds that will be reinvested. Therefore a high tax on those gains will absorb capital.

I apologize for a rather long answer to your question, sir.

Senator BYRD. The way your proposal would work, if a person owned some IBM stock and sold that and bought Xerox, say, then there would be no tax on that?

Mr. SMITH. That is right, sir.

Senator BYRD. But if he sold whatever stock it might be and bought a home with it, there would be tax?

Mr. SMITH. The home is a delicate one but yes, anything for personal consumption.

Senator BYRD. Then a person who has bought the home some years ago and sells the home for whatever purpose and does not reinvest, goes to an apartment, leases or rents or what have you, under your proposal, that person would pay an ordinary income tax on the net proceeds of the home?

Mr. SMITH. Excuse the personal aspect, but it is a very delicate subject because I am in the process of moving into a retirement home and I am confronted with that very point. I think that the law should be—this is selfish, if you like—should be such that the funds used to buy into a retirement home might well be treated as a purchase of a personal residence.

This is a highly special situation, Senator. But I am not alone on this.

I do think the proceeds of the sale of a residence which is not used for another residence but to get income for rental purposes and whatnot might well be liberalized.

Senator BYRD. Let us get it back to equity investment.

Your feeling is that we would have a better tax system, instead of having the present capital gains situation, that if a person who owns stock sells his stock and buys other stock there is not a tax on whatever appreciation there might have been?

Mr. SMITH. That is right, sir. I would go further and say, buys any other investment security.

The distinction I would make is holding an investment asset and using the proceeds for personal consumption. I would go all the way, go from a stock to Treasury bills, later on, if you like, back to another stock, or investment in real estate, not a residence, but investment in real estate.

I distinguish consumption and a capital account.

Senator BYRD. Thank you. My time has expired.

Senator Packwood?

Senator PACKWOOD. Thank you. I have no questions, Mr. Chairman.

I want to thank you for your testimony that you gave before the Ways and Means Committee on deferral last year. I used it extensively in my debates. I found it extremely reliable and persuasive.

Mr. SMITH. Thank you, Senator. I have two paragraphs which I left out on that subject in my prepared statement and if I may interject, I for some time have argued that deferral is a somewhat pejorative term.

I have referred, and others have referred, to the proposed removal of deferral as a premature or anticipatory taxation. And I have cited the analogy, which is somewhat valid, that it would be similar to a provision of the law to impose an estate tax on a person when he lived to his life expectancy even though he had not died because there was a tax-free loan from the Government to him until he finally did die.

Senator PACKWOOD. I understand the problem, but I gave up that argument long ago and turned to the argument of whether we are a democracy or a republic.

Thank you, Mr. Chairman.

Senator BYRD. Senator Roth?

Senator ROTH. Professor Smith, I would like to go back just for a minute to some of the questions raised by Senator Byrd. I think I understand the economic reasons why you want to differentiate between consumption and investment, but it does bother me from a practical point of view. I happen to be one of the people concerned about the egalitarian attitude of this Congress, and past Congresses.

At the same time, it seems to me that if Congress adopted your approach we would really be penalizing the little investors. I think anything we can do to encourage them to invest and save is very desirable. You use the illustration of housing. I can make many other similar type examples, for example, the family who saves to send a child to college, which is becoming extraordinarily difficult for the middle class. This is one of my problems.

It seems to me that you narrow the base for capital gains by appearing that we are just trying to help the rich, who are the ones now best able to keep reinvesting.

Mr. SMITH. The rollover approach that I refer to, Senator, I regard as a second-best treatment. As I indicated in my testimony, the so-called cash flow approach—and I do invite your attention to this "Blueprint for Tax Reform," the Treasury publication of January 17—would give a deduction for all savings for everyone. That is, to me, a more fundamental improvement.

If that is not adopted, then I think, to take one small step, which would be the rollover of capital already saved, would be desirable. But to repeat, the fact that something is not complete does not mean it is not necessarily good.

Senator ROTH. We should encourage and enable our people at the lower rates to share in the advantage of saving.

Mr. SMITH. I most emphatically agree with you, sir.

Senator ROTH. I would like to raise a somewhat different question than what you raised in your testimony. I am a very strong believer that high taxation is having a very burdensome effect on our economy. I promoted very actively in the recent tax legislation, and intend to do so in the future, the idea that the best thing that could happen to this country is to do something along the lines of what President Kennedy did in the early 1960's and that would be to propose an across-the-board permanent tax cut, both for individuals and business.

I am very concerned by the fact that inflation has pushed people into higher and higher brackets, making it very difficult for middle America to even keep even; as many economists have said, the middle class is facing downward mobility rather than upward mobility.

It seems to me that it is time to do what Mr. Kennedy did in the early 1960's, and that is to enact a substantial permanent tax cut. I propose a 10 percent rate reduction, and to do the same with business.

I happen to believe that that is a better approach than this constantly increasing deficit spending on the part of the Federal Government.

I wonder if you would care to comment?

Mr. SMITH. I heartily agree with you. I would go further sir, and propose that there be put into the law a succession of cuts to be adopted over the years so that a reduction in tax rates would be as fundamental a part of budget planning as the built-in increases for expenditures in some of our expenditures programs.

Senator ROTH. A form of indexing?

Mr. SMITH. I was not referring necessarily to that. I suppose one might call it that. You used the figure of 10 percent across the board. I might say, let us have 5 percent the first year, then another 5 percent the next year and another 5 percent the third year, and so on, until we get down to a level of individual taxation so that there is less distortion of decisions.

I do think, sir, on one particular facet of that, when the Congress adopted some years ago a 50 percent ceiling on earned income taxation, the revenue loss, I believe, was trivial. But the benefits in terms of getting away from—I use the term many times here, "tax shenanigans,"—the distortion of effort by those who try to minimize taxes, which really is not productive, was a very important benefit. I would urge that the arguments for reducing the maximum rate on earned income from the 70 to 50 are just as good for investment income.

Senator ROTH. Would this not be a significant way of helping employment in the private sector?

Mr. SMITH. Indeed it would.

Senator ROTH. Mr. Chairman, this is something that I intend to push, and I appreciate the support you have given me in the past, but we need a lot of help out in the public sector and the private sector in getting support for this program.

Thank you, Professor.

Senator BYRD. Mr. Smith, just two questions.

In connection with the recent changes in the estate and gift tax law, you indicated that the carryover of tax bases creates pressures on family businesses to merge with larger corporations. In what ways do you see this pressure as occurring?

Mr. SMITH. There is always a pressure, Senator. In a closely controlled family business, or any closely controlled business, as the existing owners, the founders, anticipate the estate taxes, they are going to have to have liquidity to meet those estate taxes.

Congress has wisely put in provisions for deferral of payment—for longer term payment. That has been useful, as far as it goes, but the carryover of basis means that, assuming property does go through to a second generation, the heirs will be confronted with the same—I would use my phrase, "capital levy"—when they sell that their parents would have had.

Where they need diversification of investment or where the successive generations do not have the management skills and talent and desire to continue to run the business, the only way out is a merger. The point is if they sell, they have this big capital levy. If they merge with a large company that has a diversified line of activities, they get a tax-free merger. The inducement, sir, is very strong.

Senator BYRD. It seems to me that it is not a very helpful thing for the country to be making big companies bigger and eliminating smaller companies.

Mr. SMITH. I think it is very, very unfortunate. I have said it before, perhaps even before this committee, but I will say it again: when I used to go back to a little town in Iowa where my grandparents lived and spoke at the Rotary Club, the members were owners of companies. Then it began to be when I went back, they were the temporary managers of the branch plants, of the chain stores.

The whole social structure of the community was entirely different and I, for one, and I believe many others, would sacrifice a certain amount of economic efficiency to maintain individual ownership and activity.

Senator BYRD. How do you think that carryover of tax basis could effectively and realistically be changed?

Mr. SMITH. I would simply eliminate it.

Senator BYRD. Eliminate it?

Mr. SMITH. Yes. I would go back to what we had before. I hope it is not unduly blunt to say that the idea of the presumptive realization of gain at death—a rather-vulgar way of putting it—is kicking the dead man twice. It seems to me that once a generation property should be able to be transferred. Let the estate taxes be what they are. The fact that there has been a build-up of capital useful to this society is no reason to impose an additional penalty tax on the capital. I would go back to what we had.

Further, the carryover basis is a perfectly monstrous thing administratively. How in Heaven's name would an executor who has property to be divided three ways between "my dearly beloved children," take account of the fact that some of the children are in this tax bracket, some in another tax bracket, some expect to sell the property, some expect to keep it forever. What is an equal division of property, if the children have to carry forward the basis of property which was acquired a long time ago? I think it is monstrous.

Senator BYRD. One final question.

Could you, briefly, sum up the kind of overall tax package that you feel would be the most effective in encouraging capital investment?

Mr. SMITH. If one could start from scratch, the ideal thing would be, as far as individual taxation was concerned, the so-called cash flow or expenditure tax which gives a deduction for savings when savings are made and brings into taxation funds used for consumption of various sorts, whether those funds come from one's own previous savings or previous capital.

As for business taxation, a value-added tax instead of the corporate income tax, a value-added tax of the sort that is becoming universal in Europe now. That is the tax that has virtually no distorting effects on business decisions, on capital investments, on the flow of funds. Insofar as the value-added tax is concerned, I would put that into effect over a period of years. Otherwise the transition impact would be appreciable.

You would start with a 1 percent value-added tax and bring the corporation tax down 5 percent the first year. That would be the idea in my opinion, if one had a clean slate.

Short of that, as far as individuals are concerned, I would resist full taxation of capital gains. I would try to go to a rollover treatment of reinvestment capital gains. If I could not do that, I would adopt a sliding scale on capital gains, a sliding scale related to the time the property is held. That, by the way, was the provision of the law, I believe, from 1937 to 1939, even in the so-called New Deal days. In my opinion, it was the one sensible thing that was done on tax legislation at that time, and it serves as a precedent.

On business taxation, if I could not go to a value-added tax, I would move in the direction of recognizing that the corporation income tax under inflation really is absorbing capital. As I have indicated, and as others have indicated, the accounting profession, the Financial Accounting Standards Board and the SEC both have major projects underway to revise the concept of financial accounting to take account of inflation.

I would urge this committee, the Congress, the Treasury, in one way or another, launch a major study to analyze what has been done in other countries. Almost all other countries have done something on this with respect to taxation.

I am describing what seems to me not what is the ideal, but a succession of second-bests, and third-bests.

Senator BYRD. Would the full taxation of capital gains cause the stock market to go up?

Mr. SMITH. No. I disagree with the statement that was made earlier on that. Yes; it would discourage sales, but it would also discourage purchasers. Looking at the demand side as well as the supply side, I cannot agree with any testimony that says the net effect would be to put the stock market up.

Senator BYRD. Thank you very much, Dr. Smith. I might say, in conclusion, that your recent article in the Harvard Business Review contains a unique and informative discussion of the integration issue. You make a good point when you say that those who are subject to a tax may perceive it quite differently than what the legislators or the theorists intended it to be.

I think it would be well to reprint your article as a part of the record, which we will do.

[The following was subsequently supplied for the record:]

[From the Harvard Business Review, January–February 1977]

RELIEF FROM DOUBLE TAXATION OF DIVIDEND INCOME

DOUBLE TAXATION OF DIVIDEND INCOME DISCRIMINATES AGAINST BOTH CORPORATIONS AND STOCKHOLDERS, AS WELL AS AGAINST EQUITY CAPITAL

(By Dan Throop Smith)

Just about everyone is convinced that some form of relief from double taxation is desirable. All agree that it is not equitable or sensible economic policy that corporations pay taxes on corporate income above $50,000, and that individuals pay taxes on the dividends that come from the already taxed corporate income. What people are not agreed on, however, is the best form of relief. The author of this article describes the currently proposed methods of relief, namely, at the corporate level, by allowing deductions for dividends paid; at the stockholder level, by allowing full or partial exemption for dividends received, and by imputing the full income of corporations to stockholders as presumptive partners. The author also describes Robert N. Anthony's plan for accounting for the cost of equity capital as it might be adapted for tax purposes. Although none of the methods completely ends the discriminatory treatment of equity capital as compared with debt capital, the author concludes that in the long run, a combination of relief at the corporate level by deduction of part of the dividends paid, and at the stockholder level with some part of a corporation's tax being applied as a credit to individuals' taxes, might be most effective.

Mr. Smith is professor of finance, emeritus, Harvard Business School, senior research fellow at the Hoover Institution in Stanford University, and a director of the Cambridge Research Institute Inc. He was deputy to the secretary of the Treasury (tax policy) in the Eisenhower Administration. This is Mr. Smith's twelfth article in HBR, his most recent one being, "When—if—we have the VAT," which appeared in the January-February 1973 issue.

Relief from double taxation of dividend income may at last be imminent. Many individuals and groups spanning the full range of ideologies have proposed that there be some form of relief. The Ford Administration has recommended relief, and President-elect Carter, in an interview in September 1976, said "I would tax income only once."[1] The House Ways and Means Committee and the Senate Finance Committee have both received recurring testimony on the subject.

The fact that the government doubly taxes dividend income is incontrovertible. Corporate income is taxed at the full corporation income tax rate of 48 percent for all taxable income above $50,000. Dividends paid from that same income are taxed to individual recipients at the full progressive rates from 14 percent to 70 percent. Whether one regards the double taxation as discriminatory against both corporations and stockholders, or as a "cost of business," which ultimately falls capriciously on consumers, the corporate tax is a bad tax. At least some of the burden of the double tax is on equity capital. Tax discrimination against equity capital is bad economic policy when business capital is so necessary to increase labor productivity and to finance environmental improvements.

There is little disagreement about the need for relief from double taxation. However, this has not led to agreement on the best method of relief. The central purpose in this article is to analyze the relative merits of different forms of relief from double taxation, keeping in mind that unless a method deals with the discimination against equity capital, a solution can be only partial at best.

The government could give tax relief (1) at the corporate level by allowing a deduction for dividends paid; (2) at the stockholder level by allowing full or partial exemption, directly or indirectly, for dividends received; or (3) at the corporate level by abolishing the corporate income tax, and imputing all corporate income *pro rata* to stockholders and taxing it to them as is done in partnerships. A fourth method, recently proposed, would allow a corporation to deduct for a "normal" return on equity capital.

Comparison of the methods

Although the results of the first three methods are presumed in theory to be similar, in fact they are not. If one takes account of the actual perceptions of corporate managements and investors regarding taxes as well as of their probable actions, the results of the alternative changes in the law appear to be quite different. Let's look at the proposed methods of relief in turn.

Relief at the corporate level

The first method would give relief at the corporate level by allowing corporations to deuct dividends paid when computing corporate taxable income. This procedure is equivalent to, and may be thought of as, imposing the corporate tax only on retained earnings. From the standpoint of the corporation, dividends and interest would be treated similarly.

With interest and dividends both deductible, the tax penalty against equity financing would be reduced. Distributed corporate profits would be taxed to stockholders like all other income, at whatever rates are applicable. Retained earnings would be taxed to the corporation at whatever rate or rates are appropriate. The result would be straightforward and direct with few administrative problems for corporations or the government. Complications might arise if corporations were to pay dividends out of earnings previously retained—and taxed. But this problem could be solved by arbitrary presumptions regarding the source of dividends.

The fact that the corporation income tax would apply only to retained earnings means that it would be a differential tax on growing companies which need to retain all their profits for expansion. The differential tax burden would be especially onerous for companies that are too small to secure equity funds from new stock issues.

Viewed another way, the tax relief would go to companies that have already developed their earning capacity to the point where they can pay dividends with-

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[1] *U.S. News and World Report*, September 13, 1976, p. 71.

out jeopardy. These companies would have more funds to use for either increases in dividends or for retained earnings, or both, while companies that cannot pay dividends would get no relief.

The effect of a deduction for dividends would depend on whatever corporation tax rate is effective. If the corporation tax continues at the same rate, company managements would perceive the deduction as selective relief for companies paying dividends. In deciding on financing, capital budgeting and pricing of products, managements of companies paying dividends would take the lower effective rate into account. If, on the other hand, the tax rate on retained corporate income were increased to maintain total revenue, management would perceive the deduction for dividends as a penalty on retention of earnings.

To the extent that stockholders think in terms of their pro rata share of corporate income before tax (a point of view which usually exists only in closely controlled companies), they might want to secure larger dividends to "avoid" the corporate tax on retained earnings. Stockholders subject to tax rates lower than the corporate rate would be better off having all earnings distributed and taxed to them. They could then reinvest their aftertax increase in dividends, perhaps in the same company. (In theory, this presumption of desired reinvestment in the same company exists whenever corporate earnings are retained.)

Stockholders in a closely controlled company probably would withdraw corporate income and reinvest in it the same company or elsewhere if their individual tax rates were not substantially higher than the corporate rate. Stockholders in widely owned companies, on the other hand, commonly think of present and future dividends, earnings per share, and market prices of stock. They typically do not, in common with sophisticated owner-managers, think of their pro rata shares of pretax corporate income as being part of their own funds transferable, as it were, from the corporate pocket to their individual pockets.

In widely owned companies conventional dividend rates would be likely to be increased somewhat, with the reduction in taxes on the basis of existing dividend policies used to increase both dividends and retained earnings.

The technique of giving tax relief to corporations by allowing them to deduct dividends from payable corporate income is not new, although the motivations for doing so are not necessarily the same. In 1958, the West German government reduced the corporate tax rate on distributed earnings from the 51 percent previously payable on all corporate income to 15 percent, thereby going most of the way to full deduction of dividends. The government's intent was to get the corporations to assist in the rebuilding of the West German financial markets by forcing corporations to rely more heavily on new equity issues instead of retained earnings for growth. Corporations, it was presumed, would naturally distribute most of their income if the tax on retained earnings was higher than that on dividends. In fact, it seems that West German corporations increased their dividends, at most, by the amount of the tax reductions on previously existing dividend rates. And widely owned companies did not appear to decrease their additions to retained earnings; in fact, for those companies previously paying some dividends retained earnings could be increased.

There is little solid basis for projecting precisely what the relative effects on dividends and retained earnings would be if dividends were made tax deductible in the United States. But it seems unrealistic to expect corporate managements and directors, except in closely controlled companies, to think primarily in terms of alternative uses of stockholders' pro rata interests in pretax corporate profits, or for stockholders to think or be able to act in these terms.

It seems more likely that companies already paying dividends would divide the increase in earnings arising from reduced taxes between higher dividends and larger retentions. Companies not paying dividends would continue to retain earnings unless they were controlled by tax-exempt or low-tax stockholders such as foundations, universities, or churches.

One final point is as important as it is brief. To the extent that a corporate tax is treated as a cost of doing business, the larger the proportionate distribution of earnings, the lower will be the "tax cost" to be taken into account in pricing of products and capital budgeting. Companies that must retain earnings because they cannot tap public financial markets for new equity capital, would have higher "tax costs" and be at a competitive disadvantage.

Relief at the stockholder level

Under the second form of relief from double taxation the government would make dividends wholly or partially tax-exempt to the recipients instead of to the corporation. The first and most obvious consequence of this form of relief would be that the market price of dividend-paying corporate stock would increase in comparison with alternative investments. This increase in market price would have an important effect on corporate financing in the sense that fewer shares would have to be sold to raise any given amount of capital. Or, stated differently, corporations could obtain new equity financing without diluting earnings with lower rates of pretax returns on the new capital. People seldom recognize this indirect effect of tax relief at the stockholder level.

From the standpoint of corporate management and directors, if relief is given at the stockholder level, the corporate tax remains the same regardless of the extent of dividend distribution or tax relief for stockholders. There is, therefore, no differential "tax cost" at the corporate level based on the extent of dividend distributions. Decisions on financing, capital budgeting, and product pricing would not be influenced by relief at the stockholder level, except, as previously noted, that the higher stock prices would make equity financing more attractive and would justify a lower "cost of capital."

Though stockholder relief would apply only to the extent that corporations pay dividends, double taxation exists only to that same extent. Prospective tax relief on subsequent dividends would increase the price of all corporate stock in comparison to other investments, even if a corporation does not pay dividends currently. (By analogy, a tax-exempt bond would be priced higher, that is, have a lower yield, than a taxable bond even if no interest were payable for the first few years of its existence.)

Since dividends would be more attractive to stockholders, one might think that there would be a tendency for corporations to increase distributions. But one might equally well presume that gross dividends would be reduced somewhat in widely owned companies, with an increase in net aftertax dividends still available to stockholders, and an increase in retained earnings for the corporation. The corporations would in effect divide the tax reduction to the stockholders between the stockholders and the corporaton.

Though conceivable, it seems improbable that a corporation would, in fact, reduce an established dividend rate although even with some reduction, most stockholders would still be better off. Nor does it follow that corporations would be likely to increase dividends because they had become worth more, after tax, to stockholders.

In France, where a partial relief at the stockholder level was adopted in 1965, uncertainty continued in the government and the market for several months whether dividends would be reduced. Finally a statement from a company, headed by a particularly influential person, set the precedent for continuation of the dividend rate. An unstated reason for the tax relief in France was to increase the price of company stocks, thereby discouraging takeovers by U.S. and other foreign multinational companies. At that time, a continuation of dividends was important to ensure the desired rise in stock prices, since French investors regarded dividend yields as more significant than price-earnings ratios in the market valuations of corporate stock.

Some advocates of tax relief at the stockholder level argue that the corporation income tax ought to be regarded, in effect, as a withholding tax paid by the corporation on behalf of stockholders, insofar as corporate income is distributed as dividends. Consistent with this concept dividends would be "grossed up" by the amount of the corporate income tax imputable to them, and the amount of the "gross-up" would then be applied as a credit against the tax payable by the stockholder. If the stockholder's rate were higher than the corporate rate, the difference would be due to the government.

The full corporate tax would be payable on retained earnings with no offset or imputation of income to stockholders. The process of "gross-up" and credit presents certain administrative problems if the applicable corporate tax is less than the full normal rate.

The method adopted in France treats one-half of the corporate tax as imputable to stockholders, that is as income for "gross-up" and creditable against the stockholder's tax. The Exhibit shows what the stockholder tax rate would be under this plan for individuals in the 40 percent, 50 percent, and 60 percent tax brackets on 100 units of pretax corporate income, with a corporate tax rate of 50 percent and one-half of corporate net income distributed.

CALCULATION OF EFFECT OF APPLYING ½ OF CORPORATE TAX TO STOCKHOLDERS' TAX

	Stockholder tax rate		
	40 percent	50 percent	60 percent
1. Pretax corporate income (units)	100	100	100
2. Corporate tax at 50 percent	50	50	50
3. Net corporate income	50	50	50
4. Dividend of ½ of net corporate income	25	25	25
5. Gross up (50 percent of ½ of corporate tax)	12.50	12.50	12.50
6. Taxable dividend	37.50	37.50	37.50
7. Gross tax on stockholder (line 6 times stockholder tax rate)	15.00	18.75	22.50
8. Less gross up	12.50	12.50	12.50
9. Net tax on dividend (line 7 minus line 8)	2.50	6.25	10.00
10. After tax dividend (line 4 minus line 9)	22.50	18.75	15.00
11. Tax on stockholder in absence of gross up and credit (line 4 times stockholder tax rate)	10.00	12.50	15.00
12. Aftertax dividends in absence of gross up and credit (line 4 minus line 11)	15.00	12.50	10.00
13. Increase in net dividend to stockholder (line 10 minus line 12)	7.50	6.25	5.00
14. Percentage increase in net dividend (line 13 plus line 12)	50	50	50

The uniform percentage increase in net aftertax dividend, regardless of the stockholder's personal tax rate, is notable—and equitable. This method of relief just described, and adopted in France, has been officially recommended for general application in the European Common Market.

U.S. Treasury proposal

The U.S. Treasury's recommendation for a deduction for one-half of dividends paid, and a "gross-up" and credit for one-half of the corporation tax attributable to the corporate income from which dividends were paid, is also reasonable and desirable.

This plan allows for the differing consequences of relief at both the corporate and the stockholder levels. It combines elements of the first two methods of relief. It would make dividends, to some extent, more like fully deductible interest. And inasmuch as the taxation of dividends to recipients is reduced by the tax the corporation previously paid on its distributed income, the plan would improve the investment status of common stocks. The recommendation also takes account of the uncertainty regarding the extent to which the corporation's income tax is shifted.

Imputation of Corporate Income to Stockholders

A third method of relief from double taxation of corporate and dividend income is to impute all corporate income to stockholders, *pro rata*, and tax it to them at their respective rates. This method is referred to as the presumptive partnership approach. Though feasible is an actual partnership where ownership changes infrequently and partners can agree on the extent of withdrawals with which to pay individual taxes on their respective shares of imputed income, the procedure would be utterly impractical for corporations that have thousands of shareholders who change daily and who are subject to tax rates ranging from zero to the maximum 70 percent.

Recognition of the problems and market distortions associated with allocating corporate income to stockholders as partners should be sufficient to discourage serious consideration of the proposal. As one example, should the income be allocated according to ownership for whatever portion of a year stock is held or on the basis of ownership on a specified day? Despite the inherent difficulties of determining ownership that the plan has some writers continue to give it serious attention.

As already noted, those who are subject to a tax may perceive it quite differently from what the legislators or theorists intend it to be. And their perception is likely to be more significant in determining the effects of the tax than legislative intent or a theoretical model. The difference between theory and perception could be especially large if a presumptive partnership treatment of corporate income were combined with a withholding tax at a rate similar to the preceding corporate income tax. The result might be entirely different from what it would be under a presumptive partnership treatment in the absence of a withholding tax. (Since the presumptive partnership approach has not been coupled with a withholding tax at a high rate payable by the corporation in either theoretical literature or proposed legislation, the discussion of this form of relief is very conjectural.)

Corporate management would probably regard the withholding tax as a continuation of the corporate income tax, with dividends made nontaxable for most stockholders. Corporate managements generally would still regard the corporation as subject to taxation on the basis of its income and take the tax into account in its capital budgeting, capital structure, and price policies. Most stockholders would find stock a particularly attractive investment as being at least tax-exempt and, for lower-bracket stockholders, these would be a somewhat mysterious tax credit to offset the tax on other income. Stock prices would rise and the cost of new equity financing would be reduced because corporations would have to sell fewer shares to raise any specified amount of capital.

The result of coupling the withholding tax and the presumptive partnership approach might not be what the proponents of the approach want. And those who generally think a partnership treatment is impractical, might regard it as eminently desirable. The essential element would be a withholding tax at a rate sufficiently high to cover the tax liabilities of most stockholders. If the top bracket individual rate were set at 50 percent, as many have argued that it should be for many good reasons, pressure from stockholders for more dividends, with a consequent reduction in retained earnings, would be eliminated on the further assumption that the withholding rate was set at about the existing corporate rate. And those who object to withholding on dividends as a general proposition might favor a withholding tax under these circumstances when they realize that the combined effects of the tax changes would be to make stock investment more attractive.

It would be ironic, indeed, if agreement on a major tax revision developed on the basis of different interpretations of the probable results. One group would want to abolish the corporate tax and make stockholders pay directly a tax on the shares of retained earnings. Another group could agree to a revision believing that the change would be perceived as being at least full tax exemption of dividends. Whatever the point of view, the actual result could be both equitable and economically beneficial.

Deduction for a "Normal Cost" of Equity Capital

A method for computing corporate income, developed without reference to tax concepts, deserves attention from a tax standpoint even though its adoption in the near future is unlikely.[3] This method would deal directly with a segment of the cost of equity capital regardless of what fraction of the total cost is paid out of dividends. The fact that equity capital does have a cost is recognized in both economic theory and business practice, even though this cost is not currently recorded in the company's accounts. The cost varies among industries and risk environments, and there is no reliable way of measuring exactly what the cost is for a given company.

Robert N. Anthony, who has developed the concept of the cost of equity capital, proposes the use of a "prime equity rate," namely, the minimum cost of equity capital in environments where risk is relatively low. Such a rate would be analogous to the "prime rate," which is a measure of the cost of low-risk debt. Applied to the book value of equity capital, the prime equity rate would give equity an "interest" cost which, if made tax deductible, would go a long way to reducing the discriminatory tax treatment of equity capital. It would not remove the discrepancy entirely because the rate would not measure the full cost of equity capital.

An advantage of this method, if it were adopted for tax purposes, is that it is in no way affected by a company's dividend policy, nor does it motivate companies to change dividend policies. In comparison with the dividend credit to stockholders, this method has the advantage that stockholders would continue to be fully taxed on their dividend income, thereby removing an unjustified, but nonetheless possible, political criticism of "favoring the rich."

A disadvantage is that the tax law would be recognizing as an element of cost, an item that generally accepted accounting principles say is not a cost. Many people would regard such a tax deduction as unsound for this reason alone. If accounting standards should recognize a general cost of equity capital, this criticism would disappear. The Financial Accounting Standards Board is considering this possibility.

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[3] See Robert N. Anthony's development of this idea in "Accounting for the Cost of Equity," HBR November–December 1973, p. 88.

To the extent that the corporation income tax is a "tax cost" of business, the reduction in the tax would tend to make prices charged by corporations less than they would be otherwise. There would be no "relief" from double taxation but, by definition, there would not have been full double taxation.

A major danger of a deduction for an imputed cost of equity capital is that the amount allowed would be considered as a norm, with penalty taxes at destructive excess-profit rates imposed on income above the allowable deduction. Thus no matter how one calculates the allowable deduction, with or without differentials with respect to various industries or other significant variables, the remaining corporate tax would become a tax penalty on more successful (efficient) companies.

A further objection to a deduction for the imputed cost of equity capital might be that corporations would not pay taxes currently on retained earnings, to the extent that the retentions were based on the deductible segment of profits. The current double-tax penalty would be converted, in part, into a temporary no-tax advantage. However, when stockholders sell stock benefiting from the larger retention of earnings, they will also have to pay higher capital gains taxes, thereby making up for some of the taxes not previously paid. The "carry-over" of basis at death and the increase in the minimum tax in the 1976 legislation by increasing capital gains taxes greatly reduce the long-run significance of this temporary relief. In view of the critical need for expansion of the equity capital base, this favorable tax treatment seems justified.

The best available method

None of the proposals for relief of double taxation of dividend income are ideal. As mentioned heretofore, one of the main purposes is to lessen the discriminatory tax treatment of equity capital as compared with debt capital, and thereby reduce the barrier to badly needed equity capital.

The effect of a dividend deduction at the corporate level is quite uncertain in that it would reduce the cost of equity capital as seen by management, but at the same time lead to some pressure for increased dividend payments. To the extent that corporations increase dividends, the reduction of retained earnings as a source of equity capital might offset, or even more than offset, the stimulus to new equity capital formation from the lower cost of capital. If this happens, the plan will have failed to accomplish a major purpose. The dividend exemption or credit at the stockholder level has fewer uncertainties. Almost certainly, stock prices would be higher, and the cost of new equity capital reduced, thereby lessening the existing tax impediment to business financing. Inducements to increase dividend payments would not be as strong as with the other proposal.

Relief through either dividend deductions or at the stockholder level, however, provides only a partial solution of a basic problem. Interest payments are the full cost of debt capital, but dividends are *not* the full cost of equity capital; the latter includes retained earnings as well. Any proposal that deals only with dividends does not remove the tax burden on equity capital; it merely lessens the burden. And, as pointed out heretofore, the extent of the relief will be different for different companies, depending on how they divide income between dividends and retained earnings.

The imputed partnership approach provides full immediate taxation at of all income on equity capital, but in the absence of a withholding tax at high rates is likely to create overwhelming pressure for large dividends, thereby reducing retained earnings which are the principal source of new equity capital.

A deduction to the corporation for an imputed cost of equity capital avoids any tax distinction between retained earnings and dividends, but if dividends were not paid up to the level of the "normal cost," retained earnings would not be currently taxed to either the corporation or stockholders. Though reasonable—even desirable—as a matter of economic policy, nontaxation of some segment of retained earnings might not be acceptable politically.

Throughout the foregoing analysis of different methods of relief, attention has been directed to how taxes are perceived and to probable attitudes of stockholders, managements, and corporate boards of directors. This approach differs from theoretical models which assume that corporate income is regarded by both management and stockholders as belonging *pro rata* to stockholders. Under this latter view decisions on corporate income's retention or distribution are based on a collective judgment of the best way to maximize returns after taking account of all current and prospective corporate and personal taxes. For reasons indicated, this assumption seems so unrealistic for large corporations that conclusions based on it are inappropriate as a foundation for tax policy.

Because of uncertainties regarding the actual effects of present taxation, and prospective changes in the law, a combination of partial deduction of dividends and partial credit to stockholders for the corporate tax appears to be the best available form of relief. Either full deduction or full credit would be a great improvement over the present law. So would a presumptive partnership treatment if, and only if, it were coupled with a reduction in the maximum personal rate to the level of the rate of the withholding tax, which in turn should be no higher than what might be imposed as a corporation income tax.

Mr. SMITH. Thank you. Thank you for spotting that sentence. It is a point on which I at some time propose to write an article, or even a book, on the difference between intent and perception.

Senator BYRD. Thank you, sir.

[The prepared statement of Mr. Smith follows:]

STATEMENT OF DAN THROOP SMITH*—SENIOR RESEARCH FELLOW, HOOVER INSTITUTION ON WAR, REVOLUTION AND PEACE, STANFORD UNIVERSITY

These Hearings on the impact of tax policy on the supply and use of capital are important and timely. I welcome the invitation to appear before you.

My purpose is to indicate some of the broader implications of tax policy on the structure and operation of our economy and our society. The approach is that of political economy. I shall not present an economic model or search for an idealistic tax system which may be destructive of more important values.

As regards the supply of capital, suffice it to say that two apparently contradictory statements always are true. There is always a capital shortage. There is never a capital shortage.

So long as capital is not a free good, that is so long as it is not available to everyone in unlimited amounts, it will have a price. That price is interest. The use of available capital will be limited and directed by that price and by other market and regulatory forces.

Suffice it also to say that productive uses of capital both to increase labor productivity, and thereby justify non-inflationary wage increases, and to meet public needs in housing, inner city rehabilitation and mass transportation vastly exceed any probable supply.

Any lingering notions about excess savings, a fashionable notion a generation ago when it had some momentary validity in a deep depression, is as bad as a basis for public policy as it is wrong in theory. In the world as it is, capital is socially as well as personally valuable. The false theory of a perpetual tendency towards excess savings ranks with the more recent false theory that long-term control of inflation leads to unemployment—the so-called unemployment/inflation trade-off—as the two most destructive economic fallacies of the past two centuries.

One general proposition deserves emphasis before discussion of details of tax policy. The phrase "tax incentives" implies that taxation can be used to give positive encouragement in some way. That is incorrect. Taxation as such is inherently repressive. It may even be destructive.

A provision of tax law may make taxation less repressive. The Congress has wisely included several such features in our law. But so-called incentives should not be regarded as rewards or hand-outs from the government. They are, to repeat, merely intended to *reduce* the inherent repressive effects of taxation in areas where taxation would have particularly adverse effects.

Now to the specifics. I shall have to be brief to cover the major relevant aspects of the law. Each of them deserves extensive analysis, some of which may be developed in the discussion.

Our tax system conspicuously discriminates against capital and the income from capital. Income which is the only source of new savings and capital is first taxed. Then the income from capital is also taxed. This is double taxation of the

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most fundamental sort. The most complete relief would involve a shift from income taxation to the sort of cash flow or expenditure tax which is so well analyzed in the recent Treasury publication "Blueprints for Basic Tax Reform." In addition to removal of a discrimination against capital, a cash-flow tax would be fairer in that it would fall on personal consumption from all sources, including inherited wealth and other capital accumulations. A cash-flow tax would make people share with the government for public purposes part of what they spend for personal use, while relieving the double burden on savings which benefit society generally. The tax would be on a person's drain on resources whereas an income tax is a tax on a person's claim to resources, even though the claim is not exercised for personal use. Deductions for charitable contributions should, of course, be continued since they do not represent personal use of resources.

A cash-flow tax would provide a form of automatic life-time averaging, by giving a deduction for savings as they are made and taxing them only in later retirement years when incomes and tax rates are presumably lower.

A more modest improvement would be some form of relief from the double taxation of dividend income. The successive taxation first of corporations on their profits and then of stockholders on dividends paid from what is left after the corporate tax is clearly double taxation. (The fact that savings used to purchase stock come from income which has already been taxed makes the taxation of dividends actually triple income taxation.)

The United States is laggard in giving relief in one form or another to this double/triple taxation of dividend income. Even the socialist and labor governments in Europe are moving rapidly to a uniform method of relief by which at least some part of the corporate income tax is allowed as an offset against the shareholders' tax. This would be the most effective form of relief. Another would be to allow the corporation a deduction for dividends paid. Still other forms of relief have been proposed each of which has some merit. Controversy over the type of relief should not be carried to the point where action is postponed. Some form of relief is needed—and needed promptly.

Taxation of capital gains which are reinvested is really a capital levy rather than an income tax. Proposals to tax all capital gains in full as ordinary income would increase the forced liquidation of capital already caused by the existing capital gains tax. Full taxation of capital gains, if applied to reinvested gains, would be both inequitable and economically destructive.

The concept of capital gains has been constantly strained—even perverted—by devious manipulations to bring ordinary income under the tax definition of capital gains. The Congress has had to be vigilant to prevent abuse. Last year's belated restrictions on artificial accounting losses—often referred to as tax shenanigans—might well have been even more rigorous. Those of us who contend that a tax on reinvested capital gains is a capital levy should be the first to point out abuses.

The substitution of a cash-flow for the individual income tax would relieve automatically the tax on reinvested capital gains and at the same time impose full taxation on gains used for personal consumption. Full taxation of non-reinvested capital gains would be both equitable and sound economic policy.

A more modest proposal regarding the taxation of capital gains would be the use of qualified accounts for financial assets as described in the Treasury "Blueprints for Basic Tax Reform". Authorization to use qualified accounts to permit capital accumulation and shifts among capital assets deserves the most serious consideration. Its adoption would be the most constructive single change in the individual income tax law short of substitution of full cash-flow taxation.

A second-best modification would be adoption of a sliding-scale downwards for taxability of realized capital gains, on the presumption that the longer an asset has been held the more likely it is that proceeds of a sale will be regarded as capital and reinvested.

The increase in the capital gains rate in 1976 by a change in the minimum tax and juxtaposition with the maximum tax on earned income, pushing the total rate in some instances to about 50 percent instead of the statutory maximum of 35 percent, will decrease the supply and impede the effective use of existing capital. And the fact that the increase was concealed rather than forthright added to the resentment of those subject to it.

Among the more unjustified and damaging proposals for modification of capital gains taxation is the suggestion to tax directly or indirectly the donor of appreciated property on the appreciation when a gift is made to a tax-exempt educational or other charitable organization. The burden would inevitably fall largely on the recipient institution rather than on the donor. In the interests of maintaining diversity in our pluralistic society—and in reducing the need for even larger government expenditures in education, health and welfare—the notion of an ever-more inclusive concept of taxable income must not be allowed to destroy our traditional tax treatment of private donations for public purposes.

As regards the taxation of business, a value-added tax would be less bad than the present corporation income tax which discriminates against the efficient utilization of our economic resources and distorts so many management decisions regarding capital structures, new financing, new product development, innovation, and risk-taking.

If not acceptable as a partial or full substitute for the corporation income tax with, of course, a considerable transition period, a value-added tax would be the least bad source of revenue to finance social security expenditures if, unhappily, part of those outlays were to be shifted to general revenue sources. It would be unfortunate if the contributory principle of social security finance were to be abandoned, badly mangled though it now is.

A value-added tax thus would be a least bad alternative for a second-best source of social security finance. I leave it to the semanticists to find a shorter and more precise description. Since no tax is inherently good, this small praise is probably as favorable a comment as one can make about any tax.

Inflation has made the conventional measures of business income grossly misleading. The corporation income tax under present definitions of income actually absorbs capital. Partial relief is available as regards inventories through the restricted allowance of last-in first-out (LIFO) accounting. Attention is also being given to the inadequacy of depreciation allowances based on historic cost to replace existing plant and machinery at inflated prices. In fact, more funds are needed in all forms of assets under inflation to maintain any given level of physical business activity. It even takes more cash in the cash account to carry over the inevitable fluctuations between receipts and payments for material and payrolls.

Without substantial modifications, under present definitions business income taxation may take more than the total of all funds arising from a constant level of productive activity. Business income taxation under inflation therefore not only prevents economic growth through retained earnings, it can force a contraction of an existing level of activity.

Various projects are under way in the accounting profession and the S.E.C. to modify the concept of income used for financial accounting under continuing inflation. Some of the proposals for current cost, replacement cost or other revised methods of accounting may be reasonable for tax purposes; others may not. Thus far, no comparable analysis is being undertaken regarding the concept of taxable income under inflation. I urge that a project be started promptly, either alone or in collaboration with the existing ones on financial accounting.

One particular aspect of our economy is especially vulnerable to new policies in tax administration. Business investment abroad is a source of foreign exchange and a basis for domestic employment to produce the exports associated with subsidiaries and construction projects abroad. But new rules imputing housing and other expense allowances to U.S. employees as part of their taxable income are not only a rather ridiculous extension of the concept of taxable income. They are a major deterrent to continued participation in economic activities abroad, particularly in the Middle East where living costs are notoriously high. It is certainly not in the national interest to allow a grasping tax administration which looks only at revenue and some abstruse concept of all-inclusive income to make the United States non-competitive in this and other parts of the world where our presence is both economically and politically important.

Legislation proposed in past Congresses for premature taxation of income earned by foreign subsidiaries of U.S. corporations before receipt by the U.S. parent would place U.S. business at a competitive disadvantage. No other country has or, so far as I know, contemplates similar taxation. If enacted, it would be another example of satisfying a theoretical objective of all-inclusive taxation at the expense of national well-being.

Two unfortunate and somewhat dangerous sentiments seem to have great influence on economic policy, including tax legislation. They may be noted in conclusion. The first is an excessive egalitarian attitude. The second is a misconception of the extent and function of profits—and resentment at any increase in profits. Both arise from what is sometimes called the politics of envy, arising from what has been referred to elegantly as the revolution of rising entitlements—or less elegantly as mean-mindedness.

The egalitarian attitude is carried so far in some theories and ideologies that "welfare" is deemed to be increased even if everyone is worse off, so long as those at the top are pulled down proportionately more than those at the bottom. It is doubtful that this extreme position would find widespread popular acceptance if formally presented in such strong terms. But policies designed to pull down those at the top seem frequently to be adopted intentionally or unintentionally without regard to their adverse effects on everyone, as substitutes for effective means to raise those at the bottom.

Tax reductions of 1974, for example, were based on a totally erroneous belief that progressive income taxation made the burden of inflation proportionately heavier on those in lower tax brackets than on those in higher brackets. The error arose from superficial analysis which measured the effect of an inflationary rise in incomes only on the tax burden itself when what is really significant is the effect of a tax increase on an existing net income. The difference in impact can be dramatically shown by noting that an equal 50 percent increase in the tax rate would raise the bottom rate of tax from 14 to 21 percent, reducing net income from 86 cents to 79 cents or by only 8 percent, while the same proportionate 50 percent increase in the top rate of 70 percent would push it to a more than confiscatory rate of 105 percent.

The significant burden is clearly the impact on net income. This point was, apparently, never even noted in the discussion of legislation for tax relief. Those who were most hurt by the combination of progressive taxation and inflation had reason to be doubly resentful of the fact that tax relief not only passed them by but ignored the reality of their situation. Inadvertent egalitarian legislation is more to be resented than avowed egalitarianism.

Much has been said about the importance of profits as the principal source of new equity capital and the necessary inducements to invest such capital as is available in business activities which are inevitably risky. With higher interest rates existing under the impact of persistent inflation, the levels of profits must be allowed to rise to justify business investment instead of passive investment in fixed-income securities.

The inadequate level of existing profits—and prospective profits—is dramatically revealed by the fact that in many companies the best and most profitable use of corporate funds is to purchase a company's own stock in the market and retire it. That this is not done more frequently may be evidence of a hope of eventually attaining a profit level which will justify additional investment. Or it may be evidence that directors and managements think and act in terms of what is good for the company as a separate entity, regardless of the well-being of stockholders. Though concentration on what is good for the company is clearly good the the country in such cases, stockholders may increasingly realize that partial liquidations of their companies would be more in their individual interests and insist on withdrawal of capital through stock retirement. Lest this happen to a greater extent than it has thus far, public attitudes and government policies, including tax legislation, should recognize that both the absolute level and the rates of profits must rise to justify continued access to and investment of new funds in an inflationary economy.

The need for higher prospects for profits is particularly important to justify investment of capital and effort in new business ventures—and to maintain their continued independent existence. New and relatively small independent businesses are a source of much of the initiative in our economy. Even more importantly they are principal sources of social and political stability and strength in our nation. In many respects the Congress has made our tax laws less onerous on small business than on larger corporations. But much more needs to be done. On this subject, as on so many other aspects of tax and economic legislation, we

need a broad social and political perspective. Political economy—rather than abstract economic theory or an obsession with maximum productivity—should be the foundation for economic policy.

Senator BYRD. The next witness is Dr. Gary Fromm, Stanford Research Institute.

Welcome, Mr. Fromm.

STATEMENT OF GARY FROMM, STANFORD RESEARCH INSTITUTE

Mr. FROMM. Mr. Chairman and members of this distinguished committee, it is indeed a privilege and a pleasure to appear before this committee to participate in a discussion of measures especially important to a tax program which would stimulate capital formation, economic growth, and employment.

As I understand the charge to each of the witnesses, we were to address ourselves to those issues and not to many others which have been touched on here this morning.

Senator BYRD. You may proceed as you wish. You may further identify your connection.

Mr. FROMM. Certainly. Thank you for the opportunity.

I currently am the director of the Center for Economic Policy Research of the Stanford Research Institute here in Washington, D.C. I might also add that the views I express here are not necessarily those of any other staff members, officers, or directors of the Stanford Research Institute. Research underlying my statement before this committee was, in part, supported by the National Science Foundation.

Senator BYRD. You are speaking for yourself?

Mr. FROMM. That is necessary when one speaks as a staff member of a nonprofit organization. Moreover, others within SRI may not wish to be associated with my views.

Review of earlier testimony before this committee during May 1977 and other recent statements by knowledgeable observers makes it clear that a bipartisan consensus has developed on the need to encourage capital growth. Some academic economists and consumer advocates do not agree with this conclusion, but they are in the minority.

Reasons for stimulating and removing impediments to savings and investment range from requirements to increase energy supplies and provide for more efficient energy use to goals for raising living standards quantitatively and qualitatively. The allied social target of lowering unemployment rates to 5 percent or less will also necessitate strong investment performance.

Last fall, forecasts of U.S. economic growth over the 1975–85 interval were solicited from leading organizations in this field, including services such as Chase Econometrics, Data Research, and Wharton Econometric Forecasting Associates. Also included were forecasts of a significant number of private industrial and commercial companies.

While the sample of 22 respondents is small, it is felt to be representative of the range and character of the "best" and currently most widely used economic projections for the next decade. A summary of results may be found in table 1.

TABLE 1.—U.S. ECONOMIC GROWTH, 1966–85

	Compound annual rates of change (percent)			
		Median forecasts		
	History, 1966–75	1975–85	1975–80	1980–85
GNP [1]	8.1	9.6	10.8	8.7
Real GNP	2.2	4.1	4.8	3.5
Inflation (GNP deflator)	5.8	5.3	5.7	5.0
Real capitol formation	.4	5.6	7.4	4.2
Real disposable income	3.2	3.7	4.2	3.3
Real net exports/total real trade [2]	3.7	6.4	7.3	5.1
Real exports	6.5	[3] 4.3	4.3	4.3
Real imports	4.1	6.3	7.7	5.1
Government real expenditures:				
Federal	−1.8	[3] 1.8	1.9	1.6
State and local	3.9	[3] 3.4	3.3	3.5
Population	.9	1.0	1.0	1.0
Labor force	2.2	1.5	1.9	1.3
Unemployment rate [4]	5.0	5.7	6.5	5.0
Employment	1.7	2.0	2.5	1.5
Productivity [5]	.5	2.3	2.3	2.1
Money supply	5.9	[3] 7.0	7.6	6.6
Aaa bond rate [4]	7.1	8.3	8.8	8.0
Average Government surplus or deficit: [6]				
Federal	−15.3	−31.9	−37.9	−25.0
State and local	4.9	[3] 14.0	14.6	13.3

	As percent of GNP			
	1966–75	1976–85	1976–80	1981–85
Gross private domestic investment	15.1	16.2	15.6	16.9
Nonresidential	10.2	11.2	10.9	11.6
Inventory	.7	.9	1.0	.8
Residential	4.2	3.9	4.0	3.8
Total savings	15.1	16.2	15.6	16.9
Business	11.0	11.9	11.3	12.7
Personal	4.9	4.9	5.0	4.8
Government	−1.0	[3] −.7	−.8	−.6
Federal	−1.4	−1.1	−1.5	−.8
State and local	.5	.4	.5	.4
Other	.2	.1	.2	.1
GNP by expenditure:				
Gross private domestic investment	15.1	16.2	15.6	16.9
Personal consumption expenditures	62.6	62.0	62.8	61.3
Net exports	.5	[3] .3	.2	.3
Government purchases	21.9	21.4	21.3	21.4

[1] Derived from real GNP and inflation rates.
[2] Percent of average levels of real net exports to total real trade (not rate of change).
[3] Average of 2 periods medians.
[4] Averages of annual rates of all years in each period (not rate of change).
[5] Measured as real GNP per employee. Annual rate of change for 1966–73=1.2 percent.
[6] Averages of annual surpluses or deficits in billions of dollars.

Source: Derived from Gary Fromm, "Forecasts of Long-Run Economic Growth" in U.S. Economic Growth From 1976 to 1986: Prospects, Problems, and Patterns vol 6—Forecasts of Long-Run Economic Growth, U.S. Joint Economic Committee, 1976.

In general, most of the forecasters see a favorable picture for output, inflation, and income over the period. The median forecast for the annual compound growth rate for real GNP is 4.8 percent for 1975–80 and 3.5 percent for 1980–85. These rates exceed those of most 5- and 10-year postrecession intervals following World War II. Some forecasters anticipate a recession in 1977–78 or 1978–79, which lowers output during those years and 1980, and 1975–80 growth rates. In all these cases, the recession is attributed to reactions to a tight monetary policy which the Federal Reserve is expected to undertake during 1977 in an attempt to lower inflation rates.

I might add that these forecasts were prepared, of course, before the Carter adminstration was elected and before its economic policies became evident. Currently, on the part of some forecasters, there is concern that the fiscal conservatism of the Carter administration may

92-201 O - 77 - 16

also contribute to the possibility for recession before the end of this decade.

With respect to capital requirements, most of the studies surveyed show a significantly higher proportion of GNP devoted to investment in 1975–85 than in 1966–75. Despite substantial differences in these predicted proportions, in other GNP expenditures shares, and in nominal and real GNP growth rates, there appears to be a consensus on a number of points:

One, the economy has the ability to generate sufficient savings to meet investment needs of the next decade, including increased outlays for energy conversion, pollution abatement, and capacity expansion.

Two, to make this possible, Federal expenditures should be restrained so that current high deficits are reduced and Government saving is raised.

Three, individual income tax cuts will be needed to offset a progressive tax rate schedule and limit reductions in real consumer purchasing power arising from inflation.

Four, monetary policy should be accommodating and should not foster but seek to prevent episodes of highly restrictive credit availability.

Five, the principal problem is financing increased investment in a highly uncertain inflationary setting when business exposure to working capital needs are swollen, historical depreciation falls short of replacement costs, growth in nominal retailed earnings is insufficient to fund much higher capital outlays, and relative rates of return are too low and risk too high to attract much greater equity funding.

The last conclusion holds notwithstanding the 1976–77 stock market recovery, improvements in conditions for equity finance, higher corporate margins and profits, and extension of the investment tax credit at a 10-percent rate.

Incidentally, there is no paradox in the condition that Mr. Janeway cited earlier in his testimony about the excess of loanable funds that banks now posses. The economy has come out of a recession. Corporate profits have recovered greatly. Dividend payments generally adjust very slowly. Therefore, last year the dividend payout rate, which generally has been true in this kind of cyclical situation, fell from its usual rate of about 50 percent to 40 percent. This left corporations with a large amount of liquidity and greatly decreased needs for bank loans to finance inventories.

Despite greater future internal cash flow and ease of equity finance, larger resort to borrowing will be required in the years ahead and debt/equity ratios are predicted to rise. For some companies and sectors these already are at high levels and both borrowers and investors are exposed to substantial risks of default. If investment can be accomplished only by further weakening of financial structures, many companies may decide to forgo capacity expansion even in the face of strong demands for their outputs.

This situation does not apply to all industries, but it is especially severe for sectors whose rates of return are below average, and whose prices or returns—profit rates—are subject to a high degree of Government regulation. Transportation, electric utilities, steel, paper, and a few other industries may be particularly hard pressed by finances, demand, and environmental and safety requirements. Uncertainty as to the course of future Government actions, especially on the regulatory front, provides a further significant deterrent to place such additional capital at risk.

Various proposals have been made recently to modify the Federal tax code so as both to inject a degree of reform in selected inequities and inefficiencies—such as the "double taxation" of income—and to stimulate investment outlays. While virtually any tax reduction would tend to increase investment to some extent, there are large disparities in impacts on capital spending of different alternatives.

The temptation may be strong to justify some tax proposals on grounds of investment effects, but this should strongly be resisted when the primary consequence is redistribution of tax burdens.

The converse also holds: If the goal is to stimulate investment, measures that would do so directly should not be unduly castigated because they result in limited shifts in the relative distribution of business and personal taxes.

Estimated impacts on revenues and fixed investment of selected revisions in the Federal tax code are shown in table 2. The revenue impacts are those that were estimated by the Joint Committee on Taxation of the House Committee on Ways and Means. The investment impacts are my own estimates, partially based on my research and partly based on research of others that is cited in the Ways and Means Committee report.

TABLE 2.—REVENUE AND FIXED INVESTMENT IMPACTS OF SELECTED FEDERAL TAX REVISIONS FOR 1976 INCOME LEVELS

[In billions of dollars]

	Revenue effect [1]	Investment impact [2]
Integration of corporate and individual taxes:		
Dividend integration [3]	−5.0	+2.0
Dividends and retained earnings [4]	+8.9	−4.0
No integration—Corporate changes only:		
Dividend deduction (or corporate profits tax cut) [5]	−15.0	+8.0
Repeal investment tax credit	+8.6	−10.0
Repeal asset depreciable range (ADR)	+1.6	−2.0
Repeal surtax exemption	+4.7	−3.0
Repeal percentage depletion	+1.0	−.1
Repeal DISC	+1.0	−.2
Addendum: [6]		
Nonresidential fixed investment	160.0	
Structures	55.3	
Producers' durable equipment	104.7	
Corporate profits before tax	147.9	
Profits tax liability	64.4	
Federal	55.6	
Profits after tax	83.6	
Dividends	35.1	
Undistributed profits	48.4	
Federal personal income tax payments	139.8	

[1] Source: Staff of Joint Committee on Taxation, "Tax Policy and Capital Formulation," report to the Task Force on Capital Formation, Committee on Ways and Means, April 1977.

[2] Author's estimates of total long-run impact, derived under the following assumptions: marginal propensity to consume with respect to dividend payments to taxable individuals equal 0.6; marginal propensity to consume with respect to dividend and retained earnings payments to taxable individuals equals 0.5; dividend-payout ratio equals 0.5; inventory investment as proportion of total investment equals 0.1; working capital investment as proportion of investment equals 0.1; proportion of dividends paid to tax exempt organizations, pension funds, and foreigners equals 0.2 with these groups having an overall average marginal propensity to save in forms later devoted to fixed investment of 0.5; average marginal tax rate on individual recipients of dividends equals 0.4; impact of investment tax credit and depreciation deductions estimated from sources in report cited in footnote 1 and author's other research; dividend payout ratio of corporations with taxable income less than $50,000 equals 0.3.

[3] Includes repeal of dividend exclusion. Estimate based on exact method with average effective tax rates. Addition of eligibility of tax exempt organizations, pension funds, and foreigners would add $2 to $3,000,000,000 to revenue loss. If marginal rate of 48 percent were applied instead, revenue losses would be $14,000,000,000 from taxable shareholders and $7,000,000,000 from tax exempt shareholders.

[4] Includes basis adjustment in reducing future capital gains. With a cut in top bracket individual rates from 70 to 50 percent and additional accelerated depreciation for corporation, total revenue loss equals $5,000,000,000.

[5] Includes repeal of dividend exclusion. If limited to dividends paid to taxable shareholders, revenue loss equals $12,000,000,000.

[6] Source: "Survey of Current Business," April 1977.

Per dollar of lost revenue, the most effective investment stimulus—assuming the economy is not at full employment—is the investment tax credit. Next in effectiveness are revisions in depreciation provisions. This is not surprising since both measures are tied directly to capital outlays. Given the structure of present rates, lesser impacts on investment result from various schemes to integrate corporate and individual taxes or reduce corporate profits taxes. If investment stimulus is the only goal, the rank order of preference for changes in the tax structure is as follows:

No. 1, increase investment tax credit;

No. 2, liberalize depreciation allowances;

No. 3, lower corporate taxes via rate reductions or dividend deductions;

No. 4, raise corporate surtax exemptions;

No. 5, integrate individual and corporate tax treatment of dividends and retained earnings while lowering individual tax rates;

No. 6, integrate individual and corporate tax treatment of dividends; and

No. 7, liberalize DISC or percentage depletion provisions.

For comparable Federal revenue losses, raising the investment tax credit or depreciation allowances has roughly twice the impact on investment as does lowering corporate profits taxes.

There are other possibilities for tax code revisions that would stimulate savings and investment. Incentives for broadening and deepening equity ownership by individuals in small and large business probably would lead to greater capital and output growth. Another measure that should be considered is a basic overhaul of accounting practices together with fundamental changes in the tax treatment of capital gains and losses and depreciation allowances. This is especially important in an inflationary setting when historical cost accounting, the present standard for corporate reporting to the IRS and SEC, yields biased and inconsistent conclusions about profitability and returns on investment.

Previous witnesses all have commented on that. One would hope the Congress as well would help to stimulate adoption of replacement cost accounting provisions. There is a fair amount of controversy in the accounting profession. The old guard is hanging tight to historical cost accounting. It is turning out to be a battle to get replacement cost accounting principles accepted, and some push from this committee might bring about reforms which are badly needed.

Unfortunately, research on taxation under inflationary conditions, on the impact to tax incentives on savings and investment, and on many other related economic stabilization and growth issues, has been extremely limited. Estimates, such as those presented here, are highly tentative and subject to large error. This committee is to be commended for holding these hearings and for its interest in the subject. However, it should also be urged to examine the adequacy of research funding in this area and to exert efforts to assure more substantial support.

Senator BYRD. Thank you, Dr. Fromm.

Senator Roth has another committee meeting, so I will yield my time to Senator Roth at this time.

Senator ROTH. Thank you, Mr. Chairman. I appreciate your thoughtfulness in doing so.

I just would like to bring up a point that I made earlier, and that is, to emphasize my personal strong conviction that one of the best things that we can do for the economy is to have a general tax reduction both with respect to personal income tax and with respect to business generally. I am sure that you have heard my comments earlier, there should be a permanent tax cut with a long term objective of adopting something along the line known as indexing.

This was done by the Kennedy administration in the sixties, as well as in earlier years.

I wonder if you would care to comment?

Mr. FROMM. It is clear that on the individual income tax side, we will be requiring tax cuts anyway, given the progressive tax rate schedule and given inflation. Clearly, after you agree that a rate cut would be necessary, what label you put on it, it seems to me, is relatively unimportant, whether you call that a permanent tax cut, or indexing, or whatever.

On the corporate side, it would appear that returns on investment, within this decade anyway, have been somewhat lower than they were in previous decades following World War II. Given those circumstances and given the output requirements of the economy, the goals that we have for lowering unemployment and for improving the quality of the environment, and many other targets, it would appear that higher returns to business are needed.

One way of achieving that would be to reduce their taxes. The question then arises, what form should that tax cut take? One possibility is to reduce the corporate income tax. But, if your intent is to stimulate investment, then the corporate income tax is only half as effective as an investment tax credit. That is a choice the Congress will have to make. They will have to consider the trade-offs that are involved, because if the investment is really desired as a social goal, then it ought to make the tax choice consistent with realization of that goal.

Senator ROTH. On that point, it is my understanding that Sweden has gone a very long way in liberalizing depreciation allowances.

Mr. FROMM. I am not familiar with the tax code of Sweden.

Senator ROTH. I agree that it is not so important what you call it, but the fact that it is intended to be permanent has some significance with what we do.

Mr. FROMM. Yes. I think the intent should be clear. If it is a temporary cut, one would not get—we are now talking about a business tax deduction or credit—the same investment stimulus that you intend with a permanent cut.

Senator ROTH. If I understand the thrust of your testimony, you generally agree that there needs to be individual income tax cuts as stated in your paragraph 3, on page 2. As far as business is concerned, you would probably place higher priority on an investment tax credit or liberalized depreciation allowance than on a general rate reduction?

Mr. FROMM. That is correct.

Senator ROTH. Thank you, Mr. Chairman.

Senator BYRD. Senator Packwood?

Senator PACKWOOD. I have no questions.

Senator BYRD. Senator Long?

Senator LONG. I would just like to ask the witness about one thing, and I see Mr. Cohen here. I would like to invite him to give me his thoughts on this too. Here is something that very much concerns me.

It seems to me that proper tax policy should try to take this into account. Revenue estimates have a way of being very, very far off base because of the failure to anticipate everything that happens. We are now estimating that the investment tax credit is costing us about $9 billion in revenue.

Now, when we put the investment tax credit on, we estimated that we were going to lose about $5 billion because it was a smaller economy at that time. Instead of losing the money, revenues went up in corporate income tax collections.

Then we thought it was overheating the economy. We repealed it. We thought that the Government would take in more money, but instead of making $5 billion, we lost $5 billion.

Then, after awhile, we thought we made a mistake, so we put it back on and again, instead of losing us money, it made us money.

Then, after awhile, we repealed it again and it did just exactly the opposite from what it was estimated to do again by about the same amount.

It seems to me, if we take all factors into account, we wind up with the conclusion that taking the investment tax credit alone and looking at it by itself, it is not costing us any money because the impression I gain from it is that it stimulates the economy to the extent, and brings about additional investment to the extent, that it makes us money rather than loses us money.

It has convinced me that something has to be done to try to find somebody who knows more about how to put information in the computer so that we can get more accurate answers, otherwise I am afraid that we are moving on bad advice, which tells us this thing that stimulates the economy is costing us money, when the sum total effect is to make us money.

What do you suggest we do about this feedback problem?

Mr. FROMM. One has to take feedbacks into account, that is clear. The precise estimates that you give, and the analysis that you made, I think are perfectly correct. If an investment tax credit, or some form of investment stimulus, is not introduced, I believe in the next year of two, we will find a much higher rate of unemployment that we would otherwise experience. Also, we would find ourselves with lower national income and with lower Federal revenues. Consequently, as you say, it may be desirable to give away some money to get a lot more back. Can we estimate how much that would be? I think that we can.

Senator LONG. President Kennedy, to his everlasting credit, recommended that we reduce that ridiculous wartime tax rate from 90 percent to 70 percent. Do you think that it cost the Government money to do that?

Mr. FROMM. No; I do not believe that. The amount of revenue involved, first of all, from 90 to 70 percent is relatively small. The effect on stimulating savings and investment probably was significant and the multiplier impact of that in the long run would probably create more jobs, more income, and higher taxes.

Senator LONG. It just seems to me that at a 70 percent top individual tax rate, businessmen would be more encouraged to make investment and pay the tax. With a 90 percent tax, people were just engaged in all sorts of economic waste. I have told the story many times about the poor fellows who met down at the Mayflower Hotel during the war when they had that 90 percent excess profits tax on. After a few rounds of drinks, one decided to break it up and go home. One fellow said, let me have the bill. He said, I'm in the 90 percent tax bracket; it won't cost me but 10 cents on the dollar. The other fellow said, no, let me have it. I'm on an expense account. It won't cost me anything.

The other fellow said, let me have it. I have a cost-plus contract, I'll make a 10 percent profit.

A great number of these pension plans for executives started at that time. The companies were buying company aircraft just because they needed a deduction.

One has to wonder if that 90 percent tax rate made us any money at that time. I do not think we made any money with a 90 percent tax bracket. I do not think we make any money with the 70 percent tax bracket. It would be my guess that if you reduce your top rate to 50 percent, you actually would make money with it because people, rather than just leaving money sit idle or wasting it on non-productive expenditures would put it into productive investments.

Apparently the Treasury method of estimating is, if a businessman does not put his money in this, he will put it someplace else. I do not think it works that way, from my own experience. My guess is that there is a tremendous amount of capital sitting idle because of a counterproductive tax rate. I can show situations, including my own situation, where I would be paying more taxes—making more money and paying more taxes—with such resources as I have available, if the tax were not so high.

As it is, it serves the purpose to create some good will, to have people pay me less and make money on me, by making money on funds in a savings account or checking account, by lending those funds out to others, and we end up with less tax ultimately paid to the Treasury.

Those things tend to add up, on balance, to a real loss of money at a 70 percent tax rate, where a lower rate would bring more money to the Treasury.

I would like your reaction to that.

Mr. FROMM. Of course the maximum tax rate on earned income is 50 percent, not 70 percent.

Senator LONG. Investment income.

Mr. FROMM. Senator Byrd asked some questions about capital gains. Under current law, the maximum tax on capital gains, given an individual in the top 50 percent bracket for earner income, the 70 percent bracket for total income, and minimum tax provisions, would be 49 percent. This is just about the same, of course, as the maximum rate on earned income of 50 percent, so the differential between capital gains and earned income is not very large.

You are not going to gain very much by raising the tax on capital gains, and it would probably cost a great deal in terms of savings and investment incentives.

Senator LONG. When you have a tax on capital gains of 49 percent, a lot of people are going to freeze up their assets and not move them, just sit there with them.

Mr. FROMM. That is correct. There is a locking in effect that would cause people not to shift, just for tax reasons, into other investments.

Senator LONG. It irritates me, everytime I pass by a large piece of property, virtually in the center of my hometown. Baton Rouge, La., that was use [1] for a cow pasture until recently. I am not sure what they are using it for now. There is 1,000 acres in the middle of a town of approximately 300,000 people.

You ask the people, why don't you develop it? They say, the tax would be prohibitive. They would loose too much taxwise if they did it.

When our tax law becomes counterproductive, it seems to me that we ought to do something about it. We are defeating our own purpose. The purpose is to make money for the Government, to do it in the way that does the least harm to the economy and, hopefully, the most good for the economy.

I wonder if you could give us any suggestions as to how we might find some way to have Treasury more correctly give us feedback.

Mr. FROMM. In the economics profession, we have been constructing various kinds of models to evaluate economic impacts. The investment impact estimates I have presented here are based on econometric models. Much additional research is needed to refine these estimates. But, it is extremely difficult to obtain research funds, at times, to conduct this type of research.

For example, I think it was unwitting, but the House HUD-Independent Agencies Appropriations Subcommittee, which also has jurisdiction over the NSF budget, took a large chunk out of a particular activity within the National Science Foundation Research Applied to National Needs RANN) program, because there had been some criticism of the way that program had been administered.

The House committee, I believe, was not aware, when it was making those cuts, of the full range of research being funded within that activity. They were concentrating on selective administrative practices of a few research projects.

It turns out some of the needed research to which you are referring is being funded under the RANN programs. This includes the work of Joe Pechman, for example, on tax policy, and that of Arthur Okun. It also includes research that I am conducting with James Tobin and William Brainard of Yale University.

If the House appropriation action sticks on the Senate side and through conference, and is passed into law, there will be a substantial reduction in support for economic research and, thus, in the amount of work that can be done and the quality of expert advice that can be given.

Senator LONG. Thank you very much.

Senator BYRD. Dr. Fromm, do you think that the Congress made a mistake in increasing the capital gains tax in 1969?

Mr. FROMM. Well, I am not sure about going back to 1969. The capital gains tax, of course, has been increased now, as I indicated, for people in all top brackets to 49 percent; for people in lower brackets, subject to the minimum tax, the maximum tax on capital gains is 40 percent.

This probably has had some detrimental effect on investment. On the other hand, there is a trade-off here, to some extent, in terms of equity across individuals in our society. One has to weigh those trade-offs.

Senator BYRD. It seems to me, overall, Congress made a mistake in changing the capital gains rate.

Mr. FROMM. On questions of equity, it is up to the Congress and the President to decide, or at least are the best to evaluate, social welfare questions. You are the right person to make such judgments.

Senator BYRD. What effect do reductions in business taxes have upon interest rates? Do they have any effect on interest rates?

Mr. FROMM. There may be some effect on interest rates through the medium of stimulating investment demand. Clearly, there is another side to this pair of scissors—what the Fed does in respect to monetary policy. That has a great deal of influence on interest rates.

It is difficult to say where, on net balance, it would come out. With no change in monetary policy, it is likely that interest rates would rise somewhat. I think, given the magnitude of likely business tax reductions, it would be to a modest degree.

Senator BYRD. Thank you very much, Dr. Fromm.

The next witnesses will be Dr. Thomas Reese and Dr. Gerard Brannon, representing Taxation with Representation.

I might ask a question before we start. Which is worse, taxation without representation, or taxation with no representation?

STATEMENTS OF THOMAS REESE AND GERARD BRANNON, TAXATION WITH REPRESENTATION

Mr. REESE. My name is Thomas Reese, I am legislative director of Taxation With Representation, a public taxpayers' lobby. We are a national organization based in Arlington, Va., and, for my presentation, I have distributed to the members of our committee a copy of our Taxation with Representation newsletter that I ask to be put into the record.

Senator BYRD. It will be put into the record.

Mr. REESE. I also have with us today Dr. Gerard Brannon who is a person who is well-known to this committee. Dr. Brannon was the director of the Office of Tax Analysis in the Treasury and has done research and work in tax policy for many years.

I would like to have the remainder of all of our time given to Dr. Brannon.

Senator BYRD. You may proceed.

Mr. BRANNON. Thank you, sir.

I hope that I can suggest some different ways of looking at this tax problem in front of us. I want to look at it from a political standpoint.

It seems to me that the politics of taxation in the United States has been a war between what I call facetiously the "redistributors" and the "growthpeople." Redistributors think that America will go to hell in a limousine unless we do things to stop the rich from getting richer while the poor get poorer. Growthpeople think that America will go to hell on foot unless we do things to increase the reward for thrift and initiative.

Redistributors win most of the big battles, like progressive income tax rates, high rates on corporations, and taxes on property. Growthpeople win most—but not all—of the skirmishes, like rapid depreciation, tax exempt interest, and investment credit.

On the face of this, it seems like a compromise. Some think we should be satisfied with the compromise. We have some redistribution of income, but not very much, and we have some growth, but the U.S. growth experience has not been very good either.

I think that this has not been a good compromise. I think we have managed to select the worst from each side and snatch defeat from the jaws of victory.

The way I would describe this compromise is starting with this highly redistributive tax system, we provide incentives in the way of exceptions from tax for people who do good things, like invest. The structure of this is the people who would otherwise pay most tax get the most advantage from the exemption.

Basically, we are creating a system which on the face of it seems to tax rich people very heavily and then says specifically, rich people, since we do this through a tax exemption, "we will cut your tax if you do things that we want you to do, like buy State and local bonds, drill oil wells, build machines, things like that."

One reason to say that this is obviously counterproductive is to notice that we are concentrating this investment very much on a small segment of the society. We are basically encouraging rich people to invest. It is rather like an education policy which decided we will give full college scholarships to all high school students who have an IQ of over 130. Pick out the ones who are going to college, and give them the scholarships. Obviously, this is not going to change our college education system very much.

I think that there is an alternative to this way of starting out with a very progressive system and trying to encourage investment by exceptions from that. Basically, it would be an effort to think specifically about devices that encouraged savings and investment by ordinary people.

I think there are a lot of things that one can do in this direction. I will simply describe a couple of them in order to emphasize that this is an approach rather than a highly specific prescription.

One approach is to adopt a sales tax or a value-added tax that is specifically a tax on consumption. Most people react to this kind of a suggestion by saying immediately a sales tax, or value-added tax is regressive, it hurts the poor. This is rubbish.

You can make the sales tax or value-added tax impact on anybody you want it to impact on.

For example, to construct a sales tax, or value-added tax that did not change the progressivity of the present tax system one bit, you could do the following: provide a refund of the value-added tax paid on some basic amount of income, such as the income that you would exempt from income tax.

Above that level, provide that the income tax would be reduced in each bracket just as much as the sales tax was increased, so that you still have the same amount of income being paid in each income bracket, but in every bracket you are telling people that if they save more, their tax is lower; if they consume more, their tax is higher.

I imagine there are some people in the world who want a sales tax because it is regressive. I am not addressing that. I am accepting the fact that in the politics of our current society we want a system that corresponds to ability to pay.

I am simply pointing out to you that you can accomplish this ability to pay objective and still be concerned with the savings and investment.

Another part of this approach has to do with the corporation income tax. Many other prior witnesses have talked about the double taxation on dividends. This, to my mind, is an utterly secondary aspect of the problem of the corporate income tax.

By and large our present corporate income tax is structured so that it under taxes the investment of rich people and over taxes the investment of poor people. This comes about because the corporate tax rate itself, and that is the rate on retained earnings, is lower than the top bracket rate for individuals.

This is why people organize a corporation in order to save taxes. This is why you once had subchapter R in the code that permits a partnership to pay tax like a corporation without having to pay the 70-percent returns that would be applicable to earned income.

Notice for a low-income person who would have a marginal tax rate of 20 percent or even 0, you say, if you put money into the corporation, if you buy stock, the return on that money is going to be taxed at 48 percent. That is just a tax at the corporate level and it is going to apply to the retained earnings of the corporation. The double taxation of dividends is an aspect of the whole thing that imposes a penalty on this tax relief, that the investors get through retained earnings. The proper approach to this is one of the proposals that would look to complete integration of the corporate such as the Carter Commission proposal in Canada in the mid-sixty's and not simply one that eliminates the tax on dividends. If you only eliminate the double tax on dividends, you will still have the situation where you are undertaxing high income investors that are enjoying the retained earnings that would increase the value of the stock, and you are overtaxing low income investors.

I think if you really looked at this clearly you would find areas outside of the tax law where our system is presently in a very irrational way penalizing ordinary low-income people who invest.

It should be obvious that, for low-income people, an important component of their savings is deposited in the savings bank and, for heavens sake, we have a law that says you have to limit the return on savings. We make it miserable for ordinary people to save and some say turn around separately and see what we can do to make dividends more attractive.

We offer low-income people a miserable rate of return on Series E savings bonds and spend all kinds of money telling them to buy this lousy deal.

We could, in this way, deal with this very serious problem that this society does want to grow more rapidly. The last portion of my paper offers some arguments as to why I think we should grow more rapidly. I gather from the previous discussion that you are already convinced on this and that there is no need for me to read that part of the argument, but notice the typical pattern of testimony that you get here. It gets rather mixed up, with people who are telling you at the same time that we want to grow more rapidly, I want you to cut my taxes.

After all, we are not in the situation where any one of us can write the U.S. law precisely the way we want it. We are dealing with a country of over 200 million people and one has to make compromises to get a government that corresponds to the desires of those people.

That is what taxation with representation is about. I do not want to tell you that this society would be better off if you cut the taxes on professors—it would, but I am not going to tell you that. I want to put myself in the position of balancing the interests that you face. We do have this general concern about redistribution and the way to deal with this is to concern yourself with the savings of ordinary people.

Thank you.

Senator BYRD. Thank you, Dr. Brannon.

Would you agree with Mr. Janeway that we ought to allow companies to immediately deduct the cost of nondiscretionary expenditures required to comply with the Federal mandated standards?

Mr. BRANNON. No, sir.

I think that the cost of these pollution controls is one of the reasons why you want to see to it that we have a more adequate level of savings and investment. Basically, when we say that we ought to provide more favorable tax treatment for pollution controls, you are, in effect, telling a business if there is some way to produce this product in a way that does not require pollution controls, you have one sort of cost reduction. If you can produce it in another way that is basically dirty and requires a lot of money in pollution control, we will allow you to write off the investment for pollution control.

You would be in the position of encouraging firms to produce things in more polluting ways and then incur extra control costs. Ideally, pollution control ought to be a cost like any other cost, and if the total burden of it is too heavy, cut business taxes or do other things to increase savings.

Senator BYRD. Do you feel that there is a current need to encourage business investment?

Mr. BRANNON. Yes.

Senator BYRD. What do you feel would be the consequences if the Congress took no further action in the captial formation area?

Mr. BRANNON. Perhaps the word "need" in the prior sentence was a little inappropriate. The United States is a very rich country. If we have less capital formation or if the Congress does not take this action we will grow a bit more slowly and we will still have full employment whether we grow a little bit more slowly or a little bit faster.

I think the society would be a little worse off if we did not have more capital formation, but it is not going to be the end of the world.

Senator BYRD. You advocate greater personal savings as a key to solving the capital investment problems. Is that problem really a problem of low level of personal savings, or is it a problem of a lack of confidence by business resulting in the failure to make needed capital investments?

Mr. BRANNON. I do not think that it is a problem of business confidence. On the face of it, we have, at the present time, very high interest rates, which suggest that there are a lot of people who want to borrow capital. At present, rates are high so that one cannot say that there is a great shortage of demand.

Senator BYRD. Senator Packwood?

Senator PACKWOOD. I have been reading the Taxation with Representation newsletter, which you distributed with your testimony. I am curious about a couple of things that you mention there. I would like to ask you about them.

Do you think that generally the depreciation should be based on replacement costs?

Mr. BRANNON. I speak for myself on that.

My own view is that it would be inappropriate to make the correction only for depreciation. I think that it would be sound income tax policy to go through a thoroughgoing inflation adjustment which would correct the basis for depreciation capital gains, and so forth, and correct the basis for debt. When a borrower pays back inflated dollars, he has a considerable gain and the lender has a considerable loss.

If you just make an inflation adjustment for depreciation, to a very large extent in the building area you will be telling a builder that he could borrow heavily on the mortgage to get the building. Then his depreciation adjustment would go up and he would get the advantage of paying off the mortgage debt with deflated dollars.

All of this is very carefully spelled out in some recent studies of inflation adjustment. The Brookings volume, edited by Henry Aaron, discusses this very thoroughly and the suggestion is that, if you had a thoroughgoing inflation adjustment for both debt and depreciation, the change in business taxes would not be very great.

Senator PACKWOOD. I understand your answer, to a grander scale, is yes. Basically you want to replace current rules with some kind of depreciation based on replacement costs?

Mr. BRANNON. Subject to those stipulations.

Senator PACKWOOD. You are saying you speak for yourself. I ask your fellow witness if he shares the same view?

Mr. REESE. We take quite a bit of our advice from Dr. Brannon and our positions.

The problem, once you get into any kind of inflationary adjustment, are you going to do them everywhere and across the board?

Senator PACKWOOD. Let me ask you something. In item No. 7 in your newsletter, it says you are in favor of realistic depreciation deductions. What does that mean?

Mr. REESE. I think in this particular case what we are talking about, you can see in the area of buildings. Buildings frequently, when you put them up, do not depreciate over the first 5 or 10 years. In many cases they appreciate. Accelerated depreciation is not appropriate.

Senator PACKWOOD. I may be inclined to agree with you, but the converse of that, those things that depreciate more rapidly than we now allow, we should change the laws on that also.

Mr. REESE. I think if somewhere the laws are not currently giving a good enough depreciation I would agree with that.

Senator PACKWOOD. Is the position of Taxation With Representation that depreciation should roughly be allowed to equal the replacement cost?

Mr. REESE. No; that is not what I am saying. I am sorry if I misunderstood you.

Senator PACKWOOD. I do not think you misunderstood. Dr. Brannon shook his head just as you were about to answer.

Mr. REESE. I thought what you meant, if a piece of equipment was actually depreciating more rapidly than the law was allowing it to depreciate, if you have a piece of equipment that is going to burn out in 2 years and the law says it is to be depreciated over a 10-year period, that, of course, would not be proper to require a company to depreciate that over a 10-year period when it, in fact, is only going to last 2 years.

I am sorry. That is what I thought you were referring to.

Senator PACKWOOD. If I buy a piece of equipment now for $100 that will last 10 years. It will end up in 10 years, it will cost me $300 to replace it, roughly the same rate of inflation, doing the same thing.

Do you think I should be allowed to have a depreciation cost of $300 over 10 years?

Mr. REESE. As Dr. Brannon pointed out, if you are going to deal with that kind of problem, the inflationary problem, you are going to have to deal with it in all sorts of other areas, otherwise you are going to be giving a tax break in one situation to solve a problem, but where there is an advantage from inflation to a person, you do not deal with that. It is the same sort of problem, I think, that you have in the capital gains.

Senator PACKWOOD. Let me ask the question again. I agree with Dr. Brannon that there is no point in allowing the replacement depreciation costs if you can use that against inflation to borrow on capital acquisition. Should not depreciation be roughly equivalent to the replacement costs?

Mr. REESE. I think that we could accept something like Dr. Brannon has suggested, so long as it was dealing with it across the board, and not just in individual areas.

Senator PACKWOOD. Let me ask you another question. The first item you have on your sheet is tax rate reduction, and you say the lowest bracket tax rate should be cut 14 to not more than 8 percent, comparable reductions should be made in all other tax brackets. What should those comparable reductions be?

Mr. REESE. The maximum rate would come down to 50 percent.

Senator PACKWOOD. What else?

Mr. REESE. From 50 down to 8.

Senator PACKWOOD. Do you mean to say that the equivalent from cutting the lowest rate from 14 to 8 would just bring the maximum down to 50 percent, which is a rate which very few people pay anyway? That is your equivalent on the top?

Mr. REESE. Yes.

Senator PACKWOOD. For tax reduction?

Mr. REESE. Yes.

Senator PACKWOOD. All right.

I want to ask one other question. If seems incredible to me. Very few people pay 70 percent, very few people pay 50 percent now. There is no tax reduction, for all practical purposes, in that kind of a statement.

Mr. BRANNON. I think you misunderstood his answer. He said the 30 percent tax would be cut also.

Senator PACKWOOD. I thought he meant to bring the present 70 percent maximum down to a maximum of 50 percent?

Senator BYRD. You meant across the board?

Mr. REESE. Across the board.

Senator PACKWOOD. Across the board.

What do you mean?

Mr. REESE. What I meant was that the 70 percent tax bracket that we currently have would be reduced to 50 percent.

Senator PACKWOOD. How about the other tax brackets?

Mr. REESE. All of the other tax brackets would be also reduced proportionately.

Senator PACKWOOD. Proportionately to what?

Mr. REESE. Two-sevenths.

Senator PACKWOOD. Now, can I quote that as the position of Taxation With Representation?

Mr. REESE. Yes.

Senator PACKWOOD. Thank you.

Senator BYRD. Would you yield?

Senator PACKWOOD. Yes.

Senator BYRD. So that the committee understands it, Taxation With Representation favors a maximum tax of 50 percent with a corresponding lowering of all other taxes?

Mr. REESE. Yes.

Senator BYRD. With a two-sevenths reduction down the line?

Mr. REESE. Yes.

We also point out in the rest of the statement that we have to face the problem of increased deficits.

If we continue to have increased deficits, we have to tax people through inflation. We find that repugnant also.

Senator PACKWOOD. Let me ask you some questions, if I can. We always get into this argument about tax loopholes and tax reduction whenever we have this tax reform battle.

The position of Taxation with Representation is that all deductions should be eliminated. You are not talking about gross income, a simplified tax, are you?

Mr. REESE. Legitimate business deductions, certainly.

Senator PACKWOOD. Let's talk about personal deductions.

Mr. REESE. Personal deductions, yes.

Senator PACKWOOD. Which personal deductions should we eliminate?

Mr. REESE. I would say practically all of them. I think the proposals in the blueprint for tax reform that was put out by the previous administration are good agenda for us to look at in thinking about tax reform.

Senator PACKWOOD. Let me ask you something on personal deductions——

Mr. REESE. If I just may make a small point. With the corresponding reduction in tax rates——

Senator PACKWOOD. That is what you are going to have to do if you are going to get to that two-sevenths reduction. The exclusion of benefits and allowances to Armed Forces personnel, would you eliminate those?

Mr. REESE. Yes.

Senator PACKWOOD. Exclusion of military disability pensions?

Mr. REESE. Yes.

Senator Packwood. Deductibility of nonbusiness State gasoline taxes?

Mr. Reese. Yes.

Senator Packwood. Exclusion of scholarships and fellowships?

Mr. Reese. Yes.

Senator Packwood. Parental personal exemption for students aged 19 and older?

Mr. Reese. I believe so.

Senator Packwood. Deductibility of contributions to educational institutions?

Mr. Reese. That is never going to pass, as you know.

Senator Packwood. Is that your standard of support, whether or not it will pass?

Mr. Reese. Those others we have been talking about——

Senator Packwood. What I am going to ask is a list of tax expenditures estimates by function. I am going down every one of these that are personal. Until we got to this one, you said you were going to eliminate all of them so far. For some reason, you balked at the one about contributions to educational institutions.

Mr. Reese. The problem there is that there is a philosophical question whether this is a consumption item or whether it should be considered as a nonconsumption item, as Dr. Smith mentioned earlier.

Senator Packwood. I do not understand what it has to do with the relevance whether you eliminate it as a deduction or not.

Mr. Reese. If we are talking about taxing people on the basis of their income and of their ability to pay, the amount of money that they are contributing to charity is a question——

Senator Packwood. This is educational institutions.

Mr. Reese. I would say it is a close call.

Senator Packwood. What about the deductibility of the child and dependent care expenses?

Mr. Reese. Here you are getting into a question of how the family should be taxed, the taxing unit, the single, married, all those have to be taken——

Senator Packwood. Is this a deduction that should be eliminated?

Mr. Reese. Yes, I would say yes, if you deal with the whole question of single and married.

Senator Packwood. What about the exclusion of employer contributions to medical insurance premiums and medical care? Do you know what I mean by that? When the employer buys medical insurance on the employees and the cost of the premium is not taxable as income to the employee.

Should that be a deduction for the employee? Should that be included?

Mr. Reese. We could go through every item in the tax expenditure budget, which I guess is what you are going through.

Senator Packwood. Yes.

Mr. Reese. It is really a question of whether we want to eliminate as many of those as is feasible to reduce tax rates.

Senator Packwood. Frankly, what burns me—I am delighted you are on the record on a couple of these—what burns me is that we go through tax reform every year and people come in here talking about the unfairness of the tax code. Close all the loopholes. You leave the people in this country with the impression that if we close all the loopholes somehow there would be a lot of money to distribute to everybody else.

When we start going down the loopholes that we are going to close, the answer is, "No, I don't mean that"; "No, I don't mean that one," until you get down to closing a few loopholes there is not much money left.

Mr. REESE. As you notice, I said yes to practically all of them.

Senator PACKWOOD. I have not gotten to the big ones yet. I want to go down this list. Those are easy ones, comparatively speaking.

How about disability insurance benefits under social security, do you want to tax those?

Mr. REESE. I am sorry. I would have to look into that more. I am not familiar with it.

Senator PACKWOOD. You are on social security. You get injured for the rest of your life. You get benefits from the social security system. Should those be taxable?

Mr. BRANNON. Could I answer that?

Senator PACKWOOD. No; I want him to answer, because he is talking for taxation with representation, but he can look at you.

Mr. REESE. The question we are talking about here is how to help disabled people the most——

Senator PACKWOOD. Do you want to tax the benefits——

Mr. REESE. If you will let me answer the question.

Senator PACKWOOD. All right.

Mr. REESE. The question you ask is how best to help disabled people. Is it to give them a benefit which is of more value to the people in the highest income bracket or to give people who are in the lowest income classes, the people who need the help the most, is it to give them a benefit which will help them the most?

The exclusion does not. The exclusion is upside down.

At the same time, I do not want to be the person who takes something away from someone who really needs it unless we are, at the same time, providing something in its place, and I think we have to think in terms of that, when we talk about eliminating these tax expenditures that where there will be a situation where harm will occur, then there has to be another way of handling these people.

At the same time, you know, if you have what I admit is an incredible, probably impossible, situation or unusual situation of the millionaire who is disabled, this is a class of person who would benefit from the situation most. On the other hand, a person who is too poor to pay taxes, has so little resources, this person is being helped not at all by any kind of an exclusion.

This is the problem we see with these kinds of tax expenditures. they are all upside down.

Senator PACKWOOD. Is this one upside down?

Mr. REESE. Yes.

Senator PACKWOOD. It is? Should people be taxed on it, then?

Mr. REESE. It should be turned rightside up, yes.

Senator PACKWOOD. What does that mean, turned rightside up?

Mr. REESE. Yes. The answer to your question is yes, it should be taxed.

Senator PACKWOOD. It should be taxed. All right.

Social security benefits should be taxed also?

Mr. REESE. I think here it is a question of whether the person has already been taxed on his portion of whatever goes into the social security.

Senator PACKWOOD. Say that answer to me again.

Mr. REESE. The answer to your question is yes.

Senator PACKWOOD. I will ask you a couple of more, and then I will quit. Would you get rid of the additional exemption for the blind?

Mr. REESE. Again, are you talking about a millionaire? I am not sure what Howard Hughes' condition was toward the end of his life. At the moment, the law applies equally.

Mr. BRANNON. No, it does not.

Mr. REESE. That is the point.

Mr. BRANNON. This was really what I was trying to make a point about the topic of the hearing on savings and investment. The way we do this has helped people out of this high income tax. Now what you say is if you are rich, we will give you 70 percent of $750 for being blind.

Sentor PACKWOOD. All the law does at the moment is say if you are blind you get an additional exemption.

Mr. BRANNON. That is only valuable if you have income.

Senator PACKWOOD. I understand that. I want to know if his answer is that he is going to eliminate it.

Mr. BRANNON. Yes.

Senator PACKWOOD. The last one, would you eliminate the interest deduction on mortagages, home mortgages?

Mr. BRANNON. I would say yes. Also, I would have to follow that up by saying that other types of programs would have to be initiated to help the homebuilding industry. Again, we have the present situation where the person borrowing—a situation where the person borrowing $1 million, building a huge home, is going to benefit most by this. The person earning under $12,000 who is using the standard deduction is not going to be helped by this kind of program at all.

Senator PACKWOOD. You think homebuilding and homeownership would be helped better in this country by direct Government subsidy than by mortgage interest deduction?

Mr. REESE. I would say by direct help to people in the FHA loan programs. That would be a much better way.

Senator PACKWOOD. I have no further questions.

Thank you for the extra time, Mr. Chairman.

Senator BYRD. Thank you, Senator Packwood.

In reading volume 6, No. 3 dated June 1, 1977, Taxation with Representation newsletter, I want to commend your public interest taxpayers' lobby for recognizing what many of my colleagues in the Congress do not recognize, namely—and I am quoting from your newsletter—"A major cause of inflation is excessive Federal budget deficits."

Then the newsletter goes on to say, "Tax reform cannot be used as an excuse to add to existing deficits." I think you are so right.

Also I agree thoroughly with the assertion in this newsletter that inflation is the cruelest tax of all, and, as the newsletter indicates, a major cause of inflation is the excessive Government budget deficits.

I would like to see all the Members of the Congress read this newsletter of yours in that particular regard. Thank you for your testimony.

[The prepared statement of Mr. Brannon and newsletter follow. Oral testimony continues on p. 274.]

STATEMENT OF GERARD M. BRANNON, PROFESSOR OF ECONOMICS, GEORGETOWN UNIVERSITY

Mr. Chairman, The politics of taxation in the U.S. has been a war between the redistributors and the growthpeople. (Redistributors think that America will go to hell in a limousine unless we do things to stop the rich from getting richer while the poor get poorer. Growthpeople think that America will go to hell on foot unless we do things to increase the reward for thrift and initiative.)

Redistributors win most of the big battles, like progressive income tax rates, high rates on corporations and taxes on property. Growthpeople win most (but not all) of the skirmishes, like rapid depreciation, tax exempt interest and investment credit.

(Another team, the Simplifiers, occasionally gets into a fight with one of the big two. The Simplifiers get creamed every time.)

The big picture of tax politics, today, is a standoff. We have saome redistribution of income by way of taxes, but not much. We have some growth incentives, but the U.S. growth rate is not much. This sounds like good old American compromise, and, by the ghost of Henry Clay, it should be a happy ending. It's not.

Growthpeople scream about how repressive the tax system is—70 percent rates, double tax on dividends, 70 percent rates, double tax on savings, etc. etc. The redistributors scream about all the rich investors who have slipped out from under the repression by way of real estate tax shelters, intangible drilling costs, capital gains, etc. etc.

Instead of constructive synthesis, we have compromised by selecting the worse from each side. We have managed to snatch defeat from the jaws of victory.

The compromise fatale starts with a highly progressive tax rate schedule and an anti-business tax structure. Then it cuts loopholes to restore business incentives. This is fatuous, both as equity and as incentive.

A loophole is valuable where the ostensible tax rate is high. Tax breaks on farm income are pretty useless to dirt farmers. Breaks for shopping centers are no big deal for middle income investors. It is the investor in the high brackets who is drawn into agri-business or real estate.

While loopholes cancel much of the basic progressivity, they are at the same time a bad growth policy. Consider a parallel. If we wanted more higher education, we could give scholarships of $20,000 a year to high school grads with IQ's over 130. This dumb education policy would be just like a tax policy of incentives by loophole. Both squeeze incentives on a narrow part of the potential base, the part that likely would have gone to college, or invested, one place or another anyway.

Recent tax action has been mostly fussing around with this compromise. We limit various tax shelters and impose minimum taxes. At the same time we create new incentives that pay off mostly for people in high tax brackets.

AN ALTERNATIVE APPROACH

There is an alternative to this futility. Various aspects of the alternative are increasingly discussed by academic economists and there is a chance that they will have a major impact on the Carter tax program.

The central feature of the alternative approach is to encourage more saving by low and middle income families. This strategy is fairly obvious when you recognize that the present compromise is a system that discourages saving over all, then by loopholes, encourages rich people to save and invest.

This statement is not the place to describe in detail the kind of tax law changes that would implement this strategy.[1] What can be established here is that we can simultaneously achieve goals of redistribution and growth, and that achieving both goals is worthwhile.

[1] I develop this detail in a forthcoming book "Tax Reform-Justice, Efficiency and Politics".

SALES TAX

A simple way to increase saving incentives at all brackets is to convert part of our income tax into a sales tax. This would tell each family that its tax is lower if it consumes less and taxes are higher if it consumes more.

Most persons will respond that a sales tax is regressive and therefore unacceptable. If you think about this for a minute you will see as an argument this is rubbish.

We could in the U.S. replace about half of our income tax with a 10% sales tax (or a value added tax which is just a sophisticated sales tax) without changing the progressivity of the tax system one bit! All we have to do is refund the sales tax paid on some basic level of income like the income we exempt from income tax. (This means the poor come out whole). Then you reduce the income tax, by different amounts in each bracket, but just enough to offset the sales tax paid by the average family in that bracket. (This makes everybody else whole.) At each income level saving is encouraged.

Over half the states already have some technique for refunding sales or property taxes to poor people. It is obviously a tricky job but we have a lot of experience on how to handle it. Between welfare, foodstamps and social security, we already have the channels to make refunds.

INTEGRATION

This shift to a sales tax is only one way to make savings more attractive to low and middle income people. Another is to integrate the corporate income tax with the personal income tax. To my mind the most serious problem with the corporation tax is that it overtaxes the corporate income earned on savings of low and middle income people and it undertaxes the income earned on investment of high income shareholders.

When the income on a share of stock owned by a retired school teacher pays a 48 percent corporate tax, there should be a refund when the teacher is only in the 20 percent rate bracket. If this share is owned by a scion of wealth in the 65 percent bracket there should be more tax to pay.

(If it surprises you that our way of taxing corporations can create tax relief for wealthy investors, despite the double tax on dividends, just recall those stories about highly paid entertainers who incorporate themselves to save taxes. It works.)

These approaches to tax reforms are different from the present game of creating new tax deductions for savings, like Keogh plans, and IRA's. Since these loopholes are deductions against a progressive tax, they are more valuable for rich savers.

Along with a new tax regime, we would do well to get rid of a number of other practices that discourage saving by ordinary people. If you think about it, a very large portion of the savings of ordinary people is in savings accounts in banks. We have laws limiting the interest return that banks can pay! The Treasury Department spends millions of dollars every year on advertising to con ordinary people into buying U.S. Savings Bonds which carry a miserable rate of interest.

I think most readers will grant that our laws, including our tax laws, can be changed so as to increase the rate of saving by low and middle income people. The other question that should be faced is whether this is a good thing to do.

One easy answer is based on the political analysis with which we started. If we shifted some savings incentives from rich people to low and middle income people, we could get more redistribution and just as much growth.

The nub of this political answer is my flat prediction that the redistributors don't have enough political clout to overcome the widespread political concern for some growth policy. It was not reactionary Republicans that first proposed the investment credit, it was John Kennedy. During the previous administration one of the few tax policies that President Ford and the Congressional Democrats could agree upon was raising the investment credit.

There is, in addition, a more upbeat answer than this political one. It is consistent with the basic desires of the American people that we should have a higher rate of economic growth, that is, more saving.

I willingly concede that many social "leads" can be associated with a rapid rate of growth, urban congestion, pollution, exhaustion of raw materials and so forth. I would insist, however, that these "bads" are basically associated with high rates of growth of consumption.

If we want less pollution this will be achieved by performing our economic tasks in less polluting ways. Power plants with stack gas cleaners require more capital than polluting power plants. Sewage treatment plants absorb more capital, that is to say, savings. We can develop energy substitutes for scarce oil and gas but these take more capital. We can develop mass transit systems but these also take capital (as we have found, much capital).

I think the path to building a good society is one that is characterized by using more of our income to provide a more people-oriented capital structure. This would be a capital structure that calls for less labor time, that is less polluting, and is less demanding of scarce resources.

We can have such a capital structure which is largely owned by ordinary people. The political argument about growth policy is as bitter as it is because of this mistaken view, incorporated in our tax policy, and in much of our culture, that growth policy means encouraging savings by the rich.

When the savings issues are separated from the distribution of income issues we can look at many questions more clearly. In December a labor union-sponsored conference in Rye, N.Y. was highly critical of foreign investment by U.S. multinational firms on the ground that this exported productivity increases that could have been enjoyed by American workers if the investment had taken place here.

This analysis is essentially correct as to its prediction of the effect of investment, but it is a remarkably selfish policy of take care of ourselves and let the third world starve. .

I see the selfishness growing out of two circumstances. In the first place there is a concern about there not being enough capital to go around for both adequate domestic investment and a decent level of international investment. Secondly, labor sees investment as something "they" do, not as something "we" do. More savings and investment is not an attractive policy in a total social system which features savings incentives by loopholes for rich investors. But, as we have seen, it doesn't have to be this way.

Another, bogey-man, lurking in this savings question is the largely mistaken notion that only consumption creates jobs. This is patently nonsense. We can have jobs making pollution control equipment as well as jobs producing more dirty power. If one needs a demonstration, for the last quarter century Japan has maintained a higher savings rate, and less unemployment than the United States. By all accounts Japan has much pollution, but my argument is that this is a matter of what we do with our capital. We can grow sensibly.

Basically I see tax reform as a major issue before the Congress because taxes are damned important. They absorb one-third of the gross income that the society produces. In a market economy (and even in a Socialist economy) income has a great deal to do with our economic activity. We do a lot of things simply because we get paid to do them, and when the pay isn't enough we quit or strike. We buy more of things when the price goes down and less when the price goes up.

It follows that how the government takes this one-third of the income stream, which incomes it reduces, what prices it drives up, will have a lot to do with the kind of society we live in. Better tax laws can give us a better society.

Attached is a study I did for the Joint Economic Committee on the Impact of Federal Taxation on Aggregate Savings and Investment (U.S. Economic Growth from 1976 to 1986: Prospects, Problems, and Patterns, Volume 3—Capital, pp. 33–44). I ask that it be printed as part of the record.

THE IMPACT ON FEDERAL TAXATION ON AGGREGATE SAVINGS AND INVESTMENT

By Gerard M. Brannon*

Summary

People who tell you some rate of savings or some rate of economic growth is "required" are frauds. Whether we should have more, or less growth is a matter of choice. Tax policy is a way that government can influence the private decisions which constitute our growth rate.

Heretofore our tax policy has incorporated a number of highly progressive features which could, if allowed to operate, bring about much income redistribution. The government, Congress and Administration, have built into this many growth incentive devices nearly all of which serve to reduce the taxes of the rich, who get the largest tax incentives.

The paper demonstrates that if the society wants a faster growth policy it is possible to achieve this without tax policies that undermine progressivity. The proper direction in which to go is to seek policies which increase the savings on low and middle income taxpayers.

One specific way to change the present tax structure is to change part of the present income tax into a value added tax or general sales tax. It is demonstrated that this change does not make the tax system more regressive. (That the sales tax is regressive is a bit of cultural lag that is emphasized by people who don't bother to think about the total tax system.)

Another important way to change the present tax structure is to integate the corporate income tax with regard to retained earnings. The widely held view that the only thing wrong with the corporate income tax is the double taxation of dividends is quite inadequate. The present treatment of retained earnings under taxes rich investors and over taxes poor investors.

Both of these proposals rely on a judgment that *at lower wealth levels* savings increase in response to higher rates of return after tax. We think the inconclusive evidence from studies of the response of aggregate savings to rate of return pick up an income effect which operates only on large wealth holders. Raising their rate of return substantially increases their permanent income and could lead to higher present consumption. This effect should not operate on people whose initial wealth is small.

A third way to increase savings of low income investors is to convert the Social Security System to more reserve financing which would permit liquidation of some publicly held federal debt with those funds

*Professor of Economics, Georgetown University. I wish to thank Douglas Brown for comments on the paper without committing him to the conclusions.

Reprinted from "U.S. Economic Growth From 1976 to 1986: Prospects, Problems, and Patterns," Volume 3—Capital, Joint Economic Committee, November 15, 1976

going into private investment. Since government will, through taxes, enjoy a gain from the higher private investment, the rate of return on reserves held by the Social Security System should be considerably above the long term government bond rate.

This paper does not attempt to recommend particular tax rates. This is inherently a cooperative enterprise. Other papers in this series will offer quantitative estimates on how much additional income will flow from more investment. Still others will relate to the response of savings. Still others will relate to the welfare analysis of exchanging future income for present consumption. Specific recommendations depend on judgments about these issues. The present paper only demonstrates that growth can be achieved in ways that do not undercut progressivity in the tax system.

1. Choice

Thinking about tax policy in relation to a social problem emphasizes the dimension of choice. We can invest and grow at one rate or another. It is certainly not the case that we will achieve happiness at a real growth rate of 4½ percent, and misery at rates of 3½ percent or 2½ percent. It is not obvious that 4½ percent would produce more happiness than 2½ percent.[1]

The special insight that the economist should contribute to the analysis of social problems is the clarification of the choices that are open. Certainly one of the most deceptive phrases in common use in connection with growth policy is the phrase "investment needs." Whether the real U.S. GNP in the year 2,000 is two or two and a half times the present level, we do not expect the United States to disappear.

Logically, the concept of necessity, or needs, refers to an "if" statement. "If the real GNP in the U.S. in the year 2,000 is to be 256 percent of the 1976 level, then the geometric mean growth rate over the next 24 years needs to be 4.0 percent per year." This is a logically correct sentence because the mathematics of 4 percent growth rate for 24 years produces an increase of 156 percent.

In common speech, however, people use the word "needs" without specifying the if clause, as in "The U.S. needs to grow faster." There is no explanation of what will happen if the U.S. doesn't grow faster. The analogy is very close to the notorious use of the absolute comparative in advertising. "This soap is better." They don't say better than what.

The explanation is that in this common speech "needs" is a hortative word. It is used by a speaker to encourage the listeners to adopt the speaker's viewpoint. Most commonly it is used to cover up the absence of logical arguments as to why this viewpoint should be adopted.[2]

Putting aside exhortation, the choice involved in economic growth policy is that if we devote more resources to growth this year we will

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[1] We are using the annual percentage rate of growth as an off hand way of referring to alternative growth policies in the short run. In the long run it is well known that the percentage rate of growth is quite ambiguous.

[2] For a general discussion of the use of hortative words see C. Stevenson, *Ethics and Language*.

reduce the consumption (public or private) that we would otherwise enjoy this year and increase consumption in some future years.[3]

Since the whole society will be richer in the future than it is now, it is not obvious that we should sacrifice more to make our children richer still. Nor is it obvious that we should not. This is the choice. Hopefully, other papers in this symposium will give us better information on the size of future pay-offs from devoting more resources to growth, as well as forecasts of the future situation if we don't grow faster. The function of such analyses is to lead to a more enlightened choice.

The economic insight on choice goes further. It is not the case that the level of GNP in some future year will alone determine the level of poverty, or the level of environmental degradation or the level of national defense. Within a growth policy we can pursue alternative income distribution policies, or alternative environmental policies. The important thing in studying growth is to find connectons between growth and income distribution, growth and quality of life and so forth. There is no reason to expect that these connections are simple; that is, that more growth necessarily means a more unequal income distribution or a poorer quality of life.

2. The Present Tax Choices—A Case of Schizophrenia

The Federal government does not make choices for the society no matter how severe the level of controls enacted, but it does influence private choices. (A most interesting current development is the increasing reliance on market mechanisms in the Communist world which can be seen as a move toward influencing private choice as a reaction to the failure of exclusive reliance on central planning.[4])

Private choices can be influenced by the system of law which defines private rights and responsibilities in certain ways, and by the system of governmental regulation of particular activities. Of immediate interest is the fact that in a modern economy where from a quarter to two-fifths of the GNP is spent by government, private choice is greatly influenced by government expenditures and taxes. In order to permit this level of expenditures government must take a large share of private income, and in so doing it will inevitably bring about large changes in relative prices. Neutrality in taxation is practically impossible so we have no alternative but to decide on tax policy in terms of how we want to influence private choice.

In summary fashion we can point out that tax effects can be listed under three headings: they involve the short run level of employment and price stability; they involve the distribution of income; and they involve the allocation of real resources between alternative uses, saving and consumption, pollution and anti-pollution, using and conserving scarce resources and the like.

For the present problem the use of tax policy to affect short run levels of employment and prices is not of prime interest since growth is primarily a long run issue. (We will have some incidental comments

[3] It is irrelevant that we could get greater output by being more efficient. The increased output from greater efficiency could be used for consumption or growth.

[4] See, e.g., J. Wilczynski, *Socialist Economic Development and Reforms*.

to make on the choice of short run tax policy instruments in the light of our long run analysis.)

So far as long run tax policy is concerned most political debate in the U.S. revolves around income distribution goals and resource allocations relating to economic growth. In capsule fashion, we offer two judgments. In the first place, the U.S. has committed itself to a tax system which, so far as the basic structure and rates are concerned, is highly redistributive. At the same time, the political consensus regards this basic system as involving an excessive growth inhibition and we more or less continually undercut the progressivity of the system by special treatments to encourage growth.

The balance of this section will elaborate this view of the present tax system, what we judge to be the schizophrenia of our tax system which we think underlies what has been called the "impossible dream" of tax reform.[5]

In the first place the present individual income tax system bears heavily on saving. Whether or not the catch phrase "double taxation of saving" is appropriate, it is clear that an income tax with no exemption for saving or for investment income changes the trade-off between consumption and saving in favor of consumption. With no tax an individual might be indifferent between consuming income of 100 now or investing it for 10 years and then consuming 200. Introducing a 50-percent income tax reduces the current consumption alternative to 50, but it reduces the future consumption alternative to 75, since the taxpayer will have only half as much to invest and it will grow only half as fast (actually a little less than half as fast).[6]

It is somewhat uncertain that a penalty rate on saving will reduce the aggregate volume of saving. The point at issue is whether the elasticity of savings with respect to the interest rate is positive. We think that at this point the evidence is in favor of the proposition that the effect of reducing the after tax rate of return on investment is to reduce the volume of investment.[7]

In addition to the basic income tax structure with its savings impact, the U.S. tax system involves a heavy tax on the corporation which is the principal vehicle for reinvesting profit income.[8]

The principal issue about the effect of the corporation income tax on saving and investment has to do with the assertion that the corporation income tax may be shifted. To some extent this involves a definition of shifting. If the corporation tax reduces the level of saving and investment we would expect that the resulting relative capital "shortage" would cause the rate of return on capital to be higher,

[5] J. Pechman and G. Break, *Tax Reform—The Impossible Dream*, Washington, D.C., Brookings, 1974.

[6] A good discussion of the historical debate in the public finance literature is provided by W. Andrews, "A Consumption-Type or Cash Flow Personal Income Tax" *Harvard Law Review*, 87:1113, esp. pp. 1113–1128, 1165–1177, (April, 1974).

[7] M. Boskin, *Taxation Saving and the Rate of Interest*, OTA Paper No. 11, Department of the Treasury, 1976; P. David and J. Scadding, "Private Saving: Ultrarationality, Aggregation and 'Denison's Law'", *Journal of Political Economy*, 1974; C. Wright, "Saving and the Rate of Interest" in A. Harberger and M. Bailey eds., *The Taxation of Income from Capital*, Washington, D.C., Brookings, 1969. The view that the interest elasticity of savings with respect to interest is zero or negative is developed by W. Weber "The Impact of Interest Rates on Aggregate Consumption", *American Economic Review*, September, 1970, and "Interest Rates, Inflation and Consumer Expenditures", *American Economic Review*, December, 1975.

[8] For a general discussion of the unintegrated corporate income tax see C. McLure, Jr., "Integration of the Income Taxes: Why and How", *Journal of Corporate Taxation* 2:429, 1976; J. Shoven and J. Whalley, "A General Equilibrium Calculation of the Effects of Differential Taxation of Income from Capital in the U.S.", *Journal of Pub. Econ.* 1:281, 1972.

which some may choose to call shifting of the corporate tax.[9] From our standpoint this process, whatever it is called, is not such as to overcome the presumption that an extra tax burden on corporate income reduces the level of investment and growth.

To argue that the corporate tax is shifted in a way that offsets its impact on growth and investment, one would have to argue that corporations are able to increase their share of income before tax so that a decline in the level of investment is foreclosed. We think this is unlikely.[10] Further one would except that even in the shortrun price shifting model that the decline in demand would reduce the level of investment.[11]

Another feature of the U.S. tax system taken as a whole is the heavy reliance on the property tax which is the mainstay of local finance. Although this has been popularly regarded as a regressive tax, the contemporary view of most public finance economists is that the tax is primarily borne by capital. There is implicit in this problem of property tax effects the same kind of long run-short run distinction that is involved in the corporation income tax. A tax which reduces the builders income should reduce the quantity of structures, increase their price in the long run. From our standpoint this is a reduction in the amount of capital.[12]

Finally we have a highly progressive structure of taxes on property transfers by death or gift which serve as a penalty on capital and which probably inhibits capital formation and growth.[13]

These four features of the basic U.S. tax system, the double tax on savings, the unintegrated corporate income tax, the property tax and the wealth transfer taxes are, we believe, in the tax law because they are thought to be progressive.[14] Clearly wealth is more unequally distributed than income and extra taxes on wealth holding serve to impose extra, progressive taxes on the rich.

We think that there are other features of U.S. tax law which suggest that the society has serious reservations about a tax system that bears so heavily on savings and investment.

Our income tax law is honey-combed with special provisions which moderate the implication of the basic structure to burden investment. The list of exceptions hardly needs elaboration. We have low tax rates on a major type of investment income, capital gains and for a large part of capital appreciation, individual income tax can be completely avoided by holding an appreciated asset until death. We have an investment tax credit which rebates part of the tax on capital income

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[9] See A. Harberger, "The Incidence of the Corporate Income Tax", *Journal of Political Econ*. 70:215. 1962.

[10] See R. Gordon, "The Incidence of the Corporation Income Tax in U.S. Manufacturing 1925–62. *American Economic Review*, 57:781, 1967.

[11] G. Break, "The Incidence and Economic Effects of Taxation" in A. Blinder, *et al, The Economics of Public Finance*, Washington, D.C., Brookings, 1974.

[12] For a general discussion of property tax incidence see H. Aaron "Who Pays the Property Tax" Washington, D.C. Brookings 1975. For further discussion of the long run supply effect on structures see R. Grieson "The Economics of Property Taxes and Land Values: The Elasticity of Supply of Structures" *Journal of Urban Economics* 1: 367–81 (1974) also S. LeRoy "Urban Land Rent and the Incidence of Property Taxes" *Journal of Urban Economics* 3: 167–179 (1976).

[13] See R. Wagner, *Death and Taxes*, American Enterprise Institute, Washington, D.C., 1973, pp. 23–25. For a view that transfer taxes have no net impact on saving. See S. Rickowsky. "The Effect of Saving on the U.S. Estate and Gift Tax" Appendix F. in C. Shoup Federal Estate and Gift Taxes, Washington, D.C. Brookings, 1966.

[14] This assertion as applied to the property tax is doubtful on historical grounds since that tax has been widely considered regressive. The progressivity of a property tax on capital is, however, part of the modern defense of the tax. See Aaron, *op. cit.*

when it is used for more capital formation. Similarly the accelerated depreciation rules constitute an exception to the income tax on capital. We have a variety of more specialized tax incentives for particular kinds of investment, mining, shipbuilding, timber, investment in State and local bonds, housing, and so forth.

In addition to direct tax advantages for investing, we provide various encouragements for savings, especially through the favorable treatment of pension and profit sharing plans and through the favorable treatment of financial intermediaries.

3. Inefficiency of Present Choices

Our judgment of the present expression of policy choices in the U.S. tax system is that we are inconsistent between (1) our basic structure, which puts progressivity above growth as an objective and (2) the special exceptions within that structure which put growth ahead of progressivity.

In this sort of a structure we think neither goal is efficiently served.

So far as the progressivity objective is concerned, the approach of first imposing highly progressive taxes and then allowing relief from these taxes for investment or for particular forms of savings amounts to extending a differential subsidy with the biggest subsidy going to the richest taxpayers, that is the ones who, absent incentive provisions, would be in the highest tax brackets.

The way in which a provision like accelerated depreciation for real estate investment works to the advantage of high bracket taxpayers is well known. This has developed a modest industry of tax shelters which try to maximize the tax advantages for an investment by diverting the excess deductions to a high bracket investor.[15]

It is less obvious but still the case that the investment credit as it is presently designed works to the advantage of the high bracket tax payer because the credit equivalent to an amount of tax free income is greater the higher the tax rate of the recipient.[16]

The systematic way in which the investment incentive features in our tax law help high bracket taxpayers is the basis of the political movement for tax reform.[17] In the popular sense "tax reform" is a liberal program, a major object of which is to make the tax system more progressive. A standard complaint of the tax reformer is that the tax system is not finally very progressive.[18]

While the tax system fails the designers of the basic structure in not being very progressive, we think that this patch-work approach of grafting investment incentives on a basic anti-investment structure is also an inefficient way to improve investment performance.

The defect is involved in the selective character of the investment incentives. To see that this is inefficient and not just unfair it is necessary to keep in mind the way in which tax incentives work when they are used to influence market outcomes.

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[15] See S. Surrey, *Pathways to Tax Reform*, Cambridge, Mass., Harvard University Press, 1974, esp. Chapter IV.

[16] This feature of the tax credit could be avoided if the credit were required to be a deduction from basis. The basis adjustment would "cost" the high bracket taxpayer more.

[17] For a somewhat partisan view of the extent to which these incentives undercut progressivity see P. Stern, *The Rape of the Taxpayer*, New York, Vintage. Also, Brandon, Rowe and Stanton, *Tax Politics*, Pantheon, 1976.

[18] See J. Pechman and B. Okner *Who Bears the Tax Burden*, Washington, D.C., Brookings, 1973.

If investment decisions were left to the market place, they would reflect investor judgments about the probable return on a particular investment and the cost of capital. (The cost of capital is, of course, the opportunity cost, what can be obtained in alternative employments, adjusted for risk differentials and so forth). Assume, for simplification that investors generally consider that the cost of capital is 10 percent.

If government introduced a universal investment credit of 10 percent, with basis adjustment, this could be described as reducing the required rate of return to 9 percent.[19] It would not turn out that a number of potential investments with prospective rates of return between 10 percent and 9 percent (averaging 9.5 percent) would move from the category of submarginal into the category of providing at least the required rate of return.

Consider alternatively that the investment credit is extended not to all investments, but is extended to about half of the potential investments at a rate of 20 percent instead of 10 percent. It will develop now that in the favored class of investments, projects that previously offered a prospective return of 8–10 percent (average 9 percent) will because of the 20 percent credit meet the standard 10 percent return to the investor.

Comparing the two results it can be seen that the broad investment incentive induces new projects which have an average before tax rate of return of 9½ percent while the double rate selective credit induces new investment with an average rate of return of 9 percent. This is a somewhat oversimplified demonstration that an investment incentive that is as uniform as possible will be more efficient than a selective credit per dollar of revenue loss, because the uniform credit being smaller per project will only induce investments that were close to the margin of profitability to start with. A selective credit involving the same revenue loss will be larger per project and will induce investments that were to start with further away from the margin of profitability.

Essentially the same process occurs when the investment incentives is limited by being applicable only to certain classes of investors, rather than being limited to only certain types of investment. The well known case here is the matter of tax exemption for State and local bond interest. The nature of tax exemption is to be of maximum advantage to the highest bracket taxpayer. Any particular investor will have some sort of diversified portfolio objectives and will be increasingly reluctant to put a larger and larger portion of investible funds into this vehicle. In view of the volume of State and local borrowing, the bonds are sold to marginal investors who get less advantage from tax exemption than high bracket individuals. The outcome is situation where a considerable portion of the Federal revenue loss becomes not an interest saving to states and localities but a windfall gain to rich investors.

There is reason to expect a similar result from, say, accelerated depreciation on real estate as a construction incentive. Again assume that in a free market there would be a marginal return of 10 percent. By

[19] Previously an investment costing 100 with an expected return of 9 would have been submarginal. The investment credit reduces the investor's cost to 90 and the prospective return is 10 percent.

concentrating incentives on half of the potential investors we could make investments attractive to them at marginal returns of, say, 6 percent before tax. This would drive investors out of the market when their benefit from the accelerated deductions were equivalent to less than a 4 point improvement in the rate of return.

On the supply side the inefficiency arises from the amount of revenue loss that must be used up to induce investors to carry unbalanced portfolios.

Conceivably, the inefficiencies of selective investment incentives could be overcome if there was evidence that the Congress was giving carefully consideration to the external benefits of particular kinds of investment. It is clear that nothing of the sort occurs in the political process and the outcomes are a response to something closely akin to graft.[20]

Not the least of the disadvantages of the present schizophrenic tax policy is the taxpayer demoralization in the face of what is a pattern of political favoritism.

4. An Efficient Choice System

The most striking thing about the schizophrenia of the present tax system is that it is quite unnecessary. The idea that objectives of progressivity and more saving are contradictory is pure myth.

The archetype of this myth is the old chesnut that a sales tax should be rejected because it is regressive. This is a pure irrelevancy because we could enact a sales tax without any change in regressivity. All we would have to do is refund to each family the amount of sales tax payable on some minimum amount of expenditure, say the level of income that we exempt from income tax. At higher levels we could reduce the income tax in each bracket so as to decrease the income tax liability by precisely as much as the sales tax increased the tax burden at each income bracket.

This makes plain that what is involved in the question of "do we want a general sales tax, or better a value added tax?" is do we want, at each income level, to increase the tax burden on families that spend more than average and reduce the income tax penalty on saving.

We think that it is a viable option for growth policy to be oriented toward increased savings by low and middle income people. We also think that direct incentives for investment are unnecessary provided that we get an increased flow of savings. Through the mechanism of interest rate reductions, increased savings have the effect of making investment more attractive. The investment incentives of lower interest rates have the technical efficiency advantage of pushing investment at all the margins.

An increased savings policy targeted at low and middle income recipients has considerable political viability in the proper sense of political. It is ultimately important for the Congress to enact policies that will be supported by a large portion of the people. The policy preferences of one or even a few professors are not very important. On the face of it, things are not working now when we try to make a basic anti-business tax structure less anti-business with loopholes. (By not

[20] See P. Stern, *op. cit.*

working, I mean they are not working economically. It could be argued that they are working politically. You are able to point to symbols that have great attraction for both sides.)

As to the techniques for making savings more attractive to low and middle income taxpayers, I think of two that are particularly viable. One of the transfer of part of our income tax into a general tax on consumption such as a sales tax or a tax on value added. There is now an extensive body of experience with value added taxes in Europe. The value added tax is in effect very much like a general sales tax but it tends to be more uniform in application to various kinds of consumption. It would also be reasonably simple to administer. It would be collected by return from businesses and nearly all of the information needed for the value added return would be information of a type used for income tax returns.

The unique problem in the value added tax as I have proposed it would be the necessity for creating a mechanism for refunds. This problem has already been tackled in about half of our States that employ the so-called "circuit-breaker," a device for refunding sales or property taxes to poor people. The technical difficulty in this is establishing contact with those poor people who don't generally file tax returns. This sort of thing we do on a large scale already in the food stamp plan, and the welfare programs.

The other important technique for making savings more attractive to low and middle income people is to integrate the corporate and individual income tax.

In the popular view the problem with our corporate income tax is the double taxation of dividends. It is true that at present the net extra burden generated by our corporate income tax structure is about equivalent to the individual income tax on dividends. This was the thinking behind President Ford's proposal of last year to eliminate the double tax on dividends.

From my own viewpoint, there is a more serious defect of the present income tax, viz, the way in which it overtaxes the retained earnings attributable to low income investors and undertaxes the retained earning attributable to high income investors.

Consider a corporation that pays no dividends. Ostensibly, it is taxable at a marginal rate of 48 percent on its income in excess of $50,000. With the various business investment incentives this effective rate works out to a little less than 40 percent, so let us specify for discussion a 40 percent rate.

For a high income taxpayer this amounts to considerable tax relief. If that taxpayer received business income directly it would be subject to tax, at the margin, at a rate of 70 percent. If the income is left in the corporation a rate of only 40 percent applies. It is not economically meaningful to say that, because the income has not been distributed, it is not really the income of the shareholder.

In general, the value of corporate shares will reflect at least the value of retained earnings. The fact of retained earnings represents a profit that the firm can re-invest to make more profit and further increase its net worth. Any particular reinvested dollar may be later wiped out by losses but the aggregate business system is efficient and successes far outweigh losses.

If it sounds strange to say that the corporate income tax arrangement really helps high income investors, recall that some high salaried people try to incorporate simply to save taxes.

Now let us look at a low income taxpayer who owns shares in a non-dividend paying corporation. The individuals own marginal rate may be, say 20 percent, or even zero. The income retained for this individual is, however, taxed at a typical rate of 40 percent. The contrast is striking. The retained earnings of rich investors are undertaxed and the retained earnings of low income investors are over taxed.

(This stark contrast is only moderated if we take into account a typical dividend policy of 40 percent of the retained earnings. For the top bracket investor the dividend on 100 of income after 40 percent tax will be only 24 which if taxable at 70 percent will involve an additional tax of 17. When this is added to the 40 percent the effective tax rate is still only 57 percent, which is less than the individual's 70 percent marginal rate. It is still striking that the corporate tax system undertaxes rich investors and overtaxes poor investors.)

The way to reform this system is to move toward a partnership system of taxing corporations. There should be a withholding tax of something like 50 percent on corporations. The corporation would then report to shareholders their share of the retained earnings along with their share of the tax paid. The shareholders would report income in the usual way and take credit for the withholding (just like they take credit for tax withheld on wages.) For low income investors, there would be a refund of part or all of the corporate tax. For high income investors there would be additional tax to pay.

It is a problem that in this country there has been inadequate discussion of the mechanics of full corporate integration. Canada, at the time of Carter Commission Report in the mid-1960's, developed a fairly complete approach to integration. There has been a limited amount of discussion of corporate integration with specific reference to the U.S. tax law.[21]

A great deal of the discussion over integration in the U.S. has been directed at what seems to me the limited problem of the high income investor who may have nearly all his investment in a non-dividend paying corporation. In this case reporting the share of retained income and taking the credit for the tax paid at the corporate level would leave a cash problem. The Carter Commission dealt with this by reducing the top individual income tax rate to the same level as the corporate rate. Pechman and Break have pointed out that doing this in the U.S. would wipe out the gain in progressivity related to the corporate tax.[22]

The cash problem does not appear to me to be critical. High income investors would do well to not hold stock in non-dividend paying corporations. To cover special problems provision could be made for some stock liquidation (by sale to the corporation) to cover the tax. The essential case for having integration in the first place is to avoid the concentration of wealth that has been abetted heretofore by arrangements that reduce tax on high income investors who are investing heavily, i.e., accumulating more wealth.

[21] See McLure *op. cit.*, also a symposium in the *National Tax Journal*, 1975.

[22] Pechman and Break *op. cit.*, pp. 90–104. Under the Carter Plan this reduction in progressivity was removed by other base broadening reforms that affected high income taxpayers.

It is tempting to say that a promising approach to reconciling our redistributionist and our growth objectives is to enact a progressve expenditure tax. This approach would directly serve to increase the concentration of wealth since the tax differential in favor of saving becomes enormously high as income levels rise. With sufficiently severe estate and gift taxes this concentration of wealth reownership may prove tractable but a more cautious judgement would be to start by looking for programs that avoided large savings incentives for the very wealthy.[23] (The same can be said for the devices in the income tax for allowing deductions for savings, such as Employee Stock Ownership Plans.)

Rather closely related to the two tax policies that we prefer would be the possibility of increasing the savings of low and middle income people by shifting to a policy of reserve building within the Social Security Trust Fund. In this approach the economic function of the reserve would be to permit the government to liquidate debt held by the public in the expectation that more of the publicly held debt would flow into private investment where the rate of return must be considerably more than the rate on government bonds. Out of the extra tax receipts attributable to profits from private investment the government would be in a position to, and should, credit social security reserves with more than the market rate on government bonds.

The difference between the normal tax proposals (of introducing a consumption tax and integrating the corporate tax) and the social security reserve suggestion is the degree of influence being exerted. The tax proposals makes saving more attractive and the social security proposal is close to compulsory saving.

If it is the case that the interest elasticity of savings is close to zero, the mere device of reducing tax penalties on savings would have little to do with increasing the volume of saving. We cited earlier some recent research that suggests (on the basis of aggregate analysis) that the savings rate does increase with higher returns.

It is more significant for our proposal that increased rates of return on the savings of low and middle income people should be particularly effective in increasing savings rates. An increased interest rate has both an income effect and a price effect. The price effect would tend to make future consumption more attractive relative to current consumption. This should go in the direction of increasing future consumption and reducing present consumption. The income effect is that a person's lifetime income is increased by a rise in after tax interest rates and this income effect is positively related to the amount of current wealth and expected future wealth. The general result of the income effect is to increase the level of permanent income which could increase consumption in all periods, present and future. An increase in present consumption is, of course, the same as a decrease in savings.

For a person with much wealth, the income effect could easily offset the price effect. This may predominate the aggregate studies which show near-zero interest elasticity for savings. Typically low and middle income people have low wealth levels and for them the income

[23] The argument that estate taxation alone is not a sufficient protection against very large property concentration is made by L. Thurow "Net Wealth Taxes" *National Tax Journal* 25 : 417–423. Thurow's argument would be even stronger in a system that provided additional savings rewards.

effect should not be very strong and an increase after tax return on savings should have significant effects in increasing savings.

If the voluntary savings effect is weak, however, it would make sense to rely on the stronger device for increasing savings of low and middle income people, viz., of higher reserve financing in social security.

ADDENDUM. "HOW SHOULD THE TAX LAW BE CHANGED?"

This note explains why we have not answered this question. The answer depends on—

(1) Your growth objective;

(2) The evidence on how more investment would change growth; and

(3) The evidence on how savings would change in response to a tax differential.

We submitted an overview of the evidence on (2) and (3) to this Committee in 1972 (G. Brannon "The Effects of Tax Incentives for Business Investment: A Survey of the Economic Evidence" *Economies of Federal Subsidy Programs* Pt. 3 Tax Subsidies pp. 245–268 Joint Economic Committee). At that time the evidence was quite ambiguous. Hopefully the present compendium will throw more light on these questions.

The present paper primarily discusses ways in which the tax system could be changed to achieve more growth and simultaneously achieve the distribution goals which the Congress has also sought. It is analogous to a repair job on the steering mechanism on a car. If you want advice on whether to drive the repaired car to the mountains or the seashore for a vacation, the repair manuals won't help you; you need other kinds of advice. The advice about steering mechanisms, the tax law, which this paper offers stands whether one wants to drive our economic automobile to the mountains of faster economic growth or to the seashore of zero economic growth.

If one persists in asking our opinion about where we should drive the car, our personal preference is for a somewhat higher ratio of investment to GNP and a lower ratio of consumption to GNP provided it is done in a distribution neutral way. We might favor a lower level of government expenditures to GNP, qualified by reservations about which expenditures were cut.

In the matter of tax changes, we think that a very large effort should be put on integrating the corporate tax with regard to retained earnings. We also think that part of the income tax should be converted in a distribution-neutral way into about a 5% value added tax. To deal with long term savings accumulations the taxes at death should be increased, especially on unrealized appreciation. Social Security involves too many other considerations to specify a particular rate of reserve accumulation, and this would in any case involve much political negotiation. We would only urge that we try to provide more accumulation than there is now.

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TAXATION WITH REPRESENTATION NEWSLETTER

A Public Interest Taxpayers' Lobby

TWR MODIFIES PROPOSED PROGRAM IN RESPONSE TO MEMBER COMMENTS

Last December, Taxation with Representation asked for member comments regarding TWR's proposed 1977 program. A large number of letters were received, many of which have been reproduced in the *Newsletter*.

All of these comments have been carefully analyzed, and revisions in the proposed TWR program have been made accordingly. The revised proposals are longer and more detailed, but we hope and expect that they will be more acceptable both to our membership and to Congress.

These proposals are still in draft form, so additional comments and criticisms would be welcomed. Current plans call for putting the TWR program into final form in July 1977, for submission to both Congress and the Treasury. However, because a good deal of work is being done on the program currently, comments will be of greatest use if they are submitted promptly.

Revised TWR Program for 1977 (Final Draft)

I. Tax Rate Reduction. Across-the-board reduction of individual income tax rates is an essential part of tax reform and tax simplification. Without rate reduction, taxpayers will fight hard to preserve their tax preferences and loopholes, thereby making tax reform and simplification difficult or impossible. Taxation with Representation therefore urges sharp reductions in individual income tax rates. The lowest bracket tax rate should be cut from 14% to not more than 8%, and comparable reductions should be made in all other tax brackets. These reductions should go hand-in-hand with loophole-closing tax reform.

II. An End to Back Door Elimination of the Corporate Income Tax. The proportion of federal revenue raised by the corporate income tax has been dropping steadily At the end of World War II, the corporate income tax raised almost half of all federal revenue. But, by 1957 the corporate tax contributed only 26.5% of the federal budget receipts; in 1967, the figure was 22.2%; and in the current year it is only 16.1%. The Congressional Budget Office predicts that the corporate tax yield will drop even further, to 13.8% of budget receipts, by 1982. In effect, Congress has been abolishing the corporate income tax "through the back door" by providing corporations with special tax deductions, credits, and loopholes. A new deduction for payment of corporate dividends is now under discussion, which will further undermine the corporate income tax.

Taxation with Representation believes that — if the corporate income tax is to be abolished — this step should be taken openly, through the "front door," by fully integrating the corporate and individual income taxes with respect to retained as well as distributed earnings Taking this route would make it impossible for wealthy individuals to use corporations as tax shelters, would end much of the bias in the present tax system against saving and investment, and would improve economic efficiency by ending many tax-induced misallocations of resources. But the present corporate tax system does not have any of these advantages, and the proposed deduction for corporate dividends will not attain them either.

Taxation with Representation therefore opposes both existing corporate tax loopholes — such as deferral of tax on foreign earnings, the oil company intangible drilling deduction, the Domestic International Sales Corporation (DISC) scheme, the Code's rapid amortization provisions, and the Asset Depreciation Range (ADR) System — and the proposed dividends paid deduction. Back door elimination of the corporate income tax must be halted.

III. An End to the "Inflation Tax". Inflation has been called "the cruelest tax of all." A major cause of inflation is excessive federal budget deficits. Tax reform cannot be used as an excuse to add to existing deficits. Accordingly, Taxation with Representation believes that reductions in individual income tax rates and full integration of the corporate and individual income tax systems must be accompanied by *one or more* of the following steps:

1. Reductions in federal spending,

2. Adoption of a consumption tax with progressive rates, and/or

3. Loophole-closing income tax reform

Reductions in federal spending, especially reductions that can be attributed to greater efficiency in government operations, are obviously highly desirable But Taxation with Representation believes that it would be unwise to postpone tax reform initiatives until government expenditures are reduced — since the wait for significant expenditure reductions may be very long indeed.

The second alternative involves adoption of a tax that has consumption rather than income as its base It would tax people on what they take out of the economy, rather than on what they contribute through their paid labor. Some consumption taxes, such as a value added tax, are flat-rate levies that fall more heavily on the poor than on the rich. They are therefore unacceptable. But others, — such as the cash flow, consumption base tax described in the U.S. Treasury's "Blueprints for Basic Tax Reform"

(Continued on page 2)

Revised Program *(Continued from page 1)*

— make use of progressive tax rates and thereby avoid this pitfall. Taxation with Representation believes that a consumption tax with progressive rates warrants serious study if an alternative source of federal revenue is required to prevent inflation.

However, in Taxation with Representation's view, loophole-closing income tax reform is the most desirable method of ending the "inflation tax" attributable to excessive government deficits. This method can be supplemented by a progressive consumption tax if Congress fails to raise the revenue through income tax reform that is needed to prevent inflation. But a determined effort to achieve income tax reform should precede (and accompany) any move to a consumption tax. The most important of the loophole-closing income tax reforms are the following:

1. *Across-the-board elimination of capital gains tax preferences.* These preferences are the prime reason why the income tax is so complicated. They can be safely eliminated if other steps, such as full integration of the individual and corporate income taxes, are used to stimulate investment and capital formation.

2. *Taxation of unrealized capital gains at death or gift.* Present law allows capital gains taxes to be postponed for generations — even for centuries. Meanwhile, wage earners have to pay taxes every payday. Capital gains should be taxed once a generation.

3. *Repeal of percentage depletion for all minerals.* Congress has repealed percentage depletion for approximately 70 large oil firms, but has left depletion intact for hundreds of thousands of other oil and gas producers and owners. In addition, percentage depletion has also been retained for so-called "hard minerals" such as coal, sand and gravel, and oyster shells. Billions of dollars in tax revenue continue to be lost unjustifiably through percentage depletion.

4. *Ending tax exempt bond privileges.* Preferential treatment of state and local bond interest is a major reason for the failure of wealthy individuals and commercial banks to pay federal income tax. Moreover, the existing tax exemption system is not an efficient way to aid states and localities. Prospective repeal of the right to issue new tax exempt bonds is the theoretically proper way to deal with the tax exempt bond problem. But political realities make this impossible — the political clout of states and localities is just too great. Consequently, alternate "second-best" reform approaches must be used.

For example, the taxable bond option, as reported by the House Ways and Means Committee in 1976, would give states and localities the option of issuing taxable, rather than tax exempt bonds, at no added cost to themselves. Alternatively, an Urbank type approach would provide a federal market for state and local securities; the federal government would then issue taxable rather than tax exempt bonds to raise the bank's loan capital. The cost of either of these "second-best" proposals to the federal government would be small in comparison with the substantial gain in tax equity that the proposal would produce.

5. *An end to deferral of tax on foreign earnings.* At present, U.S. corporations are able to postpone indefinitely any payment of tax on the earnings of foreign subsidiaries. Meanwhile, individuals and domestic corporations must pay extra taxes currently to make up the revenue loss. The deferral privilege should be eliminated, with appropriate exceptions for situations involving blocked currency and foreign losses.

6. *Repeal of the Domestic International Sales Corporation (DISC) provisions of the Internal Revenue Code.* The DISC scheme is a tax subsidy for exporters. It lacks any justification in an international economy characterized by floating exchange rates. More than a billion dollars annually is lost through this loophole, with the lion's share of the benefits going to the very largest U.S. corporations. DISC should be promptly repealed.

7. *Realistic depreciation deductions.* At present, the depreciation deductions which can be claimed for tax purposes bear little or no relationship to actual physical depreciation or obsolescence, or to the amount of depreciation claimed for financial accounting purposes. The unrealistically short depreciable lives permitted under the Asset Depreciation Range (ADR) System are one major cause of these disparities, as is the use of depreciation that is faster than straight line in the case of buildings. Actual useful life should be the measuring rod when computing depreciation for tax purposes, and the reserve ratio test should be made effective as a means of recapturing excessive depreciation deductions. In the case of buildings, depreciation should be computed by the straight line method. In the case of machinery and equipment, accelerated depreciation methods (but not the unrealistically short ADR System lives) should be the norm.

8. *Repeal of the intangible drilling deduction.* We should repeal the intangible drilling deduction, which allows oil firms to deduct certain of their capital expenses currently, instead of gradually as is the case with other firms. High oil prices provide all the incentive that firms need to drill for oil, and any added tax incentive is therefore wasted. Moreover, the intangible drilling deduction substantially detracts from the equity of the tax system, by permitting many individuals and firms with high real incomes to pay little or no tax.

9. *Repeal of the five-year amortization provisions of the Code.* At present, the Internal Revenue Code provides 60-month amortization for many types of special industrial equipment, including pollution control devices, coal mining equipment, railroad rolling stock, and other items. These allowances are largely ineffective in attaining their goals and are a tribute to the lobbying power of the groups involved, rather than an expression of effective tax policy. They should be repealed.

10. *Ending the proliferation of personal deductions and credits.* Because tax rates are so high, individuals have strongly supported proposals to grant deductions, exclusions, and credits to individuals in special circumstances. Almost everyone now benefits from a tax loophole of some sort. But this proliferation of loopholes has made it necessary to keep tax rates high to make up the lost revenue. In effect, the tax benefits from loopholes are canceled out by high tax rates. Everyone is a loser, because Congress has tried to make everyone a winner. The only real beneficiaries are the tax preparation firms, whose services are needed to guide confused taxpayers through the statutory maze.

The existing system of providing relief from high tax rates through specialized deductions, credits, and exclusions is bankrupt. It is a prime cause of complexity in the revenue laws, and it imposes excessive administrative burdens on the Internal Revenue Service and excessive tax preparation costs on individuals and firms. It can and must be ended.

The right approach is to repeal or restrict deductions *at the same time that tax rates are sharply reduced.* Otherwise, the enemies of tax reform and tax simplification will be able to condemn reform initiatives as simply a device to raise additional government revenue. The falsity of these charges must be demonstrated by legislative proposals in which *curbs on tax deductions* and *cuts in tax rates* go hand in hand.

IV. Improved Taxpayer Service and Administration. The administration of the Internal Revenue Code needs to be improved in several different ways:

1. *Taxpayer protection agency.* Taxpayer protection and service should be assigned to an office other than the Internal Revenue Service. The new office should carry forward and expand existing IRS taxpayer service programs, testify on behalf of the public at legislative and administrative hearings, and be empowered to sue when the IRS issues illegal rulings, regulations, or other administrative determinations. The main goals of the agency should be (a) assistance to ordinary taxpayers on a scale which will make it unnecessary for them to patronize tax return preparation firms, and (b) oversight of IRS activities to insure that the IRS respects the public and obeys the law.

2. *Improved judicial machinery.* We need to improve our system of litigating tax cases, so that judge-made law can assist in the job of tax simplification. In most areas of the law, Congress creates broad rules, and leaves it to the courts to fill in the gaps and apply the rules to specific cases. But this effective, natural approach has been thwarted in the tax area by the splintering of jurisdiction in tax cases among three different federal court systems and eleven courts of appeal, with little Supreme Court supervision.

Consequently, the courts cannot be counted on, at present, to provide interpretations of the law that will apply uniformly to all taxpayers. That makes it necessary for Congress to prescribe minutely detailed tax rules and to create endless statutory complexity. The result is a massive tax code, which no one fully understands. A rationally organized system for the adjudication of tax cases, including a single appellate forum for such cases, is therefore imperative.

3. *Improvements in income averaging.* We need to improve and extend our system of income averaging. Averaging is designed to prevent the unfairness that results when capital gains, or other types of income, are "bunched" into a single year, thereby temporarily pushing an individual into unusually high tax brackets. But as things now stand, an individual's ability to make use of the averaging technique is severely limited by a number of restrictions. Consideration should be given to adoption of five year block averaging, with the right to average either forward or backward, together with a lessening of the dollar and percentage limitations that now restrict the availability of the averaging technique.

4. *Dividend and interest withholding.* We need to prevent the widespread tax evasion that now occurs in connection with dividend and interest payments, by instituting a system of income tax withholding on such payments, just as we now withhold on ordinary wages. There is no reason why honest taxpayers should pay hundreds of millions of dollars in extra taxes every year to make up for taxes that dishonest individuals should have paid, but didn't. Banks and other payers of dividends and interest are now fully capable of withholding on such payments, and any problems for recipients in low tax brackets can be eliminated quite easily through use of the Form W-4E, Exemption from Withholding, or a claim for additional withholding

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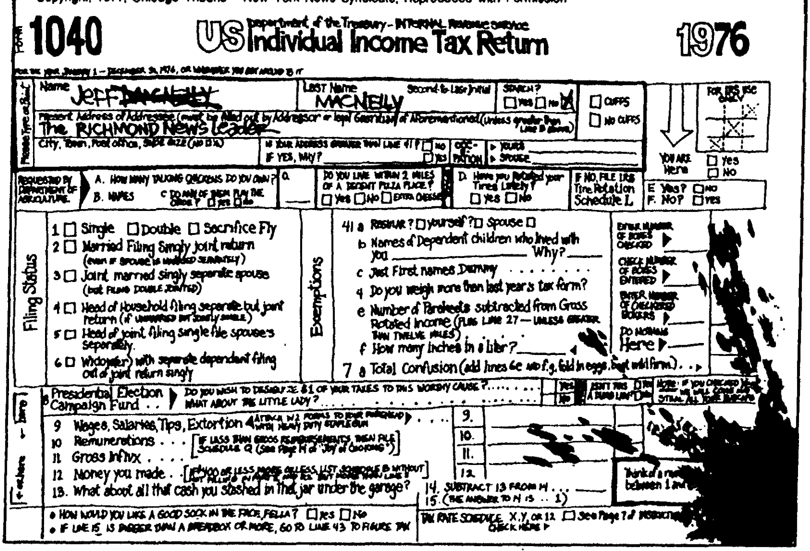

Revised Program (Continued from page 3)

allowances Failure to withhold on dividends and interest is an invitation to dishonesty that should be ended

5. *A means of reviewing erroneous of illegal IRS giveaway rulings.* During the past decade, the Internal Revenue Service, by erroneous or illegal administrative rulings, has excused wealthy individuals and firms from paying billions of dollars in taxes they would otherwise have owed. That, in itself, is bad enough. But, even worse, the IRS has been largely successful in exempting itself from court review of "giveaway rulings" for the benefit of special interest claimants. "Giveaway rulings" are those that *lose* revenue, as contrasted with rulings that raise revenue; revenue *raising* rulings are already subject to court review.

Bureaucrats make mistakes like everyone else, and that's why government agency decisions — including revenue raising rulings — are routinely reviewed in court. There is no justification for a different practice in the case of "giveaway rulings" that lose revenue.

One way to insure objective review of giveaway rulings is creation of a Taxpayer Protection Agency (see point 1, above). Another is to give ordinary taxpayers judicial "standing" to challenge giveaway rulings in court. In that way, erroneous rulings that lose money will be subjected to judicial review, just as revenue raising rulings now are. Alternatively, the staff of the Joint Committee on Taxation could be expanded to review revenue losing rulings, so that Congressional oversight of the rulings process would no longer be sporadic and haphazard. In one or another of these ways, the current practice — which permits the IRS to give away money with no review by anyone — must be ended.

6. *Improved federal-state tax cooperation.* The federal government has done nothing to implement the provisions of the Revenue Sharing Act of 1972 which were designed to provide federal assistance to state governments in collecting state income taxes. The federal collection program was intended to make state tax return filing easier for individual taxpayers and to save millions of dollars in state revenue that is now wasted on duplicative tax administration efforts. The Internal Revenue Service should take steps promptly to issue the regulations needed to get this program underway, and should actively cooperate with the states in their tax administration programs.

In addition, the federal government should help the states to establish a coherent national policy regarding the state taxation of interstate activities Among other things, action is needed to prevent double taxation of the same income in different states, due to differences in taxing formulae, residency rules, and the like Federal activity in this area should involve listening, negotiating and mediating. For the time being, the federal role should be to provide a forum in which conflicting state interests can resolve their differences. At present, the federal government is doing virtually nothing along these lines. At a minimum, clear responsibility for this work should be assigned within the Treasury Department

TAX CUT BILL BECOMES LAW

If you are married and use the standard deduction when you fill out your tax return, you will probably like the changes made by the Tax Reduction and Simplification Act of 1977, which recently became law. But if you are a single person earning more than $13,750, the new law will be hard on your pocketbook.

The tax cut bill increases the standard deduction to a flat $3,200 for married persons, in place of the old standard deduction which ranged from $2,100 to $2,800 Single taxpayers will now have a standard deduction of $2,200, rather than one that ranges from $1,700 to $2,400. Thus, 2 million single taxpayers earning more than $13,750 will find their taxes raised an average of $54 by the tax "cut" bill.

The flat standard deduction, plus other changes, will allow taxpayers who take the standard deduction to add up their income and then immediately turn to the tax tables to figure out their tax. Most of the addition, subtraction, and division required by this year's tax forms will therefore be unnecessary next year.

Bill Adds More Tax Gimmicks

The tax cut bill also contains a number of provisions opposed by Taxation with Representation, especially the so-called "jobs credit." The credit is so complicated that it is impossible to describe it adequately here. In general, it is a prime example of trying to do good things through the tax code, and ending up with a subsidy that merely pays people to do what they were going to do anyway.

Thanks in good part to our efforts, Congress finally eliminated the tax shelter aspects of the jobs credit to which we had objected earlier (see the TWR Newsletter for May 1, 1977). But the credit remains a wasteful tax gimmick, which is not likely to create many new jobs — except for tax lawyers and accountants.

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Senator BYRD. The next witness is Dr. Pierre Rinfret, a noted economist and we are very pleased to have you, Doctor. You were here several years ago and you testified before another subcommittee that I was chairman of. I am very pleased to see you today.

I have read your testimony and a good deal of hard work has gone into its preparation. We are very grateful to you.

STATEMENT OF PIERRE A. RINFRET, PRESIDENT, RINFRET ASSOCIATES, NEW YORK, N.Y.

Mr. RINFRET. Thank you, Senator, for inviting me to testify and for the privilege and honor of being here with you. I would like to say good morning to you, sir, and good morning to Senator Packwood.

I have submitted to you, in response to the request of the subcommittee under the Legislative Act of 1946, a written statement of the work that we have done in regard to your question on incentives to economic growth.

What I would like to do is briefly summarize some points that I have not put in the statement because a brief statement cannot include everything that we have done or our findings.

Senator BYRD. Your complete statement will be published, and you may summarize as you wish.

Mr. RINFRET. Thank you, Senator.

First of all, what I have attempted to do is concentrate, as per your request, on several factors which I think are the most important factors for incentives for economic growth. I have concentrated on, No. 1. The uncertain principle that applies today in the development and utilization of capital.

No. 2. What inflation is doing to capital recapture in the United States.

No. 3. The attitude of large business regarding the small businessman or the small entrepreneur in the United States.

I might point out, and I say this intentionally, that the subject of capital and capital formation is an area in which I probably concentrated my professional life for approximately 26 years. The organization that I was with in 1951 produced the first comprehensive survey of capital investment plans of American industry that was ever produced.

Five years after that, we innovated the first survey of foreign capital expenditure plans by private industry and, simultaneously with that, we developed the first 5-year spending and expansion programs of the electric and gas utilities of the United States.

These were, I might point out, a first.

Eight years ago, we instituted the first financing survey of private capital expenditures in the United States and we innovated the first pollution control survey of private industry in the United States.

In 1974, in what I think of as a major breakthrough in technical information, we innovated the first quarterly survey of capacity utilization in the United States.

The reason I am reciting that is that I think I have a very different view of businessmen than most people do. I have long said to my professional colleagues that the finest economists in the United States are not economists, but business leaders, and over the 26 years that I have worked with American industry and, I might point out, American labor, the American business leaders are, in fact, superb analysts of the business economy. They have an uncanny perception of what lies ahead, not only for their industry, but for the economy. They tend to be very objective in their evaluations. Some are cold blooded.

Finally, and most discouraging, generally their capabilities and their knowledge of the American business economy are largely ignored and, if not ignored, are denigrated. I have always believed, if you want to know something about industry, we ought to stop doing academic, intellectual, computerized, mathematical type research and just go out and talk to the people who are making the decisions.

If you would put me in a school of economics, sir, I would say you would put me with the institutionalist school that says, why do we not ask the decisionmakers why and how they make the decisions that they do. That is what I have done in order to respond to the questions that this committee has posed.

We have asked industry what they think their problems are, what they think the solutions might be, and I would like to make a few points to you which I did not include in my written statement but which I must admit, also, I am very pleasantly surprised about.

We went out and surveyed approximately 90 major organizations covering diverse segments of the American economy, covering almost every major industry in the United States.

We met with the chief executive officer of each organization and members of his staff. We did this from approximately May 10 to June 10, 1977, and it was done either by my senior staff or myself. One of the things I heard most frequently was this: Be reasonable in your testimony, do not ask for special favors, do not ask for special treatment. We are targeted enough as it is. Do not ask for anything special for private industry.

Industry's second point was this: We do not make decisions on the basis of an investment tax credit or a DISC credit. We make our investment decisions on the basis of the economic factors, not the tax treatment. Of course, we take advantage of the tax laws. We would be foolish not to, but we do not make our decisions on the basis of the tax laws of the United States.

I must say when I heard this from company after company and argued it and debated about it, I must admit I was surprised.

I would like to pose you a paradox. We could argue that there is a capital shortage in the United States. We could argue that there is not a capital shortage. The answer is that there is, and that there is not.

If we look at the net cash flow of American industry, that is, retained earnings plus depreciation going back to 1947, we see that from 1947 to approximately 1970 or 1971 American industry spent all of its cash flow, that is, retained earnings plus depreciation for new plant and equipment. No question that the two lines over the 22-year period would go hand in glove, line for line.

Beginning in 1971, cash flow has grown more rapidly than capital expenditures. Given the results of our own survey of capital spending plans in 1977, which are very similar to those of the Department of Commerce, we came to the conclusion that American industry in 1977 would spend approximately $139 billion for new plant and equipment, a 15 percent increase over 1976; inflation accounts for approximately 7 percent of that and approximately 8 percent is a gain in what you might call the real volume.

The most fascinating thing about that figure is that it is $40 billion too low. American industry, we estimate, in 1977, will have approximately $180 billion of cash flow and will spend $139 billion on new plant and equipment. In every year since 1971, cash flow has exceeded capital expenditures, and yet we sit here and discuss what we need to do to get American industry to spend more money for plant and equipment and why we need to produce more capital formation in the United States. I suggest to you it is a paradox, but there is a very simple resolution of the paradox. The most interesting part of the paradox is what I consider some devastating information.

We produce, each quarter, a survey of capacity utilization in this country. We have just finished our survey for the month of April on utilization of capacity in American industry. The shocking thing is that in the month of April 1977, we estimate that manufacturing industry in the aggregate was operating within 3 percentage points of its all-time high in 1974, in terms of operations relative to capacity. We are going to run into shortages very soon in this business cycle. There are some critical industries already operating above 90 percent of capacity. In the aggregate, we have problems in manufacturing.

So we have this paradox. Point No. 1, corporations have more cash flow than capital investment; this year they are accumulating $40 billion more in cash than they are spending for capital investment.

Point No. 2, they are running out of capacity and they know they are running out of capacity.

What is holding back investment in American industry?

I might say, Senator, that due to you and your committee I have gained new insight into American business behavior. The response to the question of what is holding back investment came as a surprise to us. I think it is a new piece of information and I would suggest to you that the key element in American industry's reluctance to invest in the United States despite available cash flow and shortage of capacity is something that is in the hands of the Congress of the United States.

We have, in the United States, what I call the normal run-of-the-mill business risk. Every businessman is willing to deal with that. He will take his business risks day to day. Those uncertainties to him are a certainty. Now he has a new kind of risk, and this new kind of risk he cannot handle. He does not know what to do about it.

The new kind of risk is what I have labeled the legislative uncertainly. The legislative uncertainty, in fact, deals with what Congress is doing to American industry. I would like to read you—I will not read all of them—several quotes from what chief executive officers told us. I might mention that these corporations are giants in American industry. Some of these corporations are so big that they could be separate countries outside the major economic powers in the world.

The first quote:

> The most important deterrent to investment in our industry is the absence of stable, realistic regulations. From one year to the next, we do not know what type of product we will be allowed to build—because of the changing safety, emissions and fuel economy regulations, many of them conflicting, and many imposed so late that waste in investment is the inevitable result. The combina-

tion of regulatory uncertainty and normal market uncertainty has led us to defer all but the most urgent investments.

Senator, I might point out that that is one of the largest corporations in the world.

The second quote:

The problem today is one of uncertainty, particularly over energy. If a company wants to build a plant today, it does not know how it will be heated. The company cannot get long-term commitments for electricity.

Third quote:

In 1976, the company was interested in a vital nonferrous mineral which is used in nuclear powerplants This would have been a multimillion-dollar project. The company was very interested in this project and a great deal of management time was spent on it. The project was dropped principally because of uncertainties over the outlook for nuclear energy.

Fourth quote:

The environment for investment is becoming increasingly uncertain. The future looks scary. Contributing to this uncertainty are Government regulations. The *Tris* case is a good example of this. First the Government required that Tris be used in children's sleepwear; then it ruled that Tris was unsafe.

Senator, I would suggest to you that the legislative uncertainties may be one of the dominant reasons why American industry is not investing its cash flow in the American economy today and I further suggest to you that this contains three elements. First, there is the energy uncertainty.

It is forgotten that energy is a major cost of production. There is no energy policy in the United States. I have not been able to speak to any so-called authority who knows what is going to happen to petroleum prices, natural gas prices, nuclear energy, to pollution laws governing the mining of coal, to regulations concerning the interstate and intrastate flow of natural gas, to the electric power available in the Northwest and the Southeast.

Business cannot plan with any degree of certainty about the future of the energy industry.

I might parenthetically point out that power authorities in the State of Washington have indicated to industrial users that within 3 years they might not be able to supply them with power for such things as aluminum production and other large scale uses of power.

Second, there is pollution uncertainty. Pollution controls are an absolute nightmare to American industry. The regulations change from one month to the next. The requirements change from one month to the next. If you put in a series of pollution controls, you do not know whether they will be adequate for new pollution laws that come along.

Finally, there is the tax uncertainty. I was privileged to be here when Senator Long discussed the investment tax credit. I think that that is the absolute classic case of tax uncertainty, but he did not cite enough cases.

The investment tax credit was implemented in 1962. It was suspended by President Johnson in the fall of 1966. It was reinstated by President Johnson in 1967.

It was repealed by President Nixon in 1969 and it was reinstated at the request of President Nixon in 1971, but they reinstated it retroactively.

Its suspension was called for on more than one occasion by the Chairman of the Federal Reserve Board in 1972 and 1973, just prior to the capacity shortage of the United States, and, of course, it has been debated endlessly ever since 1975.

Whether or not the investment tax credit is permanent or temporary or an aberration from the tax code is a question which I think nobody can answer.

Why is capital formation inadequate? I would suggest to you that if there is one certainty about the tax laws of the United States it is that the tax laws will be changed at the next session of Congress. As long as those tax laws are in the national domain, the only certainty about tax laws is that they are absolutely, totally uncertain. The only certainty about energy is the uncertainty about policy and laws; and the only certainty about pollution control is that the laws are uncertain.

Another consideration in capital formation is inflation. I would like to make a very simple point.

The tax laws of the United States assume price stability. It is that simple. They assume price stability in the American economy. They are designed under the concept of price stability and they are totally inadequate for dealing with an economy in which prices are changing rapidly and changing at differential rates in every sector of the society.

The Consumer Price Index is frequently used as a measure of inflation in the United States. It is totally inadequate.

Corporations, at one stage, were paying twice as much for capital goods in terms of inflation rates as we were paying at the consumer level.

We have differential changes in the price rates of the different sectors of the economy. But inflation has a particularly damaging impact on capital formation—again, a very simple point.

Our tax laws are designed to tax revenue, taking advantage of inflation. A worker who receives an 8 percent increase in his wages as a result of 8 percent inflation may be kicked into a higher tax bracket and he pays a higher income tax. The tax laws, in fact, require that a corporation or an individual depreciate his assets not on the basis of increases in prices, but on the basis of historical costs. We have this dichotomy: Revenues increase because of inflation but the price of the asset becomes relatively less and less relevant to the cost of replacement.

I will not quote to you what our respondents said about the depreciation laws or the depletion laws. I will merely say that anyone in business knows that in fact these regulations are totally inadequate for dealing with conditions in modern society. The most difficult thing of all—and Congress should pay attention to that—is that the IRS interprets most depreciation laws and most depletion laws in the toughest manner possible. There are times when we wonder whether the IRS is not pursuing the intent of Congress. I would say to you very simply, Senator, that the tax laws favor the destruction of capital in an inflationary environment.

Finally, there is the question of capital formation by small business. I think this is one of the most fascinating findings in our study of American industry. I would like to read a few quotes. These are from major corporations, giants.

> We need to encourage the young fellows who are the entrepreneurs, starting businesses as we did in 1939, so they will take risks, borrow money, innovate and start new ventures.
>
> The young scientists and entrepreneurs who would have started small innovative companies now find it more attractive and secure to seek affiliation with big, mature companies.
>
> It is important to revert to the earlier tradition—and tax code—that permits entrepreneurs to make money and keep it. Otherwise we will inhibit the growth of small business, of innovative business and curb the vitality of the free enterprise system.

Large business believes that the tax laws should, in fact, be liberalized to help small business. I might say that that is rather a striking recommendation, at least to me, from large business, and I would conclude with one point.

I think the time has come to look at our tax laws in a different way, in fact, our laws in general. I would suggest to you that we should institute the concept of what I call the grandfather clause. I do not see how any American businessman, or anybody else in this country, can foretell what the tax laws or the pollution laws, or energy laws are going to be.

I think if we want to stimulate capital investment in the United States, we ought to institute a grandfather clause that would say that the tax laws, the pollution laws and the energy laws prevailing at the time when the investment was made are the laws that would apply to that investment. That would replace uncertainty with certainty. I think the concept of constantly changing the law is, in fact, what is holding back capital investment in the United States.

So I would conclude with one simple thing. The U.S. Government, Congress, and the President of the United States, needs to replace uncertainty with certainty and create incentives to growth by restoring the capital investment incentives to taxpayers who now have virtually none. I listened to the questions, Senator Packwood, if I may say so, about people who do not pay a 70 percent tax rate. You know the wrong people.

I know thousands and thousands and thousands of people who are paying maximum tax rates with no so-called loopholes, whose taxes are limited only by the 50 percent Federal statutory limitation.

Mr. Byrd, I thank you for inviting me and suggest simply that American industry has the money but they are not going to invest it as long as legislative uncertainty remains as dominant as it is in the United States today.

Senator BYRD. Thank you very much. That was an excellent presentation.

I think that it is all the more significant because you went out among the business community and personally, you and your senior assistants, got from the business community their own views.

As I understand it, you did not take what their views might be, but you went into the business community and sought their own views as to the basic problem facing industry today. And I certainly concur with the assertion that legislative uncertainty is a dominant factor.

It is easier to change some of the tax laws and change that legislative uncertainty—as a legislator, I am greatly concerned about how much antibusiness feeling there is on the part of so many Members of the Congress and I guess that has been reflected in many of the legislative acts that the Congress has taken.

Let me ask you this, to get to a few specifics. If the Congress were to choose between reducing the corporate income tax rates or to begin to phase out the double taxation of dividends, which would be the more important approach?

Mr. RINFRET. We asked these 90-some representatives what they thought about the elimination of the double taxation on dividends. Of course, obviously, Senator you know better than I do that there are many ways that one can do this: The tax credit system, the deduction of the dividend, et cetera, et cetera. I can only speak for he people that we have spoken to. I can only give you the predominant view.

The predominant view was rather amazing. Executives told us this: We are not particularly interested in having dividends deducted in any size, shape or form. We do not want the stimulation of dividend payments. We do not want to be forced to pay dividends. We need the capital. You are not doing us any favors at all by making dividends deductible. You will force corporations that need the cash flow into paying higher dividends. Our survey found a negative reaction in general to that concept in American industry. Industry said: We need the capital. The corporations that are growth companies are paying out very little in dividends; they would be forced to increase their dividend payouts and use up the capital of the corporation in a competitive race with other corporations. The small, dynamically growing, unseasoned company which reinvests capital to attract capital would have to compete on dividend payments with, say, General Motors, which is fundamentally a bank. The investor looks at GM as a dividend-paying company. You do not buy it on the growth of the industry, you buy it on what the company is going to pay out in return for its stock and the percentage of its dividend relative to its earnings. The small company will be forced to compete with the large, more mature or less dynamic companies.

I must say again, I was surprised. I thought that most of the people that I talked to would embrace with vigor and dynamism this concept of eliminating dividends from double taxation. The predominant view was, do not do it; that is not the way to help us. What we need is some form of tax relief applicable to the entire economy. We do not want preferential tax treatment. Do not single us out. We get enough heat as it is.

I would have to answer you, Senator Byrd, it would seem to me—this is, again, reflecting not what I think and not what I thought before I went to these interviews—that the answer to that would be that the dividend exclusion is not preferred. If you use the choice that you offered me, the lowering of the flat rate is preferable. I do not agree with the comment made on the investment tax credit.

Everyone we spoke to said the investment tax credit is not a determining factor in the decision to make an investment. It is a fringe benefit. If the investment is any good, they told us, we are going to make it. If it is no good, we are not going to make it. We are not going to make a decision on the basis of the investment tax credit. We will take it, we will use it. What counts to us is how fast we recapture our capital.

In the mining industry, the recurring comment was that depletion needs to be realistic. Depletion is not realistic. Depreciation is not realistic. That is where industry does not seek special treatment, but just the ability to catch up with the times.

So I would answer you, Senator Byrd, that I think that the dominant view that I ran across is this: if you had only one option, the answer would be that industry does not want the preferential dividend tax treatment, but rather, prefers realistic treatment of costs in the form of increases in depreciation and depletion allowances.

Senator BYRD. Would that apply also, if a credit were given to the stockholder for the dividends?

Mr. RINFRET. We asked about it in various forms and the answer was pretty much always the same: we do not want to get involved in a dividend payment race.

Senator BYRD. I gather, then, that many businesses would regard that as, I take it from what you say, possibly an undesirable change?

Mr. RINFRET. It is fair to say that a surprising number were concerned that the pressure on the financial resources of a company would increase, that the stockholders would demand larger and larger dividends, and their rationale would be that the dividend is tax free, it does not cost you anything, pay it to us. And so the pressure on the corporation to pay out dividends would be adverse to what you, sir, are speaking or what I think you are talking about the form of incentives to capital accumulation and capital growth.

If I may, Senator, there is a quote in the text which I gave you which pertains directly to what you said and which came voluntarily from one of the leaders of American industry, making huge investments in one of the most capacity-short industries in the United States, the nonferrous metals industry where we have producion problems in this country, where we are being forced to become larger and larger importers of particular minerals. Let me merely read you the first sentence.

> It would seem that corporate tax relief should not focus on making it more desirable to pay dividends. For example, a tax deduction for dividends paid should rather stress encouragement for companies to improve their capital base.
> For example, we believe that it is imperative that percentage depletion for hard metals be retained and that present depreciation be replaced by a more realistic, flexible capital recovery allowance for plant and equipment against what is presently followed. . .

This was voiced directly by one major organization after another.

Senator BYRD. A more liberalized depreciation schedule is one of the preferred factors, I would suppose?

Mr. RINFRET. I would say depreciation and depletion.

Senator BYRD. I have other questions but at this time, I yield to Senator Packwood.

Senator PACKWOOD. Doctor, I may have misspoken myself. You know thousands of people at the 70-percent tax bracket, that is why you are in the business that you are in. I know thousands at the 25-percent level, that is why I am in the business that I am in.

Mr. RINFRET. Yes, sir, and I respect the power of the differences of opinion. There are more on your side.

Senator PACKWOOD. Your answers on the first two do not surprise me at all. Anyone in politics who has gone along has found the same thing talking to people in business that you have found, small business, too. They are just as harassed by OSHA as by anybody else, what they are going to have to do, when they are going to have to do it, can they get any help to get them to do it. They do not know.

Mr. RINFRET. May I give you an illustration. I used to manage a mutual fund and it had about $8 million at its peak. I just wanted a showcase fund. I did not want it to get any bigger. That is not my main business.

But for a small fund, regulatory requirements posed so many costly burdens that we eventually left this field.

Senator PACKWOOD. Let me ask you about the big business attitude to small business. That does intrigue me. Let me give you an example.

We are having this continuing debate on health insurance, national health insurance. On the one hand you have the Kennedy-Corman bill, genuine national health insurance, wipe out private insurance, we will pay all the bills. The alternative, almost all the plans introduced which usually mandate a certain level of medical service to be provided by employers, in some cases, paid for totally by employers, and deliver at the present system of health delivery, pretty much private.

Most of the small businesses say, they cannot afford it. You are going to mandate this system? Ford Motor Co. can afford $3,000 per employee for health, I cannot. You say Ford Motor Co., big business, will say, yes, the small company cannot, he should get a tax break, should get a tax credit for the cost. He cannot afford it.

Mr. RINFRET. That is right. We have to remember something that we conveniently forget. The reason that big business favors small business is that they look to small business for the innovations. It is there that they find the risk takers.

The large businessman knows, the President of—let's pick a name. I can pick one that is not a client of mine. That is a fair way—Xerox. The President of Xerox knows that his is a massive business. He also knows that Xerox came from almost a $1 million business about 25 years ago and it came because people were willing to risk their livelihood for what might be enormous capital gains.

Large business knows, when it gets large, that it loses that innovative drive that is in existence with the small businessman. That is why they buy small businesses all the time.

Senator PACKWOOD. As an aside—you have not touched on this in your statement—we were talking about capital formation. It bothers me, as I watch these tax reform bills over the years, we squeeze out the people that put money in Xerox, the individuals. I am not talking about corporate investment. The nut who has $50,000 to waste, to throw away, he will throw it away on what would seem to be a foolish investment and gradually we make it so unprofitable and so unattractive, he says, what the heck, I will put it in the savings and loan.

Mr. RINFRET. It may sound very strange, but I am sure you are familiar with route 128 around Boston. Route 128 around Boston, which circles Boston, is a complex of esoteric, technological companies. If you look at that highway you will find that fundamentally the whole area was developed by small, technological entrepreneurs. They were not the big ones, they were the little guys, the little guys who went in immediately, piggybacking on the big guys.

Now there is no comparable development on route 128. Now it is not worth taking those kinds of risks anymore.

Senator PACKWOOD. What you are saying, what big business is saying, basically we need innovation and creativity comes from smaller business?

Mr. RINFRET. If they came before you, I do not think they would admit it. They respect and admire what small business has contributed to this society, what it will contribute to the society, and I think there is another element. They do not want small business punished. If they do—I will quote you what John Kenneth Galbraith said many years ago:

> If we can get rid of small business, that will leave us with 100 organizations in the United States. Then we can control those 100 organizations.

I think American business realizes the importance of small business. Let me cite one statistic: A small business as defined by the Department of Commerce has 250 or less employees. Small businesses employ more people in this country than do large businesses.

I do not know why we do not pay any attention to that critical fact. We deal with the small businessman exactly as we deal with IBM and General Motors.

Senator PACKWOOD. The breaking point is 100 employees. You have 50–50.

The last philosophical question, how do you think your large business clients would answer, and how you would personally answer it, would large business have such a solicitous view about small business to go so far as to say, at some stage on quantity or size or volume, the antitrust laws ought to be changed to prohibit a company to go in beyond a certain law, forgetting conspiracy and monopoly, just big—cannot go beyond that size?

Mr. RINFRET. I have not asked that question. My inclination is yes, they would. My inclination is yes, they would.

Everybody I know of in industry wants to be a billion dollar company. The moment he reaches a billion, he wants to reach two. He gets to two, and he shoots for four billion. When he gets up to four, he starts worrying. Is the company going to be attacked? Who is going to take it over?

I have sat on the boards of enough companies to know that one of the constant worries is who is going to break down the company, who is going to take it over. Big companies are worried by the same problem of size, in many ways, as anybody else in the United States.

So, philosophically, I would answer you—this gets back to the concept that large business necessarily believes in getting bigger and bigger until there is only one company in the United States. I do not find that true at all.

The constant concern is, if you get big enough, you are going to be taken over.

I might mention one thing, if I may quote one Senator to another, I understand, for example, that Senator Hatch of Utah is going to come up with a small business bill in which he is going to attempt to increase the ability of small business to raise capital in the market.

One of the things that it is extremely difficult to get across to Congressmen and Senators is the simple fact that the laws are so punitive on the capital market ratings of small business that after awhile you give up because you cannot raise capital.

I went out of the mutual fund business. I am not the only one. I can quote you thousands like me. I went out for two reasons: I could not afford the accounting bills and the legal bills required to conform to the laws of the United States in managing a fund of $8 million. I had a net cash deficit for 4 years. The operation cost us more than $400,000.

What we do not realize is that we are imposing costs on small business, on all sizes, shapes, and forms. The large corporation is very frank. They have a galaxy of lawyers, a galaxy of accountants. They do not like the forms any more than anybody else does but they can manage.

But for the small businessman the costs of compliance are critical in his decision to move or not. That is the difference. With large business, cost of compliance is important, but not critical; with small business, it is critical.

I would say to you, if I may make this point, I found in our survey no inclination of large business wanting to give anything but help to the small business sector of the society. If you are going to give anybody tax breaks, any incentives for formation of capital, give it to the small businessman. Better to them than to the big companies, who can get the capital, who can go to the capital market, who can get the investment bankers to underwrite them. Sure, big companies have problems, but they can get money. The small guy cannot get it.

Senator PACKWOOD. I agree.

Mr. RINFRET. Does that answer you, Senator Packwood?

Senator PACKWOOD. Yes, very well. It was good testimony, and good answers.

Thank you, Mr. Chairman.

Senator BYRD. With regard to small businesses, what one or two measures would you advocate?

Mr. RINFRET. First, I suggest that the surtax exemption on small corporation income is too low. The 48 percent tax rate is applicable on income of $50,000 or more, the exemption should be raised to $200,000.

Second: The problem for small business—and let us use Senator Packwood's definition of 100 employees or less—is the formation of capital. I would suggest to you, Senator, an investment tax credit—and I have advocated this, and advocated it before you once before—of 25 percent for small business. Incidentally, I would be very careful about what I mean by small business. I would define a small business as a nonaffiliated, nonsubsidiary company. That is, an independent entity having no financial or common stock relation to any other organization.

I do not want to see General Motors spin off 2,000 small businesses. I suggest that for the genuine small business you raise the investment tax credit to 25 percent.

Third: Something you may never think of: Small businesses are constantly attacked on the accumulation of capital. The IRS on several occasions has come in to see our company, they say we are accumulating too much capital. When we accumulate capital, the IRS says we have to spend that capital. Very frankly, that capital is being accumulated for utilization in the business. It is the only way I can accumulate it. But the IRS knocks you off on that.

As that applies to small business, it is a detriment to the formation of capital in small business.

Senator BYRD. What do you think of the idea of tax-free rollover of one capital investment to another?

Mr. RINFRET. I have problems with that very honestly, Senator. It depends on how you define it. I heard one witness say that a house is not an investment. If a house is not an investment, I do not know what it is. It is a 25-year amortized investment. It is probably the biggest single purchase that any individual will make in his entire lifetime, generally made with borrowed money.

You run into incredible definitional problems. You did, in housing. I could argue, for example, and very seriously, that I buy antique furniture, not because it is for consumption, but because it is an honest investment. I am going to be entitled to a preferential tax treatment because I bought antique furniture or bought a masterpiece of painting or sculpture. These are investments—at least, I tell my wife that everytime I buy something.

My wife considers it consumption. I know it is not consumption because I can go out on the market and sell it.

American industry is increasingly distressed by the concept of preference tax treatment for what you might call capital accumulation. If anything, they look for the simplification of the laws. Business would rather take into account some basic facts, and the basic fact is that you cannot live with uncertainty, so you do not invest.

The recapture of capital is inadequate under the tax law. That needs to be changed.

Fourth, restore to the entrepreneur the incentives to growth which we have taken away from him. The problem I have with the investment tax credit is that I believe in it strongly. I testify in favor of it. Nevertheless, I also realize that American industry says more and more of these things make us targets and we do not like being targets.

Senator BYRD. You recommend grandfather clause that would permit a company to invest or accumulate capital and have the laws stay in effect at the time of investment continue to apply? Can that be done?

As a practical matter, can that be worked out?

Mr. RINFRET. I will answer you in two ways. I think that the time has come for this Congress to require, with each law proposed for the Congress, an economic impact statement. As you know, I testified before a Senate committee on common situs. The common situs bill had major impact on inflation, on employment, and minority groups. But nowhere was there available an economic impact statement.

We pass laws without understanding all the economic ramifications of what we are doing. No debate, no discussion. Point No. 1.

I think what this Congress should do is require that every proposed law have an economic impact statement attached to it and I would say not only one economic impact statement, but maybe four, from diverse sources: One from the administration, one from the Congress itself, one from each of the two major sectors of the private economy—one from the business sector and one from the labor sector.

Is the grandfather clause practical? Obviously it is a new concept. Obviously it only came up in the discussions that I have had recently. I could not give you a comprehensive answer at this point, but I would say this concept came up very soon when we began talking to industrialists about what they thought would help capital formation. They said: If we could be sure which rules would be applicable in the future, we would probably step up our investment today.

Is it practicable? I say that it is enough of a concept to start with. We should study it further, but I could not honestly say to you that I know that it is practicable. I do say this: It is something that we should consider and do something about.

Senator BRYD. I agree with you, and with regard to requiring an economic impact statement, I think that would be very desirable. I I understand that you have recently turned bullish on the administration?

Mr. RINFRET. Yes, sir.

Senator BYRD. What kind of tax package would keep you bullish?

Mr. RINFRET. I think Secretary of the Treasury Blumenthal and Mr. Lance—I am talking philosophically now—are heading in the right direction. When Secretary Blumenthal spoke at the Waldorf-Astoria in the month of March his comments were rather intriguing to me. During the campaign Mr. Carter said this country was operating at 70 percent of its manufacturing capacity, which was incorrect. In March Secretary Blumenthal pointed out that we were operating at 80 percent, which was still a bit low, but a far more acceptable figure. He recognized that there were shortages in six major industries in the United States. This was the first time that a Democratic administration admitted to capacity shortages in this country. He said they intended to bring in a series of recommendations attacking the capacity shortage problems of the United States.

May I point out that in 1973, when Wilbur Mills was Chairman of the House Ways and Means Committee, he held hearings on the very same subject, the capacity shortages in the United States. I had the privilege of testifying at that time. It is rather intriguing to find out that those industries which were short of capacity in 1973 are the exact same industries that are short of capacity in 1977—paper, petroleum, coal, certain chemicals, certain nonferrous metals. The same industries; they have not changed.

Why? Because these industries cannot form capital rapidly enough. In the paper industry, it is 5 years since we have had a fully integrated papermill put in in the United States.

In the petroleum industry, there has been one small refinery put in place, one major modification of a refinery put in place in 10 years. We are not putting in place the capacity that this economy requires.

Some may remember what President Harry Truman did in 1950 when this country went to war in Korea. I think it was the most brilliant program ever enacted in this country to stimulate the formation of capital and productive capacity. In 1950, when the United States went to war in Korea, President Truman instituted the innovative concept of certificates of necessity. He delineated those industries necessary for the economic expansion and defense capabilities of the United States.

At that time, we were capable of producing 90 million tons of steel. The counter part of the War Production Board said we should have 125 million tons by 1955. I might say that everybody laughed. There was supposedly no way that the United States could increase its steel production capabilities by one-third.

The administration invented the concept of the certificate of necessity in which it permitted the writeoff, in 5 years, of all defense-related production facilities. Industry by industry, it singled out the targets, and in 1955, our steel capability was 125 million tons.

From 1952 to 1962, the Wholesale Price Index rose by 0.2 percent a year. The industrial commodities segment didn't rise at all. For years we had built U.S. capacity by means of accelerated depreciation which we granted with certificates of necessity. Secretary Blumenthal, I think, is going to come in with something similar to that concept; they are going to target the critically capacity-short industries of the United States and move to help the capital formation side.

I think we are turning a corner in this country when the administration realizes that we are a capacity-short economy, that this is critical, and we must fact up to the problem.

Senator BYRD. One final question.

Looking at 18 months, will we have more inflation or less inflation?

Mr. RINFRET. On the question of inflation, I must say I suffered a miserable year, Senator. In March 1976 I said there would be double-digit inflation by the first quarter of 1977, and I must say that people rolled in the aisles at that ridiculous statement because everybody thought inflation had been defeated.

We have a basic underlying inflation problem in this country. There are three contributing factors: (1) a Government deficit which grows and grows—more under Republicans, I might add, than under Democrats, which is an intriguing comment on philosophy; (2) shortages in capacity; and (3) in the area of farm and food products, we are constantly on the edge of problems.

We have plenty of wheat and corn this year but lack certain other kinds of food that the American people insist on eating.

In our company we estimate that the Consumer Price Index will increase at an annual rate of 10 percent in the first quarter. We estimate the second-quarter rate of increase at 8 percent, the third quarter up at 7 percent and the fourth quarter up at 8 percent.

In the first two quarters of 1978 we think consumer price inflation will run somewhere between 8 and 9 percent, annually rated.

So to look out through the first half of 1978, we will run into production problem, we will run into capacity shortages in certain critical areas of the United States economy, and we will run, therefore, into price escalation and price inflation.

You cannot beat inflation in the short run. You can only beat it in the long run and you are going to beat inflation in the long run only when we dedeicate ourselves to the very simple fact that we are short of manufacturing capacity. We are short of manufacturing capacity because American industry does not know what the rules of the game are. Industry is therefore staying liquid and is going to maintain its liquidity.

Those who are not liquid cannot find the money quickly enough. As one of my clients said, he spent $1.2 billion on a mine originally estimated to cost $500 million and he had to raise $700 million more than his original cost over 5 years. He said his company now has a balance sheet with every form of security in it, and the problem is what to do next.

Senator BYRD. Thank you very much. That was very interesting and informative.

[The prepared statement of Mr. Rinfret follows. Oral testimony continues on p. 299.]

STATEMENT OF DR. PIERRE A. RINFRET, PRESIDENT, RINFRET ASSOCIATES, INC., NEW YORK, N.Y.

1. INTRODUCTION

The Subcommittee on Taxation and Debt Management of the United States Senate Committee on Finance has asked me to testify on the topic of Incentives for Economic Growth.

In the Subcommittee's press release of May 6, 1977, it was stated that "Witnesses before the Subcommittee are to focus upon those proposals which they consider as the key to providing for greater business growth and higher employment."

Further, it was stated that in announcing the hearings, Subcommittee Chairman Harry F. Byrd, Jr. "expressed a desire that witnesses concentrate on what they consider to be the two or three most important proposals to encourage economic growth and employment."

And, "Senator Byrd said that he wants to give special attention to the views of the small business community. 'The impact of the current proposals on small businesses, incorporated and unincorporated, should be carefully considered.' "

2. SCOPE

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

This written statement is designed to comply with the Legislative Reorganization Act of 1946. This statement, in accord with the wishes of Senator Byrd confines itself to three topics, in order of their importance:

1. The importance of uncertainty in the development and utilization of capital.
2. The impact of inflation on capital recapture.
3. The attitude of large business regarding small business.

This written statement is designed to highlight the results and conclusion of some original research which has been conducted by my organization for this testimony.

3. RESEARCH

I have been a practicing economist for 26 years. In those 26 years I have learned many things about economics, and perhaps the most important thing I've learned is that business leaders in general, understand the workings and behavior of the American economy better than economists, econometricians, statisticians, academicians and others do.

Twenty-five years ago the origanization I was with instituted the first comprehensive survey of private capital expenditure plans. Five years after that we innovated the first survey of U.S. industry's foreign capital expenditure plans and, simultaneously, the first survey of five-year spending intentions of electric and utility companies in the United States.

About eight years ago we instituted the first survey of financing plans for private capital expenditures in the United States and the first pollution control capital expenditure survey. In 1974 we instituted the first survey, on a quarterly basis, of capacity utilization in the private sector in the United States.

The point of all this is that over the years I have been impressed by the facts that (1) American business leaders are superb analysts of the business economy,

(2) they are able to perceive accurately what lies ahead for their industry nd the economy, (3) they are objective in their evaluations and (4) their capabilities and knowledge of the workings of the American business economy are largely ignored and denigrated.

In 26 years of practicing economics, if I have learned anything about broadening understanding of economic problems it is this: "go ask industry".

In order to answer the questions posed by this Subcommittee and by its Chairman, I have done just that: I have asked industry.

Rinfret Associates, Inc. has a client or clients in almost every major industry in the United States. These clients operate both domestically and abroad. They range from the multibillion-dollar corporation to the small entrepreneur grossing a few million dollars. Our clients cover the waterfront not only in sales volume but in profits as well.

When we received the Subcommittee's invitation to testify on Incentives for Economic Growth, we realized that this Subcommittee has available to it the most superb economic analysts in the United States, the almost unbelievable wealth of information generated on the subject by the Congress itself, as well as the ability to call on the innumerable statistical analyses of the subject by the private sector.

We ourselves have pursued the subject for over a decade. Our question on this occasion was: how could we add to the knowledge and information of this Subcommittee?

We decided to go to the source. We decided that we would interview our own clients on the subject. In appendix A to this report you will note a chart which indicates the industry operations of the people we queried. You will note that virtually every major industry is covered. I might point out that these respondents represent more than $50 billion in sales in the year 1976.

We interviewed our respondents in person or by telephone between May 10 and June 10, 1977. The basic questions we posed to them were these: "What incentives are needed for greater capital formation, and what incentives would lead you to increase your capital investment in the American economy?" I believe these two questions are basic to the interests of this Subcommittee.

The interviews were conducted in part by my senior staff and in part by myself. The greatest number of interviews took place with the chief executive officers and their financial vice presidents, but frequently the interview would include the director of planning, director of research, tax specialist and corporate development officer. Everyone gave freely of his time and effort. We were overwhelmed by the reception we were given and by the effort that private industry put into answering the questions we posed.

It is obviously not within the framework of this testimony to enter into the record each and every thing that was said and advocated by those we interviewed. In the analysis which follows, I believe that I have summarized fairly the predominant views of the broad range of industrial leaders regarding incentives to capital formation. In that regard I would like to thank the Subcommittee because, as a result of their inquiry, our investigation has led us to identify a particularly significant aspect of the problem of capital formation and capital investment that might not have received the emphasis it deserves.

4. THE PARADOX

Private capital expenditures, that is, corporate plant and equipment expenditures, have been declining in real terms (nominal dollars corrected for inflation) since 1969. Plant and equipment expenditures by private industry have lagged the economy since 1969 and have been a puzzling feature of the economy for at least five years.

On the basis of economic and financial history, it is fair to say that in 1977 corporate expenditures for new plant and equipment should be about $40 billion higher than they actually will be. Our organization's survey of corporate plant and equipment expenditures, conducted in February 1977 for the year 1977, indicates that industry will spend about $139 billion this year (see Appendix B, Rinfret Associates' SHORT TERM BUSINESS Study subtitled "Resurvey—Capital Expenditures", dated March 15, 1977). If corporations were to spend for new plant and equipment relative to their cash flow as they have spent historically, they would spend about $180 billion in 1977 (see Appendix C, Rinfret Associates' chart of "Cash Flow and Capital Expenditures").

Corporations have a far higher cash flow than they are utilizing for new plant and equipment, but they are not spending it.

Not only do corporations, in general, have more cash flow than they are spending for new plant and equipment, but they are very tight on capacity. Our organization conducts a survey of capacity utilization in each quarter of the year. When we initiated that survey in the Fall of 1974, manufacturing industry was operating at 92 percent of capacity, and there were many industries operating at rates above 90 percent of capacity. According to our most recent survey of capacity utilization, for the month of April 1977, manufacturing was operating at 89 percent of capacity and many industries were operating at rates near or above 90 percent. There is little room left for economic expansion (see Appendix D, Rinfret Associates staff memorandum from Barry Molefsky to Pierre A. Rinfret, entitled "Capacity Utilization", dated June 9, 1977).

For the past three years we have asked ourselves this simple but fundamental question: "If American industry has the cash for new plant and equipment expenditures and they are, at the same time, very tight on capacity, why don't they spend more than they are spending?" What is holding them back?

The paradox is this: industry has the money and the need for more plant and equipment, but the new investment in plant and equipment is not being made. Why not?

Our research reveals some surprising answers to this basic question.

5. FINDINGS

The following are the three most important findings we have made in our research effort to identify those proposals which we "consider as the key to providing for greater business growth and higher employment."

1. Uncertainty

It is axiomatic that the greater the degree of certainty about the future, the greater the willingness to invest, and the greater the degree of uncertainty, the less the willingness to invest.

Business today is based on two major kinds of uncertainty. We may call one the normal, everyday, run-of-the-mill uncertainty and risk of the business world. This is the kind of uncertainty which business is used to and can understand. More importantly, however, business can evaluate this uncertainty with a relatively high degree of certainty.

In the past five years or so, however, a new kind of uncertainty has emerged. I call this the legislative uncertainty. From one day to the next, business does not know nor can it project what new legislation will pass in the Congress and what new requirements will be imposed upon business. Legislation is a shifting sand which is never static, it changes in strange and mysterious ways and, frequently, utterly destroys all earlier calculations of the viability of investments.

Here are quotations from our survey respondents regarding the impact of legislative uncertainty on capital investment:

"The most important deterrent to investment in our industry is the absence of stable, realistic regulations. From one year to the next, we don't know what type of product we will be allowed to build—because of the changing safety, emissions and fuel economy regulations, many of them conflicting, and many imposed so late that waste in investment is the inevitable result. The combination of regulatory uncertainty and normal market uncertainty has led us to defer all but the most urgent investments."

"The problem today is one of uncertainty, particularly over energy. If a company wants to build a plant today it doesn't know how it will be heated. The company cannot get long-term commitments for electricity."

"In 1976 the company was interested in a vital nonferrous mineral which is used in nuclear power plants. This would have been a multimillion-dollar project. The company was very interested in this project and a great deal of management time was spent on it. The project was dropped principally because of uncertainties over the outlook for nuclear energy."

"The environment for investment is becoming increasingly uncertain. The future looks scary. Contributing to this uncertainty are Government regulations. The Tris case is a good example of this. First the Government required that Tris be used in children's sleepwear; then it ruled that Tris was unsafe."

"Delays caused by Government regulations and litigation are inhibiting new product development and investment. The time it takes to bring our new products to market has been stretched from three to eight years. The Government's approval process should be accelerated."

"Uncertainty about future tax laws is inhibiting investment now. People won't invest because they are uncertain about what future 'tax reform' will do to the capital gains tax. They fear even further limitations and reductions. The assumption of worsening tax provisions makes new business formation and growth of innovative scientific companies difficult. For investors it is now more attractive to invest in tax-exempt securities or conservative growth companies than in venturesome new small companies."

These comments about uncertainty, the legislative uncertainty, permeated each and every meeting we held with our survey respondents. Here are the major uncertainties facing American industry today, the uncertainties which reduce new capital formation, reduce venture capital and reduce new expenditures for plant and equipment:

The energy uncertainty.—Energy is a major cost of production. There is no energy policy in the United States. No one, but no one, knows what is going to happen to petroleum prices, to natural gas prices, to nuclear energy, to pollution laws covering the mining of coal, to regulations concerning the flow of intrastate natural gas, to electric power in the Northwest and the Southeast. Business cannot plan because with energy uncertainty there is no base upon which to plan.

The pollution uncertainty.—Pollution laws have had a major impact on the private capital expenditures of American industry. We estimate that about 6 percent of all capital expenditures in the United States are for pollution control. Pollution laws are in a constant state of flux and change. From one day to the next the laws change, and as the laws change the investments to keep pace with those laws also change. It is not possible at this date to build a plant which can anticipate the pollution laws of two to three years hence. The businessman cannot plan on pollution laws because they are constanty changing.

The tax uncertainty.—The investment tax credit was established in 1962. It was suspended in 1966. It was reinstated in 1967. It was repealed in 1969. It was reinstituted in 1971, retroactively. Its suspension was called for in 1972 and 1973 by the Chairman of the Federal Reserve Board. It has been debated endlessly since 1975. Tax laws are the quicksand of the financial world. They change in every session of Congress. There is no permanency. There is total fluidity. It is impossible to make any rational decisions based upon present tax laws or assumptions about future tax laws.

Why is capital formation inadequate? Why are capital expenditures lower than they should be relative to cash flow? Why has venture capital dried up? There are many answers to these questions but I suggest that a major reason, perhaps the major reason, is that Congress has created a nightmare for American industry in legislative uncertainty. If there is a certainty about laws passed by Congress, it is this certainty: you can be sure they will be changed in the subsequent session of Congress if the laws are in the national domain.

2. Inflation

The tax laws in the United States contain a vital but unstated assumption. This assumption is that there is little or no infalion to worry about and that economic and financial planning may be based upon the concept of price stability. The tax laws assume price stability and are totally and completely incapable of dealing with inflation.

Inflation has a particularly damaging impact on invested capital. The depreciation laws permit the recapture of historical costs but do nothing about replacement costs. In an inflationary period such as we are in now this guarantees the businessman that at some time in the future he will have to raise substantially more capital than the depreciation allowed on his assets.

"The corporate tax burden has been increasing over the years because inflation has cut deeply into depreciation allowances, which are, of course, based on historical costs. It is essential, we believe, to eliminate this inflation 'surtax' by means of indexing capital goods to reflect replacement costs. We also would strongly support further acceleration of depreciation allowances. This is one of the measures widely utilized abroad, and we believe it helps account for higher investment as a percent of GNP in such countries as Germany, Japan and France."

"We don't have enough depreciation. All non-producing costs should be expensed and immediately tax-deductible."

"* * * it would seem that corporate tax relief should not focus on making it more desirable to pay dividends, for example, a tax deduction for dividends paid, but rather stress encouragement to companies . . . to improve [their] capital base. For example, we believe it is imperative that percentage depletion for hard minerals be retained and that the present depreciation provisions be replaced by more realistic, flexible capital recovery allowances for plant euipment akin to the approach presently following by Canada. We also strongly believe that industry should be allowed current write-offs of non-productive pollution control facilities unreduced by the minimum tax and without affecting percentage depletion deductions."

"A change in depreciation rules should be considered. Either shortening the depreciation period or indexing depreciation to the rate of inflation."

"More specifically, what we are talking about is an accelerated five-year write-off for all tangible personal property and an accelerated ten-year write-off for all other eligible tangible property, including buildings and structural components. . . . Under a Capital Cost Recovery system, the impact of inflation would be substantially reduced due to the shorter recovery periods. Capital intensive companies, with their ongoing requirements for efficient productive facilities, are those most damaged by inflation as they seek to recover capital expenditures through depreciation deductions taken over the extended useful life of the assets."

Inflation does many things to a corporation. One of the most evil effects of inflation is that industry eats up, lives off, its capital. Inflation results, ultimately, in the destruction of capital because capital is consumed instead of being replaced and increased.

I said earlier that "The tax laws assume price stability and are totally and completely incapable of dealing with inflation." It is worse than that:

Because taxes are paid on an upward-sliding scale, the Federal Government benefits from inflationary increases in income.

Because deductions are based on historical costs, the Federal Government takes in revenue which is the result of the destruction of capital.

Taxes rise as income rises as a result of inflation, but historical cost deductions during the same period become less and less realistic. The tax laws favor the destruction of capital in an inflationary environment.

3. Small business

Large businesses are increasingly concerned that the laws of the U.S. overwhelmingly favor large business to the detriment of small business. Large business wants, desires and advocates a healthy and dynamic small business community. Large business believes that small business should have immediate financial and legislative help for the good of the country.

"We need to encourage the young fellows who are the entrepreneurs, starting businesses as we did in 1939, so they will take risks, borrow money, innovate and start new ventures."

"The young scientists and entrepreneurs who would have started small innovative companies now find it more attractive and secure to seek affiliation with big, mature companies."

"It is important to revert to the earlier tradition—and tax code—that permits entrepreneurs to make money and keep it. Otherwise we will inhibit the growth of small business, of innovative business and curb the vitality of the free enterprise system."

6. CONCLUSIONS AND RECOMMENDATIONS

There could be hundreds of conclusions and recomendations, but I will confine myself to just three. I believe that these three recommendations, if enacted by the Congress, would materially and favorably impact the formation and utilization of capital in the United States today and in the future:

1. The grandfather clause

The Grandfather clause would permit a company to invest or accumulate capital, and the laws that would apply thereafter would be the laws in effect at the time of investment. Consider the utilization of the Grandfather clause in legislation affecting private industry. This would replace uncertainty with certainty. The Grandfather clause would permit industry to invest with known parameters.

2. Capital recapture

Liberalize the tax laws regarding capital recapture. Ways to do it are innumerable, but it should be done and done as soon as possible. The current depreciation and depletion laws should not only be kept but liberalized as well.

3. Small business

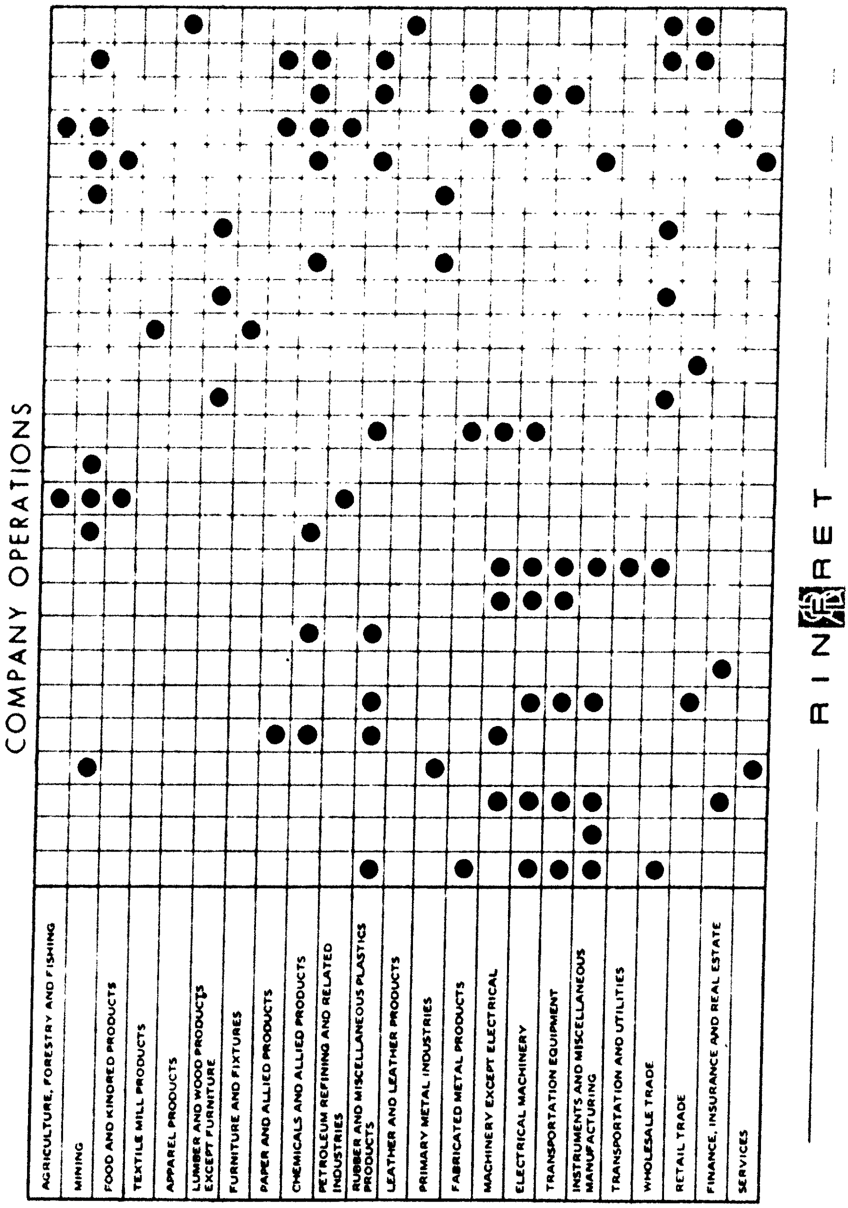
This sector of the American economy needs to receive special attention and assistance. Laws tend to favor large corporations. The time has come to give small business preferential treatment.

In conclusion, I believe that our problems of capital formation and capital investment are the direct result of sweeping changes which have taken place in the past five years in the relation of Government to the private sector.

As Congress has closed one so-called "loophole" after another, it has destroyed one capital and investment incentive after another. The legislative uncertainty grows and grows, and in growing it delays the capital investments so desperately needed.

The U.S. Government needs to replace uncertainty with certainty and to create incentives to growth by restoring the capital and investment incentives to taxpayers who now have virtually none. As the "loopholes" have been eliminated, so has the risk-taking, the creation of new capital, the drive to grow.

APPENDIX A



Appendix B-1 through B-3

Rinfret Associates, Inc.

Short-term Business Study "Resurvey—Capital Expenditures" March 15, 1977

1. On January 31, 1977 we began our resurvey of 1977 capital expenditure plans of private industry. We did the first survey of 1977 capital expenditure plans of private industry in the Fall of 1976 so that this survey is a follow-up of that one. Not only is it a follow-up but it is an update as well.

At this writing we have responses from firms representing about 41 percent of all private capital expenditures in 1976. We will obtain more responses but the current level of responses approaches the significant level. The results we present in this Study are meaningful results but they will change somewhat as more responses come in. The changes, however, are not likely to materially or significantly alter the results we present here.

Herewith the results of this resurvey.

2. *Comparison.*—In the following tabulation we compare the percentage changes in 1977 capital expenditures as originally indicated by private industry in the Fall of 1976 and as indicated currently (for the Fall of 1976 see our short term business study subtitled 1977 Capital Expenditures dated October 18, 1976). We use the percentage change figures only because there have been changes in the 1976 base figures of the U.S. Department of Commerce.

1977 DOLLAR PRIVATE CAPITAL EXPENDITURE PLANS

	Fall, 1976	Currently
All industries	10.0	15
Manufacturing	10.4	16
Nonmanufacturing	9.6	15

Point number one.—Industry has raised upwards rather materially capital expenditure plans for 1977.

In the following tabulation we compare the actual dollar figures for capital expenditures in 1976 as reported by the U.S. Department of Commerce in the Fall of 1976 and as reported currently:

1976 CAPITAL EXPENDITURE PLANS

	Billions of dollars		1976 versus 1975 percent change	
	Original	Current	Original	Current
All industries	121.2	120.5	7.4	6.8
Manufacturing	52.8	52.5	10.1	9.4
Nonmanufacturing	68.4	68.0	5.5	4.9

Point number two.—Industry fell short of its plans as late as the Fall of 1976 for the year 1976. There has been, in recent years, a tendency for industry to undershoot, to fall short of, its capital expenditure plans. Put that another way: industry tends to plan more than it actually spends. This raises an interesting question: are capital expenditure plans hypersensitive to the state of the business cycle?

Why do we make this point? For the reason that almost everyone tends to forget: capital expenditure plans are not fixed in concrete (no pun intended), they change and are modified. The outlook for capital expenditures in 1977 is better at the moment than it has been but if history is any guide, the year could end up at lesser gains than those now being indicated. That's not pessimism, it's just looking at the way the facts have tended to go in the past few years. Nevertheless, a better plus now than last Fall: That's good and pleasant.

3. Real Capital Expenditures.—In 1976 we innovated the idea of asking our respondents to indicate how much they thought capital expenditure prices would increase in the coming year. That permitted us to talk about real changes in capital spending in 1976 rather than to talk about just the nominal changes. This year we again asked industry to indicate how much capital goods prices would rise, i.e. indicate how much 1977 capital goods prices would increase. In the following tabulation we compare increases in capital goods prices for 1976 with those projected for 1977.

CAPITAL GOODS PRICE INCREASES

	Percent change	
	1976 versus 1975	1977 versus 1976
All industries	7.9	7.7
Manufacturing	7.6	7.2
Durables	6.5	7.1
Nondurables	8.6	7.3
Nonmanufacturing	8.1	8.1

Industry does not expect, for all practical purposes, the rate of inflation in capital goods to change in 1977 as compared with 1976.

Here, then, are the figures for real capital goods expenditures in 1977 as compared with 1976. The 1976 figures are the most recent estimates. The 1977 figures are, obviously, the results of our survey:

1976-77 CAPITAL EXPENDITURES

	Percent change					
	Nominal dollars		Inflation		Real [1]	
	1976	1977	1976	1977	1976	1977
All industries	6.8	15.4	7.9	7.7	−1.0	7.2
Manufacturing	9.4	16.0	7.6	7.2	1.7	8.3
Durables	8.4	22.0	6.5	7.1	1.8	14.0
Nondurables	10.3	11.0	8.6	7.3	1.6	3.5
Nonmanufacturing	4.9	15.0	8.1	8.1	−3.0	6.4

[1] Nominal divided by inflation equals real.

In 1976 the real volume of private capital expenditures declined about one percent. This meant that capital goods put in place added nothing to the growth of the economy in 1976.

In 1977 current plans by private industry call for an increase of about 7 percent in real capital expenditures. Capital goods will add to the economic expansion in 1977 and are coming through just when they are needed.

The figures for the details in "All Industries" are not nearly as reliable as the aggregate and should be used cautiously and with circumspection, but it seems fair to say that durable goods expenditures are going to increase materially in 1977.

As Gabriel Heatter used to say, "There's good news tonight" and these figures are good news.

CAPITAL SPENDING

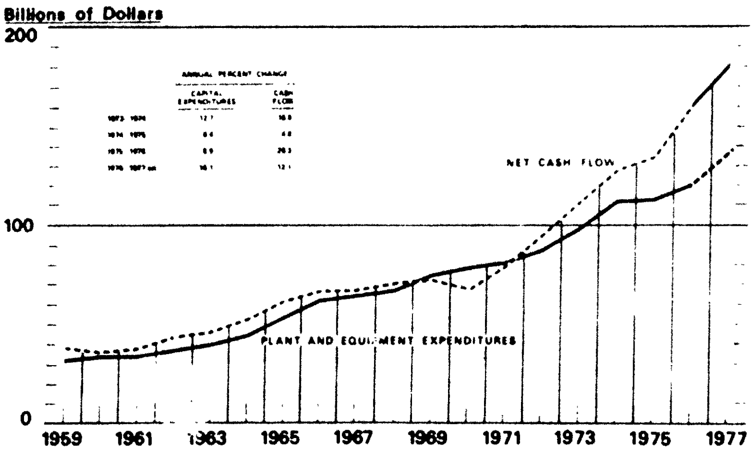
[Billions of dollars]

Industry	1975	1976	1977	Percent change 1976	Percent change 1977
All industries	112.78	120.49	139.09	6.8	15.4
Manufacturing	47.95	52.48	60.89	9.4	16.0
Durables	(21.84)	(23.68)	(28.90)	(8.4)	(22.0)
Nondurables	(26.11)	(28.81)	(31.99)	(10.3)	(11.0)
Nonmanufacturing	64.84	68.01	78.20	4.9	15.0
Durables manufacturing	21.84	23.68	28.90	8.4	22.0
Primary metals	5.99	5.97	6.39	-.3	7.1
Iron and steel	(3.03)	(2.99)	(3.15)	(-1.3)	(5.4)
Nonferrous	(2.28)	(2.16)	(2.43)	(-5.3)	(12.4)
Electrical machinery	2.31	2.62	3.08	13.4	17.5
Nonelectrical machinery	4.50	5.03	6.19	11.8	23.0
Transportation equipment	3.24	3.62	5.43	11.7	50.0
Motor vehicles	(2.06)	(2.45)	(3.84)	(18.9)	(56.6)
Aerospace	(.92)	(.94)	(1.23)	(2.2)	(30.5)
Stone, clay and glass	1.42	1.72	2.39	21.1	39.1
Other durables	4.38	4.73	5.42	8.0	14.7
Nondurables manufacturing	26.11	28.81	31.99	10.3	11.0
Food and beverage	3.26	3.75	4.25	15.0	13.3
Textiles	.66	.81	1.07	22.7	32.1
Paper	2.95	3.27	3.66	10.8	11.9
Chemicals	6.25	6.68	6.68	6.9	0
Petroleum	10.51	11.62	12.56	10.6	8.1
Rubber [1]	1.00	1.10	1.39	10.0	26.3
Other nondurables	1.48	1.58	2.39	6.8	51.0
Nonmanufacturing	64.84	68.01	78.20	4.9	15.0
Mining [1]	3.79	4.00	4.94	5.5	23.5
Railroads	2.55	2.52	2.87	-1.2	14.0
Air transportation	1.84	1.30	2.02	-29.3	55.0
Other transportation	3.18	3.63	3.73	14.2	2.9
Public utilities	20.14	22.28	26.38	10.6	18.4
Electric	(17.00)	(18.80)	(21.48)	(10.6)	(14.3)
Gas	(3.14)	(3.47)	(4.90)	(10.5)	(41.3)
Communications	12.74	13.30	14.83	4.4	11.5
Commercial and other [1]	20.60	20.99	23.42	1.9	11.6

[1] Adjusted for systematic biases.

APPENDIX C

CASH FLOW & CAPITAL SPENDING



APPENDIX D-1

RINFRET ASSOCIATES, INC., INTRAOFFICE MEMORANDUM, JUNE 9, 1977

To: Pierre A. Rinfret.
From: Barry Molefsky.
Re Capacity Utilization.

1. Final results of RAI's April 1977 Capacity Utilization Survey are now available. This survey was conducted between May 2, 1977 and June 6, 1977. Responses were received from corporations with roughly $400 billion in total assets, representing 56 percent of the survey sample. This level of response is somewhat higher than normal.

2. Operating rates for the manufacturing sector as a whole in April 1977 rose to the second-highest level ever recorded in the history of RAI's survey. For the most part this rise was due to an extraordinarily large increase in the motor vehicle industry's capacity utilization.

Automakers report that in April 1977 they were operating at 116 percent of potential. This is 20 percentage points above the January 1977 rate and 22 points above the year-earlier rate. The Federal Reserve Board reports that output of motor vehicles and parts expanded at a compound annual rate of 35.2 percent between January and April 1977. Capacity pressures evident in RAI's survey make it unlikely that production can increase further. In all probability, output will decline in coming months.

The iron and steel and stone, clay and glass industries also recorded sharp increases in operating rates between January and April 1977. The rise in stone, clay and glass utilization represents a snapback from depressed activity due to natural gas shortages this winter. The increase in iron and steel operating rates from 67 percent in January to 84 percent in April is also due in part to a recovery from weather-induced shutdowns. But strong activity in the industry's customer markets probably accounts for a larger part of this gain. Auto, appliance and business equipment production have all recorded strong gains in recent months. The iron and steel utilization rate reported in RAI's survey is virtually identical with the capability utilization rate reported by the American Iron and Steel Institute (AISI). The AISI series has been increasing since April and reached 89 percent in the last week of May 1977. Rising demand for steel products has permitted manufacturers to increase prices. Between January and April 1977 the Wholesale Price Index for iron and steel has risen at an annual rate of 7.3 percent.

The nonferrous metals industry recorded a relatively minor increase in capacity utilization to stand at 89 percent in April. This is slightly below the recent peak rate of 92 percent recorded in October 1976.

RINFRET ASSOCIATES' CAPACITY UTILIZATION SURVEY

[In percent]

	1974		1975			1976				1977	
	Sept.	Dec.	Mar.	July	Oct.	Jan.	Apr.	July	Oct.	Jan.	Apr
All industries	88	85	75	75	78	80	81	78	76	79	82
Manufacturing	92	86	79	79	81	82	86	84	83	84	89
Durables	91	86	77	72	75	76	85	78	77	82	92
Nondurables	93	87	81	86	87	88	86	89	88	86	86
Nonmanufacturing	78	79	67	66	70	73	70	66	63	70	65
Primary metals	93	90	82	69	69	72	85	86	79	70	87
Iron and steel	96	90	86	68	68	72	88	87	75	67	84
Nonferrous	97	89	78	70	71	73	80	83	92	86	89
Electrical machinery	85	87	74	62	74	78	81	69	79	82	84
Nonelectrical machinery	93	95	80	80	79	80	81	76	81	81	78
Transportation equipment	87	75	71	75	77	74	89	76	72	90	110
Motor vehicles	94	78	68	77	79	78	94	80	72	96	116
Aerospace	72	65	72	70	64	61	62	66	69	69	70
Stone, clay and glass	87	78	72	74	81	80	85	81	83	72	84
Food and beverage	88	89	80	84	80	87	86	85	85	79	87
Textiles	90	73	72	82	87	91	88	85	86	88	88
Paper	97	88	78	80	82	89	91	89	90	87	91
Chemicals	90	83	72	74	74	75	78	79	74	75	79
Petroleum	94	90	85	90	92	91	89	95	93	90	88
Rubber	91	81	63	82	82	92	67	34	93	90	89
Mining	96	95	96	95	92	95	99	92	95	88	93
Railroads	92	87	74	74	80	78	82	77	66	78	70
Air transportation	76	82	55	53	59	60	54	60	52	56	55
Other transportation	88	89	97	90	79	78	74	74	95	93	92
Public utilities	75	77	66	65	68	73	68	65	61	70	64
Electric	73	75	63	63	66	71	66	62	60	68	62
Gas	91	86	91	85	82	85	86	81	78	89	82
Commercial and other	94	85	86	79	89	78	86	89	91	83	85

Note: Aggregates include industries not shown separately.

3. Capacity utilization in the nondurable goods sector was unchanged from the 86 percent recorded in January 1977. Since July 1975 softgoods operating rates have fluctuated between 86 and 89 percent. Food and beverages is the only industry in this sector to experience a large change in operating rates: utilization increased from 79 percent in January 1977 to 87 percent in April. This gain is a return to the levels which have generaly prevailed in RAI's survey. January's dip was undoubtedly due to weather-related shutdowns.

The chemical industry remains the only nondurable industry operating below 80 percent of potential. In April 1977 the industry was running at 79 percent of capacity, four percentage points above the January 1977 level. The relatively large margin of unused capacity results from the industry's substantial capital investment program of the early 1970s. Consistent with this low operating rate has been the relatively small increase in chemical prices. In April 1977 the Wholesale Price Index for chemicals and allied products was only 3.0 percent above the year-earlier level. By comparison, the WPI for all industrial commodities rose 7.3 percent in the same period.

The paper industry reported operating at 91 percent of capacity in April 1977. This is roughly the same utilization rate reported by the American Paper Institute (API). The API rate has since risen above 94 percent. In the past, RAI survey participants have indicated that a 92 percent utilization rate represents maximum efficient operation. To raise utilization rates above 92 percent, papermakers will have to discontinue low-margin items. Shortages of certain paper products may therefore be imminent. Responding to this tight capacity, the Wholesale Price Index for paper has advanced at an annual rate of 9.4 percent during the first four months of 1977.

4. In contrast to the rise in manufacturing, operating rates in the nonmanufacturing sector registered a decline from 70 percent in January 1977 to 65 percent in April. This drop is attributable primarily to a fall-off in electric and gas utility utilization rates. The January 1977 rates had been inflated by severe weather.

5. *Conclusion.*—Capacity utilization, as measured by RAI's survey, has reached a relatively high level. For some industries operating rates are unsustainably high and portend shortages. The situation in the paper industry appears to be

critical. That industry is at or near its production ceiling and shortages later this year are a distinct possibility.

Senator BYRD. The next witness, the subcommittee is fortunate to have today is Mr. Edwin S. Cohen, former Under Secretary of the Treasury. Mr. Cohen has had a distinguished career in Government and the practice of law and the academic community. He is a law professor of the University of Virginia. He is a native Virginian, educated at the University of Richmond, and the University of Virginia.

Mr. Cohen is now a practicing attorney in Washington and a lecturer at the University of Virginia Law School.

I am glad to welcome you today.

STATEMENT OF EDWIN COHEN, ESQ.

Mr. COHEN. Thank you, Mr. Chairman. It is a privilege to appear before the subcommittee in connection with its study of incentives for economic growth. The concern over capital formation, and the effect of our income tax laws on its growth, is widespread and has been explained and emphasized by other witnesses.

Secretary Blumenthal in a recent speech referred to the shortfall in the availability of capital for the growing labor force and noted that "if we are to move toward a full employment economy over the balance of this decade, investment in productive capacity will have to absorb a higher proportion of our national output."

Among the initiatives he stated that the administration would take is "the presentation later this year of a comprehensive proposal for major tax reform, designed to promote business investment to achieve increased productivity."

I shall not attempt to review all the possible changes in the Federal tax structure that could aid in this effort, but shall discuss this morning a proposal currently under consideration to integrate the corporate and individual income tax and related suggestions to tax capital gains as ordinary income.

Double taxation of corporate income, once in the hands of the corporation and again in the hands of the shareholder, seems to me lacking in equity and fairness and inevitably has a dampening effect upon investment in corporate stocks that form the life blood of industry. Philosophically and pragmatically, I would commend to you an effort to eliminate or ameliorate this double taxation, to place incorporated and unincorporated businesses on a par, and to achieve the same level of tax on corporate income whether corporations are financed by equity investment or indebtedness.

I listened earlier to Dr. Rinfret. I gather that those he talked to, business leaders, were not interested in this proposal. This has not been my experience, but I do not want to argue with someone who sold the stocks of his clients in February 1973. I did not have that foresight.

However, I would challenge the statement that he made, that he thought he derived from his discussions with these business leaders, that they made decisions without regard to taxes, although having made those decisions they would take advantage of tax provisions of the law. I would certainly agree, from my experiences as an attorney, over many years—more than I care to remember—that businessmen do make their decisions on investments based upon the potential for gain that they see, and not primarily with regard to tax consequences.

But, on the other hand, taxes do have a bearing on the decisions that investors and businessmen make. Let me just cite one or two illustrations.

It seems to me that an obvious one is State and local bonds, which are tax exempt; inevitably they bear lower interest rates than if they were fully taxable. The market, therefore, reflects the tax characteristic of the bond.

Secondly, it occurs to me that in recent years corporations have tended to finance themselves in public issues and private placements with debt instruments to the exclusion of preferred stocks and common stocks. Although I am not an expert on this, it has been my understanding that, except with respect to public utilities, there have been very few preferred and common stocks floated in the equity market in the country in the last few years. I think a good part of this is due to the differentiation in our tax structure between the treatment of inerest on indebtedness and dividends on stocks.

Now, in recent years, Canada, France, West Germany, Japan, and the United Kingdom have changed their corporate-shareholder tax systems to ameliorate double taxation by several different methods and with a variety of different statutory provisions. While circumstances in the United States are different in numerous respects from those abroad, the positive actions of these countries indicate that the specific details can be dealt with in one way or another.

Mr. Chairman, in my prepared statement I have reviewed several different methods of eliminating or ameliorating the double taxation of corporate income. In view of the hour, I will not go into these.

In the prepared statement I discuss the so-called partnership treatment, which I think may be ideal, but which I do not think is administratively feasible under existing tax circumstances. I also refer to the dividend reduction system and the credit system.

Dr. Smith said that he had a preference for the credit system and I do not necessarily disagree with that. I am inclined to think the dividend deduction system would be simpler. The credit system perhaps would have greater flexibility for the draftsmen and designers of the system.

The most important thing is that we ought not to be caught in a quandary as to which of the two systems to adopt. It is my view that we should move ahead with one or the other of them.

I have also discussed in my statement the possibility the administration may be giving consideration, simultaneously with the introduction of an integration system, to the taxation of capital gains as ordinary income. I have dealt in the paper with a number of problems that I think exist with respect to that proposal.

In looking at that proposal, I found some statistical data that I thought was of interest. I mention, on page 14 of my statement, that the latest statistics of income published by the IRS indicate that there were approximately $22 billion of dividend income and $15.5 billion of capital gains included by individuals in their tax returns for 1975.

If you take account of the $100 dividend exclusion and the exclusion of one-half the capital gains, I would guess that that represents about $23.5 billion of dividends received by individuals in 1975, and close to $30 billion in capital gains. The aggregate adjusted gross income of individuals for 1975 was $948 billion.

There was discussion earlier today about whether investments are made by the wealthy or low and middle income individuals. I note with interest that, according to the 1975 Statistics of Income, people with incomes of less than $50,000 reported in 1975, 55 percent of all dividends in adjusted gross income and 53 percent of all capital gains.

I was somewhat surprised to note these figures. Indeed, in the returns of those with adjusted gross income of less than $30,000, we find 39 percent of the dividends and 48 percent of the capital gains.

If one were to treat capital gains as ordinary income along with integration of the corporate tax system, one would have to take into account the fact that the integration would help those who hold shares but that taxing capital gains as ordinary income would be a detriment to those who sell them at a profit.

The trade-off of one proposal against the other would also invite consideration that investments in real estate, including personal residence, would suffer along with stock investment from taxing capital gains as ordinary income; but unlike stock investments, real estate would gain nothing from the integration proposal, except for the ability to use the corporate form instead of syndications.

I think that it is vital to consider what would be done with the tax rate structure. Merely reducing the maximum tax from 70 to 50 percent on unearned income, as it now exists on earned income, would help the high bracket incomes if capital gains were taxed as ordinary income; but a person now in the 40 percent bracket who, in effect, pays 20 percent on capital gains, would not have his tax burden alleviated by reducing the maximum rate to 50 percent. To appraise the two proposals adequately we would have to know what changes in the tax rate schedule would be made.

Moreover, one of the most difficult problems is what to do with capital losses. That poses a dilemma. If you were to tax capital gains as ordinary income, in fairness—and to avoid disincentive to investment—you should treat capital losses as ordinary deductions. If you did that, the result could be that the revenue would suffer because persons who had appreciated assets would defer realizing their gains and those who had depreciated assets would realize their losses in order to reduce their income subject to tax.

If you were to continue the limitation on capital losses in the tax law, it seems to me that taxing capital gains as ordinary income would be a distinct disincentive to the investor. The Government would be playing the game, heads I win; tails you lose.

There are, of course, many things that can be done with the law. Dr. Smith suggested a qualified account or a cash-flow system of taxation which, in essence, would permit some rollover of investment without tax. If such a program were instituted along with taxation of capital gains as ordinary income when funds are withdrawn for consumption purposes, it seems to me that that might make a very sensible system.

This is, in general, a summary of my statement.

Senator BYRD. Thank you very much, Mr. Cohen.

One witness this morning expressed the view that taxing capital gains at the full rate would cause the stock market to go up. Do you agree or disagree with that?

Mr. COHEN. I have discussed that with some people in the investment industry and they point out, as someone else did—I am not certain which other witness—that while there would be a deterrent to selling, there would be an even greater deterrent to buying; so the general opinion that I received was that it would be a net deterrent to the market.

Senator BYRD. The question of trying to eliminate the double taxation of dividends to me is a lot more complex and difficult than I, at one time, thought it might be. In the first place, we cannot get any consensus on which direction we should go in, assuming that we want to do that, and also, there is some opposition to it on the part of some of those you think would be for it, such as those enumerated by Dr. Rinfret, and also as to whether there should be a trade-off in regard to capital gains in the event that the double taxation was, or is, eliminated.

How important is it that the double taxation be eliminated vis-a-vis a reduction in rates, for example?

Mr. COHEN. Senator, after thinking this over for a long period of years, it seems to me that the double taxation of corporate income is just unfair, and the problems that exist in business, especially in closely-held businesses, as to whether one should incorporate or one should not incorporate ought not to exist.

I would support the elimination of the double taxation because it seems to me to be sound and fair and equitable, and it would remove the premium on debt financing as against equity financing.

It does not seem to me that this involves a trade-off with respect to capital gains, because capital gains are involved in many other types of investment, notably real estate.

Senator BYRD. I agree with you, but increasingly, we hear this from Members of Congress and from the administration, too.

Mr. COHEN. One of the problems, Senator, is that the present system of taxation of capital gains—taxing one-half of the capital gains held for more than a year—while in essence it has been in effect for some 35 years, it is, in itself, a compromise.

Taxing 50 percent of capital gains rather than 40 percent or 60 percent, is a compromise. It is a compromise that has lasted a long time, but, nonetheless, one could substitute a different system.

As Dr. Smith mentioned today, if you taxed capital gains as ordinary income you could add some kind of qualified account that permitted a rollover of investment. It seems to me that that would be an acceptable system. But I do not see the capital gains issue as a tradeoff against the corporate tax integration.

Senator BYRD. I do not either, but I find that some of my colleagues do. I find some sentiment in the administration in that regard.

But I do agree with you. I think it is sort of apples and oranges.

In that connection, do you think that the Congress made a mistake in 1969 when it increased the capital gains rate from 25 percent?

Mr. COHEN. I think this depends on the total picture, Senator. My own feeling is that there has not been that much advantage to the economy in doing so. My answer would be yes. I would be inclined, as I think most countries abroad have done, to put a ceiling upon the capital gains tax.

The reason for it is that we do not have, and cannot have, as a practical matter, a system of taxing gains as they accrue. We tax them only as they are realized. Therefore, whether one pays the tax depends on whether one makes a conscious decision to sell.

My inclination is that when the tax on selling is that great, people hesitate to sell and a ceiling on capital gains, therefore, has an advantage to the marketplace. From the point of view of simplicity, of course, if we eliminated the distinction between capital gains and ordinary income and brought the rates down substantially, that would be the simplest system of all.

Senator BYRD. Thank you very much, Mr. Cohen. I appreciate your being here this morning.

Mr. COHEN. Thank you, Mr. Chairman.

[The prepared statement of Mr. Cohen follows:]

STATEMENT OF EDWIN S. COHEN

It is a privilege to appear before the Subcommittee this morning in connection with its study of incentives for economic growth. The concern over capital formation, and the effect of our income tax laws on its growth, is widespread and has been explained and emphasized by other witnesses. Secretary Blumenthal in a recent speech referred to the "shortfall in the availability of capital for the growing labor force" and noted that "if we are to move toward a full employment economy over the balance of this decade, investment in productive capacity will have to absorb a higher proportion of our national output." Among the initiatives he stated that the Administration would take is "the presentation later this year of a comprehensive proposal for major tax reform, designed to promote business investment to achieve increased productivity."

I shall not attempt to review all the possible changes in the federal tax structure that could aid in this effort, but shall discuss this morning a proposal currently under consideration to integrate the corporate and individual income tax, and related suggestions to tax capital gains as ordinary income.

Double taxation of corporate income, once in the hands of the corporation and again in the hands of the shareholder, seems to me lacking in equity and fairness and inevitably has a dampening effect upon investment in corporate stocks that form the life blood of industry. Philosophically and pragmatically, I would commend to you an effort to eliminate or ameliorate this double taxation, to place incorporated and unincorporated businesses on a par, and to achieve the same level of tax on corporate income whether corporations are financed by equity investment or indebtedness.

There has been much discussion of late as to the method to be selected in eliminating or reducing double taxation of corporate income. I would emphasize that while the selection of the most desirable method is important and at times involves difficult choices, it should not deter us from achieving the goal. There is a risk that the discussion can become bogged down in debate over specific details when the specific problem can be solved and the major objectives attained by several different methods.

In recent years Canada, France, West Germany, Japan and the United Kingdom have changed their corporate-shareholder tax systems to ameliorate double taxation by several different methods and with a variety of different specific statutory provisions. While circumstances in the United States are different in numerous respects from those abroad, the positive actions of these countries indicate that the specific details can be dealt with in one way or another.

While a variety of methods, or combinations of methods, can be employed, three methods have been most frequently discussed: (1) to treat the corporation in essence like a partnership, without a separate corporate tax, each shareholder reporting in his own tax return his pro rata share of the net income or loss of the corporation; (2) allowing the corporation a deduction for dividends paid to shareholders, much as it now deducts interest paid to bondholders; and (3) continuing to impose a corporate tax, but allowing the shareholder a credit in his own return for the corporate tax paid on the corporate income distributed to him as a dividend.

1. PARTNERSHIP TREATMENT

In a progressive income tax structure, it can be argued that the maximum equity would be obtained if the corporate net income or loss were allocated pro rata to each shareholder every year to be reflected in the shareholder's personal income tax in substantially the same manner as if he were a member of a partnership. Net corporate income would be included in the tax return of the shareholder whether or not it was distributed as a dividend, and his share of net corporate losses could be deducted by the shareholder. This is in essence the suggestion that was put forward last January 17 in the staff studies of the Treasury Department published by the outgoing administration under the title "Blueprints for Basic Tax Reform." It could be combined with some form of withholdng tax at the corporate level for which shareholders would be allowed a credit against their own tax liability, somewhat in the fashion of the withholding tax on salaries and wages.

However, there are numerous practical difficulties with such a suggestion. Among them are the problems of administering the system for corporations with thousands—and in some cases even several millions—of shareholders. In the case of Subchapter S corporations, for example, for which a limited system of integration has been in effect for almost twenty years, it has been confined to cases in which there are not more than fifteen shareholders. Moreover, some special rules would be needed to deal with loss corporations to avoid trafficking in their shares by high income investors seeking to reduce or eliminate their tax liability.

Under the partnership system a special problem would exist in the case of profitable corporations if individual tax rates remained as high as the present 70 percent and high bracket shareholders were required to include in their returns the corporate earnings that were not distributed as dividends. It would be unreasonable to require these shareholders to pay tax on these undistributed earnings if they did not receive the cash with which to pay the tax. This method of integration could conceivably be designed so as to increase revenue for the government—a result not likely to be conducive to capital formation. But it could be designated somewhat differently so as to produce a revenue loss to the government and a benefit to investors, particularly if it were adopted in conjunction with a reduction in the maximum individual tax rate, now 70 percent, to something close to the maximum corporate rate, now 48 percent.

This partnership-type treatment of corporation income would fully eliminate double taxation of all corporate income, whether it is distributed as dividends or retained by the corporation. Most of the other systems under consideration would grant relief from double taxation only with respect to distributed corporate income; there would still be double taxation of retained income, because under the other systems retained income would not only be subject to corporate tax but also would be reflected in taxable capital gains that the shareholder would realize when he sold his stock. But the practical problems of administering the partnership-type system on a basic fair to all seem likely to be insuperable under existing conditions. This has been the conclusion of all the nations that have addressed the problem. Hence more serious consideration seems likely to be given to a system that operates only with respect to earnings actually distributed as dividends and leaves undistributed earnings subject to potential double tax.

2. DIVIDENDS PAID DEDUCTION

The simplest such system would allow a corporation in computing its taxable income to deduct dividens paid to shareholders. Most of the machinery for its operation is already in the Internal Revenue Code for purposes of the tax treatment of regulated investment companies, real estate investment trusts, personal holding companies and the accumulated earnings tax, and it could readily be adapted to corporations generally. The dividend deduction method would grant the tax relief to the corporation rather than the shareholder.

There are several aspects of the dividend deduction method that should be noted:

1. It would grant the corporate tax relief only at the price of the corporation distributing its current earnings. The directors would then be somewhat torn between their desire to reduce the corporate tax by paying dividends and their desire to retain the funds for corporate business needs. But it must be remembered that under the existing corporate tax system directors must similarly strike a

balance between their desire to provide a dividend return to shareholders and their desire to retain funds for capital needs. At least to the extent that they now distribute dividends, the deduction to the corporation would provide further funds for corporate capital purposes; and preferred and common stock issues would be place on the same tax plane as debt issues.

2. Although the marginal U.S. corporate tax rate is 48 percent, no corporation pays that amount as an effective rate because the first $50,000 of corporate income is subject to lower rates, the tax is reduced by the investment credit and other credits, and taxable income is reduced by accelerated depreciation, percentage depletion and other items which may not be taken into account in determining earnings available for dividends. Hence if a full deduction is allowed for dividends paid, the corporate tax could be eliminated by dividend payouts that might be substantially less than the corporation's annual earnings. However, to the extent it is desired to prevent that result, the deductions for dividends paid could be limited in various ways to take account of special allowances available in computing the corporate tax.

3. The dividends paid deduction system may involve special problems with respect to foreign shareholders of U.S. companies, since there would be no corporate tax on distributed earnings and the U.S. tax on foreign shareholders would be limited to 30 percent, and to as little as 15 percent on payments to individuals in countries with which we have tax treaties. For this reason, among others, foreign countries that integrate corporate and individual taxes have generally shied away from a dividend paid deduction system. But the U.S. tax on foreign shareholders could be altered and efforts could be made to alter the tax treaty provisions, which have been modified on several occasions when other countries have adopted integration.

4. Consideration would have to be given to the deduction for dividends paid to tax-exempt shareholders, such as charities, educational institutions, pension trusts, etc. Those entities are not generally subject to tax on their income, and a corporate deduction for dividends paid to them would leave the income so distributed free to tax at both the corporate and shareholder levels. This is presently the case with respect to interest paid by corporations on indebtedness held by tax-exempt entities, and the question would be whether that treatment should be extended to dividends on preferred or common stocks, or both.

3. SHAREHOLDER CREDIT

A third alternative, and the one upon which most of the foreign integration systems are based, would continue to apply the corporate tax to both retained and distributed earnings, but grant relief from the double tax by giving a tax credit to the shareholder for the corporate tax paid with respect to the distributed earnings. In essence, the corporate tax applicable to distributed earnings would be treated as a withholding tax, much like the present tax withholding on wages and salaries. The shareholder would include in his tax return not merely the cash he receives from the corporation, but also the corporate tax applicable to the dividend.

This system is sometimes referred to as "gross-up and credit." For example, if for simplicity's sake we assume a corporate tax rate of 50 percent, and a corporation earns $100 before tax, it will have $50 remaining after tax. If the corporation then pays a cash dividend of this remaining $50, the shareholders will include in their tax returns not merely the $50 they receive in cash but they will "gross it up" to include the entire $100 before tax corporate earnings out of which both the corporate tax and the dividend were paid. If the taxpayer shareholder is in a 40 percent bracket, he will calculate a tax of $40 (i.e., 40 percent of $100) and then take credit against that tax for the $50 corporate tax that has been paid. The excess credit of $10 could then be applied against tax the shareholder owes on his other income, and if the credit exceeds the other tax due, the balance would be refunded to him. If the shareholder were in a 70 percent bracket, his tax on the dividend would be $70, which he would partially offset by his credit for $50 corporate tax, and he would pay an additional $20 tax on the dividend.

Several matters of significance should be noted in comparing the shareholder credit with the dividend deduction method:

1. Under the credit system the double tax is eliminated at the shareholder level, whereas under the dividend deduction system the relief is granted to the corporation. Under either system relief is granted only as to distributed earnings. While under the credit system the directors will not be able to reduce the corpo-

rate tax by paying dividends, they would necessarily realize that the shareholders who are in a tax rate bracket less than their credit for corporate tax would benefit taxwise from receipt of a dividend, since the excess of the credit available to the shareholders over the tax they owe on receipt of the dividend could be used to offset their tax on other income or would be refunded to them. If the directors continued to pay the same dividend as at present, introduction of the credit system would increase the after-tax rate of return on the shareholder's stock investment and should stimulate investment in the stock; if the dividends were reduced to produce the same after-tax rate of return to shareholders as at present, the corporation would retain additional internally generated funds for capital investment.

2. Under the credit system decision must also be made as to whether credit will be allowed for the top marginal corporate rate, now 48 percent, or the actual effective rate of corporate tax paid, taking into account such allowances to the corporation as the lower rate of tax on the first $50,000 of corporate income, the investment credit, percentage depletion and the credit for foreign taxes. The problems are related to those mentioned earlier with respect to the dividend paid deduction system. With respect to the lower corporate tax on the first $50,000 of corporate income, for example, it would seem excessive to allow a shareholder credit of 48 percent when only 20 or 22 percent corporate tax has been paid.

There are a variety of statutory mechanisms that can be developed to deal with these matters as may be desired. Particular attention will have to be given to the foreign tax credit, for if shareholder credit were given only for the net U.S. tax paid by the corporation, dividends paid to shareholders out of earnings which are derived overseas and which are subjected to foreign corporate income taxes would still bear the burden of double tax, whereas distributions out of domestic earnings would bear only a single tax. The effects on shareholders might be noticeably different as between companies doing business predominantly in the United States and those having substantial overseas operations.

3. The credit system seems to permit greater flexibility than the dividend deduction system in dealing with the status of nonresident alien shareholders in the tax treaties we have with many foreign countries.

4. As under the dividend deduction method, the status of tax-exempt shareholders has to be considered. Owing no tax, the question arises as to whether they should be allowed a refund of the credit for corporate tax with respect to the dividends paid to them. If not, there would remain a difference between interest on indebtedness and dividends on stocks owned by them; if they are allowed a refund, there would be neither corporate tax nor shareholder tax on corporate profits paid out in dividends to tax-exempt entities.

While these and other matters must be dealt with in determining the precise method of integration to be employed, let me emphasize once again that they all seem capable of solution, as experience abroad has indicated, once decision has been made as to the main policy directives. While care is needed to make the integration system as fair and efficient as possible, discussion of the detailed method of achieving integration should not divert us from the major goal.

The Administration has indicated that its tax reform program will contain numerous recommendations, and hence if corporate-shareholder tax integration is included as one item, its effectiveness in promoting economic growth will have to be judged in relation to the entire program. If what the right hand giveth, the left hand taketh away, there may be other advnatages to the tax structure but there may be little or no aid to capital formation.

There have been suggestions, for example, that consideration is being given to coupling corporate tax integration with a proposal to tax long-term capital gains as ordinary income. It has been suggested that the program might involve also a reduction in the maximum tax rate on all income to 50 percent, now the maximum rate on earned income, and perhaps reductions in rates in lower brackets as well. There are obvious difficulties in weighing such a proposal fully without knowing the rate schedules, but some observations may be made:

1. Corporate-shareholder tax integration would benefit those who hold stocks, but taxing capital gains as ordinary income would be a detriment to those who sell them at a profit. The so-called "lock-in" effect of taxation of capital gains would be increased. The I.R.S. Preliminary Statistics of Income for Individuals for 1975, the latest available, show that about $22 billion of dividends were included in 1975 adjusted gross income of individuals and about $15.5 billion of capital gains were included in their adjusted gross income. If adjustment

were made for the $100 dividend exclusion and for the exclusion of one-half of net long-term capital gains, the total before the exclusions would seem to be in the range of $23.5 billion in dividends and approaching $30 billion in capital gains. The 1975 dividend total is the highest in history but capital gains were some 20 percent higher in 1968, 1972 and 1973. Aggregate 1975 adjusted gross income reported from all sources was $948 billion.

2. It is interesting to note that according to the 1975 I.R.S. Preliminary Statistics, 55 percent of all dividends in adjusted gross income and 63 percent of all capital gains were reported in returns of individuals with adjusted gross income of less than $50,000. Indeed, 39 percent of dividends and 48 percent of capital gains were reported in returns of individuals with adjusted gross income of less than $30,000. These figures were substantially the same in the year 1974.

3. Pension trusts and other exempt organizations presumably would continue to be able to sell investments without tax on capital gains. Whether they would receive a direct benefit from the integration system would depend upon the terms of the program.

4. Real estate investment could suffer a detriment along with stock investments from taxing capital gains as ordinary income, but unlike stock investments, real estate would gain nothing from the integration proposal except for the ability to use the corporate form in lieu of partnership syndications.

5. Most foreign nations would still have lower taxes on capital gains than on ordinary income. The inflow of investment funds from abroad would be adversely affected unless foreign investors continued to be exempt from tax on capital gains.

6. A reduction of the maximum tax rate to 50 percent would benefit high bracket taxpayers (i.e., married couples with taxable income about $52,000) but would have no effect upon those in middle or lower brackets. A person in a 40 percent bracket today pays a tax of only 20 percent on net long-term capital gains, since only one-half of such gains are included in income. Since, as noted above, almost two-thirds of 1975 capital gains were reported in returns of persons with adjusted gross income below $50,000, it is vital to know what rate reduction might be provided for lower and middle income groups.

7. Finally, but of great importance, would be the treatment to be given to capital losses. If net capital gains were to be included in ordinary income, as a matter of logic and fairness net capital losses should be deductible against ordinary income. But if such a rule were adopted, persons who had some appreciated investments and some depreciated investments could realize their capital losses and defer realizing their capital gains, to the great detriment of the government revenue.

If to avoid that result, deductions for net capital losses continued to be limited as they are under the present law, taxation of net capital gains as ordinary income would seem to lack an element of fairness and to contain an element of discouragement to investment. In part, the current taxation of one-half of net long-term capital gains compensates for the limitation on capital loss deductions.

Undoubtedly, treating capital gains and losses as items of ordinary income and deduction would produce a major simplification of the Code. But if deductions for net capital losses were limited as at present, much of the present capital gain and loss complexity would have to remain in the law.

In general, while there could be advantages of simplification in treating capital gains and losses as items of ordinary income and deduction, I do not think one could properly judge the effect of treating capital gains as ordinary income without knowing at least (1) what proposal would be made with respect to capital losses and (2) what new tax rate schedules for individuals would be proposed as part of the new tax reform proposals. All of this together with other parts of the program, would have to be weighed in the balance against the benefits to capital formation that would flow if a system of total or partial corporate-shareholder tax integration were adopted.

Senator BYRD. We now have a most interesting witness, Mr. Albert E. Sindlinger, whom I happen to know firsthand. He was very remarkable in forecasting some of the economic events that took place about 3 years ago this month.

Mr. Sindlinger, the committee is pleased to have you. Unfortunately, we must have a short interruption. I notice the lights on the clock;

there is a vote in the Senate, and I am informed that it is on an amendment by Senator Inouye of Hawaii to the international bank bill, so the Chair must cast a vote on that measure.

The hearings will resume just as soon as I get back. We regret the interruption.

[A brief recess was taken.]

Senator BYRD. The committee will come to order. You may proceed.

STATEMENT OF ALBERT E. SINDLINGER, CHAIRMAN OF THE BOARD, SINDLINGER & CO. OF MEDIA IN PENNSYLVANIA

Mr. SINDLINGER. While you were voting I went through my statement and underscored my statement to cut some time.

I am very grateful for the opportunity to testify today and I am going to ask that you put my complete text in the record. I am going to paraphrase to save some time.

I was very much impressed by Dr. Rinfret's remarks when he talks about legislative uncertainty among business. I am here today with a little different point of view.

I have the advantage that all of the information, all of the conclusions that I come to—come from my conversations with people or daily interviews with people and it is the people of this Nation, the human beings who are often ignored in discussions such as this, and it is people who are directly affected by whatever policy government, including the Federal Reserve Board, eventually produces. It is people who, in the end, will determine whether the Government policies work or they will not work.

The worthy goals of this committee, I think, can be summarized, if we discuss how the economy works. I want to paraphrase and modernize a wise economist and how he put it in 1930: "When the monetary authorities in government of the world, especially within the United States—can figure out, and stop to think out—how to stop creating recessions," like the newest one just occurring in 1977, "the task of Congress will become relatively easy to create incentives for economic growth."

That was said by Dr. Hawtrey, teacher of Keynes, in 1930.

As I have read history, including my own data of the last 28 years gathered from talking to people, I have concluded that all recessions, just like all inflations, are provoked and fired by faulty monetary policy.

I am sorry Senator Long is not here because, if he were here, I could make a couple of points. When you asked me the question earlier today, Mr. Chairman, about the error in 1969, I will show you why it was an error in a couple of more pages.

Senator BYRD. You are speaking of capital gains?

Mr. SINDLINGER. Right. Recessions just do not happen. They are not functions of the inescapable supply and demand. Recessions are manmade by the errors in Government-inspired monetary policy.

As I address you today, this Nation is suffering the ill effects of just such a recent mistake.

During May, the Federal Reserve Board needlessly adopted a monetary policy of too much restraint that was manifested particularly in the rise of interest rates. This restrictive stance resulted from a complete misjudgment of the Fed on the strength of the American economy and on the reading of their own figures.

Let me interject here, Mr. Chairman. Remember when I called you up and asked to appear in this hearing? I said, I hope that by the time the hearing is held that the error of the Fed will be made public.

Do you recall that?

Senator BYRD. I recall that.

Mr. SINDLINGER. I would like to show you this morning's Washington Post. The headline says, "Morgan Guaranty cuts prime rate to 6.5 percent."

This made me right on exactly why I wanted to come and talk to you.

To keep this short, I would like to have you read with me on page 3.

This mistake that the Federal Reserve Board made was in using only their seasonally adjusted figures. I want to point out to the committee and to the Congress that all Government figures are seasonally adjusted.

Here is your May issue of "Economic Indicators" which every Member of Congress uses as a bible, and it is put out each month by the Council of Economic Advisers and every figure in this book that is seasonally adjusted has an error inbuilt. It is a very wide error, the kind of an error that causes the Federal Reserve Board to make the mistake that they did a month ago.

Skip to page 4 and here you see a chart that is reproduced from a recent issue of the New York Times, and what the chart says, to save time, with that M–1, the money supply upon which Government decisions are made at the Fed showed an upward rise in the growth of M–1 when it was seasonally adjusted on a 4-week annual basis in an excess of 20 percent.

If those figures had been correct then the Fed actually would have been entirely proper and we would not have created another recession. If those figures had been correct, this headline would not have been in this morning's paper.

The figures used to make that decision which affected people throughout the United States, were statistically artificial and are categorically wrong.

Thus, the decision was wrong.

On page 5, again, to save time, I have reproduced a chart showing M–1 in color as an overlay. The actual M–1 as it was counted by the Fed and as it was not read by the Fed.

In the April meeting of the Open Market Committee, it was determined that the short-term actual rate range for M–1 was to take no action unless the M–1 figure grew more than 10 percent.

I want you to look at the table on page 6. Here I show the last 28 weeks of the actual M–1 figures with the growth percentages shown in the column under that. There is no figure since January 19 that exceeds 7 percent. There was no justification in April to raise the interest rate, based on their own figures, because the target was 10 percent, and if they had looked at the raw data, looked at the information without relying completely on the seasonal adjustment information, they would never have made the decision that they did.

We will skip a couple of pages, and I hope we will read this at your leisure. I am going to get down to a point.

I have just two things that I want to stress to Congress. The simple attachment of the word "official" to government figures does not make them correct, and first, as we have discussed, it is a plea to Congress to substitute commonsense real figures for the artificial manipulations of the seasonal adjustment that are now ruling the decisionmaking roost.

The second point I want to talk about, I would like to see the battle against the flames of inflation fought from a different firehouse. The inflation firefight should not be waged at the firehouse down on Constitution Avenue, where the Fed is located, but the inflation fight should be fought here on Capital Hill where we are now sitting.

The Fed, by raising interest rates or raising the costs of money is not the way to fight inflation, because when you raise the price of money you are pouring gasoline on the fire to put it out.

The Congress, I believe, has enough sense to use cold water instead of inflammable materials to try to put out the fires of inflation.

Besides being panicked by the wrong information on monetary growth just a month ago, the Fed also was goaded into boosting interest rates by the faulty belief that bank credit was expanding too rapidly.

On this point, the Fed, to a great degree, also was trapped by the seasonal adjustment flaws, for seasonally adjusted—bank loans are up.

The purpose of these hearings, so we can keep it short, so we can have time for discussion, the purpose of these hearings is to create capital formation. I would like to discuss briefly how the economy works, and we will go to page 10.

After monetary policies establishes a recession, it is generally agreed that each economic recovery comes in two stages, the rebound of the typical cyclical cycle.

The consumer moves first. He regains confidence through expectations of greater household money supply and an optimistic view of his job security. This allows the consumer to loosen up and resume spending in a way that will absorb excess supplies that have been produced by business from wrong monetary policy which created the recession in the first place.

Once most of the excess has been absorbed, we are ready for the second stage which is an outgrowth of capital spending to enlarge productive capacity for meeting the increasing consumer demands.

So to repeat, the first stage of early recovery is that the consumer moves first and the second stage of a recovery is for capital spending to move.

Dr. Rinfret this morning talked about legislative uncertainty. What I am talking about with the various exhibits and documents that I have presented to go along with this testimony is to report the complete consumer confusion in the United States at this particular time.

This morning the subject of savings was mentioned and how important they are. I would like to instill a point.

One of the key measurements that we have been asking our people for the last 22 years is a series of questions on their spending plans and a series of questions on their savings plans. One of the key figures that make our data the most accurate is the ratio of how people plan and are currently saving and the reason for their saving.

Over the years, when the economy was moving upward, about $8 of every $10 that was saved is being saved, or was being saved, for spending. People were saving up money to build a house or to buy a car or some item and with job security they would go in debt after they had saved money for an initial downpayment.

In March of this year, the savings desire in this country and savings were almost 16 percent year-to-year growth. We had $1 of every $10 being saved to spend, a reverse of over last year.

As of the last 3 weeks, we have now $8 of every $10 being saved, being saved out of fear. That is a reverse that has taken place since the 13th of April. What caused this?

On the 13th of April, the economy was moving up forward. Everything was going very well in our recapture of consumer confidence and we had a series of events that took place one after the other.

First, we had the overnight announcement that the public was not going to get a tax rebate. I was against the idea of the tax rebate in the first place. Once you promise the people that you are going to do something and people have gone out and spent it, especially with the cold winter, you do not suddenly take it away from people if you are trying to build confidence.

In that 1 week following that 1 day's announcement we had the sharpest drop in our measurement of any time in the last 22 years. Then we followed this up with a television blitz explaining to the American people how they had to compromise on the energy problem, with only 53 percent of the people believing that we had an energy problem. Then on top of this we had the publicity that social security is going broke.

We interviewed people across the Nation who were worried if they were going to get their next social security check because how could they get their check if they had seen on television that social security was broke?

To top this off, on the 6th of May, the Federal Reserve Board raised interest rates falsely to dampen confidence.

Let's look at a chart on page 13. I think it is very interesting. I did not realize you were going to ask this question.

This chart starts in 1966. This is our level of confidence.

You notice that confidence started to fall in 1969. What was the date Congress raised that?

Senator BYRD. Raised the capital gains?

It was done in the 1969 Tax Reform Act.

Mr. SINDLINGER. I think it was in April.

Senator BYRD. The Tax Reform Act of 1969 was passed in December 1969.

Mr. SINDLINGER. April 1969 was when our confidence started to fall and you can see what confidence has been doing since then, and then we had a recovery in 1972 which was a result of the wage and price freeze. Then we had the oil embargo in 1973 and then we had the recession in 1974.

Now I want to flip to page 14 because I want to save some time for some questions.

We were recovering from the recession, the lull that was at the lowest point ever measured, in January 1975 and we were well on our way to complete economic recovery with the tax rebate.

Mr. Chairman, you and I have had many conversations about that during that particular time. My point was that the Government needed to give confidence to people to restore their confidence in money and we gave them the tax rebate, and the economy was turning around very, very sharply.

So what does the Federal Reserve Board do? The Federal Reserve Board, in June, got panicked over the seasonally adjusted figures, raised interest rates, and aborted the economy. Strikeout No. 1.

Then the consumers recovered from this by the end of 1975 and in November of 1975, if you remember, I forecasted that the stock market should turn up and the stock market did turn up in December and confidence followed it. We had a boom recovery well on its way in May of 1976 and what does the Federal Reserve Board do? They again misread their seasonally adjusted figures and raised interest rates and aborted the economy for a second time.

So that is strikeout No. 2.

We recovered from that blow late in 1976 and we started to build up in 1977. We had a temporary abortion of confidence for the deep-freeze month of February and we were rebounding sharply until we had the history that I just cited following May 13.

Skipping over to the next page, the Feds strike out in 1976 to abort the recovery. As you know from our reports I have sent you I have been warning the Fed for 2 years that they were going to make this error. Last February and March I had many meetings at the Fed and I warned them that they were going to make the same error the same week in 1977 that they made in 1976, and the argument was given to me, the economy is booming and capital spending is late, but capital spending will follow soon behind.

And I said, no, it will not follow soon behind because you have aborted two recoveries; now you are going to abort the third.

The reason capital spending is not moving today is that the second segment of the economy cannot work until the first sector goes through. If we are going to let monetary policy abort three recoveries in 3 successive years, how in the world are we ever going to get capital spending for all of the reasons that we discussed here today.

To cut this short, because the hour is late, I now come to my conclusion on page 16.

One of the things that I am asking this committee to recommend to Congress is that we change the idea of fighting inflation by raising the price of money.

My thesis—and if we had more time, you will see a document in here—when you raise the price of money, that is the same thing as raising the price of wages and raising the price of a commodity. It is inflationary in itself. Just to raise interest rates falsely on an error compounds the problem.

What we are doing in raising the price of money under the guise of fighting inflation, we are fueling inflation.

I want to suggest that Congress adopt the Democrat philosophy of low interest rates and marry this with the Republican doctrine of a balanced budget.

I want to read a quote on page 16.

We used to think you could just spend your way out of a recession and increase employment by cutting taxes and boosting government spending. I tell you, in all candour, that that option no longer exists, and insofar as it ever did exist it only worked by injecting a bigger dose of inflation followed by a higher level of unemployment. That is the history of the past 20 years.

That was said on September 28, 1976 by James Callaghan, Prime Minister of England. And he ought to know.

From my conversations with people, increasing millions of American consumers have come to equate an unbalanced budget with more inflation—the root of inflation being deficit spending—that is, people tell me this.

They tell me, "Why can our Government not understand that they cannnot do what we cannot do?" The people say, "We cannot spend more than we make. If we cannot spend more than we make, how is our Government going to spend more than we make when it is our money they are spending?"

Senator BYRD. At this point, because it is such an important point, I want to interrupt you to ask this question. You do continually——

Mr. SINDLINGER. Every day of the week.

Senator BYRD. Polling day in and day out.

Mr. SINDLINGER. Thousands of people.

Senator BYRD. All over the United States?

Mr. SINDLINGER. Forty-eight States.

Senator BYRD. You are telling the committee that this is what you get from them?

Mr. SINDLINGER. This is what people are telling me. I am reporting what people are telling me.

Senator BYRD. You are reporting what people are telling you? The people do not understand how the Government can continue to live beyond its means when they themselves cannot live beyond their means?

Mr. SINDLINGER. A household that lives beyond its means winds up in one of two things, either bankruptcy or divorce or both, which is part of the reason for the high divorce rate.

What I am saying to you, people understand this. People simply keep saying, "Why does my Government keep spending money which they do not have?"

In 1971, the Government adopted temporary wage and price controls as a quick fix to stop the consumer panic over inflation. In 1977, you will make my forecast wrong if Congress will do this, but it will not—you can initiate a similar quick fix if you convince the American people that Congress finally has learned that you cannot spend more than you make.

Confidence will shoot up very fast. But we have got to get the hands of incompetent people off other people's money. We cannot permit the Federal Reserve Board to make errors based on faulty information. Which, as I have demonstrated, aborted three recoveries, one, two, three.

In baseball, if you strike out three times, you are out.

But the most shocking thing here, as I said, we have been burned on the same combination of short-term operations and all of the Government data is off because of the seasonal adjustment. You cannot take 5 years of bad data to seasonally adjust 1977. You cannot seasonally adjust the fact that the price of oil went up in November 1973. You cannot seasonally adjust the inflation rate. You cannot take the past 5 abnormal years and mathematically say that 1977 is normal.

It is an impossibility in the statistics.

I am going to ask Congress to do two things. This is my last sentence on page 19. Congress needs to do two things: Kill that seasonal adjustment snake so that the Fed cannot make any more errors and you must move the firehouse in your fight against inflation up from Constitution Avenue and put it up here on Capitol Hill where it belongs.

And the fight to stop inflation is to convince the American people that the Congress has learned its lesson about deficit spending.

I have some comments to make later. If you have any comments on the seasonal adjustment. I telescoped this pretty fast because the time is late.

Senator BYRD. That is a tremendously interesting presentation. I find the word "confidence" a number of places in your testimony.

What is the confidence index now?

Mr. SINDLINGER. Two weeks ago it was down to 36 and that is lower than the 38 that we had during the oil crisis in 1973. It is now up to about 38 percent.

The damaging part of our figures is that at the present time, as of last week, of the roughly 70 million households that we have in the United States, 29 percent of the households are reporting to us that their current income is down and 25 percent of the households are reporting to us that their current income is up.

That means that there are 4 percent more households reporting a decline in current income than an increase in income. We have never had a spread like that in 28 years.

It is impossible for the economy to move with more people every day joining the ranks of income being down because of inflation.

In my estimation—I am glad Mr. Rinfret mentioned this—in a report in about a month or two, I am going to show that the inflation rate right now is at about 11 percent.

As you know, Mr. Chairman, the Government was going to produce a new index for the CPI in April. It is not out. This is now June. That index is not going to come out for a long, long time for two reasons. They are having trouble with their seasonal adjustment; it does not work. But the real reason is—you will find it out sooner or later—the real reason is that our inflation figures are all wrong.

We have had double-digit inflation when we thought we had 6 percent inflation. Our Government figures upon which we are making decisions are wrong, specifically when they are seasonally adjusted and more specifically on the rate of inflation.

Education is a very costly thing these days. Do you know what the cost of living includes as a measurement of education? One thing—the cost of piano lessons. There is no educational measurement in the CPI except the cost of how much it costs to take a piano lesson. Taxes are not included in the CPI. There is no relationship in the CPI to the increase in taxes.

Senator BYRD. In looking ahead, I will ask you the same question that I asked Dr. Rinfret. In looking ahead 18 months, do you see greater inflation or less inflation?

Mr. SINDLINGER. I see astronomical inflation, then the damndest deflation you ever saw, with large bankruptcies among small businesses who are the ones that did the borrowing that misled the Fed. It was only the small businessmen who were borrowing.

When the Fed can take an action on the 6th of May to raise the interest rates, and today is the 14th of June which is only a month and a half away and they cannot make the interest rates stick, it proves it was an error. It is about time when we start running our Government on information that is correct.

It is about time that the Federal Reserve Board starts to learn what the hell it is doing.

Senator BYRD. On page 16 of your statement—incidentally, I think it is very interesting and significant that pages 16, 17 and 18, that you say this:

> From my conversations with people, increasing millions of American consumers has come to equate an unbalanced budget with more inflation—the root of inflation being deficit spending, namely, the people tell me this.

To me, that is very encouraging. If the people have reached that conclusion, eventually—not now, maybe, but eventually it will reach the Congress.

Mr. SINDLINGER. I think it is reaching your Congress now. I have a question that I ask people, one of the questions, the sequence goes like this:

> Do you know the name of your Senator? Most States, of course, only have two, so they have a chance of knowing. Do you know the name of your Congressman and in what Congressional district do you reside?

Then I ask people, "When is the last time that you ever wrote a letter to a Member of Congress?"

I used to get out of a week's interviewing of 1,000 people, 1,100 people, if I got 3 people in the Nation of that sample of 1,100 that told me that they wrote to their Congressman, that was a big number.

I am getting 25 and 30 every week telling me that they are writing to the Congress. Then I say, "What do you write to your Congressman about?"

Now, I learned many years ago in talking to a Senator and a House of Representatives Member, if you ask him what is in his mail, he obviously does not tell you. If you say to him, does your mail recently show an increased number of people telling you to stop spending my money, they will say yes, how did you know?

This is what people are writing to Congress about in increasing numbers. They want their Congress to stop spending their money because they know that the creation of inflation is deficit spending.

People use the word deficit spending. You cannot spend—and people even explain to us, look how much money it costs to finance that deficit spending. This is how intelligent people are.

Senator BYRD. That is very encouraging.

Mr. SINDLINGER. The message will get to Congress, but I am worried that there will be another recession before it gets there.

Senator BYRD. In reading, at the bottom of page 16 of your statement, I gather that you feel that one of the best ways to restore consumer confidence is for the Government to put its own financial house in order.

Mr. SINDLINGER. In one of these reports I have some information on the President. The President knows about public opinion polls as well as I do and he is very shrewd and very smart and very clever in telling the American people that we have to have fiscal responsibility. I might say that the President has helped germinate this germ.

There are no more Republicans and Democrats at the national level. That is why I want you to marry the philosophy of low interest rates on the Democratic side and the Republican philosophy of a balanced budget. That is the way that people perceive the problem.

If President Carter ever drops the thesis of fiscal responsibility, he is the deadest duck we have ever had in the White House, because that is what is holding him together.

The ironical part is that he is gaining from this desire of people to get some fiscal responsibility and if the Congress could telegraph to the American people that they realize that we have to have fiscal responsibility, confidence will turn up. But you cannot have the Fed knocking it down every time you get it back up.

Mr. JANEWAY. May I interject a question? I am very fond of this young man at my right. I know his work very closely.

For fear that you may take too much for granted, may I ask you how long, for how many years, have you been picking up in your telephone work echoes of support of the concept of fiscal responsibility?

Mr. SINDLINGER. Since about 1966.

Mr. JANEWAY. Has it been growing steadily?

Mr. SINDLINGER. Every week.

Mr. JANEWAY. Did it grow with particular steadiness since 1973?

Mr. SINDLINGER. In 1972 was the one period of time where people thought we had fiscal responsibility and then, in 1973, the demand for it—you see, in 1972 when we had the wage and price freeze and the rate of inflation was 3.5 percent, we had 9 out of every 10 people in America having complete trust in the Government. That is the last time we have ever had 9 out of 10 people having trust in their Government.

Right now, if you will find 1 out of 10 that has trust in his Government, he is probably on the Government payroll.

Senator BYRD. It is really as low as you indicated, when we started from 9 out of 10 in 1971?

Mr. SINDLINGER. Nine out of ten people in 1972, on the day Nixon was elected. I had a long talk with him the week after that. I said, you know, you are the only man in the United States who voted for Nixon and did not know why you voted for him. He did not have the slightest idea why he was elected—because inflation was 3.5 percent and people thought that their Government was responsive to the people.

Senator BYRD. Do you find now that trust in Government is down to 1 out of 10?

Mr. SINDLINGER. If you get 11 to 12 percent you are pretty lucky. That is roughly 1 out of 10, and most of those are on Government payrolls.

Senator BYRD. You say for the first time we have large growing numbers of people simultaneously expressing the Democrat philosophy of low interest rates and the Republic doctrine of a balanced budget. Let me ask you two experts, Do not the two go somewhat together? Does not a balanced budget tend to bring interest rates down?

Mr. JANEWAY. It would guarantee it.
Mr. SINDLINGER. That is the logic of it.
Mr. JANEWAY. It would guarantee it.
Mr. SINDLINGER. It would guarantee it.
Mr. JANEWAY. We would not need a balanced budget, as a practical matter, if we brought the Treasury's demand on the money market each fiscal year down under $25 billion. Young people would again be able to get a mortgage on a home for 30 years for 5 percent.
Senator BYRD. What the two of you are saying, as I understand it, is that these tremendous deficits, besides being inflationary, also are forcing the interest rates up?
Mr. SINDLINGER. Because it adds to inflation.
Senator BYRD. Which in turns adds to inflation.
Mr. SINDLINGER. It fires inflation. It is like throwing gasoline on a fire to put it out.
Mr. JANEWAY. The Government is the one borrower in this system whose interest rate charges are absolute and not deductible because the Government is not a taxpayer.
Mr. SINDLINGER. The only nontaxpayer.
Mr. JANEWAY. Tax-free institutions, like pension funds, do not borrow, but the practical incentive for borrowing, is that the borrower who is solvent and has earnings is able to take them as a tax deduction. This is not true for the Government, and the Government has been paying rates, which compounded, are insupportable and which become direct diversionary charges apart from the Government's own obligations to meet other charges on the budget.
Mr. SINDLINGER. You see, on Friday, May the 13th, on the Friday, that prime interest rate was raised. I asked a question that night, what news event people recalled from the evening news; 68 percent of the people in the United States told me that the news event they remember was that the prime interest rate went up, or interest rate was raised.
The next question was, what does this mean to you?
Well, our buying plans for a new car are shot up and our buying plans for a new house of over $100,000 is shot up. I had better run out and get that big car and I had better get that big house before the mortgage rates go up.
This is how sensitive people are to the suggestion of a rise in interest rates. Because to people, not just to statisticians and not to economists, not to the Fed, people can see a raise in interest rates as inflation of money, which is exactly what it is.
People perceive it that way. Everytime you raise interest rates artificially, that would be about the economy, if you only did it as monetary policy. When you do it by mistake and then later admit it—Burns admitted he made a mistake in 1975; he admitted he made a mistake last year in 1976; and next February he will not be here, but maybe a mistake in 1977.
Three times in a row is enough.
Senator BYRD. Let me ask you a question and change the direction for a moment. In the tax area, what two or three substantive tax measures would increase consumer confidence and provide for greater economic growth?

Mr. SINDLINGER. One simple thing: fiscal responsibility and the proof that we were going to balance our budget. Nobody expects the budget to be balanced tomorrow, just proof from Congress that Congress understands how money works, how people live, that you have to live within your means and confidence will turn up.

Rinfret said it today—there is plenty of money around. Business executives are people just like consumers. They are insecure. They do not want to spend.

Just think of it. We have $8 of every $10 right now being saved out of fear. That says recession.

Mr. JANEWAY. Beyond that, beyond the confidence factor, it is impossible to demonstrate that you can get your costs back on any investment today.

I testified, as I did earlier, in full knowledge of the Sindlinger results. Sometimes it pays to draw analogies from countries in worse trouble.

In Britain, the phrase "social contract" is now common in the press. I refrained from using it in my statement, but I think, especially in light of these forceful findings, that we could propose realistically a social contract between the government and the people to allow partial equalization on the installment plan of what corporations get in the form of dividend exclusions. We will give you this for starters. We will give you more if you support this, and we bring government borrowings down.

I do not think anyone believes that if there were this reform, it would provide a free lunch. It would cost a lot of money.

I know that Bert Lance is very sensitive in his support of this measure. The trick is to pay for it without running up the deficit all over again.

I think, as I said, we demonstrated the soundness of the formula once in the day of your father. I think you would really create a lobby, a public lobby, that would make itself heard and be appreciative if you began to go in this direction.

Think of the number of people now withdrawing from a pension fund on retirement.

[You have got 2 million widows in their 60's living on $2,000 a year. Hair-raising.]

We are wasting all of these dividends, in a sense, on tax-free institutions now, which do not pass them through. By the time the beneficiaries go into retirement they are past any ability to make a contribution to the income stream, but if Sindlinger is right, if the President's feet are to the fire, if he must stay committed to fiscal responsibility and we are to hope for any expansion in expectations on the performance of the economy, the tax credit must come from the private sector, which means it must come from equity investment, which means it must come from people expecting take home pay in the form of dividend income for what they take out of the savings institutions.

Senator BYRD. At what rate would you put the rate of inflation today?

Mr. JANEWAY. I think 6 percent is a fiction. I have a stock answer on this. It depends on whether you have your health or have children in school. I would say for people who are running up health bills and education bills, it is much closer to 25 percent a year, taking the two together.

Senator BYRD. Taking it overall for the average citizen?

Mr. JANEWAY. I think it is over 10 percent.

Mr. SINDLINGER. I have it at 11.5 percent. It was never down to 6.

Mr. JANEWAY. The condition of interest rates really tells you that it is higher than stated in the statistics. The statistics have become a bromide, a very misleading bromide.

In fairness to Dr. Burns, of whom I am very fond, it wants to be remembered that when he was on our side of this table, it was he who coined the term "Seasonally adjusted, the Great Lakes never freeze."

Again, in fairness, the Chairman is very sensitive—I discussed this with him at length. He is sensitive to the propensity in the profession and in the Government to overemphasize the seasonal adjustment of the raw figures.

He is aware of it, but the wheels grind too slowly. We are in a race against time on this one.

Senator BYRD. One final question.

Yesterday this committee had a hearing on the administration's proposals in regard to social security. It proposes to dip into the general fund to the Government, partial financing of social security. My impression, and I will have to give it more detailed study, but my impression of the proposal yesterday is that what was being proposed was being proposed on an unsound basis and, if we followed that proposal, the social security will end up even more unsound than it is today.

My question is, Do either of you have any thoughts in regard to what we should do in regard to social security and, No. 2, how deeply concerned are the American people as to the solvency of the system?

Mr. SINDLINGER. I want to tell you about a phone call. I cannot remember the date. It was within the last month and at 4 o'clock in the morning my home bedroom phone, which is an unlisted number, rang, and a woman was hysterical. She called me from a small town outside of Seattle, Wash. We had interviewed her earlier in the evening and one of the questions we asked was the standard question, "What do you recall reading or hearing about in today's news?" and she had responded that she had heard that social security was going broke.

She spent 4 hours, and even talked the local long distance operator into giving her my number because she was so hysterical. She said, I cannot go to sleep because how am I going to get my next month's check if social security is broke?

What I am trying to say, Mr. Chairman, is that Congress has to be very careful in the social security discussion, because we are going to scare the hell out of people, because that problem is now worse than it was 10 years ago. She just got that idea on the evening news. There is going to have to be some responsibility in the networks in the handling of this problem.

Mr. JANEWAY. The social security system was never meant to be funded as a transfer payment system, not like an insurance company. Consequently, to raise the question as if it were unfunded is as irresponsible and incendiary as starting a run on the banks by saying they do not have cash on hand equal to all their deposits.

If you are going to have 40-percent unemployment among young nonwhites, you are going to have a problem with social security.

The only way social security can really go broke is if we run out of young entrants into the work force. We do have a demographic problem and gradually its seriousness will assert itself.

But it seems to me there are remedies. The place to scoop up that kind of cash in abundance is in the retail stream. A national sales tax probably would not sell, but in view of the concern about the bite imports are taking out of employment if we went the way I believe Chairman Long is inclined to go, if we went to the value-added tax saying that we were putting ourselves in compliance with GATT, we would then be in a position to put on an import tax that was not going to be considered a tariff. We would give an export rebate, which we need to have given anyway, and we would have access to a tremendous handful of money domestically which I do not believe would raise the cost of production.

Of course, the Europeans have the value-added tax without the income tax. In our case, if we were to go to it, we would have it because we have run out of the capacity to load new income taxes upon the system.

I am unreservedly against any proposition for an employer tax on social security.

Senator BYRD. This new program is built around that along with tapping the general revenues. As Chairman Long pointed out yesterday, in talking about financing social security out of the general fund, we do not have anything but a deficit in the general fund. What you are doing is financing it with printing press money.

Mr. SINDLINGER. In relationship to this conversation, I would like to cite something. In every other recession we have ever had before it always started with the big companies, the automotive companies first and then the housing industry second and then the small businessman being hurt third. It always started with the big corporations being hurt first.

We are sitting here today with the big corporations fluid with money because they do not want to spend it through capital spending.

Mr. JANEWAY. They are underselling their own banks by lending excess capital.

Mr. SINDLINGER. The interest rate came down because there is no demand for money. That is the only reason that it came down.

Mr. JANEWAY. You have corporations lending over half a billion dollars a day each to the short-term market that has been earmarked for new projects. These same corporate lendings to the market are undercutting the banks from which these corporations have commitments to take borrowings.

Mr. SINDLINGER. Let me add to this. What I am observing now is a fundamental error in our Government retail sales figures, because chainstores, over the last 10 or 15 years are getting bigger and bigger and they have accurate accounting of their income.

Little merchants who were in the sample are going out of business. They cease to report because they are no longer in business.

The Government is not picking up the small businessman. We do not know how many small businessmen have already gone broke and all they have to do is go to any city in the United States, big or small, and look at the empty stores downtown. And when you are going to add to the small businessman the tax for paying for social security our next recession will begin with bankruptcies of the small businessman first.

Mr. JANEWAY. Mr. Chairman, you could take the economy up briskly another 10 or 15 percent and large corporations would not want to add significantly to employment. The unions would be happy with that preference: they would prefer overtime to more hiring.

But your small businessman, your small businessperson, would be completely boxed out of any ability to hire new people. If you did not increase his social security burden and you went up 10 percent in the economy, small business would be forced to hire a lot of people. It would be happy to hire a lot of people.

That, as I testified earlier, is your first opportunity to add to employment, and I think significantly to nonwhite employment. Increasing the social security tax to employers would be the most counterproductive measure I could think of, that plus advertising the unfunded condition of the program that was never meant to be funded.

Senator BYRD. There is no practical way and not enough money in the world to make it funded.

Mr. JANEWAY. That is right.

Mr. SINDLINGER. I have one more quick point. We have the idea that unemployment and inflation were two separate problems. I would just like to close with reminding the Congress that unemployment is a result of inflation, of people pricing themselves out of a job. That is why we are not getting unemployment to move.

Senator BYRD. My feeling has been for a while now, quite a while now, that the greatest long-term threat to the people of the United States is inflation.

Mr. SINDLINGER. It is the only problem. Every other problem we can solve.

My point is that inflation is created by deficit spending based on faulty monetary policy.

Senator BYRD. Let us end on that note, and thank you, gentlemen.

[The prepared statement of Mr. Sindlinger follows. Attachments to the statement were made a part of the official files of the committee.]

STATEMENT BY
Albert E. Sindlinger
Chairman Of The Board

Sindlinger & Company Of Media In Pennsylvania

I am grateful for the opportunity to testify before your distinguished Committee --- to present the case of the American people --- in your vital considerations on --- incentives for economic growth and capital spending.

The distinguished witnesses ahead of me have made important contributions to your research in the form of learned thought.

But none has the vantage point which I enjoy --- as the head of the nation's only free enterprise organization which is in continuous and daily contact with the American consumer --- by the medium of public opinion research --- talking to people.

The people of this nation --- as human beings and potential voters --- are too often ignored in critical discussions, such as your Committee is engaged in today.

But, it is people who are directly affected by whatever policy government --- including the Federal Reserve Board --- eventually produce.

And it is people who in the end will determine whether government set policies --- work or fail.

The worthy goals that this committee seeks must begin with favorable actions by people in whom you must instill economic confidence.

Let me paraphrase and modernize on what a wise economist wrote in the 1930s:

> When the monetary authorities in the government of the world, especially within the United States --- can figure out, and stop to think out --- how to stop creating recessions (like the newest one just inspired for 1977) the task of Congress will become relatively easy to create incentives for economic growth.
>
> Author: Dr. Ralph G. Hawtrey
> Teacher of Keynes -
> Underline is Sindlinger's add.

I submit, based on my reading of history, including the 28 years of consumer generated data that my company has personally compiled, that the means to this understanding can start today.

I have concluded that all recessions --- just like all inflations --- are provoked and fired by faulty monetary policy.

Recessions --- 1) simply don't just happen --- and, 2) are not functions of a natural inescapable supply/demand cycle.

Recessions and inflations are man-made --- by errors in government inspired monetary policy.

As I address you, our nation is currently suffering the ill-effects of just such a recent mistake.

During May, the Federal Reserve Board (Fed) needlessly adopted a monetary policy of too much restraint that was manifested particularly in a rise in interest rates.

This recent restrictive stance resulted from a complete misjudgment by the Fed on the strength of the American economy.

It was a mistake that could have been avoided --- the consequence, will take long to erase.

Our Fed, yours and mine --- was misled by artificial statistics --- both on

--- the nation's economic strength and,

the growth of the money supply aggregates, which the Fed has the responsibility to measure and report each week.

Like every government agency --- the Fed relies strictly on seasonally adjusted, or so-called "official" data, to make decisions --- that affect all the people.

These seasonally adjusted data in recent years contain a very fundamental flaw which has resulted in the creation of misleading information --- upon which vital government decisions are made. (See exhibits attached.)

These errors apply to all government figures.

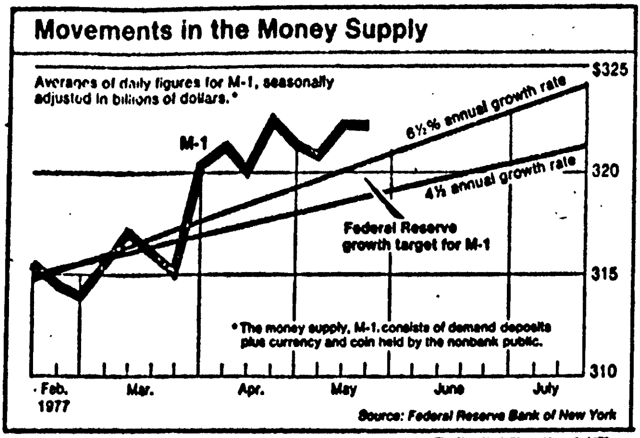
Not only for the Fed's figures --- but for all "official" seasonally adjusted government figures, unemployment, retail sales --- every figure included in the monthly data computed.

This is the crux of the problem --- let me illustrate what I mean.

I present here a chart published in the *New York Times* of June 9, 1977 to support an article defending the Fed's May action.

According to this chart, the M1 money supply aggregate skyrocked in April and surpassed the upper limit of the Fed's long-term target growth range for this aggregate --- as illustrated.

Reprinted from *The New York Times* --- June 9, 1977



The New York Times/June 9, 1977

This chart does not tell *Times* readers --- that the short-term growth ceiling, the level at which the Fed would start to move interest rates upward, was 10 percent --- according to the minutes of the Open Market Committee meeting for April.

According to the chart, and all press reporting --- the Fed took action to raise interest rates in May --- because M1 was growing at a four-week annual rate --- in excess of 20 percent.

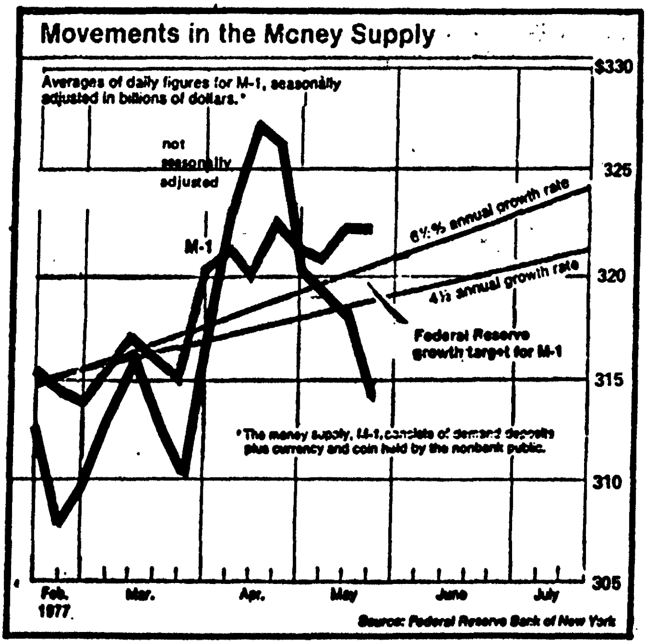
If those figures had been correct --- the Fed action was entirely proper.

But the figures used in making this critical decision --- that affected all the people --- were statistically artificial and are categorically wrong.

Thus, the decision was wrong.

If the Fed's money managers --- had taken time to just read their own raw figures the actual money counted --- and,

as we have done, plotted them over the figures shown in the *New York Times* chart, the Fed's money managers, would have come to an entirely opposite conclusion --- and,



there would have been no abortion of the recovery in May 1977.

At no time in the 29 weeks from November 24, 1976 to last Wednesday --- did raw M1 figures as counted --- grow on a year-to-year basis by more than 7.3 percent, and

growth was below 7 percent for the last 20 weeks --- that's certainly nowhere near 10 percent action level.

One can see the self-imposed handicap under which the Fed was working to make this momentous May error. They did not read their own figures.

Date	M1 Not Seasonally Adjusted		Growth Rate	Per Household In Dollars	Per Household Growth Rate
Nov. 24, '76	$308.7	billion	4.6%	$4,492.34	2.2%
Dec. 1, "	314.2		4.8	4,572.38	2.3
Dec. 8, "	318.3		5.8	4,618.33	3.1
Dec. 15, "	320.7		6.0	4,663.15	3.3
Dec. 22, "	322.3		6.5	4,676.37	3.7
Dec. 29, "	323.0		5.2	4,686.53	2.5
Jan. 5, '77	331.9		7.2	4,787.32	3.9
Jan. 12, "	326.9		7.3	4,715.20	4.0
Jan. 19, "	321.6		7.1	4,638.75	3.8
Jan. 26, "	311.6		6.6	4,494.51	3.3
Feb. 2, "	311.1		5.5	4,485.04	2.2
Feb. 9, "	312.5		6.0	4,502.22	2.7
Feb. 16, "	312.3		6.1	4,502.34	2.8
Feb. 23, "	307.5		6.7	4,433.14	3.4
Mar. 2, "	309.3		5.3	4,458.31	2.3
Mar. 9, "	313.3		5.2	4,515.97	2.6
Mar. 16, "	316.1		6.5	4,558.33	3.5
Mar. 23, "	312.0		6.6	4,497.23	3.5
Mar. 30, "	309.9		4.9	4,466.96	2.0
Apr. 6, "	323.0		6.9	4,654.98	4.1
Apr. 13, "	326.5		6.5	4,705.42	3.7
Apr. 20, "	325.4		6.0	4,689.57	3.2
Apr. 27, "	319.6		6.7	4,605.96	4.0
May 4, "	318.6		6.2	4,577.86	3.4
May 11, "	317.2		5.6	4,567.73	2.8
May 18, "	317.7		6.6	4,564.92	3.8
May 25, "	313.5		6.2	4,504.57	3.4
June 1, "	316.5		6.3	4,547.68	2.6

The per-household figures are Sindlinger's concept; just divide the Fed's figures by the number of households Sindlinger is sampling each week.

The Fed was not only using unreliable long-term money figures to begin with --- ignoring the above --- but was applying them to a short-term period when the distortions are even worse.

Therefore --- my first recommendation to this Committee in its report to Congress in planning for the nation's economic future is this:

Congress must either junk the seasonal adjustment procedure for all "official" data or,

at the very least order the side-by-side publication of every parallel shred of raw data gathered by the government.

This will at least give policy makers --- including the Fed a chance to see the FACTS alongside of that wrong seasonal adjustment.

Congress and the nation cannot proceed to the future with any degree of intelligence --- unless we know where we currently are --- and stop making monetary policy error.

With accompanying (later defined exhibits) we explain in more detail just why the seasonal adjustment has misfired only in recent years.

In brief: Seasonal adjustment factors for any given year are calculated by reaching back five years or 60 months and averaging out the economic trends for that span.

Thus, the factors presently used by the Fed and all other government agencies are based on the actual abnormal situations of the five years --- 1972-76.

The seasonal adjustment process would be viable if the factors reflected by the past 60 months were relatively normal.

But the 1972-76 period was characterized by a continuing series of monthly aberrations, such as: oil embargo price rise, energy crises, recession, double digit hyper-inflation, consumer hedge buying, a super economic boom at the beginning of the period and a seemingly mysterious sawtooth economy at the end --- where erroneous and admitted Fed actions aborted the 1975 and 1976 recovery.

It is impossible to strike any long-term average of aberrational statistics and then apply these abnormal aberrations to figures for a subsequent year in which it has no real relevance.

These aberrations are weighing excessively on the 1977 seasonal frctors and they are causing the process to generate misleading and erroneous statistics and erroneous monetary policy decisions.

The simple attachment of the word government "official" --- to these data doesn't cover up the basic errors within these errors.

I am here today to basically make two points.

- . . . First, which I already have discussed ---,is a plea that Congress substitute common sense real figures for the artificial manipulations of the seasonal adjustment that are now ruling the decision making roost.

- . . . Second point I want to make --- is that the battle against the flames of inflation are being waged from the wrong firehouse.

The inflation fire fight should not be waged at the firehouse down on Constitution Avenue but right here on Capitol Hill.

The Fed by raising interest rates or raising the costs of money as its way to fight inflation has demonstrated how its only weapon to fight a fire is to pour gasoline on it.

The Congress, I believe, has enough sense to use cold water, instead of inflammables.

Besides being panicked by the wrong information on monetary growth just a month ago, the Fed also was goaded into boosting interest rates by the faulty belief that bank credit was expanding too rapidly.

On this point, the Fed, to a great degree, also was trapped by the seasonal adjustment flaws, for seasonally adjusted --- bank loans are up.

But even if these data were precisely right, which they are not, we fear that it would be misinterpreted.

And, this is a point which bears directly on your quest for policies to promote capital expansion and capital formation.

A growth in bank credit or loans are often taken as hopeful signs of increased capital spending.

Such a credit growth can finance capital spending and is necessary for capital spending --- but this is not always the case.

An alternative reason for increased borrowing in very plainly a cash shortage.

Most of the businesses which are now borrowing --- are borrowing simply to survive, forced to borrow because of falling income. Some in the South and Southwest are, however, borrowing for hedge-buying expensive home building.

Increasing numbers of small businesses are now borrowing simply to survive, forced to borrow because of falling income due to the inflation cost squeeze.

In fact, our data suggest that any actual increase in demand for credit is actually resulting from a drying up liquidity.

Chief among these borrowers is the farmer, the small businessman, the small retailer --- all of whom have been stung by falling income and by the competition of the over-extended shopping malls --- added to buy inflation.

Visit any center U.S. city --- big or small --- and count the increasing numbers of vacant stores. A vacant store is a business quit.

And put the 2 of every 3 U.S. consumers among this group, inflation squeeze group, where most consumers are borrowing either for hedge-buying to beat inflation, or to pay unexpected bills.

We are submitting to you under separate cover a special issue of Sindlinger's *Economic Service* which documents the slippage of incomes among consumers and how this is dragging the entire economy.

And within this disturbing situation is the main reason that we have yet to enjoy that long-awaited capital spending boom.

It is generally agreed that each economic recovery (after wrong monetary policy makes a recession) comes in two stages when the rebound is in a typical V shape.

...The consumer moves first. He regains confidence through expectations of greater Household Money Supply (HMS) and an optimistic view of job security.

This allows the consumer to loosen up and begin spending in a way that will absorb excess supplies that have been produced by business from wrong monetary policy which created the recession in the first place.

Once most of the excess has been absorbed we are ready for the second stage --- which is an outgrowth of capital spending to enlarge productive capacity for meeting the consumer's demand.

Capital spending has a highly beneficial effect --- the money expended on it serving to further stoke the economy in the first place, the jobs and incomes it ultimately provides keeping the expansionary pace going over the longer term.

In the final analysis, the most important long-term effect is the creation of new jobs.

For the new jobs mean places for new entrants in the labor force, and they provide incomes that can be recycled into the economy to expand capital formation.

Why hasn't this second stage taken place in 1977?

Why has it been so long overdue? --- continually hoped for --- so elusive in coming?

Basically it is because conditions under our knee jerk monetary policy changes have never allowed the first or consumer-led stage to reach its optimum point.

A principal reason is inflation which has;

1) continued to cut into the availability of disposable funds for U.S. households and

2) instilled fear into people forcing those who can --- into a record rate of savings instead of spending i.e., *hoarding* capital.

Remember --- the economy really works like this ---

. . . faulty monetary policy which excludes any understanding of people ---

first create a man-made recession.

. . . first stage of any recovery from recessions comes from the consumer sector

. . . then the capital spending sector takes over.

But, for the past three years --- the Fed kills off the consumer sector from completing its job --- and has never given the capital spending sector a chance to start its function.

Here is where the Fed's last three annual spring-summer exercises in explosive fire fighting under the guise of interest rate futility --- have been damaging by aborting each consumer-inspired recovery.

In each of the past three years as the Fed raised interest rates, the consumer was gaining confidence and beginning to spend while some of his/her inflationary fears were subsiding.

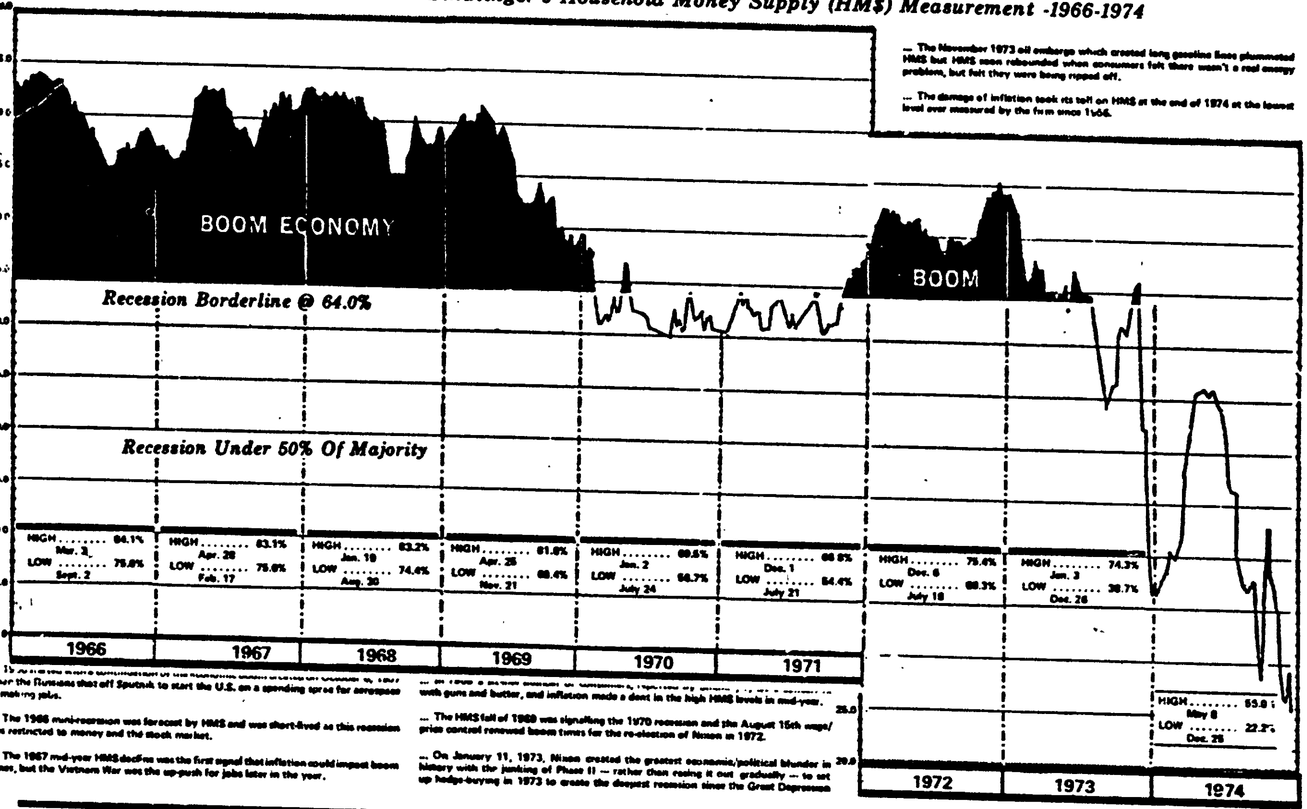
It was a torturous process at best and needed every bit of encouagement.

Instead, the Fed raised interest rates with an error --- to abort consumer spending and thereby killed each consumer-inspired spending recovery --- to delay capital spending.

So we can be reminded, what was going on from 1966 through 1974, --- we reproduce this chart from Sindlinger data.

92-201 O - 77 - 22

9 Year Week-By-Week Trend In Sindlinger's Household Money Supply (HM$) Measurement -1966-1974



— The November 1973 oil embargo which created long gasoline lines plummeted HMS but HMS soon rebounded when consumers felt there wasn't a real energy problem, but felt they were being ripped off.

— The damage of inflation took its toll on HMS at the end of 1974 at the lowest level ever measured by the firm since 1966.

— ... when the Russians shot off Sputnik to start the U.S. on a spending spree for aerospace — making jobs.

— The 1966 mini-recession was forecast by HMS and was short-lived as this recession was restricted to money and the stock market.

— The 1967 mid-year HMS decline was the first signal that inflation could impact boom times, but the Vietnam War was the up-push for jobs later in the year.

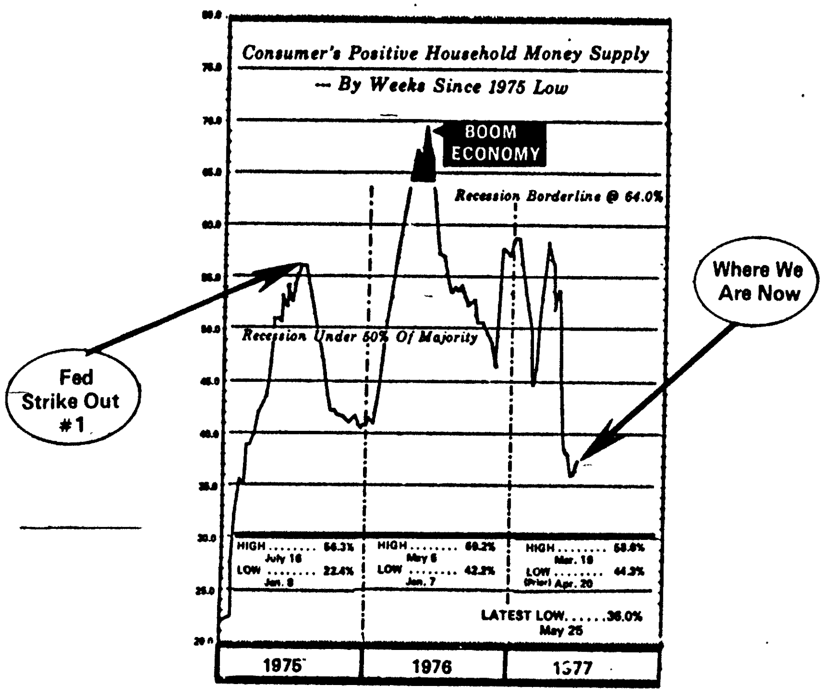
— ... with guns and butter, and inflation made a dent in the high HMS levels in mid-year.

— The HMS fall of 1969 was signalling the 1970 recession and the August 15th wage/price control renewed boom times for the re-election of Nixon in 1972.

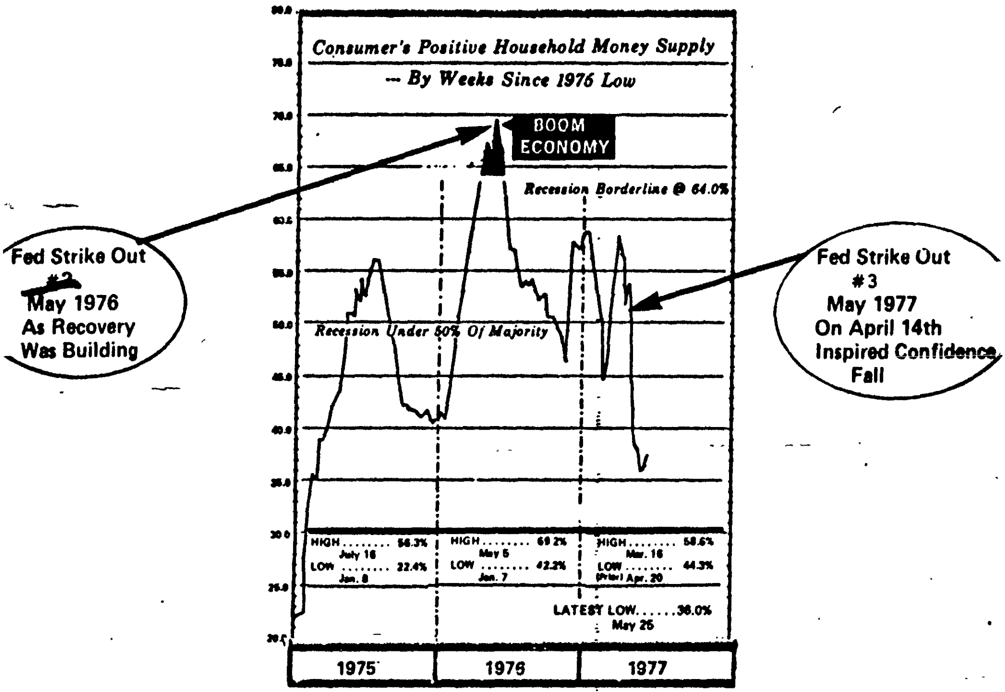
— On January 11, 1973, Nixon created the greatest economic/political blunder in history with the junking of Phase II — rather than easing it out gradually — to set up hedge-buying in 1973 to create the deepest recession since the Great Depression

The Fed refuels inflation --- throws gasoline on it --- by raising the cost of money --- on some mystic theory that you control inflation by falsely making the cost of money go up.

The facts are --- raising the cost of the price of money affects people as inflation reintensifies --- the consumers grow fearful again, spending slows down and fear savings resumes growth --- and the economy is aborted --- capital spending is postponed.



As this chart shows our Household Money Supply (HM$) a measure of consumer confidence rebounded with the 1975 tax rebate talk and reality and was on its way to full recovery in July 1975 --- and, when the Fed overreacted to the seasonally adjusted growth of the money supply in mid-year --- threw gasoline on the fire --- by raising the price of money --- and HMS turned down --- Fed strike out #1.



By late 1975 --- consumers regained from their Fed-inspired shock --- confidence rose --- the stock market with it and by March HMS had us out of recession for second year's try --- and wham --- Fed in May 1976 again misread their seasonally adjusted money supply figures --- strike out #2.

And I have already defined strike out #3 the Fed made last month --- in baseball, three strikes is OUT.

From my continuous daily interviewing of people --- I have come to the conclusion --- that on a national level, there is no longer a real Democrat or Republican party.

What I see --- in formation is an unorganized and leaderless coalition cutting across all sides of the spectrum --- as a new people's party.

And the common denominator among all these people is the adoption of a unique strategy for bringing down inflation.

For the first time, we have large and growing numbers of people simultaneously espousing the Democrat philosophy of low interest rates and the Republican doctrine of a balanced budget.

In connection with this --- I include this very unnoticed quote.

We used to think you could just spend your way out of a recession and increase employment by cutting taxes and boosting Government spending. I tell you, in all candour, that that option no longer exists, and insofar as it ever did exist it only worked by injecting a bigger dose of inflation followed by a higher level of unemployment. That is the history of the past 20 years.

That was said on September 28, 1976, by James Callaghan, Prime Minister of England. And HE ought to know.

From my conversations with people, increasing millions of American consumers have come to equate an unbalanced budget with more inflation --- the root of inflation being deficit spending --- i.e., people tell me this.

They are demanding a change and Congress is the only force of government that can provide this change.

In 1971, the government adopted temporary wage and price controls as a quick fix to stop a consumer panic over inflation.

In 1977, you can initiate a similar quick fix with a balanced budget. Make it a fact and watch Consumer Confidence do its job and watch capital spending grow.

That's is why I implore Congress to take over the fight for inflation and start by balancing the budget.

The Fed which is trapped in the flaws of the seasonal adjustment can't do the job by pouring the gasoline of high interest rates on the flames of inflation whenever they feel like it. Then when the error is clear say SORRY, we don't know what we are doing.

Why I want the firehouse moved from Constitution Avenue up to Capitol Hill where we are now -- is because the managers of the nation's money supply cannot even read their own raw counts of money -- and what the impact of these wrong decisions have on people -- never occurs to them -- they are Monks isolated in a monastery.

The Fed erred in two ways. First it chose to make a critical decision on an isolated four-week period when a far more important consideration was the longer range trend of money supply growth -- over three months, six months, even a year. Then the Fed compounded the error by using faulty and artificial seasonally adjusted data whose flaws would have been easily discovered by a quick look at the actual money figures gathered from member banks.

But most shocking is that this is the third year in a row that the Fed has been burned by the same combination of short-term aberration and mistaken data at the same point in time.

During 1975, the Fed needlessly raised interest rates and aborted an economic recovery. We warned the Fed on this error before they did it.

It committed the same mistake last year in the same week as this year --- even though we had warned them of a probable error as early as the summer of 1975 --- and they didn't listen then.

It is obvious after three such strike outs each year that there is a fundamental error in the seasonal adjustment, the process used to generate "official" figures for every agency of the government.

--- And Congress better get rid of that quick.

If Congress will not act on that now --- come next October, as all will read about the seasonally adjusted pause in the economy this summer (now) and as the economy is faltering the second half with seasonally adjusted unemployment rising --- Congress will get the message.

An unbalanced budget is as much an anathema to the American consumer as high interest rates. It keeps his taxes high, his government wasteful, his confidence down.

He and she know the government must borrow to balance the budget, thereby keeping interest rates up and depriving the economic mainstream of job-producing capital.

In short the combination of high interest rates and unbalanced budget reduces the value of everyone's money and destroys confidence.

Under these conditions, the consumer cannot and will not lead an economic recovery in the first stage so that capital spending can follow.

Looking at the problem from all angles, we also have observed that there is a basic disenchantment by Americans over their inability to share in the profits of the nation's great corporations.

About a third of American households, we calculate, have stockholders. We know a lot about these and the non-stock owning households.

But even when this minority gets dividends, it is penalized by double taxation --- first on the corporate profits themselves later on the dividends received by individuals.

We are convinced there is a better way to allow the nation's citizens to achieve a great and more satisfying return for their own labors --- all of the people.

This is to alert your Committe and Congress, Mr. Chairman, that Sindlinger & Company of Media in Pennsylvania is now in the process of conducting extensive objective surveys of the consumers of the nation on their ideas for more constructive monetary policy.

--- One which will restore *Confidence* in money ---

make capital spending grow by offering the nation's people an opportunity to observe and financially benefit from their nation's free enterprise system which can be made to work better for them.

Mr. Chairman, we will keep you informed on this project --- as we have on many other occasions over the years.

Thank you --- and please get Congress to do two things ---

. . . Kill that seasonal adjustment snake.

. . . move the firehouse for inflation fighting up here on Capitol Hill where it belongs .

[Thereupon at 2:20 p.m., the subcommittee recessed to reconvene Wednesday, June 15, at 9:30 a.m.]

INCENTIVES FOR ECONOMIC GROWTH

WEDNESDAY, JUNE 15, 1977

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
GENERALLY OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice at 9:30 a.m. in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. (chairman of the subcommittee) presiding.

Present: Senators Long, Byrd, Jr., of Virginia, Curtis, Dole, and Packwood.

Senator BYRD. The hour of 9:30 having arrived, the committee will come to order.

This hearing today is the last of a series of four hearings on the issue of incentives for economic growth in America. Each of the witnesses who have testified before this subcommittee has been helpful in providing us with a perspective on the issue of capital formation today. Their contribution has been significant.

The administration plans to submit a package to the Congress which seeks to achieve the goal of tax equity, tax simplification and business capital formation. I support these goals and commend the administration for the effort which it is making.

While supporting the goals, I want to, of course, reserve judgment on the details.

No tax package will succeed unless it is conceived and planned in an open process where the views of the American taxpayers, small businesses and large business, and Congress are given full consideration in the formulation.

The administration has said that it wants its policymaking process in the open, in the sunshine, in the public arena. These hearings present them with the perfect forum.

I hope very much that the administration will freely, frankly, and in detail let the Congress and the public in on the process. We need to be working on these problems at the same time and in the same depth, the Treasury, the White House and the Congress and the family and business circles.

In the area of capital formation, the momentum toward eliminating the double tax on corporate dividends seems strong and the potential for future growth in our economy from such a proposal is great. But, the implications of the various approaches to this proposal should not be overlooked.

Furthermore, a capital accumulation package which rearranges the component parts of our tax system but fails to provide for an increase in the overall level of funding for capital growth does not address the problem.

A program which seeks a tradeoff between the introduction of the integration of the corporate and personal taxes and the elimination of other incentives, such as the current tax treatment of capital gains, could very well leave us where we are today, or actually impede future capital growth.

We must remember that corporation and businesses are the people which compose them. If we are able to provide for the greater productivity of our corporate and business sector, we would also be providing for jobs and income for our workers and goods for our customers. To achieve these goals, however, we need to provide for future business investment.

The future that we want for ourselves and our children requires enlargement of the capital base. We must remember the most significant factor affecting private capital accumulation is massive Government spending which is occurring today.

We are sending to the Federal Government an inordinate proportion of what might be available for savings and investment.

We can no longer tolerate large Federal deficits year after year. Such a program only invites Federal expenditures whose benefits to the American people will not be worth the cost.

For our American economy to prosper and grow, we need a stable economic environment free from inflation and large Federal deficits. The ultimate solution to our problem of capital formulation will occur when the Government exercises the physical discipline and responsibility necessary to reduce Federal spending and decrease our Federal deficit.

I want to make the point that many groups who are not testifying at these hearings plan to submit written statements: the AFL-CIO is one such group who was invited but will submit a written statement. We are keeping the record open until July 1 to accommodate as many of these groups as possible.

I am also specifically contacting the National Association of Manufacturers, the U.S. Chamber of Commerce, the American Bar Association, American Institute of Certified Public Accountants, in the event that they may wish to submit written comments.

Now, we will deviate slightly from the program outlined for this morning. The first witness will be Dr. Laurence Woodworth, Assistant Secretary of the Treasury for Tax Policy.

Dr. Woodworth, we welcome you to the committee. You may proceed as you wish.

STATEMENT OF LAURENCE WOODWORTH, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. Woodworth. Thank you, Chairman Byrd.

First of all, I would like to thank the graciousness of my colleagues for letting me appear first so that I can get over to a markup session where my attendance is required. I would like, Mr. Chairman, if I may, to insert my full statement in the record, but read excerpts from it.

Senator Byrd. Your statement will be published in full in the record.

Mr. Woodworth. I should first note that capital formation is not solely or perhaps even primarily a tax issue. We must look to more fundamental reasons to understand why our present rate of investment is deficient. In the aftermath of a major bout with both inflation and recession, it perhaps is not surprising that business confidence has not yet fully recovered.

Uncertainty concerning opportunities for expansion of markets, as well as, the thrust of future government policies is not easily dispelled. In this climate, general monetary and fiscal policies to reinforce the recovery of the economy in a noninflationary manner may be more important than specific structural program changes. Nonetheless, it is still possible to define a more specific role for tax policy in stimulating capital formation.

The particular instruments that may be used to increase the after-tax returns to investment, and thereby stimulate additional capital formation, are generally familiar to all of us. They include the investment tax credit, alternative methods of depreciation, and changes in corporate tax rates.

In addition, there is a device which has not been used in this country but has been adopted by our major trading partners including Germany, Canada, England, France, and Japan. This is eliminating the double tax on corporate income, or integrating the corporate and personal income taxes.

Each of these may be discussed briefly in turn.

The investment tax credit now stands at 10 percent for eligible property, which generally includes depreciable equipment, but not buildings, used in a production process. Equipment with useful lives of less than 3 years does not receive the investment tax credit; equipment with lives of more than 3 years but less than 5 years receives one-third of the credit; and, equipment with useful lives of greater than 5 years but less than 7 years receives two-thirds of the credit.

In addition, the credit cannot exceed $25,000 plus 50 percent of the tax liability over $25,000. However, special higher limitations are temporarily provided for public utilities, railroads, and airlines. Unused credits may be carried back 3 years and carried forward 7 years. One alternative for stimulating additional capital formation is to increase the investment credit above its current level or to relax the general 50 percent of tax liability limitation.

Under current law, property held for the production of income in a trade or business is allowed a reasonable deduction for exhaustion, wear and tear, and obsolescence. Depreciation deductions are calculated, for tax purposes, by first determining the life of the property and then applying a depreciation method allowed by law.

Lives may be justified by taxpayers on the basis of either facts and circumstances or by reference to the class lives established by the asset depreciation range system for taxpayers electing to use that system. Those electing ADR are also permitted to use lives 20 percent shorter than the published class lives.

Once the asset life has been determined, the actual tax depreciation deductions are calculated by using either the straight line method or a more accelerated method such as double declining balance.

As a mechanism for reducing taxes on capital income, it is possible to allow taxpayers larger depreciation deductions. This could be accomplished by various combinations of changes in either asset lives, more accelerated methods, or indexing depreciation for inflation.

Alternatively, tax burdens on capital income could be reduced by direct corporate rate cuts. Currently, the first $25,000 of corporate income is taxed at the 20 percent rate, the next $25,000 at 22 percent, and income in excess of $50,000 at 48 percent. Any or all of these rates could be reduced as a measure to stimulate investment.

Although the idea of eliminating the double tax on corporate income has received considerable attention in recent years, it may nonetheless be worthwhile to review the various approaches which might be used to achieve this result. There are essentially three alternatives.

One is full integration of corporate and personal income taxes and the other two are alternative variants of partial integration.

Full integration is equivalent to treating the corporation as a partnership. Each corporate shareholder, as does a partner under current law, would include in his own income for tax purposes his proportionate share of the corporation's income whether or not it is distributed. The corporate tax becomes a withholding tax credited against the shareholder's final individual tax liability. In effect, the corporation pays no separate tax at all in this case. It merely serves as a collection agent for the Treasury.

The two variants of partial integration eliminate the corporate tax only on distributed earnings. The corporate tax would remain on undistributed corporate income. One version of partial integration involves a deduction for dividends paid at the corporate level in the same way that interest is currently deducted by corporations. The alternative version treats corporate taxes attributed to dividends as a withholding tax.

The individual shareholder grosses up his cash or "take-home" dividends the same way that take-home pay is grossed up to include taxes withheld by the employer. Then, in determining final tax liability, grossed-up dividends are taken into total income but a credit against tax is allowed for the corporate tax attributable to the dividends received. Again, this is similar to our current withholding system for wages and salaries where tax liability is based on "grossed-up" or before-tax wages, and a credit is taken for taxes withheld by the employer.

The choice among alternative ways of eliminating the double tax, in the event that some proposal of this kind is recommended, must also be based on considerations of simplicity and equity, as well as on possible differences in revenue costs.

It is important to specify the criteria to apply in choosing among alternative ways of stimulating investment. Let me enumerate these criteria and then briefly evaluate the alternatives.

Where possible, incentives for capital formation should be provided in a nondiscriminatory manner. This means that market forces, rather than the opportunity for specific tax advantages, should determine the particular kinds of investment to be undertaken and the particular firms and industries which undertake it.

The allocation of investment will be much more efficient when investors respond to market signals which reflect the wishes of consumers for particular goods and services.

Since the double tax on dividends in current law tends to distort the allocation of investment between corporate and noncorporate enterprise, some form of integration may make a significant contribution to economic efficiency. Other capital formation measures, to the extent that they reduce the relative taxation of corporations, have similar effects but not nearly to the same degree.

Also, tax incentives should ideally be neutral with respect to the way in which investment is financed and the extent to which corporations distribute or retain their earnings. There is considerable concern that in our present tax structure the corporation income tax biases the financing choice toward debt rather than equity financing and toward retentions rather than distributions of earnings.

To the extent that debt financing is encouraged, an unbalanced financial structure can develop with too much debt piled on a limited equity base. The result could be an economic system increasingly vulnerable to cyclical fluctuations, and investors increasingly less willing to assume risk. Similarly, tax incentives to retain earnings can lead to corporate conglomerates as large firms seek outlets for their retained earnings.

Eliminating the double tax on dividends deals directly with the bias toward debt financing since returns to debt capital—that is interest—and returns to equity capital—that is dividends plus corporate retentions—would be taxed more nearly alike. The other measures for stimulating capital formulation have no substantial effects in removing this bias. Similarly, by eliminating the double tax it is possible to achieve neutrality in the corporate decision to retain or distribute earnings.

Alternative devices for stimulating capital formation may also have quite different effects on the timing of investment per dollar of revenue loss. These differences in timing may be important since we are concerned about investment to eliminate potential short-run bottlenecks as well as to provide an expanding productive capacity to sustain long-run growth.

The investment tax credit and changes in depreciation measures tend to have a larger short-run effect on investment per dollar of foregone revenue than either corporate rate cuts or eliminating the double tax on dividends. This occurs because in the short run the investment tax credit and accelerated depreciation have a greater effect on investment decisions. In contrast, a significant portion of the tax reduction, from rate cuts and eliminating the double tax, accrues to capital already in place rather than to new capital formation.

It is difficult to determine how heavily to weigh the timing differences of alternative proposals to stimulate investment. In the long run, it seems to me, that proposals which equally increase the after-tax profitability of investment are likely to have approximately equal effects in increasing the capital stock.

The extent to which short-run differences should be given priority depends in part on one's evaluation of the short-run constraints currently impeding capital formation. If tax considerations are exerting a significant constraint on current investment decisions, then a stronger case could be made for the investment tax credit or an acceleration of tax depreciation. On the other hand, if investment is currently constrained by a concern about whether markets will be available for the additional output produced by a large capital stock, then structural tax policy may be less effective in the short-run and should perhaps be directed towards longer term objectives.

The overall objectives of tax reform—simplicity and equity—also enter into the evaluation of investment stimulus alternatives.

Of the various investment stimulus alternatives, the simplest would be a straight cut in the corporate rate, although no significant complexities would generally be involved in increasing the investment tax credit or in allowing more accelerated depreciation methods. Also, although integregation may be less familiar, it could be designed so that all the shareholder would have to do would be to copy onto the tax return information supplied by his corporation. This is particularly true for parital integration. Full integration could involve more complexity at the shareholder level since in this case shareholders would have to increase their basis in the stock for the earning which corporations retain on their behalf.

Corporate and personal tax integration would be consistent with the goal of taxing all income only once and would also be more progressive than other ways of providing an investment stimulus. This result occurs because under integration, corporate income—dividend income only in the case of partial integration—is taxed at individual marginal tax rates rather than at a flat corporate rate.

Eliminating the corporate rate with respect to dividends therefore confers greater benefits per share to the shareholder in lower tax brackets than to those in higher tax brackets.

In other words, the effect is the same as increasing by a constant factor the dividends of all shareholders. While before-tax income goes up proportionately, after-tax income goes up more for lower income than higher income shareholders because of the progressive tax rate schedule.

The other stimulus measures—the investment tax credit, accelerated depreciation, or corporate rate cuts—also provide initial relief to owners of corporate shares, since these shareholders claim the higher after-tax income stream earned by the corporation.

However, unless the cashflow gains to the corporation from lower taxes are completely paid out in the form of higher dividends, the distribution of the after-tax benefits from corporate tax cuts will tend to be proportional to dividend income. This occurs because the additional income available at the corporate level will not immediately be taxed at the marginal rates of shareholders.

If these cash flows are retained by the corporation, the values of corporate stock may increase and while corporate shareholders have experienced a gain in wealth as a result, there is no immediate increase in tax liability.

Thus, the greater progressivity from eliminating the double tax is due to the fact that the additional income accrues at the shareholder level, rather than at the corporate level; therefore, it is subject to a progressive structure of marginal tax rates.

It should be pointed out, however, that while eliminating the double tax on dividends may be more progressive among shareholders than are cuts in taxes on corporations, nonetheless, all investment stimulus measures which reduce taxes on capital income are regressively distributed in general. This is true because capital income tends to be concentrated among higher income taxpayers as a whole. It need not follow, of course, that a complete tax reform package cannot be progressive if stimulating capital formation is to be one of its objectives. But in order for the program to be progressive in its total impact, it must take into account the effect of measures to stimulate investment.

Here again there are tradeoffs. While eliminating the double tax may be more progressive per dollar of revenue loss, the investment tax credit and accelerated depreciation may require fewer dollars of revenue loss to achieve a given short-run investment effect.

In any event, the long-run effects of higher rates of capital formation on the distribution of income will be quite different from the immediate impacts. Over time, the benefits associated with real productivity gains will be generally distributed throughout the economy.

Let me conclude by assuring you that this administration is greatly concerned about the failure of our economic system to perform up to its potential over the past 10 years. We have taken seriously the need to provide adequate incentives for capital formation and risktaking. In the tax program which we shall later be presenting, this objective will be addressed in a significant way. At the same time we are also committed to developing a tax system which is more equitable and simpler.

I shall look forward to working with you in the future as we present our proposals to achieve these ends.

Senator BYRD. Thank you, Dr. Woodworth. Is the administration committed to eliminating the double taxation of dividends?

Mr. WOODWORTH. There has been no decision made in that respect.

Senator BYRD. In your judgment, if we needed to choose one or the other, which would be better, an overall rate reduction or the elimination or phasing out of the double taxation?

Mr. WOODWORTH. That is a matter which we are now considering and have not yet reached a conclusion because of the conflicting considerations that I pointed out. I wish I could give you a more positive answer, Senator Byrd.

Senator BYRD. What is the timetable for your submitting proposals to the Congress?

Mr. WOODWORTH. The Secretary of the Treasury has indicated that he thinks that it will probably be in the latter part of the summer, which I assume will be sometime late in August or early in September.

Senator BYRD. Would you envision that the program could be handled between September, when the Congress returns from the August recess and its adjournment date of October 8?

Mr. WOODWORTH. We hope that it would be possible for the House Ways and Means Committee to hold hearings on the program and if the Congress continues its session later than October 8, we hope that it will be possible for House consideration of the bill this fall.

We do not anticipate that there will be any opportunity for the Senate Finance Committee to consider it until next year.

Senator BYRD. I think that is realistic and also desirable. I might say, I assume that the administration is not particularly anxious to have Congress here after October 8.

Anyway, you feel that your program will be submitted to the Ways and Means Committee at the latter part of August?

Mr. WOODWORTH. Or early September.

Senator BYRD. Or early September.

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Mr. WOODWORTH. Yes.

Senator BYRD. The point has been made, and I think it has fallen on fertile ground, that one source of the capital formation problem is business unwillingness to invest because of the uncertainties caused by Government constantly changes the rules of the game.

Would you comment on that?

Mr. WOODWORTH. I tend to agree that business is much more inclined to make investments if they have confidence in knowing what the tax measures are going to be in the period ahead. So I think this is a factor. I have some trouble in knowing how significant it is; however, I think that it is significant.

Senator BYRD. What do you think can be done about the effects of inflation?

I am speaking now of business rather than individuals.

Mr. WOODWORTH. Well, as far as inflation is concerned, I suppose in part that it is a factor which helps limit the size of the package that can be presented. This is true in the sense that one of the major considerations, of course, is the impact on the budget which, in turn, has impact to some extent as far as inflation is concerned. It is not entirely the only factor, but it is a factor.

I think the size of the package is influenced by it. We are obviously trying to study the different options available to us from the standpoint of the impact on the economy, to see which set of proposals will provide the investment stimulus in the best manner.

That is one of the important considerations.

To the extent that we can provide for investment now, we will be substantially better off as far as the inflation aspect is concerned in the future. This will increase the availability of production in the period ahead when inflationary pressures might otherwise be in existence.

Senator BYRD. In considering the phasing out or elimination of double taxation, are you considering also changing the capital gains so capital gains would be taxed as regular, ordinary income?

Mr. WOODWORTH. That is one of the proposals being reviewed along with rate reductions and substantial individual income tax reduction. But again, there has been no decision made in that regard.

Senator BYRD. As a factual matter, if the capital gains were taxed at ordinary income rates, would this produce more revenue for the Government?

Mr. WOODWORTH. I think that depends on the other pieces of the package and it depends on how you combine it with rate reductions. I cannot imagine there being anything like that without there being very substantial rate reductions.

I would anticipate that taxing capital gains at ordinary income rates would be a plus figure in determining how much revenue would be received.

I recognize that you have to be careful to take into account any increased lockin effect which I assume some people are concerned about. I think that depends and turns on the final rate levels.

Senator BYRD. Senator Packwood?

Senator PACKWOOD. Yesterday, several of the witnesses indicated that there is no capital shortage today, there is ample money available, ample liquidity, but a reluctance on the part of businesses to invest, not only because of the uncertainty, but because so much of the investment has to go to so-called nonproductive facilities that they cannot justify the investment from a return standpoint on money. Do you think that that is a fair fear?

Mr. WOODWORTH. I think those are valid concerns. I think the concern at the present time is more a concern of investment rather than of obtaining the funds to make the investment work. It is not savings that is the problem, as long as you are substantially below full employment. It really is the investment, then, rather than the savings that you are concerned with, and that is what we are concerned with now. I am sure that the change in our economy which requires more investments in antipollution equipment, and similar things, is a factor in absorbing some of the investment which probably is viewed as nonproductive.

What you called "nonproductive" investment is a factor. I think it is around 10 or 15 percent, but probably closer to 10 percent of the investment total if I remember correctly.

So yes, I would have to say that that is an important factor.

Senator PACKWOOD. One or two of the witnesses suggested that it would be worthwhile dividing assets into productive and nonproductive assets allowing that nonproductive assets be expensed immediately rather than depreciated. What do you think?

Mr. WOODWORTH. I think it is a valid point worth considering. We have, to some extent in present law, already provided for treatment of that type. I think anti-pollution abatement facilities, if I remember correctly, are eligible for a 5-year amortization plus half of the investment credit. That might be carried further. It is certainly an important consideration.

Senator PACKWOOD. The consistent theme of all of the witnesses yesterday, including Taxation with Representation, was that depreciation be based on replacement costs, assuming you can work out a formula, figuring out what replacement cost is.

Would you agree with that?

Mr. WOODWORTH. I understand the concern. The problems that exist, as soon as you get into that topic, are which other features of the tax law are also impacted by inflation, and to what extent do you put the whole system on an indexing basis.

That is what it gets down to.

I think that you can argue, wholly apart from that, which I think is a rather comprehensive change in the system, that fast depreciation is, in part, justified by the extent of the replacement cost, yes.

Senator PACKWOOD. I have no further questions, Mr. Chairman.

Senator BYRD. Thank you, Dr. Woodworth. I have some more detailed questions, but because you have to appear before Ways and Means, I will take those up at another time.

Mr. WOODWORTH. Thank you.

[The prepared statement of Mr. Woodworth follows:]

STATEMENT OF HON. LAURENCE N. WOODWORTH, ASSISTANT SECRETARY OF THE TREASURY OF TAX POLICY ON CAPITAL FORMATION

Mr. Chairman and members of this subcommittee: My colleagues today are making a persuasive case for promoting a higher rate of capital formation in the U.S. economy. There is no need for my repeating it. In view of our disappointing record regarding economic growth, and gains in productivity and real income, the important question is what can public policy do about it. From my position, the question is even more specific: what can tax policy do about it?

I should first note that capital formation is not solely or perhaps even primarily a tax issue. We must look to more fundamental reasons to understand why our present rate of investment is deficient. In the aftermath of a major bout with both inflation and recession, it perhaps is not surprising that business confidence has not yet fully recovered. Uncertainty concerning opportunities for expansion of markets as well as the thrust of future government policies is not easily dispelled. In this climate, general monetary and fiscal policies to reinforce the recovery of the economy in a noninflationary manner may be more important than specific structural program changes. Nonetheless, it is still possible to define a more specific role for tax policy in stimulating capital formation. This can best be appreciated by considering that investment will not be undertaken unless the after-tax rewards are commensurate with the risks of adding to productive capacity. Tax policy can affect investment decisions by changing these after-tax rewards.

In fact, as I shall discuss in more detail, there are various ways in which tax policy can improve the after-tax returns to investment and risk taking. We are now critically evaluating these alternatives as part of the process of developing tax reform proposals to submit to Congress later this year. No final decisions have been made as yet on the specific components of the tax reform program. I would like to share with you, however, some of our thinking on tax incentives for capital formation. I will also address the question of the relationship between the need for additional capital formation and the other goals of the tax reform program.

The tax reform program we are now working on has two other important goals in addition to providing adequate incentives for capital investment. The first is tax simplification to which we assign a much more important role than it has generally been assigned in the past. Simplification involves making tax returns easier for the average person to prepare, reducing the burdens of financial record-keeping, and generally making the tax law more understandable for taxpayers. The second goal is to improve the equity of the tax system so that the laws are regarded as fair. This can be accomplished by removing opportunities for tax gamesmanship with high pay offs to expert legal advice and shrewd tax planning, and by making sure that individuals with equal incomes are taxed the same while those with higher incomes are taxed at progressive rates. In providing incentives for expanding productive facilities, we must continue to keep in mind the other goals of simplification and fairness.

Designing tax proposals to stimulate capital formation as well as to be consistent with tax simplification and tax equity is no simple task. I might also add that we have not yet discovered any new ways of achieving all these goals simultaneously. The problem, as always, is one of choices and tradeoffs.

ALTERNATIVE WAYS TO STIMULATE CAPITAL FORMATION

The particular instruments that may be used to increase the after-tax returns to investment and thereby stimulate additional capital formation are generally familiar to all of us. They include the investment tax credit, alternative methods of depreciation, and changes in corporate tax rates. In addition, there is a device which has not been used in this country but has been adopted by our major trading partners including Canada, England, France, Germany, and Japan. This is eliminating the double tax on corporate income, or integrating the corporate and personal income taxes.

Each of these may be discussed briefly in turn.

Investment Tax Credit.—The investment tax credit now stands at 10 percent for eligible property which generally includes depreciable equipment, but not buildings, used in a production process. Equipment with useful lives of less than 3 years does not receive the investment tax credit, that with lives of more than 3 years but less than 5 years receives one-third of the credit, and equipment with useful lives of greater than 5 years but less than 7 years receives two-thirds of the credit. In addition, the credit cannot exceed $25,000 plus 50 percent of the tax liability over $25,000. However, special higher limitations are temporarily provided for public utilities, railroads, and airlines. Unused credits may be carried back 3 years and carried forward 7 years. One alternative for stimulating additional capital formation is to increase the investment credit above its current level or to relax the general 50 percent of tax liability limitation.

Depreciation Allowances.—Under current law, property held for the production of income in a trade or business is allowed a reasonable deduction for exhaustion, wear and tear, and obsolescence. Depreciation deductions are calculated for tax purposes by first determining the life of the property and then applying a depreciation method allowed by law. Lives may be justified by taxpayers on the basis of either facts and circumstances or by reference to the class lives established by the asset depreciation range (ADR) system for taxpayers electing to use that system. Those electing ADR are also permitted to use 20 percent shorter lives than the published class lives. Once the asset life has been determined, the actual tax depreciation deductions are calculated by using either the straight-line method or a more accelerated method such as double declining balance.

As a mechanism for reducing taxes on capital income, it is possible to allow taxpayers larger depreciation deductions. This could be accomplished by various combinations of changes, in either asset lives, more accelerated methods, or indexing depreciation for inflation.

Corporate Tax Rates.—Alternatively tax burdens on capital income could be reduced by direct corporate rate cuts. Currently, the first $25,000 of corporate income is taxed at the 20 percent rate, the next $25,000 at 22 percent, and income in excess of $50,000 at 48 percent. Any or all of these rates could be reduced as a measure to stimulate investment.

ELIMINATING THE DOUBLE TAX ON CORPORATE INCOME

Although the idea of eliminating the double tax on corporate income has received considerable attention in recent years, it may nonetheless be worthwhile to review the various approaches which might be used to achieve this result. There are essentially three alternatives. One is full integration of corporate and personal income taxes and the other two are alternative variants of partial integration. Full integration is equivalent to treating the corporation as a partnership. Each corporate shareholder, as does a partner under current law, would include in his own income for tax purposes his proportionate share of the corporation's income whether or not it is distributed. The corporate tax then becomes a withholding tax credited against the shareholder's final individual tax liability. In effect, the corporation pays no separate tax at all in this case but merely serves as a collection agent for the Treasury.

The two variants of partial integration eliminate the corporate tax only on distributed earnings. The corporate tax would remain on undistributed corporate income. One version of partial integration involves a deduction for dividends paid at the corporate level in the same way that interest is currently deducted by corporations. The alternative version treats corporate taxes attributed to dividends as a withholding tax. The individual shareholder grosses up his cash or "take-home" dividends the same way that take-home pay is grossed up to include taxes withheld by the employer. Then in determining final tax liability, grossed-up dividends are taken into total income but a credit against tax is allowed for the corporate tax attributable to the dividends received. Again, this is similar to our current withholding system for wages and salaries where tax liability is based on "grossed-up" or before-tax wages, and a credit is taken for taxes withheld by the employer.

The choice among alternative ways of eliminating the double tax in the event that some proposal of this kind is recommended must also be based on considerations of simplicity and equity as well as on possible differences in revenue costs.

CRITERIA FOR CHOOSING AMONG INVESTMENT STIMULUS ALTERNATIVES

It is important to specify the criteria to apply in choosing among alternative ways of stimulating investment. Let me enumerate these criteria and then briefly evaluate the alternatives.

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

Since the double tax on dividends in current law tends to distort the allocation of investment between corporate and noncorporate enterprise, some form of integration may make a significant contribution to economic efficiency. Other capital formation measures, to the extent that they reduce the relative taxation of corporations, have similar effects but not nearly to the same degree.

DEBT VERSUS EQUITY FINANCE AND CORPORATE DIVIDENDS VERSUS RETAINED EARNINGS

Also, tax incentives should ideally be neutral with respect to the way in which investment is financed and the extent to which corporations distribute or retain their earnings. There is considerable concern that in our present tax structure the corporation income tax biases the financing choice toward debt rather than equity financing and toward retentions rather than distributions of earnings. To the extent that debt financing is encouraged, an unbalanced financial structure can develop with too much debt piled on a limited equity base. The result could be an economic system increasingly vulnerable to cyclical fluctuations, and investors increasingly less willing to assume risk. Similarly, tax incentives to retain earnings can lead to corporate conglomerates as large firms seek outlets for their retained earnings.

Eliminating the double tax on dividends deals directly with the bias toward debt financing since returns to debt capital—that is interest—and returns to equity capital—that is dividends plus corporate retentions—would be taxed more nearly alike. The other measures for stimulating capital formation have no substantial effects in removing this bias. Similarly, by eliminating the double tax it is possible to achieve neutrality in the corporate decision to retain or distribute earnings.

Timing effects.—Alternative devices for stimulating capital formation may also have quite different effects on the timing of investment per dollar of revenue loss. These differences in timing may be important since we are concerned about investment to eliminate potential short-run bottlenecks as well as to provide an expanding productive capacity to sustain long-run growth.

The investment tax credit and changes in depreciation measures tend to have a larger short-run effect on investment per dollar of foregone revenue than either corporate rate cuts or eliminating the double tax on dividends. This occurs because in the short run the investment tax credit and accelerated depreciation have a greater effect on investment decisions. In contrast, a significant portion of the tax reduction from rate cuts and eliminating the double tax accrues to capital already in place rather than to new capital formation.

It is difficult to determine how heavily to weigh the timing differences of alternative proposals to stimulate investment. In the long run, it seems to me, that proposals which equally increase the after-tax profitability of investment are likely to have about equal effects in increasing the capital stock. The extent to which short-run differences should be given priority depends in part on one's evaluation of the short-run constraints currently impeding capital formation. If tax considerations are exerting a significant constraint on current investment decisions, then a stronger case could be made for the investment tax credit or an acceleration of tax depreciation. On the other hand, if investment is currently constrained by a concern about whether markets will be available for the additional output produced by a larger capital stock, then structural tax policy may be less effective in the short-run and should perhaps be directed towards longer term objectives.

The overall objectives of tax reform—simplicity and equity—also enter into the evaluation of investment stimulus alternatives.

Simplicity.—Of the various investment stimulus alternatives, the simplest would be a straight cut in the corporate rate, although no significant complexities would generally be involved in increasing the investment tax credit or in allowing more accelerated depreciation methods. Also, although integration may be less familiar, it could be designed so that all the shareholder would have to do would be to copy onto the tax return information supplied by his corporation. This is particularly true for partial integration. Full integration could involve more complexity at the shareholder level since in this case shareholders would have to increase their basis in the stock for the earnings which corporations retain on their behalf.

Equity.—Corporate and personal tax integration would be consistent with the goal of taxing all income only once and would also be more progressive than other ways of providing an investment stimulus. This result occurs because under integration, corporate income— dividend income only in the case of partial integration and all corporate income in the case of full integration—are taxed at individual marginal tax rates rather than at a flat corporate rate. Eliminating the corporate rate with respect to dividends therefore confers greater benefits per share to shareholder in lower tax brackets than to those in higher tax brackets. In other words, the effect is the same as increasing by a constant factor the dividends of all shareholders. While before-tax income goes up proportionately, after-tax income goes up more for lower income than higher income shareholders because of the progressive tax rate schedule.

The other stimulus measures—the investment tax credit, accelerated depreciation, or corporate rate cuts—also provide initial relief to owners of corporate shares, since these shareholders claim the higher after-tax income stream earned by the corporation. However, unless the cash flow gains to the corporation from lower taxes are completely paid out in the form of higher dividends, the distribution of the after-tax benefits from corporate tax cuts will tend to be proportional to dividend income. This occurs because the additional income available at the corporate level will not immediately be taxed at the marginal rates of shareholders. If these cash flows are retained by the corporation, the values of corporate stock may increase and while corporate shareholders have experienced a gain in wealth as a result, there is no immediate increase in tax liability. Thus, the greater progressivity from eliminating the double tax is due to the fact that the additional income accrues at the shareholder level, rather than at the corporate level, and, therefore, it is subject to a progressive structure of marginal tax rates.

It should be pointed out, however, that while eliminating the double tax on dividends may be more progressive among shareholders than are cuts in taxes on corporations, nonetheless, all investment stimulus measures which reduce taxes on capital income are regressively distributed in general. This is true because capital income tends to be concentrated among higher income taxpayers as a whole. It need not follow, of course, that a complete tax reform package cannot be progressive if stimulating capital formation is to be one of its objectives. But in order for the program to be progressive in its total impact, it must take into account the effect of measures to stimulate investment.

Here again there are trade-offs. While eliminating the double tax may be more progressive per dollar of revenue loss, the investment tax credit and accelerated depreciation may require fewer dollars of revenue loss to achieve a given short-run investment effect. In any event, the long-run effects of higher rates of capital formation on the distribution of income will be quite different from the immediate impacts. Over time, the benefits associated with real productivity gains will be generally distributed throughout the economy.

Let me conclude by assuring you that this Administration is greatly concerned about the failure of our economic system to perform up to its potential over the past 10 years. We have taken seriously the need to provide adequate incentives for capital formation and risk taking. In the tax program which we shall later be presenting, this objective will be addressed in a significant way. At the same time we are also committed to developing a tax system which is more equitable and simpler. I shall look forward to working with you in the future as we present our proposals to achieve these ends.

Senator BYRD. The committee is most pleased to welcome Hon. Bert Lance, Director of the Office of Management and Budget. As I have said several times, I think Mr. Lance has both the most important position in Washington and also the most difficult one, excepting only the position of Mr. Carter.

The committee is very pleased to have you today.

If you could give us your views and your thinking on the matter of capital formation and how best to stimulate growth it would be most helpful to us, and you may proceed as you wish.

STATEMENT OF HON. BERT LANCE, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. LANCE. Thank you, Mr. Chairman and Senator Packwood.

What I would like to do, if it is agreeable with you, Mr. Chairman, is just submit my statement for the record. I think, in the interest of your time and the fact that we might have a more meaningful dialog, I will not read that statement to you.

Senator BYRD. The statement will be published in full in the record.

Mr. LANCE. I think I could make a couple of broad-based comments and we could engage along the lines that you and Senator Packwood conversed about, rather than what I might talk about.

I think what Senator Packwood just said to Dr. Woodworth is of great importance in the process. I have long had the feeling, just from the standpoint of my business background, that there is no lack of capital in this country. There has been a lack of freedom to employ capital.

This is one of the problems we face as it relates to Government regulation and Government intervention in the past and also in the future. I think that obviously the question of capital formation is one of great and vital importance to us by whatever measure that we might want to give to it. The ability to balance the budget by 1981, which is a very major commitment of the President, is dependent upon a viable economy in this country. A viable economy is dependent upon us being able to deal with the problems of inflation. Our dealing with the problems of inflation depends on our ability to have increased capital investment, increased productivity, and I think that, in turn, is based upon a sense of sureness and confidence in the predictability and consistency of government.

So that I think that we see in this situation a classic circle of one thing affecting the other very dramatically. They all have to fit pretty well in the process. This is what has caused the Carter administration a great deal of concern. Our commitment in the area of tax reform is vital to the process of increased capital investment; increased capital formation, of course, is a major part of that.

I know that you spend a great deal of your time in dealing with those questions, and the way in which we are approaching that very serious question. I think, in addition, that it requires a sense of confidence in the minds of the business community. I do not mean just from the viewpoint of large companies that make up, sometimes, the definition of the business community in this country. I think it relates to the whole of the business structure of this Nation, the small businessman as well as the large businessman, and those in between.

They want the Government to fix the rules of the game and know what those rules are so they can plan. It is obvious, when you talk about capital formation, the lack of investment and this type of thing, that it relates, Mr. Chairman, to our ability to plan.

By that, I do not mean Government doing the planning for the private sector or for the lives of individuals, but simply because of a sense of fairness and consistency and predictability, that people can once again begin to project into the future. I think that we have not had that ability in recent years.

When I tried to run the State Highway Department in Georgia, under then-Governor Carter, one of the problems that we had was the fact in 1971 or 1972 we were dealing with problems that were created in 1955 or 1960. We were always playing catch-up ball. That is a very difficult game to try to play, and I think the same thing still persists today in Government and business.

We have not had the opportunity to really plan and look at what our problems are going to be in the future and try to deal with them on that basis. The question of capital formation and the question of what to do with it is one I am vitally interested in. Having said that, I may respond to any questions that you may have in more meaningful terms.

Senator BYRD. Thank you, Mr. Lance.

Yesterday, one of the witnesses, Dr. Pierre Rinfret, pointed out or stated that he and his senior associates had personally interviewed—I forget the exact figure, but something like 120 businessmen in all types of industry throughout the country, and he did that in preparation for his comments before this committee.

He said that the one dominant theme was business is unwilling to invest. The major cause of that was the uncertainty caused by Government constantly changing the rules of the game.

I wonder if you would comment on that.

Mr. LANCE. Certainly. I think that is a valid comment. As you talk to people in the business community, you find that this problem is based upon the fact that many times the businessman gets contradictory rulings and regulations, often in the space of a short time frame, that cause a great deal of confusion and uncertainty.

I do not think that there is any question that what we need to do in Government is to begin to be very predictable and consistent in what we are doing. I do not see any reason why we cannot really do that, to lay out what our objectives and goals really are. There may be a great deal of discussion about the validity of those goals and objectives within the minds of the American people, but at least we need to set them out and say, this is the way we intend to try to achieve these goals and objectives going forward.

We must deal with the question of changed rules, the question of lack of consistency that all of us hear about all the time, and the problem of inconsistency in government, where one agency says one thing and another says something else, and somebody else gets into the act, and the ground rules are ultimately changed. It is an ongong process.

In my opinion, we have to begin to face these problems.

Of course, there are numerous ways of dealing with them. I think we will be able to turn things around as the days go by, with the cooperation of the Congress.

Senator BYRD. That is an area that your organization could have a major influence on it, I would think.

Mr. LANCE. Yes, sir, I would think so. In the reorganization, I think that this is something that very seriously has to be looked at. It is an important adjunct of the reorganization process itself.

I think that it can also be an important process of looking at things from just our normal purview of trying to make a determination about management, about some of the problems involved in the imposition of paperwork, and about the intervention of government into the lives of the American people. I think we have those facilities available to begin to make some progress in that area.

Senator BYRD. The facilities are available, but it is going to take some knocking of heads to accomplish it, in my judgment.

Mr. LANCE. It is going to take that. It is going to take that, it is going to take some leadership, and it is going to take an attitudinal change, I think, to begin this process.

Senator BYRD. It is going to take leadership and, if I sense with any degree of accuracy the feelings of the country, one of the major reasons for the results of last year's election was that Governor Carter articulated those needs. Now is the opportunity to put into effect and to make the changes which are necessary.

Mr. LANCE. I certainly think, Mr. Chairman, that that is the strong commitment of the President. He has made that very clear in his conversations and instructions to the Cabinet officers. I think they understand the sense of commitment in that regard.

I think we are beginning to see that process move along. It is a very difficult one. It does not mean that we should not do it. It does not mean that we cannot do it. It just means that we have to keep working at it.

Senator BYRD. As far as business is concerned, the paperwork and redtape is very costly. I think what many of my colleagues, and perhaps many of your colleagues, do not fully recognize is that cost has to be passed on to the consumer.

Mr. LANCE. No question about it.

Senator BYRD. I think this is the best protection for the consumer, to eliminate some of the redtape and paperwork that is being demanded from Washington.

Mr. LANCE. I asked the people in OMB to give me an estimate of the time that we are imposing upon the people of this country to spend in dealing with Government forms and regulations. I do not know how accurate this is but our best estimate, which is probably on the conservative side, is that we are now spending 135 million manhours.

Senator BYRD. OMB?

Mr. LANCE. That is overall.

Senator BYRD. Government?

Mr. LANCE. That is what businesses have to spend.

Senator BYRD. It is not only businesses which must devote time to redtape and paperwork—let me give you one example.

The superintendent of schools in the various localities throughout my State, and I find this true in talking with my Senate colleagues in other States, are being forced into a vast amount of paperwork by all of the demands of the Department of Health, Education and Welfare. It is taking time away from their normal activities of education and it is tremendously costly to the taxpayers.

Mr. Lance, less than a week ago on June 9, Charles Schultze said, in a question and answer session before the Joint Economic Committee that he thought it likely that the "administration's tax reform package would contain significant reductions in taxes."

What kind of revenue losses do you envision would be involved?

Mr. LANCE. Mr. Chairman, I think it is premature to try to make a definitive statement yet about what kind of revenues we might lose in the process of overall tax reform. I heard Dr. Woodworth testify to you in part and have also discussed the issue with him. We are still in the preliminary stages of taking a look at tax reform and no decisions have been reached yet, so that I cannot say yet what kind of revenue losses might be involved, if any.

Senator BYRD. How much of a revenue loss is compatible with the administration's goal of a balanced budget?

Mr. LANCE. Again, that is very difficult to try to answer at this particular time.

I think in the process of talking about tax reform and the attendant results in the economy itself that you have to take a look at what happens. I spent a great deal of time before Congress testifying about the stimulus proposal and, in nearly every instance that I had that privilege, there was some comment made about the Kennedy tax cuts in the 1960's whereby ultimately Government revenues rose as a result of those cuts. I think we have to look at this aspect from the overall standpoint of what we ultimately arrive at in our tax reform proposal and then try to relate it to the overall aspects of what is compatible with the goal of balancing the budget by fiscal year 1981. I think, in some instances, tax changes may result in greater revenues from the standpoint of increased economic activity.

Senator BYRD. In your statement, which will be placed in the record, you state that the administration intends to balance the budget by 1981 in the context of a relatively fully employed economy.

What do you mean by that statement?

Mr. LANCE. Again, that is a very broad statement in talking about the economic circumstances that we are faced with. When we speak of a fully employed economy, we have said that we need an economy that grows at the rate of 6 percent or so on an annual basis and that this is something that we feel is important.

This is not to say that we cannot balance the budget if the growth is somewhat less than that. In our budget projections we employ some alternative plans that relate to something less than the 6-percent growth rate to try to get a fix on the range of numbers involved.

With regard to unemployment, I think the traditional historical definition of a fully employed economy has been in the neighborhood of 4-percent unemployment.

Senator BYRD. I assume that you do not plan to go back to the old Nixon administration contention that the budget balanced on a full employment basis.

Mr. LANCE. No, sir. We need to do it on an actual basis.

Senator BYRD. That is good news. I am very glad of that. I think the Nixon administration's using the full-employment concept and telling the American people that the budget is balanced on a full-employment basis, when in fact the budget was greatly unbalanced by billions and billions and billions of dollars, was not being fair to the American people.

To use that gimmickry is like saying I would not be broke if my uncle had left me $1 million.

Mr. LANCE. That is a good analogy, Senator Byrd.

Senator BYRD. When you speak of a balanced budget in the context of a relatively fully employed economy, that is not a qualification of your commitment to a balanced budget?

Mr. LANCE. It goes without saying that we have to have a viable economy growing at a good rate in order for us to go that way. What I am talking about is a fully employed economy I am talking about the utilization of our economic resources and the ability to have investment in the economy from a capital standpoint.

Senator BYRD. But not a qualification of the commitment?

Mr. LANCE. Absolutely not.

Senator BYRD. In consideration of proposals of integration of the corporate income tax——

Senator PACKWOOD. Excuse me. What did you just ask him? It is not a commitment?

Mr. LANCE. Not a qualification.

Senator PACKWOOD. A balanced budget no matter what, is that what you are saying?

Mr. LANCE. The chairman asked, "Was that a qualification of our ability to have a balanced budget." I said, "Not at all, absolutely not."

"Come what may" is a rather large territory out there.

Senator BYRD. I think I had better yield to Senator Packwood at this point.

Senator PACKWOOD. I want to pursue that, because I have been making some notes on it. I read this full employment figure, both in yours and Mr. Gramley's statement. He phrased it, it will also seek to achieve a balanced budget when the economy reaches high employment.

What you are saying, you are going to try to balance that budget even if we are running at 6 or 7 percent unemployment and 6 percent inflation, 5 percent growth. You are still going to try to balance the budget?

Mr. LANCE. We have seen nothing, yet, Senator—I have seen nothing yet in the figures so far that says we cannot obtain a balanced budget. I think the economy is moving along at a good rate. The decline in unemployment has been significant in the first 5 months of the Carter administration.

Those numbers that we see relating to economic activity have been very positive. I see nothing that indicates that we cannot obtain that goal.

Obviously, you know much better than I, that the revenues of Government depend on viable economic circumstances. The staff at OMB told me when I came on board, that for each 1 percent decline in unemployment, we would have an offset of $15 billion. I have been looking for that over there, hoping that it would show up because we retained that 1 percent decline in unemployment.

Senator PACKWOOD. As Senator Byrd pointed out, that was a percentage of the full employment budget. If you did not have that many people unemployed, it did not work that way.

Mr. LANCE. It is an illusive thing.

Senator PACKWOOD. There are criticisms that are being leveled that you are not going to be able to keep a 6-percent growth rate and you will have a number of entrants into the labor force based on the baby boom from 1955 to 1965 in that the capital formation is not going to be there, because businesses are not going to put it up, because they are not going to put too much into nonproductive facilities. Therefore, you cannot balance the budget. I am not as pessimistic as all of those put together, but there is a grain of truth in the whole theme.

Mr. LANCE. I am sure that is correct. I am sure that all of those are very, very important factors for us to try to deal with. I think the fact that there is awareness now about this problem of capital investment and capital formation is extremely important. I think that helps us go forward.

The folks entering the labor force are something that we will have to deal with. We have seen in the last few months record numbers of people being absorbed and employed into the labor force, which is an extremely good sign—500,000 in April, I believe; 400,000 in May. This is a positive step, in my opinion. We now have nearly 91 million people employed in this country, the highest number we have ever had. These things are moving forward.

Again, it is like so many other things in the economic process—one thing begets another. We talked previously about the problems of inflation. In many instances it is a self-fulfilling prophecy. People get concerned about it; they start doing things to add to inflationary pressures. The same thing is true as people start making capital investment.

If they sense a predictability and consistency about this then, that, I think, transcends what we sometimes see in the future just from the standpoint of the numbers and projections themselves.

I am not at all pessimistic about those problems. They are out there, we cannot ignore them, we have to be aware of them. We have to shape things in a way that we can deal with them. It does not make me any less determined or have any less confidence in our ability to obtain a balanced budget.

Senator PACKWOOD. I am optimistic, also. One thing yesterday that struck me, it is worth serious consideration, why the administration—this uncertainty argument, every witness talked about it, a reluctance to commit themselves to a major new facility, some kind of pollution discharge had to reach a point and two-thirds along they discover they have to meet .2. They would never have gone into it if they had known they wanted to reach .2 so they were reluctant to go into it at all.

Mr. LANCE. It is a valid criticism of Government. It concerns me a great deal.

I just do not see how you can have real progress, as long as that sense of uncertainty prevails. It is the responsibility of the Carter administration, as well as the Congress, in relationship to your area of responsibility, that we make sure that we get to the posture of being able to say, this is the way it is going to be.

You may not always like what those rules are going to be, but at least you will know what they are, and they are not going to be changed willy-nilly because of circumstances. There are some indications in times past that rules were changed without any conception or regard of the problems that people faced because of decisions they made 2 or 3 years earlier based on the earlier rules.

We have imposed, I think, a great amount of restrictions upon ourselves in the process of time restraints where things take so long. I was talking to some people from the paper industry yesterday about the subject of capital investment. They were talking about building a plant in Houston, Tex., I believe, and it was going to take a minimum of 18 months for them to do the planning, the permit process, and this sort of thing.

Their concern was the same sort of concern that you have seen. That was fine, if that is what it was going to take. But then they did not want to get to the 17th month in the process and find out that it was going to take another 18 months because we had changed something that had not been present at the initiation of the project.

That is a thing that we have to be on our guard against.

Senator PACKWOOD. You have my support. I have no further questions.

Senator BYRD. Senator Long.

Senator LONG. Mr. Lance, I regret I was busy elsewhere when you made your presentation in chief. I do want to discuss briefly with you a problem that is apparent from where I am sitting. You are going to deal with this economizing. I applaud it. I did not agree with the economizing you did on the waterways, but, in the main, I agree with your noble efforts to economize. The Nation appreciates them, and so do I.

You are not going to balance that budget and even begin to keep all of these commitments that President Carter has made without some additional revenue. Just a day or so ago we had Mr. Califano here with his problem in regard to financing social security.

The part that I take issue with is that he wants to ask the Federal Reserve to print another $14 billion and send it to him to stash away in the social security fund. He is talking about taking it out of general revenues, but there is no general revenue to transfer in that fund. You have a deficit of $60 billion. How are you going to transfer that $60 billion to make a plus out of it?

It seems to me, if you are talking about reaching into the general funds, what you are talking about is passing a debt limit bill to put the Government deeper in debt and call on the Federal Reserve to print more money or give you a note saying they have put it on the ledger book and you have the money coming from the trust fund. It seems to me to be bypassing and ducking what will be our painful duty, one of these days, to provide the taxes for—to pay for these social security benefits.

There are more people who benefit from the social security program than any other thing I know of that the Government does. If you think of a pressure group that can be mustered to support something, if that fund is out of money, the social security people should come to mind. We ought to find more people who would be willing to write to their Congressmen and raise the devil with them when they go around looking for votes among the social security beneficiaries than anywhere else.

My question is, if we cannot find our way to vote for a social security tax to pay for these benefits, what can we vote for?

Mr. LANCE. Of course, Senator, obviously there are a great number of problems that have to be dealt with, social security being one of them. The concern that we have is the same concern that you have; I am sure that the American people do not have any sense of concern about the solvency of the system itself. I think when we start talking about that particular aspect of it, this problem always raises its head, and it is something that we have to make sure that the people fully understand, that there is a commitment there.

When you get into the question of general funds, I came out of the same school that you did with regard to this matter. Back when I was loaning money in Gordon County, Ga., we always had the argument, take it out of general funds. I said, my interpretation was there are no general funds created unless you operate out of surpluses. As long as you have a deficit, there are no general funds.

Your point is well-taken, but I am not as expert in that area as are you, and I would be ill-equipped to try to answer your question with regard to the problems of how to deal with the social security system, per se, as you bring them up this morning.

Senator LONG. Some time ago, one of our colleagues in the Senate who passed on, had some ambitious amendment to provide some new social security benefits that would come as a windfall to the people who were not already receiving them.

Basically, the theory of it was, anybody who is not getting a pension would get one whether he paid anything into the fund or not. The early draft of the amendment was so generous that he even failed to require that the person be an American citizen. Nikita Khrushchev could have gotten a pension, Charles De Gaulle would have gotten it, Mao Tse-tung would have gotten one. It would have cost more than $1 trillion added onto Government expenses.

Concerning the generosity of that amendment, I made the point that there was not one nickel of revenue to pay for all of that. I asked how are you going to pay for it? He said he was going to pay for it out of the deficit.

It seems to me that we ought to insist, if someone wants to provide more social security benefits, that he provide the tax to pay for it. That is part of his proposition. This budget procedure that has been agreed to up here is pretty well-calculated on that. Once the second budget resolution is in place and an amendment is made to it, that budget is subject to a point of order.

I think the Senate will measure up to its responsibility and sustain the point of order.

In terms of fiscal responsibility, I believe you are going to have to work with us, and we are going to have to work with you if we are going to achieve the President's objective. I do not think we have any choice but to raise social security taxes. If we are going to have to do it, it seems to me that we ought to do it in a fashion of levying any tax we need to pay for it, not by telling the Federal Reserve to print more money.

I hope that you will consider that position and support it down there. As a banker, you know we cannot afford to keep supporting all these things with printing-press money.

Mr. LANCE. I know that, sir.

Senator LONG. I hope also that you will consider and think about the possibility of substituting a value-added tax for the social security tax if you are going to have to finance health insurance and some of these other things that the President has promised to do. You may have to turn to that someday.

We are putting our manufacturers at a great disadvantage when the European countries are financing their social programs with a value-added tax. That means that they rebate it, or never charge it at all, on the imports that they are shipping to us, such as steel, shoes, and other things. And when we ship something in their direction, they have a tax waiting for us, a value-added tax, a 15-percent tax that they never apply on their exports, but they sure put it to us when our goods reach their border.

It is a trade distortion to let our people suffer that kind of burden, that is, meeting that tax that works out the same as a tariff and having them rebate it on their shipments to us. That is one of the things that I believe we ought to look at to see what the potential is, as we look at these programs. Labor does not like a value-added tax.

My idea is, if it is to finance their program, labor will be far more considerate of the idea than they would be if it is financing something they are not interested in. They are good people and they have ideas and thoughts just like we all do.

Generally, when you are trying to get a big program, beggars cannot be choosers about saying precisely how you are going to pay for all of it.

Thank you very much.

Mr. LANCE. Thank you, sir.

Senator BYRD. Mr. Lance, in regard to the dialog that you and Senator Long had, you seem a bit reluctant to get into the social security question.

Mr. LANCE. A little bit more than a little reluctant, Mr. Chairman.

Senator BYRD. The social security proposal that was submitted to the Finance Committee, is directly in your field in the sense that if a part of social security is going to be financed from the general revenues, that is going to make it more difficult to achieve the balanced budget that you and President Carter are committed to.

Mr. LANCE. Yes, sir.

Obviously, as you have demands, whether they come from the social security area or some other area, it means, as best as I can determine, that there are only two or three basic places that you can get money with which to do things. and you have to take that into consideration.

Obviously, as demands come about, then you have to make some adjustment elsewhere if you are operating within the same expenditure levels as you once were, given the inflationary increases per se.

But with regard to the social security, as I said, I am not well-equipped to really talk intelligently about the matter. I really have not had a chance to study it.

The circumstances, with regard to the social security proposal that has been presented, are again, the circumstances of trying to bring back into some sense of balance the social security system.

Senator BYRD. No one quarrels with that objective.

Mr. LANCE. No, sir. I think that there is a basic difference there in regard to what Senator Long has to say about whether you tax or how do you really pay for the system itself and the benefits that flow from the system.

What we are talking about with regard to social security is what has taken place in the past where the benefits have been added without making sure that the system was able to maintain its soundness, from whatever point that you want to measure it by.

There is a distinct difference there, I think, about where we are in the proposal and what you might be talking about in the future, and I think that they need to be separated as best they can from that viewpoint.

We are talking about trying to deal with a problem that has been present for some period of time. As you talk about other benefit increases in regard to the social security system, I am sure that is something that will have to be looked at from every viewpoint that anybody can imagine.

Certainly, Senator Long's comments have to be explored and some judgment made about them in the future, in my opinion.

Senator BYRD. I think what you decide to do and what the administration decides to do in regard to the social security recommendations is going to be one of the most important recommendations that you make to the Congress. I must say that I was not favorably impressed Monday when a presentation was made to this committee. I was not impressed for several reasons.

One reason, the presentation was made by putting up a straw man, taking a program that has never been recommended by anybody, as far as I know. The witness did not know of anyone who recommended such a program, and comparing the proposed administration recommendations to the straw man; it makes the administration proposal look very good.

The second thing is, the assumptions were totally different. The straw man assumption took a 50-percent reserve requirement whereas the administration's proposal was a 37-percent reserve requirement. So naturally you are going to get considerable distortions.

I have always felt that the greatest asset an administration can have is credibility. But I think if that is kept up, there might be some credibility problem.

In another area where it seems to me than the administration may be working at cross purposes in its proposal is in regard to social security, is to increase the portion of social security taxes.

When you do that, does that not sort of run counter to the proposals to give greater incentives for economic growth on the part of industry?

Mr. LANCE. Mr. Chairman, I am sure that you can make that argument that that is, of course, an increase in cost that is involved in the process of running a business. I do not think that there is any question about that.

To what extent it reflects itself in the overall decision process on the amount of available capital for investment, I think that that is very hard to define.

Naturally, because the business community itself is familiar with the problem of increased cost, obviously, again it does have some inflationary impact as you see this sort of thing take place, but that is one of the tradeoffs in the ability to try to deal with the problem as it now stands.

I think that this, of course, was considered, it was looked at, but this is just one of the things that you have to accept and realize that it is a part of the process.

Senator BYRD. One of the witnesses yesterday, a very able economist, gave this recommendation. That investments by industry which are, as a practical matter, mandated by the Government, pollution control and so forth, should be given special treatment so that the company required to purchase fire equipment should be permitted to write those off as expenses rather than depreciate them as a normal investment would be.

Would you have a view on that?

Mr. LANCE. I think that should be something that should be given careful consideration because of the problems evolving as we see more and more investment mandated for environmental reasons or other reasons. That is a reduction of the capital pool that is available and which needs to be replenished as rapidly as possible, in my opinion, so it can go into productive output.

That is one of the basic problems that we had. Again, yesterday, for example, in conversations with people in the paper industry, they told me they spent some $5 billion in recent years in obtaining their pollution standards. This is something that was absolutely necessary to be done. There is not any question about that; as far as productivity increases go, there is no increased productivity. We now operate an economy where we need to be cognizant of that particular problem and be sure that we see that amount of capital replenishment made available for future investment as quickly as possible. It is something that ought to be considered.

Again, it has to be viewed in light of the overall tax policy, what you are doing here and what you are doing there. Specifically, I cannot say it is something that would be the result of tax reform. I do think we should consider it. It is something that I would personally favor.

Senator BYRD. Of course, determining the revenue loss would be an important consideration.

Mr. LANCE. Of course.

Senator BYRD. It has a lot of merit, providing the revenue loss can be absorbed.

Mr. LANCE. It is something that also has another effect. I think it should go forward. It is very, very tough to deal with, but there is another cost relationship always that relates to this sort of investment; in many instances there could be significant additions to operating costs or ongoing costs through its inflationary impact and passing these costs on ultimately to the consumer. That is something we have to be aware of also.

Senator BYRD. You have had some comments recently in regard to the Federal Reserve Board and high interest rates. Do you regard high interest rates as being inflationary?

Mr. LANCE. Yes, sir, I do.

Senator BYRD. In considering the entire question of economic growth, to what extent are tax incentives an official way of encouraging business investment and growth?

Mr. LANCE. Again, I think that it would be premature to try to say specifically what would fall in that category.

At the risk of prejudging what the Treasury's involvement is with regard to tax reform, I think that there is a broader context in that regard and we need to talk about it, not just as it relates to tax incentives. I think the biggest thing that we can do is bring about a sense of sureness, a sense of consistency, and a sense of predictability which you have already discussed with regard to the business community as opposed to a specific tax incentive.

Sometimes I think we rely too much in the area of tax incentives and say we ought to do this or that. I think the free enterprise system can work best if it has a sense of fairness and predictability.

The obvious incentives that I am concerned about relate to double taxation and I think psychologically that this is of great importance. From a practical standpoint, I think it is hard to make a determination of what may be ultimately felt in the economy. If you try to answer a question, what would be better, a general tax cut or elimination of double taxation, you can get all sorts of answers to that.

The basic answer lies ultimately in what the people decide to do with whatever money may be generated at a part of this sort of action.

In the area of depreciation, we have to look at our depreciation structure and find out exactly where we are now since circumstances have changed so much. The completion of projects, for example, has been stretched out because of, again, Government regulation, Government rulemaking. Where that is the case, that means a lengthy period of time is involved in tying up funds. We are losing the productive effect.

I think all of those things have to be explored and have to be looked at, and I am sure that Treasury is taking a look at them as they make a determination about the proposal.

Senator BYRD. Judging by public statements on the part of many individuals and judging by your interview with U.S. News & World Report and judging by your comments today, there seems to be greater focus on the elimination of double taxation on dividends than any other aspect of the tax code. Would that be a proper assumption?

Mr. LANCE. I do not know that that would be a proper assumption in the broadest sense, Senator. I think it is obviously a concern that many of us have because of the viability of the free enterprise system and the fact that double taxation again, smacks of unfairness, and the fact that we do have a problem here.

I think the President has been very clear in his concern about taxation and practices and policies, that they ought to be fair, that there are things that relate to unfairness and maybe benefits to business that should be eliminated as well as other things.

Obviously, there is concern there. It has to be viewed as to whether or not it ultimately becomes reality in the light of revenue, in light of what other things, recommendations, that you make. The concern is obviously there.

Senator BYRD. On February 7 in the U.S. News & World Report interview you said that the elimination of double taxation on dividends is a final step toward regaining healthy capital formation levels. I would take that to mean you give very high priority to it?

Mr. LANCE. No question about that, sir.

Senator BYRD. I do not disagree with that at all. But I thought that Dr. Pierre Rinfret made a very interesting statement yesterday. He testified that the large growth companies which he surveyed recently—I mentioned his contacting personally a number of large businesses—he says the large growth companies are opposed to corporate integration because it would place them under pressure to distribute dividends, when they need to retain those funds for future expansion.

Do you have a view on that?

Mr. LANCE. I am sure that that is a statement that reflects the concern of some companies. I have talked to people who said that that would be a problem. As I say, there is no unanimous opinion, as best I can tell, as to which would be the best way to approach the problem.

I am sure that the companies that found themselves in that sort of posture would much prefer a general tax cut than they would elimination of the double taxation aspects.

Be that as it may, I think that is something that has to be resolved in the process of formulating tax reform and the presentation to the Congress. We need to go through the debate process to determine what really is the best policy.

Senator BYRD. I assume that that is what is being done within the administration now. This is June 15. If that program is to be submitted in August, it must be pretty far along the way.

Mr. LANCE. Conversations are being held. I have been involved in a couple of sessions about it. The Treasury has a responsibility in that area. They are working extremely hard.

Senator BYRD. I certainly agree with the theory and the desire to eliminate the double taxation, but the more one considers it, the more complex it seems to become.

Mr. LANCE. Symbolically, I think it is of extreme importance in the capital formation process and I say symbolically because I have yet to be able to find any figures that relate to what actually takes place with regard to utilization of the funds that accrue as a result of the elimination. But I think that it is important, but as you go through the process. I do not think people feel quite the importance of it that I once felt was present. I do not know what the circumstances are to bring about that sort of thinking other than the things that you have mentioned and the things that I have mentioned.

Obviously, there is some disagreement, if not disagreement, lack of agreement, on what the net results would be with regard to the overall involvement in the utilization of capital formation in the process.

Senator BYRD. Well, thank you very much, Mr. Lance.

Mr. LANCE. Thank you, Mr. Chairman.

Senator BYRD. We appreciate your being here today.

Mr. LANCE. I appreciate the opportunity to be with you.

[The prepared statement of Mr. Lance follows:]

STATEMENT OF BERT LANCE, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. Chairman and members of the subcommittee, capital formation is an essential component of aggregate demand in our economy. Without adequate capital formation in the months and years ahead we will be unable to continue recovering from the worst recession we have experienced since the 1930's. But it would be short-sighted and incomplete to view capital formation only in the context of aggregate demand. If capital formation were only desirable because it helped to restore full employment and to use our industrial capacity more fully, we would simply view it as an alternative to more consumption spending or larger government outlays. The critical difference is that as additional capital formation takes place, it not only helps to restore full employment but also contributes to our long-run commitment to bring the rate of inflation down. Increased capital formation will eliminate bottlenecks in the supply of scarce commodities that would otherwise manifest themselves in rapidly rising prices. More generally, additional capital formation will increase the rate of growth of productivity in our economy. Growing productivity, the ability to produce a larger volume of goods and services with the real resources we have, permits us to enjoy wage and salary increases that are not inflationary.

What then can we in the Administration and you in the Congress do to encourage capital formation and to assure that the capital formation that does take place is directed to the sectors of the economy where it is most needed?

One answer, of course, is to improve our tax system. All taxes discourage capital formation in the sense that they divert resources away from the private sector in order to make resources available for the provision of government services. But there can also be an additional hidden effect of taxation. The form in which taxes raise a given amount of revenue may be such that incentives to invest are unnecessarily diminished. Taxes may also artificially distort the flow of investment so that capital formation does not take place in the sectors of the economy where it is most needed. Moreover, the tax system may be so complex that investment decisions are delayed or even postponed indefinitely because of the uncertainties caused by inordinate complexity. For this reason, the relationship between the tax system and capital formation is one of the major issues being addressed within the Administration as we turn our attention to tax reform. The Treasury testimony will develop this relationship between the tax system and capital formation in more detail.

Tax reform is just one way the Administration and the Congress can improve the prospects for an adequate rate of capital formation over the next few years.

Our contribution at the Office of Management and Budget, is going to lie in balancing the budget by 1981, in the context of a relatively fully employed economy; in reorganizing the government; and in reducing the paperwork burden government imposes on businesses and individuals. Each of these will contribute in some measure to promoting capital formation.

Balancing the budget will help ensure that adequate funds are available to finance desired private investment. Large deficits would tend to "crowd out" private investment from the money markets as the economy approaches full capacity. At the same time, deficits would contribute to inflationary pressure and to the expectation o finflation. Such expectations alone would have a dampening effect on investment decisions by undermining business confidence. If the budget is not balanced as the economy approaches full capacity utilization, we will have an unstable situation. Excessive fiscal stimulus, combined with strong investment would virtually guarantee double digit inflation, a cyclical downturn and another recession.

President Carter's commitment to balance the budget by 1981 is not a concern we in the OMB can put off until 1980. The decisions we make about the 1979 budget must be consistent with that commitment. To illustrate this commitment, President Carter is using 25 hours of his time to discuss the fiscal 1979 budget with me and members of my staff. This is the first time any President has participated in the details of these spring budget reviews. We realize that decisions the President makes on this next budget will shape longer-range spending. I can assure you that the Federal deficit in the 1979 budget will be significantly lower than in fiscal 1978.

Tax reform and budget balance are the usual answers we give give when asked, "What can the Federal government do to promote capital formation?" There are, however, additional answers. These answers are to be found in reviewing the way in which the Executive Branch of the Federal government is organized and the way in which it conducts business with the private sector. When it takes years rather than months for all the government agencies involved to grant the approvals necessary to plan, build and put into operation a major industrial plant, something is wrong. When compliance with the government's demands for reports becomes a major growth industry something else is wrong. The government reorganization effort that is underway in OMB has as one of its objectives simplifying the structure of government. We seek simplification because a simpler structure of government, one that imposes fewer paperwork burdens, will restore a sense of confidence on the part of the American people that the government knows what it is doing. Reorganization will act to improve the efficiency of government—reducing costs while maintaining and improving the services delivered to the public—and improving the responsiveness of governments to individual people and businesses and their problems, and to broader problems in our society. The improvement in the responsiveness of government is going to help create the positive climate necessary to capital formation. This latter point is even more important in relation to reducing the burden of government paperwork on individuals and businesses. I can't think of one individual thing government can do that will contribute more to a sense of business confidence, a sense that the government is getting off people's backs.

We are going to do these things. We are absolutely committed to them. When businessmen come to realize how serious we are about fiscal responsibility, about curbing inflation, about fostering the growth of the private sector, and adequate capital formation, then I think business confidence is going to be greatly strengthened, and that is going to stimulate considerable investment. Tax reform is certain to be a key element in conveying that message, that sense of confidence, to business. Mr. Chairman, that concludes my prepared remarks. I will be glad to answer any questions.

Senator BYRD. The next witness will be Dr. Lyle E. Gramley of the Council of Economic Advisers.

Welcome, Dr. Gramley.

STATEMENT OF DR. LYLE E. GRAMLEY, COUNCIL OF ECONOMIC ADVISERS

Dr. GRAMLEY. Thank you, Mr. Chairman. With your permission, I would like to read my statement in its entirety. It is not quite as long as it looks. It is triple spaced.

I might call your attention that there are some charts and tables in the back of the testimony to which I will be referring and it might be that it would be easier to pull those out to have them for handy reference.

Senator BYRD. Proceed as you wish.

Dr. GRAMLEY. My testimony will focus on aspects of the problem of capital formation that I believe are important for assessing what governmental policies should be to enhance the chances of achieving our broad economic objectives. In the interests of brevity, I will try to avoid duplication with the testimony of my colleagues.

The administration has established as its goal the elimination by 1981 of the present gap between actual real output and the potential that our resource base makes possible, and the achievement of a significant reduction in the rate of inflation by that time.

It will also seek to achieve a balanced Federal budget when the economy reaches high employment. These goals are mutually interrelated, and their realization depends importantly on the rate of business capital formation.

Business investment plays a dual role in the workings of the economic system. It directly creates job opportunities and income in the capital goods industries and in the firms which supply them. In the process, it adds to the overall demand for goods and services.

But as it adds to demand, new investment also increases supply. Because business investment affects both demand and supply, it plays a crucial role in the simultaneous achievement of our several economic objectives.

Let us consider first, the demand side of the economic equation.

Achievement of a balanced budget in a high employment economy will require a gradual reduction in the Federal deficit between now and 1981. The so-called full-employment budget—that is, an estimated budget in which outlays and receipts are adjusted for the loss of revenues and the additional expenditures associated with high unemployment—is already approximately in balance in fiscal 1977.

Senator BYRD. I would like to interrupt you there. I was fearful that the Council of Economic Advisers still has in the back of its head the so-called full-employment budget. I was glad to see that Mr. Lance repudiated it.

Dr. GRAMLEY. We think it is a useful tool, and I think the next paragraph in my testimony will indicate in what sense I regard it as a useful tool for thinking about fiscal policy.

The change in the full-employment budget surplus or deficit measures in a rough way the overall effect of fiscal policy on the economy.

Senator BYRD. I want to interrupt again, if you do not mind. I am sorry to interrupt you.

I thought we had gotten away from that. You are living in the past. The Nixon administration, the whole time it was here, was basing its assumptions on the full-employment budget and we got in worse and worse and worse shape and had higher and higher deficits all the time.

I will not interrupt you any more.

Dr. GRAMLEY. Your observation is well taken. We have to consider the actual budget as well as the full-employment budget, and there is a relation between the two. That is what I am developing in this paragraph.

Senator BYRD. That is what the Nixon people said. I thought we had gotten rid of the Nixon administration and had the Carter administration.

Dr. GRAMLEY. I think the full-employment budget was a concept that antedated the Nixon administration, one that economists use.

If we are to succeed in reducing gradually the actual Federal deficit between now and 1981, the full-employment budget will have to stay relatively close to balance throughout this period. Over the next 4 years taken as a whole, therefore, the effect of fiscal policy on aggregate demand would be relatively neutral. The sources of expansion to aggregate demand would thus have to come from other sectors than the Federal Government.

Apart from the Federal Government, the four largest categories of demand in our economy are personal consumption expenditures, outlays by State and local governments, business fixed investment, and residential construction.

Some general observations can be made about the likely contribution of each of these categories to aggregate demand in the years immediately ahead.

Consumer spending—by far the largest component of gross national product—has been a strong source of stimulus over the past 5 quarters. Consumers have been in a confident, buying mood. The personal saving rate has fallen from 7.5 percent in the fourth quarter of 1975 to about 5 percent in the first quarter of this year.

If we are successful in achieving stable economic growth with inflation under control, consumers should remain relatively confident and spend a comparatively high fraction of their incomes on goods and services over the next few years. But we cannot realistically anticipate that consumer spending will rise at a faster pace than consumers' after-tax income—since the rate of consumer spending relative to after-tax is already unusually high.

The State and local sector is likely to provide less stimulus to aggregate demand between now and 1981 than it has over the past decade or two. At the present time, population growth is relatively slow, and an absolute reduction in school-age population is occurring.

Demands for public services and facilities provided by State and local governments will therefore remain moderate, and this tendency will probably be reinforced by citizen resistance to higher taxes.

Reduced population growth also limits the potential expansion of residential construction. Even with rising rates of family formation and increasingly real incomes, residential construction seems likely to grow only a little faster than total real output over the next few years.

By process of elimination, therefore, a major source of the expansion in aggregate demand needed to keep us on the path to high employment by 1981 will have to come from strong and sustained growth of business capital spending.

Accelerated growth of business capital outlays is equally important from the standpoint of the supply side of the economic equation. At the present time, industrial capacity is relatively ample in nearly all lines of activity.

In the first quarter of this year, the rate of capacity utilization in all manufacturing was 81 percent—compared with a peak rate of 88 percent in 1973. In primary processing industries, where capacity constraints were a severe problem a few years ago, the rate of capacity use in the first quarter of 1977 was 82 percent—compared with 94 percent at the peak in 1973.

The severe pinch on industrial capacity in 1973 and 1974—and the resulting shortages and pressures on industrial prices that developed then—was a unique experience that is unlikely to be repeated in the near future. Nevertheless, recent growth rates of capacity are inadequate for our longer run needs.

Unless the pace of capital formation is stepped up considerably, rates of industrial capacity utilization will rise sharply as the recovery proceeds, and before too long we may find ourselves facing rising order backlogs and an accelerated rise in the prices of industrial materials and supplies.

It is for this reason, more than any other, that we must look to strong and sustained growth of business investment, rather than to an expansive Federal budget—as the source of stimulus to overall economic activity in the years just ahead.

In the course of the current recovery to date, the pace of business fixed investment has been disappointingly sluggish. Chart 1 shows the path of business-fixed investment—adjusted for price changes—during the recent recession and recovery and compares it with the average performance of this sector of demand in the five earlier postwar expansions. In the first quarter of this year, real business fixed investment was still 8 percent below its level in the fourth quarter of 1973—the peak quarter of the previous business cycle.

At this stage of the five previous cyclical expansions, real business fixed investment averaged 8 or 9 percent above its level at the previous business cycle peak.

The shortfall of investment from its usual cyclical profile has been most notable for long-lived investments. Investment by business in structures during the first quarter of this year was still nearly one-fifth below its peak level in 1973. Investment in machinery and equipment during the first quarter of 1977 was 5 percent below its peak 3 years earlier.

Senator BYRD. Could you get to your recommendations for changing this? You have said it was below. Could you give us your recommendations as to what Congress should do to bring about a change?

Dr. GRAMLEY. What I am going to do, as my testimony proceeds, is try to stress, as well as I can, some of the major reasons that a shortfall has occurred. I will have a concluding paragraph at the end as to what seems to me this implies.

I want to note that the slow pace of investment has been a worldwide phenomenon. It has occurred in almost all industrial countries around the world, during the past several years, that is, but in the manufacturing sector, the slowdown in capacity growth actually began much earlier.

Table 1 shows estimated growth rates of capacity in all manufacturing and in two subcategories of manufacturing—advanced processing and primary processing industries.

From 1948 to 1968, the estimated growth rate of capacity for all manufacturing was about 4.5 percent. A slowdown began about that time which has persisted up to the present.

Over the years from 1973 to 1976, the estimated growth rate was only around 3 percent, and last year capacity in manufacturing apparently rose by less than 2.5 percent.

Growth of capacity has been limited not only by low rates of investment but also by environmental regulations that have required businesses to devote a significant fraction of their new investment outlays to pollution control equipment.

As table 2 indicates, over the past 6 years about 8 to 9 percent of manufacturers' new plant and equipment expenditures have yielded substantial social benefits, but they have not added to productive capacity.

Senator BYRD. I would like to ask you a question at that point. It has been recommended for such investments, mandated investments relating to pollution control; for example, that companies be permitted to write these off as a business expense rather than depreciate them. What is your view on that?

Dr. GRAMLEY. I agree with Mr. Lance on that. It is something well worth considering.

I would note, as Mr. Woodworth did, that a 5-year writeoff is already available for those investments. Certainly it would be worthwhile considering going further in this direction.

Estimates of manufacturing capacity are necessarily very rough. There is no good way to make adequate allowance for obsolescence due to technological changes, shifts in relative prices, changes in environmental requirements, or other factors. But even if a large allowance is made for possible errors of estimation, it seems evident that capacity in manufacturing has been growing much too slowly to meet our long-run requirements.

Our industrial capacity will need to rise much faster over the next 5 to 10 years to avoid an eventual reemergence of capacity shortages as we return to a high-employment economy.

Another reason for concern with the recent slow growth of the capital stock relates to its implications for productivity. Over the long sweep of our Nation's economic history, technological change has resulted in an increasing amount of capital per hour of labor input in the production process, and this has been a significant source of rising productivity.

Chart 2 shows trends in productivity growth—that is, in output per hour worked—for all private business, for private nonfarm business, and for manufacturing firms. Rates of increase in productivity began slowing in the late 1960's and are now far below trend rates of growth in output per hour measured from 1948 to 1966.

Why this slowdown occurred, and how much of it is likely to be permanent, are controversial questions on which professional opinion is divided. It is agreed, however, that our ability to regain earlier growth rates of productivity will depend heavily on increasing the rate of capital formation.

Let me turn now to consider some of the reasons why business capital investment has been lagging in recent years.

Senator BYRD. Instead of giving us the history could you not, at this point, give us recommendations as to how the Congress can best proceed to change this?

Dr. GRAMLEY. I can; yes.

My recommendations are on the last page of my testimony and they are very general in nature because I think the problem is quite general in nature.

Senator BYRD. I was under the impression that the administration wanted to tackle this problem, and necessary to tackling the problem, we must be specific and not totally general.

Mr. GRAMLEY. That is correct. There are a number of things that need to be done.

Senator BYRD. All right. Proceed.

Dr. GRAMLEY. The last paragraph of my testimony on page 18 contains the thoughts that I have in that connection.

The analysis I have presented does not suggest any simple solution for insuring the sustained growth of business investment that is essential to regain high-employment economy. Improvement is needed on many fronts.

Senator BYRD. Let me ask you this, since you mention inflation. I recall in your confirmation hearing you said one of your areas of expertise is in economic forecasting, let us look ahead 12 to 18 months. Do you see more or less inflation?

Dr. GRAMLEY. We are going through a period in the first half of 1977 where we have experienced an acceleration of inflation. It is largely due to temporary factors, particularly the very large rise in food prices as well as a runup of fuel prices.

As we look at the prospects for food prices, we have every reason to expect a slower rise in the latter half of this year. As a result, we think the rate of inflation overall is probably going to diminish in the latter part of this year and will continue at a lower rate during 1978 than it did in 1977.

That is a hope. None of us can be sure at all. Projections of price behavior are very difficult, very uncertain. But that is, I think, a reasonably realistic outlook at the present time.

Senator BYRD. Let me paraphrase what you said and see whether I understood you accurately.

As I understand it from your comments, you feel that looking ahead 12 to 18 months that the country will have less inflation than it has now.

Dr. GRAMLEY. I believe we will have a lower rate of inflation because of the better behavior of food prices. Whether we will achieve any improvement in the underlying rate of inflation, which is now at about 6 percent, I do not know.

If you look at the trend——

Senator BYRD. Do you put today's inflation at 6 percent?

Dr. GRAMLEY. The underlying rate is at about 6 percent. I derive that figure two ways. If you take the Consumer Price Index, and exclude the food and fuel——

Senator BYRD. How can you exclude things and arrive at a rate of inflation?

Dr. GRAMLEY. We are simply trying to get at those factors that are likely to be of a longer range duration and relate more to trends in industrial costs.

Senator BYRD. You gave your view that there will be a lower rate of inflation 12 to 18 months from now. Let us get at what the inflation is today.

You cannot eliminate this and eliminate that and eliminate something else and say the inflation is down to 6 percent.

Dr. GRAMLEY. That is a valid point, Senator.

Senator BYRD. In your judgment—you are an expert on this—What is the rate of inflation today, without eliminating?

Dr. GRAMLEY. Without eliminating anything, if you look at the rate of increase in both consumer and wholesale prices during the first 5 months of this year, the annual rate of inflation has been in the neighborhood of 10 percent, but I would want to point out to you that we have had a very unusual rise of food prices that has contributed importantly to the acceleration of inflation.

Senator BYRD. When I think of inflation—maybe I do not think of it in the right sense—but I am thinking about the housewife who goes to the market. I am thinking about the wage earner. I am thinking of people, I am thinking about individuals. They cannot eliminate these items. They cannot eliminate food, because they have to eat.

Dr. GRAMLEY. I agree.

Senator BYRD. They cannot eliminate education if they want to educate their children. They cannot eliminate medical care.

What I want to know, what is the rate of inflation as of today, and you say 10 percent.

Dr. GRAMLEY. Let me put the matter to you this way, Senator. Last year, during 1976, the rate of increase in consumer prices overall was about 4¾ percent. That was a consequence of the fact that food prices increased relatively little. We would have fooled ourselves in terms of underlying trends of inflation if we had said we did well last year.

In fact, if you take the food prices out, you found that other prices were going up in the neighborhood of 6 percent. I think it is important to try to look at what is causing the price increase and asking how long that source of change is likely to continue.

That is important in assessing the inflationary problem at the present time.

There is, I think, every reason to expect a moderation in the rise of food prices in the latter part of this year, and through 1978, so that the rate of inflation in the latter part of this year and in 1978 will be less than what we have seen in the first 5 or 6 months of this year.

Senator BYRD. As of now, we have a double-digit inflation?

Dr. GRAMLEY. That is correct.

Senator BYRD. Thank you.

Dr. GRAMLEY. Would you wish me to go back and proceed with my testimony?

Senator BYRD. It will be published in full in the record. I think if we get your recommendations, it will be helpful.

Dr. GRAMLEY. My first thought on this is the problem of weak investment in recent years has been a consequence of excess capacity and lack of assurance by businesses of steadily expanding markets. It has also been a consequence of fears of inflation.

One of the things that we need to do, then, is to provide businesses with the assurance that there will be steadily expanding markets for products and assurance, also, that inflation will be brought under better control.

I point out in my testimony that I think that the uncertainty of environmental and safety regulations, as has been discussed this morning, is a very important factor that has been inhibiting business investment, and I think that those regulations must be made less uncertain.

I point out that financial markets must be conducive to raising funds in ways that prevent balance sheet distortions, such as changes in debt/equity ratios.

Finally, I would suggest an additional tax incentive for investment would be of benefit, but I would defer to my colleagues in the Treasury who are considering these matters in great detail at the present time as for comments on what particular forms those tax incentives might take.

Senator BYRD. You say that a matter of major importance to business is to know that inflation will be brought under control?

Dr. GRAMLEY. That is correct.

Senator BYRD. No. 1, what assurance is there that inflation will be brought under control; and No. 2, what steps are being taken, or will need to be taken, to bring inflation under control?

Dr. GRAMLEY. I do not think we are going to be able to provide concrete assurance that inflation is being brought under control until business sees it actually happening.

The administration has a program, an anti-inflationary program, to deal with this problem. Its first important element is to pursue prudent monetary and fiscal policies, including a fiscal policy that will balance the budget by 1981 in a high employment economy.

I think that is a very critical consideration.

Senator BYRD. Let me see if I understand you, what you are saying. You think it is critical that the Federal budget be balanced by 1981?

Dr. GRAMLEY. I think it is critical that we balance the Federal budget as we get back to full employment.

Senator BYRD. I want to get an understanding of what you mean. I understood you to say that you regard it as critical that the Federal budget be balanced by 1981. I assume you mean by that on a normal budgetary basis.

Dr. GRAMLEY. That is right.

Senator BYRD. Not only the so-called full employment budget basis.

Dr. GRAMLEY. I certainly do. I am talking about the actual budget deficit.

Senator BYRD. So that you feel that it is critical, in order to get inflation under control, that the budget be balanced by 1981?

Dr. GRAMLEY. What I said, Senator, it is critical to get the budget balanced by 1981, a high-employment economy. The prospects for balancing the budget if the economy does not perform well would be slim. If we do not have a rapidly growing economy you simply will not have the increases in revenue.

Senator BYRD. If the budget is not balanced by 1981, that would mean that we will be under greater inflationary pressures. Is that an accurate statement?

Dr. GRAMLEY. I think that is true if the economy performs strongly between now and 1981 and that is why the strategy for budget planning in the administration starts out with the proposition that we should assume the economy will perform strongly and plan our budget strategy now so that we will be able to have a balanced budget in 1981, assuming that the economy does perform strongly.

I am optimistic about the prospects for a strong and sustained rate of economic growth between now and then.

Senator BYRD. There are two ways, of course, to balance the budget. One is with additional revenue and one is with some restraint on spending.

Dr. GRAMLEY. I think restraint on spending is an important part of what needs to be done. I think the administration is committed to that.

The President has indicated that he intends to reduce Federal expenditures as a proportion of our gross national product to 21 percent by 1981. That is a firm commitment.

Senator BYRD. I cannot seem to get a direct answer from you. For that reason, I am not sure whether you are qualifying your answer.

Let me phrase it again.

A moment ago, you said you regarded it as critical to balance the budget by 1981. Could you answer that, whether you do or do not regard it as critical.

Dr. GRAMLEY. Yes; I do regard it as critical, but I would like to make my statement again: that is, I think it is critical to follow prudent monetary and fiscal policies and on the fiscal side, I mean by that getting to a balanced budget by 1981, assuming the economy performs well, assuming that we get to high employment.

The prospect for balancing the budget if the economy does not perform well is not good, because it is critical to have a strong expansion of Federal revenues.

Senator BYRD. Are you committed to a balanced budget or not committed to a balanced budget?

Dr. GRAMLEY. As I said, the administration is committed to a balanced budget in 1981 in the context of a high-employment economy.

Senator BYRD. You insist on qualifying it. Could you give me your own view?

Do you favor, or do you stand by the statement that you made a moment ago, or do you insist upon qualifying it, that a balanced budget by 1981 is critical if we are going to get inflation under control?

Dr. GRAMLEY. I do not think I am qualifying it, Senator. I am optimistic on how well the economy is going to perform between now and 1981. I think that if we pursue intellignt, prudent fiscal strategy, prudent, intelligent monetary strategy, provide incentives to business investment in some form or another, do some things by the way——

Senator BYRD. How prudent—in your judgment, how prudent is a $65 billion deficit for fiscal year 1978?

Dr. GRAMLEY. I think that size of a deficit for fiscal 1978 is a consequence of the fact that our economy is still very depressed.

Senator BYRD. May I ask you the question again?

How prudent, in your judgment, is a $65 billion deficit for fiscal 1978?

Dr. GRAMLEY. I am not concerned about the size of the deficit now and its implications for economic performance, given the fact——

Senator BYRD. I have no further questions. Thank you, sir.

[The prepared statement of Dr. Gramley follows:]

STATEMENT OF LYLE E. GRAMLEY, MEMBER, COUNCIL OF ECONOMIC ADVISERS

I am pleased to meet with this Committee today to participate in your hearings on Incentives for Economic Growth.

My testimony will focus on aspects of the problem of capital formation that I believe are important for assessing what governmental policies should be to enhance the chances of achieving our broad economic objectives. In the interests of brevity, I will try to avoid duplication with the testimony of my colleagues.

OBJECTIVES FOR ECONOMIC PERFORMANCE

The Administration has established as its goal the elimination by 1981 of the present gap between actual real output and the potential that our resource base makes possible, and the achievement of a significant reduction in the rate of inflation by that time. It will also seek to achieve a balanced Federal budget when the economy reaches high employment. These goals are mutually interrelated, and their realization depends importantly on the rate of business capital formation.

Business investment plays a dual role in the workings of the economic system. It directly creates job opportunities and income in the capital goods industries and in the firms which supply them. In the process, it adds to the overall demand for goods and services. But as it adds to demand, new investment also increases supply. Because business investment affects both demand and supply, it plays a crucial role in the simultaneous achievement of our several economic objectives.

Let us consider, first, the demand side of the economic equation.

Achievement of a balanced budget in a high employment economy will require a gradual reduction in the Federal deficit between now and 1981. The so-called full-employment budget—that is, an estimated budget in which outlays and receipts are adjusted for the loss of revenues and the additional expenditures associated with high unemployment—is already approximately in balance in fiscal 1977.

The change in the full-employment budget surplus or deficit measures in a rough way the overall effect of fiscal policy on the economy. If we are to succeed in reducing gradually the actual Federal deficit between now and 1981, the full-employment budget will have to stay relatively close to balance throughout this period. Over the next four years taken as a whole, therefore, the effect of fiscal policy on aggregate demand would be relatively neutral. The sources of expansion in aggregate demand would thus have to come from other sectors than the Federal Government.

Apart from the Federal Government, the four largest categories of demand in our economy are personal consumption expenditures, outlays by State and local governments, business fixed investment, and residential construction. Some general observations can be made about the likely contribution of each of these categories to aggregate demand in the years immediately ahead.

Consumer spending—by far the largest component of gross national product—has been a strong source of stimulus over the past five quarters. Consumers have been in a confident, buying mood. The personal saving rate has fallen from 7½ percent in the fourth quarter of 1975 to about 5 percent in the first quarter of this year.

If we are successful in achieving stable economic growth with inflation under control, consumers should remain relatively confident and spend a comparatively high fraction of their incomes on good and services over the next few years. But we cannot realistically anticipate that consumer spending will rise at a faster pace than consumers' after-tax income—since the rate of consumer spending relative to after-tax income is already unusually high.

The State and local sector is likely to provide less stimulus to aggregate demand between now and 1981 than it has over the past decade or two. At the present time, population growth is relatively slow, and an absolute reduction in school-age population is occurring. Demands for public services and facilities provided by State and local governments will therefore remain moderate, and this tendency will probably be reinforced by citizen resistance to higher taxes.

Reduced population growth also limits the potential expansion of residential construction. Even with rising rates of family formation and increasing real incomes, residential construction seems likely to grow only a little faster than total real output over the next few years.

By process of elimination, therefore, a major source of the expansion in aggregate demand needed to keep us on the path to high employment by 1981 will have to come from strong and sustained growth of business capital spending.

Accelerated growth of business capital outlays is equally important from the standpoint of the supply side of the economic equation. At the present time, industrial capacitv is relatively ample in nearly all lines of activity. In the first quarter of this year, the rate of capacity ultilization in all manufacturing was 81 percent—compared with a peak rate of 88 percent in 1973. In primary processing industries, where capacity constraints were a severe problem a few years ago, the rate of capacity use in the first quarter of 1977 was 82 percent—compared with 94 percent at the peak in 1973.

The severe pinch on industrial capacity in 1973 and 1974—and the resulting shortages and pressures on industrial prices that developed then—was a unique experience that is unlikely to be repeated in the near future. Nevertheless, recent growth rates of capacity are inadequate for our longer-run needs. Unless the pace of capital formation is stepped-up considerably, rates of industrial capacity utilization will rise sharply as the recovery proceeds, and before too long we may find ourselves facing rising order backlogs and an accelerated rise in the prices of industrial materials and supplies. It is for this reason, more than any other, that we must look to strong and sustained growth of business investment—rather than to an expansive Federal budget—as the source of stimulus to overall economic activity in the years just ahead.

GROWTH OF INVESTMENT AND CAPACITY

In the course of the current recovery to date, the pace of business fixed investment has been disappointingly sluggish. Chart 1 shows the path of business fixed investment—adjusted for price changes—during the recent recession and recovery and compares it with the average performance of this sector of demand in the five earlier post war expansions. In the first quarter of this year, real business fixed investment was still 8 percent below its level in the fourth quarter of 1973—the peak quarter of the previous business cycle. At this stage of the five previous cyclical expansions, real business fixed investment averaged 8 or 9 percent above its level at the previous business cycle peak.

The shortfall of investment from its usual cyclical profile has been most notable for long-lived investments. Investment by business in structures during the first quarter of this year was still nearly one-fifth below its peak level in 1973; investment in machinery and equipment during the first quarter of 1977 was 5 percent below its peak three years earlier.

The sluggish pace of investment during this recovery—a phenomenon which has also occurred in most other industrial countries around the world—has meant that growth of the capital stock has been very slow during the past several years. In the manufacturing sector, the slowdown of capacity growth actually began much earlier.

Table 1 shows estimated growth rates of capacity in all manufacturing and in two subcategories of manufacturing—advanced processing and primary processing industries. From 1948 to 1968, the estimated growth rate of capacity for all manufacturing was about 4½ percent. A slowdown began about that time which has persisted up to the present. Over the years from 1973 to 1976, the estimated growth rate was only around 3 percent, and last year capacity in manufacturing apparently rose by less than 2½ percent.

Growth of capacity has been limited not only by low rates of investment but also by environmental regulations that have required businesses to devote a significant fraction of their new investment outlays to pollution control equipment. As Table 2 indicates, over the past 5 years about 8 to 9 percent of manufacturers' new plant and equipment expenditures have been allocated to pollution abatement. These expenditures have yielded substantial social benefits, but they have not added to productive capacity.

Estimates of manufacturing capacity are necessarily very rough. There is no good way to make adequate allowance for obsolescence due to technological changes, shifts in relative prices, changes in environmental requirements, or other factors. But even if a large allowance is made for possible errors of estimation, it seems evident that capacity in manufacturing has been growing much too slowly to meet our long-run requirements. Our industrial capacity will need to rise much faster over the next five to ten years to avoid an eventual re-emergence of capacity shortages as we return to a high-employment economy.

Another reason for concern with the recent slow growth of the capital stock relates to its implications for productivity. Over the long sweep of our Nation's economic history, technological change has resulted in an increasing amount of capital per hour of labor input in the production process, and this has been a significant source of rising productivity.

Chart 2 shows trends in productivity growth—that is, in output per hour worked—for all private business, for private nonfarm business, and for manufacturing firms. Rates of increase in productivity began slowing in the late 1960's, and are now far below trend rates of growth in output per hour measured from 1948 to 1966. Why this slowdown occurred, and how much of it is likely to be permanent, are controversial questions on which professional opinion is divided. It is agreed, however, that our ability to regain earlier growth rates of productivity will depend heavily on increasing the rate of capital formation.

REASONS FOR THE LOW LEVELS OF INVESTMENT

Let me turn now to consider some of the reasons why business capital investment has been lagging in recent years.

One fundamental reason for the relatively weak rise of business investment over the past two years has been the existence of excess capacity relative to needs for current production. The deep recession of 1974–75 reduced the rate of capacity utilization in manufacturing to the lowest level of the postwar period. Excess capacity has existed outside the manufacturing sector, also. For example, construction of office buildings and shopping centers is still depressed because of the unsustainably rapid expansion of these facilities that occurred during the building boom of 1971 to 1973.

The economic turbulence of recent years has probably raised fears in the minds of business managers that our economy may have become more unstable, and that the risks of investment have therefore increased. High and varying rates of inflation have made business profit calculations even more uncertain.

A second fundamental reason for recent low rates of investment is the high cost of capital. Capital costs have several dimensions—the prices of new capital assets, interest rates on borrowed funds, and the costs of raising funds through equity issues.

One way of summarizing these various dimensions of capital costs is to compare the market value of a corporation's outstanding common stock and the market value of its outstanding debt with the replacement cost of its assets. If the value the market places on outstanding debt and equity are above replacement costs of a firm's assets, the firm should be encouraged to borrow or float new stock issues to invest in new plant and equipment—for by doing so, it will create capital gains for owners of its securities. If, on the other hand, the value that the market places on the assets of a corporation is below their replacement costs, investment will tend to be discouraged.

Chart 3 shows trends in the ratio of the market value of debt and equity to the replacement costs of assets of nonfinancial corporations over the past quarter century. This ratio reached its peak in the middle 1960's and has since been generally declining. The relatively depressed state of the stock market in recent years has been a dominant factor in the decline of this ratio and has played an important role in inhibiting new investment in plant and equipment.

Investment incentives may also be viewed from the standpoint of trends in after-tax rates of return on investment. As Chart 4 shows, there has been a general downward trend in the rate of return on reproducible assets of nonfinancial corporations since the middle years of the 1960's -from about 10 percent in 1965-66 to about 6 percent presently. Current low rates of return are due, in part, to the fact that the economy is still depressed. Rough allowances for this suggest, however, that only about half of the decline in the rate of return since the middle years of the 1960's can be ascribed to this fact.

The underlying decline in after-tax rates of return to capital is due in some degree to the fact that, during the inflation of the past ten years, depreciation allowances for tax purposes have been below the replacement costs of depreciating assets. Chart 5 shows the ratio of depreciation allowances for tax purposes to straight-line depreciation at replacement cost for nonfinancial corporations. Over the first twenty years of the postwar period, this ratio rose markedly—because of a series of provisions that liberalized depreciation allowances for tax purposes. Since the middle 1960's, the ratio has declined steadily—except for a brief period in 1972, when the Asset Depreciation Range System took effect,

I noted earlier that the relatively low level of common stock prices in recent years has discouraged businesses from investing through its effects on the cost of capital. A depressed stock market has yet another inhibiting effect on business investment that is worth noting. When the costs of equity funds are high, businesses are encouraged to raise external funds principally through debt issues, and this increases their risk exposure. Since our tax laws permit deduction of interest as a cost for tax purposes, but do not make a comparable allowance for the costs of raising equity funds, this tendency toward debt financing is accentuated.

Over the postwar period, the bulk of total external funds raised by nonfinancial corporations has taken the form of debt issues. And from 1960 through 1974, the proportion of corporate capital outlays financed from external sources—rather than retained earnings—rose sharply. The result was a pronounced rise in ratios of outstanding debt to equity, as shown in Table 3. The ratio of debt to equity shown there. I should note, corrects for the understatement of equity on the books of corporations that occurs because inflation raises the nominal value of physical assets.

Recently, the ratio of debt to equity has declined somewhat. This improvement stems mainly from the fact that the rate of investment has been relatively depressed, and this has held down the overall amount of external financing. But it has stemmed in some measure from an increase in recent years in the amount of external financing taking the form of equity issues.

An improvement in the stock market would certainly help to increase the ability of businesses to raise funds through new issues of common stock. How much businesses would avail themselves of such an opportunity is, of course, conjectural.

Another factor affecting business investment decisions that has been of substantial importance as a deterrent to capital formation in recent years is the uncertainty of governmental regulations, particularly environmental and safety regulations. That is a matter of substantial concern to business, especially those in which expenditures for pollution control are absorbing a substantial fraction of new outlays for plant and equipment.

Uncertainties as to what new regulations will be five or ten years from now, and whether a plant built today will meet those standards, is not a matter that can be dealt with readily by tax policy, but it is a problem which the Administration intends to address.

The analysis I have presented does not suggest any simple solution for ensuring growth of business investment that is essential to regain a high-employment economy. Improvement is needed on many fronts. Businesses need assurance of steadily expanding markets for their products and assurance, also, that inflation will be brought under better control. Environmental safety and regulations must be made less uncertain. Financial markets must be conducive to raising funds—and in ways that prevent balance-sheet distortions. Additional tax incentives for investment would be of benefit, and my colleagues from the Treasury will be discussing various forms that such incentives might take.

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TABLE 1.—RATES OF CAPACITY GROWTH IN MANUFACTURING

	1948-68	1968-76	1968-73	1973-76
All manufacturing	4.6	3.6	4.0	3.0
Advanced processing industries	4.8	3.3	3.8	2.6
Primary processing industries	4.3	4.0	4.2	3.7

Source: Federal Reserve Board.

TABLE 2.—PERCENTAGE OF NEW PLANT AND EQUIPMENT EXPENDITURES ALLOCATED TO AIR, WATER, AND SOLID WASTE POLLUTION ABATEMENT, 1967-76 [1]

	All industry	Manufacturing
Year:		
1967	2.0	3.5
1968	2.1	3.7
1969	2.5	4.7
1970	3.3	5.9
1971	4.0	7.8
1972	4.9	8.4
1973	5.1	8.6
1974	5.0	8.0
1975	5.8	9.3
1976	5.6	8.3

[1] Excludes agricultural business, real estate operators; medical, legal, educational, and cultural services; and nonprofit organizations. Excludes outlays charged to current account.

Source: U.S. Department of Commerce, Bureau of Economic Analysis. Preliminary estimates prepared June 1977.

TABLE 3.—*All Nonfinancial Corporations Ratio of debt to equity*

1950	0.319	1964	0.444
1951	0.326	1965	0.456
1952	0.333	1966	0.468
1953	0.333	1967	0.476
1954	0.336	1968	0.489
1955	0.337	1969	0.491
1956	0.340	1970	0.511
1957	0.348	1971	0.526
1958	0.360	1972	0.541
1959	0.373	1973	0.539
1960	0.394	1974	0.529
1961	0.410	1975	0.501
1962	0.423	1976	0.495
1963	0.436		

Equity is computed by subtracting total liabilities from total assets, where physical assets are evaluated at current prices after deducting depreciation on a current cost straight-line basis.

Debt: Total liabilities less trade credit and other short-term accounts payable.

Source: Constructed from Balance Sheet data prepared by the Flow of Funds Section, Federal Reserve Board.

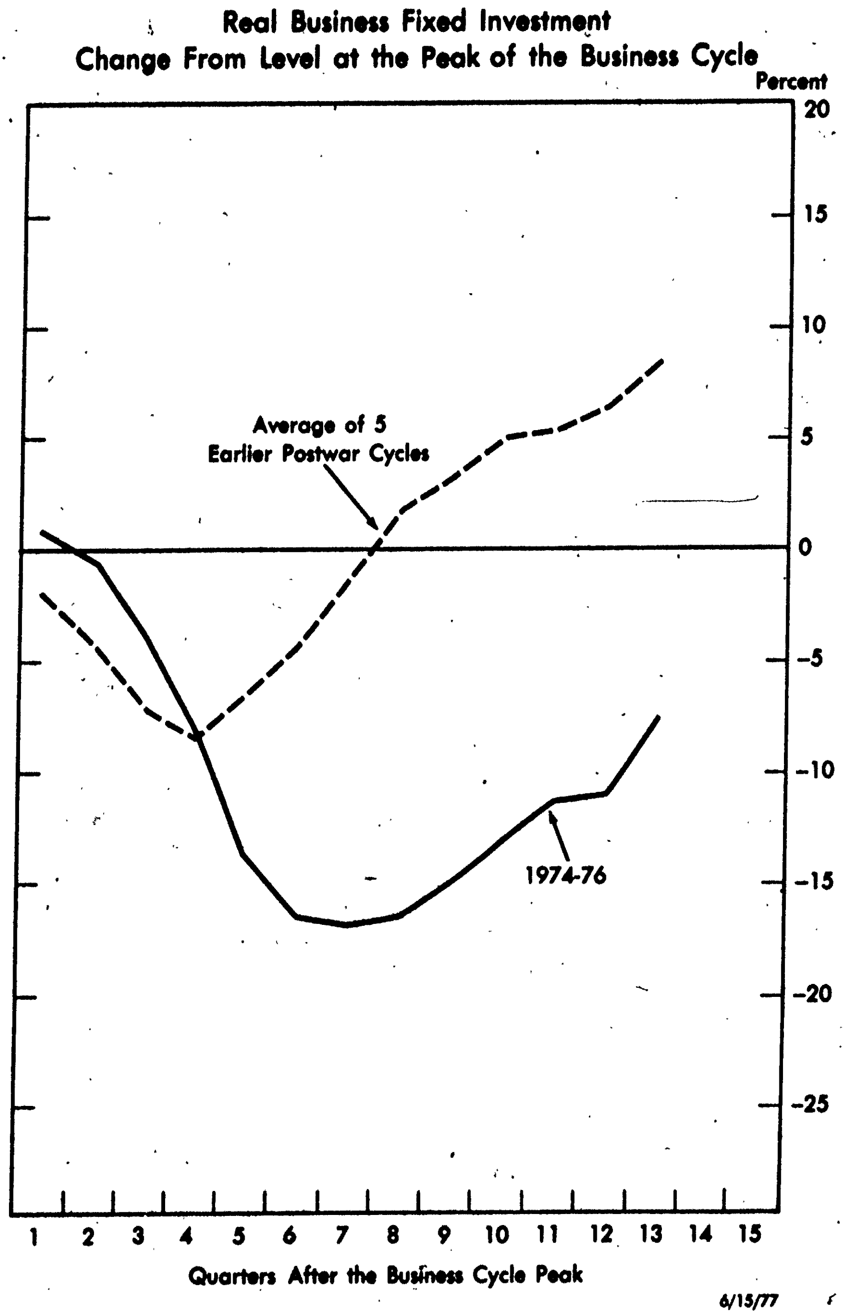
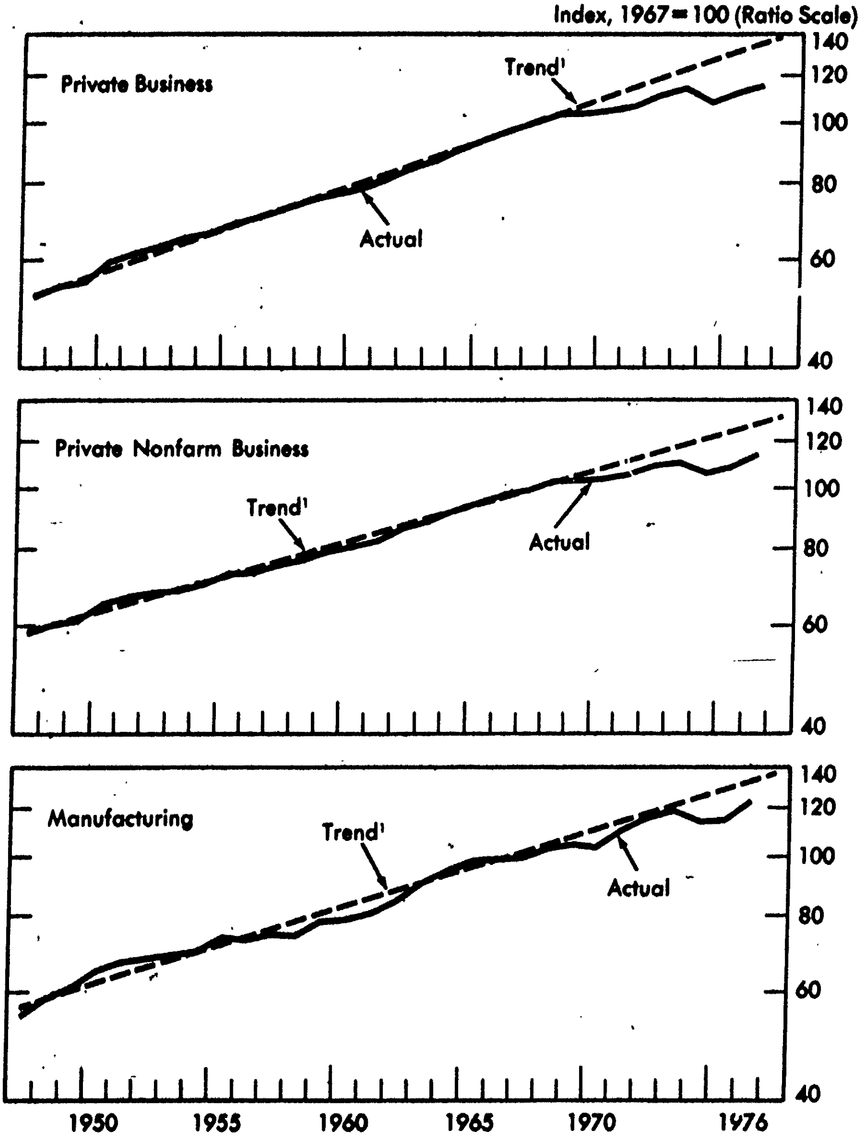

Real Business Fixed Investment
Change From Level at the Peak of the Business Cycle
Percent
20
15
10
5
0
-5
-10
-15
-20
-25
Average of 5
Earlier Postwar Cycles
1974-76
1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
Quarters After the Business Cycle Peak
6/15/77

CHART 1

Output Per Hour, All Persons



[1]Trend line computed from 1948 to 1966. Growth rates are: for private business, 3.3 percent; for private nonfarm business, 2.7 percent; and for manufacturing, 2.9 percent.

6/15/77

CHART 2

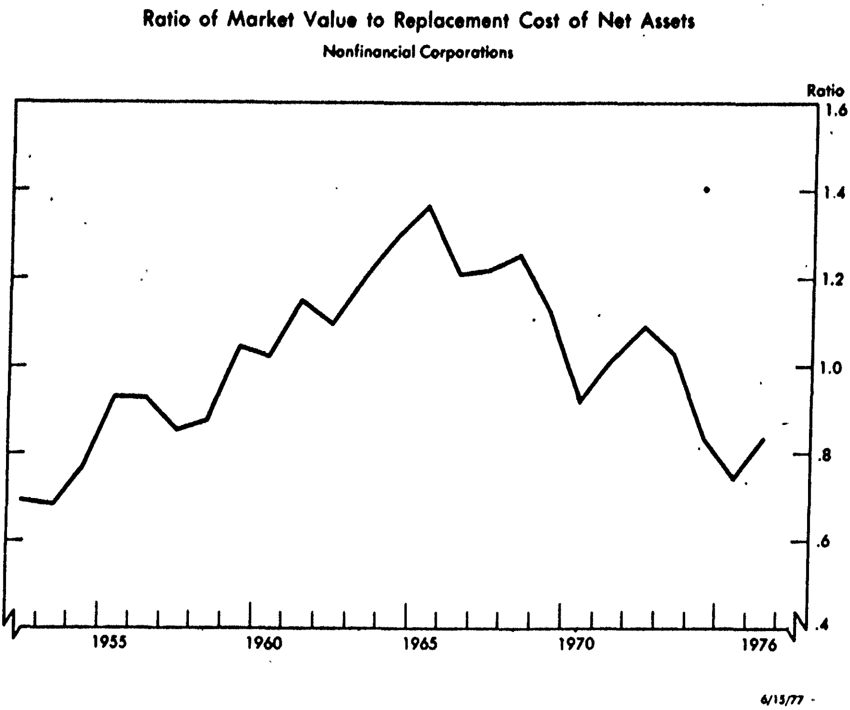
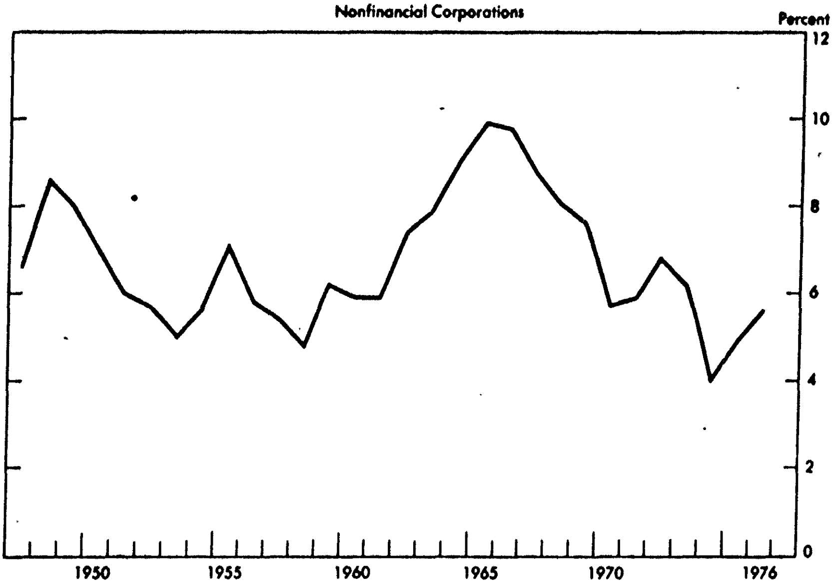

Ratio of Market Value to Replacement Cost of Net Assets
Nonfinancial Corporations
Ratio
1.6
1.4
1.2
1.0
.8
.6
.4
1955
1960
1965
1970
1976
6/15/77

CHART 3

Rate of Return on Reproducible Capital

Nonfinancial Corporations



Note: The rate of return is equal to the sum of corporate profits, adjusted for inventory and capital stock valuations, plus net interest minus tax liabilities divided by the current dollar value of reproducible capital.

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CHART 4

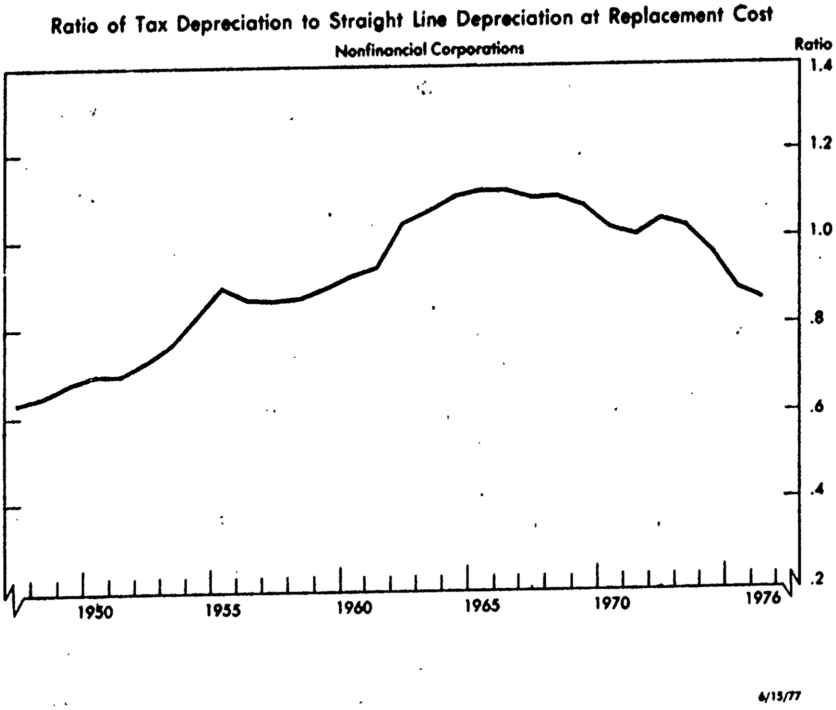

CHART 5

Senator BYRD. Our next witness will be Dr. Emil Sunley, Deputy Assistant Secretary of the Treasury for Tax Policy.

STATEMENT OF EMIL SUNLEY, DEPUTY ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. SUNLEY. Thank you, Senator. I have no additional statement to that submitted by Dr. Woodworth for the Treasury Department. I am here to make myself available for questioning.

Senator BYRD. In your judgment, is it critical to have a balanced budget by 1981?

Mr. SUNLEY. Yes. One of the goals of the administration is to achieve a balanced budget.

Senator BYRD. I know it is the goal of the administration. I am asking your viewpoint.

Mr. SUNLEY. Yes; it is critical that we achieve that goal.

Senator BYRD. If we do not achieve the goal, there will be more inflation?

Mr. SUNLEY. I can write you two scenarios on that one, Senator Byrd. If, by 1981, we have high unemployment, then I think a small deficit would not be inflationary.

Senator BYRD. What do you regard as a small deficit?

Mr. SUNLEY. In this context, $10 or $15 billion.

Senator BYRD. What do you think about a $65 billion deficit?

Mr. SUNLEY. I think that the deficit in 1976 is very large.

Senator BYRD. I am talking about 1978. That is what we are working on now.

Mr. SUNLEY. I believe that the latest estimate for fiscal 1978 is a deficit of about $58 billion, and that is a large deficit. It is consistent with a very high level of unemployment in the economy. Given the level of unemployment, and our need to move the economy toward full employment, I am not concerned with that deficit.

Senator BYRD. All of this is tremendously important to me because the President has been talking about a balanced budget. Both of you say that you are not particularly concerned about a $65 billion deficit.

Mr. SUNLEY. No.

Senator BYRD. You just said that a moment ago.

Mr. SUNLEY. I said the President did not say that about fiscal year 1978. He is concerned——

Senator BYRD. Can you speak for the President in that regard, that he is not concerned about a $65 billion deficit in 1978? I have not heard him say that. Maybe you have.

Mr. SUNLEY. He is concerned, in general, about the size of the deficit, but, there are a number of things, as you are aware, that he is concerned about in planning economic policy.

Senator BYRD. In your judgment, looking ahead 12 to 18 months, will we have more inflation or less inflation than we have now?

Mr. SUNLEY. I think my views would be consistent with Lyle Gramley's. Macro forecasting is not my primary area of expertise.

Senator BYRD. I assume that you agree that we have double digit inflation now?

Mr. SUNLEY. If you look at the actual rate of inflation, it is about 10 percent.

Senator BYRD. Which is double digit?

Mr. SUNLEY. Yes.

Senator BYRD. Do you share Mr. Lance's view that the so-called full employment budget is a gimmick?

Mr. SUNLEY. I am not sure that I would characterize it as a gimmick. For some purposes it is important to look at the budget in terms of what its position would be if the economy were operating at full employment.

It is also very important to look at what the actual deficit is at any moment. It depends for what purpose you are looking at the budget figures. I think they both can be very useful.

Senator BYRD. Is the Treasury Department now contemplating operating on a full-employment budget?

Mr. SUNLEY. No. The purpose of the longrun planning between Treasury OMB, and the Council of Economic Advisors is to simultaneously achieve full employment and a balanced budget, measured by the actual budget balance, by 1981.

Senator BYRD. You are the Deputy Assistant Secretary of the Treasury for Tax Policy. I do not want to misquote you.

As I recollect, a moment ago in response to one of my questions, you said that you were not concerned about the $65 billion deficit that we will have in this upcoming year.

Mr. SUNLEY. I am not concerned because I believe that it is not going to have a major inflationary impact.

Senator BYRD. It is your judgment that continued and accelerated Government deficits are not inflationary?

Mr. SUNLEY. No, sir.

My judgment is that whether or not the deficit is inflationary depends, in part on the level of total demand in the economy and the level of unemployment. But in a high employment economy, a large Government deficit can crowd out private investment.

Senator BYRD. Did you serve in the Nixon administration?

Mr. SUNLEY. I did not have a political appointment in the Nixon administration. I was in the Federal service.

Senator BYRD. It sounds like the testimony of the Nixon years.

Mr. SUNLEY. I also served in the Johnson administration as a civil servant.

Senator BYRD. It sounds a little bit like that, too.

All right, let's get to some tax matters, then.

I must say I am a little disappointed that the people in Treasury do not seem particularly concerned about the tremendous deficits.

Secretary Blumenthal has said, ending double taxation is a linchpin of the President's tax reform proposals. Is this because of the revenue involved or the quality of debt and equity financing, or the opportunity to end the use of corporations by wealthy taxpayers. What is it? Why is it so important?

Mr. SUNLEY. In order to make it clear, I would say at this point, as Dr. Woodworth did, that no decisions have been made on whether or not a proposal to eliminate the double taxation on dividends will be included in the administration's proposal. We are continuing to look at that proposal and at the alternatives also mentioned by Dr. Woodworth.

Senator BYRD. From the exploration that you have made from your studies, do you feel that it is practical to eliminate the double taxation of dividends? If so, in what direction would you go?

Mr. SUNLEY. At Treasury, we have been developing several schemes for accomplishing that goal. There are some pluses and minuses to different approaches that one might pursue here. I am not, at this point, prepared to make a recommendation as to which way we should go.

Senator BYRD. Do you feel that the elimination of the double taxation would be desirable?

Mr. SUNLEY. A lot can be said for it, but there are other ways to stimulate capital formation.

Senator BYRD. What?

Mr. SUNLEY. Cutting the corporate tax rate, for instance.

Senator BYRD. Do you feel that the depreciation schedule should be liberalized?

Mr. SUNLEY. I believe that is one alternative which should be considered.

Senator BYRD. I assume that most everything should be considered, should it not?

Mr. SUNLEY. Yes. We have to consider proposals in the context of how much they cost and how effective they will be in achieving not only the goal of stimulating investment, but also our goals of achieving more equity and more simplicity in the tax system. Different goals often compete with one another. We have to be concerned about the overall revenue cost of various proposals and how they fit together with other parts of the tax program as they are determined.

You have to put the entire package together and take a look at it to see if, as a whole, it makes some sense. I say again that no decision has been made about the elements of that package.

Senator BYRD. Do you have any figures, round figures, ball park figures, that would indicate what the revenue loss might be if the Government were to permit companies to write off as a business expense their mandated investments?

Mr. SUNLEY. It could easily be $2 to $3 billion the first year, assuming 10 percent—excuse me—assuming 5 percent of total investment is mandated investment, which I think is in the ball park. I heard the number 10 percent mentioned this morning. If it is around 10 percent, you are talking about something closer to a $5 billion revenue loss the first year.

It grows in subsequent years.

Senator BYRD. I realize that you have not made any decision as to what direction you will finally go. In Treasury in your discussions with the business community and in your discussions with economists and in your discussions with your colleagues at Treasury and so forth, what two or three areas do you find a consensus as being important in developing capital formation?

Mr. SUNLEY. I am not really certain that there is much consensus. Maybe there has never been consensus among economists, as people have pointed out from time to time.

Senator BYRD. Let me ask your view, then. I am not trying to commit you to any program.

In your view, what do you think could be worked out in the context of the whole package? Which areas would be of greater importance?

Mr. SUNLEY. I think I mentioned four: corporate rate cuts, accelerated tax, depreciation, investment tax credit are various schemes for eliminating double taxation on dividends.

Senator Byrd. What is your view on the capital gains tax, if any change should be made in that for or against?

Mr. SUNLEY. Again, a change in this area is under examination. Whether it becomes a part of the program depends in part, on what else is in the program.

Many people have pointed out that you could achieve significant simplification if the distinction between capital gains and ordinary income were eliminated. We are also examining what impact capital gains has on capital formation.

We recognize that any changes in this area would necesssarily be accompanied by substantial cuts in marginal tax rates. There may or may not be an increase in the level of taxation on capital gains, depending on how much you get the tax rates down.

Senator BYRD. Congress, in 1969, increased the capital gains rate. In retrospect do you think that that was wise, or unwise?

Mr. SUNLEY. I think that it was wise.

Senator BYRD. You think it was wise?

Mr. SUNLEY. Yes, sir.

Senator BYRD. Are you inclined to a further increase on the capital gains rate?

Mr. SUNLEY. As I said, we will examine it in view of the other parts of the program. I would not be inclined to have a program which only increased the capital gains tax and made no other changes in the tax system. That would be a very undesirable program.

I think you have to evaluate any change in this area, as I pointed out, in terms of the rest of the program.

I can assure you—and I think each of your witnesses this morning has done so—that we are truly interested in the impact of the entire tax system on capital formation. When we complete our tax program, and when you examine it as a whole, I believe that the program will not be anticapital formation.

What the various components of that program will be, I cannot tell you. Nobody can tell you. The decision has not been made.

Senator BYRD. I realize that—I am not pressuring you on that point at all. I am just trying to get an understanding of the alternatives.

An increase in the capital gains tax is one candidate for an increase in the rates, I take it?

Mr. SUNLEY. I am sorry. I did not understand the question. Would you repeat it?

Senator BYRD. I assume, from what you say, that the capital gains tax is one candidate for a possible rate increase?

Mr. SUNLEY. As Dr. Woodworth said this morning, it is under examination. At the moment, I do not know whether it will be in the program or not.

Senator BYRD. You did not indicate whether it was under examination upward or downward. I understand you to say it is a candidate for an upward increase.

Mr. SUNLEY. That is one direction it could go. It is the most likely.

Senator BYRD. Most of us in this room realize it can go two ways.

Mr. SUNLEY. That is the most likely direction.

I keep wanting to make certain that we all understand that any change in this area is likely to be accompanied by other changes in the tax law. Whether the program, when you take the other changes into account, increases the level of taxation on capital gains or decreases them, is not clear at this time.

Senator BYRD. I think the record is clear. If it is not, I will make it clear again that no decisions have been made. I recognize that. I am not trying to make you make a decision now. I am just trying to explore what the alternatives are and, as I understand it, while it can go in the direction of down, my impression is that it is one of the candidates for an increase, not for a decrease?

Mr. SUNLEY. As I said, it is under examination. I am not going to commit the administration by saying it is only looking at one direction. It is looking at both directions.

Senator BYRD. It is considering reducing the rate?

Mr. SUNLEY. That would be a possibility.

Senator BYRD. Do you feel that it is under consideration for a reduction of the capital gains rate?

Mr. SUNLEY. I think both are under consideration.

Senator BYRD. All right, sir.

Let me ask you one final question. I have the feeling that the greatest long-term threat to the average citizen in our country is inflation. Would you tend to agree with that or not?

Mr. SUNLEY. Inflation is a very serious problem, yes.

Senator BYRD. Inflation is a very serious problem. Would you tend to agree with my observation that it is the greatest long-term threat to the individual citizen?

Mr. SUNLEY. That would be very hard to judge. Nuclear war could be a very serious long-term threat also high unemployment.

Senator BYRD. I do not think I was putting it in the context of war. I am talking about the domestic economy.

Mr. SUNLEY. Inflation is very important. High unemployment can also cause a great deal of problems in the economy.

Senator BYRD. How important is it that inflation be reduced from its current level?

Mr. SUNLEY. I think that is quite important.

Senator BYRD. What is the best way, in your judgment, to get inflation under control?

Mr. SUNLEY. I think it requires a variety of approaches. Part of it is controlling monetary and fiscal policy. Part of it is the very kinds of things we are talking about in capital formation-restoring business confidence and increasing the capacity of the economy so that we can have increased productivity in the economy.

I do not think that there is one quick answer. Inflation has been a problem for a number of years now. A number of people have looked at it. I think one thing you would probably conclude is that people who have simple answers for curing those problems probably have the wrong answers. We have not found any simple answers.

Senator BYRD. In considering the changes in the tax code, it seems to me that small business and new business ventures need to be fully brought into the discussion that has been held.

Have you, at Treasury, conferred with the small business community in your process of developing a tax package?

Mr. SUNLEY. Yes, sir.

Senator BYRD. What groups have you conferred with?

Mr. SUNLEY. I do not know if I can name them right off the top of my head, but I think they have a small coalition which include eight groups, four national and four local. I think we have conferred with them.

Individually, I have met with the several others from time to time; but we have talked with those who are, I think, the chief spokesmen for the small business community, judging from past hearings of your committee and the Senate Small Business Committee, and we will continue to talk with them.

Senator BYRD. The small business groups, several groups have testified here, they have said that they have not been consulted.

Mr. SUNLEY. You may have talked to them a couple of days ago. There was a 3-hour meeting with them last night.

Senator BYRD. This was 2 weeks ago, I believe.

Mr. SUNLEY. We met with them—Secretary Blumenthal met with them—last night.

Senator BYRD. Well, you have a very tough job in developing a new tax package. I wish you good luck in regard to it. I would hope that a minimum of politics would be played in developing it. I do not know that politics can be entirely eliminated in anything around Washington, but I hope that it will be held to a minimum because I think it is so vitally important to so many people.

Thank you both very much.

[Thereupon, at 11:45, the subcommittee adjourned.]

APPENDIX A

COMMUNICATIONS RECEIVED BY THE COMMITTEE EXPRESSING AN INTEREST IN THESE HEARINGS

STATEMENT OF GENERAL TELEPHONE & ELECTRONICS CORP.

The intense need of the utilities to continually raise large amounts of equity capital gives urgency to the need for reform of the tax laws to encourage capital formation and to remove disincentives to personal investment. Congress should promptly adopt the following three tax proposals:

Defer taxation of automatically reinvested dividends of utilities, treating them as stock dividends (IRC § 305);

Permanently increase the investment tax credit (ITC) to 12 percent for all businesses, equalizing the utility and nonutility ITC rates, and remove the 50 percent limitation on the credit; and

Allow a corporate tax deduction by utilities for dividends paid on designated new issues of preferred stock (IRC § 247).

I. THE UTILITIES MUST CONTINUALLY RAISE LARGE AMOUNTS OF CAPITAL

The continued growth of the economy of the United States is largely dependent on the ability of the utilities to increase their facilities in line with the economic growth. The utilities, in turn, must obtain the capital to invest in new plant and facilities to meet the expanding needs of the growing economy. The utilities are the infrastructure upon which continued growth of the economy is fundamentally dependent.

Thus, the overiding challenge to the utilities—and to our domestic economy—is the necessity of raising, on an economical basis, the large amounts of new capital required to finance continued expansion and improvement of service in the years ahead. This point can be illustrated by a look at the telecommunications industry.

Historical and future capital requirements of the telecommunications industry

Demands for service translate into capital requirements and can be illustrated by both the historic and the forecasted construction expenditures of the telecommunications industry. As shown on chart 1, expenditures for new plant and equipment in the telecommunications industry totaled approximately $107 billion in the 1967–76 period, and are estimated to reach $248 billion in the 1977–86 period, a significant increase of 132 percent. U.S. Department of Commerce figures show that total expenditures for new plant and equipment have risen far more rapidly for all utilities, including the telecommunications industry, than for the economy as a whole. For example, during the period 1967 through 1976 expenditures for new plant and equipment for utilities increased by 137 percent, whereas for manufacturing the increase was only 83 percent (chart 2). Annual capital expenditures of all utilities were approximately $26 billion in 1971, increased 35 percent to $35 billion in 1976, and are estimated to increase 94 percent to $68 billion by 1981 (chart 3). The utility industry is concerned about the availability and price of funds to support these necessary expenditures. This concern will intensify as the economy continues to recover and the competition for and cost of funds increase.

Utilities are by nature capital intensive

Because of the nature of the industry and the large investment required to meet service demands, the utility industry is highly capital intensive. A comparison of the assets required to generate $1 of revenue in the utility industry with those required for all manufacturing companies illustrates this characteristic feature of the utility industry. Chart 4 shows that the utilities generally require approximately 3.5 times as many dollars in assets to generate each dollar of sales as do manufacturing companies. As a consequence, the utility industry, compared with manufacturing companies, has relied and must continue to rely much more heavily on the external capital markets. In fact, utilities, including the telecommunications industry, account for a major segment of the private external capital financing in the United States.

Other factors affecting capital needs

In addition to the growth in demand for service and the capital intensive nature of the telecommunications industry, capital requirements are also affected by other important factors such as the declining useful economic life cycle of plant and equipment, the inadequate depreciation allowed for rate-making purposes and the need for investment to improve services and to increase productivity to keep pace with wage increases.

In past decades, customer demands for totally new telecommunications services were met principally by orderly advances in technology; depreciation rates were based largely on the historically long physical service life of plant and equipment. But today, changes are occurring at a far faster rate, a trend which seems certain to continue. Exploding technology, the ever increasing customer demand for sophisticated new services, and the need to improve productivity have greatly increased overall capital requirements. Telephone companies will be unable, economically, to retain equipment developed with past technology, not only from an operational point of view, but also on the basis of demand and competition. For example, it is more costly to operate and expand some existing telephone switching systems than to install entirely new systems.

These conditions are causing economically justifiable desires on the part of telephone companies to accelerate the replacement of existing equipment with electronic telecommunications systems.

Despite the telecommunications industry's relatively high level of productivity and capital intensive nature, it remains one of the largest employers in the United States, employing in 1976 nearly 940,000 people, or over one-half of all those employed in the utility industry as a whole. The fact that improvements in productivity in the telecommunications industry are well above the national average has been brought about, for the most part, by significant and growing investment relative to the number of employees. Chart 5 shows that gross plant investment per employee was $127,000 in 1976 compared with only $42,000 in 1960. This increase of over 200 percent is based solely on historical costs. On a replacement cost basis, the 1976 investment per employee would be far greater—$180,000 compared with the 1976 historical figure of $127,000. Because of forecasted demands for service, technological improvements, and inflation, it is expected that the investment per employee in the telecommunications industry will continue to increase.

Inflation not only increases the cost of capital, it also substantially raises the price of needed plant and equipment. Chart 6 shows that actual construction expenditures grew at an annual rate of 10.1 percent between 1968 and 1976, while in terms of 1968 constant dollars the percentage growth was only 4.0 percent per year. The additional capital requirements resulting from inflation place an added burden on the industry and tend to further intensify the already highly competitive capital markets.

II. FURTHER CAPITAL REQUIREMENTS OF UTILITIES CANNOT BE MET BY INCREASING DEBT LEVELS.

The utility industry is concerned about the availability and the price of funds required to support essential capital expenditures. This concern will intensify as the competition for funds and the cost of capital increase in the future.

Largely because of the bias in the tax laws favoring the issuance of debt rather than equity, the utility industry utilized a disproportionate amount of debt to fund its rapidly growing construction expenditures from 1960 through 1976. Key indicators of financial strength now show that telephone and electric utilities are virtually precluded from financing their future construction requirements by further increasing the proportion of debt in their capital structures. The level of debt of Independent telephone utilities at year-end 1976 was 55 percent of total capitalization, slightly greater than that of electric utilities (chart 7). The important fact is that both telephone and electric utilities have about reached the practical limit of their ability to increase leverage because of the need to protect bond ratings, or the reasonableness of risk that security holders can be expected to assume.

The adverse consequences of the extensive use of debt have been magnified by the rapid increase in interest rates during the period 1960 through 1976. Interest rates on "A" rated utility bonds increased from 4.8 percent in 1960 to 9.8 percent in 1976. Although there has been a modest cyclical decline in interest rates recently, the secular trend of long-term interest rates remains upward (chart 8). Because of anticipated future inflation, long-term interest rates are expected to remain far above historical norms. As a result, the utilities will have to refinance the debt sold prior to the mid-sixties at two to three times the original interest rates while simultaneously financing new construction at the higher rates. The combined effect will be to significantly increase the amount of debt to be raised and inevitably continue to increase the embedded cost of debt capital to utilities (chart 9).

Extensive use of debt and the escalation of interest rates has caused a dramatic erosion in the interest coverage of utilities. Average pre-tax interest coverage for both independent telephone and electric utilities fell to approximately three times in the 1970-76 period, as compared to nearly four to five times in the late 1960's (chart 10). The decline in the utilities' interest coverage has reduced the credit worthiness of most utilities and increased the risk to investors. During the period 1971 through 1976, Standard & Poor's downgraded the bond ratings of 90 public utilities while upgrading only 27. As a direct result, utilities have found it more difficult and more expensive to raise needed capital.

III. CONGRESS SHOULD AMEND THE TAX CODE TO ENCOURAGE CAPITAL FORMATION AND TO REMOVE DISINCENTIVES TO CAPITAL FORMATION

To alleviate the financial problems facing the capital intensive utilities, to remove basic inequities in existing tax laws, and to stimulate the economy and employment, Congress should promptly adopt the following three proposals:

Defer taxation of automatically reinvested dividends of utilities, treating them as stock dividends (IRC § 305):

Permanently increase the investment tax credit (ITC) to 12 percent for businesses, equalizing the utility and nonutility ITC rates, and remove the 50 percent limitation on the credit; and

Allow a corporate tax deduction by utilities for dividends paid on designated new issues of preferred stock (IRC § 247).

(A) *Stockholder Reinvestment of Utility Dividends Should Be Taxed in the Same Way as Stock Dividends*

Stock issued under automatic dividend reinvestment plains of utilities should be treated for tax purposes under Section 305 of the Internal Revenue Code just as though it had been received as a stock dividend which is taxed upon disposition at capital gain rates. Under this proposal, utility stockholders would be permitted to reinvest their dividends in newly issued stock of the dividend-paying corporation without being penalized by having to pay a tax on dividends they never actually receive.

Investors in utility stocks traditionally seek a high dividend yield. As a result, the dividend payout of Standard & Poor's 40 utilities averaged 65 percent of net income for the 1967-76 period while the rate for Standard & Poor's 400 industrial was 48 percent (chart 11). Furthermore, because of the nature of their investors, utilities do not have the same degree of flexibility in dividend payouts as do most industrial firms. The importance of dividends to utility investors can be illustrated best by the traumatic experiences of Consolidated Edison when it omitted a dividend payment in 1974 and General Public Utilities when it unsuccessfully attempted to switch from cash to stock dividends.[1]

Since cash dividends are taxed to the individual recipient at ordinary income tax rates, the tax laws in effect discriminate against high dividend-paying companies (e.g. utilities) while favoring companies which retain more of their earnings (chart 12). This discrimination against investors in high dividend-paying utility stocks results in a higher cost of capital to the utility—a cost that is reflected in higher rates to consumers.

If investors in public utilities had the option of reinvesting dividends under automatic dividend reinvestment plans without a tax penalty, the adverse effects of existing discrimination would be significantly reduced because investors in utilities would be treated more equitably with investors in industrial companies.

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[1] "A Case for Dropping Dividends," Fortune, June 15, 1968, page 181.

Furthermore, the ability of utilities to obtain much needed equity capital from a far broader investor constituency would be enhanced.

Another particular advantage of this proposal is that it is simple to implement in that it builds on existing dividend reinvestment plans which have proven to be popular, particularly among utility investors. Many utility companies have already established these plans and participation rates are increasing. As an illustration of the success of these programs, participation in GTE's dividend reinvestment plan has increased from 11 percent of registered holders in 1972 to 20 percent in 1977. The amount of money invested annually by participants has increased over three times, from $5 million in 1972 to an estimated annual rate of $18 million in 1977 (chart 13). The increased participation provides an important source of new equity capital to the company.

These plans are particularly well suited to the needs of the small investor, because they provide an automatic, convenient, systematic and inexpensive means of investing. For example, in the GTE plan, participants pay no brokerage commissions or service charges. The popularity among small investors is illustrated in the case of GTE's plan wherein 80 percent of the participants own 100 shares or less. Conversely, participation among investors with large shareholdings is very modest (chart 14).

The adoption of this tax proposal would significantly increase participation in existing dividend reinvestment programs and induce other utilities to establish similar programs for their shareholders. It would enhance the attractiveness of high dividend-paying utility stocks for prospective investors interested in capital appreciation, while retaining traditional investment appeal for shareholders seeking cash dividends. The increased equity investment would help strengthen the capital structure of the utility industry, reduce reliance on outside capital markets and help provide funds required to increase capital expenditures and employment.

The initial revenue loss of this proposal to the Treasury would not only be small [2] but would be quickly overcome by the resulting expanded economic base, including jobs created both directly and indirectly.

(B) The Investment Tax Credit (ITC) Should Be Made Permanent at 12 Percent for All Businesses

There is little question that the ITC has proven to be an effective tool for stimulating investment and fighting recession, unemployment, and inflation. A permanent 12 percent ITC for all business, including telephone and electric utilities, would immediately provide and maintain needed cash flow to strengthen capital structures and to improve interest coverage, thus permitting increased construction programs. Private and governmental studies indicate that the long-term effect of the ITC on tax revenues is favorable, because an increased permanent ITC would both directly and indirectly stimulate tax revenues by providing jobs and improved earnings.

Increasing the ITC clearly provides a strong stimulus to investment. Historically, there is a strong correlation between changes in new fixed investment and changes in total employment (chart 15).

The increase in the ITC for all industries to 10 percent from the prior 7 percent for industrial companies and from a discriminatory 4 percent for all public utilities was a step in the right direction. The increased ITC must not be allowed to expire as scheduled at year-end 1980 and all utilities returned to the discriminatory 4 percent level.[3]

Importantly, it should be noted that the long-term benefit of the ITC is greatly reduced by an on-again, off-again policy, particularly in the case of many businesses such as utilities, which require long lead times in construction planning.

Similarly, the relaxation of the 50 percent limitation on the credit in Section 46 of the Internal Revenue Code should be continued. Otherwise, the benefits of the increased rate will be denied to those less profitable businesses with the highest capital needs.

The legislation should continue to require normalization for utility rate-making purposes.

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[2] There would, of course, be no revenue loss with respect to dividends paid to those shareowners who do not participate in dividend reinvestment plans.

[3] See IRC § 46(c)(3)(A).

(C) Utilities Should Have the Option of Offering Designated New Issues of Preferred Stock With Dividends Tax Deductible to the Issuer.

The ability of the utilities to at least maintain their debt/equity ratios by selling equity is severely hampered by discrimination in the tax laws which allows the deduction of interest on debt but does not allow the deduction of dividends on equity. The difference in tax treatment is particularly indefensible with respect to preferred stock which has most of the characteristics of debt and which is a commonly used vehicle for utility financing. The discrimination should be removed by making dividends on designated new issues of preferred stock deductible by the utilities.

Enactment of this proposal would make an important and substantial contribution to the ability of utilities to raise needed equity capital and to improve, or at least maintain, their debt/equity ratios. The market for preferred stock would be substantially broadened to attract new investors because the issuer could economically pay a higher dividend rate than is currently available on most fixed income securities of similar quality. Enactment of this proposal could enable utilities to almost double the amount of preferred stock sold at approximately the same cost, thus economically increasing their equity bases. Utilities not electing this new alternative could continue to sell, more advantageously, the traditional preferred stock to institutional investors who would continue to utilize the 85 percent dividend-received deduction (IRC § 243). Indeed, some utilities might offer both types of preferred stock.

This proposal would cause a minimal loss of tax revenue, since the new preferred would not have the 85 percent dividend preference of the old preferred and could be used extensively as a substitute for debt, interest on which is already deductible. Therefore, the resulting tax revenue loss would be less than the difference between the interest rate and the preferred dividend rate since both interest and dividends would be fully taxable income to the recipients. Utilities with adequate debt issuing capacity would not find this proposal economically advantageous to use, thus further minimizing the potential tax loss to the Treasury.

CONCLUSION

The long-term demand for utility services requires large and continuous capital expenditures. In the past, utilities have depended heavily upon the issuance of debt securities to finance capital requirements. They cannot depend as heavily upon this source of capital in the future, because they have virtually reached the practical limit of their debt capacity. The overall deterioration of the financial strength of utilities is reflected in the erosion of interest coverage and the numerous downgradings of utility securities. These adverse factors must necessarily be reflected in higher costs to the consumer.

Because of the importance of telephone and electric utilities to the health and growth of the economy, their financial deterioration calls for prompt action by Congress. Three changes in the tax laws are recommended which would help remedy the financing problems of utilities and remove basic inequities in the tax laws:

Defer taxation of automatically reinvested dividends of utilities, treating them as stock dividends;

Permanently increase the investment tax credit to 12 percent for all businesses; and

Allow a corporate tax deduction by utilities for dividends paid on designated new issues of preferred stock.

Enactment of these provisions would help telephone and electric utilities to attract needed capital at a lower net cost thereby allowing them to provide required plant and equipment, stimulate employment, and operate more efficiently for the benefit of the public.

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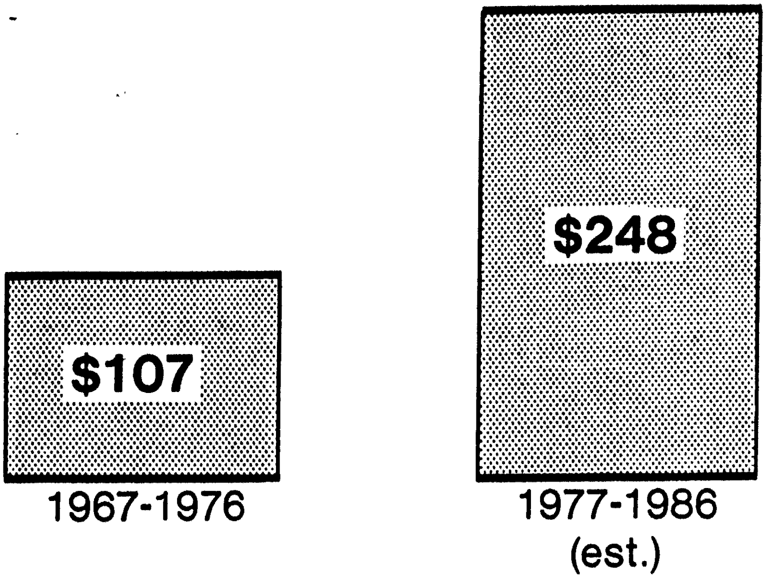
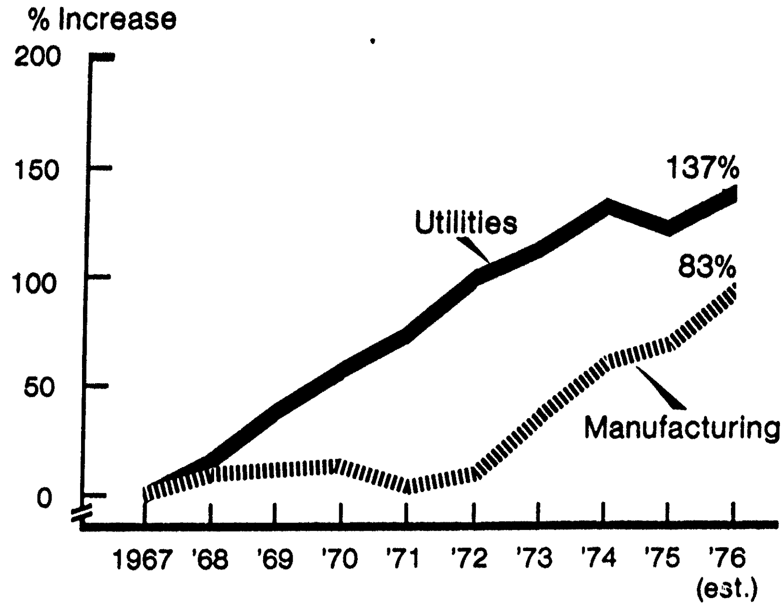
TELECOMMUNICATIONS INDUSTRY
Expenditures for New Plant and Equipment
1967-1986
($ Billions)



Source: Data Resources, Inc.
U.S. Department of Commerce

CHART 1

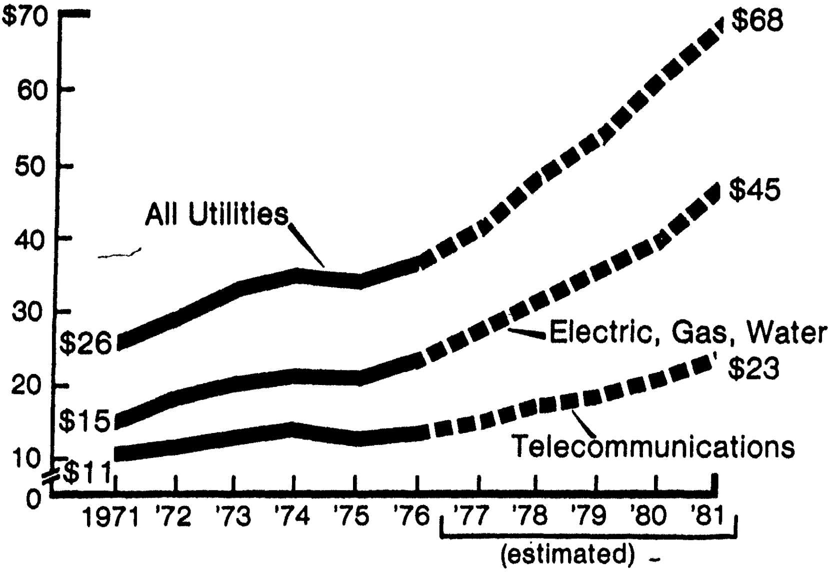
EXPENDITURES FOR NEW PLANT AND EQUIPMENT 1967-1976



Source: U.S. Department of Commerce

CHART 2

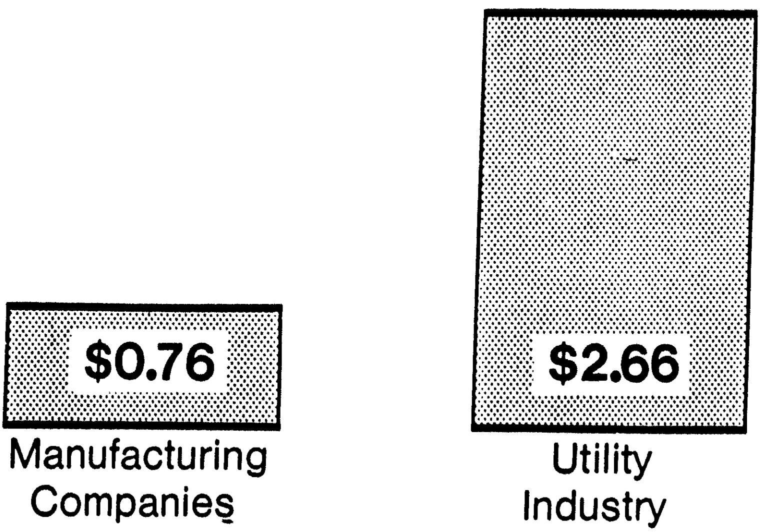
UTILITY INDUSTRY
Expenditures for New Plant and Equipment
($ Billions)



Source: Data Resources, Inc.
U.S. Department of Commerce

CHART 3

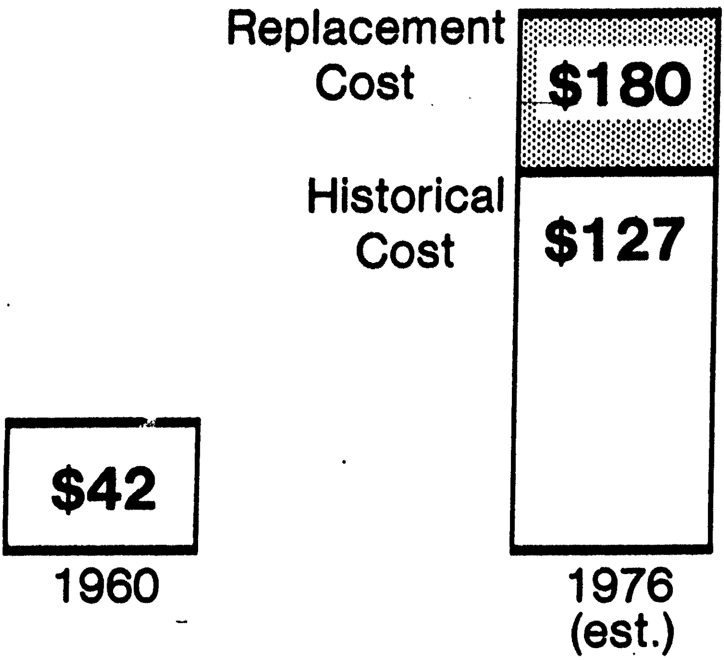
ASSETS PER DOLLAR OF REVENUE
Manufacturing Companies vs Utility Industry
1976



Source: Fortune

CHART 4

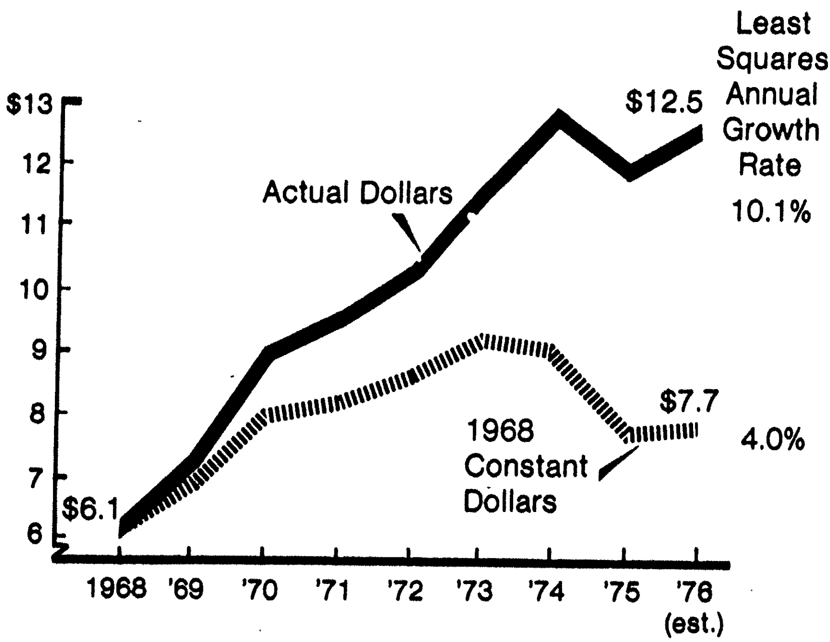
TELECOMMUNICATIONS INDUSTRY
Gross Plant Investment Per Employee
1960-1976
($ Thousands)



Source: AT&T, Moody's Investors Service, Inc., U.S.I.T.A.

CHART 5

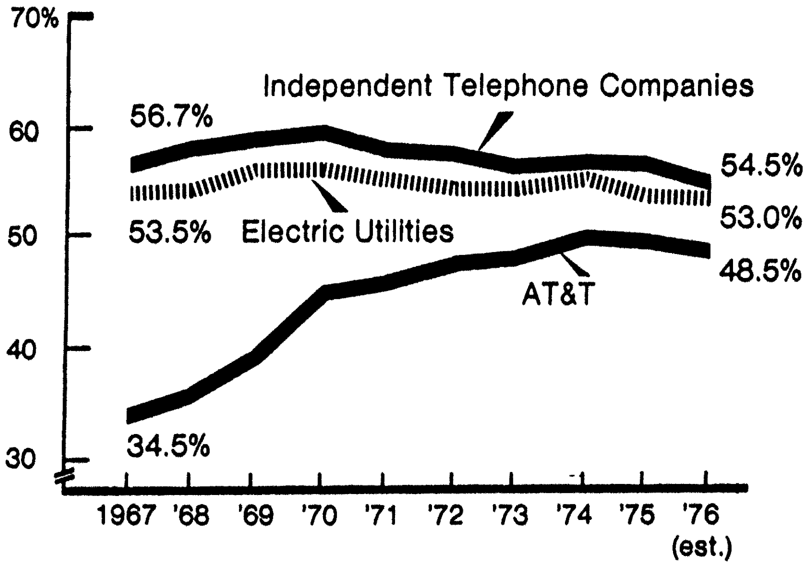
TELECOMMUNICATIONS INDUSTRY
Effect of Inflation on Construction Expenditures 1968 - 1976 ($ Billions)



Source: AT&T, U.S. Department of Commerce, U.S.I.T.A.

CHART 6

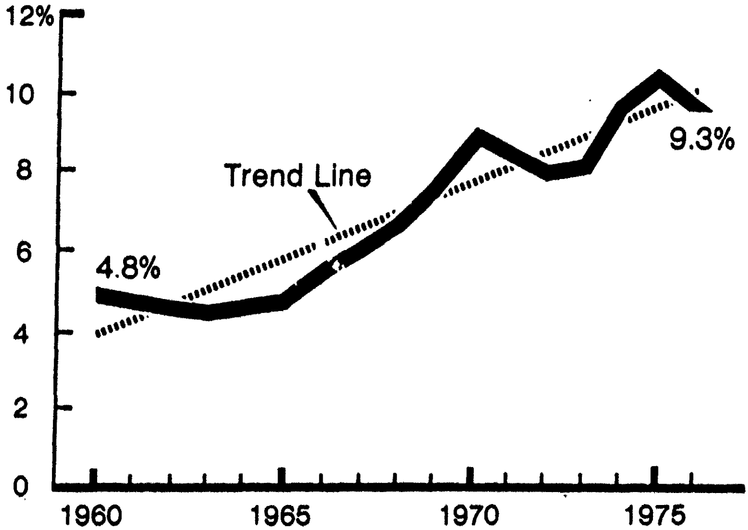
COMPARISON OF LEVERAGE
Telephone and Electric Utilities
(Total debt as a % of total capital)
1967-1976



Source: AT&T, Moody's Investors Service, Inc., U.S.I.T.A.

CHART 7

LONG TERM "A" UTILITY
INTEREST RATES
1960-1976



Source: Moody's Investors Service, Inc.

CHART 8

LONG-TERM DEBT INTEREST RATES NEW ISSUES VS. AVERAGE RATE GTE Telephone Operations 1967 - 1976

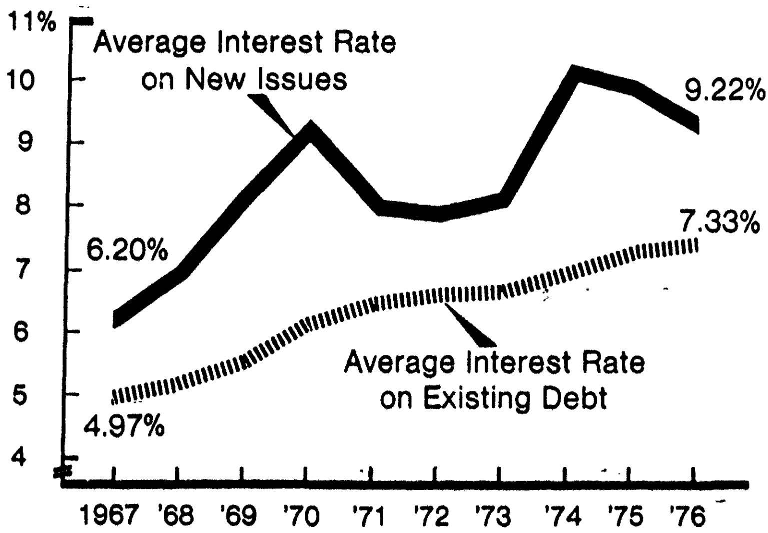
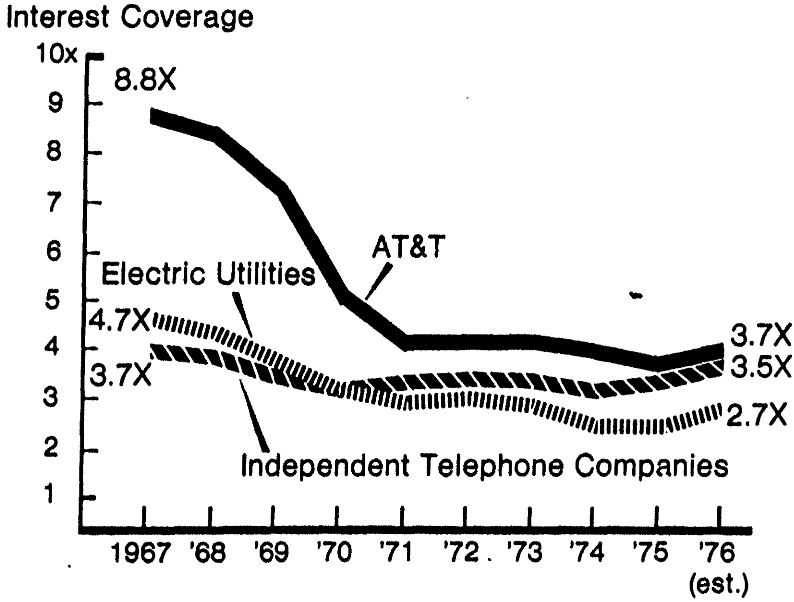


CHART 9

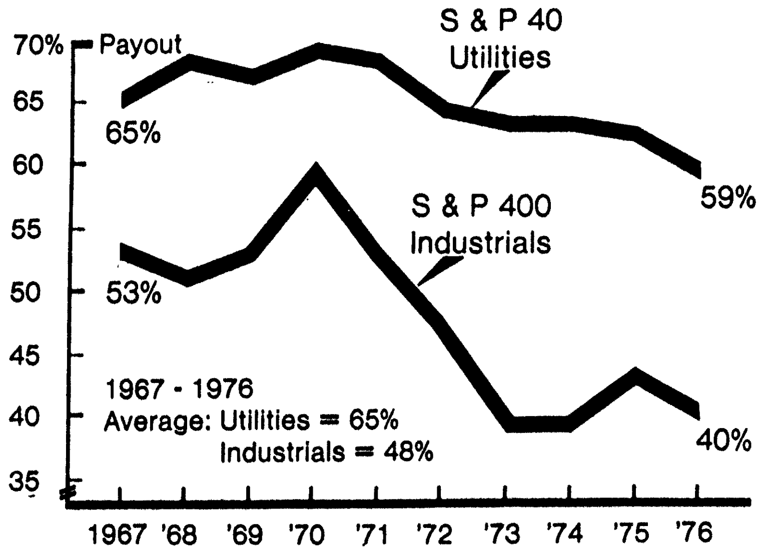
COMPARISON OF PRE-TAX INTEREST COVERAGE
Telephone and Electric Utilities
1967-1976



Source: AT&T, Moody's Investors Service, Inc., U.S.I.T.A.

CHART 10

DIVIDEND PAYOUT RATIOS UTILITIES AND INDUSTRIALS 1967 - 1976



Source: Standard and Poor's Analysts Handbook

CHART 11

TAX LAWS FAVOR HIGH GROWTH, LOW DIVIDEND INVESTMENTS OVER LOW GROWTH, HIGH DIVIDEND INVESTMENTS

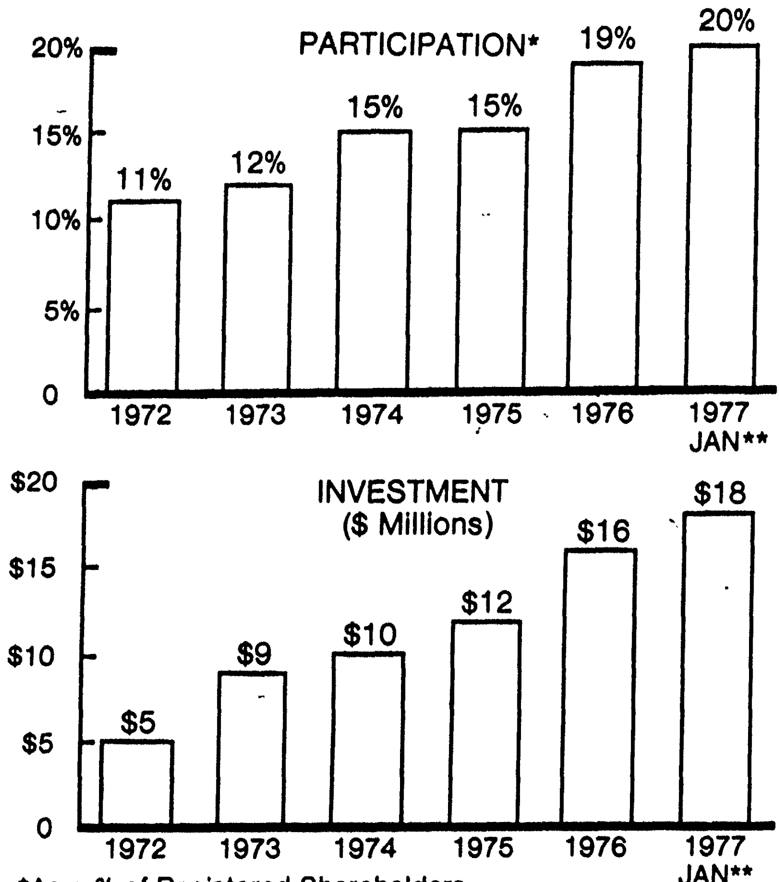
Assuming $100 Investment

Type of Company	Market Price Appre-ciation	Dividend	Pre-Tax Total Return	After-Tax Dividend*	Total Return 1st Year	After-Tax Return Upon Sale After 7 Years**
	(1)	(2)	(3) (1)+(2)	(4)	(5) (1)+(4)	(6)
Non-Utility						
High Growth Low Dividend	$10.00	$2.00	$12.00	$1.40	$11.40	$97.51
Utility						
Low Growth High Dividend	$ 4.00	$8.00	$12.00	$5.60	$ 9.60	$83.43
			Net tax advantage afforded low dividend paying stocks		$ 1.80	$14.08

* Assumes a 30% tax bracket, and therefore a 15% capital gain tax
** Assumes reinvestment of appreciation and after tax dividends

CHART 12

GTE DIVIDEND REINVESTMENT PLAN



*As a % of Registered Shareholders
**Annual Rate

CHART 13

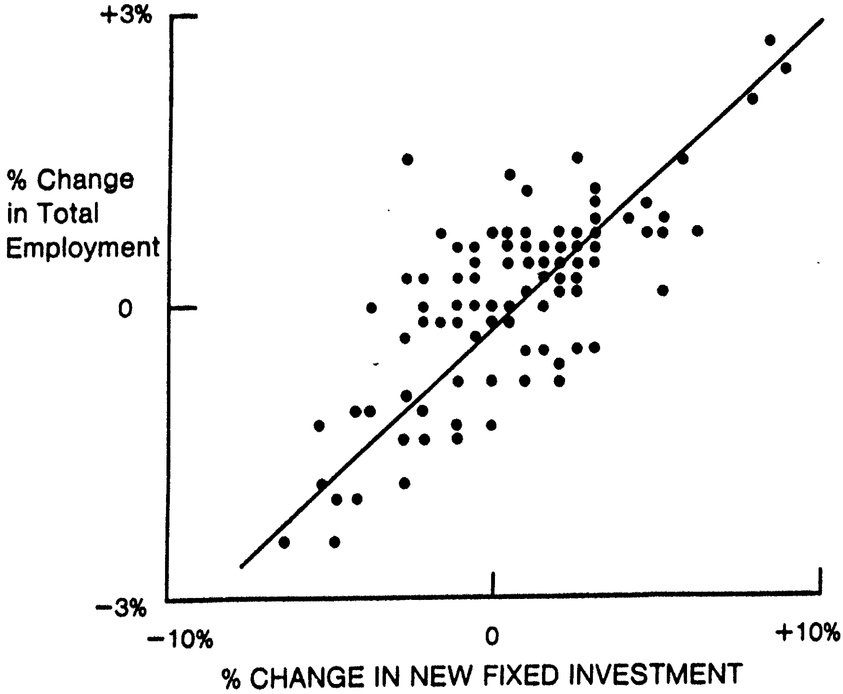
GTE DIVIDEND REINVESTMENT PLAN SHAREHOLDER PARTICIPATION

Shareholders		Plan Participation	
Shares Held	Registered Shareholders	Participants	Percent Participation
1-50	213,000	58,500	27.5%
51-100	113,000	17,500	15.5
101-200	67,000	10,400	15.5
201-500	49,000	6,700	13.7
501-1,000	14,000	1,700	12.1
1,001-over	8,000	200	2.5
Total	464,000	95,000	20.5%

CHART 14

CORRELATION BETWEEN CHANGES IN INVESTMENT AND EMPLOYMENT 1948-1976

CORRELATION = 69%



Source: U.S. Department of Commerce

CHART 15

Statement of the Chamber of Commerce of the United States, Presented by Robert R. Statham[1]

The Chamber of Commerce of the United States appreciates this opportunity to express its views on capital formation and the relationship between taxation and economic growth.

SUMMARY OF THE POSITION OF THE CHAMBER

The Chamber of Commerce of the United States supports the following changes in the tax laws to encourage capital formation:

1. To encourage modernization and expansion of productive facilities so as to make American industry fully capable of meeting its new demands, the concept of prompt capital recovery allowances designated to enconrage replacement and expansion should take the place of outmoded concepts of useful lives which have been used unsuccessfully as a measure of depreciation and obsolescence. As a first step, the Asset Depreciation Range system should provide for a 40 percent variable capital cost recovery period applied to the 1962 Treasury guidelines. The goal should be a complete capital cost recovery system that groups assets in a few general classes to which a capital cost recovery percentage is applied to assets as a class.
2. A permanent full 12 percent investment tax credit should be provided, on an expenditure basis, uniformly applied to all business, and without limitations based on tax liability.
3. Tax rates should be reduced to permit and encourage reinvestment of earnings in sufficient amounts to promote economic progress and provide jobs.
4. High tax rates have emphasized the unfairness and unsoundness of the double taxation of equity capital resulting from the taxation of corporate earnings an dof corporate dividends received by individuals. This inequity should be removed.
5. The rate of taxation for capital gains should be reduced proportionate to the length of time an asset is held, with the reduction being gradual and continuous.

CAPITAL COST RECOVERY AND DEPRECIATION

The present depreciation provisions in our tax laws are inadequate and in great need of overhaul. Although the codification of the Asset Depreciation Range system eased the siutation, it is far from being corrected. The Chamber supported the Asset Depreciation Range (ADR) system when it was codified in the Revenue Act of 1971. We continue to support the full retention of the ADR system and urge that it be liberalized to insure the continued modernization of American industry and to enable American business to compete more effectively in world markets. At the same time, we reaffirm our long-standing preference for a permanent and flexible capital cost recovery allowance system.

We have consistently asked for a permanent capital cost recovery allowance system along the lines set forth in the 1970 Report of the President's Task Force on Business Taxation as a first step toward the adoption of a full capital cost recovery system. Those recommendations include substituting a capital cost recovery allowance system for the present system based on useful life of property, and allowing full recovery of cost, unreduced by salvage value, in a period 40 percent shorter than would be allowed under the 1962 Treasury guidelines for determining useful lives. The Task Force recommendations should be adopted for their long range, permanent effect. The ADR system is an important step in encouraging investment and replacement of obsolete and inefficient machinery and equipment, increasing productivity, fighting inflation, encouraging economic growth to provide jobs and maintaining American leadership in the world marketplace.

American business is at a distinct disadvantage with regard to replacing its obsolete machinery and equipment. Most of the major industrialized nations offer cost recovery allowances superior to those provided in this country. Those nations have used such allowances to recover from the ravages of a world war, and rebuild their tools of production.

According to the November 1976, McGraw-Hill survey, 16 percent of the facilities of American business are 20 years old or older. According to the survey, business now considers 11 percent of its facilities technologically outmoded—the same share reported at the end of 1974 versus 10 percent at the end of 1972. The survey also indicates that for business to replace its outmoded facilities with the best plants and equipment, the total cost would be $235.71 billion.

The March 1975, International Economic Report of the President notes that the average age of capital equipment is higher in the United States than in most of the other industrialized nations, which replaced their equipment after World War II. This report states that it is estimated that 30 to 40 percent of American productive capital was in existence before 1960 as compared to 15 to 25 percent in these other developed countries. This report also concluded that because of the age of U.S. capital equipment, a greater portion of investment must go to replacement, rather than to additional equipment, compared to these other countries.

The May 1977, McGraw-Hill survey of business plans for new plant and equipment indicates that manufacturers plan to devote 58 percent of this year's planned investment to modernization and replacement. For 1978–1980, 52 percent of investment is expected to go for replacement rather than expansion of capacity.

We cannot afford to fall farther behind our major trade competitors and still hope to recover from our precarious balance-of-payments position. Until the time the United States can close the gap between the systems of capital recovery used by our competitors and that which is allowed by our own tax system, there will be little chance for increasing exports.

With wage increases outpacing productivity gains, there can be only one practical course of adjustment. Since wages cannot be lowered, productivity must be increased. This requires that an adequate permanent capital recovery system be worked into our tax structure. By using more modern and efficient production facilities, more goods can be produced at a lower cost per unit. By encouraging American industry to invest in the most modern machinery and equipment available, inflation can be reduced.

A piece of equipment is often depreciated at its cost over a long period of time. When the time comes to replace that piece of equipment, the cost of replacing it has greatly increased due to inflation. As a result, the increased cost of replacement must be paid for primarily from earnings.

For example, assume a $20,000 asset is depreciated using the straightline method over a period of 12 years, and an inflation rate of seven percent is compounded annually. By the time that asset is depreciated and replaced, the cost of replacement will have risen to approximately $45,000. Twenty thousand dollars of this amount can be accounted for by depreciation, but the additional $25,000 must come from earnings or from new, after-tax invested capital. Had the asset been depreciated over a shorter and more realistic period of time, the effect of inflation would have been reduced and the increase in replacement cost would be less. This story has been repeated over and over again.

In actuality, American business has been paying taxes on its capital. It has been paying what purports to be a tax on earnings but what, in reality, is a contribution of business capital. To lessen the effects of inflation on replacement costs, a shorter period for computing depreciation should be permitted.

It is important that the Congress adopt a tax policy that encourages the replacement of obsolete and inefficient plant machinery and equipment so that American enterprise will outproduce its rivals, continue to provide jobs at the highest wages on earth, and maintain American leadership in the world marketplace.

To encourage modernization and expansion of productive facilities in order to make American industry fully competitive and capable of meeting the added demands of our economy, the concept of prompt capital recovery allowances designed to encourage replacement and expansion should take the place of outmoded concepts of useful lives, which have been used unsuccessfully in the attempt to measure depreciation and obsolescence. As a first step, the Asset Depreciation Range system should provide for a 40 percent variable capital cost recovery period applied to the 1962 Treasury guidelines. The goal should be a complete capital cost recovery system that groups assets in a few general classes, to which a capital cost recover percentage is applied to assets as a class.

INVESTMENT TAX CREDIT

A permanent 12 percent investment tax credit would help stimulate the economy, reduce unemployment, increase capital investment, encourage productivity, stimulate new orders for materials, combat industrial obsolescence, and improve the climate for capital formation. We favor enactment of a permanent 12 percent investment tax credit, on an expenditure basis, uniformly applied to all business, without limitations based on tax liability, and without any corresponding reduction in depreciation allowances.

The Tax Reduction Act of 1975 increased the investment tax credit from 7 to 10 percent, 4 to 10 percent for public utilities, and to 11 percent if the extra one precent is invested in an employee stock ownership plan. Under the 1975, law, 10 percent of the cost of qualifying property—generally tangible personal property used in a trade or business—may be offset directly against income tax liability. The increase in the credit applied to property acquired and placed in service after January 21, 1975, and before January 1, 1977. There are additional limitations with regard to qualifying property with less than a seven-year useful life. Except for most public utilities, the maximum amount of the credit is $25,000, plus one-half of tax liability over $25,000. However, excess credits may be carried back for three years and forward for seven years, after which they expire if unused.

The Tax Reform Act of 1976 extends the temporary increase in the investment credit to 10 percent for four additional years through 1980. In the case of property acquired after 1980, the seven percent investment credit, and four percent credit for public utility property will apply. The additional one-percent credit allowed if the extra one percent is invested in an employee stock ownership plan is extended to qualified investments made through 1980. An additional credit of up to one-half of one percent is allowed for employer contributions which are matched by employee contributions to the employee stock ownership plan.

Property becomes eligible for the credit under present law when it is placed in service. The 1975 Act contained a new Code provision whereby a taxpayer could make an irrevocable election to have the investment tax credit apply to qualified progress expenditures for long leadtime property. It is our view that this progress payments provision should go even further by making the credit available for all investments in qualified property in the year that the expenditure is made, rather than in the year that the property is placed in service.

A 12 percent investment tax credit should become a permanent part of the law. The economy cannot afford an on-again, off-again approach to the investment credit absent a modern capital cost recovery system equal to our foreign competitors. We must continue to stimulate, rather than stifle, the productive forces of American industry in order that we may fight inflation, provide more jobs, and increase the standard of living of the American people.

The investment tax credit has been a proven stimulus to the economy. When the credit was repealed in 1969, the country went into a period of increased unemployment and reduced business activity. When it was reenacted in 1971, there followed a period of increased investment and decreased unemployment. New investment increased by nine percent in 1972 and 13 percent in 1973. The stimulus needed now is enactment of a permanent 12 percent investment tax credit.

An increase in the investment tax credit would help reduce unemployment. The ability of business to create jobs and reduce unemployment depends on its ability to equip workers with the tools of production. To equip new workers requires new investment in machinery and equipment. According to the 1977 Fortune survey of the "First 500," some industry medians of assets per empolyee are:

Petroleum refining	$239, 283
Mining, crude oil production	190, 918
Chemicals	59, 120
Metal manufacturing	58, 410
Motor vehicles	32, 478
Metal products	30, 087
Applicances, electronics	26, 099
Median for all industries	38, 937

As the labor force increases, employment need smust be met with huge investments in the capital base. Projections of the Bureau of Labor Statistics indicate that during this decade the total labor force will expand by 15.9 million, reaching 101.8 million by 1980. Only with the investment of thousands of dollars can a job be created for even one worker. Well-paying jobs require tremendous investment in capital intensive industries.

A 1976 study by the Congressional Budget Office, Sustaining a Balanced Expansion, indicates that the growth rate in the amount of private plant and equipment, excluding pollution control investments, declined from 4.3 percent per year in the period 1965–1970 to 3.3 percent per year in 1970–1975 and can be expected to decline further to 2.5 percent per year in the period 1975–1977. The growth rate in the amount of such plant and equipment per worker fell from 2.6 percent in 1965–1970 to 1.6 percent in 1970–1975 and is expected to decline further to only 1.0 percent in 1975–1977.

We cannot expect to improve the economic well-being of all Americans unless we are able to produce more goods at lower prices and provide for the employment needs of our society. Stimulating capital investment through an increase in the investment tax credit will assist efforts to meet a national goal of prosperity and a high standard of living for all of our citizens by increasing capital investment. The investment tax credit and the Asset Depreciation Range system are significant factors in encouraging investment in new plant and equipment. These new outlays for plant and equipment will stimulate construction, increase orders for materials, and result in increased employment.

An increase in the investment tax credit would help improve productivity. It is this growth in productivity that can determine the living standards Americans can expect to enjoy in the future. Unfortunately, since 1965, the United States has the worst record among the major free-world nations in productivity gains. During the sixties and early seventies, the annual growth in productivity averaged more than 10 percent in Japan and almost six percent in France and Germany. As illustrated by the following table, the annual growth in productivity averaged only 3.3 percent in the United States for the same period.

PRODUCTIVITY GROWTH, 1960–73

	Average annual rate	
	Gross domestic product per employed person	Manufacturing output per man-hour
United States	2.1	3.3
Japan	9.2	10.5
West Germany	5.4	5.8
France	5.2	6.0
Canada	2.4	4.3
Italy	5.7	6.4
United Kingdom	2.8	4.0
11 OECD nations	[1] 5.2	6.1

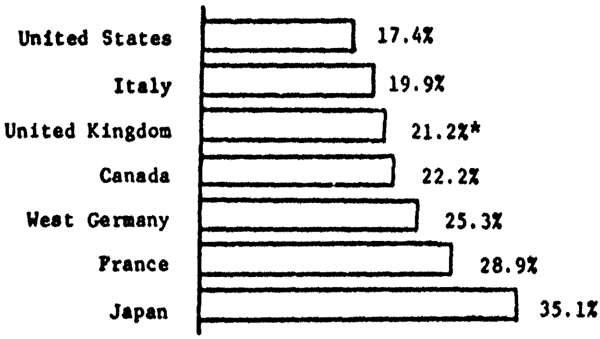
[1] Average for 6 OECD countries listed.

Source: Department of the Treasury (May 7, 1975).

Because a large proportion of Gross National Product was devoted to the replacement of obsolete plant, machinery and equipment, productivity rose rapidly in the United States after World War II. Bolstered by the new investment tax credit and the liberalization of depreciation allowances in 1962, the trend continued through 1968, when output per man hour increased 2.8 percent over the 1967 level. However, with the elimination of the investment tax credit in 1969, productivity in the private economy as measured by output per manhour increased by only 0.4 percent in 1969 and 0.8 percent in 1970. With the adoption of the Asset Depreciation Range system and the restoration of the investment tax credit in 1971, the productivity figure jumped by four percent. According to U.S. Department of Labor's Bureau of Labor Statistics, productivity in the private economy, as measured by output per man-hour, fell by 2.7 percent in 1974—the first annual decline since reporting began in 1947.

With regard to fixed capital formation as a percent of Gross National Product, the following graph indicates that in the period 1970–1975, the United States ratio of 17.4 percent was significantly lower than that of other major industrialized nations.

Fixed capital formation as a
percent of GNP, 1970-1975



* As a percent of gross domestic product.

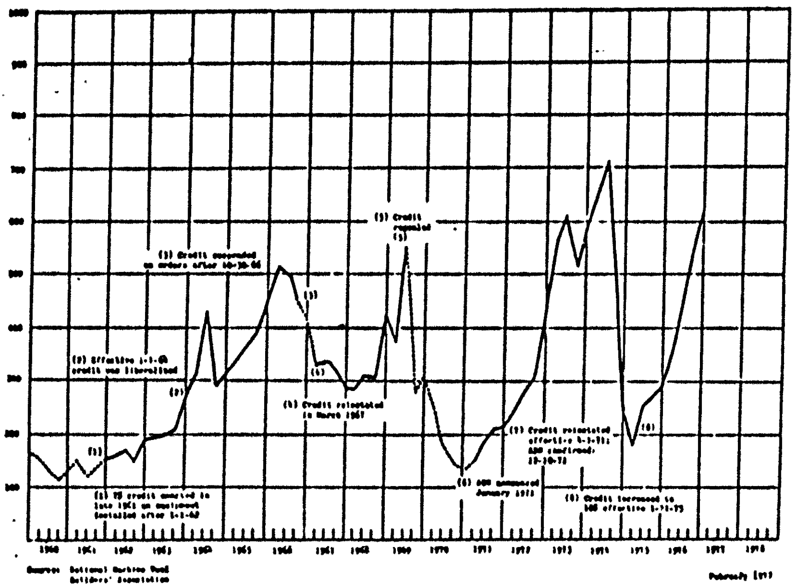
Source: International Economic Report of the President, January 1977.

An example of how the investment credit can affect productivity in the United States can be seen from the apparent impact of the credit on new orders for domestically produced machine tools, as illustrated by the following graph. These orders are viewed as an important indicator of future capital spending by business.

Machine Tools - Domestic New Orders

Quarterly

Millions of Dollars



From: Tax Reduction and Simplification Act of 1977: Hearings on H.R. 3477 Before the Comm. on Finance, 85th Cong., 1st Sess. 566 (1977).

Stringent environmental standards necessitating new abatement equipment have cut into productivity-increasing capital investment. Abatement procedures generally do not directly increase productivity or efficiency of operations. The investment credit and ADR will assist in meeting new demands to clean up the environment, and at the same time assist in meeting capital spending demands to assure continued economic growth.

We urge enactment of a permanent full 12 percent investment tax credit, on an expenditure basis, uniformly applied to all business, without limitations based on tax liability, and without any corresponding reduction in depreciation allowances.

TAX RATE REDUCTION

We favor corporate tax reduction to permit and encourage reinvestment of earnings in sufficient amounts to promote healthy economic progress. The present corporate income tax deters business expansion, diminishes sources of equity funds, and discourages new investment by reducing profit incentives. A reduction in corporate taxes would help provide the Nation with the new capital necessary to produce a better life for all.

We also favor lower an less steeply graduated tax rates on personal income. The maximum rate should be under 50 percent. Steeply graduated income tax rates make the government the principal beneficiary of the generation of additional income. This discourages individual initiative, leads to inefficiency, diverts attention from efforts to reduce taxes, and impedes economic progress.

We urge that an across-the-board tax reduction for individuals and corporations be made a major part of tax reform legislation. Tax rates should be reduced to permit and encourage the reinvestment of earnings in sufficient amounts to promote economic progress and provide jobs.

DOUBLE TAXATION OF CORPORATE INCOME

High tax rates have emphasized the unfairness and unsoundness of the double taxation of equity capital resulting from the taxation of corporate earnings and corporate dividends received by individuals. We oppose the double taxation of corporate income. Corporate income is the only form of income that is subject to two federal income taxes. It is subject to a 48 percent income tax at the corporate level and again subject to tax when paid out to an individual shareholder. This double taxation of corporate income is wholly contrary to the equitable concepts on which a tax system should be based.

From 1913 to 1936 there was no income tax on dividends. There was only a surtax that fell on a few shareholders, and the corporate tax rate was only one percent in 1913.

During the Great Depression, the House proposed a tax on undistributed corporate income. It hoped to pressure corporations to pay out more dividends to pump more money into the economy. These dividends were to be made taxable to the individual shareholder. The House had intended to eliminate the prior tax on corporate income and prevent double taxation. However, as finally enacted, a graduated surtax was imposed on top of the corporate income tax. There was no allowance for a deduction for dividends paid. Full double taxation of corporate income was a reality.

The experiment with a corporate surtax was unworkable and was repealed after three years in 1939. A full corporate income tax was imposed but the previous exemption for dividends was not reinstated. Full double taxation was to persist until 1954. What irony that double taxation should result from a plan to eliminate it.

In 1954, in an effort to mitigate double taxation, Congress passed a $50 dividend exclusion coupled with a tax credit equal to four percent of dividends received in excess of $50. In 1964, the $50 exclusion was raised to $100, but the tax credit was eliminated.

Double taxation of corporate income dramatically increases individual income tax rates. An individual in the 20 percent tax bracket in effect pays 48 percent at the corporate level and then an additional 20 percent on what is left for a total tax burden of 58.4 percent. This is nearly three times his individual rate.

The double taxation of corporate income creates additional pressures on equity capital. When a potential investor assesses the attractiveness of the variety of investments available to him, he must consider the potential after-tax return on his investment. Double taxation, therefore, means that the rate of profit on the actual investment must be higher than that required where there is no double taxation.

When a corporation seeks additional financing, it may sell new shares of stock or it may borrow money through debt financing. Since the interest on debt is tax deductible, and dividends are subject to double taxation, there is a bias toward debt financing.

The corporate form of business enterprise allows for the efficient concentration of the capital of large numbers of investors, and provides limited liability for investors. However, it is the only form of business enterprise whose owners are subject to double taxation. High tax rates have highlighted the unfairness and unsoundness of the double taxation of equity capital resulting from the taxation of corporate earnings and of corporate dividends received by individuals. This inequity should be removed.

CAPITAL GAINS DEDUCTION

The National Chamber supports modification of the rate of taxation of capital gains by providing for reduced taxation of capital gains proportionate to the length of time a capital asset is held, with the reduction being gradual and continuous. Current law provides for a deduction from gross income of 50 percent of the excess of net long-term capital gains over net short-term capital losses for individuals.

Capital gains treatment in the Internal Revenue Code has existed since the Revenue Act of 1921. From 1921 until 1933, capital assets were defined as property held for more than two years, and individuals could elect to be taxed at the alternative rate of 12.5 percent on net capital gains. With the Revenue Act of 1934, the two-year holding period was repealed along with the alternative tax rate, and a sliding scale system was substituted. Under this sliding scale system, from 30 percent to 100 percent of the net capital gain was included in income, depending in the holding period.

The Revenue Act of 1938 simplified the sliding scale and provided for three rates. Assets held for less than 18 months were taxed as short-term gains at 100 percent; assets held between 18 and 24 months were considered long-term gains and taxed at 66 percent; and assets held for more than 24 months were taxed at 50 percent. The Revenue Act of 1942 divided long- and short-term gains by a six-month holding period and provided that only 50 percent of long-term capital gains would be taxable. The Tax Reform Act of 1976 lengthened the holding period defining long-term capital gains and losses from six months to nine months in 1977, and to one year in 1978 and future years.

A strong argument favoring the expansion of the capital gains deduction is inflation. In many instances capital gains merely reflect the inflationary spiral of our economy. What appears to be a gain in the amount of dollars over a given period of time is merely a reflection of the decreasing value of the dollar invested. This is a monetary gain which does not represent an actual gain and should not be taxed.

The rate of capital gains taxation should be reduced proportionate to the length of time a capital asset is held, with the reduction being gradual and continuous. Expansion of the capital gains deduction would encourage greater capital formation through equity investment.

CONCLUSION

The American economy is faced with a major need for capital which we cannot continue to ignore. It is important that our tax policy be remolded to encourage capital formation. We must apply those principles in our taxing system that promote the modernization and expansion of our productive facilities. The other highly industrialized nations understand these principles and are applying them. If we are to continue to improve our standard of living, reduce unemployment and solve our inflation problem, we must adjust our tax policy to favor capital formation.

To encourage capital formation the Chamber urges these changes in the tax laws: a prompt capital cost recovery system, a permanent 12 percent investment tax credit, tax rate reduction for corporations and individuals, elimination of the inequity of the double taxation of corporate earnings, and reduction in the rate of taxation for capital gains based on the length of time an asset is held.

STATEMENT OF JOHN H. PERRY, JR., PRESIDENT, NATIONAL DIVIDEND FOUNDATION, INC.

I thank the Chairman and the Committee for the invitation and opportunity to talk about the National Dividend Plan and how it relates to the critical task before this Committee and the Nation: the need to restore the vitality of capitalism to achieve economic growth and full employment.

The need in our economy for additional formation and investment of capital is great and growing. Some have estimated our capital needs between now and 1985 at nearly $5 trillion.[1] However, the decline in the rate of growth in investment in plant and equipment is expected to continue.[2] At the same time, the number of Americans participating in capitalism through investment in corporate stock has declined steadily for the last several years.

Public tax and fiscal policies have a dramatic impact on the private economy. Instead of benefiting, such policies may hinder the formation and investment of the capital necessary to provide economic growth and jobs.

My own involvement with these concerns goes back many years. In 1964, I authored a book entitled The National Dividend,[3] which is a structural reform of our taxing and spending system designed to eliminate the present double tax on earnings realized in corporate form; to broaden the base of stock ownership and participation in the profits; and to place some effective restraint on the growth of government.

It was my belief at that time, and still is, that we not only must eliminate the bias against capital investment resulting from the present double tax on corporate earnings, but that we must also bring more people into direct participation and understanding of the free enterprise system. These steps would slow, and perhaps reverse, the growth of the public sector at the expense of the private.

[1] James H. Evans, New York Times, January 23, 1977, p. 14.
[2] Congressional Budget Office, Sustaining a Balanced Expansion, August 3, 1976.
[3] John H. Perry, Jr., The National Dividend, Ivan Obolensky, Inc., New York, 1964.

Since 1964, the National Dividend Plan has continued to be refined and has been subjected to extensive analysis by noted economists, business leaders and others.[4] Exhibit A contains a bibliography of the published studies and commentaries to date. In 1970, a feasibility report was prepared by a major independent consulting firm and plans are currently underway for further analysis by the use of econometric models. Presently, work on the National Dividend Plan is being carried on by the National Dividend Foundation, Inc.,[5] which is a nonprofit, private operating, research and educational foundation, devoted to the independent, objective evaluation of the existing corporate tax structure within the United States, its impact upon incentives and growth within the American economic system, and the methods of expending revenues.

The National Dividend Plan represents a serious approach to improving the U.S. corporate tax system from a broad, public policy point of view. While dealing with the present bias against capital investment and job creation inherent in the current double taxation of corporations and shareholders, the National Dividend Plan seeks also to deal, through the electorate, with the broader problems of economic misunderstanding, voter apathy, productivity, growth of the public sector, and economic equity. Implicit in the National Dividend Plan is the promise of economic growth and a higher level of employment. A detailed economic analysis of the National Dividend Plan is contained in the testimony of Dr. Martin R. Gainsbrugh before the Committee on Finance in March 1976.[5a]

Briefly described, the National Dividend Plan as presently contemplated would involve the following:

One: Integration of the corporate and shareholder taxes would be accomplished by imposing a single tax solely at the corporate level at a rate not to exceed 50 percent. That tax having been paid, the earnings would not be taxed again when distributed as a dividend to shareholders.

Two: Corporate tax revenues would be paid directly into a National Dividend Trust Fund and distributed quarterly as a dividend to the voting public on a per capita basis. Much like a national profit-sharing trust all registered voters would participate directly in the profits and losses of the free enterprise system. The National Dividend is estimated at $500 to $750 per voting adult.[5b] See also note 16.

Three: There would be a moratorium on any new Federal expenditure programs while the National Dividend was being phased-in over five years. Each year, an additional one-fifth of the corporate tax would be paid to the Trust. This would permit the National Dividend to be financed out of growth in the economy without reducing any existing expenditure programs. See testimony of Dr. Gainsbrugh, cited above.

Four: When fully effective, the National Dividend would be reduced in relation to the amount of the Federal deficit so that only "profit" net of any increase in the deficit would be available for distribution to the public as a National Dividend, thus involving the public in debt management.

Obviously, the basic elements of the National Dividend Plan are in the forefront of tax policy today. Elimination of the double tax on corporate earnings has already been undertaken in Europe and Canada, and may be proposed by President Carter for consideration here. There has already been enacted a limited version of an Employee Stock Ownership Plan (ESOP) which channels part of an employer corporation's tax liability into the purchase of stock in the company for the employees.[6]

While the ESOP is confined to employees of the corporation, the Treasury has in the past proposed tax incentives to broaden stock ownership more

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[4] For example, The Conference Board sponsored a three-day seminar on the National Dividend Plan at Airlie House, Virginia, in 1971. See M. R. Gainsbrugh, The National Dividend Plan, Pro & Con, The Conference Board, New York, 1971. More recently, on April 20, 1977, the National Dividend Plan was the subject of a seminar of the Harvard University Public Affairs Forum.

[5] 10435 Ironwood Road, Palm Beach Gardens, Florida.

[5a] Hearings, H.R. 10612, Committee on Finance, 94th Cong., 2nd Sess., Part 3, March 29, 30 and 31, 1976, at pp. 1357–1384.

[5b] Ibid.

[6] Amendments to the law in 1975 and 1976 provided an additional one and one-half percent investment credit if deposited in a trust to purchase stock in the company for the employees. The effect of the ESOP is to distribute to the employees a portion of the employer's profits that would otherwise be paid in tax.

generally, particularly by lower and middle income persons.[7] Various mechanisms have been suggested for conditioning increased spending on an increase in tax revenues or, conversely, for conditioning tax cuts on a corresponding decrease in the deficit.[8] The establishment of Budget Committees[9] in both Houses of Congress is itself a reflection of such an attempt.

We believe, however, that the National Dividend approach has special merits. As an integration device, imposition of a single tax at the corporate level is incomparably simpler than all other integration techniques which have been proposed, and when combined with distribution of the National Dividend, can be made to achieve a result similar to the two-tax "gross-up and credit" method being considered by the Treasury. The details of achieving integration under the National Dividend Plan are discussed in a succeeding section.

More important, however, are the two unique features of the National Dividend Plan: distribution of the corporate tax as a per capita dividend giving virtually each adult a direct monetary interest in productivity and profits; and the effective restraint on deficits achieved by reducing the National Dividend by increases in the deficit.

These two elements of the National Dividend Plan go directly to the fundamental concern underlying all proposals for integrating the corporate tax, broadening stock ownership and the like: worry about the decline of capitalism and a fear that it may finally be overwhelmed by the combination of a bloated bureaucracy and a majority of voters who no longer have any direct stake in the profit system. If few people are proprietors, entrepreneurs or shareholders (directly, or indirectly through stock ownership), the majority will have less interest in preserving the system. Recipients of earned compensation or government benefits do not normally perceive profits as the ultimate source of wages or transfer payments. Nor are they as likely to be concerned about increased deficits and inflation if they see themselves as benefiting more from the causes of inflation than from the entrepreneurial system it damages.

On the other hand, if under the National Dividend Plan the majority in fact did have an interest in capitalism, and shared directly in its profits and losses, the opposite attitude should exist. The prevailing public, and hence political view, would be to act in a manner best calculated to increase productivity and profits.

In summary, the National Dividend Plan is designed to provide new incentives for capital formation, and to increase citizen interest in the vitality of the private enterprise economy by introducing the principles of broader capitalism into public policy related to the taxation of corporate enterprises in the United States. From a philosophical standpoint, the National Dividend concept is neither of the right or left, nor a purely economic, social or political proposition. Instead, it is a total concept combining sound economics, political reality, and social concern.

The National Dividend Foundation, earlier this year, completed an extensive public opinion poll testing public reaction to the concept of the National Dividend. In a two-week telephone survey by Sindlinger & Company of Media, Pennsylvania, from February 17–March 2, 1977, 2,377 persons over the age of 18 in all parts of the 48 contiguous United States were polled. Nearly half—48.2 percent—immediately favored the concept of the National Dividend. This represented a projected 73.7 million adults. Almost three in ten did not like the Plan, and a quarter—22.6 percent—had no opinion. However, the implications were clear that there may be enough discerning persons answering "don't know" to give the concept a clear majority among all adults.

In a separate mail survey of individuals generally familiar with the National Dividend Plan, the Foundation found that of 444 respondents, 30.6 percent considered NDP a moderate proposal and 30.0 a conservative proposition. The balance had no opinion or found NDP to be a liberal plan. More import, however, was the finding that over 65 percent of those responding to this survey felt the NDP would be effective in building public support for our private economic system and would increase productivity in the United States.

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[7] In 1975 and 1976, the Ford Administration proposed a Broadened Stock Ownership Plan which provided a tax deduction for the cost of purchasing up to $1,500 of stock each year.

[8] Among such proposals are a constitutional amendment requiring a balanced budget, and a statutory amendment that would automatically impose a surtax in an amount sufficient to wipe out any deficit. See S.J. Res. 26, 95th Cong. A constitutional amendment may not be a realistic expectation, certainly not within a reasonable time period.

[9] Congressional Budget Act of 1974.

In a recent column in *The Washington Star*,[10] syndicated columnist and nationally know author Michael Novak summed it up this way:

"The NDP offers a neat compromise between those who recognize that a better life for all must be paid for out of earned income, not out of printing press money—and those who recognize that limits must be set on government activities * * *."

NATIONAL DIVIDEND: AS A TECHNIQUE FOR INTEGRATING THE TAXES

Imposition of a single tax solely at the corporate level has substantial merit as a technique for integrating the corporate and shareholder taxes and is incomparably simpler than any of the three other principle methods of integration. These methods are (1) to allow the shareholder a credit for the corporate tax on the portion of earnings distributed, i.e., the so-called "gross-up and credit" method; (2) to allow corporations to deduct the amount of dividends paid; and (3) to tax all corporate income directly to the shareholders, whether or not distributed, with a withholding tax paid by the corporation which is creditable by the shareholders.

The NDP single tax method of integration can be made to achieve almost the same result as the "gross-up and credit" method. In effect, dividends are excluded from tax under both methods of integration. Imposing a tentative tax on the shareholder and then allowing him a credit which is never less than that tentative tax is the same as not taxing the dividend at all. The single tax approach of the National Divdend Plan does directly what the "gross-up and credit" does indirectly.

Moreover, both methods involve direct cash distributions to individuals of corporate tax payments. Under the "gross-up and credit", every person who owns a share of stock would receive a distribution to the extent his top marginal tax rate is less than the corporate rate. Under the National Dividend Plan, the typical shareholder, plus every other registered voter, would receive a distribution equal to his per capita share of total corporate tax collections.

In making the following comparisons, it is assumed that the corporate tax rate is 50 percent and that the maximum individual tax rate is 50 percent.[11]

The following Table I compares the single-tax approach of the National Dividend Plan to the two-tax approach with "gross-up and credit" as applied to a shareholder in a 50 percent tax bracket.

TABLE I

	NDP single tax at corporate level	2 taxes with gross up and credit
Corporate taxable income	$100	$100
Corporate tax	50	50
Cash dividend received	50	50
Grossed up dividend deemed received	0	[1] 100
Tentative shareholder tax on dividend	0	[2] 50
Credit for corporate tax	0	(50)
Final shareholder tax on dividend	0	0

[1] Under this method, the shareholder's dividend is grossed up by the amount of credit for corporate tax. A tax is then computed on that grossed up dividend at the shareholder's top marginal tax rate. The shareholder then tkes a credit for the corporate tax which may equal or exceed the shareholder's "tentative" tax on the dividend.

[2] The shareholder is assumed to be in a 50-percent tax bracket.

In this example, the results of the two methods of integration are identical as shown in Table I. Obviously, however, all shareholders are not in a 50 percent tax bracket as assumed in Table I. Many lower income shareholders are, for example, in only a 20 percent tax bracket. Thus, it might appear that under the single tax approach every shareholder's portion of corporate earnings would be subject to a flat tax of 50 percent (i.e., the assumed corporate tax rate); whereas,

[10] Reprinted as Exhibit B.

[11] This appears to be a reasonablé assumption. Serious consideration has already been given in the Congress to applying the 50 percent maximum tax rate on earned income to all income. There would be little reason to maintain a 70 percent rate if dividends were not separately taxed.

under the gross-up and credit method, corporate earnings are taxed to shareholders on a progressive basis.[13]

To the contrary, as Tables II and III illustrate, when the single tax approach to integration is combined with the second element of the National Dividend Plan—the distribution of the corporate tax per capita to every adult registered—the combined effect is an integrated tax system which is progressive with respect to those shareholders. Within the lower income range, the result would be more progressive than gross-up and credit (see Table III).

In Table II, the effective rate of tax on small shareholder A is calculated by expressing the corporate tax ($500), minus the National Dividend ($500), as a percentage of the taxpayer's share of corporate earnngs ($1,000). Obviously, as the taxpayer's share of corporate earnings increases in proportion to the National Dividend, the effective rate of tax increases. See the case of large shareholder B in Table II. Where present, the relative size of dividend income is usually a good measure of the relative size of the shareholder's total income. While there might be a few high income individuals with only small amounts of dividend income. There would be no low income individuals with large amounts of dividend income.

TABLE II.—EXAMPLE OF PROGRESSIVITY OF SINGLE TAX COMBINED WITH NATIONAL DIVIDEND

	Small shareholder A	Large shareholder B
Share of corporate taxable income	$1,000	$1,000,000
Corporate tax	$500	$500,000
Cash dividend	$500	$500,000
National dividend	$500	$500
Effective rate of tax (percent)	0	49.99

TABLE III.—EXAMPLE OF PROGRESSIVITY OF GROSS UP AND CREDIT METHOD

	Small shareholder A in a 20 percent bracket	Large shareholder B in a 50 percent bracket
Share of corporate taxable income	$1,000	$1,000,000
Corporate tax	$500	$500,000
Cash dividend received	$500	$500,000
Grossed up dividend	$1,000	$1,000,000
Tentative shareholder tax on grossed up dividend	$200	$200,000
Credit for corporate tax	$500	$500,000
Additional tax owed by shareholder	$(300)	0
Refund of excess of credit over tentative tax	$300	0
Effective rate (percent) [1]	20	50

[1] The effective rate of tax is merely the corporate tax, minus the refund, expressed as a percentage of the share of corporate taxable income. In the case of small shareholder A, this is $500−$300+$1,000=40 percent.

NATIONAL DIVIDEND PLAN: BROADENING STOCK OWNERSHIP AND INDIVIDUAL PARTICIPATION IN THE PRIVATE ENTERPRISE SYSTEM

One of the critical challenges to the future of the private enterprise system is the lack of public understanding of the system and the individual's role in it. According to the Advertising Council's survey[14] of the public's opinions toward their economic system, it was shown:

that less than 1 percent of the general public, and only about 6 percent of the highly educated public, understood fully the functional elements of the American economy; and

that 54 percent of Americans favored more government regulation of business.

[13] Under the gross-up ond credit method, even though a 20 percent bracket shareholder's portion of corporate earnings would initially have borne a 50 percent tax paid by the corporation, when he gets the dividend taxable to him at a 20 percent rate he gets a credit of 50 percent applicable against his tax on the dividend. The 30 percent excess is a credit against tax on his other income and any remaining excess is refunded to him in cash.

[14] Compton Advertising, Inc., National Survey on the American Economic System, 1976.

Yet, paradoxically, a majority of the American public like the American economic system because it provides them personal freedom and economic mobility. Furthermore, these same Americans, despite their incomplete and fragmentary understanding of the economic system, do not seek any structural changes in our basic competitive private market system.

With less than 30 percent [13a] of the adult population presently directly involved in stock ownership, it becomes clear that more Americans must participate in the system. The growth and success of the economy must be in the individual's self interest, if we are to expect private enterprise to regain the popular understanding and support it must have to continue to function effectively within a democratic society.

There is no question that with proper integration of the corporate tax through the removal of the tax on dividends, stock ownership would become more attractive to more people. Yet the enhancement of incentives to invest does not guarantee or even suggest that a majority of Americans can (for economic reasons) or will (for motivational reasons) elect to become shareholders.

Against the critical need to broaden the base of the economy and the recognition that integration cannot fully guarantee this end—the National Dividend Plan closes the loop, by extending participation in the economic system to the non-stockholder and part-time stockholder.

In this context, the National Dividend Plan can be viewed in the same light as a national profit-sharing plan with individuals holding "public shares" in the success of the corporate system. This result is similar in many ways to corporate profit-sharing plans now widely utilized by corporations for their employees.

Like stock ownership and employee profit-sharing, the beneficiaries of the National Dividend have a legitimate relationship to the corporation. The corporation is in the final analysis a creature of society. Corporate profits are taxed for the "exercise of the privilege of doing business in a corporate capacity." [14] The corporate tax, which is the source of the National Dividend, is levied in exchange for the benefits conferred upon the corporation. While the burden of double taxation of corporate income is inequitable and clearly counter-productive, the right to tax profits at the corporate level is, nonetheless, fully supportable.

Under a national profit sharing system, as contemplated by the National Dividend Plan, every adult, by registering to vote, would have the opportunity to participate directly in the aggregate success of the nation's corporate enterprise. Like most preferred stockholders in corporations, participants in the National Dividend Plan would have no ownership rights, but only a privilege to participate in the earnings of corporations. Since the corporate tax is merely a percentage of profits, the National Dividend is, like other dividends, payable only out of profits.

As corporate profits increase, the National Dividend would increase and as corporate profits decrease, each individual's National Dividend check would decrease.

The National Dividend Foundation, Inc., is presently undertaking the development of a comprehensive econometric model designed to demonstrate not only the overall impact of the NDP on the nation's economy, but also to illustrate the impact of the corporate tax rate on capital formation, investment incentive, productivity and the National Dividend itself. It is conceivable that a lower tax rate on corporate profits could result in higher profits and a higher National Dividend. The fact that any increase in the rate of corporate tax likely would soon cause a decrease in pre-tax corporate profits (of which the National Dividend is only a percentage) should preclude any impulse to increase the corporate tax rate to gain a *temporary* increase in the National Dividend.

Implementation of the National Dividend Plan could be accomplished with comparative ease. There would be created a National Dividend Trust (comparable to the Highway Trust Fund) To acknowledge the role of the States as the franchisors of corporations, trustees of the National Dividend Trust might, perhaps, be appointed by the governors of the several States for specified terms.

All corporate tax receipts (only a portion, during the five year phase-in) would be deposited by the Treasury quarterly to the National Dividend Trust Fund. The Trust would provide for the administration of the Fund and establish procedures for the distribution of the Dividend through the States and local

[13a] Special News & Issues, and Political Confidence Studies, Sindlinger & Co., Inc., Media, Pennsylvania, January 19, 1977.

[14] George T. Schaffenberger, "The Penalty Taxes on Investors", Business Week, April 21, 1975, p. 16.

banking systems to the individual registered voters, using current voter registration lists. For administrative purposes, an annual registration cut-off date could be established for eligibility.

The National Dividend Trust could publish quarterly reports, comparable to those published by corporations, showing the earnings per each participant for the quarter and projected earnings for the year. This could be reported in financial journals as well as in the Federal Register. The quarterly and annual reports of the National Dividend Trust could, like the reports of corporations, include explanations of the reasons for any increase or decrease in earnings. In addition, the reports could show each person's National Dividend in both constant and current dollars to illustrate, pointedly and in personal terms, the reduction in value of the dividend resulting from inflation.

As a method of broadening the base of our private economy, the National Dividend Plan incorporates large segments of the American public who would not otherwise realize the opportunity of participation in the nation's profit system. Individuals ineligible for ESOP or corporate profit-sharing, people in lower income situations, all could become active "shareholders" in the success of American corporate enterprise. Youth, public employees and retired individuals would have the experience of direct participation in our business system.

In essence, national profit-sharing as envisioned under the National Dividend Plan would give substance to the concept of universal capitalism; building a knowledgeable and responsible citizenry favorably disposed to and supportive of a dynamic, revitalized private sector.

THE NATIONAL DIVIDEND: A MECHANISM FOR DEFEATING THE DEFICIT

The National Dividend Plan contemplates the diversion, gradually during its 5-year phasing-in, of ultimately \$50–\$70 billion from the public sector to the private. Because of the phase-in, existing Federal expenditure programs could be maintained out of economic growth.[14a] There must, however, be careful restraint through the moratorium on the implementation of new spending programs at the Federal level.

Even after the National Dividend is fully phased-in, budget restraint must continue to be exercised in order that we not end up with both a National Dividend and a set of new spending programs with the threat of further deficits. The National Dividend Plan would, however impose substantial constraint on this tendency. First, the absence of the corporate tax revenue for expenditure purposes would exert restraint.[15] Second, distribution of the National Dividend of \$1,000 to \$1,500 per household would reduce the necessity for such increases at least in the social welfare area.[16] Third, broader stock ownership resulting from integration and the universal participation in profits through the National Dividend would have changed considerably the public's attitude toward the private sector and, conversely, toward government programs and deficit spending.

Nevertheless, while these constraints are significant, alone they may not be sufficient.

Thus, the importance of the National Dividend as a self-enforcing budget limitation device. Analysis of the National Dividend Plan discloses a ready and workable mechanism for both establishing and enforcing a ratio relationship between taxes and expenditures.

This possibility could, for example, operate as follows:

First, a base period level of deficit would be adopted, such as the deficit level for fiscal 1978.[17]

Thereafter, each annual National Dividend would be reduced by the growth in the deficit for the year over the base level.[18]

[14a] See Table I, at p. 1365, Hearings, H.R. 10612, Committee on Finance, 94th Cong. 2nd Sess., Part 3, March 1976.

[15] There would also be a revenue reduction associated with integrating the corporate and shareholder tax whether by the single tax in combination with the National Dividend, or by the gross-up and credit method.

[16] Present projections estimate a National Dividend of between \$500–\$750 per registered voter (\$1,000–\$1,500 per man and wife) upon full implementation of the Plan, depending on increases in registration and the accuracy of presently projected corporate tax receipts.

[17] The base period deficit could be increased by the inflation rate to maintain a constant relationship. Alternatively, the base period deficit could be maintained at a constant dollar level.

[18] A variation might be to reduce the National Dividend by only that portion of the increase in the deficit which bears the same ratio to the total as the corporate tax bears to total Federal taxes.

As mentioned earlier, another approach could be to incorporate within the National Dividend Plan provisions designed to involve the general public directly in the process of deficit elimination after the National Dividend is fully implemented. For example, recipients of the National Dividend would, in the first year of full implementation, be subject to a deduction from their dividend check of an amount equal to the participant's pro-rata share of the budgeted deficit for that year (or of the actual deficit incurred in the previous fiscal year).

Other approaches could be developed for relating a citizens receipt of the National Dividend to his responsibility, as a voter, for excessive spending at the Federal level.

The National Dividend Plan provides a comprehensive vehicle for involving the electorate (and the individual voter's self-interest) in not only the private sector, but also in the process of ensuring fiscal responsibility in the public sector. Any growth in the deficit would directly have an adverse effect on every registered voter. This should cause the voting public to take a direct interest in a balanced budget and, in turn, make all elected officials reluctant to increase the deficit without a sufficiently satisfactory explanation to the public of why their National Dividend should be reduced.

In effect, only the net National Dividend, like the net profit of any enterprise, would be available for distribution.

This form of limitation would accomplish what other suggestions have not—it would provide a direct political pressure from every voter not to increase the deficit.

FINAL COMMENT

Worry about the decline of free enterprise and American capitalism and the fear that our private competitive economy will ultimately be overwhelmed by the exponential growth of the public sector, combined with an economically naive electorate which perceives no direct interest in the profit system, has generated new thought in socio-economics and politics.

The National Dividend Plan represents, in my opinion, and in the opinion of others, a comprehensive approach to these concerns designed to encourage individual incentives, growth in the private sector and improved economic literacy by encouraging participation in, understanding, and support of a private competitive economy. I trust the Committee will take up the ideas discussed in this testimony as it tackles the challenge of restoring vitality to the private sector.

I thank the Committee for its attention.

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[From the Washington Star, May 10, 1977]

EXHIBIT B

THE DIVIDENDS NDP PROMISES

(By Michael Novak)

There is a Puritan streak in Jimmy Carter's energy plan that will get him, and all of us, into eventual trouble. The President stresses "conservation." He insists upon "the limits" the nation must face. The problem is that a society geared for limits, steeling itself for austerity, inexorably becomes more and more conservative.

This is the trap that liberals, including not a few liberal senators and consumer advocates, have not fully grasped. A "no-growth" economy permits no new funds for social activism. As energy prices go up, the public will scream for lower taxes.

As it happens, there is a brilliant idea for reducing the tax load on individuals. When proposals to simplify the tax laws are considered, this plan will look better and better. It successfully integrates several tax purposes. Above all, in order to administer it, no new bureaucracy would have to be created.

I mean the National Dividend Plan. Recently, at a panel discussion at the Harvard Business School on this proposal, intense questioning by the students demonstrated that this plan has compelling merit. Shocking at first, stimulating skepticism, it grows on you.

The basic idea is that the corporate taxes which represent growth will be paid out in dividends to the public. This tax-free dividend would (a) constitute a substantial relief for families; and (b) provide a just return from corporate earnings to the citizens whose taxes, after all, built the roads, airports and other facilities without which corporate profits would not exist.

From a conservative point of view, the national dividend—rising and falling with corporate profits—would give every citizen a share in the experience of enterprise. It would come only from earned income, not from deficit spending by government.

From a liberal point of view, this dividend would be a substantial tool for redistributing wealth. Experts have concluded that, phased in over five years, the dividend would amount to $750 for every citizen of voting age. For a man and wife, this $1,500 increment in income would constitute substantial tax relief. Many families would move out of poverty, and others beyond the need for welfare.

In addition, as sons and daughters came of voting age, they too would receive the dividend, in time for the rising expenses of college.

As a mechanism for distribution, voting registration lists would be used. The honesty of the voters' lists and of the dividend list could be checked at one source. Incidentally, this adds a real incentive for registering to vote.

In some respects, the National Dividend Plan is like the Family Assistance Plans of the past. It puts money directly into the hands of people.

Spiritually, however, the money would be directly linked to the productivity and earned income of the corporations for which so many citizens work. For the first time, a form of national profit sharing would be realized.

The National Dividend Plan was first developed by John Perry in 1964. It has been modified often, and its economic validity and ramifications costed through by Lionel B. Edie, certain government tax lawyers, and others. It is a quiet, simple idea—too simple, at first, to believe—whose star is rising. Treasury Secretary Simon put men to work on it before he left office. Bert Lance in the President's cabinet knows of it.

The NDP offers a neat compromise between those who recognize that a better life for all must be paid for out of earned income, not out of printing press money—and those who recognize that limits must be set on government activities. And it manages to short-circuit the bureaucracy and put cash in the hands of citizens.

Bureaucrats would be its foremost enemy—if many government bureaucrats were not themselves sick at heart with the government's increasing incompetence.

A new form of liberalism is being born. This plan helps it along.

STATEMENT OF AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

The AFL-CIO finds the available evidence fails to support the contention that the economy is suffering from a capital shortage now or that one is likely to exist in the future. The major problems of the economy, including the lag in business investment, stem from the economic instability that characterized the 1970's. Government policies addressed primarily to inflation fighting in that period resulted in high interest rates, high unemployment, huge losses in output and continued inflation.

The deep recession which began at the end of 1973 touched off two successive years of decline in the nation's real output of goods and services. The percentage of productive capacity used in manufacturing dropped to the lowest level recorded by the Federal Reserve Board figures which go back to 1948. Unemployment rose to 9.0 percent, the highest level since the depression of the 1930's.

The drop in production and the huge increase in idle capacity meant there was little intent for new investment. The reluctance of the Ford Administration to stimulate the economy, and the tight money policies of the Federal Reserve Board diminished business confidence. There was little reason to expect that there would be customers for added capacity.

As the economy declined, private fixed investment spending, after accounting for inflation, declined from $191 billion in 1973 to $150 billion in 1975. Real business investment in plant and equipment (excluding housing) dropped from $131 billion to $111 billion in the same period. In 1976 as the economy slowly turned upward real business fixed investment increased by $13 billion and by another $11.1 billion (annual rate) in the first quarter of 1977. Both the level of investment and the share of GNP devoted to investment increased as the nation's output rose.

Business investment is a key factor in returning the economy to a path of growth in output and increasing productivity. However, a policy to increase investment must recognize that the principal determinant of new investment is a healthy growing economy.

The essential condition for the expansion of investment is a volume of consumer demand large enough to more fully utilize existing plant and equipment. A second condition is the expectation by investors that consumer demand will be sustained so that investors know that new additions to productive capacity will be profitable.

Advocates of business tax cuts to spur business investment claim that business investment will be significantly increased even though the demand for consumer goods is too weak to enable business to use more than about 83 percent of their present capacity to produce. The record of the investment tax credit, one of the most frequently used devices to stimulate business investment when the economy is weak, illustrates the fallacy of the point. Experience with the credit shows that it is contracyclical—businessmen tend to take advantage of the tax break only after the economy has already picked up. The result is that this tax-induced business spending takes place when overall demand is high, fueling inflation and contributing to investment booms, and excess capacity followed by job and purchasing power losses and recession.

The attached tables based on official Department of Commerce data show conclusively, in our view, that: (1) there is no underlying trend of decline in the share of the economy going to business investment capital. In fact, the opposite is true; (2) There is no cause for future concern provided the economy can avoid sharp cyclical swings, and (3) there is no justification for tilting the shares of the economy through tax policies geared to reducing consumption and increasing private business investment in plant, machinery and equipment.

Table I shows that corporate cash flow—the key measure of funds available to replace old equipment and invest in new equipment totaled $164 billion in 1976—that's more than double the 1970 level.

Table II shows that profits after tax plus net interest payments in 1976 were a higher share of GNP than in any year since 1950. This is the most significant indicator of the return to investors. It consists of profits after taxes plus the net interest payments made to investors in the debt of these corporations.

Significantly, the return to investors continued high despite the 7.7 percent unemployment rate for 1976. The return to corporate capital does fluctuate with the business cycle. A greater share of GNP is returned to corporate investors when the economy is healthy than when the economy is suffering from a recession. As the economy recovers, the return to corporate capital increases as a percent of GNP. More optimal use of plant and equipment causes profits to rise faster than costs as the output increases.

Inflationary periods do create measurement problems. "Inventory profits" for example result during periods of rapid inflation since firms buy goods at relatively low prices and sell them at much higher prices. These profits are real but, at the same time, corporations do face higher inventory replacement costs.

Also, there are substantial difficulties in measuring depreciation. Depreciation should be based on the original or historical cost of the equipment wearing out, since the relevant consideration is profits made on actual money invested. It's impossible to accurately calculate actual depreciation on an economy-wide scale but since the Commerce Department uses tax depreciation formulas which are considerably higher than historical cost of depreciation, the Commerce Department figures understate the return on investment in recent years.

Advocates of higher or "replacement" cost depreciation accounting methods cite the higher cost of new equipment but fail to point out that inflation also reduces the real value of corporate debt and the cost of paying off that debt which offsets the higher cost of replacing new plant and equipment. And, the tax provisions of recent years (The Investment Credit and ADR) have also "corrected" for inflation.

Table III shows the effect of subtracting inventory profits from the return to investors in non-financial corporations. Inventory profits are higher during inflation and were particularly large in 1973 and 1974.

Table IV shows the most conservative measure of return to investors—profits after tax plus net interest after subtracting inventory profits and depreciation at replacement rather than original cost.

Even by using this extremely conservative measure, the return to investors is higher in 1976 than in 15 of the previous 26 years and there is no downward trend.

Table V presents the key indicator of the vitality of business investment—non-residential plant and equipment.

Again, the share of GNP devoted to such investment falls during recessions and rises when the economy is healthy. The share of GNP invested in plant and equipment in 1976 is lower than the growth years of the 1960's and the recovery years of 1972 and 1973, but is higher than most of the years since 1950.

The share of GNP invested in equipment is more closely related to productivity since technological change is more likely to be embodied in equipment than in structures. The share of GNP invested in equipment has a more discernible upward trend than equipment plus plant. The 6.2 percent share in 1976 was higher than most of the years since 1950, and particularly high in view of the depth of the 1973–75 recession and the slow moving recovery. Investment in plant and equipment is reported at 9.7 percent of GNP for the first quarter of 1977 and 6.5 percent of GNP for equipment, an increase in line with the improvement in GNP.

The stock of producers durable equipment is another indicator of the vitality of investment. The growth in producers durable equipment per employee was only slightly less in the 1966–73 period compared to 1947–66 according to the Bureau of Labor Statistics. BLS data shows that the slowdown virtually disappears if employment is translated to manhours because the annual hours per employee has been declining.

[In percent]

	Average annual rate of change	
	1947–66	1966–73
GNP growth (real terms)	4.12	3.57
Equipment stock per employee	3.26	3.03
Equipment stock per employee hour	3.55	3.51

The growth in structures (plant) has not kept pace with equipment, but this does not necessarily imply a productivity problem. BLS points out that "because plant lasts longer than equipment, the total capital stock has grown more slowly than equipment."

Table VI shows the savings share of GNP has been very stable from 1950–1976. Gross private savings has fluctuated between 14.5 percent and 16.9 percent of GNP with a slight upward trend.

There is no question that the volume of savings available for investment is more than adequate at the present time as evidenced by large bank reserves, and low demand for loans. The Commerce Department data for savings does not give any evidence to support the contention that the economy is over consuming and undersaving.

Fears of federal deficits "crowding out" funds for private business investment are also without justification in view of the present and likely performance of the economy.

As recessions deepen, tax revenues fall, government spending on social welfare programs increase, and the Federal deficit automatically increases. As the economy improves the reverse occurs. The deficit goes down about $20–22 billion with a 1 percent drop in unemployment.

Maintaining or increasing government spending during a recession provides an automatic stabilizing effect by putting into the spending stream savings that would otherwise go unused. If government spending were not maintained, the economy would sink more deeply into recession and investment would sink along with the decline in consumer demand.

Thus, no evidence of impending "capital shortages" can be found in the data on profitability of investments, the volume of private investment, or savings. In fact, the upward trend in investment and savings indicates that the economy has the potential for more investment in the future, provided that fiscal and monetary policies geared to a balanced fully employed economy are pursued.

Past business tax cuts have given larger corporations substantial advantages in obtaining capital at the expense of needed public investments, consumer spending, and housing. The share of federal income taxes paid by corporations has fallen from 35 percent in 1967 to 23 percent in 1976. As a share of total federal budget receipts the decline is from 24 percent to 14 percent.

Discussions of private capital formation issues frequently overlook the fact that a large part of government spending is investment which includes schools, hospitals, water and sewer systems, transportation systems, and police and fire stations. These investments provide an increase in the delivery of vital public services for many years after the investments are made.

Some of what is called consumer spending is also investment spending. Expenditures made by individuals on education and health increase the individual's productivity as well as his well being. The importance to the economy of public investment and consumer expenditures on education has been pointed out in a study by Edward Denison who has demonstrated roughly half of the rise in productivity and one-third of the rise in total output came from advances in knowledge.

The need for more investment in the public sector is indicated by the data showing a decline in state and local government construction. According to the Commerce Department in every year but one since 1967, the real volume of outlays for state and local construction has declined. In 1976, state and local governments spent $32.1 billion on public construction (including federal aid). After adjusting for inflation, this represents a rate almost 30 percent below 1967 levels. In real terms, on a per person basis, these figures show that public construction represented $155 per capita in 1967, compared to only $102 last year.

Moreover, during 1976 state and local public construction spending after seasonal adjustment, plunged by $3.9 billion. The annual rate in January 1976 was $31.2 billion, by December the level was down to $27.3 billion—a 12 percent drop in a year considered as a "recovery" period.

In a recent Wall Street Journal article, Paul W. McCracken, chairman of the Council of Economic Advisers during the first Nixon Administration and a staunch opponent of government spending programs that might have any inflationary impact, said:

"There is, however, a case for stepped-up public works, and that case is quite simply that public works outlays have been lagging. The volume of public construction is now, in real terms, about 25 percent lower than a decade ago—in an economy that, in real terms, is 30 percent larger. Public construction is now so low, in fact, that the real value of public capital is probably not being maintained."

Housing construction has also suffered as a result of the emphasis on corporate investment in plant and equipment. Housing construction has been mercurial with a downward trend in the share of the Gross National Product invested in new housing. The share of GNP devoted to new private housing in 1976 was lower only in 1975 and three other years over the last 27 years.

The evidence shows that regardless of the economy's position on the business cycle, business investment maintains a relatively large share of Gross National Product. Total investment suffers larger cyclical swings because housing is squeezed out by business investment.

Thus, the AFL-CIO believes that the major over-all problems concerning business investment in plants and machines, in recent years, have not been a lack of funds but the adverse effects of high interest rates and the economy's instability. A relatively steady expansion of business investment, in relation to growing demand for goods and services, would generate appropriate, balanced and sustainable levels of investment in plants and machines. The only sound incentive for increasing business investment is expanding demand and high rates of capacity utilization. Business investment takes place when sales rise enough to boost industry's operating rate substantially and business executives are confident that there will be customers for the expanded output of new plants and machines.

It is possible that some special problems may develop in particular industries—most likely associated with capital needed for meeting environmental considerations, and energy conservation. Such selective problems, however, do not call for permanent across-the-board measures to change the division of the economic pie for still more private investment and even less consumption.

The relevant consideration in a tax reform program is the elimination of a variety of existing investment "incentives" which contribute to overall economic imbalance and encourage capital to flow into investments that "pay-off" in tax relief rather than additions to the nation's productive capacity—such as the investment tax credit, the depreciation speed-up and the tax provisions applying to foreign source income which encourage and subsidize the export of American jobs, and investment capital.

TABLE I.—CASH FLOW [1] NONFINANCIAL CORPORATIONS: 1950–76

	Total cash flow (billions)	Cash flow as a percent of GNP
Year:		
1950	$30.3	10.6
1951	28.0	8.5
1952	27.2	7.8
1953	29.4	8.0
1954	31.2	8.5
1955	38.9	9.7
1956	40.2	9.6
1957	41.1	9.3
1958	39.1	8.7
1959	45.5	9.4
1960	44.9	8.9
1961	45.6	8.7
1962	52.9	9.4
1963	57.2	9.6
1964	64.2	10.1
1965	73.6	10.7
1966	79.5	10.6
1967	80.5	10.1
1968	84.9	9.8
1969	86.4	9.2
1970	82.5	8.4
1971	92.0	8.7
1972	107.7	9.2
1973	123.7	9.5
1974	137.6	9.7
1975	140.8	9.3
1976	164.3	9.7

[1] Profits after tax, plus depreciation (as estimated from tax returns).

Source: Department of Commerce, Bureau of Economic Analysis.

TABLE II.—PROFITS AFTER TAX PLUS NET INTEREST NONFINANCIAL CORPORATIONS: 1950-76

	Profits after tax [1] plus net interest (billions)	As a share of GNP (percent)
Year:		
1950	$22.5	7.9
1951	19.0	5.6
1952	17.2	5.0
1953	17.7	4.8
1954	18.0	4.9
1955	23.4	5.9
1956	23.5	5.6
1957	22.9	5.2
1958	20.2	4.5
1959	25.4	5.2
1960	23.8	4.7
1961	23.6	4.5
1962	27.6	4.9
1963	30.3	5.1
1964	36.0	5.7
1965	43.3	6.3
1966	47.4	6.3
1967	46.4	5.8
1968	48.4	5.6
1969	48.2	5.2
1970	44.9	4.6
1971	51.2	4.8
1972	61.5	5.3
1973	76.2	5.8
1974	88.8	6.3
1975	86.6	5.7
1976	107.8	6.4

[1] Profit figures are before subtraction of inventory profits (IVA) and depreciation cost adjustments.

Source: Department of Commerce, Bureau of Economic Analysis.

TABLE III.—PROFITS AFTER TAX PLUS NET INTEREST NONFINANCIAL CORPORATIONS DEFLATED BY INVENTORY PROFIT ADJUSTMENTS 1950-76

	Profits after tax plus net interest (billions)	As a percent of GNP
Year:		
1950	$17.5	6.1
1951	17.8	5.4
1952	18.2	5.2
1953	16.7	4.6
1954	17.7	4.8
1955	21.7	5.4
1956	20.8	4.9
1957	21.4	4.8
1958	19.9	4.4
1959	24.9	5.1
1960	24.1	4.8
1961	23.7	4.5
1962	27.7	4.9
1963	30.1	5.1
1964	35.5	5.6
1965	41.4	6.0
1966	45.3	6.0
1967	44.7	5.6
1968	45.0	5.2
1969	42.7	4.6
1970	39.8	4.1
1971	46.2	4.3
1972	54.9	4.7
1973	57.6	4.4
1974	49.0	3.5
1975	75.2	5.0
1976	93.2	5.5

Source: Department of Commerce, Bureau of Economic Analysis.

TABLE IV.—PROFITS AFTER TAX PLUS NET INTLREST NONFINANCIAL CORPORATIONS DEFLATED B\ BOTH INVENTORY PROFITS AND DEPRECIATION AT REPLACEMENT COST

	Profits after tax plus net interest (billions)	As a percent of GNP
Year:		
1950	$13.6	4.8
1951	13.3	4.0
1952	13.8	4.0
1953	12.7	3.5
1954	14.5	4.0
1955	19.6	4.9
1956	17.8	4.2
1957	18.1	4.1
1958	16.5	3.7
1959	22.0	4.5
1960	21.8	4.3
1961	21.9	4.2
1962	28.7	5.1
1963	32.0	5.4
1964	38.1	6.0
1965	45.0	6.5
1966	49.1	6.5
1967	48.3	6.1
1968	48.6	5.6
1969	46.2	4.9
1970	41.3	4.2
1971	46.7	4.4
1972	57.6	4.9
1973	59.4	4.5
1974	46.0	3.3
1975	63.6	4.2
1976	77.6	4.6

Source: Department of Commerce, Bureau of Economic Analysis.

TABLE V.—INVESTMENT

[Dollar amounts in billions]

	Nonresidential private fixed investment		Investment in nonresidential producers durable equipment	
	Amount of dollars	As a percent of GNP	Amount of dollars	As a percent of GNP
Year:				
1950	$27.1	9.5	$17.8	6.2
1951	31.1	9.4	19.9	6.0
1952	31.2	9.0	19.7	5.7
1953	34.3	9.4	21.5	5.9
1954	34.0	9.3	20.8	5.7
1955	38.3	9.6	23.9	6.0
1956	43.7	10.4	26.3	6.3
1957	46.7	10.5	28.6	4.9
1958	41.6	9.3	24.9	5.5
1959	45.3	9.3	28.3	5.8
1960	47.7	9.4	29.5	5.8
1961	47.1	9.0	28.7	5.5
1962	51.2	9.1	31.8	5.6
1963	53.6	9.0	34.0	5.7
1964	59.7	9.4	38.2	6.0
1965	71.3	10.3	45.1	6.6
1966	81.4	10.8	52.2	6.9
1967	82.1	10.3	52.6	6.6
1968	89.3	10.3	57.7	6.6
1969	98.9	10.6	63.3	6.8
1970	100.5	10.2	62.8	6.4
1971	104.1	9.8	64.7	6.1
1972	116.8	10.0	74.3	6.3
1973	136.0	10.4	87.0	6.7
1974	149.2	10.6	95.1	6.7
1975	147.1	9.7	95.1	6.3
1976	160.0	9.5	104.7	6.2
1977	173.9	9.7	116.8	6.5

Source: Department of Commerce, Bureau of Economic Analysis.

TABLE VI.—SAVINGS: 1950-76

[Dollar amounts in billions]

	Gross private savings [1]	Government deficit or surplus	Gross private savings of a percent of GNP
1950	$41.6	$8.0	14.5
1951	49.4	6.1	15.0
1952	53.1	−3.8	15.3
1953	55.0	−6.9	15.0
1954	56.5	−7.1	15.4
1955	62.4	3.1	15.6
1956	68.4	5.2	16.3
1957	71.7	.9	16.2
1958	73.0	−12.6	16.3
1959	77.3	−1.6	15.9
1960	75.8	3.1	15.0
1961	80.0	−4.3	15.3
1962	87.4	−3.8	15.5
1963	88.9	.7	14.9
1964	102.4	−2.3	16.1
1965	114.9	.5	16.7
1966	124.2	−1.3	16.5
1967	134.6	−14.2	16.9
1968	136.3	−5.5	15.7
1969	136.8	10.7	14.6
1970	151.9	−9.4	15.5
1971	173.0	−18.3	16.3
1972	180.4	−3.5	15.4
1973	210.5	6.3	16.1
1974	211.6	−4.2	15.0
1975	255.6	−64.4	16.9
1976	274.6	−44.7	16.2

[1] Consists of personal savings business retained earnings (after deflation for inventory profit and replacement depreciation), plus depreciation allowances.

Source: Department of Commerce, Bureau of Economic Analysis.

TABLE VII.—PRIVATE RESIDENTIAL INVESTMENT

	Amount (billions)	As a percent of GNP
Year:		
1950	$20.0	7.0
1951	17.7	5.4
1952	17.8	5.1
1953	18.6	5.1
1954	20.3	5.5
1955	24.1	6.0
1956	22.6	5.4
1957	21.2	4.8
1958	21.8	4.9
1959	27.0	5.5
1960	25.0	4.9
1961	25.0	4.8
1962	27.4	4.9
1963	30.6	5.1
1964	31.2	4.9
1965	31.2	4.5
1966	28.7	3.8
1967	28.6	3.6
1968	34.5	4.0
1969	37.9	4.1
1970	36.6	3.7
1971	50.0	4.7
1972	62.0	5.3
1973	66.1	5.1
1974	55.1	4.0
1975	51.2	3.4
1976	67.7	4.0
1977	79.7	4.4

Source: Department of Commerce, Bureau of Economic Analysis.

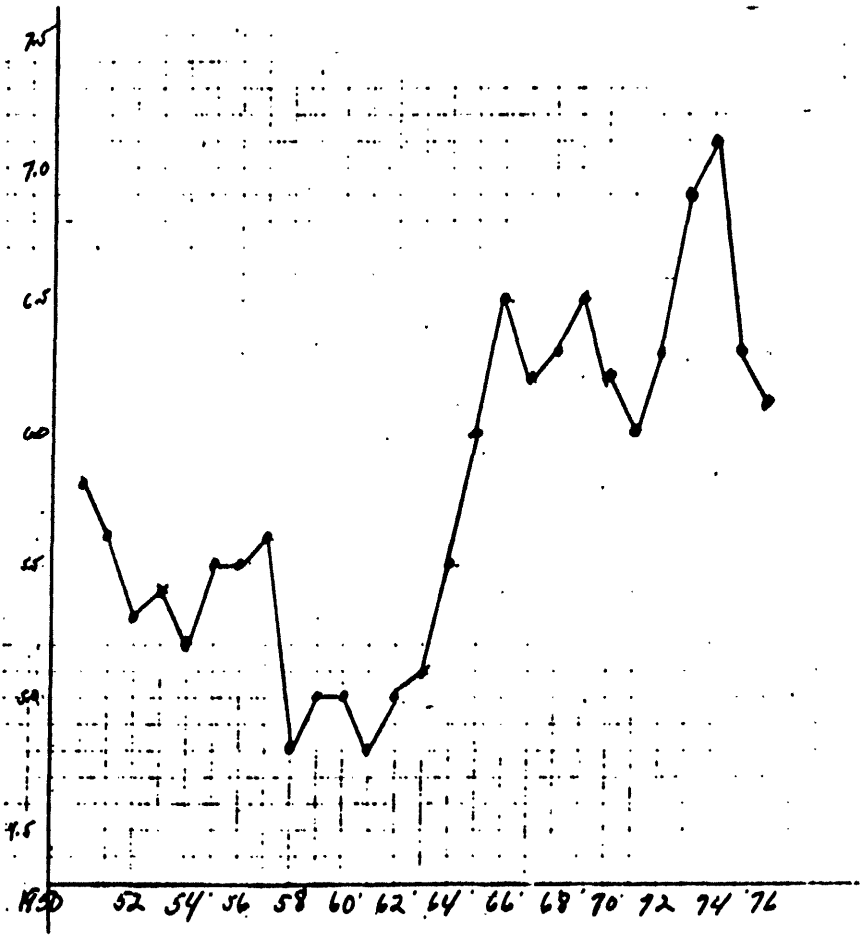
TABLE VIII.—*Cash flow* [1] *annual rate of change: 1951–76*

Year:	Percentage change	Year—Continued	Percentage change
1951	−7.6	1964	+12.2
1952	−2.9	1965	+14.6
1953	+8.1	1966	+8.0
1954	+6.1	1967	+1.3
1955	+24.7	1968	+5.5
1956	+3.3	1969	+1.8
1957	+2.2	1970	−4.5
1958	−4.9	1971	+11.5
1959	+16.4	1972	+17.1
1960	−1.3	1973	+14.6
1961	+1.6	1974	+11.2
1962	+16.0	1975	+2.3
1963	+8.1	1976	16.7

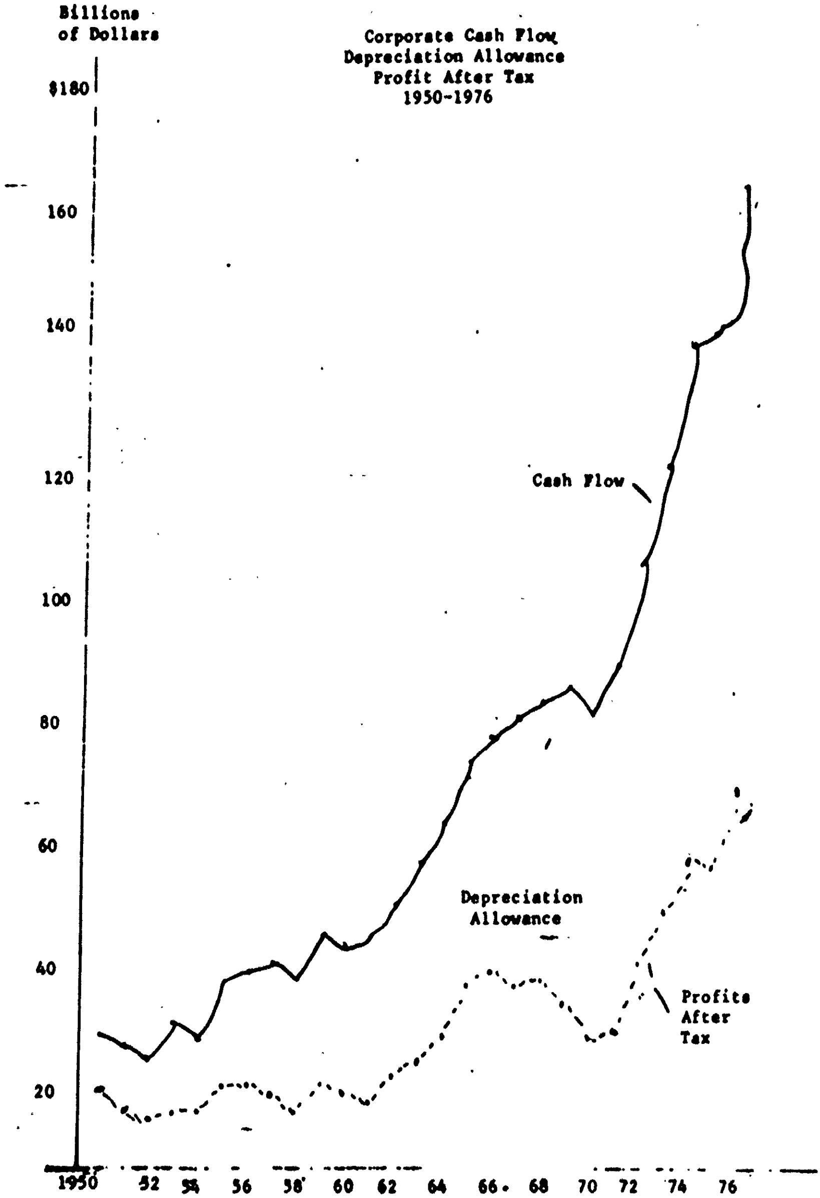
[1] Profits after tax plus depreciation.

The annual increase in cash flow to corporations was faster in the 1970's than in the previous two decades.

Investment in Producers Durable Equipment
As a Percent of GNP
(1972 Dollars)



Source: U.S. Department of Commerce, Bureau of Economic Analysis.



Corporate cash flow, i.e. profits after taxes and depreciation allowances, grew very rapidly in the 1970's. Depreciation allowances increased swiftly as a result of the new depreciation rules of 1971.

AMERICAN BANKERS ASSOCIATION,
Washington, D.C., June 30, 1977.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: This letter is being written as a followup to the testimony of Leif Olsen on behalf of the American Bankers Association before the Subcommittee on Taxation and Debt Management of the Committee on Finance of the United States Senate on May 17, 1977.

At that time you requested our views on the integration of corporate and personal income taxes. This subject was considered very carefully by a special task force on tax reform that has been assembled by our Association. This task force includes members of our Association's Economic Advisory Committee, Bank Taxation Committee, and the Executive Committee of the Trust Division.

We discussed three methods of integration. First, full integration through the elimination of the corporate income tax, and the treatment of all corporate income as if it were earned income of the shareholders. This proposal has too many problems and should not be considered at this time.

Partial integration was discussed in terms of two other proposals. The first would be to allow corporations to deduct dividends paid from their gross income in their determination of taxable income. This deduction would be allowed for dividends paid to domestic tax exempt organizations, but not for these paid to foreign shareholders unless reciprocal treatment were afforded by treaty. The second method would be to allow shareholders to use corporate tax payments on income paid out as dividends as a tax credit against their personal tax liability, after these tax payments have been included or "grossed up" in their personal income. At the current time, our Association cannot take an official position on any of these methods because we do not know what other proposals will be involved in tax reform legislation. Subject to this qualification, our task force reached a tentative consensus in favor of the dividend deduction method for the following reasons:

1. Simplicity of administration

There would be no need to estimate taxes at the time dividends are paid. Shareholders would not have to be re-educated to include the gross-up in income and take the credit. No problems arise from audit adjustments for past years, partial-year shareholders, or the variations between current and deferred taxes. There would be no necessity of elaborate record keeping to ensure the correct treatment of the credit. The records on foreign shareholders are substantially the same as those that must now be kept for withholding tax purposes.

2. Incentive to increase dividends

The dividend deduction approach would provide managers and shareholders with an incentive to increase dividends, thus passing on the tax savings to the shareholders for reinvestment. With a shareholder credit approach, in order for the dividend-paying corporation to retain any benefit directly the dividend must be cut, although the shareholder may still receive a higher gross dividend than formerly.

3. Ease of Phase-in

Under a dividend deduction alternative the phase-in is simple, with the burden of keeping up with the phase-in changes falling on professional managers rather than individual shareholders. It would also provide time for a corporation to change its business mix as necessary to accommodate the increasing deduction.

4. Preservation of existing incentives

Congress has provided a variety of tax incentives to corporations for purposes seen to be of economic or social benefit to the national interest. With a dividend deduction, these incentives are more likely to be preserved than with a shareholder credit, which might be structured in such a way as to destroy the efficacy of present or future incentives to the extent of dividend payouts.

5. Enhancement of capital formation

The dividend deduction approach would generate more capital formation for two reasons. First, the deduction guarantees a tax savings at the marginal or statutory rate, rather than at some lesser gross-up factor, as might be the case under some forms of shareholder credit. Second, the capital thus formed is automatically reinvested unless dividends are increased; it is likely that somewhat more earnings would be retained than under a shareholder credit system, and thus less would be lost by any propensity of shareholders to spend rather than reinvest dividend income.

In general, we see many advantages to a dividend deduction system although we would not be opposed to a carefully constructed shareholder credit system which took account of the reservations listed above.

We share the concern expressed by many observers about the effects of these proposals on Treasury revenues. Indeed, economic stability will be a crucial element in any program to enhance capital formation. On balance however, capital formation will only be enhanced if the net tax burden on the corporate sector is lightened, and tax incentives are altered to favor capital investment. To accomplish this we urge the Committee to also consider other forms of tax incentives. Areas for consideration might be the investment tax credit, accelerated depreciation, lowering corporate tax rates, and indexing tax rates to account for inflation.

Sincerely,

GERALD M. LOWRIE.

STATEMENT OF ALAN S. DONNAHOE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, MEDIA GENERAL, INC., RICHMOND, VA.

RECOMMENDATIONS

1. Establish a tax ceiling of 50 percent on all income, whether earned or unearned

The present maximum of 70 percent on unearned income is absolutely punitive, and strongly discourages any investment that yields income in the form of either interest or dividends.

2. For capital gains of more than one year, deduct the gain due to inflation, and tax the remainder as ordinary income

Prices in this country, for example, have risen by about 75 percent in the past decade. Thus a home worth $40,000 10 years ago will have risen to $70,000 today due to inflation alone. Only the profit beyond $70,000 should be taxed.

It is grossly unfair and inequitable to make people pay a tax on inflation itself, which is the cruel hoax inflicted, in effect by our present system.

3. Permit corporations to deduct dividends as a business expense

The typical corporation now pays 48 percent of its income in federal income taxes. If it pays out the remaining 52 cents per dollar in dividends, the taxpayer can pay up to 70 percent of this in taxes, or 36.4 cents per dollar. Thus he is left with 15.6 cents of the original corporate income dollar; and the federal government has taken the other 84.4 cents in taxes. And the situation is even worse, of course, when state taxes are included as well.

With such a negative tax system as this, it is not surprising that the United States is a laggard in investment among industrialized nations, and that we are constantly plagued with high unemployment and inflation.

It is significant that the median price/earnings ratio of all listed stocks on the New York and American Exchanges, along with principal OTC companies, is now 7.8. This means that the typical company, selling stock to get additional capital, must earn an after-tax return of 12.8 percent on that capital just to break even in terms of earnings per share. Taking account of the federal income tax, this must be doubled to a return of 25 percent on a before-tax basis, just to break even. Is it surprising, in view of this, that capital investment is being severely retarded in the United States?

If dividends could be treated as a business expense, it is reasonable to assume that most corporations would double their dividends immediately. As a result, it is a virtual certainty that stock prices would rise sharply, thus providing all companies with far greater inducement to increase their capital spending.

This effect would be even stronger, of course, if my other two recommendations were also adopted—a 50 percent maximum tax on income, and deduction of inflation before any tax on capital gains.

4. Revise the ERISA law to stop the discrimination that it has created against medium and smaller-size companies among institutional investors

A miserable by-product of ERISA has been to give pension and other fund managers a ready excuse for not investing in anything other than giant companies.

They claim, under ERISA, that they can be held guilty of negligence for investing in any company with, say, less than $100 million in annual revenue, on the theory that there is greater risk in any smaller company of this type.

The effect of this is to further limit the access of these smaller companies to the capital market, and thus sharply reduce their growth potential. In many and perhaps most instances, over time, about all they can look forward to is being gobbled up by some larger, acquisition-minded company.

So legislation intended for another purpose entirely has had the effect of putting these smaller companies at a huge disadvantage in competing with larger firms for available capital. Clearly, this inequity should be eliminated by an appropriate amendment to the ERISA legislation as quickly as possible.

SUMMARY

These simple changes would provide an enormous stimulus to capital investment in this country, and go a long way towards redressing the present imbalance in our tax system which strongly favors consumption versus savings, through the heavy penalties imposed on investment income.

With normal taxes on the additional investment and income thus generated, the federal government should more than recoup any initial losses in tax revenue in a relatively short period. Thus, properly viewed, these are revenue-producing measures which in time should lead to a balanced budget, along with additional funds to meet other needs of the country.

And, most importantly, these simple changes would set this country on the road to full employment and reduced inflation.

The only real argument against the recommended program is that it runs counter to the soak-the-rich philosophy that seems to have great popular appeal. But all of this is utterly spurious because the people really hurt by our tax system are not the rich but rather the middle class, professional people, corporate executives, and entrepreneurs. Precisely the people, in other words, who can contribute most to the vigor of our economic system.

And when these people are harassed and their incentive is reduced, then everyone in the nation suffers accordingly. The revenue from excessive taxes on this group is utterly trivial in terms of the economic damage that is wrought thereby.

The clearest example of this, of course, is England, where punitive taxes and related policies have created economic stagnation, growing unemployment, high inflation, and ever-increasing social conflict.

POSTSCRIPT

Media General has been a public company, chartered in Virginia, since 1966.

In its relatively short history as a public company, it has grown in assets from less than $14 million to more than $191 million, in revenue from $18 million to $199 million, and in stockholders' equity from $11 million to $116 million.

Media General today owns daily and Sunday newspapers in Richmond, Virginia; Winston-Salem, N.C.; and Tampa, Fla.; along with broadcast, printing, and related subsidiaries. It also owns the Garden State Paper Company which produces about 12 percent of all the newsprint manufactured in the United States through a unique recycling process which utilizes old newspapers as the basic raw material without the need for any virgin fibre.

I have been president and chief executive officer of Media General throughout its history as a public company and I have personally approved and recommended more than $100 million in capital expenditures throughout this period—a substantial investment for a company our size.

This background is provided simply to indicate that I have had some personal experience in the area of capital investment, and the decision-making process that is involved therein.

ALAN S. DONNAHOE.

STATEMENT OF THE FINANCIAL EXECUTIVES INSTITUTE

TAX SYSTEM CHANGES FOR CAPITAL FORMATION AND ECONOMIC GROWTH

Financial Executives Institute is the recognized professional association of 9,000 senior financial and administrative executives of more than 5,000 business organizations, representing a broad cross section of American national and international industry.

We believe that the substantially increased level of capital investment by business that will be required over the next decade should be encouraged by the following capital formation provisions in the tax system.

1. A flexible capital recovery allowance system permitting capital investments in machinery and equipment to be recovered over as short a period as five years, and a substantial reduction in the capital recovery period for industrial and commercial buildings, with recovery in both cases starting as progress payments on new construction are incurred.

2. A permanent 12 percent investment tax credit for all capital expenditures.

3. Immediate writeoff of pollution control expenditures at the taxpayer's election.

4. Elimination of minimum tax on corporations.

5. Mitigation of the income tax burden on capital gains.

These changes are needed in order to provide adequate employment opportunities for a growing labor force, to reduce inflationary pressures by increasing capacity to meet consumer demands, to replace and modernize obsolete and worn out facilities, to develop new energy sources and to meet environmental and safety standards.

The magnitude of the capital requirements with which we are faced is apparent from separate studies carried out in 1974 by General Electric Company[1] and the New York Stock Exchange.[2] In these studies, gross private domestic investment (including residential structures and inventory accumulation as well as business fixed investment) for the period 1974 to 1985 is estimated to be about $4.5 trillion—three times the $1.5 trillion total for the previous twelve years. Even when stated in current dollars to eliminate the effect of inflation, the 1974 to 1985 requirement is still roughly 1.5 times greater than that of the prior period.

The critical problem.—The critical problem to be overcome, if these projected capital requirements are to be met, is that of providing funds in such large amounts. For example, the New York Stock Exchange study previously referred to projected a potential capital shortfall of $650 billion through 1985. A more recent study, commissioned by Financial Executives Research Foundation,[3] found that, assuming no change in current price level, there will be a $816 billion shortfall of accumulated savings (i.e., available capital) over the next decade. At an inflation rate of three percent a year, the shortfall will increase to $983 billion; at an inflation rate of five percent, the shortfall will increase to $1.1 trillion.

A report issued by the Staff of the Joint Committee on Taxation in March 1977[4] noted that "there are several reasons to be concerned whether the United States will have an adequate amount of capital accumulation." The Committee's Staff found that "the growth rate of the labor force has not been matched by growth of capital investment." Growth of private plant and equipment (excluding pollution control investment) declined from a rate of 4.3 percent in 1965-70 to a projected rate of 2.5 percent in 1975-77. Growth of plant per worker fell from 2.6 percent in 1965-70 to a projected rate of 1.0 percent in 1975-77. Moreover, inadequate plant investment was found to be a major factor in a decline in the growth rate of productivity, and in a decline in the growth rate of real wages.

Contributing to the problem is the fact that the ability of American industry to generate funds has been seriously inhibited by the deterioration of real corporate profits due to inflation and by an increased reliance on debt financing.

Analyses prepared by the Department of Commerce indicate that although after-tax corporate profits were widely reported as "record breaking" in 1976, "real" profits, after adjustments for inventory profits and under-depreciation of assets, actually declined. While reported after tax profits of non-financial companies for 1976 totalled $84 billion compared to $47 billion in 1966, an apparent 77 percent increase, real profits when adjusted for inflationary factors actually declined by 37 percent, and this despite a substantial increase in the volume of business.

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[1] Business Capital Requirements—1974–1985; by Reginald H. Jones; Financial Executive; November 1974.

[2] "The Capital Needs and Saving Potential of the U.S. Economy"; The New York Stock Exchange; September 1974.

[3] "The Effects of Tax Policy on Capital Formation"; by Norman B. Ture and B. Kenneth Sanden; Financial Executives Research Foundation; 1977. Page 38.

[4] "Report on Tax Policy and Capital Formation"; by Staff of Joint Committee on Taxation; for House Ways and Means Committee Task Force on Capital Formation; March 1977. I.2., 3.

Retained earnings available for reinvestment by business, restated to account realistically for inventories and depreciation, show a decline from $26 billion in 1966 to $13 billion in 1976—a period in which real gross National product (the total economy) grew 29 percent.[5]

The deterioration of real business profits and retained earnings, along with the depressed state of the equity markets, has forced corporations to rely more and more on debt financing. From 1965 to 1974 non-financial corporations raised a total of $267.4 billion of long term funds of which long term debt accounted for 83 percent. This gave rise to an increase of outstanding debt reflected on corporate balance sheets of $220 billion ($141.4 to $362.3).[6]

Effects of tax policies.—Federal tax policies affect capital investment decisions by determining the after-tax earnings and cash flow available for investment and by establishing incentives or disincentives for future investment. Recognition of the important role played by such policies in helping business to generate internal funds to finance capital investment led to the enactment of accelerated depreciation in 1954 and the investment credit in 1962, the issuance of the depreciation guidelines in 1962 and the Asset Depreciation Range (ADR) system in 1971.

Despite these changes, American businesses still bear a heavier tax burden on capital than do businesses in other leading industrial countries, which have generally adopted more favorable capital recovery allowances than the United States. An American firm using both ADR and the investment tax credit can recover 54.7 percent (or 60.7 percent with the temporary 10 percent credit) of the value of new investments over the first three years. By comparison, the allowances in other nations within the first three years are as follows:[7]

	Percent
Canada	105.0
France	67.5
Italy	67.9
Japan	63.9
United Kingdom	100.0
West Germany	49.6

In addition, depreciation allowances based on historical costs have been seriously eroded by inflation and are thus inadequate to provide funds for replacements of existing assets. In an article published by Machinery and Allied Products Institute in December, 1974, entitled "Inflation and Profits", George Terborgh makes a comparison on current cost double-declining balance depreciation of non-financial corporations with depreciation allowed them for income tax purposes for the years 1965 to 1973. Mr. Terborgh's analysis shows an understatement of capital costs for 1973 of $9.3 billion and a cumulative understatement of $43.1 billion over the nine year period. The comparable figure for 1974, based on a 9-month actual, was $11.2 billion.

A prime example of an industry suffering from the erosion of depreciation allowances by inflation is the steel industry. The extent to which inflation has deflated the dollars recovered by the steel industry through statutory capital recovery allowances since 1953 is graphically set forth by the American Iron and Steel Institute in its revised study entitled "Steel Industry Economics and Federal Income Tax Policies" (June 1975). This AISI study projected a trend of steadily increasing deficiencies in statutory allowances.

Another drain on available funds is the demand for capital to protect the environment which has been steadily increasing and can be expected to continue to increase in the future. According to the U.S. Department of Commerce Survey of Current Business, non-farm business spent $5.6 billion for air and water pollution abatement plant and equipment in 1974, $6.5 billion in 1975 and planned to spend 7.3 billion in 1976.[8] These amounts represented 5.0 percent, 5.7 percent and 6.1 percent, respectively, of total expenditures for new plant and equipment.

Pollution control expenditures are obviously different from those made for productive facilities. Even though resulting in physical property, they are generally not income producing and, in addition, increase annual operating and maintenance costs.

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[5] Survey of Current Business (February 1977) and Business Conditions Digest (March 1977)—Department of Commerce.

[6] Statement of Treasury Secretary William E. Simon—Senate Finance Committee Hearings. March 1976.

[7] Ture and Sanden, op. cit., page 150.

[8] Survey of Current Business (July 1976, page 14).

The magnitude of future capital investment needs, the projected shortfalls in available capital funds, the impact of inflation, the rapid pace of technological change, and the growing intensity of competition from foreign industries—much of which is subsidized by their governments—pose a tremendous threat to our continued economic well-being.

In its report,[9] the Staff of the Joint Committee on Taxation noted that in the United States most investments are undertaken by private business and individuals. Therefore, a necessary step in increasing the rate of capital accumulation is to make the private sector of the economy more willing to invest in plant, equipment and other types of capital.

Conclusion.—In order to meet the long range challenge thus posed, business must be permitted to develop the capability to more effectively modernize its productive capacity by assurance of the available of an adequate supply of capital funds. Financial Executives Institute agrees with the Staff of the Joint Committee on Taxation in their conclusion that federal tax policy can and does influence the level of capital investment. Financial Executives Institute believes that the most effective way to provide such funds is through realistic Federal income tax treatment of capital costs, from the standpoint both of allowances for capital recovery and of other sources of capital investment, such as reinvestment of earnings.

STATEMENT OF NORMAN B. TURE, PRESIDENT, NORMAN B. TURE, INC., WASHINGTON, D.C. AND B. KENNETH SANDEN, PARTNER, PRICE WATERHOUSE & CO., NEW YORK, N.Y.

The Financial Executives Research Foundation has just published a study on "The Effects of Tax Policy on Capital Formation". We were asked to undertake this study in order to stimulate further serious dialogue about the nature and extent of the capital formation problem. In the study we have attempted to delineate the problem, to establish base line saving and capital requirements for the decade 1976–1985, and to describe and discuss tax changes to meet our saving requirements.

As set forth in the study, without an adequate increase in the stock of private capital, the rate of growth of the nation's economy will falter—employment and real wages will grow more slowly, inflation will continue, and public policy goals will be more difficult to achieve. While labor will be hardest hit, there will be less for all of us to share. As a matter of public policy these results must be unacceptable to all Americans.

Whether we will add enough to our stock of capital over the next decade depends critically on whether we can increase the rate of private saving. What is earned is either spent for consumption or saved for the future. Private capital formation has no source other than saving.

Increasing the rate of private saving enough to meet these private and public goals will require substantial changes in our tax system. The present tax structure exerts a severe bias against saving and capital formation and in favor of consumption. Moderating that bias is essential if the economy is to realize the advances in living standards to which all Americans aspire.

IS THERE A CAPITAL SHORTAGE?

Economists, leaders, and public policy makers differ as to whether a capital shortage exists or is in prospect, and, if so, its magnitude. Maintaining the postwar trend rate of increase in employment, in productivity, and real wages, however, will require maintaining at least the postwar trend rate of increase in the capital-labor ratio.

When adjusted for inflation, profits at current and prospective rates cannot be expected to provide as large a portion as formerly of business saving to finance capital expenditures. Government mandated programs such as for pollution control, however desirable in the long run, add substantially to projected capital requirements, hence compete for the Nation's total saving. This is not to imply a collision course between environmentalists and businessmen but rather a recognition that the saving rate must be increased to encompass the aims of both. In many instances, because of underdepreciation of assets and distortion of inventory values, taxes are, in fact, being assessed on essential business capital. Increases in business saving from more adequate capital recovery allowances and

[9] Joint Committee on Taxation, op. cit., II, Determinants of investment, 1.

lower effective tax rates on profits plus increases in personal saving from more nearly neutral tax treatment of saving uses of income are needed if total saving is to be adequate.

With the current slack in the economy and consequent idle plant capacity, some question whether current rates of saving and capital formation are, in fact, inadequate. At issue, however, is whether we will save enough to meet our capital requirements not merely today but over an extended period. Looking ahead 10 years, we should be concerned by the fact that much of the nation's stock of capital equipment is outdated and shopworn; among the industrialized countries, the United States has the highest percentage of obsolete production facilities. We should be concerned about the fact that the U.S. has the lowest ratio of capital investment to GNP and the lowest rate of productivity increase of any of the major industrial nations. Achieving the objectives of high employment and rising real wage rates without inflation, along with numerous other public policy goals, will require us to accelerate modernization and expansion of the stock of capital. Over the next decade, this requirement cannot be met if we pursue policies which encourage us to use ever-increasing shares of income and production capability to satisfy consumption demands.

ESTIMATES OF SAVING SHORTFALL

The critical question is whether the required amount of gross private saving will be forthcoming. Business in the aggregate cannot invest more than people—households and businesses—save. The most optimistic study ("Capital Needs in the Seventies", Bosworth, Dusenberry, Carron—The Brookings Institution, 1975) indicates ". . . that we can afford the future, but just barely." Given the underlying assumptions of employment, inflation and government expenditure policies, this prophecy requires more faith than most of us would be willing to rely on for guaranteeing the fruitful lives of future generations. Alternatively, more is involved than adding together what business and other groups indicate they would like to have and arrive at a shortfall of several trillion dol ars. In any event, whatever the approach, there is basic agreement that no capital surplus exists and accordingly we are in danger of rapidly becoming underachievers in growth, research and development, new industries and technologies so vital to our economic health.

The analysis presented in this study shows that the accumulated saving shortfall, assuming no change in the price level, will be $816 billion for the decade. At a 3-%-a-year inflation rate, the shortfall would increase to $983 billion and at a 5-percent rate, it would increase to $1.113 trillion.

Capital market adjustments and changes in government deficits or surpluses will not be sufficient to eliminate the saving shortfall in prospect. The primary difference to be taken into account is the capital-labor ratio in the United States which exceeds that of most other countries. This means we must try harder to stimulate capital formation or fall faster if we do not.

TAX POLICY—WORLDWIDE

There has been increasing worldwide recognition that tax policy plays an important role in meeting the challenge of capital formation. Many countries have recently removed impediments in their tax laws or instituted other forms to stimulate saving and consequently capital expenditures. Of all the industrialized countries, it appears that the United States taxes saving far more heavily than consumption, as follows:

Capital recovery.—Even with the temporary increase in investment credit we are just about tied for last place.

Capital gains.—With few exceptions we tax capital gains far more harshly and, with losses limited and gains taxable, treat investors somewhat as professional gamblers.

Corporate income.—A double tax is imposed on earnings distributed—and even undistributed when capital gains taxes are involved while all other major industrialized countries have some form of relief.

Foreign income.—Constant whittling away from economic neutrality concept while other countries exempt entirely or allow tax credit for foreign levies.

Benefits to saving.—No saving benefits while others exclude income from taxation or grant special writeoffs or allowances.

Reliance on income tax.—We rely more heavily on income tax with its bias against saving and investment while other countries are using more nearly neutral taxes such as VAT.

CAPITAL FORMATION AND RELATED TAX POLICY

Adjustment to the U.S. tax system in the foregoing areas would not call for special incentives or loophole parity but rather the elimination of disincentives restricting saving and capital formation.

The time is ripe to begin consideration of a bold new policy which would result in drastic changes in the tax structure of the United States. Included among these changes should be repeal of the corporation income tax and individual income tax revisions to achieve neutrality with respect to saving and consumption. This neutrality can be accomplished by excluding from the base of the tax either the amount of net saving in the taxable year or the returns on saving realized in that year. As a practical matter, a deduction of saving from gross income with inclusion of all the returns on saving in the tax base is more feasible than taxing current saving and exempting the returns thereto.

These basic revisions are so sweeping that there is little prospect for their early enactment. Nevertheless, these concepts provide guides for the consideration of far more limited tax changes which could be enacted in the near term to reduce the bias against saving and capital formation. One or more of the following alternatives are worthy of consideration for early enactment:

1. Provide a capital recovery allowance system for plant and equipment which is not related to useful life of the asset.
2. Make the Investment Tax Credit permanent and increase the rate.
3. Provide inflation adjustments for fixed assets as well as for inventories.
4. Reduce corporate and individual income tax rates.
5. Remove the double tax on corporate profits by providing a deduction for dividend payments.
6. Eliminate the minimum tax on corporations and individuals.
7. Extend the maximum tax rate limitation on individuals to cover income from investments and saving.
8. Substitute a Value Added Tax for part or all of the Income Tax on business income.
9. Permit a limited deduction or credit against income tax for net saving by individuals.
10. Revise the treatment of capital gains and losses to provide a lesser burden relative to the tax on income.

Even within the present tax structure, tax changes considered politically unthinkable a decade ago have become economically indispensable. It is hoped that the analysis presented and the recommendations made in this study will be a positive contribution toward the ultimate solution of this important problem.

STATEMENT OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

The National Association of Manufacturers represents 13,000 members primarily engaged in manufacturing and employing a majority of the industrial labor force in the United States. Approximately 75 percent of our members are small businesses which employ 500 or fewer persons.

The Association is pleased to provide industry's views on the relationship between federal tax policy and economic growth in the United States. Recognizing that the Subcommittee hearings are concerned primarily with significant long-term tax policy issues, this statement will discuss only three major proposals for tax reform—an end to double taxation of dividends, capital recovery allowances, and rate reductions. A number of other changes supported by the Association are listed in testimony submitted to the Committee on Finance during the consideration of the 1976 Tax Reform Act.

I. CAPITAL FORMATION AND ECONOMIC GROWTH

During recent years, capital formation in our economy has become a critical concern. There has been an increased awareness within the business community, within the Federal government, and by the public of the importance of capital formation as the seed corn for future self-generating economic growth which provides new jobs for a growing labor force, higher productivity, and increased real wage rates. An even more important factor of immediate interest is the heightened awareness that we must fuel the production process with increased amounts of net new investment just to stay even in terms of real per capita living standards and to further reduce the level of unemployment.

One factor probably contributing to this increased understanding has been a comparison of savings and growth rates among various industrialized countries. As is noted in the following table, the economies of Japan, West Germany, Canada, and France have devoted significantly more gross domestic product to savings and investment than have the U.K. and United States, and these same economies have grown at a faster rate than those of the U.K. and United States. While there can be other circumstances influencing such relationships, the message should be clear—there is a direct relationship between the level of investment and the rate of economic growth.

INVESTMENT AND ECONOMIC GROWTH: INTERNATIONAL COMPARISON (1960-74)

[In percent]

	Total investment (of gross domestic product)	Gross domestic product (annual change)
Japan	24.9	9.7
West Germany	19.2	4.6
Canada	17.1	5.1
France	15.7	5.7
Italy	14.5	5.1
United Kingdom	14.1	2.7
United States	13.4	3.8

Source: U.S. Department of the Treasury.

As concern has grown over the rate of capital formation, various studies have provided quantitative estimates of capital needs for the next decade. The New York Stock Exchange, the General Electric Company, and Chase Econometric Associates have reported results of studies suggesting that there will be a significant gap between the level of investment the economy will need to achieve certain objectives and the level of total savings which can fund that investment.

Forecasting such developments over a period of years is not a simple matter, and perhaps too much has been made of some attempts to provide specific dollar estimates. But the basic point remains that the known forecasts indicate there will be very substantial capital requirements in the coming decade—not only to keep up some semblance of economic growth, but to account for mandated environmental and personal safety standards and at least to get a start on energy self-sufficiency—and it is unlikely that those requirements can be met unless the general climate for capital formation is improved.

II. TAX POLICY AND CAPITAL FORMATION

Tax policy is a key factor affecting the level of capital formation in the private sector. While not the only factor, it can be critical at the margin and may well determine the success or failure of regaining a better productivity performance and achieving more satisfactory increases in real income for workers.

This critical impact results from the effects tax policy has on available sources of capital. For industry, three sources are: (1) retained earnings, which are affected by the tax rates and depreciation system; (2) equity, which is impacted by the double taxation of dividends and the imposition of capital gains taxes; and (3) debt, which is also affected by the double taxation of dividends.

Congress obviously faces difficult choices in reducing tax obstacles to capital formation, given the context of multibillion dollar federal budget deficits and the concern such deficits raise as inflationary potentials in the economy. The justification for reducing any taxes in periods of such substantial budget deficits is simply the fact that estimated direct revenue impacts do not reflect changes in economic activity which would follow basic tax changes. When a new investment is made and people are put back to work, or new jobs created, as a result of the tax changes recommended, the federal income tax base will grow. The revenue losses are then substantially or fully offset due to the feedback effects of the original tax reductions.

In addition to the particular effects of specific tax policies, the general stability of tax law is a major concern. Uncertainty as to the favorable nature of the general tax climate can affect both the timing of new investments and even the decisions to make such investments at all. The investment tax credit is virtually the only tax provision enacted in the last twenty years which favorably affects the capital formation process. And it has been suspended, reinstated, repealed, reenacted, raised, and extended six times since its creation. If it were viewed as the capital recovery mechanism that it is, rather than as a fine-tuning device which can be turned on and off at will, its long-term impact probably would be even more favorable than has been the case.

The planning of investment decisions, whether by corporations or individuals, would not be aided by recurring upheavals in tax policy, such as would occur, for example, if various so-called "tax expenditures" were to expire every five years. Such proposals are being discussed, and they pose a significant new threat to investment planning.

III. PROPOSED TAX REFORMS

There are a number of possible tax changes which would, to varying degrees, improve the climate for capital formation. Three are of particular interest, and the NAM strongly favors adoption of any of these proposals either alone or in combination.

Tax Treatment of Dividends

The economy has long endured the double taxation of dividends, first at the corporate level through the corporate income tax on earnings and then again at the shareholder level through the individual income tax on earnings paid out as dividends. Because of this long history, some claim it just doesn't matter. In fact, most efforts to enact relief from such double taxation have fallen largely on deaf ears. Even the very limited 4 percent credit for dividends received by individuals was repealed as part of the 1964 general tax reduction legislation.

Industry believes that it does matter—that the apparent indifference has been a case of growing accustomed to a chronic pain. Perhaps this pain didn't become really noticeable until the equity and new issues markets collapsed in the 1970's. Nevertheless, the problem has been with us right along. One result of such double taxation has been to enhance the appeal of debt financing relative to equity because of the tax penalty imposed on dividends but not on interest. Another has been the diversion of some funds to other forms of investments where the pre-tax rates of return need not be so high as that necessary in industry which generally utilizes the corporate form.

Industry's position with respect to double taxation should be clearly understood—double taxation of dividends is inequitable and economically undesirable, and it should be ended. There are collateral issues which are discussed below, but this general statement represents the policy position of the NAM.

While an end to double taxation is desirab'e, Congress should be wary of packaged proposals which would result in a climate for capital formation worse than that which already exists. "Tradeoffs" for an end to double taxation have become the number-one topic of discussion, and herein lies the concern of the business community. The end to double taxation would be an equitable tax relief action and, taken alone, would be a net benefit to the capital formation process. But, when combined with repeal or restriction of existing provisions which mitigate the adverse effects of tax law on capital formation, the end of double taxation could produce an overall adverse impact. This would not be desirable.

For example, if shareholders were allowed to take a tax credit for the corporate taxes already paid on their dividends but were taxable on 100 percent of the capital gains on sale of the stock, the impact might well be to discourage investment by individuals. From a different perspective, a shareholder credit having an estimated revenue loss of $10 bi'lion, offset by a $5 billion revenue gain from other capital-related provisions, would produce a net benefit only if shareholders reinvested more than $5 billion of their tax savings.

The NAM does not have a preference as to the method used to end double taxation. A shareholder credit attached to dividends or a corporate deduction for dividends paid are the two methods generally discussed, and either could produce desirable results. Whatever alternative is adopted, the fair and equitable ending of double taxation is the primary objective.

Capital Recovery Allowances

While double taxation impacts the creation of capital and the level and form of new investment, existing depreciation policy has a substantial adverse impact on maintaining the real value and usefulness of previously invested capital. When any business asset is purchased, capital is expended. In order to prevent taxing such capital when it is recovered during the sales of goods and services, the Code allows for the deduction of the cost of assets purchased. If this were not allowed, our capital base would be eaten away by taxes, and enormous amounts of new investment would be needed just to maintain the status quo.

Unfortunately, the depreciation system now permitted by the Code sanctions a small-scale version of the same destructive process because it is based on the "useful life" concept rather than fast recovery of invested costs. The problem with the useful life concept is that its theoretical recovery of invested capital does not work in the real world of inflation and technological change. The longer the depreciable life assigned to an asset class, the more devastating the eroding effect of inflation on recovering real capital costs. This is particularly true with regard to manufacturing industries because the bulk of their assets have minimum depreciable lives of at least nine years. The principal result is a loss in value of real capital even though the historical dollars have been recovered. Therefore, a portion of the new capital formed each year must be used just to stay even in real terms. Another adverse result is the extent to which long recovery periods tie up capital which would be productively reinvested more quickly.

The Revenue Act of 1971 introduced the Class Life System and ADR as revisions to depreciation policy. Coupled with accelerated accounting techniques, these reforms have increased somewhat the speed of cost recovery for companies which can handle their complexities. However, even these provisions remain tied to the useful life concept, and their purpose can be frustrated by the inability of many businesses—particularly small businesses—to adopt them.

The NAM recommends a complete change in the capital recovery system in the Code through enactment of a capital recovery allowance system which would abandon the useful life approach. The system would include the following features:

Machinery, equipment, and pollution-control facilities would be subject to an accelerated five-year writeoff;

Industrial buildings used in the process of manufacturing, extraction, transportation, communication, etc., would be subject to an accelerated ten-year writeoff.

No salvage values would be used;

Taxpayers would elect deductions of 0 percent to the maximum allowed for any year and, unused deductions would be carried forward indefinitely;

The system would be applicable as costs are incurred; and

A full-year convention could be applied for all costs.

Rate Reduction

The corporate rate structure itself continues to be a fundamental tax obstacle to productive investment. The maximum 48-percent rate applied to each dollar of income above $50,000 is a heavy drain on a firm's ability to generate new internal capital.

The most recent across-the-board reduction in rates was in 1964. The 4 percentage point reduction enacted then probably would have been even larger if the investment credit had not been adopted only two years earlier. Since that time, only the temporary 1975 increase in the surtax exemption and rate cut for small business have been enacted. But even these rather limited reductions will expire at the end of 1978 unless further action is taken.

A reduced rate of tax on corporate income would maximize the market system's allocation of funds to productive uses and, therefore, could be the most productive of real wage gains. The NAM supports an across-the-board reductions resulting in a single lower normal tax (currently 20 percent on the first $25,000 and 22 percent on the excess over $25,000), a lower surtax (currently 26 percent of income in excess of $50,000) and a permanent increase in the surtax exemption to at least $100,000. This rate package would reduce tax obstacles to corporate operations in general—whether capital or labor-intensive, large or small, new or mature in age—while giving relatively more boost to small and moderate-size businesses.

Across-the-board rate reductions for individuals are also highly desirable. The 70 percent maximum rate on dividends, interest, and the included portion of capital gains is a burden on and deterrent to productive investment and should be reduced to the 50-percent maximum applicable to earned income. Reductions throughout the rate structure would result in more potential capital among all individuals and would be particularly appropriate for the hundreds of thousands of small businesses operated by sole proprietors and partners.

While possibly not affecting investment decisions as directly as other proposals, rate reductions would be simple and easily understood and could be put in place immediately without any confusion as to new regulations, new qualifications, or campaigns to explain it. Such reductions would be a limited answer to the overall problem of correcting the tax system's bias against productive investment, but it would help and would not interfere with more basic reforms which could be instituted over a period of time.

IV. CONCLUSION

Any tax structure will remove funds from the private sector which could otherwise be invested to produce economic growth. Industry's concern over existing tax policy is that it goes beyond being a relatively neutral revenue-raising structure and, in fact, erects obstacles do the capital formation process; by creating a bias against savings and investment, tax policy inhibits economic growth. Imposing a penalty tax on dividend income, sanctioning the erosion of capital through useful life depreciation, taxing business and investment income at high rates—these and other features of tax law adversely affect the capital formation process which sustains the creation of new jobs, increased productivity, and real wage rates. Fundamental tax reforms such as the end to double taxation, a rapid capital recovery system, and sizable rate reductions would enhance the prospects for continued growth for the U.S. economy, and they should be adopted.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS,
Washington, D.C., June 30, 1977.

SENATOR HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: Thank you for your letter of June 16, requesting our views on incentives for economic growth. We have pulled together comments on several important aspects of this subject, and several copies of our summary are enclosed.

We commend you and your Subcommittee for your interest in this subject. The impact of our tax system on economic growth and capital formation is extremely important, and it is encouraging that many Congressional and Administration leaders have stated publicly the importance of capital formation to our economic well-being and to long range employment goals.

Because of the relatively short time we have had to develop the views covered by the enclosed summary, we have for the most part relied on positions previously taken by the AICPA Tax Division in Congressional tax hearings. At the present time, we are considering other aspects of capital formation and basic tax reform problems, and we hope to have further input on these matters in the next few months. Although I know the record of these hearings ends on July 1, we would appreciate the opportunity to submit additional data to you at a later date.

A new edition of the Federal Tax Division's "Recommended Tax Law Changes" will be distributed shortly to members of Congress. While these changes are primarily technical in nature, we believe that a number of them would have a positive effect on economic growth, and would welcome the opportunity to discuss such items with you or your staff.

If we can assist you or your staff further in your considerations, we would of course be pleased to do so. In that regard, please feel free to phone Charles Lees, Chairman of our Legislative Affairs Subcommittee (212-758-9700), or me here in Washington (785-9510).

Very truly yours,

WILLIAM C. PENICK.

Division of Federal Taxation of the American Institute of Certified Public Accountants—Comments on Incentives for Economic Growth

(Prepared for the Subcommittee on Taxation and Debt Management, July 1, 1977)

Table of Contents

Excerpt from the Tax Division's Testimony Before the Senate Finance Committee, March 18, 1976

ELIMINATION OF THE DOUBLE TAX ON DIVIDENDS

The Institute believes that the present tax treatment of corporate-source income does not measure up to accepted standards of tax equity, and that such treatment inhibits the growth and development of not only the corporate sector but all phases of the U.S. economy. Furthermore, the double-taxation of corporate-source income has added to the complexity of tax law administration. And finally, since the incidence of the corporate income tax is unknown, the present system has hindered the Congress's ability to predict the effect of proposed legislation and to thereby design the legislation that most accurately and effectively accomplishes its social and economic purposes. We believe that some measure of integration of the corporate and individual income taxes would alleviate these problem areas.

Based on our analysis of the various alternatives available, we urge the adoption of either a dividends-paid deduction for corporations or a "gross-up" method of calculation that would allow a tax credit to shareholders for those taxes paid by the corporation which are attributable to the income distributed as dividends. Properly structured, either alternative would be feasible from an administrative standpoint and would correct many of the shortcomings of the current system of taxing corporate-source income.

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[1] These items were made a part of the official files of the committee.

The dividends-paid deduction

Allowing a corporation to claim a deduction for dividends paid to its shareholders would achieve integration but would require corollary modifications in the present tax system.

Adoption of a dividends-paid deduction should carry with it the repeal of IRC Section 243 and related provisions dealing with the dividends-received deduction (85 percent in most cases) allowed to corporate distributees.

Attendant with the repeal of the dividends-received deduction, there appears to be no reason why the tax treatment of property distributions to corporate distributees (IRC Section 301(b)(1)(B) and related provisions) cannot be simplified. Since a stepup in basis can no longer be achieved by only a 15 percent inclusion in gross income, why not treat corporate and individual distributees equally? Thus, the fair market value of the property would be the measure of the dividend income, and such value would become its basis in the hands of the distributee shareholder—whether individual or corporate. The deduction of the distributing corporation should be limited to the corporation's adjusted basis in the property distributed.

The Institute believes that the dividends-paid deduction should be denied with respect to dividends distributed to tax-exempt organizations.

Advantages

Corporate-source income that is distributed to shareholders would be taxed equitably—both from a horizontal and vertical standpoint. The tax disparity between debt and equity financing would be considerably eased. Since dividends paid would become deductible, one important reason for choosing the debt route disappears. As dividends become deductible, equity financing becomes more attractive both to corporate management and to potential investors. By shifting to an equity source of funds, corporations can avoid the potentially hazardous commitment that accompanies debt obligations. During periods of low or nonexistent earnings, dividend distributions can be postponed. Interest and debt repayments must continue, however, if the business is to survive.

Making dividend distributions deductible undoubtedly would increase the flow of funds from corporations to shareholders. With respect to lower-income shareholders, these additional spendable funds would lead to increased consumption power.

Although the dividends-paid deduction has not had wide application in the United States, it is used with various modifications in other developed countries. For example, the "split-rate" system in effect in West Germany is a partial deduction for dividends paid. This does not imply that the United States should pattern its tax laws after other nations. However, in the international market setting, we must remain sensitive to the possibility that our tax system may place domestic corporations at a competitive disadvantage.

The adoption of the dividends-paid deduction alternative would ease certain tax problems inherent to closely held corporations. Once both dividends and interest become deductible, the motivation leading toward "thin" capitalization weakens, although it does not disappear. Shareholders may still wish to withdraw some of their investment in the corporation without income tax consequences (that is, by means of the repayment-of-debt principal). Perhaps more pronounced will be the resolution of the unreasonable compensation issue. Except for limited situations where excessive salaries may be paid in order to qualify a shareholder-employee for the maximum tax on earned income (IRC section 1348), preference for salaries over dividends would be neutralized. The same can be said for the current practice of shareholders' leasing property to a corporation in order to generate a rental deduction. At the corporate level it does not matter whether the distribution is characterized as interest, salaries, or rent because all such legitimate expenditures are deductible.

Disadvantages

Several objections can be raised against the adoption and implementation of the dividends-paid deduction as a vehicle toward achieving partial integration.

Complete integration is not achieved within the dividends-paid deduction alternative as it is in the partnership approach, since the corporate income tax would continue to apply to undistributed corporate profits. It would seem feasible, however, to partially rectify this inequity by allowing some type of carryback and/or carryforward procedure for dividends paid in excess of earnings. Thus, a corporation which chose not to make a dividend distribution in one year and accumulated its profits instead would be penalized only temporarily. The corporation would be able to make excessive distributions in later years with carryback relief against the corporate income tax originally imposed. Obviously, such a procedure would require certain safeguards to prevent manipulation directed toward tax avoidance. If a carryback procedure is established, a cut-off date must be set to preclude dividends in excess of current earnings from leading to the refund of prior corporate income taxes paid. To illustrate, if the enacting legislation is approved in 1976, the carryback could be made applicable only to earnings and profits accumulated for tax years beginning after 1975.

Another major objection might be that the dividends paid deduction will penalize growing firms that need funds for expansion and development and accord preference to mature firms that do not. The answer might lie in a consent dividend procedure such as is currently provided for by IRC Section 565 (relating to the penalty tax on the unreasonable accumulation of earnings and the personal holding company tax). Under such a procedure, a shareholder could agree (on a timely basis) to include in gross income as a dividend a pro rata share of current undistributed corporate profits. As a result, the corporation would be allowed a dividends-paid deduction even though it retains the amount of the consent dividend. The shareholders who agreed to the consent dividend, in turn, would increase the basis of their stock investment by the amount taxed but not received. However, the shareholders would have to use funds from other sources to pay the tax on the dividend.

The dividends-paid deduction places a premium on distributions to shareholders that could conceivably impede economic growth within the corporate sector. Thus, if corporations maximize the deduction, what is left for capital spending? (The answer involves comments stated above plus a consideration of the vagaries of the securities markets.) First, presuming the inclusion of an effective carryback/carryover procedure, the dividend distribution could be postponed with only interim tax consequences. Second, a consent dividend procedure would permit an immediate tax benefit to the corporation with the advantage of the retention of the funds. Third, with the increase in dividend output that the proposal will generate, further investor interest in equity securities might well be encouraged. There is, of course, no way to know whether the inflow of equity funds would match the outflow of actual dividend distributions.

Suppose a corporation making a dividend distribution has tax-free and/or preferentially taxed income for the year. Should the dividends-paid deduction be allowed in full or should it be reduced by the portion attributable to the nontaxable or preferentially taxed income? As long as the deduction did not exceed the corporation's taxable income (as determined under present law) for the year, there should be no need to make any such adjustment. If the distribution exceeds current taxable income, a carryback or carryover would be in order.

Would not the provision for a dividends-paid deduction cause an immediate and severe revenue loss to the U.S. Treasury? That there would be a revenue loss can hardly be doubted. But then, any integration scheme, whether partial or complete, by definition must carry a similar effect. The only question is the severity of the loss and what can be done about it.

First, one would expect the deduction to be available only for the distribution of corporate profits earned after the effective date of the enacting legislation. Distributions of earnings accumulated prior to this date would not qualify. It would seem appropriate that the present source of dividend rules continue to apply where current earnings and profits would be deemed to have been distributed first. Second, recall that the dividends-paid deduction alternative does not envision the repeal of the corporate income tax—it would still apply to undistributed corporate profits. Third, the immediacy of any substantial losses might be avoided by some sort of phase-in period. For example, if the deduction is to become operative in 1976 it could be limited to 20 percent of the dividends paid, with progression to 40 percent in 1977, 60 percent in 1978, and so on until 100 percent is reached. Fourth, and perhaps most important, are the long-range effects of the proposal. If it is true that the dividends-paid deduction leads to economic stimulation and growth, any initial revenue loss might well be compensated for once the phase-in effect has passed.

What effect, if any, would the dividends-paid deduction have at the state level? In those states imposing an individual income tax, it is doubtful that the result could be anything but an increase in revenue. Because the prospect of the federal deduction will stimulate dividend distributions, more income will be subject to state and local taxes in the hands of recipient shareholders. Unless states levying corporate income taxes also permit a dividends-paid deduction, there should be no offsetting loss from this source.

The "Gross-Up" Method

Like the dividends-paid deduction alternative, the gross-up method depends on retention of the corporate income tax. But instead of focusing on the corporation, relief is provided at the shareholder level. Under this proposal a shareholder includes in gross income the net dividends received plus the corporate income tax attributable to such dividends (that is, the dividends would be "grossed up"). The shareholder then computes the income tax in the regular manner but is permitted to claim as a tax credit the amount of the gross-up. In effect, the corporate income tax is withheld by the corporation on behalf of its shareholders then passed through to them as a credit when dividends are distributed. Several observations, both pro and con, can be made about this attractive method of partial integration.

In terms of tax equity, the result would parallel that achieved under the dividends-paid deduction alternative. Thus, vertical and horizontal tax equity would be achieved for distributed profits but not for those accumulated.

Under the gross-up method, dividends would become more attractive to the investor than interest. The taxpayer, in addition to receiving dividend income, also would receive a tax credit that would more than offset the additional tax liability attributable to the inclusion of the grossed-up amount. Thus, since dividend income is preferred by the investor over interest income, some easing of the preference for debt over equity financing would seem bound to occur. But, because dividends are not deductible to the corporation, those in control of corporate policy are still apt to lean toward debt and the accompanying interest deduction. One might surmise, therefore, that the gross-up method would lessen disparity between debt and equity investments but not to the extent anticipated under he dividends-paid deduction alternative.

In comparing the gross-up method with the dividends-paid deduction alternative, one important advantage in favor of the former is the effect on corporate accumulations. Since the corporate income tax must be paid whether profits are distributed or not, the incentive to distribute dividends would not be nearly as compelling. Thus, the gross-up method would be more advantageous for new and growth corporations planning little or no dividend payout.

The gross-up method should do much to ease the problem of accumulations by closely held corporations which are motivated by the avoidance of tax at the shareholder level (that is, the matter dealt with in IRC Secs. 531–537 and 541–547). In other words, shielding shareholders from dividend income is less apt to occur if the distributions entitle them to a tax credit.

As has been suggested for the dividends-paid deduction, provision should be made to preclude retroactive application to years prior to the effective date of the enacting legislation. Thus, corporate taxes paid and attributable to profits accumulated before that date would not be eligible for gross-up and credit treatment.

Some form of the gross-up method has been adopted by other developed countries (for example, France, Canada, and the United Kingdom).

If the United States denies integrated tax treatment (except on a treaty basis) to foreign shareholders, the gross-up method would be preferable to the dividends-paid deduction alternative. This is true from a compliance and administration standpoint, since the corporation, under the gross-up method, would be spared the burden of having to determine the citizenship status of each of its shareholders.

One problem posed by the gross-up method arises with respect to determining the corporate tax attributable to the dividend distribution. An exact allocation approach, seemingly the most equitable in terms of its result, could become very complex if adjustments are to be made for income from tax-free sources.

In the interest of taxpayers in similar situations, the credit allowed for the amount of the gross-up should not be limited to overall tax liability. Any other approach would penalize shareholders in low marginal tax brackets. Although certain policy considerations may dictate otherwise, the gross-up procedure should not be available to shareholders that are tax-exempt organizations.

The withholding alternative could cause some instability at the shareholder level when determining the final income tax in any one year. Later modifications of corporate income tax liability, either by action of the IRS or through other events, might well change the gross-up computation of previous distributions. In such cases, affected shareholders may be required to file amended returns. In this regard, the dividends-paid deduction would create less difficulty, since only the corporation is affected by subsequent adjustments to prior tax years.

Elimination of Double Taxation of Corporate Income

COMMENTS ON THE INTERACTION WITH INTERNAL REVENUE CODE PROVISIONS ON CORPORATE DISTRIBUTIONS AND ADJUSTMENTS ("SUBCHAPTER C")

A. General

This paper discusses the impact which adoption of the "deduction method" or the "gross-up method" of integrating corporation and shareholder income taxes might have on the operation and tax effect of the provisions of Subchapter C (Sections 301–385) of the Internal Revenue Code ("IRC").

If partial integration is adopted (e.g. if only one-half of a dividend payment could be deducted by a corporation), the effects would be the same as of full integration but in reduced amounts. A combination of the two methods would generally also produce a combination of the effects of each method.

Generally, integration would probably require few changes in Subchapter C and would not materially affect its rules.

It would still be necessary to determine whether a stock redemption, liquidation, or reorganization exchange with "boot" should, for tax purposes, be treated as a sale or exchange (usually eligible for capital gains treatment by the recipient and producing no tax benefit to the corporation) or as a dividend distribution. In the latter case, under the deduction method the shareholder would be fully taxed while the corporation gets a deduction, while under the gross-up method the corporation gets no tax benefit but the shareholder receives the benefit of the credit of a part of the corporate tax payment against his own tax liability (after first adding the corporate tax to his dividend).

The extent of the benefit will depend on the shareholder's income tax bracket and on whether a low-bracket taxpayer will be allowed a refund for any excess of the corporate tax deemed paid by him over his actual tax liability.

The distinction between corporate interest and dividend payments to shareholders would disappear under the deduction method but would remain under the gross-up method.

While the rules of Subchapter C would not need to be changed materially under integration, the relative desirability of the possible tax results of a transaction (e.g. capital gain v. dividend) could change substantially. For example, under the gross-up method, a taxpayer with very large earned income who already has $50,000 or more of long-term capital gains will pay less tax on a dividend of $1 than on $1 additional long-term capital gain. Under the deduction method, this would not be the case, but the corporation could afford to distribute more if the transaction results in a deductible dividend rather than capital gain, so that here, too, the shareholder might have more after-tax cash under dividend treatment.

B. Specific Provisions of Subchapter C Which Might Need to be Amended

(1) Section 304 should be amended to provide that the gross-up should be computed by reference to, or the dividend deduction allowed to, the acquiring corporation under Section 304(a)(1) or the issuing corporation under Section 304(a)(2). This would merely be a clarification.

(2) Under the deduction method, if a "boot" distribution in a reorganization is treated as a dividend, the resulting dividend paid deduction could easily exceed the distributing corporation's taxable income for the year in which the reorganization occurs. Since the distributing corporation will usually disappear under the plan of reorganization, provision should be made for the use of the excess deduction either as carryback by the distributing corporation or as a carryover to the acquiring corporation. Such excess deduction should not be subject to disallowance under Section 382, because the distribution will actually have enured to the benefit of the shareholders of the distributing corporation.

(3) Integration proposals might also have impact on stock redemptions under Sections 302(b) and 302(d), complete or partial liquidations under Sections 331 and 346, and possibly corporate separations where Section 355 comes into play. The exact changes that might be required in these sections would involve policy considerations by Congress if it is deemed likely that opportunities for tax avoidance would be created by the integration rules.

EXCERPT FROM TESTIMONY PRESENTED TO THE WAYS AND MEANS COMMITTEE ON MARCH 12, 1973

Your Committee has already heard testimony suggesting that the investment credit, accelerated depreciation (including the Asset Depreciation Range system) and other special amortization and depreciation provisions of the Code be further restricted, cut back or repealed.

It is our view that the investment credit and the ADR system are beneficial and effective incentives to stimulate capital investment necessary to finance the continued growth, productivity and modernization of this nation's productive facilities. Particularly in these times of rapidly-advancing technology, it is vital to our national interest to remain competitive with foreign businesses—and these incentives seem desirable to better enable American businesses to so compete. In any event, considering the relatively short time that these provisions have been enacted into the Code, we suggest that they be tested longer in actual practice before they are again modified, suspended or discarded.

EXCERPT FROM TESTIMONY PRESENTED TO THE SENATE FINANCE COMMITTEE ON H.R. 10612 ON MARCH 18, 1976

Investment tax credit

The Institute agrees with the provisions of H.R. 10612 extending until 1980 the temporary increase in the credit to 10 percent and also agrees with the temporary increase to $100,000 in the maximum amount of used property qualifying for the credit. The investment tax credit should be made permanent to provide certainty for business planning.

EXCERPT FROM TESTIMONY PRESENTED TO THE WAYS AND MEANS COMMITTEE ON MARCH 12, 1973

II. Capital Gains and Losses

Some problems and questions

In attempting to establish a policy regarding the taxation of capital gains, a number of fundamental questions immediately arise. These questions include: What are capital gains? Are capital gains income? Should they be taxed? These questions inevitably lead to a consideration of the elements of what are commonly accepted as capital gains in the United States, and a recognition of the definitional problems which must be faced if only capital elements are to be included in the term.

Other questions include a consideration of the effect of taxing capital gains on federal revenues, on taxpayers and on the economy. These considerations lead to the question as to how they should be taxed. Should they be differentiated from ordinary income and taxed differently? If so, how should preferences granted to capital gains be determined?

Our comments and recommendations at this time will be limited to the following areas of capital gains taxation:

Should there be preferential treatment for capital gains? If so, how should they be treated for tax purposes?

A definition of capital assets.

The minimum holding period.

The treatment of capital losses.

We are hopeful that our comments and suggestions will be helpful in improving and simplifying this very complicated area of taxation.

Historical background

Historically, two approaches have been used in providing preferential treatment for capital gains. Sometimes separately and at other times together, ceiling rates and exclusions have been employed for this purpose. The first trial was in 1922 when a 12½-percent ceiling rate was introduced for net gains from the sale or exchange of capital assets held for more than two years. Because the ordinary income rates were so low during the period 1922–1933, higher income taxpayers alone benefited from this 12½-percent ceiling.

In 1934, exclusions were first introduced in the form of variable percentages ranging from 20 percent for gains from the sale of capital assets held between one and two years to 70 percent for assets held longer than ten years. The 12½-percent ceiling rate previously in effect was eliminated. Obviously, the exclusion approach introduced some equitable considerations. It benefited all taxpayers reporting net gains, and it differentiated among gains accrued over different periods of time.

Public dissatisfaction arose over the "lock-in" effect produced by the variable exclusions. A revised schedule of exclusions on a monthly basis was passed by the House of Representatives to meet these objections, but the plan was rejected by the Senate as too complex. In 1938, the classes of capital assets were reduced to two with an exclusion of 33⅓ percent for assets held from 18 to 24 months and 50 percent for assets held longer than 2 years, and the alternative tax concept was reinstated through the provision of a ceiling rate of 30 percent which resulted in effective ceiling rates of 20 percent and 15 percent for sales involving the respective holding periods.

In 1942, the alternative tax ceiling rate of 50 percent together with a flat 50 percent exclusion for gains from the sale of assets held more than six months was introduced and retained until 1969. The gradual increase of the alternative tax ceiling provided by the 1969 Tax Reform Act represented a congressional response to public pressure to remove this provision which was of primary benefit to higher income taxpayers.

Holding period requirements have fluctuated through the years. Throughout, there has been the intention to exclude speculative gains from the relief provisions. On the other hand, there have been objections to the "lock-in" effect which might result from longer holding periods.

A summary of the historical evolution of the federal income tax treatment of capital gains and losses in the United States is attached as appendix B to this statement.

The Importance of Incentives for Capital Investments

In the normal course of practice, certified public accountants have broad experience in working with businesses and investors. Through this experience, we are in a position to judge the effectiveness and impact of taxation on the availability of capital for investment and the willingness of investors to accept the risks associated with investments. Much has been said and written about the needs of this Nation for capital investment during the next few years, but this cannot be overemphasized. Some economists have estimated our capital needs to be at least $100 billion per year for the foreseeable future. If we are to meet the challenges of greatly increased competition from abroad (both in domestic and foreign markets) and also the needs to solve problems at home—social, environmental and economic—we must continue a tax structure that will encourage citizens to accumulate capital and take the risks inherent in investing it.

As an example of the problems faced by American business in competing in worldwide markets, a Fortune survey of our 500 largest industrial companies shows that the average amount of capital investment per employee has risen from approximately $16,400 in 1957 to $31,800 in 1971. Total assets for these companies increased over this period from roughly $150 billion to over $450 billion. In spite of this increase in capital investment, U.S. industry presently has the highest percentage of obsolete industrial facilities of any leading industrial nation. Furthermore, we are replacing facilities at a slower rate than other leading countries. As an example, fixed asset investment in relation to gross national product for Japan and West Germany is currently running about 27 percent and 20 percent respectively, while our percentage is less than 13.

Rapidly changing technology and modernization of facilities will continue to require large amounts of capital. If preferential treatment for capital gains is eliminated, there are serious doubts as to the availability of the capital needed and the willingness of investors to take the risks.

Impact of Inflation

Much has also been said about the severe impact of inflation on our economy. Changes in price levels affect all of us in many ways, but particularly acute problems arise where assets are held for relatively long periods of time. There are many indexes designed to measure inflation, but they all indicate the same picture. The United States Department of Labor Consumer and Wholesale Price Indexes, using 1967 as the base year, indicate the following changes:

	Consumer price index	Wholesale price index
Year:		
1957	84.3	93.3
1962	90.6	94.8
1967	100.0	100.0
1972	125.3	119.1

Expressed as a percentage increase, the Consumer Price Index has risen nearly 50 percent in the last 15 years, and about 25 percent in the last 5 years.

If a taxpayer invested $100,000 in a corporate security in 1957 and sold it for $150,000 in 1972, he would have been approximately even in terms of purchasing power. However, even under our present capital gains tax structure, he probably would have incurred a tax of at least $12,500. This would have placed him in a worse position economically in 1972 than he would have been 15 years earlier. In effect, this represents a tax on capital and not a tax on income or real gain. By analogy, it represents a failure to distinguish between the tree and its fruit—a tax on the tree, rather than on the fruit. The combined effects of inflation and taxation have clearly eroded the amount of capital available for additional investment. If the present preferential treatment for capital gains were eliminated, the erosion of capital would be much greater, and in our judgment could create serious problems for our economy.

Recommendations

Preferential treatment for capital gains.—We believe that full taxation of capital gains will diminish the willingness of investors to risk capital in new ventures. Furthermore, high tax rates obviously discourage investors from selling appreciated assets. This leads to undesirable results. It tends to inhibit the flow of funds into other investments, thereby prolonging the life of certain entities or ventures that may have become comparatively less productive. And, if nothing else, it produces the so-called "lock-in" effect which severely restricts the free flow of capital. We believe that these counter incentives are not in the best interests of our free enterprise system which is basically responsible for the relatively high standard of living in the United States.

Preferential treatment is also needed to relieve the financial hardships created by the bunching of income in a progressive tax system when there is a realization of substantial gains which have accrued over a long period of time. Without preferential treatment, such gains would be subjected to unfair and confiscatory taxation. While the present income averaging provisions provide some relief in this connection, this relief is too limited and inadequate under the circumstances.

For these reasons we believe that preferential tax treatment for capital gains should be continued.

Definition of capital assets.—While we favor the retention of some preferential treatment for capital gains, we recommend several modifications of the present law in this area. We believe these modifications would improve and simplify the capital gain and loss provisions of the Code and, at the same time, be responsive to public pressure for further legislative changes in this connection.

At present, capital assets are defined negatively in Section 1221 of the Code. Under Section 1221, all assets are considered capital assets unless they are specifically excepted in the statute.

We suggest a revision of Section 1221 to make it positive rather than negative. In addition, we would narrow the definition of a capital asset along the following lines:

1. The term "capital asset" means property which:
   (*a*) Is a corporate security or other "investment asset";
   (*b*) Has been held by the taxpayer for more than 1 year; and
   (*c*) Is not held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.
2. The term "investment asset" for this purpose means property other than a corporate security which consists of:
   (*a*) Real estate or tangible personal property the ownership and use of which does not constitute the conduct of a trade or business; or
   (*b*) An interest in a partnership, joint venture or other similar type of entity.

We believe this more limited definition of a capital asset provides greater clarity, contributes to simplification of a very complicated section of the law and continues to provide an incentive for desirable capital accumulation and the assumption of risk essential for the growth, strength and prosperity of our free enterprise system.

We are aware that our tax laws now contain special provisions which extend capital gain treatment to many items which would ordinarily not be considered capital assets. In our judgment, the general approach taken in the Mills-Ullman type of legislation introduced in the 92d Congress, providing for a systematic and periodic congressional review of all special provisions in order to determine the continuing justification for such special treatment, is an appropriate way to deal with these items. These special provisions should be evaluated on their merits, and more direct ways of providing desirable incentives should be considered.

Extension of the holding period.— We believe that the present 6-month holding period for long-term gain should be extended to a year. This would be responsive to the contention that quick profits contain an element of speculation which should not be rewarded by the law. A 1-year holding period also corresponds to the period generally used to distinguish a capital expenditure from a current expense.

Sliding scale for inclusion of capital gains.—In conjunction with the adoption of a longer holding period, we also recommend a return to the sliding scale of exclusions similar to those in effect during the period 1934 to 1937. Although we are not recommending a reestablishment of the 1934–1937 exclusion ratios, we do support the concept of encouraging longer term investments in our Nation's productive facilities. Gains on assets held longer than 1 year could be excluded from income at the rate of 10 percent per year or at any other rate that Congress deems appropriate.

Long-term losses.—Although we do not recommend unlimited deductibility of capital losses at this time, we do believe the present structure for the deduction of capital losses and carryovers should be improved. We suggest that a 3-year carryback of capital losses on a basis similar to that already prescribed in the case of corporate taxpayers should be allowed. In our view, such carrybacks in the case of noncorporate taxpayers should be limited to previously realized capital gains. We feel that this 3-year carryback is more appropriate and equitable, since gains are taxed as they occur and fairness would seem to indicte that losses which occur shortly afterward should be available to offset such gains.

The deductibility of net capital losses from ordinary income has been arbitrarily limited to various amounts since 1934. In view of the fact that the present rules for allowance of a $1,000 per year write-off of excess capital losses against ordinary income dates back to 1942, we feel that an increase in this allowance may be warranted at this time.

Excerpt From Testimony Presented to the Senate Finance Committee on March 18, 1976

PART 1. CAPITAL GAINS AND LOSSES

After careful consideration of the impact of inflation, the need for capital formation, and the retention of incentives for investment, it is the Institute's view that continuation of the present rules for taxing capital gains is desirable, subject to certain suggestions for modification which follow:

Extend the Holding Period Requirement

The present six-month holding period requirement for long-term capital gains treatment creates opportunities for speculators to realize quick profits at lower tax rates. One of the principal reasons for continuing present rules is the need for capital formation and the assumption of long-term risk. Lower taxation of profits realized in as little as six months does not seem compatible with that objective. Accordingly, the Institute favors extension of the holding period for long-term capital gain treatment to one year.

Provide a Sliding Scale of Exclusions

The Institute recommends the adoption of a sliding scale of exclusions, increasing with the holding period for capital assets, for two reasons. First, this would recognize to some extent the impact of inflation. If a smaller percentage of gain is taxed, based on a longer holding period, this would tend to offset the loss in purchasing power of the dollar. Second, by adopting a sliding scale of exclusions, if the scale is gradual enough, the lock-in effect would be reduced. The investor could give greater weight to the value of the use of money in deciding when to sell an asset.

For individual taxpayers, an exclusion scale starting at 50 percent after one year and increasing by 5 percent each year thereafter, to a maximum of 80 percent after seven years, might be appropriate. Since the present method of taxing capital gains realized by corporations is in essence a flat 30 percent rate, a graduated rate scale for corporate gains consistent with that for individuals would be equitable.

Extend the Capital Loss Carryback Provisions to Individuals

The present rule prohibiting capital loss carrybacks to individuals is inequitable. If the exclusion rules discussed above are adopted, an overall net loss from sales of capital assets in a particular year would be applied first against other income of the year. If this creates a net operating loss, it should be subject to the regular operating loss carryback rules. Alternatively, if Congress believes this too great a liberalization of the capital loss provisions, the net capital loss in a particular year should be allowable as an offset aginst ordinary income to the extent of $5,000, as recommended below, and any excess should be allowed as a capital loss carryback for individual taxpayers, as is now the case for corporations.

Increase the $1,090 Limitation on Deductibility of Net Capital Losses

In lieu of the ordinary loss treatment of net capital losses described in the preceding proposal, the Institute believes that the $1,000 limitation on the deductibility of net capital losses from ordinary income of individual taxpayers should be increased to $5,000. The $1,000 amount was established in 1942, and in view of the inflation that has been experienced since that time it seems appropriate to grant an increase in relief to those taxpayers who enjoy no capital gains against which to apply their losses. Furthermore, it is recommended that this treatment be extended to corporate taxpayers.

Conclusion

The subject of capital gains taxation has been and will continue to be controversial. There are opposing forces and philosophies that are difficult, if not impossible, to reconcile. The present capital gain tax structure may be too lenient, and some changes therefore seem appropriate. On the other hand, current economic conditions and problems justify retention of preferential treatment for true capital gains despite the fact that considerable simplification could be achieved if the special rules applicable to capital gains were abolished.

EXCERPT FROM TESTIMONY PRESENTED TO THE WAYS AND MEANS COMMITTEE ON MARCH 15, 1976

You are aware of the alternatives that have been suggested to either (1) impose an additional tax at the time of death, perhaps equivalent to a capital gains tax had the appreciated property been sold, or (2) continue the decedent's basis in the property in the hands of the beneficiary.

We have reviewed very carefully these alternatives, and recommend that neither of them be adopted. In our view, it is incorrect to say that unrealized appreciation is not subject to tax, since it is subject to up to a 77 percent level of estate taxes.

It is also important to keep in mind the basic premise that estate and gift taxes as a whole are in effect a levy on capital. With our likely shortage of capital both present and for the foreseeable future, we are concerned with a change that would impose an additional levy on the capital represented by the unrealized appreciation of assets transferred through an estate.

Both of the basic proposals for change in this area would introduce significant complexities and we do not think the alleged benefits derived would be sufficient to offset them. We have worked with the present system for many years and there is merit in continuing a system that is understood and that reaches a reasonable result.

AMERICAN BAR ASSOCIATION,
Washington, D.C., July 7, 1977.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management,
U.S. Senate Committee on Finance, Washington, D.C.

DEAR SENATOR BYRD: The Section of Taxation of the American Bar Association appreciates the opportunity afforded by your letter of June 16, 1977, to express views on the several tax matters mentioned therein.

The Section has actively underway several studies on matters concerning tax incentives for capital formation. These include integration of the corporate and individual income taxes, conforming changes in Subchapter C, consideration of the continuing role of the foreign tax credit, and studies of taxation and price indexing. Other studies concerning tax simplification will also be relevant to capital formation.

At the same time, I regret to respond to your invitation by stating that none of these studies will be completed in time for inclusion in the record of your current hearings.

It is probable that these studies will be completed by the end of August. As each study is completed, the Section would appreciate the opportunity of submitting it to members of your Committee staff and thereafter meeting with members of your staff to discuss the studies.

I have orally reported the foregoing to Mr. Bruce of your Committee staff, and have thought it advisable to write this confirmatory letter.

Sincerely yours,

DON V. HARRIS, Jr.

PRULEASE, INC.,
Boston, Mass., June 6, 1977.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management,
U.S. Senate Finance Committee, Washington, D.C.

DEAR SENATOR BYRD: President Carter will soon be sending a major tax reform program to the Congress.

As you consider this legislation, I hope you will keep in mind two important points relating to employment:

1. Capital investment and increased employment go hand in hand. Realistic investment incentives are essential to the acquisition of a modern and productive stock of plant and equipment, the development of new technologies and the growth of this nation's small businesses—the basis of a healthy economy and an expanding work force.

2. Adequate levels of job-creating investment cannot be obtained through a program concentrating solely on reinvestment of internally-generated capital. Individual investors are a major source of external risk capital, and investment incentives must be an integral part of any policy to encourage employment.

One essential route to spur job formation and capital investment is through the tax code. I have recently written the attached article, scheduled to be published at an early date, outlining the connection between unemployment and the present system of taxing capital gains. I respectfully urge you to read this article and consider its proposals for encouraging new capital formation and job creation.

Sincerely yours,

ALVIN ZISES.

CAPITAL GAINS TAXES AND UNEMPLOYMENT

(By Alvin Zises)

> "The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital from static to more dynamic situations, the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth of the economy."
>
> —Tax Message of President John F. Kennedy to the 88th Congress, First Session, January 24, 1963.

When the late President sent his tax message to the Congress fourteen years ago, he sought to reduce the maximum tax rate on capital gains from 25 percent to 19.5 percent. The Tax Reform Act of 1976, which raised the "minimum" and "maximum" taxes on so-called "preference income", increased the effective capital gains tax to as much as 49.125 percent. The long-term effect of this change will be felt by those who may never pay significant amounts of capital gains taxes—by American workers in search of jobs.

There is a causal relationship between higher capital gains taxation and higher unemployment. Equity capital is the foundation for other kinds of monetary capital including debt. Without total monetary capital formation, expansion of physical capital in the form of plant and equipment will be retarded. Without physical capital, job formation is impeded. Thus, to enhance job formation equity capital formation must come first.

Although there was much that was sound socially and economically in the Tax Reform Act of 1976, the impact of the uneconomic and inequitable sections of the Act is dawning upon investors as evidenced by such recent statements as that of Walter B. Hoadley, Chief Economist for the Bank of America:

"The Tax Reform Act of 1976 is widely seen as a further step to redistribute income and wealth * * *. The danger is that further steps in this direction will only compound the fears of potential investors, already very skeptical about the prospects for adequate reward, and discourage them from taking on new venture risks needed to create jobs."

Seemingly oblivious to these warnings, "tax reform" proponents continue to urge elimination of what little remains of the capital gains concept. They disregard the fact that, if tax penalties are imposed upon equity capital formation, investors will turn to the more certain returns of other investments not as conducive to long-term job formation.

Frederic Hickman, formerly Assistant Secretary of the Treasury for Tax Policy, in a March 1977 article, excerpts of which are quoted below, explains that, because of the intricacies of the Act, its economic consequences may have eluded some Congressman:

"* * * the Act was a back-door increase in the effective rate of tax on capital gains. This increase came disguised as changes in the so-called minimum and the maximum tax * * *.

"Were the members of the tax-writing committees fully aware that what they were enacting was a very substantial boost in the tax on capital gains? The record and the dialog at committee session suggest that most were not. Most Congressmen doubtless thought that they were addressing the situation of the high income taxpayer who pays little or no Federal income tax. The interaction of the minimum, maximum and regular taxes had become sufficiently intricate that even those who voted to enact them can be excused for misunderstanding them * * *. In fact, some of the members who voted for these provisions were the same members who had been calling for reductions in the tax on capital gains!

"Unfortunately, the increase to 49-plus percent in the top tax rate is only part of the story. A 49 percent rate for capital gains is, in reality, more like a 70 percent effective rate on economic income because such a large part of the nominal capital gains taxed is created by inflation."

Elimination of the capital gains tax system is not a matter of closing a supposed "loophole" which benefits only those with sufficient substance to afford the risks of investing in equity ventures. It directly affects a major portion of this nation's population: approximately 30 million shareholders in publicly-held corporations which look to individual investors as a source of new equity investment; and additional millions who invest their savings in small businesses. It indirectly affects millions who depend upon both for jobs.

UNEMPLOYMENT AND EQUITY INVESTMENT BY INDIVIDUALS

Current estimates of total capital investment necessary over the next decade to build new plant and facilities and to maintain full employment vary, but they are all staggering. A recent Department of Commerce study indicated that total investment necessary over the next five years to meet our full employment goals by 1980 and also to bring about effective control over pollution and expand our energy production will have to be some $800 billion above the 1971–1975 level. Similarly, the New York Stock Exchange estimated that capital investment by 1985 will have to be increased almost $650 billion over current levels to accomplish the same objectives. In 1976, however, capital investment as a percentage of our gross national product showed little increase over that of 1975.

The Small Business Administration in January 1977 released the results of a Task Force Study on Venture and Equity Capital in Small Business to determine the current availability of long-term capital to small businesses. The study revealed that small businesses comprise 97 percent of all unincorporated and incorporated businesses in the United States. More than one-half of all business receipts are generated by their operations, and they employ more than half the United States business work force.

Small businesses cannot grow or compete effectively if they have to finance solely out of retained earnings. External sources must provide the funds needed for significant growth. Current inflationary factors, however, increase the willingness of companies to borrow rather than to issue equity. In a competitive economy it makes considerable sense to borrow dollars of known purchasing power today for repayment with dollars of reduced purchasing power tomorrow. This incentive toward debt financing is increased by the fact that interest costs are a tax deductible expense. However, high interest rates coupled with high levels of debt repayment lead to a burden of fixed charges that reduces a small company's ability to withstand adversity and obtain credit from lenders. Thus, the growth which produces economic stability and significant numbers of new permanent jobs depends upon the availability of new equity investment.

The S.B.A. Task Force noted that small firms lack established earnings records and large amounts of outstanding common stock that are prerequisites for investment by large institutions Thus, in the sale of their equities, small businesses are almost entirely dependent upon the individual investor. Though individual investors must often accept large risks in purchasing the securities of such ventures, increases in capital gains taxes effected by the Tax Reform Act of 1976 have so reduced the after-tax return on equity that many such equity investments are no longer acceptable. Even before these changes, high capital gains levies contributed to the decline in venture capital investment. The study indicated that in 1972 there had been 418 underwritings for companies with a net worth of less than $5 million. In 1975 there were four such underwritings. The 1972 offerings had raised $918 million while the 1975 offerings brought in $16 million. Over the same period of time, smaller offerings under the Securities & Exchange Commission's Regulation A fell from $256 million to $49 million and many of these were unsuccessful.

THE FLIGHT OF THE INDIVIDUAL INVESTOR

Small business is obviously not the only sector of the economy hurt by declining individual investment. In terms of volume of trading in our equity securities exchanges, the individual has largely been replaced by the institutional investor. Although performing essential services in regard to professional money management and family security, such institutions do not necessarily serve the same market-making and liquidity functions as do masses of individual investors. Individuals contribute the great variety of opinions and judgements that make a free market place, and it is the individual who has traditionally been the principal source of equity capital for smaller companies.

James M. Roche, former Chairman of the Board of General Motors, summarized the value of the individual investors to our securities markets and small businesses to our economy when he stated:

"* * * Every large corporation depends upon hundreds or thousands of small enterprises, as suppliers of components, as generators of ideas and products, as producers of income for their owners and shareholders who buy our products.

"These small companies must depend upon the smaller, non-institutional investors for equity investment, and all companies, small and large, as well as the institutions themselves, depend upon the individual investor to supply liquidity, depth and continuity to the market."

REDUCTIONS IN CAPITAL GAINS TAXES AND INCREASED TAX REVENUES

One of the most detrimental consequences of increases in the capital gains tax is its effect on individuals' willingness to "roll over" their investments—sell existing holdings, pay capital gains taxes and reinvest the remainder. It is this "roll over" or "unlocking" process which simultaneously produces both job-creating new investment and additional revenue to the Treasury. The results of a poll undertaken in 1973 by Oliver Quayle and Company, a national opinion research company, present some findings which demonstrate the benefits to the Treasury of reducing capital gains taxes. The Survey showed that reducing the capital gains rate would produce significant increases in both sales of appreciated securities and tax revenue to the Treasury. If the 25 percent maximum rate had been cut to 12.5 percent maximum, and the 35 percent rate to a 25 percent maximum, an additional $1.7 billion would have been received by the Treasury in tax revenues, or an increase in such revenues of 43 percent over 1972. Cutting the then-lower capital gains tax rate in half for all investors would have produced even more tax revenue to the Treasury—$3.2 billion more than received in 1972, or an 82 percent increase in taxes from long-term gains. The Quayle Survey also demonstrated that if the capital gains tax had been 20 percent higher for all investors, sales from which capital gains were realized would have been significantly less, and the Treasury would have received an estimated $358 million less in tax revenue than it actually received from long-term gains. If the holding period had been one year, capital gains tax revenue would have been $467 million less to the Treasury. These findings highlight: To obtain greater tax revenue from capital gains, the rate should be reduced.

ALTERNATIVE INCENTIVES FOR CAPITAL INVESTMENT

A number of proposals to stimulate business investment have been offered which include some long overdue changes in corporate taxation. One suggestion has been a revision of depreciation deductions permitted to corporations to recognize the increasing cost of replacing plant and equipment. Other proposals involve further expansion of the investment tax credit to spur new equipment acquisitions and the integration of the corporate and personal income tax to end the double taxation of dividends. Another overdue proposal is to eliminate taxation of that portion of capital gains produced by inflation by means of indexing the cost basis of assets under a deflator formula.

All these proposals would stimulate capital formation and private sector employment. However, they are not sufficient either individually or collectively to spur the equity capital investment projected to be needed over the next decade. They focus primarily on increasing the profitability and efficiency of existing or internally-generated capital and only secondarily on expanding the total pool of new or externally-generated equity capital. These recommendations do not adequately encourage the formation of new business units which require comparatively large amounts of externally-generated risk or seed capital.

Some advocates have proposed an end to the double taxation of dividends as a trade-off for an increase in capital gains taxation. They expect that the revenues lost to the Treasury through the ending of double taxation of dividends will be offset by the $4.7 billion of additional revenues they estimate would be realized from increased capital gains taxes. However, there are a number of reasons why such a trade-off will not result in the tax revenues or the new capital formation that such proponents believe would be obtained.

Most tax reformers would agree on at least two points: that if capital gains were taxed at ordinary rates, capital losses shou'd also be treated as ordinary losses; and that the portion of capital gains created solely by inflation should not be taxed. The net result cannot be foreseen, but few experts believe that the Treasury would collect the additional $4.7 billion in revenue that some tax reform advocates expect.

Although corporations may be encouraged to pay higher dividends if double taxation were eliminated, the distribution of dividends and their eventual reinvestment by recipients do not create new equity capital.

The change merely shifts existing capital from retained earnings to new financings. Unless dividend recipients were to reinvest all dividends received, an unlikely possibility, the effect would be a net reduction in capital formation.

Furthermore, to the extent that such a change benefits companies paying dividends, it may adversely affect those companies which do not—by directing the flow of investment capital away from small and growing companies. Many companies in industries critical to our economy, such as electronics, are subject to fast changing technology, high research and development costs and wide swings in demand; often these companies pay little or no consistent dividends. Many of these companies provide an entirely new strata of jobs which would not exist except for such new technologies.

TAX SYSTEM MUST RECOGNIZE UNCERTAINTY OF EQUITY'S RETURN

At the heart of the arguments put forth by those who seek to tax capital gains at the same rate as ordinary income is the achievement of greater tax "equality". Proponents argue that each dollar of income should be taxed the same way. But all sources of income are not equal—not equal in their risks or certainty—not equal in their impact upon capital formation and job creation. President Kennedy recognized the inherent differences in risk between dynamic and static investments, between equity's return on one hand and interest or wages. Ordinarily income derived from salary and wages is contracted income, relatively certain of realization and similar to contracted income in the form of interest from bonds.

On the other hand, income from equity investment is uncertain of realization. If future appreciaton from risk-taking ventures is taxed at the same rate as contracted or relatively non-risk income, an even greater portion of the flow of risk capital will be channeled, not as President Kennedy intended, "from static to more dynamic situations" in equities, but into fixed income or low-risk investments.

The current return today on investment-grade corporate bonds is approximately 8 to 8½ percent, and such income is contractually certain. On the other hand, income from equity is derived from two sources: dividends and possible appreciation. The dividend return today on most listed stocks averages approximately 3½ percent of market value. Dividends are discretionary and thus uncertain, having to be voted on periodically by the board of directors. The greater portion of equity's return, consequently, must come from market gain, the least certain source of all. The former system of taxing only half of any gain realized was designed to reflect the uncertainty of gain.

Although many companies, as a result of the 1976 tax amendments and new proposals for still higher taxes on capital gains, may be totally unable to sell any new equity, for other companies the market mechanism will adjust stock prices downward to offset higher capital gains taxes upon individuals. If the selling price of new equity is below book value, the original holders will suffer dilution of their investments, a consequence not conducive to further equity sales. In any event, there will be continued flight of capital from the equity markets, lower stock prices for many corporations and a reduced level of job-creating equity capital investment. Investment strategists at banks and investment bankers report that this trend is underway.

I recommend two courses to Congress and the Administration:

First, just as the capital gains tax on a home may be deferrable, I suggest that the tax on the gain from sale of equity securities be deferred if the individual, within ninety days of receiving the proceeds of sale but within the same tax year, reinvests those proceeds in other equities. Individuals presently achieve the same result through their tax-exempt pension funds. Why protect saving in one from and penalize it in another?

Second, repeal the punitive taxes on capital gains which consume up to 49,125 percent of gains and erode our base of "seed corn available for replanting" and, instead, institute a capital gains tax having a maximum effective rate of 35 percent upon a one-year holding period, reducing to 25 percent upon a five-year holding period. Proportionate tax reductions should be made for lesser amounts of capital gains based on the same timetable.

If we don't reduce the present penalties upon capital gains, we shall all be losers; but the greatest losers will be those trying to enter the labor force over the next several years and finding jobs unavailable.

THE BUSINESS ROUNDTABLE,
New York, N.Y., July 19, 1977.

Senator HARRY F. BYRD. Jr,
Chairman, Subcommittee on Taxation and Debt Management, Senate Committee on Finance, Washington, D.C.

DEAR MR. CHAIRMAN: I am pleased to enclose a set of the tax papers prepared under the auspices of The Business Roundtable and respectfully request that they be included in the printed record of the hearings recently conducted by your subcommittee on the impact of taxation on the economy

As you probably know, Mr. Irving Shapiro, Chairman of The Business Roundtable, is also Chairman and Chief Executive Officer of duPont, and Reginald Jones, Co-Chairman of The Business Roundtable is also Chairman and Chief Executive Officer of General Electric and Chairman of The Roundtable's Task Force on Taxation.

Sincerely yours,

JOHN POST.

Enclosures.

CAPITAL FORMATION

A NATIONAL REQUIREMENT

Over the long-term, increased productivity is essential to sustained economic growth, the battle against inflation and continued improvement in the standard of living of the nation's citizens. Productivity improvements, in turn, are dependent upon and are a function of the level of investment in productive capacity. Although a higher rate of capital investment does not guarantee lower rates of inflation, there is a close correlation between the rate of capital investment and increases in a nation's productivity and its standard of living.

U.S. private investment and economic and productivity growth rates lag

A study released April 1, 1975, by the Office of Financial Analysis, United States Treasury Department, provides compelling evidence that the United States needs more favorable tax treatment of capital investment to improve its competitive position vis-a-vis its principal international competitors The study, which covered the years 1960–73, showed that among the principal industrialized countries of the world the United States ranked at or close to the bottom in all of the following: Investment as percent of real national output; economic growth rate; and productivity growth rate.

The Treasury data compare each country's nonresidential fixed investment rates, expressed as a percent of Gross Domestic Product, and real growth rates, during 1960-73, and rank each accordingly:

NONRESIDENTIAL FIXED INVESTMENT RATIOS AND GROWTH RATES OF REAL OUTPUT, 1960-73 [1]

	Investment ratio		Output growth rate	
	Percent	Rank	Percent	Rank
Japan	29.0	1	10.8	1
West Germany	20.0	2	5.5	3
France	18.2	3	5.9	2
Canada [2]	17.4	4	5.4	4
United Kingdom [2]	15.2	5	2.9	7
Italy	14.4	6	5.2	5
United States	13.6	7	4.1	6

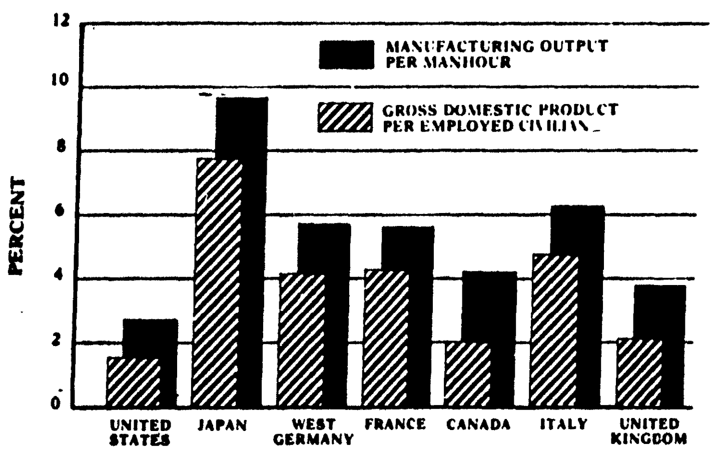
[1] Data estimated for 1973.
[2] Data apply to 1961-73 and are not strictly comparable to data presented for other countries.

As the foregoing data indicate, there is a strong correlation between high investment ratios and high growth rates.

The extent to which the United States trails in productive growth is illustrated by the following chart (which is based upon Treasury Department data and represents an updating of the data included in the April 1975 study):

PRODUCTIVITY GROWTH, 1960-1975

(Average Annual Rate)



Source: U.S. Department of the Treasury.

The Treasury study acknowledges that factors other than fixed capital formation also contribute to productivity and real economic growth. However, the study notes that even after allowing for these other factors, there would still remain large benefits to productivity resulting from larger growth in the stock of fixed capital.

The study concludes that the falling share of United States resources allocated to investment has:

Lowered rates of advance in living standards of the average consumer in the United States.

Created shortages in basic materials industries during periods of economic expansion.

Added substantially to the inflationary pressures in recent years.

Limited job opportunities because had the growth of plant and equipment exceeded that of the labor force, more jobs would have been required to utilize that increased capacity.

The study also concluded that the policy implications for the United States to attain greater productivity growth from this source would require some alteration in the nation's consumption and saving patterns and point towards encouragement of capital formation by minimizing tax disincentives, use of accounting methods which adjust earnings for replacement cost of capital and elimination of tax barriers to the flow of capital into productive uses.

Need for capital formation

The report on "Tax Policy and Capital Formation", prepared for the use of the House Ways and Means Committee Task Force on Capital Formation by the Staff of the Joint Committee on Taxation (April 1977) commented on the critical importance of capital formation as a source of economic growth as follows:

"When a society accumulates capital, it foregoes current consumption in order to provide a higher standard of living in the future—through construction of plant, equipment and housing, accumulation of inventories, discovery and development of mineral deposits, research and development of new products and processes and improvements in the skills and health of workers."

The report identified several reasons to be concerned about whether the United States will have an adequate amount of capital accumulation, including:

There are several national goals whose fulfillment would require high levels of investment. These include: Housing; environmental standards; energy independence; occupational health and safety standards; and rebuilding many parts of the large cities.

In the past decade, there has been a significant increase in the rate of growth of the labor force which has not been matched by a corresponding increase in the rate of growth of the amount of plant and equipment. As a result, the growth rate of the amount of plant and equipment available for each employee has declined significantly. This has reduced the growth of labor productivity and the decline in the growth rate of productivity has reduced the growth rate of real wages.

The report, citing a recent study by the Congressional Budget Office, measures these disturbing trends in investment and productivity as follows:

The growth rate in the amount of private plant and equipment (excluding pollution control investments) declined from 4.3 percent per year in the period 1965–70 to 3.3 percent per year in 1970–75 and can be expected to decline further to 2.5 percent per year in the period 1975–77.

The growth rate in the amount of such plant and equipment per worker fell from 2.6 percent in 1965–70 to 1.6 percent in 1970–75 and is expected to decline further to only 1 percent in 1975–77.

The growth rate in worker productivity fell from 2.4 percent in 1965–70 to 1 percent in 1970–75. (To some extent, this resulted from unusually low productivity in the recession year of 1975, but inadequate investment in plant and equipment was also a major factor.)

The estimated contribution of increased plant and equipment to the increase in labor productivity fell from 0.9 percent per year in 1965–70 to 0.4 percent per year in 1970–75 and is estimated to be only 0.2 percent per year in 1975–77.

Noting that, without major structural changes in the economy, the growth rate of real wages over the long run is determined primarily by the growth rate of productivity, the study concludes that:

"The recent slowdown in the growth rate of the amount of plant and equipment per worker and the resultant slowdown in the growth rate of labor productivity, therefore, have contributed to the extremely sluggish growth in real wages in recent years. (Since 1969, real hourly wages in private nonfarm employment have grown by only 5.2 percent, less than 1 percent per year.) To the extent that workers have responded to what they perceive to be an inadequate growth in real wages by demanding higher money wage rates, the rate of inflation has increased. More capital accumulation would raise real wage rates and could also reduce the rate of inflation."

Need to create more jobs

Another major reason for capital formation is the need to equip a rapidly expanding labor force. The ability of the country to create jobs and reduce unemployment depends on its ability to equip its workers with the tools of production; the dimensions of the problem are as follows:

The civilian labor force is expected to rise from 93 million in 1975 to 103 million in 1980 and to 110 million in 1985.

This is an average annual increase of more than 1.5 million workers to be equipped.

The total investment required to equip these new workers, as business attempts to continue providing higher quality, more energy efficient equipment (at higher prices) in order to increase productivity, will require huge amounts of capital spending.

A comprehensive Commerce Department study (December 1975) concluded that the U.S. needs to devote 12 percent of its real GNP to business fixed investment during the period 1975–80 to achieve the following minimum economic and employment goals by 1980: Create enough jobs to reduce unemployment to 5 percent; Improve productivity and real wage gains; Meet the requirements of environmental legislation currently on the books; Keep the 1980 share of imported oil from rising above the 1973–74 proportion.

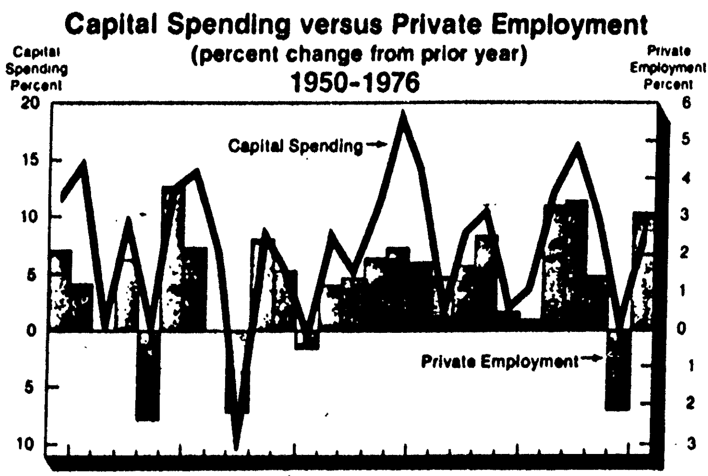
However, between 1965 and 1974 business fixed investment averaged only 10.5 percent of GNP and during 1975 and 1976 it averaged only 9.3 percent.

Based on this record, it should be obvious to even the most casual observer that the required levels of investment needed to attain these minimum economic and employment goals cannot be achieved without new and effective investment incentives.

Impact of capital spending on employment

Some critics argue that increased capital spending will aggravate rather than alleviate unemployment. They reason that increased capital spending means increased investment in labor-saving equipment and this in turn will lead to further unemployment. This view was responsible, at least in part, for the jobs credit provisions of the Tax Reduction and Simplifications Act of 1977.

Although this view may have superficial appeal, those that argue this case are ignoring the facts; historically, increased capital spending consistently has led to increased levels of employment in the private sector. The close correlation between capital spending and private sector employment is clearly illustrated by the following:



Source: U.S. Department of Commerce and Labor.

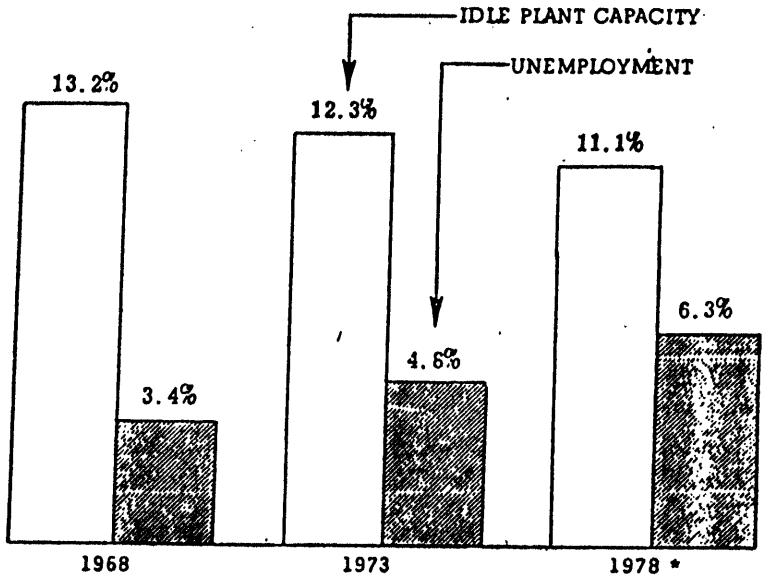
Furthermore, increased capital spending permits industry to manufacture goods at prices which will be lower relative to increased income. This will leave the consumer with more income after purchasing manufactured goods to purchase services which, in turn, will create more jobs in service related industries.

Plant capacity and unemployment

Another way to view the effect of capital spending, or lack thereof, on employment is to examine the relationship between idle plant capacity and unemployment.

IDLE PLANT CAPACITY AND UNEMPLOYMENT

(Final Quarter of Year)



*Forecast based on assumption that capacity grows at same rate as in 1971–76 and real GNP grows 6 percent per year from 1976:4 to 1978:1.

Source: Federal Reserve Board and Bureau of Labor Statistics (Historical Data).

In considering the implications of the above chart, one might be tempted to describe the current stock of plant and equipment as adequate. However, it is important to keep in mind that, although indicated idle capacity in 1968 and 1973 was 13.2 percent and 12.3 percent, respectively, the economy was operating during both periods at close to full effective capacity. Much, if not most, of the idle capacity in those years was comprised of over-aged and inefficient equipment and facilities which were maintained for standby use only in emergencies or to meet other special situations. As a result, and particularly in 1973, as the nation's utilization of its plant capacity approached 90 percent, inflationary bottlenecks and shortages, as noted previously, occurred in a number of key industries.

However, in both 1968 and 1973, the nation's stock of plant and equipment was such that as the capacity utilization rate approached 90 percent, or effective capacity levels, the jobless rate declined to 3.4 percent in 1968 and 4.8 percent in 1973. This picture has now changed. As a result of the lag in capital investment in recent years, it now appears that the country will run out of capacity before it runs out of unemployment. This may be as early as the end of 1978 when, according to some forecasts, the economy will again hit "full" capacity (utilization rate approaching 90 percent) and "bottleneck" situations may again occur. However, the unemployment rate then is expected to be still above 6 percent.

This means that it can no longer be assumed that an economy operating at full capacity will result in full employment.

Present economic recovery

The lag in capital spending has continued during the present economic recovery and represents the principal weak spot in the present economic outlook.

As noted by Arthur Burns, in testimony before the House Committee on the Budget (March 2, 1977), real business capital spending has only increased 8 percent during the current recovery versus an average of 15 percent during the corresponding period of previous post-war recovery cycles (more recent estimates put the spending gap at about 8 percent for the first quarter of 1977).

Key financial indicators—improved but still a long way to go

Key financial indicators are improved since the depths of the recession in 1974; however, in general, they still have a long way to go to regain the levels attained during the 1960's.

The trend in profits, before and after tax, since 1965, of nonfinancial corporations, as reported and adjusted for underdepreciation and inventory profits due to inflation, is shown in the following table:

ADJUSTMENT OF REPORTED PROFITS OF NONFINANCIAL CORPORATIONS

[In billions of dollars]

	Profits before tax as reported (1)	Income tax liability (2)	Profits after tax as reported (1)—(2) (3)	Under statement of costs [1] (4)	Profits before tax as adjusted (1)—(4) (5)	Profits after tax as adjusted [2] (3)—(4) (6)
1965	$64.4	$27.2	$37.2	$1.2	$63.2	$36.0
1966	69.5	29.5	40.0	2.3	67.2	37.7
1967	65.4	27.7	37.7	3.0	62.4	34.7
1968	71.9	33.6	38.3	5.2	66.7	33.1
1969	68.4	33.3	35.1	8.0	60.4	27.1
1970	55.1	27.3	27.8	10.0	45.1	17.8
1971	63.3	29.9	33.4	10.8	52.5	22.6
1972	75.9	33.5	42.4	10.1	65.8	32.3
1973	92.7	39.6	53.1	23.8	68.9	29.3
1974	102.3	42.6	59.7	51.3	51.0	8.4
1975	95.5	39.7	55.8	32.1	63.4	23.7
1976 estimate	126.1	54.0	72.1	39.3	86.8	32.8

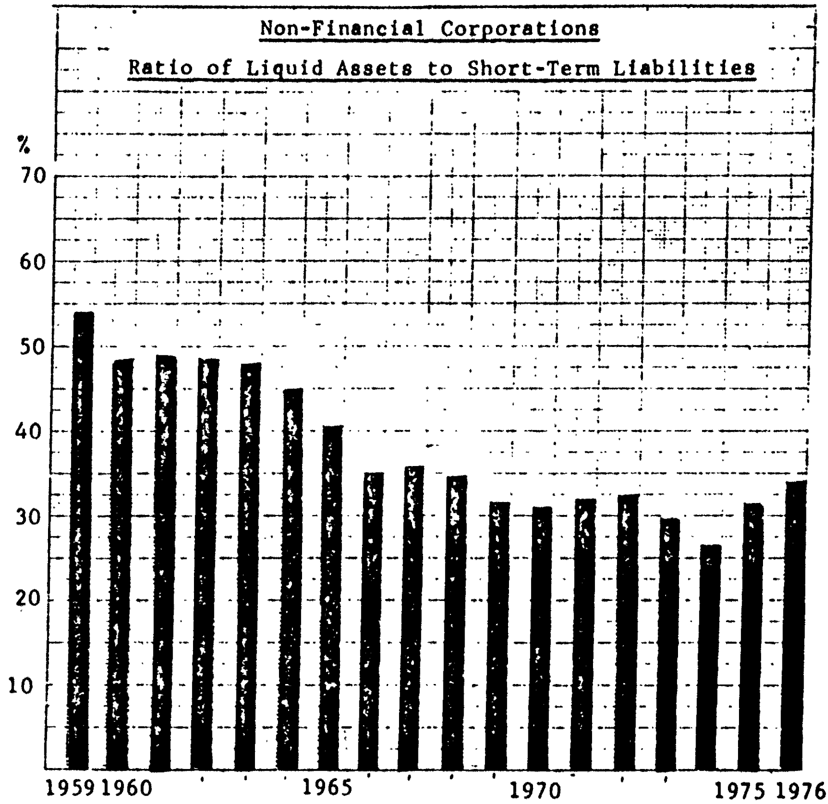
[1] The sum of the excesses of current costs over tax costs with respect to depreciation and inventory.

[2] Since this is a retrospective recomputation of profits, it takes as given the corporate income taxes actually paid. If tax liabilities had been figured on the adjusted pretax profits, the aftertax effect of the adjustment would, of course, have been reduced by the tax saving resulting therefrom. But since they were actually figured on the reported profits throughout, there were no such tax savings. Adjusted after tax profits are simply adjusted pretax profits minus actual taxes on reported profits.

Source: Department of Commerce.

As these data indicate, corporate profits after tax, both as reported and after adjustment for inflation, have recovered significantly since 1974; however, adjusted after-tax profits which were about the same as the reported figures in 1965 were only 45 percent as large as reported profits in 1976. To put it another way, since 1965, reported after-tax profits have increased 94 percent whereas adjusted after-tax profits have declined 10 percent.

Corporate liquidity (defined as the ratio of liquid assets to short-term liabilities) for nonfinancial corporations shows a similar picture:



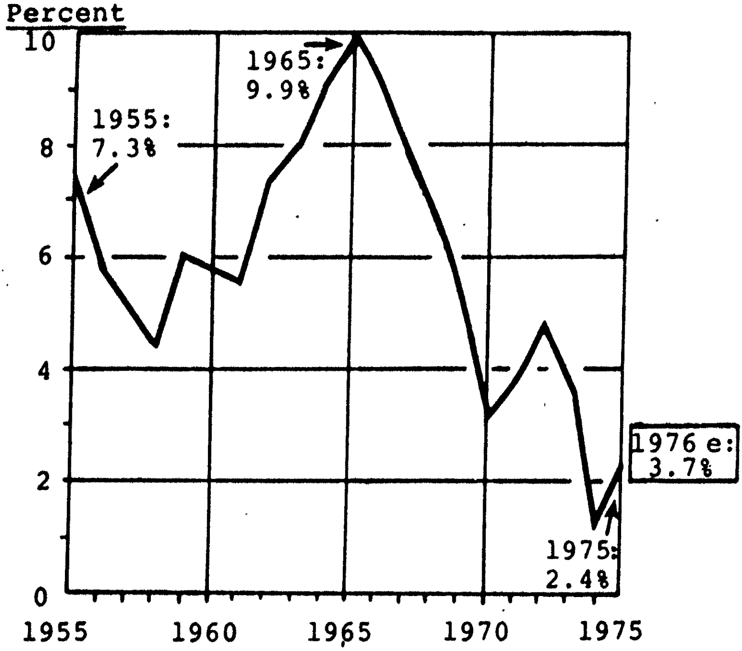
Source: Federal Reserve Board.

Corporate liquidity reached its low point in 1974 when the liquidity ratio dropped to 26.6 percent; by the end of 1976 it had risen to 34 percent. However, this level is only about the same as in 1968 and is well below the ratios achieved in the late 1950's and early 1960's. Moreover, the economic risks are, or at least are perceived to be, greater today than they were in 1968. In this connection, the recent experience of two severe "cash crunches" coming close together in 1967–70 and again in 1974–75 (the previous crunch occurred in 1957–58) have had a severe and negative impact on management attitudes with respect to risk investment. Business does not want to get caught short again, some predict another cash crunch could come again as early as 1979, and this concern, as noted previously, has been an important factor in holding down capital spending.

Perhaps the single most important consideration in capital spending decisions, return on investment, remains at depressed levels. Although after-tax return on investment for nonfinancial corporations increased to 3.7 percent in 1976 from a low of 2.4 percent the year before, this key indicator remains far below the levels achieved in earlier years. As the following chart shows, the after-tax rate of return on investment, which was 7.3 percent in 1955, reached a high of 9.9 percent in 1965; as recently as 1972, the rate was about 5 perecnt.

RETURN-ON-INVESTMENT* AFTER TAXES

Nonfinancial Corporations



*After tax profits, excluding inventory profits, and adjusted to reflect economic depreciation (double declining balance, .75 Bulletin F service lives) as a percent of plant, equipment, and inventories valued at replacement cost.

Source: Calculated from Commerce Department data.

Effective corporate tax rate

The effective corporate tax rate (all corporations) adjusted for phantom inventory profits and underdepreciation, shows a drop from the 1974 high of 59.7 percent. However, the 1975 and 1976 rates of 51.6 percent and 51.2 percent, respectively, are the highest since the 1950's.

Effective corporate tax rate[1] all corporations

Year:		Year:	
1947	49.3	1962	42.5
1948	42.0	1963	42.8
1949	37.5	1964	40.6
1950	52.9	1965	39.0
1951	58.9	1966	40.0
1952	54.7	1967	40.4
1953	57.4	1968	45.1
1954	51.0	1969	48.0
1955	49.0	1970	50.1
1956	51.2	1971	47.1
1957	51.4	1972	42.5
1958	51.1	1973	46.7
1959	48.6	1974	59.7
1960	48.0	1975	51.6
1961	47.7	1976	51.2

[1] Taxes paid as a percent of reported before-tax profits minus inventory gains and an allowance for under-depreciation (the difference between historic cost depreciation and replacement cost depreciation calculated on the basis of double declining balance, .75 Bulletin F service lives.

The effective rate was larger during the early 1950's because of Korean war excess profits tax. However, aside from expiration of the excess profits tax, corporate tax cuts enacted over the years have been insufficient to offset the ravages of inflation.

Earnings for reinvestment down

The decline in real corporate profits (as discussed above) has resulted in a dramatic decline in retained earnings available for reinvestment by business. Undistributed profits of nonfinancial corporations after restatement for the effects of inflation on inventory values and depreciation, declined from about $19 billion in 1965 to about $5 billion in 1973—this despite an increase of 36 percent in the real Gross National Product during the same period. In 1974, undistributed profits were a negative $18 billion and by 1976 they had recovered to only $1 billion.

Increased interest costs

The deterioration of real business profits and retained earnings has been reflected in the equity markets. The state of the stock market has made it difficult for other than the most credit worthy companies to raise funds in the equity markets. Venture capital companies have found it particularly difficult to acquire such funds. As a result of this and the status of real corporate profits, corporations have been forced to rely more heavily on borrowings to meet their current working capital requirements and capital investment needs.

With profitability still depressed and depreciation falling short of replacement costs (estimated to be in excess of $24 billion in 1976), industry has had to turn increasingly to outside sources for its capital funds. Over the past 20 years, new equity shares have provided only 3.5 percent of the total new funds raised by nonfinancial corporations. New debt, on the other hand, has been used to meet a growing share of corporate financial needs, averaging 41 percent during the past five years compared with 33 percent during the first half of the 1960's. This reflects the preference for savers to lend their money instead of risking it in equities that offer a small and uncertain return. There is also a strong bias in the tax structure. Interest and dividends are both costs of capital—fees paid to people for the use of their savings; however, interest is tax-deductible and dividends are not. Hence, the tax structure is pushing corporations toward debt financing, and the Tax Reform Act of 1976 made equity financing even more difficult by increasing the taxes on disposition of capital assets.

Energy and environmental problems have also aggravated the situation. The increased cost of petroleum products alone has significantly increased the cost of doing business. Industries that rely heavily on oil usage have been hit particularly hard. However, virtually all business operations have been adversely affected to some degree.

The critics

Some critics have expressed the view that, one way or another, corporations have received sufficient incentives and generated adequate funds for capital investment; they do not need further incentives, i.e., corporate tax cuts or other tax "breaks". However, flow of funds data do not support the critics' related claim that corporate "savings" currently exceed corporate investment. Although sharp cutbacks in plant and equipment and inventory spending boosted cash flow above business capital spending during 1975, this is no longer true as 1976 data indicate (capital expenditures were $16 billion higher than cash flow in 1976).

CORPORATE CASH FLOW AND INVESTMENT (FEDERAL RESERVE FLOW OF FUNDS)—NONFINANCIAL CORPORATIONS

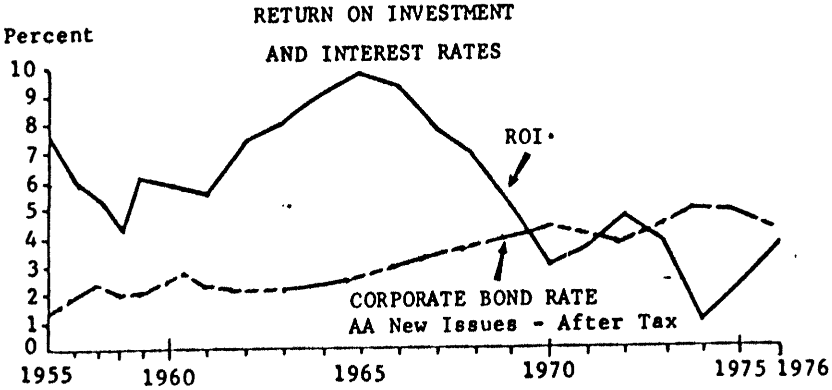
[In billions of current dollars]

	1972	1973	1974	1975	1976
Cash flow [1]	80.8	83.8	77.6	103.4	122.4
Capital expenditures	101.0	124.4	134.6	95.7	138.4
Plant and equipment	87.0	102.2	111.9	107.9	119.0
Residential structures	5.5	5.7	4.2	2.9	3.3
Change in inventories	7.6	13.3	12.0	−16.4	12.2
Mineral rights from U.S. Government	.9	3.2	6.5	1.3	4.0
Addendum: Total uses of funds	154.0	181.7	183.0	145.5	204.6

[1] Gross internal funds equals the sum of retained earnings minus inventory profits, plus repatriated foreign earnings, plus book capital consumption allowances.

Source: Federal Reserve Board.

Other critics have argued that "return to capital", which includes corporate profits and long-term interest rates, has been stable in relation to Gross National Product. This is a misleading measurement; return to creditors cannot be combined with return to entrepreneurs to create a meaningful measure of inducement to invest. Rather, return on investment should be compared with long-term interest rates which offer a yardstick for measuring the adequacy of return on investment. As the following chart clearly shows, return on investment has declined sharply since the 1960's while long-term interest rates have continued, until recently, the slow but steady climb that has characterized interest rates since the end of World War II.



•After-tax profits as a percent of inventories and P. & E. at replacement cost—nonfinancial corporations.

Uncertainty

A major reason for the lag in capital spending during the present economic recovery can be summed up in one word—uncertainty. Businessmen are hesitant to invest in new ventures, expansion and modernization of facilities and the like in periods of uncertainty. In today's economic climate, businessmen are uncertain about a great many things, including:

Energy availability and costs. (Utilities baffled, nuclear industry at a standstill.)

Regulations—especially EPA and OSHA—that delay projects, subject them to arbitrary interruption, adding mountains of cost.

Congress—Although it has considered the problem of capital formation and has a special task force of the Ways and Means Committee working on it, Congress has yet to accept recommendations for legislation, nor has it suggested any of its own.

The Administration—Although many members of the Administration have expressed concern over the problem of capital formation, no definitive proposal has yet been made. Indeed, it was discouraging to see that the increase in social security costs proposed by the Administration was heavily weighted against business (at an additional cost to business of $30 billion in new taxes over a 4-year period).

The concern that vocal and strident critics of the enterprise system will use tax reform to tilt further the tax structure against investment and industry cash flow.

The possibility of another credit crunch (which pushed many companies to the wall in 1969 and 1974).

Possible renewed inflation—increasing labor and materials costs triggering government controls or tight money.

Stop-and-go fiscal and monetary policies and possible downturn in 1979–80.

- The very high risk/reward ratio, erosion of return on investment, lack of strong incentive to invest now.

Role of tax policy in providing funds for capital investment

The Federal government has recognized for many years the important role of tax policy in helping industry to generate internal funds for capital investment. Such tax policy measures have included the enactment of accelerated depreciation methods in 1954 and the investment tax credit in 1962, the issuance of the liberalized depreciation guidelines in 1962 and the Class Life Asset Depreciation Range (ADR) system of depreciation in 1971.

The investment tax credit and the ADR system have been improperly attacked by some as "loopholes". The critics imply that national policy objectives were somehow unintended. This simply is not the case. Congress recognized these as necessary measures to encourage activity that it considered to be in the best interests of the country.

When the investment tax credit was restored and the ADR system was added to the tax law in 1971, the Reports of both the House Ways and Means Committee and the Senate Finance Committee stressed that these provisions were needed to: Stimulate the economy; create additional jobs; combat inflation by increasing the flow of goods into the market; encourage expenditures for machinery and equipment; help our exporters compete in foreign markets; and improve our balance of payments. Certainly these continue to be necessary national objectives.

What can be done

As the Staff of Joint Committee on Taxation noted: "A necessary step in increasing the rate of capital accumulation is to make the private sector of the economy more willing to invest in plant, equipment, and other types of capital. Several tax changes have been suggested to accomplish this goal: integration of the individual and corporate income taxes, the investment tax credit, larger depreciation deductions, a cut in the corporate tax rate, indexing the tax system for inflation, and more liberal deductions for losses."

CAPITAL FORMATION

A CUT IN THE CORPORATE TAX RATE

Corporate tax rate reduction is an action which should be taken to stimulate business capital spending. Available data indicate the vital importance of capital investment to economic vitality (see also paper, CAPITAL FORMATION—A National Requirement):

Over the past decade there has been a significant increase in the rate of growth of the labor force which has not been matched by a corresponding increase in the rate of growth of the amount of plant and equipment.

The growth rate of the amount of plant and equipment available for each employee has declined significantly.

This has reduced the growth of labor productivity and the decline in the growth rate of productivity has reduced the growth rate of real wages.

It is therefore desirable to increase capital accumulation; however, most of this investment must, of necessity, come from corporate profits after taxes and this figure, in turn, depends in large measure upon the corporate tax rate.

In addition to providing funds for investment in productive machinery and equipment, increased after-tax profits and resultant cash flow will stimulate the pursuit of research and development opportunities, provide working capital to finance expansion of receivables, inventories, property held for lease and the like, and generate funds for new ventures and new services—the sum total of which is job creation.

Offset to energy-related costs

Recent and continuing increases in energy-related costs have made many business operations less profitable. Almost every industry has been hard hit by unprecedented increases in fuel and raw material costs. Further cost increases are certain to occur, and will further increase pressure on corporate earnings.

A substantial reduction in the corporate tax rate could make an important contribution to provide funds for investment to improve productivity; improved productivity will lead to improved real wages which will provide the consumer with funds to offset his escalating energy costs. Thus, the circle will be complete as both business and consumer (and the nation) are better able to cope with the energy cost problem.

Importance of corporate cash position

Adequate corporate cash flow is critical to the growth and vitality of the economy. Cash flow also affects the judgment of corporate management as to the expansion possibilities. A corporate tax rate cut would improve corporate cash flow and increase capital investment because of: Availability of increased working capital; availability of increased retained earnings; and availability of increased return from otherwise marginal investment projects.

A cut in the corporate tax rate, by adding to cash flow, would help corporations maintain dividend rates or, in some cases, permit corporations to respond to the need to increase dividend rates which have been eroded by inflation. The importance of such responsive dividend policy impacts not only on individual investors but upon the public; thus,

Dividends are the lifeblood of many charitable and educational institutions.

Dividends (and related stability of stock prices) are essential to the financial soundness of both the public and private pension systems which have invested billions of dollars in corporate stock in recent years.

Millions of policyholders of fire, casualty, and life insurance companies rely on the dividends received by these companies on their stock investments to keep their premium rates down or at least from rising as rapidly as they would otherwise.

Millions of elderly persons, including large numbers of widows, look to dividend checks for funds on which to live.

Thus, the benefits of dividends sustained (or possibly increased) as a result of a cut in the corporate tax rate will flow largely to those most hurt by the inflation of recent years—schools, charities, and millions of low- and middle-income individuals.

It should also be noted that a significant portion of the dividends received by shareholders in the higher tax brackets flows back to the Government through the individual income tax system.

Stock prices which are influenced by dividend rates are important not only to shareholders in the particular companies but also to maintaining a market for new equity issues. A reduction in the corporate tax rate would help keep open the equity capital markets. This would reduce the need of corporations to borrow.

There are those who contend that any reduction in the corporate tax rate is an invitation to high income individuals to shelter their income by increasing their use of the corporate form of doing business. Rather than denial of relief to corporations which need and would use the added funds for bona fide corporate purposes such as investment in capital equipment, an appropriate response to such a sheltering argument would be the enforcement of the accumulated earnings tax; equally appropriate would be a reduction in the top individual rate to the level of the corporate rate. In addition, any appreciation in the value of the shares of stock in a corporation, resulting from increased retained earnings, would be realizable only through sale of such shares and recent changes in the tax law have reduced the opportunity for shelter provisions. The present system for taxing capital gains, recognizing as it does the element of tax preference and the offset to amounts taxed as earned income, is sufficiently well developed to avoid characterization as a tax shelter; also recognizing that realization of capital gains is an acknowledgement of the inherent risk in the equity equation.

Corporate vs. individual tax burdens

Some oppose corporate rate reduction by citing that individuals now bear a larger share of the Federal income tax burden. It is true that between 1966 and 1976 corporate income taxes rose 77.1 percent whereas individual income taxes for the same period rose 138.6 percent.

These figures present a misleading comparison because they fail to take into account differences in the growth of the amount of GNP going to corporations and to individuals. According to calculations based on Department of Commerce data,[1] individual income rose 122 percent during the past decade whereas corporate income rose only 43 percent.

These data indicate that corporate income taxes rose from 38.1 percent of adjusted income in 1966 to 47.2 percent in 1976—a 24 percent increase in the "effective" tax rate. In contrast, individual taxes rose from 10.5 percent of ad-

[1] Commerce adjustments eliminate inventory gains, capital gains, and underdepreciation from individual as well as corporate income. This provides a comparable measure of the amount of GNP going to individuals and the amount going to corporations.

justed income in 1966 to 11.8 percent in 1976—an 8 percent increase in the "effective" tax rate.

In short, analysis indicates that the corporate Federal income tax burden rose three times as much as that of individuals during the decade.

Significance of substantial cut

To make a meaningful contribution, a corporate rate cut should be substantial. As noted by many public figures, a prime requirement for a continued business recovery is public confidence. Only a meaningful and appreciable tax rate reduction will have a favorable effect on corporation finances, stock prices and dividends, which, in turn, will help restore badly shaken confidence.

Former Chairman of the Council of Economic Advisers, Paul W. McCracken, has stated that proposals to reduce corporate profits taxes are not likely to produce strong applause from the galleries. Yet, he said some reduction is urgently needed to provide means of financing capital additions required to provide employment for a growing labor force.

Dr. Peter Drucker, a noted business consultant, has observed that business earnings are the largest single source of capital formation for tomorrow's jobs, and also for the financing of tomorrow's pensions.

Accordingly, it is essential within the operation of our private enterprise economy that after-tax profits of corporations increase to provide the captial needed for jobs.

A permanent cut in the U.S. Federal income tax rate on corporations from 48% to 42% would improve the cash flow of U.S. corporations and provide the wherewithal for job-producing capital investment. To the extent dictated by revenue considerations, corporate rate reduction could be phased-in—perhaps scheduled over a three-year period.

Benefits to service industries

An across-the-board cut in the corporate income tax rate, unlike other tax measures for special purposes, would benefit all corporations—those in labor intensive service companies, those with heavy working capital needs as well as those in capital intensive manufacturing industries.

* * * * * * *

ACTION REQUIRED

Congress should enact a permanent cut in the corporate tax rate of at least 6 points; from 48 percent to 42 percent.

Capital Formation

CAPITAL RECOVERY ALLOWANCES

Congress should replace the existing and outmoded system of tax depreciation with a capital recovery allowance system to enable American business to maintain a high level of capital investment in productive plant and equipment. A sustained high level of capital investment is essential to permit American industry to: Combat chronic inflation; modernize and expand its facilities; provide needed jobs for a growing labor force; contribute to a higher standard of living; and compete effectively in domestic and foreign markets.

The attached paper, "Capital Formation"—A National Requirement, demonstrates the need for capital investment to attain these goals. Over the past decade there has been a significant increase in the rate of growth of the labor force which has not been matched by a corresponding increase in the rate of growth of the amount of plant and equipment; the growth rate of the amount of plant and equipment available for each employee has declined significantly. This has reduced the growth of labor productiivity and this in turn has reduced the growth rate of real wages.

Understatement of capital costs

Although Congressional actions in 1971, principally enactment of the Class Life Asset Depreciation Range (ADR) system, went part way to improve the rate of capital recovery in the United States, existing capital allowances, which are based on the outmoded concept of depreciable life, still do not take into account fully the ever-increasing cost of asset replacement in an inflationary economy.

The extent to which nonfinancial corporations have understated their capital costs is shown in the following tabulation comparing current-cost double-declining balance depreciation of nonfinancial corporations with depreciation allowed such corporations for Federal income tax purposes.

NONFINANCIAL CORPORATIONS, EXCESS OF CURRENT-COST DDB OVER INCOME TAX DEPRECIATION, 1965-76

[In billions of dollars]

	Current cost DDB[1] (1)	Income tax depreciation (2)	Excess of (1) over (2) (3)
1965	35.7	36.4	-0.7
1966	39.7	39.5	.2
1967	44.2	42.9	1.3
1968	48.5	46.7	1.8
1969	53.8	51.3	2.5
1970	59.5	54.6	4.9
1971	64.5	58.7	5.8
1972	68.8	65.3	3.5
1973	75.7	70.5	5.2
1974	89.3	77.8	11.5
1975	105.7	85.0	20.7
1976 estimate	117.0	92.3	24.7

[1] 75 percent of bulletin F lives.

Note: The excess of current-cost DDB over tax depreciation has grown from a negative amount in 1965 to $24,000,000,000 in 1976.

Source: Department of Commerce.

Either full indexing of the tax system or adoption of some form of replacement cost depreciation probably represents the only real solution to the problem of understated capital costs during periods of inflation. Short of adopting either of these concepts, enactment of a capital recovery allowance system, which would significantly shorten the capital recovery period, would contribute importantly to alleviating the problem.

Capital recovery allowance system

To attain the desired objectives, a capital recovery allowance system should include the following provisions:

Shorter capital recovery periods would be established for property as follows: Machinery and equipment—5 years; industrial, distribution and retail buildings and other tangible property—10 years.

A full and permanent investment tax credit would be allowed on all property eligible for the credit.

Accelerated methods (such as double rate declining-balance) of computing the annual capital recovery allowance would be permitted.

Expenditures with respect to the construction or acquisition of a capital asset would be subject to an allowance for capital recovery when incurred rather than when the property is placed in service.

A new capital recovery allowance system based on the foregoing provisions would represent a significant improvement over the present tax depreciation system. It would contribute to improved cash flow for businesses investing in productive facilities. Such assets must be financed before they contribute to productivity. To the extent recovery of investment is accelerated, after-tax funds are made available sooner for maintaining, upgrading, or further expanding the stock of capital assets.

It is recognized that in accelerating the capital recovery period for buildings, adequate legislative provisions must be adopted to preclude tax shelter abuses.

However, the effectiveness of such a capital recovery allowance system would be significantly impaired if either the availability of the investment credit at full rate or the use of accelerated methods were denied.

The importance of retaining the investment tax credit at full rate and the use of accelerated methods of computing the annual capital recovery allowance may be illustrated by comparing the present worth of the invesmtent credit and depreciation deductions under the existing Class Life Asset Depreciation Range System (the class life for electrical equipment has been used for illustrative purposes), and a capital recovery system under which a taxpayer's investment in machinery and equipment would be recoverable over a 5-year period, The following present worth values are based upon a $1 million investment eligible for the full investment credit (at 10 percent) recoverable in the year of acquisition, use of the most favorable combination of accelerated recovery methods and a discount rate of 9 percent:

$1 million investment in electrical equipment

Recovery period (years):	*Present worth at 9 percent 10 percent ITC*
Present system:	
12.0—ADR class life	$447,520
9.5—20 percent reduction in ADR class life	470,140
5.0—New capital recovery system	517,810

From the foregoing analysis. it is clear that a five-year capital recovery allowance system which retains the investment credit at full rate, and provides for accelerated methods of computing capital recovery allowances would make available more funds for investment than the present depreciation system. Furthermore, by increasing return on investment, it would increase the likelihood that certain otherwise financially marginal projects would be underaken. This, in turn, would lead to more employment.

U.S. still lags in capital recovery rates

Enactment of a capital recovery system which would shorten the recovery period is also needed to bring United States capital recovery allowances more in line with those of other industrialized countries to improve the competitive position of U.S. businesses vis-a-vis their principal international competitors. Other industrial countries have a variety of favorable capital recovery provisions in their tax laws; for example, the United Kingdom allows a 100 percent writeoff on machinery in the first year and Canada a 2-year writeoff. Although the temporary increase in the investment tax credit enacted under the Tax Reduction Act of 1975 improved somewhat the position of U.S. businesses, competitive advantages are still retained by most of our principal industrial foreign competition.

Pollution control facilities

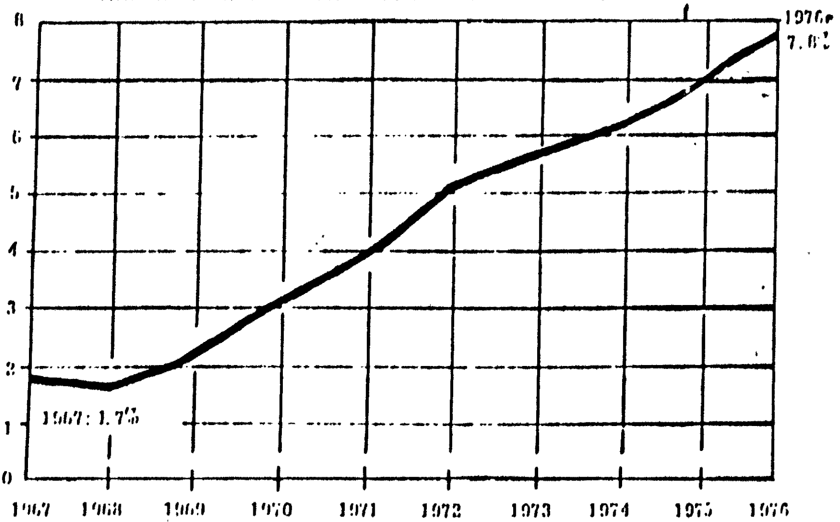
As shown in the chart on page 5, the percentage of annual business investment in plant and equipment being diverted from production assets to pollution control expenditures has more than quadrupled in the past ten years. It has been a dramatic increase and one which is expected to accelerate in the future as the mation moves away from oil and gas to a greater reliance on coal; a situation which will require new facilities and pollution control equipment.

Pollution control expenditures benefit the general public; however, they do not increase capacity or productivity—they do not generate any direct return on investment to the business making the expenditure. In addition, expenditures for pollution control facilities, if capitalized, are not under present law subject to a depreciation or amortization deduction until the facilities are placed in service. In effect, the taxpayer is penalized twice; once for havng to divert capital funds to pollution control projects and second by having to wait for depreciation or amortization to commence.

POLLUTION CONTROL EXPENDITURES

AS A % OF

ANNUAL BUSINESS INVESTMENT IN PLANT AND EQUIPMENT



Source: McGraw Hill and U.S. Commerce Department.

As a further recognition of the need for adequate and timely capital recovery:

Expenditures for pollution control facilities, including land, buildings and equipment, should be amortizable over any period selected by the taxpayer, including the immediate write-off of such costs in the year the funds are expended.

The expenditures should qualify for immediate deduction whether incurred as part of a new plant or as part of an existing plant, or whether or not the facility encompasses a recovery process.

The 15 percent minimum tax on tax preferences should not be applicable to the excess of the amortization of the pollution control facility over depreciation otherwise allowable.

Certification of a pollution control facility by the Federal and State certifying authorities should be simplified so as to eliminate unnecessary duplication, immediate write-off of pollution control expenditures would be consistent with cept that the costs of pollution control facilities should be shared equally with the general public through the participation of the Federal government. In addition, although the concept of tying tax depreciation deductions to the underlying asset's useful productive life is obsolete and should be discontinued, the immediate write-off of pollution control expenditures would be consistent with the concept because such assets seldom are of an income producing character. The imediate write-off of such expenditures would help to minimize the impact of the diversion of funds from other capital programs involving projects which would provide a financial return and result in increased output of goods and services.

Simplified system.

The enactment of a capital recovery system would foster investment in productive facilities and would be a major step toward simplification. A capital recovery system would eliminate most of the complexities of the present depreciation tax law including the determination of useful life, proper guideline classification and salvage value.

• • • • • • •

ACTION REQUIRED

Congress should enact a capital recovery allowance system under which: The recovery period for machinery and equipment is 5 years; the recovery period for industrial, distribution and retail buildings is 10 years; and expenditures for pollution control facilities may be expensed as incurred.

CAPITAL FORMATION

THE INVESTMENT TAX CREDIT

There is an urgent need for permanent revisions to the investment tax credit to: Replace and expand industrial capacity; increase productivity; and create additional jobs and improve existing jobs.

The attached paper, "Capial Formation"—A National Requirement, demonstrates the need for capital investment to achieve these goals. Over the past decade there has been a significant increase in the rate of growth of the labor force which has not been matched by a corresponding increase in the rate of growth of the amount of plant and equipment; in fact, the growth rate of the amount of plant and equipment available for each employee has declined significantly. This has reduced the growth of labor productivity and the decline in the growth rate of productivity has reduced the growth rate of real wages.

1975 and 1976 revisions

Revisions of the investment tax credit provisions in 1975 and 1976 were a step in the right direction. The Tax Reduction Act of 1975, which was enacted on March 29, 1975, was responsive to the need for immediate tax relief to combat the recession. It provided for a temporary increase in the investment tax credit to 10% for all taxpayers, including public utilities (11 percent if the extra 1-point increase is invested in an employee stock ownership plan—ESOP).

The Tax Reform Act of 1976 extended the 10 percent investment credit from 1976 through 1980, increased the ESOP by one-half percent, relaxed the 50 percent tax liability limitation for railroads and airlines (100% limitation in 1977 and 1978, phasing down 10 percent per year until it returns to 50 percent in 1983), provided for FIFO use of investment credits (carryover credits are used first, then credits in the current year, and finally carryback credits) and increased the eligibility of used property from $50,000 to $100,000.

Increases must be permanent

While an immediate increase in the credit was needed in 1975 as a response to the recession, that increase and any new increase should be made permanent to ensure that longer term projects are accelerated. In addition, a permanent increase would permit informed planning of long lead-time projects with predictable results which would ensure sustained growth of the nation's productive capacity and provide for the modernization and replacement of existing equipment. Availability of additional supplies of goods and services will also help in the fight against inflation.

In its report on the Revenue Act of 1971, the Senate Finance Committee commented on the need for a permanent investment tax credit at a flat rate as follows:

The committee concluded that a flat rate credit was preferable to a credit which initially was larger.

It believed that a varying credit would be inconsistent with the basic objective of providing an incentive for adequate investment on a long-term basis.

A credit which is scheduled to drop abruptly after a period of operation would be likely to encourage investments in the earlier period at the expense of the later period.

A varying credit would be likely to produce inequitable results.

Businesses needing assets which can be produced only after a long lead-time would frequently not be able to qualify for the higher credit because they would not be able to place the assets in operation in time.

Similarly, the mere fact that the availability of an asset was delayed, perhaps because of construction or production difficulties, could reduce the amount of the credit.

In short, a permanent investment tax credit reduces the uncertainty of business planning and accordingly increases the amount of investment to be expected at any given level of market price—thus promoting stable and increased growth with lower inflation.

Investment credit has proved effective

Based on the record, the investment credit has proved to be a very effective device for generating economic growth through capital expenditures. Economists Dale Jorgenson of Harvard and Roger Gordon of MIT, using the Data Resources, Inc. econometric model of the U.S. economy, have made an extensive study of the effectiveness of the investment credit. As reported in the November 16, 1974, issue of Business Week, they found that "the introduction of the tax credit in 1962 made investment expenditures 7.7 percent higher after three years over what they would have been otherwise, and 10.2 percent after 5 years."

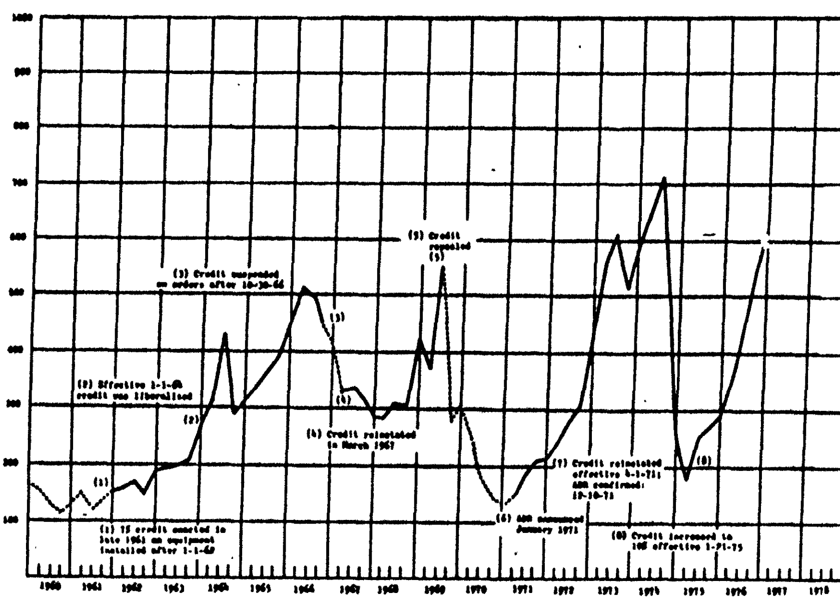
They are strongly critical of the repeal of the credit in early 1969, contending that this action caused a slow-down in private investment, coincident with a precipitous drop in real government purchases of goods and services. "Leaving the tax credit in effect," they say, "would have alleviated the severity of the ensuing recession" which resulted in a period of rising unemployment and business stagnation.

Reenactment of the credit in late 1971 gave a substantial push to investment which grew at an annual rate of more than 13 percent (with the effects of inflation removed) between the third quarter of 1971 and the third quarter of 1973. Jorgenson and Gordon concluded that the nation's stock of productive assets at the end of 1972 was 5.5 percent higher than it would have been in the absence of the tax credit over the 1962–72 decade.

Moreover, they found that a constant 7 percent over the period (without the temporary suspension, repeal, and revival) would have added another 3.3 percent to today's stock of capital. Their conclusion was that the credit should be "kept on premanently at a relatively high rate to foster the longrun goal of stimulating the growth of the capital stock."

The close correlation between machinery orders and the investment credit was also demonstrated lucidly by the Senate Finance Committee in its Report on the Revenue Act of 1971 which included therein the chart shown on the following page which has been updated and was used in the National Machine Tool Builders' Association statement before the Senate Finance Committee Hearings on H.R. 3477 on March 11, 1977.

MACHINE TOOLS
Domestic New Orders Quarterly
Millions of Dollars



Source: National Machine Tool Builder's Association

Should not be countercyclical control device

The investment credit was originally conceived as a permanent feature of the tax system which would provide an incentive to increased investment programs over the long-term. Over the years, however, the credit has been used as a countercyclical control device—enacted or restored, as in 1962 and 1967, respectively, to permit attainment of a higher rate of growth, sustained full employment and stable prices; or suspended or repealed, as in 1966 and 1969, to moderate economic growth and to curb inflation. Today, there are still those who contend that the credit should not be a permanent provision of the tax law but should be used only when the economy is in a recession and needs a stimulant.

The central problem in using the credit as a countercyclical device relates to the fact that it is impossible to control the timing of its effects due to lead-time considerations and delayed responses. As a rule, capital equipment has a long production period and the time lag between placement of an order and receipt and installation of the equipment can easily run to a year or more depending upon the nature and complexity of the equipment—and to periods of three to seven years for the major projects. (Lead times are especially long in minerals exploration-production ventures and in cases where there are environmental disputes over the siting of new plants, such as electric power facilities.) Because of this, any change in the credit, whether involving a change in the rate or outright repeal and reenactment, will not have an immediate impact on the level of capital expenditures and related employment. The change most inevitably will be late and in response to current conditions rather than conditions which actually develop later. Nor will the timing of the change in investment be predictable because of delays in construction and changes in the mix of long and short lead-time projects. As a result, the change is very likely to be counterproductive in that by the time it takes effect, the economy may be in the next stage of the business cycle when contrary action to-that taken is required.

Because of the timing problem, the investment credit should not be used as a countercyclical device. Moreover, even if it could be used effectively for this purpose, to do so would defeat the basic purpose of the credit which is continuously to increase productivity and to create jobs in order to improve the economic potential of the country and to raise its standard of living.

Should not be applied selectively

The investment credit should not be applied selectively to a given industry or geographical region. To do so, as some advocate, would represent further government intrusion into the market place. It would result in a misallocation of resources and a distortion of consumption decisions; economic decisions should not hinge on such distortion. Moreover, it could be inflationary. If, for example, an extra credit were given to industries when they reach, say, 90 percent of capacity, firms would have an incentive to wait for that day before expanding. By then, demand-pull inflation of the price of the product would have already begun.

Conclusion

Current and long-range capital requirements in the United States argue strongly for a permanent investment tax credit for all taxpayers. This would provide an incentive to economic growth through continuous modernization and replacement of existing facilities and investment in new facilities; would become a significant contributor to the war against long-term inflation by expansion of capacity; and would contribute to improved liquidity of business enterprises.

* * * * * * *

ACTION REQUIRED

The investment credit should be made permanent.

Consideration should be given to an increase in the investment tax credit rate if other aspects of tax reform do not produce the needed increases in capital formation.

The credit should be made applicable to expenditures as incurred in the case of property being constructed by or for the taxpayer, thereby accelerating the recovery of the initial cash outlay. This procedure would produce a more equitable result than continuation of the phase-in period and the construction period limitation established by the Tax Reduction Act of 1975.

TAXATION OF CAPITAL GAINS

It is essential that the United States retain a strong securities market to supply the capital needed to maintain business growth, to solve social and environmental issues, and to satisfy the energy requirements of the country. A substantial part of this capital should be obtained through the sale of equities. If the capital needed is obtained instead through debt financing, the solvency and liquidity of many American businesses could be jeopardized.

Any tax on capital gains serves as a serious deterrent to investment and it generally penalizes U.S. investors as compared to those in other industrialized countries. A case can be made for exempting all capital gains from taxation. However, it is expected that there will be a strong move in Congress to subject capital gains to ordinary income taxation treatment. In view of these considerations, the following principles should be followed in taxing capital gains:

Capital gains should be taxed at a reduced rate which would depend on the length of time the asset is owned.

Only capital gains that are realized should be taxed.

Capital gains should not be treated as tax preferences and thus: Should not be subject to the minimum tax; should not reduce amount of personal service income subject to 50 percent maximum tax rate.

Corporations should be allowed to carry forward capital losses indefinitely.

Any change to treat capital gains as ordinary income should be conditioned on inclusion of a roll-over provision, an inflation factor and full deductibility of losses.

Capital gains should be taxed at a reduced rate

The present 50 percent deduction for long-term capital gains of individuals (as well as the present maximum corporate tax rate of 30 percent on such gains) should be retained. In addition, the gain on assets held between 5 and 25 years should be reduced to the extent of 1 percent a year as approved by the Ways and Means Committee in 1974. This would mean that 70 percent of the gain on an asset held for 25 years or more would be excluded.

Only realized capital gains should be taxed

The present provision taxing only realized capital gains should be retained. A tax should not be imposed on unrealized gains on property transferred at death or by gift. Property transferred at death is already subject to the estate tax (with rates up to 70 percent) and to state inheritance taxes. To also impose an income tax on the unrealized gains on such property would reduce the incentive for personal investment to accumulate an estate and restrict the supply of capital available for business investment. The taxation of unrealized gains in property transferred by gift would tend to reduce the number of gifts made, thereby further impairing the mobility of capital.

Long-term capital gains should not be treated as tax preferences

Taxing long-term capital gains at a reduced rate is not a tax preference because it basically alleviates the unfair burden which results from the bunching of income in one year and from treating as gain increments in value attributable to inflation. Treating 50 percent of long-term capital gains of individuals as a preference in effect raises the maximum tax on long-term capital gains. For the same reasons, no part of corporate capital gains should be treated as preference income.

Net capital losses of corporations should be carried forward indefinitely

Corporations should be allowed a carryforward of net capital losses for an indefinite period as for individuals. Such losses represent an economic loss and corporations should be allowed to recoup them to the extent of capital gains.

Proposal to treat capital gains as ordinary income

The Administration has taken a strong stand in favor of simplification of the tax laws and of proposals designed to tax different types of income alike. Elimination of the special treatment of capital gains (including only 50 percent of long-term gain in ordinary income or the alternative tax) would achieve both purposes. While there may be some justification for taxing relatively short-term gains and trading profits at ordinary rates on a current basis, long-term gains which continue to be embodied in capital should not be taxed until they are made available for consumption. Furthermore, in the case of long-term gains, only "real" income, those gains not attributable to inflation, should be taxed.

Deferral of tax until capital gains are consumed

Across-the-board taxation capital gains at ordinary tax rates would tend to freeze asset holdings. Taxpayers would certainly hold off selling capital assets where large gains had accrued. This would result in an abnormal performance of the capital markets which could not allocate past and current savings into the most productive uses of capital. Any tax-induced immobilizaion of savings tends to inflate the market value of the stock of established companies while making it more difficult for new dynamic companies to obtain the financing they need for their growth.

Deferring the taxation of capital gains to the time when those gains are not reinvested and are available for consumption would eliminate this locking-in effect. Such an approach would free capital which even under existing rules is not realized because of the resultant tax.

The inflation factor

It has always been recognized that substantial mounts of capital gains do not constitute accretions of capital in any real sense but simply reflect the effects of inflation on the prices of capital assets. This is most obvious to the ordinary homeowner. While it may not be quite so evident to the investor in common stocks, over 80 percent of the apparent capital gains on common socks, as measured by the Standard and Poor's Composite Index of 500 Common Stocks, for the years from 1960 through 1973 was inflation gain. Taxing even one-half of these gains leaves the investor with a substantial real loss on his investment.

The need to give some effect to inflation in measuring capital gain which is to be treated as ordinary income is recognized even by the more aggressive tax reformers. H.R. 1040, which was introduced by Congressman Corman and has as its purpose the broadening of the income tax base as well as reforming the tax provisions, would allow 6 percent of the adjusted basis of property to be added to the basis for each year the property was held after 12 months in computing gains subject to full tax. Certainly gain which is attributable to inflation alone should not be taxed and some method of recognizing the inflation factor must be taken into consideration.

Deduction of losses

Under present law, capital losses can be deducted only to the extent of capital gains plus $3,000 in 1978 and subsequently. This inhibits investment in relatively high-risk properties and immobilizes past investment. Deferring the offset of excess losses reduces the value of the offset. Since capital gains are fully subject to tax in the year they are realized, the tax offset for losses may very well be less than the additional tax burden on gains. Thus, the risk of investment is increased. In addition, where losses have accrued on an investment, not being able to deduct the losses in full tends to inhibit liquidation of that investment and its replacement by other assets.

Paricularly, if capital gains are to be taxed as ordinary income, capital losses should be fully deductible in the same way. Any artificial limit on the amount of capital losses which can be deducted cannot be justified on any logical or reasonable grounds.

* * * * * * *

ACTION REQUIRED

Capital gains should be taxed at a reduced rate which would depend upon the length of time the asset is owned.

Only capital gains that are realized should be taxed.

Capital gains should not be treated as tax preferences.

Corporations should be allowed to carry forward capital losses indefinitely.

Any change to treat capital gains as ordinary income should be conditioned on: Inclusion of a roll-over provision deferring tax until gains are consumed; adjustment of such gains for inflation; full deductibility of capital losses.

Natural Resource Policy

PERCENTAGE DEPLETION AND THE PUBLIC INTEREST

Over the years, Congress has recognized consistently the significance of natural resources to the security and the economy of the nation.

The percentage depletion provision in the Federal tax laws reflects a judgment by Congress that money which could be obtained by the public sector through taxes can serve the public interest better by remaining in natural resource industries, where it can be put in helping to offset deterioration of America's vital raw materials and energy base. This incentive has been available to the extractive industries for over half a century ond has served well the purpose for which it is intended. Percentage depletion is as important today to the natural resource industries as in the past—perhaps even more so.

Percentage depletion: sound theory, sound results

The case for percentage depletion has three cardinal points:

Taxation, finance and accounting for the extractive industries involve different considerations from those of other industries.

Percentage depletion increases development and expansion of production of natural resources.

Exploration for, and development of, natural deposits requires capital investment; the nation must make that investment.

The extractive industries differ from other industries

For a manufacturing company, the cost of a facility, such as a machine, is a reasonable indicator (if one ignores inflation) of what it would cost to replace that facility. Under the tax laws, the company is therefore allowed, over a period of time, to deduct such cost as a capital recovery allowance.

In the case of mineral deposits, original cost is not an adequate measure of what it may cost to find and develop a replacement. History indicates a clear trend of replacing exhausted deposits with deposits which are more difficult to find and which—because of their lower grade or geographic location, or both—are more costly to develop and operate.

Percentage depletion provides a realistic method of reflecting the reduction in value which occurs as a deposit is exhausted, thus generating through reduced taxes part of the capital necessary for replacement. Subject to certain limitations, percentage depletion permits the extractive industries to deduct a portion of their gross income each year while a deposit is productive, thus assuring a fair approximation between the tax positions of extractive and nonextractive industries.

In short, percentage depletion recognizes that the dollar received by a natural resource company for sale of products extracted from the earth is not the same as the dollar received by a manufacturing company for sale of manufactured products. The natural resource company dollar respresents a payment in part for its operating costs and in part for the sale of a nonrenewable capital asset. Thus, the fundamental purpose of the allowance for depletion of a wasting mineral asset is to provide capital for high-risk natural resource industries.

Percentage depletion increases production of natural resources

Without the allowance for depletion the American extractive industries would be handicapped in their ability to meet the vital need for increased production of metals, minerals and oil and gas.

The domestic demand for natural resources will increase. The projected needs for iron, copper, aluminum, lead, zinc, uranium, oil, gas, coal, and other basic minerals by 1985 are great. The needs can be met in only two ways: greater production by U.S. companies or greater dependence on foreign controlled suppliers.

The hazards involved in depending on foreign controlled suppliers were illustrated in the 1973–74 energy crisis stemming from the Arab oil embargo.

Capital requirements

The cost of discovering minerals is increasing. The minerals industry must obtain capital for exploration. Most of the rich ore bodies have already been discovered; low grade deposits are left. Exploring underground is particularly costly. In many cases, the deposits that are discovered are of such low grade that the technology required to make production economically feasible must first be developed. Moreover, to process low grade mineral resources at a commercially economic cost per unit of production requires investment in facilities for large scale operations.

The extractive industries also are faced with increases in costs as a result of environmental and health and safety legislation which has been enacted in recent years.

Historically, the extractive industries met their capital needs with internally generated cost flow. This, however, is no longer possible. Recently, these industries have turned increasingly to debt financing, thereby significantly increasing costs and debt/equity ratios. The ability to generate capital internally, and to attract outside capital, is dependent on profitability since that determines cash flow and return on investment.

Thus, percentage depletion is essential because: While it will not generate all the capital needed to finance the required expansion of mineral output, it will contribute significantly to that end. It helps generate earnings and to that extent helps attract investment funds.

Conclusion

Anything that increases production of domestically controlled basic minerals, exploration and development of new resources, and return on investment in natural resource operations, decreases U.S. dependence on foreign controlled sources for these vital raw materials. Percentage depletion unquestionably has had that effect.

It is clear that government policy to enhance the extractive industries ability to generate greater earnings, and to attract needed additional capital should continue. The percentage depletion allowance is a vital element of such a policy.

Recommendation 4B.6 of the National Commission on Materials Policy is as valid today as it was when it was made in June 1973:

"We recommend that 4B.6 * * * the Congress continue the percentage depletion provisions of our tax laws as a time-tested major incentive to discovery and development of mineral resources * * *."

DOUBLE TAXATION OF DIVIDENDS

The double taxation of dividends—once when the corporate income is taxed to the corporation and again when the dividends from that income are taxed to shareholders—is a long-standing inequity in our present tax system.

It has now become widely recognized that this tax penalty on corporate income distributed as dividends is having undesirable effects on the American economy. These include: Unbalanced capital structures caused by increased use of debt instead of equity issues in raising new capital. Diversion of capital from the corporate sector to the non-corporate sector.

Currently, a great deal of interest is being expressed in alleviating the double tax burden. The discussion which follows examines the various methods by which this may be achieved, their advantages and disadvantages, the results of the various methods to the corporation and its shareholders, and the related risks.

Methods of Eliminating Double Taxation

Dividend deduction method

Corporation would be allowed a deduction for dividends paid.
Could be phased in to soften revenue impact.

Shareholder credit method

Tax credit would be allowed to shareholders for the corporate tax on distributed earnings. Shareholders would add amount of credit to dividend received (called "gross-up" of dividend), figure tax on total amount, and claim a refundable credit for the corporate tax. Could be phased in.

Combination method

Shareholder would increase (gross-up) dividend by 50 percent and take a refundable tax credit for the amount of the gross-up. Corporation would be allowed a deduction for approximately 50 percent of dividend (percentage could be varied to fine tune tax relief on basis of corporate tax rate). Both credit and deduction could be phased in.

Advantages and Disadvantages of Various Methods

Dividend deduction method

Advantages.—Simple to administer; puts equity financing more nearly on a par with debt financing (both dividends and interest deductible); tax savings accrue to corporation and increase cash flow and reported earnings; and savings may be passed on to shareholders by increasing the dividend rate.

Disadvantages.—Corporate tax becomes a tax on earnings retentions. Puts great pressures on corporations to increase dividends, perhaps substantially, to reduce the corporate tax. Will result in transfer of funds out of corporations where they are needed currently for capital formation projects; replacement of such funds will take time and will delay implementation of investment projects.

Reduces amount of tax against which investment tax credit and foreign tax credit may be taken, which may limit the benefit derived from these credits.

Will make it difficult to deny the benefits to tax-exempt and foreign shareholders.

Will reduce effective corporation tax rates below present levels—and in some cases eliminate corporation tax entirely. Will heighten present criticism of low effective rates.

Congress may look only to the corporate sector for increased revenues to offset the cost of eliminating double taxation.

Shareholder credit method

Advantages.—Tax savings accrue directly to shareholder. May be more acceptable, politically, than dividend deduction method which gives tax relief to the corporation; will improve reporting of dividends by shareholders; and provides more flexibility in treatment of tax-exempt foreign shareholders.

Disadvantages.—Complicates return filing of shareholders; will be hard for shareholders to understand; presents difficult question of rate of credit to allow, particularly if the rate of shareholder credit is based on the effective rate of corporate tax after reduction for the investment tax credit and foreign tax credit; and savings may be retained by the corporation only by reducing the dividend rate.

Combination method

Advantages.—Divides tax relief between corporation and shareholders without adjustment of the dividend rate; and reduces significance of shareholder credit and gross-up percentage.

Disadvantage.—Has all the complexities of both methods and will be hard for shareholders to understand.

Results of the Various Methods

The three methods have different results to the corporation and its shareholders if the level of cash dividend payout remains unchanged: The dividend deduction method retains the tax savings for the corporation; the tax credit under the shareholder credit method produces the same increase in the shareholder's net-after-tax income as an equivalent increase in the cash dividend under present law. The tax savings accrue to the shareholders with greater relative benefit to low bracket, than to high bracket, shareholders; and the combination method divides the tax saving between the corporation and the shareholders.

Theoretically, by adjusting the cash dividend payment upward or downward, the corporations directors can achieve the same distribution of the tax savings between the corporation and its shareholders under any of the three methods. This is illustrated on the three exhibits attached.

Exhibit A shows the dividend levels required under the three methods to retain the tax savings in the corporation. Exhibit B shows the dividend levels required in order to pass the tax savings on to the shareholders. Exhibit C divides the savings equally between corporation and shareholders (that is, same dollar increase in earnings retention and in total dividend, inclusive of gross-up amount, to shareholders).

It should be noted that any reduction in the dividend would impact adversely on foreign and tax-exempt shareholders if the tax credit were not extended to them.

It should be recognized that none of these methods eliminates the double taxation of retained earnings—once to the corporation and again to the shareholders to the extent realized as capital gain. Therefore, they are of little or not benefit to new and fast growing companies with low dividend payout policies.

Choice of method

The choice of a method is not an easy one, because technical, economic, and political considerations are involved. The need to arrive at solutions to the many technical questions which have been identified (and undoubtedly others which have not yet been identified) must be recognized. Among these questions are the dividend gross-up percentage, the treatment of foreign income and the foreign tax credit, how to handle corporate capital gains and the investment tax credit, and the treatment of tax-exempt and foreign shareholders.

An even more complicated question—which should be basic to the political acceptability of the deduction or credit method—is which of the two would make the greater contribution, both short- and long-run, to capital formation and employment.

There has been much discussion of the question of whether tax-exempt organizations and foreign shareholders should be extended the benefit of a refundable tax credit if the shareholder credit method is adopted. In fact, one of the principal arguments advanced in favor of the method is that it lends itself to denial of the credit to such shareholders.

If these shareholders were not allowed a tax credit, they would be worse off than under present law if dividend payments were reduced to retain for the corporation part of the benefit which shareholders would realize from the credit. Further, the fact that taxable U.S. shareholders would be receiving benefits not made available to all shareholders would introduce a serious question of equity.

Any denial of benefits would impact adversely on exempt U.S. shareholders and could be exepected to encourage some form of retaliation by foreign governments on behalf of foreign shareholders. Finally, those not benefiting would be discouraged from investing in U.S. equities.

The equity would be particularly unfair in the case of qualified employee savings plans and pension funds, where taxation of the income is merely deferred until it is distributed to the participants or their beneficiaries.

Risks

The impact on Federal tax revenues of legislation to reduce or eliminate the double taxation of dividends can be very substantial. Statements by key Government officials signal that an attempt might be made to minimize or completely offset the revenue loss by a trade-off against existing capital formation incentives such as the investment tax credit and the Asset Depreciation Range System (ADR). It should also be recognized that either the dividend deduction method or the shareholder credit method based on other than the statutory rate of corporate tax, or any combination of these two methods, would reduce the value of the investment tax credit as a capital formation incentive, even if that provision remained unchanged. In other words, there is a real risk that the business community would pay a prohibitive price for removal of this inequity.

Another risk stems from the fact that the economic effects of legislation to eliminate double taxation have not been developed fully. Proposals to date have not identified adequately the effects on capital formation, saving, or inflation. It is probable that the different methods would have different effects on individual levels, retained earnings, employment market values of securities, and other critical elements of the economy. A great deal would depend upon the amount of revenue loss involved in the method selected, the rate at which the change is phased in, and the source of the replacement, if any, for the lost revenue.

One economic risk is that investor preference might shift away from companies with low dividend payout rates toward companies with high payout rates. This would be unsettling to the securities markets but might be largely eliminated by a properly scheduled phase-in period.

Generally, tax reduction is followed by feedback effects which can result in at least partial recoupment of the lost revenues over a period of years. Therefore, although hard to quantify, it seems reasonable to assume that elimination of double taxation would have favorable feedback effects; yet whenever it is mentioned, the need for trade-offs is inevitably asserted.

This was not the case when the investment tax credit was enacted or when ADR was put in place. These were considered so beneficial that compensating tax increases were not needed. The same should be true of legislation to eliminate double taxation. If it will accomplish worthwhile objectives, it should be enacted and allowed to perform its intended function. If necessary, the effect on revenue can be tempered by phasing it over a period of years.

Nevertheless, there is a strong possibility that Congress would cut back on various provisions which reduce the present tax burden on corporations, as a full or partial offset to the revenue loss involved. This would indeed be unfortunate, because it would reduce substantially the beneficial effects on the corporate sector. Business would be trading valuable tax benefits which contribute to profitability and provide investment incentive for tax relief which might flow largely to shareholders with unpredictable effects on capital formation and corporate cash flow.

It is generally considered that the shareholder credit method stands the best change of enactment because it would provide the tax reduction at the individual, rather than the corporate, level. Since this method would give all the benefits to shareholders, it would present corporations with the problem of creating acceptable plans for sharing in the tax savings.

Many who favor the shareholder credit method assume that it should be possible to "package" dividends in a way which would convince shareholders that the dividend gross-up was a part of the dividend, even though it took the form of a credit against the shareholder's tax liability. Given this premise, they assume that cash dividends could be reduced below the levels that would otherwise prevail, and total earnings retentions could be increased.

If double taxation could be eliminated without a negative impact on existing capital formation provisions, this analysis might well be valid. However, it should be recognized that many corporations would find it impractical to reduce actual dividend payments. The most they could hope to achieve would be a deferral of dividend increases.

Furthermore, it cannot be assumed that a corporation could recapture by other means the savings accruing to its shareholders in the form of higher constructive dividend payments. Some of the money would be spent and much of it would find its way into other investments.

Nevertheless, if the corporation were given time to work out a sharing of the benefits of the elimination of double taxation with its shareholders, and if it did not have to pay a penalty in the form of trade-offs to obtain this tax reform, it could gradually improve its earnings retentions and step up its capital investment programs. Proper phase-in should help to make this possible.

It should be recognized, however, that the "packaging" of dividends in the manner described above would be an exceedingly difficult task and that it is a problem which would not exist under the dividend deduction method.

Another way for the corporation to share in the tax savings might be through dividend reinvetment plans allowing shareholders to purchase stock for cash as well as with dividends.

These measures not only would provide investment capital directly but would build the equity base and support the raising of additional capital through debt offerings.

There is no question that elimination of double taxation of dividends is a desirable objective. If it could be done in a way which would enhance the availability of investment capital in the corporate sector by improving corporate profitability and increasing the return from investments in equity securities, the business community would strongly support such a program. On the other hand, other forms of tax reduction such as increased capital recovery allowances, together with a permanent investment tax credit, or a reduction in the corporate income tax rate should have a more direct and measurable effect on corporate profitability and, if so, would be preferred if they are achievable.

* * * * * * *

ACTION REQUIRED

Enact legislation to eliminate double taxation of dividends to provide more equitable tratement of corporate shareholders.

Give highest priorty to improved capital recovery allowances, together with a permanent investment tax credit, and a reduction in the corporate tax rate, both to increase productivity, real wages, and employment and to benefit corporate shareholders.

Resist, under any circumstances, attempts to reduce tax incentives to capital formation now available to business as the price of obtaining elimination of double taxation of dividends.

Maintain the momentum which proposals to eliminate double taxation of dividends have thus far achieved, recognizing that this form of tax reduction could be of significant benefit to the corporate sector.

Study further the economic effect of elimination of double taxation of dividends, and related unresolved questions, to assure a net contribution to increased capital formation and reduced unemployment.

Encourage the implementation of a properly structured program for elimination of the double taxation of dividends on a phased-in basis without the sacrifice of existing capital formation incentives or the overall objective of reducing the tax burden on the corporation. The objective should be to provide, over time, an additional capital formation incentive and to preserve the opportunity of maintaining or obtaining future improvements in existing incentives of proven effectiveness.

EXHIBIT A

COMPARISON OF METHODS OF ELIMINATING DOUBLE TAXATION OF DIVIDENDS

TAX SAVINGS RETAINED BY CORPORATION

	Present law	Dividend deduction	Shareholder credit	Combination method
Corporation:				
Profit before tax	$1,000	$1,000	$1,000	$1,000
Dividend deduction	0	250	0	83
Taxable income	1,000	750	1,000	917
Tax at 50 percent	500	375	500	458
Profit after tax	500	625	500	542
Dividends paid[1]	250	250	125	167
Retained after tax	250	375	375	375
Shareholder (40 percent bracket):				
Dividend received	250	250	125	167
Dividend gross-up	0	0	125	83
Total dividend	250	250	250	250
Tax at 40 percent	100	100	100	100
Tax credit	0	0	(125)	(83)
Net tax	100	100	(25)	17
Retained after tax	150	150	150	150
Tax-exempt shareholder:				
Credit allowed:				
Dividend received	250	250	125	167
Tax credit	0	0	125	83
Total realized	250	250	250	250
Credit not allowed: Dividend received	250	250	125	167

[1] Variable.

EXHIBIT B

COMPARISON OF METHODS OF ELIMINATING DOUBLE TAXATION OF DIVIDENDS
TAX SAVINGS PASSED ON TO SHAREHOLDERS

	Present law	Dividend deduction	Shareholder credit	Combination method
Profit before tax	$1,000	$1,000	$1,000	$1,000
Dividend deduction	0	500	0	167
Taxable income	1,000	500	1,000	833
Tax at 50 percent	500	250	500	417
Profit after tax	500	750	500	583
Dividends paid[1]	250	500	250	333
Retained after tax	250	250	250	250
Shareholder (40 percent bracket):				
Dividend received	250	500	250	333
Dividend gross-up	0	0.	250	167
Total dividend	250	500	500	500
Tax at 40 percent	100	200	200	200
Tax credit	0	0	(250)	(167)
Net tax	100	200	(50)	33
Retained after tax	150	300	300	300
Tax-exempt shareholder:				
Credit allowed:				
Dividend received	250	500	250	333
Tax credit	0	0	250	167
Total realized	250	500	500	500
Credit not allowed: Dividend received	250	500	250	333

[1] Variable.

EXHIBIT C

COMPARISON OF METHODS OF ELIMINATING DOUBLE TAXATION OF DIVIDENDS TAX SAVINGS DIVIDED BETWEEN CORPORATION AND SHAREHOLDERS

	Present law	Dividend deduction	Shareholder credit	Combination method
Corporation:				
Profit before tax	$1,000	$1,000	$1,000	$1,000
Dividend deduction	0	333	0	111
Taxable income	1,000	667	1,000	889
Tax at 50 percent	500	334	500	445
Profit after tax	500	666	500	555
Dividends paid[1]	250	333	167	222
Retained after tax	250	333	333	333
Shareholder (40 percent bracket):				
Dividend received	250	333	167	222
Dividend gross-up	0	0	166	111
Total dividend	250	333	333	333
Tax at 40 percent	100	133	133	133
Tax credit	0	0	166	111
Net tax	100	133	(33)	22
Retained after tax	150	200	200	200
Tax-exempt shareholder:				
Credit allowed:				
Dividend received	250	333	167	222
Tax credit	0	0	166	111
Total realized	250	333	333	333
Credit not allowed; Dividend received	250	333	167	222

[1] Variable.

APPENDIX B

CAPITAL FORMATION OPTIONS TO FINANCE POLLUTION CONTROL

By

SCOTT C. WHITNEY

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Capital Formation Options to Finance Pollution Control

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The economic cost of environmental pollution and the cost of implementing far-reaching corrective measures are increasingly recognized as significant national problems.[1] Extensive effort has been expended in recent years to analyze and quantify pollution abatement and control costs and forecast capital demands that will be necessary to comply with environmental laws and regulations.[2]

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1. *See, e.g.*, COUNCIL ON ENVIRONMENTAL QUALITY, ENVIRONMENTAL QUALITY: THE SIXTH ANNUAL REPORT OF THE COUNCIL ON ENVIRONMENTAL QUALITY 494 (1975) [hereinafter cited as SIXTH ANNUAL REPORT]:

> The U.S. economy has been experiencing severe economic problems over the past few years. Inflation, unemployment, and capital scarcity have affected everyone. These difficulties have focused attention on the economic effects of government programs. Environmental programs in particular have come under close scrutiny in their effects on both jobs and prices. The changed economic climate makes it more important than ever to subject these programs to rigorous economic analysis.

Also *see* COUNCIL ON ENVIRONMENTAL QUALITY, ENVIRONMENTAL QUALITY: THE SEVENTH ANNUAL REPORT OF THE COUNCIL ON ENVIRONMENTAL QUALITY 150 (1976) [hereinafter cited as SEVENTH ANNUAL REPORT]:

> Concern about sufficiency of capital has grown during the last year. Will the economy be able to generate enough capital to make all the investments needed to satisfy our society's many goals—e.g., for a cleaner environment, energy self-sufficiency, more goods and services, and better housing?

See also COUNCIL OF ECONOMIC ADVISORS, ECONOMIC REPORT OF THE PRESIDENT 39-47 (1976).

2. *See, e.g.*, U.S. ENVIRONMENTAL PROTECTION AGENCY, THE ECONOMICS OF CLEAN WATER (1973); NATIONAL COMMISSION ON WATER QUALITY, STAFF DRAFT REPORT (1975); *The Economic Impact of Environmental Regulations: Hearings Before the Joint Economic Comm., Cong. of the U.S.*, 93d Cong., 2d Sess. (1974); U.S. ENVIRONMENTAL PROTECTION AGENCY, THE COST OF CLEAN AIR, ANNUAL REPORT OF THE ADMINISTRATOR OF EPA TO THE CONGRESS IN COMPLIANCE WITH PUBLIC LAW 91-604, THE CLEAN AIR ACT, AS AMENDED (1974); ENERGY & ENVIRONMENT GROUP, OFFICE OF PLANNING & EVALUATION, ENVIRONMENTAL PROTECTION AGENCY, THE ECONOMIC IMPACT OF EPA'S AIR AND WATER REGULATIONS ON THE

As this analysis has become more sophisticated, environmental costs have been classified into four basic categories: damage costs, avoidance costs, abatement costs, and so-called "transaction" costs.[3] Although official concern for pollution abatement costs dates from 1972,[4] and although increasingly frequent studies of this problem have subsequently been undertaken,[5] it has generally been recognized that this analysis is still in its infancy.[6]

Despite the difficulties of cost quantification and the recognition that forecast environmental costs are at best approximations, it seems clear that environmental costs will be a major factor affecting the national economy in the foreseeable future. Similarly, it is not feasible at this time to forecast with precision the captial investment that will be required by the private sector during the next decade and beyond to comply with existing federal environmental laws and regulations, and the various state and local requirements. The most recent comprehensive forecast was published by the Council on Environmental Quality (CEQ) in its 1976 Annual Re-

ELECTRIC UTILITY INDUSTRY, Vols. I-IV (1975); U.S. DEPARTMENT OF COMMERCE: THE EFFECTS OF POLLUTION ON INTERNATIONAL TRADE, Vol. I (1973), Vol. II (1974), Vol. III (1975).

3. COUNCIL ON ENVIRONMENTAL QUALITY, ENVIRONMENTAL QUALITY: THE FOURTH ANNUAL REPORT OF THE COUNCIL ON ENVIRONMENTAL QUALITY 74 (1973). The CEQ was created by Title II of the National Environmental Policy Act of 1969 (NEPA), 42 U.S.C. §§ 4321-47 (1970), for the purpose *inter alia* of developing and recommending programs and policies to the President to foster and promote the improvement of environmental quality. For enumeration of the duties and functions of the CEQ, *see id.* § 204, 42 U.S.C. § 4344 (1970). Under the CEQ cost classification, damage costs include such items as blighted crops, ill health, corrosion of buildings and the like. Avoidance costs include buying an air or water filtration system or the cost of moving to an unimpacted area. Abatement costs include those resources expended to reduce or eliminate pollution including indirect costs arising from the impact of these expenditures on economic growth, productivity or employment. Transaction costs include the value of resources allocated to research, planning, monitoring and similar activities necessary for pollution abatement.

4. *See* the summary relating to cost classification in SIXTH ANNUAL REPORT, *supra* note 1, at 496-532.

5. *See* note 2 *supra*.

6. SIXTH ANNUAL REPORT 496-511. For an account of the methodological difficulties of environmental cost quantification, *see* Whitney, *The Trade Act of 1974: Coping with Unequal Environmental Control Costs*, 16 B.C. INDUS. & COM. L. REV. 577, 585-92 (1975). *See also* ENVIRONMENTAL PROTECTION AGENCY, ENVIRONMENTAL NEWS, THE IMPACT OF ENVIRONMENTAL REGULATIONS ON CAPITAL MARKETS AND ON INDUSTRY CAPITAL-RAISING PROBLEMS 2 (1975) [hereinafter cited as EPA CAPITAL STUDY], in which it is candidly admitted that "EPA analysis of the impacts of capital requirements for pollution control has been quite limited so far and is limited by the state-of-the-art to only modest improvements."

port.[7] The CEQ estimates incremental[8] pollution control expenditures for the private sector alone during the period 1975-1984 will exceed $300 billion, of which approximately $275 billion will consist of capital investment and capital costs.[9]

This analysis considers legislative and regulatory options available to cope with future private sector capital requirements to meet both "conventional" and environmental needs. While by no means agreed as to the precise amount of these needs, virtually all studies indicate they will be immense and will place great strain on the national economy.[10]

Moreover, it must be recognized that these pollution abatement costs will tend to increase rather than decrease. The as yet unchecked force of inflation is of course one important factor contributing to this problem. More importantly, most existing statutory environmental abatement programs are structured in a way that progressively increases the stringency of environmental requirements and consequently their cost. For example, the incremental cost to achieve national secondary ambient air quality standards will undoubtedly significantly exceed the cost to achieve primary standards.[11] Furthermore, the law requires that once the

7. SEVENTH ANUAL REPORT, *supra* note 1.

8. Incremental costs are expenditures necessitated by designated federal environmental legislation beyond those expenditures that would have been made absent the legislation. The designated legislation includes air, water, radiation, noise and solid waste. Estimates for land reclamation, strip mining, coastal zone planning, ocean dumping, oil spills, pesticides and other environmental categories are not included. Likewise, the cost of compliance with state and local environmental laws and regulations is not included.

9. SEVENTH ANNUAL REPORT, *supra* note 1, at 167, Table 1-37.

10. B. BOSWORTH, J.S. DUESENBERRY, & A.S. CANON, CAPITAL NEEDS IN THE SEVENTIES (1975) (published by the Brookings Institution), the most optimistic study, concludes "[w]e can afford the future, but just barely." The Brookings forecasts are confined to the decade of the Seventies. The methodology of the Brookings forecasts excludes consideration of abatement costs for air pollution, radiation, solid waste, noise, land reclamation, strip mining, pesticides, coastal zone management and other categories including the cost of compliance with state and local programs. The New York Stock Exchange Study, probably the most pessimistic analysis, forecasts an overall capital gap of $650 billion during the period 1974-1985. EPA CAPITAL STUDY, *supra* note 6, at 4. CEQ in its most recent analysis posed the question, "[w]ill the economy be able to generate enough capital to make all the investments needed to satisfy our society's many goals—e.g. for a cleaner environment, energy self-sufficiency, more goods and services, and better housing?" CEQ noted "the answer is probably no." SEVENTH ANNUAL REPORT, *supra* note 1, at 150.

11. National primary ambient air quality standards are standards the attainment and maintenance of which are requisite to protect the public heath. National secon-

national ambient air quality standards are attained, they must then be maintained. This maintenance will necessitate an indefinitely ongoing comprehensive nationwide air quality maintenance program.[12] Furthermore, compliance with the judicially enunciated goal of no significant deterioration of the air quality in regions with air cleaner than that required by secondary standards will likewise create increasing direct and indirect incremental costs.[13]

The same cost augmentation phenomenon is built into the Federal Water Pollution Control legislation, which likewise envisions implementation of progressively more stringent standards culminating in the goal of eliminating discharges of all pollutants by 1985.[14] Like the clean air strategy, maintenance of water quality is required once the mandated goal is achieved. Here too, this maintenance will necessitate costly continued planning and regulatory strategies to accommodate the apparently inevitable national growth while yet adhering to the no discharge requirement.[15]

To date no environmental cost forecast methodology has evolved accurate indicia to measure this phenomenon of disproportionately increasing costs, but it is essential to consider this factor when considering what legislative, regulatory or other action is appropriate to devise effective capital formation and/or capital recovery strategies.

Before considering possible specific legal-legislative options for capital formation, two basic policy issues must be considered: first, whether it is appropriate for the federal government to assist the

dary ambient air quality standards are standards the attainment and maintenance of which are requisite to protect the public welfare from any known or anticipated adverse effects associated with the presence of such air pollutant in the ambient air. Clean Air Amendments of 1970, §§ 109(b)(1), (2), 42 U.S.C. §§ 1857c-4(b)(1), (2) (1970).

12. *Id.* § 110, 42 U.S.C. § 1857c-5 (1970).

13. Sierra Club v. Ruckelshaus, 344 F. Supp. 253 (D.D.C. 1972), *aff'd*, 412 U.S. 541 (1973) (no opinion). *See also* 39 Fed. Reg. 42510-17 (1974).

14. The Federal Water Pollution Control Act of 1972, 33 U.S.C. §§ 1251-1376 (Supp. V 1975), structures a progressively more stringent control program which requires by July 1, 1977, "the best practicable control technology currently available" and by July 1, 1983, "the best available technology economically achievable" which will result in "reasonable further progress" toward the elimination of all discharges of pollutants by 1985. *Id.* § 301(b), 33 U.S.C. § 1311(b) (Supp. V 1975).

15. *Id. See, e.g., id.* § 208, 33 U.S.C. § 1288 (Supp. V 1975) (areawide waste treatment management planning); *id.* § 209, 33 U.S.C. § 1289 (Supp. V 1975) (basin planning). Other examples of cost augmentation include the increasing cost of federal decision-making arising from judicially expanded NEPA requirements. Current aircraft noise abatement regulations pursuant to the Noise Control Act of 1972, 42 U.S.C. §§ 4901-4918 (Supp. V 1975), likewise involve increased incremental cost.

private sector to meet the costs of federally enacted environmental laws and regulations, and second, if it is determined that it is either necessary or desirable that the federal government assist private sector compliance, what form the assistance should take.

I. FEDERAL GOVERNMENTAL OPTIONS OR INTERNALIZATION OF ABATEMENT COSTS?—A CRITICAL NATIONAL DECISION

For the private sector to be able to alter its plants and processes to comply with existing environmental laws and regulations it must develop the funds to pay for abatement. The CEQ correctly recognizes that these costs and capital needs are "incremental"; that is, expenditures are necessitated by the designated federal environmental legislation beyond those "business as usual" expenditures that would have been made absent the legislation.[16] Consequently these incremental environmental requirements are *additional* to the so-called "conventional" capital requirements that are necessary to a growing and productive economy capable of assuring that the *other* vital national goals of adequate employment and containment of inflation are achieved. Given the forecast capital shortfall during the coming decade,[17] there is a distinct likelihood that rival claims on existing capital supply by the productive sector of the economy versus legally mandated environmental reform may well increase the cost of capital to the point that expansion of productive capacity and economic growth may be retarded with adverse effects on employment and the ability to control inflation. The Environmental Protection Agency (EPA) notes that "this spectre is particularly troubling because of the experience of 18-30 months ago when capacity shortages in the basic materials-producing industries seemed to throttle economic growth and spur inflation with unemployment at very high levels."[18]

Consequently, the nation is faced with the reality that *additional* capital formation methods (beyond those necessary to meet "conventional" needs) must be devised if we are to achieve the multiple national goals of a healthy economy and a protected environment.

Two basic possibilities of forming the necessary capital exist: (1) some form of federal assistance (grants, subsidies, tax incentives or "tax expenditures" of various kinds), or (2) "internalization" of en-

16. *See* note 8 *supra*.
17. *See* note 10 *supra*.
18. EPA CAPITAL STUDY, *supra* note 6, at 3.

vironmental costs by inclusion of the environmental increment into the pricing of goods and services to the consumer.

The CEQ has considered the option of imposing effluent charges set at a sufficiently high level to compel extraction of most of the pollutant, with the effluent charge being passed on to the consumer in the form of higher prices.[19] This option entails serious disadvantages. First, to "internalize" environmental costs of the magnitude involved by passing them to the consumer in the form of higher prices would aggravate the inflationary price spiral and create further stresses between labor and management. The environmental cost increment added to the price of goods and services would undoubtedly give rise to increased wage demands and the cost would in large part redound to industry in the form of higher labor costs. Moreover, imposition of effluent charges only indirectly addresses the critical problem of how to rid the environment of pollution. If a given plant simply pays the charge and continues to pollute then the pollution is not abated. If instead, the plant chooses to install appropriate abatement equipment and avoids the effluent charge the problem of how to obtain the capital to buy the abatement equipment remains unanswered.

An additional disadvantage of internalizing environmental costs is that to do so would further weaken the United States international trade position by further pricing United States goods out of competitive markets. The "distortions" arising from unequal environmental control costs incurred by the United States private sector vis-a-vis competitors from its eleven principal trading partners constitute a major national problem which Congress sought to address in the Trade Act of 1974.[20] Given the national commitment to contain inflation within acceptable limits, it is rather clear that the nation's pricing structure cannot be expected to absorb some 300 billion dollars of additional environmental costs.

Moreover, the CEQ concept envisions use of varying charge levels to achieve desired degrees of pollution abatement:

> Since the costs of removing any given pollutant presumably will vary as between processes, products and plants, a requirement of the same proportionate reduction, or a reduction to the same absolute level, would impose high costs on some and rela-

19. REPORT OF THE TAX POLICY ADVISORY COMMITTEE TO THE COUNCIL ON ENVIRONMENTAL QUALITY 21 (1973) [hereinafter cited as TAX POLICY REPORT].

20. *See* Whitney, *The Trade Act of 1974: Coping with Unequal Environmental Control Costs*, 16 B.C. INDUS. & COM. L. REV. 577 (1975).

> tively low costs on others. The same aggregate reduction in an area could be achieved by an effluent charge which will lead to substantial or very large proportionate reductions in pollution where that could be achieved relatively inexpensively, with little reduction where it was relatively more expensive to make improvements.[21]

To be effective, this system must produce a program of pollution abatement which results in compliance at any given time with statutory environmental standards. Coordination of a schedule of fees which might well vary from industry to industry and from plant to plant to produce pollution levels that comply with standards required by law would be extraordinarily difficult to determine accurately and costly to administer. Thus it would appear that "internalization" could not produce adequate net capital accretions and would create problems at least as troublesome as those it seeks to solve.

Finally, it seems clear that Congress by enacting the various environmental laws has elevated environmental protection to a major national policy not unlike public health (with which the environmental quality is closely related), law enforcement and national security. Consequently, whenever private sector compliance is either impossible as an economic matter, or is attainable only at the expense of major impacts on the national economy, it seems appropriate, in fact necessary, that public funds, whether in the form of so-called tax expenditures, in the form of tax incentives, or in the form of grants, guaranteed loans or subsidies, be used to achieve the national goal of environmental protection. Congress has repeatedly recognized this principle in its appropriation of grants for, *inter alia*, publicly owned treatment works, environmental planning, research and development, and monitoring systems.

II. ASSUMING FEDERAL FISCAL ACTION, WHAT FORM SHOULD IT TAKE?

Given the determination that federal fiscal action is preferable to "internalization" of environmental costs in the price structure, the *form* this federal action should take is controversial. Leaving out of account certain tax incentives devised to influence conduct that

21. TAX POLICY REPORT, *supra* note 19, at 21.

tends to have beneficial environmental consequences,[22] Professor Stanley Surrey[23] has identified two basic federal options:

1. "Direct government expenditure programs," a process under which programs are normally given direct and searching budget management evaluation (this would include grants, subsidies and loan guarantees).[24]

2. "Tax subsidies" or "tax expenditures," a process by which some program or project is financed by tax liability concessions of one kind or another (this would include investment tax credits, accelerated depreciation and tax exemption).[25]

Professor Surrey opposes "tax expenditures" because they "tumble into the law without supporting studies, being propelled instead by cliches, debating points, and scraps of data and tables that are passed off as serious evidence."[26] Apart from this rhetoric, it appears that Professor Surrey's *substantive* objections to use of the "tax expenditure" option are:

(1) That the need for programs supported by tax expenditures receives inadequate or at least less consideration than the need for direct expenditure programs;
(2) That the costs and benefits of a program are given less or inadequate consideration when tax expenditures are employed;
(3) That program effectiveness evaluation is less likely to occur when programs are supported by tax expenditures;
(4) That program objectives of tax expenditure programs are more apt to be obscure.[27]

Professor Surrey advocates that the antidote to ill-considered programs supported by tax expenditures is to "restate the tax program as a direct expenditure program and ask whether such a pro-

22. *See, e.g.*, S. REP. NO. 938, 94th Cong., 2d Sess. 24 (1976), which lists various energy related activities for which Congress through special tax provisions provides incentives to develop environmentally beneficial programs.

23. Professor Surrey is Professor of Taxation at the Harvard Law School and has served as Assistant Secretary of the Treasury for Tax Policy.

24. *Hearings on Tax Subsidies as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditure Before the Subcomm. on Priorities and Economy in Government of the Joint Economic Comm.*, 92d Cong., 1st Sess. 48-59 (1972) (statement of Stanley S. Surrey).

25. *Id.*

26. *Id.*

27. *Id.*

gram represents a desirable policy.[28] But even if the program when "directly" evaluated turns out to be a "desirable policy," Professor Surrey still believes that support of the program should be in the form of a direct expenditure program:

> Thus, for example, if it is decided that elimination of tax expenditures for natural resources should be accompanied by government assistance in oil and mineral exploration, the direct programs can be readily devised.[29]

Whether some, many or all tax expenditure programs in fact "tumble into the law" without the four-fold program evaluation Professor Surrey advocates is a question that need not be resolved herein. It is elementary good government that all programs should receive such evaluation regardless of what funding process is utilized. In the ensuing portions of this analysis devoted to consideration of the various capital formation and/or recovery options available through tax legislation such direct program evaluation will in fact be undertaken. Such direct evaluation demonstrates that adoption of improved investment tax credit measures, a special environmental investment tax credit system, and improved capital recovery measures are all essential to achieve the multiple national goals of a sound economy and environmental protection.

The fundamental dispute arises over the proposition that tax expenditure programs should or must be "translated" into direct government expenditure programs to be effective and accountable.

One of the primary realities that must be recognized is that the investment tax credit and the special environmental credit are not "tax subsidies." As shown hereinafter,[30] *neither* will produce any revenue dilution but rather, based on some fifteen years' experience, will *stimulate* treasury receipts due to the increased production of pollution abatement devices which thereby increases the private sector taxable basis.

In contrast, given the presence of perennial budget deficits, to address capital formation problems by direct grants would aggravate the federal deficit picture and necessitate further federal borrowing to obtain grant funds that would otherwise be available through tax credits without incurring interest charges. Thus a direct expenditure approach to the capital formation problem would

28. *Id.*
29. *Id.*
30. *See* notes 34-36 and accompanying text *infra*.

be more costly in absolute numbers of dollars and would contribute to increasing the national deficit. Moreover, the various investment tax credit provisions are virtually self-administering, thereby obviating the cost of additional grant administration personnel.

The importance of the foregoing is underscored by the fact that the federal government is already heavily involved in direct environmental grant programs that are increasing rapidly: $5.9 billion in 1975, $7.1 billion in 1976 (estimated) and $8.6 billion in 1977 (estimated).[31] Moreover, the federal government also expends substantial amounts to assist state and local governments in bearing their share of environmental abatement costs and programs. CEQ forecasts that the federal government will subsidize state and local governments by more than $3 billion between 1975 and 1983 quite apart from the above-noted grants.[32]

III. Capital Formation by Tax Legislation

A. *The Investment Tax Credit*

During the period 1962 through 1975, the various investment tax credit measures have provided an important source of capital for American industry. Experimentation with the investment credit during this period has demonstrated that it is a particularly effective means of controlling the level of capital supply thereby significantly affecting productivity, employment levels, and the rate of inflation.[33] Moreover, use of the investment credit can be made without incurring dilution of Treasury revenues.[34] The increased productivity resulting from investment credit expenditures increases the corporate income base and thus produces corporate tax revenues to the Treasury which substantially exceed revenue dilution. This factor was implicitly recognized by the Congress in it's recent enactment of the Tax Reform Act of 1976[35] which extended the existing investment credit until December 31, 1980 (which would otherwise have expired December 31, 1976).[36] In addition, there

31. Seventh Annual Report, *supra* note 1, at 349.

32. *Id.* at 151.

33. *See* R.H. Gordon & D.W. Jorgenson, Policy Alternatives for the Investment Tax Credit 13 (1975) [hereinafter cited as Policy Alternatives Study].

34. Internal Revenue Service, U.S. Dep't of Treasury, Tax Revenue Statistics (1961-1975).

35. Pub. L. No. 94-455, 90 Stat. 1520 (1976).

36. Tax Reduction Act of 1975, § 301(a)(1), 26 U.S.C. § 46(a)(1) (Supp. V 1975),

is a long-lasting continued increase in budget revenues as a result of the investment tax credit.

While a four year extension constitutes some progress, it is evident that *indefinite* extension of investment credit provisions is a minimum essential merely to accommodate *existing non-environmental* capital needs. Former Secretary of the Treasury Simon recently stressed the serious effects of corporate borrowing, which has sharply increased during the past decade as internally generated corporate funds and equity financing fell short of meeting capital needs.

> One of the factors which can inhibit the future growth of needed capital formation is the financial condition of American corporations. Analysis of debt-equity ratios indicates that corporate balance sheets have shown signs of deterioration over the past decade, which is a break from the pattern which persisted in earlier periods. Debt has increased dramatically, both in absolute terms and relative assets and income. Interest costs have risen appreciably, roughly doubling over the past ten years. The combination of increased debt financing and higher interest rates has resulted in a decline in the coverage ratios reported by American corporations—that is, the ratio of earnings to interest charges. The ratio of liquid assets to debt has shrunk. As a result of these developments, there is a serious question about the potential capability of companies to be able to finance the capital investment that will be required to achieve our basic economic goals of reducing unemployment and inflation as I outlined earlier in my testimony.[37]

The investment credit device offers significant advantages. First, the taxpayer is entitled to the credit *only* when the proceeds are in fact used for the designated statutory purpose thereby assuring that the purpose of the credit is achieved. It thus possesses the advantage of being for all practical purposes self-administering, unlike direct government expenditure programs.

Second, the investment credit is a highly effective means of "capital deepening" and can, over the years, contribute significant-

amended by Tax Reform Act of 1976, Pub. L. No. 94-455, § 802(a), 90 Stat. 1580. *See* H. CONF. REP. NO. 1515, 94th Cong., 2d Sess. 443 (1976). The Tax Reduction Act of 1975 had increased the prior level from seven percent (four percent for certain utility property) for qualified investments to ten percent. Tax Reduction Act of 1975, § 301, 26 U.S.C. § 46 (Supp. V 1975).

37. *Tax Reform Act of 1976: Hearings on H.R. 10612 Before the Senate Comm. on Finance*, 94th Cong., 2d Sess. 2367 (1976) (statement of William Simon, then Secretary of the Treasury).

ly to the capital base of the economy that will be necessary for increased productivity and employment, and containment of inflation to an acceptable rate. To achieve these goals the investment credit must be both adequate in amount and of sufficiently long duration.

As to the amount, Congress in its wisdom in the Tax Reform Act determined that 10 percent was appropriate during the period through December 31, 1980. Yet virtually every responsible economic forecaster predicts that the "capital gap" will increase during the next decade and probably for the remainder of the century.[38] It would have been more consonant with economic realities had Congress followed the Senate bill[39] and enacted an investment credit provision of indefinite duration. Moreover, such investment credit should be structured to increase in amount from the basic irreducible 10 percent to higher rates which would generate increasing capital necessary to maintain acceptable levels of productivity and employment. By such a system the amount of investment credit could be adjusted to keep pace with capital requirements without resort to the time-consuming process of enacting new tax legislation periodically, and in addition the long term continuity that is essential would thereby be provided. Experience with the Tax Reduction Act of 1975 demonstrates that due to long lead times in obtaining heavy equipment, there must be a long term investment credit program if companies are to utilize the credit effectively.

The Tax Reform Act of 1976 contains other important provisions that facilitate capital formation. Congress modified the prior limitation of the investment credit to $25,000 of tax liability plus 50 percent of liability in excess of $25,000[40] and provided a three year carry-back and a seven year carry-forward for credits not used due to the above-noted limitations.[41] Under this system, credits accruing in a given taxable year are applied against the tax liability for that year before any carry-overs or carry-backs of unused credits from other taxable years become applicable.

In addition, under the 1976 Act a so-called "first-in first-out" method of handling investment credits was adopted. Thus in a

38. *See* note 10 *supra*.

39. *See* S. REP. NO. 94-938, 94th Cong., 2d Sess., pt. 1 at 17-18 (1976).

40. Tax Reform Act of 1976, Pub. L. No. 94-455, § 802(a)(2), 90 Stat. 1581, *amending* 26 U.S.C. § 46 (1970), *as amended* (Supp. V 1975).

41. Tax Reform Act of 1976, Pub. L. No. 94-455, § 802(b)(2), 90 Stat. 1582. A ten year carry-forward is available for unused pre-1971 credits.

given taxable year the *oldest* pending credit is used first, the next oldest next, and so on.[42] The effect of this provision is to enhance the likelihood that credits will be fully utilized by effectively extending the duration of credit eligibility. Lengthening the potential duration of earned credits likewise increases somewhat the possibility that uprofitable or marginally profitable companies may utilize such credits.

B. *Environmental Investment Tax Credit*

Prior to enactment of the Tax Reform Act of 1976, federal tax provisions provided little in the way of "tax expenditures" to meet pollution control capital requirements. One such provision provides that the interest earned on industrial development bonds shall not be included in the gross income of the bondholder if he either qualifies as an "exempt person" (*i.e.*, an Internal Revenue Code Section 501(c)(3) entity exempt from tax under Section 501(a)) or if substantially all of the proceeds of the bond are used, *inter alia*, (A) for sewer or solid waste disposal facilities, or (B) for air or water pollution control facilities.[43] However, provision (A) may well (among other disadvantages and limitations) actually encourage waste disposal rather than recycling; and as to air and water pollution control facilities, most if not all bond proceeds would inure to the benefit of state or local governments rather than meeting private sector needs.[44]

The other "environmental" provision prior to passage of the 1976 Act allows "every person" to elect five year amortization for "any certified pollution control facility" which is "a new identifiable treatment facility which is used, in connection with a plant or other property in operation . . . to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, or storing of pollutants, contaminants, wastes or heat" if both the

42. *Id.* § 802(a), 90 Stat. 1580.

43. I.R.C. § 103(c).

44. One article forecast that during the period 1973-1980 approximately 25 percent of an estimated capital requirement of $26 billion might be derived by industrial development bonds. BUS. WEEK, July 29, 1972, at 51. Whatever may be said of the accuracy of these forecasts it is clear that such funds as are derived will not be available to meet or provide a substitute for private sector capital needs. A minor possible exception would be a situation in which a private corporation purchased either a recycling facility or an air or water pollution facility (both would have to be available for general public use) and under I.R.C. § 48(h)(12) obtained an investment credit and took depreciation under either section 167 or 169. Such situations must be rare if they occur at all.

state and federal "certifying authorities" approve.[45] By virtue of the definition of "new identifiable treatment facility" this five year amortization can be elected only as to "tangible property" (not including a building and its structural components, other than a building which is exclusively a treatment facility) which is of a character subject to the allowance for depreciation provided in section 167 "but only if the construction is completed after December 31, 1968 and placed in service before January 1, 1976.[46] The amortizable basis of such a facility was not eligible for the investment credit.[47]

The 1976 Act provides for two significant improvements:

1. As to qualifying facilities constructed after January 1, 1969, but before January 1, 1976, the taxpayer can elect a five year amortization plan *and* take one-half the investment credit provided the investment did not lead "to a significant increase in output or capacity, a significant extension of useful life, or a significant reduction in total operating costs for such plant or other property (or any unit thereof), or a significant alteration in the nature of a manufacturing production process or facility."[48]

2. As to qualifying facilities placed in service after December 31, 1976, the taxpayer can elect *both* a five year amortization schedule *and* an investment credit not to exceed two-thirds of the 10 percent standard investment credit.[49].

Adoption of the principle of a special environmental investment credit by the Congress is of the utmost importance. As already noted[50] it is highly doubtful the capital formation produced by the

45 I.R.C. § 169.

46. *Id.*

47. H.R. REP. NO. 1515, 94th Cong., 2d Sess. 498 (1976).

48. *Id.* "Significant" was deemed by the Conferees to mean a change of more than five percent, a standard applied to the operating unit most directly associated with the pollution control facility.

49. *Id.* at 498-99. To achieve maximum capital formation it is essential that investment credit provisions and depreciation rates be coordinated rather than working against each other. When the tax credit was first implemented in 1962, the so-called Long amendment subtracted credit claims from the basis used to calculate depreciation schedules. The effect was to dilute total capital recovered and was thereby counterproductive to the objective of maximizing capital supply. The provision was deleted in 1964 in part because it substantially complicated calculation of depreciation writeoffs. Apart from administrative complications, the subtraction of credits from basis is essentially self-defeating. It must be recognized that any constraint on achieving total available investment credits runs counter to basic capital formation goals and should be avoided.

50. *See* note 44 and accompanying text *supra*.

standard investment credit provision of section 802 will be sufficient to meet future needs and, as suggested above, should be keyed flexibly to increasing capital requirements. Without special provision for an environmental investment credit to meet capital requirements created by private sector compliance with federal environmental laws and regulations, an unhealthy competition for capital would arise which would both impede productivity and related employment and thwart or delay unduly compliance with national environmental objectives. In this latter connection it should be stressed that a number of environmental statutes condition compliance and attainment of standards upon economic practicability.[51] Hence congressional recognition of the need for special environmental investment credits is of landmark significance.

It should be further noted that were Congress to adopt the "sliding scale" approach to the regular investment credit, as advocated, the special environmental credit for qualifying facilities placed in service after December 31, 1976, which amounts to two-thirds of the regular credit would likewise escalate when the regular credit escalated to meet increased capital needs.

Although Congress in the 1976 Act expanded somewhat the definitional scope for qualifying facilities, it still remains unduly circumscribed. The credit should be available not only for pollution abatement equipment and buildings that are entirely pollution abatement facilities, but for other buildings and structures as well. The credit should extend to environmentally designed production facilities and processes as well if reform objectives are to be realized. In future years when the national air and water quality goals have, hopefully, been reached, then the predominant regulatory objective will be the maintenance of these standards. Necessarily, with anticipated growth in population and industrial activity, air and water quality maintenance objectives will be feasible only by fundamental redesign of many plants and processes. Extension of investment credits for plants would provide a needed stimulus to phase out existing operations which are costly and not optimally feasible to modify, and to replace these with environmentally designed plants better capable of achieving future standards at acceptable maintenance and operation cost levels. It is

51. *See, e.g.*, note 14 *supra*. The Noise Control Act of 1972, 42 U.S.C. §§ 4901-4918 (Supp. V 1975), and the Clean Air Amendments of 1970, 42 U.S.C. §§ 1857-1857*l* (1970), also contain economic conditions.

widely recognized that the incremental cost of achieving higher levels of environmental purity mounts steeply as stricter goals are met and maintained.[52] In the long run it will thus be cheaper to convert to plants and processes which have been designed to achieve a high degree of environmental protection rather than continue to "fix," or modify or retrofit, existing plants to meet and maintain increasingly stricter standards.

To be fully effective, tax incentives should be available for *any* control facility or abatement procedure required by federal, state or local environmental laws or regulations. Accordingly, existing law should be amended to include a broad tax incentive definition, such as:

> The term "pollution control facility" means any facility (including buildings and equipment) the primary purpose of which is to abate, control or prevent actual or potential environmental pollution.

While air and water pollution control at present appears to comprise the major portion of forecast environmental cost, Congress has enaeted extensive legislation addressed to other kinds of pollution.[53] Abatement strategies for stripmining, solid waste, pesticides, oil spills, ocean dumping and other categories are in their infancy. As regulatory programs in these areas are developed, significant additional costs will undoubtedly result. Congress, therefore, should provide for comprehensive environmental tax incentives keyed to the full range of environmental protection and reform programs that it has enacted.

While there has as yet been no actual experience with implementation of the environmental tax credit, available data suggests it will offer all the same advantages that the conventional credit provides. Like the conventional credit, the environmental credit program is self-administering and avoids the cost of grant administration personnel. Furthermore, recent CEQ economic studies conclude that funds spent on environmental abatement will not only significantly enhance the productivity of existing firms that manufacture or build abatement equipment and facilities but will attract new private sector activity as well.[54]

52. *See* TAX POLICY REPORT, *supra* note 19, at 20.

53. *See* note 8 *supra*.

54. COUNCIL ON ENVIRONMENTAL QUALITY, ENVIRONMENTAL TAX PROGRAM AND EMPLOYMENT 1 (1975): "Environmental programs are stimulating construction,

While these CEQ studies do not undertake to quantify the amount by which Treasury tax receipts are increased by the new economic activity stimulated by the "environmental industry," CEQ does estimate "that approximately 300,000 people are now employed who would not otherwise be."[55] CEQ adopted a rule-of-thumb indicator that a billion dollar expenditure generates directly or indirectly about 70,000 jobs.[56] Thus given the expenditure of the forecast private sector environmental capital requirements during the period 1975-1984,[57] it is evident that the federal tax base will be expanded enormously, and such expansion will increase the Treasury tax revenue yields as well. Thus there is every reason to conclude that the revenue yield history of the conventional investment credit will also hold true for the environmental tax credit.

Moreover, since it is virtually universally conceded that a protracted period of capital shortage will prevail, it is evident that without the environmental tax credit, every investment dollar diverted from "conventional" production activity to meet legally mandated environmental requirements will thereby increase the expected capital gap and so contribute to less productivity, lower employment and, correspondingly, less tax revenues.

Finally, to the extent that the special environmental credit contributes to the ability of United States industry to compete effectively costwise with our eleven leading trade partners, the credit will contribute to solution of the "distortion" problem arising from unequal United States versus foreign environmental costs without recourse to import relief measures.[58]

equipment, and research expenditures that would not otherwise be undertaken." *See also*, COUNCIL ON ENVIRONMENTAL QUALITY, POLLUTION CONTROL AND EMPLOYMENT 8 (1976):

> In brief then, pollution control expenditures are seen as having a net positive impact on employment at the present time. And a new industry has been established which has been a source of growing employment during the past few years. This industry has the opportunity and challenge to devise innovative abatement systems which will conserve natural resources, save energy, and reduce costs. If it is successful in meeting this challenge, this industry will not only provide a source of continuing employment itself, but will help contribute to the continued viability and stability of our whole economy.

55. COUNCIL ON ENVIRONMENTAL QUALITY, POLLUTION CONTROL AND EMPLOYMENT 8 (1976).

56. *Id.* at 7.

57. *See* note 10 and accompanying text *supra*.

58. *See* note 20 and accompanying text *supra*.

C. *Accelerated Capital Recovery*

As with investment credits, United States policy with respect to capital recovery provisions must take into account both the so-called conventional needs of the economy to achieve increased productivity and employment and the special demands resulting from environmental pollution abatement. Despite the recent upturn in the United States economy, certain basic long-term indicators suggest that major increases in investment will be necessary to restore its vitality. The United States has lagged significantly behind other industrialized nations in terms of productivity growth during the period 1960-1973.[59] This trend is particularly ominous because in the past the United States has been able to preserve viable market shares against foreign competition despite price disadvantages by virtue of superior worker productivity.[60]

A similarly bleak trend is evident in the comparative real gross national products (GNP) per employed civilian of several nations during the period 1950-1972. The declining worker productivity in the United States has produced a condition in which the GNP per worker in the United States has fallen below that enjoyed by such nations with troubled economies as Great Britain, France and Italy. Given the well-established relationship between the level of investment and growth, it is clear that expanded capital recovery provisions are necessary to augment capital supply and production investment to counter these trends. It is no coincidence that virtually all of the industrialized nations have more liberal capital recovery provisions than those presently in force in the United States under the Asset Depreciation Range (ADR) System.[61] These facts suggest the immediate need to increase the permissible range under the ADR System for depreciating capital assets from 20 percent to a significantly higher level.

A further important corrective measure would be the elimination of the salvage increment in depreciation schedules. During periods of inflation, depreciation allowances based on original cost fail to recover capital adequate to finance facilities having significantly higher replacement costs. Moreover, during such inflationary periods corporate profits, unless adjusted for inflation, are over-

59. INTERNAL REVENUE SERVICE, U.S. DEP'T OF TREASURY, TAX REVENUE STATISTICS (1961-1975).

60. U.S. DEP'T OF LABOR, BUREAU OF LABOR STATISTICS (1960-1973).

61. Treas. Reg. § 1.167(a)-11 (1971).

stated. It has heretofore been noted[62] that the inability to generate sufficient capital from corporate profits has weakened the economy by creating increasing dependence on debt financing with resultant deterioration of debt-equity ratios. This shortfall in capital recovery during a period of higher replacement costs and declining profits is aggravated by inclusion of a salvage factor in depreciation schedules. It must be recognized that the salvage increment is a holdover from the archaic policy of gearing depreciation schedules to the actual life of assets. Retention of such anomalies in the tax law impedes attainment of adequate capital supplies and is thus counterproductive.

Given the magnitude of capital requirements to increase productivity and employment, the additional drain on capital funds created by environmental requirements mandates special treatment. Pollution control costs have increased and are forecast to continue to increase dramatically. The CEQ study notes that expenditures for pollution control totalled $12.3 billion for capital expenditures in 1974, and that these are forecast to reach $27.5 billion for operating and maintenance and $27.8 billion for capital expenditures in 1983.[63] In view of the increasingly high incremental cost of attaining progressively stricter goals that are structured into major existing environmental laws, these estimates may indeed be low.

IV. CONCLUSION

For at least the remainder of this century the United States faces uniquely complex and difficult challenges. It must cope with already well-established trends of declining productivity, inflation and unemployment. To do so, adequate domestic energy resources must be developed at economically viable levels and industrial productivity must be expanded. Both goals also involve major impacts on the environment which will be increasingly costly to control within acceptable limits. What constitutes acceptable limits has been defined by Congress in terms of legal deadlines established by comprehensive legislative and regulatory programs. These programs were structured by Congress to impose progressively more stringent standards which will become increasingly costly to achieve. Moreover, environmental control programs are likely to

62. *See* note 37 and accompanying text *supra*.

63. SIXTH ANNUAL REPORT, *supra* note 1, at 564.

expand—*e.g.*, to protect more effectively ocean, outer continental shelf and coastal resources. Significant additional effort will be required in the areas of research, planning and environmental design.

All of these efforts must be undertaken and implemented contemporaneously. Consequently, the government must devise capital formation and recovery provisions capable of financing *all* of these deeply interrelated activities. At a minimum the following program appears to be indispensable:

1. Continuation on an indefinite basis of existing investment credit provisions amended to provide sliding scale adjustments to reflect changes in capital requirements.

2. Adoption of the perfecting amendments to existing investment credit provisions.

3. Continuation of the special investment credit for environmental control expenditures keyed to the level of the standard investment credit as adjusted by the sliding scale procedure.

4. Reform of existing capital recovery provisions for non-environmental investment.

5. Expensing in the year invested rather than depreciating facilities installed pursuant to environmental requirements.

Anything short of this multi-dimensional program will seriously jeopardize the prospects for attaining one or more indispensable national goals. With the exception of certain suggested improvements the validity of all of the foregoing has been recognized in principle by the Congress in the Tax Reform Act of 1976. These measures have in fact been carefully scrutinized, their costs and benefits weighed, and the ultimate program objectives considered. Important improvements and refinements remain to be made but it is clear that the tax legislative approach is a far sounder method of coping with capital formation requirements and offers many more advantages than the direct government expenditure alternative.

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