S. HRG. 99-246, Pt. X

TAX REFORM PROPOSALS—X

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

JUNE 27, 1985

(Economists)

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

51-236 O WASHINGTON : 1986

COMMITTEE ON FINANCE

BOB PACKWOOD, Oregon, *Chairman*

ROBERT J. DOLE, Kansas
WILLIAM V. ROTH, JR., Delaware
JOHN C. DANFORTH, Missouri
JOHN H. CHAFEE, Rhode Island
JOHN HEINZ, Pennsylvania
MALCOLM WALLOP, Wyoming
DAVID DURENBERGER, Minnesota
WILLIAM L. ARMSTRONG, Colorado
STEVEN D. SYMMS, Idaho
CHARLES E. GRASSLEY, Iowa

RUSSELL B. LONG, Louisiana
LLOYD BENTSEN, Texas
SPARK M. MATSUNAGA, Hawaii
DANIEL PATRICK MOYNIHAN, New York
MAX BAUCUS, Montana
DAVID L. BOREN, Oklahoma
BILL BRADLEY, New Jersey
GEORGE J. MITCHELL, Maine
DAVID PRYOR, Arkansas

WILLIAM DIEFENDERFER, *Chief of Staff*
MICHAEL STERN, *Minority Staff Director*

CONTENTS

PUBLIC WITNESSES

ADDITIONAL INFORMATION

TAX REFORM PROPOSALS—X

THURSDAY, JUNE 27, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m. in room SD-215, Dirksen Senate Office Building, Hon. Charles Grassley presiding.

Present: Senators Roth, Chafee, Symms, Grassley, Bentsen, Baucus and Bradley.

[The press release announcing the hearing follows:]

[Press Release]

CHAIRMAN PACKWOOD ANNOUNCES FINANCE TAX REFORM HEARINGS

Senator Bob Packwood (R-Oregon), Chairman of the Committee on Finance, today announced further Committee hearings in June on President Reagan's tax reform proposal.

Chairman Packwood announced the second five days of hearings, as follows:

On Wednesday, June 19, 1985, the Committee will receive testimony from witnesses representing taxpayer organizations and public interest groups.

The Committee will hear from public witnesses on the impact of the tax reform proposal on capital formation on Thursday, June 20, 1985.

On Tuesday, June 25, 1985, invited witnesses will discuss the issue of whether the tax-exempt use of industrial development bonds ought to continue.

On Wednesday, June 26, 1985, public witnesses will testify on research and development tax credits, and venture capital formation.

The Committee will receive testimony from economists on the impact of the President's tax reform proposal on the economy on Thursday, June 27, 1985.

All hearings will begin at 9:30 a.m. and will be held in Room SD-215 of the Dirksen Senate Office Building.

Senator GRASSLEY. I'm Senator Grassley from Iowa. I am a member of the committee and I have been asked by Senator Packwood in his temporary absence to open the hearing. I have no opening statement so I will go immediately to the witnesses, to be heard in the order that they appear on the list.

We have Alan Greenspan, Henry Aaron, Michael Boskin, and John Makin. And I would ask that we start with Dr. Greenspan.

STATEMENT OF DR. ALAN GREENSPAN, PRESIDENT, TOWNSEND-GREENSPAN & CO., INC., NEW YORK, NY

Dr. GREENSPAN. Thank you very much, Mr. Chairman.

I will be brief, but request that my full testimony be made part of the record.

Senator GRASSLEY. Yes, it will be. Your entire statement will be included in the record and we would ask that you summarize in 5 minutes. The yellow light comes on at the fourth minute, and the red light is the fifth minute.

So proceed, Dr. Greenspan.

Dr. GREENSPAN. Thank you, Mr. Chairman.

The President's proposed tax simplification bill goes a long way to eliminating the uneconomic distortions currently embodied in our Internal Revenue Code. It is certainly not perfect, but then taxation never is. Nonetheless, I believe this bill deserves the support of the Congress.

Because of the exceptionally detailed number of changes in the Internal Revenue Code being suggested by the President, I will limit my comments this morning to just a few issues.

The President's proposal to eliminate the investment tax credit and to lengthen depreciation deductions would likely reduce investment and economic activity in the short run. Over the longer run, however, a much sounder economy is likely to result as a consequence of the shift away from tax subsidies. Unsubsidized capital investment is on the margin likely to be significantly more productive than investment which has to be subsidized through tax preferences. There is a close correlation between pre-tax earnings generated from a facility and its degree of productiveness. In fact, the real rate of return on a facility tends to be determined by improved labor productivity and/or increased capacity. If all investments were made on the basis of pre-tax earnings with depreciation reflecting true economic wear and tear, then capital would be directed toward those investment which have the highest marginal productivity. Even investments which are initiated solely because of the investment tax credit, however, usually create some increase in productivity or capacity. The issue generally is that they produce less than projects which meet the required cost of capital.

The only current valid argument for tax subsidization is that the cost of capital is inordinately high on a temporary basis and subsidies merely simulate the market conditions which would exist under more normal cost of capital situations. There appears to be some substance to that argument at the moment, but if the budget deficit can be brought down, and long-term interest rates and capital costs fall, even this argument fades. Under those conditions, of course, no subsidized investment would be needed either.

Changes in incentives created by the new tax rate structure and broadening the tax rate will induce very substantial changes in the market value of assets, which I consider a critical aspect of an evaluation of this bill.

Just as farm subsidies are capitalized in the market value of farmland so are tax subsidies capitalized in the value of all forms of properties. In this sense, real estate market values are higher than they would otherwise be without the tax preferences currently in the code, and their removal will eventually bring down the values of real estate relative to other assets. Indeed, many of the property value changes would occur as soon as the markets believe that the passage of something similar to this bill was likely.

For example, commercial real estate construction is likely to be impacted more negatively than one would assume based strictly on the change in the prospective cash flows and rates of return under the new tax regime. The expectation of declining property values could, for a while, induce a pullback in activity even greater than that which would be assumed in the context of tax changes and cash flows themselves. There also may be some modest upward pressure on commercial and residential rents, although new owners coming in at lower property values, and hence less equity requirements, would enjoy a benefit which partially offsets the loss of tax benefits and would limit the upward pressure on rents.

The market value of owner occupied residential real estate will be pulled in both directions. Modest upward pressures on rents will tend to encourage homeownership and enhance values. Downward pressure will result from eliminating the deductibility of State and local real estate taxes. The net impact is likely to be to depress prices of owner-occupied residences somewhat. The geographical differences, however, are likely to be quite significant, with the pressures in New York State, and especially in the city, being far more negative than those experienced nationally. Overall, however, the response is apt to be small.

I go on further to review the impact on stock prices, which I suspect to be marginally higher under this bill as a consequence of it. I go on to discuss the issues of what occurs in some of the rust belt areas of the economy. And, finally, I raise some very serious questions about the whole issue of windfall depreciation benefits recapture, which I believe raises some fundamental questions with respect to taxing windfall benefits generally, which also raises the question of whether in fact hold harmless not only investment when taxes go down, but also when it goes up. I think that's the type of policy which I don't believe the Congress would like.

Thank you, sir.

Senator GRASSLEY. Thank you, Dr. Greenspan.

[The prepared written statement of Dr. Greenspan follows:]

Excerpts from the Testimony of Alan Greenspan*

Before

The Committee on Finance

United States Senate

June 27, 1985

....

The President's proposed tax simplification bill goes a long way to eliminating the uneconomic distortions currently embodied in our Internal Revenue Code. It certainly is not perfect, but then, taxation never is. Nonetheless, this bill deserves the support of the Congress. Some legislation can be significantly altered without changing its fundamental structure. A tax simplification bill of this scope and complexity, however, in which all parts depend on all other parts, must, with only minor revisions, be subject to an up or down vote. There are many provisions I like about this bill and many I don't, but in total it is a good bill.

Because of the exceptionally detailed number of changes in the Internal Revenue Code being suggested by the President, I will limit my comments this morning to the bill's impact on the economy, on market values, and on economic efficiency.

The President's proposal to eliminate the investment tax credit and to lengthen depreciation deductions would likely reduce investment and economic activity in the short run. Over the longer run, however, a much sounder economy is likely to result as a consequence of a shift away from tax subsidies. Unsubsidized capital investment is, on the margin, likely to be significantly more productive than investment which has to be subsidized through tax preferences. There is a close correlation between the pretax earnings generated from a facility and its degree of productiveness. In fact, the real rate of return on a facility tends to be determined

*Dr. Alan Greenspan is President of Townsend-Greenspan & Co., Inc.

by improved labor productivity and/or increased capacity. If all investments were made on the basis of pretax earnings, with depreciation reflecting true economic wear and tear, then capital would be directed toward those investments which have the highest marginal productivity. Even investments which are initiated solely because of the investment tax credit, however, usually create some increase in productivity or capacity. The issue generally is that they produce less than projects which meet the required cost of capital.

An investment whose pretax rate of return is otherwise too low can become desirable for an individual company if lower taxes boost its after-tax rate of return. The investment tax credit, for example, is an effective means of inducing business to invest in capital equipment even when that equipment fails to meet the test of pretax rate of return on an unsubsidized basis.

The only current valid argument for tax subsidization is that the cost of capital is inordinately high on a temporary basis and subsidies merely simulate the market conditions which would exist under more normal cost of capital situations. There appears to be some substance to that argument at the moment, but if the budget deficit can be brought down, and long-term interest rates and capital costs fall, even this argument fades. Under those conditions, of course, no subsidized investment would be needed either.

Even if we eliminate tax preferences on investments, the playing field is still less than level owing to accounting conventions of long standing. While the proposed bill commendably endeavors to move depreciation charges into a more realistic relationship to true economic lives, as best these can be estimated, it must be remembered that there are, nonetheless, many quasi-capital investments which have always been expensed and, indeed, are still treated in this way. We write off capital investment over a series of years on the grounds that such investments produce income over a comparable time period. This is also true, however, for many expensed outlays such as research and development, institutional advertising, work force training, etc. The crucial question is whether the particular expenditure is directed at immediate earnings or future earnings. Obviously, expensing is appropriate as a charge against those activities which are endeavoring to produce profit immediately. In principal, write-offs should match the timing of the profit producing characteristics of the activity. In this regard, there is no fundamental difference between a brick-and-mortar facility, which lasts fifteen years, and research and development activities which produce a product and profit over the same time frame. Institutional advertising and work force training clearly have much of the same characteristics. Many companies which report high effective corporate tax rates do so not because their taxes are high, but because the reported pretax profits are low owing to the expensing of a large number of activities which are directed toward the production of future income. Many companies have low reported implicit tax rates because their expensing relative to their depreciation charges is low.

We know that removing tax subsidies from the capital investment process will improve the efficiency of the economy and ultimately the level of output in the long run, but the evaluation of short-term impacts is more difficult. The number and magnitude of the changes in President Reagan's proposed tax bill are too great to be evaluated easily by our existing macroeconomic models. Macromodels can effectively evaluate only changes made at the margin, that is, small tax changes and/or small expenditure changes. Policy innovations which create abrupt changes in the incentive structure, which the President's bill surely would do, present far more difficult analytic problems. By design, macromodels endeavor to reflect the near-term implications of the most recent past. The immediate future under this proposed new tax regime, however, would be substantially different from the economic and mathematical conditions upon which these models are based. That will make it difficult to get anything but a judgment of gross impact. Matching pluses and minuses suggests that the short-term impact of the tax bill on the economy would be mildly negative. It's difficult to be more precise since in this tax bill we have to deal not only with changes in cash flows, changes in after-tax incomes, and changes in incentives created by the new rate structure and broadened tax base, but also with the very substantial changes in the market value of assets which would occur following passage of the bill.

Just as farm subsidies are capitalized in the market value of farm land, so are tax subsidies capitalized in the value of all forms of properties. In this sense, real estate market values are higher than they would otherwise be without the tax preferences currently in the Code, and their removal will eventually bring down the values of real estate relative to other assets. Indeed many of the property value changes would occur as soon as the markets believed that the passage of something similar to this bill was likely. For example, commercial real estate construction is likely to be impacted more negatively than one would assume based strictly on the change in the prospective cash flows and rates of return under the new tax regime. The expectation of declining property values could, for awhile, induce a pullback in activity even greater than that which would be assumed in the context of tax changes and cash flows themselves. There also may be some modest upward pressure on commercial and residential rents, although new owners coming in at lower property values, and hence less equity requirements, would enjoy a benefit which partially offset the loss of tax benefits and would limit the upward pressure on rents.

The market value of owner occupied residential real estate will be pulled in both directions. Modest upward pressure on rents will tend to encourage homeownership and enhance values. Downward pressure will result from eliminating the deductability of state and local real estate taxes. The net impact is likely to be to depress prices of owner occupied residences somewhat. The geographical differences, however, are likely to be quite significant, with the pressures in New York State, and especially in New York City, being far more negative than those experienced nationally. Overall, however, the response is apt to be small.

The impact of the tax bill on common stock values will be important in tracking the future of capital investment in the next year or two. The pricing of stocks is, of course, far more important to the economy than the mere casino characteristics of the stock exchange. As the measure of the underlying market value of existing plant and equipment in our economy, high stock prices create significant incentives for new capital investment. Certainly a reduction in the marginal tax rate on dividends as well as a lower capital gains tax rate would, other things equal, enhance price earnings ratios. In the short term, of course, after-tax earnings of American corporations are likely to be curtailed moderately under the proposed tax structure. Since the longer term profit outlook as a consequence of the tax bill is less negative, however, there is at least the possibility that stock evaluation might look beyond this dip in earnings and thereby create an improved outlook for stock values. Hence the outcome of the clash between lower short-term earnings and better price earnings ratios has considerable significance for the level of economic activity.

The major adverse impact of the tax bill is likely to be in manufacturing industries which have already been significantly depressed by high interest rates and the strong dollar. The average increase in corporate taxation under this bill is far greater for these groups, which depend heavily on the investment tax credit, than for the more service related or high tech industries. Effective tax rates for many companies would rise rather substantially. These include companies which have, through safe harbor leasing provisions, purchased tax credits to lower their effective tax rates, as well as companies with low pretax operating earnings and large capital investments.

One particular provision of the President's proposal which has created considerable concern in the business community is the windfall depreciation benefits recapture. One can obviously argue, as indeed the Treasury does, that capital investments made since 1981 would be facing virtually the same tax rates that existed at the time they were implemented. That, of course, is true only if investment tax credit carryovers follow current law. Technically, such investments were made not only with the 46% marginal tax rate in mind, but also with the full effect of the investment tax credit either taken currently or contemplated as a carryover benefit. Unless I have missed it in the 461 page explanatory Treasury document, no mention is made concerning preservation of investment tax credit carryovers.

A more difficult problem for this provision is the initiation of windfall recapture in only one segment of the tax law. There are, of course, innumerable tax windfalls from lower rates which the current bill does not endeavor to recapture. Investments made in long-term securities with the expectation of being taxed at the 46% rate will achieve a higher after-tax rate of return as a consequence of the tax cut. Similarly, expensed research and development outlays made in the past create a windfall as a consequence of the lower tax rate applied to earning which will flow from them in the future, but the Treasury does not endeavor to recapture this windfall. Any tax revision as comprehensive as this one must create a variety of windfall gains and losses. While it may be deemed necessary for total revenue purposes, singling out one such situation for application of a recapture provision is a disturbing feature of this particular tax program.

STATEMENT OF DR. HENRY J. AARON, SENIOR FELLOW, BROOKINGS INSTITUTION, WASHINGTON, DC

Senator GRASSLEY. Dr. Aaron.

Dr. AARON. Thank you very much. I would like to associate myself with the remarks that Dr. Greenspan made. If you had to vote up or down on the President's proposal, I believe you should vote for it because it would be an improvement over current law.

But there are a number of areas where I believe the bill can be improved. And I would urge you to make them.

My written testimony, which I submit for the record, makes a number of major points. I shall cover all but one of them summarily in my oral remarks, and touch in detail on only one.

The first point concerns the taxation of income from capital. Almost every change made from the Treasury's draft proposal of November to the White House proposal was a change for the worse. That stalement includes the liberalized of depreciation rules included in the White House proposal; the move away from indexing of all capital gains and taxing them in full; and the abandonment of any attempt to index interest income. The reasons why these changes were a move for the worse were stated cogently by Mr. Greenspan. All lead to tax-induced distortions in investment choice away from market indicators.

The second point that I would like to make is that I think Congress should look for a compromise on the denial deductibility of State and local taxes. I suggest one in my testimony. I propose that deductibility should be retained only to the extent that all State and local taxes added together exceed 5 percent of adjusted gross income.

This approach would generate additional revenues to support rate reduction and to increase personal exemptions, but it would permit deductibility at the margin for many tax payers, and it would deal with some of the problems of high tax States and high taxpayers in all States.

Third, I believe the White House move away from Treasury's recommendation to tax fringe benefits was a mistake. I recognize the political difficulties in moving in this direction. Again, I suggest a compromise in my testimony. Specifically, I propose that the principle advocated by the Treasury in November for health insurance and embodied in the current law treatment of term life insurance be extended to all fringe benefits taken as a package. Specifically, I propose that a ceiling be set above which fringe benefits would be taxed. The exclusion of no fringe benefit would be terminated.

The one topic I would like to address in detail concerns the issue of international competitiveness. A lot has been said about the importance of retaining the investment tax credit for international competitiveness. I believe there is very little to this argument, and that it should not be taken seriously.

Would the removal of the investment tax credit have a significant impact on the ability of American industry to compete abroad? The answer is it wouldn't have much effect. Out of all value added by nonfinancial corporations in the United States, about 24 percent was attributable to capital in 1983. But only about 4 percent of all that value added was attributable to equipment. If the effective tax rate on net income attributable to equipment were increased by 25 percent, and all of that increase were shifted forward to purchasers in the form of higher prices, the average increase in prices would be about 1 percent.

Since the value of the dollar often changes by 2 percent or more in 1 day and the overvaluation of the dollar is estimated by many experts to be in the range of 30 to 40 percent, the possible direct effect on international competitiveness of the increase in taxes on equipment that would arise from repeal of the investment tax credit would be hard to detect.

Senator BENTSEN. What was that?

Dr. AARON. Hard to detect.

It is not legitimate to argue that low tax rates serve to encourage investments that reduce prices of U.S. products by large amounts. Investments with high rates of return would be undertaken without those inducements. Those that would be put over the top, merely by the existence of the investment tax credit, cannot have a large effect on cost. I believe that you should subject to very severe scrutiny claims by those who suggest that the investment tax credit is essential for international competitiveness.

In some industries the effects may be somewhat larger, but I would suggest even in the industries most severely affected by repeal of the credit, the effects are going to be tiny relative to those of the foreign exchange market.

Thank you.

[The prepared written statement of Dr. Aaron follows:]

Statement
of
Henry J. Aaron*

to
the Committee on Finance
The United States Senate

June 27, 1985

Mr. Chairman and members of the committee:

Thank you for the opportunity to testify on the president's proposal for tax reform. I believe that the president's plan, if enacted without change, would represent a modest improvement over the current tax system. But a number of specific changes would make it a major improvement over the current system. Many of these changes would restore elements of the Treasury Department's November proposal.

The remainder of my statement is divided into two main parts: a summary of my major recommendations and a detailed statement that presents the reasoning behind these recommendations.

*It is customary for faculty of the University of Maryland and employees of the Brookings Institution to dissociate other staff and members of the board of trustees from responsibility for their views. My Brookings colleague Harvey Galper, from whom you have heard, cannot be exculpated so easily. My testimony benefited from his comments and criticisms and draws heavily from Assessing Tax Reform, a book that he and I coauthored. That book presents principles that should guide thinking about tax reform, and applies these principles to major proposals now under discussion.

Summary of Major Recommendations and Conclusions

I urge six specific changes in the president's plan:

- The schedules for indexed depreciation based on true economic asset lives proposed by the Treasury last November should be enacted rather than those proposed by the president.
- All capital gains should be indexed, and real gains should be taxed as ordinary income, along the lines proposed by the Treasury Department in November.
- The Treasury's proposal to index interest income and expense should be restored, subject to certain technical and substantive modifications.
- Fringe benefits should be more fully taxed than suggested in the president's proposal; I present a compromise plan that preserves incentives for worker and employers to negotiate fringe benefits.
- The president's plan for denying deductibility of state and local taxes is unduly harsh, given the cut backs in grants in aid that have been enacted and are now under consideration; I suggest a compromise plan that raises most of the revenues that the president's plan would generate, but that also recognizes the fact that many state and local services provide benefits to people who live outside their borders.
- The personal exemption should be raised to $1,500 (rather than $2,000, as proposed by the president) and the zero-bracket to $5,500 (rather than $4,000 for joint filers and $3,600 for heads of household, as proposed by the president); this exchange protects poor families from having to pay income taxes as well as the president's plan, but it would at less revenue cost than occurs from the proposed increase in personal exemptions to $2,000.

In addition to these specific suggestions, I shall address two important and controversial issues surrounding the tax reform debate: are tax concessions to equipment investment necessary to help American industry fend off foreign competition; and will the president's plan be revenue neutral.

On these issues I shall argue that:

- The arguments that tax concession are necessary to promote international competitiveness of American industry are unjustified. Tax concessions for equipment investment can at best have only a trivial effect on international competitiveness; the trivial gains that might be achieved are not worth the serious distortions and inefficiencies that result from the investment tax credit.

- The estimates that the president's plan would be revenue neutral are done honestly with generally accepted methods; but the plan contains a number of provisions that were added for no reason other than that they add to revenue. The removal of these provisions will reduce revenues and necessitate still other changes if the plan is to turn out revenue neutral. <u>Under no circumstances should Congress enact any tax bill, however meritorious on other grounds, that runs a serious risk of reducing federal revenues.</u>

Full Statement

The current income tax system suffers from three extremely serious problems:

- The tax base has been narrowed. As a result, the tax system needlessly distorts consumption, saving, investment, and production.
- Because the tax base has been narrowed, rates are higher than necessary to raise current revenues. These unnecessarily high rates aggravate economic distortions and inequities.
- The tax system raises too little revenue to pay for current government expenditures or for expenditures that will remain after Congress is done cutting all the spending programs it can.

The president's program deals in some measure with the first two problems, but it does nothing about the third. I shall organize my comments around these three problems and the president's proposed approach to them.

Because I shall have a number of critical comments about the president's plan and shall suggest a number of changes to it, I want to stress that his plan would, in my view, represent an improvement over the current system even if no changes in it were made. But I think that this committee, the Senate, and the House of Representatives can greatly improve the president's plan, particularly if you restore some of the innovative and constructive proposals put forward by the Treasury Department last November.

The Tax Base and Rates

The U.S. economy is based on the principle that individuals and businesses are better qualified than government to decide how to produce income and to spend it. This principle is not absolute, as the existence of large government expenditures and far-reaching regulations attest. For example, few would leave policy on national defense, social security, or the national parks wholly to individual decisions.

On the revenue side, this principle implies that we should design our taxes to distort economic decisions as little as possible. Again, this principle is not absolute. Most of us, for example, are prepared to support tax rules that encourage charitable giving. But the principle does mean that anyone who would use tax policy to distort the voluntary decisions of entrepreneurs, managers, and consumers must shoulder a heavy burden of proof to demonstrate that the purpose of the incentive is important, that tax incentives better advance that purpose than do alternative instruments, and that the gain is worth the increased complexity that each new special provision generates.

The job of trying to reform our tax system is so hard in part because that principle has been flouted recklessly and often and in part because it is very hard to measure and to tax some kinds of economic income. Partly through inadvertence, partly through intention, various sources and uses of income have received favored tax treatment in order to encourage a wide range of objectives.

The current zoo of exclusions, deductions, credits, exemptions, and allowances is the result. Most of these tax provisions were designed to advance meritorious objectives. The problem is that they do so with gross inefficiency, scattering incentives helter-skelter in patterns unrelated to the underlying objectives. In addition, each new deduction, credit, exclusion, and allowance adds the the complexity of the tax code. The result is that ordinary taxpayers cannot understand the rules and suspect rightly that they are forced to pay more tax than they should to cover the loss of revenue from clever tax avoidance by those who can afford costly advice. And although the maximum personal tax rate has come down in recent years, the rate faced by the typical taxpayer has gone up, in large part because of the unplanned and uncoordinated use of the tax system to achieve nonrevenue objectives.

Measuring Business Income

Current law imposes ridiculously uneven taxes on business income. The Treasury Department, the Council of Economic Advisers, and numerous economists and business analysts have documented the large variation in effective tax rates.[1] Depending on the source of funds, the type of investment, the nature of ownership, and the industry in which the investment occurs, effective rates of tax for broad classes of investment can vary from positive tax rates of over 90 percent to negative tax rates (actual subsidies) of more than 20 percent.[2] In particular, business equipment is heavily favored over structures, and profits on nondepreciable capital are taxed most heavily of all. Such enormous variations in effective tax rates induce appalling economic inefficiency, as the illustration presented in the footnote demonstrates.[3]

These discrepancies flow from a number of sources. Among the most important are:

-- the investment tax credit, which discriminates against investments in structures and inventories and in favor of investments in equipment;

-- depreciation schedules that deviate from true economic depreciation by widely different amounts for various assets, and which, since depreciation deductions are not indexed, deviate by different amounts depending on the rate of inflation;

-- interest deductions that are not indexed for inflation and, hence, lead to very different returns on equity investments depending on the degree to which they can be financed by debt;

-- the failure of current law to index capital gains for inflation and to tax real gains in full.

In short, the problems arise in large part from the failure to measure business income correctly.

The president's plan would reduce those discrepancies. I shall not comment in this statement on provisions concerning specific industries. The most important of the general provisions are: repeal of the investment tax credit; replacement of the ACRS depreciation system with indexed and somewhat accelerated depreciation rules; and the indexation of some capital gains.

These reforms do not go as far as provisions recommended last November by the Treasury Department in narrowing differences in effective rates on different kinds of investment.

- The depreciation schedules recommended in November came close to matching true economic depreciation indexed for inflation. The president's plan provides greater-than-true economic depreciation for structures and the discrepancy is especially large for equipment.
- In November Treasury proposed to index all capital gains for inflation and then to tax them like other realized income. The president's plan does not index most capital gains, and it would exclude 50 percent of long-term gains from tax; the exceptions are capital assets used in a trade or business, which would be indexed and real gains from the sale of which would be taxed in full.
- In November the Treasury proposed a "rough justice" method of indexing interest income and expense for inflation. The president's plan skips this vital adjustment entirely. The Treasury proposals were flawed; but they could have been significantly improved with modest changes.

Is more favorable tax treatment of equipment and other depreciable capital than of other investment justified? Are special capital gains rules justified for nondepreciable capital and depreciable capital not used in a trade or business? The answer to both questions is: no.

Two major arguments are advanced for taxing equipment at lower rates than are applied to other investments. First, it is alleged that investments in equipment add more to productivity than do other investments. Second, it is alleged that tax concessions to firms trading in international markets are justified to help such firms compete in the face of an over-valued dollar.

The Productivity Argument. The first argument -- higher productivity on equipment investment -- makes no economic sense whatsoever. If productivity or profitability were higher on such investments than on others, the market would surely recognize it. Why are subsidies needed? For any given national savings rate, output and growth are maximized when private rates of return are as high as possible.

To be sure, there are cases when subsidies to particular industries are justified. When they are, lets not foul our tax system with poorly-targetted tax concessions to a broad class of investments. Let's own up and provide the subsidy to the firm or activity we wish to assist.

When tax concessions push whole classes of investments with relatively low (and sometimes even negative) rates of return ahead of investments with high rates of return, output may even be reduced and welfare is reduced. And this is just as true when the low productivity investment pushed to the head of the queue by tax advantages is called equipment. Though investment in structures and inventories may not tickle our technological fancies the way robotics and continuous casting do, they are better investments whenever they yield higher before-tax returns. By preventing the market from rendering its verdict, current tax breaks for equipment reduce the efficiency of our economy and make it less able to compete with foreign firms. These tax concessions are not pro-growth; they are anti-growth. They do not help American firms compete; they hinder them.

Let me be clear. A strong case can be made for trying to increase saving by Americans, a point that I shall return to momentarily. And a case can be made for a uniform incentive for all investments. But no respectable case can be made for systematically distorting the allocation of capital into low-productivity uses.

International Competition. Even if one grants the general undesirability of using tax concessions to favor certain investments, some people argue that they are justified at this particular time to help U.S. firms against foreign competition. In appraising this argument, one should keep in mind that all existing or proposed tax concessions for investment would apply equally to capital goods produced here and abroad; discrimination based on place of manufacture would violate the General Agreement on Tariffs and Trade (GATT). Hence, tax concessions may increase total U.S. demand for equipment, but they in no way assure that the equipment will be made in the United States.

But what about users of capital goods? Wouldn't tax concessions for the purchase of equipment help them against foreign competitors? The answer is: not much. Of total value added in nonfinancial corporations in the United States, about 24 percent was attributable to capital in 1983. But only about 4 percent was net income attributable to equipment and less than 4 percent more to structures. Even if the effective tax rate on net income attributable to equipment were increased by 25 percent and all of the increase were shifted forward to purchasers in the form of higher prices, the effect would be only a 1 percent increase in prices. Since the value of the dollar often changes by 2 percent or more in one day and the overvaluation of the U.S. dollar is estimated by many experts to be 30 to 40 percent, the possible direct effects on international competitiveness of the increase in taxes on equipment that the president has requested would be hard to detect.

It is not legitimate to argue that low tax rates serve to encourage investments that reduce prices of U.S. products by large amounts. Investments with high returns will be undertaken without the added inducement of tax concessions. Tax concessions may make the difference for marginal investments. But the reduction in production costs cannot be large; if it were, the project would pass muster without the tax inducement.

The charge for this committee is to examine critically the claims that certain tax provisions must be retained to preserve international competitiveness. Witnesses who assert this position should not go unchallenged in their claims that the tax code must be tilted to favor their preferred investments. They should be asked to show in detail, not by glib generalities, how international competitiveness will be strengthened by particular tax changes, and how a 20 percent lower tax rate on equipment, or even on both equipment and structures, can offset the disadvantages of grossly overvalued dollar. Should we not deal squarely with the problems of high real interest rates, an overvalued dollar, and enormous budget deficits rather than offering a placebo in the form of investment incentives that do nothing about the real issues and distort the economy at the same time?

<u>Capital Gains</u>. Congress can strengthen the president's plan by replacing his recommendations regarding the taxation of long-term capital gains and the measurement of depreciation with the Treasury Department's proposals of last November. Under the Treasury Department's plan tax would be levied only on real, inflation-adjusted gains. These gains would be taxed in full, but no tax would be imposed on illusory inflation gains, as can occur under current law or under the president's proposal.[4] The Treasury's proposed depreciation schedule would have approximated true economic depreciation, thereby ending the distortions of investment decisions attributable to discriminatory rules.

<u>Interest Indexing</u>. Under current law borrowers are allowed to deduct all interest payments (subject to certain restrictions), but are not required to treat as income the decrease in the real value of fixed price debt caused by inflation. Similarly, lenders are required to pay tax on all interest income, but are not able to take as losses the decrease in the value of outstanding debt. The change in the real value of debt varies with the rate of inflation and can be large. By ignoring such changes in the value of debt, current tax rules foster tax shelters and distort the allocation of investment. Indexing, which would prevent these inflation-related changes in values from affecting tax liabilities, is essential if these distortions are to be avoided.

The proposals for indexing of interest contained in the Treasury Department's November tax plan were a major and imaginative step forward in the tax treatment of interest income and expense. They contained two major, but correctable, flaws regarding the treatment of financial institutions and of owner-occupied housing, and they raise difficult problems of transition. And they would have necessitated some additional computations by taxpayers. But the importance of removing inflation premiums from the tax system fully justifies these computations and the structural changes that would need to be made.

The gains to be achieved from accurate measurement of capital income would be far-reaching.[5] Not only would this step improve the allocation of capital and add to economic efficiency, but it would also reduce the need for business planners to take tax factors into account in planning investments. The importance of achieving this goal -- pushing tax planning out of its currently preeminent place in the corporate board room -- dwarfs the significance of adding or subtracting a few lines from the form 1040.

<u>Measuring Personal Income</u>

The president proposes to broaden the personal income tax base in a number of ways and to use the revenues from base-broadening to lower personal tax rates. In most respects, his plan is markedly more timid than the one advanced last November by the Treasury Department. Treasury proposed to raise $19 billion in 1990 from taxing certain fringe benefits; the president would raise only $4 billion. Treasury proposed to raise $45 billion in 1990 by curbing itemized deductions; the president would raise $40 billion.[6]

<u>Fringe</u> <u>Benefits</u>. The president's plan is too timid in its approach to fringe benefits. The exclusion of fringe benefits encourages employers to provide them even when workers would prefer consumption goods of equal economic cost that they must buy themselves. The reason, of course, is that consumption through fringe benefits is subsidized to the extent of foregone personal taxes.

At the same time, we all recognize that there is some value in assuring that people have basic health insurance or some life insurance; and we understand that people sometimes lack the foresight to provide these things for themselves. The case for encouraging the provision of basic amounts of such fringes is strong; the case for encouragement of unlimited amounts of these fringes is weak. The question is how to reconcile these conflicting objectives: to retain some encouragement to the provision of basic levels of certain benefits, while discouraging the excesses traceable to the currently unlimited tax incentive.

In my view, the Treasury got matters about right last November when it recommended a ceiling on the exclusion from personal income tax of employer-financed health insurance and the full taxation of all other noncash fringe benefits. But this approach encountered strong opposition, especially from the chairman of this committee.

As a compromise, I suggest broadening to all noncash fringes the principle the Treasury Department would have applied only to health insurance. Each individual would report the dollar value of all currently excluded fringe benefits -- employer-purchased health insurance, group term life insurance up to $50,000, cafeteria plans, and other smaller items -- and would be required to include in income the excess of the total value of these benefits over a specified threshold.

This approach has some advantages over both the president's plan and the Treasury Department's November proposal. It can raise more revenue from the inclusion of fringe benefits than the president's plan. Like the Treasury proposals, and unlike the president's plan, it would increase sensitivity to medical costs by denying deductions for excessively generous health insurance plans. But unlike the Treasury plan, it does not extinguish the exclusion of any particular fringe benefit. Rather, it retains tax incentives for providing any of a specified list of fringe benefits, with the choice left to employers and employees. It simply says that abuse in the form of excluding tax of excessive amounts of fringe benefits will not be tolerated.

State and Local Taxes. A related problem exists with respect to the president's and the Treasury Department's recommendation to disallow deductions for state and local taxes. Strong arguments can be made that some of the costs of state and local services should be borne by people who live outside their borders. The arguments rest on the demonstrable fact that many state and local services provide benefits to people who live outside their borders. Expenditures to educate children in Mississippi, New York, or Oregon clearly affect my well-being as a resident of Washington D.C. If I do not pick up part of the cost, it is quite possible that residents of those states, who derive only part of the benefits from their education expenditures, may spend too little. Similar arguments can be made with respect to other state or local services, including police protection, health expenditures, or welfare outlays. We are simply too mobile and interconnected a society to treat each jurisdiction as a fiscal island.

The foregoing line of argument points toward a system of grants-in-aid from higher- to lower-level jurisdictions. It does not, however, point to the particular pattern of implicit grants expressed in deductibility of state and local taxes, a system under which the size of the implicit grant depends on how many local residents itemize their deductions and on what tax bracket they are in.

In a well-ordered world, a set of grants in aid would match benefits and costs of state and local services, and no deductions would be permitted for state and local taxes. In fact, our system of grants is far from ideal, and it is being scaled back in the face of budgetary exigencies. To deny completely the deductibility of state and local taxes at such a time places extraordinary burdens on states and localities. A fully persuasive case for the complete elimination of deductibility can be made, but only if it is linked to a reform and extension of grants-in-aid.

Since no reform or extension of grants in aid seems likely in the near future, we are faced with a set of conflicting goals. First, reductions in federal individual income tax rates cannot go very far unless deductibility of state and local taxes is reduced. Second, state and local taxes are a rather poor grant-in-aid program. But, third, the relative importance of deductibility to states and localities is growing as grants-in-aid are curbed.

These goals can be partially reconciled if an approach similar to the one I have suggested for fringe benefits is adopted. I recommend that state and local taxes remain deductible, but only to the extent that they exceed a stipulated fraction of adjusted gross income. If the ceiling above which deductibility would be permitted were set at 5 percent of adjusted gross income, federal revenues would rise by roughly two-thirds of the amount the Treasury estimates revenues would rise from complete denial of deductibility of state and local taxes. Some citizens of all states would continue to be able to deduct part of their state and local taxes, although clearly the fraction would be larger in relatively high tax states. Table 1 shows the average ratio of deductions for state and local taxes to income by income class in 1982.

Low-Income Relief

The president proposes to increase personal exemptions to $2,000, nearly a doubling of the current level. He also calls for an increase in the zero-bracket amount, but by a much smaller proportion, by 9 percent for joint filers, by 17 percent for single filers, and by 45 percent for heads of household.

Measures to increase tax-free income levels are long overdue, as no adjustment was made from 1979 through 1984, despite considerable inflation. However, the relatively large on increase in personal exemptions and the proportionately smaller increase in the zero-bracket amounts is a particularly costly way of boosting tax-free income levels. The increase in the exemption is available to all taxpayers, while changes in the zero-bracket amount have no significance to itemizers.

The same tax entry points could be preserved for a family of four if the personal exemption were raised $100 less and the zero-bracket amount were increased $400 more. Tax entry points would remain the same as under the president's plan if the personal exemption were set at $1,700 and the zero-bracket amount were set at $5,200. By way of comparison, the Bradley-Gephardt plan would increase the personal exemption for joint filers to $1,500 each ($1,000 for additional dependents), but would raise the zero-bracket amount to $6,000 for joint filers. My highly tentative estimate is that revenues would be roughly $5 billion higher than under the president's plan with the $1,700 exemption and the $5,200 zero-bracket amount and $8 billion higher with a $1,500 exemption and a $6,000 zero-bracket amount. In view of the revenue-losing consequences of many of the changes to the president's plan that Congress may find it necessary to make, the additional revenues from a larger increase in the zero-bracket amount and a smaller increase in the personal exemption than he suggests may prove attractive.

Revenue Neutrality

To an economist interested in restoring balance to federal finances the most disturbing aspect of the president's tax plan is the threat that it will turn into a tax cut. This concern arises both from the design of the plan and the way the president is presenting it to the American public.

The president has said that taxes should be increased only as a last resort after spending has been reduced as much as possible. He has also said that tax reform will make it harder to raise rates in the future. For quite different reasons, both Republicans and Democrats have agreed to devote this year to trying to cut spending and to reform the tax system and to leave tax increases for a later date.

But this year's struggles over spending must make clear that the budget cannot be balanced by significant further spending cuts, unless Congress is prepared to jettison social insurance or to enact security-threatening cuts in defense outlays. The budget deficit can be closed only if the United States is prepared to raise taxes and to raise them significantly.

The president's plan contains a number of provisions that are unlikely to yield as much revenue as he has estimated after Congress has made quite reasonable changes in his plan.

- The president calls for repeal of income averaging, a retrograde proposal that Congress should reject (revenue loss of $4 billion to $5 billion per year).

- The president's proposal to recapture the rate differential on accelerated depreciation is an inherently sound idea, but it is likely to yield less revenue than he estimates, even if Congress accepts the idea. Some firms are likely to be able to demonstrate hardship and to win relief. In addition, there is as much logic in applying the same principle in areas (loss carryforwards, for example) that would reduce revenues as there is in applying it to depreciation.

- Corporate rate reductions are deferred until July 1, 1986, while the introduction of the new depreciation schedules (which result in some short run increase in revenues) and the repeal of the investment tax credit would take effect on January 1, 1986. The personal rate reductions are also deferred until July 1, although nearly all other personal tax provisions would take effect on January 1. These assymetries in effective dates have no rationale in tax policy and seem to be motivated only by a desire to forestall estimates of large revenue losses in 1986.

If there is one thing the United States economy does not need -- in fact cannot stand -- it is yet another tax cut which would make the deficit still worse, the dollar still stronger, the international competitiveness of U.S. industries still weaker. Under no circumstance, in my view, should Congress approve any tax bill, however meritorious on other grounds, that does not at least maintain revenues.

Such a move would further reduce the U.S. national savings rate, which is already at a post-world-war-II low because government deficits are absorbing about two-thirds of net private saving. We should not be confused by the respectable investment rates now occuring in the United

States into thinking that we as Americans are investing a sufficient amount. The high U.S. dollar has put America on sale, and foreigners are buying. Foreigners, not U.S. residents, will derive most of the benefits from these investments because the returns from these investments will flow abroad. The most direct and effective way to restore U.S. saving and simultaneously to promote investment here is to bring down the deficit.

For this reason, it is vital that the American people be told that tax reform and simplification will facilitate and make less burdensome the increase in tax rates necessary to help balance the budget. Raising tax rates on a base as distorted and unfair as the current one would aggravate tax-generated inequities and inefficiencies. These costs would be much reduced if the tax system is significantly improved. The president does a disservice to the cause of fiscal responsibility, high saving, and a strong U.S. economy when he suggests that his plan is another installment in an agenda for cutting taxes.

Summary

The president has sent to Congress a tax reform plan that has important positive elements. Most notably it reduces marginal tax rates on both individuals and businesses and it moves toward equal taxation of business income regardless of source. But there is room for improvement, much of it along lines charted for you by the Treasury Department last November and in plans previously developed by members of Congress. The most important of these improvements would be to move further toward equal taxation of capital income, including complete indexation of capital gains and full taxation of real capital gains and the adoption of depreciation schedules indexed for inflation that reflect the true loss of economic asset values. In addition, the fuller taxation of fringe benefits would remove distorting incentives in employee compensation. Finally, tax reform must be understood not only as a means to reduce statutory rates and make life simpler for tax payers, but as a step toward restoring fiscal balance in federal affairs.

FOOTNOTES

1. Annual Report of the Council of Economic Advisers, 1982, pp. 122-124; The President's Tax Proposals to the Congress for Fairness, Simplicity, and Growth; Office of the Secretary, Department of the Treasury, Tax Reform For Fairness, Simplicity, and Growth, vol. 1, Overview, November, 1984; Mervyn A. King and Don fullerton, The Taxation of Income from Capital: A Comparative Study of the United States, the United Kingdom, Sweden, and West Germany (University of Chicago Press, 1984).

2. King and Fullerton, p. 244.

3. "Suppose that type A investments are taxed at 80 percent (that is 80 percent of their yield is paid in taxes), type B investments are taxed at 40 percent, and type C investments are free of tax. If the investment risks of each are the same, investors will put their money where they earn the most after taxes. If type C investments yield 6 percent before and after tax (that is, they pay the investor 6 cents per year for every dollar invested), how much will the other two investments have to yield in order to attract investors? The answer is that type B investments will have to earn 10 percent before tax (paying a tax of 40 percent on a return of 10 percent leaves a 6 percent after-tax yield), and type A investments will have to earn 30 percent. That means that a type A investment that yields, say 29 percent before tax will lose out to a type C investment that yields only 6 percent. When tax rules cause investors to select projects yielding 6 cents per dollar invested in place of others yielding 29 cents, the economy as a whole sacrifices 23 cents (nearly four-fifths) of the potential return. Not all misallocations attributable to the tax system are so extreme. But some are worse." Henry J. Aaron and Harvey Galper, Assessing Tax Reform (Brookings, 1985), p. 3.

4. After 1990 the president's plan would permit taxpayers to choose between paying tax on 50 percent of nominal gains or all of inflation-adjusted gains. This option is worse tax policy than either taken alone, as it would permit taxpayers to manipulate sales of capital assets, selling in one year those on which one approach is more favorable and selling next year those assets on which the other approach is more favorable. The result would be an even larger discrepancy between the tax rate on capital gains and that on other income. For an eloquent and correct argument on why concessionary rates on capital gains are not necessary to elicit venture capital, see Office of the Secretary, Department of the Treasury, Tax Reform for Fairness, Simplicity, and Growth, vol. 1, Overview, November 1984, pp. 180-181.

5. One of the gains from accurate measurement of income is that it facilitates changes in tax rates. The president's plan, for example, contains a provision to recapture some of the depreciation deductions allowed in the past several years. This provision has some justification because it hardly seems fair to permit investors to take deductions against one tax rate and pay tax on subsequent income at another rate. But this problem would not arise if depreciation deductions matched true economic depreciation. In that event, there would be no need to recapture anything, because the deductions claimed would exactly match the expenses incurred.

6. In one respect, the president's plan is sterner than the Treasury plan. Treasury would have phased in the denial of deductions for state and local taxes over - years; the president makes the denial fully effective in January 1986.

Table 1. Deductions for State and Local Taxes as a Percent of Adjusted Gross Income on Returns with Itemized Deductions, 1982

Size of adjusted gross income	Number of returns with taxes paid deduction (millions)	Amount of deduction: as percent of adjusted gross income
Under $5,000	0.5	22.5
$5,000 under $10,000	1.6	11.9
$10,000, under $15,000	2.7	9.3
$15,000, under $20,000	3.2	8.3
$20,000, under $25,000	4.2	7.6
$25,000, under $30,000	4.7	7.5
$30,000, under $40,000	7.7	7.4
$40,000, under $50,000	4.2	7.3
$50,000, under $75,000	2.9	7.6
$75,000, under $100,000	0.7	8.0
$100,000, under $200,000	0.6	7.5
$200,000, under $500,000	0.1	7.0
$500,000 under $1,000,000	0.02	6.8
$1,000,000 or more	0.008	6.7

Source: Internal Revenue Service, Statistics of Income-1982: Individual Income Tax Returns, USGPO, 1984, Table 2-1, p. 60. Percentage is based on amount of taxes paid deduction per return with taxes paid deduction, divided by adjusted gross income of all returns with itemized deductions per return with itemized deductions.

STATEMENT OF DR. MICHAEL J. BOSKIN, PROFESSOR OF ECONOMICS AND CHAIRMAN, CENTER FOR ECONOMIC POLICY RESEARCH, STANFORD UNIVERSITY, PALO ALTO, CA

Senator GRASSLEY. Dr. Boskin.

Dr. BOSKIN. Thank you, Mr. Chairman. It's a pleasure to be here again and to share my thoughts on the President's tax plan with members of the committee.

I again ask that my full written remarks be included in the transcript of the meeting.

I will take issue during my brief remarks with a few of the comments made by Dr. Greenspan and Dr. Aaron, although I agree with many of the comments they made.

Our tax system is complex, inefficient, and inequitable. We all agree that it needs to be reformed. But, first, let us put the problem of tax reform in perspective. We should not take tax policy in a vacuum, but in the context of our overall economic policies and problems.

On a list of such problems our fiscal and trade deficits, productivity slowdown, and declining international competitiveness, while partially related to problems in our Tax Code, are more important than tax reform.

A substantial fraction of economic growth is due to our increased capital formation and technological change. Our investment rates, while up substantially in the course of this recovery—and, in part, due to the investment incentives and ERTA/TEFRA—is still below that of all the major economies with whom we trade and compete.

While the benefits from tax reform can be substantial, the costs of reform are high and rising as we continually change our Tax Code. We have had five major tax reforms in less than a decade and three in the past 4 years. Therefore, I would urge the committee to adopt a major reform package, the President's or some other, only if it can agree that such a change is likely to make sense for a decade, not just a year or two.

Broadening the tax base and lowering the rates in the income tax is highly desirable, and I commend the President and other tax reformers for highlighting the importance of doing so. I believe there are a number of ways that we could do so without giving up some of the revenue that is implicit in some of the proposals the President has made.

For example, there is no reason that tenured, full professors at Stanford need an increase in the personal exemption. We should phase the increase in the personal exemption out as we move up the income scale and save perhaps $20 to $25 billion per year in revenue. And I mention that as a prelude to saying that the biggest problem I have with the President's proposal is one that has gotten much attention recently: It is likely to fall short of revenue neutrality. And any inadvertent worsening of the Federal Government's fiscal deficit should be avoided. It would not be prudent to adopt a tax reform plan, this or any other, that had lurking in it a substantial probability that revenues would be less than projected under current law.

Such changes are particularly unfortunate in my view, given the evidence that investment incentives in the 1981-82 tax reforms were responsible for about a quarter of U.S. net investment in 1982-84. Combined with the shift in burden to corporate taxes and likely revenue losses, I believe the President's proposal as a whole would exert upward pressure on interest rates.

The definition of tax neutrality, as used by Drs. Greenspan and Aaron, is unidimensional. We would not like to talk about a level playing field if we were football players purely from sideline to sideline, but also from goalpost to goalpost. There are two types of distortions in investment incentives. One is among the types of investments one might engage in, given one has decided to invest. The other is whether one invests or consumes. In a society that has the lowest saving and investment rates, and has had for a very long time, of any advanced economy and in a society that is disseminating new technology more slowly throughout its capital stock than other societies, it is not likely any gains in neutrality across investments could offset the potential harm to the economy from any substantial slowing of investment. It would be ironic and tragic if a society so concerned with leaving massive deficits and debts to their children, and therefore leaving them greater liabilities, wound up adopting an anti-investment tax reform which resulted in them having fewer assets with which to accumulate income to pay off those liabilities.

I believe that if we keep an income tax system rather than moving to a consumed income tax or an expenditure tax system, we should have a strong and, hopefully, general across the board saving and investment incentive.

Thank you very much.

[The prepared written statement of Dr. Boskin follows:]

THE PRESIDENT'S TAX PLAN:

PERSPECTIVES, PRAISE, PROBLEMS

TESTIMONY BEFORE THE COMMITTEE ON FINANCE

UNITED STATES SENATE

by

Michael J. Boskin
Professor of Economics
and
Chairman, Center for Economic Policy Research
Stanford University
and
Research Associate
National Bureau of Economic Research, Inc.

June 27, 1985

Perspectives

Tax Reform in the Context of our Economic Problems

Our system of federal corporate and personal income taxation is complex, inefficient, and inequitable. These are serious problems and worthy of correction. However, among our many problems, our rapidly declining international competitiveness, our massive trade and federal fiscal deficits, the enormous difficulty in controlling federal spending and our long-term productivity slowdown are at least as important as the problems in our tax code. Tax policy should not be made in a vacuum; it should be coordinated with our overall fiscal, monetary and regulatory policy.[1]

For example, a large part of the investment boom since the trough of the recession in 1982 is attributable to the investment incentives in ERTA/TEFRA. The recent investment boom is detailed in Table 1. The President's proposals would eliminate the Investment Tax Credit (ITC), and (while a major improvment over the Treasury's November 1984 proposal), slow down or speed up depreciation for alternative investments, depending on the inflation rate. The net result would be an increase in the cost of capital and a reduction in investment in the

---

1. These issues are important on both the broad macroeconomic concerns of the economy and the narrower problems of specific industries, regions, or households. For example, without passing judgement on the wisdom of disallowing "excess bad debt deduction for banks", this Committee in its deliberations ought to note that simultaneously with the original issuance of that proposal by the Treasury in November 1984, our bank regulators insisted that the banks increase their bad debt reserves against future likely loan losses. Thus, tax policy would be taking us in one direction and regulatory policy in another.

United States. Eliminating the ITC would raise the cost of equipment about 10-15%. Also, because ITC and ACRS (Accelerated Cost Recovery System) are available only on investment in the United States, the location of investment might well shift away from domestic U.S. investment to investment abroad. As detailed below, the proposal is likely to lose considerable revenue, thus inadvertently worsen the deficit. It is also likely to decrease short-run investment due to the shift in tax burden from the individual to the corporate tax. The net result would be to exert upward pressure on interest rates, increasing the before tax cost of capital, slowing investment, and future growth.

Tax Stability and Predictability

The President's proposals would not only be the most substantial tax reform in many years, they would come rapidly upon the heels of five major tax reforms in less than a decade, and three in the last four years. At that pace, even much maligned tax advisors have difficulty keeping up with changing legislation. Simply put, while there are potential efficiency gains from tax reform, the cost of major reform is high and rising as we continually change our tax laws. Only after careful consideration and a consensus that this was not just the tax reform plan for 1985, but the tax reform for the next decade, should we pass another tax reform bill this year.

ACRS, ITC and the Investment Boom

In this context, it is important that our tax policy as well as our spending, deficit, and monetary policies pay particular attention to our international competitiveness, our rate of technological innovation, and our rate of capital formation, for these are the three most important determinants of the productivity, and hence wages, of American workers in the future.

The substantial acceleration in depreciation allowances and the extension of the investment tax credit in ERTA/TEFRA ~~are heavily~~ responsible for the investment boom we have had in the United States. Undoubtedly, other factors contributed. For example, investment is highly correlated with the business cycle. But once out of the severe recession and back to a reasonable rate of capacity utilization, investment in the United States increased dramatically. My research (discussed in more detail below) suggests that these structural tax changes are responsible for about 25% of net investment in business structures and equipment in the United States in the period 1982 through 1984, and are likely to contribute a corresponding amount in 1985. Unfortunately, there tends to be substantial confusion about the factors determining business investment. Some people tend to think that all that matters is the total amount of tax revenue collected from the corporate income tax. Lower corporate tax rates combined with slower depreciation designed to raise the same amount of revenue may well result in seriously retarding investment.

Rate Reduction and Removing the Poor from the Tax Rolls

The President's proposals for fairness, growth and simplicity, like several other major reform proposals, seek to lower tax rates without losing revenue by broadening the tax base substantially. The main characteristics are a reduction in the number of individual income tax brackets from fourteen to three, and of tax rates from a range of 11% to 50% to three rates of 15%, 25%, and 35%;[2] a doubling of personal exemptions to $2,000.00 per person, and an increase in the zero bracket amount to $4,000.00. These two features would remove a substantial number of very low income, indeed poor, households from the federal individual income tax rolls.

However, the increase in the personal exemption and zero bracket amount would cost $55 billion in revenue in FY1990. The increase could be phased out as we moved up the income scale, and we could remove the poor from the tax rolls at half this cost.

Decreasing marginal tax rates and tightening rules should lead to a substantial decrease in the use and abuse of tax shelters, and thus are highly desireable. They also should lead to a more efficient allocation of our capital stock and some modest increase in work effort.

The basic thrust of attempting to broaden the base and lower the rates, eliminate abuses, and increase public acceptance of the reasonableness and fairness of our tax system, all deserve support, and indeed, praise. In addition, relative to the original Treasury proposals of 1984, the President's proposals receive high marks for keeping the tax deduction for charitable contributions [3] and for

---

2. Simplicity is not a feature of the number of rates or the roundness of the numbers, but of the level of the rates and their differentials across alternative activities. Who really has trouble looking up their tax in the tax table once they have calculated their taxable income?

3. This deduction is an efficient device for channelling funds into charities. It nets charities more than the government loses in revenue and allows decisions concerning charitable activities to be made by millions of private philanthropists and thousands of philanthropic organizations rather than a government agency. See M. Boskin and M. Feldstein, "The Impact of the Charitable Deduction," Review of Economics and Statistics, 1978.

moving a substantial, but incomplete, step in the right direction concerning the taxation of investment income. The President's proposal contains more rapid depreciation than the Treasury proposal. It reintroduces a capital gains differential to help stimulate the supply of risk capital and of entrepreneurship. It extends, but tightens the R&D tax credit. Unfortunately, the elimination of the investment tax credit and the limitation of the accelerated cost recovery system (ACRS) are not fully offset either in their revenue impact by a reduction of the corporate tax rate from 46% to 33%, or (even more important), in their impact on investment.

The enhanced IRAs are another sensible feature of the President's proposals. Although some of the funds that have poured into IRAs are undoubtedly just tax arbitrage coming from existing tax assets, some come from new saving. There are those who argue that it is undesireable to allow tax free accumulation for retirement. This "break" is better understood as an attempt to remove the double taxation of saving inherent in an income tax, which taxes saving first when it is earned as part of income and again when it earns a return. Offsetting the enhanced IRAs and the potential beneficial effects of somewhat lower marginal tax rates for many Americans are features such as those taxing the inside buildup in life insurance which work in the opposite direction to retard private saving.

Despite their attempts to make the tax system more neutral with respect to the types of investment, the President's proposals are unlikely to do very much in this regard.

Overall, they would raise taxes on corporate source income substantially to finance a modest reduction in personal taxes. The wisdom of doing so at a time when the economy is slowing down, the incentives in the 1981-82 tax acts have demonstrated their effectiveness and on the heels of a three year phased in personal tax cut is hardly obvious. Our marginal personal tax rates are currently among the lowest among advanced economies.

Revenue Neutrality?

The first major problem with these tax proposals, however, is that they are undoubtedly not revenue neutral. They are likely to raise less revenue than the existing tax code would have raised if continued.

Treasury estimates the proposals would reduce individual income taxes 7% and raise corporate income taxes 9% in the long-run. Since individual income tax revenues are several times corporate tax revenues, even ignoring taxpayer responses and any deleterious growth consequences, the proposal must lose substantial revenue, about $25 billion in FY1990. In addition, the estimates ignore taxpayer responses. For example, the taxation of interest on mortgages on second homes is supposed to raise over a billion dollars per year, gradually rising as it is phased in. Unfortunately, it will not take long for intelligent taxpayers or their advisors to suggest that they just increase the mortgage on the first home, pay off the mortgage on their second home, and take all the "perfectly legal" interest deductions. Thus, a more reasonable estimate would be that Treasury would raise nothing by eliminating this deduction, rather than the substantial and rising amount they estimate. This kind of problem permeates the revenue estimates that have been done. If elimination of the investment tax credit reduces investment substantially, the revenues again are overstated. I do not suggest that there is an easy answer or alternative for the Treasury's very competent technical staff in making these revenue estimates, but in the context of the enormous current fiscal deficits, extreme care should be taken to guard against revenue losses.

Tax Neutrality?

The President's proposals, like the original Treasury proposals, argue that tax neutrality is desireable and that the proposals introduced will move us a long way toward achieving it. But neutrality must be understood in several dimensions. The original Treasury proposals couched neutrality exclusively in terms of the tax rates on alternative investments and completely ignored the quantitatively much more important decision whether to invest or to consume. Several studies comparing the efficiency loss to the economy from distorting the consumption/investment choice relative to the decision about the types of investment one makes suggest that the intertemporal distortions are several times more important than the distortions in the allocation of investment.[4] The Treasury proposals would drastically worsen the intertemporal distortions, the President's proposals somewhat less so.

---

4. If intertemporal neutrality could be achieved, neutrality among types of assets would be a desireable benchmark, to be abandoned only for well-documented substantive reasons, such as national security or a strong presumption of the social returns to one type of activity drastically exceeding the private return (as may be the case with the generation of new technology via R&D, since it is probably impossible to appropriate all of the returns from a new invention privately). See M. Boskin, "Taxation, Saving and the Rate of Interest," Journal of Political Economy, April 1978 and D. Fullerton, J. Shoven and J. Whalley, "Gains from Replacing the U.S. Income Tax with a Progressive Consumption Tax," Journal of Public Economics, 1983.

The questionable gains from greater neutrality are unlikely to offset the cost of the lost investment. The repeal of the investment tax credit and the replacement of ACRS with CCRS will reduce the incentive to invest. Just as one should not define obesity merely by one's weight without reference to one's height or build, one should not define neutrality purely in one dimension. The President clearly understood the problem and accelerated the Treasury's original depreciation schedules, but it would be detrimental to the economy if a tax bill were passed which dramatically slowed down depreciation and/or eliminated the investment tax credit. The <u>only</u> neutral tax treatment of investment is (any combination of interest deductibility and depreciation allowances which yield the same present value of deductions as) expensing. That is, equity financed investment should be expensed, as should debt financed investments if borrowing were brought into the tax base. Any tax system which would allow slower depreciation than this through its many features is discriminating against investment in favor of consumption. Let me take umbrage at the public reporting of ACRS or previous accelerated depreciation as "business tax breaks". They are better understood as a reduction in the disincentives to invest caused by a system of income taxation, which doubly taxes investment. The primary beneficiaries of the increased investment they bring forth are workers because of the enhanced productivity due to greater capital per worker, and the embodiment of new technology in this larger and newer capital stock.

Thus, moving towards neutrality across types of investments is undesireable if it worsens the intertemporal distortions or the investment versus consumption choice in our society.

Investment Incentives

The worst feature of the President's proposal is the failure to preserve, let alone improve, the investment incentives -- really the reduction in investment disincentives — enacted in 1981-82 which played a large role in our recent investment boom. When ACRS was put into place in 1981, its stated objective was increasing our rate of capital formation. Despite unprecedented high real interest rates, it has been successful in achieving this goal. In a study I have undertaken at the reqrest of the National Chamber Foundation, I estimate that the change in investment due to ERTA/TEFRA amounted to between 20% to 25% of all net investment in business plant and equipment in the United States in 1982-84![5] They are likely to be a major contributor to our investment rate in 1985. A summary of the results is reported in Table 2. It should be emphasized that these estimates should be taken as a lower bound. That is because it may well be that the recovery itself might have been slower had it not been for the investment incentives in ERTA/TEFRA and the subsequent investment boom.

Further, ACRS and the extended ITC almost certainly substantially shifted the location of investment to the United States from abroad. This not only produced greater capital formation and productivity for our domestic workers, but substantially relieved the pressure which might have been caused by our burgeoning federal fiscal deficits and the increased demand for capital due to these incentives on interest rates. As Table 1 indicates, our investment rate increased substantially in

---

5. These results will be reported more fully in my study to be released next month.

1982-84 from a post-war low in 1982. The increase in investment is approximately double what would have been expected at this stage of the recovery based on typical post-war business cycles.

Finally, it is worth noting while we have had an investment boomlet, our net investment rate is still substantially below that of any advanced economy in the world, including those with whom we trade and compete. The reduction in the net outflow of U.S. capital, partly due to ACRS and the ITC and the increased inflow of foreign capital offset about a half of the federal government's fiscal deficit in 1984. (See Table 3.) Without it, interest rates would have been substantially higher, and the before-tax cost of capital driven up. As a result a substantial reduction in the expansion of investment would have occurred. Thus, the ITC and ACRS provisions of ERTA/TEFRA had additional beneficial effects on U.S. investment working through the effect on interest rates of the location of investment. Whether the Federal Reserve would have adopted a different policy had we had a slower investment recovery, and therefore, kept us on the same GNP growth path is a moot question. In short, the investment incentives worked. It would be foolish to adopt a corporate income tax law which did not contain a strong investment incentive (or more properly, a strong reduction in the investment disincentives inherent in income taxation). For all of you concerned about the potential deleterious impact of deficits, it would be ironic if the crowding out of investment we all eventually fear from large federal fiscal deficits was brought about by anti-investment structural tax reform.

There is substantial euphoria over the pace of the recovery in 1984 (although it has slowed recently) and our recent investment boom. We should not be overconfident that investment will stay at high rates independent of the tax system. As noted above, a substantial share of the investment boom is attributable to the incentives in the 1981 tax law. As Table 3 indicates, our current net national saving rate is still quite low, heavily due to substantial government borrowing, which eventually will crowd out some private capital. Our long-term productivity and economic growth are closely tied to higher rates of investment over the long-term. We need to raise our rate of investment for decades, not quarters or years. This is a necessary input to a higher long-term real rate of economic growth, and it would be particularly unfortunate if in the pursuit of other goals, we did not pay careful attention to the effects of our tax system on the investment incentives.

Problems with Estimated Tax Rate Differentials

Much has been also made of fairness across industries and firms. As with neutrality, fairness has many dimensions. Firms with few new investment opportunities will benefit substantially from the reduction in the corporate rates without caring about the reduction in incentives for new investment. However, the economy as a whole will suffer immensely. Investment will be reduced, thereby slowing the rate of capital formation and dissemination and generation of new technology. This, in turn, will lead gradually to a slower increase in real wages for American workers. While a boon (somewhat offset by the recapture provision) to existing capital, the President's proposals and others which repeal the investment tax credit and slow down depreciation will slow the rate of capital formation and growth in the United States. The Treasury and numerous commentators suggest that current tax law favors capital intensive industries. This is a drastic overstatement. As Greg Ballentine and others have pointed out, while ACRS and the ITC obviously are only taken on new investment, there is also substantial investment in what economists call intangibles: R&D, advertising, goodwill. These are written off in the first year, whereas capital outlays for plant and equipment are amortized over some length of time. A good example occurs in Silicon Valley with the immense advertising campaign of Apple Computer for its MacIntosh product line.[6] These intangible investments are written off immediately. Most calculations of effective tax rates conclude that equipment is subsidized and structures heavily taxed, as are land and inventories. There are a variety of problems with these claims. Most effective tax rate calculations ignore the fundamental distinction between equipment and structures defined in the tax law and equipment and structures as recorded in the national income and product accounts. Much of what is called structures in the national income accounts — more or less anything that is bolted down, such as a rolling mill — is treated as equipment (and properly so) in our tax law. My NBER colleague Larry Summers of Harvard University states the problem succinctly: Don't you find it somewhat surprising that structures are considered to be taxed much more heavily than equipment, given that a substantial fraction of the tax shelter industry is based on structures?

Given we have more or less decided as a society not to tax owner-

---

6. Some economists have argued that the tax laws discriminate against "hi-tech" firms in favor of "smokestack" firms. This ignores the fact that the features of the tax law allegedly causing this are responsible for a substantial increase in the demand for hi-tech firms' output.

occupied housing in the United States, which accounts for a substantial fraction of all tangible capital in the United States, slowing the rate of depreciation and eliminating investment tax credits in the presence of the tax incentives for owner-occupied housing will worsen any non-neutral taxation of housing and tangible business investment. Tangible business investment would be placed on a par with housing, and our tax system rendered much more efficient if we moved to expensing (with the appropriate adjustment for debt).

<u>Capital Formation, Economic Growth and the Legacy of Tax Reform</u>

The President's tax proposals to the Congress for fairness, growth, and simplicity contain many desireable features. We have long since outlived the day when many features of the tax code served their original intent. A broader base and lower tax rates are socially desireable *if* they can be achieved with minimal correlative costs. But a substantial increase in corporate taxes, heavily focused on increasing the taxation of new investment, is *not* a sensible reform. It moves us in exactly the wrong direction at the wrong time with respect to the important goal of increasing capital formation. The President rightly has made much of the goal of economic growth throughout his term in office. An increased rate of economic growth of even a half a percentage point per year would result in the next generation of Americans being substantially better off than the current one. And investment and growth are highly correlated. A sufficient rate of investment raises the amount of capital available per worker, thereby increasing productivity and real wages. It is the primary vehicle by which technical change is generated and disseminated throughout our economy. We have an immense stake in our future economic growth, besides just the well-being of the next generation.

We are in a highly competitive international environment. U.S. net investment has averaged about half of that in countries such as France and Germany, and less than half of that in Japan, over the past decade and a half. Correspondingly, our productivity growth rate was only half of that in these countries. We cannot continue on such a path. The depreciation reforms in the 1981-82 tax acts were an important step away from antigrowth tax policy. It would indeed be unfortunate if any bill voted out of this Committee reduced our capital formation incentives. That would be true even in an environment where our overall fiscal policy was in balance. The confluence of very substantial federal government fiscal deficits, heavily financed by increased foreign capital inflows, decreased U.S. outflows of capital, and the possibly temporary state and local government surpluses, render the need for extreme care in revision of capital formation incentives in the tax law paramount. <u>We should be as concerned about not decreasing the assets we leave our children as we are about not increasing the liabilities we leave them.</u>

Perhaps it would be simplest to highlight this problem by stating that it would be a sad situation if we left our children a substantially larger national debt upon which they must pay taxes to finance interest payments, while leaving them a smaller capital stock and lower productivity because of anti-investment structural tax reforms. That would be doubly impoverishing our children relative to the natural course of the economy.

If we engage in fundamental tax reform, we should move toward a consumed-income or cash flow tax (or replace the personal and corporate income taxes with a value-added tax), since this kind of tax system would be neutral with respect to the decision of whether to save or invest on the one hand or consume on the other and among types of investment. It would ultimately be simpler and could be made fairer than our current tax system.

If, however, we stay with income taxation, strong, and hopefully general, saving and investment incentives (better understood as ameliorating the bias inherent in income taxation toward consumption) are imperative.

Table 1
Annual Gross Private Domestic Investment
In Constant 1972 Dollars and as Share of GNP

Year	% Share of GNP	Constant 1972 Dollars (billions)
1955	17.1%	103.8
1956	16.8	102.6
1957	15.6	97.0
1958	13.8	87.5
1959	16.0	108.0
1960	15.0	104.7
1961	14.3	103.9
1962	15.1	117.6
1963	15.2	125.1
1964	15.3	133.0
1965	16.4	151.9
1966	16.6	163.0
1967	15.4	154.9
1968	15.3	161.6
1969	15.8	171.4
1970	14.5	158.5
1971	15.4	173.9
1972	16.4	195.0
1973	17.3	217.5
1974	15.9	195.5
1975	13.3	154.8
1976	15.0	184.5
1977	16.9	214.2
1978	17.9	236.7
1979	17.5	236.7
1980	15.3	208.5
1981	16.4	230.9
1982	13.5	194.3
1983	14.3	221.0
1984	17.4	289.7

Table 2

IMPACT OF ERTA/TEFRA ON INVESTMENT

I. Direct calculation of change in desired capital stock, change in net investment assumed spread over 3 or 5 years and change as % of net investment.*

Change in Desired Capital Stock	Change in Net Investment ($billions) 3 yr.	5 yr.	If Spread Over 3 yrs. Change per year as % of averg net investment 1981-4
7.8%	31.1	18.7	25.2%

*Assumes unitary elasticity of desired capital stock with respect to the cost of capital.

II. Econometric estimates of change in investment due to investment incentives in ERTA/TEFRA.

Year	% increase gross investment	dollar amount of increase (billions)	increase as % of net investment
1982	2.24	9.53	15.8
1983	3.92	14.42	29.0
1984	7.36	31.93	29.8
1985 predicted		22.75	

Source: M. Boskin, "Impact of Investment Incentives in ERTA/TEFRA on U.S. Investment," in process.

Table 3

U.S. NET SAVING AND INVESTMENT, 1951-84

	1951-60	1961-70	1971-80	1981	1982	1983	1984
Total Net Saving	6.9%	7.5%	6.1%	5.2%	1.6%	1.8%	4.0%
Net Private Saving	7.2	8.0	7.1	6.1	5.4	5.9	7.4
Personal Saving	4.7	4.7	4.9	4.6	4.4	3.6	4.3
Corporate Saving	2.5	3.3	2.2	1.4	1.0	2.3	3.2
State-Local Govt. Surplus	-0.2	0.1	0.9	1.3	1.1	1.3	1.4
Federal Govt. Surplus	-0.2	-0.5	-1.9	-2.2	-4.8	-5.4	-4.8
Total Net Investment	7.0%	7.5%	6.3%	5.4%	1.6%	1.8%	3.8%
Net Foreign Investment	0.3	0.5	0.1	0.2	-0.2	-1.0	-2.6
Private Domestic Investment	6.7	7.0	6.2	5.2	1.8	2.9	6.4
Plant and Equipment	2.7	3.5	3.0	3.1	2.0	1.5	4.8
Residential Construction	3.2	2.5	2.5	1.3	0.6	1.8	[illegible]
Inventory Accumulation	0.8	1.1	0.7	0.9	-0.9	-0.4	1.6
Memoranda: Capital Consumption	8.9%	8.5%	9.9%	11.2%	11.7%	11.4%	11.0%
Gross Private Saving	16.1	16.4	17.0	17.2	17.1	17.3	18.4

Notes: Data are averages (except for 1981-84) of annual flows, as percentages of gross national product.
Total net saving and total net investment differ by statistical discrepancy.
Detail may not add to totals because of rounding.
Source: U.S. Department of Commerce.

STATEMENT OF DR. JOHN MAKIN, DIRECTOR OF FISCAL POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH, WASHINGTON, DC

Senator GRASSLEY. Dr. Makin.

Dr. MAKIN. Thank you, Mr. Chairman.

I'm pleased to testify before this distinguished committee on the overall impact of the President's tax reform plan.

My testimony examines three areas: The overall economic impact of the President's plan, the plan's impact on the high level of uncertainty that surrounds tax policy, and international aspects of the plan, particularly its implications for the exchange rate; the balance between domestic savings and investment.

Initial analysis of the President's plan suggests that if enacted promptly, it would result in economic gains equivalent to an annual addition to GNP of about $25 billion in 1985 dollars. These gains would arise from a leveling of tax burdens across different uses of capital, and favorable incentive effects arising from lower marginal tax rates that increase after-tax income and thereby labor, supply, and savings.

Gains also would result from indexing provisions for depreciation, inventories, and capital gains that would reduce the capricious effects of inflation on the level and distribution of the tax burden.

On Tax Code uncertainty, it's important to bear in mind, I think, that a major redirection of the Tax Code, like the President's plan, unavoidably creates uncertainty while it is under consideration. Such transitional uncertainty is not, in my view, a legitimate basis to reject the plan if its adoption would mean less uncertainty about the future shape of the Tax Code and about the level and distribution of future tax burdens.

The keys to a stable Tax Code are inflation indexing and low marginal rates that reduce incentives to alter the code. A major step to simplifying the Tax Code would be to refrain from changing it every year. This requires a return to the concept of a passive Tax Code aimed primarily at raising revenue rather than as achieving a myriad of social goals.

The rate lowering, base broadening approach to tax reform constitutes a fundamental attack on the activist use of the Tax Code that has characterized the past half century. In my view, this is desirable.

The aims of tax incentives are laudable, but their failure to achieve their goals is obvious in many ways. Tax investment incentives eventually fail because they are constantly being removed and reinstated in a manner that makes investment planning virtually impossible.

Since 1962, there have been 14 introductions, modifications, or eliminations of investment incentives. Investment planning is nearly impossible under such circumstances, save attempting to squeeze as much investment as possible between enactment and rescissions of incentives. The 1983-84 investment surge, which I would note has since swooned, is a good example of the squeezing phenomena.

Some perspective on the level of American investment incentives comes from a comparison with similar measures in Japan. There do exist special tax measures for Japanese corporations related to depreciation reserves and special tax credits. Some such special measures were enacted in 1984 and their total value, valuated as tax expenditures, was $1.5 billion. This is very small compared to the 1985 revenue loss of $95 billion linked to tax expenditures on U.S. corporations in the U.S. Tax Code.

Many of the special measures like ITC and ACRS provisions favored in the United States serve to affect only the timing of investment and not its overall level.

Let me turn also to another area that I think is important. That is the treatment of interest income and expense. The U.S. Tax Code treats those measures exactly the reverse of the way they are treated in Japan. Interest expense is not deductible and interest income is largely exempt from taxation in Japan, and, therefore, interest rates are lower and the saving rate nearly triple that of the United States. One of the reasons for an unusually strong dollar is the fact that the asymmetry in the treatment of interest income under the Tax Code makes American interest rates look particularly high to Japanese savers. As a consequence, large amounts of Japanese savings flow into the United States, and in the process strengthen the dollar against the yen.

I'll stop there, sir.

Senator GRASSLEY. Thank you.

[The prepared written statement of Dr. Makin follows:]

Statement of John H. Makin, Director of Fiscal Policy Studies, American Enterprise Institute

Summary

This testimony examines three areas: the overall economic impact of the President's plan; the plan's impact on the high level of uncertainty that surrounds tax policy; and international aspects of the plan, particularly its implications for the exchange rate and the balance between domestic saving and investment.

The President's plan, if promptly enacted in current form, would result in moderate economic gains equivalent to an annual addition to GNP of about $25 billion. Its reduction of marginal rates and indexing provisions represent partial progress toward the important goal of a more stable tax code. The President's plan contains adequate investment incentives judged by its better balance across alternative investment categories relative to the current system and its progress toward indexation against capricious effects of inflation on the level and distribution of tax burdens.

Primary among the shortcomings of the President's plan are its failure to index interest income and expense and its lack of saving incentives. The former misses an opportunity to lower interest rates by about 2 percentage points while expediting a constructive dollar depreciation. The latter means that imported saving will be required to finance adequate capital formation with the result that future returns from investment will only go to enhance future consumption outside of the United States.

Broadly viewed, the President's plan represents moderate progress toward a more neutral tax system that is primarily aimed at raising revenue while not attempting to achieve a myriad of social goals. Perhaps its major flaw is that it does not go far enough in this

direction. Unbalanced base broadeners, like rescission of the ITC and deductibility of state and local taxes, should be replaced by a comprehensive phase-back of tax expenditures. This could be accomplished by converting all existing deductions, exemptions and exclusions into non-regressive tax credits evaluated at the lowest marginal rate. The result would be an increase in the tax base sufficient to lower all marginal rates below 30 percent and reduce regressivity of existing tax expenditures.

Lowering the value of tax preferences would stabilize the code by reducing the incentive, proportional to the top marginal tax rate, to seek tax preferences. In addition, since tax expenditures like full deductibility of household interest expense carry a strong consumption bias, phase-back would increase saving incentives and help lessen the current need to resort to dollar-strengthening capital inflows in order to finance investment.

Mr. Chairman, I am pleased to testify before this distinguished committee on the impact of the President's tax reform proposal on the economy.

My testimony first focuses on the overall economic impact of the President's plan and then considers its effects on the ongoing problem of tax uncertainty and on exchange rates and international competitiveness of American industry. Suggested changes and their effects are briefly discussed. This testimony is partially based on results of an AEI study comparing overall effects of the President's plan, Treasury I and the Bradley-Gephardt proposal and on an ongoing AEI research project comparing tax and budget policies of the United States and Japan. AEI Visiting Scholar Don Fullerton reported to this committee on June 20, 1985 on investment incentives under the President's plan and discussed some findings on Japanese tax policy drawn from AEI's Japan project.

Initial analysis of the President's plan suggests that if enacted promptly it would result in economic gains equivalent to an annual addition to GNP of about $25 billion in 1985 dollars. These gains would arise from a leveling of tax burdens across different uses of capital and favorable incentive effects arising from lower marginal tax rates that raise after-tax income, and thereby labor supply and saving. Gains also would result from indexing provisions for depreciation, inventories and capital gains that would reduce the capricious effects of inflation on the level and distribution of the tax burden.

Tax Code Uncertainty

A major redirection of the tax code like the President's plan unavoidably creates uncertainty while it is under consideration. Such transitional uncertainty is not a legitimate basis to reject the plan if its adoption would mean less uncertainty about the future shape of the tax code and about the level and distribution of future tax burdens. The keys to a stable tax code are inflation indexing and low marginal rates that reduce incentives to alter the code. A major step toward simplifying the tax code would be to refrain from changing it every year. This requires a return to the concept of a passive tax code aimed primarily at raising revenue rather than achieving a myriad of social goals.

One of the most desirable features of the President's plan, its potential to reduce uncertainty surrounding the shape of the tax code, follows from its reduction of marginal tax rates. The simple fact that the value of a tax deduction, exemption, or exclusion is reduced by about 30 percent under the President's proposal by virtue of its reduction of the top marginal tax bracket for individuals from 50 to 35 percent (and the reduction of the corporate tax rates from 46 to 33 percent) means that the incentive to seek preferential tax treatment is sharply reduced. Of course, this desirable result is mitigated, particularly for individuals, by high state and local tax rates, so that the President's proposal wisely includes incentives for a reduction of tax rates at the state and local level.

Viewed in this light, the "fourth bracket" idea is a bad one. It raises the incentive to retain deductions such as state and local taxes, since their value rises from 35 cents on the dollar to whatever is selected for the fourth bracket. Increasing the incentive to narrow the tax base by increasing marginal tax rates reduces the likelihood of reducing tax rates.

This Committee has heard testimony from corporate executives suggesting that the economy would benefit from not having a tax bill every year. I couldn't agree more. Fundamental tax reform, if it is to be undertaken, should aim toward a system that once adopted does not invite further adjustment. There are three primary reasons for the frequent changes in the tax code that have plagued American households and businesses in recent years. The first is the activist attitude of the Congress to use the tax code either to redistribute income or to subsidize what it deems desirable social activities. The second is the devastating impact on the level and distribution of tax burdens of inflation with an unindexed tax code. The third is the simple fact that high marginal rates make the quest for tax breaks a profitable activity.

The experience with the use of investment incentives since 1981 illustrates the problem of tax code uncertainty very well. The rapid inflation of the late 1970s and early 1980s increased the tax burden for households through bracket creep, while increasing the tax burden for corporations through unindexed depreciation and inventory allowances. The problem for corporations was offset for a time as inflation sharply lowered the burden of financing their activities through the issue of debt. However, as lenders came to realize the need to protect themselves against inflation, interest rates rose sharply and corporate borrowers were hit with the full force of their own brand of bracket creep. The 1981 tax act reduced tax rates for individuals to offset the effect of bracket creep and enacted investment tax credits and accelerated cost recovery provisions for firms to offset their additional tax burdens under high inflation. The bracket creep problem for individuals was addressed in a fundamental way through bracket indexing which became effective in January of this year. No similar indexing provisions were introduced for corporations, and as inflation fell more rapidly than anticipated, the 1981 investment incentive measures had to be cut back in 1982 and again in 1984.

The rate-lowering, base-broadening approach to tax reform constitutes a fundamental attack on the activist use of the tax code that has characterized the past half century. In my view this is desirable. The aims of tax incentives are laudable, but their failure to achieve their goals is obvious in many ways. Tax investment incentives fail because they are constantly being removed and reinstated in a manner that makes investment planning virtually impossible. Since 1962 there have been 14 introductions, modifications or eliminations of investment incentives. Investment planning is nearly impossible under such circumstances, save attempting to squeeze as much investment as possible between enactments and rescissions of incentives. The 1983-84 investment surge, which has since swooned, is a good example of the squeezing phenomenon.

Some perspective on the level of American investment incentives comes from a comparison with similar measures in Japan. There do exist special tax measures for Japanese corporations related to depreciation, reserves and special tax credits. Some such special measures were enacted in 1984. The associated total annual revenue was estimated at about $1.5 billion by the Ministry of Finance. This is very small compared to the 1985 revenue loss of $95 billion linked to tax expenditures on U.S. corporations. Many of the special measures like ITC and ACRS provisions favored in the United States serve to affect only the timing of investment and not its overall level. (See AEI

Studies in Fiscal Policy, Working Paper No. I, The Effect of Debt Accumulation on Capital Formation, November 1984.)

The example of owner-occupied housing illustrates another failure of tax incentives: they don't achieve their goals. Tax breaks for owner-occupied housing don't bring home ownership within the reach of more Americans because home-ownership tax incentives carry a value that is quickly reflected in the price of housing. The effect is to reward homeowners at the expense of nonhomeowners. Further, the effect is to reward home owners in the higher tax brackets and those who itemize far more than those in lower tax brackets. The family in the 35 percent tax bracket that stretches to buy a house in a neighborhood where the average marginal tax rate is 50 percent will pay "too much" for the house since the price of housing in a high tax bracket neighborhood reflects the tax sheltering benefits to those in the highest tax bracket. It is no accident that with an unindexed tax code during the rapid inflation of the last 1970s, the most rapid increases occurred in areas like housing favored by the tax system. A revenue neutral reduction in tax rates below 30 percent made possible by even-handed base broadening would virtually eliminate their aggressive impact on tax preferences, as illustrated by this example of the very popular tax preference for housing.

Exchange Rates and International Competitiveness

The President's plan includes adequate investment incentives but largely ignores the problem of a need to remove consumption subsidies or saving disincentives which have resulted in a United States saving rates that is the lowest in the industrial world, about one third the rate in Japan. An international comparison of saving rates suggests that it is the United States, not Japan, which has the most unusual (low) saving rate. Most industrial countries' saving rates are closer to Japan's rate than they are to those of the United States.

Perhaps the worst feature of the President's plan is its retreat from interest indexing provisions in Treasury I. The technical flaws in those provisions could easily have been remedied. As it stands, the President's plan forgoes a chance to lower interest rates by about two percentage points while bringing about a constructive depreciation of the dollar. This result followed from the rescission of treatment of interest income and expense under current law that provides a tax on lenders and a subsidy to borrwers by virtue of allowing borrowers deductibility of interest expense, including the inflation portion of interest expense, while taxing lenders on the inflatin portion of interest income.

It is worth noting that the U.S. tax code treats interest income and expense in a way exactly the reverse of the tax code treatment of interest income and expense for households in Japan. In that country, where interest expense is not deductible and interest income is largely exempt from taxation, interest rates are lower and saving rates nearly triple those of the United States. One of the reasons for an unusually strong dollar is the fact that the asymmetry in the treatment of interest income under the tax code makes American interest rates look particularly high to Japanese savers. As a consequence, large amounts of Japanese savings flow into the United States and in the process strengthen the dollar against the yen. This is just one example of a general need to say more about the international effects of American tax and budget policy. The effects of our easy fiscal/tight money mix have been widely discussed, but little attention has been paid to consequences of our tax code for trade and capital flows and exchange rates.

Investment incentives need to be balanced with saving incentives if Americans are to reap the rewards of increased investment. There is a tendency to speak in a single breath of incentives for saving and investment, but the two are not identical. The 1981 tax act contained powerful investment incentives, but few saving incentives. Consequently, to sustain the increase in investment that followed, it was necessary to import large quantities of saving. By 1984 the United States was importing over $100 billion of foreign saving to sustain domestic spending. Imported saving means future debt service requirements will absorb returns on investment financed by nonresidents.

The President's proposal raises 1986-90 tax receipts for corporations by $118 billion, or by about 24 percent over expected corporate tax payments under current law. Individual taxes fall by $132 billion, or about 6 percent over the 1986-90 period. To the extent that personal saving rates are below corporate saving rates, the shifting of the tax burden from individuals to corporations is likely to reduce the saving rate further. The real need is to increase personal saving rates. This could be accomplished by eliminating or curtailing deductibility of interest expense for household borrowing for consumption purposes while eliminating or reducing taxation of household's interest earnings on their accumulated savings. While the President's proposal does increase allowable IRA contributions for nonworking spouses, these measures have had little effect on overall savings rates because they are fully utilized only by higher-income households which simply shift accumulated savings to IRA accounts rather than increase marginal saving rates.

Suggested Changes

A major flaw of the President's plan is in its unbalanced approach to base broadening. A successful tax reform that is durable enough to reduce the heavy burden of tax code uncertainty will likely require a combination of even-handed reduction of tax preferences to broaden the tax base and a reduction of the top marginal tax rate for households and corporations below 30 percent to minimize the incentives to seek tax preferences. The President's plan could be modified in a way that would enhance its bipartisan appeal by adopting the Bradley-Gephardt technique of converting all deductions, exemptions, and exclusions into tax credits evaluated at a low marginal tax rate of 15 percent. Applied comprehensively, along with a halving of the level of existing tax credits and indexing to shield the value of remaining tax incentives from inflation, such modification would reduce the value of total tax expenditures by about 50 percent. Such reduction would provide revenue sufficient to reduce the top tax rate for households and corporations to 30 percent or below.

Capping the value of tax expenditures at the level of their value to those in the 15 percent tax bracket also has the desirable feature of reducing the regressivity of deductions, exemptions, and exclusions that results from a progressive rate schedule. Under the existing system a deduction is worth 50 cents on the dollar to a high-income individual in the top tax bracket and only 15 cents on the dollar to a low-income individual in a low tax bracket. The progressivity lost by sharp reductions in the top marginal tax rate, which have resulted in large gains for high-income individuals and calls for a fourth bracket in response to the President's proposal, can be offset by removal of the regressive impact of uncapped tax expenditure provisions under current law.

Like any fundamental change, this system would entail burdens for existing heavy users of tax incentives. Costs of transition to a new system could be reduced by stepwise adoption over a period of years. The most direct route to a new system would be to begin by capping deductibility at 35 cents on the dollar in 1986 and moving down in increments of 5 percentage points per year to 15 cents on the dollar in 1990. Marginal rates over that period could also be continuously adjusted so as to maintain revenue neutrality.

This is not an "all or nothing" plan. Congress can select the degree and pace of reform by adjusting initial and terminal levels of the deduction cap and a corresponding set of marginal rates. The base-broadening/rate-lowering mix could be adjusted for revenue neutrality over the next five years, revenue enhancement being either front- or back-loaded.

Summing Up

The search for a political consensus on a stable and more neutral tax system will be difficult. It might be desirable, however, to start the process for fundamental tax reform by postulating an ideal system and then identifying the ways in which we wish to diverge from it, with full knowledge of the costs of doing so. The President's plan perhaps represents his best judgment of where we would end up under such a process. If he is right, perhaps the plan will be quickly passed intact and we will have achieved a modest improvement over the current system. Alternatively, a more even-handed base broadening approach to lower and more stable tax rates may enjoy wider support.

Senator GRASSLEY. Thank you all very much for your testimony. And I would like to start the questioning.

On balance, based on its overall impact on the economy, are the tax changes recommended by the President favorable from your individual points of view? I will start with Dr. Greenspan and just go down the table.

Dr. GREENSPAN. Over the long run, I would say definitely yes. Over the very short run, meaning the first 6 to 9 months of the bill, they are probably marginally negative. I might add, just paranthetically, that our macroeconomic models, as complex as they are, are not sufficiently calibrated to capture the types of impacts that this type of bill suggests. And, therefore, there will be, as you have probably already observed, a quite significant range of expectation with respect to the impact of this bill. And I know of no way in which that could be narrowed.

All I would say is that I know of nobody who believes that the effect of the bill over the long run is drastically either negative or positive.

Senator GRASSLEY. Dr. Aaron.

Dr. AARON. I think the longrun effects are positive. The President's bill is a good bill. It could have been a better one if the administration had stayed closer to Treasury's November recommendations.

As far as the short-run macroeconomic effects are concerned, I don't have any reason to disagree with Mr. Greenspan. But I would emphasize that the likely effects of the President's plan on the economy as a whole, even over the first 6 months or a year, will almost certainly be smaller than the macroeconomic effects of, say, the budget reductions you are now contemplating or such other economic events as the change in the value of the dollar that can occur in 1 month. Our monetary authorities and debt managers have been competent to deal with such shocks.

So I would urge that concern about the macroeconomic effects of this bill not play a significant part in your deliberations. I think you should focus on the structural issue of whether this tax law makes good sense or not.

Senator GRASSLEY. Dr. Boskin.

Dr. BOSKIN. Were this the only opportunity for major structural tax reform in the next decade, I would only find it an improvement if the saving and investment incentives could be strengthened, but made more equal across types of investments and if we guarded against the likely revenue losses that would inadvertently worsen the deficit. Under those two conditions, I would see it as an improvement.

However, I would not be anxious to buy into this as the only major structural reform, if we think better ones might be available in the future.

Senator GRASSLEY. Dr. Makin.

Dr. MAKIN. I think that if the President's plan were enacted tomorrow, it would result in an improvement on the current system, a significant improvement. So it would be worth doing. I think the major difficulty with the President's plan as it is now structured is that the base broadeners are concentrated in two areas—the rescission of investment tax credit and the end to deductibility of State and local taxes.

I think a desirable change would be to smooth out the base broadening process, and a good device to do that would be to essentially evaluate exemptions and exclusions and deductions at their value to those in the 15-percent tax bracket and gradually phase down all tax expenditures in order to gain the revenue to get the top marginal rate below 30 percent.

Senator GRASSLEY. Although to some extent you have addressed this next question, but perhaps you could elaborate more fully. If you could change any one aspect of the President's proposal, regardless of its revenue effect, in order to promote greater economic growth—that being the purpose—what would that be?

Dr. Greenspan?

Dr. GREENSPAN. I have problems with the question, Senator. I think one of the problems we are going to have with this bill is to create revenue neutrality; you are going to have to talk in terms of pluses and minuses. And I am concerned, as, indeed, I am sure you are, in observing the phenomenon we are now beginning to see evolve that it is very difficult to think in terms of having a new incentive coming on without basically creating problems on the revenue side.

The one thing, however, which I would like to see dropped because I think it is bad tax policy is the windfall depreciation benefits recapture.

Senator GRASSLEY. Dr. Aaron.

Dr. AARON. Although not a lot of money is involved in the short run, the worst proposal is to give people with capital gains the option starting in 1991 to choose annually whether they wish to be taxed on 50 percent of nominal gain or all of inflation adjusted gain. To permit people to exercise that option annually strikes me as an outrageous recommendation which would do untold harm. If I wanted to pick one individual provision that needed to be fixed, I would point to that one.

Senator CHAFEE. What was that one again, please?

Dr. AARON. Starting in 1991, the President's plan, following the Kemp-Kasten bill, proposes that taxpayers have the right annually to decide whether to pay on 50 percent of realized nominal gains or all of inflation-adjusted capital gain. That annual option would create enormous opportunities for people with even moderately balanced portfolios to choose what to realize in what year and to play games with the tax system. It's really an indefensible recommendation, in my opinion.

Senator GRASSLEY. Dr. Boskin, any recommendation beyond the increased savings incentive?

Dr. BOSKIN. Yes; I would just like to amplify on that, which is that we know we can't get a lot more out of old capital and old capital is the primary beneficiary of the reduction in the corporate rates from 46 to 33 percent. Were we to have the choice, I would replace the capital cost recovery system proposed by the President with a strong across-the-board investment incentive and trade that off against a slightly higher corporate rate, because I see no reason beyond the recapture period to be rewarding old capital since we will get no more of it.

Senator GRASSLEY. Dr. Makin.

Dr. MAKIN. I would return to the Treasury's plan in the treatment of interest, income, and expense. That is, indexing. I think that addresses a number of problems, including the slow saving rate in the United States. It also, as I pointed out in my earlier remarks, would lower interest rates and would help to create what I would call a constructive depreciation of the dollar.

Senator GRASSLEY. All right.

Under the early bird rule, Senator Bentsen will be first; Senator Roth, Senator Baucus, Senator Chafee.

Senator Bentsen.

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

I think I pretty well buy the idea of tax neutrality, if you limit it to the borders of the United States. But I am still concerned and disturbed about the problem of competitiveness and incentives being given in other countries.

I hear Dr. Aaron say that that is relatively inconsequential, if I understand his statement.

I believe I heard Dr. Boskin talking about approximately 25 percent of the investment in capital equipment resulting from the tax incentives involved, if I don't misinterpret him.

I would like the two of you to enlighten me a little more on that one. We've had the format of a debate here before. Would you touch on that, Dr. Aaron? Because you concern me with your statement, and I want to better understand it.

Dr. AARON. What I'm saying is that the effect on prices of goods in the United States and hence on the ability of U.S. firms to compete with foreign firms can only be affected to a small degree by the investment incentives that we have under discussion in this bill.

Senator BENTSEN. Would you further define "small degree?"

Dr. AARON. Yes; I define "small" in my testimony to mean perhaps 1 percent of prices on the average. Perhaps 2 percent in some industries.

The point is that U.S. firms in competing abroad are laboring under other burdens such as an over-valued dollar that are vastly larger.

Senator BENTSEN. Well, I don't quarrel with that.

Dr. AARON. My point would be that if one is concerned about U.S. competitiveness abroad, one should not build long-term structural distortions into the tax system that will reduce the efficiency with which the U.S. investment is undertaken. One should deal with the root cause, which is, in my judgment, the Federal budget deficits, which contribute in a major way to the overvaluation of the dollar. That's big ticket stuff.

Senator BENTSEN. Well, I understand that. I understand that. But I'm still trying to narrow it down. A lot of times we deal in a whole series of Band-Aids around here to try to ameliorate a problem. And sometimes we have to. People have a tendency to say, well, this one is not significant. But when you get through all of them, it becomes significant. And that's why I would like to narrow it down to talking about that one particular one.

Dr. Boskin, would you comment?

Dr. BOSKIN. Yes, Senator Bentsen. I agree with much of what Dr. Aaron has said about the over-valuation of the dollar being the most important, but I would like to highlight those particular industries where the nature of their international competition is not necessarily producing a standardized, long life consumer product and laboring under a cost disadvantage due to the overvalued dollar in world markets, but where very much the nature of their survival is in technological competition. And in that situation, the investment incentives may well wind up creating the demand for and a cash flow that enables our firms to compete in generating new technology and disseminating it rapidly throughout their capital stock to stay abreast of that competition.

I agree with Dr. Aaron that we would be better off to have an across the board, general, neutral investment incentive. I believe the notion that taxing income, which doubly taxes investment, as you know—first, as you earn it as part of your income and then when it earns its return—would be neutral is, again, as I mentioned, unidimensional. I think that there is enough evidence that investment incentives work and stimulate investment and technological progress that we should have a strong investment incentive. And for some sectors of our economy, I believe it is vital.

Senator BENTSEN. Let me get my one last question in.

Go ahead.

Dr. BOSKIN. I was going to say that we have heard all this discussion of neutrality and while I agree that in the sense that allocation across investments the current tax system is very uneven—and I associate myself with the neutrality remarks of Drs. Greenspan and Aaron. I urge you to take all those studies with a certain grain of salt.

One simple example will suffice. The National Income Account's definition of a structure versus equipment is very, very different from the tax definition. Most of the studies conclude that structures are heavily taxed relative to equipment; in my opinion, that somewhat overstates the case.

Senator BENTSEN. I'm deeply disturbed that the administration's tax plan may not be revenue neutral. I think the last thing we need right now is a further tax cut.

I notice, Dr. Boskin, you suggested phasing out the personal exemption increase to try to make up for the deficit we are facing.

Would anyone else have any particular recommendation as to where we pick up the difference?

Dr. AARON. Yes, I would. I agree with the nature of the problem that Dr. Boskin suggests. I would suggest an alternative way of achieving a similar purpose. And that is simply to raise the personal exemption by a smaller amount—in my testimony I suggest $1,500 rather than $2,000. But I would preserve the protection from tax liability for low-income people by increasing zero bracket amount not to $4,000, but to $6,000. That, incidentally, is the pair of numbers contained in the Bradley-Gephart proposal. Other combinations of personel exemptions and zero-bracket amounts could achieve similar results.

The point is you can trade off zero bracket amount increases for smaller increases in the personal exemption, thereby protecting people at the bottom of the income scale, but not spending so much money on tax relief for people like Professor Boskin and myself.

Senator BENTSEN. I see my time has expired.

Thank You.

Senator ROTH. Thank you, Senator Bentsen.

Like Sénator Bentsen, I'm very concerned about the impact of whatever tax reform we adopt has on growth in this country. And it seems to me that one of the areas in which the proposal is defective is in savings. I think we have to recognize we are in a world economy, we must become competitive in it, and that in order to do so that we are going to have to promote savings. We have to have a constant flow of new savings to provide the capital to make the changes that are going to enable us to be competitive.

Prime Minister Nakasone and other Japanese very frankly have told me, and I am sure many others, that their high savings rate and tax neutrality in this area has been a key fact in their economic growth.

I wonder if each of you could comment on that. It seems to me that there is no point in going through major tax reform if we don't build the kind of environment for long-term growth and jobs, because that seems to me to have to be a key proposition. I'm concerned as to whether this proposal in its present form does enough. Some of you may be aware that I have proposed in the so-called Best legislation to build on the IRA; to permit individuals ultimately after a number of years to save as much as $10,000. You can quarrel with the figure, and I am not asking you on that.

But do you think it makes sense to try to build on the IRA as a means of promoting individual savings?

Dr. MAKIN. I certainly agree with your remarks on the need to increase the saving rate in the United States. Right now, we are importing most of the saving we need to keep expenditures underway in the recovery. The IRA approach is one way to go, although we have moved partly in that direction in the past few years. And the evidence seems to suggest that there isn't much effect on overall saving rates at current levels, because those who participate fully merely shift existing assets into IRA accounts.

Now moving to a higher level, as you suggest, creating a large IRA account, may help.

Senator ROTH. May I just inject one thought? When I say "build upon," No. 1, we would have none of the limitations on what we call the supersavings. You could save for any purpose. And there would be no penalty when you withdraw. Now there are studies made that show that the IRA has not—would attract, some say, as many as 19 million additional accounts if we had removed some of those things.

Dr. MAKIN. Well, I think this plan describes a crucial part of a consumption based tax along the lines that the Treasury proposed in 1977. So in that sense, if it were part of a broadly construed consumption based tax, I think it would be the best way to increase the saving rates.

Dr. Boskin has pointed to the double taxation of saving in the current system. I would add that full taxation of interest income compounds the problem so that if essentially we move to a system where we get away from the double taxation of saving, an integral part of it would be the very large saving account which I think would very much——

Senator ROTH. Are you familiar with the so-called Best plan?

Dr. MAKIN. Yes; I am.

Senator ROTH. Would you care to comment on it? Dr. Makin. The part of the savings, as I indicated, if it were included in an overall consumption tax plan—and I think it's the core of that type of a plan——

Senator ROTH. Correct.

Dr. MAKIN. I think it's a very good idea.

Senator ROTH. Dr. Boskin.

Dr. BOSKIN. I would like to associate myself with those remarks. I think we badly need stronger saving incentives. I would like to say that while some of the funds that have flowed into IRA's pursuant to making them universal have come from existing assets. It is not widely perceived that there was sort of an automatic decline, because of the rise in real interest rates, in contributions to defined benefit pension plans in the United States of $30 billion a year for the last couple of years.

So those people who look at the overall saving rate and say that therefore saving is not responsive to the rate of return, I think are not paying careful enough attention to the structure of the saving—the target-saving nature of defined benefit pension plans has led to this sort of automatic negative effect that IRA's and other things have had to overcome

I would just add that in Japan a household of four can save $50,000 or more tax free in the equivalent of an IRA. There are many other differences between our economy and the Japanese that would explain this saving rate.

Senator ROTH. Dr. Aaron, would you care to comment?

Dr. AARON. I would just describe to you what I do every January. I write a $2,000 check on one account I have with T. Rowe Price and I deposit those funds in my IRA with T. Rowe Price. That's the effect on savings in my case.

Senator ROTH. Dr. Greenspan?

Dr. GREENSPAN. We ought to focus on the fact that if we are trying to increase savings, we have to ask ourselves whether we can do it more efficiently by suppressing consumption or inducing savings through higher interest rates. The evidence suggests that we are more apt to get true net savings increases through suppressing consumption than by inducing an increase in the real rate of return and thereby holding down consumption by higher interest rates. Unless we focus on the issue of increased savings always in terms of reducing consumption, I think we are apt to miss the boat. And in this particular instance, I would like to add further that one of the problems I have with merely trying to induce investment is that it's not so much the absolute amount of gross investment that we make each year which contributes to the growth of this economy, but the underlying productivity of that capital. Investment incentives generally tend to increase those types of investments which have inferior productivity-producing characteristics. Whereas the type of investment which really improves productivity and growth has a pretax rate of return which is in excess of the real cost of capital and therefore requires no investment incentives.

So I'm concerned that while there is no doubt that the most important thing that we can do is to induce savings and investment in this country, it's terribly important to focus on the output of that process in a way which we will get what we are looking for. I am concerned that we tend to too often look merely at the symbols.

Senator ROTH. Thank you, Alan.

My time is up.

Senator BAUCUS. I would like to follow up, Dr. Greenspan, that last point. Are you saying that the increased savings—that we are spending too much time looking at the carrots—that is, the additional savings incentives—and not enough time at the sticks in trying to discourage consumption. Is that what you are saying?

Dr. GREENSPAN. Yes, sir. I'm saying, Senator, that the evidence at this stage is mixed to probably negative that increased real rates of return significantly increase, in the United States, the net savings of our system. There is very considerable evidence that the shifting around from one account to the other to feed into the IRA's occurs with very little change in the net savings amounts.

What I am emphasizing is that whenever we talk about an increase in savings, we have to remember what we are saying is somebody is consuming less out of their given income. And we should not focus on where they put that excess. They will put it somewhere. And, therefore, I would be inclined to do such things as shifting from income tax to a consumption tax if our true purpose was to increase savings. That will do it. Much of the other stuff we are doing, I think, is just shifting sources of savings and not getting at the base.

Senator BAUCUS. Let's go back to assumptions here. I would like to ask each of you pretty much a yes or no answer. And the question is: Do you think that U.S. savings rates are too low if we are going to compete? Are U.S. savings rates based too low?

Dr. GREENSPAN. Yes, sir.

Dr. AARON. U.S. national savings rates are too low——

Senator BAUCUS. Yes.

Dr. AARON [continuing]. Because Government dissaving is so high.

Senator BAUCUS. Well, whatever the reason. I'm just asking your conclusion.

Dr. AARON. Yes.

Dr. BOSKIN. Yes by a substantial margin.

Dr. MAKIN. Yes. They are one-third of what they should be.

Senator BAUCUS. You just stated my next question. Next question is: What percent do you think we should aim for?

Dr. Greenspan?

Dr. GREENSPAN. That's very difficult because there is a market out there which essentially tries to reflect what each individual person tried to do.

Senator BAUCUS. Just a rough approximation.

Dr. GREENSPAN. I would say if I had my choice, I would like to see it at twice where it is.

Senator BAUCUS. Today it is what? Five?

Dr. GREENSPAN. It depends on how you measured it. I believe it would be 5 percent of the personal income level. I would prefer to see it at 10 percent.

Senator BAUCUS. See it 10 percent today. Dr. Aaron?

Dr. AARON. I can't give you a number. It's so much higher than where we are that I think we just ought to start on that trip.

Senator BAUCUS. Dr. Boskin.

Dr. BOSKIN. I'd like to just follow up what Dr. Greenspan said. If we removed all the distortions favoring consumption at the expense of saving in our Tax Code and many of our other features of our economy, and our budget deficits as Government dissavings, I think we would get a natural answer. And I think the natural answer that the market would tell us would wind up approximating twice what our current net saving rate is. But only a modest increase in the gross saving rate.

Senator BAUCUS. OK. Two to three times.

Next question is a little bit more difficult to answer. That is, what should we do in this tax proposal, very briefly, to push us in that direction? I assume, although you have slightly different points of view, that it would be a combination of a tax system that moves a little bit more toward taxing consumption as opposed to income. And I suppose you would enact some kind of carrots and sticks to push us in that direction. Am I correct? And if I am correct—I know it's tough—in 60 seconds, the four of you, what would you do?

Dr. GREENSPAN. I would lower all marginal rates down to 25 percent, and raise the revenue from some form of consumption tax.

Senator BAUCUS. OK.

Dr. AARON. The most important thing you can do to increase national saving is to increase taxes or to cut Government spending in the aggregate.

Senator BAUCUS. I'm sorry. I couldn't hear you.

Dr. AARON. The most important thing you can do to increase national savings is either increase taxes in the aggregate or reduce Government spending and thereby reduce the Government deficit.

Senator BAUCUS. What would you do?

Dr. AARON. I think I would do a mix.

Senator BAUCUS. 50-50?

Dr. AARON. Congress, it seems to me, is going about as far as it can go in cutting spending this year. That's going to leave deficits on the order of $175 billion at the end of this decade. Taxes ought to be increased sufficiently along with reductions in the cost of the debt to close that deficit.

Senator BAUCUS. Dr. Boskin.

Dr. BOSKIN. I would associate myself with both remarks. I think that lower marginal tax rates would eliminate a lot of distortions and enable us to allocate our existing capital and work force more efficiently. I would make up the revenue by a consumption tax, if necessary. And I also believe that the quickest and most direct way and most even-handed way would be a reduction in the Federal Government deficit and let the net savings flow to its highest productivity uses.

Senator BAUCUS. OK.

Dr. MAKIN. I would lower the top marginal tax rate to between 28 and 25 percent. I would get the revenue by capping all exemptions, deductions, and exclusions, including those related to owner-occupied housing, at a value of 15 percent, and evaluate them—give their value at 15 percent as if they were a tax credit. This would phase back all of the many tax expenditures and bring in an additional $200 billion.

Senator BAUCUS. Thank you.

Senator ROTH. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Dr. Greenspan, in your statement on page 8, you indicate, the major adverse impact of the tax bill is likely to be in manufacturing industries which have already been significantly depressed by high interest rates and the strong dollar. I assume these are industries that are suffering from imports or a decline in exports. Heavy manufacturing industries, as you say.

Yet we are hitting these industries pretty hard by eliminating the investment tax credit and changing the depreciation schedules. What do we say about this? This is just a temporary situation and they will have to tough it through or are they liable to go down the tube in the interim?

Dr. GREENSPAN. Well, Senator, I said in my prepared testimony that I think the one provision which I think should go is the windfall depreciation benefits recapture which essentially hits that group and creates a very significant increase in their effective tax rates.

The problems that exist in the manufacturing area vis-a-vis foreign competition is something that is not going to be resolved by this bill one way or the other. The issue is so closely related to the value of the dollar that we need essentially to look toward a more competitive dollar than we do toward incentives which somehow are going to improve productivity of the underlying industries.

I've seen innumerable companies which are highly efficient and extremely low cost, run into very severe competition in the export markets wholly because of the exchange rate of the dollar. I know of no investment that they could make other than some action which would reduce their labor cost by 20 or 30 percent, which I don't think is feasible, which would enable them to offset the impact that the dollar is creating.

I would not look to this tax reform bill as a vehicle which is going to improve or ameliorate the very serious problems which the manufacturing sector has got. I'm terribly concerned that we will put on, as Senator Bentsen was saying, a number of Band-Aids in the expectation that that will improve it. We've got to approach this problem very seriously but make certain that those remedies which we choose are ones that work and not ones that merely look good and have very little impact.

Senator CHAFEE. Well, I know this is a little bit off of the immediate reason for you gentlemen being here this morning, but, as you know, this committee struggles with these matters, and if there is anything that we worry about, it's the value of the dollar. When we first started this this year on the budget reduction effort, the deficit reduction effort, we all were advancing on the cheerful assumption that we get those deficits down and the value of the interest rates would come down, the value of the dollar would come down. Now we are beginning to see signs that if you get the deficits down, the country will be more stable, and the value of the dollar might even strengthen. So that's no reason for not bringing down the deficit. One should bring down the deficit for tons of other reasons than just the strength of the dollar. But how are we going to weaken the dollar?

And I'm not asking you to do that in 10 seconds or less.

Dr. GREENSPAN. I'd just like to follow that for a moment. I don't think it's by reducing interest rates necessarily. It is to reduce interest rates in part. The major part is, however, that the dollar will eventually come down under its own weight. If we wait for the next year, we are going to find that the dollar will be down somewhere between 15 and 25 percent and there is no particular governmental policy which will induce that to move any sooner.

Senator CHAFEE. Well, that's the most cheerful news we've heard in this room for a long time, Doctor Fifteen or twenty-five percent you think in the next year, the dollar?

Dr. GREENSPAN. Yes; We are approaching a point where the accumulation of dollars in international portfolios is beginning to run into saturation. And at some point the dollar can no longer be accumulated at the rate at which it has been accumulated. It will then proceed to fall.

Senator CHAFEE. I think you have given the quote of the day. I see every scribe's pencil hustling.

Dr. Aaron, do you agree with that? I guess really my question isn't whether you agree or don't agree with Dr. Greenspan. It's what can we do, we, in the Finance Committee, other than making this tremendous effort, which we have made, to bring down the deficit? What can we do about the dollar?

Dr. AARON. Since we are talking about taxes, I would say the major thing you can do is make sure any tax bill you report out is not a revenue loser.

Senator CHAFEE. Is not a revenue loser?

Dr. AARON. Is not a revenue loser.

Senator CHAFEE. Could you pull the mike a little bit closer, Doctor?

Dr. AARON. Certainly.

Given the inevitable uncertainty of revenue forecasting and I have no reason to think it's being done any less honestly today than it has been in the past it would be prudent on the part of the committee to aim, even if its real goal is revenue neutrality, for a small tax increase.

Senator CHAFEE. But that all ties in with deficits, though, doesn't it?

Dr. AARON. It does tie in with deficits, and I believe that ties in with the value of the dollar.

Senator CHAFEE. Well, do you think if we do our duty here in this Congress—and you took an even gloomier view than we have taken. In your remarks—you said that you see the deficits of the United States being in the $175 billion range annually at the end of this decade, 1990, I think you said.

Obviously, you know our goal is to get down to $100 billion. Suppose we do our duty and get those deficits down to $100 billion in

1988. Will the dollar weaken because of that or will that have no effect on it?

Dr. AARON. On balance, the dollar will weaken. The deficit is not the only influence on the dollar. Obviously, the willingness of foreigners to invest in the United States depends on the actual and expected state of our economy and on the state of economies abroad.

But the direction of the effect on the value of the dollar of a major reduction in the deficit of the United States is clear. A major reduction in the deficit would tend to reduce real interest rates and slow or reverse capital inflow into the United States. That would bring down the value of the dollar. I cannot give you a numerical estimate as of 1990. But the direction of the effect, it seems to me, is reasonably clear.

Senator CHAFEE. Do you agree with that, Dr. Boskin?

Dr. BOSKIN. Yes, I do. I would also like to associate myself with Dr. Greenspan's remarks. I also expect the dollar to fall because of the dollar denominated assets held in foreign portfolios eventually reaching a saturation point. I'm not as confident as he is that it will fully occur in the next 12 months, but I do expect it to occur soon. Getting back to what Senator Roth said, history knows no convincing example of an economy that has been able to finance its long-term growth by continuing to import capital. The only successful stories of doing so are less developed economies today or, indeed, the United States in the 19th century when it was less developed.

Senator CHAFEE. Mr. Chairman, I know my time is up. I just want to ask Dr. Makin if he agrees with that, and then I have got one quick question I would like to ask.

Senator ROTH. Go ahead.

Dr. MAKIN. Yes. And since we are talking about tax policy, I would return to my written and spoken testimony. That is, that U.S. tax treatment of interest income and expense makes U.S. interest rates look artificially high to foreign investors. And that strengthens the dollar. And the Treasury's proposal to index interest income and expense would lower interest rates in a way that would constructively depreciate the dollar. I would much rather bet on that than the prospect that reducing the deficit is going to lower the dollar. The reason is I, like others, thought that substantial progress on deficit reduction would lower the dollar, and I also thought that a slowing of the U.S. economy would lower the dollar. And I bet some money on that and lost it.

I think it's virtually impossible to predict when the dollar is going to come down. And the portfolio argument is correct, but I certainly wouldn't want to bet any more money on it.

Senator CHAFEE. Let me ask you a final question. There has been some suggestion of increasing the tax rates, the marginal rates, on the higher income people. It is acknowledged that it won't get an awful lot of money. What would be the result, do you think, if we increased the rates under this bill to 40 percent?

Dr. MAKIN. Well, I think that you would increase the return to seeking tax preferences. And so those affected would be more aggressively opposed to any base broadening measures, such as deductibility of State and local taxes that are necessary to get rates down.

Senator CHAFEE. No, let's say we slammed it down their throats. We passed this bill with a higher rate on the upper brackets. Would it discourage savings? Would it affect investment substantially?

Dr. MARIN. I don't think so. I don't think it would be a substantial effect. Again, I think the major problem with the higher rates is that you simply increase the rate of return to seeking tax shelters, and that tends to be wasteful.

Senator CHAFEE. Dr. Boskin.

Dr. BOSKIN. I would agree that in the short run that it would raise a small amount of revenue, and that the amount of revenue would gradually abate because people would find ways to reallocate their activity.

Senator CHAFEE. Do you agree, Dr. Aaron?

Dr. AARON. I don't think the effects would be major, but if your goal is to prevent excessive cuts in rates paid by taxpayers in the top income brackets, there are better ways to go after that goal than raising top bracket rates. Specifically, you should look at the tax preferences that are disproportionately enjoyed by people in upper income brackets. Two I would mention would be first the exclusion of 50 percent of nominal long-term capital gains rather than indexing them and taxing all gains for assets not used in a trade or business, and second the retention of expensing of intangible drilling expenses.

Senator CHAFEE. What do you think, Dr. Greenspan?

Dr. GREENSPAN. I think it's a bad idea. Our basic purpose is to increase savings and investment and the growth of the economy. There is no way that that can be of help, I see no particular benefits achieved on the revenue side from doing that.

Senator CHAFEE. You don't gain any more revenues?

Dr. GREENSPAN. For the negligible amount of revenue, it is a social policy which I suspect is probably fading as a goal in this country, and rightfully so. It has certainly adverse economic effects, and no positive effects of which I am aware.

Senator CHAFEE. Thank you, Mr. Chairman. I went over my time.

Senator ROTH. That's all right.

I have a few more questions I would like to ask. Let me go to the other side of the coin in relationship to what Senator Chafee was asking. There used to be a theory that it was a good idea for everybody to pay some taxes; that there is no free lunch. Now we are moving in the opposite direction in this proposal. And in my own proposal, which is pretty much along the lines of exempting the lower income people from any taxation. Does that give any of you cause for concern? Do you think that we are building a large constituency that will think that everything is free and they will constantly be trying to increase their exemptions? Does that bother you, Dr. Greenspan?

Dr. GREENSPAN. It certainly does, Senator, because I think that what we need in this country is a very broad constituency—in effect, virtually everybody—who is in favor of restraining expenditures. If you have a fairly significant group which looks at the budget and fiscal processes as all benefits and no costs, I think you bias it in a direction which is undesirable.

Senator ROTH. Dr. Aaron.

Dr. AARON. This is the first time I disagree fairly specifically with Mr. Greenspan. No, it gives me no trouble at all. The real tax exempt levels proposed under the President's plan and under all of the other major tax reform plans are still considerably lower than that with which the United States lived throughout the 1950's and much of the 1960's.

It seems to me that it verges on harassment to insist that all individuals or all families be required to file a return, paying a pittance in revenues, in order to achieve a diffuse goal of moral uplift. The fact of the matter is we already do collect significant amounts of revenue through payroll taxes, sales taxes and other taxes that are levied and that fall on people at all income levels.

I do not think that requiring people to file a 1040 each April is a guarantee of good citizenship.

Senator ROTH. Dr. Boskin.

Dr. BOSKIN. So long as we kept to the poverty line or below at the level at which families typically paid no taxes, I would have no problem with that at all. As a matter of fact, I probably would support it.

I share Dr. Greenspan's concern that we don't get into a race between—for major votership between those who are net beneficiaries of Government programs and those who are net suppliers of funds to the Government. That would be inherently unstable. But I don't think we are close to being in that situation yet.

Dr. MAKIN. I generally concur with Dr. Boskin's remarks and would add that trying to deal—to select a poverty level and say that below this level we want to be sure people are given enough income if necessary through a negative tax would be appropriate if every time any other issue, such as freezing COLA's or something along those lines came up, it did not founder on the poverty issue.

Senator ROTH. As I am sure most of you know, I have floated an idea of a business transfer tax. This tax we are looking at currently could be imposed, say, at a rate of anywhere from 5 percent to maybe as high as 10 percent.

It seems to me that this could have a number of advantages. I want to get your reaction to this. It seems to me, No. 1, it's GATT legal so that it helps level the trading field; two, we would make the tax creditable against FICA so in that sense we think it would help employment. And we would take that revenue and use it to make some changes that I think are valuable. For example, if you went as high as 10 percent, you could lower your marginal rates, as you were suggesting, to, say, 15, 20, 25 percent perhaps. You might do something to neutralize savings as well as make some other reforms in the corporate area, such as the recapture provision.

Dr. Greenspan, would you care to comment on that proposal?

Dr. GREENSPAN. Any shift from income tax rates to consumption taxes, on a revenue equal basis, I would consider highly desirable. And presumably that is the major thrust of your bill. And I find, in general, it is something very well worth considering.

Senator ROTH. What about reducing the marginal rates along the lines I was suggesting?

Dr. GREENSPAN. I would say that would be part of the process. In fact, if it was merely to try to raise revenue to solve the problem that exists in this tax reform bill, I'm not sure that it's desirable. But if it is used very specifically to lower marginal tax rates, I would think it would be highly desirable.

Senator ROTH. Dr. Aaron.

Dr. AARON. I guess I would make two comments. The first is that for better or for worse, the current tax reform debate is about reforming an income tax. Like you and like Dr. Greenspan, I might prefer other tax arrangements. But that isn't where most of the debate seems now to be taking place.

The worst thing we can do is mix principles from consumption and income taxation because all we do in the process is create enormous opportunities for tax avoidance. So if we are going to focus on the income tax and talk about improving it, which is the game as long as we are talking about taxing income from capital, then I believe it's a mistake to lard over that income system with consumption tax elements because it leads to tax avoidance and tax distortion opportunities.

I could be very happy moving to a consumption tax or to a tax on all uses of resources whether consumed or transferred to others. But that requires wholesale changes in order to end up with a consistent framework. And I think it's mischievous to try and intermix elements from the two systems.

Senator ROTH. Well, of course, my best proposal—the other proposal—does go to a consumption tax. But let me just point out that I think the BTT is gathering considerable support—a number of individuals on this committee have indicated a real interest. And as far as tax avoidance is concerned, it seems to me that by lowering the marginal rate, if we could lower them as low as 15, 20, 25, you are taking away an awful lot of the incentive to look for other tax shelters.

My basic proposal was to go totally to a consumption, but I suspect we will end up amending the administration's proposal.

Dr. AARON. May I just add that I think the point you have made is correct. When reducing marginal rates, it does reduce the incentives for tax avoidance. However, as long as we do have an income tax, it is important to get that base, the tax base, defined in a neutral and sensible manner.in order to get rid, to the extent that we can, of the distortionary incentives.

So I tend to view a value added or a business transfer tax in the current tax reform discussion as primarily a device for raising revenues. I would prefer, as long as we are debating a tax reform proposal, to try and get the tax base of the income tax as soundly defined as we can.

Senator ROTH. Well, of course, I strongly support the President in keeping it revenue neutral. The last thing we need now is a tax increase. So I would fight that very actively.

Dr. GREENSPAN. Senator, I was wondering if I may excuse myself. I have an emergency meeting at 11 which I have to be at.

Senator ROTH. Yes. Let me thank you for being here, Alan. It's always a pleasure to hear your views.

Dr. GREENSPAN. Thank you, Mr. Chairman.

Senator CHAFEE. I want to join in those thanks. Appreciate you coming.

Senator ROTH. Dr. Boskin, again, I would like to go back to my basic question of introducing the BTT as a means of leveling the trading field; I think helping employment, but more important, giving us the revenue to reduce the marginal rates to build some savings incentives either along the line of what I have discussed or otherwise. Would you care to comment?

Dr. BOSKIN. I would just like to make three simple points about that. No. 1, is that to introduce a new tax, we ought to make sure that it is done at a sufficient level that we amortize the administrative costs over enough of a revenue base. No. 2, that the funds raised be used either to substantially lower effective marginal tax rates in the personal income tax, or to replace a substantial fraction of what is now raised by the corporate tax, or some combination of the two. And, finally, I would just say that it is important in the design of any tax system that the top marginal tax rate or the marginal tax rate and the personal tax be roughly the same as that on the corporate tax to minimize opportunities for people to rearrange their affairs between corporate and noncorporate forms to game the system.

With those provisos, I would strongly support the move toward raising more of our revenue from consumption taxes and less from income taxes.

Senator ROTH. Thank you, Dr. Boskin.

Dr. Makin.

Dr. MAKIN. Senator Roth, I still think Best is best. I think that there are some things we want to consider with an add-on vat or an add-on business transfer tax. The way I look at those is really the way I look at painting my house. I like to scrape off all the old paint before I put on a new coat. If we are going to a consumption base tax, let's do it all the way. I'm a little uncomfortable as is Dr. Boskin that if you add a consumption-type tax on top of another tax with a very high administrative cost there will be some opportunities for gaming the system that none of us, I am sure, could anticipate, given the great ingenuity that is applied in those areas. Last, on the business transfer tax, I am uncomfortable with the idea of what amounts to a 5- to 10-percent import surcharge. I think that tends to help one sector of the economy while imposing an additional burden on the other.

Senator ROTH. You see, what bothers me now is that our foreign competition already has this advantage. Really what we are doing is merely trying to level the field because of the GATT rules, and that Bill Brock has pointed out in the case of an American car, it has roughly a $600 to $700 disadvantage, tax disadvantage, over that of the Toyota or the foreign-made cars. So it does seem to me that that's an issue we have got to address. And the advantage of this proposal is that it is under GATT.

Well, gentlemen——

Senator CHAFEE. I had a couple of more questions.

Gentlemen, it seems to me you all agree that some kind of a consumption tax is good. And, second, that we've got to increase savings in the Nation. That's good.

But if that's so, both of those points, then isn't it unwise for this program to be shifting the burden of taxation from individuals to corporations? I think, Dr. Boskin, that's what you say in your summary. That this isn't good.

What do you say about that, Dr. Aaron? Would you agree?

Dr. AARON. I don't think it's a major consideration, quite frankly. I think if I had been planning this thing, I would have tried to have kept the proposal revenue neutral on the individual side and on the corporate side separately.

But it seems to me that the magnitudes that are involved are not going to have a major effect one way or another on the issue of growth potential for the United States.

I would point out that there are some fairly unpalatable implications of going in the direction of consumption taxation which one ought to contemplate, although I can see the attractions of it. One is that you would be required to tax annually all withdrawals that individuals make from their savings account. Because that's negative savings, it would be part of their consumption.

And that would represent a major change from current law. It certainly would have the effect of encouraging abstention from such withdrawals, hence, increase in savings, as Mr. Greenspan suggested.

But one has to make changes like that at the same time that one excuses from tax deposits into savings accounts, or one courts the risk of creating significant tax avoidance opportunities.

Senator CHAFEE. Well, let me just say that Senator Roth is enthusiastic about exploring some kind of a consumption tax, but I think that that represents, whether it is right or wrong, it represents such a major departure from what we have been doing that I don't see it occurring.

Dr. AARON. That was the basis of my answer. It seems to me that the debate for better or worse is about reforming the income tax. And we could have our opinions on cosmic right and wrong, but this debate is taking place within the framework of the income tax. Let's try and get it right.

Senator CHAFEE. Right.

What do you think, Dr. Makin, about the shifting of the burden of taxation, some of it, from individuals to corporations?

Dr. MAKIN. Well, I think that it comes out of the unbalanced base broadening approach that the President's plan takes to make up enough money for the reduction in rates. And I would recommend, as I say, a much more broadly based approach. If we are going to stick with an income tax, let's try to cut out some of the distortions in that system. The Treasury plan went further than the President's plan in doing that. I think that you need a rather evenhanded base broadening, because if you don't do that, then the two big victims—State and local and ITC losers—tend to have a red flag that they can focus on in resisting the move. So, again, I would return to the idea of spreading the pain a little bit more by phasing back all the exemptions and deductions and exclusions evaluated at the 15-percent rate.

Senator CHAFEE. You mention the exemptions. Dr. Feldstein testified here a week or so ago. One of his suggestions was that perhaps we had gone too far with the suggestion that the individual exemption go up to $2,000 a person. Instead, he proposed, if I remember it correctly, that the lower rate bracket people get $2,000 and then the others get what they currently get.

Dr. MAKIN. Well, his proposal illustrates my point very well. I think he suggested evaluating the $2,000 exemption at a 15-percent rate and giving it as a tax credit. That tends to get the lower income group protected and takes away the regressive impact of the exemption. That you get more money from the higher income individuals because if you are in a 50-percent tax bracket, it's worth $1,000. And if you are in a 15, it's worth $300. Give everybody $300 and you get more revenue. That's what I'm suggesting on a very broad basis for all tax expenditures.

Senator CHAFEE. I suspect those are big dollars, big ticket items, too.

Finally, if we agree that the dollar is the big problem that our manufacturers face in trying to compete abroad, and we also agree that we are doing what we can in these deficit-reduction efforts, then accepting that, where are we when we then go ahead and hit these manufacturers with the loss of the ITC, lengthening of their depreciation schedules in many instances, and the recapture provisions? Maybe we will take out the recapture, but taking it out, we've got to find a lot of revenue.

But let's just assume we get that out. Isn't the loss of the ITC and the change in the depreciation schedules going to be a real blow to our manufacturing industries that are already on the ropes?

Dr. AARON. Let me point out that although the timing of depreciation deductions under the President's plan differs from that under current law and is more backloaded than frontloaded compared to the ACRS system, the present value of depreciation deductions at plausible rates of inflation is greater for each class of assets under the President's plan than it is under current law. So focusing on the depreciation provision alone, leaving the ITC aside, this bill is a liberalization of depreciation deduction; not a curtailment of them.

Senator CHAFEE. I'll accept your statement, but we had a chart from Ernie Christenson the other day that showed of the leading manufacturing nations in the world, seven of them, the United States under this new proposal in the first 2 years would have the lowest recovery of depreciation of any of the countries by far, and particularly in the first year would be incredibly low.

Dr. AARON. I saw that chart. Along with the United States are other such slow movers as Hong Kong, Japan, Korea that have the highest rates of economic growth in the world. Those with the most liberal rates included Great Britain, which is among the slowest growing economies in the world.

The fact is that there are a lot of factors that determine how rapidly a country grows. And I think it's a mistake to draw a direct line of argument from the generosity of investment incentives.

Dr. Greenspan made, in my judgment, a profoundly important point. It's not only how much you invest, it's how well you invest.

Senator CHAFEE. How?

Dr. AARON. It is how well you invest that determines your economic growth. And as long as we have incentives that distort market decisions and cause investments with rates of return below the cost of capital to move ahead of investments with rates of return above the cost of capital, we have investment incentives that are antigrowth, not progrowth.

Senator CHAFEE. Dr. Boskin.

Dr. BOSKIN. I would like to take exception, I think. Dr. Aaron is trying to condense two dimensions into one. I certainly agree that to the extent we have nonneutralities across types of investment, we sometimes get lower social productivity investments made rather than higher social productivity investment made. .

But as he says, in cleaning up our income tax, we will be strongly moving toward a system where the cost of capital will rise; where the hurdle rate will rise and we will be doing less investment. And I think it's very important to keep those two things separate.

My analysis of the President's plan suggests that the combination of the loss of the ITC and the change to CCRS from ACRS at a modest 5-percent inflation rate, what we used to call a high inflation rate, would lower the cost of using structures somewhat and raise the cost of using equipment substantially. CCRS is less generous than ACRS at low inflation rates and more generous at high inflation rates.

Now I think it is important to point out that many of the manufacturing concerns and many of the industries you are talking about do rely heavily on the ITC to finance their modernization. Whether we should continue to have something that is limited to equipment and not available in general, I think there is an overwhelming case for a strong domestic investment incentive. I think it's very important to point out that there are sometimes scars from long periods of an overvalued dollar on firms and industries just as there are sometimes scars on workers from a prolonged period of unemployment. And my concern is that if the dollar does not fall rapidly, as Dr. Greenspan was predicting, then I think we should be worried about the potential scars that are caused. I don't think we should primarily base our tax policy on that concern; nor should our tax policy be made totally in a vacuum independent, as you pointed out, of what is actually going on in the rest of the economy.

Dr. AARON. Could I just add one point? There is a pair of tables in the White House proposal which summarize the points that Mr. Boskin just stated about the changes in the effective rates of tax on structures, equipment, and, I might add, inventories, which are a significant category of business investment.

Those tables also make clear that the President's plan reduces the overall effective rate of tax on equity financed investment. So I think it's misleading to suggest that in the aggregate the President's plan will increase the cost of capital. It does change the relative incentives to invest in equipment as opposed to structures and inventories.

A related question concerns whether we ought to have a general investment incentive. And I think a strong case can be made for such an incentive. But it is not one that should single out one category of investment over another. Although it may not be as romantic or tickle our technical fancies to the same degree, investments in inventories and structures may be economically more productive than investments in equipment. We should let the market make those choices.

So an investment incentive, if it's available, should equally encourage investment in all areas.

Senator CHAFEE. Thank you.

Thank you, Mr. Chairman.

Senator ROTH. I want to express my appreciation to each of you for being here. I think the panel has been most helpful. We look forward to hearing more from you. Thank you very much, gentlemen.

This time we have another very distinguished group, a panel consisting of Paul Craig Roberts, who is a senior fellow at the Center for Strategic & International Studies; Nariman Behravesh—I hope I didn't muddle that too badly.

Dr. BEHRAVESH. You did just fine.

Senator ROTH. He is vice president of U.S. services, Wharton Econometric Forecasting Associates; Robert Brinner, chief economist, Data Resources, Inc.; and Leon Taub, who is chief economist, Chase Econometrics.

Gentlemen, we appreciate very much your patience, and are delighted to have you here with us today.

I'll ask Dr. Roberts, if he would, to begin his statement.

Welcome.

PAUL CRAIG ROBERTS, PH.D., SENIOR FELLOW, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, GEORGETOWN UNIVERSITY, WASHINGTON, DC

Dr. ROBERTS. Thank you, Mr. Chairman. I appreciate the opportunity to present my views on the administration's proposals to this committee, which will play an important role in the decision as to whether there will be a major tax reform, and if so, whether it will be based upon static distributional issues or on dynamic concerns of economic growth and opportunity.

The committee cannot know the aggregate effect of the administration's tax reform proposal on the economy until it knows the impact of the proposal on the cost of capital and labor. The committee cannot assume that the administration has made these calculations or given them adequate weight in developing the tax reform proposal.

Today, I can share with you some of my analysis of the effect of the administration's proposal on the cost of capital. My calculations are based on the effect that the proposal would have on the service price of capital or on the gross income flow necessary to cover taxes, recover the cost of the asset, and earn a normal return.

Overall, the administration's tax reform proposal would have the following impact on the cost of capital:

Capital cost of using machinery would increase by about 5 to 6 percent. The cost of using buildings would decrease about 10 percent. And the cost of holding inventories would decline by about 20 percent.

These changes in the service price capital would have uneven effects on various industries, depending on the composition of each industry's capital investment. Equipment-intensive industries in the Rust Belt would be adversely impacted by the proposal, while inventory intensive industries, such as retail trade, would benefit from the proposal.

In particular, the agriculture, timber, machine tool, and transportation industries would be adversely impacted. The amusement, media, retail trade and real estate industries would be helped by the proposal.

The goal of tax reform should be to reduce the cost of labor and capital in order to improve our competitiveness in the world market, and to increase the rate of income growth at home. The administration's proposal probably does not meet these goals well enough to justify the adverse impact it would have on particular sectors of the economy.

Mr. Chairman, that concludes the summary of my testimony. I would only like to point out in regard to competitiveness and the dollar that our competitive problems began in the 1970's. The 1970's were a period in which the dollar collapsed and lost most of its value against other major currencies. For example, it began the decade at 4.2 West German marks to the dollar, 4.3 Swiss francs to the dollar. At the end of the decade, the dollar stood at 1.8 and 1.6. And despite this collapse in the value of the dollar, large merchandise trade deficits appeared for the first time in our accounts. So I really think it would be very misleading to assume that our competitiveness problem is a creature of the recovery of the dollar these past few years, or the partial recovery of the dollar.

The partial recovery of the dollar in the last few years, I think, reflects the collapse of the inflation rate in the United States, and a somewhat higher after-tax rate of return due to the 1981 tax reduction bill.

It seems to me if you really want to collapse the dollar, you need to return to the policies of the 1970's: inflate and raise taxes. That will collapse the dollar very rapidly.

Senator ROTH. Thank you, Dr. Roberts.

[The prepared written statement of Dr. Roberts follows:]

Testimony before the Senate Finance Committee, June 27, 1985

Paul Craig Roberts
William E. Simon Chair in Political Economy, Center for Strategic and International Studies, Georgetown University, and Chairman, The Institute for Political Economy

Mr. Chairman, Members of the Finance Committee, I appreciate the opportunity to present my views on tax reform to this committee, which will play an important role in the decision as to whether there will be a major tax reform, and, if so, whether it will be based upon static distributional concerns or dynamic concerns of economic growth and opportunity.

This committee cannot know the aggregate effect of the administration's tax reform proposal on the economy until it knows the impact of the proposal on the cost of capital and labor. The committee cannot assume that the administration has made these calculations or given them adequate weight in developing the tax reform proposal. For example, the administration, pointing to a 19 percent tax rate reduction, said that the typical family in New York state would have a tax reduction despite the loss of state and local tax exemption. However, in making this claim the Treasury did not take into account other provisions in its proposal, such as the proposed repeal of the two-earner provision. When this is taken into account, it appears that approximately 60 percent of New York taxpayers will face a tax increase. This oversight does not give me great confidence in any other calculations that the Treasury's Office of Tax Policy might have performed.

In my view, the purpose of tax reform should be to reduce the cost of capital and labor in order to improve our competitiveness in world markets and to increase the rate of income growth at home. Today I can share with you some of my analysis of the effect of the administration's proposal on the cost of capital.

My calculations are based on the effect that the proposal would have on the service price of capital, or the gross income flow necessary to cover taxes, recover the cost of the asset, and earn a normal return. An appendix to my testimony describes the service price calculation.

Overall: The capital cost of using machinery will increase by about 5 to 6 percent. The cost of using buildings will decrease by about 10 percent and the cost of holding inventories will decline by about 20 percent.

The impact on a specific firm, industry or sector depends on how much of each type of asset is used. To compute the effect on a specific firm or industry, it is necessary to calculate the service price of each type of asset (machinery, structures, inventories) under current law and under the proposal, weighted by the total value of the stock of each asset. Keep in mind also that the service price of a short-lived asset is higher than that of a long-lived asset, because it has to recover the original principal over a shorter period.

Clearly, an equipment-intensive industry in the rust belt would be adversely impacted by the proposal, leading to further protectionist pressures, while inventory-intensive industries such as retail trade would benefit from the proposal.

Agriculture: The agriculture sector would be especially hard hit. I estimate that agriculture would suffer a 5 to 10 percent increase in the cost of capital under the administration's proposal. This is because agriculture is not a heavy user of buildings. Most agricultural investment is classified as equipment for tax purposes and, therefore, currently qualifies for the investment tax credit, which is repealed in the administration's proposal. The reduction in tax rates is not sufficiently large to compensate agriculture for the loss of the investment tax credit.

Specifically, breeding stock industry would lose its current accounting rules and would move to a different depreciation system. The net result would be a small increase in the cost of operating such farms. The increased accountant fees would likely be larger than the increased taxes collected by the government. Many of the costs of this industry would no longer be expensed as they are incurred. Instead, they would have to be spread over a number of years. Soil and water conservation, fertilization and soil conditioning, land clearing and reforestation would no longer qualify as current expenses. Indeed, under the administration's proposal, many of these costs cannot be recovered until the land itself is sold. An arbitrary de minimis rule would help some farms, but it seems to be a hit or miss proposition depending on the specific crop or livestock involved.

Timber: The timber industry would lose the tax treatment that has allowed it to compete in world markets.

The industry would experience a doubling of its effective tax rate due to the redefinition of sales eligible for capital gains treatment. This would continue the contraction of this industry.

Transportation: Transportation would be the hardest hit of any of the large sectors. This is mainly due to an almost total absence in transportation investment of the categories--buildings and inventories--favored by the administration's tax reform proposal. Transportation relies heavily on the investment tax credit, which is eliminated. I estimate that the capital costs of the transportation industry would increase by 5 to 10 percent.

Utilities: Regulated public utilities would receive a long overdue redress of the discrimination shown over the past decades in the tax law. This industry has repeatedly been assigned longer tax lives for the same assets owned by other industries. The administration's proposal corrects this, and utility assets are conformed to all other industries. The net result is a smaller increase in this industry's cost of capital than would be experienced by other equipment-intensive industries.

Amusement and media industries: Because of its heavy investment in structures, the amusement industry would prosper under the administration's proposal. The print and electronic media would also do well. I estimate that these sectors would experience a 2 to 5 percent reduction in the cost of using capital. There would be adequate information about, and diversion from, the hard times the tax reform would cause in other sectors.

Trade: Wholesale and retail trade, where investment is concentrated in structures and inventories, would greatly benefit from the plan. In this sector, the cost of business fixed investment would be reduced by about 5 percent and the cost of inventories by 20 percent.

Real estate: Real estate, the home of tax shelters, would also do well. The industry would be slightly hurt by the accounting changes. However, the improved inflation protection would more than offset the accounting changes. The inflation protection is a good feature of the administration's proposal. Overall, I estimate that the cost of a building, such as a multi-unit housing building, would fall by 10 percent under the proposal.

Conclusion: Mr. Chairman, Members of the Finance Committee, I would legislate no tax reform unless I knew its dynamic effects and was confident that the result would be to reduce the cost of labor and capital and to make American labor and manufacturers more competitive in markets at home and abroad. I see no point in a tax reform that does little, if anything, to improve the overall performance of the economy, or in one that benefits some sectors at the expense of others. The main result of a tax reform that benefits grocers, retailers, and the service sector at the expense of the machine tool, timber, agriculture, and transportation industries would be to increase protectionist pressures. There is no point in suffering the headaches of a major tax reform simply in order to acquire more headaches.

The administration has proposed a major tax reform that is based on static revenue estimates, which assume, unrealistically, that changes in taxation do not affect economic behavior and the economy's performance. This approach leaves out of the analysis all of the important effects that taxes have on prices, costs, real output, U.S. competitiveness in world markets, employment, and economic growth. All that is left is gainers and losers in static distributional terms. This simplistic, misleading approach is guaranteed to produce unexpected results. It is also guaranteed to resurrect the politics of envy, which had been crowded out by the politics of opportunity.

The Finance Committee has an opportunity to craft a bill that is unambiguously pro-growth. Your criteria should be: does this reform lower the cost of capital and labor? If so, it will help the poor, make us more productive and competitive in world markets, reduce protectionist pressures, help our allies, and help third world countries struggling to service heavy debt burdens. All of these are good reasons to undertake a tax reform. In contrast, distributional reasons are treacherous because they open the door to giving the poor a tax cut in a way that throws them out of work or restricts their future income growth and opportunities.

Consider a simple case. Assume that investment is taxed and income redistributed with no rise in unemployment or consumer prices. Even in this unlikely case, we cannot say that the worker is better off. The lower aftertax rate of return earned by investment means less investment, which means the worker will have less capital with which to work, which means his productivity will improve at a slower pace, which means his future income will be less. Such a tax reform makes the worker better off today at the expense of his future and that of his country.

Mr. Chairman, I request that the attached article from Business Week be included in the record as part of my testimony. That concludes my statement.

Economic Watch

WARNING: 'TAX EQUITY' HASN'T WORKED THAT WAY

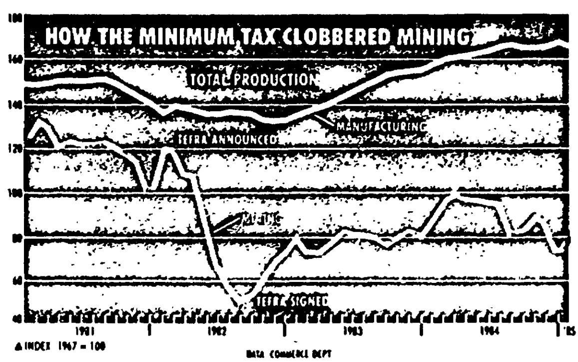
BY PAUL CRAIG ROBERTS

The corporate minimum tax, created to help cut the deficit, instead cut mining output, Social Security revenue, and federal income taxes

In a recent speech, Federal Reserve Board Chairman Paul A. Volcker expressed concern that important sectors of the U.S. economy, such as mining, are being left out of the recovery. Volcker believes that the federal budget deficit is the root cause of this "economic imbalance." ~~In fact,~~ neither the deficit nor the dollar's recovery is responsible for the depressed state of U.S. mining. The industry owes its hard times to a deficit-reduction package known as the Tax Equity & Fiscal Responsibility Act of 1982 (TEFRA).

The centerpiece of TEFRA was a corporate minimum tax designed to assure that every profitable corporation pays some tax. It took the form of a 15% surcharge levied on an arbitrary selection of allowable tax deductions. The minimum tax is an add-on tax that raises production costs and forces producers to respond by reducing the scale of their operations.

TINY PROFITS. One new item subject to this minimum tax was "mineral exploration and development costs." TEFRA added 3.6¢ in costs to each dollar of output sold. In 1980 the average aftertax profit on each dollar of mining sales was only 5.7¢. Obviously, lower-cost operations yielded higher profits, while higher-cost operations yielded less profit. Overall, the minimum tax wiped out 63% of the profits necessary to maintain the 1981 level of mining activity. As soon as the new tax was announced, the industry began shrinking, shedding marginal operations and retaining only those still profitable after the add-on tax had been taken into account. As the chart shows, TEFRA caused a decline in mining production that was much more severe than the drop in manufacturing caused by the recession.



Even a cursory glance at the mining market would have revealed to the policymakers that the industry's domestic prices are substantially determined by world prices. It should have been obvious that the minimum tax could not be passed on to consumers and would have to be absorbed mainly by shrinking the domestic industry. But since policymakers are addicted to static revenue estimates that assume no behavioral response to tax increases, they looked for none and proceeded to collapse the U.S. mining industry. This unanticipated result suggests the kind of surprises that can be expected from the major tax reform that is now being prepared.

The proponents of the 1982 minimum tax estimated that it would raise \$4.4 billion over six years as part of the \$238 billion TEFRA package. This estimate relied on the standard static revenue method. An after the fact examination of the revenue change from this provision makes clear that the minimum tax was a revenue loser. Capacity-utilization figures from the Fed confirm that mining activity has retreated by more than 15% from previous levels. This translates into \$30 billion of lost labor compensation over the six-year period.

LOST JOBS. The shrunken labor income means a \$4.2 billion reduction in Social Security tax revenues and \$3.5 billion less in federal income taxes. As for the human costs, about 180,000 mining jobs were lost. The normal estimate is that two support workers are displaced each time a primary worker loses his job. When the lost revenue from displaced shopkeepers and other support workers is included, the overall effect of the minimum tax will be to increase the deficit by \$23 billion rather than to reduce it by \$4 billion. It is doubtful that the 540,000 workers who lost their jobs are pleased with the greater "tax equity and fiscal responsibility" the Treasury Dept. delivered in 1982.

With our domestic industries facing the competitive discipline of world market prices, domestic tax changes that raise the cost of production will cause shrinkage of the affected domestic industries and a rise in protectionist pressures. It is also noteworthy that the sharp drop in U.S. mining activity occurred despite the 25% reduction in personal income taxes. This outcome is at odds with the claim of supporters of the Treasury Dept.'s tax reform proposal that lower tax rates on individuals will automatically offset the called-for increase in the cost of capital that would stem from the loss of the present accelerated cost-recovery system, the investment tax credit, and other so-called "tax preferences" for business. ■

PAUL CRAIG ROBERTS IS THE WILLIAM E. SIMON PROFESSOR OF POLITICAL ECONOMY AT THE CENTER FOR STRATEGIC & INTERNATIONAL STUDIES, GEORGETOWN UNIVERSITY

Technical Appendix

Description of Service Price Calculations

In order to evaluate alternative tax regimes, it is necessary to measure their impact on the cost of capital services. An increase in these costs would require an increase in the gross returns required by acceptable investment opportunities and, hence, a decrease in the amount of real investment undertaken. This, in turn, would mean a lower capital stock, a less productive labor force, and a lower GNP. We have measured the alternative costs of capital implied by various depreciation proposals via a "service price" calculation for each of 37 different asset categories covering 73 different industry classifications. This appendix describes those calculations.

The service prices calculated for each asset category represent the current marginal products required per dollar of corporate investment in that asset by each industry. They are the before-tax rates of return required to be produced by the asset in order that the anticipated taxes, depreciation, and a "normal" rate of return are covered. The normal real rate of return is assumed equal to 2.7 percent, a level we estimate to have prevailed during 1983. An asset category's rate of <u>economic</u> depreciation is assumed generally to vary across industries. Allowable <u>tax</u> lives also generally differ across industries, and allowable depreciation methods vary among the several alternative tax regimes in place in the U.S. during the period 1954 to 1983. These regimes include

(1) Bulletin F Guideline Lives
(2) Class Lives, using ADR write-off methods.
(3) Asset Depreciation Range (ADR), using that life within the given range that minimizes the service price (accounting for different investment tax credit rates according to the chosen depreciable life).
(4) Accelerated Cost Recovery System (ACRS) as originally passed in 1981 under ERTA
(5) ACRS as currently implemented.

The algebraic expression used for the calculation of the service price is derived from the first order condition for a wealth maximization problem. It assumes a constant investment deflator, measured relative to an overall price deflator, is expected to prevail over the relevant future. The maximization calculus is performed from the standpoint of the ultimate investor -- the individual stockholder. The existence of a corporate legal structure is deemed important only insofar as it creates an additional tax liability for the investor. The alternative, i.e., neglecting taxes on dividends, would be unsatisfactory; a corporation that (either explicitly or implicitly) neglects the additional taxes on dividends would fail to provide its stockholders with a market level, after-tax rate of return.

The service price expression for corporate capital is given as

Service Price = tp/(1-ts)

+ (1-k-D)/[(1-ts)*((1-tcf)*(1-td)*(1-tcs))*E]

where

- tp = the rate of property taxation, assumed equal to 3.22% for current law examples.
- ts = the rate of tax on output (e.g. a VAT or sales tax on all final product), assumed equal to 5.26%.
- tcf = the federal corporate tax rate, assumed equal to 46% for current law examples.
- tcs = the state corporate tax rate, assumed equal to 9.67%
- td = the marginal dividend tax rate, adjusted to reflect the average timing difference between profit accruals and dividend receipts, assumed equal to 16.37% initially. This rate is assumed to be subject to bracket creep for future periods. See below.
- k = the effective rate of the investment tax credit (the statutory credit, adjusted for the net income limitation), assumed equal to 9.23% for equipment and nonbuilding structures. This rate is adjusted downward for short lived assets under Class Lives, ADR, and ACRS.
- D = the present value of the future stream of tax depreciation allowances, adjusted to an after-tax basis, i.e., the stream is multiplied by an appropriate tax factor. A nominal interest rate of 6.7% is used as the discount factor, reflecting a 4% rate of inflation assumed throughout. See below for a further description.
- E = the present value of the "efficiency stream", i.e., the present value of the future real returns, measured as a percentage of the asset's initial marginal contribution to output. A real interest rate of 2.7% is used as the discount factor. See below for a further description.

The assumed average economic life for each asset/industry category is the applicable class life under the old ADR system. These lives were first introduced in 1962 under the Guidelines depreciation system. In some cases, the BEA asset categories that were used do not correspond exactly with the IRS class life categories. In those cases an average or representative life was chosen.

Variation in expected asset lives is simulated by the use of a truncated normal distribution centered on the assumed average economic life. This distribution is used to derive an asset "discard" function. The discard function assumes that some (small) proportion of an original investment in assets of a certain type is discarded beginning at 50% of the assumed average economic life. It also assumes that some (equally small) proportion of the original investment is maintained up to 150% of the assumed average life. The other capital assets constituting the original investment bundle are discarded at ages in between 50% and 150%, with the greatest number being discarded at the average economic life. In addition, a concave efficiency function is assumed for all nondiscarded assets to reflect factors such as technological change. This function assumes that the loss of productive efficiency is smallest in the early years, and greatest in the final years for each particular asset. (This is the reverse of a geometrically declining efficiency schedule in which the greatest absolute efficiency losses are incurred immediately.) Combining the discard function with the concave efficiency function yields an overall efficiency function for a given investment bundle. The general shape of this function indicates an initial slow rate of efficiency loss for the investment, a faster rate as the original investment ages and assets are discarded, but again a slower rate as we reach the upper tail of the discard function. The overall function becomes zero at 150% of the average economic life. This methodology is identical to that used by the Office of Business Analysis, Department of Commerce in generating their capital stock database.

As stated above, the variable E represents the present value of the efficiency function just described. Alternatively, it can be viewed as a measure of the average life of a given asset category expressed in units of current output. In the absence of taxation, the inverse of E by itself, would represent the "cost of capital". For example, with an infinitely lived asset (no efficiency loss and no discards), E would equal the present value of an infinite series of ones, or simply one over the discount rate. the inverse of E would therefore equal the real rate of interest. Similarly, under an assumption of geometrically declining efficiency, the inverse of E would equal the sum of the interest rate and the (constant) rate of depreciation. With the efficiency schedule described above, however, the present value formula cannot be so easily condensed, and the more general form of the inverse of E must be used to measure the joint requirement for interest and economic depreciation.

The <u>tax</u> depreciation write-offs used in deriving the D term are calculated according to the relevant taxation scheme. In all cases, a half-year convention is used. The appropriate tables found in the tax regulations are used for calculating personal property allowances under ACRS. A choice is allowed whereby either the original depreciable basis is adjusted downward by 50% of the investment tax credit or a 2% reduction in the allowable credit is taken. The allowance schedule for 18-year real property was constructed using the 175% declining balance method. Under the ADR and class life proposals, either a declining balance method (with a switch to straight line at the appropriate time) or sum of the years' digits method is chosen. For Section 1245 property, either 200% declining balance or the sum of the years' digits method is used, depending on which yields the greatest present value of depreciation allowances. For Section 1250 property (which we equate with BEA's building categories), the method is limited to the 150% declining balance method.

The straight-line method of depreciation is used in calculating taxable dividends under all regimes. For ACRS, the lives specified in Code Section 312(k) are used. A five year write-off is used under the expensing alternative. Inflation indexing is not taken into account in this calculation.

The tax rate on dividends is assumed to increase slowly over time due to bracket creep. Both a real growth adjustment and an inflation adjustment in the marginal rate is incorporated. Possible anticipated future tax "cuts" intended to correct for bracket creep are not taken into account. The real growth factor used in the calculations is 2%; inflation is assumed to be 4%. Bracket creep elasticities of .3 are used, so that a 1.8% (.3(.02+.04)) annual increase in dividend tax rates is assumed. This translates into roughly a 30 basis point increase in the dividend tax rate per year. A dividend tax rate ceiling of 50% is imposed.

The nominal depreciation allowances are multiplied by the appropriate tax rates in order to express their impact in after-tax terms. The D term, mentioned above, is defined by the following expression, which accounts for the deductibility of state corporate taxes on the federal return:

D = Present value[

(tcf+tcs-tcs(tcf+td))*Corporate Allowance

+(td)*Straight Line Allowance]

This D term is akin to the investment tax credit as regards its impact on the cost of capital. The depreciation allowances reduce the cost of the initial investment in present value terms by a percentage equal to D. Notice that there is no necessary connection between D, which is based on the allowable <u>tax life</u>, and E, which is based on the assumed distribution of <u>economic lives</u>. Equating the tax life with an average economic life does not necessarily yield a more or less burdensome tax system. Also, varying the assumptions regarding the economic lives and the pattern of efficiency decay do not change the relative rankings of alternative depreciation rules on the service prices.

STATEMENT OF ROGER E. BRINNER, PH.D., CHIEF ECONOMIST, DATA RESOURCES, INC., LEXINGTON, MA

Dr. BRINNER. Thank you very much for this opportunity. I will summarize my remarks and note that in advance that I, too, unfortunately will have to leave at approximately 11:30. I will be happy to respond to questions in writing at a later date.

Senator CHAFEE. Well, you can see that we keep you fellows a long time because we are interested in what you have to say.

Dr. BRINNER. I believe that the President's proposals would enhance the public's perception of fairness, but that they would come at a cost to business investment and, hence, to labor productivity growth. The measures do really offer few gains in simplicity.

With respect to fairness and simplicity in personal income taxation, the central principle underlying the initial Treasury plan was to treat all income equally whether its source was labor, equities, bonds, or real estate. Portions of this approach have survived in the President's proposals, led by the simplified rate structure. Inflation adjustment in the measurement of capital gains, and of interest income, and expense are largely gone, probably a wise choice, given the complexity that this would add to the code and the acceptance of permanent inflation of 5 percent or greater this would signify.

On the other hand, a prime Tax Code distortion motivating much sheltering activity has returned to life: special treatment for capital gains. There are better vehicles available to support capital formation.

On the corporate side, it's difficult to state flatly that greater fairness or simplicity would be achieved. The investment tax credit would be scrapped and the current accelerated cost recovery system would be replaced by a new system with typically longer effective service lives than under ACRS, but with an inflation indexation of the undepreciated cost base. This indexation would make the proposed system more generous than ACRS.

I believe this depreciation indexation is a mistake in the context of the President's plan. The Treasury recognized in its original plan that inflation adjustments could not be made on a piecemeal basis. A substantial new distortion and a new complexity would be added to the code by allowing full interest cost deduction in financing while allowing inflation adjustment of each asset's depreciable base.

With respect to growth, my main criticism of the original Treasury plan was that it created large disincentives for capital formation by removing the investment tax credit, eliminating accelerated depreciation, and shifting the tax burden from the household to the corporate sector.

I could applaud the introduction of dividend deductibility, but the net impact of the changes would have been negative.

In the President's proposal, some acceleration of depreciation has been restored, but dividend deductibility has, unfortunately been scaled back from 50 percent to 10 percent. The President's plan would apparently raise corporate taxes by about $24 billion per year, 1986 to 1990, compared with the Treasury estimated increase of $33 billion in the original plan, both changes measured on a static basis.

The total package for business is moderately proinvestment compared to the Treasury plan, and moderately anti-investment compared to current law. On the latter score, the conclusion is inescapable. The President's proposal raises corporate taxes and it substitutes low-powered incentives—such as corporate rate cuts—for high-powered incentives—such as investment tax credits and accelerated depreciation. Cash flow would be cut and the cost of financing would be increased. Thus, investment logically would be reduced.

Combining the proposed personal and corporate tax changes, the Treasury estimates that the first plan would have raised Federal taxes by $4 billion for a year over the next 5 years while the President's version would cut taxes by $2 billion.

More significant, both plans would reduce national savings by shifting income away from the corporate sector toward the low-saving household sector. The loss of savings would amount to $15 to $20 billion per year.

The flaws in the President's proposals can be eliminated by making the plan permanently revenue neutral for corporations and for individuals, removing inflation adjustments to depreciation if interest payments remain fully deductible and maintaining special incentives for investment. These could be achieved by replacing the current 10 percent equipment tax credit with a 7½-percent tax credit for all structures and equipment, by creating depreciation schedules that provide inflation protection without explicit indexing, by reducing the cost of equity capital either by allowing corporations 50 percent dividend deductibility or by treating corporate taxes paid on dividends as withheld personal taxes creditable to the shareholder, and, finally, by allowing individuals no overall tax reduction. This last point implies standing firm on the nondeductibility of State and local taxes, broadening the taxation of fringe benefits, and retaining the zero to 35 percent personal rate structure proposed, but narrowing the brackets to raise revenue.

Thank you very much.

Senator CHAFEE. Well, thank you very much, Dr. Brinner.

[The prepared written statement of Dr. Brinner follows:]

Testimony by Dr. Roger E. Brinner, Group Vice President and Chief Economist, Data Resources, Inc.

TAX REFORM II: "THE PRESIDENT'S TAX PROPOSALS FOR FAIRNESS, GROWTH, AND SIMPLICITY"

Although they could enhance the public's perception of fairness, the President's tax reform proposals could also come at a cost to business investment, and hence to labor productivity growth. The measures offer few real gains in simplicity.

Fairness and Simplicity

The central principle underlying the initial Treasury plan was to treat all income equally whether its source was labor, equities, bonds, or real estate. To the extent that income represented a multi-period return, the asset cost would have been indexed to inflation. Incentives to shift income from ordinary tax to capital gains treatment, together with benefits from delayed reporting of current income (such as accelerated depreciation), would have been largely eliminated.

Each taxpayer's comprehensively-defined income was then to be subject to a simplified rate schedule with only four income brackets: a "zero" bracket not subject to tax followed by three relatively broad brackets with tax rates of 15%, 25% and 35%.

Portions of this approach have survived in the President's Proposals, led by the simplified 15-25-35 rate structure. Inflation adjustments in the measurement of capital gains and of interest income and expense are largely gone, probably a wise choice given the complexity this would add to the code and the tacit acceptance of permanent inflation (of 5% or better) this would signify.

On the other hand, a prime tax code distortion motivating much sheltering activity has returned to life: special treatment for corporate capital gains. There is only anecdotal evidence and no hard analysis--near "religious" belief rather than science--motivating this gross deviation from tax reform and, if included in the final bill, it will certainly haunt the code by generating persistent, legitimate accusations of unfairness and abuse. There are better vehicles available to support capital formation. Even if gains are fully included in taxable income without any inflation adjustment, such income still enjoys the benefit of taxation deferred until the asset is sold.

On the corporate side, it is difficult to flatly state that greater fairness or simplicity would be achieved. The investment tax credit (favoring producer durable equipment and most utility investment) would be scrapped. The current Accelerated Cost Recovery System (ACRS) would be replaced by a system with typically longer effective service lives than under ACRS, but with an inflation-indexation of the undepreciated cost base which would make the proposed system more generous than ACRS.

This depreciation indexation is a mistake in the context of the President's plan. The Treasury recognized in its original plan that inflation adjustments could not be made on a piecemeal basis: if introduced into the measurement of expense, inflation adjustment must be thoroughly executed (including interest expense) and it must be done for both personal and corporate taxation. A substantial new distortion and a new complexity would be added to the code by allowing full interest cost deduction (including the inflation premium) in financing while allowing inflation adjustment of each asset's depreciable base.

Growth

My main criticism of the original Treasury plan was that it created large disincentives for capital formation by removing the investment tax credit, by eliminating accelerated depreciation, and by shifting the tax burden from the household to the corporate sector. Although I could applaud the introduction of (partial) dividend deductibility and inflation indexation of depreciable assets, the net impact of these changes would have been negative. The Treasury plan would have achieved efficiency gains by creating unbiased incentives for various types of investment, but these gains would have been more than offset by productivity losses stemming from lower aggregate capital spending.

What would be changed in the President's Proposals? In the area of business taxation, some acceleration of depreciation schedules has been restored. Dividend deductibility at the corporate level, however, has been scaled back from 50% to 10%. The maximum Federal capital gains tax rate has been cut from the current

20% to 17.5%, but the compound Federal-state rate has actually risen due to nondeductibility of state income taxes; in Treasury I, it was to be 35% of each inflation-adjusted gain. As in the original proposal, the President's Proposal sets the maximum statutory corporate tax rate at 33%, down from 46% today. In combination, these features would apparently raise corporate taxes by about $12 billion per year in 1986-90, compared with a Treasury-estimated increase of $33 billion in the original plan, both changes being measured on a static basis.

To fill the near-term revenue gap created by a personal tax cut averaging $26 billion per year through 1990, the President's plan includes a new "recapture" provision worth another $12 billion per year. This provision would avoid letting recent investments enjoy the best of both tax worlds. For example, an investment made in 1981 could conceivably have qualified for both the investment tax credit and accelerated depreciation allowances during the past five years. With most of the yield from this asset finally being recognized in 1986 and beyond, this income would have been taxed at an unexpectedly low 33% rate. The special recapture mechanism eliminates this "windfall" potential. This proposal seems both fair and logical.

The total package for business is moderately pro-investment compared to the Treasury plan, and moderately anti-investment compared to the current law. On the latter score, the conclusion is inescapable: the President's Proposal raises corporate taxes and it substitutes low-powered incentives (corproate rate cuts) for high-powered incentives (investment tax credits and accelerated depreciation). Cash flow would be cut and the cost of financing would be increased; investment, logically, would be reduced.

The popular selling point of the President's plan is that it would significantly reduce personal marginal tax rates and cut average tax rates for families earning less than $20,000. A family of four currently pays taxes on any income above $8,000; under the new plan, the base is raised to $12,000. The top personal tax rate would fall from 50% to 35%. These revenue losses are only partially offset by provisions to broaden the tax base by eliminating deductions for state and local taxes and form some fringe benefits. Again according to Treasury estimates, personal tax payments in the second plan would be cut $26 billion annually for the next five years, a slightly smaller reduction than in the original proposal ($30 billion).

Based on the consensus of professional opinion, I assume that lower marginal tax rates would increase the number of low-to-middle income family "second-earners" willing to join the labor force and the average workweek an individual would seek. Over a generation, I assume the labor force could expand ½% and hours per worker could rise 2%. The plan is therefore given credit for raising total potential hours by 2½%.

Combining the proposed corporate and personal tax changes, the Treasury estimates that the first plan would have raised Federal taxes by about $4 billion per year over the next five years, while the President's version would cut taxes by about $2 billion per year. Although both estimates assume no changes in spending and investment behavior, adjustments would no doubt occur. Since it is reasonable to assume that these behavioral changes would be made to reduce rather than to increase taxes, both Treasury plans would be modest revenue losers, during the first five years.

More significant, both plans would reduce national savings by shifting income away from the corporate sector toward the low-saving household sector. In the President's Proposals, the loss would initially amount to $15 to $20 billion dollars. Interest rates are the market price of savings, hence a lower supply of savings would necessarily dictate higher post-tax interest rates.

Market (i.e. pre-tax) rates would be little changed initially because a downward impetus to credit costs from lower marginal tax rates would offset the upward push of lower national savings.

This scenario changes during the 1990's: the corporate tax increase fades away as "recapture" taxation ends and as inflation-indexed depreciation allowances reduce taxable corporate income. The plan is no longer revenue neutral even on a static basis. National savings are clearly lower because a larger Federal deficit is once again financing heavier personal consumption. (This part of the tax reform debate will unfortunately resemble the rhetoric-laden debate of 1981-1982 over "supply side" tax cuts.)

Putting the labor force and capital stock growth effects together, I conclude that the President's proposals would tend to create an economy with slightly higher gross national product, heavier consumption and weaker business and residential investment. A lower capital-labor ratio implies, even after generous adjustment for potential efficiency gains from more similar taxation of alternative investments, weaker labor output per hour and hence lower real hourly wages.

To restore public confidence and to make investment decisions more efficient, tax reform is essential. The flaws in the President's proposals can be eliminated by:

- Making the plan permanently revenue-neutral for corporations and for individuals.

- Removing inflation adjustments to depreciation if interest payments remain fully deductible.

- Maintaining special incentives for new investment.

It is possible to achieve these objectives by:

- Replacing the current 10% tax credit on producers' durable equipment and utility structures with a 7.5% credit for all equipment and structures. This would provide neutrality and efficiency as well as boost overall capital formation.

- Creating depreciation schedules that provide inflation protection without explicit indexing, i.e., by slightly shortening tax lines relative to "economic" lives.

- Reducing the cost of equity capital either by allowing corporations 50% dividend deductibility or by treating corporate taxes paid on dividends as "withheld" personal taxes, creditable to the shareholder. A move to allow full deductibility/crediting for dividends on net <u>new</u> issues of shares is also worth considering.

- Allowing individuals no overall tax reduction. This implies standing firm on the nondeductibility of state-local taxes; broadening the taxation of fringe benefits, by placing a cap on the dollars deductible per employee; and retaining the 0%-15%-25%-35% personal tax rate structure, but narrowing the brackets to raise revenue.

THE PRESIDENT'S TAX REFORM PROGRAM

Changing Marginal Tax Rates on Capital Income

Changing Marginal Tax Rates on Capital Income

		Effective Federal		Effective State & Local	= Total
Current	Interest or Dividends	.32	+	.063(1-.320)	= 0.363
	Gains	(.32 x .4	+	.063 x .4(1-.32))/2	= 0.073
Reform	Interest or Dividends	.259	+	.063	= 0.322
	Gains	(.259 x .5	+	.063 x .5)/2	= 0.080

Higher Corporate Taxes Imply a Weaker Stock Market

	Current Law		The President's Proposal		Comment
Pre-Tax Profits	$1,000		$1,000		
- Corporate Taxes	300		366		: 30% Effective avg. rate today; 22% Avg. increase in avg. rate during next five years
= Post-Tax Profits	700		634 (-9.4%)		
= Dividends + Retained Earnings	350	350	327	307	: Initially split 50-50; 3% higher payout due to 10% deductibility
- Personal Taxes	x(1-.363)	x(1-.073)	x(1-.322)	x(1-.080)	: Changes in Fed rates on dividends, gains, state tax deductibility
= Post-Tax Returns	223	324	222	282	
= Total Investor Return	547		504 (-7.9%)		

Market Interest Rates Would Change Very Little

- **THEY WOULD BE PUSHED DOWN ABOUT 3/4% BY LOWER MARGINAL TAX RATES:**

For example, to obtain a 7% post-tax return,

an 11% pre-tax, market rate is required today.
11% x (1 - .363) = 7%

but only a 10.3% rate would be required under reform.
10.3% x (1 - .322) = 7%

- **THEY WOULD BE PULLED UP BY LOWER NATIONAL SAVINGS**

The President's proposal during the first five years raises corporate taxes by $24 billion, cuts personal taxes by $26 billion, and reduces Federal revenue by $2 billion (before changes in behavior or the economy are recognized).

Assume households save at a 10% rate and businesses save at an 80% rate (i.e. retained earnings bear the brunt of a change in earnings, and dividends adjust only slightly).

	Reduction in Taxes	x	Saving Rate	=	Change in Savings
Households	26		.10	=	2.6
Business	-24		.80	=	-19.2
Government	-2		1.00	=	-2.0
Net	0				-18.6

The $18.6 billion (static) reduction in national savings can be meaningfully compared to the 1984 $404 billion sum of personal savings ($156 billion), corporate net cash flow ($367 billion), and net government savings (-$119 billion).

MODEL SIMULATION OF CHANGES IN NATIONAL SAVINGS

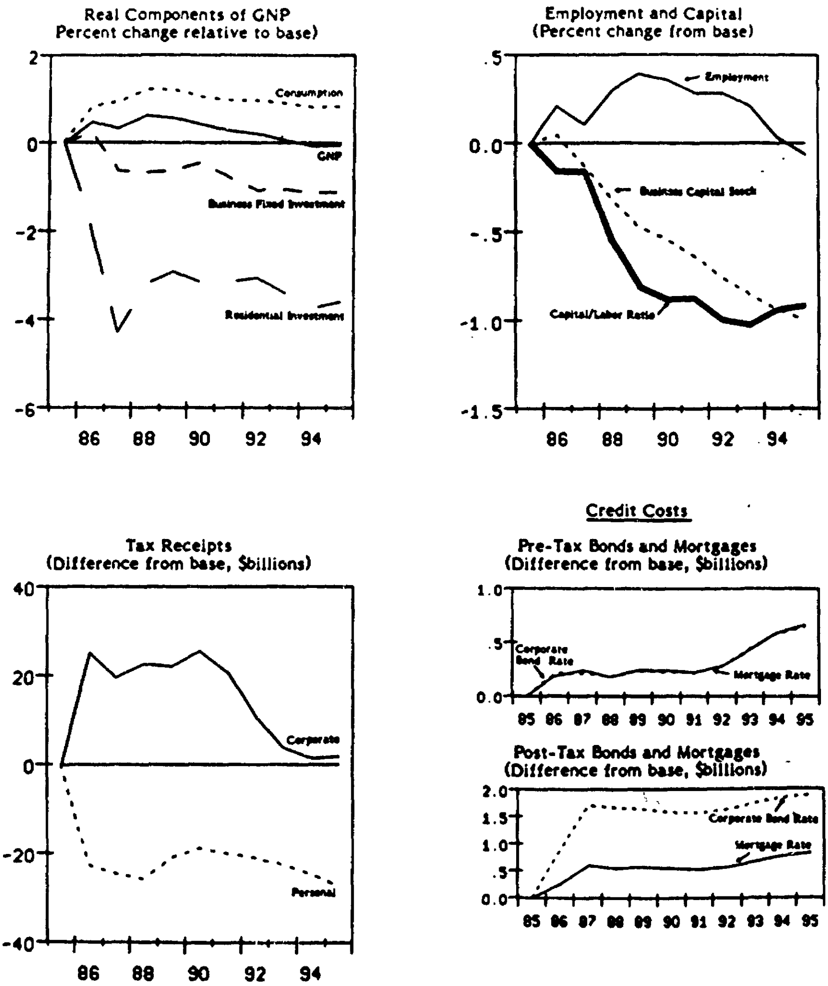
	Changes: President's Proposal Minus Base Case ($Billions)		
	1987	1991	1995
Nominal GNP	12	47	46
Personal			
Disposable Income	42	77	106
Savings	15	24	34
Percent Saved	36%	31%	32%
Corporate			
Gross Cash Flow	-24	-30	7
Dividends	-2	-1	4
Savings	-22	-29	3
Percent Saved	92%	96%	43%
Government			
Federal Taxes	-3	7	-23
Surplus	-6	1	-49
Percent Saved	nm	10%	nm
State-Local Taxes	2	13	13
Surplus	-4	-12	-21
Percent Saved	-200%	-91%	-162%
National Savings	-16	-15	-33
Fixed Investment			
Nominal	-12	-3	-8
1972 Prices	-5	-4	-6
Percent Difference	-1.4%	-1.2%	-1.5%

Impacts of the President's Tax Proposals
(Percent difference from baseline unless otherwise indicated)

	86	87...	91...	95	Average 87-95
Supply					
Potential manhours.............	0.2	0.6	2.0	2.0	1.7
Actual manhours................	0.1	0.2	1.0	1.1	0.8
Business capital stock.........	0.0	-0.1	-0.6	-1.0	-0.7
Number of homes................	-0.1	-0.2	-0.4	-0.6	-0.4
Full-employment GNP............	0.1	0.3	1.1	1.1	0.9
Actual non-farm output per hour	0.2	0.0	-1.1	-1.0	-0.9
Demand					
Consumer Spending..............	0.8	0.9	1.0	0.8	1.0
Fixed investment...............	-0.3	-1.4	-1.2	-1.5	-1.3
Residential..................	-2.0	-4.3	-3.2	-3.6	-3.4
Nonresidential...............	0.2	-0.6	-0.8	-1.1	-0.9
Equipment..................	0.3	-1.5	-1.6	-1.9	-1.8
Structures.................	0.0	1.5	1.5	1.0	1.7
Real GNP.......................	0.5	0.3	0.3	0.0	0.2
Wages and Prices					
Hourly wages...................	0.0	0.0	0.0	-0.1	0.0
Consumer prices................	0.0	0.0	0.5	0.8	0.5
Real wages.....................	0.0	0.0	-0.5	-0.9	-0.5
Wholesale industrial prices....	0.0	0.0	1.0	1.0	0.8
Financial Conditions					
Standard & Poor 500 index......	-8.0	-8.0	-8.0	-8.0	-8.0
Dividend yield*..............	-0.13	-0.19	-0.11	0.30	-0.01
Prime rate*....................	0.18	-0.03	-0.12	0.68	0.15
Mortgage rate*.................	0.18	0.24	0.22	0.66	0.34
Corporate bond rate*...........	0.21	0.21	0.21	0.65	0.34
Post-tax profits...............	-16.7	-20.3	-5.7	-25.0	-15.3
Post-tax cash flow.............	-6.1	-5.2	-5.0	0.5	-2.7
Other Indicators					
Unemployment rate*.............	-0.1	0.1	0.1	0.2	0.1
Employment.....................	0.3	0.2	0.3	0.0	0.2
Industrial production..........	0.6	0.1	-0.3	-0.8	-0.3
Capacity utilization rate......	0.6	0.0	0.1	-0.2	0.1
Federal Budget					
Taxes**........................	4	-3	7	-23	-4
Personal**...................	-23	-25	-20	-27	-23
Corporate**..................	25	19	21	2	14
Expenditures**.................	0	1	6	26	9
Interest**...................	0	0	1	16	4
Deficit**......................	-5	4	-1	49	13

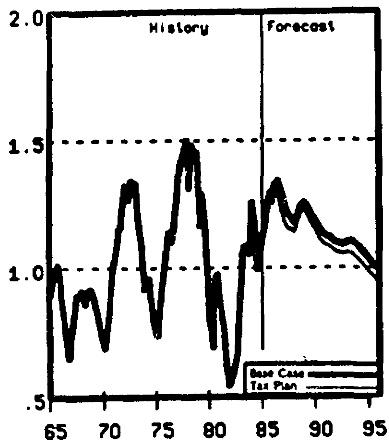
*Absolute difference in rate
**Absolute difference: billions of dollars

Changes in Macro Parameters:
The Economy with the President's Proposal Compared to DRI Long-Term Control

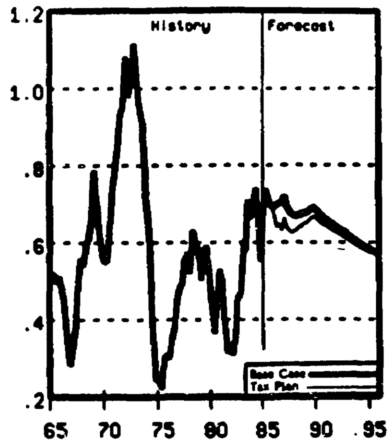


HOUSING AND TAX REFORM

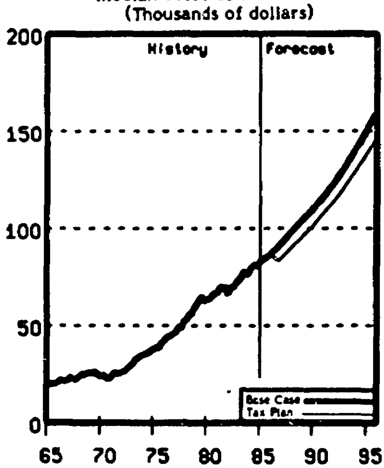
Single Family Housing Starts
(Millions of units)



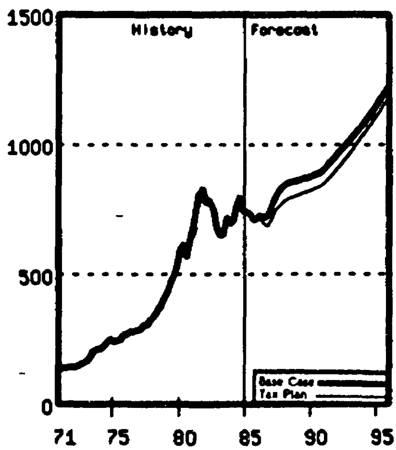
Multi-Family Housing Starts
(Millions of units)



Median Price of New Homes
(Thousands of dollars)

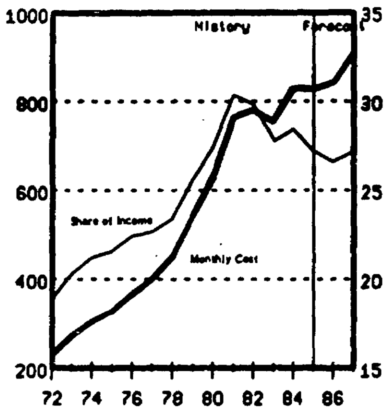


Monthly Mortgage Payment
(Dollars)



HOUSING AND TAX REFORM (continued)

Housing Affordability:
The Effective Cost of Homeownership
(Dollars per month, left scale) and
the Housing Share of Personal Income
(Percent, right scale)



Cost of Homeownership
(Dollars per month)

	1986			1987			1990		
	Base	President's Proposal	%	Base	President's Proposal	%	Base	President's Proposal	%
Pre-Tax Mortgage Payment ($)	724.2	699.7	-3.4	797.1	753.3	-5.5	885.3	832.4	-6.0
Mortgage Rate (%)	11.88	12.06	1.5	12.34	12.58	1.9	11.39	11.63	2.1
Price of Homes (000's)	88.8	84.6	-4.7	94.4	86.8	-8.1	112.7	104.0	-7.7
Post-Tax Mortgage Payment ($)	496.5	492.2	-0.9	545.3	541.6	-0.7	603.2	601.4	-0.3
Avg. Marginal Federal Tax Rate (%)	0.271	0.245	-9.5	0.271	0.220	-19.0	0.271	0.220	-19.0
Avg. Marginal Composite Rate (%)	0.314	0.297	-5.7	0.316	0.273	-13.5	0.319	0.278	-12.9
Post-Tax Property Taxes ($)	68.3	99.6	45.9	72.4	105.9	46.3	86.9	128.6	47.9
Other Costs ($)	277.4	273.1	-1.5	293.2	284.7	-2.9	345.6	337.2	-2.4
Effective Housing Costs($)	842.1	865.0	2.7	910.9	932.1	2.3	1,035.7	1,067.1	3.0
Share of Personal Income	26.6	27.2	2.3	27.2	27.7	1.8	25.6	26.1	1.9

Note: The cost of homeownership = the monthly mortgage payment adjusted for federal income tax deduction,

+ property taxes adjusted for federal income tax deduction,

+ the cost of household operation, insurance, and maintanence.

CAPITAL SPENDING AND DEPRECIATION UNDER TAX REFORM

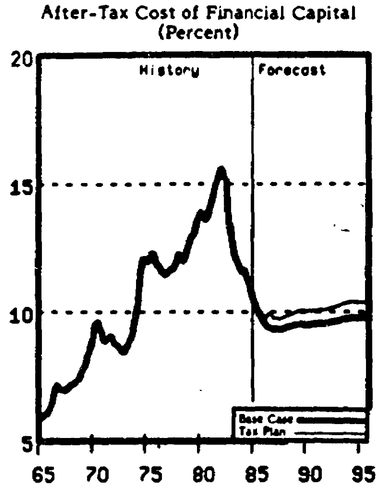
Investment Incentives and the Changes in Corporate Income Taxation

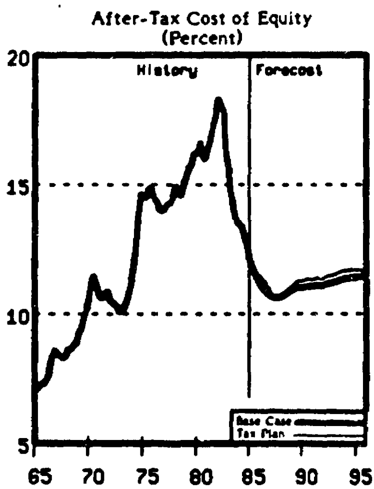
Tax Changes Reported Prior to Economic Responses	Fiscal Years				
	86	87	88	89	90
Tax Changes in High-Powered Incentives					
ITC Elimination	14.0	25.6	29.4	33.3	37.4
Depreciation Rules	0.3	-0.7	2.3	8.7	15.4
10% Dividend Deductibility	--	-3.4	-6.2	-7.2	-8.0
Subtotal	14.3	21.5	25.5	34.8	44.4
Tax Changes in Low-Powered Incentives					
Permanent*	-5.1	-19.1	-26.7	-26.1	-26.8
(Rate Reduction)	(-10.0)	(-26.7)	(-35.9)	(-39.0)	(-41.8)
Recapture	7.6	19.4	20.4	9.1	--
Subtotal	2.5	0.3	-6.3	-17.0	-26.8
Tax Changes in Industry-Specific Provisions					
Energy	--	0.1	0.2	0.4	0.7
Financial	2.1	4.2	4.9	5.7	6.9
Subtotal	2.1	4.3	5.1	6.1	7.6
Total	18.9	26.1	24.3	23.9	25.2

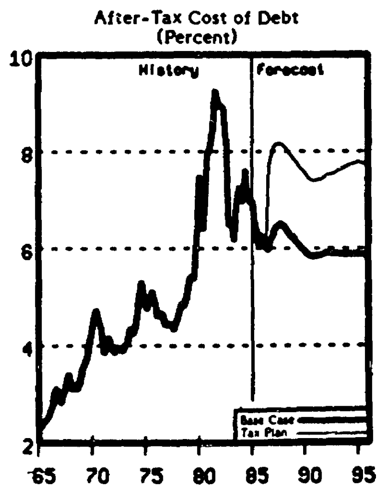
*Permanent is defined as Total less Industry-Specific subtotal less Recapture less High-Powered subtotal.

Ingredients of the Required Annual Return/Cost of Capital

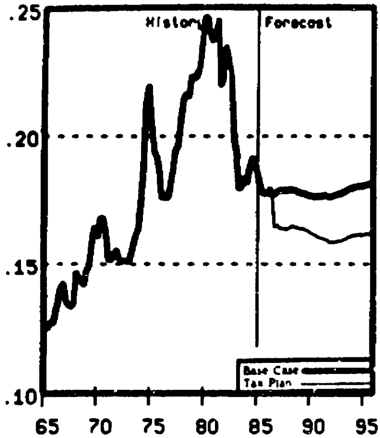
	EFFECT ON THE ANNUAL COST	
COST OF FUNDS		
EQUITY	+	
DEBT	+	
ECONOMIC DEPRECIATION RATE	+	
EXPECTED INFLATION RATE	-	
DPV OF DEPRECIATION	-	
ITC	-	
CORPORATE TAX RATE		
HIGHER RETURN REQUIRED	+	+
DEPRECIATION MORE VALUABLE	-	
DEBT DEDUCTIBILITY MORE VALUABLE	-	


After-Tax Cost of Financial Capital
(Percent)
History
Forecast
Base Case
Tax Plan
20
15
10
5
65
70
75
80
85
90
95

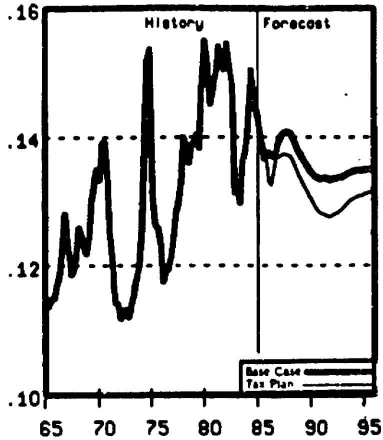

After-Tax Cost of Equity
(Percent)
History
Forecast
Base Case
Tax Plan
20
15
10
5
65
70
75
80
85
90
95


After-Tax Cost of Debt
(Percent)
History
Forecast
Base Case
Tax Plan
10
8
6
4
2
65
70
75
80
85
90
95

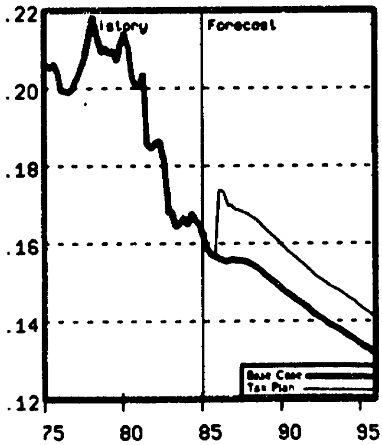
Required Annual Return
Nonresidential Structures Excluding
Public Utilities
(Percent of purchase price)



Required Annual Return
Public Utility Structures
(Percent of purchase price)



Required Annual Return
Producers' Durable Equipment
(Percent of purchase price)



The Value of Depreciation Allowances
under Current Law and the President's Proposal

	Present Value of Depreciation Per $1[a]		Depreciation Rate as Percent of Purchase Price[b]			
			Year 1		Year 2	
	Current Law	President's Proposal	Current Law	President's Proposal	Current Law	President's Proposal
Producers' Durable Equip.	0.83	0.89	16.8	16.3	23.1	28.0
Utility Structures	0.63	0.86	5.6	8.5	10.0	16.4
Nonutility Structures	0.57	0.61	10.2	4.2	11.7	8.0

[a]Current law permits depreciation of the entire (nominal) purchase price of an asset. Because depreciation allowances are spread out over the life of the asset, however, the value of the deduction is less than dollar-for-dollar. The present value of a dollar of depreciation discounts the flow of tax deductions by the corporate cost of funds. Immediate write-off—full expensing—has a value of 1.00.

[b]The lower depreciation rate in the first year assumes the asset is placed in service at the mid-point in the taxpayer's fiscal year.

STATEMENT OF NARIMAN BEHRAVESH, PH.D., VICE PRESIDENT, U.S. SERVICES, WHARTON ECONOMETRIC FORECASTING ASSOCIATES, PHILADELPHIA, PA

Senator CHAFEE. Dr. Behravesh.

Dr. BEHRAVESH. Thank you, Mr. Chairman.

I'm pleased to appear before this committee to discuss the views of Wharton Econometrics regarding the impact of the President's tax reform proposal.

The President's proposals that I will henceforth refer to as Reagan 1 are qualitatively the same as the Treasury 1 proposals insofar as the tax base is broadened while tax rates are lower; that personal taxes are cut on average; and corporate taxes are raised on average.

According to the analysis done by Wharton Econometrics, the impact on the economy of Reagan 1 is also qualitatively similar to Treasury 1. Consumer spending is higher than the current law baseline; spending by businesses on plant and equipment is lower than the current law baseline; construction of multifamily dwelling units and commercial structures is also lower than the current law baseline.

However, the impact on real GNP at the end of 10 years is minimal as the lower investment spending is offset by higher consumer spending. In the short run, the personal tax cuts in Reagan 1 raise the deficit, they raise growth, lower the unemployment rate, raise inflation and interest rates all by small amounts. In the longer run as the higher corporate taxes take effect, the resulting lower investment pulls growth down to the current level baseline.

I want to emphasize that these macroeconomic results are quite small.

Looking at some of the details of our analysis, Wharton estimates that the implied personal tax cut in Reagan 1 is larger than that estimated by the Treasury. This means that the revenue shortfall for the 1986–90 period, due to Reagan 1, is somewhat larger than the $11½ billion calculated by Treasury. We estimate that this revenue shortfall is going to be closer to $30 billion.

As a result of this cut in personal taxes, consumer spending rises relative to the current law baseline. We estimate that by 1994, the level of consumer spending in 1972 dollars is roughly 1 percent higher in the Reagan 1 scenario than in the baseline.

The net effect of the corporate tax provisions on the economy can be measured through the cost of capital which is the before tax rate of return that an investment must earn to cover the after-tax cost of funds. Wharton estimates that the President's tax plan would raise the cost of capital on average by about 15 percent.

The impact of that is to lower investment growth in the aggregate for the economy. Specifically, we have estimated that the level of nonresidential business fixed investment is 2.3 percent lower in 1972 dollars by 1994 as compared to the current law baseline.

Investment is reduced in many major industrial sectors. Specifically the equipment the equipment-intensive manufacturing sector would suffer the most.

In Wharton's analysis of Reagan 1, the housing sector is also hurt—rather housing and construction. The cost of home ownership rises. The increases will probably be small at lower income levels, but will rise as income rises. We estimate that the cost of capital for owner-occupied homes would rise by about 14 percent by 1994, and as a result of this, single-family housing starts would be about 4 percent lower in that year.

The proposed revisions would have a more dramatic effect on the cost of rental housing. Wharton estimates that the cost of capital for rental housing would rise by some 45 percent. This would result in a 16-percent reduction of multiple family housing starts by 1994.

The cost of commercial structures would rise also, but somewhat less than the cost of rental houses. That largely has to do with the different ways in which they depreciate their assets.

To sum up, looking at the macro results, in the short run, the cut in personal taxes more than offset the rise in corporate profits taxes, so this means the deficit rises in the short run. We estimate that by 1987, the deficit is roughly $20 billion higher than the current law baseline, but by 1994, this gap narrows somewhat.

The rise in consumer spending will also more than offset the lower investment spending in the early years, and this results in a slight increase in real GNP early on, but then we come back down to the baseline by the end.

The higher growth rate is accompanied by slightly higher inflation and interest rates. We estimate about three-tenths of 1 percent higher interest rate and inflation resulting from this plan by 1994. Finally, by the end of the decade, the lower investment, higher interest rates, and higher inflation slow growth down to the point where the level of real GNP is almost the same in the Reagan 1 scenario as the current law baseline.

Thank you, Mr. Chairman.

[The prepared written statement of Dr. Behravesh follows:]

WHARTON ECONOMETRIC FORECASTING ASSOCIATES

THE ECONOMIC IMPACT OF PRESIDENT REAGAN'S TAX REFORM PROPOSALS

Statement of

NARIMAN BEHRAVESH
Vice President, U.S. Services

Wharton Econometric Forecasting Associates, Inc.
3624 Science Center
Philadelphia, PA 19104

Before the

SENATE FINANCE COMMITTEE

U.S. SENATE
219 Dirksen Building
Washington, DC 20510

June 27, 1985

WHARTON

SUMMARY AND INTRODUCTION

Mr. Chairman, I am pleased to appear before this committee to discuss the views of Wharton Econometrics regarding the economic impact of the president's tax reform proposals.

The president's proposals (henceforth referred to as Reagan I) are qualitatively the same as Treasury I, insofar as

- o the tax base is broadened while tax rates are lowered;
- o personal taxes are cut on average; and
- o corporate taxes are raised on average.

According to analysis done by Wharton Econometrics, the econometric impact of Reagan I is also qualitatively similar to Treasury I:

- o Consumer spending is higher than in the current-law baseline.
- o Spending by businesses on plant and equipment is lower than the current-law baseline.
- o Construction of multifamily dwelling units and commercial structures is lower.
- o However, the impact on real GNP at the end of 10 years is minimal, as the lower investment spending is offset by higher consumer spending.

In the short run, the personal tax cuts in Reagan I raise the deficit, raise growth, lower the unemployment rate, and raise inflation and interest rates by a little. In the longer run, as the higher corporate taxes take effect, the resulting lower investment pulls growth down toward the current-law baseline. These macroeconomic results are, however, quite small.

The Wharton analysis of the president's tax package was carried out using the Wharton Long-Term Model, which measures some—but not all—of the efficiency gains that could result from such tax reform. These are typically long-term gains which, in the short run, are outweighed by the macroeconomic impacts.

PERSONAL TAXES AND CONSUMER SPENDING

Reagan I cuts taxes for most consumer by

- o reducing marginal tax rates;
- o increasing the zero bracket amount; and
- o raising the personal exemption.

These changes are offset, in part, by removing most of the deductions and exemptions in the current law. The deduction with the largest revenue impact is the one for state and local taxes.

The cut in personal tax rates more than offsets the broadening in the tax base. As a consequence, tax liabilities for individuals decline. Wharton estimates that the implied personal tax cut in Reagan I is larger than that estimated by the Treasury. This means that the revenue shortfall for 1985-90 due to Reagan I will be larger than the $11.5 billion calculated by the Treasury. We estimate this revenue shortfall to be about $30 billion.

As a result of this cut in personal taxes, consumer spending rises relative to the current-law baseline. By 1994, the level of consumer spending, in 1972 dollars, is roughly 1% higher in the Reagan I scenario.

CORPORATE TAXES AND INVESTMENT

Economists have developed the concept of the cost of capital to analyze the effect of taxation on investment incentives. The cost of capital is the before-tax rate of return that a particular investment must yield to cover the after-tax cost of funds to the firm. If the cost of capital increases, business investment is discouraged; if it declines, investment is encouraged. The cost of capital can be estimated for particular assets and industries as well as for the business sector as a whole. clearly, increases or reductions in taxes, through changes in capital consumption allowances, special preferences or reductions in tax rates, can have significant effects on the cost of capital and hence on investment decisions. Wharton estimates that the president's plan would raise the cost of capital by about 15%, on average.

In analyzing the impact of the president's plan on the cost of capital, Wharton considered the major provisions of the plan, as follows:

- o The removal of the investment tax credit raises the cost of capital.
- o The modification of the Accelerated Cost Recovery System (ACRS), by lengthening tax lives, raises the cost of capital.
- o The reduction in the statutory corporate profits tax rate lowers the cost of capital.
- o The partial deductibility of dividend payments lowers the effective corporate profits tax rate and, therefore, lowers the cost of capital.
- o The removal of tax preferences for the energy, financial and construction industries raises the effective corporate profits tax rate and, thus, raises the cost of capital in those industries.
- o The recapture provision on old investments would effectively delay the lowering of tax rates for many industries and, thus, temporarily keep their cost of capital higher than it would otherwise be.
- o The other, smaller provisions of the president's plan affect the cost of capital only to the extent that they raise of lower the effective corporate profits tax rate.

In the Wharton analysis, the combined impact of the president's corporate tax reform proposals slows investment growth. Specifically, the level of non-residential business fixed investment is 2.3% lower, in 1972 dollars, by 1994 compared to the current-law baseline. Investment is reduced in almost all major industrial sectors, with the equipment-intensive manufacturing sectors suffering the most. More specifically, the losing industries include banking, insurance, chemicals, paper, timber, oil and gas. Industries that either gain or, at least, don't lose include retailing and most of the service industries.

EFFECTS ON HOUSING AND OTHER CONSTRUCTION

In Wharton's analysis of Reagan I, the cost of homeownership increases. The increase would likely be small at the lower income levels, but it would rise considerably for households with high incomes. The rise reflects the effect of the proposed reduction in the marginal tax rate (which would reduce the tax value of the interest deduction) and the elimination of the deduction for property taxes and mortgage interest payments for second homes. We estimate that the cost of capital for owner-occupied homes would rise 14% by 1994. As a result, single-family housing starts would be about 4% lower in that year.

The proposed revisions would have a more dramatic effect on the cost of rental housing. Wharton estimates that the cost of capital for rental housing would rise by 45%. This would result in a 16% reduction of multiple-family housing starts by 1994.

The cost of commercial structures would rise also, but by somewhat less than the cost of rental housing. The smaller rise in the cost of commercial than of rental structures reflects the fact that, typically, straight-line depreciation is used in the former and ACRS in the latter, so that the change to depreciation rules has a much larger effect on rental structures.

Construction of rental housing and commercial structures would decline if the president's plan were enacted. Owner-occupied housing would become more attractive, and the ratio of owner-occupied housing units to rental units would rise. Clearly, the virtual elimination of tax shelter possibilities would have a major effect on the construction sector. Overall, we have estimated that investment in residential structures would be about 4% lower by 1994 in real terms.

MACROECONOMIC IMPACTS

- o In the short run, the cut in personal taxes more than offsets the rise in corporate profits taxes. This means that as a result of the president's proposals, the deficit will rise in the first five years. By 1987, the deficit is roughly $20 billion higher. However, by 1994, this gap is narrowed to about $4 billion.

- o The rise in consumer spending will also more than offset the lower investment spending, resulting in a rise in real GNP. By 1990, real GNP, in 1972 dollars, is 0.5% higher in the Reagan I scenario than in the current-law baseline.

- This higher growth is accompanied by slightly higher inflation and interest rates. Both the rate of inflation and long-term interest rates are about 0.3 percentage point higher by 1994.

- By the end of the decade, lower investment, higher interest rates and higher inflation slow growth down to the point where the level of real GNP is almost the same in the Reagan I scenario as in the current-law scenario.

ALTERNATIVE REAGAN I SCENARIO WITH LOWER INTEREST RATES

Some economists believe that a tax reform package like Reagan I will actually lower interest rates by lowering marginal tax rates. We have developed an alternative scenario that examines the sensitivity of our results to a fall in interest rates. In this scenario, long-term interest rates are assumed to be reduced by 50-75 basis points relative to the Reagan I scenario. Under this alternative scenario, all the basic macroeconomic results are qualitatively the same as the Reagan I scenario. By 1994,

- the level of real GNP is 0.4% higher compared to the current-law baseline;

- consumer spending is 1.3% higher;

- nonresidential fixed investment is 0.7% lower; and

- inflation is 0.5% higher.

Investment is lower in this scenario because the downward impact of lower interest rates on the cost of capital is more than offset by the rise in the cost of capital that comes about as a result of the president's plan. Interest rates would have to drop by more to fully offset the impact of the president's plan on the cost of capital.

THE WHARTON LONG-TERM MODEL
PRESIDENTS TAX REFORM PROPOSAL VS JUNE 1985 BASELINE

TABLE 1.00 SELECTED INDICATORS

		1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
GNP$	GROSS NATIONAL PRODUCT (CUR $)											
	PRESIDENTS TAX REFORM	3661	3913	4207	4540	4932	5349	5656	6150	6601	7077	7614
	BASELINE	3661	3913	4191	4533	4920	5323	5616	6100	6537	6995	7518
	DIFFERENCE	0	0	15	7	11	26	40	49	64	81	95
	% DIFF	0	0	0	0	0	0	1	1	1	1	1
GNP	GROSS NATIONAL PRODUCT (72 $)											
	PRESIDENTS TAX REFORM	1639.0	1682.2	1732.8	1784.3	1847.5	1907.3	1916.0	2002.9	2062.6	2114.9	2169.8
	BASELINE	1639.0	1682.2	1726.1	1780.9	1843.2	1900.3	1907.4	1996.4	2057.5	2112.0	2170.5
	DIFFERENCE	.0	.0	6.8	3.4	4.3	7.1	8.6	6.5	5.1	2.9	-.7
	% DIFF	.0	.0	.4	.2	.2	.4	.5	.3	.2	.1	.0
RGNP	% CHANGE											
	PRESIDENTS TAX REFORM	6.8	2.6	3.0	3.0	3.5	3.2	.5	4.5	3.0	2.5	2.6
	BASELINE	6.8	2.6	2.6	3.2	3.5	3.1	.4	4.7	3.1	2.6	2.8
	DIFFERENCE	.0	.0	.4	-.2	.0	.1	.1	-.1	-.1	-.1	-.2
	% DIFF	.0	.1	15.4	-6.5	1.2	4.6	21.8	-2.8	-2.6	-4.3	-6.3
PDGNP	GROSS NAT. PROD. DEFL. (1972=100.0)											
	PRESIDENTS TAX REFORM	223.4	232.6	242.8	254.4	266.9	280.4	295.2	307.0	320.1	334.6	350.9
	BASELINE	223.4	232.6	242.8	254.5	266.9	280.1	294.4	305.6	317.7	331.2	346.4
	DIFFERENCE	.0	.0	-.1	-.1	.0	.3	.8	1.5	2.3	3.4	4.5
	% DIFF	.0	.0	.0	.0	.0	.1	.3	.5	.7	1.0	1.3
RPDGNP	% CHANGE											
	PRESIDENTS TAX REFORM	3.7	4.1	4.4	4.8	4.9	5.1	5.3	4.0	4.2	4.5	4.9
	BASELINE	3.7	4.1	4.4	4.8	4.9	4.9	5.1	3.8	4.0	4.2	4.6
	DIFFERENCE	.0	.0	.0	.0	.0	.1	.2	.2	.3	.3	.3
	% DIFF	.0	.0	-.7	-.2	.7	2.4	3.1	6.0	6.6	7.1	6.2
NPT	POPULATION (MILLIONS)											
	PRESIDENTS TAX REFORM	238.17	240.64	243.05	245.35	247.54	249.65	251.71	253.70	255.67	257.64	259.60
	BASELINE	238.17	240.64	243.05	245.35	247.54	249.65	251.71	253.70	255.67	257.64	259.60
	DIFFERENCE	.00	.00	.00	.00	.00	.00	.00	.00	.00	.00	.00
	% DIFF	.00	.00	.00	.00	.00	.00	.00	.00	.00	.00	.00
NLC	LABOR FORCE (MILLIONS)											
	PRESIDENTS TAX REFORM	113.53	115.54	116.57	117.90	119.51	121.19	122.46	124.22	125.75	127.32	128.89
	BASELINE	113.53	115.54	116.58	117.89	119.50	121.16	122.42	124.16	125.67	127.22	128.77
	DIFFERENCE	.00	.00	-.01	.01	.01	.03	.04	.06	.08	.10	.12
	% DIFF	.00	.00	-.01	.01	.01	.02	.03	.05	.06	.08	.09
NRLC*	PARTICIPATION RATE											
	PRESIDENTS TAX REFORM	64.0	64.4	64.3	64.3	64.6	64.9	65.0	65.3	65.6	65.8	66.0
	BASELINE	64.0	64.4	64.3	64.3	64.6	64.9	65.0	65.3	65.5	65.8	66.0
	DIFFERENCE	.0	.0	.0	.0	.0	.0	.0	.0	.0	.1	.1
	% DIFF	.0	.0	.0	.0	.0	.0	.0	.0	.1	.1	.1
NEMT	EMPLOYMENT (MILLIONS)											
	PRESIDENTS TAX REFORM	105.00	106.94	107.95	109.41	111.54	113.42	113.64	116.54	118.36	119.98	121.62
	BASELINE	105.00	106.94	107.78	109.21	111.30	113.05	113.12	115.94	117.71	119.32	121.03
	DIFFERENCE	.00	.00	.17	.19	.24	.37	.52	.60	.65	.65	.59
	% DIFF	.00	.00	.16	.18	.22	.33	.46	.52	.55	.55	.49
WRC$	WAGE RATE PER WEEK, ALL INDUSTRIES											
	PRESIDENTS TAX REFORM	398.0	417.3	438.2	460.8	490.2	523.2	559.8	590.7	624.2	661.7	702.9
	BASELINE	398.0	417.3	437.8	460.0	489.0	521.3	556.7	585.8	617.4	652.5	691.2
	DIFFERENCE	.0	.0	.4	.8	1.2	2.0	3.2	4.8	6.8	9.1	11.7
	% DIFF	.0	.0	.1	.2	.2	.4	.6	.8	1.1	1.4	1.7

A PRODUCT OF WHARTON ECONOMETRICS, 3624 MARKET ST, PHILA, PA 19104 WRITTEN PERMISSION MUST BE OBTAINED FOR SECONDARY DISTRIBUTION.

THE WHARTON LONG-TERM MODEL
PRESIDENTS TAX REFORM PROPOSAL VS JUNE 1985 BASELINE

TABLE 1.00 SELECTED INDICATORS

			1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
1	GNPPP	PRODUCTIVITY - ALL INDUSTRIES											
2		PRESIDENTS TAX REFORM	15.610	15.730	16.052	16.309	16.564	16.816	16.860	17.186	17.426	17.627	17.841
3		BASELINE	15.610	15.730	16.014	16.307	16.561	16.809	16.862	17.219	17.479	17.700	17.934
4		DIFFERENCE	.000	.000	.037	.002	.002	.007	-.001	-.033	-.053	-.072	-.093
5		% DIFF	.000	.001	.233	.013	.014	.042	-.009	-.191	-.302	-.409	-.518
6	XMFPP	PRODUCTIVITY - ALL MANUFACTURING											
7		PRESIDENTS TAX REFORM	20.211	20.449	21.039	21.751	22.753	23.635	24.172	25.054	26.077	27.033	27.826
8		BASELINE	20.211	20.449	20.971	21.757	22.754	23.621	24.175	25.111	26.166	27.157	27.994
9		DIFFERENCE	.000	.000	.069	-.006	-.001	.014	-.002	-.057	-.089	-.124	-.168
10		% DIFF	.000	.001	.328	-.029	-.006	.060	-.010	-.225	-.339	-.458	-.598
11	GNPPC	REAL PER CAPITA GNP (THOU 72 $)											
12		PRESIDENTS TAX REFORM	6.882	6.990	7.129	7.273	7.463	7.640	7.612	7.895	8.067	8.209	8.358
13		BASELINE	6.882	6.990	7.102	7.259	7.446	7.612	7.578	7.869	8.047	8.198	8.361
14		DIFFERENCE	.000	.000	.028	.014	.017	.028	.034	.026	.020	.011	-.003
15		% DIFF	.000	.001	.392	.191	.233	.372	.453	.326	.248	.137	-.032
16	YPD/NPT,	REAL PER CAP DISP INC (THOU 72$)											
17		PRESIDENTS TAX REFORM	4.912	4.996	5.133	5.261	5.375	5.504	5.538	5.701	5.808	5.902	5.984
18		BASELINE	4.912	4.996	5.082	5.188	5.294	5.424	5.449	5.614	5.734	5.843	5.940
19		DIFFERENCE	.000	.000	.051	.073	.081	.080	.089	.088	.073	.059	.044
20		% DIFF	.000	.001	.999	1.407	1.521	1.483	1.631	1.561	1.281	1.018	.742
21	CPUBTS	CORPORATE PROFITS BEFORE TAXES											
22		PRESIDENTS TAX REFORM	233.8	228.3	246.4	268.2	326.7	370.1	352.2	400.3	445.8	468.7	531.5
23		BASELINE	233.8	228.2	241.9	264.3	309.0	336.2	310.4	367.6	419.0	449.9	525.6
24		DIFFERENCE	.0	.0	6.5	3.8	17.8	33.9	41.7	32.7	26.8	18.8	5.9
25		% DIFF	.0	.0	2.7	1.4	5.7	10.1	13.4	8.9	6.4	4.2	1.1
26	FRMCSAAA	MOODY'S CORP. BOND RATE, AAA RATED											
27		PRESIDENTS TAX REFORM	12.71	11.70	10.80	11.05	11.10	11.19	11.52	10.10	9.80	9.89	10.00
28		BASELINE	12.71	11.70	10.79	11.05	11.09	11.15	11.44	9.95	9.59	9.62	9.69
29		DIFFERENCE	.00	.00	.01	.00	.00	.03	.09	.15	.21	.27	.31
30		% DIFF	.00	.00	.13	.03	.03	.30	.75	1.52	2.20	2.76	3.17
31	FRMTB3MY	MARKET YIELD, 3 MONTH TREAS BILLS											
32		PRESIDENTS TAX REFORM	9.52	7.56	6.96	7.50	8.10	8.51	9.16	7.08	6.87	7.15	7.34
33		BASELINE	9.52	7.56	6.91	7.55	8.08	8.40	9.00	6.88	6.60	6.84	7.04
34		DIFFERENCE	.00	.00	.05	-.05	.02	.11	.16	.20	.26	.31	.31
35		% DIFF	.00	.00	.70	-.66	.30	1.32	1.78	2.90	3.99	4.49	4.38
36	FM2$	MONEY SUPPLY, M2 BASIS (CURRENT $)											
37		PRESIDENTS TAX REFORM	2278	2466	2657	2858	3076	3345	3570	3903	4173	4479	4815
38		BASELINE	2278	2466	2649	2852	3070	3332	3549	3875	4137	4433	4760
39		DIFFERENCE	0	0	7	6	6	13	22	28	36	46	56
40		% DIFF	0	0	0	0	0	0	1	1	1	1	1
41	RFM2$	% CHANGE											
42		PRESIDENTS TAX REFORM	7.9	8.3	7.7	7.6	7.6	8.8	6.7	9.3	6.9	7.3	7.5
43		BASELINE	7.9	8.3	7.4	7.6	7.6	8.6	6.5	9.2	6.8	7.2	7.4
44		DIFFERENCE	.0	.0	.3	-.1	.0	.2	.2	.1	.2	.2	.1
45		% DIFF	.0	.0	4.0	-1.0	-.1	2.4	3.7	1.3	2.3	2.5	1.8
46	NRUT	UNEMPLOYMENT RATE (%)											
47		PRESIDENTS TAX REFORM	7.51	7.44	7.40	7.20	6.67	6.41	7.20	6.18	5.88	5.77	5.64
48		BASELINE	7.51	7.44	7.55	7.36	6.86	6.70	7.60	6.62	6.34	6.21	6.01
49		DIFFERENCE	.00	.00	-.15	-.16	-.19	-.29	-.40	-.44	-.46	-.44	-.37
50		% DIFF	.00	-.01	-2.01	-2.15	-2.81	-4.29	-5.23	-6.63	-7.21	-7.09	-6.17

THE WHARTON LONG-TERM MODEL
PRESIDENTS TAX REFORM PROPOSAL VS JUNE 1985 BASELINE

TABLE 1.00 SELECTED INDICATORS

			1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
1	YPDSAVR	SAVINGS RATE (%)											
2		PRESIDENTS TAX REFORM	6.12	4.94	5.39	5.88	5.86	6.13	5.81	6.42	6.49	6.61	6.64
3		BASELINE	6.12	4:94	5.06	5.44	5.49	5.87	5.52	6.16	6.34	6.53	6.60
4		DIFFERENCE	.00	.00	.33	.45	.37	.26	.29	.26	.15	.08	.04
5		% DIFF	.00	-.01	6.52	8.25	6.82	4.41	5.24	4.22	2.41	1.28	.54
6	GVSURPF$	SURPLUS OR DEFICIT, FEDERAL (CUR $)											
7		PRESIDENTS TAX REFORM	-175.4	-177.2	-185.2	-198.2	-183.1	-170.7	-176.5	-171.8	-168.4	-175.9	-176.7
8		BASELINE	-175.4	-177.2	-178.4	-178.8	-168.1	-166.7	-173.9	-163.0	-162.1	-171.4	-172.4
9		DIFFERENCE	.0	.0	-6.8	-19.4	-15.0	-4.0	-2.6	-8.8	-6.3	-4.5	-4.4
10		% DIFF	.0	.0	3.8	10.8	8.9	2.4	1.5	5.4	3.9	2.6	2.5
11	GVSURPS$	SURPLUS OR DEF, STATE & LOC (CUR $)											
12		PRESIDENTS TAX REFORM	53.3	54.0	53.1	60.0	72.4	82.8	73.4	80.3	84.2	80.3	77.1
13		BASELINE	53.3	54.0	51.0	58.7	69.9	78.1	67.3	76.4	82.9	82.3	83.9
14		DIFFERENCE	.0	.0	2.0	1.3	2.6	4.6	6.1	3.9	1.3	-2.0	-6.9
15		% DIFF	.0	.0	4.0	2.2	3.7	5.9	9.1	5.1	1.6	-2.5	-8.2
16													
17	WBC$/VN$	COMPEN. TO EMPLOYEES TO NAT. INCOME											
18		PRESIDENTS TAX REFORM	73.5	73.8	73.0	72.2	71.6	71.4	72.4	71.7	71.6	71.8	71.8
19		BASELINE	73.5	73.8	73.1	72.0	71.5	71.3	72.3	71.4	71.3	71.5	71.4
20		DIFFERENCE	.0	.0	-.1	.1	.1	.1	.1	.2	.3	.4	.4
21		% DIFF	.0	.0	-.2	.2	.2	.1	.1	.3	.4	.5	.6
22	CPABT$/VN$	PROFITS TO NATIONAL INCOME											
23		PRESIDENTS TAX REFORM	9.6	9.4	9.3	8.9	9.2	9.0	7.7	8.5	8.8	8.7	9.1
24		BASELINE	9.6	9.4	9.2	9.1	9.4	9.2	8.0	8.8	9.1	8.9	9.3
25		DIFFERENCE	.0	.0	.1	-.2	-.2	-.1	-.2	-.3	-.2	-.2	-.2
26		% DIFF	.0	.0	1.0	-2.0	-1.9	-1.6	-3.1	-3.4	-2.5	-1.9	-1.7

THE WHARTON LONG-TERM MODEL
PRESIDENTS TAX REFORM PROPOSAL VS JUNE 1985 BASELINE

TABLE 2.10 GROSS NATIONAL PRODUCT (BILLIONS OF 1972 $)

		1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
	--------CONSTANT 72 DOLLARS--------											
GNP	GROSS NATIONAL PRODUCT----------											
	PRESIDENTS TAX REFORM-------------	1639.0	1682.2	1732.8	1784.3	1847.5	1907.3	1916.0	2002.9	2062.6	2114.9	2169.8
	BASELINE--------------------------	1639.0	1682.2	1726.1	1780.9	1843.2	1900.3	1907.4	1996.4	2057.5	2112.0	2170.5
	DIFFERENCE------------------------	.0	.0	6.8	3.4	4.3	7.1	8.6	6.5	5.1	2.9	-.7
	% DIFF----------------------------	.0	.0	.4	.2	.2	.4	.5	.3	.2	.1	.0
CE	PERSONAL CONSUMPTION EXPENDITURES--											
	PRESIDENTS TAX REFORM-------------	1062.4	1102.2	1137.6	1171.4	1209.3	1246.9	1269.9	1310.9	1346.0	1378.3	1409.3
	BASELINE--------------------------	1062.4	1102.2	1130.1	1160.3	1195.4	1231.4	1252.4	1293.2	1330.0	1364.4	1398.2
	DIFFERENCE------------------------	.0	.0	7.4	11.0	13.9	15.5	17.4	17.7	16.1	13.9	11.1
	% DIFF----------------------------	.0	.0	.7	1.0	1.2	1.3	1.4	1.4	1.2	1.0	.8
CED	DURABLE GOODS---------------------											
	PRESIDENTS TAX REFORM-------------	178.0	189.4	197.6	205.1	212.6	219.3	219.5	229.6	237.9	243.3	249.0
	BASELINE--------------------------	178.0	189.4	194.0	200.7	208.1	214.9	214.4	224.7	233.9	240.4	247.2
	DIFFERENCE------------------------	.0	.0	3.6	4.3	4.5	4.5	5.1	4.9	4.0	2.9	1.8
	% DIFF----------------------------	.0	.0	1.9	2.2	2.2	2.1	2.4	2.2	1.7	1.2	.7
CEN	NONDURABLE GOODS------------------											
	PRESIDENTS TAX REFORM-------------	393.5	403.0	415.0	426.2	437.9	449.2	456.6	467.9	475.4	483.0	489.3
	BASELINE--------------------------	393.5	403.0	412.5	422.6	433.4	444.3	451.2	462.5	470.8	479.1	486.5
	DIFFERENCE------------------------	.0	.0	2.5	3.6	4.5	4.9	5.5	5.3	4.6	3.8	2.8
	% DIFF----------------------------	.0	.0	.6	.8	1.0	1.1	1.2	1.2	1.0	.8	.6
CES	SERVICES--------------------------											
	PRESIDENTS TAX REFORM-------------	490.8	509.8	525.0	540.1	558.9	578.3	593.7	613.4	632.8	652.0	671.0
	BASELINE--------------------------	490.8	509.8	523.7	537.0	554.0	572.2	586.8	606.0	625.3	644.9	664.5
	DIFFERENCE------------------------	.0	.0	1.3	3.1	4.9	6.1	6.9	7.4	7.5	7.2	6.5
	% DIFF----------------------------	.0	.0	.3	.6	.9	1.1	1.2	1.2	1.2	1.1	1.0
IBT	GROSS PRIVATE DOMESTIC INVESTMENT--											
	PRESIDENTS TAX REFORM-------------	289.7	298.6	313.0	323.4	335.9	348.4	322.9	365.6	381.6	388.4	398.3
	BASELINE--------------------------	289.7	298.6	312.1	330.4	345.8	357.3	331.3	375.9	391.8	398.8	409.3
	DIFFERENCE------------------------	.0	.0	.9	-7.0	-9.9	-8.8	-8.3	-10.4	-10.2	-10.4	-11.0
	% DIFF----------------------------	.0	.0	.3	-2.1	-2.9	-2.5	-2.5	-2.8	-2.6	-2.6	-2.7
IBF	FIXED INVESTMENT------------------											
	PRESIDENTS TAX REFORM-------------	265.0	281.4	296.3	307.9	321.0	332.6	322.9	348.9	364.8	372.1	382.3
	BASELINE--------------------------	265.0	281.4	296.2	315.2	331.0	341.8	331.5	359.1	374.7	382.0	392.5
	DIFFERENCE------------------------	.0	.0	.0	-7.3	-10.0	-9.2	-8.5	-10.2	-9.8	-9.8	-10.2
	% DIFF----------------------------	.0	.0	.0	-2.3	-3.0	-2.7	-2.6	-2.8	-2.6	-2.6	-2.6
IBFN	NONRESIDENTIAL--------------------											
	PRESIDENTS TAX REFORM-------------	204.8	219.4	232.2	248.4	261.2	273.1	267.6	289.0	301.6	311.5	321.0
	BASELINE--------------------------	204.8	219.4	232.5	251.5	266.6	279.5	274.4	296.0	308.5	318.6	328.5
	DIFFERENCE------------------------	.0	.0	-.3	-3.1	-5.3	-6.5	-6.8	-7.0	-6.9	-7.1	-7.5
	% DIFF----------------------------	.0	.0	-.1	-1.2	-2.0	-2.3	-2.5	-2.4	-2.2	-2.2	-2.3

THE WHARTON LONG-TERM MODEL
PRESIDENTS TAX REFORM PROPOSAL VS JUNE 1985 BASELINE

TABLE 2.10 GROSS NATIONAL PRODUCT (BILLIONS OF 1972 $)

		1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
IBFR	RESIDENTIAL STRUCTURES											
	PRESIDENTS TAX REFORM	60.1	62.0	64.1	59.5	59.7	59.5	55.3	59.9	63.2	60.7	61.3
	BASELINE	60.2	62.0	63.8	63.7	64.4	62.3	57.0	63.1	66.2	63.3	64.0
	DIFFERENCE	.0	.0	.3	-4.2	-4.7	-2.7	-1.8	-3.2	-2.9	-2.7	-2.7
	% DIFF	.0	.0	.5	-6.6	-7.3	-4.4	-3.1	-5.0	-4.4	-4.2	-4.2
IBIT	CHANGE IN BUSINESS INVENTORIES											
	PRESIDENTS TAX REFORM	24.7	17.2	16.7	15.5	14.9	15.9	.0	16.7	16.8	16.3	16.0
	BASELINE	24.7	17.2	15.9	15.2	14.8	15.5	-.2	16.9	17.2	16.9	16.8
	DIFFERENCE	.0	.0	.9	.3	.1	.4	.2	-.2	-.4	-.5	-.8
	% DIFF	.0	.0	5.6	1.9	.6	2.5	-112.7	-.9	-2.4	-3.2	-4.8
TBB	NET EXPORTS OF GOODS AND SERVICES											
	PRESIDENTS TAX REFORM	-15.1	-29.1	-33.9	-30.7	-27.0	-26.0	-23.8	-30.1	-31.1	-27.5	-23.1
	BASELINE	-15.1	-29.1	-32.3	-30.1	-27.3	-26.4	-23.3	-29.3	-30.4	-26.8	-22.3
	DIFFERENCE	.0	.0	-1.6	-.6	.3	.4	-.5	-.8	-.7	-.7	-.8
	% DIFF	.0	.0	4.8	2.0	-1.2	-1.5	2.0	2.8	2.4	2.5	3.5
TEB	EXPORTS											
	PRESIDENTS TAX REFORM	146.1	146.9	154.6	162.7	173.9	183.8	192.8	199.5	209.0	219.5	230.2
	BASELINE	146.1	146.9	154.5	162.3	173.4	183.3	192.4	199.4	209.0	219.6	230.6
	DIFFERENCE	.0	.0	.1	.3	.5	.5	.3	.1	.0	-.1	-.4
	% DIFF	.0	.0	.0	.2	.3	.3	.2	.1	.0	-.1	-.2
TMB	IMPORTS											
	PRESIDENTS TAX REFORM	161.2	176.0	188.5	193.3	200.9	209.8	216.6	229.6	240.2	247.0	253.3
	BASELINE	161.2	176.0	186.8	192.4	200.7	209.7	215.8	228.7	239.4	246.5	252.9
	DIFFERENCE	.0	.0	1.6	.9	.2	.1	.8	.9	.7	.5	.4
	% DIFF	.0	.0	.9	.5	.1	.1	.4	.4	.3	.2	.2
GVPT	GOV'T PUR. OF GOODS AND SERVICES											
	PRESIDENTS TAX REFORM	302.1	310.5	316.1	320.3	329.3	338.0	347.0	356.5	366.0	375.6	385.3
	BASELINE	302.1	310.5	316.1	320.3	329.3	338.0	347.0	356.5	366.0	375.6	385.3
	DIFFERENCE	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0
	% DIFF	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0
GVPF	FEDERAL											
	PRESIDENTS TAX REFORM	122.5	128.0	130.4	131.6	135.6	139.3	143.2	147.5	151.7	155.9	160.1
	BASELINE	122.5	128.0	130.4	131.6	135.6	139.3	143.2	147.5	151.7	155.9	160.1
	DIFFERENCE	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0
	% DIFF	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0
GVPS	STATE AND LOCAL											
	PRESIDENTS TAX REFORM	179.5	182.5	185.7	188.7	193.6	198.7	203.8	209.0	214.3	219.8	225.2
	BASELINE	179.5	182.5	185.7	188.7	193.6	198.7	203.8	209.0	214.3	219.8	225.2
	DIFFERENCE	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0
	% DIFF	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0

STATEMENT OF LEON TAUB, PH.D., CHIEF ECONOMIST, CHASE ECONOMETRICS, WASHINGTON, DC

Senator CHAFEE. Dr. Taub.

Dr. TAUB. Thank you, Mr. Chairman. It is an honor to be here this morning. The views I will present today do not necessarily represent those of the Chase Manhattan Bank, the parent corporation of Chase Econometrics. I would request that the full text of my remarks and a report prepared by Snyder, Newrath on the impact of the proposal on a typical real estate construction project be entered into the record.

Senator CHAFEE. That will be done.

[The prepared written statement of Dr. Taub and the Snyder, Newrath report follow:]

Testimony of Leon Taub, Chief Economist, Washington Chase Econometrics Before the Senate Finance Committee June 27, 1985

Mr. Chairman and Members of the Committee:

It is an honor to be here this morning. The views I will present today do not necessarily represent those of The Chase Manhattan Bank, N.A., the parent corporation of Chase Econometrics. The main points of my testimony are as follows:

First, tax reform should be accepted or rejected on its own merits, not its secondary economic impacts.

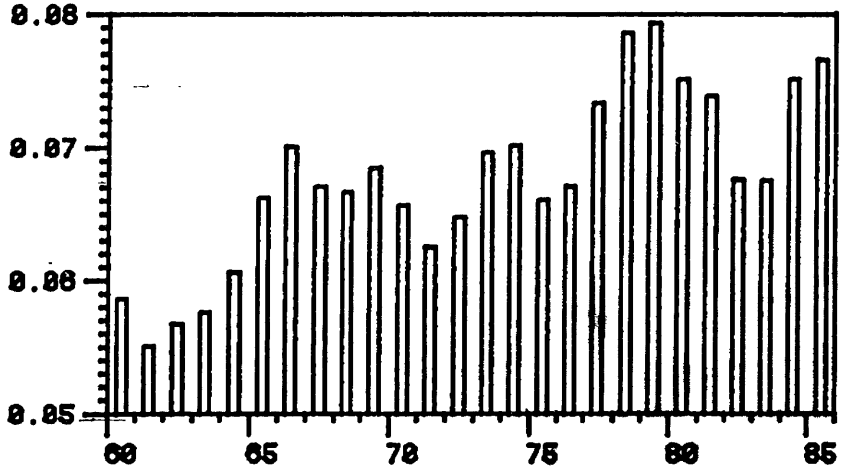
Second, my work with the Chase Econometrics Macroeconomics Model indicates that the President's proposal would cause a demand shock which would have a modest depressing impact upon real GNP in 1986 but that demand induced changes after 1986 would be slightly positive. Although econometric models are not designed to measure the microeconomic effects of tax reform, they can: (a) warn of possible changes to demand which will result in a shock to the economy; and (b) describe the sectorial and industrial impacts of these shocks. Over 50% of the 1986 demand shock covered by the proposal could be avoided simply by beginning the personal tax rate reduction on January 1, 1986. Most of the remainder of the shock would result from reduced tax shelter-motivated construction activities. (See the attached study by Snyder Newraith and Company, a major Washington, D.C. accounting firm which indicates that rents would have to rise approximately 6% to provide developers the same return they receive under current tax law.)

Third, most tax-based incentive (supply-side) impacts will be favorable, but the magnitudes will be small. For example, despite the 1981 tax cuts, tax sheltering activity has increased; labor force growth has slowed; and the savings rate has fallen. Even without U.S. tax incentives (and long-term fixed-rate mortgages), Canadians have shown almost the same propensity to purchase expensive housing as U.S. citizens. During the past five years, business investment has been increased somewhat by tax incentives, but the dominant influences clearly have been demand-related phenomena. (See attached Figures.) The supply-side impacts of tax reform will be less than those of the 1981 tax cuts since, on average, rates are reduced less and from lower levels. In addition, the President's tax reform proposal would cause an implicit change in our industrial policy from "protecting losers" to "encouraging winners." The long-term impacts of these developments will be favorable and a "supply side" based growth improvement of perhaps 0.1% per year, in addition to the results shown in our macroeconomic simulation, can be expected.

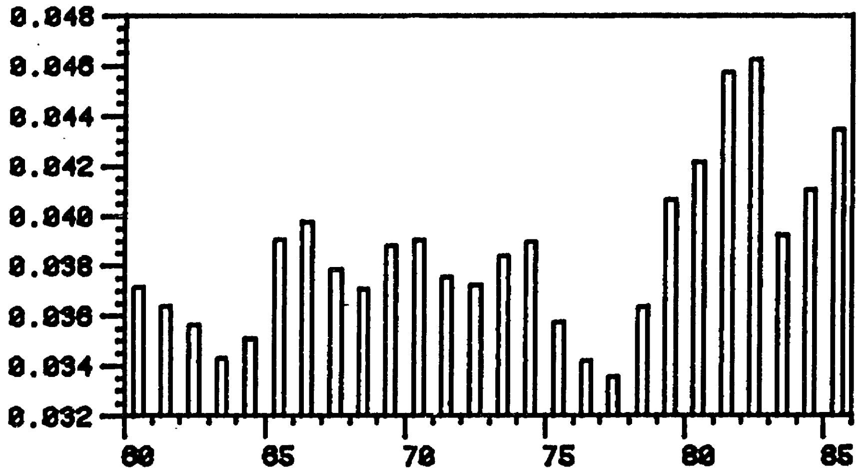
Most of the changes proposed by the President are long overdue. Some particularly important items include resurrecting the corporate income tax (which last year raised revenue equal to only 1.5% of GNP despite marginal tax rates of 46%), taking a more balanced approach to real estate investments, indexing depreciation and capital gains, and restricting tax-exempt bond financing. Items which seem to be steps backward in terms of both fairness and economic efficiency include: (1) the disproportionate tax rate cut for upper-income Americans (see attached Figures); (2) the further acceleration of depreciation benefits; (3) the increase in the penalty on two-earner families; and (4) the extremely generous treatment of capital gains income. Also, although 15 tax rate brackets are clearly too many, having 3 "giant" steps rather than 4 or 5 smaller steps promotes neither simplification, nor equity, nor efficiency. Finally, taxing all medical insurance is unfair and does not accomplish anything other than raising a small amount of money. Instead, we should tax only those plans which act to oppose public policy by leading to overconsumption and a lack of price sensitivity in the medical care field.

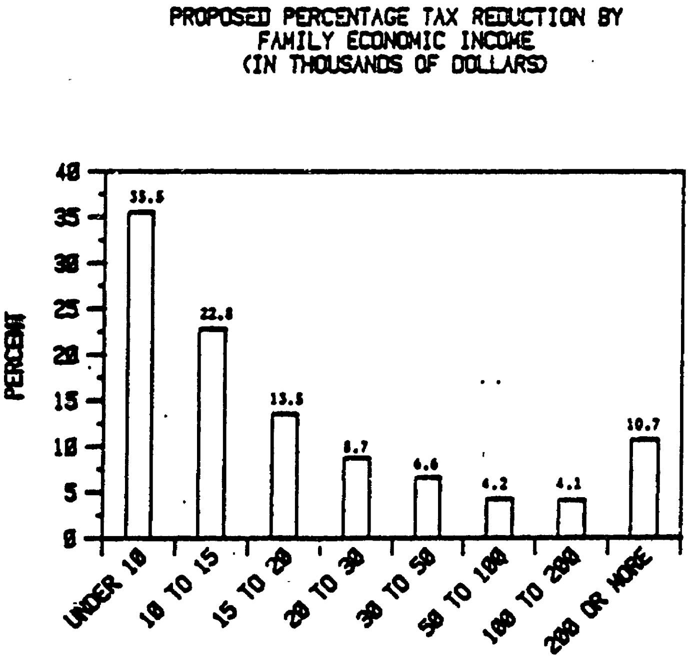
Thank you.

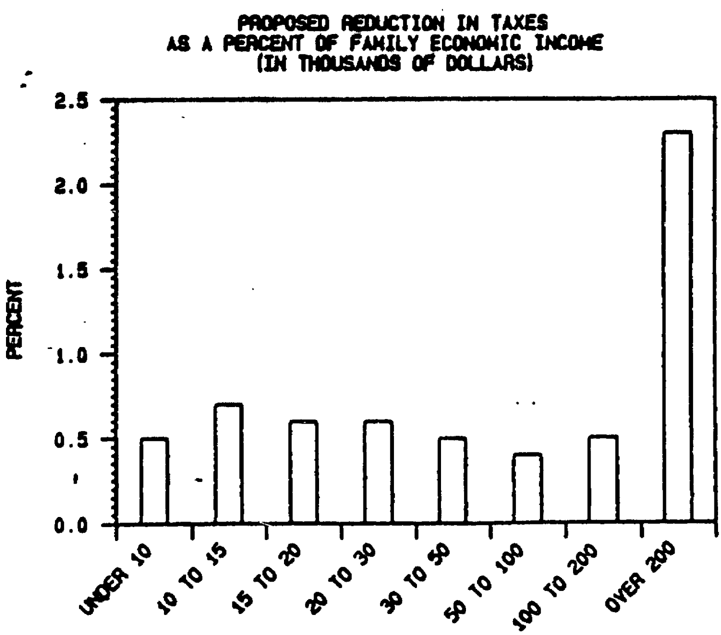
INVESTMENT IN PRODUCERS DURABLE EQUIPMENT
RELATIVE TO GNP



INVESTMENT IN NONRESIDENTIAL STRUCTURES
RELATIVE TO GNP




PROPOSED PERCENTAGE TAX REDUCTION BY
FAMILY ECONOMIC INCOME
(IN THOUSANDS OF DOLLARS)
PERCENT
40
35
30
25
20
15
10
5
0
35.5
22.8
13.5
8.7
6.6
4.2
4.1
10.7
UNDER 10
10 TO 15
15 TO 20
20 TO 30
30 TO 50
50 TO 100
100 TO 200
200 OR MORE


PROPOSED REDUCTION IN TAXES
AS A PERCENT OF FAMILY ECONOMIC INCOME
(IN THOUSANDS OF DOLLARS)
PERCENT
2.5
2.0
1.5
1.0
0.5
0.0
UNDER 10
10 TO 15
15 TO 20
20 TO 30
30 TO 50
50 TO 100
100 TO 200
OVER 200

President Reagan's Tax Reform Proposal

Leon Taub

SUMMARY

Tax reform has become an extremely popular political cause. Support for tax reform is widespread throughout the country and has been voiced by virtually every elected official who will have a major impact on the tax reform process. While tax reform clearly means very different things to different people, we believe that this support will result in the passage of legislation patterned on the President's tax reform proposal, either late in 1985 or during early 1986.

Just as defense spending programs should be evaluated based upon their impacts on national defense rather than their secondary economic impacts, tax reform should be judged on its own merits, not its secondary economic impacts. Economic systems are resilient and can function under any of a wide variety of tax systems. Furthermore, in sharp contrast with the original Treasury proposal, we do not expect the secondary impacts to be dramatic. In particular, the President's proposal appears to eliminate two-thirds of the transition difficulties associated with the original Treasury proposal. Only a modest negative transitional impact of less than 1 percent of GNP is expected in 1986. (Half of this impact is a result of the delay in the personal rate reduction to July 1.) However, we would also caution that any short-run positive supply-side claims for the proposal are probably overstated. We do believe that the long-run impacts of tax reform on economic efficiency and growth will be favorable, although the effects will occur only gradually during the next two decades.

THE CURRENT TAX SYSTEM

The basic problem with our income tax system (both the individual and the corporate tax systems) which President Reagan's tax proposal seeks to address, is that the combination of base erosion and increased marginal rates have resulted in tax systems which are exceptionally annoying and difficult to follow, provide relatively severe unanticipated economic incentives, and yet raise relatively little amounts of revenue. Last year the personal income tax raised only $315 billion, less than 11 percent of personal income. The corporate income tax, excluding those taxes paid by the Federal Reserve System to the Treasury, raised only $54 billion, less than 1.5 percent of GNP. This relatively meager revenue raising achievement was accomplished through a tax system which contained marginal tax rates rising to 50 percent on the personal side and 46 percent on corporate income.

Of the two tax systems, the corporate income tax undoubtedly has been affected the most severely by base erosion. In fact, the combination of the investment tax credit, rapid accelerated depreciation, and the sharp slowdown in inflation have caused effective tax rates on many types of capital investment to be negative. Corporate income taxes as a share of corporate economic income and Federal tax receipts have fallen dramatically during the last three decades (see Figures 1 and 2.)

Although most tax experts would agree that the corporate income tax base has been eroded more severely than the personal income tax base, many Americans are concerned primarily about personal income taxes. Years ago, most Americans rated the personal income tax as one of the "best" taxes. Today many Americans would rate it as one of the worst. The decline in popular confidence in the income tax system has sev-

Figure 1

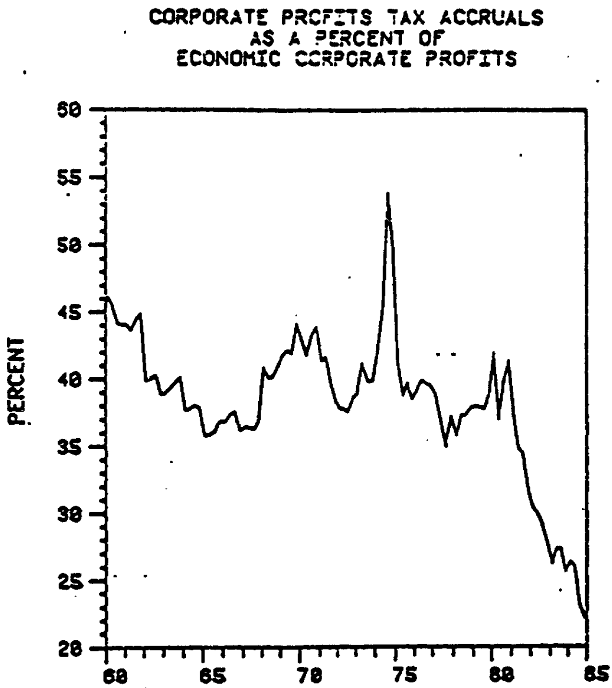
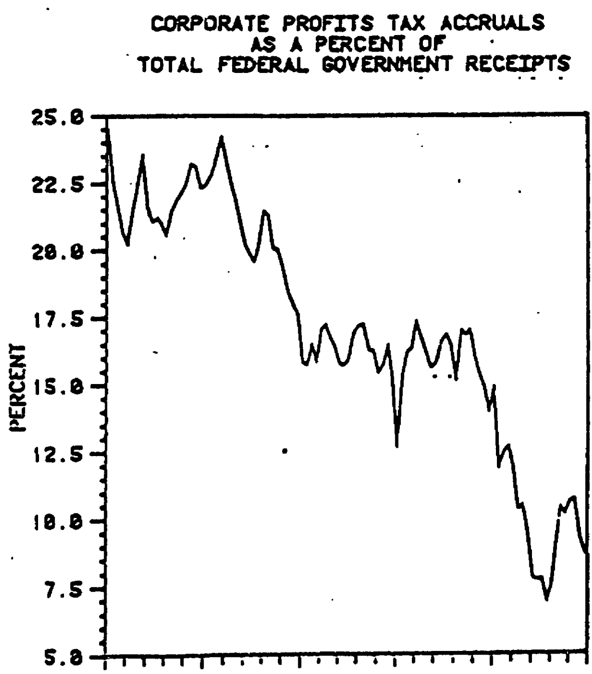


Figure 2



ral causes. We believe that the most important of these is that personal income taxes have been "crowded out" by Social Security taxes. In 1960, maximum employee Social Security taxes were only $144. As these taxes rose from insignificant levels to their current ones, the Congress tried to tilt the tax system away from low income individuals, in an effort to maintain the progressivity of the tax system as a whole. Needless to say, this process resulted in sharply higher marginal tax rates for all middle-income individuals. The response of these individuals was both political and economic. In the political arena, middle- and upper-income taxpayers argued for increases in the number and types of exemptions and deductions which would shelter portions of their income. In the economic arena, individuals increasingly moved to take advantage of the opportunities for sheltering income. Vicious cycles of an eroding tax base, tighter IRS restrictions, and higher tax rates resulted. Since the basic cause of dissatisfaction with the income tax system (high wage taxes) cannot be addressed given political realities, tax reform proposals usually address themselves to unwinding the secondary spirals.

In 1981 the Congress tried to eliminate tax sheltering by reducing marginal tax rates, particularly those for upper-income Americans. However the impact of this action, except in the very top brackets, was disappointing. Despite the lower tax rates and two attempts by the Congress to close loopholes in the tax code, tax sheltering activities and the public's perception of the unfairness of the tax system have increased. No clear evidence of "supply-side" impacts has been found, except for taxpayers whose brackets had been over 50 percent.

One interesting aspect of the tax debate is that there is a huge gap between individual perceptions of the base erosion problem and its reality. The Congress of the United States does not pass unpopular legislation which costs the Federal Government large sums of money. As a result, special interest items tend to be relatively small revenue losers. The large tax expenditure items are shown in Table 1. (Those items which are largely or completely eliminated by the President's tax proposal are marked with double **; those items which are modified by the Treasury tax reform proposal are marked with *.) The most striking aspect about the items on Table 3 is that, with the possible exception of accelerated depreciation, very few Americans would call these tax expenditures "loopholes."

The intermediate revenue loss expenditure items are shown in Table 2. Again, the extent to which most Americans would regard these items as matters of right rather than as "loopholes" is shocking. Furthermore, the revenue losses for each item are not large. Clearly tax reform, if it is to be significant, cannot be accomplished by eliminating a few relatively unpopular loopholes. Significant reductions in rates are possible only if some major popular tax expenditures and a host of minor tax expenditures are eliminated.

THE REAGAN PROPOSALS—THE REVENUE IMPACTS

The summary of the major revenue impacts of President Reagan's tax reform proposal is provided in Table 3. Table 3 also compares the proposal to the original Treasury proposal. Whereas the original Treasury proposal had resulted in slight average revenue gains during the 1986-90 period, the Reagan proposal results in slight revenue losses. Given the difficulty of estimating revenue impact changes, the differences between the revenue estimates and zero are not significant and it is fair to call each of the proposals "revenue neutral." However, since it is much easier to reduce taxes than to raise taxes, and the uncertainty concerning the amount of revenue which will result from the individual changes, not to mention the interaction of the changes, is high, most analysts would be more comfortable with a proposal which was likely to yield small revenue gains than one likely to yield small revenue losses. The accuracy of the Treasury revenues estimates has been the subject of some debate. Unfortunately, the

Table 1
Revenue Loss Estimates for "Large" Tax Expenditure Items
($6 billion and greater)

	FY 1984	FY 1985	FY 1986
Deductibility of interest on consumer credit	12.7	14.6	15.9
** Deductibility of property tax on owner-occupied homes	8.8	9.7	10.7
Deductibility of mortgage interest on owner-occupied homes	22.7	24.9	27.3
Capital gains	19.1	19.9	20.9
** Investment credit	23.3	23.8	25.3
* Accelerated depreciation of buildings	6.3	8.1	9.6
** Deduction for two-earner married couples	6.2	6.7	7.3
Accelerated depreciation of machinery and equipment	14.1	20.2	23.0
Deductibility of charitable contributions	10.1	11.1	13.0
** Exclusion of employer contributions for medical premiums and care	19.1	21.2	23.7
OASI benefits	13.8	12.8	13.4
* Net exclusion of pension contributions and earnings:			
employer plans	44.0	44.2	55.1
individual retirement accounts	11.0	12.0	13.4
** Exclusion of interest on public purpose state and local debt	8.1	8.8	9.5
** Deductibility of nonbusiness state and local taxes other than on owner-occupied homes	20.9	22.5	24.7

*Modified
**Eliminated

Table 2
Revenue Loss Estimates for "Intermediate" Tax Expenditure Items
($1 billion to $6 billion)

	FY 1984	FY 1985	FY 1986
Exclusion of benefits to Armed Forces personnel	1.8	2.0	2.1
Exclusion of income earned abroad	1.3	1.4	1.5
Expensing of R&D expenditures	3.5	3.6	3.9
Credit for increasing research activities	1.4	1.6	1.1
Expensing of exploration and development costs	1.4	2.0	2.3
Exclusion of interest on state and local IDB's for pollution control	1.1	1.3	1.4
Exclusion of interest on small issue industrial development bonds	2.3	2.6	2.9
Exclusion of interest on life insurance savings	3.2	3.9	3.7
Exclusion of interest on state and local housing bonds for owner-occupied housing	1.5	1.9	2.5
Deferral of capital gains on home sales	1.7	1.8	1.9
Carryover basis of capital gains at death	3.9	4.4	4.9
Safe Harbor leasing rules	2.8	2.3	2.0
Reduced rates for the first $100,000 of corporate income	4.9	5.0	5.3
Parental personal exemption for students age 19 or over	1.1	1.1	1.2
Deductibility of charitable contributions	1.1	1.2	1.4
Investment credit for ESOPs	1.4	1.9	2.3

Table 2 (continued)
Revenue Loss Estimates for "Intermediate" Tax Expenditure Items
($1 billion to $6 billion)

	FY 1984	FY 1985	FY 1986
Credit for child and dependent care expenses	1.9	2.2	2.5
Deductibility of medical expenses	3.2	3.4	3.8
Exclusion of interest on state and local debt for nonprofit health facilities	1.3	1.6	2.0
Disability insurance benefits	1.2	1.2	1.2
Benefits for dependents and survivors	3.8	3.8	4.0
Exclusion of workmen's compensation benefits	2.2	2.3	2.5
Exclusion of untaxed unemployment insurance benefits	2.0	1.6	1.3
Keoghs	1.4	1.6	1.7
Additional exemption for elderly	2.5	2.7	2.9
Exclusion of veterans disability compensation	1.6	1.7	1.7
Premiums on group term life insurance	1.9	2.0	2.2
Tax credit for corporations receiving income from doing business in United States possessions	1.3	1.4	1.6

Table 3
Primary Revenue Impacts
Comparison of Reagan Proposal and Treasury One
(Billions of Dollars)

	1986	1987	1988	1989	1990
Total Change in Receipts - Reagan Proposal					
Individual	-17.9	-26.0	-32.0	-29.0	-26.9
Corporate	18.9	26.1	24.3	23.9	25.2
Other	0.2	0.3	0.4	0.4	0.4
TOTAL	1.2	0.4	-7.3	-4.6	-1.2
Addendum					
ACRS recapture	9.6	19.4	20.4	9.1	--
Corporate w/o ACRS recapture	11.3	7.7	3.9	14.8	25.2
Total Change in Receipts - Treasury One					
Individual	-22.1	-36.6	-25.2	-25.9	-37.7
Corporate	22.2	30.6	29.3	38.1	44.7
Other	0.4	0.2	-0.2	-1.8	-3.1
TOTAL	0.5	-5.8	3.9	10.3	3.9

issue can probably be resolved only after the fact or via access to the Treasury's tax models. Even a glance at the tax expenditure estimates shown in Tables 1 and 2 and the Treasury's revenue gain estimates (which will be shown below) reveals striking differences. Further, one would suspect that reactions to the tax proposals will be asymmetric, i.e., that loopholes which have been closed inadvertently are relatively few and far between, whereas loopholes which may have been opened inadvertently may prove to be significant. Also, funds forced out of one loophole will migrate to other loopholes. However, it should also be noted that the nature of the tax system is such that tax savings can build upon one another. Since the tax system is progressive, the elimination of one tax expenditure will place people in higher tax brackets, thus increasing the gain from eliminating a second tax expenditure. As a result of the complexities in the tax code, including those enumerated above, we believe it is impossible to make meaningful statements either supporting or criticizing the Treasury's revenue estimates, other than to note that it appears that the numbers were generated using a "bottom-up" rather than "top-down" approach. Thus, there is some reason to believe that the Treasury estimates are unbiased.

A second striking difference between the two proposals is that the current Administration proposal contains less of a revenue shift between personal income taxes and corporate income taxes. In large part, this change is a reaction to the unfavorable comments by many economists and by corporate America about the possible negative transition and incentive impacts of the original Treasury proposal. Furthermore, a simple examination of the change in corporate tax receipts does not reveal the extent to which the Reagan proposal tries to avoid eliminating the investment incentive impacts of current law. During the first three years of the proposal, virtually all of the increase in corporate tax receipts is accomplished through a "recapture" of tax revenues which would otherwise have been lost due to the interaction of "front loaded" ACRS depreciation benefits and the proposed reduction in corporate tax rates. Since the tax is levied on the profits earned from "old" investment, the incentive effects should be minimal. (The cost of this proposal is an effective delay in the reduction of tax rates for heavy industry until 1989.) While not shown in Table 3, the relatively small impact of the proposal upon investment incentives continues beyond 1988. As we will see below, most of the corporate tax increases in 1989 and thereafter can be attributed to accounting changes, including changes to the completed contract method of accounting, and industry-specific tax changes which will have very low direct impacts upon fixed investment. Given the small increase in corporate taxes, we believe that it is unreasonable to argue that large negative effects on total factor productivity will result from the Reagan proposals.

Although the level of corporate taxes does not change very much, the proposed changes do shift the cost of capital relative to the cost of labor. Thus it is possible that the proposals could shift the proportion of factor inputs from capital to labor. (Whether this would be good or bad for the economy is unclear.) We seriously doubt that a major shift will occur since there is a large body of economic literature suggesting that industry capital/labor ratios tend to be fixed more by technology and by management practices than by small differences in the relative costs of capital and labor. Certainly, most of the low wage countries which have given the U.S. manufacturing companies the most severe competition have capital/labor ratios which are at least as high as those in the United States.

THE IMPACT OF THE TAX PROPOSAL UPON INDIVIDUALS

The major revenue impact items in the Reagan tax proposals are shown in Table 4. The top half of the table shows the revenue impacts of the proposals aimed at changing the taxation of income which is not directly related to business or capital income. An examination of the three revenue loss items is instructive. Somewhat over half of the revenue losses come from the reductions in marginal tax rates. Virtually all of the remainder comes from further reductions in the tax base via the expansion of the personal exemption and an increase in the zero bracket amount (ZBA). (If one accepts our explanation of the cause of the tax problem, it could be argued that the Reagan plan continues and expands the basic structural problem. However, Social Security taxes have continued to rise. If the increases are to be offset by personal tax reductions for low-income Americans, and marginal tax rates are to be reduced, the only solution is to narrow the income base for all Americans.) The expanded exemption and ZBA allow for significant tax progessivity despite the relatively few tax brackets proposed. Unfortunately, these changes also eliminate the prospects of changing the tax system enough to cause a major reduction in the marginal and average tax rates of the middle class. Also, these changes require a large amount of unpopular loophole closings to reduce tax rates. (In effect, approximately $50 billion per year of loophole closings are needed to offset the increase in excluded income resulting from the increase in the exemption and the ZBA. The only other alternative is a corporate tax increase.)

Table 4
President Reagan's Tax Proposal--$ Billions
Primary Revenue Impacts--Selected Items

	1986	1987	1988	1989	1990
Personal Taxes					
Personal rate reductions	-11.1	-49.5	-60.1	-66.7	-72.7
Increased exemption to $2,000	-18.8	-39.1	-42.1	-45.1	-48.0
Increased zero bracket amount	-4.4	-6.2	-6.6	-7.1	-7.6
Repeal second-earner deduction	1.6	7.1	7.7	8.3	9.0
Tax a portion of health insurance	2.4	3.5	3.7	3.8	4.0
Repeal S&L tax deduction	4.5	33.3	34.1	37.0	40.0
"Tax Abuser" repeal	0.9	2.2	2.6	3.0	3.3
Repeal income averaging	1.0	3.9	4.3	4.6	4.9
Capital and Business Taxes					
Reduce corporate rates	-10.0	-26.7	-35.9	-39.0	-41.8
Repeal investment tax credit	15.7	30.4	35.0	39.7	44.6
Adjust depreciation schedule	0.4	-0.4	3.6	12.3	21.2
Recapture of ACRS	7.6	19.7	20.7	9.6	--
10% dividend paid deduction	--	-3.6	-6.5	-7.8	-6.7
Income measurement (esp. multiperiod construction)	3.5	7.8	11.8	15.5	17.1
Financial institutions	1.9	3.7	4.4	5.0	6.0
Nongovernmental S&L bonds	0.3	1.5	2.9	3.8	4.5
Tax shelter curtailment	--	0.2	0.4	1.1	1.5
Per country tax credit	0.9	2.5	3.0	3.3	3.6

Since Table 4 lists all of the major loophole closing provisions contained in the President's tax proposal, it is evident that the only large personal tax-oriented loophole closing item which was included is the elimination of the deduction for state and local taxes. For this reason, we believe that the elimination of the state and local tax deduction is likely to remain a fundamental element of the tax proposal, despite its great unpopularity along both coasts. If the Congress were to retain this tax expenditure, offsetting the revenue loss would require either: (a) eliminating the rate reductions, or (b) replacing the revenues by eliminating an even less popular base-broadening move.

With the exception of the repeal of "tax abuses" (items such as excessive entertainment expenses) which, even by 1990, would raise less than $3.5 billion per year, the other significant labor income base-broadening moves are also unpopular. The repeal of a second earner deduction would clearly have negative "supply-side" effects, as well as, at least arguably, anti-family and anti-equity aspects. Although income averaging certainly serves to benefit younger taxpayers primarily, its elimination would also seem to decrease the fairness of the tax system. The Treasury Department has argued that with fewer brackets the need for the second earner deduction and income averaging is reduced. However, this argument is in large part fallacious. Replacing a staircase which has 14 small steps with one which has three very large steps, does not change the height of the next floor. The reduction in the top marginal rate from 50 to 35 percent does reduce the need for these provisions somewhat. However one could argue that the larger zero bracket amount and the repeal of the state and local tax deduction increases the need for these provisions.

Clearly the major labor income base-broadening items do not provide nearly enough revenue to offset the base and rate reduction items. Some of the difference is made up through higher personal taxes on capital-related income. For example, many individuals, particularly those who are self-employed, are significant beneficiaries of items such as the investment tax credit. Also, the Treasury proposal eliminates a lot of items which are small individually, such as the dividend deduction, but whose cumulative impact is significant. However, even with these items, it is clear that the personal tax changes can be made in a revenue neutral environment only if corporate income taxes are increased significantly.

THE BUSINESS CAPITAL INCOME TAX CHANGES

The major business and capital income tax changes are also shown in Table 4. The two large items turn out to be almost exactly offsetting on a revenue raising basis. In effect, the Administration is able to propose a dramatic reduction in corporate tax rates by the repeal of the investment tax credit. Although this change in emphasis by the Administration from enhancing labor productivity to enhancing total factor productivity is not likely to cause a major direct change in the amount of capital purchased relative to the amount of labor purchased, there is no question that these two changes to the tax system amount to a very strong statement on industrial policy. Under current law the tax system is strongly tilted toward capital-intensive industries. If the President's proposal is adopted, most of the tilt toward capital-intensive industries would be eliminated. In fact the system would be tilted to R&D oriented industries.

The impact of the President's proposed changes to depreciation schedules needs to be examined with some care. In general the President's new proposed Capital Cost Recovery System (CCRS) is not significantly less favorable to capital than the current Accelerated Cost Recovery System (ACRS). Indeed, under current or higher rates of inflation, CCRS is significantly more favorable to capital than the current ACRS system for most classes of investment. The major exception is structures. The impact of the switch from CCRS to ACRS on the cost of structures depends upon one's assumed discount rate. If one assumes, as the Treasury does, that investors in structures require a 4 percent real rate of return or less, CCRS is still more favorable to investment than ACRS. If one believes that a higher discount factor is appropriate for these risky investments, ACRS remains more attractive. A summary of the present discounted value of depreciation benefits under CCRS and ACRS (assuming a 4 percent real rate of return) is shown in Table 5. The pattern for a representative class of equipment and for structures are shown in Figures 3 and 4.

Under virtually any reasonable inflation scenario, a shift to CCRS will, in the aggregate, have no major impact upon the level of tax depreciation taken in the short term. In the long term, the inflation adjustments, coupled with longer tax lives, will result in higher rates of tax depreciation. In the intermediate term, CCRS will yield somewhat less tax depreciation. As is shown in Table 4, the short-term revenue impact of the shift to CCRS is negligible. In 1987, there is a slight revenue loss associated with the change in depreciation schedules. However, as the decade of the 1980s closes, the change from ACRS to CCRS results in some significant revenue gains. If the projections on Table 4 were carried through the end of the century, these revenue gains would gradually disappear. Since the change in depreciation allowances has a significant revenue impact only during the late 1980s and early 1990s, any increases in corporate tax receipts necessary to balance personal tax reductions must come from some other source. (To some extent this need is lessened by the typical assumption that, if left unchecked, some of the closed personal tax loopholes, particularly in pension and income shifting areas, would grow rapidly during the 1990s.)

Table 5
Present Discounted Value of
Depreciation Benefits--$1,000 Investment
Capital Cost Recovery System (CCRS)
Versus Accelerated Cost Recovery System (ACRS)

CCRS Asset Class	Inflation Rate Percent	CCRS	ACRS
1	5	954	908
	10	955	865
2	5	940	837
	10	940	766
3	5	920	837
	10	920	766
4	5	890	837
	10	891	766
5	5	853	707
	10	853	603
6	5	610	570
	10	610	454

Figure 3

DEPRECIATION ALLOWANCES UNDER ACRS AND CCRS
CLASS 3 ASSETS - 5 PERCENT INFLATION

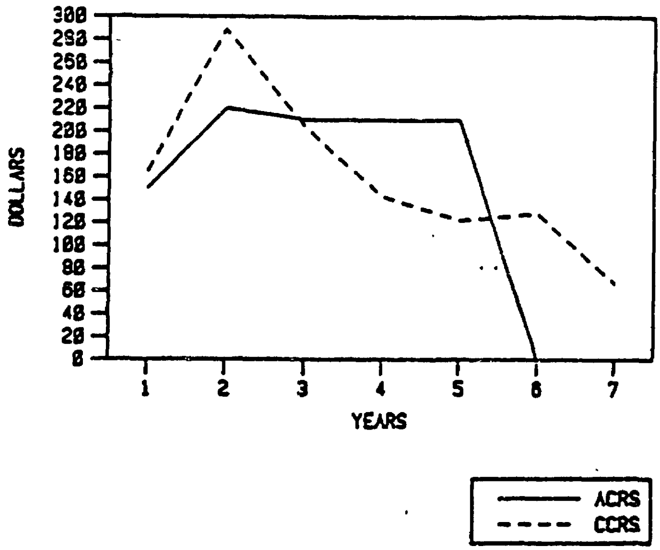
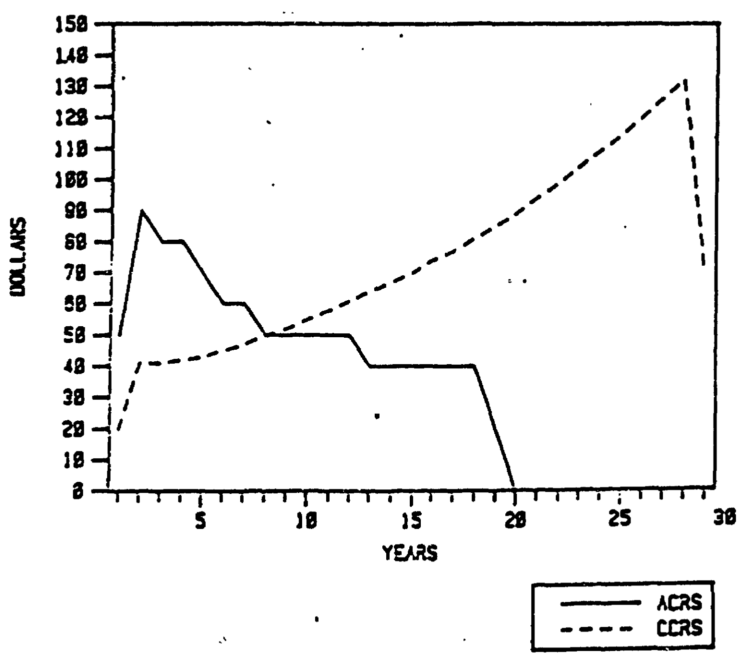


Figure 4

DEPRECIATION ALLOWANCES UNDER ACRS AND CCRS
CLASS 6 ASSETS - 5 PERCENT INFLATION



The long-term increases in corporate tax receipts come largely from three or four base broadening changes. These changes do not affect the structure of the tax system, but strike heavily at specific practices in place in particular industries. Therefore, they can be expected to have strong industry-specific effects. For example, significant changes are made to the provisions of tax codes which allow fairly rapid expensing of costs incurred in the production of multiyear income. Those industries, such as defense-related industries and construction companies, which historically have been able to deduct expenses ahead of income, will face significant increases in taxes. Financial institutions will also be faced with significant tax increases due to some provisions such as a stricter limitation on excess bad debt deductions. Multinational companies will face tighter reductions on their accounting systems which will have the effect of raising their U.S. tax liability. (A detailed summary of the Administration's tax proposals and a comparison with previous proposals is contained in an Appendix to this report.)

Although these base-broadening items will probably meet the Administration's long-run revenue balancing needs, they do not provide sufficient funds in the middle 1980s to make the proposal revenue neutral. The Administration has therefore proposed to tax corporations based upon past ACRS deductions. The argument is that corporations who received large "front-loaded" benefits from ARCS would receive a windfall to the extent that their deductions were taken under old marginal corporate tax rates, and much of the revenue that will accrue from the investment would be received under the new, lower marginal tax rates. Thus the Treasury proposed a tax which would "recapture" some of the tax benefits provided by ACRS. Since this tax would be on old rather than new investment, presumably it would have minimum incentive effects, although corporate cash flow would certainly be reduced. In effect, companies which received large ACRS benefits would have their tax cut partially or entirely delayed for several years.

THE DISTRIBUTIONAL IMPACTS— PERSONAL INCOME TAXES

The largest individual distributional impacts of the President's tax reform proposals will be between itemizers and nonitemizers. Those persons who have structured their economic affairs so as to take maximum advantage of the current tax code will receive small tax reductions, and in many cases substantial tax increases. Since the largest "loophole" to be closed is state and local taxes paid, it is clear that the differential regional impacts will be immense. In particular, most taxpayers in high tax areas will suffer both higher Federal income taxes and reduced property values. The economies of the regions will also suffer on a relative basis. Interestingly, some taxpayers in high tax regions may even face significant increases in their marginal tax rates. As is shown in Table 6, the size of the marginal tax rate cuts differs significantly by income segment. In particular, many people taxed at a 15 percent marginal rate were previously taxed at rates ranging from 11 to 18 percent. Similarly, many persons in the new 25 percent marginal rate bracket were taxed at rates ranging from 23 to 26 percent. Some persons who will be in a 35 percent tax rate bracket were taxed at rates ranging from 38 to 42 percent. Since state and local income, property, and sales taxes will no longer be deductible and, for some of these persons taxes are roughly proportional to income, these individuals will find that their marginal as well as their average tax rates have actually increased!

Much has been said about the impact of the tax proposal on income distribution. The standard analysis, depicted in Figure 5, shows that the tax cuts are about proportional overall. Substantially larger tax cuts, as a percent of total taxes, were made at the lowest income level; somewhat higher than average percentage tax cuts were made at the upper-income level, and slightly smaller than average tax cuts were made for middle-income taxpayers.

Another way of looking at the distributional aspect of the tax cuts is to compare

Table 6
Comparison of Marginal Tax Rates
Under Current Law and Proposal for 1986
Joint Returns

Current Law		President's Proposal	
Taxable Income	Marginal Tax Rate	Marginal Tax Rate	Taxable Income
Less than $3,670	0	0	Less than $4,000
$3,670 - 5,930	11		
$5,930 - 8,200	12		
$8,200 - 12,840	14		
$12,840 - 17,260	16	15	$4,000 - 29,000
$17,260 - 21,800	18		
$21,800 - 26,540	22		
$26,540 - 32,260	25		
$32,260 - 37,980	28		
$37,980 - 49,420	33	25	$29,000 - 70,000
$49,420 - 64,740	38		
$64,740 - 92,360	42		
$92,360 - 118,040	45		
$118,040 - 175,230	49	35	$70,000 or more
$175,230 or more	50		

Source: Office of the Secretary of the Treasury

the cuts to income. This comparison is shown in Figure 6. As is indicated, the tax cuts are roughly proportional to income for a wide range of taxpayers. In particular, virtually all income classes of taxpayers who pay significant income taxes will receive tax cuts equal to between 0.5 and 0.7 percent of economic income. The only major exception is upper-income taxpayers, who will receive tax cuts equal to almost 2.5 percent of their economic income. The popularity and long-run sustainability of this type of change is far from clear.

One other significant distributional impact concerns two-income families. In announcing his tax proposal, President Reagan suggested that it would help preserve the nuclear family. Certainly the proposal discourages two-worker households in several ways. The second largest tax "loophole" to be closed is the second-earner deduction. In addition, nonworking spouses are allowed to establish IRAs, a provision which not only calls the entire concept of an IRA as a pension into question, but also increases the implicit after-tax cost of a working spouse. Other provisions, such as the nondeductibility of state and local income taxes, the changing of the child care credit to a deduction, and the moving of miscellaneous business expenses "above the line" also will make it less attractive economically for second earners in a household to work.

Figure 5

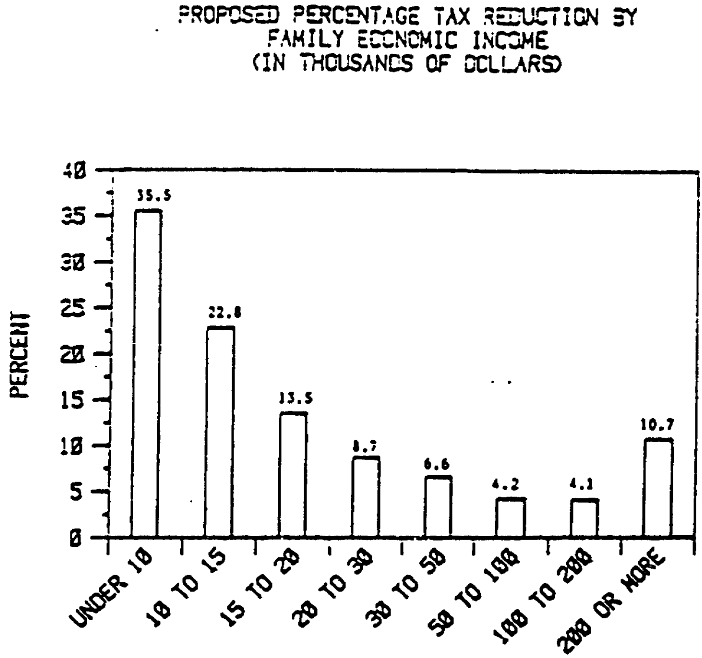
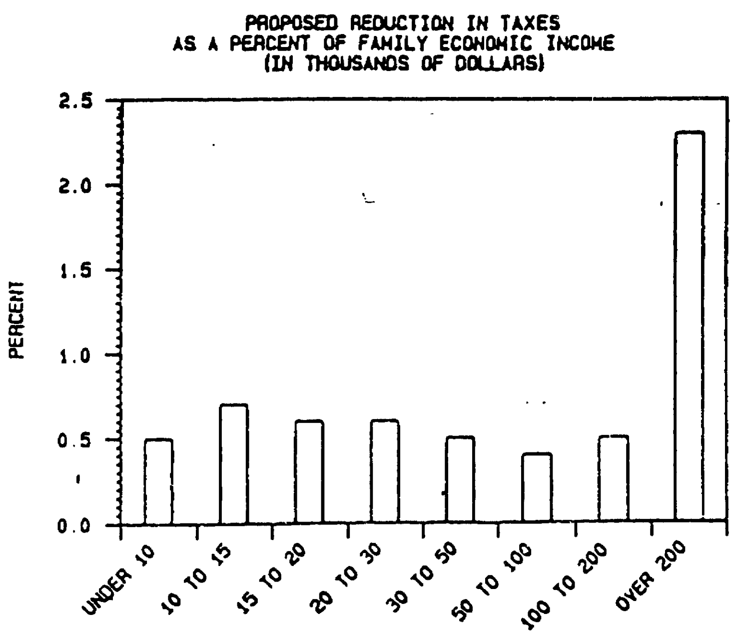


Figure 6



INDUSTRY DISTRIBUTION IMPACTS

The distributional issues affecting corporations are at least as important as those which affect individuals. The Treasury argument that it is not skewing the tax system against specific industries but merely removing current subsidies is largely correct. Nevertheless, when it happens to you, the loss of a subsidy can hurt as much as the imposition of a penalty. The industry distribution impacts occur for four major reasons. First, the current bias in the tax code against investment by unprofitable firms is removed. Second, accounting practices commonly utilized in several industries are specifically targeted for repeal. The most important of these changes are in multiperiod expense and income matching, energy subsidies, and tax benefits utilized by financial institutions.

The second distributional issue affects profitable companies in industries which require large amounts of capital investment. Large capital users are hit hard by the repeal of the investment tax credit. Only a very small portion of this loss is offset by the slightly more generous depreciation provisions. Also, companies in these industries, to the extent that they took advantage of ACRS depreciation during the past four years, will not receive their tax cut in 1986; rather, they will have all or a portion of it deferred until 1989.

The third group of companies which will be impacted by this proposal are those which are heavily dependent upon those parts of the economy which are likely to be adversely affected by the proposal. Sellers of equipment and multifamily housing construction and commercial construction will undoubtedly be hurt disproportionately.

Needless to say, companies which are not capital intensive, either because they are labor intensive (and most expenditures are automatically expensible) or are research and development intensive (and can benefit from both the immediate write-off of R&D expenditures and the research and experimentation tax credit) will prove to be large winners should this tax system be adopted. It has been suggested that producers of high-technology equipment will suffer somewhat from the loss of the investment tax credit. We find this argument unpersuasive in part because investments in these types of equipment typically show rates of return substantially in excess of a company's hurdle rate even without the tax credit, and in part because the lower corporate tax rate enhances the profitability of all types of investment activity. Furthermore, for products which have falling prices, an increased effective cost will, at most, affect the timing rather than the substance of an investment decision.

A summary of the expected impacts of the tax proposal on industry output is shown in Table 7. These output estimates are based upon the macroeconomic forecast scenario presented below.

THE MACROECONOMIC IMPACTS

The "supply-side" impacts of the Administration's tax proposal cannot be estimated using a standard economic model for several reasons: (1) Supply-side economic impacts are known to be relatively small in the short run. Since most econometric models are designed for analysis of fluctuations in the economy, they are dominated by the more immediate demand side phenomena. (2) Econometric models do not contain the detailed microeconomic linkages in the economy necessary to analyze the impact of this type of proposal. The cost of building a model which would combine both the microeconomic and macroeconomic linkages would be prohibitive. (3) The impacts are to some extent unknowable because the proposed tax policy does not have a relevant historical precedent.

Nevertheless it is possible to make some broad general statements about the supply-side impacts. First, the change in personal income taxes is not likely to be sufficiently large to cause major changes in people's work incentives. In virtually all cases, the effective marginal tax rate reductions will be far less than those passed in

Table 7
Industry Output Impacts
(Percent Difference in Industrial Production)

Industry	1985	1986	1987	1988	1989	1990
Total production	.27	-1.7	.61	1.09	.74	.13
Metal-mining (10)	.36	-2.3	.28	.84	.90	.71
Food processing (20)	.16	0.0	.95	1.68	1.54	1.21
Apparel products (23)	.08	0.0	.55	1.06	1.01	.75
Lumber & products (24)	.16	.51	1.54	2.80	1.66	1.53
Furniture & fixtures (25)	.28	-.98	.60	1.72	1.57	1.28
Paper & products (26)	.24	-.51	.78	1.32	1.47	1.03
Printing & publishing (27)	.11	.19	.72	1.06	.96	.87
Chemicals & products (28)	.52	-.28	1.59	2.38	1.96	1.27
Petroleum products (29)	.24	.18	1.63	1.55	1.28	.82
Rubber & plastic products (30)	.66	.24	2.47	3.90	3.37	2.44
Leather & products (31)	.34	.01	.32	.66	.76	.73
Stone, clay, glass products (32)	.22	-.42	.91	2.21	1.29	.97
Metals (33)	.70	-3.72	.35	.84	1.29	.89
Fabricated metal products (34)	.88	-4.85	-1.66	-.94	-1.35	-2.25
Nonelectrical machinery (35)	1.55	-3.48	-.72	-.48	-1.16	-2.19
Electrical machinery (36)	.65	-3.05	-.23	.27	-.13	-.70
Transportation equip. (37)	.68	-1.79	-.08	.23	.20	-.25
Instruments (38)	.76	-2.48	.28	.56	-.29	-1.12

1981; in many cases, the effective marginal rate changes will be minimal. Although we do not know the precise labor force expanding impact of the 1981 tax cuts, it is clear that no large unexpected jumps in the labor force occurred as a result of those cuts. Furthermore, the labor supply may even be slightly decreased by the high penalties on two-worker families. Second, individual tax sheltering activities should be reduced significantly by the tax proposal in several ways. The elimination of the investment tax credit, along with several other aspects of the Administration's proposal, will make tax shelters less attractive. Also, with top marginal tax rates of 35 percent, a shelter without a strong economic foundation will have to offer exceptionally high write-offs to be attractive. Finally, some of the "hype" surrounding the tax shelter industry may disappear, particularly if the simpler forms allow the IRS to concentrate more heavily on monitoring tax shelter activity.

Incentives to save probably will be affected only slightly by the proposal. The situation is not as bad as in 1981, since the excess savings of individuals have presumably been "sopped up" into IRAs. Therefore, for the overwhelming majority of Americans, the marginal Federal income tax rate on saved income is probably near zero. However, increasing one's saving is neither easy nor pleasant. As the evidence of the past three years has shown, personal saving is almost entirely insensitive to changes in real interest rates. As a result, immediate changes in saving behavior are most unlikely. (As is the case with many of the supply-side influences, we would not be surprised if the President's proposal gradually built an ethic toward individual savings; the short-run impact, however, will be insignificant. Similarly, we doubt people will suddenly work harder since tax rates are lower. (Few individuals are paid piecework anyway.) However, over the course of a lifetime, people may find themselves more willing to substitute work effort for higher pretax incomes.

On the corporate side, the incentives impacts may be more significant. As noted above, we do not expect the changes in tax law to dramatically affect capital/labor ratios in particular industries. However, the tax law defines a powerful industrial policy in the United States. The net impact of this shift in tax laws should be an acceleration of the current restructuring of the American economy away from heavy industry toward "high technology" industry. Again, we doubt that the results will be sufficiently striking to be apparent on a year-by-year basis. However, we would expect that over a period of several years the structure of the economy will shift considerably and growth rate of the United States economy might be improved by as much as 0.1 percent per year on average.

While it is impossible to capture the supply-side impacts of a proposal such as this one in a macroeconomic model, there are some meaningful things which can be said about the demand-side impacts. First, a shift in tax incidence from individuals to businesses will tend to raise consumption relative to investment. Second, the adoption of the Administration's proposal will undoubtedly have a depressing impact upon construction activity. Multifamily housing construction and commercial construction are likely to be the two areas which are affected most severely. However, as noted above, the impacts of the President's proposals on investment will be much less dramatic than those of the original Treasury proposal.

The model simulation we prepared to illustrate the impacts of the President's proposal was a relatively "clean" one in that the major changes were to the tax parameters of the model—reductions in the marginal and corporate tax rates, the elimination of the investment tax credit, and level adjustments to the corporate and personal tax functions. In addition, we also included some negative adjustments to the equations for investment in equipment and for investment in commercial and multifamily structures. Dividends were also raised somewhat to reflect the 10 percent dividend deduction. Since the present value of the depreciation allowances was not changed very much, we did not make changes to the depreciation variable, other than in arbitrary stretch-out of the tax life for structures to 24 years in an attempt to reflect the reduced inducement to invest-

::t in structures (based upon an assumed . discount rate for real estate investors). :her, we assumed that interest rates ..d drop by one percentage point in 1986, ~ver one-half percentage point in 1987, hold one-half percentage point lower reafter, a consequence of the slowdown in economy in 1986 and the shift in the :nomy away from investment and toward ·ings. As was the case in the Treasury I -oposal, we did assume small bulges in in-_stment activity in late 1985 to reflect in-_stors' "last chance" to receive some of the -urrent investment incentives. The Presi-ent's proposal will undoubtedly have far -anging impacts upon a wide variety of :rices. Unfortunately, the exact impacts in these areas are extremely difficult to esti-mate. For example, presumably the prices of multifamily rental units will rise as would business office rents after one or more years. However, the prices charged by some retail firms, which currently must cover very high marginal tax rates, might fall. Rather than guess at all of these kinds of price changes we decided not to make adjustments in this area.

A summary of the macroeconomic impacts of these simulations is shown in Table 8. In general, the negative 1981 impacts appear to be about one-third of those found in the original Treasury proposal. After 1986, the simulation indicates that GNP would be slightly higher than the baseline. (Again please recall that any supply-side growth impacts which occur, would be in addition to the impacts shown in the simulation.) Interestingly, an alternative simulation, which included the same changes as the final simulation, except that the personal tax rate change began January 1, 1986 instead of July 1, 1986, cut the transition impact in half.

THE PROSPECTS FOR PASSAGE

As a concept, tax reform is extremely popular. The details of tax reform are far less appealing. However, polls indicate that Americans strongly dislike the current tax system, and, as a result, favor tax reform. Furthermore, from a Washington perspective, taxpayer dissatisfaction has grown to the point that the choice is either to reform the current system or to let it be destroyed by continually growing loopholes. As a result, the political leaders—both Republicans and Democrats—who will determine the course of tax reform legislation have agreed that tax reform is necessary and that the government should move quickly. Thus we expect to see the passage of a tax reform proposal either in the waning days of the current session of the Congress or early in 1986.

The tax reform proposal currently under discussion is far less revolutionary than the Treasury's initial proposal. Furthermore, the amount of reform is likely to decline rather than grow as the proposal winds its way through the Congress. However, the bill has already moved to center stage. If the Congress failed to pass a bill it would be considered a defeat by virtually all key government leaders. Therefore, something called "tax reform" will be passed. Since the opportunity for finding additional popular base-broadening options is so small, we believe that the final bill will be similiar to the one proposed by the President. The only major additional changes we expect are: (1) an increase in the progressivity of the individual tax changes perhaps through the addition of a fourth bracket for upper-income individuals and the elimination of some additional upper-income preferences (perhaps energy-oriented preferences), and (2) a further shift in the tax burden from personal income taxes to corporate income taxes.

Estimated Impact of the President's
Tax Reform Proposal

	1985	1986	1987	1988	1989	1990
Gross National Product (constant $) Percent Difference	0.14	-0.93	-0.01	0.41	0.38	0.21
Gross National Product (current $) Percent Difference	0.12	-0.96	-0.20	0.35	0.55	0.54
Inflation (GNP deflator) Percent Difference	-0.03	-0.04	-0.19	-0.07	0.17	0.33
Unemployment Rate (percent) Actual Difference	-0.01	0.18	0.18	0.02	-0.10	-0.09
Treasury Bill Rate (percent) Actual Difference	0.01	-0.90	-0.80	-0.44	-0.21	-0.19
Federal Budget Margin (current $) Actual Difference	1.3	4.4	7.8	8.1	16.2	10.0
Federal Interest Expenditures (current $) Actual Difference	0.0	-3.1	-8.3	-8.1	-7.7	-8.1
Investment, Equipment (constant $) Percent Difference	1.2	-4.8	-1.0	-0.6	-1.4	-2.6
Investment Structures (constant $) Percent Difference	0.5	-10.2	-8.6	-6.3	-5.1	-4.5
Capacity Utilization (percent) Actual Difference	0.2	-0.9	0.7	1.2	0.9	0.4
Industrial Production (1967=100) Percent Difference	0.27	-1.17	0.61	1.09	0.74	0.13
Net Exports (current $) Actual Difference	-0.36	3.89	2.90	-0.02	-1.72	-2.10
Multifamily Housing Starts (Mil. Units) Actual Difference	0.01	-0.20	-0.14	-0.11	0.02	0.01
Single-Family Housing Starts (Mil. Units) Actual Difference	0.00	0.04	0.13	0.15	0.13	0.09

Revised 6/7/85

Estimated Impact of the Treasury
Tax Reform Proposal

	1985	1986	1987	1988	1989	1990
Corporate Profits Before Taxes (current $)						
Actual Difference	1.24	-8.68	1.90	7.40	8.64	8.44
Corporate Profits After Taxes (current $)						
Actual Difference	1.31	-21.99	-15.21	-7.44	-5.30	-4.28
Real Disposable Income						
Percent Difference	0.03	0.01	0.77	1.00	0.79	0.78
Saving Rate (percent)						
Actual Difference	0.02	0.05	0.48	0.36	0.08	0.07

Source: Chase Econometrics

Revised 6/7/85

APPENDIX

COMPARISON OF HIGHLIGHTS OF CURRENT LAW, NOVEMBER 1984 TREASURY PROPOSAL, AND PRESIDENT'S PROPOSAL

	Current Law (1986)	November 1984 Treasury Proposal	President's Proposal
…vidual tax rates	14 rate brackets from 11 to 50%, indexed	3 rate brackets 15,25 & 35%,indexed	3 rate brackets 15,25 & 35%, indexed
…emptions			
…elf, Spouse	$1,080, indexed	$2,000, indexed	$2,000, indexed
…ependents	$1,080, indexed	$2,000, indexed	$2,000, indexed
…ero Bracket Amount			
…ingle	$2,480, indexed	$2,800, indexed	$2,900, indexed
…oint	$3,670, indexed	$3,800, indexed	$4,000, indexed
…eads of Household	$2,480, indexed	$3,500, indexed	$3,600, indexed
…wo-earner …eduction	Yes	No	No
…arned Income Credit	Yes ($550 max.)	Yes, indexed	Increased and indexed ($726 maximum)
…hild Care Expense	Tax credit	Deduction	Deduction
…ringe Benefits			
Health Insurance	Not Taxed	Taxed above a cap	Limited amount taxed
Group-term life insurance, legal services, dependent care, education assistance	Not Taxed	Taxed	Not Taxed
Parsonage allownc.	Not Taxed	Taxed	Not Taxed
…age Replacement			
Unemployment Compensation	Taxed if AGI over $12,000 ($18,000 if married)	Taxed	Taxed
Workers' Compensation	Not Taxed	Taxed, but eligible for special credit for elderly and disabled	Taxed, but eligible for expanded and indexed credit for elderly & disabled
Veterans' disability benefits	Not Taxed	Taxed	Not Taxed
…temized Deductions			
State and Local Income Tax	Deductible	Not Deductible	Not Deductible
Other State and Local Taxes	Deductible	Not deductible, unless incurred in income-producing activity	Not deductible, unless incurred in income-producing activity

	Current Law (1986)	November 1984 Treasury Proposal	President's Proposal
Charitable Contributions	Deductible by itemizers and nonitemizers	Deductible (above 2% of AGI) for itemizers, but no deduction for non-itemizers or for unrealized gains on contributed property	Deductible for itemizers, but no deduction for non-itemizers
Mortgage Interest	Deductible	Deductible, for principal residences	Deductible, for principal residences
Other personal interest	Personal interest deductible; investment interest limited to $10,000 over investment income	Limited to $5,000 over investment income for expanded definition of interest subject to limit	Limited to $5,000 over investment income for expanded definition of interest subject to limit (with phase-in)
Medical expenses	Deductible (above 5% of AGI)	Deductible (above 5% of AGI)	Deductible (above 5% ov AGI)
Tax Abuses			
Entertainment Expenses	Deductible	Not Deductible	Not Deductible
Busines Meals & Travel Expense	Deductible	Deduction denied for meal costs above cap	Deduction denied for 50% of meal costs above cap
Income shifting to children and via trusts	Permissible	Curtailed	Curtailed, except for post-death trusts
Retirement Savings			
IRA	$2,000	$2,500	$2,000
Spousal IRA	$ 250	$2,500	$2,000
Corp. Pensions	Tax deferred	Tax deferred	Tax deferred
Social Security	Generally not taxed	Generally not taxed	Generally not taxed
Capital and Business Income			
Corporate Tax Rates	Graduated, up to 46%	33% flat rate	Graduated, up to 33%
Limited Partnerships	Losses flow through to partners	No loss flow through	Current Law

	Current Law (1986)	November 1984 Treasury Proposal	President's Proposal
Dividend Relief	$100/200 exclusion	Exclusion repealed; 50% dividend-paid deduction	Exclusion repealed; 10% dividend-paid deduction
Depreciation	ACRS	Economic depreciation, indexed	Indexed, with investment incentive
Investment tax credit	6% - 10%	No	No
Capital gains	60% excluded	Indexed, taxed as ordinary income	50% excluded (optional indexing in 1991)
Interest income/ expense	Fully taxed/ deductible	Indexed, partially excludable/ nondeductible	Fully taxed/ deductible
Inventory accounting LIFO conformity required	Yes	No	No
FIFO	Not Indexed	Indexed	Indexed
Uniform production cost rules	No uniform rules	Uniform rules	Uniform rules
Installment sales	Deferral	No deferral if receivables pledged	Generally no deferral if receivables pledged
Bad debt reserve deduction	Yes	No	No
Oil industry Percentage depletion	Yes	No; Indexed cost depletion	Phased out with stripper exception
Expensing of intangible drilling costs	Yes	No	Yes
Windfall profits tax	Will phase out in 1991	Phase-out accelerated	Will phase out in 1991
Financial Institutions Special bad debt deduction	Yes	No	No
Deduction for interest to carry tax-exempts	Yes	No	No

	Current Law (1986)	November 1984 Treasury Proposal	President's Proposal
Exemption of credit unions	Yes	No	No, except for small credit unions
Deferral for life insurance income and annuity income	Yes	No	No, except for existing policies
Exemption of certain insurance companies including fraternal organizations	Yes	No	Yes
Municipal Bonds			
Public purpose	Tax-exempt	Tax-exempt	Tax-exempt
Private purpose	Tax-exempt	Taxable	Taxable
Rehabilitation and energy credits	Yes	No	No
Minimum tax on individuals and corporations	Yes	Not necessary	Retain and tighten

Source: Office of the Secretary of the Treasury, May 28, 1985

IMPACT ON RESIDENTIAL RENTAL PROPERTY OF THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS

Prepared by:

SNYDER, NEWRATH AND COMPANY, P.C.

SNYDER, NEWRATH AND COMPANY, P.C.

Certified Public Accountants
4520 East-West Highway
Bethesda, Maryland 20814
652-6700

We have analyzed the effect of the proposed changes in the tax law on rental prices for a typical residential rental property in Herndon, Virginia assuming that an investor will demand total cumulative benefits from cash flow and tax savings equivalent to those available prior to the tax law changes. No effect was given to the proposed extension of the at-risk rules to real estate investments. Similarly, no effect was given to the proposed new interest limitations and classifications since the effect would vary greatly among investors.

June 24, 1985

Snyder, Newrath and Company, P.C. is a Washington, D.C. firm of Certified Public Accountants in practice since 1927 with specialized expertise in Real Estate Taxation.

CHANGE #1

Increase in monthly rents needed to compensate investor for decrease in maximum tax rate from 50% to 35%. All other factors are according to current law.

	1986 (9 months)	1987	1988	1989	1990	1991	1992	1993	1994	1995
Average Monthly Rent Before Tax Law Change	$475	$508	$544	$582	$623	$666	$713	$763	$816	$873
Average Monthly Rent After Tax Law Change	477	510	546	584	625	669	716	766	820	877
Gross Increase	2	2	2	2	2	3	3	3	4	4
Percent Increase	.4%	.4%	.4%	.3%	.3%	.5%	.4%	.4%	.5%	.5%

CHANGE #2

Increase in monthly rents needed to compensate investor for change in depreciation method from ACRS (18 year S.L.) to CCRS (29 year S.L). All other factors, including tax brackets, are according to current law.

	1986 (9 months)	1987	1988	1989	1990	1991	1992	1993	1994	1995
Average Monthly Rent Before Tax Law Change	$475	$508	$544	$582	$623	$666	$713	$763	$816	$873
Average Monthly Rent After Tax Law Change	482	515	551	590	631	675	723	773	827	885
Gross Increase	7	7	7	8	8	9	10	10	11	12
Percent Increase	1.5%	1.4%	1.3%	1.4%	1.3%	1.4%	1.4%	1.3%	1.3%	1.4%

CHANGE #3

Increase in monthly rents needed to compensate investor for elimination of capital gain treatment on disposition of property. All other factors, including tax brackets, are according to current law.

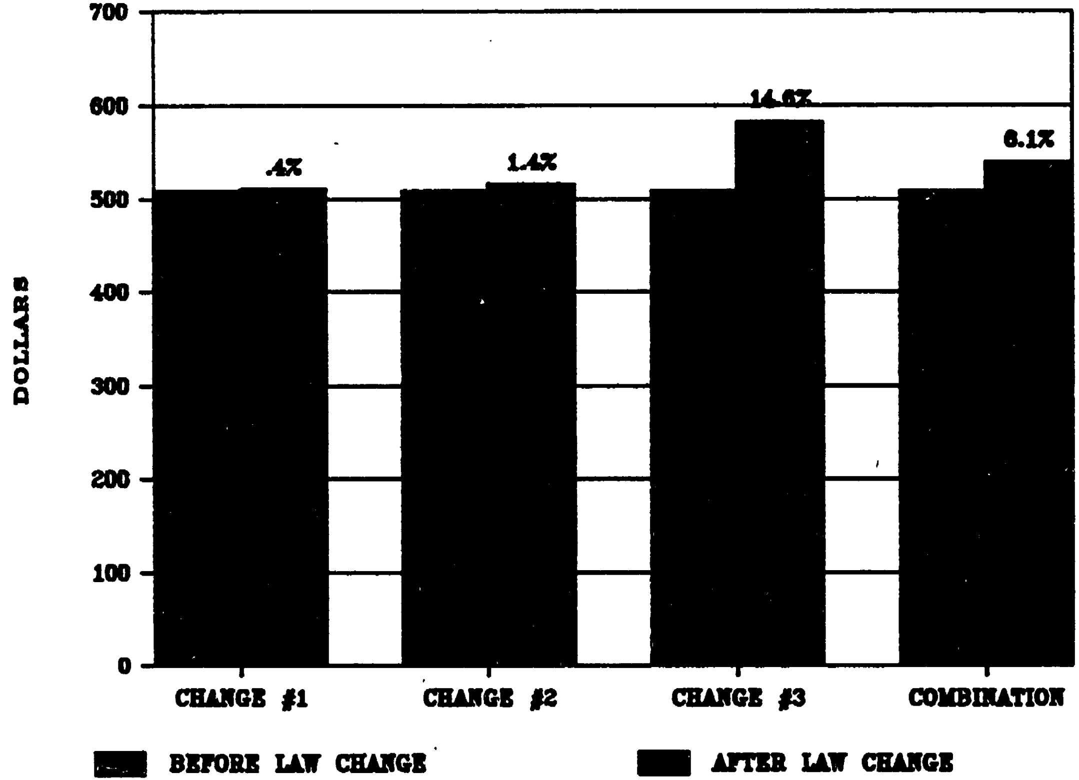
	1986 (9 months)	1987	1988	1989	1990	1991	1992	1993	1994	1995
Average Monthly Rent Before Tax Law Change	$475	$508	$544	$582	$623	$666	$713	$763	$816	$873
Average Monthly Rent After Tax Law Change	544	582	623	667	714	763	817	874	935	1,001
Gross Increase	69	74	79	85	91	97	104	111	119	128
Percent Increase	14.5%	14.6%	14.5%	14.6%	14.6%	14.6%	14.6%	14.5%	14.6%	14.7%

COMBINATION

Increase in monthly rents needed to compensate investor for decrease in maximum tax rate, change in depreciation method, and elimination of capital gain treatment on disposal of property.

	1986 (9 months)	1987	1988	1989	1990	1991	1992	1993	1994	1995
Average Monthly Rent Before Tax Law Change	$475	$508	$544	$582	$623	$666	$713	$763	$816	$873
Average Monthly Rent After Tax Law Change	504	539	577	617	660	707	756	809	866	926
Gross Increase	29	31	33	35	37	41	43	46	50	53
Percent Increase	6.1%	6.1%	6.1%	6.0%	5.9%	6.2%	6.0%	6.0%	6.1%	6.1%

ANALYSIS OF EFFECT OF LAW CHANGES
ON MONTHLY RESIDENTIAL RENTS



COMMENTS

The conversion of capital gain treatment to ordinary income treatment on the sale of the property, leaving the maximum 50% bracket untouched, results in nearly a 15% rent increase. Reducing the top federal bracket to 35% makes the loss of capital gain treatment less dramatic as shown in the "COMBINATION" Chart.

Dr. TAUB. The main points of my testimony are as follows: First, tax reform should be accepted or rejected on its own merits, not on the secondary economic impacts.

I would echo the remarks made earlier this morning of others that the most important action you can do if you are interested in secondary economic impacts is to reduce the Federal budget deficit.

Second, my work with the Chase Econometrics macroeconomic model indicates that the President's proposal would cause a demand shock which would have a modest depressing impact upon GNP in 1986, but that demand induced changes after 1986 would be slightly positive. Although econometric models are not designed to measure the microeconomic effects of tax reform, they can warn of possible changes to demand, which will result in a shock to the economy, and describe the sectorial and industrial impacts of these shocks.

Over 50 percent of the 1986 demand shock covered by the proposal could be avoided simply by beginning the personal tax rate reduction on January 1, 1986 instead of July 1, 1986. Most of the remainder of the shock results from reduced tax shelter and construction activities. The study by Snyder, Newrath & Co., a major Washington, DC, accounting firm which I referred to earlier, indicates that rents for a multifamily housing project would have to rise approximately 6 percent to provide developers with the same return they receive under current tax law.

Third, most tax based incentive supply side impacts will be favorable, but their magnitudes will be small. There is substantial evidence on this point. For example, despite 1981 tax cuts, tax sheltering activities increased, labor force growth has slowed and the savings rate has fallen. Even without U.S. tax incentives on long-term fixed rate mortages, Canadians have shown almost the same propensity to purchase expensive housing as U.S. citizens. During the past 5 years, business investment has increased somewhat by the tax incentives, but the dominant influences clearly have been a demand-related phenomena.

At this point, I would refer you to the first set of figures in my handout, which show that investments and equipment relative to GNP is lower today than it was before the 1981 incentives were passed. Despite the extremely generous accelerated depreciation and investment tax credit, this occurred.

Where there has been an increase in investment relative to GNP is the structures where we have, of course, extremely generous incentives to tax sheltering. The supply-side impacts of tax reform will be less than those of the 1981 tax cut since on average, rates are reduced less and from lower base levels.

In addition, the President's tax reform proposal would cause an implicit change in our industrial policy from protecting losers to encouraging winners. Our net, the long-term impacts of these developments, will be favorable and the supply side base growth improvement of perhaps a tenth of 1 percent per year in addition to the results shown in our macroeconomic simulation can be expected. In other words, the secondary impacts on the supply side basis may be 1 percent at a higher real GNP after 10 years.

Most of the changes proposed by the President, I believe, are long overdue. Some particularly important items include resurrecting the corporate income tax, which last year raised revenue only equivalent to 1½ percent of GNP despite marginal tax rates of 46 percent; taking a more balanced approach to real estate investments; indexing depreciation and capital gains and restricting tax-exempt bond financing.

Items which seem to be steps backward in terms of both fairness and economic efficiency include: a disproportionate tax rate cut for upper income individuals—and on this point I would refer you to the second set of figures which show that as a percent of family economic income, virtually all income categories receive about a half a percent tax cut. The only exception is persons making over $200,000 a year, which receive over a 2 percent, close to a 2-½ percent tax cut, almost five times what everyone else gets—the further acceleration of depreciation benefits, which has been commented on extensively already; the increase in the penalty for two-earner families; and the extremely generous treatment of capital gains income. Also, although 15 tax rate brackets are clearly too many, having 3 giant steps rather than 4 or 5 smaller steps promotes neither simplification, nor equity, nor efficiency.

Finally, taxing all medical insurance is unfair and does not accomplish anything other than raising a small amount of money. Instead, we should tax only those plans which act to oppose public policy by leading to overconsumption and a lack of price sensitivity in the medical care field.

Thank you.

Senator CHAFEE. Thank you, Dr. Taub.

Let me ask you this: What would be the effect, if we kept the capital gains rate at 20 percent?

Mr. TAUB. As opposed to the maximum rate of 17½ percent?

Senator CHAFEE. Yes. That's right. As opposed to what is suggested in the President's plan. What would the effect be?

Mr. TAUB. There would be no significant economic impact other than the revenue raising impact.

Senator CHAFEE. Do you agree, Dr. Brinner?

Dr. BRINNER. Yes. In fact, when you look at the fact that State and local income taxes are not deductible under the President's plan, the composite tax rate on capital gains turns out to be higher under the President's plan than under current law. But differences on this order of scale are not significant.

Senator CHAFEE. I must say I don't understand how that works. Could you lead us through that?

Dr. BRINNER. Sure. If you have a capital gain, it's taxable at both the Federal and at the State and local level. If you can no longer deduct your State income taxes at the Federal tax level, then that effectively raises the State capital gains tax rate. And it turns out that that increase is larger than this 2-½ point reduction for the Federal rate.

Senator CHAFEE. That's assuming that the States all have the same rates.

Dr. BRINNER. Certainly, it will vary from State to State, but I'm speaking of it in average terms.

Senator CHAFEE. Go ahead.

Senator BRADLEY. Under that argument, wouldn't it also raise the rate on wages if you can't deduct State and local taxes. You are saying without the deductibility, you pay more tax than with the deductibility.

Dr. BRINNER. There is an irony to the fact that the President has proposed these tax changes as a major reduction in marginal rates described as on average being 19 percent, but by then including—and I laud this inclusion—of State and local taxes in the tax base, the composite of the tax rate only declines on the average rate of 10 percent. It's the correct thing to do. I'm just saying that that moves it back in the other direction so it's almost a wash on the capital gains, a slight increase, and about half the size of the cut in the composite marginal rate on wage income.

Senator CHAFEE. Dr. Brinner has to go in 7 minutes, so if any of the Senators want to ask him a question, perhaps now would be the time to ask him.

Senator Roth.

Senator ROTH. Well, I, myself, have to go in a few minutes, too, so I am anxious to get in my questions.

Senator CHAFEE. Of Dr. Brinner?

Senator ROTH. Well, no, it's of some of the others.

Senator CHAFEE. How about you, Senator Bradley?

Senator BRADLEY. No.

Senator CHAFEE. Well, why don't you go ahead, then, Senator Roth, if you have to go.

Senator ROTH. Thank you, Mr. Chairman.

Dr. Roberts, in your statement you said something to the effect that whatever we do it's important that we take measures that will help develop what I call an environment of growth; that that's the real purpose of tax reform. It's the best thing we can do for the underemployed and unemployed. That is to create an economy that develops additional jobs, if I correctly understand you. And I very strongly agree with that purpose.

And it bothers me, if I understand a number of you, that you don't see the administration's tax reform bringing a lot of spark into the economy. That at best, its impact is relatively minimal. One of you, I think, said from the supply side there would only be new growth of 0.1 percent per year. That's not good enough, it doesn't seem to me.

And I strongly agree that we've got to take those measures that make this country competitive in world markets. That seems to me the key test. Not only for tomorrow but for the rest of this century.

So I would like to ask, beginning with you, Dr. Roberts, how can we improve upon this? What should we do that will give us a favorable economic tax climate?

Dr. ROBERTS. Well, you would probably need to start over on tax reform and take as your main criteria the effect that the proposed provisions have on the cost of labor and capital. You would, of course, want to structure it so that you reduce these costs. That should be the main point of guidance, and then you will meet your goal. If your point of guidance is something else, for example, static distributional issues, then you will stay far away from meeting the improvement in competitiveness. So it basically depends on what sort of criteria you set when you start to develop the reform.

I think that you think about it in the right way. You think in terms of a consumption-based income tax, which basically excludes saving from the tax base. That's a helpful way to think about it.

Senator ROTH. You are suggesting the best approach should be along those lines.

Dr. ROBERTS. Your bill is a partial approach. It's not an effort at a major revamping, but at least you are thinking about it in the right way.

Senator ROTH. Do you agree that savings is of major importance?

Dr. ROBERTS. Yes. I think that, basically, we have a system in which income from saving is taxed, so any interest income is taxed, but interest expenses are deductible. This obviously, biases the system away from saving. This differential treatment of interest is also the origin of all tax shelters—the fact that interest income is taxed and interest expenses are deductible—that is the basis of tax shelters. If that was not in the code, there wouldn't be any shelters. The notion that shelters stem from accelerated elements in depreciation is not true. It derives from this treatment of interest.

Senator ROTH. Dr. Brinner.

Dr. BRINNER. Yes. I have made my specific suggestions. If I could ask you to look at the table I have on page 11 of my testimony. I can use that table to put this tax reform proposal into perspective of the deficit and what the impact of the deficit has been on capital formation and international competitiveness. You will notice the bottom line there, corporate taxes increased by, on average, $24 billion over the next 5 years. That's a reduction in national savings of $20 billion flowing from this change.

Senator ROTH. I'm on page 11?

Dr. BRINNER. I'm sorry. It's page 12.

The bottom line there presents the total change in taxes. There is a reduction in national savings, as I mentioned in my testimony, from this shift of taxation from the personal sector to the corporate sector, from the low-saving to the high-saving sector.

But equally important is this shift away from high-powered incentives, things that give you tax relief for new investment and not just on old investment. And there, in the top block of the table, you can see that by 1990, you can see that we will have reduced the high-powered incentives by $44.4 billion while increasing the low-powered incentives by only $26.8 billion. That's a major problem.

Compare those numbers to the Federal deficit, running on the order of $200 billion. Proposed reforms imply a reduction in national savings of $20 billion. Therefore, the reforms have perhaps one-tenth of the impact of the Federal deficit on our competitiveness problem, although I would probably scale that up to one-fifth, given the mix change, that is, the loss of high-powered incentives.

Senator ROTH. Thank you, Dr. Brinner.

Senator CHAFEE. Mix change?

Dr. BRINNER. Yes, the change. Giving tax relief through rate cuts, taking it way, increasing taxes through reducing the ITC and changing the accelerated depreciation. I agree. Efficiency is something we should pursue. Therefore, if you want to eliminate the differential between equipment and structures, put a 5- or 7½-percent investment credit on all equipment rather than removing the 10 percent on equipment.

Senator ROTH. My time is up, but I would appreciate it if the remaining two gentlemen would give a——

Dr. TAUB. I guess some disagreement among economists is healthy. Let me put a bell around the cat. Between this——

Senator CHAFEE. Thank you, Dr. Brinner. We appreciate you coming.

Dr. TAUB. The testimony, I believe, of the previous two gentlemen would suggest that if you really wanted to encourage economic growth what you should have is a 100-percent tax on all income. That would be raising the low-powered incentives. Then you could have a 100-percent credit for certain specific things like buying specific types of investment goods, or buying toilet bowls or buying whatever you want people to buy.

That's all nonsense. If you really want to improve economic growth, what you should do is eliminate the preferences, eliminate the excess depreciation, eliminate the things in the Tax Code that don't belong, and use that money to do two things. One is to cut marginal rates, and the second is reduce the Federal deficit.

Senator ROTH. Thank you.

Dr. BEHRAVESH. I guess the one thing that troubles me the most from a growth perspective is this peculiar definition of revenue neutrality that existed in Treasury 1 and in Reagan 1, in which you raise corporate taxes and you lower personal taxes. Why not have it neutral, with respect to both corporate taxes and personal taxes? And in defining a neutral reform, for corporate taxes, you actually could get the kind of efficiency gains that everybody is talking about. At the same time, you would not have the depressing effect on investment that we and others have come up with as a result of this tax reform plan.

So, from a growth perspective, that's where I would come out. Let's, indeed, have a neutral plan with respect to both corporate and personal taxes.

Senator ROTH. Thank you, Mr. Chairman.

Senator CHAFEE. Senator Bradley.

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

Let me thank the panel for the testimony. I found it very interesting, as I usually do. There are just a couple of points that I would like to go over.

One is you get hooked on the idea that in order to produce growth or jobs you have to do something very specific. In a political context you need to be able to say, yes, this legislation caused the jobs or the growth. And in this committee that boils down to saying we gave this or that tax credit.

The counter to that argument and the choice tax reform poses for us is that lower rates do what a specific targeted incentive cannot do. And it seems to me that that is the ultimate argument for tax reform. How would each of you answer that question? What can lower rates do that a more targeted incentive does not do?

Dr. BEHRAVESH. I think the philosophy here is to reduce the distortions that the tax system imposes economic decisionmaking.

I think that's the basic philosophy.

Senator BRADLEY. Describe that. The distortion the tax system imposes on——

Dr. BEHRAVESH. Well, in the sense that you are not making decisions, based on the Tax Code, whether it's in terms of one kind of an investment or another or in terms of equity versus debt financing. You are making it based on economic decisions.

Senator BRADLEY. In other words, if there were no taxes, people would do certain things. But because there is a Tax Code, that code tells you not to do what might be the most efficient thing, but to do what the Tax Code favors.

Dr. BEHRAVESH. That's essentially correct.

Senator BRADLEY. Dr. Taub.

Dr. TAUB. Yes; I would echo that. Lower rates and less incentives for various and sundry things are advantageous to the economy because it stops people from doing stupid things. It stops people from building empty apartment buildings in Houston. It stops people from overbuilding commercial construction. It stops people from spending too much in very short life investments which actually get subsidies. It stops people from buying firms that are bankrupt to get their tax credits. It stops all sorts of unproductive tax sheltering economic activities—uneconomic activities. And when you do that, you can't put your finger on where the growth comes, but over the long term, if you trust Americans to use their money wisely, you end up with more rapid growth and a better economy.

Senator BRADLEY. Well, what about this last point? How do we know that?

Dr. TAUB. How do we know that lower tax rates would do this?

Senator BRADLEY. Right.

Dr. TAUB. What we have is evidence of what the tax rates and incentives do.

Senator BRADLEY. Right.

Dr. TAUB. And together they clearly result in too much buying of one company by another, too much emphasis on tax sheltering activities, on changing ordinary income into capital gains, too much commercial construction.

Senator BRADLEY. But are you saying that if we had a much simpler system with fewer tax expenditures and lower rates, Americans would have more money in their pockets and they would spend it or invest it in a way that would generate more growth.

Dr. TAUB. Yes. There is some evidence across countries. You can look at countries like Great Britain, which have very low-corporate tax rates, and tremendous incentives all over the place—they have very low-growth rate. You can also look at even worse cases, like India. If you look at countries with relatively clean tax systems, they do seem to do better.

Senator BRADLEY. Dr. Roberts.

Dr. ROBERTS. I think, Senator, we are in danger here of focusing or putting too much concern on a relatively minor problem to the exclusion of a relatively major one. Now it is true that various things called tax expenditures can distort the mix of investment and lead to the choice of some investments over others at the margin.

And it is true, if you did not have those distortions, there might be some efficiency gains, and the economy would improve, although I don't think it would be anything striking. It wouldn't be any great, major improvement and could very easily be offset by monetary policy or anything else, and you might never see it.

That kind of neutrality question is important. And I lend my support to wanting to have it more neutral in the choice of the mix of investments. But there is another neutrality problem. And that concerns the decision about the level of investment. And that has not been given consideration. It was given no consideration in the Treasury's approach to the tax reform.

Our existing Tax Code is seriously biased against saving and investment. There is the multiple taxation of saving and investment income. And, therefore, the main lack of neutrality in the code is not in the choice of the mix, but in the decision to invest or not to invest.

Now how can you get rid of that? Well, one way is to go to a consumption-based income tax, and that gets rid of it. How did we get rid of it in our code? Well, you can't get rid of it in our code. Let me ask that differently. How did we mitigate it? Well, things like investment tax credits, accelerated depreciation tend to reduce that first order of bias.

In doing so, they may worsen the second order bias. But the first order carries the more weight. If you attempt to reform the tax system by fixing the secondary problem at the expense of increasing the bias against saving and investment, you are not going to improve anything because the efficiency gains you expect from fewer distortions in the mix of investment are going to be completely swamped by the increased tax bias against the level of investment. And that is the fundamental problem with the Treasury tax reform—certainly of Treasury 1. Once they realized what they had done after the event, they tried to pull back and mitigate some of those adverse effects.

Earlier in the preceding panel and I think here, there has not been any consideration, except from Mr. Boskin, given to the fact that the main problem of our Tax Code is the bias against saving and investment.

Senator BRADLEY. Wouldn't the best way to get savings up be to balance the budget?

Dr. ROBERTS. It depends on how you balance it.

Dr. TAUB. Absolutely—in fact, in 1981 when it was first proposed to load the Tax Code with all these savings incentives like IRA's, at that time I testified that the result would be lower national saving.

In point of fact, that's exactly what happened. And if you really want to increase savings in the United States, you would get rid of the savings incentives, which don't do anything, and lower tax rates and balance the deficit. That increases national savings.

Dr. BEHRAVESH. If I could just add here that there is no question that in the very short run reducing the deficit would have a much bigger impact on savings than would any of these tax reform proposals being discussed.

Senator BRADLEY. Thank you.

Senator CHAFEE. Senator Symms, you have to go at a quarter of. Why don't you go ahead.

Senator SYMMS. All right. Thank you.

I want to ask primarily one question that is plaguing my constituency in the State that I come from, Idaho. Our biggest source of income in the State is agriculture. The second one is timber. And minerals are very important. It's a resource-producing State. We have one other area that's a bright spot in our economy. Those three are very bleak spots in our economy. One bright spot is recreation business. Places like Sun Valley, McCall, Coeur d'Alene, where we have a very high percentage. In 10 counties, over 20 percent of the homes are second homes. And in another 10 counties between 10 and 20 percent are second homes.

And, Dr. Roberts, you stated in your testimony that the rust belt would be adversely impacted by the administration's proposal while inventory-intensive industries, such as retail would benefit. In particular, agriculture, timber and transportation would be adversely affected. Amusement, media, trade, and real estate would be helped by the proposal.

Now my question is this: Let's say this bill passes in its current form, with no amendments. What is going to happen if Hecla Mining Co. has to pay more money for taxes—which they have done the numbers and they have shown that they would—the price, then, of their stock would, I would assume, go down in value if they paid more taxes because we would be taking away some of the preferences that are in the value. The real estate values, wouldn't they go down? Or at least there would be a reflection of that?

My question is: What is going to happen to real estate values in a resource-producing region of the country, whether it be Idaho or some other area, even if the taxpayers thought on the front end that they were going to have lower taxes? What happens to the asset values of farms, of ranches, of real estate properties, of rental properties, of resort areas, of mineral, and timber properties, if those sectors have to pay higher taxes? What's the impact going to be?

I'd like to hear each one of you on this.

Dr. ROBERTS. Let's take mining. I'm not sure what this company you mentioned produces, but most mining products face the world price. And if you face the world price, you can't pass taxes off in higher prices. And so you have to absorb them. And so generally what you tend to do is shrink your size.

Senator SYMMS. That means some men are going to lose their jobs.

Dr. ROBERTS. That's right. In fact, if you look at the impact that the minimum tax provision in TEFRA had on the mining industry, it did tremendous damage in terms of shrinking the mining industry because the companies cannot pass these taxes on in higher prices. So I would say it would be bad for mining. The agricultural sector will suffer an increase in the cost of capital, because most agricultural investment is classified as equipment for tax purposes; not as structures, so they will find higher costs there.

There are other things happening to them. The change in accounting rules, for instance. People with breeding stock are now going to have to amortize or capitalize what were formerly current expenses.

Timber, of course, is hit. Your State——

Senator SYMMS. These are major——

Dr. ROBERTS. Your State will look like it has been through a war.

Senator SYMMS. Well, do you generally concur with that, Dr. Taub?

Dr. TAUB. Well, I think I have spoken to people from about 35 of the States, and everyone believes that they are going to be hurt much worse than any one else.

I would agree with Dr. Roberts that mining will suffer a decline in land values. There's no reason why that should affect employment. That's a change in the value of a fixed asset, gain or loss.

Agriculture is very complex. There probably will be a decline in land values. On the other hand, there will probably be people moving out of agriculture who are in it now just for tax sheltering purposes. It's not clear but most studies suggest that farmers might end up somewhat better off.

Second homes will probably benefit substantially. You are actually increasing consumer income significantly; particularly that of upper income consumers. Anyone who owns a second home for rental purposes can still deduct the interest, because anyone who owns a second home also has a first home. Persons can take a higher mortgage on the first home and deduct their second home that way. So I would guess second homes would benefit.

In addition, Idaho is a low tax State, and, as a result, will probably have a higher increase in disposable income than most other States.

So, yes, some of the negative are true, but it's very hard to tell how it would net out.

Dr. BEHRAVESH. In the interest of time I basically agree with what Dr. Taub has to say. Agriculture probably is not going to get hurt terribly badly, if at all. Mining will. And it's not clear what is going to happen to the value of second homes. Resort areas, to the extent that they provide a service, may benefit. The corporations that run resorts may benefit from this kind of a tax bill. So the Sun Valleys of this world may, in fact, be better off just from a tax point of view.

So I don't know that you can say categorically that Idaho or any other State, depending on their industry mix, is going to be necessarily worse or better off. But certainly mining, to the extent that Idaho depends on mining, is going to be hurt pretty badly.

Senator SYMMS. Thank you, Mr. Chairman.

I appreciate this hearing. This is good. I'm sorry I was late getting here.

Senator CHAFEE. I thought these last few statements would be music to your ears. [Laughter]

Gentlemen, let me ask you this: Are we necessarily discouraging savings and investment when we lower the rates and take away the preferences?

If you lower the rates, presumably, the American people are going to spend their money on what they think is most important. Indeed, suppose they did spend it all on criss-crafts, on boats or whatever it is that some might consider frivolous. But if they did that, presumably somebody is going to produce the boats or the second homes or whatever and, thus, there is going to be a demand for wood, a demand for metal, a demand for engines. Isn't that what keeps the wheel turning? Am I missing something?

Dr. ROBERTS. Senator, the answer is this: Consider, for example, the taxation of business income. When you lower the corporate income tax rates, the main beneficiary—most of that goes to capital that's already in place. So the existing capital stock, investment in place, gets a windfall gain. When you take away the so-called preferences, investment tax credit or accelerated elements in depreciation, you are affecting new capital. If you look at Treasury 1, it is completely clear that the impact of the proposal was to greatly increase the taxation of new investment and to give a windfall gain to investment that is already in place because the lower rates did not compensate new capital investment for the loss of the investment tax credit and the accelerated depreciation.

So if you take that approach, you have to figure what are you doing on the margin for new investment. Has the after-tax rate of return gone up or down? You can't assume that a reduction in the rates automatically compensates for the loss of the preferences.

Now I don't think the rates have been cut enough to compensate, certainly not for machinery and equipment. And so you face a situation where the cost of capital employed in machinery rises as a result of the proposal. The cost of capital employed in structures and inventories fall as a result of the proposal.

Senator CHAFEE. What do you say, Dr. Taub?

Dr. TAUB. I believe you are absolutely correct. There are several issues involved. The one that impresses me the most is that Mr. Roberts' argument would have you go to a British system where you have very, very high marginal tax rates, and then give credits to investors.

Dr. ROBERTS. That's simply not true. I'm talking about the changes from an existing point in tax law. We have current law. I'm talking about the changes posed to this overall system.

Senator CHAFEE. In other words, what you were talking about is the maximum rates being at 46 percent, but having the ITC plus the ACRS as opposed to 33 percent and no ITC.

Dr. ROBERTS. That's right.

Senator CHAFEE. And the change in the depreciation.

Dr. ROBERTS. And in that case, some forms of capital benefit, others don't. The net change will be against the rate of return earned on machinery.

Dr. TAUB. But——

Dr. ROBERTS. I'm glad to see Mr. Taub is now out supply siding me. I think this is a hopeful development.

Senator CHAFEE. Well, let's let him have his chance.

OK, Dr. Taub.

Dr. TAUB. That's right. It really is. You are raising a very important point. I think the point, as the four gentlemen who were here earlier this morning said, is that more investment by itself is not a goal of the Congress. What the goal of the Congress is, is promoting economic efficiency, and promoting economic growth. And as all four panelists said before and as I am arguing now out supply siding Mr. Roberts as he points out, is that to have economic efficiency and have growth what you want to do, is lower tax rates.

The unemployment rate is currently over 7 percent. There is no logical reason why the policy of the United States should be to encourage unproductive investments at the expense of labor. In other words, hire machines and fire workers. What you want people to do is to do what is most efficient. And the way you increase total productivity is by having lower marginal tax rates and less incentives which are subsidies, for all things, including investment.

Senator CHAFEE. And so you say to the industries that have primarily been the beneficiaries of the ITC, which are our manufacturing industries, it's going to be rough, but in the long run the country will be better off if we just lower rates and don't give these preferences. Is that it?

Dr. TAUB. Well, the first thing I would argue, although it hasn't yet been discussed—but changes of this magnitude should be phased in or phased out. It shouldn't be done January 1. I would certainly say that. That's No. 1.

No. 2, it's not clear that a lot of these companies were helped tremendously by the policy of the last 3 years.

Dr. ROBERTS. The policy of the last 3 years was to raise taxes.

Dr. TAUB. Gee, I missed that one.

Dr. ROBERTS. That was in 1982, 1983, and 1984.

Dr. BEHRAVESH. I'd like to——

Senator CHAFEE. Let's take it in order here.

Dr. Behravesh.

Dr. BEHRAVESH. I would like to make two points here. One, I would like to come to the point that Dr. Taub made which I think is a——

Senator CHAFEE. You have got to help me get your names straight. Behravesh.

Dr. BEHRAVESH. Behravesh, yes. The one point that Dr. Taub made was that on many of these provisions you should phase them in. I agree wholeheartedly. We have gone around and around on this issue of hurting those industries, the manufacturing industries, that are already being clobbered by the strength of the dollar. So the timing on this time couldn't have been worse because here you are going to be hitting them again at a time when they are down.

So I would argue for phasing some of these provisions in over a long period of time. I think that's very important.

The other issue is the point I made earlier; namely, I don't understand why you have to have tax reform where you raise corporate taxes and lower personal taxes. I think if you really were neutral with respect to corporate taxes, you could lower corporate tax rates even further than the President's plan and offset some of the negative effects on the cost of capital that we have been talking about today.

Mr. ROBERTS. Mr. Chairman, I want to correct here for the record. Mr. Taub didn't listen very carefully to what I said, and I don't want his explanation of my statement standing.

Neither did he listen very well to the previous panel, because Mr. Boskin dissented quite strongly from the panel and agreed with me that you have to be very careful in reducing the distortions in the choice of the mix of investment not to increase the bias against the level of investment, or the decision about the level of investment. And I think this is the failure of the tax reform debate. To address that.

Now what my position is——

Senator CHAFEE. Now is that the same point that Dr. Behravesh made? In other words, you are shifting your——

Dr. ROBERTS. The point that Dr. Boskin made in the prior panel.

Senator CHAFEE. Yes.

Dr. ROBERTS. What they have done, they've addressed a secondary question to the exclusion of a major one. They are worried about distortions in the Tax Code that govern the choice of different kinds of investments. They are neglecting the distortions in the Tax Code that determine whether to invest or not.

So the level of investment is being neglected. The decision determining the level of investment is being neglected, and people are focusing on a secondary problem; that is, the mix of investment.

The level problem is the fundamental one— the biases in the Tax Code against saving and investment. That is a more fundamental problem than distortions in the the mix of investment.

Now my position is that I am perfectly prepared to reduce tax rates, and I do not see this as a question of do we reduce tax rates or do we keep preferences? That is not my position at all, Mr. Taub. What I am reporting to you is that according to my calculations, the loss of the preferences is not offset by the reduction in tax rates for certain classes of investment; particularly, those in machinery and equipment.

Senator CHAFEE. OK.

Anything else, gentlemen?

[No response.]

Senator CHAFEE. Well, thank you all very much for coming. We appreciate it. You have helped us out.

[Whereupon, at 11:56 a.m., the hearing was concluded.]

O